Divorce and Taxes: Important Tax Issues to Consider During Divorce Proceedings

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"Am I liable for my ex-spouse's tax debt?" This question, among many other tax related questions, often arises before, during and after a divorce. More often than not, clients come in after the fact with large tax problems that could have been mitigated with relatively simple tax planning. This article provides a general outline to help identify tax related issues that frequently arise as a result of divorce proceedings.

What is my filing status?

"How should I file my taxes this year?" is probably the most common tax-related question family law practitioners will be asked by their clients during divorce proceedings. If your client is married, he/she can file married filing joint or married filing separate. If taxpayers are divorced, they are confined to single individual or head of household. However, the confusion sets in for a client when determining what the term "married" means. Under the Internal Revenue Code ("Code"), a taxpayer is unmarried for the whole year if: a) he/she (hereinafter called "he") has a final divorce decree or decree of separate maintenance by the last day of the tax year; or b) the marriage is annulled. It should be noted that the Internal Revenue Service (hereinafter "IRS") does not view interlocutory decrees as "final" for purposes of determining marital status. *See, Marcia W. Seaman v. Commissioner*, TC Memo 1970-284; IRS Pub. 504.

For a taxpayer to claim head of household filing status, he must: 1) be unmarried or "considered unmarried" (as set forth below) on the last day of the year, 2) have paid more than half the cost of keeping up a home for the year, and 3) have had a "qualifying person" lived with him in the home for more than half the year (except for temporary absences, such as school).
A taxpayer is "considered unmarried" on the last day of the tax year if he meets the following tests: 1) he filed a separate return (this can include married filing separately, single, or head of household), 2) he paid more than half the cost of keeping up the home for the tax year, 3) his spouse didn't live in the home during the last six months of the tax year, 4) the home was the main home of the child, stepchild, or foster child for more than half the year and 5) he is able to claim an exemption for the child. The benefit to claiming head of household status allows clients to claim a larger standard deduction than single or married separate, along with additional credits and deductions that are not available when filing married separate.

Can I claim my child?

The next most common question asked by a divorce client is whether she can claim a child as a tax exemption on her tax return. For purposes of claiming children as exemptions on tax returns, the general rule is that the custodial parent is the taxpayer who gets to claim the child. The reason for this is that the child must have lived with the taxpayer for more than half of the year in order to meet the residency requirement of the "qualified child" test.

However, a child will be treated as the qualifying child of a noncustodial parent if all four of the following statements are true: 1) the parents are either divorced or legally separated under a decree of divorce or separate maintenance, are separated under written separate agreement, or lived apart at all times during the last six months of the year, whether or not they were married; 2) the child received over half of his or her support for the year from the parents; 3) the child is in the custody of one or both parents for more than half of the year; and 4) the custodial parent has transferred the right to claim the child. As for the last requirement, the year that the decree went into effect will determine whether Treas. Form 8832 (or other similar declaration) must be submitted with the tax return or if the underlying agreement will suffice. If the decree is 2008 or before, the taxpayer can submit pages of the decree or agreement. If the decree is 2009 or after, the taxpayer must submit Treas. Form 8832 or similar statement. Lastly, the form or statement must release the custodial parent's claim to the child without any conditions. For example, the release must not depend on the noncustodial parent paying support.

Am I liable for my ex-spouse's tax debt?

Another common tax related divorce question that tax practitioners hear is "Am I liable for my deadbeat spouse's tax debt?". The answer is it depends. Generally, married couples who file a joint federal income tax return are jointly and severally liable for the tax reported or reportable on the return. *Code §* 6013(d)(3). However, *Code §* 6015 allows a spouse to obtain relief from joint and several liability in certain circumstances. *Code §*

§ 6015(b) – Traditional innocent spouse relief

Traditional innocent spouse relief grants clients relief from additional tax the client owes because a spouse or former spouse failed to report income, reported income improperly or claimed improper deductions or credits. *Code § 6015(b)* provides that a taxpayer will be relieved of liability for an understatement of tax if: (1) a joint return was filed for the taxable year in question; (2) there is an understatement of tax attributable to erroneous items of the

nonrequesting spouse; (3) the taxpayer requesting relief "did not know, and had no reason to know, that there was such understatement" when he or she signed the return; (4) taking into account all of the facts and circumstances, it would be inequitable to hold the taxpayer liable for the deficiency attributable to such understatement; and (5) the taxpayer elects to have section 6015(b) apply within two years of the initial IRS collection action. *See, Scott v. Commissioner*, TC Memo 2015-18.

§ 6015(c) – Separate liability election

Under *Code §* 6015(c), a divorced or separated spouse may elect to limit liability for a deficiency on a joint return to the portion allocable to him or her. A taxpayer can make a valid election under this section only if: 1) the taxpayer is no longer married to, is not part of the same household of, or is legally separated from his or her spouse; 2) the taxpayer makes a timely election; 3) the IRS does not demonstrate that the taxpayer had actual knowledge at the time the taxpayer signed the return of an item giving rise to a deficiency; and 4) the claim for this protection occurs no later than two years after the Secretary commences collection activities with respect to that taxpayer. Relief under this section often hinges on the requesting spouse's knowledge. To prove actual knowledge of fictitious or inflated deductions on the tax return, the IRS must prove the requesting spouse actually knew that the expenditure was not incurred or not incurred to the extent claimed. Treas. Reg. § 1.6015-3(c)(2)(i)(B)(2). This knowledge limitation disqualifies only items giving rise to the deficiency that are not allocable to the requesting spouse. Consequently, in these situations, the IRS must prove the requesting spouse had actual disqualifying knowledge of the items attributable to the nonrequesting spouse. *See, Kellam v. Commissioner*, TC Memo 2013-18.

§ 6015(f) – Equitable relief

Equitable relief may apply when your client does not qualify for innocent spouse or separation of liability for something not reported properly on a joint return and generally attributable to your client's spouse. A taxpayer may also qualify for equitable relief if the amount of tax reported is correct on their joint return but the tax was not paid with the return. The IRS may grant equitable relief from joint and several liability under *Code §* 6015(f) if it finds that, taking into account all of the facts and circumstances, it is inequitable to hold the individual liable for any unpaid tax or deficiency. Unlike relief requests made under *Code §* 6015(b) and (c), a request for equitable relief is not time barred by the two (2) year limitation on initial collection action by IRS. Factors considered by the IRS under this section include economic hardship, knowledge or reason to know, abuse by the nonrequesting spouse, legal obligation, significant benefit from the unpaid taxes, subsequent compliance and mental or physical health.

§ 66(c) Community property states

Nevada is a community property state, and under *Code §* 66, married couples who do not file joint tax returns "generally must report half of the total community income earned by the spouses during the taxable year" unless an exception applies. See, Treas. Reg. § 1.66-1(a). Consequently, this means where there is a gross disparity in earnings between husband and wife, in the year of divorce, the lower earning spouse will have a substantial tax liability for the one-half of all community income earned by the higher earning spouse up until the dissolution of the marriage. Fortunately, Congress recognized this potential disparity and enacted *Code §* 66(c).

In order to qualify for relief under *Code §* 66(c), the following must be true: 1) the spouses must live apart at all times during the calendar year; 2) they must not have filed a joint tax return for that year; 3) they must have earned income which is community income; 4) no assets were transferred between the spouses as part of a fraudulent scheme by the spouses; 5) the requesting spouse did not knowingly participate in the filing of a fraudulent joint return; and 6) the income tax liability from which the requesting spouse seeks relief is attributable (either in full or in part) to an item of the nonrequesting spouse. If these conditions are met, then the earned community income will be reportable by the party who earned the income rather than one-half being allocated to the non-earning spouse under community property laws.

More complex tax issues can and do arise in many divorce proceedings. However, the above questions are those that are most frequently encountered.

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