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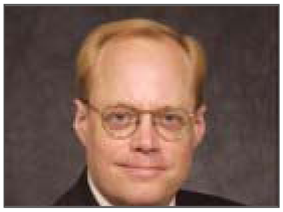

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How To Make Divorce Less Taxing

Death and taxes may be prominently linked, but many Americans face divorce long before death, and a divorce can be almost as, well, taxing. If you're careful, it's possible to divorce and not face major tax bills. But a surprising number of tax flubs are committed every year in this area, even by professionals. Very slight differences in mechanics can yield huge tax differences for one or both spouses. What's more, your divorce lawyer may not be competent to address these tax rules so you may need a tax advisor.

Here are 10 things about taxes and divorce you should know:

1. Property settlements are tax-free.

If you divide property between spouses (or within limits, even after marriage), Section 1041 of the tax code says there's no tax to either party. Enacted in 1984, this provision reversed a Supreme Court case that ruled property divisions were taxable. This tax-free rule means you can divvy up property between spouses however you want. (That's provided they're both citizens; if one isn't a citizen, there may be income and gift tax issues.) But when you divide property, you'd better consider future taxes and the tax basis of the property in addition to its fair market value.

Example: Al and Betty are getting divorced and own a home worth $5 million, which they bought 30 years ago for $200,000. Betty is awarded the house. A year later Betty sells the house for $5 million. She has a whopping gain of $4.8 million, all of which is taxable to her!

Al and Betty might have cash, securities and other assets to divide, some with a high basis, some with a low basis. It can be more equitable for each spouse to take a mix of high and low basis assets.

2. Transfers “incident to divorce” are covered.

All transfers between spouses during marriage are covered by Section 1041 and transfers “incident to divorce” are covered, too. A transfer is incident to divorce if it occurs within one year after the marriage ceases, or if it is “related” to cessation of the marriage. Any transfer more than one year after the end of the marriage is open to scrutiny by the Internal Revenue Service, but if the divorce or separation instrument requires that transfer, it is probably covered. Any transfer more than six years after the end of the marriage is presumed to be outside Section 1041, but this presumption can be rebutted with documentation.

3. Sometimes you’ll want to avoid tax-free transfers.

If the parties want to sell assets to each other as part of their divorce, can they do so? Yes, but unless you do it very carefully the sale won’t be effective for tax purposes.

Example: Harry and Wanda are divorcing in a community property state. They own a house worth $1 million with a basis of $200,000, and various other assets they split equally. Under community property law, Harry already owns half the house. Harry “purchases” Wanda’s interest in the house from her for $500,000 by borrowing from a bank. Two years later Harry sells the house for $1.1 million. Harry’s tax basis is still $200,000, so he’s got a whopping $900,000 gain.

Under limited circumstances you can orchestrate a true sale to avoid this, but you usually need a third party to help and a competent tax lawyer.

4. Unmarried couples don’t qualify.

Section 1041 only applies to married couples, so cohabiting couples do not qualify. In some states you can have a lawful marriage as common law, so what constitutes marriage varies.

Example: Billy and Betty have been married for seven years in California and amicably divorce, only to find that unbeknown to them both, Billy’s divorce from his first wife wasn’t final when he “wed” Betty seven years before! Under California law, their marriage is void, so Section 1041 cannot apply. If they divide property, it is taxable as a sale for its fair market value even though no money changes hands. One of them will have taxable income with no cash to pay the tax.

Outside marriage, dividing property usually triggers taxes. That makes resolving palimony and cohabitation cases tough from a tax viewpoint. In extreme cases some people actually get married so they can promptly get divorced to take advantage of Section 1041! (For a real-life example, click here.) For the financial reasons many older couples are choosing to live together, without marrying, click here.

5. Businesses and retirement accounts are tricky.

If you're dividing a business, beware. If one party buys out the other, there are different ways to get stung.

Example: Jim and Jane founded Funbook, a social networking site. When they divorce, Jim has Funbook buy out Jane's shares (a stock redemption, for the company buys back its own shares). Jane may think this is a tax-free property division. Jim may think this was a taxable sale. It may be either, depending on the facts. Plus, the IRS may treat Jim as receiving a constructive dividend, meaning he's taxed, too. These tax traps are avoidable, but you must plan ahead and move cautiously.

Retirement accounts can also 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 painful.

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.

6. Alimony has tax consequences.

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 directly 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, and 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 alimony is paid.

7. 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. 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 have to be consistent in its two audits!

There are also many disputes about what qualifies as alimony. It's possible to designate mortgage payments, car payments, educational expenses and lawyer's fees as alimony, but the rules are technical so be careful.

8. Past due alimony can be a tax mess.

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.

9. 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 common confusion, often leading 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.

10. 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 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. (For more on dependency exemptions and divorce, click here.)

The bottom line.

Divorce isn't easy for anyone, even with today's no-fault divorce laws. The last thing you need is tax problems, too. Often, these tax problems don't become clear until a year or more after a divorce, and by then they 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.

You can reach me at Wood@WoodLLP.com. This discussion is not intended as legal advice, and cannot be relied upon for any purpose without the services of a qualified professional.