Critical Tax Information

to Consider Before Agreeing to Your Divorce Settlement

By Heather L. Locus

As if living through a divorce was not hard enough, I know from personal experience how learning new legal acronyms and jargon while also learning about the issues you have to address can feel like you are back in school getting a new degree. Unfortunately, I often find new clients so engrossed in the legal and personal issues with the divorce that they often do not have the time or energy to ensure they are making smart financial decisions, which can result in a costly tax bill.

The complexity of new tax laws further increases the importance of tax planning during a divorce. Accurate tax estimates improve your chances of getting an equitable settlement and help you understand if you need to make quarterly tax payments to avoid unnecessary penalties. The information below is designed to empower you to feel knowledgeable when speaking with your attorney, accountant and financial advisor and to make sure someone on your team is focused on how much of your settlement you will get to keep after paying the tax man.

All assets are not equal in a divorce settlement. Retirement accounts have embedded tax liability and a $100,000 IRA may only be worth $75,000 after taxes, while a $100,000 investment account may have a $90,000 tax basis and be worth $98,000 after taxes. New legislation magnifies the impact of taxes as there are increased income tax rates, limitations on deductions and a Medicare surtax that all became effective January 1, 2013. To estimate how much the embedded tax liability is when calculating the after-tax value of proposed divorce settlements, it is critical to pay attention to key terms on your tax return. While the new laws affect primarily high income taxpayers, anyone going through a divorce should be aware of the impact of taxes to make sure they are getting an equitable settlement.

Adjusted Gross Income (AGI)

The total of all of your earnings from working and investments minus retirement plan contributions and other potential adjustments. This is the figure that determines whether the benefit of deducting the children will be phased out, if itemized deduction such

as mortgage interest will be reduced and whether the Medicare surtax will be applicable.

The **personal exemption** is a deduction for yourself and your children. It's $3,900 per dependent in 2013. Therefore, if you have 3 kids the potential exemption totals $11,700 for them. It is reduced if a single person's AGI is over $250,000, in which case it may make sense to let your former spouse take the exemption and agree to use the tax benefit to help fund college or some other mutual expense for the children.

The **3.8% Medicare surtax** is assessed on investment income such as taxable interest (not Municipal Bond Interest), dividends, capital gains and annuities when a single taxpayer has AGI in excess of $200,000. This can result in higher taxes when selling assets to equalize a divorce settlement or provide cash to pay expenses.

Taxable Income

AGI minus allowances for personal exemptions and itemized deductions such as mortgage interest and property taxes. This is the figure you use to calculate how much tax you owe. We have a graduated tax system which results in portions of your income falling into different brackets that are assigned different rates. The first dollar you make is taxed at a lower rate than the last dollar you make. Your highest marginal rate is the rate at which the next dollar of income will be taxed. It is important to know what your marginal rate will be as well as what your former spouses marginal rate will be when negotiating whether maintenance will be taxable and who gets to deduct the personal exemptions for the children. Gains on stocks or mutual funds that you sell after owning them 1 year or longer are eligible for a lower capital gains tax rate.

As you will see highlighted in table 1 (page 22p), the increase in rates from the new law only impacts taxpayers with taxable incomes of at least

Divorce Mediators:

If you want to reach your own decisions about the issues involved in your divorce, consider working with one of the following neutral, third-party mediators who specialize in divorce mediation.

KAREN A. COVY (THE LAW OFFICES OF)
(312) 236-1670 • www.karencovy.com • karen@KarenCovy.com
A successful divorce attorney and mediator in Chicago. Author of the book *How to Survive Your Divorce Emotionally, Financially and Legally*, Karen is dedicated to helping couples resolve their family disputes outside of the court system. Karen also volunteers as a facilitator in the Domestic Relations Division of the Cook County Court system.

SANDRA M. ROSENBLOOM, ATTORNEY AT LAW
(847) 441-1886 • www.rosenbloomlaw.com • sandra@rosenbloomlaw.com
Sandra M. Rosenbloom helps clients mediate personal/family disputes and premarital agreements, providing opportunities to settle divorce or post-decree matters privately and non-adversarially. By discouraging confrontation and acrimony, Sandra helps clients work toward mutually satisfactory resolutions from her Northfield office. She also teaches mediation and Collaborative practice as an adjunct Professor at Loyola University Law School.

Table 1:

Taxable Income — Line 43 from 2012 1040 Tax Return			Ordinary Income	Capital Gains & Dividends
Married Filing Joint	Head of Household	Single		
$0 to $17,900	$0 to $12,750	$0 to $8,950	10%	0%
$17,900 to $72,500	$12,750 to $48,600	$8,950 to $36,250	15%	
$72,500 to $146,400	$48,600 to $125,450	$36,250 to $87,850	25%	15%
$146,400 to $223,050	$125,450 to $203,150	$87,850 to $183,250	28%	
$223,050 to $398,350	$203,150 to $398,350	$183,250 to $398,350	33%	
$398,350 to $450,000	$398,350 to $425,000	$398,350 to $400,000	35%	
$450,000+	$425,000+	$400,000+	39.6%	20%

$400,000. Keep in mind, these are federal income tax rates only and state income taxes would be additional.

The tax issues below often come up during a divorce and are primarily unchanged by the new laws:

- For the sale of a principal residence, taxpayers can exclude $250,000 per person if they owned and used the house for 2 of the last 5 years. A non-occupying spouse can include the use of an occupying spouse if it is pursuant to a divorce decree.
- A Qualified Domestic Relations Order (QDRO) is an order from the court to a retirement plan administrator detailing how the plan's benefits are to be assigned to each party. Retirement accounts split pursuant to a QDRO are exempt from a 10% penalty on withdrawals before age 59 ½ but IRA withdrawals are not. Use caution in rolling money from a QDRO retirement plan to an IRA if you are younger than 60.
- Taxable maintenance will qualify as 'earned income' for IRA/Roth IRA contribution qualification. This allows you to make IRA/Roth IRA contributions of up to $6,500 even if you do not have employment earnings.
- Legal fees paid to obtain taxable maintenance or for tax research and advice qualify as miscellaneous itemized deductions, but now have the phase out limitations discussed above.
- Contributions to 529 Plans for college may have tax benefits. In Illinois, contributions to Bright Start and Bright Directions qualify for deduction up to $10,000 per taxpayer. The 5% Illinois tax rate makes that worth $500.

This summary highlights only a few key terms, revised laws and common tax issues that affect divorcees. There are many more potential deductions or credits you may be eligible for that may save you significant tax dollars, especially if you have children. The rules for many of these are complicated and even more so with parents filing separate returns. Therefore, it is important that you meet with an experienced tax expert before finalizing your divorce to ensure all issues have been considered based on your unique situation.

Heather L. Locus, CPA, CFP® is a principal at Balasa Dinverno Foltz LLC, a fee-only wealth management firm. Heather is passionate about helping women make smart financial decisions so they can enjoy their wealth. As an owner and leader of BDF's Women's Service Team, Heather provides financial guidance to divorcees and business owners before, during and after the challenging transitions in their lives. www.bdfllc.com

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