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Getting Divorced

Undergoing the throes of divorce can be pretty traumatic. There are many issues that must be handled. When it comes to tax and financial matters, there are numerous important areas that, if handled properly, can lead to a successful–and less financially damaging conclusion. There are 7 main issues that impact divorce and they will be outlined in this text. Also enclosed are a number of tips on certain steps to take to make things go better.

Alimony

This is one of the most common issues in divorce. Basically, a qualified alimony payment is deductible by the payor and taxable to the recipient. In order for the payment to qualify it must be unallocated–that is, not specified as support for children. It must be an actual payment for items directly on the financial behalf of the ex-spouse; and the payments must end at death or re-marriage of the ex-spouse. Some third party payments(as part of the decree), may be allowed as alimony. Some examples are: medical expenses, life insurance, and certain payments for jointly owned residences.

Also, child support payments should not be "sneaked" in as alimony. If alimony payments are tied in to age or events in the children's lives, this could be grounds for denial as alimony by the IRS.

Further, alimony shouldn't be a disguised property settlement. As such, there are parameters on the terms of payment, and the amount the alimony can vary from year to year. If payments fall by more than $15,000 in year two or year three, prior alimony payments may be ruled invalid as to deductibility, under current 2000 IRS tax rules.

Children

The two areas of concern here are child support payments, and who gets to claim the children as dependents for tax purposes. Basically, child support payments are not deductible by the payor, nor income to the recipient. Further, if the payor becomes delinquent in making child support payments, any alimony payments being made may be disqualified as a deduction until child support payments are current.

Regarding the dependency question: Who gets to claim the kids for tax purposes? It is generally determined by the primary custodial parent; with whom did the child live the majority of the year? This is the person who usually gets to claim the deduction. There is an exception if the non-custodial parent has a written statement from the custodial parent waiving the right to claim the dependency exemption.

Property Settlements

This is a tax-planning area that requires careful thought, and some attention to detail. The overriding issue is the IRS rule that, for all divorces after July 18, 1984, any transfer of property is no longer subject to income tax liability by the transferor. But, the basis of the property being transferred is treated like a gift; the recipient takes over the property with the same basis as the payor– not the fair market value at date of transfer. This can result in major tax consequences if it is not handled properly.

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For instance, if the couple had a stock that was worth $80,000 at transfer date, but only cost $10,000, the recipient would have a potential capital gain of $70,000. If they also had a bank account with $80,000 in it, there would be no capital gain problem. So the nature of the asset, and its appreciated value become important issues–and important bargaining tools in a divorce.

If property is in joint names when sold instead of being transferred to one spouse, any gain on the sale will normally be taxed 50/50. This is true even if the divorce decree specifies that one party is to receive more than the other. However, if the property has been transferred prior to sale, the entire gain is taxable to the seller, even if all the proceeds go to the other spouse. This is an area that frequently is misinterpreted by attorneys, so care must be taken to get good tax advice prior to any agreements to avoid potential inequities.

These same rules apply to a primary residence, with further complications due to special wrinkles in the tax codes involving sales of primary residences. According to present 2000 tax laws, if you sell a primary residence that has appreciated, you can exempt up to $250,000 as a single filer, and up to $500,000 as joint filers. Thus, a possible planning opportunity exists here if the house has potential capital gains in excess of $250,000 , and both names are on the property. It may make sense to sell it before divorce instead of transferring title to one spouse and then selling it. An extra $250,000 in capital gains may be exempt.

Estate Planning, Beneficiary Adjustments

When divorce occurs, this can have a major impact on any prior estate planning techniques(such as trusts, title ownership), so it must be immediately reviewed. Similarly, Wills must be reviewed and altered. If there are any life insurance policies, pension or profit- sharing plans, IRA's, Keogh's, or SEP's, these must be reviewed to see if beneficiary names need to be changed. Otherwise, money may end up going to the wrong people.

If the overall taxable estate exceeds $675,000, all the previous estate-planning techniques that the couple used prior to divorce may have to be revised. This should be considered and changed as soon as possible after divorce.

Similar care should be taken to review health insurance plans, home and auto insurance, living wills, and any durable powers of attorney to see if names and directions need to be changed.

IRA'S & Pensions

Many divorce settlements require a division of IRA or other pension/profit sharing savings. How this is handled can make a huge difference in taxes and penalties. Basically, if done properly using IRS Code Section 408(d), an interest in an IRA or pension can be given to an ex-spouse without tax consequence to the payor. However, if not done properly, it could be taxable to the payor, and if the payor is under age 59½ there could also be a 10% penalty. The proper way to do this is with a Qualified Domestic Relations Order. What this does is to accept the ex-spouse as an alternate payee so the distributions go directly to the ex-spouse instead of the plan participant. In effect, it passes the tax and penalty burden to the ex-spouse. If the ex-spouse rolls the money into an IRA, the tax burden can be shielded by the ex-spouse as well.

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The Timing Issue

The IRS rule on divorce and marriage is simple. You are considered married or divorced for the entire tax year, no matter when the event occurred during that year. Thus, if you are divorced on the last day of the year, your tax return gets filed as if you were divorced for the entire year. This can have serious tax consequences since tax rates vary for Married Filing Joint vs. Single vs. Married Filing Separately, and according to one's separate taxable income.

So a divorcing couple should do a mini-tax return using joint vs. single filing to properly plan for the best time to finalize the divorce. This is especially true if the divorce is pending during the last few months, weeks, or days of a given tax year. Timing can be everything here!

Adjust Your Withholdings

Many people forget to do this after divorce. You should reconsider how to file your W-4 form at work or your estimated tax vouchers if you pay any of your taxes directly to the taxing authority. Since your filing status has changed, this can have a marked impact on your tax liability, your allowable deductions and exemptions (especially if your income exceeds certain levels). A quick call to your tax accountant is in order here.

Tips Regarding Divorce

Here are a few tips that could save you thousands of dollars:

1. Get a lawyer who specializes in divorce if you expect a nasty fight. If you use your "pal" or a generalist you could get "financially slaughtered" in the divorce.
2. Legal fees in divorce are usually not deductible unless they involve alimony issues, or tax advice. Additionally, legal fees related to property settlement can be added to the basis of the property, hence ultimately deductible. However, the lawyer must separately state the amount of legal fees paid for these items. Work out the deal with the lawyer before you pay the bill to maximize your possible tax deductions here. Some lawyers may not be as cooperative in this area once they have been paid.

3. Try to reach general agreements with your spouse on property splits and issues related to children before going to Divorce Court. Consider using a Divorce Mediator before having your attorneys "duke it out" in court at your expense. It can save a great deal of money.

4. Make copies of all financial and tax records for each spouse so after divorce you can each set up your own tax files. This is especially true for property that will not be sold on or before divorce.

5. If estimated taxes have been paid prior to divorce, and if a tax refund or tax liability is expected upon filing, decide on the split before divorce.

6. If you will be divorcing and you have no credit card in your own name, try to get one prior to divorce.

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7. If one of the spouses has been filing as a sole proprietor and/or any potentially damaging tax issues may exist on any joint returns previously filed during the marriage, work out a settlement of possible damages to the innocent spouse. Keep in mind that the IRS position on a joint return is that either spouse can be held liable for the taxes owed by the other even after divorce, unless the "innocent souse " doctrine can be proven.

8. Close out all joint checking accounts, bank accounts, and credit cards as soon as possible.

9. Remember that any outstanding debts jointly signed for can be chargeable to either spouse, so account for this potential disaster in the divorce settlement.

Conclusion

While contemplating divorce can be a sad matter, one is no longer in the minority. Statistics show that over 50% of all marriages now end in divorce. The important thing to remember is to cut your losses. But do it the smart way. Careful planning ahead of time with the appropriate advisors can save a fortune in taxes – and further grief.

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