

Tax Issues In The Year Of Divorce Thoughts About Appropriate Allocations

By Susan A. Moussi

A taxpayer's filing status, for any year, is determined by his or her marital status as of December 31. Therefore, if you are single on December 31, you will file as a single taxpayer for the entire year ending December 31, no matter what your status was during the year. This rule, when unknown or forgotten, may leave one party, solely, to bear the tax cost of (or to receive benefit of) the tax consequences that occurred during the marriage. It also means that certain items of income and deduction will need to be allocated between the two separate returns.

Asset or Liability- Taxes As of Date of Valuation

The typical marital balance sheet includes cash, investments, real estate, autos, household items, retirement plans, mortgages, loans, and credit card debt. Many taxpayers find themselves with some amount to be paid (or an amount due to them) when they file.

If tax returns were not required to be prepared on a calendar-year basis, married couples who divorce would have two tax returns in the year of divorce. One would be a joint return that would reflect income and deductions from January 1 through the date of divorce. The other return would be a single return (or Head-of-Household) for the remaining portion of the calendar year. The joint return would leave both husband and wife obligated for any tax liability (or both entitled to any refund). This would seem to be a reasonable way to handle a dual-status tax year, yet this is not how it's done.

A value could be calculated by preparing a draft of a partial-year return, which reflects the income and deductions, up to the time of the valuation date, to determine any tax liability or refund.

Documents should be available, for the most part, to do this. Year-to-date pay statements could be used to determine income and withholdings as of the date of valuation; broker statements would provide investment income and gains/losses; self-employed individuals could produce year-to-date profit and loss statements; charitable contributions could be summarized; and information on mortgage interest incurred and real estate taxes paid could also be available. Some information may not be available, like information for partnership interests, but could be estimated based on the last year's information or some other reasonable method.

Income and Deductions in the Year of Divorce

Some months after the divorce is final, each spouse will be sitting down with their respective preparers to file their tax return for the year before. Questions about claiming mortgage interest, real estate taxes, and estimated tax payments (made while married) often come up. If these were agreed to while the couple was disentangling their financial affairs, each would be clear on how they were going to allocate these marriage-related items.

There are some guidelines issued by the IRS on the allocation of income, deductions, and other tax-related payments that occurred during the marriage. Here are some of those guidelines:

- Income is reported by the person who has earned the income. Therefore, all wages and self-employment income is reported by the husband or wife who earned it, even though this income may have been used to support both husband and wife.
- Investment earnings in joint accounts are normally reported

under one primary social security number, but would be divided equally on two separate returns. If the investment earnings are generated from an individually-owned account, with earnings allocated to one spouse only, that spouse claims the income.

- Deductions are generally claimed by the individual who paid it from their own account. However, if a deductible expense was paid from a joint account, the deduction is typically divided equally, with exceptions for mortgage interest and real estate taxes.
- Estimated tax payments will be considered to be paid in proportion to the taxpayers' separate tax liability, unless agreed otherwise. It has been my experience that the IRS gives credit to the primary taxpayer (usually the husband), even when you instruct them otherwise. This is usually corrected with some letter writing.

The tax issues listed above relate to the year the couple is divorcing, not some time in the future when an asset is eventually sold or liquidated; they should not be confused with "after-tax" marital balance sheets. Tax laws and rates do not have to be presumed when discussing the year of divorce; they are known, for the most part.

Encourage your clients to seek out the assistance of a tax preparer to help them understand these issues and to assist them in developing an allocation of the tax-related items that makes sense. I believe your clients will thank you for bringing these issues to their attention.



Susan A. Moussi is the founder and owner of Susan A. Moussi & Associates (CPA, CFPTM, CDFA)

susan@susan
moussicpa.com

Susan A. Moussi,
Susan A. Moussi &
Associates

