



Understanding the Tax Consequences of Divorce

In any area of tax planning, it is important to understand applicable tax laws before making any major decisions. A marital separation or divorce is no exception. In fact, for most taxpayers, determining the tax consequences that can arise during a divorce or marital separation can be vital for the financial protection and well being of you and your family.

Alimony

Generally speaking, alimony is the amount paid to a spouse for his or her living expenses, education, etc. It is not for the purpose of providing child support. The person who receives alimony is called the “payee spouse,” and the person paying alimony is called the “payor spouse.” The payee spouse must pay taxes on the alimony in the year it is received, and the payor spouse may deduct the amount in the year it is paid, provided the alimony meets all of the following conditions.

1. The payment is made in a cash form, which includes checks, bank deposits, etc. Payment in the form of such things as bonds, stocks, money market shares, or actual objects are not considered alimony for tax purposes.
2. The payment is made as the result of a legal separation agreement or divorce decree.
3. There is no liability for payment after the death of the payee spouse.
4. The payor spouse and payee spouse do not live in the same household at the time the payment is made.
5. The divorce instrument does not designate the payment as nontaxable to the payee spouse and nondeductible by the payor spouse.
6. The payments are not “fixed” (or treated as “fixed”) as child support.

Child Support

Child support, as opposed to alimony, is not taxable to the payee spouse, nor is it tax-deductible by the payor spouse. This is true regardless of how the payment is

described in the divorce papers. A divorce decree may specifically call a payment “alimony,” but that payment may have the “characteristic” of child support. One characteristic of a child support payment might be the designation in the divorce document that the payment be terminated if the child’s situation changed. If it appears to be more like child support than alimony, the payee spouse will not pay taxes on it, and the payor spouse will not deduct it, no matter what it’s called in the divorce papers.

Dependency Exemption

Who gets to claim the dependency exemption when a divorce occurs? In order for a taxpayer to claim another person as a dependent for tax purposes, the individual must meet the following tests:

1. Dependent must not be able to be claimed as a dependent on someone else’s tax return.
2. Dependent was a U.S. Citizen, resident alien, U.S. national or resident of Canada or Mexico, for some part of the year and was unmarried or if married, does not file a joint tax return.
3. Meet the definition of qualifying child or qualifying relative
 - a. Qualifying child:
 - i. Taxpayer’s child, stepchild, eligible foster child, brother, sister, stepbrothers, stepsister or a descendent of any of them.
 - ii. At the end of the tax year, was either under age 19, under age 24 and a full-time student, or permanently and totally disabled (at any time during the year).
 - iii. Did not provide more than half of his own support, and
 - iv. Lived with the taxpayer for more than half the year (**Consult with tax professional on complexities due to divorce**).
 - b. Qualifying relative:
 - i. Taxpayer provided more than half of the individual’s support during tax year.
 - ii. Individual was the taxpayer’s:
 1. Child, stepchild, eligible foster child or a descendent of any of them,
 2. Brother, sister, niece or nephew,
 3. Father, mother, grandfather, grandmother, aunt or uncle,
 4. Step-brother, -sister, -father, -mother or any of the following in-laws – son, daughter, father, mother, brother or sister, or
 5. Any other person who lived with the taxpayer all year as a member of the taxpayer’s household.
 - iii. Individual was not a qualifying child of another person during the tax year, and
 - iv. Individual had gross income less than the personal exemption amount for the tax year

The custodial parent (the parent who has physical custody for a greater portion of the year) is generally treated as the parent who provided more than half the child’s support and is awarded the dependency exemption. However, it is possible for that custodial parent to transfer the exemption to the non-custodial parent. To do that, the custodial parent either files Form 8332, entitled “Release of Claim to Exemption,” or a statement that contains the required information (such as the divorce decree). This release of claim by the custodial parent can be made for only the current year, for a specified period of time, or for all future years.

Property Transfers

There is typically no gain or loss on the transfer of property from one spouse to another (or to a former spouse if the transfer is “incident to divorce”). This rule applies to both separate and community property in divorces that occurred after July 18, 1984.

If a transfer is to be considered “incident to divorce,” it must occur within one year of the divorce date, or it must be made according to the terms of the divorce or separation document, and not more than six years after the divorce date.

Also, because there is no gain or loss recognized at the time of the transfer, the basis of the property received is not adjusted, even if the transfer is part of a bona fide sale at the fair market value.

Attorney Fees

Legal fees paid to obtain a divorce are usually not deductible for tax purposes. However, fees paid in connection with the collection of alimony or other income producing property are deductible.

Did You Know?

- If a joint tax return is filed, both the husband and the wife can be held jointly and individually liable for the tax due as well as any interest and penalty related to the joint tax return, without regard to what is stated in the divorce decree.
- A distribution from retirement plan combined with a subsequent rollover (by the other spouse) without a “qualified domestic relations order” (QDRO) can cause a penalty for both taxpayers.
- For purpose of the child care credit and the earned income credit; a child of divorced or separated parents is treated as a qualifying child of the custodial parent. This is true even if the non-custodial parent can claim the child as a dependent. The parent who is eligible to claim the child as dependent is also eligible to claim the Hope/Lifetime Learning Credit. For the education credits, this is true regardless of which parent paid the tuition.
- After July 19, 1998, a Separate Liability Election can be made which will limit your liability for tax, interest, and penalty on the tax liability allocated to your former spouse on a joint return.

Tax problems during the following a divorce are common, but they can be minimized with some knowledge about tax laws and IRS procedures. Financial planning is an important part of the divorce process. As always, see your tax advisor for additional information and answers related to your specific situation.

IRS Circular 230 disclosure: To ensure compliance with requirements imposed by the IRS, we inform you that any U.S. federal tax advice contained in this communication (including any attachments) is not intended or written to be used, and cannot be used, for the purpose of (i) avoiding penalties under the Internal Revenue Code or (ii) promoting, marketing or recommending to another party any transaction or matter addressed herein.

Not every item in our library will be applicable to your situation. If you need further advice, please feel free to give us a call any time at (608) 756-5354. Summit Accounting Group Inc. of Janesville, Wisconsin

