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## Quick reference guide to divorce-related tax-matters

American Institute of Certified Public Accountants. Family Law Tax Force

American Institute of Certified Public Accountants. Forensic and Valuation Services Section

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# **QUICK REFERENCE GUIDE**

TO DIVORCE-RELATED TAX MATTERS

## Quick Reference Guide to Divorce-Related Tax Matters

Welcome to the *Quick Reference Guide to Divorce-Related Tax Matters*. It conveniently contains a detailed chart that summarizes many of the tax issues that arise during divorce proceedings and the challenges that may affect family law practitioners.

Topics covered in this handy reference guide include the following:

- Filing status
- Stock options and deferred compensation
- Exemptions
- Innocent spouse and separate liability relief
- Mortgage interest
- Cost of getting divorced
- Retirement plans, IRAs, and more!

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## Tax Issues Related to Divorce

### Tax Consequences of Divorce

Under Internal Revenue Code (IRC) §1041(a), no gain or loss is recognized on transfers if incident to divorce.

*Incident to divorce* is defined as follows:

- It occurs within one year after the divorce.
- It is related to the ending of the marriage, meaning it
  - is pursuant to a divorce or separation instrument and
  - occurs within six years after the date on which the marriage ended.

Property acquired after the marriage ends qualifies for IRC §1041 treatment if all other requirements are met.

### Costs of Getting Divorced

Legal and professional fees, as well as court costs related to getting a divorce, are generally not deductible. Payment of the former spouse's attorney or professional fees also are not deductible unless they meet the requirements of deductible alimony (§71 payments).

Nondeductible costs

- Expenses paid in arranging child custody and support
- Expenses paid in arriving at a financial settlement and retaining income-producing property

## Deductible costs (legal or accounting)

- Fees paid for tax advice related to a divorce
- Fees paid to determine or collect alimony
- Fees paid to determine estate tax consequences of a property settlement
- Fees paid to professionals, such as appraisers and actuaries, if the services were performed to determine the correct amount of tax or to assist in obtaining alimony
- Obtain deductibility breakdown from attorney or accountant
- The expenses will be deducted as miscellaneous itemized deductions subject to the 2 percent limitation and also a preference for Alternative Minimum Tax (AMT) purposes

The parties frequently are in need of cash to pay attorney fees, experts, and so forth. In the absence of other sources, consider using cash value in life insurance policies or transfer funds (including tax consequences) from retirement plans to the other spouse to be used to pay joint debts or to make cash available to either or both.

## Consideration of Income-Producing vs. Non-Income-Producing Assets

### Income-producing assets:

- Rentals
- Royalties
- Business interests
- Receivables

### Non-income-producing assets:

- Residence
- Vacation home
- Investment land
- Personal property

*Legal and professional fees, as well as court costs related to getting a divorce, are generally not deductible.*

## Alimony vs. Child Support

### Qualifications of Alimony—IRC §71(b)

- Cash payments or third-party payments required under divorce or separation instrument.
- Payments must be required by written instrument.
- Instrument may not designate the payment as “not alimony.”
- Spouses may not be members of the same household.
- Payments may not be treated as child support.
- Payments must cease upon death of the recipient.
- Parties may not file a joint return.

Payments that do not qualify as alimony:

- Child support
- Noncash transfers
- Payments that are the spouse’s part of community property income
- Payments for use of property
- Payments to keep up the payer’s property

## Recapture of Alimony

Recapture rules may apply if there is a decrease or termination of alimony during the first three calendar years of payment. Recapture rules apply if alimony paid in the second or third calendar year is \$15,000 less than in the prior year. A calendar year may be as short as one day (for example, December 31 or January 1).

May occur for

- failure to make timely payments.
- change in the divorce or separation agreement.
- reduction in the spouse's support needs.
- reduction in the payer's ability to provide support.

Consider option to treat as "Not Alimony" when

- payer has little or no gross income.
- payer's other deductions exceed gross income.

## Child Support Before Alimony

If a person is obligated to pay both alimony and child support, but pays less than the monthly amount due, payments first applied satisfy the child support obligation. Child support obligations must be met before any amount of alimony is deductible.



## Personal Residence

A capital gain exclusion of \$250,000 (single) and \$500,000 (married) exists for sale of the principal residence. *Principal residence* is defined as the home where you lived for any two of the last five years. Consider when to sell the house—before or after the divorce.

**Caution:** Waiting too long after the party moves out of the home before their interest gets sold.

Effectively, the home must be sold within three years after the departing spouse moves out for exclusion to apply to the departing spouse. If the remaining spouse has the right to live in the home pursuant to the divorce or separation agreement, the remaining spouse's residence in the house will be counted as the departing spouse's residence for purposes of calculating the two-year requirement.

## Filing Status

Marital status for tax filing is set as of the last day of the year—December 31. If you are divorced as of December 31, you must file as single taxpayers (or head of household for that year, even if you lived together as a married couple more than half the year). If you are married as of December 31, and you and your spouse lived in the same household and were not legally separated, you must file as married—either joint or separate returns.

**Caution:** Filing separate and the use of standard and itemized deduction. The first one to file establishes the requirement of the other to do the same.

**Caution:** Joint return = Joint liability no matter what the divorce instrument says.

You may be able to file as head of household, even if you were legally married on December 31. To qualify as head of household, you must be considered “unmarried” on December 31. In order for you or the other parent to claim a tax exemption for a child or other qualifying person, you or the other parent must have paid more than half the cost of keeping up a home for the year for the child or other qualifying person, and that child or other qualifying person must have lived with you or the other parent in the home for more than half the year.

**Caution:** You are considered unmarried if you were legally separated on December 31 or if your spouse did not live in your home for the last six months of the year.

<b>Marital status at 12/31</b>	<b>Legally separated</b>	<b>Living together in the same household 7/1-12/31</b>	<b>Dependent child or other dependent living in the house</b>	<b>Tax filing status available for a year</b>
Married	no	yes	n/a	mfj, mfs
Married	yes	no	no	s
Married	yes	no	yes	s, hoh
Married	yes	no <sup>1</sup>	yes	mfj, mfs, hoh <sup>1</sup>
Divorced	n/a	yes	no	s
Divorced	n/a	no	no	s
Divorced	n/a	no	yes	hoh
Divorced	n/a	yes	yes	hoh

mfj: married, filing jointly  
mfs: married, filing separately  
hoh: head of household  
s: single

<sup>1</sup> IRC §§ 2(c) and 7703(b).

## Children and Dependency Exemptions

The custodial parent is entitled to the dependency exemption. Parents, together or separately, must provide at least one-half of the child's support.

Two exceptions to the general rule that the custodial parent is entitled to the dependency exemption are as follows:

1. A multiple support agreement is in place—§152(d)(3).
2. The custodial parent relinquishes the rights to the exemption (either annually or permanently IRS Form 8332—§152(e)(2)(A)).

*The custodial parent is entitled to the dependency exemption. Parents, together or separately, must provide at least one-half of the child's support.*

	<b>Age Requirement</b>	<b>Qualifying Child Relationship</b>	<b>Residence</b>	<b>Support</b>	<b>Citizenship</b>
Dependency Exemption	<19, or 24 if full-time student	Son or Daughter	Child resides with the taxpayer for > one-half of the year.	Qualifying child cannot provide more than half of their own support for the year.	A citizen or resident of the U.S.
		Stepson or Stepdaughter	Exceptions include temporary absences due to education, illness, vacation, or military service.		A citizen or resident of a country contiguous to the U.S.
Child Tax Credit	<17	Descendents of sons, daughters, stepsons, or stepdaughters Individuals who are legally adopted or a foster child placed with the taxpayer by an authorized agency or by court decree, order, or judgment			
Tuition Credits or Deductions	<19, or 24 if full-time student		Child must have the same principal place of abode in the U.S. as the taxpayer for > one-half of the year.	Support test does not apply for EIC.	
Earned Income Credit (EIC)	<19, or 24 if full-time student		Child must have the same principal place of abode in the U.S. as the taxpayer for > one-half of the year.	Support test does not apply for EIC.	



## Mortgage Interest and Real Estate Taxes

### In General

The joint owner who makes the payment is entitled to the deduction. If payments are made out of a joint account, there is a rebuttable presumption that a 50 percent payment is made by each party. Example: If Husband (H) pays 70 percent of the payment and Wife (W) pays 30 percent, the deductible portion of the payment is allocated in the same proportion.

### In a Divorce Context

If payments are not made pursuant to a divorce or separation instrument, general rules apply. If the home is jointly owned and payments are made directly to the mortgagee by H, the nonoccupant

- half of the qualifying interest and real estate taxes are deductible by H.
- half qualifies as alimony, provided the requirements of IRC § 71 are met (accordingly, this is deductible by H and taxable to W, and W may deduct her half of the mortgage interest and real estate taxes).

If the home is solely owned by W and H is still obligated on the mortgage

- the treatment of the interest deduction is the same as if jointly owned, provided a minor child of the marriage resides in the home with W.
- H cannot deduct any of the real estate taxes because he has no ownership interest.

If the home is solely owned by H (even though W may be living there with or without children of the marriage) and H makes the payments, then

- H would deduct 100 percent of the mortgage interest and taxes.
- none of the payments would qualify as alimony to W.

If W makes the payments, then

- they may be taxable as alimony to H, who would then be able to deduct 100 percent of the interest and taxes.

*The joint owner who makes the payment is entitled to the deduction. If payments are made out of a joint account, there is a rebuttable presumption that 50 percent of the payment is made by each party.*

## Retirement Plans and IRAs

### Qualified Retirement Plans

- Qualified Domestic Relations Order (QDRO)/Eligible Domestic Relations Order (EDRO)—Court can allocate an interest in a qualified retirement plan to a nonemployee spouse (alternate payee).
- To qualify as a QDRO, funds must be distributed to the alternate payee, or his or her designee, directly from the plan.
- Payments made as a result of a QDRO to the alternate payee have no effect on the participant in the pension plan.
- Benefit is taxed to the alternate payee when payments are received (not subject to 10 percent early withdrawal penalty) or may be rolled over tax-free into an IRA or other qualified retirement plan.
- DROs can be very complicated and costly to set up; a specialist is typically hired to do this.
- Alternate Solution—Borrowing from a retirement plan for property settlement payment.
- IRA transfers pursuant to a divorce or separation instrument are not taxable. Methods of transfers include the following:
  - Changing the name on the account, and
  - Making a direct trustee-to-trustee transfer of IRA assets.
- Divorce or separation instrument should state that the transfer is intended to be tax-free under IRC §408(d)(6).
- DROs do not apply to IRAs.
- Spousal IRA Contribution—If final decree is obtained by the end of the tax year, a spouse cannot deduct contributions made to a former spouse's IRA.
  - Withdrawing funds from an IRA to satisfy a divorce judgment causes the IRA owner to be taxed on the distribution and, if applicable, imposition of the 10 percent early withdrawal penalty.
  - Ten percent early withdrawal penalty can be avoided if withdrawals are “annuitized” over the recipient’s life expectancy. Once a series of withdrawals commences, it must continue at least until the
    - IRA owner reaches 59½.
    - taxable alimony received is treated as compensation for purposes of the IRA contribution and deduction limits.

*Qualified Domestic Relations Order (QDRO)/Eligible Domestic Relations Order (EDRO). A court can allocate an interest in a qualified retirement plan to a nonemployee spouse (alternate payee).*



## Stock Options and Deferred Compensation

### Equitable Distribution of Stock Options and Deferred Compensation in Divorce

Revenue Ruling 2002–22

1. A taxpayer who transfers an interest in nonstatutory stock options and nonqualified deferred compensation to the taxpayer's former spouse incident to divorce is not required to include an amount in gross income upon the transfer.
2. The former spouse, and not the taxpayer, is required to include an amount in gross income when the former spouse exercises the stock options or when the deferred compensation is paid or made available to the former spouse.

The same conclusion would apply in a case in which an employee transfers a statutory stock option (such as those governed by §422 or 423(b)) contrary to its terms to a spouse or former spouse in connection with divorce. The option would be disqualified as a statutory stock option (see §422(b)(5) and 423(b)(9)), and treated in the same manner as other nonstatutory stock options. IRC §424(c)(4), which provides that a §1041(a) transfer of stock acquired on the exercise of a statutory stock option is not a disqualifying disposition, does not apply to a transfer of the stock option.

This ruling does not apply to transfers of property between spouses other than in connection with divorce. This ruling also does not apply to transfers of nonstatutory stock options, unfunded deferred compensation rights, or other future income rights to the extent such options or rights are unvested at the time of transfer, or to the extent that the transferor's rights to such income are subject to substantial contingencies at the time of the transfer.

## Transferring and Redeeming Stock of a Closely Held Company

Often there is insufficient cash or other property to satisfy a division of marital assets when there is a closely held family corporation in the marital estate. When the desired result is the sole ownership of the business by one of the parties, the transfer of stock ownership for cash in divorce may involve two steps:

1. Transfer of stock from one spouse to the other, followed by
2. The recipient spouse transferring the shares to the corporation in redemption of all the shares received from the soon-to-be ex-spouse.

Carryover rules related to basis and holding period of the transferred shares apply in determining gain on the redemption. This can be a tax trap for the unsuspecting spouse. Structured properly, redemption at capital gain rates to the nonowner spouse can be accomplished. Structured improperly, the spouse retaining the business can be deemed to have received a constructive dividend (currently taxed at the same rate as capital gains, but historically has been at ordinary income tax rates), albeit while not receiving any cash to pay the tax. IRS Regulation 1.1041-2 indicates if a divorce or separation agreement between spouses or former spouses includes the following, the transferor spouse will be taxable:

- Section (c)(1)(i). Both spouses or former spouses intend for the redemption to be treated, for federal income tax purposes, as a redemption distribution to the transferor spouse; and
- Section (c)(1)(ii). Such instrument or agreement supersedes any other instrument or agreement concerning the purchase, sale, redemption, or other disposition of the stock that is the subject of the redemption.

Section (c)(2) relates to situations in which the nontransferor spouse will be taxable, including circumstances under which the nontransferor spouse will be deemed to have received a constructive distribution from the corporation followed by the deemed transfer of cash to the transferor spouse in redemption of his or her stock. If the divorce or separation agreement sets forth the following agreements of the parties, the transfer will be treated as a constructive distribution to the nontransferor spouse:

- Section (c)(2)(i). Both spouses or former spouses intend for the redemption to be treated, for federal income tax purposes, as resulting in a constructive distribution to the nontransferor spouse; and
- Section (c)(2)(ii). Such instrument or agreement supersedes any other instrument or agreement concerning the purchase, sale, redemption, or other distribution of the stock that is the subject of the redemption.



## Innocent Spouse and Separate Liability Relief

Relief from tax liability from the IRS is available to qualified individuals in three alternatives (IRC §6015):

1. Innocent Spouse—IRC §6015(b) and IRS Publication 971
2. Separation of Liability—IRC §6015(c)
3. Equitable Relief—IRC §6015(f) and Revenue Procedure 2003-61

Factors considered for relief by the IRS and courts (Revenue Procedure 2000-15, Section 4.03):

- Knowledge
- Economic hardship
- Significant benefit to the person seeking innocent spouse relief
- Later compliance with federal tax laws
- Tax liability attributable to nonrequesting spouse
- Nonrequesting spouse responsibility for the tax pursuant to the divorce decree
- Marital status
- Spousal abuse

Burden of proof for relief is on the taxpayer (IRC §6015(c)(2) and *Shafman v. United States*, 267 B.R. 709 (2001)).

Joint tax returns signed under duress are not joint (IRS Regulation §1.6013-4(d)).

IRS tax form for requesting relief under any of the three provisions (IRS Form 8857 [June 2007]).

Separate liability election requires the following:

1. The person is no longer married.
2. The person is legally separated.
3. The person is not a member of the same household at any time during the 12-month period prior to electing separate liability.

Filing the divorce complaint is not legal separation (*Vetrano v. Commissioner*, 116 T.C. 272, 282 (2001)).



Disclaimer: This guide is intended as a basic resource guide for family law practitioners. It should not be construed as providing divorce, tax, or legal advice and it is not intended to replace the advice and expertise of a qualified professional in the accounting or legal fields. Working with a qualified professional is strongly recommended. Applicable tax rules, laws and regulations change frequently and may have changed since the publication date of this guide. The material in this guide should be verified against the specific laws within your state.

Provided by the AICPA Family Law Task Force and the AICPA Forensic and Valuation Services Section



## Quick Reference Guide To Divorce-Related Tax Matters

[aicpa.org/FVS](http://aicpa.org/FVS)

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This **Quick Reference Guide** covers the essential information you need to know about the tax implications of divorce. Within you'll find concise explanations and helpful charts on topics such as:

- costs of getting divorced
- child support
- retirement plans
- transfer of stock

Experts in the field—the American Institute of CPA's Family Law Task Force and Forensic and Valuation Services interest area—created this practical guide.

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