Podcast: Divorce Tax Considerations at Year-End and Beyond

SK: Hello and thank you for joining us today for our podcast: Divorce Tax Considerations at Year-End and Beyond. I'm Sharon Klein, President of Family Wealth's Eastern Region here at Wilmington Trust, and head of our National Divorce Advisory Practice. I'm so pleased to be here today with my friend and colleague, Rachael Leberstien, who is a CPA and senior relationship manager, to talk about those key tax issues you and your client should discuss before a divorce is finalized. Welcome Rachael.

RL: Thank you Sharon. I'm so happy to be here.

SK: Yes so, let's look at the fact that the end of the year is looming and soon, wow I can hardly believe it we'll be filing taxes for 2021. Let me ask you Rachael, if a divorcing couple was previously married filing jointly, they will need to rethink their tax filing status, right?

RL: Yes Sharon, you are correct. And yes, I can't believe it's year-end either. There will likely be a change to tax filing status. Advisors may be wondering what that means for their clients. A taxpayer's tax filing status is used to determine several factors on the tax return, including the tax rate. A taxpayer's marital status on the last day of the tax year determines the filing status for that entire tax year. An individual will be considered to be divorced for the entire year if the divorce was finalized on or before December 31 of the tax year. A divorced individual can use the Single or Head of Household filing status for the year in which the divorce was finalized.

SK: Okay, so here we are at year-end and many divorces may still be in process. What happens if a divorce has not been finalized at the end of the tax year?

RL: That's a great question Sharon. Taxpayers not legally divorced or separated on December 31 are considered married for that tax year and will have the option to file their tax returns as Married Filing Jointly, Married Filing Separately, or Head of Household. The Married Filing Jointly filing status will usually result in a lower overall tax bill, but many individuals don't want to have to work with their spouse to get the return filed, as there may be disagreement regarding factors that impact the tax return. If your client is in this situation, then their next best option may be the Head of Household filing status. Please note, that a taxpayer can file as Head of Household if the taxpayer is not married or is legally separated at the end of the tax year or the taxpayer did not live with their spouse for the last six months of the tax year. The taxpayer also must have paid for more than one-half of the costs to maintain the household and the taxpayer's children must qualify as dependents and live with the taxpayer for more than one-half of the year. All these rules probably seem overwhelming, but it's important for your client to know there are options when trying to determine the correct filing status. A tax advisor can work with your client to determine the most advantageous filing status for their circumstances.

SK: Okay, very helpful to know. And in terms of dividing taxable income between a divorcing couple, can you tell us what considerations should be top of mind?

RL: Yes. If your client has been filing a return jointly with his or her spouse since they were married, then they reported all their income on the same tax return without having to determine what income belonged to each spouse. When divorcing, your client will need to figure out their income separately so that each spouse reports the proper amount of income.

Keep in mind that determining the proper allocation of income and deductions in the tax year a divorce is finalized or when a divorcing couple chooses to file separately is dependent on the distribution laws of the state where the divorce decree was issued. Taxpayers in most community property states are required to equally split all community income up to the date of the divorce decree. After the divorce has been finalized, all income from that date through the end of the tax year is reported by the individual who earned it. Taxpayers divorcing in an equitable distribution state will report all income they earned individually, and any income received from property they personally own.

SK: Very interesting, Rachael. Thank you. And also, as you know, at the end of the year, people are usually scrambling to take advantage of tax deductions to reduce their tax hit. Are there any tips you have for those maneuvering through divorce now?

RL: Yes, Sharon. It's commonly asked whether any of the attorney or advisor fees incurred during a divorce are tax deductible. Fees paid for tax planning and legal tax advice are not tax deductible for federal purposes. Unfortunately, the 2017 Tax Cuts and Jobs Act legislation repealed the deduction for legal and other professional fees for individual taxpayers beginning January 1, 2019. This provision of the law does sunset, meaning that as of January 1, 2026, the deduction for legal and professional fees will once again be allowed. There are some states that still allow a tax deduction for legal and professional fees so you can recommend that your client discuss the tax deductibility of these fees with a tax advisor to ensure you don't miss a tax deduction.

SK: Okay and what about credits for children, who is entitled to claim them?

RL: Great question, Sharon. Only the custodial parent, who is the parent a child lives with for most of the year, can claim the child tax credit. For eligible families in 2021, the credit is between $3,000 and $3,600 per child, depending on the child's age. It is possible for the noncustodial parent to claim the credits if the custodial parent signs a waiver agreeing not to claim the exemption.

SK: Okay, very interesting. Let me ask you the next question I have. What if a divorcing couple has overpaid their taxes, are there issues regarding who is entitled to the refund?

RL: Yes, there certainly can be! An overpayment on your client's prior year tax return that has been applied to next year's estimated tax, and estimated tax payments that have been paid during the tax year, can be allocated between spouses.

The IRS allows taxpayers to allocate these payments in any agreed upon manner if an explanation for the allocation is attached to the tax return when it is filed. The distribution laws in your client's state may dictate the allocation of these payments. The payments will likely have to be allocated equally to each spouse if the divorce is in a community property state and the tax payments were made with community funds. The laws for equitable distribution states may require that any estimated tax payments be divided among spouses in proportion to each spouse's separate tax liability.

SK: Wow that is really interesting! Getting back to deductions for a moment. I want to clarify something. It used to be that spousal support payments were deductible to the spouse making the payments, but that has changed, right?

RL: Yes, and that change is very significant! Spousal support payments are commonly used in divorce settlements to shift cash from one spouse to another to provide income. It's important to understand how these payments will impact your client's taxable income and cash flow. Alimony is one type of spousal support payment. The Tax Cuts and Jobs Act tax legislation changed the tax treatment of alimony paid and received. It used to be that alimony was includable in the income of the person receiving the alimony and deductible by the payor. With the payor likely to be in higher income tax bracket than the recipient, pushing the income down to be taxed in the recipient's lower bracket often resulted in tax savings for the couple. Under the new law, any divorce or separation agreement signed on or after January 1, 2019 is governed by the new tax law and alimony income is not taxable to the recipient and there is no tax deduction for alimony paid. Only those agreements completed by year end **2018** are not subject to this legislation.

SK: Wow, that's really an important point, and just to drill down a little further, not all payments made from one spouse to another are considered alimony, correct?

RL: That's right, for spousal support to qualify as alimony, the payments need to be made pursuant to a divorce decree or separation agreement. Payments must be made in cash, not property. The spouses may not live in the same household, they may not file a joint tax return, and there can be no requirement that payments be made to the payee after death.

SK: Very important, thanks for clarifying that. Finally, perhaps we can end with some evergreen advice, important at year-end and really any time during the year: can you speak to the significance of determining your client's post-divorce cash flow?

RL: Absolutely, Sharon. Examining cash flow is essential in divorce planning. An analysis of projected cash flow helps you determine if a proposed divorce settlement will allow your client to maintain their current lifestyle. Your client will need to provide you with their current sources of income, anticipated expenses and their assets and liabilities for you to be able to determine an equitable divorce settlement

SK: That's exactly right Rachael and I might add that this information can also be used to simulate potential asset division scenarios, correct?

RL: That's right, Sharon. Advisors can analyze simulated asset division scenarios to project estimates of their client's annual cash flow and the length of time that the client's assets will last based on their spending needs. Providing this type of cash flow analysis to your client can help them feel confident in their financial future after the divorce is finalized.

SK: Which is so important Rachael, thank you. Any final words of advice you would like to share?

RL. Sure Sharon, I would love to. It is very important to have expert advice when dividing marital assets to ensure that the division equitably allocates the assets and liabilities of the divorcing couple. A tax advisor can determine any tax ramifications of assets or liabilities your client will receive in the divorce. Each type of asset can be taxed differently, even when they seem to be comparable assets. One example is the division of retirement assets such as a 401k or IRA. There is a big tax difference between receiving traditional or Roth IRA or retirement plan assets. Traditional IRA and retirement plan assets are taxable when the assets are distributed to the beneficiary, but Roth IRA and retirement plan assets are distributed to the beneficiary tax-free – that's a huge difference. It is also important to consider the cost basis of assets received in divorce, like stocks or real estate, since some assets may have a big built-in gain, which will be realized when the asset is sold. For example, real estate received as part of a divorce settlement may generate capital gains taxes when sold if the sales price exceeds the basis, so it is important to know the cost basis of any real estate received along with any tax deductions that have been claimed on the real estate, such as deprecation. The cost basis and depreciation will impact your taxable income when this asset is sold. The potential tax on the sale or distribution of assets received in a divorce should be considered when these assets are divided.

SK: Wow, thanks so much Rachael. You have really underscored the importance of clients surrounding themselves with the right advisors so they can navigate all these tax issues that are associated with divorce, so that they can take advantage of opportunities, so

they can maneuver around the potential traps that you've mentioned and generally position themselves for a successful settlement.

Thank you, Rachael, for your insights on this important topic and thanks very much to all our listeners for joining us today.

If you would like to discuss divorce planning in greater detail, please reach out to your Wilmington Trust advisor or send an email to SharonKlein@wilmingtontrust.com or call 212-415-0539. We would be delighted to help you.