Divorce - General Tax Considerations

A divorcing couple will be faced with many important decisions and issues ranging from the type of divorce action to pursue, the timing of it, and, of course, a fair division of property and possibly payment of alimony and child support by one spouse. You should be aware that in looking at a potential property settlement or cash payments, it is important to consider the impact of taxes. They can greatly affect alimony, child support, property settlements, distributions of retirement benefits and other items that you may be addressing in your divorce or separation agreement.

Alimony or separate maintenance is deductible by the paying spouse and is taxed to the payee spouse unless both agree that it will be tax-free to the recipient and nondeductible by the payer. A spouse may agree to give up the deduction if it would be of little or no value, such as where he or she has deductible tax losses from other sources. Another important point about alimony is that you can't just label a payment as alimony and expect it to be treated as such for tax purposes. A number of requirements must be met. Also, special rules prevent alimony deductions for what are disguised property settlements.

Child support payments are not deductible or taxable. As with alimony, merely labeling payments as child support is not enough. Various requirements must be met. Closely related to child support is the issue of who gets to claim the dependency exemption for the child. In general, it goes to the parent who has custody of the child, even if the bulk of the child's support comes from the noncustodial parent. However, the custodial parent can release the exemption to the noncustodial parent.

Property settlements, such as you get the house and your spouse gets stocks, generally are tax-free to both parties. Does that mean taxes are not important in property settlements? Not at all. While the property settlement itself ordinarily is not taxable, who gets what property can greatly affect either spouse's potential future taxes if the property received is later sold. This is because of the rules regarding basis, which is the yardstick for measuring tax gain or loss when you sell an item.

For instance, let's say a house worth $350,000 was purchased a few years ago for $300,000 and $350,000 of stock was purchased several years ago for $150,000. The spouse receiving the stock would have a $200,000 gain ($350,000 less basis of $150,000) on an immediate sale, whereas a sale of the house would result in only a $50,000 gain ($350,000 less $300,000). Of course, there may be no tax for several years if both parties plan to hold the assets for some time. Still, even if you plan to retain assets, you should carefully consider basis when negotiating for specific assets because circumstances may change and property may have to be sold sooner than you may think.

Finally, special considerations come into play when there are company pension and profit-sharing benefits, Keogh plan benefits, and/or IRAs to split up. Complications and tax traps can also occur when a jointly-owned business will be transferred to one spouse in connection with a divorce.

As you can see, taxes can and do play a very important role in shaping a divorce agreement. We would be happy to explore any of the above items in greater detail with you.