Avoid Financial Errors

In Divorce Settlement

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FINANCIAL SERVICES

Overview

- Transfers of Property
- The Importance of Basis
- Retirement Plans
- Tax Issues: Sale of Residence
- Spousal and Child Support
- Carry Forward Rules
- Innocent Spouse Rules
- Social Security
- COBRA

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Why Is This Important

- 45 % of first marriages will end in divorce
- 60 % of second marriages end in divorce
- The number of people seeking divorces was 34 % higher from March through June 2020, compared to the same period in 2019

Source Canterbury Law Group 2020

Workable Settlements

- You could reach a settlement without worrying about taxes
- Tax problems are not always apparent at the time you reach settlement

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Section 1041
Transfers of Property

Section 1041

Section 1041 of the Internal Revenue Code:

- No gain or loss on a transfer to a spouse or former spouse incident to divorce
- Except for transfers to non-resident aliens and some transfers in trust
- Accrued interest on savings bonds recognized on transfer §1.454-1(a)

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Section 1041

Documentation and timing requirements:

- A transfer of property must be pursuant to a divorce or separation agreement
- The transfer must take place within six years of the end of the marriage (Treas. Reg. §1.1041-1T, A-7)

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Section 1041

Practice Pointer

§1.1041-1T, A-14 requires transferor to supply records of basis and holding period to transferee; adding this requirement to the judgment allows court enforcement

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Section 1041

Practice Pointer

§1.1041-1T, A-18 requires transferor and transferee attach a statement electing the non-taxable provisions of §1041 to subsequent returns

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The Importance of Basis

What is Basis?

- Original cost adjusted as provided in IRC §1016
- Additions to basis
  - Capital expenditures
- Subtractions from basis
  - Depreciation
  - Amortization
  - Depletion
  - Any deferred gain from previous principal residence reducing basis of current principal residence (pre5/7/1997) sales under IRC Section 1034.

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Situational Overview

Land : $200,000 **401(k):** $100,000 **CD:** $150,000

Asset Type	Assets	June	Dan
Land Value	$200,000		
Mortgage	- 150,000		
Equity	$50,000	$50,000	
401(k)	100,000	100,000	
CD	150,000		$150,000
Total	**$300,000**	**$150,000**	**$150,000**

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June Sells the Land

Land : $200,000 **401(k):** $100,000 **CD:** $150,000

Category	Calculation
Sells Land for	$200,000
Basis	- 10,000
Capital Gain	**$190,000**
Federal Tax (15%)	$28,500
State Tax (4.35%)	8,265
Total Capital Gain Tax	**$36,765**

Disclaimer: Tax rates are for example purposes only. Consult current tax rates at IRS.gov

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June and Dan: the Reality

Land : $200,000 **401(k):** $100,000 **CD:** $150,000

Asset Type	Assets	June	Dan
Land Proceeds	$50,000		
Taxes	- 36,765		
Actual Value	**13,235**	$13,235	
401(k)	$100,000		
Taxes	- 33,000		
Actual Value	**67,000**	67,000	
CD	$150,000		$150,000
Total	**$230,235**	**$80,235**	**$150,000**

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Retirement Plans and QDROS

Retirement Plans

Types of retirement plans:

- Qualified
  - Defined contribution
  - Defined benefit
- Non-qualified
- Tax-advantaged- Government

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Defined Contribution Plans

- Employee takes investment risk
- No guarantee of future benefit
- Plans have individual accounts
- Examples:
  - 401(k)s, profit-sharing plans
  - Money purchase pension plans
  - Thrift Savings Plan

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Defined Contribution Plans (cont.)

Division Considerations:

- Divided by QDRO/court order
- Does plan allow withdrawal?
  - Some plans do not allow withdrawal until retirement
  - Some plans have investment options that do not allow withdrawal

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Defined Contribution Plans (cont.)

Tax Considerations of Division:

- Tax-free direct transfer to IRA or qualified plan
- Distributions subject to 20% withholding by plan and taxable to recipient
- IRC§72(t)(2)(C) avoids the 10% penalty for distributions before age 59 ½.

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Defined Contribution Plans (cont.)

IRC§72(t)(2)(C) Tax Considerations Example (next slide):

- Client has no other taxable income or deductions, needs $80,000 to pay bills (no state income tax)
- Client is not participating/employed

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Tax Considerations

Withdrawals from Contribution Plans

Client needs to pay $80,000 in bills

1. Client draws $102,564 from the 401(k), pays $22,564 Federal Tax, and nets $80,000
2. Client transfers funds to an IRA, draws $102,564 from the IRA, pays $22,564 Federal Tax, nets $80,000, but will owe another $10,256 early withdrawal penalty tax
3. If client pays early withdrawal penalty from IRA funds, an additional $16,129 would need to be withdrawn

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Defined Contribution Plans After Tax Funds

- After tax accounts
- Roth 401(k)
  - Taxable portion of withdrawals are subject to penalty and regular tax
- If transferred to a Roth IRA, contributions can then be withdrawn without tax

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Defined Benefit Plans

- Employer guarantees benefit
- Employer assumes investment risk
- Examples are:
  - Pension plans
  - State retirement plans
  - Federal retirement plans
  - Others

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Defined Benefit Plans (cont.)

- Plans have pooled money and no individual account
- Divided by QDRO
- Valued and offset other assets if not divided

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Defined Benefit Plans (con't)

Questions on Valuation to Offset

- State rules or Actuarial Standard 34
- Underlying assumptions:
  - Discount rate
  - Mortality
  - Retirement age
  - Pension estimate
- Underfunding and PBGC take over

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Government Employee Plans

Non-ERISA Plans

- Divisible by court order
- Limited benefits if the member dies before retiring
- Survivor benefits not usually calculated on the basis of the non-participating spouse's life

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Example: Splitting a State Pension vs. a 401(K)

Plans	Value	Frank	Janice
Contributions	$92,000	$92,000	
401(K)	$93,500		$93,500
	$185,500	$92,000	$93,500

Aside from the $1,500 difference, what could be wrong with this split?

Present Value For Frank = Close to $300,000

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The Coverture Fraction

$$\frac{\text{Number of years married while working}}{\text{Total number of years working}}$$

x benefit at retirement

x % of marital portion spouse is entitled to receive (e.g., 50%)

Bob and Sue example:

20 / 25 x 4,600 x 50% = 1,840

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Qualified Domestic Relations Orders (QDROs)

- Required for ERISA-qualified plans under IRC §414
- Court order, subject to approval by plan administrator
- State law “trumped” by federal law (U.S. Constitution, Article VI, Paragraph 2)
- Federal and state plans require special court orders

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Liability with QDROs

Here are a few common mistakes:

- Requiring payments that the plan does not allow
- Inadequate survivor benefits
- QDRO not approved by divorce date
- Omitted early retirement benefits
- Incorrect division method

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Individual Retirement Account (IRA)

- A tax-advantaged plan
- Not a qualified plan
- No 20% withholding
- Tax-free transfer to ex-spouse under §408 (d) (Order to divide must satisfy IRA custodian)
- Limited early withdrawal penalty-free distribution

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Tax Issues on the Sale of a Residence

Capital Gains Exclusions

- Single exclusion: $250,000
- Married exclusion: $500,000
- In order to take the exclusion, the individual must own the home and have used it as his/her primary residence for two of the last five years
- Only one sale every two years
- Capital gains are currently taxed at 15% for most people

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Two Special Rules Relating to Divorce

- Ownership period:
  The non-owner spouse can use the period of time that the owner spouse owned the home
- Use period:
  A non-occupying spouse can use the period of time that the occupying spouse used the home

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Use Period Exception

Sales Price	$750,000
Basis	- 100,000
Capital Gain	**$650,000**
Mary's half of sale	$375,000
Mary's half of basis	- 50,000
Mary's half of gain	$325,000
Mary's exclusion	- 250,000
Taxable Gain	**$75,000**

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Short Sale Rules

Short Sales of Home can still result in two sources of gain

- Net sales in excess of basis (but can be negated by I.R.C. §121)
- Income from the Discharge of Indebtedness I.R.C. §61 (exemption of up to $2 million expires in 2012)

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Spousal Support (aka Alimony or Maintenance) and Child Support

The Eight "D"s of Alimony

1. **Dollars** must be received by or on behalf of a spouse
2. **Documented** by a divorce or separation agreement
3. **Designation** of payments: cannot opt out of §71 or §215
4. **Distance**: couple cannot live in the same residence
5. **Dependents** cannot change alimony
6. **Dual returns**: separate returns must be filed
7. **Dumping:** front-loaded payments not allowed
8. **Death** must end payments

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Alimony and Taxes

Alimony as a tax-planning tool – No longer available on decrees finalized after December 31, 2018

Prior to January 1, 2019 – could be used to shift income

- Alimony is deductible from income by the payor spouse [IRC §215]
- Alimony is includible in income by the receiving spouse [IRS §71]
- Difference in tax brackets creates additional income

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Alimony and Taxes

Impact to post 2018 Divorces

- Alimony is no longer deductible from income by the payor spouse [IRC §215]
- Alimony is no longer included in income by the receiving spouse [IRS §71]
  - May decrease the receiving spouse's ability to contribute to IRA
  - May increase availability of other tax credits and benefits for receiving spouse

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Carry Forward Rules

Carry Forwards

- Unused capital losses are divided based on ownership of the asset
- Net operating losses belong to the spouse that would have reported the loss had they filed separate returns
- Suspended passive losses added to the basis of the property

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Other Carry Forwards

- Charitable contribution carryovers are based on who would have claimed the deduction if they filed separate returns
- There are no set rules for allocating investment interest expense; a reasonable method of allocation should be used

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Innocent Spouse Rules

Innocent spouse rules may be helpful in:

- Cases where one party to a divorce has been much too creative with the tax rules
- Cases where one spouse operates cash businesses, such as restaurants or bars
- Cases where one spouse has been having the other spouse sign their name on a tax return while covering up everything but the signature line

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Social Security

After Ten Years of Marriage

If a couple has been married for ten years or longer:

- The lower-earning spouse *either* receives half of the higher-earning spouse's benefit *or* 100% of his/her own benefit – whichever is greater
- Payments do not reduce the higher earning spouse's benefit
- When the primary claimant dies, the benefit that is paid out jumps to 100% for all of his surviving ex-spouses that qualify

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Married Less than Ten Years

What if the couple has been married for slightly less than ten years?

- If the divorce can be postponed until they have been married for 10 years, the lower-earning spouse might have another income stream available to him or her at retirement

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COBRA

COBRA

- Many attorneys are aware that if an employer is covered under COBRA, an ex-spouse can opt to receive coverage at 102% of the actual employer's premium
- Although expensive, this can allow 36 months of coverage that is not subject to pre-existing condition coverage

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COBRA Surprise

- Many attorneys and their clients are unaware that if an employer is not informed of the divorce within 60 days, **the non-employee spouse will lose his/her COBRA rights**

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Questions?

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