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Hidden Tax Traps in Divorce: Observations After Tax Reform

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Tax Issues in Divorce

Divorce is rarely amicable and is often described as an emotionally traumatic experience.

In addition to the emotional impact, the financial impact can be even more devastating. Tax considerations in divorce are integral to the marital dissolution process and the traps that result from poor tax planning may not surface until months or years after a divorce when it is often to late to correct.

This presentation addresses several key issues that should be considered when working with divorcing high net worth spouses where the assets and associated income are more complex.

Hidden Tax Traps in Divorce

Tax Filing Status

Timing of Divorce

Married Filing Jointly

Married Filing Separately

Single

Head of Household

Name Changes

Dependency Exemptions and Child Tax Credits

- TCJA *eliminated* dependency exemptions for 2018 through 2025, however, it *increased* the child tax credit for 2018 through 2025 from **$1,000 to $2,000 per child,** and it *increased* the phase out limit for the child tax credit during that same period.*
- As of 2018 the phase-out for the child tax credit begins for married taxpayers **at $400,000** and the phase-out for all other taxpayers begins at **$200,000**.*
- Requirements of the Dependent (for dependency exemption, child tax credit or family credit)

- Trading dependency exemptions – 2 requirements
- Spouses may be able to structure the use of dependency exemptions or child tax credits as part of a creative settlement solution
- IRS Form 8832

Example:

*See TCJA section 11022 and IRC section 24(h).

Sale of Principal Residence Exclusion

- **Requirements**
- **Exclusion Amounts ($250,000 if single; $500,000 if married)**
- **"Ownership" Test**
- **Partial Exclusion of Gain**
- **Example**

 *See TCJA section 11022 and IRC section 24(h).

Mortgage Deductions

TCJA deductible interest limitations*

- Acquisition Indebtedness
- Home Equity Indebtedness

Home Mortgage Interest Deduction Qualifications

Former Spouses living under one roof – Voss v. Commissioner of Internal Revenue

Unmarried Individuals who prefer to stay unmarried

*See T.C.J.A 11043 AND I.R.C. 163(h)(3)

Deductions Related to Divorce

- Divorce fees and expenses generally considered non-deductible personal expenses
- Exception for 2018-2025, during which the TCJA eliminated miscellaneous itemized deductions, certain divorce-related fees that are attributable to the collection of income or tax advice are deductible.

This includes expenses that are:[1]

1. **“for the production or collection of income;**
2. **for the management, conservation, or maintenance of property held for the production of income;**

   or

3. **in connection with the determination, collection, or refund of any tax.”***

[1] I.R.C. section 212

Deductions Related to Divorce

Examples of fees and costs

Taxpayer has ultimate burden of proving the amount of deductible expenses*

Careful Records – Attorney and CPA	+	Separately Itemized Billings	+	Even if deductible, other limitations may apply (2% floor loss of itemized deductions, or AMT)

 *See INDOPCO, Inc. v. Comm'r, 503 U.S. 79, 84 (1992).

Allocation of Tax Carryovers

Tax carryovers are property rights that have inherent value and must be considered in a divorce proceeding.

These include:

- Capital loss carryovers*;
- Charitable contribution carryovers**;
- Net operating loss carryovers; and
- Passive loss carryovers***.

*Divide post-marriage. See Treas. Reg. section 1.1212 – 1(c)(1)(iii)

**By ratio, not agreement. See Treas. Reg section 1.AG170A-10(d)(4)(1)(b); see Dombrowski v. Dombrowski, 559 A.2d 828 (N.H. 1989); see Rev Rule 76-267, 1976-2 C.B. 71.

***By Trial Court separation. See Silverstein v. Silverstein, 943 S.W.2d 300 (Mo. Ct. App. 1997).

Payments After Divorce

Child Support

Tax Neutral

General Rule:

Not deductible for Parent Paying the support nor Taxable as income to the Parent Receiving the support

Alimony

Taxable Event

Pre–2019

- Deductible for Payor
- Income to Payee
- Divorce or separation agreement finalized before January 1, 2019 will be grandfathered

TCJA permanently repeals existing alimony rules – for any year after 2018

- Post 2018 Alimony Rules
- T.C.J.A. section 11051

Retirement Accounts

Qualified Retirement Plans and Qualified Domestic Relations Orders

- Administrator to ensure QDRO is properly drafted – no tax consequences
- Advantages to rollover – Non employee spouse's IRA
- Advantages to keeping funds in former spouse's qualified retirement plan

IRAs

- Governed by I.R.C. and not ERISA, in other words QDRO is not appropriate
- Not taxable if transfer meets requirements
- Written agreement incorporated into or approved by the court entering the decree intention of the parties – transfer tax-free under section 408(d)(6).*
- Donee spouse is treated as owner after transfer – "Trustee to Trustee Transfer"

Example:

 *See Priv. Ltr. Rul. 9344027 (Nov. 3 1993)

Retirement Accounts

Beneficiary Designations

The Beneficiary Designations for qualified retirement plans and IRAs should always be reviewed and updated following a divorce

- ERISA – federal statute preempts state law and trumps contractual law*
- IRA Beneficiary designation on file typically controls – note, however, that many states have laws that override beneficiary designation of a former spouse post-divorce. CAL Probate Code; Texas

Make necessary changes to ALL estate planning documents such as:

1. Executor/personal representative;
2. trustee;
3. trust beneficiary (ies);
4. attorney in fact;
5. health care agent; and
6. insurance policy beneficiary.

*See Kennedy v. DuPont, 555 U.S. 285 (2009); Engelhoff v. Engelhoff, 532 U.S. 141 (2001). Note that the ERISA exception for spousal protection may override beneficiary designations

Property Transfers and Division of Property

Income Tax Consequences and Gift Tax Consequences –

Transfers of property from one spouse to another spouse during a marriage, or incident to a divorce generally are non recognition events for income and gift tax purposes. See IRC §1041.

If provisions in a premarital agreement require a transfer –

For example, the need to give a spouse certain assets in a divorce:

It is recommended that the premarital agreement require that the provision also be included in the divorce decree to maintain tax-free treatment of the transfer both for income tax and gift tax purposes.

While the tax treatment of non-US persons is beyond the scope of this presentation, it should be noted that there may be additional income and gift tax issues if either spouse is a non-US person.

Thank You

Disclosure Appendix

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