

Planning After ATRA: The CPA's Guide to Financial and Estate Planning Taxation of Divorce

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Introduction

■ About the PFP Section & PFS Credential

- The AICPA PFP Section provides information, resources, advocacy and guidance for CPAs who specialize in providing estate, tax, retirement, risk management and investment planning advice to individuals and their closely held entities
- The CPA/Personal Financial Specialist (PFS) credential distinguishes CPAs as subject-matter experts who have demonstrated their financial planning knowledge through experience, education and testing

Introduction



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Agenda

- **Alimony payments**
- **Recapture of alimony payments and separate maintenance payments**
- **Child support issues**
- **Property settlement issues in divorce and separation**
- **How to handle the dependency exemption**
- **Filing status for divorced and separated individuals**

Alimony Payments (Code Section 71)

■ Nature and definition of alimony

- Payment to or for a spouse or former spouse made under a divorce or separation instrument.
- Deductible by the payor and includible in the income of the payee spouse or former spouse.
- Income and deduction are reported on IRS Form 1040.
- Alimony is an “above the line deduction.”
- No requirement for the payor spouse to withhold income taxes on alimony payments.
- Taxable income to the payee spouse,
 - Be sure to include any alimony received in client’s tax calculation for purposes of determining liability for estimated taxes.
- Alimony is not considered income from self-employment, so that social security and Medicare taxes are not applied to it.
- Alimony is treated as earned income.
 - Divorced recipient spouse may separately create and IRA and contribute to it based on the amount of alimony received.

Alimony Payments (Code Section 71)

■ General requirements for a payment to be deemed alimony:

- In order to be considered alimony, a payment must meet certain specific requirements.
- The payments do not have to be fixed, nor a specific amount, nor must they be periodic in nature.
- It is not required that the payments constitute support of a spouse.

Alimony Payments (Code Section 71)

■ Seven Specific Requirements for a Payment to be Deemed Alimony

1. Payment is made in cash
 - Transfers of services or property, the execution of a promissory note, or other debt instrument, or allowing the payee to use property of the payor do not qualify as cash payments of alimony

Alimony Payments (Code Section 71)

■ Seven specific requirements for a payment to be deemed alimony

2. The payment must be received by or on behalf of a spouse pursuant to a “qualifying instrument”, namely a divorce decree, decree of separate maintenance, or a written separation agreement.
 - The payment must be made under the instrument.
 - Cash payments to a third party on behalf of the payee spouse under the terms of a divorce or separation agreement can qualify as a cash payment to the spouse.
 - Cash payments made to a third party at the written request, consent, or ratification of a spouse qualify as alimony, provided the payments are in lieu of payments of alimony directly to the spouse; are intended by both spouses, per the written request, to be treated as alimony.
 - Where the property constitutes jointly-owned residential property, one-half of the total amount of mortgage payments, including both principal and interest, may be treated as alimony, and one-half of the interest may be deducted as mortgage interest, if it is qualified residential interest

Alimony Payments (Code Section 71)

■ Seven specific requirements for a payment to be deemed alimony

3. The parties do not designate that the payment is not alimony; i.e., the divorce or separation agreement does not designate the payment as nondeductible by the payor or excludable from the payee's income.
 - The decree must make the tax effect known directly or expressly.
 - The payee spouse must attach a copy of the instrument designating the payments as not constituting alimony to his or her income tax return for each year that such a designation applies.

Alimony Payments (Code Section 71)

■ Seven specific requirements for a payment to be deemed alimony

4. The divorced or legally separated spouses must reside in separate households when the payment is made. A formerly shared home is considered one household, even if the parties are physically separated within the home.
5. The payor is not liable to make any payment for any period after the death of the payee spouse.
 - An agreement may provide that payments are to continue to the payee spouse after the death of the payor spouse.
6. The parties must file separate income tax returns. Code Section 71(e). The payor must include the payee's social security number on his or her first tax return for the taxable year in which the payment is made. Alimony payments will not be recognized if the payor and payee file a joint return.

Alimony Payments (Code Section 71)

■ Seven specific requirements for a payment to be deemed alimony

7. The payment must not be a payment for child support.
 - When a payor having both an alimony obligation and a child support obligation makes a payment that is less than the amount otherwise specified as due under the agreement, the payment is first applied to the child support obligation, and then to the alimony obligation

Recapture of Alimony & Separate Maintenance Payments

■ Purpose of recapture:

- The alimony recapture rule exists to prevent taxpayers from “disguising” otherwise nondeductible property settlement payments as alimony payments by attempting to “front-load” and deduct property settlement payments that are purportedly characterized as alimony.

Recapture of Alimony & Separate Maintenance Payments

■ How the recapture rules work:

- If the payor's alimony payments decrease or terminate during the first three calendar years in which payments are made, the alimony recapture rule may be applicable.
- Applies with respect to excess amounts of alimony payments made in the first and the second post-separation years.
- Only payments made in the first and second post-separation years are subject to recapture. Payments made in the third post-separation year and subsequent years are not subject to recapture.
- The law provides a “safe harbor” threshold of \$15,000 per year.
- Apply in the third post-separation year if the alimony paid in the third year decreases by more than \$15,000 from the second year, or the alimony paid in the second and third year's decreases significantly from the alimony paid in the first year.

Recapture of Alimony & Separate Maintenance Payments

■ A two-step process to determine excess alimony payments:

- **Step One**: Compare the aggregate amount of alimony payments in the third post-separation year to the aggregate alimony payments made in the second post-separation year.
- **Step Two**: Compare the aggregate amount of alimony payments made in the first post-separation year to the average of the aggregate amount of the non-excessive alimony payments made in the second post-separation year and the alimony payments made in the third post-separation year.

Recapture of Alimony & Separate Maintenance Payments

■ Exceptions to the alimony recapture rules

- Payments in the three post-separation years are under \$15,000 per year.
- No recapture is required if either spouse dies before the end of the third post-separation year, and the alimony payments cease as the result of such death.
- No recapture is required if the payee spouse remarries before the end of the third post-separation year, and the alimony payments cease as the result of such remarriage.
- The recapture rules do not apply to support payments made pursuant to a court order for temporary or pendente lite support.
- The recapture rules do not apply to payments made pursuant to a continuing liability to pay a fixed portion of the income derived by the payor spouse from a business or rental property, or from compensation for employment or self-employment.

Recapture of Alimony & Separate Maintenance Payments

■ Planning to avoid the alimony recapture rules

- If equal payments of alimony are made over at least three years
- If payments increase over the three-year period
- If payments are structured to avoid triggering recapture
- If the agreement provides that the obligation of the payor spouse to make payments of alimony terminates upon the death of the payee spouse, and the payee spouse in fact dies during the three year “testing” period

Child Support Issues

■ Nature of child support payments

- Payments that are specifically designated as child support or treated as specifically designated as child support under a divorce or separation instrument are not alimony, and are not includible in the recipient's gross income

■ Tax consequences

- Payments made for child support are not deductible by the payor spouse and are not taxable income to either the payee spouse or to the child.

■ Payments “fixed” as child support

- Refers to a clearly determinable payment for child support, rather than a specific amount
- May be treated as constituting child support even if the parent does not have a legal obligation under state law to support the child.

Child Support Issues

■ Designated payments; contingent payments

- A contingency relates to a child if it depends on any event relating to that child
 - Dying
 - Becoming employed
 - Leaving school
 - Leaving the household of the custodial parent
 - Marrying
 - Attaining a specified age or income level

Child Support Issues

■ Allocation of payments to alimony and child support

- In a situation where the operative divorce instrument calls for payments of both alimony and child support, and the payor pays less than the entire amount required, the payment is first allocated to child support until that requirement is satisfied in full.

■ Recharacterized payments

- If a payment is recharacterized as child support, defeating an attempted characterization of it as alimony, an amount equal to the reduction in alimony is treated as child support from the outset, causing both the payor and payee spouse to possibly be required to amend a number of their income tax returns.

Child Support Issues

■ **Strict construction of contingencies and ambiguities**

- A payment reduction will not be treated as being clearly associated with the happening of a contingency relating to a child of the payor unless one of the factual situations described above is present. Accordingly, payments of unallocated family support may still be taxable to the payee spouse as alimony unless child support is “fixed” with some specificity.

■ **Seizure of refund to satisfy delinquent child support obligation**

- The IRS may seize an income tax refund to pay a parent’s delinquent child support obligation.
 - If the parent is filing a joint return, the non-obligated spouse may file a claim as an injured spouse to avoid having the portion of the refund attributed to his or her income from being seized.
 - The non-obligated spouse must write “Injured Spouse” in the upper left corner of Form 1040 and attach Form 8379 “Injured Spouse Allocation”.

Property Settlement Issues in Divorce and Separation

- The transfers and payments between spouses and former spouses generally fall into three categories, namely payments for alimony, payments for child support, and property settlements.
- **Pre-1984 Act Rules**
 - Transfer of property incident to divorce was a sale or exchange of property made in consideration of the relinquishment of valuable marital property rights, and a taxable event
 - Code Section 1001; United States v. Davis

Property Settlement Issues in Divorce and Separation

■ Current Rules - Code Section 1041

- Provides that the transfer of property outright or in trust between spouses or former spouses incident to divorce is not a taxable event.
- “Property” includes all property, whether real or personal, tangible or intangible, or separate or community
- Applies to property acquired before, during or after the end of a marriage and transferred to a former spouse. It applies regardless of whether the transfer is of property separately owned by the transferor, or is a division (whether equal or unequal) of marital property or community property
- Does not apply to services

Property Settlement Issues in Divorce and Separation

■ Basis Rules - Analogy to a Gift

- Property is treated as if it had been acquired by the transferee by gift. The transferee's basis in the transferred property carries over from the transferor.
- Applies whether the property's adjusted basis is less than, equal to, or greater than either the property's value at the time of the transfer, and ignores any consideration paid for the property by the transferee.
- Transferee spouse must take a carryover basis.
- Applies if the liabilities associated with the property at the time of its transfer exceed its adjusted basis
 - Carryover basis from the transferor applies for purposes of determining loss as well as gain when the transferee subsequently disposes of the transferred asset.

Property Settlement Issues in Divorce and Separation

■ Basis Rules - Analogy to a Gift

- Circumstances where the transferor will be required to recognize gain
 - Transfer to trusts of installment obligations
 - Transfers of U.S. Savings Bonds bearing accrued interest

■ Holding period

- Transferee of any carryover basis property is permitted to include the holding period during which the transferor held the property.

Property Settlement Issues in Divorce and Separation

■ Transfers of property incident to a divorce

- Code Section 1041 applies to all transfers of property between spouses. There is no requirement that a divorce or separation ever occur for this Code Section to apply. In order for Code Section 1041 to apply to a property transfer between former spouses, the transfer must be “incident to the divorce”. In order for a transfer to be considered “incident to a divorce” one of the two following conditions must be satisfied:
 - Transfer occurs not more than one year after the date on which the marriage ceases.
 - Transfer is related to the cessation of the marriage.

Property Settlement Issues in Divorce and Separation

■ Transfers to third parties on behalf of a spouse

- a transfer to a third party “on behalf of” a spouse or former spouse may allow the transferor to be treated under Code Section 1041 if:
 - The transfer to the third party is required by a divorce or separation instrument; or
 - The transfer to the third party is pursuant to the written request of the transferee spouse; or
 - The transferor receives from the transferee spouse a written consent or ratification of the transfer to the third party.

Property Settlement Issues in Divorce and Separation

■ Redemption of stock in a closely-held business

- The Section 1041 Regulations (1.1041-2) provide clear rules that someone must recognize taxable income on the distribution of funds in connection with a stock redemption pursuant to a divorce.

Property Settlement Issues in Divorce and Separation

■ Transfers of property into trusts

- Transfer is treated as if the transferee spouse received the beneficial interest in the trust as a gift from the transferor spouse.
- For income tax purposes, Code Section 682 applies to trusts involved in a divorce or separation, not Code Section 71.
 - Code Section 682 applies if the transferor and transferee are divorced, have a written separation agreement, or are legally separated.
 - Code Section 682 provides that the transferee spouse is taxed as a trust beneficiary, and not as the recipient of alimony.
 - Since the recipient spouse is not receiving alimony, the transferor spouse is not entitled to an income tax deduction when the trust is created.
 - Code Section 682 does not apply to the portion of any income of a trust fixed as child support payments under a divorce decree, written separation agreement or the trust instrument

Property Settlement Issues in Divorce and Separation

■ Transfers of property into trusts

- Use of a trust avoids most of the alimony restrictions contained in Code Section 71.
- Trust may be designed to continue payments to the estate of the payee spouse, or to his or her beneficiaries.
- Trust may make decreasing payments to a spouse without any concern for recapture

Property Settlement Issues in Divorce and Separation

■ Special types of property transfer issues considered

- The transfer of property incident to divorce will not result in the recognition of depreciation or investment tax credit recapture.
- Except in the case of a transfer to a trust, the transfer of an installment obligation will not be treated as a disposition of the obligation, and will not cause acceleration of gain to the transferor spouse. The same tax treatment as would have applied to the transferor spouse will be applied to the transferee spouse.
- The transfer of Series E and EE United States Savings Bonds will be taxable to the transferor spouse to the extent of untaxed accrued interest inherent in the bonds at the time of the transfer. Section 1041 is not applicable here since Section 1041 shields gain from recognition, not income.

Property Settlement Issues in Divorce and Separation

■ Special types of property transfer issues considered

- Any suspended losses incurred by the transferor are transferred to the transferee.
- Transfer will not trigger a deduction for suspended losses by the transferor spouse.
- Transfer of a life insurance policy pursuant to divorce, even though made for consideration, does not trigger the transfer for value rule.
- Transfers of interests in an IRA to a spouse or former spouse are treated as nontaxable transfers provided that the transfer is pursuant to a decree of divorce or separate maintenance or a written instrument incident to such a decree.
 - Transfer in accordance with a written separation agreement is not sufficient to achieve a nontaxable transfer of an IRA.
 - Under a divorce or separation agreement, the participant's interest in the IRA is treated as owned by and taxable to the transferee spouse.

Property Settlement Issues in Divorce and Separation

■ Special types of property transfer issues considered

- ERISA rules prohibit the transfer (“alienation”) of qualified retirement plans.
- Transfers of interests in qualified retirement plans may be made when they are in the form of a Qualified Domestic Relations Order (QDRO) that satisfies the requirements of ERISA.
 - A “qualified domestic relations order” includes a judgment, decree, or order, including an order approving a property settlement agreement, that relates to the provision of child support, alimony payments or marital property rights to an alternate payee, who may be a spouse, former spouse, child, or other dependent of the participant which is made pursuant to a state domestic relations or community property law.
 - A QDRO must create or recognize the existence of an alternate payee’s right to, or assign to an alternate payee the right to receive all or a portion of the benefits payable to a participant.

Property Settlement Issues in Divorce and Separation

■ Disposition of the marital residence

- If the selling spouse is holding property obtained from a spouse or former spouse that was transferred in a transaction qualifying under Code Section 1041, the period of ownership for such seller includes the period during which his or her spouse or former spouse owned the property.
- If a spouse or former spouse is granted use of the home under a divorce instrument described in Code Section 71(b)(2), such spouse's use of the property as his or her principal residence during the period of occupancy allowed by the divorce instrument is imputed to the other spouse.

Property Settlement Issues in Divorce and Separation

■ Disposition of the marital residence

- Neither party recognizes gain or loss on the transfer, and the transferee spouse takes the cost basis of the transferor's interest in the property, and adds it to his or her own basis in such property.
 - Applies whether the home was originally owned by the couple as tenants by the entirety, joint tenants with right of survivorship, tenants in common, community property, or by one spouse only.
- Transfers of a principal residence between former spouses not incident to divorce, and transfers of the residence to third parties allow qualifying taxpayers to exclude from gross income gain of up to \$250,000 (\$500,000 for qualifying joint filers).

How to Handle the Dependency Exemption

- A taxpayer is permitted to deduct an amount each year as a personal exemption for him or herself and for his or her dependents. The amount of the allowable exemption is adjusted annually for inflation.
- Exemption amount is \$3,900 for 2013.
- **Claiming the dependency exemption**
 - Only one parent may claim an exemption for each child.
 - For purposes of this rule, “custody” refers to physical custody.

How to Handle the Dependency Exemption

■ Release of claim to dependency exemption

- Parent may agree to release that exemption to the other parent.
- The following criteria must apply:
 - The parents are divorced or legally separated under a decree of divorce or separate maintenance, or are separated under a written separation agreement; or the parents lived apart at all times during the last six months of the calendar year.
 - One or both parents provide more than half of the child's total support for the calendar year.
 - One or both parents have custody of the child for more than half of the calendar year.
 - The custodial parent signs a written declaration (IRS Form 8332) constituting an unconditional release that the custodial parent waives the right to claim the child as a dependent for any taxable year commencing with the year in which the declaration is executed.
 - Waiver of the dependency exemption will also result in the release of the child tax credit
 - The parties may enter into a multiple support agreement

How to Handle the Dependency Exemption

■ Medical expense benefits and deductions

- Either parent may claim the child for purposes of benefit eligibility and for the deduction for medical expenses paid on behalf of such child, regardless of which parent is entitled to claim the dependency exemption for the child.

Filing Status Issues for Divorced and Separated Taxpayers

- Marital status for the entire tax year is determined on the last day of the taxable year (which is December 31 for calendar year taxpayers, and a person's date of death if he or she dies during the year).
- Spouses who are legally separated under a final decree of divorce or separate maintenance are not considered married for tax purposes.

Filing Status Issues for Divorced and Separated Taxpayers

- **Income tax return filing alternatives, which are subject to a number of rules**
 - Married filing jointly
 - Married filing separately
 - Head of household

Questions?

PFP Section Resources (aicpa.org/PFP)

- [*The CPA's Guide to Financial & Estate Planning*](#)– Volumes 1-4
- Planning After ATRA and the Net Investment Income Tax Toolkit: aicpa.org/pfp/proactiveplanning
- More resources on estate, tax, retirement, insurance, and investments (aicpa.org/pfp)
- Forefield Advisor (aicpa.org/pfp/forefield)
 - Client education and communication tool
 - Written by CPAs, attorneys and other subject matter experts.
 - More than 3,000 resources covering personal financial planning, including estate, tax, retirement, investment and risk management planning.
 - Keyword search: American Taxpayer Relief Act
- AICPA Advanced Personal Financial Planning Conference (cpa2biz.com/PFP) – January 20-22, 2014 in Las Vegas
 - 2-day session (Jan 18-19) for those in earlier stages of PFP
 - Implementing PFP Services: Step by Step Plans for Success
- For the full calendar of upcoming PFP Section events, visit www.aicpa.org/PFP and click on CPE & Events.

Upcoming PFP Section Webcasts

■ Register now for these events:

- *Do the New PFP Standards Apply to You?* (December 6, 1:00-2:00p.m. ET)
- *Implementation of the 3.8% Net Investment Income Tax Series*
 - S corporations and their shareholders (January 7, 1-2p.m. ET)
 - Partners and partnerships (January 28, 1-2p.m. ET)
 - Estates and trusts (January 29, 1-2p.m. ET)
 - Individuals (January 30, 1-2p.m. ET)

■ AICPA Advanced Personal Financial Planning Conference (cpa2biz.com/PFP) – January 20-22, 2014 in Las Vegas

- 2-day session (Jan 18-19) for those in earlier stages of PFP
 - Implementing PFP Services: Step by Step Plans for Success

■ For the full calendar of upcoming PFP Section events, visit aicpa.org/PFP and click on CPE & Events.

■ To access the archives, visit aicpa.org/pfp/webseminars.

CPA/PFS News and Events

■ PFS Referral Program

- Receive 100% credit to apply toward future CPA/PFS dues by referring a CPA to become a PFS or sit for the PFS exam

■ PFS Exam

- Registration open for winter window
- Discounts, sponsorships and volume pricing available

■ Education Opportunities

- Live 2 ½ day review class – 3 locations in Oct/Nov: OH, AZ, GA
- In-depth courses in estate, retirement, tax, investments, insurance, and PFP process
- Self-study PFS exam review course

■ Learn more at aicpa.org/pfp/pfs