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Tax Considerations in Divorce

Tax issues you and your client should consider discussing before a divorce is finalized

Key points

- Taxes may not be the top priority of your clients when you are helping them through their divorce, but there are many decisions made in a divorce that can impact your client's tax situation for a long time
- These decisions can be costly and if you are not aware of the tax implications of these choices, then any additional tax cost will not be accounted for in the divorce settlement
- Being equipped with information regarding the tax implications of divorce may help you navigate these complex tax issues with your clients and help them work toward a reasonable divorce settlement agreement

Taxes may not be the top priority of your clients when you are helping them through their divorce, but there are many decisions made in a divorce that can impact your clients' tax situation for a long time. These decisions can be costly and if you are not aware of the tax implications of these choices, then any additional tax cost will not be accounted for in the divorce settlement.

It's important that your client consult a tax professional who can work with you and your client to help ensure that there are no unknown or unintended tax consequences in the divorce settlement. Working with a tax attorney or tax accountant who understands the tax laws may help ensure that your client will not incur any current or deferred tax liabilities that you are unaware of when executing the divorce agreement. A tax advisor can review the divorce or separation agreement before it is finalized to determine the tax consequences of the agreement. While this advisor will typically consider any potential tax issues from a technical standpoint, there are some basic things that may be helpful for you and your client to know.

Spousal support payments are commonly used in divorce settlements to shift cash from one spouse to another to provide income

It's important to understand how these payments will impact your client's taxable income and cash flow. Alimony is one type of spousal support payment. The Tax Cuts and Jobs Act tax legislation changed the tax treatment of alimony paid and received. Any divorce or separation agreement instituted on or after January 1, 2019, is governed by the new tax law and alimony income is not taxable to the recipient and there is no tax deduction for alimony paid. The tax treatment of alimony for agreements completed by December 31, 2018, was not changed by this legislation and payments that qualify as alimony are taxable income to the payee and tax deductible to the payer.

Not all payments made from one spouse to another are considered alimony

In order for spousal support to qualify as alimony, the payments need to be made pursuant to a divorce decree or separation agreement. Payments must be made in cash, not property. The spouses may not live in the same household, they may not file a joint tax return, and there can be no requirement that payments be made to the payee after death.

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A tax advisor can work with your client to determine the most advantageous filing status for his or her circumstances.

Determining an individual's projected post-divorce cash flow can be essential in divorce planning

An analysis of projected cash flow enables you to determine if a proposed divorce settlement may allow your client to maintain his or her current lifestyle by considering the anticipated income and spending needs of your client. Your client will need to provide you with his or her current sources of income, anticipated expenses, and assets and liabilities in order for you to determine an equitable divorce settlement. This information can also be used to simulate potential asset division scenarios that can be analyzed to project estimates of your client's annual cash flow and the length of time that the client's assets may last based on his or her spending needs. Providing this type of cash flow analysis to your client can help instill confidence in a secure financial future after the divorce is finalized.

The division of the marital assets is used to equitably allocate the assets and liabilities of the divorcing couple

A tax advisor can determine any tax ramifications of assets or liabilities your client will receive in the divorce. Each asset can be taxed differently, even when the asset seems to be comparable. One example is the division of retirement assets such as a 401(k) or Individual Retirement Account (IRA). There is a big tax difference between receiving traditional or Roth IRA or retirement plan assets. Traditional IRA and retirement plan assets are taxable when the assets are distributed to the beneficiary while Roth IRA and retirement plan assets are distributed to the beneficiary tax free. Real estate received as part of a divorce settlement may be taxable when the asset is sold, so it is important to know the cost basis of any real estate received along with any tax deductions that have been claimed on that real estate, such as depreciation. The cost basis and depreciation will impact your client's taxable income when this asset is sold. The potential tax on the sale or distribution of assets received in a divorce should be considered when these assets are divided.

Once your client is divorced or separated there will likely be a change to his or her tax filing status

You may be wondering what this means for your client. A taxpayer's tax filing status is used to determine a number of factors on the tax return, including, but not limited to, the tax rate. A taxpayer's marital status on the last day of the tax year determines the filing status for that entire tax year. An individual will be considered to be divorced for the entire year if the divorce was finalized on or before December 31 of the tax year. A divorced individual is able to use the Single or Head of Household filing status for the tax year in which the divorce was finalized.

Going through a divorce can be a long process, and in many cases a couple in the middle of a divorce is still married at the end of the tax year

Taxpayers not legally divorced or separated on December 31 are considered married for that tax year and will have the option to file their tax returns as Married Filing Jointly, Married Filing Separately, or Head of Household. The Married Filing Jointly filing status will usually result in a lower overall tax bill, but many individuals don't want to have to work with their spouse to get the return filed, as there may be disagreement regarding factors that impact the return. If your client is in this situation, then his or her next best option may be the Head of Household filing status.

The Head of Household filing status is typically more advantageous than the Single or Married Filing Separately filing statuses if the taxpayer has a dependent child

A taxpayer is able to file as Head of Household if the taxpayer is not married or is legally separated at the end of the tax year or the taxpayer did not live with his or her spouse for the last six months of the tax year. The taxpayer also has to have paid for more than one half of the costs to maintain the household and the taxpayer's child(ren) must qualify as dependent(s) and live with the taxpayer for more than one half of the year. All these rules probably seem overwhelming, but it's important for your client to know that there are options when trying to determine the correct filing status. A tax advisor can work with your client to determine the most advantageous filing status for his or her circumstances.

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There are also taxable income division considerations that are helpful for your client to know

If your client has been filing a return jointly with his or her spouse since they were married, then they reported all income on the same tax return without having to determine what income belonged to each spouse. When divorcing, your client will need to figure out his or her income separately so that each spouse reports the proper amount of income. Determining the proper allocation of income and deductions in the tax year a divorce is finalized or when a divorcing couple chooses to file separately is dependent on the distribution laws of the state where the divorce decree was issued. Taxpayers in most community property states are required to equally split all community income up to the date of the divorce decree. After the divorce has been finalized, all income from that date through the end of the tax year is reported by the individual who earned it. Taxpayers divorcing in an equitable distribution state will report all income they earned individually and any income received from property they personally own.

Not only is divorce difficult, but it can be very expensive

It's commonly asked whether or not any of the attorney or advisor fees incurred during a divorce are tax deductible. Fees paid for tax planning and legal tax advice are not tax deductible for federal purposes. Unfortunately, the Tax Cuts and Jobs Act legislation repealed the deduction for legal and other professional fees for individual taxpayers beginning January 1, 2019. This provision of the law does sunset, meaning that as of January 1, 2026, the deduction for legal and professional fees will once again be allowed, unless further legislative action occurs. There are some states that still allow a tax deduction for legal and professional fees so you can recommend that your client discuss the tax deductibility of these fees with a tax advisor to fully understand the rules for his or her state.

There is another piece of information that is easy to overlook but has a big impact on the actual amount of tax paid.

An overpayment on your client's prior year tax return that has been applied to next year's estimated tax and estimated tax payments that have been paid during the tax year can be allocated between spouses.

The IRS allows taxpayers to allocate these payments in any agreed upon manner as long as an explanation for the allocation is attached to the tax return when it is filed. The distribution laws in your client's state may dictate the allocation of these payments. The payments will likely have to be allocated equally to each spouse if the divorce is in a community property state and the tax payments were made with community funds. The laws for equitable distribution states may require that any estimated tax payments be divided among spouses in proportion to each spouse's separate tax liability.

Tax laws are complicated. However, being equipped with information regarding the tax implications of divorce may help you navigate these complex tax issues with your clients and help them work toward a reasonable divorce settlement agreement.
