# Breaking Up May Be Hard to Do

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A divorce can be a difficult and emotional process. Besides facing a dramatic change in lifestyle, you must deal with the financial consequences of the dissolution of the marriage. This includes certain tax implications for each ex-spouse.

State law controls the distribution of assets in a divorce. For residents of the nine community property states—Arizona, California, Idaho, Louisiana, New Mexico, Nevada, Texas, Washington and Wisconsin—the assets you have accumulated during the marriage are divided 50/50. In other words, each spouse is entitled to half of the total community property, minus any liabilities. However, assets owned by either spouse prior to the marriage or assets received by gift or bequest during the course of the marriage are treated as belonging solely to the recipient spouse.

In all other states, assets are split under equitable distribution rules applicable to that particular state. That may work out to a 50/50 split, but not necessarily. Of course, the spouses can create their own legally binding agreement regarding the division of assets.

Generally, there are no federal income or gift-tax consequences to transfers triggered by a divorce. If this tax-free transfer rule applies, the spouse receiving a capital asset assumes its existing tax basis and holding period. Currently, appreciated assets held longer than a year may qualify for a maximum tax rate of 15% if sold before 2013 (0% for certain low-income taxpayers). A capital asset sold at a loss can offset capital gains realized during the year and up to $3,000 of ordinary income in 2011.

The tax-free transfer can take place before the divorce or at the time it becomes final. Tax-free treatment also applies to postdivorce transfers if made “incident to the divorce” (i.e., within one year after the end of the marriage or, if the transfers are made pursuant to a divorce or separation agreement, within six years after the end of the marriage).

However, be aware of a major exception to the tax-free transfer rule for employer-provided retirement accounts such as 401(k) plans. To qualify for a tax-free transfer, the divorce decree must include special language establishing a “qualified domestic relations order” (QDRO). If a QDRO is used, each ex-spouse is liable for tax on his or her share of the assets. Other special rules apply to distributions of IRAs. See your professional tax adviser for more details.

Finally, you should know that alimony paid as part of a divorce agreement is deductible by the payor and taxable to the recipient. Conversely, child support payments are neither deductible nor taxable. These tax aspects should be factored into the negotiations.

This is only a brief summary of several key economic ramifications to consider in a divorce proceeding. Be sure to obtain expert advice from your Henry & Horne, LLP adviser every step of the way.

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