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How to Avoid the TAX TRAPS in Divorce & Remarriage

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Your Marital Status and Taxes

Marital status is an important factor in the amount of income and estate taxes you will pay. Taxes should not be the determining factor in your decision to marry, divorce or remarry. However, an understanding of the part taxes play in this as well as in other areas of life will help you to keep your taxes as low as possible.

This brief review shows how far-reaching the tax implications of divorce and remarriage can be.

Property Settlement

A transfer of property as part of a divorce settlement is not subject to income tax. However, the basis (the cost for determining taxable gain) of the property transfers with the property and may create income tax for the spouse who receives the property if the property is later sold.

To illustrate, if a couple has a $100,000 house and a $100,000 bank account, it would not be an equal split to have each spouse take one asset. The $100,000 bank account has no income tax consequences connected with it. But if the house had a cost of $30,000, the person who gets it in the settlement could pay tax on $70,000 of gain when the house is sold at some future date.

When dividing property at the time of divorce, this potential tax liability should be factored into the valuation of various assets.

Alimony

Alimony is deductible by the person paying it and taxable to the person receiving it.

Certain requirements must be met for payments to be considered alimony. The payments must be in cash. The written instrument or decree must not designate that the payments are excludable from the income of the receiving party or nondeductible by the paying party. The payments must be received by or directly for the benefit of the receiving spouse. Liability for such payments or any substitute payments cannot extend beyond the death of the receiving spouse.

Any portion of a payment that is specified as support for the couple's minor children is not considered alimony.

In order to ensure that the payments deducted as alimony are not disguised property settlements (which are nondeductible), the regulations provide certain limitations on the term of payment and the fluctuation in the amount of annual payments.

Alimony may be paid out in as few as three years. If the payments in either year two or three drop by more than $15,000, the payor must pay taxes on a portion of the payment he or she deducted in year one and/or year two.

Both spouses' tax situations should be considered in determining whether you want amounts paid to qualify as alimony or not.

Child Support

Payments made for child support are not deductible by the spouse paying them, nor are they income to the spouse receiving them.

Child support may not be disguised as alimony. Payments not designated as child support will be reclassified as child support if they are to be reduced by a certain event in the child's life (i.e., when the child reaches a certain age, graduates, leaves home, etc.)

Dependency Exemptions

The law states that the custodial parent is entitled to the dependency exemption for children unless that parent waives the right to the exemption in writing.

Before a noncustodial parent may claim a child as a dependent, he or she must have a written statement from the custodial parent granting the dependency exemption. Exemptions for dependents are phased out for higher-income taxpayers. In the settlement, consider giving the exemptions to the spouse who will benefit most from them.

The parent who maintains a home for a dependent child for more than half of the year may still qualify for the earned income credit, the child care credit, and the head of household rate even if that parent has waived the dependency exemption to the noncustodial parent.

The parent who pays the child's medical expenses may claim them along with his or her own, regardless of which parent gets the dependency exemption.

Some Facts about Divorce, Remarriage, and Taxes

The statistics on divorce vary, depending on whose figures you use, but somewhere between 30% and 50% of marriages end in divorce.

One group of studies concluded that the most common form of marriage will soon be "remarriage." 75% of all people who divorce will remarry, and 60% of all people who remarry will divorce again.

Divorce and remarriage involve significant changes in the financial situation of the parties involved, and only careful planning with the assistance of an experienced tax advisor will minimize the tax cost of these events.

■ Deductible Fees

The cost of getting a divorce is not deductible. However, legal fees that relate specifically to a property settlement may be added to the basis of the property. Fees that you pay for obtaining alimony and for tax advice in connection with the divorce are deductible as miscellaneous itemized deductions.

■ Sale of Residence

If you or your spouse is age 55 or older at the point of divorce or remarriage, you should consult a tax advisor about the once-in-a-lifetime election to exclude up to $125,000 of the gain on the sale of a personal residence. If you sell your home before you divorce and elect the exclusion, neither of you may use the exclusion again, either singly or jointly with a new spouse.

If you're contemplating marriage and both you and your future spouse own homes that you want to sell, you should consider selling them before you marry. Each of you may then take the exclusion. If you wait and sell after you marry, the exclusion will apply on only one of the homes.

Professional advice is essential in this area.

■ Prenuptial Agreements

The conventional prenuptial agreement typically involves a transfer of money or property from the wealthier individual to the other individual in exchange for release of rights or claims against the richer one's property or estate. Where one individual has many assets or is involved in a family business, a prenuptial agreement may be a wise choice.

A prenuptial agreement is no do-it-yourself project; contact your lawyer for assistance if you think one is appropriate in your situation.

■ Wills and Estate Planning

Divorce and remarriage can have significant impact on the taxes that will be assessed upon an individual's estate when he or she dies. Any change in marital status should be followed immediately by a review of wills and estate plans. This is especially important where sizeable assets, children, or a family business is involved.

DIVORCE & REMARRIAGE: *A Tax & Financial Checklist*

Use the following checklist if you find yourself considering divorce or remarriage. The list is not all-inclusive and is no substitute for the professional assistance of your accountant and attorney.

When Contemplating Divorce –

- ☐ If you don't already have a credit card in your own name, apply for one.
- ☐ Consider establishing a credit history in your own name by taking a small bank loan. If necessary, have a friend or relative co-sign.
- ☐ Make an inventory of all assets, noting market value and cost. List all debts. This inventory gives you a starting point for a division of joint assets.

When Divorce Has Been Decided Upon –

- ☐ Get a lawyer. If you don't know any, ask friends or the state bar association for recommendations. Interview several, if necessary, to find one with experience and personal compatibility. Don't hesitate to ask about fees.
- ☐ Close out joint charge and checking accounts.
- ☐ If appropriate, notify creditors in writing that you will no longer be responsible for your spouse's debts.
- ☐ Work with your spouse to try to reach an agreement on property division and matters concerning children. If you can't agree, your divorce could be more costly, or decisions could be left up to a court.

  Using a professional mediator to help you work out a nonbinding agreement may save time and money. Your accountant should assist with financial details and both parties' attorneys should review any agreement before it is signed.
- ☐ Be aware that assets equal in value may not be equal in their tax consequences. Be sure taxes are taken into account in dividing property.
- ☐ Get the tax records you'll need for any property you receive in the divorce.
- ☐ Have your attorney specify the tax advice portion of his bill. If you meet the level for deducting miscellaneous expenses, this amount will be tax deductible.
- ☐ Be sure your divorce agreement addresses estimated taxes already paid. Decide who gets to claim them. Also, decide who pays any additional IRS assessments, if any, on joint returns filed in prior years.

After Divorce –

- ☐ Check all health, life, disability, auto, home and other insurance policies as well as your IRA and other pension plans. Change coverage and beneficiaries as appropriate.
- ☐ Review your will for appropriate revisions.
- ☐ If you're receiving alimony, consider an IRA. Alimony is considered compensation for IRA contribution purposes.
- ☐ Review your tax withholding and estimated tax payments for any necessary adjustments.
- ☐ Review your eligibility for the earned income tax credit.

When Contemplating Remarriage –

- ☐ If you or your spouse-to-be is 55 years or older, check the tax consequences of selling one or both of your residences before rather than after you marry.
- ☐ If one of you has sizeable assets, consider a prenuptial agreement.
- ☐ If one or both of you have children from a previous marriage, discuss your financial obligations and expectations.

After Remarriage –

- ☐ Revise wills and estate plans. Consider trusts for children of a prior marriage.
- ☐ Check all insurance policies, pension plans and IRAs again for coverage and beneficiary designations.
- ☐ Review the manner of holding title for various assets to be sure you're achieving the result you want.
- ☐ Review your withholding and estimated tax payments for necessary adjustments.
- ☐ Review your eligibility for an IRA deduction to see if it has changed.