Family Courts Don't Always Pay Attention to Federal Tax Law

Article Highlights:

- Family Court Errors
- Property Settlements
- Children
- Alimony
- Conflicts of Interest

All too often, family law courts make rulings that are contradictory to federal tax law, causing confusion and inequity in divorce actions since family court rulings cannot trump federal tax law.

An issue for divorced parents is who gets to claim the children for tax purposes. Federal tax law provides that the parent with physical custody claims the child unless that parent releases the exemption to the other parent. Frequently, family courts award physical custody to one parent and the tax exemption to the other. To make matters worse, the courts assume that the exemption deduction will provide a financial benefit to the non-custodial parent. Then the court adjusts child support accordingly, leaving the non-custodial parent with two unpleasant surprises when filing his or her tax return: the child support is not deductible and the child cannot be claimed as a dependent without a release from the custodial parent.

Who is to blame? At first glance, one would tend to blame the court. However, it is not the job of the court, but the duty of the attorney to bring the judge's attention to federal tax law so that he or she is aware of what applies in order to make a correct judgment. Few family law judges know tax law.

Avoid mistakes – Consult with your tax advisor. Go over the proposed settlement and determine what the tax implications will be before the divorce is finalized. Here are some of the tax issues that need to be considered as part of a divorce:

Property settlements – When property is divided in a divorce, the spouse who keeps the property assumes the community basis. This, in effect, means that spouse assumes any tax liability when the property is sold.

Example: A couple has a home worth $450,000 and a mortgage of $50,000, which provides a net equity of $400,000. They also have a bank savings account worth $400,000. They divorce, and agree that the wife will keep the home and the husband will keep the bank account. On the surface, this sounds equitable, but, after taxes are considered, it may not be. Let's assume the couple purchased the home for $100,000 several years ago. The wife assumes the community basis of $100,000. If the wife sells it for $450,000, she will net only $373,000 from the sale after paying the selling costs of approximately $27,000 and paying off the $50,000 loan. In addition, she has a taxable profit from the sale that is computed as follows:

Sales Price:	*$450,000*	
Community Basis:	*<100,000>*	
Sales Costs:	*< 27,000>*	
Home Sale Exclusion	*<250,000>*	
Taxable Gain	*$ 73,000*	
Federal Tax @ 15%	*10,950*	*(there may also be a state tax, and Federal tax could be as high as 20%)*

So, in our example, the wife nets $362,050 ($373,000 less taxes of $10,950), while her spouse nets a full $400,000 from the savings account. Not exactly even after taking into account the tax liability.

Issues involving Children – There are substantial tax issues related to the children. Here are some of them:

- *Dependency* – Federal tax law gives the dependency to the custodial parent unless the custodial parent releases, in writing, the dependency to the non-custodial parent. There is a tax deduction of $4,000 (2015) for each dependency exemption.
- *Child Credit* – The 2015 child tax credit, $1,000 for each child under age 17, goes to the parent who claims the child as a dependent.
- *Joint Custody* – Some courts award joint custody to the parents. In this situation, the IRS does not split the benefits of claiming the child as a dependent. Instead, the parent with physical custody the greater part of the year receives all of the benefits.
- *Education Credits* – The education tax credits for college tuition expenses go to the one who claims the exemption for the child, regardless of who paid the tuition.
- *Child Care Credit* – The parent who claims the child's exemption is the only one who can claim a tax credit for child care expenses This can cause issues where both parents work and share custody.
- *Child Support*– is not deductible by the parent who pays the support and is not taxable to the one who receives it.

Alimony - is deductible by the spouse who pays it and includable in income by the spouse who receives it. To be treated as alimony, payments must be in cash, required by the divorce instrument, and end upon the death of the payee. In addition, alimony payments cannot be contingent on the status of a child and are valid only while the taxpayers live apart.

Conflict of Interest – Rules of Practice do not allow a tax practitioner to represent clients where there is a conflict of interest. This is an issue for divorcing couples since the divorce creates a conflict of interest and a practitioner may not be able to provide services to both clients and, in some cases, may not be allowed to provide services to either.

As you can see, there are a number of complications related to divorce and the status of the children of divorced parents. If you have questions, please give this office a call.