

Five more tax rules to know for divorce

By Robert W. Wood

In my last column (July 5) I covered five key rules that make divorce less taxing. Here are five more.

Retirement accounts can trigger taxes.

Retirement accounts can be troublesome. They may be tax-free now, but someday when they start paying out, they'll be taxed. Plus, if you take out money early, it can be subject to taxes and penalties.

Example: Boris has three IRAs and is awarded all three in his divorce from Natasha. He withdraws \$100,000 from the IRAs and sends it to Natasha so she can pay her taxes. Boris assumes the withdrawals are tax free because he was required to give Natasha \$100,000 under his divorce decree (but it did not require him to transfer an interest in the IRAs). Boris will probably be taxed on the \$100,000 withdrawal, plus a penalty.

The division of workplace 401(k)s also requires care. These can be split without triggering immediate tax, but only if it's done as part of a divorce settled with a "Qualified Domestic Relations Order." See "FAQS About Qualified Domestic Relations Orders" at http://www.dol.gov/ebsa/faqs/faq_qdro.html.

Alimony has tax consequences.

Property settlements may be tax-free, but alimony is not. Alimony (also called spousal support) is tax deductible to the payor and taxable income to the payee. To qualify as alimony, payments must be made under a decree of divorce, separate maintenance or written separation agreement.

Payments can be directed to the spouse or to a third-party (on behalf of the spouse), but the agreement must be very clear the payments are alimony. But beware: Just because something is labeled alimony or spousal support in your divorce documents doesn't mean it is alimony for tax purposes.

The payments must meet other tests. They cannot be made while the payor and payee are part of the same household. They also must be restricted in duration, not extending beyond the payee's death. Also, payor and payee can't file joint tax returns in the same year the alimony is paid.

Beware audits and in-kind alimony.

There are many tax disputes about alimony. In fact, it is such a fertile ground of confusion that the IRS routinely audits both parties after a divorce. Mismatches between the parties are common. Many recipients claim payments are not alimony so are not income.

Similarly, many payors claim a payment is deductible alimony when it is actually property settlement. An audit is likely to be triggered if one party deducts "alimony" and the other does not include it in income. Such inconsistencies spell trouble, often for both parties. The IRS doesn't even have to be consistent in its two audits!

There are also many disputes about what qualifies as alimony. It's possible for payments in-kind and to third parties to qualify as alimony. This might include mortgage payments, car payments, educational expenses and lawyer's fees as alimony. But the rules are technical so be careful. The tax rules get even more complicated - involving tax recapture - when alimony is past due. Most of the controversy focuses on confusion between alimony and child support, which can become even murkier when there are arrearages. This segues nicely into our next topic, child support.

Child support isn't deductible or taxable.

Child support payments are not income to the child or to the custodial spouse. They are also not deductible by the payor spouse. Once again, there is frequent confusion. This often leads to tax audits of one or both parties.

Example: Melvin and Beulah get divorced, and Beulah gets custody of little Johnny. Melvin pays a flat \$10,000 per month to support them and deducts it on his tax return. Beulah does not report it as income, treating it all as child support. What's the result? We need more facts here, but Beulah is probably right and Melvin is probably wrong. Alternatively, the amount would have to be divided between alimony and child support. Their divorce agreement should have been clearer, explicitly dividing the amount between alimony and child support.

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Dependency exemptions require careful handling.

You'd be surprised how frequently there are disputes about who is entitled to claim a child as a dependent. With joint custody, which is increasingly common, only one parent can claim the dependency exemption. The tax benefit is not all that valuable, but spouses sometimes dispute it.

Bottom line: the parties should agree. Surprisingly, even if only one spouse has custody, that spouse can give up the dependency exemption and allow the other spouse to claim it. It may be worth more to the noncustodial parent depending on his or her tax situation.

The Bottom Line.

Divorce isn't easy for anyone. The last thing you need is tax problems, too. Often, these tax problems don't become clear until years after a divorce. By then the problems can be difficult and expensive to fix. If you address the tax issues up front while you're negotiating terms of a divorce, you'll usually end up spending less money and sleeping much better.

This discussion is not intended as legal advice, and cannot be relied upon for any purpose without the services of a qualified professional.



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