Divorce Planning Workshop

Financial and Tax Issues

Presented by Terri A. Lastovka, CPA, JD, ASA

August 2003

- Filing of Income Tax Returns
    - Filing Status
    - Standard Deduction
    - Dependency Exemption
    - Child Tax Credit
    - Earned Income Credit
    - Child Care Credit
    - Sale of Jointly Owned Property
- Alimony
- Child Support
- Property Settlements
- Innocent Spouse Relief
- Retirement Plans
    - Qualified Domestic Relations Order (QDRO)
    - Individual Retirement Arrangements (IRA)
- Social Security Benefits

Filing Status

Your filing status is partly determined by your marital status on the last day of the year.

You are un-married if you have obtained a **final decree of divorce** or **separate maintenance order** by the last day of the year. You will file either single, or head of household. An exception to this rule is if you live apart from your spouse (see head of household requirements below).

If you obtain a **decree of annulment** (which holds that no valid marriage ever existed), you must file amended returns for all tax years that you filed "married" for those years that are not closed by the statute of limitations (3 years after the due date of the original return). On the amended returns, you will change your filing status to either single or head of household.

Head of Household requirements:

Even if you are married, you will be considered un-married on the last day of the year if you meet ALL of the following tests:

1. You do not file a joint return.
2. You paid more than half the cost of keeping up your home for the year. (Child support received is considered the other parent's contribution to the upkeep of the home).
3. Your spouse did not live in your home during the last 6 months of the year.
4. Your home was, for more than half the year, the main home of your child. Generally, you must be able to claim an exemption for your child (even if you released the exemption to the non-custodial parent).

Benefits of filing head of household:

1. You can claim the standard deduction even if your spouse files separately and itemizes deductions.
2. Standard deduction is higher for head of household than for single or married filing separate.
3. Tax rates are lower for head of household than for single or married filing separate.
4. You may be able to claim certain credits (e.g. child care credit and earned income credit) that you may not claim on a married filing separate return.
5. The limits on itemized deductions and the phase-out for personal exemptions are at income levels twice as high as for single or married filing separate.

Standard Deduction vs. Itemized Deductions

If you are married and filing a separate return, and your spouse itemized deductions, then you are not eligible for the standard deduction and must itemize deductions even if the amount is below the standard deduction amount.

Dependency Exemptions - Who gets it?

Custodial parent – per divorce decree or separation agreement.

If there is no divorce decree or separation agreement - Parent with physical custody for the greater part of the year that they did not live together.

Note: The custodial parent can release the exemption to the non-custodial parent by using Form 8332 or a similar statement making a written declaration.

If there is no decree or agreement, you must look to who provided more than half the support of the child.

> All child support payments actually received from the non-custodial parent are considered used for the support of the child. However, if you fail to pay child support in the year it is due, but pay it in a later year, your payment of the overdue amount is not considered paid for the support of your child either for the year the payment was due or for the year it is paid. *Coveat – Pay on time!*

Phaseout of Exemptions:

> The amount you can claim as a deduction for exemptions is phased out once your adjusted gross income (AGI) goes above a specified level for your filing status.

Child Tax Credit

Taxpayers who have children for whom (s)he claims a dependency exemption and the children are less than 17 years old as of the close of the year, are entitled to a child tax credit. This is in addition to the credit for child and dependent care expenses and the earned income credit. The credit was jus increased to $1,000 per child. The credit begins to phase out when AGI reaches certain levels.

There is an additional child tax credit for those taxpayers who get less than the full amount of the child tax credit due to either number of children or income limitations. The additional child tax credit may even give you a refund even if you do not owe any tax. This additional credit is claimed on Form 8812.

Earned Income Credit

This credit should not be overlooked. The EIC is particularly useful for a non-working spouse who has just recently become divorced. Earned income does NOT include alimony and child support.

Filing status cannot be married filing separately.
Must be a U.S. citizen.
Must be at least 25 years old, but not over age 65.
Cannot have any foreign earned income.
Investment income must be less than $2,450.
You cannot be a dependent or qualifying child of another person.

Earned income must be less than:

> $32,121 if you have more than one qualifying child.
> $28,281 if you have one qualifying child.
> $10,710 if you do not have a qualifying child.
>
> To be considered qualifying, your child must be under age 19 (or under 24 if a student) and lived with you for more than half of the year.

If you and someone else have the same qualifying child, the person with the higher modified AGI is the only one who may be able to claim the EIC using that child.

Example: You and your son lived with your mother all year. You are 25 years old. Mother's income is higher than yours. Your son is a qualifying child of both you and mother because all the tests are met for both you and mother. However, because you both have the same qualifying child, only one of you can claim the EIC. Only Mother may be able to claim the EIC. You are precluded from claiming the credit either with or without a qualifying child.

Credit for Child/Dependant Care Expenses

Qualifying Person Test

A dependent who was under the age 13 when the care was provided and for whom you can claim an exemption (unless released to ex-spouse).

Your spouse who was physically or mentally not able to care for him/herself.

Your dependent, regardless of age, who was physically or mentally not able to care for him/herself and for whom you can claim an exemption (or could claim an exemption except the person had $2,900 or more of gross income).

Keeping Up a Home Test

To claim the credit, you must keep up a home, with you and your qualifying persons living in the home. You must provide more than half the cost of keeping up your home. Welfare funds received from the state are not considered to be provided by you.

Earned Income Test

To claim the credit, you must have earned income. This includes non-taxable earnings such as strike benefits and disability pay you report as wages. It does not include pensions, social security payments, workers' compensation, interest, dividends, or unemployment compensation.

Work-Related Expense Test

Child and dependent care expenses must be work related to qualify for the credit. Expenses are considered work related only if both of the following are true:

1. They allow you (and your spouse) to work or look for work.
2. They are for a qualifying person's care.

To be work related, your expenses must allow you to work or look for work. If married, both you and your spouse must work or look for work. The work can be full time or part time. Work includes actively looking for work. However, if you do not find a job and have no earned income for the year, you cannot take this credit.

Expenses are not considered work related merely because you had them while you were working. They must *enable you to be gainfully employed*. For example, you are not gainfully employed if you do unpaid volunteer work.

Credit for Child Care Expenses (cont.)

Care of a Qualifying Person
Expenses are for the care of a qualifying person only if their main purpose is the person's well-being and protection. You do not have to choose the least expensive way of providing the care.

Household services meet the test if they are at least partly for the well-being and protection of a qualifying person. You must divide the expenses between household services and care of a qualifying person and then count only the care of the qualifying person towards the credit.

Schooling costs can be counted towards the credit in full if both are true:

1. Your child is in a grade level below the 1st grade.
2. The amount you pay for schooling is incident to and cannot be separated from the cost of care.

Example 1: Your 5 year old child goes to kindergarten in the morning. In the afternoon, she attends an after-school day care program at the same school. Your total cost is $3,000, of which $1,800 is for the after-school program. Only the $1,800 qualifies for figuring the credit.

Example 2: You place your 10 year old child in a boarding school so you can work full time. Only the part of the boarding school expense that is for the care of your child is a work-related expense. You cannot count any part of the amount you pay the school for your child's education.

Example 3: The cost of sending your child to an overnight camp is not considered a work-related expense.

Provider Identification Test

You must identify all persons or organizations that provide care for your child or dependent on Form 2441. You must give the provider's name, address, and taxpayer ID.

Sale of Jointly-Owned Property

If you sell property that you and your spouse own jointly, you must report your share of the recognized gain or loss on your income tax return for the year of the sale. If you are still considered "married" at the end of the year and file a joint return, you can exclude up to $500,000 of gain on the sale. If you file separately, you can exclude up to $250,000 of the gain.

Alimony

Alimony payments are income to the recipient and are deductible by the payor. Alimony paid is taken as a deduction from gross income in arriving at adjusted gross income and thus may be claimed by taxpayers who do not itemize. The requirements are as follows:

a. The payment is in cash.
b. The payment is received by the spouse under a divorce or separation instrument.
c. The instrument does not designate the payment as not includible in gross income and not allowable as a deduction.
d. The payee and payor must not be members of the same household at the time payment is made.
e. There is no liability to make any payment for any period after the death of the payee spouse or to make any payment (either in cash or property) as a substitute for such payments after the death of the payee spouse.
f. The spouses must not file joint returns with each other.
g. The divorce or separation instrument does not designate the payment as child support. Child support is non-taxable and non-deductible.

A special recapture rule applies to “excess” alimony payments. Its purpose is to prevent property settlement payments from qualifying for alimony treatment.

Excess alimony, the amount that must be recaptured in the third post-separation year, is defined as the sum of the excess payments made in the first post-separation year plus the excess payments made in the second post-separation year. The amount of excess payments in the first and second years is determined under a statutory formula.

Child Support

To qualify as non-taxable and non-deductible child support, the amount specified in the instrument must specifically provide that the payments are for child support, or the amount is to be reduced based on a contingency relating to a child. A child related contingency can be things such as the child attaining a specified age, dying, leaving school, or marrying.

Property Settlements

No gain or loss is recognized to the transferor on a transfer of property between spouses incident to divorce (Code Sec. 1041), nor is the value of the property included in the gross income of the transferee. The transferee's basis is equal to the transferor's basis immediately before the transfer. (i.e. carry-over basis)

A transfer between former spouses is "incident to divorce" if it occurs within one year after the marriage ceases or is related to the cessation of the marriage.

Non-recognition is not available if the liabilities assumed by the transferee (including liabilities to which the property is subject) exceed the transferor's adjusted basis in the property. The transferee's basis will be increased for any such gain recognized by the transferor.

Spousal Relief from a Joint Tax Return

Both taxpayers are jointly and individually responsible for the income tax and any interest or penalty due on the joint return even if they later divorce. This is true even if a divorce decree states that a former spouse will be responsible for any amounts due on previously filed joint returns. In come cases, a spouse may be relived of the tax, interest, and penalties on a joint tax return. They are 4 types of relief available:

2. Innocent spouse relief
3. Separation of liability
4. Equitable relief
5. Injured spouse relief (Form 8379)

<u>Innocent Spouse Relief Requirements:</u>

A. A joint return was filed which has an understatement of tax due to **erroneous items** of the spouse.
B. At the time of signing the joint return, the innocent **spouse did not know, and had no reason to know,** that there was an understatement of tax.
C. It would be **unfair** to hold the innocent spouse liable for the understatement of tax.

Erroneous items – either (1) unreported income or (2) incorrect deduction, credit, or property basis.

Indication of unfairness – two indicators the IRS may consider is whether (1) the innocent spouse received any significant benefit from the understatement of tax, or (2) the couple was later divorced.

Spousal Relief from a Joint Tax Return (cont.)

Relief by Separation of Liability Requirements:

Under this type of relief, you allocate the understatement of tax (plus interest and penalties) on the joint return between the two spouses.

1. Must have filed a joint return.
2. The spouse filing for relief must not have actual knowledge that any items giving rise to the tax deficiency were incorrect.

3a. No longer married or are legally separated at the time relief is filed for, or
3b. The taxpayers were not members of the same household at any time during the 12-month period ending on the date relief is filed for.

Equitable Relief Requirements:

If you do not qualify for innocent spouse relief or separation of liability, you may still, however, be relieved of responsibility for tax, interest, and penalties through equitable relief.

1. You are not eligible for innocent spouse relief.
2. You are not eligible for separation of liability.
3. Considering all facts and circumstances, it would be unfair to hold you liable for the understatement or underpayment of tax.

Note: Unlike innocent spouse relief or separation of liability, you can get relief from an understatement of tax OR an underpayment of tax through equitable relief.

Injured Spouse Relief Requirements:

This one is different from the above types of relief. When a joint return is filed and the refund is used to pay one spouse's past due child and/or spousal support, a past-due federal debt, or past-due state income tax, the other spouse may be considered an injured spouse. The requirements are:

1. A joint return was filed.
2. The injured spouse received income (such as wages, interest, etc.).
3. Made tax payments (such as withholding or estimated tax payments).
4. Reported the income and tax payments on the joint return, and
5. An overpayment, all or part of which was applied to the past-=due amount of the other spouse.

TAXATION OF QDROS

<u>Qualified Domestic Relations Order (QDRO's) defined</u>

QDRO is essentially a court order issued under domestic relations law that:

1. Relates to the rights of someone other than the plan participant to receive benefits from a qualified retirement plan,
2. Relates to payment of child support, alimony, or marital property rights to a spouse or child, and
3. Specified the amount or portion of the participant's benefits to be paid to the spouse or child.

If the benefits are paid to the child, then they are treated as paid to the participant.

If the benefits are paid to the spouse, then the payments must be included in the spouse's income. If the participant contributed to the retirement plan, a prorated share of the participant's cost (investment in the contract) is used to figure the taxable amount.

If you receive an eligible rollover distribution under a QDRO, you may be able to roll it over tax free into an IRA.

Alternate Payee Defined - The term "alternate payee" means any spouse, former spouse, child or other dependent of a participant who is recognized by a domestic relations order as having a right to receive all, or a portion of, the benefits payable under a plan with respect to such participant. IRC §414(p)(8)

<u>Former Spouse as Alternate Payee</u>

An alternate payee who is the spouse or former spouse of the participant will be treated as the distributee of any distribution or payment made to the alternate payee under a QDRO. The effect of this provision is that the spouse or former spouse is responsible for any income tax liability resulting from the distribution of the QDRO benefit. The 20% income tax withholding rules are applied as if the spouse or former spouse of the participant is the employee. When a distribution is made from a qualified plan to a participant's spouse or former spouse pursuant to a QDRO, the spouse or former spouse is to be considered the "alternate payee" and to be taxed on the distribution as the distribute.

For purposes of the eligible rollover distribution provisions, any amount distributed pursuant to a QDRO to a spouse or former spouse alternate payee is treated in the same manner as if the distribution was made to the participant. Therefore, all or any portion of the QDRO distribution made to a spouse or former spouse alternate payee is eligible for rollover to an IRA.

Non-Spousal Alternate Payee

Distributions made pursuant to a QDRO during the life-time of the participant to a non-spousal alternate payee are included in the participant's income. Note that 20% is to be withheld from the distribution as if the plan participant is the payee.

Because the QDRO distribution to a non-spousal alternate payee is includible in the gross income of the participant rather than the alternate payee, a non-spousal alternate payee may not rollover any part of the distribution.

10% Early Distribution Additional Tax

An exception under IRC §75(t)(2)(C) provides that the 10% additional tax on early distributions from qualified plans does not apply to any distribution made to an alternate payee pursuant to a QDRO. Therefore, both the alternate payee who is a former spouse of the participant and the non-spousal alternate payee are not subject to the 10% additional tax on early distributions. However, it does not apply to distributions from an IRA

To qualify for this exception, the domestic relations order must create or recognize the existence of the alternate payee's right to receive all or a portion of the qualified plan benefits and must be in existence before the plan benefits are distributed. The distribution of the plan benefits to a party other than the alternate payee or in advance of the finalization of the decree will not be considered made pursuant to a QDRO and will be subject to the 10% additional income tax.

Individual Retirement Arrangements (IRA's)

When an IRA is transferred as a result of divorce, it is not considered a taxable transfer.

All taxable alimony you receive is treated as compensation for the contribution and deduction limits for traditional IRA's.

Social Security Benefits and Divorce

Many people may not be aware that they may be eligible to receive a portion of the Social Security benefits earned by their ex-spouses. According to eligibility requirements issued by the Social Security Administration, a divorced spouse may be eligible to receive benefits earned by his or her ex-spouse (the participant) if he or she meets the following eligibility requirements:

1. He/she was married to the participant at least ten years.
2. He/she is <u>not</u> presently married if under age 62 (under age 50 if disabled; age 60 if widowed).
3. The participant is at least age 62 (unless deceased or disabled).
4. He/she is not entitled to an increased benefit on his/her own record that exceeds one-half of the participant's unreduced benefits

Once these eligibility requirements are met, the divorced spouse may petition the Social Security Administration upon reaching the age of 62 (age 50 if disabled OR age 60 if the participant is deceased). To petition, the Social Security Administration requires the divorced spouse to produce identification, the participant's social security number and an original or certified copy of the marriage license and the divorce decree.

When approved, the divorced spouse will receive an amount equal to 37 ½ to 50 percent (graduated scale based on the divorced spouse's age at the time the petition is made – between 62 and 65) of the participant's monthly Social Security benefits. It is important to note that the divorced spouse's benefits <u>will not</u> reduce the participant's benefits.

After petitioning and meeting the eligibility requirements, benefits will begin the first day of the month following the completion of one calendar month of eligibility. However, the benefits of the divorced spouse will not begin until the earlier of the following: (1) the participant reaches age 62 (age 50 if disabled; age 60 if widowed), has met the eligibility requirements AND the divorce was final at least two years prior, OR (2) the participant reaches age 62 (age 50 if disabled; age 60 if widowed), has met the eligibility requirements AND the participant begins receiving benefits.

If the participant dies and the divorced spouse meets the eligibility requirements set forth above, the divorced spouse will be entitled to receive an amount equal to 71 ½ to 100 percent (graduated scale based on the divorced spouse's age at the time the petition is mad3) of the participant's monthly benefits. Benefits of the divorced spouse are not affected by remarriage(s) of the participant.

There are some exceptions to the situations described above, specifically related to widow and disability benefits. More information regarding divorced spouse benefits, widow benefits, disability benefits and married non-working spouse benefits can be found on the Social Security Administration Web site at www.ssa.gov.