

## Dollars & Sense

by Deb Johnson, ChFC, CDFA - printed in *Denver Woman* magazine December/January 2009

### Divorcing in 2008? What you need to know about Divorce & Taxes now, before it's too late

The mere thought of taxes is enough to put beads of sweat on your brow; add divorce to it and it becomes a full-fledged torrent. The April 15 filing date seems far away, so you put the whole idea of taxes out of your mind for now - you have other things to worry about.

#### **MOST IMPORTANT DATE TO REMEMBER**

“The most important deadline is December 31,” states **Deb Johnson**, a Certified Divorce Financial Analyst (CDFA) and a Denver-based partner in the *Divorce Resource Centre of Colorado* (DRCC). “Everything you may win, or lose in tax dollars must be complete and documented by the end of the year.” DRCC Denver-based partner **Jane Euell**, also a CDFA, agrees. “In the case of divorce, how you file your taxes can make a difference and have a huge financial impact,” she adds.

#### **Two things to do right now**

“Don’t make the divorce process any tougher by making decisions based on emotion instead of financial know how,” Johnson continues. She offers two tax tips that could help divorcing couples realize significant savings right off the bat:

##### **1 Determine tax outcome of divorcing in current year**

Parties need to have a tax specialist do a tax projection using their actual income and deductions for the current tax year as if they were:

- Married filing jointly
- Divorced

Both scenarios are important because, depending on how much their total deductions are and if they can take advantage of the Head of Household filing status, they could experience significant tax savings.

For instance, Mark and Mary have two children and have decided that in their post divorce parenting plan, they will equally share parenting time. This means they can both take advantage of the Head of Household filing status, which carries the most favorable tax rates. Based on this filing status for both and their combined taxable income, Mark and Mary can save \$3,800 in Federal and State income taxes in 2008 if their divorce is final by 12/31/08. Keep in mind that each case is very unique with regard to tax characteristics.

##### **2 Fund IRA for one spouse with divorce property settlement**

Maintenance is treated as “earned income” for the purpose of IRA deductions. Therefore, it might be wise to designate a \$5,000.00 (\$6,000 if over 50) property

settlement as spousal support (alimony). By characterizing it as alimony, the spouse making the payment is allowed to deduct it from their income.

While it would be considered as taxable to the recipient spouse, there is a way to offset that. By making a contribution to a traditional IRA, it could be immediately deducted as an IRA contribution in the current tax year. This would save the recipient spouse about \$1,250-\$1,300 of income tax. This can benefit the lower wage-earning spouse who may not be able to contribute as much to their retirement post-divorce.

## **SMALL THINGS ADD UP IF YOU ORGANIZE, CATEGORIZE AND PRIORITIZE**

**Jane Euell** offers more common sense tax tips that divorcing couples often overlook amid the emotional turmoil:

### **Organize paperwork, seek guidance:**

- Make sure your personal filing is up-to-date
- Gather all year-end statements in a folder marked “2008 Taxes”
- If you are computer savvy, set up spreadsheets for deductible expenses.
- If you don’t have an accountant, ask friends and family for recommendations, then interview several to find a good fit.
- Review the prior year’s tax return to determine whether there are significant changes to your tax picture. Ascertain whether there are any narrative explanations or numerical worksheets that could simplify tax preparation this year.

### **DON’T OVERLOOK THE FOLLOWING:**

#### **Check your flexible spending account (FSA)**

When it comes to FSAs, use it by 12/31 or lose it. For example, does anyone in the family need new glasses?

#### **Deductible items such as cash donations, medical services, prescriptions**

A check mailed by 12/31 can be deducted even if the check does not clear until next year. The only plastic you should use is a bankcard (debit) because it can be deducted in tax year 2008. Using a credit card means that the deduction can only be taken in the tax year you pay the credit card bill.

#### **Be very wary of buying a mutual fund late in the year**

If the fund pays a dividend in 2008 after you buy it, the payout is taxed this year. You are **not** better off because of the added dividend since the fund's share price will decline by a corresponding amount. Avoid the problem—buy after the dividend has been distributed.

### **Understand how a QRDO affects pension benefit payments**

A QDRO (Qualified Domestic Relations Order), filed at the time of legal divorce proceedings, governs the tax status of pension and retirement benefits. There is a provision in the tax code that allows for an exemption from the 10% early distribution penalty (prior to age 59 ½) if the distribution is taken properly prior to rolling it into an IRA. This can be a very useful planning divorce tip.

### **Liability for Taxes Owed may be affected by IRS rule**

The IRS has what is called the “innocent spouse rule.” If during your marriage joint returns were filed, you may not be responsible for the failure of your ex-spouse to pay taxes. Proof is needed that you had no knowledge, or any reason to know that your ex-spouse entered misleading information on your joint tax return. Keep in mind that the IRS considers: the specific circumstances of the tax error and the level of your financial sophistication.

### **Deducting the Cost of Divorce Tax Advice**

The entire cost of a divorce lawyer is not deductible. However, expenses related to obtaining or maintaining taxable alimony are deductible provided that the attorney itemizes that amount on their bill. In addition, the costs associated with tax advice from an appraiser, actuary, accountant, or Certified Divorce Financial Analyst may qualify as a deduction.

## **HOLIDAYS, DIVORCE CAN BE ALL CONSUMING**

“Don’t let the hectic pace of the holidays and the emotions associated with a divorce divert your focus from the all important end-of-year tax issues you need to address,” says DRCC’s **Deb Johnson**. “The minute you ring in the New Year, it will be too late.” The choices you make in 2008 can make a significant difference in how much you pay in taxes come April 15<sup>th</sup>. Putting your financial house in order means that you will control your finances; they will not control you.

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