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Divorce: A Taxing Experience—25 Divorce-Related Tax FAQs

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Family law attorneys are expected to be experts in domestic law, but few (if any) are experts in tax law. Nonetheless, because virtually all divorces have some tax consequences, there is an obligation to be both informed and proactive regarding divorce-related tax issues. Such issues present a unique challenge because failures may not be identified for months or even years after the divorce is resolved, most often through examination by a third party—the IRS. Common divorce-related tax issues include those relating to alimony, filing status, exemptions, property transfers, and innocent spouse relief. Failures may result in additional tax due, as well as penalties and interest charges. Moreover, the amplified emotions inherent in family law increase the risk of an ethics complaint or malpractice claim.

The purpose of this article is to provide a knowledge base of divorce-related tax issues via 25 FAQs (frequently asked questions). For ease of reference and understanding, I've organized the FAQs into three groups: (1) alimony; (2) equitable distribution and property transfers; and (3) filing issues. Readers are encouraged to consider the authoritative references cited. As a prelude to the FAQs, two foundational tax concepts will be discussed—pretax versus posttax and effective versus marginal tax rates. Following the FAQs, I present three common-sense, but effective, risk management strategies. Finally, I conclude with a brief discussion of divorce-related tax implications for same-sex couples following the U.S. Supreme Court's decision in *Windsor* that the Defense of Marriage Act (DOMA) is unconstitutional.[1]

PRETAX VERSUS POSTTAX

As the names imply, pretax means before taxes and posttax means after taxes. Proper qualification (pre- versus posttax) of both assets and deductions is imperative when negotiating for an equitable resolution. For example, an IRA (a pretax asset) with an account value of $100,000 is worth less than a savings account (a posttax asset) with the same value. How much less is determined by the costs (taxes and penalties) of converting the pretax asset to posttax status, allowing for an apples-to-apples comparison. For the purpose of discussion, let's assume a tax rate of 25 percent and no penalties. Thus, the posttax value of the IRA is $75,000. Likewise, pretax deductions and expenses (*e.g.*, health insurance, retirement, and alimony) have a lower cost than expenditures made with posttax dollars (*e.g.*, child support and life insurance).

This seemingly simple concept can quickly become complicated when the marital estate includes appreciated assets such as stocks, real estate, and closely-held businesses. To effectively negotiate an equitable distribution, appreciated assets must be tax-affected to determine their consumable value to the recipient spouse. This

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tax-affecting exercise is a five-step process: (1) determine the appreciated value (or gain), calculated as fair market value (FMV) less the tax basis; (2) confirm the character of the appreciated value (ordinary income or capital gain); (3) determine the applicable tax rate (capital gains rate or ordinary income rate); (4) compute the tax on the appreciated value; and (5) reduce the FMV by the computed tax (*i.e.*, the tax effect) to determine the consumable (and thus equivalent) value.

It is commonly argued that the tax-affecting is speculative, given the uncertain issues of when an asset will be liquidated and what the prevailing future tax rates will be. Although this argument may have theoretical merit, the practical objective is to negotiate apples-for-apples. Generally speaking, using an imprecise tax adjustment is a more equitable approach than ignoring tax considerations altogether.

EFFECTIVE VERSUS MARGINAL TAX RATES

Negotiating for equity also requires an understanding of the applicable tax rates, specifically the effective versus marginal rate. An effective tax rate is the total tax burden as a percentage of total income,[2] representing the average rate paid on *all* dollars of income. A marginal tax rate, on the other hand, is the rate paid on a specific component of income—the next marginal (incremental) amount of income. Commonly identified as a client's highest tax bracket, the marginal tax rate does not consider the nature, significance or consequence of other income and deductions—just the last dollar taxed. In practice, marginal tax rates are used to measure the incremental tax consequences of different strategies (A versus B), while effective tax rates are used to measure one's total tax obligation relative to his or her total income.

An IRA is worth less than a savings account with the same value.

Recall, for example, the political banner regarding Mitt Romney's 2011 income tax return. His total income was $13.7 million, and his effective tax rate was 14.1 percent.[3] Romney's seemingly low effective tax rate reflects the tax code's preference for investment income (capital gains of $6.8 million, taxable interest of $3 million; and dividends of $3.7 million), which was taxed at 15 percent. Throw in exemptions, deductions and credits, including $2.25 million in charitable donations, and you have an effective tax rate of 14.1 percent. In contrast, Romney's marginal tax rate (for taxable income over $388,350) was 35 percent.

Now consider another scenario: In negotiating alimony, the payee's counsel proposes $5,000 per month (or $60,000 per year), stating that the payor's 35 percent marginal tax rate results in an actual out-of-pocket cost of only $39,000[4]—a substantially reduced value. In response, opposing counsel argues that the payor's effective tax rate is 26 percent, indicating an out-of-pocket cost of $44,400.[5] Which party is correct?

Divorce commonly places the parties in different tax brackets.

In this instance, I would gravitate to the marginal tax rate because it provides a measure of the burden (or savings, as the case may be) on this specific component of income. That said, the complications of our tax code (*e.g.*, seven tax brackets and phase-outs for itemized deductions and personal exemptions) require a detailed analysis to determine the applicable (effective or marginal) tax rate, measuring the increase or decrease in taxes as income increases or decreases. Moreover, divorce commonly places the parties in different tax brackets (one spouse's being higher than the other), which creates leverage or negotiating opportunities.

DIVORCE-RELATED TAX FAQs

Alimony

1. What is alimony?

   - Alimony is a court-ordered payment that one spouse pays to the other for maintenance and support while they are separated, involved in a matrimonial lawsuit, or divorced.[6]

2. When are alimony payments includable in the gross income of the recipient (payee) and deductible by the payor?

- When *all* of the following requirements are met:[7]
  - The payment is in cash or its equivalent.
  - The payment is "required" under a divorce or separation instrument.
  - The instrument *does not* designate the payment as "not deductible."
  - The parties are not members of the same household at the time of payment.
  - The payments cease upon death of the recipient (payee spouse).
  - The parties do not *file joint returns*.
  - Payment is not fixed as child support.[8]

3. May alimony payments be made in a form other than cash?
   - No. Only cash payments qualify as alimony. Transfers of services or property (including a debt instrument) or use of the payor's property do not qualify.[9]
4. Must the divorce or separation instrument be in writing to qualify payments as alimony?
   - Yes. A written instrument, which confirms a meeting of the minds, is a necessary condition for an alimony deduction.[10]
5. Are payments made *before* a written instrument is executed or decree becomes effective considered alimony?
   - No. Absent a written instrument, there is no meeting of the minds between the parties.[11]
6. Do payments of cash made to a third party on behalf of a spouse qualify as alimony if the payments are pursuant to the terms of a divorce or separation instrument?
   - Yes, if made on behalf of the payee's spouse.[12]
7. Are payments, pursuant to a divorce instrument, made while the parties are members of the same household considered alimony?
   - No. However, there is an exception for a spouse "preparing to depart" who does so within a month after the payment is made.[13]
8. What are the consequences of required alimony payments *after* the death of the payee spouse?
   - Loss of *all* alimony deductions, made *before or after* the death of the payee spouse. The IRC prohibits any liability to make any payment (including substitute payments) for any period after the death of the payee spouse. Importantly, the payee treats such payments as nontaxable gifts.[14]
9. Must divorce instruments expressly state that alimony payments will terminate no later than the death of the payee's spouse?
   - Yes.[15]
10. What are the consequences of required alimony payments after the death of the payee's spouse?
    - No effect. Such obligations are common and are generally funded by life insurance.[16]
11. Are payments made after the payee's remarriage considered alimony?
    - It depends. The obligation is established by the divorce decree, not state law.[17]
12. If an instrument permits a former spouse to occupy a residence (nonmarital) owned by the other spouse rent-free, is the fair rental value deductible as alimony?
    - No, because no cash has been paid.[18]
13. Are payments related to the maintenance of a marital residence occupied by the other spouse deductible as alimony (*e.g.*, mortgage payments, insurance, taxes, and maintenance)?

- It depends—who benefits? Such payments are considered to benefit the owner of the property, thus: YES if the property is titled to the possession spouse, NO if titled to the nonpossession spouse, and SPLIT if titled jointly.[19]

14. Are utility payments made by the nonpossession spouse deductible as alimony?

    - Yes; such payments benefit the possession spouse regardless of ownership.

15. Are legal fees paid for the other spouse, either by agreement or decree, treated as alimony?

    - Yes, if all other requirements are satisfied.[20]

Equitable Distribution and Property Transfers

16. Do property transfers between spouses incident to divorce create taxable events?

    - No. No gain or loss is recognized on these transfers; the property is treated as acquired by the transferee by gift.[21]

    - Moreover, this exemption is extended to third-party transactions when the transfer is required by a divorce instrument and the nontransferring spouse receives a benefit.[22]

17. What is the "tax basis" of property received (transferee spouse) incident to a divorce?

    - The same basis held by the transferor spouse, thus preserving any gain or loss in the property for future realization.[23]

18. What is the holding period of property received (by the transferee spouse) incident to a divorce?

    - The same as held by the transferor spouse.

19. Does the sale of a personal residence received in a divorce settlement create a taxable event?

    - Yes—it's a postdivorce transaction, that is, not incident to the divorce. However, any gain (*e.g.*, $250,000) realized may be excluded.[24]

20. Is the transfer of an IRA account (or any part thereof) to a former spouse, pursuant to a divorce decree, considered a taxable distribution?

    - No. The IRA transferred to the former spouse is treated as an IRA of the recipient spouse.[25]

Filing Issues

21. What filing options are available to married couples who are legally separated?

    - Two unconditional options: married filing joint and married filing separate.

    - A third option (head-of-household) is available if the parent provides a principal place of abode for a dependent child for more than one-half of the year.

22. Should couples in the process of getting divorced, but still considered married, file a joint return?

    - It depends. A joint return requires cooperation between the parties and involves joint and several liability for the tax. Importantly, indemnification agreements are not binding on the IRS.

23. During the pendency of a divorce, which spouse claims the dependency exemption for a qualifying child?

    - Usually the parent who has primary custody. However, the custodial parent may relinquish the exemption via *Form 8332*.

    - Absent a written declaration (*e.g.*, *Form 8332*) from the custodial parent, a noncustodial parent cannot claim head-of-household status, the dependency exemption, or the child tax credit.[26]

24. Are legal fees incurred to obtain a divorce or child support deductible?

- No. However, fees related to alimony are deductible.

25. What options are available to an "innocent spouse" with respect to liabilities arising from a joint return?

    - Three types of innocent spouse relief are available to the electing spouse: (1) liability relief; (2) separation relief; and (3) equitable relief.[27]
    - On August 12, 2013, the IRS issued proposed regulations (Reg. 132251-11) changing the filing deadlines for submitting a request for relief from two years (determined from the time the IRS begins its collection efforts) to the period of limitation on the collection of tax—generally 10 years. This deadline change applies to all requests for relief filed *on or after* July 25, 2011.
    - A request for relief is made via *Form 8857*.
    - Key elements in the evaluation process include knowledge and substantial benefit.

RISK MANAGEMENT

Given the duty to exercise reasonable diligence and skill on behalf of a client, how do you protect your client (and yourself) from divorce-related tax failures? The first step, of course, is to recognize your limitations (competencies) and qualify your engagement accordingly. If funding is available, the second step is to engage a CPA or other licensed professional (*e.g.*, a forensic accountant, an enrolled agent, or a financial planner) to assist in identifying tax-related issues and developing strategies to leverage or mitigate the issues. If funding is not available, the client should be advised to consult his or her own tax advisor.

A third step is to provide every client with a copy of IRS Publication 504 titled *Divorced or Separated Individuals.* Pub. 504, which can be accessed online at no charge,[28] provides readable and understandable explanations about most divorce-related tax matters. Two other IRS publications that may also be useful include Pub. 501—*Exemptions, Standard Deduction, and Filing Information*, and Pub. 971—*Innocent Spouse Relief*. These publications, although written from the perspective of the IRS, are very informative and client-friendly.

SAME-SEX MARRIAGE

The US Supreme Court's recent decision in *Windsor* will have a broad impact on the IRC, including equal treatment of divorce-related tax provisions for same-sex married couples. Importantly, the decision maintained same-sex marriage as a state-level issue, meaning that the provisions (benefits) apply only to same-sex couples *considered married under state law*. Questions regarding the impact of residency still hang in the balance. For example, to be considered married under state law, must the same-sex couple reside in a state that recognizes same-sex marriage? For tax purposes, the answer is no. If taxpayers are legally married under the laws of *any* state (*i.e.*, the state in which the marriage occurred), then the marriage is recognized for tax purposes, even if they later move to another state that prohibits same-sex marriage.[29]

Indemnification agreements are not binding on the IRS.

The *Windsor* decision presumably applies retroactively to all open years. That said, I encourage you to take a second look at your same-sex divorce cases in light of the many issues discussed above. In some cases, an amended return may be warranted. As a rule, an amended return will be accepted by the IRS if it is filed within the statutory period of limitations, generally within three years from the due date of the original return.[30] An amended return filed after the statute of limitations may be accepted, rejected, or ignored by the IRS in its sole discretion.[31]

CONCLUSION

Although every divorce case has its own unique cast of characters and body of facts, virtually all involve tax-related issues. Our discussion, although limited in scope, is intended to familiarize you with the primary rules. As a former IRS agent and practicing forensic accountant, I cannot overemphasize the importance of this fundamental knowledge or the negative consequences of a divorce-related tax failure.

NOTES

1. *U.S. v. Windsor*, 570 US ______ (2013), June 26, 2013, 2013-2 USTC¶50,400.

2. Total income, found on line 22 of Form 1040, is most commonly used as the base (denominator). Alternatives include adjusted gross income (AGI) and taxable income, found on lines 37 and 43, respectively.

3. Based on his AGI (adjusted gross income).

4. 100% − 35% = 65%; 65% × $60k = $39k.

5. 100% − 26% = 74%; 74% × $60k = $44.4k.

6. *Black's Law Dictionary*. (2009). 9th Ed., p. 85. *Also see* IRC § 71.

7. IRC § 71 and § 215; Reg. § 1.71-1T.

8. G.W. Doolittle, TC Summary Opinion 2012-103. *Also see* S.F. Schilling, TC Memo. 2012-256, Dec. 59,185(M).

9. Reg. § 1.71-1T (Q&A-5).

10. IRC § 71(b)(2).

11. J.J. Faylor, TC Memo. 2013-143, Dec. 59,558(M). *Also see* D.R. Martin, TC Summary Opinion 2013-31.

12. Reg. § 1.71-1T (Q&A-6)

13. Reg. § 1.71-1T (Q&A-9).

14. Reg. § 1.71-1T (Q&A-11). *Also see Hoover v. Commissioner* (97-1 USTC ¶50,111).

15. Reg. § 1.71-1T (Q&A-12).

16. Reg. § 1.71-1T (Q&A-10).

17. *Strealdorf et al. v. IRS* (84-1 USTC ¶9292).

18. Reg. § 1.71-1T (Q&A-5).

19. T. Reg. § 1.71-1T (Q&A-6).

20. A. Sa'd, TC Memo 2012-348, Dec. 59,288(M).

21. IRC § 1041.

22. Treasury Reg. § 1.1041-1T. *Also see Arnes v. Commissioner*, 91-1 USTC ¶50,207.

23. IRC § 1041(b)(2).

24. IRC § 121. *Also see Ingham*, 99-1 USTC ¶50,249.

25. Reg. § 1.408-4(g).

26. M. Shenk, 140 TC—, No. 10, (May 7, 2013) Dec. 59,528. *Also see P.E. Vokovan*, TC Memo. 2013-37, Dec. 59,438(M).

27. IRC § 6015.

28. Pub. 504 can be found at: *http://www.irs.gov/pub/irs-pdf/p504.pdf*.

29. *See* Rev. Rul. 58-66, 1958-1 CB 60.

30. *See* IRC § 6501.

31. *See Birmingham Corp. v. Commissioner*, CA-5, 43-2 USTC ¶9618, 138 F2d 455, cert. denied, 321 US 781; *Automobile Loans, Inc. v. Commissioner*, 36 BTA 809.