



Divorce Planning: Tax Issues To Think About

Things to Consider in the Settlement Proceedings

One of the most contentious periods in a divorce typically occurs during negotiations over division of property and establishing support obligations. A shrewd divorce attorney is going to be someone who is well versed in not only the facets of family law, but who is aware of the tax implications in property settlements.

While the term "alimony" is commonly understood to be payments by one spouse to another for their support after separation, this term is very specific for purposes of income taxation. First and foremost, alimony **must** be in cash. While the term "cash" includes things such as checks and money orders, transfers of services or property (or use of property) are **not** treated as alimony. The transferor spouse receives no income tax deduction for the property transferred to their spouse and the receiving spouse does not report the property as income. Furthermore, there is no taxable gain or loss recognized on property transfers incident to a divorce.

Since the reality of life is that a divorce settlement will hardly ever result in an all-cash alimony arrangement, an evaluation by tax and legal advisors of specific assets or tax strategies is recommended before heading to the negotiating table. For example:

- If a joint residence has appreciated in value, a taxpayer may be able to completely avoid taxable gain on the sale of the home by utilizing the IRS exclusions on the sale of a primary residence.
- Property received incident to divorce will retain the same cost basis as that of the transferor, so finding out the cost basis of property (such as stocks and bonds) before agreeing to accept it can help avoid big capital gains occurring when appreciated assets are sold for cash.
- If a spouse is buying out another spouse's interest in a closely held business, the IRS will allow the parties to specify who pays the tax through the terms of the divorce agreement when the money is coming from the corporation redeeming the stock of the departing spouse (Treas. Reg. §1.1041-2(c)(3)).
- Deciding which parent "claims" the children might carry greater implications than a tax exemption:
 - If a child has significant unearned income from their investment accounts, they will be taxed at the tax rate of their custodial parent, which could create greater tax liability for the child (or for the parent if the child's income is included on the parent's return).
 - High earning taxpayers who negotiate for the dependency exemptions might be completely phased out of these same tax exemptions and things such as education credits or tuition deductions due to adjusted gross income limitations.

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- With the imposition of the individual health insurance mandate, the child (or children) may need to be claimed by a specific parent in order to keep health insurance coverage.
- While fees paid to a divorce attorney are not tax deductible, if those legal fees are to address tax matters or protect wealth, these fees can be claimed as an itemized deduction.

Gone But Not Forgotten – Innocent Spouse Relief

Even when spouses have parted ways, tax problems can still arise years after the divorce if erroneous or fraudulent joint tax returns were filed during marriage. When individuals file a joint return with their spouse, each spouse is personally attesting that the return is accurate and complete, and are thereby personally responsible (jointly and severally) for any tax, penalty, or interest due on those joint returns.

If an individual is receiving assessments from the IRS due to erroneous or fraudulent misstatements by a former spouse on a joint income tax filing, the potential exists for relief under the “innocent spouse” provisions of the Internal Revenue Code. The analysis of whether a person qualifies under the innocent spouse relief is an analysis based on facts and circumstances, including (but not limited to):

1. Whether the requesting spouse had knowledge or reason to know of an understatement;
2. If he or she actually knew of the understatement, or if a reasonable person in similar circumstances would have known of the understatement;
3. The nature of the erroneous item and the amount of the erroneous item relative to other items;
4. The couple's financial situation;
5. The requesting spouse's educational background and business experience;
6. The extent of the requesting spouse's participation in the activity that resulted in the erroneous item;
7. Whether the requesting spouse failed to inquire, at or before the time the return was signed, about items on the return or omitted from the return that a reasonable person would question;
8. Whether the erroneous item represented a departure from a recurring pattern reflected in prior years' returns.

Another way to protect spouses from potential assessments occurring after a divorce would be to have an independent tax professional examine prior year returns before the divorce proceedings. If there are concerns about misstatements or understatement of income on joint returns, a request for indemnity can become part of the divorce settlement.

Family Considerations after the Divorce is Final

Once the dust has finally settled and the ink has dried, there are still considerations to be discussed with spouses who have existing children from the former marriage. Any fresh relationships have the potential to create tension between the new significant other and the children of the original marriage. Parents who have children with an original spouse

and then later divorce and have additional children with a new spouse create what are often referred to as “blended families.”

Blended families require special consideration to ensure that all significant others, both new and old, are protected in the event of the unthinkable. While a good relationship can exist between the new spouse and the children of a former spouse during life, the relationship cannot be monitored or mediated after the parent’s passing. Children of a previous marriage may have feelings of entitlement, especially when money passes to a non-parent or children of that non-parent.

Estate planning for a blended family is a delicate balance of making sure that there are sufficient funds to provide the new spouse (and children) the financial security they require, while protecting or providing an inheritance to pass along to the children of the original marriage. For individuals who have created a blended family, here are a few items for consideration:

- Since most estate plans require a trustee and an executor, appointment of an independent and/or corporate trustee and executor are paramount to ensuring all beneficiaries are treated fairly, and helps remove the perception that certain beneficiaries are receiving special treatment if the new spouse were appointed these roles.
- Engaging third parties such as family law attorneys, tax or financial advisors to discuss and explain the long term goals and planning of a parent can help in starting the difficult conversation with children of former spouses, along with helping to mediate mistrust and perceived favoritism.
- The creation and funding of trusts during life can extinguish uncertainty and make sure all loved ones are provided permanent protection.
 - A “qualified terminable interest property” trust (QTIP trust) is an estate planning devise which pays income to the current spouse for their life, and then passes the remainder of the trust assets to the children of the previous marriage in a gift tax and estate tax efficient manner.
 - An “irrevocable life insurance trust” (“ILIT”) is a way to ensure a fixed amount is left to children of a first marriage, and since the trust is the owner of the policy, the life insurance proceeds distributed to the children are not included in the estate of the parent or the surviving spouse.
 - Irrevocable trust setups have been approved by the IRS which will effectively allow an irrevocable trust to be named the beneficiary of an IRA, provide income to a second spouse for life (or principal if needed), and then leave the remaining assets to children of a first marriage (Private Letter Ruling 9846034).

If you have any questions about the information in this article, please contact:

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