DIVORCE AND SEPARATION

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When you think about divorce and separation, the tax consequences are probably not the first issue that comes to mind. However, the way you structure payments under the terms of a divorce or separation can have a tremendous impact on your income tax liability and, therefore, your overall financial condition.

The tax rules applicable to payments made from one spouse to another incident to divorce or separation should be given serious consideration *before* entering into a separation agreement or divorce settlement. In addition to having an attorney represent you when you are involved in a divorce or separation, your tax advisor should review any proposed agreement or settlement before it is finalized.

This guide highlights the tax consequences of certain payments that may be arranged as part of a divorce settlement, as well as other tax issues that arise in connection with the events of divorce or separation. The areas that will be discussed include:

- Alimony and separate maintenance payments;
- Child support;
- Qualified Domestic Relations Orders (QDROs);
- Individual retirement arrangements (IRAs);
- Property settlements and transfers of property incident to divorce;
- Jointly-owned businesses; and
- Innocent spouse relief.

Three types of payments or transfers

If you are going through a separation and/or a divorce, all payments or transfers of property – either from you to your spouse or from your spouse to you – fit into one of the following three categories:

- Nontaxable transfers of property;
- Taxable alimony or separate maintenance payments; or
- Nontaxable child support payments.

It can sometimes be unclear whether a particular payment or transfer of property is alimony or child support. It can also be difficult to determine whether certain payments or transfers of property constitute taxable alimony or nontaxable property transfers. The tax treatment of each type of payment is

different, making it extremely important to understand the proper classification of these transactions.

ALIMONY

Alimony is a payment to or for a spouse or former spouse under a divorce or separation instrument. It does not include voluntary payments that are not made under a divorce or separation instrument.

Alimony and separate maintenance payments constitute taxable income to the payee-spouse and are deductible by the payer-spouse. However, both parties can agree to change the tax treatment of qualified alimony payments by designating them as nonalimony, or otherwise agreeing that the payments will be tax-free to the payee-spouse and nondeductible by the payer-spouse.

You can't just label a payment as alimony, however, and expect it to be treated as such for tax purposes. To qualify as alimony, payments must meet several requirements:

- The payments must be in cash;
- They must be received by or on behalf of the payee-spouse under a divorce or separation instrument;
- Spouses who are legally separated under a decree of divorce or separate maintenance must not live in the same household;
- The payment obligation must end upon the payee's death;
- The parties must not file a joint tax return with each other; and
- The payments must not be child support.

> ***Comment.*** State laws differ as to the treatment of alimony payments after remarriage of the payee-spouse. When state law provides that alimony stops upon the payee-spouse's remarriage, the payer-spouse's continuing payments under a final decree of divorce after the ex-spouse has remarried are not made under a legal obligation to pay alimony and are generally not includable in the ex-spouse's income.

Assuming you structure your payments to meet these basic requirements, if you are the payer-spouse, you will be able to deduct your payments and the payments will be included in your spouse's taxable income.

But you have the flexibility, if you both agree, to *not* have future payments treated as alimony (to be tax-free to your spouse and nondeductible by you). This will save taxes for the recipient spouse. As a payer-spouse, you may agree to do this if you don't need the deduction, or your former spouse is in a higher tax bracket.

Special rules apply to spouses in community property states. Payments that may otherwise qualify as alimony are not deductible by the payer if they are

the recipient spouse's part of community income. They are deductible as alimony only to the extent they exceed that spouse's portion of community income.

> **Caution.** Since no taxes are withheld from alimony payments, you may need to make estimated tax payments or increase the amount withheld from your paycheck.

What is a divorce or separation instrument?

A divorce or separation instrument is a:

- Decree of divorce or separate maintenance, or a written instrument incident to the decree;
- Written separation agreement; or
- Decree requiring a spouse to make payments for the support or maintenance of the other spouse, including a temporary support order.

> **Caution.** In all events, oral agreements or oral modifications don't count for tax purposes.

Payments of alimony to third parties

When the spouse who is required to pay alimony instead makes cash payments to a third party on behalf of the other spouse, these payments may qualify as alimony or separate maintenance payments. However, the payments must be required by the divorce or separation instrument and must meet all the requirements above to qualify as alimony.

Qualifying payments. Cash payments of rent, mortgage, taxes, or tuition liabilities of the spouse receiving the alimony, medical and dental expenses, or attorney's fees made under the terms of the divorce or separation instrument are qualifying payments. Payments of life insurance premiums can also qualify as alimony as long as the payee-spouse owns the policy.

> **Example.** Under your divorce decree, you must pay your former spouse's medical and dental expenses. If the payments otherwise qualify as alimony, you can deduct them as alimony on your return. Your former spouse must report them as alimony received and can include them in figuring deductible medical expenses.

However, payments to maintain property owned by the spouse paying the alimony, but used by the spouse receiving the alimony, do not qualify as alimony even if they are made under the terms of the divorce or separation instrument.

Example. Under your written separation agreement, your spouse lives rent-free in a home you own and you must pay the mortgage, real estate taxes, insurance, repairs, and utilities for the home. Because you own the home and the debts are yours, your payments for the mortgage, real estate taxes, insurance, and repairs are not alimony. Neither is the value of your spouse's use of the home.

Comment. The treatment of payments made with respect to jointly owned property is determined based on the spouses' proportional interests. However, as the owner of the property, the payer-spouse can take itemized deduction for mortgage interest and real estate taxes.

Cash payments to a third party on behalf of the payee-spouse also qualify if they are made at the payee's written request. For example, a cash payment to a charitable organization at the request of the payee-spouse qualifies as an alimony payment if the payment is made pursuant to the payee-spouse's written request, consent, or ratification.

CHILD SUPPORT

Child support payments are not deductible by the payer-spouse or taxable to the payee-spouse.

Caution. As with alimony, merely labeling payments as child support is not enough. There are many requirements that must be met.

Child support payments are payments fixed by the terms of the divorce or separation instrument as a sum payable for the support of the child. A fixed payment may be reduced upon the happening of a contingency specified in the instrument relating to the child, such as attaining a certain age, marrying, dying, or leaving school. Most child support agreements end when the child reaches age 21, although frequently provision is made to cover college costs. Special terms are also provided for children who cannot fully care for themselves.

Dependency exemption. Closely related to child support is the issue of which spouse gets to claim the dependency exemption for the child. Generally, the parent who has custody of the child gets to claim the exemption. However, the custodial parent can release the exemption to the noncustodial parent.

Caution. Release of the dependency exemption to the noncustodial parent must be done by an express waiver by the custodial parent, usually by completing IRS Form 8332, Release of Claim to Exemption for Child of Divorced or Separated Parents. A divorce or separation instrument may not sufficiently release the exemption to the noncustodial parent if it provides only that the noncustodial parent "may" claim the exemption for designated tax years, and not that the custodial parent will not claim it.

Caution. A payor-spouse may combine payments of alimony and child support in a single monthly payment to the payee-spouse. You should note, however, that payment in this manner does not make the child support qualify as deductible alimony or separate maintenance payment. The portion of the payment representing child support is not deductible by the payer or includable in the income of the spouse receiving it to the extent the payment under the instrument is fixed or treated as fixed as support for the payer-spouse's children. Moreover, if the amount paid is less than the payer's total spousal and child support obligations, the payments are first allocated to child support and then to spousal support.

Payments for the benefit of persons other than the payer-spouse's children are not child support. They may be treated as alimony if they meet the alimony requirements and the parties do not state in the instrument that they are not deductible or includable in income. Step-children who were not formally adopted may fall into this category.

QUALIFIED DOMESTIC RELATIONS ORDER (QDRO)

A QDRO is a type of court order that creates or recognizes the existence of a former spouse's right to receive all or a portion of the benefits payable to the plan participant-spouse. A QDRO is a judgment, decree, or court order (including an approved property settlement

agreement) issued under domestic relations law that:

- Relates to the rights of someone other than a participant to receive benefits from a qualified retirement plan or a tax-sheltered annuity;
- Relates to payment of child support, alimony, or marital property rights to a spouse, former spouse, child, or other dependent of the participant; and
- Specifies the amount or portion of the participant's benefits to be paid to the participant's spouse, former spouse, child, or dependent.

Plan distributions under a QDRO. Any amount actually distributed to a distributee under a qualified plan is taxable to the distributee in the year of distribution. Thus, a spouse or former spouse who receives plan distributions under a QDRO is taxed on those distributions. This is the case even if the QDRO provides that all taxes that are due on distributions under the QDRO are to be paid by the participant.

Retirement plan benefits paid without a QDRO

Rather than having the retirement benefits paid directly from the plan as they are under a QDRO, the couple may prefer to enter a cash settlement with the spouse participating in the retirement plan making direct cash payments to the other spouse in lieu of any marital rights in the plan benefits or merely as part of a property settlement.

Individual Retirement Arrangements (IRAs)

Divorce and separation can have an impact on traditional IRAs and other retirement plans. Some of the effects on individual retirement arrangements, other than Roth or simple IRAs, are:

- ***Spousal IRA.*** If you get a final decree of divorce or separate maintenance by the end of your tax year, you cannot deduct contributions you make to your former spouse's traditional IRA. You can only deduct contributions to your own traditional IRA.
- ***IRA transferred as a result of divorce.*** The transfer of all or part of your interest in a traditional IRA to your spouse or former spouse, under a decree of divorce or separate maintenance or a written instrument incident to the decree, is not considered a taxable transfer. Starting with the date of the transfer, the traditional IRA interest transferred is treated as your spouse's or former spouse's traditional IRA.
- ***IRA contribution and deduction limits.*** All taxable alimony received by the recipient-spouse under a decree of divorce or separate maintenance is counted as compensation for purposes of determining the recipient spouse's contribution and deduction limits on his or her traditional IRAs.

Property settlements

No gain or loss is recognized when an individual transfers property to a spouse or former spouse incident to a divorce. Property settlements – whether in a lump sum or installments - even though required by the divorce decree or other written agreement, do not qualify as alimony.

This nonrecognition rule also applies regardless of whether the transfer of property is for the relinquishment of marital rights or the cancellation of debt. Moreover, it applies regardless of whether the property transferred was owned separately or together during the marriage.

> **Comment.** Transfers of property in trust for the benefit of a spouse or incident to divorce generally are not taxable. However, gain is realized on these transfers to the extent that the liabilities assumed, or to which the property is subject, exceed the adjusted basis of the property.

Incident to divorce

Property transfers are incident to divorce if they occur within one year after the date of divorce, or are related to the end of the marriage. A transfer is related to the end of the marriage if the property is transferred under a divorce or separation instrument, and the transfer occurs within six years after the divorce date.

Transfers of property to or from a third party on behalf of a former spouse qualify for nonrecognition treatment in some cases. A transfer to a third party will qualify if it is required by the divorce instrument, made pursuant to the written request of the transferee spouse, or the transferor receives from the transferee spouse a written consent or ratification of the third-party transfer.

> ***Caution.*** Nonrecognition treatment does not apply when the spouse or former spouse receiving the property is a nonresident alien. Gain or loss is recognized on those transfers.

> ***Comment.*** The nonrecognition rules apply to all types of transfers, including transfers of stock options, deferred compensation, and other intangible property.

Tax impact

Although property settlements are generally tax-free to both parties, this does not mean that taxes are not important in property settlements. While the property settlement itself ordinarily is not taxable, who gets what property can greatly affect either spouse's potential future taxes if the property received is later sold because of the rules regarding basis. The spouse receiving the property transferred incident to a divorce takes a carryover basis equal to the adjusted basis of the property in the hands of the transferor-spouse immediately before the transfer.

> ***Example.*** A vacation home worth $350,000 was purchased a few years ago for $300,000 and $350,000 of stock also was purchased several years ago for $150,000. The spouse receiving the stock would have a $200,000 gain ($350,000 less basis of $150,000) on an immediate sale, whereas a sale of the vacation property would result in only a $50,000 gain ($350,000 less $300,000).

Distinguishing between property settlements and alimony

Generally, if a payment meets all alimony requirements and restrictions, it automatically qualifies as an alimony payment and is deductible by the payer and includable in income by the payee, without any approval required from the IRS.

Recapture rule. To ensure that payments deducted as alimony are not actually disguised property settlements, special "front-loading" rules provide for the recapture of excess alimony payments as income. The recapture rule comes

into play when alimony payments are reduced or terminated during the first three years.

Excess alimony payments are recaptured in the payer-spouse's tax year beginning in the third post-separation year by requiring the payer-spouse to include the excess in income that year. The payee-spouse, who previously included the payments in income as alimony, may deduct the recaptured amount from gross income in the payee's tax year beginning in the third post-separation year.

Jointly-owned businesses

Complications and tax traps can arise when a jointly-owned business is to be transferred to one spouse in connection with a divorce.

> ***Caution.*** The importance of properly structuring the transfer of a business owned with your spouse cannot be overstated. When one spouse winds up with the family business as the result of a divorce, the tax consequences will largely depend on how the transaction is accomplished.

Buyouts

A common way for divorcing spouses to separate their interests in a jointly-owned business is for one spouse to buy out the other, with the buy-out funds coming from the company. The company redeems the stock of the spouse

being bought out, giving that spouse cash or other property in exchange for his or her equity interest.

In general, the tax consequences of a stock redemption incident to divorce will be determined under "applicable tax law." Applicable tax law will treat a redemption as a constructive distribution to the nontransferor spouse if that spouse has a primary and unconditional obligation to purchase the stock of the transferor spouse. In other words, if a husband has a binding obligation to purchase his wife's stock in their corporation, he will be treated as receiving a (taxable) constructive distribution when the corporation redeems the wife's stock in order to satisfy the obligation.

If the nontransferor spouse does not have a primary and unconditional obligation to purchase the departing spouse's stock, then the redemption will be taxed under the usual rules applicable to redemptions, and the nonrecognition

rules that typically apply to property transfers in connection with a divorce will not apply.

However, the IRS allows divorcing spouse to decide which party bears the tax consequences of the stock redemption, regardless of which party would have otherwise been subject to tax on the transaction under the general rules above. Spouses can elect, by expressly providing in a divorce or separation instrument or other valid written agreement their mutual intent as to which spouse will bear the tax consequences of the redemption.

- ***Planning tip.*** Stock redemptions incident to a divorce are a zero sum game: either the wife or the husband will be taxed. To make sure that the intended party ends up with the tax, there are some steps practitioners can take. If the spouse whose stock is redeemed is to be taxed, then the parties should make sure that the nonredeeming spouse has no obligation to purchase the stock and the corporation is not acting on the spouse's behalf. On the other hand, if the nonredeeming spouse is to be taxed, then the parties should make sure that spouse is obligated to buy the stock.

Home sales

Homeowners may generally exclude from income up to $250,000 of gain realized on the sale or exchange of a residence under Code Sec. 121. The exclusion increases to $500,000 for joint filers. Ownership and use requirements must be met. For example, the taxpayer must have owned and used the property as a principal residence for a total of two years during the five-year period before the sale. Moreover, there are exceptions for periods of nonqualifying use.

If property is transferred to a spouse or former spouse incident to divorce, the period the transferee spouse owns the property includes the period the property was owned by the transferor spouse. A transfer for these purposes is one that qualifies for the nonrecognition rule applicable to transfers between spouses or between former spouses incident to a divorce.

In addition, and only for purposes of the gain exclusion, a taxpayer is treated as using property as his principal residence during any period that the taxpayer's spouse or former spouse is granted actual use of the property under an instrument of divorce or separation.

Example. Jim and Tina have owned their house jointly for many years. Their divorce decree provides that Tina may continue to reside in their home. She lives there for six more years and then sells the house for a gain of $450,000. Both Jim and Tina are entitled to exclude up to $250,000 of the gain.

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Deductibility of legal and accounting expenses

Many cases have dealt with whether legal and accounting expenses incurred in connection with divorce, property settlement, and alimony proceedings are deductible. To be deductible, any such expenses must be related to the taxpayer's profit-seeking activities. Personal expenses are not deductible. Deductibility depends on the origin and the character of the claim with respect to which the legal expenses were incurred, rather than the potential consequences to your profit-seeking activities that may result.

Divorce and separation. Claims asserted by a spouse in a divorce action are almost always found to arise from the marital relationship rather than a profit-seeking activity. Therefore, legal fees and other costs connected with a divorce, separation or decree for support are generally not deductible, even if they are partly to protect business or investment property from the claims of a spouse.

"So what's deductible?"

Legal and accounting costs paid specifically to produce or collect taxable alimony are deductible. The portion of legal fees in a divorce that pertains solely to advice on tax matters is also deductible.

Fees expended to secure the right to another non-alimony form of income that arises as part of a divorce action are deductible. For example, the portion of legal fees incurred in a divorce to obtain the right of possession (as distinct from ownership), or the right to participate in the income from business property is deductible. Legal fees incurred as part of a divorce action in an attempt to obtain an accounting of joint venture profits or a share in the profits of a corporation are also deductible.

Innocent spouse relief

If you file a joint return with your spouse, you are both jointly and severally liable for the entire tax due, including penalties and interest, even if you later divorce. This is the case even if one spouse is unaware of inaccuracies on the return.

However, under the innocent spouse rules, a spouse may be relieved of responsibility for a joint tax liability if certain conditions are satisfied.

> ***Comment.*** The Tax Court has jurisdiction to review IRS innocent spouse determinations and, based on case law, has become more sympathetic to requesting spouses in recent years.

There are three types of innocent spouse relief: general innocent spouse relief, separate liability relief, and equitable

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innocent spouse relief. The three types of relief share several common elements, including the requirement of a joint return filing, formal election of relief, notice and participation rights for the other spouse, and the opportunity to seek judicial review of decisions to deny relief.

Another form of relief is available to married individuals who did not file joint returns with a spouse, but are liable for an underpaid or understated tax resulting from state community property laws. Individuals who qualify may be granted relief based on grounds that are similar to those used for general innocent spouse relief or on equitable grounds that are similar to those used for equitable innocent spouse relief.

General innocent spouse relief. General innocent spouse relief is available if the following conditions are met:

- The couple filed a joint return;
- There is an understatement of tax resulting from erroneous tax items attributable to the non-requesting spouse (e.g., omissions of income, improper deductions, etc.);
- The requesting spouse did not know or have reason to know of the understatement when he or she signed the return;
- It would be inequitable to hold the requesting spouse liable for the deficiency; and
- The requesting spouse elects innocent spouse relief no later than two years after the IRS first attempts to collect the tax liability from him or her.

Separate liability relief. Separate liability relief is a special relief provision for spouses who are divorced, separated, or widowed, or treated as no longer married because they have not been members of the same household during the last 12 months. These individuals can elect to allocate the understatement of tax, plus penalties and interest, on a joint return between the requesting and nonrequesting spouse.

To qualify for separate liability relief, a requesting spouse must not have had actual knowledge of the understatement at the time the return was signed. However, there is an exception for spouses who can establish that they signed a return under duress or because of prior abuse.

Equitable relief. If an individual does not qualify for general innocent spouse relief or separate liability relief, he or she may still be relieved of a joint liability through equitable innocent spouse relief. Equitable innocent spouse relief is available when certain requirements are met and, taking into account all the facts and circumstances, it would be inequitable to hold the requesting spouse liable for any unpaid tax or deficiency.

In addition to deficiencies arising from an understatement of tax, equitable

relief is also available for underpayments of tax shown due on the return.

> *Comment.* General innocent spouse relief and separate liability relief are available only with respect to tax deficiencies, not underpayments.

If certain threshold requirements are met, the IRS will make a streamlined determination granting equitable relief if the spouses are separated or no longer married at the time of the request for relief, the requesting spouse did not know or have reason to know that the nonrequesting spouse would not pay the liability shown on their joint return, and the requesting spouse will suffer economic hardship if relief is not granted.

If the requesting spouse satisfies the threshold conditions for innocent spouse relief, but does not satisfy the conditions for streamlined relief, the IRS will consider several additional factors in deciding whether to grant relief, including:

- The requesting spouse's current marital status;
- Whether the requesting spouse would suffer economic hardship if relief were not granted;
- The requesting spouse's knowledge or reason to know of the deficiency or underpayment;
- The non-requesting spouse's legal obligation to pay the liability;
- Whether the requesting spouse significantly benefited from the deficiency or underpayment;
- The requesting spouse's compliance with income tax laws; and
- The requesting spouse's mental or physical health.

A spouse must request general innocent spouse relief or separate liability relief within two years after the IRS first attempts to collect the tax liability from him or her. Requests for equitable relief generally must be filed within the period of limitation on collection (generally within 10 years after the tax is assessed).

> *Comment.* A requesting spouse seeking equitable relief must file Form 8857, Request for Innocent Spouse Relief (and Separation of Liability, and Equitable Relief), or other similar statement.

CONCLUSION

Divorce has important and often subtle tax implications that must not be ignored or put aside because of the emotion of the moment. The decision to terminate a marriage ends an economic partnership and often involves significant payments and transfers of property between spouses. The way these transactions are structured can have significant tax consequences. However, careful planning with your tax advisor will help protect your interests and minimize your tax liability to the extent allowed by law.