

Avoiding Tax Traps in a Divorce

Over the past several years, numerous changes have been made to the tax treatment of dependents, alimony, child support, property settlements, and other divorce related issues which can produce unintended results for divorced individuals. Failure to understand these rules can be very costly.

Child Dependency Exemption

The custodial spouse is entitled to the outright exemption for the dependent child for any divorce or separation agreement granted on or after January 1, 1985.

There are certain exceptions which allow the non-custodial spouse to claim the exemption for the child:

1. The custodial parent releases the exemption of the child(ren) to the non-custodial spouse through the use of IRS Form 8332. In lieu of Form 8332, the IRS will accept a copy of the cover page of the agreement (with the custodial parent's social security number added), the specific clause unconditionally stipulating the exemption to the non-custodial parent, and the signature page showing the date of the agreement.
2. There is a pre-1985 divorce agreement, whereby a completely different set of rules and regulations are in effect.

Child Tax Credit

Eligible taxpayers may claim a basic credit of \$1000 for each qualifying child in 2004. The basic credit reduces your taxes dollar for dollar but is non-refundable. There is an additional child credit for low-income taxpayers that may be refundable if they qualify. A qualifying child must be under 17 at the close of the tax year on December 31, claimed as a dependent on the taxpayers return, be a decedent of the taxpayer (includes step and foster children) and be a U.S. citizen or resident alien

Child Care Tax Credit

If, under the terms of the divorce or separation agreement, you may not claim your child as a dependent, you are nevertheless entitled to the child care tax credit. To be able to claim this credit these criteria must be met: (1) You must file a separate return; (2) Provide your home as the home of the qualifying child for more than half the year; (3) Pay more than half the cost of keeping up your home for the year; (4) Your spouse may not live in your house for the last six-months of the year.

Alimony

Payments of alimony made under a decree of divorce or separation are deductible by the payer spouse and taxable to the payee spouse. In order to qualify as alimony, the payment must be in cash and cannot be a transfer of property or assets. There must also be a requirement that these payments will cease upon the death of the payee. This need not be stipulated in the agreement if state law requires that payments cease after the death of the payee spouse. If the individuals are either divorced or separated, they must not be living together when the cash payments are made.

Single payments of cash may qualify as alimony if the amount is \$15,000 or less. Payments exceeding \$15,000 per year are subject to a recapture rule if they do not continue for 3 years or more unless ended because of the death of either spouse or the remarriage of the payee.

Any cash payments made to a third party, if required by the agreement on behalf of the payee spouse, will still qualify as alimony payments. Thus, payments made for rent, mortgage, tuition, or living expenses of the payee spouse under the terms of the divorce or separation instrument can qualify as alimony payments.

The agreement may also call for property settlement payments to be made from pension or retirement funds under a Qualified Domestic Relations Order (QDRO). Transfers made under a QDRO are exempt from the 10% penalty on premature distributions from qualified retirement plans.

Disposition of Principal Residence

What happens to a jointly-owned principal residence is usually a key item in a divorce agreement. The three most frequent provisions chosen are (1) sell the house and divide the proceeds with each spouse reporting his or her share of the sale on separate returns; (2) transfer the house to one spouse or the other; (3) retain joint ownership allowing the custodial parent to reside therein but delay the sale of the house until the occurrence of a specific event (remarriage of the custodial parent, children reaching specific ages, etc.).

Child Support

Child support is neither taxable to the recipient nor deductible by the payer. Under current law, if part of an alimony payment is based on a child's situation (such as coming of age, marriage, college), that portion of the payment is presumed to be child support and is not deductible or taxable.

IRA Deduction

Alimony payments received by a payee are considered to be "earned income" for the purpose of allowing alimony recipients to contribute to an Individual Retirement Account. This is true even if the alimony recipient is not employed.

Deductibility of Legal Fees

Legal fees paid in connection with obtaining a divorce are not deductible. Fees paid for obtaining and/or maintaining alimony or income producing property and for tax advice are deductible. In order to qualify as deductible legal fees, the attorney must stipulate, on the bill, the amount or percentage of the fee which is attributable to tax matters. Legal fees are miscellaneous itemized deductions subject to the 2% of AGI limitation.

Innocent Spouse Provisions

The IRS Restructuring and Reform Act of 1998 made the benefits of Innocent Spouse status easier to obtain. The Act expands the benefits to all understatements of tax attributable to erroneous items of the other spouse, regardless of the dollar amount.

The Act offers three types of potential relief based on factors such as how much the innocent spouse was aware of the understatement, for taxpayers no longer married to or legally separated from the person with whom they originally filed a joint return, and for taxpayers for whom the IRS may grant equitable relief. Consult your Enrolled Agent for details.

Community Property States

If you live in a Community Property State (AZ, CA, ID, LA, NV, NM, TX, WA, or WI), the tax rules for filing the tax return for the year of the divorce or legal separation are different from the instructions in the tax booklet you receive from the IRS. These special rules may also apply to any returns filed Married Filing Separate prior to the divorce or legal separation.