

**THE BASICS (REALLY!) OF
 INCOME TAXES & FAMILY LAW**
 Judge Nancy E. Gordon
 Durham County District Court
 July 2009, NC Judicial College

Why is information about basic income tax important in Family Law Cases?

BECAUSE UNDERSTANDING THE BASICS WILL INFORM YOUR DECISIONS




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AND WE CARE...BECAUSE THE STATUTES REQUIRE JUDGES TO CONSIDER INCOME TAX ISSUES

Consideration of income tax consequences is required in Equitable Distribution Cases; it is a consequence of your decision in a Postseparation Support/Alimony case; and there are a variety of tax effects that relate to child support/custody decisions you make



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DIVORCE COURT ORDERS DO NOT CONTROL TAX CONSEQUENCES

Many federal judges, when ruling on the tax effect of a divorce court's rulings, say: "a State court or the intention of the state court judge in rendering a divorce decree does not determine the Federal income tax consequences of the divorce judgment rendered."

Coltman v. Commissioner, T.C. Memo 1991-127

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BUT, ADDED THE US SUPREME COURT:

"...fashioning a divorce agreement in accordance with tax consequences is an appropriate and legitimate practice. After all, the parties may for tax purposes act as their best interest dictates. . ."

• *Commissioner v. Lester*, 366 U.S. 299, 81 S. Ct. 1343 (1961)

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LET'S BEGIN WITH PROPERTY DISTRIBUTION & BASIC INCOME TAX ISSUES:

When judges value assets, we need to know the nature of the asset in tax terms

- ❖ Retirement money- is it tax deferred?
- ❖ Business Concerns- are there tax effects which affect or will affect the value of the business?
- ❖ Assets which may need to be sold-if an asset needs to be liquidated, will there be a tax effect to the parties?



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SALE OF PRINCIPAL RESIDENCE



The "gain" on the sale of a principal residence used to be taxed to the sellers unless they were over 65 years of age

Under §121 of the IRS Code, up to \$500,000 per married couple who file taxes jointly or up to \$250,000 per individual taxpayer may be excluded from income tax

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CONSIDERATION OF "TAX CONSEQUENCES" IS A DISTRIBUTIONAL FACTOR



NCGS § 50-20 (c)(11) "The **tax consequences** to each party, including those federal and State tax consequences that would have been incurred if the marital and divisible property had been sold or liquidated on the date of valuation. The trial court may, however, in its discretion, consider **whether or when** such **tax consequences** are reasonably likely to occur in determining the equitable value deemed appropriate for this factor."

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BEFORE THE TAX REFORM ACT OF 1984

Transfers between spouses used to be taxable transactions resulting in gain or loss to the transferor (you might remember this from law school: the "Davis Rule)



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Under the present Internal Revenue Code, transfers between spouses are governed by §1041 which states:

1. Transfers between *spouses* &
2. Transfers between *former spouses incident to divorce*:



ARE TREATED AS GIFTS AND ARE NOT SUBJECT TO TAXABLE GAIN OR LOSS AT THE TIME OF THE TRANSFER

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"INCIDENT TO DIVORCE" DEFINED:

- ❖ Within **one year after** the date of divorce
- OR
- ❖ Related to the **cessation of marriage**

So, when the judge makes a **DISTRIBUTIVE AWARD**, which is, by statutory definition, not supposed to carry income tax consequences, it, presumably, must be made within 6 years of the "cessation of the marriage"

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WHEN IS A TRANSFER OF PROPERTY "RELATED TO THE CESSATION OF THE MARRIAGE"? THE INTERNAL REVENUE SERVICE REGULATIONS PROVIDE GUIDANCE-

A transfer of property is treated as **related to the cessation of the marriage** if the transfer is pursuant to a divorce or separation instrument, as defined in section 71(b)(2), **and** the transfer occurs **not more than 6 years after the date on which the marriage ceases**. . . any transfer occurring more than **6 years** after the cessation of the marriage is **presumed** to be not related to the cessation of the marriage.

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THE 6 YEAR RULE IS A REBUTTABLE PRESUMPTION

"This presumption may be rebutted only by showing that the transfer was made to effect the division of property owned by the former spouses at the time of the cessation of the marriage." (IRS Regs)



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LAWING V. LAWING, 81 NC APP 159, 344 SE2D 100 (1986)

"...we interpret the language of G.S. 50-20(b)(3) as authorizing the court to make distributive awards for periods of "not more than six years after the date on which the marriage ceases," *except* upon a showing by the payor spouse that legal or business impediments, or some overriding social policy, prevent completion of the distribution within the six-year period...Awards for periods longer than six years, if necessary, should be crafted to assure completion of payment as promptly as possible. This will serve both statutory goals: affording the recipient's share non-recognition treatment under the Code, and fairly wrapping up the marital affairs as quickly and certainly as possible."

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WHAT'S REQUIRED?



- o The parties must make "a showing"
 - THE COURT SHOULD BE COGNIZANT OF TAX ISSUES, BUT THE BURDEN IS ON THE PARTIES TO PRESENT EVIDENCE;
 - The parties must put on evidence about the tax consequences to either or both of them of a property transfer or a distributive award;
 - THIS IS NOT HYPOTHETICAL TAX CONSEQUENCES- *Wilkins v. Wilkins*, 111 NC App 541, 432 SE2d 891 (1993): "We conclude that to predict variables (including *inter alia* the government's tax structure, plaintiff's financial condition, the date of plaintiff's early withdrawals, if any, and the date of plaintiff's eventual retirement) that far in the future requires the trial court to engage in impermissible speculation."

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DISPUTED QUESTION- NCGS 50-20(c)(11)- WHAT DOES IT MEAN?

As recently as 2008, COA examined the question of what is required of the Trial Court:

"The trial court is not required to consider possible taxes when determining the *value* of property in the absence of proof that a taxable event has occurred during the marriage or will occur with the division of the marital property. We construe Section 50-20(c)(11) of the General Statutes as requiring the court to consider tax consequences that will result from the distribution of property that the court actually orders."

Weaver v. Weaver, 72 N.C.App. 409, 416, 324 S.E.2d 915, 920 (1985)

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PELLOM V. PELLOM, 669 SE2D 323 (2008)

"The trial court complied with the statute by considering the tax consequences to plaintiff. However, plaintiff was ordered to pay a distributive award, not liquidate his interest in DAA, which may have had a significant tax consequence."



So is a taxable event required? A probable taxable event?

REASONABLE PEOPLE DISAGREE!

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TAX CONSEQUENCES: ALIMONY & PSS

NCGS 50-16.9(b) states:



"If a dependent spouse who is receiving postseparation support or alimony from a supporting spouse under a **judgment or order of a court** of this State **remarries or engages in cohabitation**, the postseparation support or alimony shall terminate. Postseparation support or alimony **shall terminate upon the death of either the supporting or the dependent spouse.**"

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**MANNER OF PAYMENT OF ALIMONY-
NCGS §50-16.7:**

- o Alimony or postseparation support shall be paid by
 - o lump sum payment
 - o periodic payments
 - o by transfer of title or possession of personal property or any interest
 - o possession of real property



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**IRS ALIMONY MEANS INCOME WILL
BE TAXED TO THE DEPENDENT
SPOUSE AND DEDUCTED FROM THE
INCOME OF THE SUPPORTING SPOUSE**



**OFTEN, THAT MEANS THAT INCOME
WILL BE TAXED AT A LOWER RATE OF
THE DEPENDENT SPOUSE INSTEAD OF
THE HIGHER TAX BRACKET OF THE
SUPPORTING SPOUSE**

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**PAYMENTS BETWEEN SPOUSES WILL BE
CONSIDERED ALIMONY FOR FEDERAL TAX
PURPOSES IF:**

Parties DO NOT file a <u>joint return</u> with each other	Payments must be made in <u>CASH</u> or cash equivalent
The "writing" does not say that the payment is <u>NOT alimony</u>	The parties are not members of the <u>same household</u> when the alimony payment is made
No <u>liability to make the payment</u> after the death of the Payee spouse	Payment is not treated as <u>child support</u>

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POINTS OF COMMONALITY BETWEEN NC STATUTE & IRS DEFINITION



- ❖ Payments made based on a writing (order/judgment or agreement) and
- ❖ Termination on death of payee spouse (NC law includes death of payor spouse, too)

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No payment required after death of dependent spouse

Payments pursuant to a writing and not described as "not" alimony

No joint tax return filed

Parties live in different houses

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WHAT IS NOT TAXED?



Child support is never deductible to the Payer or taxed to the Payee

Noncash property settlements (e.g., transfers of property or possession of property) do not qualify as IRS/taxable alimony.

Voluntary payments (i.e., payments not made because they are required by a divorce decree or separation agreement) do not qualify as taxable alimony.

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The Payer spouse may deduct from his or her income the amount of alimony or separate maintenance actually paid;

Conversely, the Payee spouse must include in his or her income the amount of alimony or separate maintenance actually received.

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Not all payments under a divorce or separation instrument are alimony.

Alimony does not include:

- Child support,
- Noncash property settlements,
- Payments to keep up the Payer's property, or
- Use of the Payer's property.

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WHAT ABOUT THIRD PARTY PAYMENTS?

Payments made to 3rd parties by a supporting spouse for a dependent spouse can qualify as alimony.

Examples: utility payments, mortgage payments, insurance payments

WILL THE IRS TREAT 3RD PARTY PAYMENTS AS ALIMONY?

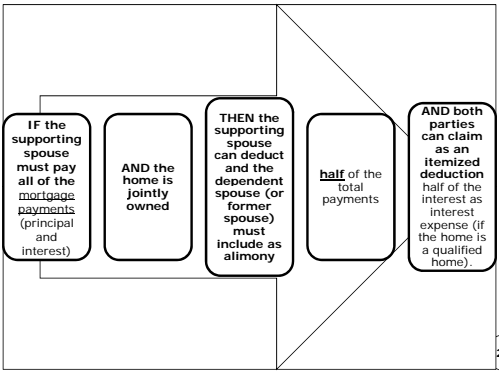
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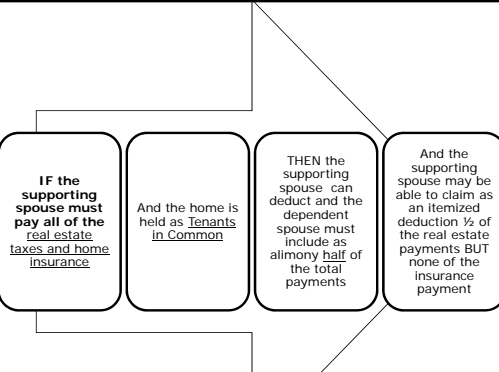
IS TREATING A PAYMENT TO A 3RD PARTY AS ALIMONY EVER A GOOD IDEA?



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IF the supporting spouse must pay all of the real estate taxes and home insurance

And the home is held as tenants by the entirety or in joint tenancy

The supporting spouse can deduct NONE of the payments

But he/she may claim as itemized deductions all of the real estate taxes and none of the home insurance.

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WHAT IS "ALIMONY RECAPTURE?"

The alimony recapture rules permit the Service to retroactively "recharacterize" the payments and reverse the tax consequences to the parties- sometimes called "frontloading" alimony or "excess" alimony

This is one of the sometimes "unforeseen" consequences of the way alimony payments are set up that can have a devastating effect on the parties down the line

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THE 3 YEAR ALIMONY RECAPTURE RULE

- o If alimony payments decrease or terminate in the first 3 calendar years, the deduction may be "recaptured" if:
 - payment in the 3rd year is \$15,000 less from the 2nd year
 - Or
 - There is a significant decrease from the 1st year to the 2nd or 3rd year.

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3 YEAR RECAPTURE RULE CONT'D.

- o The rule does not include payments under a temporary order- so it will not include PSS orders
- o The rule does not apply if, because of death or remarriage of the payee spouse, payments are terminated during the first three years
- o The rule does not apply to fixed percentage awards, that is a payment that's calculation as a fixed percentage of income from property, a business or compensation from employment

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DOES PAYMENT OF ATTORNEYS FEES HAVE ANY TAX CONSEQUENCE?



Payment of attorney fees (and hence, attorneys fee awards) may have an impact on the parties' income taxes

If the fees are paid "for the production and collection of taxable income" they may be deductible as an itemized deduction by the dependent spouse (there is a 2% of AGI limitation on this deduction)

On the other hand, payments to an attorney for personal advice, counseling or other divorce-related matters is not related to taxable income and is not deductible

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CHILD-RELATED CHANGES IN ALIMONY PAYMENTS...



Payments of "alimony" which terminate or are reduced at a time close to the occurrence of a contingency in the life of a child may be reclassified as "child support" by the IRS

examples: payments which terminate around a child's 18th birthday or another specific age, a child's marriage, death or even leaving school

The IRS doesn't examine whether the contingency was/is likely or even certain to occur

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(NOTE: this presumption can be rebutted by, for example, the establishment that the payments are going to cease under the 6 year rule.)

THE FOLLOWING PAYMENTS ALMOST CERTAINLY WILL BE RECLASSIFIED AS CHILD SUPPORT

Payments which are going to be reduced not more than 6 months before or after the date a child is to attain the ages of 18 or 21 (or the local age of majority)

Payments which will be reduced on two or more occasions which occur not more than one year before or after a different child or the payer spouse attains a specific age between 18 & 24, inclusive



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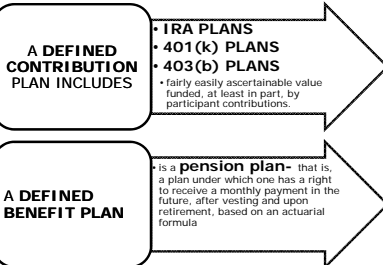
Assets with inherent tax issues: RETIREMENT BENEFITS

There are two types of retirement plans

DEFINED CONTRIBUTION PLANS	DEFINED BENEFIT PLANS
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IRAs

- o There are two kinds of IRA Plans: a ROTH IRA and a Conventional IRA. While withdrawal of funds from these retirement plans carries income and other tax consequences for the party who owns the funds, they are not **ERISA Qualified** Plans and they do not require a **DOMESTIC RELATIONS ORDER** to distribute any or part of the funds held.

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QUALIFIED DOMESTIC RELATIONS ORDERS



- o **All monies** that are paid from retirement funds, except ROTH IRAs which are funded with after-tax dollars, are taxable as **ORDINARY INCOME** to the party who owns the funds.
 - **PAYMENTS FROM RETIREMENT WILL BE MADE WITH TAXABLE AND DEFERRED FUNDS; THIS IS A VALUE ISSUE**
- o **IT IS BECAUSE OF THESE TAX CONSEQUENCES THAT WE HAVE DOMESTIC RELATIONS ORDERS** (when the DRO is qualified by the Plan Administrator, it becomes a **QUALIFIED DOMESTIC RELATIONS ORDERS**, that is, a QDRO)

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Generally, a QDRO is an exception to the IRC prohibition against assignment of income.

The Tax Code, through a QDRO, permits an Alternate Payee (the non-owner spouse) to receive an interest in the deferred retirement funds, subject to the same Plan conditions as the Payee spouse (that is, the owner), and provides for the taxation of those payments to the Alternate Payee.

The distribution is taxed as income to the Alternate Payee **when they are received**. This is not a valuation issue.

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CAN A COURT RELY ON A QDRO TO TRANSFER CASH FROM ONE PARTY TO THE OTHER PARTY?

Yes. There are several ways to "raise cash" via a QDRO:



1. Payment of benefits to an Alternate Payee if the AP is entitled to payment
2. Distributions for child support
3. Enforcement of Alimony & Child Support Orders
4. Obtaining a loan against a defined contribution Plan (no tax consequences)

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EXAMINATION OF CHILDREN & TAXES- THE NC CHILD SUPPORT GUIDELINES MAKE ASSUMPTIONS ABOUT TAX CONSEQUENCES & CHILDREN



DEPENDENCY EXEMPTION -The Child Support Guideline calculation of child support generally assumes that the parent who receives child support claims the tax exemptions for the child.

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NC CHILD SUPPORT GUIDELINES- DEPENDENCY EXEMPTION CONT'D

BUT

if the parent who receives child support has minimal or no income tax liability, the court may consider requiring that the custodial parent assign the exemption to the other parent **AND** deviate from the guidelines



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WHAT IS THE DEPENDENCY EXEMPTION?

The IRS permits people with dependents to claim deductions for those dependents. In 2009, a taxpayer will deduct **\$3650** per dependent.

Each exemption reduces your taxable income and, in addition to the personal exemption generally available to each taxpayer, there are exemptions permitted for dependents. A dependent includes a "qualifying child."

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"QUALIFYING CHILD" MEANS:

- o A child must be the taxpayer's son, daughter, stepchild, foster child, brother, sister, half brother, half sister, stepbrother, stepsister, or a descendant of any of them.
- o The child must be (a) under age 19 at the end of the year, (b) under age 24 at the end of the year and a full-time student, or (c) any age if permanently and totally disabled.
- o The child must have lived with the taxpayer for more than half of the year.
- o The child must not have provided more than half of his or her own support for the year.
- o If the child meets the rules to be a qualifying child of more than one person, the taxpayer must be the person entitled to claim the child as a qualifying child.

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ASSIGNMENT OF DEPENDENCY EXEMPTION

When ordering the custodial parent to assign the dependency exemption, the Court should order that parent to execute an **IRS Form 8332** and provide that form to the other parent. As of tax year 2009, the non-custodial parent must attach an 8332 to his/her income tax return when claiming the child[ren].

See *Ticconi v Ticconi*, 161 NC App 730, 589 SE2d 371 (2003)

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THE "CHILD TAX CREDIT"- WHAT IS IT?

There may be a child tax credit available for each qualifying child who is under the age of 17. The credit is up to **\$1000** per child; limitations on the credit amount are determined by the filing status and the Adjusted Gross Income ("AGI") of the taxpayer(s).

The child tax credit is not mentioned in the NC Child Support Guidelines. In 2009, it may be affected by the federal stimulus package and can provide a tax refund to a taxpayer even if he/she doesn't owe any tax.

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CHILD CARE CREDIT & THE NC CHILD SUPPORT GUIDELINES

There are established levels of income where the calculation takes into account 100% of the work-related child care expenses incurred.

1 child	\$1,100	4 children	\$1,900
2 children	\$1,500	5 children	\$2,100
3 children	\$1,700	6 children	\$2,300

At this income level, the parent **who pays the child costs** does not benefit from the tax credit for child care.

When the income of the parent who pays child care costs exceeds these charted amounts, only 75% of actual child care costs are added (because the parent is entitled to the income tax credit for child care expenses).

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WHAT IS THE DEPENDENT CARE TAX CREDIT?

A Tax Credit may be available to persons with children under the age of 13 if the parent:

- ❖ pays someone to take care of the child so he/she can work
- AND
- ❖ has EARNED income
- AND
- the parent is the custodial parent



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TAX FILING STATUS

o **FILING STATUS IS DETERMINED BY MARITAL STATUS ON THE LAST DAY OR THE TAX YEAR- this makes year end divorces financially valuable**

OR

IF MORE THAN ONE FILING STATUS APPLIES TO THE TAXPAYER, THEY SHOULD CHOOSE THE ONE WHICH RESULTS IN THE LOWEST TAX OBLIGATION

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THERE ARE 5 FILING STATUS POSSIBILITIES

- 1. **Single.** This will generally apply to anyone who is unmarried, divorced or legally separated according to state law.
- o 2. **Married Filing Jointly.** A married couple may file a joint return together.
- o 3. **Married Filing Separately.** A married couple may elect to file their returns separately.
- o 4. **Head of Household.** This generally applies to taxpayers who are unmarried but can apply to those who are legally separated. In order to qualify for HoH, one must have paid more than half the cost of maintaining a home for the parent and a **qualifying child**.
- o 5. **Qualifying Widow(er) with Dependent Child.**

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FILING STATUS CAN BE TRICKY...

- o What is "legally separated" in North Carolina and what that means for the IRS may or may not be the same thing
- o Only a person with a qualifying dependent can claim HoH status

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But Filing Status makes a great difference in tax liability

In order of cost:

- ❖ Filing individually or Head of Household is least expensive.
- ❖ Filing Married Joint is next least expensive
- ❖ Filing Married & Separate is the most expensive filing status

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UNDERSTANDING SOMETHING ABOUT INCOME TAXES IS NOT AN IMPOSSIBLE MISSION. . .



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