

Divorce & Taxes



Determining the tax consequences that can arise during a divorce or marital separation can be vital for the financial protection and well being of you and your family. That's why it's important to understand applicable tax laws before making any major decisions.

Alimony

Generally, alimony is the amount paid to a spouse for his or her living expenses, education, health or life insurance, property taxes, or mortgage payment. Alimony is not for providing child support. The person receiving alimony is called the "payee spouse," and the person paying alimony is called the "payor spouse." The payee spouse must pay taxes on the alimony in the year it is received, and the payor spouse may deduct the amount in the year it is paid, provided the alimony meets all of the following conditions:

- The payment is made in a cash form, which includes checks, bank deposits, etc. Payment in the form of such things as bonds, stocks, money market shares, or actual objects are not considered alimony for tax purposes.
- The payment is made as the result of a legal separation agreement or divorce decree.
- The payor spouse and payee spouse do not live in the same household at the time the payment is made.
- The divorce instrument does not designate the payment as nontaxable to the payee spouse and nondeductible by the payor spouse.
- The payments are not designated as child support.

Note: There can be no liability for payments after the death of the payee spouse.

Child Support

Child support, unlike alimony, is not taxable to the payee spouse, nor is it tax deductible by the payor spouse. This is true regardless of how the payment is described in the divorce papers.

A divorce decree may specifically call a payment "alimony," but the payment may have the "characteristics" of child support. One characteristic of a child support payment might be the designation in the divorce document that the payment be terminated if the child's situation changes. If the payment appears to be more characteristic of child support than of alimony, the payee spouse will not pay taxes on it, and the payor spouse will not deduct it, despite what it's called in the divorce papers.

Dependency Exemption

Who claims the child's dependency exemption when a divorce occurs? For a taxpayer to claim another person as a dependent for tax purposes, the person must be either a qualifying child or a qualifying relative. A qualifying child must meet the following tests:

- **Relationship.** The child must be your son, daughter, step-child, eligible foster child, or a descendent of any of them, or your brother, sister, half brother, half sister, step-brother, step-sister, or a descendent of any of them.
- **Age.** The child must be under the age of 19, under the age of 24 if a full-time student, or be permanently and totally disabled.
- **Residency.** The child must live with you in the same home for more than half the tax year.

A qualifying relative must meet the following tests:

- The person cannot meet the qualifying child tests.
- The person must be related to you or a member of your household for the entire tax year.
- The person cannot have gross income that exceeds the personal exemption amount for the year.
- You must provide over half of the person's total support for the year.

The custodial parent (the parent who has physical custody for a greater portion of the year) is generally treated as the parent who meets the qualifying child test and is awarded the dependency exemption. It is possible for that custodial parent to transfer the exemption to the noncustodial parent.

If you are the child's noncustodial parent, your child will be treated as your qualifying child or qualifying relative only if all of the following apply:

- You were divorced, legally separated, separated under a written agreement, or lived apart from your former spouse at all times during the last six months of the year.
- Your child received over half of his or her support for the year from you and your former spouse.
- Your child is in the custody of you or your former spouse for more than half of the year.
- The custodial parent signs Form 8332.

If you meet all these rules, you can claim the dependency exemption and the child tax credit as a noncustodial parent. The noncustodial parent cannot claim the child as a qualifying child for head of household filing status, the child and dependent care credit, or the earned income tax credit.

Property Transfers

There is typically no gain or loss on the transfer of property from one spouse to another, or to a former spouse if the transfer is "incident to divorce". This rule applies to both separate and community property in divorces that occurred after July 18, 1984.

If a transfer is to be considered "incident to divorce," it must occur within one year of the divorce date, or must be made according to the terms of the divorce or separation document, and not more than six years after the divorce date.



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Because there is no gain or loss recognized at the time of the transfer, the basis of the property received is not adjusted.

Attorney Fees

Legal fees paid to obtain a divorce are usually not deductible for tax purposes. Fees paid in connection with the collection of taxable alimony or in relation to income-producing property are deductible as miscellaneous itemized deductions. Subject to 2% of AGI floor.

Related Issues

- If a joint tax return is filed, both the husband and wife can be held jointly and individually liable for the tax due, as well as any interest and penalty related to the joint tax return, without regard to what is stated in the divorce decree.
- An IRA interest transferred per a "qualified domestic relations order" (QDRO) and treated as a IRA of the receiving spouse is not taxable.
- The parent who is eligible to claim the child as a dependent is eligible to claim the American Opportunity Tax or Lifetime Learning Credit. This is true regardless of which parent paid the tuition.
- A Separate Liability Election is allowed, which limits your liability for tax, interest, and penalty on the tax liability allocated to your former spouse on a joint return.

Summary

Tax challenges during and following a divorce are common, but they can be minimized with some knowledge about tax laws and IRS procedures. Financial planning is an important part of the divorce process. As always, see your tax advisor for additional information on issues related to your specific situation.

This brochure contains general tax information for taxpayers. As each tax situation may be different, do not rely upon this information as your sole source of authority. Please seek professional advice for all tax situations.

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