

Tax Considerations for Divorcing Couples

Presented by 4Rivers Wealth Management

In a divorce, the division of property, payment of alimony, and receipt of child support come with federal income tax implications. Understanding the rules and exceptions can help you avoid falling into a tax trap.

Property Settlements

As a general rule, no gains, losses, or taxes are recognized when assets are transferred between ex-spouses within one year of the marriage's end. The transfer can occur anytime within six years of the divorce if a separation or divorce agreement instructs the parties to make the transfer.

The property's cost basis and the holding period carry over to the recipient. The basis will not increase even if one spouse buys (or trades) the property from the other. The transfer of property with deferred gains to a spouse does not usually trigger immediate taxes. One exception is a change of ownership of U.S. savings bonds.

As a result of the Supreme Court's ruling in *Obergefell v. Hodges*, same-sex couples who are legally married under applicable state law will receive the same tax treatment as opposite-sex couples in the event of a divorce.

The IRS rules for tax-free division of marital property do not apply, however, to same-sex couples who are not legally married, nor do they cover transfers to a nonresident alien spouse. A transfer of assets between a divorcing same-sex couple not legally married or to a non-U.S. citizen spouse living abroad may be treated as a gift. Any transfer greater than \$17,000 between nonmarried same-sex partners, or greater than \$175,000 between nonresident alien spouses, requires the filing of a federal gift-tax return. Any available lifetime gift exemption will be applied to offset taxes.

For more details about the tax treatment of property settlements, please see IRS Publication 504 at <https://www.irs.gov/publications/p504>.

The Family Home

If the couple's primary residence is sold after the divorce and at least one of the spouses owned and lived in the home for two of the previous five years, both spouses can potentially qualify for the IRS's \$250,000 gain exclusion. If your home was transferred to you by your former spouse as a result of the divorce, you are considered to have owned it during any period of time when your spouse owned it. You are also considered to have lived in the home for the purpose of this exclusion if you owned it and your former spouse was allowed to live in it under a divorce or separation agreement and used it as their main home.

A divorce or legal separation under a decree of divorce or separate maintenance is also considered an "unforeseen circumstance" safe harbor, qualifying for a partial gain exclusion from the sale of the family home.

See IRS Publication 523 at <https://www.irs.gov/publications/p523> for more information about the tax consequences of selling your home.

Alimony and Child Support

Depending on when the divorce occurred, alimony may be taxable income to the recipient and is potentially deductible by the person paying it. To qualify as alimony, the amount must be required by the divorce or separation agreement and paid by cash, check, or money order. Another requirement is that the divorced couple cannot live in the same household or file a joint return. If you pay alimony to a former spouse, you cannot claim that spouse as a dependent for income tax purposes. If you are a recipient of alimony, you may wish to consider quarterly tax payments to the IRS or additional withholding on your other income to avoid potential penalties.

Under the Tax Cuts and Jobs Act of 2017, alimony payments are no longer deductible by the payer, and, consequently, the payee cannot include the money as taxable income. This change applies to divorce settlements made after December 31, 2018. It can also apply to existing agreements that are modified after that date but only if the modification explicitly states that the new rule applies. It is worth noting that, unlike many provisions of the Tax Cuts and Jobs Act, the removal of the alimony deduction will not sunset in 2025.

Child support is not treated as taxable to the recipient, nor is it deductible by the payer. Sometimes, the court will order a sum that represents both child support and alimony. Child support is that part of the payment that will be reduced or cease due to an event relating to or associated with the child. If you pay for a child's medical expenses, you may be able to take a medical expense deduction even if you are not the primary custodian or do not claim the child as a dependent.

IRS Publication 504 provides more information about alimony and child support tax issues.

Income Tax Returns

For federal tax purposes, your marital status on December 31 determines your tax filing status for the year. If you are legally married on the last day of the tax year, you are considered married for income tax purposes. If you are considered married, you and your spouse can elect to file a joint return and benefit from certain tax advantages.

A single parent may claim head-of-household filing status if they provide more than half the cost of running the household for a qualifying dependent and live apart from a spouse. This filing status generally results in lower taxes than filing as single or married filing separately.

As a general rule, a dependent deduction and child tax credit are allowed for the parent who cares for the child for the majority of the year, even if that parent pays less than 50 percent of the child's support. Both parents can, however, agree (in writing) to allow the noncustodial parent to take the deduction until the child reaches the state's age of majority and to take the child tax credit until the child is 17. The dependency exemption is usually not available after the child reaches age 19 (or, if a full-time student, 24) unless the child is permanently and totally disabled, or unless the child's gross income for the year is less than \$4,400 and the parent provided more than half the child's total support for the year.

Childcare tax credits and reimbursement from a dependent care flexible spending account (DCFSA) may be available for expenses incurred for children younger than 13. Only the custodial parent can claim a childcare tax credit or be reimbursed from a DCFSA, even if they are not eligible to claim the child as a dependent for tax purposes.

See IRS Publication 504 for more information about the filing status options and deductions for divorced or separated taxpayers.

Retirement Accounts

Retirement assets are often split to equitably divide marital assets. The only way to avoid immediate taxation when retirement assets are shifted to the other spouse is for the division to be spelled out in the divorce or separation agreement. In addition, the courts will often issue a qualified domestic relations order (QDRO) instructing the employer on how to separate the assets. If the employer allows, you can move your share of your spouse's retirement account to an IRA. To avoid withholding tax, elect a direct transfer to the new IRA custodian.

Often, traditional pension plans don't offer a rollover option. The employer will account for your benefits in a separate account within the plan or, alternatively, when a pension payment is due, write two checks, one for each party. Generally, each party is responsible for their own taxes. Note that a QDRO-ordered distribution to a child or other dependent is always taxed to the participant spouse.

One of the advantages of a QDRO is that the 10 percent penalty does not apply for early withdrawals from 401(k), 403(b), or 457(b) plans made to a former spouse who is younger than 59½; however, the mandatory 20 percent withholding tax does. Unlike with QDROs, a divorce does not qualify as an exception to the 10 percent early withdrawal penalty for IRA distributions before age 59½.

Remember that an informal or mediated agreement between spouses to divide retirement assets is not recognized by the IRS and will result in immediate income taxes. It is important to time the distribution after the agreement is finalized or at the written direction of the court. IRS Publication 575, available online at <https://www.irs.gov/publications/p575>, provides more information about the taxation of retirement assets.

This material has been provided for general informational purposes only and does not constitute either tax or legal advice. Although we go to great lengths to make sure our information is accurate and useful, we recommend you consult a tax preparer, professional tax advisor, or lawyer.



4Rivers Wealth Management
Foster Plaza 5 - 651 Holiday Drive | Suite 540 | Pittsburgh, PA
15220 412.216.8222 | www.4riverswm.com