Divorce and Taxes

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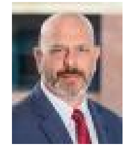

Divorce is a painful process. I know this because for the last 20 years, I have counseled hundreds of clients struggling through this very difficult transition in their lives. Ignoring the tax implications and consequences of divorce inevitably creates far greater pain than that which normally accompanies the divorce process.

Taxes and the Division of Property

A property settlement in a divorce situation may include transfers of cash or property in exchange for the release of support or marital rights, exchanges of individually-owned property, and divisions of co-owned property. When the transfer is in cash, the initial step in characterizing the payment for tax purposes is determining whether the payment represents alimony, child support, or a property settlement. If the payment is not mutually agreed to be alimony or child support, then, ordinarily, it is treated as a property settlement.

Generally, subject to a few statutory exceptions which are discussed below, if property is transferred between spouses or between former spouses incident to a divorce, the tax treatment of the transfer is determined under Section 1041 of the Internal Revenue Code ("Section 1041").

History of Section 1041

Enacted by Congress in 1984, Section 1041 applies to all qualifying transfers made after July 18, 1984, unless such transfers are made pursuant to a divorce instrument or property settlement agreement which was effective on or before that date. Section 1041 was enacted in response to a growing body of case law emanating from the United States Supreme Court's 1962 decision in United States v. Davis. Case law interpreting Davis resulted in significantly disparate tax treatment of similar transactions in different states. Thus, by enacting Section 1041, Congress sought to impose a uniform federal standard.

No Gain or Loss on Transfer

Section 1041(a) provides that no taxable gain or loss is recognized on a transfer of property from a spouse to, or in trust for, the other spouse or former spouse if the transfer to the other or former spouse is incident to a divorce. By way of contrast, if, in connection with a divorce, the parties agree to sell marital property to a third party, or a court orders the sale of marital property to a third party, the conveyance is not considered to be a transfer to the other or former spouse incident to the divorce within the meaning of Section 1041(a)(2). Any tax consequences of the sale to the third party, such as gain, loss, or depreciation recapture, will be recognized by the record owner or owners (that is, the divorcing spouses) in accordance with general tax principles.

The division of retirement accounts carries with it a host of tax consequences. Generally, the tax-free transfer of retirement accounts such as 401(k)s, profit sharing plans, and defined benefit plans to the non-employee spouse (the "alternate payee") requires a specific court order known as a Qualified Domestic Relations Order ("QDRO"). An improper or poorly planned distribution of a retirement account may result in unintended, significant, and unpleasant tax consequences to the employee spouse. In a worst case scenario, the employee spouse will receive none of the disbursed funds, but still will be liable for the payment of all income tax due on the distributed amount, plus a 10% penalty. If the alternate payee needs money right away, the parties may be able to avoid the 10% penalty with a specific directive in the QDRO for a direct payment from the retirement plan. Such funds still will be included in the alternate payee's income for the year in which the disbursement occurred, but not in the employee spouse's income.

Alimony

A cash payment of alimony will be includable in the income of the recipient and deductible by the payor if the payment meets the statutory requirements set forth in Section 71 of the Internal Revenue Code ("Section 71"). Cash payment includes payment by check or money order, but does not include payment by promissory notes or other debt instruments, property or the use of property, or services. Section 71(b)(1) sets forth the requirements a cash payment must meet in order to be considered alimony. The payment will be considered alimony if it is:

1. Received under a divorce or separation instrument;
2. Not designated as not includable in the taxable gross income of the recipient and not allowable as a tax deduction by the payor;
3. Not made to a divorced spouse still living in the same household as the payor; and,
4. Not payable after the death of the recipient and the payor has no liability to make any payments as a substitute for such payment after the death of the recipient.

Opting Out of Alimony Designation

Payments which otherwise would fit the Section 71 definition of alimony may be designated specifically in the divorce instrument or property settlement agreement as being not includable in the taxable gross income of the recipient and not allowable as a tax deduction to the payor. Section 71(b)(1)(B) allows divorcing spouses to so avoid the otherwise applicable statutory tax allocation scheme if they choose. However, the converse is not true. Payments that do not qualify as alimony under Section 71 are not deductible by the payor or includable in the recipient's taxable gross income, even if the divorce instrument or property settlement agreement calls such payments "alimony."

Child Support

Generally, the payment of child support carries no tax burden or benefit. The payment is neither deductible to the payor nor is it income to the recipient. However, the allocation of child-related tax exemptions may have an impact on tax liability. The child support calculations set forth in the North Carolina Child Support Guidelines used by the courts assume that the custodial parent receiving child support will receive the tax exemption for any child for which support payments are made. If the custodial parent receiving child support has minimal or no income tax liability, the court may consider requiring the custodial parent to assign the tax exemption to the supporting parent and thereby deviate from the Guidelines. However, if you have an agreement with your spouse or a court order that permits you to claim a child as a dependent when you otherwise would not be permitted to do so, you now must attach a signed Form 8332 to your income tax return.

Conclusion

Dividing up the assets and liabilities from a marriage, determining the appropriate amount of child support, and resolving the issue of alimony are difficult and often highly contentious tasks. Do not complicate them even further with unintended but significant and entirely avoidable tax consequences. Seek out the help of a qualified family law attorney and consider including a certified public accountant in the process. These two professionals will help you navigate this often treacherous path.

For further information regarding the issues described above, please contact William S. Durr.

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