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Tax Tips for Family Law Lawyers

Family law attorneys can find themselves in trouble if they are not familiar with tax laws. The following are tips to help family law attorneys avoid some of the biggest traps in this area.

Sale of the Family Home

Under 26 USC §121, an individual may exclude from income up to $250,000 of gain from the sale of a principal residence if he or she owned and occupied the property as a principal residence for two out of the last five years. Married couples filing jointly can exclude up to $500,000 if either spouse meets the two-out-of-the-last-five-years test. A divorced spouse can attach the ownership of the former spouse for purposes of meeting the test but can still only exclude up to $250,000.

Tax Tip: It may make sense for the parties to sell a low-basis, highly appreciated residence before the divorce is final to maximize the $500,000, but they must still be married at the end of the tax year to maximize the exclusion.

Spousal Support

Spousal support is tax-deductible to the payor (and taxable income to the payee) under 26 USC §71(a) and §215 if the payments are made in cash and:

1. The payment is received by a spouse or ex-spouse under a divorce or separation instrument;

2. The applicable instrument does not identify the payment as not deductible to the payor and not includable in the income of the payee (an opt-out provision);

3. The payor and payee are not members of the same household when the payment is made (there is a limited exception to this); and

4. There is no liability to make any such payment after the death of the payee ex-spouse.

Tax Tip: Make sure that the spousal support is designated to terminate at the death of the payee each time it is referenced, even in the Money Judgment summary. *See Fifthian v. United States*, 90 AFTR2d (RIA) 6210 (9th Cir. 2002), in which the Ninth Circuit affirmed a district court ruling that held payments were not tax-deductible alimony because the Money Judgment section did not state that the spousal support payments terminated at the death of the obligee. Despite such language in the body of the judgment and the property settlement agreement, the court found ambiguity and gave greater weight to the Money Judgment section because it was certified by the lawyers.

Tax Tip: Be careful of stair-stepping spousal support down too fast. Under the front-loading rules of 26 USC §71(f), if alimony decreases too rapidly, some portion will be reclassified (recaptured) as property settlement. The calculation is complicated, but be mindful of recapture if the annual alimony amounts decrease by more than $15,000 a year in any of the first three years of payments.

Property Settlement

Under 26 USC §1041, no gain or loss is recognized on the transfer of property between spouses, or between former spouses if the transfer is incident to divorce. A transfer is considered incident to divorce if it occurs within one year of the end of the marriage or is "related to" the cessation of the marriage. Under the regulations, a transfer is presumed "related to" the cessation of the marriage if it is pursuant to a divorce in-

strument and occurs within six years of the cessation of the marriage.

Tax Tip: The six-year period is only a presumption. Sometimes transfers incident to divorce need to occur outside the six-year window. In such cases, the divorce instrument should clearly designate the transfer as tax-free under 26 USC §1041.

Tax Tip: The redemption of corporate stock or other business interest in a closely held entity can be a trap for the unwary. Unexpected ordinary income dividend treatment may occur in the corporate context if the tax ramifications are not clearly defined in the divorce instrument. See Treas. Reg. 1.1041-2(c) for the particulars of allocating the tax burden. In the partnership and limited liability company context, the deemed relief of entity liabilities under 26 USC §752 may result in taxable income when the transferor assumed that no tax ramifications would occur due to Section 1041.

Stock Options

Stock options come in two forms for income tax purposes: incentive stock options (ISOs) (*See* 26 USC §§421-424) and non-qualified stock options. ISOs are generally non-transferrable. *See* 26 USC §422(b). Stock received from the exercise of an ISO may be transferred incident to divorce, and such transfer will not be a disqualifying transfer. *See* 26 USC §424(c)(4).

Non-qualified stock options are freely transferrable, unless restricted by the governing instrument. The IRS, in Rev. Rul. 2002-22, held that the transferee spouse will recognize the income from the exercise of a non-qualified stock option.

Tax Tip: The exercise of a non-qualified stock option will trigger tax withholdings. Under Rev. Rul. 2004-60, the employer is required to withhold a 25% flat supplemental wage rate for income taxes and additional amounts for FICA and FUTA taxes. The transferee needs to factor these amounts in valuing the options. The transferee will get the credit for the income tax withholding, but the FICA and FUTA taxes are credited to the transferor's account for purposes of calculating future benefits.

Dependency Exemptions

The tax laws contain a number of favorable provisions for the support of a dependent child or other dependent. These provisions include the dependent exemption, the child tax credit, the child and dependent care credit, the earned income credit, and the Hope and Lifetime Learning Credits. To qualify as a dependent under 26 USC §152, a child must:

1. Be the taxpayer's natural or adopted child, stepchild, eligible foster child, sibling, or descendant;

2. Reside with the taxpayer for more than half the year;

3. Be under the age of 19, or 24 if a full-time student, or permanently disabled; and

4. Not have provided more than half of his or her own support.

For purposes of claiming the dependent exemption, under 26 USC §152(d), a taxpayer may claim another individual, who is not the taxpayer's child, as a qualifying relative if:

1. The individual is related to the taxpayer, including an individual, other than a spouse, who has the same principal place of abode as the taxpayer and is a member of the taxpayer's household;

2. The individual's gross income is less than the exemption amount;

3. The taxpayer provides over half of the individual's support; and

4. The individual is not a qualifying child of the taxpayer or anyone else.

The taxpayer could also claim the Hope and Lifetime Learning Credits for such an individual.

In the divorce context, the custodial parent is entitled to claim a qualifying child unless the custodial parent signs an instrument releasing the right to the dependency exemption to the non-custodial parent. The preferable approach is to have the custodial parent sign an IRS Form 8332. The release of the dependency credit also releases the child tax credit, but not the child care credit, earned income credit, or head of household status.

Tax Tip: The custodial parent is defined as the parent with whom the child spends the most overnights. If the parents share equal parenting time, the custodial parent is the parent with the higher income. This rule is only relevant if the custodial parent has not effectively released his or her right to the exemption.

Tax Tip: The circuit court handling the divorce has no jurisdiction to allocate the dependency exemption to the non-custodial parent. The divorce decree itself is insufficient, unless it contains all of the information required by the regulations and on IRS Form 8332, including the custodial parent's signature. *See Mace v. Comm'r*, T.C. Summ. Op. 2005-89.

Domestic Partners and Unmarried Individuals

Due to the Federal Defense of Marriage Act, P.L. 104-199 (1996), 1 USC §7, registered domestic partnerships are not recognized for federal income tax purposes. In addition, many same-sex and opposite-sex couples for whatever reason

never take the step to register or marry. When these couples split up, payments or transfers of property will not be covered by the tax rules above.

Tax Tip: The parties should agree on the tax consequences of any payments or transfers in any settlements. Otherwise, the transferor may issue an IRS Form 1099 to claim a deduction and the transferee will bear the burden of proving that the amounts or property received were gifts or in exchange for property, not compensation income. *See Reynold v. Comm'r*, T.C. Memo 1999-62, and *Yang v. Comm'r*, T.C. Summ. Op. 2008-56.

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