

# Splitting Tax Liability Is Harder than Splitting Up

## by: Christy Lee<sup>1</sup>

The tax perspective: Whether structuring a property settlement, choosing how to split up retirement savings, or simply figuring out the filing status after the couple part ways, the transition is a bit easier if you know the tax consequences to each transaction.

**\*\*DO NOT INCLUDE ANY FEDERAL INCOME TAX DEBT IN DIVISION OF PROPERTY.\*\***

### Three Stages:

1. Pre-nuptial.
2. Marriage .
3. Separating/Dissolving the Marriage.

### There Is a 3-step Process when Splitting Up:

1. Identify the marital property and debt.
  - The current balance in all bank accounts.
  - The value of any brokerage account.
  - The value of investments, including any IRAs.
  - Your residence(s).
  - Your autos.
  - Your valuable antiques, jewelry, luxury items, collections, and furnishings.
2. Value of the marital property and debt.
3. Divide the marital property and debt.

### Accountants:

- Conflict of interest!
- Married Filing Separately.

### Child Support:

- No tax deduction for child support.
- Do *not* pay more than required; include the additional funds as alimony.

### Retirement Accounts and Pensions:

- If a retirement plan is cashed out to give money to an ex-spouse, the IRS considers that action a taxable distribution—and the retirement account owner will be stuck paying the tax.
- Avoid this tax-trap by transferring the funds under a Qualified Domestic Relations Order (QDRO). This gives the soon-to-be-ex-spouse the right to the funds and relieves the retirement account owner of the tax burden.

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<sup>1</sup> Christy Lee is a tax attorney at Law Offices of Christy Lee, P.C., a tax boutique with locations in Anchorage and Texas.

- A QDRO is not needed to transfer the retirement account funds, as spelled out in the divorce agreement.
- Tied together forever. Really?
- "Time value of money": The idea that money available at the present time is worth more than the same amount in the future due to its potential earning capacity. This core principle of finance holds that, provided money can earn interest, any amount of money is worth more the sooner it is received.
- Civil Service Pension:
  - "1/2 of Husband's Federal Employee Retirement System benefits accrued between his date of hire (if after marriage) and date of parties' separation. Wife's interest shall include any future cost-of-living increases in her portion of such benefits, but shall not include any future increases resulting from husband's increased pay or years of service."

**Alimony** (one way around Civil Service Pension or division of Retirement):

- A tax deduction for the person making the payment.
  - does not have to use income to get deductions.
  - could sell car or savings.
- Taxable income for person accepting the payment.
- Must put recipient's SSN on tax return.
- If alimony recipient does not file tax return, it is certain the payer will be audited.

**Marital Property Transfer:**

- No tax will be owed on the transfers of assets to/from spouses or ex-spouses (under a separation agreement).
- Basis of asset transfers to ex-spouse.
- \$100,000 cash is more valuable than \$100,000 in stocks with a basis of \$50,000.

**Exemptions for Dependent Children:**

- Child must have lived with you for a longer period of time during the year than with the ex-spouse.
- Waiver pledging that custodial parent will not claim the child.
- Child care credit.
- American Opportunity higher education credit or Lifetime Learning higher education tax credit.

**Medical Expenses:**

- Can still claim even if not custodial parent.

**Residence:**

- Avoidance of capital gains if lived in 2 years of the last 5 years.
- \$500,000 exclusion for couples.
- \$250,000 exclusion for single.

**Married Filing Separately:**

- Jointly liable for any return signed together.
- Itemize deduction -
  - If one spouse itemizes, both must itemize, splitting the items to be listed on a separate Schedule A for each.
  - That means a partner with few deductions can't use the standard amount and might get cheated when it comes to reducing taxable income.
- Many tax-cutting credits and deductions are forfeited.
  - Earned-income credit.
  - Claim adoption expenses.
  - Child and dependent-care costs.
  - Use educational tax credits.
  - Interest you paid on a student loan.
- Amount of capital gains/losses you can deduct is cut in half.

**2013 Tax Rates (What is your status on December 31?):**

<u>Rate</u>	<u>Single Filers</u>	<u>Married Joint Filers</u>	<u>Head of Household Filers</u>
10%	\$0 to \$8,925	\$0 to \$17,850	\$0 to \$12,750
15%	\$8,925 to \$36,250	\$17,850 to \$72,500	\$12,750 to \$48,600
25%	\$36,250 to \$87,850	\$72,500 to \$146,400	\$48,600 to \$125,450
28%	\$87,850 to \$183,250	\$146,400 to \$223,050	\$125,450 to \$203,150
33%	\$183,250 to \$398,350	\$223,050 to \$398,350	\$203,150 to \$398,350
39.6%	\$400,000 and up	\$450,000 and up	\$425,000 and up

\*\*Married Filing Separately is 1/2 for Married Joint Filers.

## INNOCENT SPOUSE RELIEF

- Step 1: A joint tax return must have been filed under IRC §6013
- Step 2: The relief afforded under §6015 is only with respect to income taxes
- Step 3: Spouse must file Form 8857 within 2 years after the date on which the IRS began “collection activity” §1.6015-5(b)(3).
- A. Remember to check the SOL on the notice of deficiency
- Step 4: §6015(b) is used almost exclusively by those who are not divorced or separated. Spouse must prove each of the following elements:
- A. An understatement attributable to erroneous items of the other spouse.
  - B. In signing the return, the spouse “did not know” there was an understatement on the return and “did not have reason to know” of its existence
  - C. Taking into account all the facts and circumstances, it would be inequitable to hold the requesting spouse liable for tax.
- Step 5: §6015(c) is essentially a “no-fault” relief. Unless the IRS can establish the existence of a condition defeating relief, relief is granted to the extent the spouse proves the portion of the understatement is not attributable to him.
- A. Only available to unmarried or separated spouses
  - B. The IRS has the burden of proving that the spouse had “actual knowledge” §1.6015-3(c)(2).
  - C. Anti-Avoidance Rules
    - a. Neither spouse can elect if part of a fraudulent scheme
    - b. Watch out for Disqualified Assets and the Presumptions
- Step 6: §6015(f) provides relief when, taking into account all the facts and circumstances, it would be inequitable to hold the requesting spouse responsible for more than his portion of the unpaid tax. Rev. Proc. 2003-61 Spouse must show:
- A. Relief is not available under §6015(b) and (c)
  - B. Item for which relief is sought is attributable to the other spouse
  - C. No impermissible transfers of assets or fraudulent conduct took place
  - D. No longer living together
  - E. “did not know” or “did not have reason to know”
  - F. Requesting spouse would suffer economic hardship if relief is not granted
- Step 7: If election is filed under §6015(b) or (c), collection and SOL is suspended until the date of the decision plus 60 days. (§6015(e)(1) and (2)).