Divorce settlements affected by tax law

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Thinking divorce? Think Internal Revenue Service.

No, the IRS is not the cause of the divorce rate in this country, but it has benefitted to a degree from couples splitting up.

The Tax Reform Act of 1984 makes several changes in the rules, including eliminating taxation of property transfers in a divorce settlement, redefining alimony and clearing up a source of contention between spouses — which one can claim exemptions for children.

Tax consequences of property received in a divorce settlement are as important to look at as the value of the property, advise three Baton Rouge certified public accountants, William C. Potter, Roy Hebert and Neil Ferrari, who comment on the changes.

"Out of a tax bill, by and large, bad for taxpayers, made more complex, with loopholes tightened up," the rules governing domestic relations "was a bright spot," says Potter.

The biggest single change in the law is very simple, making non-taxable the transfer of property between spouses in a divorce settlement, he says.

Under the old law, the transfer of an asset such as a house from one spouse to another was treated as a sale, making the spouse giving the asset liable for capital gains on the increased value of the property. Now the spouse receiving the transfer is obligated to pay the capital gains tax, but only if the property is sold, according to Ferrari.

Because some property which appears to have equal value may have hidden tax liability, consideration should be given to the extent of those taxes before agreement is reached, Potter says.

His example concerns a tractor and stock, both with a market value of $50,000. Each spouse takes one, apparently an even exchange. However, the tractor was depreciated by $5,000 and, if sold for its market value, the amount of taxable income would be $45,000. The stock, purchased for $35,000, if sold at market value would earn a long term capital gain of $15,000, 60 percent of which is excluded from taxes, leaving only $6,000 taxable income.

"You need to look at a divorce settlement after taxes to see if it is equitable," Hebert says. "The uninformed half of the community could be burned by what is received in the settlement."

The spouse who receives an insurance policy in a property settlement will no longer be taxed on its cash value.

The property rules are effective July 1983 and other provisions are effective for decrees and agreements reached after Dec. 31. Earlier agreements can be modified to provide for new law coverage.

The IRS has said that determining which parent could claim the $1,000 dependency exemption for each child has been one of the most litigated sections of tax law, while producing the least revenue, according to Potter.

Under the 1984 TRA, the parent who has custody claims the exemption unless a written agreement says otherwise.

"This can change from year to year as circumstances change, giving the exemption to whom it will do the most good, assuming both parties are speaking," Hebert says.

"In a joint custody arrangement, the settlement should stipulate who gets the exemption," Potter says.

A child's medical expenses can be deducted by the parent who pays them, regardless of who has the exemption. These deductions had previously been limited to the parent with the exemption, Hebert says. The parent with custody can qualify for head-of-household status, with a lower tax rate, plus child care and earned income credits, even if the exemption is claimed by the other parent.

Alimony is a deduction to the person who pays, and income to the one who receives payment, Ferrari points out. Payments are considered alimony by the IRS if these conditions are met:

- Payments are made by cash, check or money order. Cash payments to third parties, for rent, mortgage or charitable donations, for instance, are considered alimony, if made at the written request of the spouse for whose benefit the payments are made.
- The parties must live in separate households after a separation or divorce decree is entered or one must leave within one month after payment is made. An exception: Payments made by one spouse to another as required by a written agreement or court order may qualify as alimony, though the parties share a household.
- The divorce or separation agreement must include a statement that the person paying the alimony does not have to

(See TAXES, 2D)