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WEALTH MANAGEMENT

Eight Critical Tax Considerations for Divorcing Couples

When facing a divorce, most people aren't thinking about the potential long-term tax consequences. They simply want to finalize what can be a stressful and emotional process and move on with their lives. However, poor tax planning can cause problems that may not become apparent until much later—sometimes years after the final divorce decree was issued. Such problems can be difficult and expensive to resolve.

Paying attention to these eight key tax issues early in the negotiation and settlement process can help avoid costly missteps and allow couples to disentangle their financial lives in the most efficient way possible.

1. Determining the Appropriate Tax Filing Status

A couple's tax filing status is determined by their marital status on the last day of the tax year, typically December 31.

If the divorce has not been finalized by that date, the couple will need to determine whether they should continue to file a joint return, or whether they should choose "married filing separately."

Filing joint tax returns may result in lower taxes for both spouses. However, doing so also means that each spouse can be held responsible for the taxes and any interest and penalties due. In a relationship where one spouse earned most or all of the income, this can be a significant risk for the lower-earning spouse. Filing separate returns allows each spouse to report his or her own income, exemptions, deductions and credits, so responsibility for the associated tax obligation rests with each spouse individually.

After the divorce is final, individuals may be able to file as "head of household" if they can claim a dependent who lives with them in their home, provided it is the dependent's main residence and the individual pays for more than half of the home's maintenance for at least half the year. Head of household offers a more favorable tax treatment than filing as "single," and can be an important bargaining point between spouses when devising a settlement.

2. Choosing the Appropriate Time to Finalize the Divorce

There are circumstances in which waiting to finalize the divorce until after December 31 may be more advantageous from a tax perspective. For example, if one spouse earns significantly more income than the other, having to file as single could result in a higher tax bill, as the tax brackets for single filers are generally less forgiving than for those who can choose "married filing jointly."

However, in cases where both spouses are high earners, filing jointly could put them in the highest tax bracket, whereas filing separately would not.

3. Sorting Out Who Gets Tax Credits

A dependent cannot be claimed by more than one person, so divorcing spouses need to understand the rules that the IRS uses to determine who is entitled to do so. It's presumed that a parent who has physical custody of a child for most of the year is entitled to claim the Child Tax Credit. There are, however, times when it can make sense for the non-custodial spouse to claim the credit, and it may be possible to structure the divorce agreement creatively, by alternating who gets the credit each year or splitting multiple dependents between spouses.

4. Understanding Changes to the Tax Treatment of Alimony Payments

Tax legislation passed at the end of 2017 eliminated deductions for many previously deductible expenses. For divorce agreements entered into after December 31, 2018, alimony payments are no longer tax deductible for the paying spouse and no longer taxable for the receiving spouse. However, alimony-paying spouses who enter into divorce agreements prior to that date can still take advantage of the deduction.

5. Determining the Best Way to Transfer Property

Generally speaking, property transfers made during the divorce are treated as non-taxable events for federal income and gift taxes.

However, in certain situations, it may make sense to forego the tax-free treatment that the law affords divorcing spouses for property transfers, and instead intentionally create a taxable event by structuring the transaction as a "true sale" more than one year after the divorce is finalized. This could allow the spouse who purchases their ex-spouse's share to benefit from an increased cost basis on the property.

When selling a personal residence that was used as a principal residence for two of the last five years, up to $250,000 (filing as single) or up to $500,000 (filing as married) may be excluded from capital gains tax.

6. Recognizing the Value of Tax Carryovers

Also, remember that when negotiating how assets and liabilities will be divided, tax carryovers like capital losses, passive activity losses, net operating losses, and charitable deductions are considered to have inherent value, just like property.

Waiting until tax time to discuss the allocation of tax carryovers may be too late. They should be discussed during negotiations, just like other assets.

7. Transferring Retirement Assets

In order to transfer all or part of a qualified retirement plan as part of a divorce settlement, a court must issue a qualified domestic relations order (QDRO). There are no tax consequences if the transfer is structured appropriately as an eligible rollover distribution.

When receiving a portion of a former spouse's retirement account under a QDRO, the recipient needs to decide whether to keep it in the existing plan or whether to roll the funds into an IRA.

QDROs do not govern the division and transfer of IRA assets. However, it's possible to transfer IRA dollars using a trustee-to-trustee (direct) transfer with no tax consequences, as long as the transfer is related to the divorce. To be exempt from taxes and early withdrawal penalties, such transfers must be handled in accordance with IRS regulations.

8. Finding the Right Solution for Spousal Support

Spousal support (alimony) payments are common in divorce scenarios. However, alimony may not always be the best option to provide support for a lower-earning spouse.

It may be advantageous to set up a trust that makes payments to an ex-spouse and have those assets revert back to the grantor (or ultimately be paid to the children) if they are not fully used.

Thoughtful Planning Can Help Avoid Further Entanglement

When contemplating and negotiating divorce settlements, the best approach is to look at each asset individually and as part of the bigger picture. A thoughtful advisor should be able to provide an objective, clear-headed perspective on the potential benefits and consequences of each decision in order to create a divorce settlement that is designed to avoid the costly and frustrating tax consequences that can result from poor planning.

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