Taxing Issues for Divorcing Couples

Caught up in the emotional turmoil that usually accompanies divorce, it is easy to for estranged couples to overlook the serious financial issues that arise as they seek to divide up their assets and establish independent lives. But even in the midst of fraught divorce proceedings, it is important to consider the tax implications of property division, custody arrangements, and child and spousal support agreements.

To steer clear of potential tax-planning pitfalls, consider the following issues before signing any divorce-related legal agreements:

What is my filing status? If you and your partner were divorced on the final day of the tax year, you must file as single or head of household. You may also be permitted to choose these filing categories if you and your partner lived apart for at least the final six months of the year, or if you have a legally binding separation agreement.

If, however, you were still legally married on December 31 and were not living separately during the second half of the year, you are required to file a joint return or individual returns with the married filing separately status. Assuming you and your partner trust each other to provide honest information and divide fairly your collective tax obligations, you may choose to file a joint return. But if the divorce is acrimonious—especially if you suspect your spouse of tax evasion or criminal activity—filing separate returns could be the safer route.

The filing status most advantageous for you and your ex-spouse depends on your individual circumstances. In most cases, married filing jointly and head of household filers owe less in federal taxes than single and married filing separately filers. A major drawback of the married filing separately status is that the partners may not itemize deductions individually: if one spouse itemizes, the other must as well. You also forfeit certain tax deductions by filing separately instead of jointly.

Who claims dependent exemptions? The IRS generally presumes the custodial parent will claim the exemption for dependent children following a divorce or legal separation. But, while it is never possible to split the exemption for a single child, the divorced or separated parents may agree to divide between them the exemptions for two or more children. The custodial parent also has the option of transferring one or more exemptions to the non-custodial parent.

Should we agree to alimony or child support payments? Child support payments are not deductible to the parent paying them, while alimony payments are taxable to the parent receiving them. Because the non-custodial parent making the payments is often the higher earner, he or she may wish to save on taxes by remitting the money in the form of alimony, rather than child support. While this is generally allowed, the IRS has complex rules about what forms of alimony may be deducted. Alimony that looks like some form of child support or property settlement, such as spousal support payments that taper off or stop as the children get older, may not be considered fully deductible.

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What happens to the house and other property? You and your spouse are permitted to make tax-free transfers of property before signing divorce papers, usually as part of a property settlement agreement. Your options include signing over ownership of major assets such as a house or car, or selling the property and splitting the proceeds.

If, however, one partner retains ownership in appreciated property and buys out the other partner's share, the tax consequences are more complicated. Before agreeing to pay out half the value of appreciated property, take into account any capital gains or other taxes that could eventually be owed when the item is sold. If you are leaving the marital home while your ex remains in residence, a properly framed agreement should allow you to retain a stake in the property but avoid owing taxes when the house is sold.

How do we split the retirement accounts? Retirement savings in the form of company pensions, 401(k) accounts, or IRAs may be among a couple's biggest assets. Even if an account is in one partner's name only, a divorce agreement may specify that the ex-spouse receive a designated portion of the account's funds. A qualified domestic relations order (QDRO) is typically used to make a former spouse a co-beneficiary of a qualified employer-provided retirement account. Like the plan participant, the partner who receives the retirement benefits is responsible for paying any taxes owed upon withdrawal of the funds. If transfers are made to a child under a QDRO, the participant must pay the taxes due.

No QDRO is needed to transfer all or a portion of the funds from your own IRA to an IRA set up for your ex-partner, but the divorce agreement must contain the proper language specifying that the rollover is intended to be tax free, or you will be liable to pay taxes, and possibly a penalty, on what is essentially considered to be a premature withdrawal of funds.

Even divorces that are relatively straightforward and amicable can be surprisingly complicated when it comes to paying taxes. If you are preparing to divorce, call us for advice.

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