CLIENT INFORMATION LETTER #61

TAX CONSIDERATIONS

Preface

Tax Considerations are an aspect of divorce negotiations and settlement agreements that are often overlooked. The Taxpayer Relief Act of 1997 made changes in the law which could potentially effect divorcing couples. This pamphlet is not designed to take the place of a consultation with and advice from a tax professional, such as a Certified Public Accountant. Rather, it is an attempt to identify some issues relating to taxes you may want to consider in your domestic situation.

Q. If my husband and I are separated but not divorced, do we have to file a joint tax return?

A. No, even married taxpayers who are living together are not required to file joint returns, but only married taxpayers are eligible to file joint returns if they so desire. For tax filing purposes, you are considered unmarried if a final divorce decree was entered by the last day of the tax year. There may be both advantages and disadvantages to filing separately. For example, spouses who file separate returns report their own incomes. However, if one spouse itemizes deductions, the other must also itemize and cannot claim the standard deductions. The best idea is to make the decision about filing separately or jointly, if you are entitled to do so, after discussing with your tax advisor the best way to minimize the tax paid to "Uncle Sam." You and your spouse may agree to file jointly, if that is most advantageous, and then provide a method for sharing the tax savings (or dividing the liability).

Q. Who gets to claim the kids?

A. For parents who are divorced, separated under a written separation agreement, legally separated under a court order, or who lived apart at all times during the last six months of a calendar year, the parent who has custody of the children for the greater portion of the year (the custodial parent) is generally entitled to claim the dependency exemption. However, the non-custodial parent may claim this exemption if there is a court order or separation agreement that gives that parent the <u>unconditional</u> right to claim the exemption or if the custodial parent releases the exemption to the non-custodial parent by completing IRS Form 8322 and attaching it to his or her tax return. Where parents are in different tax brackets, it often makes sense to transfer the exemption to the parent in the higher tax bracket (although individuals in the highest income bracket have all exemptions phased out and disallowed). This can be a good bargaining chip in the hands of a custodial parent in a lower tax bracket. In addition, a provision in a separation agreement which provides that the custodial parent will transfer the dependency exemption to the non-custodial parent if that parent is current in all child support and related obligations by the end of each year can be a good incentive for the non-custodial parent to stay current with his or her child support obligations.

Q. What's so important about the dependency exemption anyway?

A. The dependency exemption reduces your taxable income and consequently decreases the amount of taxes you pay. For the 2005 tax year, the amount of the dependency exemption is $3,300 for each dependent. The ability to claim at least one dependent is also important in determining whether you can claim "head of household" status which results in a lower amount of tax owed and a higher standard deduction than if your filing status is "single." In addition, there is a child tax credit of $1,000 for each child under the age of 17 and this important credit is linked to the dependency exemption. Only the parent eligible to claim the child as a dependent can take the tax credit for that child. This tax credit is subtracted directly from the amount of taxes you have to pay. The dependency exemption is also important in determining which parent can claim the new education credits which may be available for expenses paid for a child's post-secondary education. Caution: the dependency exemption, child tax credit and education credits all have high-income phase-out provisions which must be considered in determining whether you are eligible for these tax benefits.

Q. Will I have to pay taxes on the child support I receive?

A. No. Child support is not taxable to the person receiving it and is not tax-deductible to the person paying it. Therefore, $600 a month received in child support is actually $600 "in your pocket" which you will be able to spend on expenses without having to worry about taxes.

Q. I am a dependent spouse and I have figured out that I will need an extra $1,000 per month in order to pay my monthly expenses. If I get $1,000 a month in alimony, I'll be able to pay all my bills, right?

A. Wrong. Don't forget that alimony, unlike child support, is taxable as income to the recipient and tax-deductible for the payor. In order to determine how many "real dollars" you'll have to pay expenses each month, you need to consider your tax liability on the alimony you receive. For example, if you are in the 15% tax bracket, you will need to receive $1,176.47 in alimony to have $1,000 available after taxes (since you would pay $176.47 in taxes on that sum of alimony). On the other hand, if you are the person paying alimony, you will want to consider the tax benefit you'll get from the payments of alimony in determining the "out-of-pocket" effect of such a payment. For example, if you are paying $1,000 per month in alimony and you are in the 31% tax bracket, you will in effect be "out-of-pocket" $690 per month because you will get a tax deduction of $310. Caution: the tax effect of alimony described here depends on the payments meeting the IRS definition of alimony. This means that the payments:

- Must be in cash;
- Must be made pursuant a divorce or separation instrument, i.e., a court order for spousal support or a written separation agreement;
- Must not be made while the spouses are members of the same household;
- Must end upon the recipient's death;
- Must not be disguised property division or child support payments; and
- Must not be designated as a payment which is "not includable in the gross income of the recipient and not allowable as a deduction by the payor."

Q. My spouse and I have agreed to sell our home so that we can each get our share of the equity in it. What will I have to pay in capital gain taxes?

A. Probably nothing. The Taxpayer Relief Act of 1997 changed the law drastically as to capital gains on the sale of a home. No longer do taxpayers need to roll over the sale proceeds into another home to avoid capital gain taxes. Under the new law, regardless of age, each taxpayer can exclude up to $250,000 in capital gains ($500,000 for joint return) on the sale of the marital residence which has been owned and used by the taxpayer as his or her principal residence for two out of the five years prior to the sale. The spouse who acquires ownership of the house related to the divorce or separation can tack on the transferring spouse's period of ownership to his or her own. This is good news for a taxpayer who didn't qualify for the exclusion under prior law because he or she moved out of the marital residence leaving the other spouse in possession.

Q. Now that I've read your client information letter on tax considerations, I don't need to consult a tax specialist, right?

A. Wrong. The tax laws are complicated and have implications far beyond what can be addressed in this client information letter. The general information set out here is not a substitute for consulting with a tax professional. He or she can provide invaluable assistance to you in identifying tax consequences and developing strategies to minimize the negative consequences of your particular situation.

Thank you for asking about our helping you. Please let us know if you want a copy of "Yours for the Asking...," which is a list of our client handouts which will help explain specific domestic topics that might come up in your case. We'll be happy to send this to you. And, if you want any of these handouts, please send us a self-addressed, stamped envelope and circle the ones you want; we'll send them back to you free of charge.