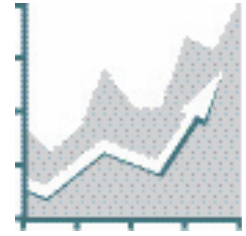


Financial Adviser



Dissolution of Marriage

Understanding the Financial and Tax Impact of Divorce Settlements

A divorce can be just as devastating financially as it is emotionally. In many cases, if not most, married couples going through a divorce are not aware of the long-term financial ramifications or potential tax consequences of their contemplated settlement agreement. Now more than ever, financial professionals are playing an active role in helping sort through these complex financial issues.

It is essential to approach the financial issues of divorce comprehensively. By looking at each asset or source of income separately, divorcing parties may fail to recognize the interaction of inflation, timing issues, capital gains, investment losses, taxes and other areas of the full financial picture. Tax planning is essential to ensure that unnecessary increases in tax liability do not create additional problems later.

Child support, spousal support and property transfers require careful consideration in the process. Failure to address ambiguous areas when structuring a settlement may produce unfavorable results, as the value of marital assets, and costs involved in a settlement, can become complicated.

Child Support and Spousal Support (Alimony)

Child support payments are not deductible by payors and are not taxable income to recipients. Payments that qualify as spousal support are deductible by payors and taxable to payees. Under certain carefully structured settlements, it is possible to make larger spousal support payments to the payee spouse at less after-tax cost to the payor spouse. Under two scenarios, if any amount specified in a divorce or separation instrument

will be reduced, the amount of the reduction may be treated as child support (non-deductible, non-taxable), rather than spousal support (deductible, taxable), from the start. These include:

- Upon the happening of any contingency relating to the child (for example, age); or
- At a time that can be clearly associated with a contingency related to the child.

In addition, rules exist to prevent non-taxable property transfers from being disguised as spousal support. Exercise caution to avoid having excess spousal support payments recaptured as taxable income to the payor spouse.

Property

There is virtually no limit as to what is considered property – such as the family home, rental property and cars, as well as bank accounts, retirement plans, stock options and family owned businesses. When negotiating property settlements, it is important to consider the future tax consequences of the distribution. Without knowing the basis of each asset and its tax impact, a true comparison of value is not possible, meaning net dollars received could be less than expected.

Marital Residence

If the proposed settlement has limited liquidity, be sure that there will be enough cash flow throughout the years to handle living expenses. Keeping the house while foregoing other liquid assets of the marital estate may not prove to be best in the long run. Additionally, unnecessary tax liabilities can be avoided. Presently, single taxpayers can exclude up to

\$250,000 of gain from the sale of the principal residence, while married couples filing joint returns can exclude up to \$500,000.

Retirement Plans

In most states, retirement benefits are considered assets subject to division in divorce. For defined contribution plans, it is critical to properly structure any transfer to a spouse to avoid unnecessary withholdings or tax consequences. However, there are options that provide a distribution to a spouse under the age of 59 1/2 without triggering penalties.

Defined benefit plans can be divided by discounting the future benefit to the present value and offsetting it with other assets, or via a QDRO (Qualified Domestic Relations Order) if allowed by the plan. The QDRO should be drafted before the final settlement, sent to the plan administrator for pre-approval, and be ready for the judge to sign at the same time as the final orders. Mistakes made when using a QDRO can leave a spouse without the portion of the marital assets that were previously awarded.

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