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Tax Issues Related to Divorce

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What are the tax issues related to divorce?

If you're separated or divorced, it's important for you to become familiar with certain tax issues. Familiarity with the tax consequences of your financial and personal decisions might cause you to alter your plans in some areas. You should be aware of the tax impact of your filing status, and you should know how a married couple's income and expenses may be divided for tax purposes. You should also be aware of the tax treatment of pensions, alimony, and child support, and you should know the significance of claiming a child as a dependent. Additionally, the tax treatment of property settlements and the redemption of a spouse's stock in a family business should be understood, as should the use of trusts and escrow accounts in divorce proceedings.

Why is filing status so important?

Your filing status is important because it determines, in part, the deductions and credits available to you, the amount of standard deduction that you may be entitled to, and your correct amount of tax. Therefore, you should know which filing statuses are available to you and which one will best fit your needs. There are five possible filing statuses:

- Single
- Married filing jointly
- Married filing separately
- Head of household, or
- Qualifying widow(er) with dependent child

For tax purposes, whether you're considered married or unmarried isn't as obvious as it may seem. It depends on a number of rules and your legal status as of the last day of the tax year (December 31 for most individuals). In order to minimize your income tax liability when you're contemplating divorce, it may be possible for you to plan the timing of any changes in your filing status.

If you're separated or considering a divorce, you and your spouse might wish to continue filing your tax returns jointly for as long as possible. If this is the case, you should be aware of the advantages and disadvantages of this filing status. Particular attention should be paid to the impact that joint filing may have on your right to all or a portion of any tax refunds and how the liabilities of your spouse may affect you. For example, signing a joint return obligates you and your spouse to be jointly and severally liable for any errors (intentional or otherwise) on your tax return.

Furthermore, you should be aware that if your spouse is delinquent on certain debts to government agencies (such as student loans), the entire refund due on your joint return might be diverted by the IRS to the appropriate agency.

Allocating income and deductions

Along with the division of assets and the assignment of debt during divorce proceedings, tax-related issues involving income and expenses (deductions) must be resolved. For example, division of interest and dividends on jointly held assets must be discussed, as should the deduction for real estate taxes paid and the allocation of tax carryovers.

What should you know about the taxation of pensions and alimony?

A retirement plan is a form of property and can be divided by spouses at the time of a divorce, as can houses, cars, and bank accounts. If you (or your spouse) have a retirement plan, you should understand what a qualified domestic relations order (QDRO) is and whether a QDRO applies to your retirement plan. You should also know the income tax ramifications when retirement plans are divided pursuant to a court order.

Alimony is a support payment made to a former spouse under a divorce decree that is intended to make it possible for the recipient to maintain his or her pre-divorce lifestyle. For a payment to be considered alimony for tax purposes, it must meet a number of requirements. You should know the tax ramifications of alimony for the spouse who pays it and for the spouse who receives it.

What about child support and claiming a child as a dependent?

You should know not only the legal rules surrounding child support but also the tax ramifications of child support for the parent who pays it and for the parent who receives it.

If a separated or divorcing couple has children, another important tax decision involves assignment of the child as a dependent. Although several tests must be met for you to claim a child as a dependent, special rules apply for separated or divorced parents.

What should you know about property settlements?

When marital separation occurs and a divorce is contemplated, spouses must decide how to divide their property. A formal property settlement agreement is usually drawn up, assigning assets to one spouse or the other. In some cases, the couple may decide to sell one or more assets to a third-party, splitting the proceeds. Although it's important for divorcing spouses to understand the property laws of their state regarding the division of marital property, it's also essential for spouses to understand the tax implications of their decisions. The tax effects of property dispositions can vary greatly, depending on whether you decide to transfer property immediately to your spouse, sell the property to a third-party, or sell it to your spouse at some future point.

A family business is also a piece of property that may be subject to division at the time of a divorce. Because each spouse may have a stake in the business, it's typical for one spouse to buy out the other's share in the business or to trade assets of equal value for that share. If you're considering a stock redemption incident to your divorce, you should appraise the business, evaluate alternative methods of dividing the business, and become familiar with the tax consequences of stock redemptions and other methods of apportioning the business.

How are trusts and escrow accounts used in divorce proceedings?

Although trusts aren't particularly common in divorce situations, they can be used to provide economic protection and to achieve particular income and estate tax goals. If you decide to employ a trust in your divorce settlement, you should be aware of the tax ramifications.

Escrow arrangements are sometimes employed in divorce situations to ensure that sufficient funds will be available to pay for contingencies. You should be aware of the legal and tax ramifications of these arrangements.

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