McKINLEY IRVIN

FAMILY LAW

DIVORCE AND TAXES CHECKLIST

8 Important Tax Considerations for Divorcing Couples

1. TIMING OF YOUR DIVORCE

Decide how you want to file your taxes before your divorce is final.

For Federal Income Tax purposes, taxpayers are considered "married" if they are legally married according to state law on the last day of the taxable year (December 31st) and unmarried if they are divorced by the last day of the taxable year. As a result, you should carefully consider what filing status you want to file your taxes under (married filing jointly, head of household, etc.) before the court enters your final divorce decree. The timing of your divorce and its affect on your filing status can dramatically influence the amount of your income tax liability or refund.

- Although generally speaking the status of "married filing jointly" produces the largest refund or smallest liability, if you and your spouse have similar incomes, it may be advantageous to file single or as head of household.
- If you are concerned that your spouse may be underreporting or acting fraudulently, filing separately will reduce your liability for your spouse's misrepresentations.
- For some divorcing spouses, more than the potential financial consequences come into play when deciding whether to file taxes jointly or separately. Filing as a certain status may have emotional or symbolic significance.

2. POTENTIAL LIABILITY FOR JOINT RETURNS

If you are filing jointly, make sure you review all tax documents before submitting to the IRS.

If you and your spouse are in the process of getting a divorce but are still married at the end of the taxable year, you are considered married for your Federal Income Taxes. Although the status "married filing jointly" is generally preferable, particularly for couples with disparate incomes, filing your taxes jointly with a spouse you are divorcing does present some risks.

- Divorcing couples should be aware that if they choose to file a joint return, they are jointly and severally liable for all representations made in the return. In other words, you are liable for both the tax liability arising from the return and for any fraudulent representations made in the return.
- For many divorcing couples, trust that once existed in the relationship is shattered upon filing for divorce. If your spouse prepares your tax return and you are concerned that the return is not 100% accurate, you should have an accountant or tax attorney review the return before you sign it and subject yourself to potential liability.

3. DEPENDENCY EXEMPTIONS

If you have children, determine who will claim them as dependency exemptions in your Order of Child Support.

Under IRS regulations, the parent entitled to claim a qualifying child for the dependency exemption is generally the parent who has custody of the child for more than half of the taxable year. However, at divorce, entitlement to the dependency exemption is often negotiated, regardless of the residential schedule of the dependent child. In light of the outcome of such negotiations, the parent entitled to claim the exemption under IRS regulations can elect to release his or her claim to the exemption to the other parent. This release is effectuated by attaching a signed written declaration to the releasing parent's tax return.

- During your divorce proceedings, you should keep in mind that the dependency exemption can be allocated in different ways and can be used as a bargaining tool at the negotiation table.

4. ASSET TRANSFERS AT DIVORCE

Decide whether to engage an accountant or tax attorney to review your property division prior to finalizing your divorce.

The general rule is that asset transfers at divorce or related to a divorce result in no tax consequences. However, depending upon you and your spouse's basis in different assets allocated at dissolution, the subsequent selling of assets awarded at divorce could result in disparate tax consequences. If you and your spouse have substantial assets or a complicated financial structure (for example, if you own your own business), you should have an accountant or tax attorney review your property settlement before you sign it and file your divorce decree.

5. DIVISION OF RETIREMENT ASSETS

Prepare required QDROs or other property division devices to avoid tax consequences resulting from the early withdrawal of retirement funds.

For many divorcing couples, retirement accounts are the major assets to be divided. Although pre-retirement withdrawals of funds from retirement accounts usually result in hefty tax penalties, divorcing employee spouses can allow funds to be withdrawn and allocated to non-employee spouses without penalty. Under the Employee Retirement Income Security Act (ERISA), the withdrawal of retirement funds at divorce can generally only be obtained without penalty if the division is specified in a qualified domestic relations order (QDRO). To be valid, QDROs must be carefully drafted to fully comply with ERISA. Depending upon the type of plan, a different type of property division device may be required. If you and your spouse are dividing a retirement asset at divorce, you should consider sending your drafted QDRO or other property division device to the retirement account plan administrator to review. Even if the court signs a QDRO, it will not be honored by the plan administrator if it fails to meet all required specifications.

- The type of QDRO or other property division device required depends upon the type of tax deferred plan you have. Consult with an experienced family law attorney or tax attorney to determine what type of device will avoid potential tax liability.

6. ASSETS SOLD AT DISSOLUTION

Make sure to consider potential capital gains taxes.

If you and your spouse plan to sell a capital asset as a part of your property division, you should consider the potential tax consequences of such a sale and bargain for their allocation. If you are awarded the proceeds of the sale of a capital asset, for example, a house, you may be responsible for all capital gains tax resulting from the sale. It is important to keep this reality in mind when negotiating your property settlement agreement.

7. CHILD SUPPORT

Child Support Payments are tax neutral.

Child support payments result in no tax consequences. They are not deductible by the spouse making the payments (the obligor) and are not taxable to the spouse receiving the payments (the obligee).

8. SPOUSAL MAINTENANCE

Consider the income tax implications of maintenance/alimony awards.

Spousal maintenance is deductible for the obligor and taxable as income to the obligee. Therefore, if you are seeking maintenance, you should consider the resulting increased income tax liability.

- Because property awards at divorce generally result in no tax consequences and maintenance awards result in significant tax consequences, you should carefully consider how you classify any property received in connection with your divorce.

- In Washington State maintenance is modifiable and property awards are non-modifiable. Therefore, if the spouse paying maintenance can show a "significant change in circumstances," the maintenance obligation awarded at divorce may subsequently be reduced by the court. However, maintenance may be deemed "non-modifiable" in a separation contract signed by both parties. You should discuss the classification of your property award with your family law attorney to determine what type of award will result in the maximum benefit to you.

- Although the payment of maintenance is generally deductible by the obligor, the maintenance recapture rule requires the obligor to pay income tax on maintenance payments in some instances in order to prevent the frontloading of maintenance. The maintenance recapture rule only applies to the first three years maintenance is received and it is triggered when maintenance varies by more than $15,000 per year.