

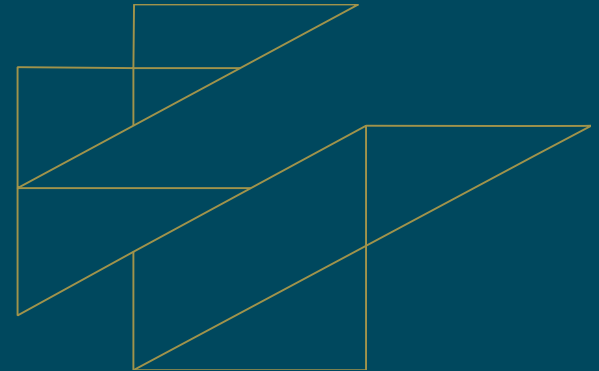


**BNY MELLON**  
WEALTH MANAGEMENT

November 19, 2020

# Hidden Tax Traps in Divorce: Observations After Tax Reform

Belinda Stark Herzig  
*Senior Wealth Strategist*  
[Belinda.Herzig@bnymellon.com](mailto:Belinda.Herzig@bnymellon.com)



# 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 too 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.

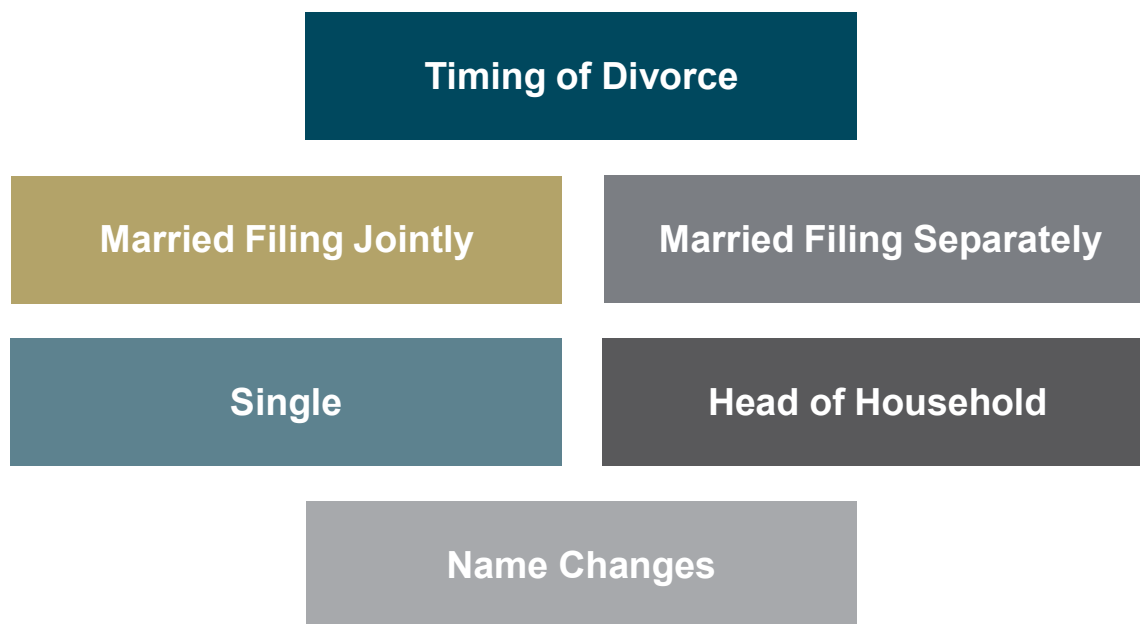
# Hidden Tax Traps in Divorce

---

Page	Topic
4	Tax Filing Status
5	Dependency Exemptions and Child Tax Credits
6	Sale of Principal Residence Exclusion
7	Mortgage Deductions
8	Deductions Related to Divorce
10	Allocation of Tax Carryovers
11	Payments After Divorce
12	Retirement Accounts
14	Property Transfers and Division of Property

# Tax Filing Status

---



# 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:

5 \*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**

# Mortgage Deductions

---



## **TCJA deductible interest limitations\***

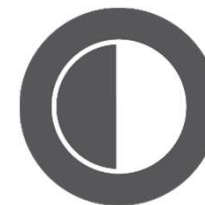
- Acquisition Indebtedness
- Home Equity Indebtedness



## **Home Mortgage Interest Deduction Qualifications**



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



## **Unmarried Individuals who prefer to stay unmarried**

7 \*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:<sup>1</sup>**

- 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.”\***

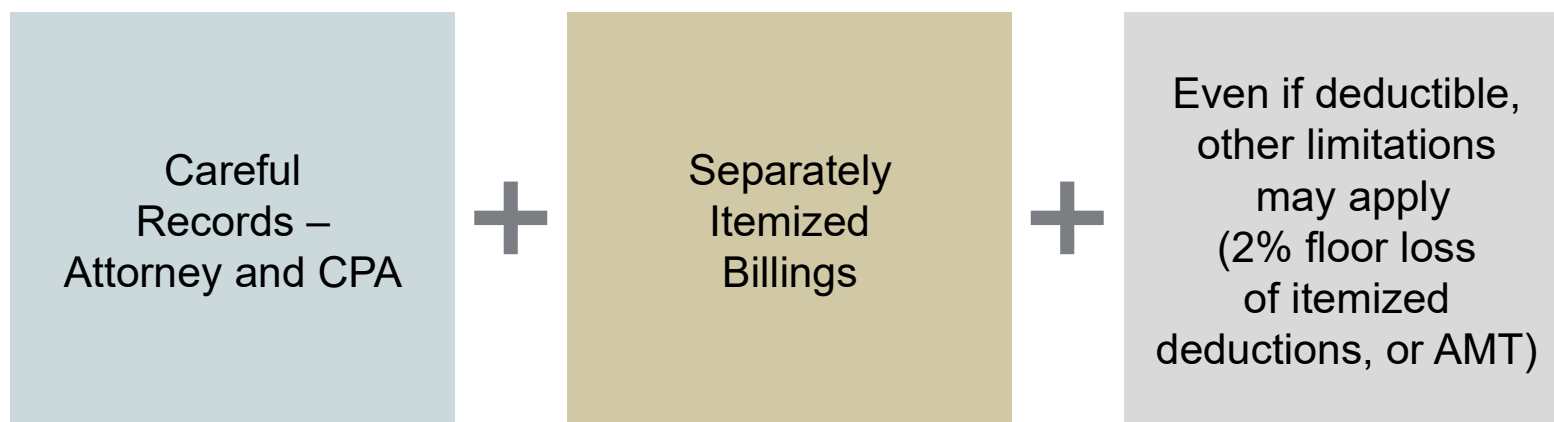


# Deductions Related to Divorce

---

## Examples of fees and costs

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



9 \*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.

10 \*\*\*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:

12 \*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; | 4 | attorney in fact;             |
| 2 | trustee;                          | 5 | health care agent; and        |
| 3 | trust beneficiary (ies);          | 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

---

The information provided is for illustrative/educational purposes only. All investment strategies referenced in this material come with investment risks, including loss of value and/or loss of anticipated income. Past performance does not guarantee future results. No investment strategy or risk management technique can guarantee returns in any market environment. This material is not intended to constitute legal, tax, investment or financial advice. Effort has been made to ensure that the material presented herein is accurate at the time of publication. However, this material is not intended to be a full and exhaustive explanation of the law in any area or of all of the tax, investment or financial options available. The information discussed herein may not be applicable to or appropriate for every investor and should be used only after consultation with professionals who have reviewed your specific situation. BNY Mellon Wealth Management may refer clients to certain of its affiliates offering expertise, products and services which may be of interest to the client. Use of an affiliate after such a referral remains the sole decision of the client.

BNY Mellon Wealth Management conducts business through various operating subsidiaries of The Bank of New York Mellon Corporation.

©2020 The Bank of New York Mellon Corporation. All rights reserved.