Family Tax Matters:
Capital Gains, Filing Status, Deductions and Alimony

By Scott David Stewart

Now that tax time is approaching, we thought it a good idea to discuss some common tax issues associated with divorce and separation. As with every other aspect of divorce, a well-prepared decree and clear communication with your former spouse are the best ways to avoid misunderstandings that could cause you problems when dealing with the Internal Revenue Service (IRS). Another way to avoid problems is to utilize the services of your tax professional before you make filing decisions that you could come to regret later.

Capital Gains Tax and the Principal Residence Rule.

More often than not, the marital residence is the most valuable asset that a married couple owns. During the divorce, it is not unusual for the couple's home to be sold and the proceeds distributed between them. If the home was sold for more than it was purchased for, meaning there was a gain on the capital asset, then there are specific rules affecting the spouses' capital gains tax liability.

Transfer Between Spouses. In general, if you transfer your interest in the marital home to your spouse, or former spouse as incident to your divorce, you will not have a capital gain or loss. That's the result even if you received cash or some other property in exchange for your interest in the marital home. (The exception is if your spouse or former spouse is a nonresident alien.) The marital "home" could be a house, houseboat, mobile home, cooperative apartment, or condominium, but generally not vacant land.

When your home is sold and there is a capital gain, can you avoid a capital gains tax? That depends on whether you owned and lived in the home, as your ***main home*** (not a secondary residence), for at least two years in a five-year period ending on the day the home was sold. This is the *principal residence rule* for capital gains tax purposes.

Maximum Exclusion. If you satisfy the principal residence rule, then you can exclude up to $250,000 of the gain on the sale of your main home. And if you are married and file a joint tax return, that exclusion could be $500,000 ($250,000 for each spouse).

Problems can arise when the marital home isn't sold to a third party during or shortly after the divorce. Say, for example, that after the divorce is final, the home is lived in by one ex-spouse who has primary physical custody of the children. He or she lives there for many years before the home is sold and the proceeds divided. The ex-spouse who resided in the home for two years in the five-year period ending on the date of sale would avoid capital gains tax. The other ex-spouse – *who doesn't satisfy the principal residence rule* – would not avoid capital gains tax.

Selecting Your Filing Status.

After you've filled in your name, address, and social security number, your tax status is the next question to answer on your individual income tax return (Form 1040). Your options for filing status are determined by your marital status on December 31, 2010. Selecting your filing status can have an impact on your overall tax liability, so it's a good idea to consult with your tax professional about which option is best for you based on your particulars.

Single Taxpayer. If your divorce was finalized by the last day of the tax year (December 31), the IRS will consider you unmarried for the entire year and you can file as a "single" taxpayer.

Head of Household Taxpayer. If you are considered unmarried and you pay more than half the costs of keeping up your home and at least one other qualified person, you may qualify for "head of household" filing status. Filing as a "head of household" would allow you a higher standard deduction and a lower tax rate. If you're not a "head of household," however, your filing status will be "single."

Married Taxpayer. If your divorce was not final until January 1, 2011, or thereafter, then you may select "married filing jointly [with your spouse or former spouse]" or "married filing separately," but not as a single taxpayer even if you were living separately. If you file jointly with your spouse or former spouse, both of you must sign the joint return.

Individual and Joint Liability. When you file jointly with your spouse or ex-spouse, and you both sign the return, then you are both liable for any tax, interest, or penalties that are due. There may be language in your divorce decree stating that one spouse, or the other, will be liable for any taxes, interest, penalties due on any jointly filed return. The IRS, however, says that your joint and individual "responsibility applies even if your divorce decree states that your former spouse will be responsible for any amounts due on previously filed joint returns."

Important Deductions.

Deduction for Dependents. In general, the parent with child custody will claim the dependency deduction. This issue may have been addressed in the divorce decree, however, and both parties must follow the provisions of the court's decree.

Deduction for Alimony or Spousal Maintenance. Make sure that the spousal maintenance tax obligation shifts to the recipient of the money. The supporting spouse may deduct the money paid for spousal maintenance, or alimony. The spouse or former spouse receiving the alimony ***must*** include it as income on his or her tax return. If you made a non-cash property settlement in payments or as a lump sum for the benefit of the other party, then that is not deductible spousal support for federal income tax purposes. Any voluntary payments made, meaning payments that were not ordered in the decree of dissolution, are not deductible as alimony from income either.

No Deduction for Child Support. Child support payments are never deductible. If you are paying child support and spousal maintenance, and you didn't satisfy your total obligation, then the IRS requires that you account for the child support first (which is not deductible) before you account for the spousal maintenance paid (which is deductible).

Deduction for Mortgage Interest. Who shall claim the home mortgage interest deduction may also have been addressed in your final divorce decree. If it was not, then this needs to be discussed with your former spouse because you cannot both claim the entire amount on your respective returns. The mortgage deduction goes to the person who paid the mortgage and interest out of his or her separate funds. If both parties contributed to the mortgage, or it was paid out of marital assets, then the deduction should be divided proportionately. The IRS will cross-check both spouses' returns against the 1098 Mortgage Interest Statement, so exercise caution.

Whenever you have specific questions about your personal tax liability – about what forms you should file, what you must report, or which deductions you should claim against your income – you should speak with your tax professional before relying on general information alone.

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Scott David Stewart, a Martindale-Hubbell AV-rated attorney, is the founder and principal of the Law Offices of Scott David Stewart, pllc.

The Law Offices of Scott David Stewart, pllc, a Maricopa County divorce and family law firm with offices in Phoenix and Chandler, represents clients in Phoenix, Chandler, Scottsdale, Mesa, Gilbert, Glendale, Peoria, Tempe and Surprise. Areas of practice include divorce, child custody, parenting time and visitation, child support, spousal support (alimony), property and asset division. Every case accepted by the Law Offices of Scott David Stewart, pllc, receives personal attention, careful meticulous preparation, skilled negotiation, and aggressive litigation.
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