



QUICK REFERENCE GUIDE

TO DIVORCE-RELATED TAX MATTERS



aicpa.org/FVS
July 2014

American Institute of CPAs | 220 Leigh Farm Road | Durham, NC 27707-8110

As applicable tax rules, laws and regulations change frequently and may have changed since the publication date of this guide, we strongly recommend working with a qualified professional. The material in this guide should also be verified against the specific laws within your state.

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Welcome to the **Quick Reference Guide to Divorce-Related Tax Matters**. It contains for your convenience a detailed chart that summarizes many of the tax issues that arise during divorce proceedings and the challenges that may affect family law practitioners.

Topics covered in this handy reference guide include:

- Filing status
- Stock options and deferred compensation
- Exemptions
- Innocent spouse and separate liability relief
- Cost of getting divorced
- Mortgage interest
- Retirement plans/IRAs
- And more!

Quick Reference Guide to Divorce-Related Tax Matters

How and When to File

How: IRS tax form for requesting relief under any of the three provisions — Form 8857

When: Generally, you must file Form 8857 no later than 2 years after the first IRS attempt to collect the tax, EXCEPT (Notice 2011-70, 2011-32 IRB)

- **Exception for equitable relief.** The amount of time to request equitable relief depends on whether you are seeking relief from a balance due, seeking a credit or refund, or both:

Balance Due — Generally, you must file your request within 10 years from the date the tax liability was assessed. In certain cases, the 10-year period is suspended.

Credit or Refund — Generally, you must file your request within 3 years after the date the original return was filed or within 2 years after the date the tax was paid, whichever is later.

Both a Balance Due and a Credit or Refund — If you are seeking a refund of amounts you paid and relief from a balance due, the time period for credit or refund will apply to any payments you have made, and the time period for collection of a balance due amount will apply to any unpaid liability.

- **Exception for relief from liability for tax attributable to an item of community income.**

If you are requesting relief from liability for tax attributable to an item of community income (other than equitable relief), a different filing deadline applies. Community property rules are beyond the scope of this guide.

Other Notes

- Burden of proof for relief is on the taxpayer — §6015(c) (2) and *Shafman v. United States* 267 B.R. 709 (2001).
- Joint tax returns signed under duress are not joint returns — Reg. §1.6013-4(d).

Tax Rate Chart

Taxable Income/Tax Rate Starting Point

Rate	Single		Married Filing Jointly		Head of Household	
	2013	2014	2013	2014	2013	2014
15%	8,925	9,075	17,850	18,150	12,750	12,950
25%	36,250	36,900	72,500	73,800	48,600	49,400
28%	87,850	89,350	146,400	148,850	125,450	127,550
33%	183,250	186,350	223,050	226,850	203,150	206,600
35%	398,350	405,100	398,350	405,100	398,350	405,100
39.6%	400,000	406,750	450,000	457,600	425,000	432,200

Increased for inflation after 2014

Filing Status

Marital status for tax filing is set as of the last day of the year — Dec. 31. If you are divorced as of Dec. 31, you must file as single taxpayers (or head of household) for that year, even if you lived together as a married couple more than half the year. If you are married as of Dec. 31, and you and your spouse lived in the same household and were not legally separated, you must file as married — either joint or separate returns.

Marital status at 12/31	Legally separated	Living together in same household 7/1 thru 12/31	Dependent living in home	Tax filing status available for year
MARRIED	NO	YES	N/A	MFJ, MFS
MARRIED	YES	NO	NO	S
MARRIED	YES	NO	YES	S, HOH
MARRIED	NO	NO	YES	MFJ, MFS, HOH
DIVORCED	N/A	YES	NO	S
DIVORCED	N/A	NO	NO	S
DIVORCED	N/A	NO	YES	HOH

- “(i) Both spouses or former spouses intend for the redemption to be treated, for federal income tax purposes, as resulting in a constructive distribution to the non-transferor spouse; and
 - (ii) such instrument or agreement supersedes any other instrument or agreement concerning the purchase, sale, redemption or other distribution of the stock that is the subject of the redemption.”
- Carryover rules related to basis and holding period of the transferred shares apply in determining gain on the redemption. This can be a tax trap for the unsuspecting spouse. Structured properly, redemption at capital gain rates to the non-owner spouse can be accomplished. Structured improperly, the spouse retaining the business can be deemed to have received a constructive dividend (currently taxed at the same rate as capital gains, but historically has been at ordinary income tax rates), albeit while not receiving any cash to pay the tax. Internal Revenue Service Regulation 1.1041-2 indicates that if a divorce or separation agreement between the spouses or former spouses includes the following, the transferor spouse will be taxable.
- Section (c)(1)(i) Both spouses or former spouses intend for the redemption to be treated, for federal income tax purposes, as a redemption distribution to the transferor or spouse; and
 - Section (c)(1)(ii) such instrument or agreement supersedes any other instrument or agreement concerning the purchase, sale, redemption, or other disposition of the stock that is subject to the redemption.

Transferring/Redeeming Stock of a Closely Held Company:

Often, there is insufficient cash or other property to satisfy a division of marital assets when there is a closely held family corporation in the marital estate. When the desired result is the sole ownership of the business by one of the parties, the transfer of stock ownership for cash in divorce may involve two steps:

1. Transfer of stock from one spouse to the other, followed by
2. The recipient spouse transferring the shares to the corporation in redemption of all the shares received from the soon to be ex-spouse.

Carryover rules related to basis and holding period of the transferred shares apply in determining gain on the redemption. This can be a tax trap for the unsuspecting spouse. Structured properly, redemption at capital gain rates to the non-owner spouse can be accomplished. Structured improperly, the spouse retaining the business can be deemed to have received a constructive dividend (currently taxed at the same rate as capital gains, but historically has been at ordinary income tax rates), albeit while not receiving any cash to pay the tax. Internal Revenue Service Regulation 1.1041-2 indicates that if a divorce or separation agreement between the spouses or former spouses includes the following, the transferor spouse will be taxable.

Section (c)(2) relates to situations in which the non-transferor spouse will be taxable including circumstances under which the non-transferor spouse will be deemed to have received a constructive distribution from the corporation followed by the deemed transfer of cash to the transferor spouse in redemption of his or her stock. If the divorce or separation agreement sets forth the following agreements of the parties, the transfer will be treated as a constructive distribution to the non-transferor spouse:

- “(i) Both spouses or former spouses intend for the redemption to be treated, for federal income tax purposes, as resulting in a constructive distribution to the non-transferor spouse; and
- (ii) such instrument or agreement supersedes any other instrument or agreement concerning the purchase, sale, redemption or other distribution of the stock that is the subject of the redemption.”

MFJ — Married Filing Jointly
MFS — Married Filing Separately

S — Single
HOH — Head of Household

Caution: Filing separate and the use of standard/itemized deduction. The first one to file establishes the requirement of the other to do the same.

Caution: Joint return = Joint liability no matter what divorce instrument says.

You may be able to file as head of household, even if you were legally married Dec. 31. To qualify as Head of Household, you must be considered “unmarried” on Dec. 31 and you must have paid more than half the cost of keeping up a home for the year for a child or other qualifying person for whom you or the other parent is entitled to claim the tax exemption and that person lived with you in the home for more than half the year.

** You are considered unmarried if you were legally separated on Dec. 31 or if your spouse did not live in your home for the last six months of the year.

Allocation of Tax-Related Carryforward Items

Under IRC 1041, the basis of property transferred incident to a divorce carries over with the property to the transferee (recipient) spouse. Generally, the other tax attributes associated with that property also follow the property award to the transferee spouse. However, some carryovers and tax attributes may be negotiated and agreed upon, while others are governed by IRS regulations. Some examples follow.

Alternative Minimum Tax Credit Carryforward. There is no published guidance on how to allocate AMT credit carryforwards. Any reasonable, non-abusive method would likely be accepted by the IRS. Typically, such amounts are allocated as if the divorcing parties had filed separate returns in the year(s) generating the AMT.

Capital Loss Carryforward. Under IRS Regulation 1.1212-1(c)(1)(iv), capital loss carryforwards are allocated based on the calculation of separate capital gains and losses of each of the spouses. Gains and losses on jointly owned property are generally divided equally.

Stock Options and Deferred Compensation

Equitable distribution of stock options and deferred compensation in divorce:

Revenue Ruling 2002-22

1. An employee spouse who transfers an interest in vested non-statutory stock options and vested non-qualified deferred compensation to the employee's spouse or former spouse incident to divorce is not required to include an amount in gross income upon the transfer.
2. The former spouse, and not the employee spouse, is required to include the taxable amount in gross income when the former spouse exercises the stock options or when the deferred compensation is paid or made available to the former spouse.

The same conclusion would apply in a case in which an employee transfers a statutory stock option (such as those governed by §422 or 423(b)) contrary to its terms to a spouse or former spouse in connection with divorce. The option would be disqualified as a statutory stock option, see §422(b)(5) and 423(b)(9), and treated in the same manner as other non-statutory stock options. Section 424(c)(4), which provides that a §1041(a) transfer of stock acquired on the exercise of a statutory stock option is not a disqualifying disposition, does not apply to a transfer of the stock option.

Restricted Stock Units

Restricted Stock Units (RSUs) have become increasingly popular in recent years. They are less complicated and less risky to the employee than stock options. Typically, the RSUs vest fully in one to three years. Upon vesting (lapsing of restrictions) the RSUs are taxable to the employee spouse. The value (and taxable income) from vested RSUs is equal to the share value of the stock upon lapse of the restrictions. Gain or loss on subsequent sale is measured by increase or decrease from share value when the restrictions lapse and the RSUs are vested.

This ruling does not apply to transfers of property between spouses other than in connection with divorce. This ruling also does not apply to transfers of non-statutory stock options, unfunded deferred compensation rights, or other future income rights to the extent such options or rights are unvested at the time of transfer or to the extent that the transferor's rights to such income are subject to substantial contingencies at the time of the transfer.

Retirement Plans and IRAs

Qualified Retirement Plans:

- Qualified Domestic Order (QDRO)/Eligible Domestic Relations Order (EDRO) — Court can allocate an interest in a qualified retirement plan to a non-employee spouse (alternate payee).
- To qualify as a QDRO, funds must be distributed to the alternate payee or his or her designee directly from the plan.
- Payments made as a result of a QDRO to the alternate payee have no effect on the participant in the pension plan.
- Benefit taxed to the alternate payee when payments received (not subject to 10% early withdrawal penalty) or may be rolled over tax-free into an IRA or other qualified retirement plan.
- DROs can be very complicated and costly to set up; A specialist is typically hired to do them.
- Alternate Solution — Borrowing from retirement plan for property settlement payment.
- IRA transfers pursuant to a divorce or separation instrument are not taxable. Methods of transfers include:

- Changing the name on the account, and
- Making a direct trustee-to-trustee transfer of IRA assets.
- Divorce or separation instrument should state that the transfer is intended to be tax free under the IRC §408(d)(6).
- DROs do not apply to IRAs
- Spousal IRA Contribution — If final decree is obtained by the end of the tax year, a spouse cannot deduct contributions made to a former spouse's IRA.
- Withdrawing funds from an IRA to satisfy a divorce judgment cause the IRA owner to be taxed on the distribution, and if applicable, imposition of the 10% early withdrawal penalty.
- 10% early withdrawal penalty can be avoided if withdrawals are "annuitized" over the recipient's life expectancy. Once a series of withdrawals commence, it must continue at least until the IRA owner reaches 59½.
- Taxable alimony received is treated as compensation for purposes of the IRA contribution and deduction limits.

Charitable Contribution Carryforward. Under IRS Regulation 1.170A-10(d)(4), charitable contribution carryforwards will be split in proportion to what the charitable contribution and resulting carryforwards would have been had the parties filed separate returns.

Net Operating Losses. Under IRS Regulation 1.172-7(d), net operating loss (NOL) carryforwards will be split in proportion to what the NOL's would have been had the parties filed separate returns.

Passive Activity Loss Carryforward. Tax-free transfers incident to divorce under IRC 1041 are treated as if the property was transferred by gift. Under the passive loss rules (IRC 469(j)(6)), when a passive activity is disposed of by gift, any suspended losses are added to the basis of the activity immediately prior to the gift. When passive activities are transferred in divorce, the suspended losses are added to the basis of assets transferred. If the titled spouse retains the property, the carryovers remain available to offset current and future passive income.

S-Corporation Losses. When S-Corp shares are transferred in divorce under §1041 the disallowed losses due to previous At-Risk or basis limitations are transferred to the transferee spouse. IRC Sec 1366 (d) (2) states "... shall be treated as incurred by the corporation in the succeeding taxable year with respect to the transferee"

Costs of Getting Divorced

Legal and professional fees as well as court costs related to getting a divorce are generally not deductible. Payment of former spouse's attorney or professional fees also not deductible, unless they meet the requirements of deductible alimony (§71 payments).

Non deductible costs:

- Expenses paid in arranging child custody and support
- Expenses paid in arriving at a financial settlement and retaining income-producing property

Deductible costs (legal or accounting):

- Fees paid for tax advice related to a divorce
- Fees paid to determine or collect alimony
- Fees paid to determine estate tax consequences of a property settlement
- Obtain deductibility breakdown from attorney or accountant

Consideration of Income vs. Non-income Producing Assets

The parties frequently are in need of cash to pay attorney fees, experts, etc. In the absence of other sources, consider using cash value in life insurance policies, or transfer funds (including tax consequences) from retirement plans to other spouse to be used to pay joint debts or to make cash available to either or both. If funds are distributed directly from a QDRO before being rolled over, the 10% early withdrawal penalty is not applicable. This may be a source of liquidity for the payment of fees.

Mortgage Interest and Real Estate Taxes:

In General: The joint owner who makes the payment is entitled to the deduction. If payments are made out of a joint account, there is a rebuttable presumption that the payment is made 50% by each party. Example: If Husband (H) pays 70% of the payment and Wife (W) pays 30%, the deductible portion of the payment is allocated in the same proportion.

In a Divorce Context: If payments are not made pursuant to a divorce or separation instrument — general rules apply.

<p>If the home is solely owned by H (even though W may be living there with or without children of the marriage):</p>	<p>If the home is solely owned by W and H is still obligated on the mortgage:</p>	<p>If the home is jointly owned and payments are made by H, the non-occupant, directly to the mortgage:</p>
<p>If H makes the payments:</p> <ul style="list-style-type: none"> • H would deduct 100% of the mortgage interest and taxes. • None of the payments would qualify as alimony to W. 	<p>• The treatment of the interest deduction is the same as if jointly owned, provided a minor child of the marriage resides in the home with W.</p>	<p>• ½ of the qualifying interest and real estate taxes are deductible by H.</p>
<p>If W makes the payments:</p> <p>May be taxable to H as alimony who would then be able to deduct 100% of the interest and taxes.</p>	<p>H cannot deduct any of the real estate taxes however, since he has no ownership interest.</p>	<p>• ½ qualifies as alimony provided the requirements of Section 71 are met. (Accordingly, this is deductible by H and W may deduct her half of the mortgage interest and real estate taxes)</p>

Personal Residence:

Capital gain exclusion of \$250,000 (single) and \$500,000 (married) for sale of principal residence. "Principal residence" — home where you lived for any two of the last five years. Consider when to sell the House: before or after the divorce.

Risk: waiting too long after party moves out of the home before their interest gets sold. Effectively, the home must be sold within three years after departing spouse moves out for exclusion to apply to the departing spouse. If remaining spouse has the right to live in the home

pursuant to divorce or separation agreement, the remaining spouse's residence in the house will be counted as the departing spouse's residence for purposes of calculating the two-year requirement.

- Fees paid to professionals such as appraisers and actuaries if the services were performed to determine the correct amount of tax or to assist in obtaining alimony

Income producing assets:

- Rentals
- Royalties
- Business interests
- Receivables

Non-income producing assets:

- Residence
- Vacation home
- Investment land
- Personal property

Tax Consequences of Divorce:

Under IRC §1041(a), no gain or loss is recognized on transfers if incident to divorce. "Incident to Divorce" if:

- Occurs within one year after the divorce, or
- Is related to the ending of the marriage meaning:
 - Pursuant to a divorce or separation instrument, and
 - Occurs within six years after the date which the marriage ended.

Property acquired after the marriage ends qualifies for 1041 treatment if all other requirements are met.

Citizenship		Residence Support		Qualifying Child Relationship	Age Requirement	
A citizen or resident of the U.S.	Qualifying child cannot provide more than one-half of their own support for the year.	Child resides with the taxpayer for > one-half of the year.	Child must have the same principal place of abode in the U.S. as the taxpayer for > one-half of the year.	Son or daughter	< 19, or 24 if full time student	Dependency Exemption
A citizen or resident of a country contiguous to the U.S.	Exceptions include temporary absences due to education, illness, vacation or military service.	Stepson/stepdaughter	Individuals whom are legally adopted or a foster child placed with the taxpayer by an authorized agency or by court decree, order or judgment.	Descendants of sons, daughters, stepsons, or stepdaughters	< 17	Child Tax Credit
					< 13	Dependent Care Credit
					< 19, or 24 if full time student	Tuition Credits or Deductions
					< 19, or 24 if full time student	Earned Income Credit

1. A multiple support agreement is in place — §152(d)(3)
 2. The custodial parent relinquishes the rights to the exemption (either annually or permanently IRS Form 8332) — §152(e)(2)(A).
- Custodial parent is entitled to the dependency exemption. Parents, together or separately, must provide at least one-half of the child's support. Two exceptions to the general rule that the custodial parent is entitled to the dependency exemption.

Children/Dependency Exemptions

Innocent Spouse and Separate Liability Relief:

- Relief from tax liability from the IRS is available to qualified individuals in three alternatives — IRC §6015.
 - 1. Innocent Spouse — IRC §6015(b) and IRS Pub. 971
 - 2. Separation of Liability — IRC §6015(c)
 - 3. Equitable Relief — IRC §6015(f) and Rev. Proc. 2013-34
- Separate liability election requires:
- No longer married or
 - Legally separated, or
 - Not a member of the same household at any time during the 12 month period prior to electing separate liability
- (Filing the divorce complaint is not legal separation — Vetrano vs. Commissioner, 116 T.C. 272, 282 (2001).

- **Exception for equitable relief:** The amount of time to request equitable relief depends on whether you are seeking relief from a balance due, seeking a credit or refund, or both:
 - Balance Due** — Generally, you must file your request within 10 years from the date the tax liability was assessed. In certain cases, the 10-year period is suspended.
 - Credit or Refund** — Generally, you must file your request within 3 years after the date the original return was filed or within 2 years after the date the tax was paid, whichever is later.
- **Both a Balance Due and a Credit or Refund** — If you are seeking a refund of amounts you paid and relief from a balance due, the time period for credit or refund will apply to any payments you have made, and the time period for collection of a balance due amount will apply to any unpaid liability.

Same Sex Marriage and Repeal of the Defense of Marriage Act (DOMA):

- Same-sex couples who are married under state law are now treated as married for federal tax purposes. Couples who enter into registered domestic partnerships or civil unions are not treated as married by the IRS.
- For tax returns filed on or after Sept. 16, 2013 (tax year 2012 and future years), same-sex spouses must use a married filing jointly or married filing separately status for their federal income tax return.
- Same-sex spouses may choose to amend federal tax returns for years in which they were married if the statute of limitations for amending the tax return has not expired.
- Spouses who marry in a state that allows same-sex marriage are treated as married for federal tax purposes, even if they reside in or move to a state that does not recognize the marriage.
- Qualified retirement plans must treat same-sex spouses as married. Therefore, a same-sex spouse will be the default beneficiary, and the rules regarding spousal consent with respect to loans, distributions, and beneficiary designations will apply. A same-sex spouse is eligible to receive benefits pursuant to a QDRO.

Factors considered for relief by the IRS and Courts (Rev. Proc. 2013-34 Sec. 4.03)

- Marital status
- Economic hardship
- Knowledge or reason to know non-requesting spouse's legal obligation pursuant to the divorce decree
- Significant benefit to the person seeking innocent spouse relief
- Compliance with federal tax laws
- Spousal abuse
- Mental or physical health

How and When to File

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• *Exception for relief from liability for tax attributable to an item of community income.*

If you are requesting relief from liability for tax attributable to an item of community income (other than equitable relief), a different filing deadline applies. Community property rules are beyond the scope of this guide.

Other Notes

- Burden of proof for relief is on the taxpayer — §6015(c)(2) and *Shafman v. United States* 267 B.R. 709 (2001).
- Joint tax returns signed under duress are not joint returns — Reg. §1.6013-4(d).

Alimony vs. Child Support:

Qualifications of Alimony — §71(b)

- Cash payments or third-party payments required under divorce or separation instrument
- Payments must be required by written instrument
- Instrument may not designate the payment as "not alimony"
- Spouses may not be members of the same household
- Payments may not be treated as child support
- Payments must cease upon death of the recipient
- Parties may not file a joint return

Payments that do not qualify as taxable/deductible alimony

- Child support
- Non-cash transfers
- Payments that are the spouse's part of community property income
- Payment for use of property

- Payments to keep up the payer's property
- Spousal payments where the parties' have "elected out" of taxable alimony treatment

Recapture of Alimony

Recapture rules may apply if there is a decrease or termination of alimony during the first three calendar years of payment. Recapture rules apply if alimony paid in the second or third calendar year is \$15,000 less than in the prior year. A calendar year is not required to be 12 months. A partial year is considered to be a calendar year.

May occur for:

- Failure to make timely payments
- Change in divorce or separation agreement
- Reduction in spouse's support needs
- Reduction in payer's ability to provide support
- Consider Option to Treat as "Not Alimony" when Payer has little or no gross income
- Payer's other deductions exceed gross income

Child Support Before Alimony — If obligated to pay both alimony and child support, but pays less than monthly amount due, payments first applied to satisfy the child support obligation. Child support obligation must be met before any amount of alimony is deductible.