VALUATION OBSERVATIONS

Some practical observations from a practicing business appraiser.

VLC

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THE SOON TO BE DIVORCED, THE NEWLY DIVORCED, AND TAX RETURNS…

With the New Year, comes the time to get back to business, for you and your clients. Considered to be one of the more dreaded things to do in the beginning of the year is filing tax returns. Tax filing can become quite problematic when someone is either in the process of getting or has recently finalized a divorce. Divorce creates a number of unique tax filing issues that need to be considered before returns can be accurately and timely filed. The adversarial nature of many divorces compounds the difficulties of these filing situations.

The first question you must answer is whether the marriage is officially terminated at the end of the year for tax purposes. We need to know this to determine the proper filing requirements. IRC §6013 and §7703 state that a couple remains married for tax purposes until they are legally separated under either (1) a final decree of divorce or (2) a final decree of separate maintenance. Taxpayers whose divorce becomes final during the year cannot file a joint return together for that year.

If the divorce has become final during the year, the choices are either Single or Head of Household (one who maintains a home for a child). Head of Household is tax advantageous. But there are rules. A person may claim head of household status if he/she is unmarried as of December 31 and has the same residence as a qualifying child for more than ½ of the year. The child does not need to be claimed as a dependent, just live in the same household for more than ½ of the year.

Even if the divorce has not been finalized, Head of Household may still be an option. Recently, the Tax Court held in *E. Lozoya, T.C. Summary Opinion 2005-73* that although the separated father was technically married at the end of the tax year, the taxpayer was entitled to file as head of household because (1) he filed a separate return, (2) he paid over half the cost of maintaining a household, (3) he used that household as the principal place of abode for at least one dependent, and (4) the taxpayer's spouse was not a member of the household during the last six months of the year. Here again, the taxpayer does not need to claim the child as a dependent so long as the child lived in the same household for more than ½ of the year.

If the requirements for Head of Household are not met, the choice becomes whether to file a Joint Return or Married Filing Separate Return. The two primary considerations when making this decision are (1) liability and (2) tax savings.

If the couple files a Joint Return, each spouse will be jointly and severally liable for the tax on the combined income, including any additional tax that the IRS may assess, plus interest and penalties. What this means is that the IRS can go after either spouse to collect the full amount, unless a spouse is able to establish qualification for innocent spouse relief under IR §6015. This applies even if the divorce decree states that one spouse is responsible for any additional taxes due on previously filed joint returns. Refer back to *Valuation Observations Vol. 5, No. 8* for a detailed discussion of innocent spouse relief. So, if an individual does not want to be potentially responsible for the tax of the other spouse, that individual should consider filing a separate return - even if some of the tax savings of filing joint would be lost.

If filing separate returns seems to make sense, there are rules. Yes, the IRS has lots of rules. A sampling of the applicable rules are:

1. If one spouse itemizes deductions, the other must also itemize.
2. Credits for child care, earned income, education, and adoption generally are not available.
3. A greater percentage of social security benefits may be taxable.
4. The exclusion of gain on sale of a principal residence is only $250,000, rather then the $500,000 for a joint return.
5. The benefit of the $25,000 passive loss exception for rental real estate will be lost.
6. No exclusion is allowed for interest income from Series EE bonds used for higher education expenses.
7. The deduction for interest on qualified education loans is not available.
8. A traditional IRA cannot be converted to a Roth IRA when separate returns are filed.
9. If "kiddie tax" comes into play, the child's tax rate on unearned income is based on the higher taxable income of the two parents.
10. If a taxpayer is supporting a relative of his/her spouse, that dependency deduction may be lost. The relationship or member-of-household test for dependency exemptions must be met personally by the spouse claiming the deduction.

Each case is based on the specific facts and circumstances. The costs and benefits must be weighed and balanced.

Watch for next month's edition, where we will discuss some of the often over-looked credits that may be available.

If you would like additional information, or have a question, please do not hesitate to call.

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Terri Lastovka is the founder of Valuation & Litigation Consulting, LLC. Her practice focuses on business valuations and litigation consulting in the areas of domestic relations, gift and estate tax, probate, shareholder disputes, economic damages, and forensic accounting. She draws from a wide range of experiences, including public accounting, law, banking, and CFO. She has received extensive training from the American Society of Appraisers in the area of business valuation and works closely with members of the bar to effectuate practical settlements. Terri also serves as the Director of Legal & Finance for Journey of Hope, a grass roots non-profit organization providing financial support to cancer survivors.