

TAX CONSEQUENCES OF DIVORCE

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I. Introduction

Divorce has many potentially meaningful tax repercussions to separated and divorced taxpayers. Outlined below are some of the significant tax considerations.

II. Alimony

A. The following rules for alimony apply to payments under divorce or separation instruments executed after 1984. To qualify as alimony:

1. the payment is made in cash. See § 71(b)(1).
2. the payment is received by (or on behalf of a spouse) under a divorce or written separation instrument. See § 71(b)(1)(A)
3. if the spouses are divorced or legally separated, they reside in separate households when payment is made; See § 71(b)(1)(C);
4. the payments to a third party are evidenced by a timely executed writing; See Regs. § 1.71-1T(b), Q & A-6, 7.
5. the payor spouse's liability to make the payment does not continue for any period after the payee spouse's death; See § 71(b)(1)(D) and R.T. Reynolds v, CIR, TC Summary Opinion 2010-157 (Held that alimony payments received by ex-wife not includible as income because marital settlement did not indicate that the alimony payments would terminate upon taxpayer's death.
6. the payor and payee (if married) do not file a joint return; and
7. the divorce or separation instrument does not designate nonalimony treatment. See § 71(b)(1)(B).

B. Payment must be in cash: the following do not qualify as alimony

1. Transfers of services or property
2. Execution of a debt instrument by the payer
3. The use of the payer's property

C. Pendente Lite Support (Allocated v Unallocated): In a divorce action, support paid while the divorce is pending prior to Final Judgment is called Pendente Lite Support but it can not be deducted or reported as spousal support unless specifically allocated as such in an Order.

D. Legal fees incurred in collecting alimony for the dependent spouse are deductible pursuant to § 212(3).

III. Child Support

1. Child support payments are not deductible by the paying spouse or taxable income to the recipient spouse.
2. Includes payments specifically designated as child support as well as payments which otherwise might qualify as alimony but are linked to an event related to a child such as a child turning 18.
3. Such disguised child support payments are recharacterized as nondeductible /non taxable child support.

IV. Property Transfers Between Spouses and Former Spouses

A. IRC Code Section 1041

As a general rule, if property is transferred between spouses or between former spouses incident to a divorce, the tax treatment of the transfer is determined under IRC Code Section 1041.

Prior to the enactment of IRC Code Section 1041, the tax treatment of property transfers between spouses or former spouses incident to divorce was subject to the Davis case.

B. Gain or Loss

No gain or loss is recognized on a transfer of property from an individual to a spouse or former spouse if the transfer is incident to divorce. 1041(a).

C. Transferee's Basis

The transferee basis in the transferred asset is the transferor's adjusted basis immediately before the transfer. 1041(b)(1).

V. Marital Home

A. Sale of Personal Residence

1. If the parties sell the jointly owned residence, each party must report his/her share of the recognized gain or loss on his/ her income tax return for the year of the sale.
2. Taxpayer may exclude up to \$250,000 (up to \$500,000 if parties file a joint return) of gain on the sale.

VI. Innocent Spouse Relief

A. General Requirements - § 6015

1. Joint tax return was filed
2. Understatement of tax due to erroneous items of the other spouse
 1. Underpayment of tax –Equitable Relief is available
 3. At the time requesting spouse signed the return, she did not know and had no reason to know that there was an understatement of tax.
 4. Inequitable to hold requesting spouse liable for tax liability.

B. Types of Relief

1. Classic Innocent Spouse - §6015(b)
 1. Must file request for relief within 2 years of first collection action (i.e., refund offset)
 2. Requesting spouse has burden of proof that she did not know or had no reason to know about understatement of tax
2. Separation of Liability - §6015(c)
 1. Must file within 2 years of first collection action.
 2. Requesting Spouse must be separated, divorced, or widowed.
 3. IRS has burden of proof that requesting had knowledge about understatement of tax.
3. Equitable Relief
 1. Requesting spouse does not qualify for relief under (b) or (c).
 2. No knowledge or understatement or underpayment
 3. It would be inequitable to hold requesting spouse liable.
 4. Generally, requesting spouse is separated, divorced, or widowed from non-requesting spouse.
 5. The understatement or underpayment is due to items on the non-requesting spouse's return.

VII. Estate Planning – Matrimonial Issues

A. Introduction

On December 17, 2010 President Obama signed the Tax Relief, Unemployment Insurance Reauthorization and Job Creation Act of 2010 (the "Act"). The Act significantly changes the federal estate tax and presents meaningful estate planning opportunities. This outline summarizes the Act's key changes and provides you with our observations about the Act's impact from an estate planning perspective. Please note that there are several important changes made by the Act that this outline does not summarize.

B. Summary of Key Estate and Gift Tax Provisions of the Act

(1) Estate Tax

(a) Before the Act, the federal estate tax was gradually reduced over several years and then eliminated for decedents dying in 2010. Prior law provided that the federal estate tax, with a maximum tax rate of 55 percent and a \$1 million applicable exclusion amount, would be reinstated after 2010. Additional changes scheduled for years after 2010 affected the gift and generation-skipping transfer ("GST") taxes.

(b) The Act reinstates the estate tax for decedents dying during 2010, but at a significantly higher applicable exclusion amount of \$5 million, and a lower maximum tax rate of 35 percent, than under prior law. This estate tax regime continues for decedents dying in 2011 and 2012. Unfortunately, this new regime is itself temporary and will sunset on December 31, 2012 and the prior estate tax regime, with a 55 percent maximum estate tax rate and a \$1 million applicable exclusion amount, is reinstated at that time.

(c) The Act also eliminates the modified carryover basis rules for 2010 and replaces them with the stepped-up basis rules that had applied before 2010. Property with a stepped-up basis generally receives a basis equal to the property's fair market value on the date of the decedent's death. Under the modified carryover basis rules that applied during 2010 before the Act, executors could increase the basis of estate property only by a total of \$1.3 million (plus an additional \$3 million for assets passing to a surviving spouse, for a total increase of \$4.3 million), with other estate property taking a carryover basis equal to the lesser of the decedent's basis or the property's fair market value on the decedent's death.

(d) The Act gives estates of decedents dying during 2010 the option to apply (1) the estate tax based on the new 35 percent top rate and \$5 million applicable exclusion amount, with stepped-up basis, or (2) no estate tax and modified carryover basis rules under prior law.

(e) The Act also provides for "portability" between spouses of the estate tax applicable exclusion amount for estates of decedents dying in 2011 and 2012 if both spouses die before 2013. Generally, portability allows surviving spouses to elect to take advantage of the unused portion of the estate tax applicable exclusion amount (but not any unused GST tax exemption) of their predeceased spouses, thereby providing surviving spouses with a larger exclusion amount. Special limits apply to decedents with multiple predeceased spouses.

To preserve the first deceased spouse's unused applicable exclusion amount, the executor for such spouse must file an estate tax return and make an election on such return, even if such an estate tax return would otherwise not be required.

(2) Gift Taxes

(a) For gifts made in 2010, the maximum gift tax rate is 35 percent and the applicable exclusion amount is \$1 million. For gifts made in 2011 and 2012, the Act limits the maximum gift tax rate to 35 percent and increases the applicable exclusion amount to \$5 million. As discussed below, this change provides an opportunity to move meaningful amounts of wealth free of estate and gift taxes.

(b) Donors continue to be able to use the annual gift tax exclusion before having to use any part of their applicable exclusion amount. For 2010 and 2011, the annual exclusion amount is \$13,000 per donee (married couples may continue to "split" their gift and may make combined gifts of \$26,000 to each donee).

(3) Generation Skipping Transfer ("GST") Tax

The Act provides a \$5 million GST exemption amount for 2010 (equal to the applicable exclusion amount for estate tax purposes) with a GST tax rate of zero percent for 2010. For transfers made after 2010, the GST tax rate would be equal to the highest estate and gift tax rate in effect for the year (35 percent for 2011 and 2012). The Act also extends certain technical provisions under prior law affecting the GST tax.

C. Observations Regarding the Act

(1) Generally

Generally, the estate and gift tax provisions of the Act are very favorable to taxpayers because of the substantial increase in the applicable exclusion amount, to \$5 million, and the lower maximum estate and gift tax rate of 35 percent. The Act also addresses several technical estate, gift and GST tax issues in a manner that is favorable to taxpayers (e.g., the impact of the lapse of the estate tax, including the application of basis rules, on decedents passing away during 2010).

(2) Temporary Fix

The Act is a temporary fix, which sunsets on December 31, 2012, immediately after the next election cycle. It is impossible to predict whether it will be extended in either its current or some modified form, especially given the fact that it is a hot button issue with both major political parties. If Congress fails to act, the Act will lapse and the estate tax will revert to what it would have been under prior law (i.e., \$1 million applicable exclusion amount and 55 percent maximum estate and gift tax rate).

(3) Increased Gift Tax Applicable Exclusion Amount

(a) From 2001-2010, the applicable exclusion amount for gift tax purposes has been \$1 million. The Act increases this to \$5 million, or \$10 million per married couple. This change provides an unprecedented opportunity to move substantial amounts of wealth out of individuals' estates. There are several techniques that individuals can use to leverage this \$5 million applicable exclusion amount, to move substantially more wealth out of their estates.

(b) Given the fact that the Act will sunset without further Congressional action in 2012, it may be prudent to implement estate planning techniques utilizing lifetime gifts before the December 31, 2012 sunset date.

(4) New Jersey Death Taxes

(a) Despite the new and generous federal estate tax exemption of \$5 million, New Jersey residents still need to plan for the New Jersey Estate Tax and the New Jersey Inheritance Tax. New Jersey exempts \$675,000 or less per estate and carries a top rate of 16%. Also New Jersey imposes an inheritance tax on money left to anyone other than the decedent's spouse or domestic partner, descendants, ancestors, and charities. Any estate tax owed is reduced by the inheritance tax paid.

(b) To avoid the New Jersey death taxes, many individuals are establishing domicile in Florida. New Jersey has become very aggressive in challenging change of tax domicile particularly in those cases where the taxpayer spends considerable time in New Jersey after the change in domicile. Careful planning is critical. You should be mindful of the famous Dorrance decision in which the owner of Campbell Soup was found to be subject to both Pennsylvania and New Jersey death taxes due to the court's determination that the decedent had multiple domiciles.

(c) Establishing Florida as a domicile should cause changes to your tax reporting on your NJ income tax return. Often New Jersey will send a questionnaire as a result of these changes. It will be important that you have your domicile in Florida tacked down. You should switch your "address of record" for everything possible to Florida, including your voter registration, driver's license, bank, brokerage, and other financial accounts, credit cards, all insurance coverages, subscriptions, memberships, and federal tax returns. Use your new address on every document you fill out, every website on which you're registered. You should maintain detailed records of your comings and goings to and from NJ. Again, please realize that NJ is getting very aggressive. If audited, they will check credit card records to track location of purchases and cell phone records to track origin of phone calls. You should stop seeing NJ doctors and dentists, if possible.

(5) Portability

(a) One of the more notable provisions contained within the Act is the "portability" provision, which provides in general terms that if one spouse does not fully utilize his/her entire \$5 million applicable exclusion amount, the unused portion can be used by the surviving spouse's estate. This provision is intended to avoid the need for credit shelter trusts in

estate planning documents. Unfortunately, both spouses must die before 2013 in order to benefit from the portability provision.

(b) In addition, credit shelter trusts continue to provide significant additional benefits beyond just the use of each spouse's applicable exclusion amounts. These include the following:

- Ensuring that assets contained in the credit shelter trust pass to children of the couple and not to any new spouse of the surviving spouse.
- Ensuring that appreciation on the assets contained within the credit shelter trust, which may exceed the applicable exclusion amount at the surviving spouse's death, are not subject to estate tax at that time.
- Protection of assets in the credit shelter trust from creditors of the surviving spouse, including any marital claims of future spouses.

Given the fact that the portability provision will sunset in 2012, as well as for the reasons stated above, estate plans should continue to incorporate credit shelter trusts.

(6) GRATs/Valuation Discounts

There are two key provisions that many professionals feared would be in the Act, but which were not included in it. Specifically, there have been several proposals to limit the estate tax planning opportunities using Grantor Retained Annuity Trusts ("GRATs"). There have also been several proposals to limit valuation discounts in connection with certain estate planning techniques such as family limited partnerships. There were no such provisions included in the Act.

(7) Summary

To summarize, the Act makes significant estate and gift tax changes. The key points discussed above include the following:

- The estate tax exclusion amount increases to \$5 million per person for 2010 through 2012.
- The maximum estate and gift tax rate is reduced from the 55 percent maximum rate under prior law to a maximum estate and gift tax rate of 35 percent for 2011 and 2012.
- A "portability" provision is included, which allows surviving spouses to use any applicable exclusion amount that is not used by the first spouse to pass away.
- The GST exemption amount is increased to \$5 million for 2010 through 2012.
- The Act sunsets at the end of 2012, thus making the foregoing changes temporary in nature.

VIII. Transfers of Stock Options and Deferred Compensation Incident to Divorce

A. Elective Deferral Compensation Plans.

1. Employer adopts deferral plan to provide retirement benefits to a select group of management or highly compensated employees.
2. Participants elect to defer regular and/or incentive compensation. Amounts deferred are subtracted from the participant's compensation when it becomes payable and are credited to the participant's deferral account. Interest will be credited on the deferrals at the rate provided in the plan.
3. The deferral plan balance is solely a bookkeeping entry. Participant is a general, unsecured creditor of the employer with respect to the amounts deferred under the plan.
4. The benefits payable under the plan are represented solely by the employer's unsecured promise to pay the benefits. To this extent, the participants and their beneficiaries will be general, unsecured creditors of the employer.

B. Supplemental Executive Retirement Plans (SERPs).

1. The employer promises to pay the employee a benefit equal to a specified dollar amount or a percentage of final compensation.
2. No salary reduction.
3. The promise to pay is unfunded and unsecured. An employee is a general, unsecured creditor of the employer.
4. Typically, the benefit is subject to a vesting schedule. In some cases, there is a 100% forfeiture of benefits if the employee terminates prior to a designated retirement age for reasons other than death, disability, or change in control.
5. In PLR 200442003, the IRS addressed the tax consequences of a present-value buy-out of future SERP payments. This ruling is particularly useful for taxpayers structuring divorce settlements where significant marital assets consist of inchoate promises from the employees employer to pay both spouses pension benefits in the future, but payment of those benefits are subject to the claims of the employers creditors until the payments are actually made.

C. ERISA Excess Plans.

1. A SERP may be designed as an ERISA Excess Plan as defined in ERISA Section 3(36). Such a plan provides benefits which would have been paid but for the limitations on contributions and benefits contained in Section 415.

D. ISOs Versus Nonqualified Options.

1. With an ISO, the employee does not recognize current compensation upon the exercise of the option. Any gain on the exercise is deferred until the stock is sold and all the gain is characterized as capital gain.

To qualify for capital gain treatment, the employee must hold the stock for at least 2 years after the date the ISO was granted and at least one year after it was exercised.

2. An employee does not receive tax-favored treatment on the exercise of a nonstatutory or "nonqualified" stock option. Under section 83(a), a nonqualified stock option results in ordinary income to the employee in the year of exercise on the spread between purchase price and fair market value at exercise and capital gain on the appreciation realized between exercise and sale.
3. In PLR 200519011, the IRS ruled that employee-spouse's transfer of non-qualified stock options to the non-employee spouse, pursuant to a divorce decree will not be treated as a disposition of the options.
4. The employer sponsoring the ISO never receives a tax deduction for the compensatory bargain element in the ISO. A nonqualified stock option is more favorable for the employer because it gets a deduction.
5. In PLR 201016031, the IRS ruled that the division of restricted stock which occurred in the context of a judicial proceeding formalized in a divorce decree is a non-taxable event under Code Section 1041. The income attributable to the vesting of the restricted stock is includible in the gross income of the transferee former spouse for federal income tax consequences, and all subsequent tax consequences with respect to such stock will be the responsibility of the transferee former spouse.

E. ISO Requirements.

1. The employer must have a written option plan that sets forth the maximum number of shares that may be issued under the plan, as well as the class of employees eligible to receive options.

The plan must be approved by a majority of the stockholders of the company within 12 months of its adoption by the board of directors.

The plan must provide that the aggregate value of the stock with respect to which ISOs are first exercisable by the optionee in any calendar year cannot exceed \$100,000.

2. Assuming that the plan satisfies these requirements, the option grant must also conform to a number of statutory prerequisites under Section 422(b), including:

- a. The option exercise price must be no less than the fair market value of the shares (as determined by the board of directors in good faith) on the date of the grant.
- b. The option must be granted within 10 years of adoption of the plan.
- c. The option, by its terms, cannot be exercisable for a period longer than 10 years after the date of the grant.
- d. The option may be granted only to a person who is an employee of the company (or its parent or subsidiary) on the date of the grant.
- e. The option must be exercised by the employee no later than 3 months after termination of employment (except in the case of death or disability, after which an ISO can be exercised for up to one year).
- f. The option, by its terms, cannot be transferable (other than by will or laws of descent) and can only be exercised during the employee's lifetime by the employee.
- g. If an option is granted to a more-than-10% shareholder of the company (or its parent or subsidiary), the exercise price can be no less than 110% of the fair market value at the date of grant and the option cannot be exercised for a period longer than 5 years after the date of the grant.

F. Sequential Exercise Rule.

Prior to the 1986 Tax Reform Act, pursuant to the sequential exercise rule, an ISO could not be exercisable before any prior ISO granted to the same optionee by the same company had been exercised in full or had expired (by lapse of time) under the terms of the grant.

This rule was repealed by the 1986 Tax Reform Act.

G. Grant Limitation Rule.

Prior to the 1986 Tax Reform Act, the grant limitation rule required that the terms of the ISO plan provide that no employee could be granted ISOs for more than \$100,000 worth of stock in any calendar year.

This rule was repealed by the 1986 Tax Reform Act. Post-1986 ISOs are subject to a \$100,000 exercise limitation rule rather than a grant limitation rule.

H. Alternative Minimum Tax.

The spread on exercise of an ISO is a tax preference for alternative minimum tax purposes.

I. Rev. Rul 2002-22.

In Rev. Rul. 2002-22, the IRS issued guidance on the tax treatment of nonstatutory stock options and nonqualified deferred compensation rights incident to a divorce. According to the ruling, a spouse who transfers interests in nonstatutory stock options and nonqualified deferred compensation to his or her former spouse incident to divorce does not recognize income on the transfer by reason of § 1041. The transferee spouse who receives the option/compensation must include the amount in income under § 83 upon exercise of the option or when the compensation is paid or made available. The ruling clarifies, however, that it does not apply to transfers of nonstatutory stock options, unfunded deferred compensation rights, or other future income rights to the extent such options or rights are unvested at the time of the transfer or to the extent that the transferor's rights to the income are subject to substantial contingencies at the time of the transfer.

IX. Qualified Domestic Relations Order

A. What is a Qualified Domestic Relations Order?

A "qualified domestic relation order" (QDRO) is a domestic relations order that creates or recognizes the existence of an alternate payee's right to receive, or assigns to an alternate payee the right to receive, all or a portion of the benefits payable with respect to a participant under a retirement plan, and that includes certain information and meets certain other requirements. IRC § 414(p)(1)(A)

B. What is a Domestic Relations Order?

A domestic relations order is a judgment, decree, or order (including the approval of a property settlement) that is made pursuant to state domestic relations law (including community property law) and that relates to the provision of child support, alimony payments, or marital property rights for the benefit of a spouse, former spouse, child, or other dependent of a participant.

A state authority, generally a court, must actually issue a judgment, order, or decree or otherwise formally approve a property settlement agreement before it can be a domestic relations order under ERISA. The mere fact that a property settlement is agreed to and signed by the parties will not, in and of itself, cause the agreement to be a domestic relations order.

There is no requirement that both parties to a marital proceeding sign or otherwise endorse or approve an order. It is also not necessary that the retirement plan be brought into state court or made a party to a domestic relations proceeding for an order issued in that proceeding to be a domestic relations order or a qualified domestic relations order. Indeed, because state law is generally preempted to the extent that it relates to retirement plans, the Department takes the position that retirement plans cannot be joined as a party in a domestic relations proceeding pursuant to state law. Moreover, retirement plans are neither permitted nor required to follow the terms of domestic relations orders purporting to assign retirement benefits unless they are QDROs. IRC § 414(p)(1)(B)

C. What information must a domestic relations order contain to qualify as a QDRO under ERISA?

QDROs must contain the following information:

- The name and last known mailing address of the participant and each alternate payee
- The name of each plan to which the order applies
- The dollar amount or percentage (or the method of determining the amount or percentage) of the benefit to be paid to the alternate payee
- The number of payments or time period to which the order applies

IRC § 414(p)(2)(A)-(D)

D. Are there other requirements that a domestic relations order must meet to be a QDRO?

There are certain provisions that a QDRO must not contain:

- The order must not require a plan to provide an alternate payee or participant with any type or form of benefit, or any option, not otherwise provided under the plan
- The order must not require a plan to provide for increased benefits (determined on the basis of actuarial value)
- The order must not require a plan to pay benefits to an alternate payee that are required to be paid to another alternate payee under another order previously determined to be a QDRO
- The order must not require a plan to pay benefits to an alternate payee in the form of a qualified joint and survivor annuity for the lives of the alternate payee and his or her subsequent spouse

IRC §§ 414(p)(3)(A)-(C), 414(p)(4)(A)(iii)

E. In Kennedy v. Plan Administrator for Dupont Savings and Investment Plan, et al., decided January 26, 2009, the Supreme Court found that where an employee failed to change the beneficiary of their employer related retirement plan, i.e. 401(k), pension, etc. subsequent to the entry of a Final Judgment of Divorce, despite the clear terms of a Judgment of Divorce or Agreement between the parties, the Plan Administrator must divide the retirement asset in accord with the Plan documents, i.e. to whom the plan participant designated.

In this matter, the parties had been divorced for several years. In their Agreement, the former Mrs. Kennedy waived her interest in Mr. Kennedy's Savings and Investment Plan. After the divorce was finalized, Mr. Kennedy failed to change the beneficiary designation of this Plan to someone other than his former spouse. Upon his death, his Plan benefits were paid to Mrs. Kennedy. His estate requested that the funds be distributed to them but the Plan administrator, relying on Mr. Kennedy's designation form and the Plan documents, would not do so.

The matter was litigated up to the Supreme Court who found that Mrs. Kennedy did not waive or assign her interest in the Plan despite the terms of the parties Agreement. The Court also found that Dupont's plan administrator acted correctly by enforcing a QDRO but also enforcing the plan documents.

While it is important to make sure that QDRO's are completed either before or shortly after a divorce is finalized, if there are retirement assets to divide and those assets fall under ERISA and require a QDRO, it is equally important to ensure that employee's participating in ERISA governed plans, by virtue of their employment, take whatever steps necessary to change their plan beneficiaries to avoid situations like the one above.