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# Colorado Wealth Management - Divorce Resources

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RAYMOND JAMES®

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# Planning Concerns of Divorcing Couples

## Why is it important for you to understand the basics of divorce law?

While divorce is certainly a time of emotional turmoil, it's a time of financial upheaval as well. The financial change brought about by divorce can be particularly devastating to families with children and to older couples who have assigned the career duties to one spouse and the homemaking duties to the other.

When seeking a divorce, you should become familiar with the major topics: legal fees, marital property versus separate property, alimony, debt, retirement plans, property settlement, taxation, budgeting, and, if you have children, child custody and child support. You should also consider risk management, and, if you're older, Social Security.

By becoming knowledgeable about these areas, you can provide your attorney (if any) with a complete and accurate outline of your wishes regarding the divorce settlement, and you will be able to make an informed decision before signing your divorce agreement.

## What do you need to know about legal fees?

When seeking a divorce, you'll want to consider whether a simple, amicable arrangement is likely or whether attorneys should be hired. If you wish to hire an attorney, you should note that divorce attorneys typically charge hourly rates and require you to submit retainers (lump sums) up front. It's not unusual, for example, for an attorney to charge as much as $150 to $200 per hour, and require an initial retainer of up to $2,500 to $5,000. These fees can be less expensive or more expensive, depending on the complexity of the case, the reputation and experience of the divorce attorney, and the geographic location.

If you're a financially dependent spouse (such as a homemaker), it's possible for a court to award sufficient legal fees and costs to enable you to retain competent counsel. Upon your submission of an appropriate motion to the court, a judge could order your spouse to subsidize your legal fees for the divorce.

You should also consider the deductibility of divorce expenses. In general, most legal fees and court costs for obtaining a divorce are considered personal expenses and aren't deductible for income tax purposes. However, you may deduct as a miscellaneous deduction on IRS Schedule A, subject to the 2 percent floor, any money paid for advice related to the tax consequences of your divorce or securing income. Specifically, deductible items include fees for advice on securing and collecting alimony and the tax consequences of property and payments received. On your legal bill, your attorney should make a reasonable allocation of the legal expenses between tax-related (deductible) and non-tax-related (nondeductible) advice.

## How is property classified for divorce purposes?

Assets are divided in accordance with state law, so it makes a difference whether you live in a community property state (presently Alaska (which has an optional system), Arizona, California, Idaho, Louisiana, New Mexico, Nevada, Texas, Washington, and Wisconsin) or Puerto Rico, or an equitable division state. Within these two categories of states, property may be classified as either separate property or marital property, but again, these definitions will vary depending on your state. Therefore, it's important for you to know how your state classifies property. For example, one state may mandate that separate property consist of gifts, inheritances, and property owned prior to the marriage, and that such items will not be divided between the spouses in the event of a divorce. Another state may proclaim that all property owned by the couple is marital property, subject to division at divorce --it doesn't matter who inherited what.

## What should you know about child custody, child support, and alimony?

When parents separate and divorce, one of the most emotionally charged issues involves the decision regarding who will live with the children. Determining the extent of child support, and possibly the necessity for enforcement of child support payments, is also cause for stress.

Child custody is based on a number of factors. Most judges place primary importance on the best interests of the children. Custody may be classified as physical or legal, and can be awarded to one or both parents.

Most states have child support guidelines for determining the amount of child support to be paid. Child support orders can be modified when there's a substantial change in circumstances, and most states provide a number of methods for collecting unpaid support.

Alimony is also an important topic, particularly to spouses with custody of minor children and to older homemakers. Alimony is based on one party's need and the other's ability to pay. Deciding whether a spouse should receive alimony (and, if so, how much) is based on certain criteria, which can vary from state to state.

## What should you know about property division?

Property division is a complex area, encompassing such subtopics as the marital residence, debt, and retirement plans and QDROs.

It also involves a number of other areas as well, including: classification and valuation of property, hidden assets, family businesses, and structuring property settlements.

## What should you know about taxation?

If you're legally separated or divorced, it's important to become familiar with the applicable tax rules regarding filing status, dependent children, alimony, and property disposition. Indeed, understanding the tax implications of your initial preferences regarding child custody and property settlement may alter or influence your final decisions. For more information about these topics, see our separate topic discussion, Tax Issues Related to Divorce.

## What should you know about budgeting and finances?

During the divorce process, both spouses must determine and disclose their monthly income and expense needs. Claims for support (based on need and an evaluation of the other party's ability to pay) are based on this financial affidavit.

It's not uncommon in a marriage for one spouse to assume primary responsibility for the family budget. For some couples, bills are paid when due, but neither party tries to stick to a budget. When two households are created incident to a divorce, cash becomes tighter and it becomes necessary to develop a budget. A number of tools can be used for this purpose. For more information, see our topic discussion, Budgets and Cash Flows.

## Do you need to know about risk management and Social Security?

Risk management should certainly be considered when a divorce seems likely. The selection of beneficiaries for your life insurance policy will probably be revised, and, in some cases, your health insurance coverage may terminate. Often, for example, one spouse participates in a group health insurance plan at work that provides coverage for both spouses. When a divorce occurs, coverage for the nonemployee spouse may end. You need to know what your health insurance options are and how life, disability, and property insurance should factor into your divorce agreement.

Social Security may be an issue if you're an older individual seeking a divorce after a long-term marriage. Be aware that, if you've been married to your spouse for at least 10 years, you may (in certain cases) be able to qualify as a dependent for Social Security purposes. Thus, you might be entitled to benefits, even if you never worked.

## What information should you gather before consulting with an attorney?

Before sitting down with an attorney to commence a divorce, go through the following list to make sure you provide all relevant information:

- Your name, address, telephone number

- Spouse's name, address, telephone number
- Each spouse's date of birth
- Names and birth dates of children
- Date and place of marriage and length of time in present state
- Existence of prenuptial agreement
- Information about parties' prior marriages, children, etc.
- Date of separation and grounds for divorce
- Current occupation and name and address of employer (both parties)
- Social Security number of both parties
- Income of each party
- Education, degrees, and training of each party
- Extent of employee benefits for each party
- Details of retirement plans for each party
- Joint assets of the parties, including: House
- Other real estate
- Stocks, bonds, and securities
- Bank accounts
- Individual retirement accounts (IRAs), and
- Boats and other assets
- Liabilities and debts of each party
- Life and other insurance of each party
- Separate or personal assets of each party, including trust funds and inheritances
- Financial records, including: Bank statements
- Tax returns
- Loan applications, and
- Investment statements
- Family business records, including: Type of business
- Shareholders
- Percentage of ownership
- Bank statements of business

- Tax returns of business
- Applications for loans
- Income and balance sheets
- Financial reports, and
- Buy-sell agreements
- Collections, artwork, and antiques

Obviously, you won't have all of the above information and documentation at your fingertips. Provide whatever you can. The rest can be ascertained during the divorce discovery process. You'll need to think about a few other questions as well once you've provided your attorney with the basic checklist of information. Consider the following:

- Which assets do you really want, and which are you willing to assign to your spouse?
- How do you feel about the family home? Do you feel strongly about living there, or should it be sold or allotted to your spouse?
- With respect to the children (if any), what are your wishes regarding custody, visitation, and child support?
- Do you earn enough money to adequately support yourself, or should alimony be considered?
- Will you have sufficient liquidity to pay the debt on whatever assets you keep?
- What are the income tax consequences of your decisions regarding property disposition?
- Regarding a family business, does your state value assets at the time of separation, settlement, divorce, or some other time?

Discuss these and any other questions with your attorney.

# Dealing with Divorce

Divorce can be a lengthy process that may strain your finances and leave you feeling out of control. But with the right preparation, you can protect your interests, take charge of your future, and save yourself time and money.You certainly never expected divorce when you cut the wedding cake--you and your spouse planned on spending the rest of your lives together. Unfortunately, the fairy tale didn't work out, and you're headed for a divorce. So where do you begin?

## First things first: should you hire an attorney?

There's no legal requirement that you hire an attorney when divorcing. In fact, going it alone may be a sensible option if you're young and have been married only a short time, are childless, and have few assets. However, most divorcing couples hire attorneys to better protect their interests, even though doing so can be expensive. Divorce attorneys typically charge hourly rates and require you to submit retainers (lump sums) up front. The charges will depend on the complexity of the case, the reputation and experience of the divorce attorney, and your geographic location.

You should know that if you're a homemaker or earn less income than your spouse, it's still possible to obtain legal representation. You can submit a motion to the court, asking a judge to order your spouse to pay for your attorney's fees.

If you and your spouse can agree on most issues, you may save time and money by filing an uncontested divorce. If you can't agree on significant issues, you may want to meet with a divorce mediator, who can help you resolve issues that the two of you can't resolve alone. To find a mediator, contact your local domestic relations court, ask friends for a referral, or look in the telephone book. Certain attorneys, members of the clergy, psychologists, social workers, marriage counselors, and financial planners may offer their services as mediators.

## Save time and money by doing your homework before meeting with a divorce professional

To save time and money, compile as much of the following information as you can before meeting with an attorney or other divorce professional:

- Each spouse's date of birth
- Names and birthdates of children, if you have any
- Date and place of marriage and length of time in present state
- Existence of prenuptial agreement
- Information about parties' prior marriages, children, etc.
- Date of separation and grounds for divorce
- Current occupation and name and address of employer for each spouse
- Social Security number for each spouse
- Income of each spouse
- Education, degrees, and training of each spouse
- Extent of employee benefits for each spouse
- Details of retirement plans for each spouse

- Joint assets of the parties
- Liabilities and debts of each spouse
- Life (and other) insurance of each spouse
- Separate or personal assets of each spouse, including trust funds and inheritances
- Financial records
- Family business records
- Collections, artwork, and antiques

If you're uncertain about some of these areas, you can obtain the necessary information through your spouse's financial affidavit and/or the discovery process, both of which are mandated by the court.

## Consider the big questions, such as child custody and alimony

Although your divorce professional will help you work through the big issues, you might want to think about the following questions before meeting with him or her:

- If you have children, what are your wishes regarding custody, visitation, and child support?
- Whose health insurance plan should cover the children?
- Do you earn enough money to adequately support yourself, or should alimony be considered?
- Which assets do you really want, and which are you willing to let your spouse keep?
- How do you feel about the family home? Do you feel strongly about living there, or should it be sold or allotted to your spouse?
- Will you have enough money to pay the outstanding debt on whatever assets you keep?

In addition to an attorney, you may want to see a therapist to help you clarify your wishes, express yourself more clearly, and deal with any child-related issues. Such counseling is typically covered by health insurance.

## Some dos and don'ts when divorcing

Keep the following tips in mind:

- Do prepare a budget and a financial plan to sustain you until your divorce is final. Get help if you don't currently have the skills and energy to do this on your own.
- Do review monthly bank and financial statements and make copies for your attorney.
- Do review all tax returns that have been filed jointly or separately by your spouse.
- Do make sure all taxes have been paid to date.
- Do review the contents of any safe-deposit boxes.
- Do get emotional support for yourself--talk to friends, join a support group, or see a therapist.
- Don't make large purchases or create additional debt that might later cause financial hardship.
- Don't quit your job.

- Don't move out of the house before consulting your attorney.
- Don't transfer or give away assets that are owned jointly.
- Don't sign a blank financial statement or any other document without reviewing it with your attorney.

# Financial Affidavits

## What is it?

***What is a financial affidavit and how is it used in a divorce context?***

When divorce proceedings are commenced, each spouse is required to fill out a financial affidavit. This form, which becomes part of the court record, shows income from all sources, debt (or liabilities), living expenses, and assets. Each party swears (under the pains and penalties of perjury) that the information contained on his or her affidavit is true. A judge will use the information contained in this affidavit when he or she issues temporary orders regarding separate maintenance (temporary alimony), child support, and other financial matters during the period of separation. The document is useful to attorneys, as it becomes the basis for seeking (or arguing against) temporary support and assists the attorney later during the discovery and property settlement phases of divorce.

***What can happen if you underreport your income or exaggerate your expenses?***

Because you sign the financial affidavit under oath, deliberately falsifying your financial information can be considered perjury. Additionally, if your divorce ends up in trial, your credibility as a witness will be seriously undermined if your spouse's attorney can prove that you lied in your affidavit. This, of course, may sway the court's sympathy toward your spouse. And finally, even if your case never makes it to trial, your spouse may be able to force a property settlement in his or her favor if you gave false information in a court document.

> **Example(s):** Frank handled the finances in his family and secretly stashed away $50,000 in a bank account during the last years of his marriage. When divorce proceedings began, he wire-transferred the money to his mother, a resident of Colombia. Frank's wife Liz learned of the money when she found a receipt for the wire transfer in her husband's coat pocket. Since Frank had not disclosed the existence of this money at discovery or in his financial affidavit (submitted to the court), Liz was able to use this fraudulent transfer to force a favorable property settlement.

It's not uncommon for spouses to be less than truthful when completing their financial statements. If you suspect that your spouse has not disclosed some assets, there are a number of places where you (or your attorney) can look for these hidden assets. The following documents should be scrutinized:

- Personal income tax returns
- Partnership and corporate tax returns
- Pay stubs
- Savings account passbooks and statements
- Canceled checks, check registers, and bank statements
- Securities and mutual fund statements
- Children's bank accounts
- Life insurance contracts

However, it's often the case (with married couples) that one spouse handles the bills and other financial affairs for the sake of convenience. The other spouse may or may not be well informed. Therefore, it may be difficult for a spouse to determine if the other party is being truthful in the affidavit. Fortunately, you and your attorney will have many other opportunities to engage in fact-finding.

### *What are some of the more common mistakes people make when completing financial affidavits?*

Sometimes hidden assets aren't the problem; frequently, people unintentionally underestimate their expenses. For instance, if you note your monthly grocery bill as under $150, you're spending less money than most people, given that approximately $200 is typical for one person. And if you get a haircut every six weeks or so, be sure to include the cost under miscellaneous or personal care.

Under the heading, "Health Insurance," many mistakes are also made. Often, the wife will put nothing in this expense category because she isn't currently making an insurance payment. If you're going to be taken off your husband's plan shortly, you can call the benefits department of his employer to find out how much the COBRA payment will be. For more information about health insurance and COBRA, see our separate topic discussion, Divorce and Risk Management.

Under the "Miscellaneous" section of the affidavit, don't forget to include gifts (Christmas, birthday, wedding), newspaper and magazine subscriptions, cable TV, pet food and pet care, lawn service, and the like. But don't exaggerate your expenses, either. During a deposition or at trial, you'll have to defend your figures.

### *What information must you provide in your affidavit?*

You'll probably be asked about the following:

- Name and address
- Occupation and job title
- Employer's name and address
- Frequency of your paychecks (i.e., weekly, biweekly, monthly, etc.)
- Monthly gross pay
- Type and amount of monthly payroll deductions
- Net monthly take-home pay
- Other sources (and amounts) of income
- Net monthly income from other sources
- Monthly housing expenses
- Monthly utility expenses (gas, electric, telephone, water and sewer, trash)
- Monthly grocery bill
- Monthly restaurant and entertaining expenses
- Monthly out-of-pocket medical expenses (doctor, dentist, prescriptions)
- Monthly insurance expenses (life, health, disability, homeowners)
- Monthly transportation expenses (fuel, repair and maintenance, insurance, parking)
- Monthly clothing expenses
- Monthly child-care (and child-related) expenses
- Monthly personal care and toiletries

- Educational expenses
- Miscellaneous expenses
- Debts of all kinds, including car loans, mortgages, 401(k) loans, student loans, etc. (monthly payment, unpaid balance)

Because divorce is based on state law rather than federal law, each state will have its own requirements regarding the financial statement. Nevertheless, the above-listed information is fairly typical. For additional information, contact a divorce attorney.

# How do I protect my assets in the event of a divorce?

## Question:

How do I protect my assets in the event of a divorce?

## Answer:

If protecting your assets means that you want to keep all of your money, property, and possessions out of your soon-to-be ex-spouse's hands, you're probably out of luck. Any assets acquired during marriage are considered marital property and must be divided according to state law.

If you live in a community property state (i.e., California, Texas, or one of eight other states), you and your spouse must split any marital assets equally. However, in all other states, assets must be divided equitably (fairly) rather than equally. Your best protection is to make sure that your interests are represented. Hire an experienced attorney who will help you negotiate a fair settlement.

Don't shortchange yourself by overlooking hidden assets. For instance, you may know your joint savings account balance and what possessions you must divide, but do you know the balance of your spouse's pension plan? Does your spouse own a prepaid life insurance plan? Does your spouse have retirement funds (e.g., 401(k), IRAs) in his or her own name? These things will be considered marital assets as well.

Finally, don't forget about debt. In general, you'll be responsible for any debt acquired during the marriage, even if you didn't run up the debt yourself. Make sure that the divorce settlement states who will be responsible for paying off all debts, and close all joint accounts.

# Establishing a Budget

Do you ever wonder where your money goes each month? Does it seem like you're never able to get ahead? If so, you may want to establish a budget to help you keep track of how you spend your money and help you reach your financial goals.

## Examine your financial goals

Before you establish a budget, you should examine your financial goals. Start by making a list of your short-term goals (e.g., new car, vacation) and your long-term goals (e.g., your child's college education, retirement). Next, ask yourself: How important is it for me to achieve this goal? How much will I need to save? Armed with a clear picture of your goals, you can work toward establishing a budget that can help you reach them.

## Identify your current monthly income and expenses

To develop a budget that is appropriate for your lifestyle, you'll need to identify your current monthly income and expenses. You can jot the information down with a pen and paper, or you can use one of the many software programs available that are designed specifically for this purpose.

Start by adding up all of your income. In addition to your regular salary and wages, be sure to include other types of income, such as dividends, interest, and child support. Next, add up all of your expenses. To see where you have a choice in your spending, it helps to divide them into two categories: fixed expenses (e.g., housing, food, clothing, transportation) and discretionary expenses (e.g., entertainment, vacations, hobbies). You'll also want to make sure that you have identified any out-of-pattern expenses, such as holiday gifts, car maintenance, home repair, and so on. To make sure that you're not forgetting anything, it may help to look through canceled checks, credit card bills, and other receipts from the past year. Finally, as you list your expenses, it is important to remember your financial goals. Whenever possible, treat your goals as expenses and contribute toward them regularly.

## Evaluate your budget

Once you've added up all of your income and expenses, compare the two totals. To get ahead, you should be spending less than you earn. If this is the case, you're on the right track, and you need to look at how well you use your extra income. If you find yourself spending more than you earn, you'll need to make some adjustments. Look at your expenses closely and cut down on your discretionary spending. And remember, if you do find yourself coming up short, don't worry! All it will take is some determination and a little self-discipline, and you'll eventually get it right.

## Monitor your budget

You'll need to monitor your budget periodically and make changes when necessary. But keep in mind that you don't have to keep track of every penny that you spend. In fact, the less record keeping you have to do, the easier it will be to stick to your budget. Above all, be flexible. Any budget that is too rigid is likely to fail. So be prepared for the unexpected (e.g., leaky roof, failed car transmission).

## Tips to help you stay on track

- Involve the entire family: Agree on a budget up front and meet regularly to check your progress
- Stay disciplined: Try to make budgeting a part of your daily routine
- Start your new budget at a time when it will be easy to follow and stick with the plan (e.g., the beginning of the year, as opposed to right before the holidays)
- Find a budgeting system that fits your needs (e.g., budgeting software)

- Distinguish between expenses that are "wants" (e.g., designer shoes) and expenses that are "needs" (e.g., groceries)
- Build rewards into your budget (e.g., eat out every other week)
- Avoid using credit cards to pay for everyday expenses: It may seem like you're spending less, but your credit card debt will continue to increase

# Budgets and Cash Flows

## Why is the preparation of financial statements important during the divorce process?

Before a reasonable property settlement can be negotiated, it's important for both spouses in a divorce to disclose all assets, liabilities, sources of income, and expenses. By arranging this information in standard financial statements and by analyzing these statements, a financial planner or attorney with financial expertise can help you: (1) develop a realistic budget to follow prior to divorce; (2) devise a fair divorce agreement at the appropriate time; and (3) create an appropriate budget for your post-divorce life.

## What information should you provide your attorney or financial advisor?

To help you plan effectively, your financial planner or attorney will need information from both spouses regarding:

- Wages and salaries (including pay stubs, W-2 statements, 1099 Forms, and employment contracts)
- Pensions, retirement plans (including IRAs), and employee benefit information
- 

Home ownership or rental documentation (including deeds, leases, insurance data, appraisals, and tax bills)

- Income tax returns for the past three to five years
- Life, health, and disability insurance policies
- Wills and trusts
- Investment portfolio information
- Bank account balances and ownership
- Partnership or family business tax returns for the past three to five years (along with other information about ownership interests and valuation)
- Liabilities, debt, and periodic expenses (including credit cards, student loans, taxes, automobile loans and insurance, and other obligations)
- Data regarding amount of--and sources for--periodic income, and
- Data regarding the value of personal assets, including furniture, antiques, collectibles, boats, equipment, automobiles, etc.

**Tip:** Courts, as part of the divorce process, typically require each spouse to complete a financial affidavit disclosing information regarding periodic income and expenses.

## What is a net worth statement?

A net worth statement is also known as a balance sheet. Its purpose is to provide a snapshot of your assets and liabilities today (or as of a particular date). For obvious reasons, this document will be helpful to your attorney when he or she is contemplating dividing marital property (assets) between you and your spouse. Your net worth (or net loss) may be defined as your total assets minus your total liabilities.

Very likely, three sets of balance sheets will be drawn up: (1) reflecting your financial situation, (2) reflecting your spouse's position, and (3) showing your worth as a couple. This is because some assets (and liabilities) may be joint and others individual. Additionally, state laws will influence how these assets and liabilities will be divided. This, of course, involves the notion of community property versus equitable distribution.

A net worth statement can serve as:

- A record of your financial progress over time
- A record of property ownership and value for insurance planning purposes
- A tool for creating a will (or settling an estate)
- A tool to help you apply for a mortgage, personal loan, or credit card
- A measure of your total debt and home equity
- A record of retirement savings (that is, your vested pension benefits and total IRA contributions), or
- A planning and decision-making tool for your financial advisor or attorney

## How does a net worth statement work?

To begin your net worth statement, list your assets on the left side of a piece of paper, along with the value of each asset as of a particular date (use the same date for each asset). You need to obtain the fair market value of your personal assets--not their original cost to you. With respect to investments, your broker (or a business newspaper) can give you the value. You should separate your list of assets into four major groups: cash (and cash alternatives), investments, retirement funds, and personal assets. Within these groups, include assets in the following manner:

- Cash and Cash Alternatives: Savings accounts
- Checking accounts
- Money market accounts
- Certificates of Deposit (a year or less in maturity)
- Money market mutual funds
- U.S. Treasury bills, and
- Any other cash on hand
- Investments: Stocks
- Bonds
- Mutual fund investments
- Certificates of Deposit (over a year maturity)
- Cash value life insurance
- Gold, silver, and gems
- Investment real estate
- Land
- Limited partnerships

- Municipal bonds
- Ownership interests in businesses
- U.S. savings bonds
- U.S. Treasury notes and bonds
- Stock options
- Interests in law suits, and
- Trust Funds
- Retirement Funds: Pensions (current accrued benefit and lump sum present value)
- IRAs
- Keogh and other retirement plans
- Employee savings plans (401(k) plans, SEP, ESOP), and
- Tax-sheltered annuities (403(b) plans)
- Governmental savings plans (Federal TSP plan, 457(b) plans)
- Nonqualified deferred compensation plans
- Personal Assets: Principal residence
- Other real property
- Antiques
- Art and collectibles
- Automobiles
- Home furnishings
- Furs
- Boats
- Computers and other small business equipment
- Jewelry, and
- Other

After you've listed all assets, total them up at the bottom of your page. Next, you need to list your liabilities (and their pay-off figures) on the right side of your piece of paper. In this section, you should include:

- Charge account balances
- Student loans
- Personal loans
- Automobile loans

- 401(k) loans
- Home mortgages
- Investment loans
- Home equity loans
- Life insurance loans
- Estimated income tax liability, and
- Additional debts owed to others

After you've listed all liabilities, place the total at the bottom of the page. Subtract your total liabilities from your total assets to arrive at your net worth (or net loss). Your net worth is the amount you would have if you turned all of your assets into cash and paid off your debts. Different ratios derived from a net worth statement can provide useful insights. For instance, by dividing cash and cash alternatives by liabilities (excluding a mortgage), you can ascertain your liquid asset to debt ratio (i.e., your ability to handle your financial obligations). Over the course of a year or longer, analysis of your net worth statements can also illustrate whether your assets and liabilities have increased or decreased, how the equity in your home has changed, and whether you have established an adequate emergency fund. A net worth statement is easy to prepare once you've gathered the appropriate facts. The following example shows a simplified net worth statement:

> **Example(s):** Assume Mary has the following assets and liabilities: $10,000 in a money market account, $40,000 in stocks, $2,000 in an IRA, a $200,000 house with a $150,000 mortgage, a $20,000 student loan balance, a $5,000 automobile with a $5,000 loan, and a $2,000 credit card balance. Her net worth statement would look like this:

| Net Worth Statement | |
|---|---|
| Assets | Liabilities |
| Cash Alternatives<br>• Money Market - $10,000<br><br>Investments<br>• Stock - $40,000<br><br>Retirement<br>• IRA - $2,000<br><br>Personal Assets<br>• House - $200,000<br>• Car - $5,000 | • Mortgage - $150,000<br>• Student Loan - $20,000<br>• Money Loan - $5,000<br>• Credit Card - $2,000 |
| Total Assets = $257,000 | Total Liabilities = $177,000 |
| Net Worth = $80,000 | |

## What is a cash flow statement?

A cash flow statement tracks income and expenses, showing how much money you earned and spent during a given time period. At the end of a month, if you've earned more money than you've spent, you've got a positive cash flow. Consistent negative cash flows, on the other hand, will indicate that you're depleting your savings or using borrowed funds (and credit cards) too much. Analyzing your cash flow statements will help a financial advisor devise a spending plan or budget for you to improve your financial position.

You'll need to keep detailed records for at least one month (preferably for three or four months) to see where your money comes from and where it goes. Begin by listing your cash balance at the beginning of a month. Next, list all sources of income. Make a similar list of all expenses, including personal savings. Cash flow is determined by comparing your total monthly income to your total monthly expenses. As with the net worth statement, you may want to prepare three sets of documents: one for you, one reflecting your spouse's financial situation, and one reflecting your position as a couple. Alternatively, you could put all of this information on one statement by using three columns (you, spouse, and couple).

## How does a cash flow statement work?

To begin, divide a piece of paper into two sections: income and expenses. Because the expense section is more complicated, you'll want to subdivide that category into smaller categories. For instance, you could use savings and investments, fixed expenses, and variable expenses as your sub-headings within the general heading of expenses.

Next, list your beginning cash balance (as of a particular date) at the top of the page. Under the income section, write down the sources and amounts of your income. You should include the following sources of income (if applicable):

- Salary and wages
- Periodic bonuses
- Commissions
- Trust, estate, and royalty income
- Business income
- Pension and retirement income
- Social Security
- Unemployment compensation
- Disability income
- Interest and dividends
- Net rental income
- Alimony
- Child support
- Annuities
- Inheritances, and
- Tips

Total your income at the bottom of this section. Next, list all of your expenses according to the sub-headings you've chosen. For instance, you may wish to include:

- Savings and Investments Personal savings (bank account, CDs, Christmas club)
- Individual retirement accounts (IRAs)
- Employer plans, such as 401(k) accounts
- Keogh plans

• Stocks and money markets, and

• Tax-sheltered annuities and thrift plans

• Fixed Expenses Mortgage payments

• Installment debt

• Personal loan payments

• Insurance premiums

• Rent

• Car loans

• Payroll deductions, and

• Property taxes

• Variable Expenses Groceries

• Utilities and cable fees

• Car maintenance

• Home repair and grounds-keeping

• Child care

• Clothing

• Entertainment and meals outside the home

• Water and telephone bills

• Gasoline

• Grooming

• Gifts

• Vacations

• Club memberships

• Magazine subscriptions

• Dental and medical expenses

• Legal and professional fees

• Tax withholdings, and

• Transportation and parking

Total your expenses at the bottom of this section. Next, subtract your total expenses from your total income. If the result is a positive number, you have a positive cash flow for the month. This means that you'll be able to increase savings and set the money aside to attain a future goal. If your cash flow is negative, you'll need to analyze the statement (particularly the variable expenses) to see where you can cut back. For instance, you may wish to stop impulse shopping on credit cards or skip the weekly restaurant lunch. Also, you may want to increase income by taking on a second job or by turning a hobby into a side business. But note that some of your expenses may be paid off in the near future if, for example, you have only a short time left to pay on your car loan. From a divorce perspective, you'll want to know your cash flow situation right now, as well as your spouse's situation. This will help your attorney negotiate temporary alimony and child support payments. Additionally, your attorney will need to predict your future cash flow position according to your proposed divorce agreement or property settlement. If, for example, you're not paying alimony right now but will have to commence payments after the divorce is finalized, your cash flow statement will be dramatically different in the future. The same holds true if you'll end up with the house (and its mortgage, property taxes, and insurance costs) post-divorce.

**Example(s):** Assume George has the following monthly expenses and sources of income: $3,500 net salary, $200 interest, $100 dividends, $1,200 mortgage, $250 car loan, $200 insurance, $300 food, $200 utilities, $60 transportation, and $400 miscellaneous. His cash flow statement would look like this:

| Cash Flow for the Month Ending March 31, 20XX | |
|---|---|
| Income | Expenses |
| Net Salary - $3,500<br><br>Interests - $200<br><br>Dividends - $2,000 | Fixed Expenses<br>• Mortgage - $1,200<br>• Car - $250<br>• Insurance - $200<br><br>Variable Expenses<br>• Food - $300<br>• Utilities - $200<br>• Transportation - $60<br>• Miscellaneous - $400 |
| Total Income - $3,800 | Total Expenses of $2,610 + Net Cash Flow $1,190 |
| Cash Balance at End of Month - $2,690 | |

## What is a budget?

A budget is a financial planning tool serving many functions. It can ensure that you have enough cash (and other liquid assets) to conduct your ongoing financial affairs, and it can create an adequate emergency fund to help you meet unforeseen problems (such as a job loss). Additionally, it can create long-term savings to help you attain your future goals (such as retirement, purchase of a house, etc.), and it can help you to eliminate debt.

## How does a budget work?

Budgeting may be defined as the ability to estimate the amount of money to be received and spent for various purposes within a given time frame. The budget process begins with a discussion of your financial goals. What are your short-term goals? What are your long-term goals? Some people want to eliminate negative cash flows, and others want to increase savings for retirement (and other) purposes. Certainly, being able to survive a financial emergency (such as a job loss) is a priority for many people. Additionally, most people want to establish control over their expenditures, eliminate wasteful spending practices, and retire certain debts.

Saving is an important part of any budget, and one of the cardinal rules of financial planning is to pay yourself first. You should treat yourself as an important creditor; when it comes time to pay your monthly bills, be sure to deposit a particular sum of money into your own savings account as well. It's wise to build an emergency fund equivalent to three to six months of your expenses. Additionally, you can save money by engaging in the following practices:

- Bank your bonuses, tax refunds, and one-time windfalls
- Start a Christmas club account

• Participate in your employer's 401(k) or thrift plan, and

• Use direct deposit of your paycheck to contribute a monthly amount to an IRA

Just as savings is an important part of your budget, it's equally important to cut your expenses. To cut your expenses, consider the following approaches: Stop buying on impulse (some financial planners suggest that when you see something you like, think about it for three days before buying it)

• Stop using credit cards to make purchases

•

Buy clothes and seasonal equipment when they're on sale rather than when they're first introduced in the stores

• Compare prices at different stores to get the best deal, and

• Payoff credit cards and other small loans

To construct a budget, you need to first estimate your annual income and annual expenses. Begin by identifying your sources and amounts of fixed income. Next, identify sources and amount of expenses. You should break expenses down into two categories: fixed expenses and variable expenses. By subtracting total expenses from total income, you'll arrive at your total yearly savings or cash flow. To increase this figure, you should consider the above methods for increasing savings and decreasing expenses. Once you've gained an overview of your financial picture, create a monthly cash flow statement to determine how much money can be set aside each month for savings and to ensure that you don't overspend. From a divorce standpoint, you'll need to construct and follow one budget during the period of separation and another budget after the divorce has become final. Your attorney or financial planner should consider not only issues of alimony, child-support, and division of property but also financial questions regarding your future living expenses and spending habits.

# Divorce and Debt

## What is debt and how is it classified for divorce purposes?

Like property, debt is classified as marital or separate. In general, both spouses are responsible for any debts incurred during the marriage. It doesn't matter which party actually spent the money. When the property is divided at the time of divorce, it's often the case that the person who gets the asset also gets the responsibility for paying any indebtedness secured by that asset. Even if your spouse agrees to take over the debt, joint obligors on a loan will remain jointly responsible. That is, the creditors can seek payment from either of you.

There are basically four types of debt:

- Secured debt
- Unsecured debt
- Tax debt
- Divorce expense debt

### *Secured debt*

Secured debt gives the lienholder or lender a right to repossess the property in the event of your default on the loan. Some examples of secured debt include mortgages on your real estate, car loans, and boat loans. If a loan stands in the joint names of you and your spouse, you'll need to make it very clear in your separation agreement who will be responsible for making payments on the loan. Otherwise, if one spouse fails to make timely payments, the creditor can pursue the other spouse or (eventually) seek repossession.

### *Unsecured debt*

Unsecured debt does not give the lender the right to repossess any specific property, although there are other remedies at law. Typical examples of unsecured debt include credit cards, personal bank loans or lines of credit, and loans from family and friends.

### *Tax debt*

If you sign a joint return with your spouse, you're each liable for the tax debt. For three years after the due date for filing your return, the IRS can perform a random audit of your joint tax return (although the period may be longer than three years in cases of fraud or failure to file). To avoid potential tax problems in the future, your divorce agreement should spell out what happens if any additional interest, penalties, or taxes are imposed for any prior tax year. Notwithstanding any such agreement, you should be aware of the so-called innocent spouse rules, which provide certain protections to a taxpayer whose spouse understated the tax due on a joint return. A number of rules and conditions apply.

### *Divorce expense debt*

Divorce can be expensive, and sometimes a spouse will seek a court order to make the other party subsidize attorney's fees for both sides. This might happen, for instance, when only one spouse works. Since the homemaker-spouse may have no income to pay for a divorce attorney, a judge might order the working spouse to pay.

Sometimes both parties work or have sufficient funds with which to retain attorneys. In these cases, you'll need to spell out who pays for what. For instance, if both parties want the family business, the family home, or a pension to be appraised, you'll have to apportion the costs. The same holds true if you both decide to transfer title to an asset after a divorce.

Debts can also be incurred during the separation period. If luxuries are purchased during this period, courts are likely to assign the debt solely to the party who ran up the debt. In general, debts incurred after the separation date and before the divorce is final are the responsibility of the spouse who incurred them. One exception is family necessities (i.e., food, clothing, shelter, and medical care). These necessities can be paid by the other spouse if the incurring-spouse can't afford to pay.

## What are the rules regarding joint credit card debt?

Either signer on a joint credit card can be held responsible for 100 percent of the debt, not just one-half of the debt.

> **Example(s):** Hal and Jane are seeking a divorce. During their marriage, Hal handled the finances and Jane stayed home with the children. During the discovery period of their divorce, Jane learned that Hal ran up over $30,000 on their joint credit cards to pay for his expensive suits, dinners for friends, recreational pursuits, and the like. Since they live in a community property state, all assets and debts will be divided down the middle. Thus, Jane will be responsible for paying $15,000 of the debt (from a judge's perspective). However, if Hal fails to keep up with his monthly payments (or, if he decides not to pay any of his $15,000), the credit card companies can go after Jane for the full $30,000 because the divorce settlement is not binding on creditors.

During divorce proceedings, several issues can arise regarding credit cards, such as removing a spouse as an authorized signer, and understanding the obligations of joint credit card owners versus single card owners with two authorized signers.

## Will my former spouse's bankruptcy affect me?

Bankruptcy law allows debts between ex-spouses to be wiped out. Therefore, the assets you were promised in your divorce settlement may never materialize. Be aware of this if you're considering the use of a property settlement note (a form of promissory note) to equalize a property division.

> **Example(s):** Assume Nicholas and Sandra wanted to divide their assets 50-50. After assigning the house to one and the pension to the other, Nicholas still owed Sandra $40,000. Nicholas signed a property settlement note to Sandra, promising to pay her $40,000 over a five-year period at 7 percent interest. After the divorce, Nicholas filed for bankruptcy and listed the note as one of his debts. The debt was discharged, and Sandra never received her money.

> **Tip:** Alimony and child support can't be discharged in bankruptcy. Therefore, in the above scenario, alimony should have been considered as an alternative to the property settlement note.

If your ex-spouse files for bankruptcy, other problems may arise for you. While a bankruptcy might wipe out your spouse's obligation to pay marital debt, it doesn't wipe out your own. The creditors can contact collection agencies about you (damaging your credit), or sue you for the full amount of the debt.

## How do you divide debt at divorce?

Basically, you have five options in allocating your marital debts:

- You and your spouse can sell joint property to raise the cash to pay off your marital debts.
- You can agree to pay most of the debts. In return, you can request a greater share of the marital property or a corresponding increase in alimony.
- Your spouse can agree to pay the bulk of the debts. In exchange, your spouse may get a greater share of the marital property or increase in alimony.
- You and your spouse divide the property and debt equally; that is, each of you gets one-half of the property and each of you agrees to pay one-half of the debt.
- 

If you're a homemaker with children, your spouse might be ordered to pay the bulk of the debt, pay alimony, and perhaps allow you to keep the house and a portion of other significant assets, such as your spouse's pension.

Because of the threat of bankruptcy and/or damage to your credit report, it might be wise to sell joint assets to pay off debt, or to assume responsibility for the debts yourself.

## How can I repair my credit after a divorce?

Credit problems generally stay on your record for seven years, while bankruptcies can remain for up to 10. There are some steps you can take to repair credit damaged during a divorce:

1. Obtain a copy of your credit report and look for errors. Sometimes, your credit history may be confused with someone else who has a similar name.

2. Meet with a consumer credit counseling representative. A representative can provide you with tools to negotiate with your creditors. He or she can also give you some useful suggestions for paying your bills.

3. Open a secured credit arrangement with your bank. If you deposit a specific sum of cash with a bank (such as $500), the bank will sometimes provide you with a secured credit card. Making timely payments will help to repair your credit over time.

## What questions (relative to debt) should you consider before entering into a divorce settlement agreement?

Before sitting down with an attorney, think about which debts were contracted prior to marriage (separate debt) and which debts were contracted during the marriage (marital debt). With respect to marital debt, consider the following questions:

- If I wish to keep a particular marital asset, will I have sufficient income to keep up with the loan payments?

- Should I liquidate other assets to retire the debt completely (or partially)?

- If my spouse proposes a property settlement agreement, is there any likelihood that he or she would subsequently declare bankruptcy?

- Can I collateralize property settlement notes from my spouse so that bankruptcy will not eliminate his or her obligation to me?

- If, pursuant to our divorce agreement, my ex-spouse assumed responsibility for all credit card debt, what are my legal remedies if he defaults? How can the divorce agreement be enforced?

# Am I liable for my spouse's debts?

## Question:

Am I liable for my spouse's debts?

## Answer:

The general rule is that spouses are not responsible for each other's debts, but there are exceptions. Many states will hold both spouses responsible for a debt incurred by one spouse if the debt constituted a family expense (e.g., child care or groceries). In addition, community property states will hold one spouse responsible for the other's debts because both spouses have equal rights to each other's income. Also, you are both responsible for any debt that you have in both names (e.g., mortgage, home equity loan, credit card).

# Divorce and Social Security

## Can a divorced person benefit from an ex-spouse's Social Security entitlement?

If you're married, it's possible for you to claim Social Security benefits at the appropriate time in one of two ways. You can claim benefits in your own name (if you have been employed and have accumulated enough credits over the years), or you can claim benefits as a dependent (whether or not you ever worked), provided that your spouse satisfied the applicable requirements. In the latter case, you'll probably be entitled to only 50 percent of your spouse's primary insurance amount (PIA)--the benefit that your spouse is entitled at normal retirement age. (For more information, see Social Security Retirement Benefits.) In certain cases, a divorced party can qualify as a dependent for Social Security purposes. Thus, you may be entitled to 50 percent of your former spouse's benefits. Note: That this entitlement doesn't reduce your ex-spouse's benefits by one-half; rather, this merely establishes the amount of money you may collect. For basic information about the Social Security program and for detailed treatment of Social Security rules, see Social Security.

## What requirements must be met?

The requirements vary, depending on whether your former spouse is presently of retirement age or has died.

### *If ex-spouse is of retirement age*

In order to qualify for one-half of your ex-spouse's Social Security benefits, all of the following conditions must be met:

- Your ex-spouse is currently entitled to receive Social Security retirement or disability benefits
- You and your ex-spouse had been married for at least 10 years before the divorce became final
- You are not currently married
- You are age 62 or older, and
- You aren't entitled to collect a retirement or disability benefit based on a PIA that equals (or exceeds) one-half of your ex-spouse's PIA

Note: If you're age 62 or older and you've been divorced for at least two years, you can receive Social Security benefits immediately (based on your former spouse's earnings) regardless of whether that spouse has chosen to retire or has submitted an application for Social Security benefits. This, of course, is assuming that the other four requirements listed above have been satisfied. However, if you choose to receive benefits at age 62 instead of your normal retirement age, the benefit that you would have received at your normal retirement age will be reduced by at least 25 percent (assuming you don't have a dependent child who's entitled to benefits on the deceased spouse's Social Security record). In other words, if you choose to receive reduced benefits at age 62, you will not be entitled to collect full benefits when you reach your full retirement age.

> **Example(s):** Assume Jack will collect $750 per month in Social Security benefits when he retires. If he has been married to Joan for at least 10 years before he divorces her, Joan can collect $375 per month (one-half of Jack's benefit) when she reaches age 65. Naturally, Joan will have the option to take the Social Security benefits she earned in her own name. Obviously, she'll choose the higher figure.

If you're age 62 or older and are caring for a dependent child who is entitled to child's benefits based on a deceased parent's Social Security record, then your benefits won't be reduced currently and will remain unreduced later, after you reach your full retirement age. Bear in mind that you can't receive a spouse's benefits prior to age 62, even if you have a dependent child.

***If ex-spouse has died***

You may also qualify for Social Security benefits if your former spouse has died. You may qualify if:

- Your ex-spouse was entitled to Social Security benefits
- You and your ex-spouse had been married to each other for at least 10 years before the divorce was finalized
- You are age 60 or over (or are between ages 50 and 60 and are disabled)
- You aren't currently married, and
- You aren't entitled to a retirement benefit that is equal to or greater than 100 percent of your deceased spouse's benefit

Note that if you meet the above conditions, you will be entitled to full widow's or widower's benefits; that is, you will collect an amount equal to 100 percent of your former spouse's PIA, not merely one-half. However, if you're under full retirement age, your benefits will be reduced for each month you receive benefits under your full retirement age. Benefits at age 60 will be 71.5 percent of your former spouse's PIA. (For more information, see Social Security Survivor's Benefits and the Lump-Sum Death Benefit.) It's also important to note that a divorced spouse may be entitled to a mother's or father's benefit if caring for the dependent child (under age 16 or disabled) of his or her deceased former spouse. Typically, the amount of a mother or father's benefit is equal to 75 percent of the deceased spouse's PIA. Unlike a spousal benefit, it isn't necessary for the marriage to have lasted 10 years. (For more information, see Social Security.)

## How does remarriage of the husband and/or the wife impact Social Security benefits?

If your ex-spouse gets remarried and you don't, your Social Security entitlement will be unaffected. If your ex-spouse is married to a second spouse for at least 10 years and then they get a divorce, you and that second spouse will each be entitled to collect an amount equal to one-half of the former spouse's benefits (assuming that you each meet the requirements set forth above).

If you're the one who remarries, you would then look to your current spouse's PIA in computing your dependent Social Security benefit. However, if you worked for a sufficient period of time, you may be entitled to a larger benefit amount computed based on your own earnings record. For more information about Social Security in general, see Social Security.

# My husband and I are divorcing. Will I continue to receive Social Security based on his record?

## Question:

My husband and I are divorcing after 30 years of marriage. Will I still be able to receive Social Security retirement benefits based on his earnings record after our divorce?

## Answer:

Yes. If you already receive Social Security based on his earnings record, you'll continue to receive it as long as you live (or in some cases, until you remarry). If you don't receive Social Security yet, you can apply for a reduced benefit when you turn 62 or wait until age 65 if you want to receive an unreduced spousal retirement benefit. If you've been divorced for more than two years, you can apply as soon as your ex-husband becomes eligible for benefits, even if he hasn't started receiving them (assuming you're at least 62). However, if you've been divorced for less than two years, you must wait to apply for benefits based on your ex-husband's earnings record until he starts receiving his own benefits.

You don't have to worry about losing your benefit even if your ex-husband remarries. Benefits for a divorced spouse are calculated separately from those of a current spouse.

# Health Insurance and Divorce

How will a divorce affect your health insurance coverage? During marriage, it's common for one spouse to maintain health coverage for the entire family through his or her group health insurance plan at work. After a divorce, coverage for the other spouse and the children could terminate. State and federal laws offer protection to families in danger of losing health-care coverage, especially to children. But it's important to re-examine your family's health insurance situation before a divorce occurs to avoid serious complications afterward.

## Health insurance coverage can be included in a divorce settlement

Because health coverage is such an important benefit, some divorce decrees stipulate that a spouse who provided health coverage for the other spouse or family during the marriage must continue to provide such coverage following a divorce. This is especially true if the other spouse didn't work outside the home and has no immediate access to health insurance. Neither an insurer nor an employer can deny such court-ordered coverage when children are involved.

If you're the spouse who carries the health coverage, you may have to pay additional premiums to continue coverage for your ex-spouse and your children, depending on the policy provisions. Some group policies will routinely allow you to continue full coverage for your family even after your divorce. Of course, this may change if you later remarry and want to include your new family on your policy. In any case, the premium for a group family plan may be less expensive than single coverage for two adults.

## If your family has individual health insurance

If the issue of health insurance is not included in your divorce settlement, you'll need to do some scrambling around if your ex-spouse is the insured on the family's individual health insurance policy. It's very possible that the coverage provided to you and your children could be terminated. Talk to your insurance agent to determine if you're still covered, and for how long. If you're still included in the policy, find out how much the premiums will be over the next 6 to 12 months. Also, begin looking into new health insurance for you and your children.

## Secure health coverage for your children

Hopefully, you and your former spouse can work out an agreement regarding health coverage for your children. The child support section of the divorce agreement assigns responsibility for providing the children's health insurance. But if the noncustodial parent or that parent's insurance company or employer refuses to cooperate, federal law provides for a court order that secures your children's continued health insurance coverage. This court order, known as a Qualified Medical Child Support Order (QMCSO), stipulates that custodial parents have the right to obtain health insurance coverage for their children through the noncustodial parent's group health plan, if the noncustodial parent has such coverage. The children can't be denied access to the plan, although limitations can be placed on the coverage. The order will not require the plan to provide additional benefits not actually offered in the plan.

The QMCSO can require that policy premiums be deducted directly out of the employee's paycheck. Reimbursements for medical care are made directly to the custodial (nonemployee) parent, when that parent pays a provider. Also, the noncustodial parent can't choose a medical plan that is unsuitable for the children. If you're the custodial parent, get copies of your ex-spouse's medical plan, medical claims and election forms, the summary plan description outlining your former spouse's employee benefits, and the page designating the current insureds of the health plan.

## Temporary coverage through your former spouse's employer

Temporary protection may be available through the Consolidated Omnibus Budget Reconciliation Act (COBRA). This federal law was designed to protect employees and their dependents at companies with 20 or more workers from losing group insurance coverage as a result of job loss or divorce.

If your former spouse maintained family health coverage through work, you may (at your own expense) continue this group coverage for up to 36 months after the divorce or legal separation. Your cost of continuing COBRA coverage can't exceed 102 percent of the cost to the plan for providing identical benefits to an active participant. Be aware that you have the right to pay the premiums in monthly installments. Also, you must pay premiums on time or you'll lose your coverage. COBRA coverage will terminate sooner than 36 months if you remarry or obtain coverage under another group health plan. Certain governmental plans and church-sponsored plans are exempt from the act.

Several states have enacted their own laws that preserve a spouse's eligibility for health insurance after a separation or divorce. Some of these laws may provide you with rights more generous than those offered under COBRA, so check your state's laws first. Ask your divorce attorney or contact your state insurance commissioner's office.

Also, if you're over a certain age, it may be wise to purchase individual health insurance or to make sure your working former spouse maintains health coverage as part of the divorce settlement. Otherwise, when COBRA coverage terminates after 36 months, you may find that poor health in your later years presents an insurability problem or that the cost of coverage is exorbitant. In addition, the Health Insurance Portability and Accountability Act of 1996 may provide certain protection regarding pre-existing conditions.

# My husband and I are divorcing. Whose health insurance policy will cover the children?

## Question:

My husband and I are getting divorced. How do we decide whose health insurance policy will cover the children?

## Answer:

As parents, both of you will want to keep the best interests of your children in mind. That means you should compare your health plan with your spouse's health plan and determine which one offers the most comprehensive health coverage and flexibility in choosing health-care providers.

Your ultimate decision will also involve other considerations, such as job security. If you and your spouse are eligible to participate in employer-sponsored group health insurance plans, which of you is more likely to remain employed? Expense is probably another issue you'll face. If your employer pays a larger portion of the premiums than your spouse's employer pays, your spouse may argue that you should cover the children under your health plan. If you have custody of the children, though, you may find the extra expense too burdensome.

The issues of child support and child custody are quite relevant when you discuss health insurance coverage of the children. For example, if you have custody of the children, receive child support, and need your spouse to provide health insurance coverage for the children, you may be able to obtain a court order (if necessary) to ensure his or her compliance. This is known as a qualified medical child support order.

You'll resolve the issue of health coverage--and many other issues--during your divorce settlement negotiations. Because state divorce laws may vary, you should seek advice from a divorce attorney before making any decisions.

# Tax Planning for Marriage and Divorce

## What is tax planning for marriage and divorce?

If you're married or considering a divorce, you should be aware of the income tax ramifications of the financial decisions you'll be making. Regarding marriage, you should be knowledgeable about selecting a filing status for tax purposes (and the concept of the marriage penalty). In addition, you should be aware of the concepts of innocent spouse and injured spouse relief. Finally, you might wish to perform a second-income analysis to determine the economic feasibility of both spouses working outside of the home. As for divorce-related tax matters, numerous issues should be considered, including the tax aspects of property settlement, alimony, dependency exemptions, and child support.

## What are some tax issues related to marriage?

If you're married or are contemplating marriage, there are several tax issues to consider, including:

### *Filing status*

Marital status is determined on the last day of the year (December 31 for most individuals). The following rules will apply:

- Unmarried: You can select unmarried as your filing status if you were unmarried as of the last day of the tax year.
- Head of household: The rules for qualifying for head of household status vary, depending on whether you are treated as married or unmarried.
- Married filing jointly: You and your spouse (or former spouse) can choose to file a joint return if you were married to each other through the last day of the tax year, even if you were living apart.
- Married filing separately: You can select married filing separately as your filing status if you are married or if you are no longer married but had remained married to your former spouse up to and including the last day of the tax year (generally December 31).
- Qualifying widow(er): You may qualify for this status if your spouse died during the past two tax years, you qualified to file jointly with your spouse in his or her year of death, you have not remarried by the end of the current calendar year, you have a qualifying dependent child, and you provide over half the cost of supporting your child.

### *Married filing jointly vs. married filing separately*

Generally, couples who file married filing separately tend to pay more in total taxes than couples who file married filing jointly. This is because some deductions and tax credits are not available for married taxpayers who file separately. However, in some circumstances, filing separate returns can actually result in a lower combined tax liability. You should figure your tax both on a joint return and on separate returns to be sure you are using the method that results in the least amount of tax.

### *Married filing jointly vs. unmarried*

Would delaying a marriage or accelerating a divorce save you taxes? It might. Sometimes a couple who files as married filing jointly (MFJ) winds up with a tax liability that is greater than it would have been if they were unmarried and filing as unmarried individuals. This is known as the marriage penalty. The marriage penalty occurs when the tax code provides a standard deduction for MFJ filers in an amount that is less than twice the amount for unmarried filers, tax brackets that are wider but not twice as wide as those for unmarried filers, and other inequities.

Whether spouses experience the marriage penalty depends on many factors including the distribution of earnings between them. Spouses who earn relatively equal amounts are more apt to experience the penalty than spouses who earn disproportionate amounts.

On the other hand, some spouses may actually experience the reverse effect (the marriage "bonus"). You should figure your tax both on a joint return and on unmarried returns to determine which method results in the least amount of tax.

The Economic Growth and Tax Relief Reconciliation Act of 2001, the Jobs and Growth Tax Relief Reconciliation Act of 2003, and the Working Families Tax Relief Act of 2004 reduce, but do not completely eliminate, the marriage penalty by (1) increasing the MFJ standard deduction to twice the unmarried standard deduction, and (2) widening the MFJ 15 percent tax bracket to twice as wide as the unmarried 15 percent tax bracket. These changes are effective through 2010.

### *Innocent spouse relief*

If you file a joint return, each spouse is generally jointly and severally liable for 100 percent of the taxes due on the return (as well as for any penalties and interest assessed).

However, you may be entitled to relief from tax liabilities arising from a joint return if:

- An understatement on a joint return is attributable to erroneous items of your spouse, and you didn't know and had no reason to know of the understatement, and
- Taking into account all of the facts, it would be inequitable to hold you liable for any portion of a deficiency

### *Injured spouse claims*

In general, debts that you contract before your marriage are construed as separate debt, and debts that you and your spouse contract together during your marriage are considered marital debt. As a general rule, you're not responsible for paying--either during the marriage or after a divorce--the separate debts that your spouse contracted in his or her name alone before your marriage.

However, if you file a joint tax return with your spouse, and your spouse is liable for certain debts, including student loans, taxes, and child support arrearages, the IRS may intercept any refund that might be due for the joint return and may forward such refund to the appropriate federal or state agency. Since it would be inequitable for you to lose your portion of the tax refund simply because your spouse owes money, the IRS allows you to file an injured spouse claim (IRS Form 8379) in certain cases to claim your share of the refund. To be considered an injured spouse, you must not otherwise be required to pay your spouse's past due amount and you must have:

- Filed a joint tax return
- Reported income (e.g., wages, interest) on the joint return
- Made and reported payments (e.g., federal income tax withheld from wages or estimated payments) or claimed the earned income credit or any other refundable credits on the joint return, and
- Had an overpayment, all or part of which may be applied against the past due amount

**Example(s):** Beau and his wife, Shirley, filed a joint tax return and expected a $2,000 refund ($1,000 of which was attributable to Beau, and $1,000 of which was attributable to Shirley). Subsequently, they received an IRS letter informing them that the entire $2,000 was to be offset against Beau's defaulted student loan obligation. After filing an injured spouse claim with the IRS, Shirley eventually received her $1,000 tax refund.

### *Second-income analysis*

Another decision facing married couples is whether both spouses should work outside of the home. This decision often arises when a couple has children, or when a retiree collecting Social Security considers a re-entry into the workforce. If you wish to consider whether a second household income is advisable, you need to consider the personal ramifications as well as the financial and tax aspects of your decision. A second-income analysis involves an evaluation of the net benefit derived from a second income, with a particular emphasis on tax aspects.

## What are some tax issues related to divorce?

If you're legally separated or divorced, it's important to become familiar with the applicable tax rules regarding a number of topics, including filing status, dependency exemptions, child support, alimony, and property settlement. Also, if either spouse has a pension, it's wise to understand what a qualified domestic relations order is, and how it impacts the division of your retirement plan assets.

# Filing Status Considerations: Divorce

## What are filing status considerations?

If you're separated, considering a divorce, or are already divorced, you should be aware of the income tax ramifications of your divorce-related financial decisions. An important consideration should be the filing status you select for your federal income tax return. 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. Depending on your situation, you may or may not have a choice regarding your filing status. Generally speaking, there are four filing statuses available to individuals who are divorced or are considering a divorce: unmarried (single), married filing jointly, married filing separately, and head of household.

Thorough familiarity with the concept of filing status also involves some understanding of the innocent spouse rules, as well as divorce timing considerations.

## For filing status purposes, when are you considered married or unmarried?

Your selection of a filing status for a given year will depend on your marital status as of the last day of your tax year (usually December 31).

> **Example(s):** Assume you marry on December 31, 2010. You'll be considered married for all of 2010. Assume, instead, that you married on December 31, 2009 and divorce on December 31, 2010. You'd be considered married for all of 2009 but unmarried for all of 2010.

### *Divorce and separate maintenance decrees*

You're considered unmarried for the entire year if, on the last day of your tax year (usually December 31), you're unmarried or legally separated from your spouse by a divorce or separate maintenance decree.

> **Caution:** You're still considered married if you're separated under an interlocutory (not final) decree of divorce.

> **Caution:** State law governs your legal status under a decree of separate maintenance. If the domestic relations laws of your state view you as married when a separate maintenance decree has been issued, you're considered married for purposes of filing federal income tax returns.

> **Caution:** If you and your spouse obtain a divorce solely for the purpose of filing tax returns as unmarried individuals (with the intent to remarry) and you remarry the same individual the following tax year, you and your spouse will be treated as if you were never divorced.

### *Legal annulments*

If you obtain a court decree of annulment (which holds that no valid marriage ever existed), you are considered unmarried for the tax year, provided that you have not remarried.

> **Tip:** You must also file amended federal income tax returns (IRS Form 1040X) for all tax years affected by the annulment (if not barred by the statute of limitations). These returns should amend previously filed tax returns to single (or head of household, if you qualify) filing status. The statute of limitations generally doesn't expire until three years after your original return was filed.

### *Married persons living apart*

Generally, if you live apart from your spouse but are not legally separated by a decree of divorce or separate maintenance, you're still considered married. However, if you meet all of the following requirements in addition to living apart from your spouse, you're considered unmarried for the entire year:

- You file a separate return (meaning that you don't file jointly),
- You paid more than half the cost of keeping up your home for the tax year,
- Your spouse did not live in your home during the last six months of the tax year, and
- Your home was, for more than half the year, the main home of your child, stepchild, or adopted child, whom you can claim as a dependent. This qualification is also met if your home was the main home of a foster child (whom you can claim as a dependent) for the entire year.

If you're considered unmarried under the above requirements, you probably will qualify for head of household status.

### *Common law marriage*

You're considered married if you live in a common law marriage that is recognized in the state where you now live or in the state where the common law marriage began. This is true even if you later moved to a state that does not recognize common law marriage.

### *What filing status should you select?*

Taking into consideration that marital status is determined on the last day of the year (December 31), the following rules will apply:

### *Unmarried (Single)*

You must select unmarried (single) as your filing status if you were unmarried as of the last day of the tax year and were not eligible to claim head of household, or qualifying widow(er) status.

### *Head of household*

The head of household rules vary, depending on whether you're unmarried (including divorced) or married.

If you're unmarried:

- You must provide more than one-half of the costs of maintaining your household, and
- Your household must be the principal home of at least one dependent.

If you're married:

- You must file a separate return,
- 

You must maintain your home and have your child or stepchild living there for more than one-half of the tax year,

- You must claim the child as a dependent or waive that claim,
- You must furnish more than one-half of the cost of maintaining the household during the tax year, and
- Your spouse must not have lived in your household at any time during the last six months of the year.

**Example(s):** Assume John and Mary have an eight-year-old son, Jimmy. John and Mary obtain a divorce on January 1, 2010, whereby Mary is awarded custody of Jimmy. Jimmy lives with Mary throughout the year. When Mary files her 2010 tax return, she can file using head of household status.

### *Married filing jointly*

You and your spouse (or former spouse) can choose to file a joint return if you were married to each other through the last day of the tax year, even if you were living apart. If living apart, you can't file as married if you are legally separated under a final decree of divorce or separate maintenance. You can, however, file as married if you are separated under an interlocutory (not final) decree of divorce.

**Example(s):** Assume John and Mary unofficially separate on February 1, 2010. Mary continues to reside in the family house, while John rents an apartment. On September 8, 2011, they divorce. When considering their 2010 tax situation, John and Mary can choose to file a married filing jointly return, since they remained married through December 31, 2010.

### *Married filing separately*

You can select married filing separately as your filing status if you're married or if you're no longer married but had remained married to your former spouse up to and including the last day of the tax year (December 31).

**Tip:** If you and your spouse are unable to agree on which filing status to select, you should file separately. This is because your two separate returns can be amended later (if necessary) into a married filing jointly return. The opposite is not true, however; you can't subsequently amend a joint return into two separate returns.

## What other filing status considerations should you keep in mind?

You should know how the timing of your divorce can impact your tax liability. Also, joint filers should be aware of the rules for innocent spouse relief.

### *Timing of divorce*

If filing as married individuals (either jointly or separately) would be more beneficial than each of you filing as single, consider delaying a divorce until after the end of the tax year. Conversely, finalizing a divorce before the end of the tax year will allow both of you to file as unmarried individuals; that is, as single or, if one of you qualifies, as head of household.

**Tip:** If you desire to file as a single individual, also, consider obtaining a decree of separate maintenance before the end of the tax year. This will also allow you to file your tax return for the year as an unmarried individual.

### *Innocent spouse relief*

If you file a joint return, each spouse is generally jointly and severally liable for 100 percent of the taxes due on the return (as well as for any penalties and interest assessed). Even after your divorce is finalized, you will be liable for any unpaid taxes attributable to prior years unless you qualify for relief as an innocent spouse.

**Tip:** If you're going to file a joint return while in the process of a divorce or separation, consider utilizing an indemnification clause or an escrow arrangement as a way of protecting yourself from future liability. An indemnification clause is a clause within a divorce decree that states that one spouse agrees to reimburse the other for future tax liabilities. An escrow arrangement can be used to set aside funds for estimated future taxes that will be due as the result of a joint return.

**Caution:** The IRS doesn't care whether you have an indemnification clause or an escrow arrangement. The IRS can still collect any tax deficiency from either you or your former spouse.

# Allocate Income and Deductions

## What does it mean to allocate income and deductions?

One of the goals of divorce proceedings is to divide marital property between the spouses. Along with the division of assets and the assignment of debt, issues involving the allocation of income and expenses (deductions) must be resolved as well. For example, division of interest and dividends on jointly held assets must be discussed, as should the deduction for real estate taxes paid. And allocations of tax carryovers--although sometimes overlooked--are an especially important tax issue related to divorce. Carryovers frequently take the form of losses that could not be used (deducted) in a given tax year and are available for use in future years.

To aid parties and their attorneys to uncover all items of income, debt, expenses, and assets, it's necessary for each spouse to complete a financial affidavit and to participate in the discovery process. A thorough understanding of the rules regarding the division of debt is also helpful to divorcing spouses.

## What filing status should a divorcing couple select?

Your selection of a filing status for a given year will depend on your marital status as of the last day of the tax year (December 31). If you're still legally married as of the last day of the year, you and your spouse can choose to file a joint return together, if certain conditions are met. However, many attorneys advise their clients to file married filing separately in order to avoid liability for a spouse's taxes and/or possible penalties. If you choose to file married filing separately, or if you're drafting a property settlement agreement, you need to consider how to allocate income and expenses.

## When do you allocate income and expenses?

Allocations of tax items are often made retroactive to the date of separation. For example, if a couple owns a piece of property jointly, the income and expenses pertaining to the property (including depreciation, depletion, and amortization) could be allocated 50/50 to each spouse after the date of separation. However, state law (or agreement between the parties) will determine the actual allocation date.

## Are allocations affected by whether you live in an equitable division state or a community property state?

The rules governing the reporting of income and deductions differ significantly between equitable division states and community property states.

### *Equitable division states*

The majority of states are equitable division states. In these states, dividing income between divorcing spouses is relatively straightforward. The general rules are as follows:

- Earned income is taxable to the spouse who earns it (e.g., wages or salary).
- Income from property is taxable to the property's owner (state law determines the nature of ownership rights).
- When property is owned as joint tenants, tenancy by the entirety, or 50 percent tenancy in common, income from that property is generally taxed 50 percent to each joint owner. If joint ownership is other than equal (50/50), taxation follows the percentage of ownership.

Dividing deductions is also fairly simple. A spouse who pays an expense with separately owned funds is generally entitled to that deduction. Deductions paid out of a jointly owned account are presumed to be split 50/50 between each spouse. However, that presumption may be rebutted by one spouse establishing that he or she alone paid the expenses.

***Community property states***

There are 10 community property states: Alaska (if elected), Arizona, California, Idaho, Louisiana, Nevada, New Mexico, Texas, Washington, and Wisconsin (and also Puerto Rico). In these states, what constitutes "community income" and what constitutes "separate property" are determined by state law. There can be some variation by state. Generally, each spouse is taxed on one-half of community income and on 100 percent of his or her income from separate property. When deductions are paid from community property, they are presumed to be split 50/50 between each spouse. When deductible expenses are paid from separate property, the property's owner is entitled to the deduction.

There is an exception to the general rule, however. Community income may be treated as separate income for federal tax purposes if all of the following conditions are met:

- The spouses live apart at all times during the year
- They do not file a joint return
- At least one spouse had earned income--such as wages, which is considered community income--during the year
- No portion of such earned income is transferred between the spouses during the year (except for mandated child support and de minimis amounts)

If all of the above conditions are met, the following rules apply:

- Earned income will be taxed only to the spouse who earned it by performing services (i.e., it won't be considered community income)
- Trade or business income is taxed to the spouse carrying on the business
- Partnership income is taxed to the spouse who is the partner
- Social Security benefits are taxed to the spouse receiving them
- Income from separate property is taxed to the owner of the property
- All other community income (e.g., interest, dividends, rents, royalties, gains) is taxed as provided by state community property law

## What about tax carryforwards?

The final joint return of a divorcing couple may contain various types of tax carryovers, which could be used to reduce tax liability in future years. Examples of these include capital loss carryovers, charitable contribution carryovers, and net operating loss carryovers. IRS regulations specify what happens to some of these carryovers in the event of a divorce. When the tax regulations don't specify how the carryforwards should be allocated between the divorcing spouses, the couple must allocate the carryforwards themselves. In many cases, the carryforwards may qualify as marital assets, the allocation of which should be subject to negotiation.

A more detailed explanation of tax carryforwards is beyond the scope of this discussion. For more information, consult additional sources.

## What is a financial affidavit and how is it used in a divorce context?

When divorce proceedings are commenced, each spouse is required to fill out a financial affidavit. This form, which becomes part of the court record, shows income from all sources, including debt, living expenses, and assets. Each party declares (under the pains and penalties of perjury) that the information contained on his or her affidavit is true.

A judge will use the information contained in this affidavit when he or she issues temporary orders regarding separate maintenance (temporary alimony), child support, and other financial matters during the period of separation. The document is useful, moreover, to attorneys. The financial affidavit becomes the basis for seeking (or arguing against) temporary support and assists the attorney later during the discovery and property settlement phases of divorce.

## What can happen if you underreport your income or exaggerate your expenses?

Because you sign the financial affidavit under oath, deliberately falsifying your financial information can be considered perjury. Additionally, if your divorce ends up in trial, your credibility as a witness will be seriously undermined if your spouse's attorney can prove that you lied in your affidavit. This, of course, may sway the court's sympathy toward your spouse. And finally, even if your case never makes it to trial, your spouse may be able to force a property settlement in his or her favor if you are caught lying in a court document.

> **Example(s):** John handled the finances in his family and secretly stashed away $50,000 in a bank account during the last years of his marriage. When divorce proceedings began, he wire-transferred the money to his mother, a resident of Colombia. John's wife, Mary, learned of the money when she found a receipt for the wire transfer in her husband's coat pocket. Since John had not disclosed the existence of this money at discovery or in his financial affidavit (submitted to the court), Mary was able to use this fraudulent transfer as an ace in the hole to force a favorable property settlement.

It's not uncommon for spouses to be less than truthful when completing their financial statements. If you suspect that some assets haven't been disclosed by your spouse, there are a number of places where you (or your attorney) can look for these hidden assets. The following documents should be scrutinized:

- Personal income tax returns
- Partnership and corporate tax returns
- Pay stubs
- Savings account passbooks
- Canceled checks and check registers
- Securities statements
- Children's bank accounts

However, it's often the case (with married couples) that one spouse handles the bills and other financial affairs for the sake of convenience. The other spouse may or may not be well informed. Therefore, it may be difficult for a spouse to determine if the other party is being truthful in the affidavit. Fortunately, you and your attorney will have many other opportunities to engage in fact-finding.

## What are some of the more common mistakes people make when completing financial affidavits?

Sometimes hidden assets aren't the problem; frequently, people unintentionally underestimate their expenses. For example, if you note your monthly grocery bill as under $150, you're spending less money than most people. For one person, approximately $200 is typical. And if you get a haircut every six weeks or so, be sure to include the cost under miscellaneous or personal care.

Under the heading "Health Insurance," many mistakes are also made. Often, one spouse will put nothing in this expense category because he or she is not currently making an insurance payment. If you're going to be taken off your spouse's plan shortly, you can call the benefits department of your spouse's employer to find out how much the COBRA payment will be.

Under the "Miscellaneous" section of the affidavit, don't forget to include gifts (e.g., Christmas, birthday, wedding), newspaper and magazine subscriptions, cable TV, pet food and pet care, lawn service, etc.

> **Tip:** Don't exaggerate your expenses. During a deposition or at trial, you'll be asked to defend your figures.

## What information must you provide in your affidavit?

You'll probably be asked about the following:

- Name and address
- Occupation and job title
- Employer's name and address
- Frequency of your paychecks (e.g., weekly, biweekly, monthly, etc.)
- Monthly gross pay
- Type and amount of monthly payroll deductions
- Net monthly take-home pay
- Other sources (and amounts) of income
- Net monthly income from other sources
- Monthly housing expenses
- Monthly utility expenses (e.g., gas, electric, telephone, water and sewer, trash)
- Monthly grocery bill
- Monthly restaurant and entertaining expenses
- Monthly unreimbursed medical expenses (e.g., doctor, dentist, prescriptions)
- Monthly insurance expenses (e.g., life, health, disability, homeowners)
- Monthly transportation expenses (e.g., fuel, repair and maintenance, insurance, parking)
- Monthly clothing expenses
- Monthly child care (and child-related) expenses
- Monthly personal care and toiletries
- Educational expenses
- Miscellaneous expenses
- Debts of all kinds, including car loans, mortgages, 401(k) loans, student loans, etc. (monthly payment, unpaid balance)

Because divorce is based on state law rather than federal law, each state will have its own requirements regarding the financial statement. Nevertheless, the information listed is fairly typical.

## What is debt and how is it classified for divorce purposes?

Debt is classified as marital or separate. In general, both spouses are responsible for any debts incurred during the marriage--it doesn't matter which party actually spent the money. When the property is divided up at the time of divorce, it's often the case that the person who gets the asset also gets the responsibility for paying any loans against that asset. And even if your spouse agrees to take over the debt, joint obligors on a loan will remain jointly responsible. That is, the creditors can seek payment from either one of you.

There are basically four types of debt to consider: secured debt, unsecured debt, tax debt, and divorce expense debt.

- Secured debt--Secured debt gives the lienholder or lender a right to repossess the property in the event of your default on the loan. Some examples of secured debt include mortgages on your real estate, car loans, and boat loans. If a loan stands in the joint names of you and your spouse, you'll need to make it very clear in your separation agreement who will pay which debt. If one spouse fails to make timely payments, the creditor can pursue the other spouse or, eventually, seek repossession.

- Unsecured debt--Unsecured debt involves no repossession, although there are other remedies. Typical examples of unsecured debt include credit cards, personal bank loans or lines of credit, and loans from family and friends.

- Tax debt--If you sign a joint return with your spouse, you're each liable for the tax debt. For three years after your divorce, the IRS can perform a random audit of your joint tax return. To avoid potential tax problems in the future, your divorce agreement should spell out what happens if any additional interest, penalties, or taxes are found.

- Divorce expense debt--Divorce can be expensive, and sometimes a spouse will seek a court order to make the other party subsidize attorney's fees for both sides. This might, for example, happen when only one spouse works. Since the homemaker-spouse may have no income to pay for a divorce attorney, a judge might order the working spouse to pay.

- Sometimes both parties work or have sufficient funds with which to retain attorneys. In these cases, you'll need to spell out who pays for what. For example, if both parties want the family business, the family home, or a pension to be appraised, you'll have to apportion the costs. The same holds true if you both decide to transfer title to an asset after a divorce.

- Debts can also be incurred during the separation period. If luxuries are purchased during this period, courts are likely to assign the debt solely to the party who ran up the debt. In general, debts incurred after the separation date and before the divorce is final are the responsibility of the spouse who incurred them. One exception would be for family necessities (e.g., food, clothing, shelter, and medical care). These necessities could be the responsibility of the other spouse if the incurring-spouse can't afford to pay.

## What are the rules regarding credit card debt?

Either signer on a credit card can be held responsible for 100 percent of the debt, not just one-half of the debt.

> **Example(s):** Assume John and Mary are seeking a divorce. During their marriage, John handled the finances and Mary stayed home with the children. During the discovery period of their divorce, Mary learned that John ran up over $30,000 on their joint credit cards to pay for his expensive suits, dinners for friends, recreational pursuits, etc. Since they live in a community property state, all assets and debts will be divided down the middle. Thus, Mary will be responsible for paying $15,000 of the debt (from a judge's perspective). However, if John fails to keep up with his monthly payments (or, if he decides not to pay any of his $15,000), the credit card companies can go after Mary for the full $30,000--the divorce settlement is not binding on creditors.

During divorce proceedings, several issues can arise regarding credit cards, such as removing a spouse as an authorized signer on a credit card and understanding the obligations of joint credit card owners versus single card owners with two authorized signers.

## Will your former spouse's bankruptcy affect you?

Bankruptcy law allows debts between ex-spouses to be wiped out; therefore, the assets you were promised in your divorce settlement may never materialize. Be aware of this if you are considering the use of a property settlement note (a form of promissory note) to equalize a property division.

> **Example(s):** Assume John and Mary wanted to divide their assets 50/50. After assigning the house to one and the pension to the other, John still owed Mary $40,000. John signed a property settlement note to Mary, promising to pay her the $40,000 over a five-year period at 7 percent interest. After the divorce, John filed for bankruptcy and listed the note as one of his debts. The debt was discharged, and Mary never got her money.
>
> **Tip:** Alimony and child support can't be discharged in bankruptcy. In the example, alimony should have been considered as an alternative to the property settlement note.

If your ex-spouse files for bankruptcy, other problems may arise for you. While a bankruptcy might wipe out your spouse's obligation to pay marital debt, it doesn't wipe out your own. The creditors can contact collection agencies about you (damaging your credit) or sue you for the full amount of the debt.

## How do you divide debt at divorce?

Basically, you have five options in allocating your marital debts:

- You and your spouse can sell joint property to raise the cash to pay off your marital debts
- You can agree to pay most of the debts; in return, you can request a greater share of the marital property or a corresponding increase in alimony
- Your spouse can agree to pay the bulk of the debts; in exchange, your spouse gets a greater share of the marital property or increase in alimony
- You and your spouse divide your property and debt equally; that is, each of you gets half of the property and each of you agrees to pay one-half of the debt
- 

If you're a homemaker with children, your spouse might be ordered to pay the bulk of the debt, pay alimony, and possibly allow you to keep the house and a portion of other significant assets, such as your spouse's pension

Because of the threat of bankruptcy and/or damage to your credit report, it might be wise to sell joint assets to pay off debt or to assume responsibility for debts yourself.

## How can you repair your credit after a divorce?

Credit problems generally stay on your record for seven years, while bankruptcies can remain for up to 10. There are some steps you can take to repair credit damaged during a divorce:

- Obtain a copy of your credit report and look for errors. Sometimes, your credit history may be confused with someone who has a similar name.
- Meet with a consumer credit counseling representative, who can provide you with tools to negotiate with your creditors. He or she can also give you some useful suggestions for paying your bills.
- Open a secured credit arrangement with your bank. If you deposit a specific sum of cash with a bank

(such as $500), the bank will sometimes provide you with a secured credit card. Making timely payments will help to repair your credit over time.

## What questions (relative to debt) should you consider before entering into a divorce settlement agreement?

Before sitting down with an attorney, think about which debts were contracted prior to marriage (separate debt) and which debts were contracted during the marriage (marital debt). With respect to marital debt, consider the following questions:

- If you wish to keep a particular marital asset, will you have sufficient income to keep up with the loan payments?
- Should you liquidate other assets to retire the debt completely (or partially)?
- If your spouse proposes a property settlement agreement, is there a possibility that he or she would subsequently declare bankruptcy?
- If, pursuant to the divorce agreement, your ex-spouse assumed responsibility for all credit card debt, what are your legal remedies if he or she defaults? How can the divorce agreement be enforced?

# Alimony

## What is alimony and who is responsible for paying it?

Alimony is a support payment made to a former (or legally separated) spouse under a divorce decree (or separation instrument) in an attempt to maintain the pre-divorce lifestyle. Alimony is determined by state law and is sometimes called maintenance. It is based on one party's need and the other party's ability to pay.

## What is the basis for receiving alimony?

The decision whether a spouse should receive alimony (and, if so, how much) is based on certain criteria, which can vary from state to state. Alimony essentially allows one spouse with limited means to benefit from the earning power (acquired during the marriage) of the other spouse. In a long-term marriage, for instance, often the wife has not worked outside the home, or perhaps has spent many years at home caring for the children. As a couple, she and her husband may have decided that she would be responsible for caring for the children and/or running the household. These responsibilities limit her ability to build a career and can leave her in dire straits when the marriage ends.

Alimony is awarded based on any of the following criteria:

- Need--One of the most important reasons for alimony is the recipient-spouse's basic need of money for food, shelter, clothing, utilities, and water. Obviously, the state has an interest in keeping residents off public assistance, and, although child support is a separate issue, courts will certainly consider the existence of minor children when considering a spouse's financial need for alimony. In considering the appropriateness of alimony, courts will evaluate a prospective recipient's current sources of income, such as wages or salary, earnings from property received in the property division, and earnings from separate property (such as a trust fund). Debt, both individual and joint, will also be considered.

- Ability to pay--The next consideration is whether the payor-spouse can afford to pay what is needed and still have enough money left over to live on or to support a lifestyle somewhat similar to his or her previous one. The needs of both spouses are important.

- Prior lifestyle--Because courts will also consider how the spouses were accustomed to living during their marriage, it is clear that alimony isn't based simply on need. For instance, if Bill is a Hollywood star earning $3 million per year, he'll have a hard time convincing a judge that his former spouse, Dinah, should only be paid $35,000 per year in alimony.

- Length of marriage--A marriage that lasts for only a year or two may not qualify for alimony, but a 30-year marriage probably will. The spouses may have become quite dependent on one another, and one spouse may have sacrificed a career in order to manage a house and/or raise a child.

- Age and health--Courts will also look at the respective ages and health of the spouses when determining alimony. A judge will want to know whether either party is disabled or retired. If retired, what sources of income exist? If both parties are young, able-bodied, and college-educated, alimony might not be awarded. However, if a wife is a 58-year-old homemaker with health problems, it might be difficult (if not impossible) for her to find adequate employment. In such a case, an award of permanent alimony might be appropriate.

- Contribution to education--The courts will also consider whether a spouse contributed to the education, training, or career advancement of the other spouse. Often, one spouse will work while the other pursues a college or graduate degree. When the degreed spouse obtains a well-paying position, the working spouse might stay home to care for the children or may continue to work in a low-paying job.

## What types of alimony exist?

Alimony may be classified as rehabilitative, permanent, modifiable, or nonmodifiable.

- Rehabilitative--Rehabilitative alimony may be defined as a temporary financial award to help a spouse until such time as he or she can become self-sufficient. If one party was the primary breadwinner, it is unrealistic to expect that the other spouse could automatically earn the same amount of money after the divorce. Rehabilitative alimony can help a former spouse get a college degree or take courses to update old skills. Ideally, the payments would continue while the spouse gained some working experience.

- Permanent--As was mentioned earlier, permanent alimony may be appropriate when the spouses are older and one party has sacrificed career for family. That party simply doesn't have the ability to get hired late in life (with no experience) in a lucrative position. Permanent alimony may also be appropriate when the recipient spouse is disabled or has health problems.

- Modifiable--Modifiable alimony simply means that the alimony award can be changed (i.e., increased, decreased, or terminated). A change in circumstances can warrant a change in alimony. For instance, the payor-spouse may become unemployed, or the recipient-spouse may suddenly become disabled or ill and unable to seek employment. Additionally, the recipient-spouse might win the lottery or receive an inheritance. After the divorce is finalized and an order of support has been made, a modifiable arrangement will allow either spouse to go back to court to ask for a modification.

- Nonmodifiable--Nonmodifiable alimony is not often used, since it is difficult to predict the future. Still, it provides some security or peace of mind for the recipient. If the divorce decree states that the wife is entitled to ten years of nonmodifiable alimony, for instance, she knows she can count on that money and will continue to receive it, even if she gets remarried.

## Do relocation and/or remarriage affect alimony?

Relocation of one or both of the spouses does not affect alimony. If you obtained a judgment in one state and have since moved to another, state laws allow you to enforce the judgment in the second state. However, if the recipient-spouse gets a roommate or shares rent with someone else, the payor-spouse might be able to get a reduction in monthly alimony payments. The presumption is that the recipient-spouse needs less financial support, since his or her rent has been lowered.

Unlike relocation, remarriage does affect alimony. In fact, remarriage of the recipient-spouse will usually cause a termination of the payor's alimony obligation (unless alimony is nonmodifiable). The written agreement between the parties will specify the conditions that will terminate alimony.

## When can alimony be terminated?

Alimony ceases upon the death of the payor or recipient. Alimony can also be terminated on the conditions agreed upon by the parties.

## Is it possible to guarantee alimony payments?

Because alimony terminates on the death of the payor, it is advisable for the recipient to take measures to ensure a continued income stream in the event of the payor's death. This can be accomplished by using such tools as life insurance, disability insurance, and annuities.

- Life insurance--You can stipulate in the divorce decree that life insurance will be purchased on the life of the payor. That way, alimony payments continue in the event of his (or her) death. If you're going to purchase a new policy, however, be sure you do it before the divorce is final, because health or insurability is not predictable. The recipient-spouse should either own the life insurance policy or be an irrevocable beneficiary in order to ensure payment of the premiums, and to create favorable tax treatment for the payor of the premiums. For tax purposes, the insurance premiums will be construed as alimony (i.e., they are tax-deductible to the payor and income to the recipient) if the beneficiary-spouse owns the policy (or is an irrevocable beneficiary) and the premiums are made under a legal obligation imposed by the divorce decree.

- Disability insurance--While a former spouse cannot own a disability policy on the ex-husband (or ex-wife), the former spouse can pay the premiums on the policy to ensure that it stays in force. Disability insurance can be an important consideration.

**Example(s):** Assume Ralph agreed to pay his ex-wife, Diane, $2,000 per month alimony, based on his $7,000 per month salary. While preparing a lobster dinner, Ralph has an accident and becomes disabled. If he has no disability insurance and no salary, he can go back to court to get his alimony obligation modified. If, however, he had appropriate disability insurance, he might receive $5,000 per month tax-free from the insurance, and perhaps could continue paying all of the alimony.

- Annuities--The payor-spouse can also choose to buy an annuity that pays a monthly sum equal to the alimony payment. For instance, the husband can buy a $200,000 annuity that pays out $700 per month (the agreed-upon alimony amount) in interest only. If the payments are interest only, they are taxable to him as income, but also deductible by him as alimony. The payments will be income to his ex-wife.

## How is unpaid alimony collected?

Unfortunately, an award of alimony does not guarantee the actual receipt of alimony. There are a number of methods for enforcing alimony orders, including contempt of court proceedings, garnishment of wages, and the placement of liens on property. In those cases where a spousal award contains both a child support portion and an alimony portion, see our separate topic discussion, Child Support, for additional methods of collecting past-due amounts.

- Contempt of court--If a judge orders a spouse to pay a particular amount of periodic alimony and that order is ignored, the recipient-spouse can file a motion with the court asking that the other party be held in contempt. A hearing will be scheduled, and if the delinquent spouse fails to attend, a warrant may be issued for his or her arrest. The payor-spouse can be jailed, or the judge may order him or her to make future payments in a timely manner, and to pay the arrearage according to a set schedule. The judge can also order that the payor-spouse's wages be garnished, or can place a lien on his or her property.

- Wage garnishment--With this method, a portion of the payor-spouse's wages is removed from his or her paycheck at the source and delivered to the recipient spouse (or to the court). To garnish wages, the recipient-spouse obtains authorization from the court to seize a percentage of wages. Typically, a sheriff notifies the payor-spouse's employer of the garnishment. Once the employer has been instructed to garnish wages, it will inform the employee. Of course, the payor-spouse can request a court hearing to oppose the garnishment, presenting a number of objections. For instance, he or she can assert that the amount owed was computed incorrectly, or that the amount to be taken will leave him or her with too little to live on.

- Property liens--In some states, a spouse who is owed alimony can ask the court to grant a lien on the real or personal property of the payor-spouse. A real estate attachment, for instance, may prevent the property owner from refinancing or selling his or her house until the lien has been paid off. Sometimes, the recipient-spouse can even force a sale of this property to satisfy the lien.

## What are the tax ramifications of alimony, including the recapture rules?

Simply stated, alimony is taxable income to the one who receives it and tax-deductible by the one who pays it. But, to be considered alimony under present tax rules, the payments must meet all of the following requirements:

- All payments must be made in cash, check, or money order--Alimony payments must take the appropriate form. Transfers of services or property do not qualify as alimony.

- A written court order or separation agreement must exist which establishes the terms and amount of the alimony payment.

**Example(s):** Sam is ordered to pay Marian $800 per month in alimony for seven years. Three years after their divorce, Marian loses her job and convinces Sam to increase her alimony for six months so she can find a new position. Sam sends her an extra $200 per month for the next six months. At tax time, Sam tries to deduct the extra $200 as alimony. However, the IRS will disagree. Since only an oral agreement for modification existed, not a written one, Sam cannot deduct the extra money as alimony.

- The couple cannot opt out of alimony tax treatment by agreement--It doesn't matter if a recipient of alimony payments does not wish to report the money as taxable income and the payor-spouse agrees not to take a tax deduction. The payments are still taxable to the recipient and tax-deductible by the payor.

- The divorced couple cannot stay in the same household--Sometimes, a couple gets divorced, but neither party can afford to move out. Consequently, they might agree to live together. If alimony is paid, however, the payor will not be able to deduct it on his or her federal income tax return. Living in the same household prevents this tax treatment.

- Obligation to pay alimony must end at death of spouse--The obligation to make payments ceases upon the death of the payor or payee.

- The former spouses may not file a joint tax return--Many couples mistakenly file a joint return for the year in which they obtain a divorce. This is incorrect because filing status is determined by their marital status on December 31.

- If any portion of the payment is considered child support, that portion cannot be treated as alimony. Sometimes an order for spousal support will not use the words "child support," but a portion of the payment can be inferred to be child support. Different rules may apply if your divorce was finalized before 1986. For more information about previous rules, contact an attorney.

## Recapture rules

The tax deductibility of alimony may encourage spouses to disguise property settlement payments as alimony. Therefore, the law provides alimony recapture rules. Alimony recapture is calculated by looking only at the first three calendar years during which deductible alimony was claimed. Therefore, any alimony payments made after the third calendar year are not subject to the recapture rules.

Alimony recapture rules require deductible alimony payments during the first three years to be structured so that payments are substantially equal. The goal is to prevent "front-loading" of alimony. Deductible alimony payments will be recharacterized as nondeductible property settlement payments to the extent that payments made during the first two years are excessively front-loaded (i.e., if high sums of alimony are paid during the first two years). Essentially, the recapture rules apply if alimony paid in the second or third year of the three-year period drops by more than $15,000, compared to the prior year.

**Example(s):** Assume Ken pays Sue alimony of $60,000 in Year 1, $60,000 in Year 2, and $20,000 in Year 3. The recapture rules apply because the alimony paid in Year 3 was more than $15,000 less than that paid in Year 2. In other words, front-loading is apparent.

There are four exceptions to the recapture rules. Recapture does not apply:

- If either spouse dies during the first three years and the payments cease by reason of that death

- If the recipient-spouse remarries during the first three years and payments cease by reason of the remarriage

- To temporary support payments made pursuant to a court order

- To payments that fluctuate for reasons beyond the control of the payor-spouse

**Example(s):** Ray agrees to pay Dorothy 25 percent of the net income from his farm each year for three years. In the first year, his net income is $120,000, so Dorothy gets $30,000. In the second year, severe weather wipes out many crops, and the net income is only $32,000, so Dorothy gets $8,000. In the third year, the farm suffers a loss, rather than net income, so Dorothy gets nothing. In this case, no recapture will be required.

For more information about the recapture rules, contact an attorney or accountant.

# Are alimony payments considered taxable income?

## Question:

Are alimony payments considered taxable income?

## Answer:

Alimony is a support payment made to a former (or separated) spouse under a divorce decree or separation instrument in an attempt to maintain the predivorce lifestyle. Alimony is sometimes called maintenance. Simply stated, alimony is taxable income to the one who receives it and tax deductible to the one who pays it. To be considered alimony under present tax rules, however, the payments must meet several requirements.

These requirements include (but are not limited to) the following:

- All payments must be made in cash, check, or money order
- A written court order or separation agreement must exist regarding the alimony
- The order or agreement must not designate the payment as not being alimony (i.e., it cannot be designated as child support)
- The couple generally cannot live in the same household while alimony is being paid (although an exception applies in the case of payments to a separated spouse living in the same household if the payments are made under a written separation agreement, support decree, or other court order)
- The obligation to pay alimony cannot continue past the death of the payor-spouse
- The former spouses cannot file a joint tax return

You should also be aware of the alimony recapture rules. Because alimony is tax deductible, some spouses are tempted to disguise property settlement payments as alimony. They might accomplish this by front-loading alimony during the first couple of years. That is, one spouse might agree to pay high sums of alimony during the first two years after the divorce, and to continue with normal payments thereafter. According to the alimony recapture rules (which are fairly complex), deductible alimony payments will be recharacterized as nondeductible property settlement payments to the extent that payments made during the first two years are excessively front-loaded.

For more information, consult a tax professional.

# Alimony: Tax Planning

## What is alimony?

Generally, alimony is a support payment made to a former (or separated) spouse under a divorce decree (or separation instrument) in an attempt to maintain the predivorce lifestyle. Alimony is determined by state law and is sometimes called maintenance. It is based on one party's need and the other party's ability to pay. If you're contemplating a separation or divorce, you should understand the tax treatment of alimony.

### *What is the basis for receiving alimony?*

Deciding whether a spouse should receive alimony (and, if so, how much) is based on certain criteria that can vary from state to state. Alimony essentially allows one spouse with limited means to benefit from the earning power (acquired during the marriage) of the other spouse. In a long-term marriage, for example, often the wife has not worked outside the home or perhaps has spent many years at home caring for the children. As a couple, she and her husband may have decided that she would be responsible for caring for the children and/or running the household. These responsibilities limit her ability to build a career and can leave her in dire straits if the marriage ends.

Alimony is awarded based on any of the following criteria:

- Need--One of the most important reasons for alimony is that the recipient-spouse needs enough money to take care of basic needs, such as food, shelter, clothing, and utilities. Obviously, the state has an interest in keeping residents off of public assistance, and although child support is a separate issue, courts will certainly consider the existence of minor children when considering a spouse's financial need for alimony. In considering the appropriateness of alimony, courts will evaluate a prospective recipient's current sources of income, such as wages or salary, earnings from property received in the property division, and earnings from separate property (such as a trust fund).
- Ability to pay--The next consideration is whether the payor spouse can afford to pay what is needed and still have enough money left over to live on or to support a lifestyle somewhat similar to his or her previous one. The needs of both spouses are important.
- Prior lifestyle--Because courts will also consider how the spouses were accustomed to living during their marriage, it's clear that alimony isn't based simply on need. For example, if John is a Hollywood star earning $3 million per year, he'll have a hard time convincing a judge that his former spouse, Mary, should only be paid $35,000 per year in alimony.
- Length of marriage--A marriage that lasts for only a year or two may not qualify for alimony, but a 30-year marriage probably will. This is because a longer marriage will illustrate more sacrifice and dependency of the spouses and will likely involve the sacrifice of one career for management of the home and/or child rearing.
- Age and health--Courts will also look at the respective ages and health of the spouses when determining alimony. A judge will want to know whether either party is disabled or retired. If retired, what sources of income exist? If both parties are young, able-bodied, and college-educated, alimony might not be awarded. However, if one spouse is a 58-year-old homemaker with health problems, it might be difficult (if not impossible) for him or her to find adequate employment. In such a case, an award of permanent alimony might be appropriate.
- Contribution to education--The courts will also consider whether a spouse contributed to the education, training, or career advancement of the other spouse. Often, one spouse will work while the other pursues a college or graduate degree. When the degreed spouse obtains a well-paying position, the working spouse might stay home to care for the children or may continue to work in a low-paying job.

### *What types of alimony exist?*

Alimony may be classified as rehabilitative, permanent, modifiable, or nonmodifiable.

- Rehabilitative--Rehabilitative alimony may be defined as a temporary financial award to help a spouse until such time as he or she can become self-sufficient. If one party was the primary breadwinner for the couple, it's unrealistic to expect that the other spouse could automatically earn the same amount of money after the divorce. Rehabilitative alimony can help a former spouse get a college degree or take courses to update old skills. Ideally, the payments would continue while the spouse gained some working experience. Note that some states do not allow for rehabilitative alimony.

- Permanent--As was mentioned earlier, permanent alimony may be appropriate when the spouses are older and one party has sacrificed career for family. That party simply doesn't have the ability to get hired late in life (with no experience) in a lucrative position. Permanent alimony may also be appropriate when the recipient spouse is disabled or has health problems.

- Modifiable--Modifiable alimony simply means that the alimony award can be changed (i.e., increased, decreased, or terminated). A change of circumstances can warrant a change in alimony. For example, the payor spouse may become unemployed, or the recipient-spouse may suddenly become disabled or ill and unable to seek employment. Additionally, the recipient-spouse might win the lottery or receive an inheritance. After the divorce is finalized and an order of support has been made, a modifiable arrangement will allow either spouse to go back into court to ask for a modification.

- Nonmodifiable--Nonmodifiable alimony is not often used, since it is difficult to predict the future. Still, its value is that it provides some security or peace of mind for the recipient. If the divorce decree states that the wife is entitled to ten years of nonmodifiable alimony, for instance, she knows she can count on that money and will continue to receive it, even if she gets remarried.

### *Do relocation and/or remarriage affect alimony?*

Relocation of one or both of the spouses doesn't affect alimony. If you obtained a judgment in one state and have since moved to another state, state laws allow you to file the judgment in the second state and enforce it there. However, if the recipient-spouse gets a roommate or shares rent with someone else, the payor spouse might be able to get a reduction in monthly alimony payments. The presumption is that you need less financial support, since your rent has been lowered.

Unlike relocation, remarriage most certainly affects alimony. In fact, remarriage of the recipient-spouse will usually cause a termination of the payor's alimony obligation (unless alimony is nonmodifiable). The written agreement between the parties will specify the conditions that will terminate the alimony.

### *When can alimony be terminated?*

Alimony will cease upon the death of the payor or recipient. Alimony can also be terminated on the conditions agreed upon by the parties.

### *Is it possible to guarantee alimony payments?*

Because alimony terminates on the death of the payor, it's advisable for the recipient to take measures to ensure a continued income stream in the event of the payor's death. This can be accomplished by using such tools as life insurance, disability insurance, and annuities.

- Life insurance--You can stipulate in the divorce decree that life insurance will be carried on the life of the payor to replace alimony in the event of his or her death. If you're going to purchase a new policy, be sure you do it before the divorce is final. This is because health and insurability aren't predictable.

The recipient-spouse should either own the life insurance policy or be an irrevocable beneficiary in order to ensure payment of the premiums and to create favorable tax treatment for the payor of the premiums. Regarding the tax aspect, the insurance premiums will be construed as alimony (i.e., they'll be tax-deductible to the payor and income to the recipient) if the beneficiary-spouse owns the policy (or is an irrevocable beneficiary) and the premiums are made under a legal obligation imposed by the divorce decree.

- Disability insurance--While a former spouse can't own a disability policy on his or her ex-husband or ex-wife, the former spouse can pay the premiums on the policy to ensure that it stays in force. Disability insurance can be an important consideration.

**Example(s):** Assume John agreed to pay his ex-wife, Mary, $2,000-per-month alimony, based on his $7,000-per-month salary. John suffers an accident and becomes disabled. If he has no disability insurance and no salary, he can go back to court to get his alimony obligation modified. However, if he had appropriate disability insurance, it's possible that he might receive $5,000 per month tax free and could continue paying alimony.

- Annuities--The payor spouse can also choose to buy an annuity that pays a monthly sum equal to the alimony payment. For example, the payor spouse can buy a $200,000 annuity that pays out $700 per month (the agreed-upon alimony amount) in interest only. If the payments are interest only, they are taxable to the payor spouse as income and are also deductible as alimony. The payments will be treated as income to the recipient spouse.

### *How is unpaid alimony collected?*

Unfortunately, an award of alimony doesn't guarantee the actual receipt of alimony. There are a number of methods for enforcing alimony orders, including contempt of court proceedings, garnishment of wages, and the placement of liens on property.

- Contempt of court--If a judge orders a spouse to pay a particular amount of periodic alimony and that order is ignored, the recipient spouse can file an action, asking that the other party be held in contempt. A hearing will be scheduled, and if the delinquent spouse fails to attend, a warrant may be issued for his or her arrest. The payor spouse can be jailed, or the judge may order him or her to make future payments in a timely manner and to pay the arrearage according to a set schedule. The judge can also order that the payor spouse's wages be garnished or can place a lien on his or her property. The judge may also order the payor spouse to pay the legal fees of the recipient spouse.

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Wage garnishment--With this method, a portion of the payor spouse's wages is removed from his or her paycheck at the source and delivered to the recipient spouse (or to the court). To garnish wages, the recipient-spouse obtains authorization from the court to seize a percentage of wages. Typically, a sheriff notifies the payor-spouse's employer of the garnishment. Once the employer has been instructed to garnish wages, the employee will be informed.

Of course, the payor spouse can request a court hearing to oppose the garnishment, presenting a number of objections. For example, he or she can assert that the amount owed was calculated incorrectly or that the amount to be deducted will leave him or her with an insufficient amount to live on.

- Property liens--In some states, a spouse who's owed alimony can ask the court to grant a lien on the real or personal property of the payor spouse. For example, a real estate attachment may prevent the property owner from refinancing or selling his or her house until the lien has been paid off. Sometimes, the recipient-spouse can even force a sale of this property to satisfy the lien.

### *What are the tax ramifications of alimony?*

Simply stated, alimony is taxable income to the one who receives it and tax-deductible to the one who pays it. But to be considered alimony under present tax rules, the payments must meet all of the following requirements:

- All payments must be made in cash, check, or money order (alimony payments must take the appropriate form; transfers of services or property don't qualify as alimony)

- There must exist a written court order or separation agreement

**Example(s):** John is ordered to pay Mary $800 per month in alimony for seven years. Three years after their divorce, Mary loses her job and convinces John to increase her alimony for six months so she can find a new position. John sends her an extra $200 per month for the next six months. At tax time, John tries to deduct this extra money as alimony. However, the IRS will disagree. Since the extra payments were not made under the terms of a divorce or separation instrument, John can't deduct the extra money as alimony.

- The couple can't opt out of alimony tax treatment by agreement after the fact--If a recipient of alimony payments doesn't wish to report the money as taxable income and the payor spouse agrees not to take a tax deduction, it doesn't matter; the payments are still taxable to the recipient and deductible by the payor. However, in the divorce decree itself, spouses may designate payments as "not alimony" even though the payments would otherwise qualify as alimony. Such payments are not taxable to the recipient or deductible by the payor.

- The divorced couple can't stay in the same household--Sometimes, a couple gets divorced but neither party can afford to move out. Consequently, they might agree to live together. If alimony is paid, the payor will not be able to deduct it on his or her federal income tax return and the recipient will not include it in income. Living in the same household prevents this tax treatment.

- The obligation to pay alimony must end at death of spouse--The obligation to make payments ceases upon the death of the payor or the recipient.

- The former spouses may not file a joint tax return--Many couples mistakenly file a joint return for the year they get divorced; this is incorrect. Filing status will be determined by their marital status on the last day of the year (December 31).

- If any portion of the payment is considered to be child support, that portion can't be treated as alimony. Sometimes an order for spousal support will not use the words "child support," but a portion of the payment can be inferred to be child support nevertheless.

Different rules may apply if your divorce was finalized before 1985. For more information about previous rules, contact an attorney.

## What are the recapture rules?

The tax deductibility of alimony may encourage the spouses to disguise property settlement payments as alimony, so, the law provides alimony recapture rules. Alimony recapture is calculated by looking only at the first three calendar years during which deductible alimony was claimed. Therefore, any alimony payments made after the third calendar year are not subject to the recapture rules.

Alimony recapture rules require deductible alimony payments during the first three years to be structured so that payments are substantially equal. However, alimony payments of less than $15,000 per year aren't subject to the recapture rules. The goal is to prevent "front-loading" of alimony. Deductible alimony payments will be recharacterized as nondeductible property settlement payments to the extent that payments made during the first two years are excessively front-loaded. In other words, high sums of alimony are paid during the first two years.

There are four exceptions to the recapture rules. The recapture doesn't apply:

- If either spouse dies during the first three years and the payments cease by reason of that death

- If the recipient-spouse remarries during the first three years and payments cease by reason of the remarriage

- To temporary support payments made pursuant to a court order

- To payments that fluctuate for reasons not in control of the payor spouse

**Example(s):** Ray agrees to pay Dorothy 25 percent of the net income from his farm each year for three years. In the first year, his net income is $120,000, so Dorothy gets $30,000. In the second year, severe weather wipes out many crops, and the net income is only $32,000, so Dorothy gets $8,000. In the third year, the farm suffers a loss rather than net income, so Dorothy gets nothing. In this case, no recapture will be required.

For more information about the recapture rules, contact an attorney or accountant.

# Child Custody

## What is child custody and upon what basis is it awarded?

When parents separate and seek a divorce, one of the most emotionally charged issues involves who will live with the children. A judge considering an award of custody must place primary importance on the best interests of the children.

In the past, custody of children of tender years (i.e., age five and under) was almost always given to the mother when parents divorced. Currently, most states require that courts determine custody on the basis of the children's best interests, without regard to the gender of the parent. As a practical matter, very small children often end up with the mother.

In granting custody, courts usually consider many factors, including the following:

- The child's age, gender, and mental and physical health
- The mental and physical health of the parents
- The parent's ability to provide the child with food, shelter, clothing and medical care
- The extent to which a parent has personally washed, fed, clothed, and tended to the needs of the child, the primary caregiver)
- The work schedules of the parents
- The respective lifestyles of the parents, including exposure to secondhand smoke and history of child abuse or other physical violence
- The love and emotional ties between the parent and the child, as well as the parent's ability to give the child guidance
- The child's established living pattern (school, home, community, religious institution)
- The child's preference if the child is above a certain age (usually about 12), and
- The ability and willingness of the parent to foster healthy communication and contact between the child and the other parent

## What are the different types of custody arrangements?

Custody may be classified as physical or legal. Physical custody refers to living with the child, and legal custody involves making decisions that substantially affect the child, such as medical, educational, and religious decisions.

Custody may further be awarded to one parent only (sole custody), to both parents together (joint custody), or to a third party. For example, a judge could award sole physical custody to the mother (with visitation rights to the father) and joint legal custody to the couple. Or, a judge might order joint physical and legal custody to the parents, in which case a child might spend one-half of the year with one parent and roughly one-half of the year with the other parent, although this is rare.

Third-party custody might be awarded when neither parent is able to care for the child. The court will usually turn first to grandparents or other relatives and later to foster care or adoption.

## Can a custody order be changed?

Once a parent has been awarded custody in a court order, a judge will change the order only if there has been demonstrated a substantial change in circumstances. Usually, it must be proven that the change will have a direct and favorable effect on the child.

## What are the tax benefits of receiving custody?

The tax benefits of a taxpayer receiving custody of his or her child include the following:

- Claiming the child's dependency exemption (this exemption can be negotiated between the parents, however--it doesn't absolutely have to go to the parent with physical custody)
- Qualifying for head of household filing status
- Claiming the child and dependent care tax credit
- Claiming the child's medical care expense deductions (Note: The noncustodial parent may claim medical expenses he or she actually paid for a dependent even if the custodial parent claims the child as a dependent.)

For more information, see our separate topic discussion, Child Support.

# Child Support

## What is child support and who is responsible for it?

Every parent is obligated to financially support his or her children, providing such necessities as food, clothing, shelter, and the like. Divorce doesn't cause this obligation to cease. When a divorce occurs, the noncustodial parent is usually ordered to pay child support to the custodial parent; the custodial parent pays the rest of the expenses.

Child support usually ends at the child's 18th birthday, although some states set a cutoff at 21 years of age (absent an agreement between the parties for a higher age). Also, some courts may order that child support continue until the child has graduated from college.

## How do you determine the amount of child support?

The amount of child support that the noncustodial parent pays to the custodial parent can be simply a matter of agreement between the parents or it can be ordered by a judge. All states now have child support guidelines that help the court decide the amount of child support to be paid. However, there can exist considerable variation among states regarding the precise formula used to determine child support. Judges will carefully review agreements by the parents to ensure that the best interests of the child (or children) are kept in mind.

Often, the support obligation of each parent is based on the ratio of each parent's income, the percentage of time the child spends with each parent, the number of children, and the amount of alimony paid (if any). A child support worksheet is provided by the court to determine the amount. To complete a typical worksheet, each parent must determine his or her weekly (or monthly) available income (gross income minus taxes, Social Security, and other mandatory deductions). Optional deductions (like contributions to a 401(k) plan) aren't deducted.

When both parents are working, one method of determining support assigns a percentage of child-rearing costs to each parent based on his or her proportionate contribution to household income. When only one parent is employed, the amount of child support may be assigned after determining the basic living expenses necessary for that parent.

> **Example(s):** Assume Liz and Frank have two children and are seeking a divorce; Liz shall have custody of the kids. Liz grosses $900 per month and Frank grosses $4,300, for a combined total of $5,200. Thus, Frank earns 83 percent and Liz 17 percent of the total. Their particular state mandates that a household with two children should provide $983 per month to maintain two children. Since 83 percent of $983 is $813, Frank owes Liz $813 per month in child support.

There are a number of methods for determining the amount of child support to be paid; it's recommended you consult with the child support guidelines and worksheets provided by your own state. You should be able to obtain a worksheet at the probate and family court for your county.

## Can you modify a child support order?

Child support orders can be modified by a court even after a divorce has been finalized unless there was a "no modification" agreement to the contrary. The basis for modifying a child support order is that there has been a substantial change in circumstances for one or both parties.

For instance, perhaps the father lost his job after the divorce or the mother got a big raise or won the lottery. In general, a substantial change in circumstances may be defined as any change that significantly increases living expenses or increases (decreases) the income of a parent. Of course, a modification can also be sought if one parent fraudulently failed to disclose all of his assets and income when the child support worksheet was completed.

Your request for modification of child support will be either contested or uncontested. Courts often provide a standard form for modifying child support--you fill in all relevant information (including how circumstances have changed) and check off a box to indicate whether the matter is contested. In an uncontested case, the parents will voluntarily agree to a different amount so there will be no opposition filed. In a contested matter, you will have to take your dispute to court. Generally, motions will be filed on each side and a hearing will be scheduled. Keep in mind that once a court sets a support order, only a court can modify it. If you make an informal modification and your ex-spouse changes his or her mind, you won't have any recourse regarding the arrearage.

## Who pays for the child's medical expenses, education, and other incidentals?

The provisions of your child support agreement must be specific and free of ambiguities in order to prevent disagreement at a later date. Try to anticipate future expenses. For instance, dental bills can normally be expensive for children since braces are often needed. Medical insurance is also vital. In some families, a college education is expected and viewed as a necessity. Finally, paying for day care or other forms of child care when both parents work is also a great expense and should be considered in any agreement.

If one parent is working and the other stays at home to care for the children, it's probably advisable to provide in the child support agreement that the working parent maintain health and dental insurance for the children on his or her employer's plan. For high net-worth families, the agreement might provide that the party with the higher income completely subsidizes the college education for the child (or children). On the other hand, perhaps each party will agree to pay a percentage of the college costs. Other questions you might want to consider include:

- Who will be responsible for repaying student loans?
- Who will be responsible for subsidizing graduate school (if any)?
- Who will pay for SAT preparation courses?
- Who will pay for uninsured medical and dental expenses?

Naturally, if the parents can't reach an agreement on these incidentals, it will be up to the judge to decide.

Finally, you should consider the issue of insurance--both life and disability insurance. A child support agreement will do you little good if the noncustodial parent dies or becomes severely disabled and unable to work. The settlement agreement can require the parent paying child support to purchase life and disability insurance to protect the income stream. If you suspect that the premiums won't be paid, you (the spouse receiving support) can own the policies and pay the premiums.

## How is unpaid child support collected?

Unfortunately, an award of child support doesn't guarantee the actual receipt of support. There are a number of methods for enforcing child support orders, including garnishment of wages, intercepted tax refunds, commencing contempt of court proceedings, public humiliation, the placement of liens on property, and the denial of state licenses.

### *Wage garnishment*

The most common method of collecting a judgment for child support is a wage garnishment. Here, a portion of the noncustodial parent's wages is removed from his or her paycheck at the source and delivered to you; with child support, up to 50 percent of net wages can be taken. To garnish wages, the custodial parent obtains authorization from the court to seize a percentage of the noncustodial parent's wages. Typically, a sheriff notifies that parent and his or her employer of the garnishment. Once the employer has been told to garnish wages, the employer will inform the employee.

Of course, the noncustodial parent can request a court hearing to oppose the garnishment and present a number of objections. For instance, he or she can assert that you incorrectly computed the amount owed or that the amount to be taken will leave him or her with too little to live on.

### *Intercepted tax refunds*

Federal and state income tax refunds may be intercepted by the IRS and state departments of revenue and forwarded to your district attorney's office (or other state office charged with overseeing child support enforcement).

The appropriate office will see that you get the money.

Before a refund is taken, the debtor will receive a written intercept notice, notifying him or her of a chance to request a hearing to object to the intercept. Relevant grounds for an objection include that the amount of the back support has already been paid or that the notice requests more than what is owed.

If you're remarried and file a joint tax return, your spouse's share of the federal refund can generally be returned. He or she should file IRS Form 8379 (Injured Spouse Allocation) and attach it to the tax return.

### *Contempt of court*

If a judge orders a parent to pay a particular amount of periodic child support and the parent doesn't pay, the parent who is owed the child support can file a motion before the court to ask that the other party be held in contempt. A hearing will be scheduled, and if the delinquent spouse fails to attend, a warrant may be issued for his or her arrest. The noncustodial party can be jailed, or the judge may order him or her to make future payments in a timely manner and to pay any arrearages according to a set schedule. The judge can also order his or her wages garnished, place a lien on his or her property, or order him or her to post a bond.

### *Public humiliation*

In recent years, states have come up with more creative ways to obtain back child support. For instance, most state child-support enforcement agencies now publish a "Most Wanted" list of parents who owe substantial child support, posting photographs and amounts owed. (However, if the payer-spouse has dissipated his or her wages, this remedy may not be particularly helpful on its own.)

### *Property liens*

In some states, a custodial parent who is owed child support money can ask the court to grant a lien on the payer-spouse's real or personal property. For instance, a real estate attachment may prevent the payer-spouse from refinancing or selling his or her house until the lien has been paid off. Sometimes the custodial parent can force a sale of the payer-spouse's property to satisfy the lien.

### *Denial of state license*

In a number of states, the debtor-parent's professional license (e.g., doctor's license, attorney's license, etc.) will not be renewed by the state if substantial back child support is owed. Some states will even fail to renew driver's licenses.

## Do relocation and/or remarriage affect a child-support order?

Relocation of the parties and/or remarriage doesn't affect the validity or enforceability of child support orders. The natural parents of a child continue to be responsible for support of the child, even if the custodial parent remarries.

Regarding arrearages in child support payments, even if a judgment was obtained in one state and you have since moved to another state, state laws allow the custodial parent to file the judgment in the second state and enforce it there.

## What are the tax ramifications of child support?

Child support isn't taxable to the one who receives it and isn't tax deductible to the one who pays it.

### *Is it child support?*

For payments to be classified as child support, the divorce decree or separation agreement must:

- Provide a fixed sum that is payable for the support of a child (this can be either a dollar amount or a specific fraction of a payment).

**Example(s):** Larry will pay $500 per month child support to Shelby, or Larry will pay 25 percent of his weekly wages to Shelby for the purposes of child support.

- Provide that the amount payable by the payer spouse to the receiving spouse will be reduced in the event of some contingency relating to a child (such as the child's marrying, dying, leaving school or reaching a designated age).

**Example(s):** Larry will pay $500 per month child support to Shelby until child reaches age 18.

- Provide that the amount payable by the payer spouse to the receiving spouse will be reduced at a time that can clearly be "associated with" a contingency relating to a child. Here, a payment that would otherwise qualify as alimony will be treated as child support if payments are reduced no more than six months before or after the child attains the age of 18, 21, or the local age of majority.

**Example(s):** Larry agrees to pay Shelby $2,500 per month until she dies. (The words "child support" aren't specifically mentioned.) Shelby has custody of the couple's child, Justin. The divorce agreement states that on a certain date, Larry's required payment to Shelby will decrease to $1,700 per month. Because Justin turns 18 years old within six months of the date on which the payment is scheduled to decrease, the payment reduction is assumed to relate to Justin's reaching 18 years old. Therefore, the $800 per month reduction is treated as child support, regardless of the parties' intent.

In the above example, part of Larry's payment is characterized as alimony and part as child support.

### *Who qualifies for the child dependency exemption?*

The general rule is that unless otherwise specified, the dependency exemption usually goes to the parent who has physical custody of the child for the greater part of the calendar year (i.e., the custodial parent), regardless of how much support was provided by each parent.

**Example(s):** Frank and Liz separated in May. Their daughter, Carol, lived with Liz for the rest of the year, and Frank provided all the support for Liz and Carol that year. Because Carol lived with Liz longer than she lived with Frank, Liz may claim the dependency exemption, even though she made no actual financial contribution toward Carol's support.

However, there are circumstances when the noncustodial parent can claim the dependency exemption instead of the custodial parent. To do so, the noncustodial parent must meet one of the following conditions:

- The custodial parent must sign a written declaration that he or she will not claim the exemption for the child for the tax year, and the noncustodial parent must attach this declaration (IRS Form 8332) to his or her tax return, or

- A qualified pre-1985 instrument between the parents must provide that the noncustodial parent can claim the child as a dependent (the noncustodial parent must also have provided at least $600 for the support of the child during the year).

Note: Once the minor child reaches majority age under state law, the exemption goes to the parent who actually provides more than 50 percent of the child's support.

### *Child-care credit*

A custodial parent who pays child-care expenses so that he or she can work may be eligible for a tax credit for a portion of those expenses--up to 35 percent, depending on income. The qualifying expenses on which that percentage is based are limited to $3,000 for one qualifying dependent, or $6,000 if there is more than one dependent. To claim this credit, the parent must maintain a household that is the home of at least one child, and the day-care expenses must be paid to someone who is not claimed as a dependent.

Only the custodial parent is entitled to claim the child and dependent care credit. This is true even if the custodial parent doesn't claim the dependency exemption for the child. A noncustodial parent may not claim a child-care credit for expenses incurred even if that parent is entitled to claim the dependency exemption for the child.

**Example(s):** Assume Louis and Ella have a son, Benny, who lives with Ella four days a week and with Louis three days a week. Louis and Ella are both singers and work outside the home. Each parent pays half of the $4,000 per year that it costs to keep Benny in day care during the week. Ella is entitled to claim a child-care credit for her share of the day-care expenses. She's considered the custodial parent because Benny spends a greater portion of time with her than with his father. This is true even if the parties' separation agreement granted Louis the dependency exemption.

### *Head of household filing status*

The head of household filing status is available for those who are divorced (single) at the end of the calendar year, who provide more than half the cost of maintaining the household, and whose household is the principal home of at least one qualifying person for more than half of the year. (A qualifying person is the taxpayer's child or any other person who qualifies as the taxpayer's dependent.)

**Example(s):** Jerry and Helen have an eight-year-old son, George. Jerry and Helen obtain a divorce on January 1, and Helen is awarded custody of George. George lives with Helen throughout the year. When Helen files her tax return for that year, she will claim head of household filing status.

The head of household filing status is also available to a married (separated) taxpayer under certain circumstances. The taxpayer must meet all of the following tests:

- The taxpayer's spouse didn't live in the taxpayer's household at any time during the last six months of the calendar year
- The taxpayer files a separate return for the year
- The taxpayer maintains his or her home as a household that was the main home for a child, stepchild, or adopted child for more than half of the year (A foster child must be a member of the household for the entire year)
- The taxpayer is entitled to claim the child as a dependent, and
- The taxpayer provides more than 50 percent of the cost of maintaining the household

# Child Support: Tax Planning

## What is child support and who is responsible for paying it?

Every parent is obligated to financially support his or her children, providing such necessities as food, clothing, shelter, etc. Divorce doesn't cause this obligation to cease. When a divorce occurs, the noncustodial parent is usually ordered to pay some child support to the custodial parent; the rest of the child's expenses are paid by the custodial parent.

Child support may end at the child's 18th birthday, although some states set a cutoff at 21 years of age if the child is principally dependent on one parent (absent an agreement between the parties for a higher age). Also, some courts may order that child support continue until the child has graduated from college.

> **Tip:** Some courts may also order child support to continue if the child has significant special needs.

## How do you determine the amount of child support?

The amount of child support that the noncustodial parent pays to the custodial parent can be simply a matter of agreement between the parents or it can be ordered by a judge. All states now have child support guidelines that help the court decide the amount of child support to be paid. However, there can exist considerable variation among states regarding the precise formula used to determine child support. Judges will carefully review agreements by the parents to ensure that the best interests of the child (or children) are kept in mind.

Often, the support obligation of each parent is based on the ratio of each parent's income, the percentage of time the child spends with each parent, the number of children, and the amount of alimony paid (if any). A child support worksheet is provided by the court to determine the amount. To complete a typical worksheet, each parent must determine his or her weekly (or monthly) available income (gross income minus taxes, Social Security, and other mandatory deductions). Optional deductions (like contributions to a 401(k) plan) aren't deducted.

When both parents are working, one method of determining support assigns a percentage of child-rearing costs to each parent based on his or her proportionate contribution to household income. When only one parent is employed, the amount of child support is assigned after determining the basic living expenses necessary for that parent.

> **Example(s):** Assume Mary and John have two children and are seeking a divorce. Mary will have custody of the kids. Mary grosses $900 per month and John grosses $4,300, for a combined total of $5,200. Thus, John earns 83 percent and Mary earns 17 percent of the total. Their particular state mandates that a household with two children should provide $983 per month to maintain two children. Since 83 percent of $983 is $813, John owes Mary $813 per month in child support.

Because there are a number of methods for determining the amount of child support to be paid, it is necessary for you to consult with the child support guidelines and worksheets provided by your own state. You should be able to obtain a worksheet at the probate court for your county.

## Can you modify a child support order?

Child support orders can be modified by a court even after a divorce has been finalized. The basis for modifying a child support order is that there has been a substantial change in circumstances for one or both parties. For example, perhaps the father lost his job after the divorce or the mother got a big raise or won the lottery. In general, a substantial change in circumstances may be defined as any change that significantly increases living expenses or increases (decreases) the income of a parent. Of course, a modification can also be sought if one parent fraudulently failed to disclose all of his assets and income when the child support worksheet was completed.

Your request for modification of child support will be either contested or uncontested. Courts often provide a standard form for modifying child support--you fill in all relevant information (including how circumstances have changed) and check off a box to indicate whether the matter is contested. In an uncontested case, the parents will voluntarily agree so there will be no opposition motion or pleading filed. In a contested matter, you will have to take your dispute to court. Keep in mind that once a court sets a support order, only a court can modify it. If you make an informal modification and your ex-spouse changes his or her mind, you won't have any protection regarding an arrearage.

## Who pays for the child's medical expenses, education, and other incidentals?

The provisions of your child support agreement must be specific and free of ambiguities in order to prevent disagreement at a later date. Try to anticipate future expenses. For example, dental bills can normally be expensive for children since braces are often needed. Medical insurance is also vital. In some families, a college education is expected and viewed as a necessity. Finally, paying for day care or other forms of child care when both parents work is also a significant expense and should be considered in any agreement.

If one parent is working and the other stays at home to care for the children, it's probably advisable to provide in the child support agreement that the working parent maintain health and dental insurance for the children on his employer plan. For high-net-worth families, the agreement might provide that the party with the higher income completely subsidize college education for the child (or children). On the other hand, perhaps each party will agree to pay a percentage of the college costs. Other questions you might want to consider include:

- Who will be responsible for repaying student loans
- Who will be responsible for subsidizing graduate school (if any)
- Who will pay for SAT preparation courses

Naturally, if the parents can't reach an agreement on these incidentals, it will be up to the judge to decide. Few, if any, states require payment for graduate school.

Finally, you should consider the issue of insurance--both life and disability insurance. A child support agreement will do you little good if the noncustodial parent dies or becomes severely disabled and unable to work. The settlement agreement can require the parent paying child support to purchase life and disability insurance to protect the income stream. If you suspect that the premiums won't be paid, you (the spouse receiving support) can own the policies and pay the premiums.

## How is unpaid child support collected?

Unfortunately, an award of child support doesn't guarantee the actual receipt of support. There are a number of methods for enforcing child support orders, including garnishment of wages, interception of tax refunds, commencement of contempt of court proceedings, public humiliation, the placement of liens on property, and the denial of state licenses.

### *Wage garnishment*

The most common method of collecting a judgment for child support is a wage garnishment. Here, a portion of the noncustodial parent's wages is removed from his or her paycheck at the source and delivered to you; with unpaid child support, up to 50 percent of net wages can be taken. To garnish wages, the custodial parent obtains authorization from the court to seize a percentage of the noncustodial parent's wages. Typically, a sheriff notifies that parent and his or her employer of the garnishment. Once the employer has been told to garnish wages, the employee will be informed.

Of course, the noncustodial parent can request a court hearing to oppose the garnishment and present a number of objections. For example, he or she can assert that you incorrectly computed the amount owed or that the amount to be taken will leave him or her with an insufficient amount to live on.

### *Intercepted tax refunds*

Federal and state income tax refunds may be intercepted by the IRS and state departments of revenue and forwarded to your district attorney's office (or other state office charged with overseeing child support enforcement). The appropriate office will see that you get the money.

Before a refund is intercepted, the debtor will receive a written intercept notice, notifying him or her of a chance to request a hearing to object to the intercept. Relevant grounds for an objection include that the amount of the back support has already been paid or that the notice requests more than what is owed.

If the payer spouse is remarried and files a joint tax return, and that spouse's refund is intercepted, his or her new spouse's share of the federal refund can generally be returned. The new spouse should file IRS Form 8379 (Injured Spouse Claim and Allocation) and attach it to the tax return.

### *Contempt of court*

If a judge orders a parent to pay a particular amount of periodic child support and the parent doesn't pay, the parent who's owed the child support can file an action before the court to ask that the other party be held in contempt. A hearing will be scheduled, and if the delinquent spouse fails to attend, a warrant may be issued for his or her arrest. The delinquent party can be jailed, or the judge may order him or her to make future payments in a timely manner and to pay the arrearage as well according to a set schedule. The judge can also order the delinquent spouse's wages withheld, place a lien on his or her property, or order him or her to post a bond. In addition, the judge can order the delinquent spouse to pay the opposing party's legal fees.

### *Public humiliation*

In recent years, states have come up with more creative ways to obtain back child support. For example, most state child-support enforcement agencies now publish a "Most Wanted" list of parents who owe substantial child support, posting photographs and amounts owed.

### *Property liens*

In some states, a custodial parent who is owed child support money can ask the court to grant a lien on the payer spouse's real or personal property. A real estate attachment, for example, may prevent him or her from refinancing or selling the house until the lien has been paid off. Sometimes the custodial parent can force a sale of the payer spouse's property to satisfy the lien.

### *Denial of state license*

In a number of states, the debtor-parent's professional license (e.g., doctor's license, attorney's license, etc.) will not be renewed by the state if substantial back child support is owed. Some states will even fail to renew driver's licenses.

## Can relocation and/or remarriage affect a child support order?

Relocation of the parties and/or remarriage don't affect child support orders. The natural parents of a child continue to be responsible for support of the child, even if the custodial parent remarries. However, if the custodial parent moves out of state with the children, a noncustodial parent's increased transportation costs to visit with his or her children may constitute a substantial change in circumstances and warrant a decrease in child support.

Regarding arrearages in child support payments, even if a judgment was obtained in one state and the payer spouse has since moved to another state, state laws allow the custodial parent to file the judgment in the second state and enforce it there.

## What are the tax ramifications of child support?

Briefly put, child support is not taxable to the one who receives it, nor is it deductible to the one who pays it.

### *Is it child support?*

For payments to be classified as child support, the divorce decree or separation agreement must:

- Fix a sum that is payable for the support of a child (this can be either a dollar amount or a specific fraction of a payment). For example: Husband will pay $500 per month child support to Wife.

- Provide that the amount payable by the payer spouse to the receiving spouse will be reduced in the event of some contingency relating to a child (such as the child's marrying, dying, leaving school or reaching a designated age). For example, Husband will pay $500 per month child support to Wife until child reaches age 18.

OR

- Provide that the amount payable by the payer spouse to the receiving spouse will be reduced at a time that can clearly be "associated with" a contingency relating to a child.

> **Example(s):** Husband agrees to pay Wife $2,500 per month until she dies. (The words "child support" are not specifically mentioned.) Wife has custody of the couple's child, Justin, who was born on October 20, 1992. The divorce agreement states that on January 1, 2011, Husband's required payment to Wife will decrease to $1,700 per month. Because Justin will turn 18 years old within six months of the date on which the payment is scheduled to decrease, the payment reduction is assumed to relate to Justin's reaching 18 years old. Therefore, the $800 per month reduction is treated as child support unless the parties can rebut this presumption.

In this example, part of the husband's payment is characterized as alimony and part as child support.

### *Who can claim an exemption for the child as a dependent on the federal income tax return?*

The general rule is that unless otherwise specified, the dependency exemption usually goes to the parent who has physical custody of the child for the greater part of the calendar year (i.e., the custodial parent), regardless of how much support was provided by each parent.

> **Example(s):** Frank and Liz separated in May. Their daughter, Carol, lived with Liz for the rest of the year, and Frank provided all the support for Liz and Carol that year. Because Carol lived with Liz longer than she lived with Frank, Liz may claim the dependency exemption, even though she made no actual financial contribution toward Carol's support.

However, there are circumstances when the noncustodial parent can claim the dependency exemption instead of the custodial parent. To do so, the noncustodial parent must meet one of the following conditions:

•

The custodial parent must sign a written declaration that he or she will not claim the exemption for the child for the tax year, and the noncustodial parent must attach this declaration (IRS Form 8332) to his or her tax return, or

- A qualified pre-1985 instrument between the parents must provide that the noncustodial parent can claim the child as a dependent (the noncustodial parent must also have provided at least $600 for the support of the child during the year).

Note: Once the minor child reaches majority age under state law, the exemption goes to the parent who actually provides more than 50 percent of the child's support.

### *Child-care credit*

A custodial parent who pays child-care expenses so that he or she can work may be eligible for a tax credit for a portion of those expenses--up to 35 percent, depending on income. The qualifying expenses on which that percentage is based are limited to $3,000 for one qualifying dependent, or $6,000 if there is more than one dependent.

Only the custodial parent is entitled to claim both the child and the dependent care credit. This is true even if the custodial parent does not claim the dependency exemption for the child. A noncustodial parent may not claim a child-care credit for expenses incurred even if that parent is entitled to claim the exemption for the child.

> **Example(s):** Assume John and Mary have a son, Benny, who lives with Mary four days a week and with John three days a week. John and Mary are both singers and work outside the home. Each parent pays half of the $4,000 per year that it costs to keep Benny in day care during the week. Mary is entitled to claim a child-care credit for her share of the day-care expenses. She's considered the

custodial parent because Benny spends a greater portion of time with her than with his father.

### *Head of household filing status*

The head of household filing status is available for those who are unmarried (or treated as unmarried for tax purposes) at the end of the calendar year, who provide more than half the cost of maintaining the household, and whose household is the principal home of at least one qualifying person for more than half of the year. (A qualifying person is their child or any other person who qualifies as their dependent.)

**Example(s):** John and Sue have an eight-year-old son, Tim. John and Sue obtained a divorce on January 1, 2010, and Sue was awarded custody of Tim. Tim lived with Sue throughout the year. When Sue files her 2010 tax return, she can claim head of household filing status.

The head of household filing status is also available to a married (separated) taxpayer under certain circumstances. The taxpayer must meet all of the following tests:

- The taxpayer's spouse did not live in the taxpayer's household at any time during the last six months of the calendar year
- The taxpayer files a separate return for the year
- The taxpayer maintains his or her home as a household that was the main home for a child stepchild, or adopted child for more than half of the year (a foster child must be a member of the household for the entire year)
- The taxpayer is entitled to claim the child as a dependent
- The taxpayer provides more than 50 percent of the cost of maintaining the household

# What are the tax implications of child support payments?

## Question:

What are the tax implications of child support payments?

## Answer:

When a separation or divorce occurs and the couple involved has one or more children, the noncustodial parent is usually ordered to pay some child support to the custodial parent. The child's expenses over and above this sum are generally borne by the custodial parent. Whether you are paying or receiving child support, you should be aware of the federal income tax consequences. You are not taxed on child support that you receive, and you cannot deduct child support that you pay.

Payments will be classified as child support for federal income tax purposes if the divorce decree or separation agreement:

- Fixes a sum that is payable for the support of a child (this can be either a dollar amount or a specific fraction of a payment), or
-

Provides that the amount payable by the payor-spouse to the receiving spouse will be reduced when a contingency relating to a child actually happens, or at a time that can clearly be associated with a contingency relating to a child

For example, John agrees to pay his ex-wife, Carol, $2,500 per month until she dies. (Note that the words child support are not specifically mentioned.) Carol has custody of their child, Justin. The divorce agreement states that upon a certain date, John's required payment to Carol will decrease by $800. Because Justin will turn 18 within six months of the date on which the payment is scheduled to decrease, the payment reduction is assumed to be related to Justin's reaching 18 years old. Therefore, the $800 per month reduction is treated as child support, regardless of the parties' intent.

From a tax perspective, being a custodial parent can be advantageous in terms of claiming the child dependency exemption and the child-care credit. In addition, the custodial parent can potentially qualify for head of household filing status.

# Dependency Exemptions: Divorce

## What is a child dependency exemption?

If a separated or divorcing couple has children, an important tax decision involves assignment of the child dependency exemption. Exemptions are fixed amounts that you subtract from your adjusted gross income (AGI) to calculate taxable income. You can deduct $3,650 for each exemption you claim (for 2009 and 2010). Along with personal exemptions, you're generally allowed one exemption for each person you can claim as a dependent. To claim a dependency exemption, you must first have a "qualifying child" or a "qualifying relative." In making this determination, special rules apply to separated or divorced parents. For purposes of this discussion, it is assumed that the child is a "qualifying child" of one or both parents and not a "qualifying relative."

For more information on the dependency exemption, including the tests to determine who is a "qualifying child" or a "qualifying relative," see IRS Publication 501 entitled Exemptions, Standard Deduction, and Filing Information.

## Who can claim the child dependency exemption?

Assuming you have a child who is under age 19 at the end of the year (or a full-time student under age 24 at the end of the year, or a child who is permanently and totally disabled at any time during the year, regardless of age), the general rule for separated or divorced parents is that the custodial parent (the one with whom the child lived for the greater part of the year) is typically the one who claims the dependency exemption, regardless of how much support was provided by each parent.

> **Example(s):** Frank and Liz separated in May. Their daughter, Carol, lived with Liz for the rest of the year, but Frank provided all the financial support for Liz and Carol that year. Because Carol lived with Liz longer than she lived with Frank, Liz may claim the dependency exemption, despite the fact that she made no actual financial contribution toward Carol's support.

## What are the exceptions to the general rule?

There are exceptions to the general rule that the custodial parent is the one who claims the dependency exemption. Specifically, a child will be treated as the "qualifying child" of the noncustodial parent if one of the following conditions is met:

- The custodial parent must sign a written declaration that he or she will not claim the exemption for the child for the tax year, and the noncustodial parent must attach this declaration (IRS Form 8332) to his or her tax return, or
- A qualified pre-1985 instrument between the parents must provide that the noncustodial parent can claim the child as a dependent (the noncustodial parent must also have provided at least $600 for the support of the child during the year).

## Does the child dependency exemption affect your ability to claim the child-care credit?

A custodial parent who pays dependent child care expenses so that he or she can work may be eligible for a tax credit for a portion of those expenses--up to 35 percent, depending on income. The qualifying expenses on which that percentage is based are limited to $3,000 for one qualifying dependent, or $6,000 if there is more than one qualifying dependent. To claim this credit, the parent must maintain a household that is the home of at least one dependent, and the day-care expenses must be paid to someone who's not claimed as a dependent.

Only the custodial parent is entitled to claim the child and the dependent care credit. This is true even if the custodial parent doesn't claim the dependency exemption for the child. A noncustodial parent may not claim a child care credit for expenses incurred even if that parent is entitled to claim the exemption for the child.

**Example(s):** Assume John and Mary have a son, Benny, who lives with Mary four days a week and with John three days a week. John and Mary are both singers and work outside the home. Each parent pays half of the $4,000 per year that it costs to keep Benny in day care during the week. Mary is entitled to claim a child-care credit for her share of the day-care expenses; John is not entitled to claim his portion. She is considered the custodial parent because Benny spends a greater portion of time with her than with his father.

# Marital Residence

## To whom does the house belong?

When a couple divorces, assets (including the marital residence) are divided in accordance with state laws. Property division rules can vary considerably from state to state, so check your state's laws (or check with an attorney) to see which rules your state enforces.

### *Community property states*

Community property states focus on the difference between separate property (that which you bring to the marriage, inherit during the marriage, and receive as a gift during the marriage) and community property (that which is acquired during the marriage). Separate property can usually be kept by the owner-spouse after a divorce, while community property is usually divided equally between the spouses.

### *Equitable distribution states*

The majority of states are equitable distribution states. These states generally agree that the couple's property is marital property and should be divided between the spouses equitably and fairly. Some of these states will make exceptions for separate property, such as inheritances and gifts, and some will not.

There are three types of equitable distribution states. They're categorized according to how they identify marital property:

- The first type of equitable distribution state identifies marital property as all property except that which the husband or wife brought into the marriage, or obtained by gift or inheritance at any time. This definition is very similar to the one held by community property states.

- The second type of equitable distribution state says that regardless of how property was brought into the marriage or who has title presently, all property of both spouses is subject to division and disposition at divorce. These states don't differentiate between marital and separate property. They divide property fairly and equitably, and may allow property brought into the marriage by gift or inheritance to go to the other spouse if this form of distribution is more fair, all things being considered. However, the source of the property (i.e., gift, inheritance, owned prior to marriage) is often very important in the judge's decision-making process.

- The third category of equitable distribution state is a mix of rules. Such states use equity as a means of division, but they don't exempt all gifts, inheritances, or property brought into marriage. Instead, they may exempt one or two of these types of property.

For more information about property division in general, see our separate topic discussion, Property Settlement.

### *Ownership of the family home--special rules apply*

The marital residence or family home receives special treatment in both community property states and equitable distribution states. In a community property state, for example, the family home can be considered marital property, even if one spouse separately brought it to the marriage. This is true if both spouses lived in the home during the marriage, and if the nonowner spouse contributed to the house's appreciation in value over the years. Naturally, in equitable distribution states, a court will consider numerous factors when deciding upon an award of the house.

So, to whom does the house belong? Title on the deed is certainly a useful starting point, but it also depends on whether you live in a community property state or an equitable distribution state. It further depends on whether you owned the house prior to marriage, whether you received the house as a gift or inheritance, and whether both spouses lived in the house during marriage. Therefore, it's important to review the domestic relations law of your own state to answer this question. Nevertheless, in general, it's safe to say that both spouses probably have a claim on the house and should be prepared to divide this asset along with other marital assets.

## What factors should be considered if you want to keep the house?

In many divorces, the family home is the most valuable asset. For financial and emotional reasons, the biggest question involves who gets the house. If you wish to keep the house, these questions should be considered:

### *Can you afford to make the mortgage payments (if any), or is the house paid off?*

Often, alimony will involve one spouse paying the mortgage for the other spouse. But, if you will not be receiving alimony from your spouse, you'll need to earn enough income to continue making the mortgage payments. To do that, you'll need a secure job and sufficient wages or salary.

### *Can you afford to continue the other costs of upkeep, such as insurance, taxes, and repairs?*

Again, ascertain your total monthly obligation regarding the house and consider whether your income stream will be adequate. Remember that property taxes in some areas can be extremely high, and regular groundskeeping will be necessary.

### *Do you have the financial ability to buy out your spouse in return for keeping the house?*

Often, divorcing spouses are forced to compromise and trade various assets. For example, one spouse may want the house, while the other might keep the pension. This isn't always the case, but it may be the only way to reach an amicable agreement and avoid a trial. In a community property state, you need to be aware that an award of a house to one spouse must be balanced by an award of equal value to the other spouse.

### *Do you have any children?*

If a couple has very young children, a judge will often award the family home to the custodial parent, who often turns out to be the wife. A judge will place great importance on the welfare and happiness of the children, and will often feel that a house is a better environment than an apartment. Sometimes the trading of assets simply isn't necessary. For example, if one spouse is a homemaker with young children and the other spouse earns a good living, a judge may award the house to the homemaker, have the working spouse pay alimony and child support, and award part of the pension to both parties. Such an arrangement may be more likely in a marriage of long duration.

### *What are the potential tax liabilities?*

Transactions between spouses incident to a divorce aren't taxable. Nevertheless, if one spouse becomes sole owner of the family house pursuant to a divorce settlement and later sells it, the entire capital gain tax liability will be his or hers alone. Nevertheless, there is always the possibility of using the $250,000 capital gain tax exclusion (more on that later).

## What can be done with the house when a divorce arises?

When considering the issue of who gets the house, there are four options that are most frequently used: sell the house, buy out the other spouse, joint ownership, or agree to give to the homemaker.

### *Sell the house*

One of the easiest ways to deal with the marital residence, particularly when there are no children involved, is to sell the house and divide the profits that remain after the mortgage is paid and the selling costs have been paid. Profits can be divided equally or otherwise, based on the parties' wishes. Most people will want to have an independent appraiser value the property, hire a real estate agent to sell it, consult with a real estate attorney, and obtain a mortgage payoff figure. These selling costs can sometimes be significant. For information about deducting settlement costs and other costs involved in the sale of a house, see our separate topic discussion, Sale of Principal Residence: Tax Considerations.

The divorcing spouses will both need to find new residences and weigh the costs and benefits of purchasing a new home versus renting an apartment. If there are no children, selling the marital residence is probably a much simpler solution for a younger couple than for an older one. An older spouse, particularly a homemaker, may have stronger emotional ties to the home and may fear the loss of security associated with a sale of the home and a new life in an apartment.

### *Buy out the other spouse*

If one party wants to keep the family home, buying out the other spouse might be an attractive solution. You can buy out your spouse by trading another asset (like a pension), forgoing alimony, paying cash, or granting a mortgage (or second mortgage) to your spouse.

If you wish to buy out your spouse, the first thing you'll need to do is to value the property. An independent appraiser should be hired to fix the value. Next, obtain a mortgage payoff figure (if any). The value minus the mortgage shall be viewed as your equity in the property and, once divided in half, can serve as the buyout figure. Alternatively, the couple can decide on a buyout figure of their own choosing. It doesn't necessarily have to be one-half of the equity. For more information, see our separate topic discussion, Selling a Home.

The method of payment is the next question to be considered. Certainly, trading assets is one option. If one-half of the net equity in the house amounts to $25,000, for example, and the husband has a pension worth approximately $15,000, the wife might wish to relinquish her rights in the pension in return for keeping the house. Of course, she'd need to carefully weigh such a decision in light of the fact that the pension will probably increase dramatically over the years and she may be left with no retirement income. A cash exchange is another method of payment if one party has an inheritance or trust fund. Refinances and mortgages should also be considered. The house could be refinanced to provide enough cash to pay the other spouse. Alternatively, a note payable (with reasonable interest) or private mortgage can be drawn up between the spouses. However, this approach could present some problems.

> **Example(s):** Debby and Jose are seeking a divorce and own a home with $20,000 worth of equity. Debby wants to keep the house, but has just started a new job and doesn't have sufficient cash on hand to buy out Jose. Debby promises to make a balloon payment of $10,000 to Jose seven years after their divorce date, securing this promise with a $10,000 private mortgage to Jose. When Debby tries to refinance the house some years later in order to payoff Jose, she finds that conventional mortgage lenders will not grant her a mortgage unless Jose subordinates his mortgage claim to theirs. If Jose refuses to subordinate, Debby will have difficulty finding the cash to pay off Jose.
>
> **Tip:** If private notes and mortgages are used, the divorce agreement should stipulate that subordinations and other accommodations will be freely given by the creditor-spouse. Also, if one spouse merely deeds his or her interest in the house to the other spouse while a mortgage is outstanding, both spouses shall remain liable for the mortgage if both signed the mortgage initially. For example, if the spouse who lives in the house stops making mortgage payments, the other spouse may be liable and may suffer severe credit consequences.

### *Joint ownership*

Joint ownership is often used when the parties envision selling the house at some point in the future (e.g., when the minor children reach age 18 or when the resident spouse remarries). The parties might agree that the spouse who lives in the house shall be responsible for making the mortgage payments, or that both parties will pay the mortgage, insurance, and taxes until the children graduate from school.

Property values should be a concern if you promise to pay a certain dollar amount in the future. Rather than promising to pay $20,000 when the property is sold 15 years from now, you might wish to promise one-half or one-third of the net sale proceeds. This would protect the resident spouse if the property value declines. If you're the creditor-spouse, a dollar amount might be better.

### *Agree to give to homemaker*

There are cases when assets won't be traded in any significant sense. Rather, the parties will simply agree to give the greater portion of assets to one spouse. This can be particularly true when a homemaker of many years is involved. For older women who sacrificed a career for the care of children and the upkeep of a house, it may be impossible for them to jump into the working world at age 58 and earn a sufficient living. In such cases, judges may decide simply to award the house to the homemaker. Additionally, the judge may order alimony payments for life and a portion of the pension set aside. Such measures may be deemed equitable under the circumstances.

Note: The upkeep of a house and its grounds might be too burdensome and expensive for certain individuals.

## What are the tax ramifications when a house is sold pursuant to a divorce?

### *In general*

Property transfers between spouses during marriage or incident to divorce aren't taxable. But the tax effects on the sale or transfer of your home incident to divorce can vary substantially, depending on whether you (as a couple) decide to keep the house, sell it to a third party, or transfer it to one spouse with a view toward a future sale.

### *Transfer to one spouse incident to divorce*

Neither spouse recognizes gain or loss if you transfer the title of the home to your spouse incident to a divorce. A transfer of property is viewed as incident to a divorce if the transfer occurs within one year after the date on which the marriage ends, or if the transfer is related to the ending of the marriage. Any transfer of property between spouses made pursuant to a divorce or separation instrument, and occurring within six years after the date the marriage ceases, is treated as if related to the ending of the marriage.

### *Basis*

The spouse receiving the property takes the basis of the transferring spouse, and ends up with the combined basis. This result occurs even if the spouse that retains the residence pays cash or other assets in return for the house and the transaction is basically a sale.

> **Example(s):** Joan and John own a home that is presently worth $170,000. Joan sells her one-half ownership of their home to her spouse, John, for $85,000 as part of their divorce settlement. Because the property had initially been purchased for $80,000, Joan's basis was $40,000 and John's was $40,000. Joan doesn't recognize any gain on the sale to John because the sale was incident to their divorce. John's basis in the property will be $80,000.

### *Delayed sale of house*

The parties might decide (in their divorce agreement) that the house shall be sold at some point in the future. Typically, only one spouse remains in the house, but the other spouse continues to be listed on the deed as a joint owner. This raises a question concerning exclusion of the capital gain when the house is later sold.

In general, the law states that if all requirements are met, a taxpayer of any age can exclude from income up to $250,000 of gain (up to $500,000 for joint filers meeting certain conditions) from the sale of a home owned and used by the taxpayer as a principal residence for at least two of the five years before the sale. Generally, an individual (or either spouse in a married couple) can use this exemption only once every two years.

> **Caution:** For sales and exchanges of a principal residence after December 31, 2008, the $250,000 ($500,000 if married filing jointly) homesale exclusion does not apply to the extent the gain is allocated to periods (not including any period before January 1, 2009) during which the property is not used as the principal residence of the taxpayer or the taxpayer's spouse.

At first glance, this law would seem to preclude the spouse who moved away and has lived elsewhere for several years from claiming the exclusion. However, under the following circumstances, a separated or divorced taxpayer can add someone else's ownership and/or use period to his or her own ownership and/or use period:

- An individual is treated as using a home as his or her principal residence during any period of ownership that the individual's spouse or former spouse is granted use of the property under a divorce or separation instrument, and
- An individual who receives a home in a tax-free transfer from one spouse to another may tack on the transferor's ownership period to his or her own ownership period

> **Example(s):** John and Mary are divorcing. Their divorce decree provides that Mary can continue living in the house until their daughter, Jane, turns 18, eight years from now. At that time, the house will be

sold and the proceeds split between John and Mary. In this case, John will be eligible for the $250,000 capital gain exclusion, even though he didn't reside in the family home for two of the past five years, since he meets one of the exceptions.

In addition, even if you don't meet the two-out-of-five-years test or the one-exemption-every-two-years test, you may qualify for a partial exclusion. You may claim a partial homesale exclusion if the primary reason for selling your principal residence is a change in place of employment, for health reasons, or for certain other unforeseen circumstances. Temporary regulations issued by the IRS specifically list divorce or legal separation as an unforeseen circumstance.

### *Sale of house to third party immediately*

Often, a house will be sold to a third party as part of a divorce settlement. The proceeds will be split equally between the spouses. In such a case, both the husband and wife would normally recognize one-half of the gain on the sale. But, this will not be the case if they qualify for the capital gain exclusion mentioned above.

**Example(s):** Liz and Frank are seeking a divorce. During the course of their marriage, they purchased a house for $100,000. The house is now worth $200,000, and the couple decides to sell it through a real estate broker and split the net proceeds equally. If their net proceeds from the sale amount to $186,000, Frank and Liz will each realize a $43,000 gain. Assuming they qualify for the full capital gain exclusion, Liz and Frank can each exclude up to $250,000 of gain from the sale of the home.

**Tip:** When structuring divorce settlements, the timing of property sales and the tax ramifications should always be considered, along with the domestic relations law (i.e., community property states versus equitable distribution states). Therefore it's wise to consult with a divorce attorney, even if the property settlement appears to be a simple and amicable one. For additional information, see our separate topic discussion, Divorce and Personal Residence Considerations.

# Divorce and Personal Residence Considerations

## What personal residence considerations are there in connection with a divorce?

When considering the issue of who gets the house when a divorce arises, there are four options that are frequently used: sell the house, have one spouse buy out the other's half, have both spouses continue to own the property jointly, or simply agree that one spouse (typically, a homemaker) should get the house outright along with (or instead of) other assets. These options involve different tax effects. It is important to understand how tax basis and holding periods are calculated in these cases. It is also important to understand how the sale of a marital residence relates to the exclusion of capital gain income.

In general, property transfers between spouses during a marriage or incident to a divorce are not taxable. However, the timing of transfers between spouses can have tax ramifications. Additionally, transferring the home to third parties can create tax consequences.

## What is a transfer incident to a divorce?

Neither spouse recognizes gain or loss if one transfers title of the marital home to the other incident to a divorce. A transfer of property is viewed as incident to a divorce if the transfer occurs within one year after the date on which the marriage ends or if the transfer is related to the ending of the marriage. Any transfer of property between spouses, made pursuant to a divorce decree or separation instrument and that occurs within six years after the date the marriage ceases, is presumed to be related to the ending of the marriage.

For detailed treatment of tax issues related to divorce and personal residences, see Marital Residence. See also Property Settlements and Third-Party Transfers.

# Retirement Plans and Qualified Domestic Relations Orders (QDROs)

## What is it?

### *To what extent are retirement assets subject to probate and family court jurisdiction?*

A retirement plan is a form of property. Like a house, cars, and bank accounts, it can be divided between spouses at the time of a divorce. If a husband, for example, participates in a pension plan at work while his wife stays home to care for the children, a judge has numerous options with respect to the retirement plan. Among other choices, he or she can award the entire pension to the husband, award all of it to the wife, or divide it between the parties. Judges often use qualified domestic relations orders (QDROs) to effect these pension assignments. In a marriage of long duration, a pension plan may be one of the most valuable marital assets.

### *How are retirement plans classified?*

Many different kinds of retirement plans exist, with individual retirement accounts (IRAs) being one of the more common forms. In terms of employer-sponsored retirement plans, plans are classified as either qualified or nonqualified. Qualified plans are those that satisfy federal requirements and are afforded special tax treatment. Most qualified plans can be further categorized as either defined contribution plans or defined benefit plans.

- Defined contribution plans: Each participant in a defined contribution plan has an individual account. When you retire, you're entitled to receive what's in your account (no more and no less). Funding depends on the type of plan, and numerous possibilities exist for contributing. With some plans, the employees alone contribute. With other plans, the plan is either funded entirely by the employer, or funded by both employer and employees. Common examples of defined contribution plans include 401(k) plans and profit-sharing plans. For more information, see Defined Contribution Plan.

- Defined benefit plans: A traditional defined benefit plan does not use individual accounts. Instead, benefits for the participants in the plan are fixed under a particular formula. Specified benefits are paid to participants, based on such factors as age, length of service, and amount of compensation. Using these factors, most plans promise to pay the employee a certain amount per month upon retirement. Contributions to the plan are calculated by actuaries as the amounts needed to fund the promised benefits. For more information, see Defined Benefit Plan.

Before you think about dividing pension plans, it's important to grasp the difference between defined contribution plans and defined benefit plans. For more information, see Saving for Your Retirement.

### *What is a qualified domestic relations order (QDRO) and what requirements must it satisfy?*

A QDRO is a court judgment, decree, or order establishing the marital property rights of a spouse, former spouse, child, or dependent of a pension plan participant. Specifically, a QDRO:

1. Provides for child support, alimony payments, or marital property rights for a spouse, former spouse, child, or other dependent of a qualified plan participant and is made pursuant to a state domestic relations law, and

2. Creates or recognizes the existence of the right of the individual named in item 1 (i.e., the alternate payee ) to receive all or a portion of a participant's benefits under a qualified retirement plan

A QDRO must satisfy certain requirements. It must clearly specify:

•

The name and last known mailing address of the participant and each alternate payee covered by the order

- The amount or percentage of the participant's benefits that the plan must pay to each alternate payee (or the manner in which an amount or percentage is to be determined)

- The number of payments or periods to which the order relates, and

- Each qualified retirement plan to which the order applies

However, a QDRO may not require the plan to do any of the following:

- Mandate increased benefits

-

Pay benefits to an alternate payee that must already be paid to a different alternate payee under another QDRO

- Provide a type or form of benefit (or any option) not otherwise provided under the plan

For example, the QDRO can't require the plan to provide cost-of-living increases if the plan doesn't already have cost-of-living provisions. Furthermore, a husband's plan can't allocate 60 percent of his benefits to his ex-wife if 50 percent of the benefits had previously been allocated to a prior spouse.

### *In what ways may retirement plans be divided pursuant to a QDRO?*

The QDRO specifies what the plan administrator does with the spouse's share of the plan. But, if under the plan a participant has no right to an immediate cash payment, then a QDRO can't require the plan administrator to make an immediate cash payment to the spouse. Instead, a QDRO is generally used to segregate plan assets into a subtrust for the benefit of the alternate payee-spouse, with cash distributions made at the earliest time they would be permitted under plan provisions.

Defined contribution plans are easy to value (since the money is sitting in an individual account), and the plan administrator usually provides a quarterly report of the value. Defined benefit plans can pose a problem and often require the services of an actuary to ascertain the present value. This can be particularly true when your eventual pension payout is tied to your compensation during your three highest paid years.

> **Example(s):** John is 50 years old and has a defined benefit plan that has no cash value right now. When John retires, he currently expects to receive $1,200 per month. His ex-wife, Jill, will get a portion of the payout. If there is a 50/50 split of the present value according to a QDRO, John and Jill will each get $600 per month at retirement time. However, if John actually receives $1,800 per month when he retires, Jill will still only get $600 per month.

In general, the following QDRO options are available:

- Segregation of plan assets: Segregate the alternate payee's portion of the plan until the employee reaches retirement age. At that time, the alternate payee can access the funds. With this approach, the alternate payee is treated as a participant in the plan. The employee's defined contribution plan balance (or defined benefit plan accrued benefit) is valued as of a certain date, and that benefit is divided between the participant and the alternate payee in accordance with the QDRO. Once divided, the alternate payee is treated similarly to a terminated participant with a vested deferred benefit . There are certain advantages to this approach. For example, if you're the alternate payee, you're probably assured of receiving some retirement income in the future. Also, you won't have to deal with the problems of how to invest your money right now and how to value the plan today. On the downside, staying in the plan maintains your economic ties to your ex-spouse, so you might lose some money if your ex-spouse takes early retirement. Also, you will not be able to control the investment decisions for your share of the retirement assets. Finally, your share of the plan will generally not be accessible to you until your ex-spouse reaches retirement age.

- Current distribution of plan assets: If the plan allows, the plan administrator can distribute (to the alternate payee) the full amount of money due. The alternate payee can then either keep the money and pay tax on it now, or roll it into an IRA or other plan within 60 days, thus delaying taxation. The best approach depends on the particular circumstances. For example, if you need cash now to fund expenses, you may want to keep all of the distribution. You're also able to control investment decisions. However, several potential drawbacks exist. First, there are tax problems if you don't roll the money into an IRA or qualified retirement plan within 60 days (the IRS can waive this 60-day rule under certain circumstances, such as proven hardship). Also, requesting a current distribution requires you to make your own investment decisions. Finally, you'll lose the long-term tax deferral advantage (as well as the retirement savings themselves) if you spend the money currently. For more information, see IRA and Retirement Plan Distributions.

### *Aside from QDROs, what options may spouses consider with respect to retirement plan assets?*

One option is to trade retirement assets for something else. For example, a divorcing couple can simply decide that one spouse gets the entire retirement plan and the other gets the house, plus alimony. Alternatively, the other spouse receives a big cash buyout right now, instead of a claim on the pension assets. For more information about trading assets, see Property Settlement.

There are advantages to avoiding QDROs. You save time and money by not having to draft a QDRO. QDROs can be very expensive, especially when actuaries must be hired. Trading assets can simplify the property settlement considerably, which saves attorney's fees. Also, you may be able to trade for an asset you really want, like the house. In terms of disadvantages, you may jeopardize your future financial security if you relinquish pension rights today. Also, you and your spouse may not have enough other assets to make a fair division if your spouse keeps the entire retirement plan. In addition, if the retirement plan is a defined benefit plan, it will have to be valued in order to determine what amount of other assets would make an equitable offset.

**Tip:** QDROs don't apply to most nonqualified retirement plans, such as certain annuity plans and deferred compensation plans. So, if your spouse's plan is nonqualified, the specific QDRO rules don't have to be followed.

**Tip:** QDRO rules don't apply to IRAs. Nevertheless, it's possible for a QDRO to require a distribution of pension benefits to an employee, and then a transfer of the distribution to an IRA for the benefit of the former spouse.

### *When retirement plans are divided pursuant to a court order, what are the income tax ramifications?*

- Tax impact of QDRO on plan participant: If a QDRO orders a distribution of funds from a participant's plan to a spouse or former spouse, those funds will not represent taxable income to the plan participant. The 10 percent early withdrawal penalty will not apply. However, if the alternate payee is a child or dependent (rather than a spouse), the distribution will be taxed to the plan participant. In such a case, the 10 percent early withdrawal penalty will not apply.

- Tax impact on plan participant if there is no QDRO: If there is no QDRO and retirement plan assets are distributed to a spouse (or anyone else), the distribution will be taxed to the plan participant. Furthermore, the 10 percent early withdrawal penalty may apply. Also, beware of withholding requirements. For more information, see IRA and Retirement Plan Distributions.

- Tax impact of QDRO on former spouse (or alternate payee): A spouse or former spouse who receives a distribution under a QDRO steps into the shoes of the plan participant. Thus, such distributions become taxable to the spouse rather than to the plan participant. The money will be included in the alternate payee's gross income in the year of distribution. However, any cost basis that the participant had in the plan must be apportioned. It will be allocated on a pro rata basis between the present value of the alternate payee's interest and the total present value of all the benefits payable with respect to the plan participant. If the alternate payee is the spouse or former spouse, the taxable part of any distribution received by such person will qualify as an eligible rollover distribution. Thus, it can be rolled over to an IRA or other plan. If the alternate payee is a child or other dependent, the money may not be rolled over to the IRA.

**Example(s):** Assume Donald was married to Helen and had a vested balance in his 401(k) plan of $300,000. Donald had made after-tax contributions to the plan in the amount of $30,000. Donald and Helen negotiated a divorce and a QDRO was approved. Pursuant to the QDRO, Helen would get 50 percent of the plan assets immediately ($150,000). Donald's $30,000 after-tax basis in the plan will be allocated to him and Helen based on the ratio of their respective interests in the plan. Thus, $15,000 of the $150,000 distribution to Helen will be nontaxable. The remaining $135,000 will be taxable to Helen, unless she rolls this money over to an IRA or other plan within 60 days after receipt (subject to certain exceptions, as indicated above). Since the distribution was made pursuant to a QDRO, there will be no 10 percent early withdrawal penalty.

- Tax impact on former spouse if there is no QDRO: If there is no QDRO, the former spouse doesn't include the distribution in gross income. The distribution is taxable to the plan participant. Also, the plan participant may be subject to the 10 percent early withdrawal penalty. Such a distribution doesn't qualify to be rolled over to an IRA or other plan.

**Tip:** If you receive a distribution or payment under a QDRO from an eligible government Section 457 plan in which your spouse or former spouse is a participant, you generally must pay the applicable income tax. This treatment is a result of the Economic Growth and Tax Relief Reconciliation Act of 2001. Prior to 2002, the plan participant generally would have been responsible for paying the tax. However, under the act, the plan participant still must pay the tax if the distribution or payment is made to a child or other dependent.

# Qualified Domestic Relations Order (QDRO)

## What is a qualified domestic relations order (QDRO)?

A qualified domestic relations order (QDRO) is a court judgment, decree, or order establishing the marital property rights of a spouse, former spouse, child, or dependent of a pension plan participant with respect to certain qualified retirement plans. Several requirements and restrictions apply.

## To what extent are retirement assets subject to divorce court jurisdiction?

A retirement plan is a form of property. Like houses, cars, and bank accounts, a retirement plan can be divided between spouses at the time of a divorce. For example, if one spouse participates in a pension plan at work while the other spouse remains at home to care for the children, a judge has numerous options with respect to the retirement plan. Among other choices, he or she can award all of the pension to the working spouse, award all of it to the nonworking spouse, or split it equally (50/50). Judges often use QDROs to effect these pension assignments. In a marriage of long duration, a pension plan may be one of the most valuable marital assets.

## How are retirement plans classified?

Many different kinds of retirement plans exist, with individual retirement accounts ( IRAs) being one of the more common forms. In terms of employer-sponsored retirement plans, plans are classified as either qualified or nonqualified. Basically, qualified plans are those that satisfy federal requirements and are afforded special tax treatment. Most qualified plans can be further categorized as either defined contribution plans or defined benefit plans.

- Defined contribution plans--Each participant in a defined contribution plan has an individual account. When you retire, you're entitled to receive your entire account balance. Funding depends on the type of plan. With some plans, the employees are the only ones who contribute, and with others, the employers do all the contributing or may match employee contributions dollar for dollar (or according to a certain percentage). Typical examples of defined contribution plans include 401(k) plans and profit-sharing plans.

- Defined benefit plans--A defined benefit plan does not use individual accounts. Instead, benefits for the participants in the plan are fixed under a particular formula. Specified benefits are paid to participants based on such factors as age, length of service, and amount of compensation. Generally, the plan promises to pay the employee a certain amount per month at retirement time based on enumerated factors.

Before you think about dividing pension plans, it's important to understand the difference between defined contribution plans and defined benefit plans.

## What requirements and restrictions apply to QDROs?

A QDRO provides for child support, alimony payments, or marital property rights for a spouse, former spouse, child, or other dependent of a qualified plan participant and is made pursuant to a state domestic relations law. It creates or recognizes the existence of the right of the individual other than the plan participant (i.e., the alternate payee) to receive all or a portion of a participant's benefits under a qualified retirement plan.

A QDRO must satisfy certain requirements. It must clearly specify:

- The name and last known mailing address of the participant and each alternate payee covered by the order

- The amount or percentage of the participant's benefits the plan must pay to each alternative payee (or the manner in which such amount or percentage is to be determined)

- The number of payments or periods to which the order relates, and
- Each qualified retirement plan to which the order applies

However, a QDRO may not require the plan to do any of the following:

- Mandate increased benefits
- Pay benefits to an alternate payee that must already be paid to a different alternate payee under another QDRO, or
- Provide a type or form of benefit (or any option) not otherwise provided under the plan

For instance, the QDRO can't require the plan to provide cost-of-living increases if the plan doesn't already have cost-of-living provisions. Furthermore, a spouse's plan can't allocate 60 percent of the benefits to his or her former spouse if 50 percent of the benefits had previously been allocated to another prior spouse.

## In what ways may retirement plans be divided pursuant to a QDRO?

The QDRO specifies what the plan administrator is to do with the spouse's share of the plan. If under the plan a participant has no right to an immediate cash payment, a QDRO can't require the plan administrator to make an immediate cash payment to a spouse. Instead, a QDRO will probably be used to segregate plan assets into a subtrust for the benefit of the alternate payee-spouse, with cash distributions made at the earliest time they would be permitted under plan provisions.

Defined contribution plans are easy to value because the money is in an individual account and the plan administrator usually provides a quarterly report of the value. Defined benefit plans can pose a problem, however, and often require the services of an actuary to ascertain the present value of the fund. An actuary may be necessary, for example, if your eventual pension payout is tied to your compensation during your three highest paid years.

> **Example(s):** John is 50 years old and has a defined benefit plan that has no cash value right now. When John retires, he currently expects to receive $1,200 per month. His ex-wife, Mary, will get a portion of the payout. If there is a 50 percent split of the present value according to a QDRO, John and Mary will each get $600 per month at retirement time. However, if John actually receives $1,800 per month when he retires, Mary will still only get $600 per month.

### *Segregation of plan assets*

One option is to segregate the alternate payee's portion of the plan until the employee reaches retirement age. At that time, the alternate payee can access the funds. With this approach, the alternate payee is treated as a participant in the plan. The employee's defined contribution plan balance (or defined benefit plan accrued benefit) is valued as of a certain date, and that benefit is divided between the participant and the alternate payee in accordance with the QDRO. Once divided, the alternate payee is treated similarly to a terminated participant with a vested deferred benefit.

There are certain advantages to this approach. For example, if you're the alternate payee, you're probably assured of receiving some retirement income in the future. Also, you won't have to deal with the problems of how to invest your money right now and how to value the plan today.

However, staying in the plan maintains your economic ties with your ex-spouse, so you might lose some money if your ex-spouse takes early retirement. Also, you will not be able to control the investment decisions for your share of the retirement assets. And finally, your share of the plan will generally not be accessible to you until your ex-spouse reaches retirement age.

### *Current distribution of plan assets*

If the plan allows, the plan administrator can distribute (to the alternate payee) the full amount of money due. The alternate payee can then either keep the money and pay tax on it now, or roll it into an IRA within 60 days, delaying taxation until later. There are also certain advantages to this approach. For example, if you need cash now for living expenses, you can keep all of the distribution. Also, you're able to control the investment decisions.

There are some drawbacks. For example, you may be subject to income tax (and perhaps the 10 percent penalty tax) if you don't roll the money into an IRA account within 60 days. Also, requesting a current distribution requires you to make your own investment decisions. And finally, you'll lose the long-term tax-sheltering advantage as well as the retirement savings if you spend the money now.

> **Tip:** The IRS has authority to waive the 60-day rule for rollovers under certain circumstances, such as proven hardship.

## Aside from QDROs, what options may spouses consider with respect to retirement plan assets?

One option is to trade retirement assets for something else. For example, a divorcing couple can simply decide that one spouse gets the entire retirement plan and the other gets the house plus alimony. Or perhaps the other spouse gets a big cash buyout right now instead of a claim on the pension assets.

There are advantages to avoiding QDROs. You will save time and money by not having to draft a QDRO. QDROs can be very expensive, especially when actuaries must be hired. Trading assets can simplify the property settlement considerably, which saves attorney's fees. Also, you may be able to trade for an asset you really want, like the house.

However, you may jeopardize your future financial security if you relinquish pension rights today. Also, you and your spouse may not have enough other assets to make a fair division if one of you keeps the entire retirement plan. And if the retirement plan is a defined benefit plan, it will have to be valued in order to determine what amount of other assets would make an equitable offset.

> **Tip:** Remember that QDROs don't apply to most nonqualified retirement plans, such as certain annuity plans and certain deferred compensation plans. So, if your spouse's plan is a nonqualified one, the specific QDRO rules may not have to be followed.

> **Tip:** Also, the QDRO rules don't apply to IRAs. Nevertheless, it is possible for a QDRO to require a distribution of pension benefits to an employee and then a transfer of the distribution to an IRA for the benefit of the former spouse.

## When retirement plans are divided pursuant to a court order, what are the income-tax ramifications?

- Tax impact of QDRO on plan participant--If a QDRO orders a distribution of funds from a participant's plan to a spouse or former spouse, those funds will not represent taxable income to the plan participant. The 10 percent early withdrawal penalty will not apply. If the alternate payee is a child or dependent (rather than a spouse), then the distribution will be taxed to the plan participant. In such a case, the 10 percent early withdrawal penalty will still not apply.

- Tax impact on plan participant if there is no QDRO--If there is no QDRO and retirement plan assets are distributed to a spouse (or anyone else), then the distribution will be taxed to the plan participant. Furthermore, the 10 percent early withdrawal penalty may apply. Beware, also, of withholding requirements.

- Tax impact of QDRO on former spouse (or alternate payee)--A spouse or former spouse who receives a distribution under a QDRO steps into the shoes of the plan participant. As a result, such distributions become taxable to the spouse rather than to the plan participant. The money will be included in the alternate payee's gross income for the year of distribution. However, any cost basis that the participant had in the plan must be apportioned. It will be allocated on a pro rata basis between the present value of the alternate payee's interest and the total present value of all the benefits payable with respect to the plan participant.

**Example(s):** Assume John was married to Mary and had a vested balance in his 401(k) plan of $300,000. John had made after-tax contributions to the plan in the amount of $30,000. When John and Mary negotiated a divorce, it was decided that Mary would get 50 percent of the plan assets immediately ($150,000). John's $30,000 after-tax basis in the plan will be allocated to him and Mary based on the ratio of their respective interests in the plan. Thus, $15,000 of the $150,000 distribution to Mary will be nontaxable. The remaining $135,000 will be taxable to Mary unless she rolls this money over into an IRA within 60 days of receipt. Since the distribution was made pursuant to a QDRO, there will not be a 10 percent early withdrawal penalty.

**Tip:** Distributions to children and other dependents will be taxable to the plan participant.

- If the alternate payee is the spouse or former spouse, the taxable part of any distribution received by such person will qualify as an eligible rollover distribution. Thus, it can be rolled over into an IRA within 60 days of receipt. If the alternate payee is a child or other dependent, the money may not be rolled over into an IRA.
-

Tax impact on former spouse if there is no QDRO--If there is no QDRO, the former spouse doesn't include the distribution in gross income; the distribution is taxable to the plan participant. Also, the plan participant may be subject to the 10 percent early withdrawal penalty. Such a distribution doesn't qualify to be rolled over into an IRA.

**Tip:** Distributions from a Section 457 plan made pursuant to a QDRO are taxed under the same rules that apply to qualified plans.

# Choosing a Beneficiary for Your IRA or 401(k)

Selecting beneficiaries for retirement benefits is different from choosing beneficiaries for other assets such as life insurance. With retirement benefits, you need to know the impact of income tax and estate tax laws in order to select the right beneficiaries. Although taxes shouldn't be the sole determining factor in naming your beneficiaries, ignoring the impact of taxes could lead you to make an incorrect choice.

In addition, if you're married, beneficiary designations may affect the size of minimum required distributions to you from your IRAs and retirement plans while you're alive.

## Paying income tax on most retirement distributions

Most inherited assets such as bank accounts, stocks, and real estate pass to your beneficiaries without income tax being due. However, that's not usually the case with 401(k) plans and IRAs.

Beneficiaries pay ordinary income tax on distributions from 401(k) plans and traditional IRAs. With Roth IRAs and Roth 401(k)s, however, your beneficiaries can receive the benefits free from income tax if all of the tax requirements are met. That means you need to consider the impact of income taxes when designating beneficiaries for your 401(k) and IRA assets.

For example, if one of your children inherits $100,000 cash from you and another child receives your 401(k) account worth $100,000, they aren't receiving the same amount. The reason is that all distributions from the 401(k) plan will be subject to income tax at ordinary income tax rates, while the cash isn't subject to income tax when it passes to your child upon your death.

Similarly, if one of your children inherits your taxable traditional IRA and another child receives your income-tax-free Roth IRA, the bottom line is different for each of them.

## Naming or changing beneficiaries

When you open up an IRA or begin participating in a 401(k), you are given a form to complete in order to name your beneficiaries. Changes are made in the same way--you complete a new beneficiary designation form. A will or trust does not override your beneficiary designation form. However, spouses may have special rights under federal or state law.

It's a good idea to review your beneficiary designation form at least every two to three years. Also, be sure to update your form to reflect changes in financial circumstances. Beneficiary designations are important estate planning documents. Seek legal advice as needed.

## Designating primary and secondary beneficiaries

When it comes to beneficiary designation forms, you want to avoid gaps. If you don't have a named beneficiary who survives you, your estate may end up as the beneficiary, which is not always the best result.

Your primary beneficiary is your first choice to receive retirement benefits. You can name more than one person or entity as your primary beneficiary. If your primary beneficiary doesn't survive you or decides to decline the benefits (the tax term for this is a disclaimer), then your secondary (or "contingent") beneficiaries receive the benefits.

## Having multiple beneficiaries

You can name more than one beneficiary to share in the proceeds. You just need to specify the percentage each beneficiary will receive (the shares do not have to be equal). You should also state who will receive the proceeds should a beneficiary not survive you.

In some cases, you'll want to designate a different beneficiary for each account or have one account divided into subaccounts (with a beneficiary for each subaccount). You'd do this to allow each beneficiary to use his or her own life expectancy in calculating required distributions after your death. This, in turn, can permit greater tax deferral (delay) and flexibility for your beneficiaries in paying income tax on distributions.

## Avoiding gaps or naming your estate as a beneficiary

There are two ways your retirement benefits could end up in your probate estate. Probate is the court process by which assets are transferred from someone who has died to the heirs or beneficiaries entitled to those assets.

First, you might name your estate as the beneficiary. Second, if no named beneficiary survives you, your probate estate may end up as the beneficiary by default. If your probate estate is your beneficiary, several problems can arise.

If your estate receives your retirement benefits, the opportunity to maximize tax deferral by spreading out distributions may be lost. In addition, probate can mean paying attorney's and executor's fees and delaying the distribution of benefits.

## Naming your spouse as a beneficiary

When it comes to taxes, your spouse is usually the best choice for a primary beneficiary.

A spousal beneficiary has the greatest flexibility for delaying distributions that are subject to income tax. In addition to rolling over your 401(k) or IRA to his or her IRA, a surviving spouse can generally decide to treat your IRA as his or her own IRA. This can provide more tax and planning options.

If your spouse is more than 10 years younger than you, then naming your spouse can also reduce the size of any required taxable distributions to you from retirement assets while you're alive. This can allow more assets to stay in the retirement account longer and delay the payment of income tax on distributions.

Although naming a surviving spouse can produce the best income tax result, that isn't necessarily the case with death taxes. One possible downside to naming your spouse as the primary beneficiary is that it will increase the size of your spouse's estate for death tax purposes. That's because at your death, your spouse can inherit an unlimited amount of assets and defer federal death tax until both of you are deceased (note: special tax rules and requirements apply for a surviving spouse who is not a U.S. citizen). However, this may result in death tax or increased death tax when your spouse dies.

If your spouse's taxable estate for federal tax purposes at his or her death exceeds the applicable exclusion amount (formerly known as the unified credit), then federal death tax may be due at his or her death. The applicable exclusion amount is $5 million in 2011.

## Naming other individuals as beneficiaries

You may have some limits on choosing beneficiaries other than your spouse. No matter where you live, federal law dictates that your surviving spouse be the primary beneficiary of your 401(k) plan benefit unless your spouse signs a timely, effective written waiver. And if you live in one of the community property states, your spouse may have rights related to your IRA regardless of whether he or she is named as the primary beneficiary.

Keep in mind that a nonspouse beneficiary cannot roll over your 401(k) or IRA to his or her own IRA. However, a nonspouse beneficiary can roll over all or part of your 401(k) benefits to an inherited IRA.

## Naming a trust as a beneficiary

You must follow special tax rules when naming a trust as a beneficiary, and there may be income tax complications. Seek legal advice before designating a trust as a beneficiary.

## Naming a charity as a beneficiary

In general, naming a charity as the primary beneficiary will not affect required distributions to you during your lifetime. However, after your death, having a charity named with other beneficiaries on the same asset could affect the tax-deferral possibilities of the noncharitable beneficiaries, depending on how soon after your death the charity receives its share of the benefits.

# Divorce and Risk Management

## What is risk management and how is it relevant to divorce?

Risk may be defined as the possibility of harm, injury, loss, danger, or destruction. One option to help manage risk is to purchase sufficient insurance to pay for losses. Risk management is an important topic for separated or divorcing couples. When a divorce occurs, the selection of life and health insurance beneficiaries may have to be revised and, in some cases, insurance coverage may terminate. Because it's common for one spouse to maintain health insurance for the family, for example, the breakup of a marriage can have serious consequences for the nonworking spouse. Therefore, it's important to revisit the issue of risk management when a divorce seems likely.

## How will a divorce affect your health insurance coverage?

Often, one spouse participates in a group health insurance plan at work; typically, this plan will provide coverage for both spouses. When a divorce occurs, coverage for the nonemployee spouse may eventually end (unless the divorce decree requires a spouse to continue carrying coverage on the ex-spouse).

However, temporary protection may be provided by the Consolidated Omnibus Reconciliation Act of 1986, COBRA. This federal law was designed to protect employees of larger companies (20 or more workers) and their dependents from losing group insurance coverage as a result of job loss or divorce. If your former spouse maintained family health coverage through work, you may (at your own expense) continue this group coverage for up to 36 months after the divorce or legal separation. This COBRA coverage will terminate sooner than 36 months, if you remarry or obtain coverage under another group health plan.

> **Caution:** Bear in mind that COBRA doesn't apply to a group health plan if the employer maintaining the plan normally employs fewer than 20 employees on a typical business day. Also, certain governmental plans and church-sponsored plans are exempted from the act.

> **Caution:** Several states have enacted laws that preserve a spouse's eligibility for health insurance after separation and divorce. These laws may provide a former spouse with more generous rights than those provided under COBRA.

- Health insurance for you--When analyzing the issue of health insurance during divorce proceedings, you should consider whether it's cheaper to continue COBRA coverage, to purchase individual coverage, or to seek coverage from your own employer (if you're employed). For young homemakers with children and older homemakers who sacrificed career opportunities for domestic concerns, COBRA coverage and purchasing individual policies may be the only choices available. Keep the cost of insurance in mind. Individual policies are often more expensive than group policies, so COBRA coverage is certainly attractive. If you decide to exercise your COBRA rights, note that your cost of continuing COBRA coverage can't exceed 102 percent of the cost to the plan for providing identical benefits to an active participant. Additionally, be aware that you have the right to pay the premiums in monthly installments. For older persons, it may be wise to purchase individual health insurance or to insist, in the divorce agreement, that the working spouse maintain health coverage for you. Otherwise, when the COBRA coverage terminates after 36 months, you may find that poor health in your later years presents an insurability problem or that the cost of your insurance is exorbitant. Nevertheless, federal law may provide certain protection regarding pre-existing conditions.

- Health insurance for your children--When there are children born of the marriage, the child support section of the divorce agreement should address the issue of health insurance for the children--you need to assign responsibility for providing health insurance. A federal law, the Omnibus Reconciliation Act of 1993, provides some protection to those spouses who have custody of the children. This act provides for the existence of a court order that secures your children's continued health insurance coverage. This court order is called a Qualified Medical Child Support Order (QMCSO). In accordance with this order, custodial parents have the right to obtain health insurance coverage for the children through the noncustodial parent's group health plan (if any). The children can't be denied coverage by the noncustodial parent, that parent's employer, or that parent's insurance company based on any of the following reasons:

- The child doesn't live with the noncustodial parent
- The child isn't claimed as a dependent on the noncustodial parent's federal income tax return, or
- The child lives outside of the plan's service area

Along with covering an employee's child under an employer-sponsored health care plan, a QMCSO can require the following:

- Deducting the premium out of the employee's paycheck
- Making insurance reimbursements directly to the nonemployee parent (if that parent pays the provider), and
- Giving the nonemployee parent information requested regarding the health care plan and reimbursements

To qualify as a QMCSO, the court order must:

- Create the child's right to receive benefits under the group plan
- Specify the employed parent's name and last known mailing address and the names of each child covered by the plan
- Specify each plan and time frame to which the order applies, and
- Not require the plan to provide any additional benefits not actually provided in the plan

## How will a divorce affect your life insurance coverage?

When you get a divorce, you need to reconsider whom to name as the beneficiary of your life insurance policies. Perhaps you might wish to name your children as sole beneficiaries. If so, be aware that if your children are under age 18 when you die, the probate court will require that a guardian be appointed to manage the insurance proceeds until your children reach age 18.

You might also consider naming your ex-spouse as beneficiary of your life insurance policy. Although this may not be your preference, it may be required as part of your divorce agreement. Because alimony terminates on the death of the payer, for example, life insurance may be used as a tool to guarantee a stream of income if the alimony-paying spouse passes away. This is equally important to ensure that child support money will continue to be available. Often the parties will stipulate in the divorce decree that life insurance will be carried on the life of the payer to replace alimony and/or child support in the event of death.

In such cases, the recipient-spouse should either own the life insurance policy or be an irrevocable beneficiary in order to ensure payment of the premiums (and to create favorable tax treatment for the payer of the premiums, if alimony is involved).

> **Example(s):** Assume Liz was receiving $300 per month in alimony from her ex-husband, Frank. The court had ordered Frank to carry life insurance on his life (payable to Liz) for as long as alimony was required. After five years, Frank stopped paying his insurance premiums and the policy lapsed. When Frank died of a heart attack the next month, alimony payments ceased and Liz learned (for the first time) that there would be no life insurance proceeds forthcoming.

> **Tip:** If your divorce agreement stipulates that a new insurance policy will be purchased on the life of the working spouse (to secure alimony or child support), make sure that the working spouse applies for the policy before the divorce is final. That way, if he or she can't pass the physical exam and is uninsurable, there's still time to modify the final property settlement to make up for this problem.

## Should disability insurance be considered?

Another risk to your income is that you may become disabled or your ex-spouse (who is paying your support) may become disabled. During the discovery process of divorce, your attorney should uncover information about any disability plans at your spouse's place of employment.

While a former spouse can't own a disability policy on their ex-spouse, the former spouse can pay the premiums on the policy to ensure that it stays in force. Disability insurance is important and is a topic you may wish to address in your divorce agreement.

> **Example(s):** Assume Ken agreed to pay his ex-wife $2,000-per-month alimony, based on his $7,000-per- month salary. After the divorce was finalized, Ken suffered an accident and became disabled. If he has no disability insurance and no salary, he can go back to court to get his alimony obligation modified. If Ken has disability insurance, he might receive $5,000 per month tax-free and could probably continue paying the same amount of alimony.

## What about property insurance?

Real and personal property must be insured by the actual owner of the property. Therefore, applicable insurance policies must be modified or rewritten to reflect the proper owner as the insured. With respect to married homeowners, for example, the title is usually held by both spouses as joint tenants or as tenants by the entirety. In such cases, the death of one spouse will automatically vest the title to the other spouse. At the time of a divorce, a new deed should be drawn up to reflect the new arrangement and the homeowner's policy should be updated.

Divorce negotiations provide you with a number of choices regarding the house. For instance, the house can be sold immediately and the proceeds divided. Or, both spouses can continue to own the house jointly (with a view toward a future sale). Alternatively, one spouse can keep the house and buy out the other's interest. Finally, one spouse can be awarded the house without trading other assets in return.

Again, it's the divorce agreement that should address the issue of the title to assets and property insurance. In cases involving an older homemaker or a younger spouse who has custody of children, it's not uncommon for a judge to award the entire house to such a party and to order that the other spouse pay the mortgage, property taxes, and subsidize the homeowner's insurance.

# Insurance Concerns of Divorcing Couples

Few life changes are of more consequence than a divorce. In addition to the financial and emotional difficulties, you'll face special concerns about your insurance coverage. Planning for these changes should begin long before the divorce is final. The selection of life and health insurance beneficiaries may have to be revised. If you have children, many of your insurance concerns will center on whether you are granted custody. And because it's common while married for one spouse to maintain health insurance for the family, the breakup of a marriage can have serious insurance consequences for the other spouse, especially if he or she was not employed outside the home.

## Protecting alimony and child support payments

The spouse given custody of the children (custodial parent) should make sure that the life of the noncustodial parent is insured. If you're the custodial parent, you don't want to end up in a position where child support payments suddenly end because your ex-spouse dies. The same thing applies to alimony payments. Life insurance can protect you and your children in case of untimely death. Some agreements require the noncustodial parent to pay for a policy on his or her life and to name the custodial parent as beneficiary. Your agreement should also state that you periodically receive proof that the policy is still in force.

## If you're the custodial parent

If you're receiving alimony or child support payments, purchasing a life insurance policy on your former spouse is the easiest way to protect yourself and your children. If you can't get new insurance on your former spouse, have his or her existing policies transferred to you as the new policyowner and beneficiary. This can be planned as part of the divorce agreement. Make certain that you are designated as the outright policyowner or as the irrevocable beneficiary. If you have trouble paying the policy premiums, you can petition the court to have alimony and child support payments increased to cover the cost of insurance. The court may even require your former spouse to pay the premiums. In this case, monitor the policy periodically to make sure that the payments are being made.

## If you're the noncustodial parent

Even though you don't have custody of your children, you'll want to ensure that they are protected financially. You may also have certain responsibilities to your former spouse. Insure your obligations by paying for a new policy on your life for the custodial parent. That way, you can keep any policies you currently have and protect your children's future at the same time. The policy can be given to your former spouse free from gift tax if given either before or as part of the divorce agreement. If the policy is entirely in your former spouse's name, any premiums you pay will likely be considered alimony for income tax purposes and are tax deductible. You should also insure the life of your former spouse. Remember that if he or she were to die, you would most likely gain custody of the children, increasing your expenses dramatically.

## Naming life insurance beneficiaries at divorce

Changing the beneficiary on a life insurance policy is as easy as calling up the insurer and requesting the appropriate paperwork. You can designate any person or entity to be the beneficiary, although some states require that the beneficiary have an insurable interest in your life (i.e., someone to whom you have a financial obligation). But after a divorce, your choices may be somewhat limited.

If a court has ordered, for instance, that you must continue an existing policy with your former spouse as beneficiary, you cannot change it. If you're under no such constraints, however, your choice usually boils down to either your estate, your ex-spouse, or your children. Designating your estate as beneficiary will tie up the insurance proceeds in probate. And unless you need to protect alimony or child support payments, you probably have no need or desire to name your ex-spouse. Designating your children as beneficiaries may be your best course, but doing so can be very complicated if they are minors. One solution is to create a trust for the children and name the trust as beneficiary. Consult an experienced insurance professional before proceeding.

## Health insurance coverage and divorce

Often, one spouse participates in a group health insurance plan at work that provides coverage for both spouses. When a divorce occurs, coverage for the nonemployee spouse will often end, unless the divorce decree requires continuation of coverage. If there is no such requirement, temporary protection may be provided by the Consolidated Omnibus Budget Reconciliation Act (COBRA). This federal law protects employees of companies with 20 or more workers and their dependents from losing group insurance coverage as a result of job loss or divorce. Certain governmental and nonprofit enterprises are exempt. If your former spouse maintained family health coverage through work, you may (at your own expense) continue this group coverage for up to 36 months, or until you remarry or get coverage under another group health plan. Several states have enacted laws that may provide a former spouse with more generous rights than those under COBRA.

## Disability income insurance and divorce

If you receive alimony or child support, another risk to your income may arise if your former spouse becomes disabled. If he or she has no disability insurance and is unable to work, the court may modify the alimony and child support obligation, reducing or eliminating payments to you. With a disability policy, your ex-spouse will receive benefits each month and may be capable of paying the same amount of alimony and child support. Planning for disability insurance should be completed before the divorce is final. Unlike life insurance, you can't own a disability policy on someone else. So, the divorce decree may require that your ex-spouse pay the premiums on a policy and that you are entitled to regularly receive proof that the policy is in force.

## Property insurance and divorce

Real and personal property must be insured by the actual owner of the property (e.g., a car registered in your name must be owned by you). So, property insurance policies must be modified or rewritten to reflect the proper owner as the insured. Also, if a husband and a wife enter into an agreement covering their property rights, and divorce occurs within a specified period, all transfers of property are considered made for full consideration and are not subject to gift tax. With respect to married homeowners, the house can be sold immediately and the proceeds divided. Or, both spouses can continue to own the house jointly with a view toward a future sale. Another alternative is for one spouse to keep the house and buy out the other's interest. Or, the court may award the house to one spouse without trading assets while the title is held by both spouses. If the ownership is changed, a new deed should be drawn up to reflect the new arrangement, and the homeowners policy should be updated.

If you move into an apartment (even temporarily), you should buy renters insurance to cover your possessions.

# Life Insurance and Divorce

## What effect does divorce have on life insurance?

Like most of your financial planning objectives, your life insurance needs are related to the circumstances of your life. As your life goes through changes, your life insurance often needs to change with it.

No life change may be of more consequence than a divorce. In addition to the financial and emotional difficulties that often accompany divorce, there are special concerns about your life insurance. Generally, one spouse is the beneficiary of the other's insurance, and vice versa. So you have to think about whether to change your beneficiary and whom your new one will be. You also have to consider whether a new designation will have tax consequences. One thing is certain: A divorce will have an effect on your life insurance needs, and your policy must be updated to reflect them. Not all life insurance policies are just for death protection. You may have cash value policies such as whole life, universal life, variable universal life, or variable life that you've used to save for your children's college education or as a supplement to retirement. Divorce may not directly affect the savings side of your life insurance. Keep in mind, however, that the cash value of any savings may be considered part of the marital assets.

## New and continuing needs for life insurance

### *In general*

Early planning is essential for evaluating your new and continuing needs for life insurance. Your planning should begin long before the divorce is final. If you have children, protecting them will be one of your first concerns.

If you don't have children, protecting alimony payments that you are receiving may be on the top of your list. Life insurance could prove to be a beneficial protection. Your needs will differ depending on your post-divorce point of view. The parent who is responsible for the children (custodial parent) has different concerns than the parent who is not (the noncustodial parent). If you are a custodial parent, you should make sure that the life of the noncustodial parent is insured. You don't want to be in a position where the child support payments suddenly end because of the death of the parent responsible for paying them. The same thing applies to alimony payments. Life insurance can protect you and your children in case of the other parent's untimely death. If you are the noncustodial parent, you should insure the life of your custodial counterpart. If the other parent were to die, you would most likely gain custody of the children. This will increase your expenses dramatically, especially when multiple children are involved. Life insurance coverage can be used to help you protect your children's future.

## Protecting yourself as the former spouse who has no insurance

### *Purchase a new policy on the life of your former spouse*

Going out and purchasing a life insurance policy on your former spouse is the easiest way to protect yourself. You may not be able to afford it, however, or the other spouse may not be willing to go through the necessary physical examination and blood tests. The insurance company also has to agree that there is an insurable interest between former spouses.

### *Have existing policies transferred to you*

If your former spouse has an existing policy on his or her life, it can be transferred to you as the policyowner and beneficiary for the protection of your alimony/child support payments. This can be planned as part of the divorce agreement. It's also a good option when you can't obtain new insurance on your former spouse.

> **Tip:** Including this in a divorce agreement is generally a good idea with respect to gift tax planning. Generally, if a husband and a wife enter into an agreement covering their property rights and divorce occurs within a specified period, all transfers of property under the agreement are considered made for full consideration and, therefore, are not subject to gift tax.

### *Have alimony/child support payments increased to cover the cost of additional insurance*

If you receive alimony payments, you can seek an increase in the amount of alimony paid by your former spouse by the amount necessary to insure his or her life. The insurance likely cannot be issued unless your former spouse agrees to be insured.

> **Caution:** The downside is that when you receive alimony payments, they are included as taxable income to you and can end if you remarry or die.

If you receive child support payments, you can similarly seek to have them increased to cover the cost of life insurance. From the custodial parent's point of view, it's better to have the payments categorized as child support because they are not included as income to the custodial parent. The decision as to whether the payments are alimony or child support has to be worked out between you and your former spouse. This can, and should, be planned for in the divorce agreement.

## Protecting your children as the parent who has insurance

### *Have the insurance proceeds paid to your child*

Using the proceeds of your life insurance policy to protect your children is an obvious and practical planning choice. What's not so obvious is how to use your existing policy in a way that is most beneficial to you and your child.

### *Purchase a policy on your life for the custodial parent*

If you are the noncustodial parent, a second option is to purchase a new policy on your life for the custodial parent. This way you can keep any policies you currently have and protect your children's future at the same time.

> **Tip:** The benefit of this choice is that the policy can be given to your spouse free from gift tax if given either before or as part of the divorce agreement.

> **Tip:** If the policy is entirely in your former spouse's name and you have no incidents of ownership with respect to the policy (i.e., you don't retain any control of the policy in the event of contingencies, such as death or remarriage), you can pay the premiums on the policy and the premiums will likely be considered alimony and deductible for income tax purposes. The court decides many of these alimony/child support issues.

> **Caution:** If you purchase a new policy for your former spouse, you won't be able to control who is designated beneficiary. Other options may provide you with more control.

## Beneficiary designation issues

### *In general*

If you have a policy that designates your former spouse as beneficiary, the first thing you will probably want to do is change the designation. Before you do, there are beneficiary designation issues to consider.

Generally, the divorce itself will not remove your former spouse as the beneficiary, so you need to take action if you wish to change the beneficiary. If a court has ordered you to maintain an existing policy in favor of your former spouse, you cannot change it. Changing the beneficiary is usually as easy as calling up the insurer and requesting the appropriate paperwork. Occasionally, a physical endorsement will also be required.

### *Who to designate as beneficiary*

You can generally designate any person or entity to be the beneficiary of your life insurance proceeds. The choice, however, typically boils down to either designating your estate or your children.

> **Caution:** Designating your estate as beneficiary may tie up the insurance proceeds in probate and may cause the insurance to be subject to estate taxes.

If you have children, it's a good idea for you to designate them as your beneficiaries. This may not be as simple as it seems, however. There are many different ways to go about it, and each has various benefits and drawbacks. Four options are illustrated in the following table:

*Children As Beneficiaries of Life Insurance--The Options*

| | Option | Benefits | Drawbacks |
|---|---|---|---|
| 1. | Name your child beneficiary of your existing life insurance | • Easy to create<br>• Inexpensive | • Proceeds are includable in your gross estate at death<br>• Problematic for younger (minor) children<br>• No control over how the proceeds are used |
| 2. | Purchase an insurance policy on your life in your child's name | • Inexpensive and easy<br>• Takes the proceeds of the insurance out of your gross estate<br>• You can gift money to the child to pay the premiums (tax free up to the annual gift tax exclusion amount) | • Possible gift tax repercussions (depending on the cash value of the policy)<br>• Minor children may not be able to own the policy<br>• No control over how the proceeds are used |
| 3. | Set up a trust to receive the insurance proceeds for the benefit of your child | • Great if you have young children<br>• Greater control over how the proceeds are used<br>• Easier to plan for multiple children | • Proceeds are includable in your gross estate at death<br>• Involves cost to create (legal fees) and to maintain (trustee costs); means less money for your children |
| 4. | Set up an irrevocable trust to purchase life insurance on your life for the benefit of your child | • Great if you have young children<br>• Greater control over how the proceeds are used<br>• Easier to plan for multiple children<br>• Takes the proceeds of the insurance out of your gross estate, assuming that you retain no incidents of ownership<br>• You can gift money to the trust to pay the premiums (tax free up to the annual gift tax exclusion amount and beneficiary has Crummey power) | • Possible gift tax repercussions (depending on the cash value of the policy)<br>• Even more expensive to create (legal fees) and to maintain (trustee costs), because it's in existence longer than option 3 |

# New and Continuing Needs for Life Insurance in Divorce

## What is it?

You and your spouse have recently divorced or are planning to divorce. Either one of you may have life insurance policies in effect, and you probably have questions about your new and continuing needs for life insurance. You may be wondering if you still need to have life insurance coverage at all. More likely, you're wondering whether you will need additional insurance to protect your alimony or child support payments.

While married, you purchased life insurance as protection in case of the untimely death of yourself or your spouse. After a divorce, life insurance is still valuable protection for yourself and your family. Many of the concerns you shared while married will still apply after divorce. Almost as certainly, divorce will also create new concerns for you and your family.

## Protecting your children

### *Insure the life of noncustodial parent*

Much of the reason you purchased life insurance in the first place may have been to protect your children. The death of the parent responsible for child support payments could have a devastating impact on your children's financial future. The lost income could mean financial hardships for children who are dependent on the support for their basic needs and educational expenses. You will likely want to ensure that there is a sufficient amount of insurance on the life of the support-paying spouse to protect the children's financial future.

### *Change the beneficiary designation*

Divorce may also create beneficiary designation issues. Your former spouse is often the beneficiary of your life insurance policy. Many people overlook the need to change the designation after a divorce--in fact, it should be one of the first things you do. Designating your child as the beneficiary is one option; designating your estate is another.

> **Caution:** Designating the estate isn't as beneficial, however, because it could greatly increase the value of your estate and, thus, increase the potential estate tax exposure at the time of your death. As long as you live for three years after the designation, making your child beneficiary of an irrevocable life insurance trust can avoid these estate tax consequences. See Introduction to Estate Planning for more details.

## Protecting your alimony/child-support payments

### *In general*

If you are receiving alimony or child support payments, you should protect those payments by insuring the life of your former spouse. Support payments can be critical to your own well-being, as well as to your children's. There are some options.

### *Be named the beneficiary of your former spouse's policy*

As part of the divorce settlement, the easiest option is to be named the beneficiary of any existing policies on your spouse's life. This will protect you in the event of your former spouse's untimely death.

> **Caution:** Be aware that you will have no real control over the policy. The problem is that if your former spouse still owns the policy, anything can happen. He or she may take loans on the policy or fail to pay the premiums. There is more than one story in the big city of an unscrupulous spouse changing the beneficiary designation or taking a loan on the policy, leaving an unsuspecting former spouse with little or no protection.

*Have existing life insurance policies transferred to you*

Having the policy transferred or assigned to you can be a valuable alimony-protection tool. When you own the policy, you are protected from your former spouse taking loans or making any other changes to it. Another benefit of ownership is that the insurance company notifies you if the premium is not paid on time. Such a transfer should be part of the divorce agreement to avoid gift tax consequences.

You may also be able to have the divorce agreement require your former spouse to continue paying the premiums on the policy transferred to you. Depending on the cost of the premiums, this can be a big help. If there's some controversy over who will pay the premiums, think of it this way: If you pay them, you have the peace of mind to know that they are being paid in a timely fashion. Moreover, if your former spouse pays the premiums, they will likely be considered alimony and, therefore, taxable to you. More on tax considerations later.

*Purchase additional insurance on your former spouse*

As a slightly more difficult option, purchasing a policy on your former spouse can give you the protection you need along with much more control than if you are just the designated beneficiary. If it's too late to make any changes to the divorce or separation agreement, purchasing a separate insurance policy on the life of the former spouse may be your only option for protecting your alimony payments.

> **Caution:** Buying life insurance can be an expensive proposition, especially if your former spouse is older or in poor health.
>
> **Caution:** An unwilling ex-spouse may not go along with extensive physical examinations or underwriting that may be required to purchase a new policy. It's a good idea to make sure that the former spouse is willing to be insured before relying on this option.

*Seek to have the alimony/child-support payments increased to cover the cost of additional insurance*

It may be the most beneficial option for both of you to increase the alimony or child-support payments by the amount necessary to pay for a new policy. You and your spouse can agree to this as part of the divorce settlement. This option gives you total control over the policy while at the same time protecting your alimony/child support payments.

> **Caution:** Remember that the alimony payments you receive are considered taxable income to you and are deductible by your former spouse. Notice the tax consequences in the following example.
>
> **Example(s):** As part of their divorce agreement, John's former spouse, Mary, is required to pay $500 per month in child support to John for their daughter, Abby (whom John has custody of) until she reaches age 18. Abby is 8 years old. The parties agree in the divorce settlement that the $500 includes the cost of a 10-year term life insurance policy on Mary's life. Results: (1) The child support payments are protected until Abby reaches age 18, when they are to end normally, (2) Mary is happy because term life insurance is inexpensive, and (3) John is happy that the additional child support payments are not taxable to him as income.

## Protecting yourself as the noncustodial parent

*Insure the life of the custodial parent*

Insuring the life of the custodial parent can protect you and the well-being of your children. If the custodial parent dies, you're the one who will have to take custody of the children. Financially, this could be a very difficult situation. All of the costs of raising the children will now fall on you as the only parent. From basic needs to higher education, these costs can be extensive. A policy on your former spouse's life can prove invaluable in meeting these costs.

## Options if you have remarried

### *Qualified terminable interest property (QTIP) trust*

If you have remarried, a QTIP trust can be a great method for supporting your new spouse, protecting children of a prior marriage, and deferring estate taxes. Upon your death, a QTIP trust holds assets for the benefit of your current spouse for his or her life and then pays the remaining funds to a third person (typically your children) designated by you. Since the transfer is between spouses, gift taxes are avoided because the amounts used to fund the QTIP trust fall within the unlimited marital deduction. The QTIP trust also defers possible estate tax on the trust amount until the death of the surviving spouse.

> **Caution:** The potential downside of the QTIP trust is that the children (or whomever you designate) will not be able to make use of the assets until the death of your spouse.

## What are the tax considerations?

### *The gift tax applies to transfers and purchases of insurance policies*

As part of the divorce settlement, you may decide to transfer your existing life insurance policy or purchase a new policy for your spouse or children.

> **Caution:** Transfer of an existing cash value policy to your ex-spouse or your children may entail a substantial federal gift tax.

> **Tip:** If the policy is transferred to your former spouse prior to--or as part of--the divorce, gift taxes are avoided because the transfer is between spouses. A little pre-divorce planning can go a long way.

### *Can the payment of insurance premiums be considered alimony?*

The payment of insurance premiums can be considered alimony under certain circumstances. Payments that are considered alimony are deductible by the payor (the person making the payments) and includable as taxable income to the payee (the person receiving the payments). So, if the premium payments are considered alimony, the payor spouse gets a tax benefit.

Generally, premiums paid by the payor spouse for life insurance on the payor's life made under the terms of the divorce or separation instrument will qualify as alimony to the extent that the payee spouse is the owner of the policy. For the payment of premiums to be considered alimony, the beneficiary spouse must be made the owner and the irrevocable beneficiary of the policy. There cannot be any contingencies. For example, an agreement to pay insurance premiums until the payee spouse remarries or dies is a contingent one and, therefore, not tax-deductible as alimony.

> **Tip:** If you can plan it ahead of time, it is better for the payor to agree to increase the amount of cash alimony paid by the amount necessary for the payee spouse to secure insurance on the payor's life and pay the premiums. This will be deductible as alimony by the payor and can be limited to contingent circumstances, such as remarriage or death. This solution serves both spouses' interests by creating a tax deduction for the payor and giving the payee complete control over the insurance policy.

> **Example(s):** Spouse A agrees to an alimony payment of $500 per month until Spouse B dies or remarries. Spouse B agrees to purchase insurance on the life of A with the money paid in alimony. Consequences: Spouse A receives a $6,000 ($500 X 12) income-tax deduction for alimony payments. Spouse B gets $6,000 additional income for income-tax purposes but also gets a substitute for the lost alimony if Spouse A dies.

# Life Insurance Beneficiary Designation Issues in Divorce

## What is it?

You are (or are about to be) divorced, and you have life insurance that most likely designates your former spouse as the beneficiary. You've decided to keep your current policy. Should you change your beneficiary? If you have children, should they be your beneficiaries? If you do change the beneficiary, are there tax repercussions? There are many options to weigh when deciding who will be your beneficiary. Care should be taken to ensure that you make the most informed choice possible.

## What factors affect your designation of beneficiary?

### *The beneficiary doesn't automatically change*

Many married couples name each other as beneficiaries on their life insurance policies. This is a perfectly acceptable thing to do. In a majority of states, the designation of the spouse, by name, as beneficiary, entitles that spouse to the proceeds of the insured spouse's policy, even if they are divorced. This rule is true even if the former spouse remarries.

This could be a problem for you. Most divorced people don't want their ex-spouse to receive the benefits of their life insurance policy. If you fit that description, you need to change the beneficiary designation on your policy.

> **Caution:** In a few states, divorce automatically revokes a beneficiary designation that names the ex-spouse. Check your local jurisdiction for more information.
>
> **Tip:** If your life insurance is provided as part of an Employee Retirement Income Security Act (ERISA) plan, state law is preempted and only the specific terms of the plan will control. In that case, you don't have to worry about state law affecting your beneficiary designation.

### *The divorce decree*

A divorce settlement may require that you maintain life insurance in favor of your ex-spouse as beneficiary. In these situations, deciding whether to change your beneficiary is easy: You can't. If you plan correctly though, the premiums you pay may be considered alimony and as such deductible for federal income tax purposes. For more information, see New and Continuing Needs for Life Insurance.

### *Your estate as beneficiary*

If you have living family members, naming your estate as the beneficiary is not usually a good idea. One of the great benefits of life insurance is that the death benefit is immediately (usually within a few days) paid to your family at the time of your death. When the benefit is payable to your estate, depending on the size of your estate, it may have to go through probate along with all of your other assets. This can tie up the money for as long as a year or possibly even longer.

## Changing the beneficiary designation

The owner of a life insurance policy generally has the right to change the beneficiary designation as often as is desirable (assuming, of course, that the owner of the policy has not transferred that right).

### *It always has to be in writing; sometimes it has to be endorsed*

Following the particular protocol of your insurance policy is essential. All insurers require that a beneficiary change be in writing. This is usually as easy as calling the insurer and requesting the proper paperwork. Some require that an endorsement be made to the policy itself. Endorsement is the physical act of changing the policy to reflect a new beneficiary. This is often done by adding a change of beneficiary designation to the existing policy.

### *What if you can't get the policy endorsed?*

A common problem with the endorsement method of changing the beneficiary is that the beneficiary you want to replace (your ex-spouse) may have possession of the policy and refuse to release it. If the final divorce order requires that the beneficiary not be changed, you have no legal right to change it. But if there is no such order and the existing beneficiary wrongfully refuses to release the policy, the endorsement requirement can be bypassed. Notify your insurer and complete all the necessary forms. The change will be effective once all forms are complete.

## Children as beneficiaries

### *In general*

If there are children involved in your prior marriage, protecting them should be a priority. Much of the reason you purchased life insurance in the first place probably was to protect your children. Divorce may create additional needs, too. The death of the parent responsible for child support payments could have a devastating impact on your children's financial futures. See New and Continuing Needs for Life Insurance.

Using life insurance to protect your children is an obvious and practical planning choice. There are a number of different ways to achieve it, however. The options range from the easy (e.g., naming your child as beneficiary of an existing insurance policy) to the more difficult (e.g., setting up a life insurance trust to purchase the policy on your child's behalf). Following are four basic options.

### *Designate your child as the beneficiary of your existing policy*

The easiest way to protect your children is to designate them as the beneficiaries of your existing life insurance policy. Changing the designation is usually easy to do. Upon your death, the proceeds are paid directly to the child you designate. If the child is not old enough to receive the proceeds, a custodial account can be set up to receive the funds on the child's behalf.

The first drawback is that the death benefit proceeds paid from your policy are includable in your gross estate at death, which could mean estate tax burdens. Second, it may be difficult for you to make a single designation that accounts for multiple children, especially if there are children of a prior marriage involved. And third, you have no control over how the proceeds are used. Naming a beneficiary merely directs who gets paid.

### *Purchase an insurance policy on your life in your child's name*

As a second option, you can acquire additional insurance on your life in your child's name. This option is slightly more involved, because you may have to go through a medical examination and underwriting. The benefit of purchasing the policy in your child's name is that at the time of your death, the proceeds will not be included in your taxable estate. Any policies you own at the time of your death are considered assets for estate tax purposes. If the child owns the policy, these taxes can be avoided. But note, there may be gift tax implications if you transfer an insurance policy from yourself to your child. When a life insurance policy is transferred from the original insured to a beneficiary, this transaction is deemed a gift and may be subject to gift tax.

> **Caution:** In some instances, a child may not be able to be the owner of the policy if he or she is a minor. The age of majority differs from state to state, so check your local jurisdiction.
>
> **Tip:** During your lifetime, you can use the annual gift tax exclusion as a tax-free way to give money to your child. The child can then use this money to pay the premiums for an insurance policy on your life. This will protect your children's future while decreasing your tax burdens. For more information, see New and Continuing Needs for Life Insurance.

There are drawbacks to this choice. First, you have no real control over how the funds are used. Second, it won't work for minor children.

### *Set up a trust to be funded by the proceeds of your policy*

A third option is to set up a life insurance trust to receive the proceeds of your life insurance.

A trust has advantages because it provides flexibility in determining how insurance proceeds are paid after death. The trust, for instance, can provide for a spouse, a child, or multiple children. If the beneficiary is a minor at the time of your death, the trustee can be directed to invest the proceeds into specific investments until the child reaches a particular age. A trust is simply much more flexible than most life insurance contracts.

> **Caution:** Setting up a trust requires payment of legal costs to an attorney to draft the document and paying a trustee to administer it.

### *Set up an irrevocable life insurance trust to purchase a policy on your life*

Perhaps the best option is to set up an irrevocable trust to purchase a policy on your life with your child named as beneficiary. This option has the benefits of trusts that were mentioned previously. It offers much flexibility. In addition, assuming that you retain no incidents of ownership in the policy, the proceeds of the insurance may not be includable in your taxable estate. If you give your beneficiary Crummey powers of withdrawal, your annual gift tax exclusion can be used to give the trust the money to pay for the premiums tax free.

The drawbacks? Well, it is irrevocable. Moreover, it costs money to set up a trust. You have to pay lawyer's fees, the trustee's fees, and possibly other expenses. Setting up a trust to purchase and manage the insurance is probably going to cost even more because it will have to manage the policy while you're alive and handle the proceeds when you're dead. Time is money when it comes to trusts. To summarize:

*Protecting Your Child with Life Insurance - The Options*

| | Option | Benefits | Drawbacks |
|---|---|---|---|
| 1. | Name your child beneficiary of your existing life insurance | • Easy to create<br>• Inexpensive | • Proceeds are includable in your gross estate at death<br>• Problematic for younger (minor) children<br>• No control over how the proceeds are used |
| 2. | Purchase an insurance policy on your life in your child's name | • Inexpensive and easy<br>• Takes the proceeds of the insurance out of your gross estate<br>• You can gift money to the child to pay the premiums (tax free up to the annual gift tax exclusion amount) | • Possible gift tax repercussions (depending on the cash value of the policy)<br>• Minor children may not be able to own the policy<br>• No control over how the proceeds are used |
| 3. | Set up a trust to receive the insurance proceeds for the benefit of your child | • Great if you have young children<br>• Greater control over how the proceeds are used<br>• Easier to plan for multiple children | • Proceeds are includable in your gross estate at death<br>• Expensive to create (legal fees) and to maintain (trustee costs); means less money for your children |

| | | | |
|---|---|---|---|
| 4. | Set up an irrevocable trust to purchase life insurance on your life for the benefit of your child | • Great if you have young children<br>• Greater control over how the proceeds are used<br>• Easier to plan for multiple children<br>• Takes the proceeds of the insurance out of your gross estate, assuming that you retain no incidents of ownership<br>• You can gift money to the trust to pay the premiums (tax free up to the annual gift tax exclusion amount, if beneficiary has Crummey power) | • Possible gift tax repercussions (depending on the cash value of the policy)<br>• Even more expensive to create (legal fees) and to maintain (trustee costs), because it's in existence longer than option 3 |

## Life insurance proceeds and your taxable estate

### *In general*

When you die, the life insurance proceeds may be includable in your taxable estate. Generally, life insurance proceeds are includable an estate in the following situations:

- When the proceeds are to be paid to the estate
- When the proceeds are receivable for the benefit of the estate
- When gifts of the policy have been made within three years of death
- When incidents of ownership have been retained in the policy at the time of death

### *Transfers at divorce and estate taxes*

Sometimes, the divorce agreement will provide that you must transfer an existing policy to your spouse or that you must name your former spouse as the beneficiary of your policy. A straight transfer of your existing policy to your former spouse, who becomes the policyowner, gives that spouse total control over the beneficiary designation. You are not able to make the designation contingent on, for example, your former spouse's death or remarriage.

When the divorce decree requires that you name your former spouse as beneficiary, it could result in increased estate taxes or complicated situations if you attempt to avoid them. If you want to avoid having the proceeds included as part of your taxable estate, you must not retain any "incidents of ownership."

> **Tip:** The best way to do this--while at the same time keeping some control over how the proceeds will be used--is to set up an irrevocable life insurance trust.

You can fund this trust tax free by using your annual gift tax exclusion. The money you gift to the trust can be used to pay the premiums on the policy. The best part of a trust is that when you set it up, you can designate who will be paid and under what circumstances. To have the proceeds not included in your taxable estate, the trust needs to be irrevocable (i.e., you can't change the beneficiary down the road), and the proceeds cannot be payable to your estate.

> **Tip:** Be sure to name alternate beneficiaries (i.e., your children) in case your former spouse dies before you.

Only gifts of present interest qualify for the annual gift tax exclusion. The problem is that when you give money to the trust, it's not really a present interest for the beneficiaries. If you want the payments you make to the trust to qualify as a gift of present interest, a beneficiary must be given a Crummey power. The Crummey power gives the beneficiary the right to withdraw funds from the trust for a short period of time after each annual gift is made (typically 15 to 30 days). This limited right of withdrawal is enough to make your gift to the trust qualify as a present interest. See Crummey Powers for more information.

**Example(s):** As part of her divorce agreement, Melissa creates an irrevocable trust that is to be funded by a life insurance policy on her life. She directs the trustee that upon her death, the insurance proceeds are to be paid to her former spouse, Mark, if he is alive and unmarried. If he is not, then the proceeds are to be paid to the Museum of Art. If she gives Mark a Crummey power, Melissa can use her annual gift tax exclusion to gift money for the policy premiums to the trust. Results: (1) Mark is protected in case of Melissa's untimely death, (2) Melissa can make the proceeds payable to Mark only if he has not remarried or died, and (3) the proceeds are not included in Melissa's taxable estate.

# Divorce and Estate Planning

## How does divorce affect estate planning?

Wills for both spouses are often drawn up sometime during the marriage--particularly if there are children involved. When divorce is contemplated, the selection of beneficiaries and executors will likely be revised to reflect the absence of your former spouse. Additionally, you will need to re-examine the gift and estate tax aspects of your estate plan. For these reasons, many divorcing couples revise their estate planning documents during the period of separation or soon after the divorce has been finalized.

## What should you be concerned about during the separation period?

If divorce proceedings have begun, it's important to draft a formal separation agreement as soon as possible, establishing the spouses' rights regarding property, debts, temporary alimony, child support, and child custody. When drafting the provisions, you (or your attorney) will want to consider the possibility of your spouse dying prior to entry of the final divorce decree. You may wish to make the agreement binding on heirs and assigns so that the obligations will continue if one party dies.

If you expect to receive alimony and child support from your spouse, you may want to require (in the separation agreement) that your spouse buy a life insurance policy (or keep the existing one in force), naming you as the beneficiary. The policy should be in an amount sufficient to cover the sum of support obligations and property distribution payments contemplated. You could even be named as the owner of the policy insuring your spouse's life.

Similarly, your agreement might require your spouse to maintain minimum will provisions in favor of you (and/or your children). Often, the parties to a separation agreement include a provision that both waive the right to elect a share of the estate of the other in the event that one party dies before the divorce decree is entered. For more information about elected shares, see our separate topic discussions, Surviving Spouse's Elective Share and Probate.

## When revising your estate plan, which areas require particular note?

First of all, you should make the necessary changes in your will or other estate planning documents to ensure that your former spouse isn't named as your personal representative, successor trustee, beneficiary, or holder of the power of attorney. A new will will likely be drafted during the separation period. Note that in some states, wills drawn up during a marriage are considered void after a divorce unless specifically ratified after the divorce. This means that intestacy rules would apply, instead of the will being controlling.

Next, consider gift tax implications if funding your children's education is required by your property settlement. Although your direct tuition payments (even for adult children) are exempt from gift tax when required by a property settlement agreement, be aware that your payments for related educational expenses (e.g., books and room and board) may be subject to gift tax.

> **Example(s):** Liz and Frank have a daughter, Carol. Carol has reached the age of majority under state law. When the couple divorced, Frank agreed (as part of the settlement) to pay for Carol's college tuition, books, room, and board. During the year, Frank pays $20,000 tuition directly to Carol's university, and he gives Carol $15,000 in cash for living expenses. The tuition isn't a taxable gift, but the $15,000 in cash will be treated as a taxable gift.

Finally, consider the absence of the unlimited marital deduction. A deduction is allowed for qualifying transfers to one's spouse during lifetime or at death. Because this gift and estate tax deduction is one of the most important estate planning tools for married couples, your loss of this tool at divorce can affect your tax situation adversely when you die.

# Prenuptial Agreements

## What is it?

### *Definition*

A prenuptial agreement (also known as a premarital agreement, antemarital agreement, or prenup) is a binding contract executed by prospective spouses to define the rights, duties, and obligations of the parties during marriage and in the event of legal separation, annulment, divorce, or death.

### *What issues are addressed in a prenuptial agreement?*

A prenuptial agreement should include you and your spouse's decisions in four basic areas:

- Assets and liabilities--What assets are you each bringing into the marriage? How much are they worth? Who owns them? Which ones will become marital property and which ones will continue to be owned by you or your future spouse individually? Will gifts and inheritances be shared or kept separate? What liabilities do you each have, such as back taxes or other debt?

- Divorce--Will there be alimony or a lump-sum payment? Will you divide or exempt appreciation of assets brought to the marriage? How will you divide assets purchased from joint funds?

- Estates--What will go to children from a previous marriage or children you may have in the future? Who gets what after either spouse dies?

- The contributions of each partner--How will you compensate for special contributions, such as one spouse limiting a career or losing pension benefits due to childrearing responsibilities? How will you compensate for one spouse bringing in more liabilities to the marriage?

## When can it be used?

### *Draw up a prenuptial agreement before you get married*

Financial planners generally recommend that couples consider entering into a prenuptial agreement before marriage if they have substantial assets (especially if there is an imbalance in their assets), if one or both may inherit substantial assets, or if they have children from previous marriages. Small-business owners and the elderly are also strong candidates for prenuptial agreements, as well as couples in which one spouse will be supporting the other spouse through professional school (e.g., law or medical) so that the supporting spouse will share fairly in the professional's future income.

If the prospective spouses are young and have comparable net worths, an agreement may provide little benefit. As a precaution, however, most couples should at least discuss the issue with a financial advisor before getting married.

## Strengths

### *Protects your premarital property*

If you combine your assets with those of your spouse after you get married, you risk losing them in the event of divorce. To preserve your premarital property, keep all of your assets in your own name after you are married and designate ownership of your property in a prenuptial agreement. Keep in mind that joint ownership can make your assets marital property, which is subject to a property settlement.

### *Enables you to provide for your family members*

A prenuptial agreement can give you the security of knowing that your loved ones will be provided for in the manner in which you intend. If you have children and decide to remarry, such an agreement can ease the fears of your children over how your estate is going to be divided.

A trust is a particularly useful tool in remarriage when you want to provide for your spouse after you die, but make sure your money ultimately goes to your own children, not your spouse's children. When used in conjunction with a prenuptial agreement, a trust eliminates or greatly reduces the possibility of a challenge by your spouse or other heirs, reduces legal costs, and avoids scrutiny by the court.

### *Reduces or avoids litigation costs*

Considerable amounts of money can be lost by both spouses when divorce proceedings turn into a long, messy battle. By explicitly stating how property should be divided in the event of divorce, however, both sides can greatly reduce the fees charged by attorneys, expert witnesses, and appraisers. A prenuptial agreement can also reduce litigation costs associated with contesting the will of a deceased spouse.

> **Caution:** Litigation costs may be a factor, however, if there is a breach of contract claim associated with the prenuptial agreement during divorce proceedings.

### *Offers you protection against your future spouse's creditors*

If your future spouse incurred substantial debt prior to marriage, you may wish to protect your assets from his/her creditors. This can be accomplished in a prenuptial agreement by having your future spouse waive any claims to your assets, except in the event of divorce or death.

Another option is to set up a trust in conjunction with a prenuptial agreement. Assets placed in the trust prior to your marriage would not be owned jointly with your spouse and could not be considered marital property. Your spouse's creditors would therefore have no claim on your assets, but your own creditors might be able to go after them.

### *Enables you to protect your business assets*

In cases where a business is owned by a small number of parties (e.g., a closely held business or a partnership), the owners may wish to prevent a spouse from obtaining voting rights or claims against the business. In such cases, the owners can enter into an agreement that requires each, in the event that they marry, to execute a prenuptial agreement in which the prospective spouse waives all rights to the owner-spouse's interest in the business in the event of divorce or death.

The co-owners may also wish to enter into a buy-sell agreement, whereupon the death of a shareholder or partner, the remaining owners would be required or given the first option to purchase the decedent's interest in the business for a specified amount over a specified period of time.

## Tradeoffs

### *Prenuptial agreements can become outdated*

What was fair the day you got married could be completely unfair a few years later. The birth of children that requires one spouse to leave work, or a move that is advantageous to one spouse and detrimental to the other, are examples of changes that could affect the fairness of the agreement. Once the balance shifts, a judge is likely to void the contract, and his or her determination of fairness--not yours--will prevail.

The good news is that, like any legal contract, a prenuptial agreement can be amended or modified to meet your or your spouse's needs as conditions change during the marriage.

> **Tip:** As a precaution, review and update your prenuptial agreement every few years or following significant events such as a change in economic circumstances or the birth of children.

***Relationships between your future spouse or family members may be damaged***

Prenuptial agreements are far less likely to damage relationships between couples and their families when they are negotiated for people who have been previously married and who have children from previous marriages. In these cases, each party has loyalties to third parties--usually their children--and each has a legitimate interest in protecting the rights of their children to inherit his or her estate.

A more difficult situation can arise when a prenuptial agreement is negotiated between two people who have never been married before and have no children or third parties they are obligated to support. In such cases, the agreement is often negotiated at the suggestion of the parents, whose concern may be to minimize any financial risk incurred by their child as a result of his or her marriage. In this case, a family's suggestion to create an agreement could be construed as hostility or distrust.

***Prenuptial agreements aren't cheap***

A lawyer might charge you $750 for a simple prenuptial agreement, but the majority of agreements are fairly complex and cost between $3,000 and $5,000.

> **Tip:** The price may be worth it, since a contested divorce could be far more costly, both in legal fees and emotional strain.

## How to do it

***Allow plenty of time between the signing of the prenuptial agreement and the wedding***

In order for a prenuptial agreement to be valid, it should be written only after you and your future spouse have had enough time to negotiate satisfactory terms. In other words, the longer the time between the signing of the agreement and your wedding, the better. If you wait until the night before the wedding to give your future spouse a prenuptial agreement to sign, it probably won't be considered valid later on, should it be contested. Time may also be needed to properly value assets such as a small business.

***Obtain independent counsel***

Although there is no requirement that you and your spouse be represented by separate attorneys when drafting a prenuptial agreement, both parties must be offered the opportunity to retain independent counsel. Be aware, too, that a judge may scrutinize the agreement more carefully when one attorney represents both parties. Both you and your prospective spouse should therefore have your own lawyers: If your attorney handles everything for both you and your prospective spouse, a court will probably rule that your spouse was not adequately represented, and the prenuptial agreement will be disregarded.

Prenuptial agreements drawn up without an attorney's help may or may not hold up in court. However, certain variables within a prenup that an attorney would know to look out for could be overlooked by a couple drawing up an agreement alone.

***Provide full and accurate disclosure of financial information***

The key to a solid prenuptial agreement is full and fair disclosure of you and your future spouse's income, assets, and liabilities. By presenting an accurate snapshot of your respective financial positions before you are married, you will both be able to track the asset gain or loss and come to a fair decision in the event of divorce.

> **Caution:** If you are getting divorced and your spouse uncovers assets that you did not declare in your prenuptial agreement, a court may not uphold the contract. For this reason, lawyers often advise wealthy clients to overestimate their net worth rather than minimize it when drawing up a prenuptial agreement. Usually, both prospective spouses will exchange financial statements listing all assets and sources of income. This information can be obtained from sources such as bank statements, cancelled checks and old check registers, savings account passbooks, income tax returns (both personal and business), estate and gift tax returns, financial reports, loan applications, and income and balance sheets for a business. Both parties must also be thorough about disclosing any debts and financial obligations, including child support, alimony, or back taxes.

### *Make sure the agreement is free of any hint of duress*

The court is likely to throw out any agreement that it determines was made under emotional stress, physical or mental disability, or threat of force. Many lawyers will videotape the signing of the agreement to show that both sides were fully aware of what they were doing and acted of their own free will.

> **Example(s):** Amusement park developer Ronald Bump has decided to marry his girlfriend Darla, an aspiring acrobat. Having lost a substantial portion of his multimillion-dollar fortune to his first wife, Imelda, however, Ronald has a prenuptial agreement drawn up that would allow him to hold on to his remaining assets if his marriage to Darla fails. Although she is deeply in love with Ronald, Darla feels pressured and is uncertain about signing the agreement. "Why would Ronald do this to me two weeks before our wedding?" she asks Bumpy the Clown. "After all," she rationalizes, "he left Imelda to be with me--and our twins are due in less than a month!" Bumpy tells her that Ronald probably wants to make sure that she and the babies are properly taken care of in the event of his death, and Darla reluctantly signs the agreement two days before marrying Ronald at the Bumptown U.S.A. theme park.

> **Example(s):** Fast forward two years: Ronald and Darla's prenuptial agreement is thrown out during divorce proceedings after the judge decides that Darla signed the agreement under duress.

### *Be fair*

If your spouse is dependent on you financially, the provisions of your prenuptial agreement cannot leave him or her destitute in the event of divorce. It is against the law for the court to violate public policy (i.e., place your spouse on public assistance), and a judge will likely rule against you.

The fairness of an agreement, however, varies from state to state. Although several states have adopted the Uniform Premarital Agreement Act's requirement that a prenuptial agreement not be unconscionable at the time it was executed, other courts have held that the agreement must be fair at the time of divorce. Some states require that it be fair both at the time of execution and at the time of divorce. Determining whether an agreement is unconscionable is based on the circumstances and facts of each case, as certain provisions are more likely than others to be considered unconscionable. In the case of death, most states include a provision in their probate laws preventing one spouse from completely disinheriting the surviving spouse. These laws generally give the surviving spouse the right to elect against what was provided in the will and instead take a set percentage of the deceased spouse's assets. Nevertheless, prenuptial agreements in which a surviving spouse gives up his or her right to an elective share have been deemed enforceable. To ensure that the terms of the agreement will be enforced, the agreement should state that the new spouse agrees to waive all claims against specific assets and instead agrees to satisfy any marital property rights only with other assets in the event of divorce or death.

### *Distinguish between marital property and separate property*

A prenuptial agreement should clearly differentiate between marital property and separate property. Marital property generally includes all assets that were acquired by either or both spouses during the marriage. Separate property falls into three categories: what you bring into the marriage, what you inherit during the marriage, and what you receive during the marriage as a gift. Be sure to familiarize yourself with the laws of your state pertaining to separate property and marital property, since different states have different definitions of what constitutes one or the other.

If you want to keep your assets separate when you marry, a trust is an excellent option. If the trust is set up in conjunction with a prenuptial agreement, assets placed in the trust are owned by the trust and are not considered marital property during the marriage, even in community property states.

> **Caution:** If you set up a trust without a prenuptial agreement, you may have little or no protection, since a court could consider assets in the trust marital property subject to division. Your spouse's signature on a prenuptial agreement would prove that you did not use the trust to fraudulently transfer your assets out of your spouse's reach.

### *Consider including a "triggering event" within the agreement*

When included in a prenuptial agreement, a triggering event (e.g., the sending of a registered letter) could be used to automatically initiate divorce proceedings. It would also distinguish between marital property and separate property as of the date of the event. Such a strategy could work to your advantage, especially if your agreement is based on providing your spouse with a percentage of your wealth and you are anticipating future earnings or an inheritance.

## Tax considerations

### *Income tax*

Executing a prenuptial agreement does not usually result in any immediate tax consequences. Tax consequences do arise, however, after one of two events--divorce or death--activates the terms of the contract. To properly plan for your desired tax consequences, you should be aware of the tax ramifications of all property transfers you made before signing the agreement. These not only include transfers made upon divorce or the death of you or your spouse but also transfers made at the time the agreement is executed and during marriage. For more information, see our separate topic discussion, Tax Issues Related to Marriage.

> **Tip:** Since tax laws are constantly changing, you should have your agreement examined periodically to ensure that it accurately reflects the wishes of you and your spouse.

### *Clarify tax responsibilities within the agreement*

A prenuptial agreement should clarify who will pay to defend a tax audit, if necessary, as well as who will pay any assessed taxes, interest, and penalties. Some agreements stipulate that the couple will file as married filing separately so that the tax problems of one spouse will not affect the other--even though the couple will end up paying more taxes that way.

> **Tip:** Even when spouses file their taxes as married filing jointly, one spouse may be protected against the actions of the other under innocent spouse rules, which were revised by the IRS Restructuring and Reform Act of 1998. Under these rules, although each spouse who signs a joint return is fully responsible for the accuracy of the return as well as the payment of tax, if one spouse failed to report income or reported deductions or other items improperly, the other spouse can sometimes be relieved of the tax, interest, and penalties related to these items.

### *Filing joint tax returns*

If you choose to file as married filing jointly, both you and your spouse should be entitled to receive copies of the return and supporting documents each year. By doing so, you will avoid future problems in the event of divorce negotiations, if either you or your spouse cannot access necessary tax records.

### *Gift tax*

Generally, property transfers made before marriage may have adverse gift tax consequences, whereas transfers made during marriage are not subject to gift or income tax. When drawing up a prenuptial agreement, therefore, you should stipulate that any transfer of property occur after the wedding.

> **Example(s):** Ken and Sue have decided to get married. Ken owns a substantial share in Icy Frozen Foods that he wants to hold on to if the marriage doesn't work out. He and Sue decide to draw up a prenuptial agreement that provides for Ken to transfer $250,000 to Sue in exchange for her release of all marital claims against any of Ken's property in the event of divorce. A month before the wedding, Ken transfers stock worth $250,000 to Sue. Ken had purchased the stock several years ago for $50,000. The transfer of the stock causes Ken to have a taxable gain for income tax purposes of $200,000. In addition, Ken has made a gift (subject to the gift tax rules) of $250,000, and Sue's basis in the stock is $250,000.

> **Example(s):** If the transfer of the stock had occurred after the wedding, Ken would not have recognized gain on the transfer, since property transfers between spouses do not result in recognition of gain or loss. He would have also avoided the gift tax because of the unlimited marital deduction for gifts between spouses.

### *Estate tax*

When a prenuptial agreement takes effect due to the death of a spouse, assets passing from the deceased spouse to the surviving spouse under the terms of the agreement may qualify for the estate tax marital deduction. The deduction cannot exceed the value of the adjusted gross estate, however, and only certain assets qualify for it. For a complete list of property that qualifies for the estate tax marital deduction, see Schedule M (Bequests, etc., to Surviving Spouse) of Form 706.

## Questions & Answers

### *Does a prenuptial agreement mean that the prospective spouses don't trust each other?*

Perhaps, but a prenuptial agreement is generally grounded in realism rather than a lack of trust. For instance, an older couple marrying for the second time may simply want to protect the inheritances of their children. Some younger couples, on the other hand, might feel that they will save money in the future if the marriage doesn't work out.

### *Can a domestic partner agreement that you had drawn up when you decided to live together be converted to a prenuptial agreement?*

Yes, by following these steps:

Review your domestic partner agreement and make any changes and updates that you have both agreed upon. Rewrite the contract and call it a prenuptial agreement. Be sure to state that the agreement is in contemplation of marriage and does not take effect until you marry. Since there is no good self-help resource for writing a prenuptial agreement, have your agreement reviewed by an attorney. Even a small mistake on your part can invalidate your agreement. Lastly, sign your new agreement in front of a notary.

### *Is it possible to write an ironclad prenuptial agreement?*

Although you may have done everything correctly, you may still find yourself without an ironclad prenuptial agreement. In New York State, for example, anyone who signs a prenuptial agreement has six years from the time the agreement was signed to contest its contents.

### *Can a prospective spouse waive his or her right to retirement plan benefits in a prenuptial agreement?*

In general, if the retirement plan is covered by the Employee Retirement Income Security Act of 1974 (ERISA), an individual can not agree to waive his or her statutory right to benefits under the plan as part of a prenuptial agreement. While ERISA allows a spouse to waive his or her right to plan benefits (for example, a spouse can waive the right to receive a qualified joint and survivor annuity), only an actual spouse (not a prospective spouse) can exercise those waiver rights. In addition, the waiver must comply with specific statutory procedures. However, it may be possible for a prenuptial agreement to provide that the prospective spouse agrees to waive his or her rights once the marriage is consummated. Consult a qualified attorney if protection of retirement plan benefits is important to you.

# Property Settlements and Third-Party Transfers

## What are property settlements and third-party transfers?

When marital separation occurs and a divorce is contemplated, spouses must decide how to divide their property. Property includes such assets as the family home, rental property, automobiles, pensions, bank accounts, and stocks and bonds. It also includes art and antique collections, furniture, IRAs, life insurance cash values, and family businesses. A formal property settlement agreement is usually drawn up and signed by the couple, formally 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. This type of transaction is known as a third-party transfer.

Although it's important for divorcing spouses to understand the property laws regarding the division of marital property, it's also essential for them to understand the tax implications of their decisions.

## How is property classified for divorce purposes?

Assets are divided in accordance with state laws, and states can be divided into two categories, based on their property division rules: community property states and equitable distribution states.

### *Community property states*

In general, community property states focus on the difference between separate property and community property. Separate property is that which you bring to the marriage, including inheritances and gifts received prior to marriage. Community property, on the other hand, may be defined as property acquired during the marriage (except for inheritances and gifts received during the marriage). Separate property can usually be kept by the owner-spouse after a divorce, while community property must be divided equally (50/50) rather than fairly between the spouses.

> **Example(s):** Assume John and Mary are married and live in California, a community property state. Prior to their marriage, Mary received a $50,000 inheritance from her grandmother. During the course of their marriage, Mary received a $20,000 inheritance from her aunt. John and Mary bought a $500,000 house together during their marriage and amassed a $50,000 savings account. If John and Mary seek a divorce, both of the inheritances are considered separate property and will go to Mary only. However, the house and savings account are considered marital property and must be divided equally (50/50) between John and Mary. That is, each spouse will get $25,000 from the savings account and $250,000 in cash (or assets), assuming that the house is worth $500,000 on the date the spouses select for valuation.

At present, the following are community property states: Alaska (which has an optional system), Arizona, California, Idaho, Louisiana, Nevada, New Mexico, Texas, Washington, and Wisconsin (and also Puerto Rico).

### *Equitable distribution states*

The majority of states follow an equitable distribution philosophy. These states agree that marital property should be divided equitably (fairly) rather than equally. Some of these states will include separate property (such as inheritances and gifts) in equitable distribution, and some will not.

Equitable distribution states fall into three categories, based on how they identify marital property.

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Type 1--The first type of state identifies marital property as all property except that which either spouse brought into the marriage or obtained by gift or inheritance at any time. This definition is identical to that espoused by the community property states. The difference is that marital property will be divided equitably, as opposed to equally.

- Type 2--The second type of equitable distribution state proclaims that regardless of how or when property was acquired, all property (of both spouses) is subject to division at divorce. These states don't differentiate between marital and separate property. They divide property fairly and equitably and may allow property brought into the marriage by gift or inheritance to go to the other spouse if this form of distribution seems more fair, all things being considered. However, the source of the property (i.e., gift, inheritance, owned prior to marriage) is often very important in the judge's decision-making process.

**Example(s):** Assume John owned a $10,000 savings account and a $100,000 house. When he got married to Mary in a Type 2 equitable distribution state, he kept the title to these assets in his name alone. During the course of their marriage, the couple bought a vacation condominium in Florida and two automobiles and amassed $100,000 in mutual funds. If John and Mary seek a divorce, all of the property (including John's house and personal savings account) will be subject to equitable distribution principles.

- Type 3--The third category of equitable distribution state favors a mix of rules. Such states use fairness as a means of division but don't exempt all gifts, inheritances, and property brought into marriage from division. Instead, they may exempt one or more of these types of property.

**Tip:** To determine which category your state falls into, check the domestic relations laws of your state or consult with an attorney.

## How is property valued?

Once property has been classified as marital or separate, the next step in the process is to establish values for all of the identified property. Valuation may be by mutual agreement of the spouses. Certainly it's a simple matter to ascertain the fair market value of bank accounts, stocks, and bonds. And the fair value of household goods is usually determined by mutual agreement. However, in complicated cases involving pensions, family businesses, real estate, stock options, and so on, both sides may need to hire experts to establish values. This may be particularly true if your state recognizes professional licenses, advanced degrees, and enhanced earning power as marital property.

**Example(s):** Assume two premed students, Mary and John, got married. The couple agreed that John would complete his education first, while Mary supported him. When he finished, she would then complete her education. After John's second year of residency, he decided to divorce Mary. The court decided that because John's medical school degree and license to practice were both obtained during the marriage, they should be considered marital property, subject to valuation and division. An expert provided the court with present-value calculations of John's future earnings and came up with the figure $500,000.

**Tip:** In second marriages, sometimes a house is brought into the marriage. When such a house appreciates in value during the course of the second marriage, valuation can be a problem. Keep in mind that although separate property may not be subject to division in some states, the appreciation in value of separate property during the course of the marriage may be subject to division, particularly if both spouses used the property and contributed to the increased value.

**Example(s):** Assume Mary owned a $100,000 house with a $60,000 mortgage when she entered into a second marriage with John. Mary kept the title to the house in her name but lived there for many years with John. Mary now wishes to divorce John. The house is presently worth $160,000, and the mortgage has been brought down to $40,000. How should the property be valued?

**Example(s):** Mary may assert that the only marital asset is the increase in property value--$60,000. She obtained this figure by subtracting $100,000 from $160,000. John could argue that the increase in equity (not the increase in property value) is the marital asset. This figure would amount to $80,000 ($120,000 equity minus $40,000 equity). In most states, there is no definitive answer--the parties will have to agree or a court will have to decide.

**Caution:** The concept of gifting must also be considered when discussing valuation. In this example, if Mary had added John's name to the deed during their marriage, nearly all courts would hold that Mary converted the separate property into marital property. Thus, the entire house would be subject to division rather than the mere increase in appreciation.

The date of valuation is a matter usually determined by the parties themselves. For example, a couple might agree to value assets as of the separation date or at another mutually acceptable time. In some states the date of valuation is the date of the divorce trial.

## How do you approach property division?

The division of property will eventually be reduced to a written agreement--the Property Settlement Agreement. A property settlement agreement, once it has been signed by the parties, is a binding agreement and becomes part of the divorce decree. In cases where alimony or child support is needed immediately, a temporary order is often sought first.

When considering the division of property, both spouses must gather information about their assets. If you hire a divorce attorney, he or she will want to see financial statements from each spouse. It is necessary to know the amount, the frequency, and the source of periodic income. Likewise, parties must disclose the sources, locations, and fair market values of their assets. Of course, debt must also be disclosed.

There are occasions when one spouse has been kept in the dark about financial matters or perhaps chose not to take an active role. For example, one spouse may have handled the bills, bank accounts, and securities, while the other cared for the children and ran other domestic affairs. In legal terminology, the discovery process will help the less financially savvy spouse gather the necessary information.

During discovery, a spouse can request copies of income tax returns, any insurance policies that may exist, credit reports, employee benefit statements and summaries, bank account summaries, and other documents. Written questions (called "interrogatories") about income, assets, debts, and documentation may be served on (and answered by) the other spouse. Also, depositions of each spouse may be taken.

## What about hidden assets?

Sometimes, when a marriage has been deteriorating for many years, one spouse will hide the existence of assets from the other spouse in the expectation that a divorce may occur someday. If you find hidden assets, you will probably want to reveal them prior to trial in order to obtain your spouse's consent to a more equitable settlement. However, you can also choose to wait until the trial, undermining the credibility of your spouse.

> **Example(s):** John handled the finances in his family and secretly stashed away $50,000 in a bank account during the last years of his marriage. When divorce proceedings began, he wire-transferred the money to his mother, a resident of Columbia. John's wife, Mary, learned of the money when she found a receipt for the wire transfer in her husband's coat pocket. Since John had not disclosed the existence of this money at discovery or in his financial affidavit (submitted to the court), Mary was able to use this fraudulent transfer as leverage to force a favorable property settlement.

There are a number of places where you can look for hidden assets:

- Personal income tax returns--A review of the personal returns filed for the past five years may indicate sources of interest or dividends. They may also reveal unknown sources of income or loss from trusts, partnerships, or real estate holdings. You should review federal, state, and amended returns, comparing them to 1099s and W2s.
- Partnership tax returns--Compare partnership returns (IRS Form 1065 and Schedule K-1) over a number of years to see whether any sudden changes in the partnership interest or distribution occurred around the time of a marital separation. (Sometimes, compensating adjustments are made after the divorce has been finalized.)
- Corporate tax returns--If one spouse is the principal owner of a closely held business, he or she may be manipulating salary by taking loans from the corporation or may be charging personal expenses to corporate accounts. Corporate returns should also be checked for excessive retained earnings, as this may disguise available profits or an artificially low salary level.
- Financial statements--If your spouse took out a loan for his or her business or for personal purposes, he

or she submitted a financial statement to the lending institution. Look back at these statements for a five-year period to find assets that may no longer be accounted for.

- Savings account passbooks--You should acquire the passbooks for any savings accounts opened in the last five years, looking for substantial withdrawals close to the time of separation. Also, periodic withdrawals (or deposits) could indicate mortgages (or income) from hidden sources.
- Canceled checks and check registers--You may come across canceled checks for the purchase of property that you never knew existed. Compare the canceled checks against the applicable bank statement to make sure that you were given all of the canceled checks (some may have been removed by your spouse).
- Securities statements--Brokers furnish periodic statements, indicating transactions involving stocks and bonds. A review of these statements may raise a question about sales proceeds--where did the money go? You can cross-check securities transactions with bank account information by date and amount to see what may have happened.
- Uncollected bonuses and commissions--By subpoena, check with your spouse's employer to learn if any bonus or commissions are being held back.
- Children's bank accounts--Sometimes, a spouse who wishes to hide money will open a custodial account in the name of his or her child. If the annual interest from this account is less than the standard deduction amount for a dependent for that tax year, it's not shown on income-tax returns, nor are returns filed for the children.
- Phony loans, debts, or employees--To keep cash from being divided, a spouse may suddenly announce that he or she needed to repay a relative or friend for a loan made many years ago. These loans are suspect if made proximate to the marital separation. Also, if one spouse controls the payroll of a sole proprietorship, partnership, or closely held business, he or she may have a relative or friend on the payroll who's not really providing adequate services for the business. Thus, the business's profits will be reduced, and your spouse may be drawing a lower salary and getting a kickback.

## In what ways may property settlements be structured?

Property settlements may be structured in a number of different ways.

### *Equal divisions*

You begin by listing all of the marital assets (and their corresponding values). In a 50/50 split, of course, each party would be given one-half of the cash value of the assets. But perhaps one spouse might want to keep the entire house and one-half of the savings account, while the other spouse might want to keep the entire pension, one-half of the savings account, and the sole proprietorship. An example will illustrate that one spouse might end up owing the other spouse money if a 50/50 split is necessitated.

**Example(s):** Assume John and Mary have been married for 20 years and are now seeking a divorce. They own a house (worth $150,000), a pension (valued at $80,000), a savings account (worth $30,000), and a sole proprietorship (Acme Industries, estimated at $100,000). They don't want to sell assets and split proceeds; rather, Mary and John have tentatively decided to divide their assets as follows:

| Asset | Mary | John |
| --- | --- | --- |
| House | $150,000 | |
| Pension | | $80,000 |
| Savings Acct. | $15,000 | $15,000 |
| Acme Ind. | | $100,000 |
| | | |
| Total | $165,000 | $195,000 |

**Example(s):** If a 50/50 property split is contemplated, John will owe $15,000 to Mary. In this example, the appropriate division can be accomplished with a property settlement note. John can make monthly payments to Mary (with interest) until the $15,000 has been paid in full.

### *Property settlement note*

A property settlement note is a promise from the payer to the payee to pay a particular sum, for a particular length of time, with reasonable interest. The note should be collateralized. For tax purposes, the note doesn't represent alimony; it's purely a property settlement. Therefore, the payer can't deduct these payments from income. Likewise, the recipient doesn't include the principal payments in income (but he or she does include the interest portion in income).

**Caution:** Also, keep in mind that a property settlement note can be discharged in bankruptcy, whereas alimony and child support payments cannot.

### *Equitable divisions*

A 50/50 split may not produce equal results--or equal standards of living after the divorce--if the two spouses are unequally situated after the divorce. For example, an older homemaker who sacrificed her career for the care of her children and the upkeep of her home may not be able to maintain a standard of living equal to her former spouse after a divorce, even with a 50/50 split. Later in life, her husband may command a top salary, while she has no work history and few marketable skills. After a divorce, he will continue to reap a high income, while she will need to receive alimony or be required to drain assets.

Another example involves separate property. If the homemaker wife, for example, has $4 million worth of separate property sitting in a trust fund, a judge may find that a 50-50 split of the marital assets would be inequitable to the husband. States that use equitable principles in dividing property may consider a number of factors, including the following:

- Contribution by the spouses--Courts will consider financial contribution to assets and also non-economic contributions, such as homemaker services (child-rearing, housecleaning, career-sacrifice, etc.). Some states will assume that the contributions of a homemaker are equivalent to the contributions of the full-time wage earner, while others will admit expert testimony to place a value on homemaker services.
- Courts will also look at contribution by one spouse to the education of the other spouse. As cited in an earlier example, one spouse might work to put another through medical school. The increased earning power of the doctor-spouse might be viewed as "property" in some states.
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Duration of marriage--In a short-term marriage, direct financial contribution to assets plays a larger role, whereas in a long-term marriage, greater weight is given to noneconomic contributions, such as homemaker services.

- Future financial needs--Some states will consider the future financial needs of the spouses and/or the children when dividing property. While this is seldom a factor in marriages of very short duration, it can be a factor in long-term marriages.

- Income--If the income of one spouse differs substantially from that of the other spouse, this may influence the judge's division of property. For example, the judge may award a higher percentage of the property to the more dependent spouse, or alimony payments may be ordered.
- Assets and separate property.
- Extent of debts and ability to pay.
- Age and health of the spouses.
- Employability and future earning capacity.
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Educational degrees and professional licenses--When a spouse's education, degree, or training received during marriage substantially enhances that spouse's earning capacity, a court may order that spouse to compensate the other spouse for financial support and reduced discretionary income during the educational process. For example, the court may: Reimburse money spent on tuition, student loans, books, supplies, and other educational costs

- Allocate balances remaining on student loans solely to the educated spouse for repayment
- Use alimony to compensate the nonstudent spouse for financial and emotional support

**Tip:** Alternatively, of course, the court may determine that the degree or license is marital property, subject to division. As was mentioned earlier, a present value of future earnings might be divided between the spouses in such a case.

- Tax consequences.
- Financial and emotional needs of the children--Note that a marital home may be given to the custodial parent if minor children are involved.
- Standard of living during the marriage.
- Fault (in some states).
- Conduct during the marriage (in some states).

## What are the tax implications of property dispositions?

Property transfers between spouses during the marriage or incident to divorce aren't taxable. However, the tax effects of property dispositions can vary greatly, depending on whether you decide to transfer property immediately to your spouse, sell it to a third party, or sell it to your spouse at some future time.

### *Transfer to spouse incident to divorce*

Neither spouse recognizes gain or loss if you transfer the title of the property to your spouse incident to a divorce. A transfer of property is viewed as incident to divorce if the transfer occurs within one year after the date on which the marriage ends or if the transfer is related to the ending of the marriage. Any transfer of property between spouses that is made pursuant to a divorce or separation instrument and that occurs within six years after the date the marriage ceases is presumed to be related to the cessation of the marriage.

### *Basis*

The spouse receiving the property takes the basis of the transferring spouse. This result occurs even if the spouse that retains the property pays cash or other assets in return for the property and the transaction is basically a sale.

**Example(s):** Assume Mary sells her half-ownership interest of their home to her spouse, John, for $85,000 as part of their divorce settlement. Because the property had initially been purchased for

$80,000, Mary's basis was $40,000 and John's was $40,000. Mary doesn't recognize any gain on the sale to John because the sale was incident to their divorce. John's basis in the property will be $80,000.

### *Sale of property to third party immediately*

Often, a piece of property will be sold to a third party as part of a divorce settlement, and the proceeds will be split between the spouses. In such a case, each spouse will recognize one-half of the gain on the sale (unless they qualify for a capital gains exclusion).

### *Delayed sale*

The parties might decide that the property will be sold to the other spouse at some point in the future. If sold later than six years from the marriage cessation date, the sale will generally not be considered incident to the divorce. Thus, the seller will recognize capital gains and losses. This is not to be confused with the promissory note arrangement mentioned earlier.

> **Tip:** While a sale made more than six years after the marriage cessation date is presumed not to be incident to the divorce, the presumption will not apply if it can be demonstrated that the transfer was made to carry out the division of property owned at the time the marriage ended. For example, a sale might be considered made incident to a divorce if business or legal factors prevented an earlier transfer of the property and the transfer was made promptly after those factors were taken care of.

## Is the family home given special treatment?

With respect to ownership and division of the family home, special rules apply both in community property states and in equitable division states. In a community property state, the family home can be considered marital property even if one spouse separately brought it to the marriage. This is true if both spouses lived in the home during the marriage and also if the nonowner spouse contributed to the house's appreciation in value over the years. In equitable distribution states, a court will consider numerous factors when deciding on an award of the house.

So, then, to whom does the house belong? Title on the deed is certainly a useful starting point, but it also depends on whether you live in a community property state or an equitable distribution state. It further depends on whether you owned the house prior to marriage, whether you received the house as a gift or inheritance, and whether both spouses lived in the house during marriage. It's important, therefore, to review the domestic relations law of your own state to answer this question satisfactorily. Nevertheless, in general, it's safe to say that both spouses probably have a claim on the house and should prepare to divide this asset along with other marital assets.

## What can be done with the house when a divorce arises?

When considering the issue of who gets the house, there are four options that are most frequently used: sell the house, have one spouse buy out the other's half, have both spouses continue to own the property jointly, or simply agree that the homemaker spouse (if any) should get the house along with other assets.

### *Sell the house*

Selling the house and dividing the profits that remain after the mortgage is paid off and the selling costs have been paid is certainly one of the easiest ways to deal with the marital residence, particularly when there are no children involved. Profits can be divided equally or otherwise, based on the parties' wishes. Most people will want to have an independent appraiser value the property, hire a real estate agent to sell it, consult with a real estate attorney, and obtain a mortgage payoff figure. These selling costs can sometimes be significant. For information about deducting settlement costs and other costs involved in the sale of a house, see Selling a Home.

Of course, the divorcing spouses will both need to find new residences and weigh the costs and benefits of purchasing a new home versus renting an apartment. If there are no children, selling the marital residence is probably a much simpler solution for a younger couple than for an older one. An older spouse, particularly a homemaker, may have stronger emotional ties to the home and may fear the loss of security associated with a sale of the home and a new life in an apartment.

### *Buy out the other spouse*

If one party wants to keep the family home, buying out the other spouse might be an attractive solution. You can buy out your spouse by trading another asset (like a pension) or foregoing alimony, by paying in cash, or by granting a mortgage (or second mortgage) to your spouse.

If you want to buy out your spouse, the first thing you'll need to do is to value the property. An independent appraiser should be hired to fix the value. Next, obtain a mortgage payoff figure (if any). The value minus the mortgage shall be viewed as your equity in the property and, once divided in half, can serve as the buyout figure. Alternatively, of course, the couple can decide on a buyout figure of their own choosing; it doesn't necessarily have to be one-half of the equity.

The method of payment is the next question to be considered. Certainly, trading assets is one option. For example, if one half of the net equity in the house amounts to $25,000, and one spouse has a pension worth approximately $15,000, the other spouse might want to relinquish his or her rights in the pension in return for keeping the house. Of course, the other spouse needs to carefully weigh such a decision, in light of the fact that the pension will probably increase dramatically over the years and he or she may be left with no retirement income.

A cash exchange is another method of payment, if one party has an inheritance or trust fund. Refinancings and mortgages should also be considered. The house could be refinanced to provide enough cash to pay the other spouse. Alternatively, a note payable (with reasonable interest) or private mortgage can be drawn up between the spouses. However, this approach could present some problems.

> **Example(s):** Mary and John are seeking a divorce and own a home with $20,000 worth of equity. Mary wants to keep the house, but has just started a new job, and doesn't have sufficient cash on hand to buy out John. Mary promises to make a balloon payment of $10,000 to John seven years after their divorce date, securing this promise with a $10,000 private mortgage to John. When Mary tries to refinance the house some years later in order to pay off John, she finds that conventional mortgage lenders will not grant her a mortgage unless John subordinates his mortgage claim to theirs. If John refuses to subordinate, Mary will have difficulty finding the cash to pay off John.
>
> **Tip:** If private notes and mortgages are to be used, the divorce agreement should stipulate that subordinations and other accommodations will be freely given by the creditor-spouse. Also, if one spouse merely deeds his or her interest in the house to the other spouse while a mortgage is outstanding, both spouses shall remain liable for the mortgage (if both signed the mortgage initially). If the spouse who lives in the house stops making mortgage payments, the other spouse may be liable and may suffer severe credit consequences.

### *Joint ownership*

This option is often used when the parties envision selling the house at some point in the future (e.g., when the minor children reach age 18 or when the resident spouse remarries). The parties might agree that the spouse who lives in the house shall be responsible for making the mortgage payments or that both parties will pay the mortgage, insurance, and taxes until the children graduate from school.

Property values should be a concern, however, if you promise to pay a certain dollar amount in the future. Rather than promising to pay $20,000 when the property is sold 15 years from now, you might wish to promise one-half or one-third of the net sale proceeds. This would protect the resident spouse if the property value declines. If you're the creditor-spouse, a dollar amount might be better.

### *Agree to give to homemaker*

There are cases when assets won't be traded in any significant sense; rather, the parties will simply agree to give the greater portion of assets to one spouse. This can be particularly true when a homemaker of many years is involved. For older women who sacrificed a career for the care of children and the upkeep of a house, it may be impossible for them to jump into the working world at age 58 and earn a sufficient living. In such cases, judges may decide simply to award the house to the homemaker. Additionally, the judge may order alimony payments for life and a portion of the pension set aside. Such measures may be deemed equitable under the circumstances.

Be aware, however, that the upkeep of a house and its grounds might be too burdensome and expensive for certain individuals.

## What are the tax ramifications when a house is sold pursuant to a divorce?

Generally speaking, property transfers between spouses during marriage or incident to divorce aren't taxable. However, the tax effects on the sale or transfer of your home incident to divorce can vary substantially, depending on whether you (as a couple) decide to keep the house, sell it to a third-party, or transfer it to one spouse with a view toward a future sale.

### *Transfer to one spouse incident to divorce*

Neither spouse recognizes gain or loss if you transfer the title of the home to your spouse incident to a divorce. A transfer of property is viewed as incident to a divorce if the transfer occurs within one year after the date on which the marriage ends or if the transfer is related to the ending of the marriage. Any transfer of property between spouses that is made pursuant to a divorce or separation instrument and occurs within six years after the date the marriage ceases is presumed to be related to the cessation of the marriage.

### *Basis*

The spouse receiving the property takes the basis of the transferring spouse and ends up with the combined basis. This result occurs even if the spouse who retains the residence pays cash or other assets in return for the house and the transaction is basically a sale.

> **Example(s):** Assume Mary and John own a home that is presently worth $170,000. Mary sells her half-ownership of their home to her spouse, John, for $85,000 as part of their divorce settlement. Because the property had initially been purchased for $80,000, Mary's basis was $40,000, and John's was $40,000. Mary does not recognize any gain on the sale to John because the sale was incident to their divorce. John's basis in the property will be $80,000.

### *Delayed sale of house*

The parties might decide (in their divorce agreement) that the house shall be sold at some point in the future. Typically, only one spouse remains in the house, but the other spouse continues to be listed on the deed as a joint owner. This raises a question concerning exclusion of the capital gain when the house is later sold.

In general, the law states that if all requirements are met, a taxpayer of any age can exclude from federal income tax up to $250,000 of gain (up to $500,000 for joint filers meeting certain conditions) from the sale of a home owned and used by the taxpayer as a principal residence for at least two of the five years before the sale. Generally, an individual (or either spouse in a married couple) can use this exemption only once every two years.

At first glance, this law would seem to preclude the spouse who moved away (and has lived elsewhere for several years) from claiming the exclusion. However, under the following circumstances, a separated or divorced taxpayer can "tack on" someone else's ownership and/or use period to his or her own ownership and/or use period:

- An individual is treated as using a home as his or her principal residence during any period of ownership that the individual's spouse or former spouse is granted use of the property under a divorce or separation instrument
- An individual who receives a home in a tax-free transfer from one spouse to another may tack on the transferor's ownership period to his or her own ownership period

> **Example(s):** Assume John and Mary are divorcing. They agree that Mary can continue living in the house until their daughter, Jane, turns 18 in eight years. At that time, the house will be sold and the proceeds split between John and Mary. In such a case, John will be eligible for the $250,000 capital gains exclusion--even though he didn't reside in the family home for two of the past five years--since he met one of the exceptions.

In addition, even if you don't meet the two-out-of-five-years test or the one-exemption-every-two-years test, you may qualify for a partial exemption. You may claim a partial homesale exemption if the primary reason for selling your principal residence is a change in place of employment, for health reasons, or for certain other unforeseen circumstances. Temporary regulations issued by the IRS specifically list divorce or legal separation as an unforeseen circumstance.

### *Sale of house to third party immediately*

Often, a house will be sold to a third party as part of a divorce settlement and the proceeds split between the spouses. In such a case, if the capital gain exclusion did not apply, the husband and wife would each recognize his or her proportionate share of the gain on the sale (based on the division of the sales proceeds). But this will not be the case if the husband and wife qualify for the capital gain exclusion mentioned above.

> **Example(s):** Assume Mary and John are seeking a divorce. During the course of their marriage, they purchased a house for $100,000 and there have been no adjustments to Mary and John's basis in their home. The house is now worth $200,000, and the couple decides to sell it through a real estate broker and split the proceeds evenly. If their net proceeds from the sale amount to $186,000, John and Mary will each experience a $43,000 gain. Assuming they qualify for the capital gains exclusion, however, Mary and John can each exclude up to $250,000 of gain from the sale of the home.

> **Tip:** When structuring divorce settlements, the timing of property sales and the tax ramifications should always be considered, along with the domestic relations law (i.e., community property states versus equitable distribution states). It is wise, therefore, to consult with a divorce and/or tax attorney even if the property settlement appears to be a simple and amicable one.

# Redemption of Spouse's Stock in Closely Held Business: Divorce

## What is a redemption of spouse's stock in a closely held business?

A stock redemption occurs when a shareholder sells stock back to a corporation. Unlike a complete liquidation, the corporation generally continues to exist after the transaction. In a divorce context, if either spouse owns a closely held corporation, that business will probably be a part of the property division. Clearly, the business will be considered marital property if it was started during the marriage with joint funds. If the business was started prior to marriage or financed with separate funds, however, it is necessary to consult state law to determine the rights of the other spouse. And although the rules will vary from state to state, most states mandate that a portion of the business will be considered a marital asset.

For instance, the marital portion might be the amount of joint funds used to expand an existing business (plus the appreciation attributed to that contribution). Or, the nonowner spouse may have helped operate the business, and that assistance may have contributed to the growth of the business during the marriage. Because each spouse will probably have a stake in the business, it is typical, in divorce situations, for one spouse to buy out the other's share 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 do you value the business?

Once you have determined the marital portion of the business, you need to determine the value of the business. Business appraisers and forensic accountants are qualified to place dollar values on businesses. Their goal is to establish a fair market value for the business (i.e., to fix the amount of money the business would bring if it were placed on the open market).

Appraisers use a number of methods. For example, they might total the value of the equipment, analyze the cash flow by reviewing the balance sheets and other financial documents, or compare the company to similar ones on the market. Although competent appraisers should come up with similar values, each spouse will often hire an expert appraiser to value the family business.

The date used to fix the business's value is important and can vary from state to state. In some states, businesses are valued as of the date of separation. In others, businesses may be valued at a settlement date agreed upon by the parties. A number of factors can cause fluctuations in the business's value, including the state of the economy, market forces, and perhaps the efforts of the spouse working in the business.

### *Finding an appraiser*

If you and your spouse are on good terms and are fairly sophisticated about business matters, perhaps you can agree on the business's value. If your business, for example, was recently appraised for purposes of getting a loan, you can use that figure. Otherwise, you might wish to consider hiring a certified appraiser.

A certified business appraiser is one who has been certified by the American Society of Appraisers. You can find the names of appraisers in your area by calling the Society at (800) 272-8258. Alternatively, you can get a referral to a competent appraiser by asking other small business owners, accountants, financial planners, and attorneys for recommendations.

Most appraisers typically charge an hourly fee, although some will charge a flat fee. The appraiser will send you an appraisal report when he or she has completed the valuation process. It should include the following information:

- The fair market value of the business

- The methods used to arrive at the value
- A description of the business appraised
- The name and qualifications of the appraiser
- The documents reviewed and the names of people interviewed
- A list of data analyzed, and how it was analyzed
- The appraisal techniques chosen
- An explanation of why those techniques were chosen

### *Methods of appraising the business*

Appraisers use a number of valuation methods. The following are the most common methods:

- Adjusted book value--The business's adjusted book value consists of the firm's total assets (including depreciation) minus its total liabilities. This method is often used when a company has substantial capital investments in hard assets, such as machinery.
- Comparable sales--A business appraiser can get a rough idea of the value of your business by comparing it to the prices quoted in classified advertisements under the heading "Businesses for Sale." This value, of course, is only an estimate.
- Comparable values method--The appraiser surveys similar businesses and appraisers to establish a basis for buying or selling a particular company. Certain rules of thumb or "industry rules" exist. For example, experts generally believe that a retail business is worth one to two times its yearly earnings, and a sandwich shop is worth four to nine times its monthly average sales. In terms of a professional practice, an attorney's practice might be valued at the amount it would take to buy in as a partner in the firm. Like the comparable sales method, the comparable values method is merely a starting point in valuing the business.
- Capitalization of excess earnings--This approach combines the adjusted book value with the value of goodwill. By capitalizing excess earnings, the appraiser arrives at the goodwill. Any established business has a name and reputation which, by themselves, can be expected to generate a certain amount of income in the future. This intangible asset is called "goodwill." Along with name recognition, the goodwill of a business depends on the length of the company's existence and the extent of its revenues. Most states require that the goodwill of a business be included as part of the overall appraisal.

## How can a family business be divided?

As with assets in divorce, one spouse's interest in a business can be kept, sold, or exchanged for other property. Or, the entire business can be sold and the proceeds divided between the spouses according to their marital interests in the property.

### *One spouse keeps the business*

If one spouse wishes to keep the business, he or she can buy out the other spouse's share with cash, have the corporation redeem the stock, or trade assets of equal value. If there are no assets large enough to trade, a property settlement note can be drawn up, and the spouse can be paid over time.

### *Both spouses continue to operate the business*

In a family business, both spouses may have enjoyed serving the public for many years, and neither spouse wants to stop working. If you have an amicable relationship, it's possible (though risky) to continue working as long as your financial rights in the business are well documented. Or, you may decide that while you'll both own the business, only one spouse will run it. In such cases, you'll need to consider the following questions:

- What constitutes a reasonable salary for the spouse who runs the business
- When will profits be paid
- How will profits be divided and taxed
- What role will the nonmanaging spouse play in decision-making
- Do both parties have a right to enter the premises and inspect the books, and
- What personal expenses or perks will be allowed the managing spouse?

***Business is sold***

The spouses may sell the business and divide the profits according to their respective marital interests. The problem with this approach is that it may take years to find a buyer. In the meantime, you'll have to decide who runs the business.

## What are the tax implications of property dispositions, in general?

Property transfers between spouses during the marriage or incident to divorce aren't taxable, according to Section 1041 of the Internal Revenue Code (IRC). But the tax effects of property dispositions can vary greatly, depending on whether you decide to transfer property immediately to your spouse, sell it to (or have it redeemed by) a third-party, or sell it to your spouse at some future time.

***Transfer to spouse incident to divorce***

In general, neither spouse recognizes a gain or loss if one spouse transfers the title of property to the other spouse incident to a divorce. A transfer of property is viewed as incident to divorce if the transfer occurs within one year after the date on which the marriage ends or if the transfer is related to the ending of the marriage. Any transfer of property between spouses that is made pursuant to a divorce or separation instrument and that occurs within six years after the date the marriage ceases is presumed to be related to the cessation of the marriage.

You might, for example, want to use a promissory note to buy out your spouse's share in the family business. In such a case, taxation really won't be an issue. The buying spouse can't deduct the principal payments, and the selling spouse doesn't report the principal payments as income (the interest is income). Because the payments are being made to equalize a divorce settlement, the spouse buying the business gets the business's original tax basis.

***Basis***

The spouse receiving the property takes the basis of the transferring spouse. This result occurs even if the spouse who retains the property pays cash or other assets in return for the property and the transaction is basically a sale.

> **Example(s):** Assume Mary sells her half ownership interest of their home to her spouse, John, for $85,000 as part of their divorce settlement. Because the property had initially been purchased for $80,000, Mary's basis was $40,000 and John's was $40,000. Mary doesn't recognize any gain on the sale to John because the sale was incident to their divorce. John's basis in the property will be $80,000.

***Sale of property to third party immediately***

Often, a piece of property will be sold to a third party as part of a divorce settlement, with the proceeds being split between the spouses. In such a case, both spouses will recognize their proportionate share of the gain on the sale, based upon their division of the sales proceeds (unless they qualify for a capital gain exclusion).

***Delayed sale***

The parties might decide that the property will be sold at some point in the future. If sold later than six years from the marriage cessation date to the other spouse, the sale will not be incident to divorce. Thus, the seller will recognize gain or loss. (This is not to be confused with the promissory note arrangement.) In addition, a delayed sale may prove extremely risky, because during that period, the property will be exposed to the creditors of the spouse who continues to hold the property.

## What are the tax consequences of a stock redemption?

As a result of court decisions that have varied in different jurisdictions, the question of which spouse is taxed on a divorce-related stock redemption is unclear. However, a certain trend is apparent and is supported by a temporary IRS regulation.

It's clear that a transfer of ownership of a closely held business interest in divorce doesn't trigger recognition of gain or loss on the transfer if the transfer of that ownership is made directly between the spouses (e.g., one spouse pays cash to the other spouse in return for a release of all claims on the jointly owned stock).

In some cases, the spouses are financially unable to directly transfer ownership of a closely held business between themselves. In such cases, a stock redemption is often used. The corporation that redeems the stock is viewed as a third party in the transaction involving the spouses.

The general rule is that neither gain nor loss is recognized on transfers of property between spouses incident to a divorce. IRC Section 1041's nontaxable treatment is applied to transfers to third parties when:

- The transfer to the third party is required by a divorce or separation agreement or decree,
- The transfer to the third party is pursuant to the other spouse's written request, or
- The nontransferring spouse consents to the transfer in writing, specifically references IRC Section 1041, and this statement is attached to the transferring spouse's tax return for the year of transfer.

A stock redemption on behalf of a spouse or former spouse is treated first as a transfer to the receiving spouse (governed by IRC Section 1041), followed by a transfer from the receiving spouse to the third-party corporation (not governed by IRC Section 1041). According to many courts (and the IRS temporary regulations), the first transfer is nontaxable, while the second transfer is not.

**Example(s):** Assume John and Mary are getting divorced and jointly own 100 percent of a small corporation. The stock is worth $100,000 at present, and Mary's adjusted basis in the stock amounts to $1,000. Pursuant to the divorce agreement, Mary will transfer her 50 percent interest in the company to John by way of a stock redemption. The corporation will redeem Mary's stock for $50,000. Since the transfer is incident to a divorce agreement, Mary's initial transfer of stock will be nontaxable to her under IRC Section 1041. For federal tax purposes, it is deemed that John received the stock from Mary and immediately retransferred it to the corporation in a complete redemption. The deemed transfer from John to the corporation lies outside the protective scope of IRC Section 1041. Thus, while Mary escapes taxation, John must recognize capital gain on the transaction ($50,000 value minus $1,000 basis).

**Caution:** Again, be aware that some tax courts have treated the taxation of stock redemptions differently. In fact, it's even possible that both spouses will avoid taxation of a stock redemption in accordance with IRC Section 1041. It is advisable to consult an attorney in connection with any divorce-related stock redemption.

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