

## **Jon Feder Podcast 1**

*A family lawyer from New Mexico discusses taxation, business, and financial issues in divorce situations.*

### **How can somebody's income taxes be affected by their divorce?**

**Feder:** Divorce can affect income taxes in many serious ways, because New Mexico is a community property state. Section 66 of the Internal Revenue Code says that in a community property state, each party is required to report one half of the income. They also get credit for one half of the withholding taxes against the income.

The year of divorce is very difficult for the parties, because they don't trust each other and getting them to exchange the information needed to file a tax return is difficult. Rule 122 under the New Mexico Rules of Procedure provides that the community income either shall be divided between the parties or a written waiver must be filed in court. In a final hearing, the courts do not want to do accounting for the monies during the separation period.

When the parties do file tax returns, they usually file with a primary name. If they file a joint return, the second name is not going to be noticed by the Internal Revenue Service after a divorce unless they follow up with a notice of changing their mailing address. It also affects the primary spouse if they move out of the house, because they may not get notices from the Internal Revenue Service unless they file a notice of change of mailing address. The year of divorce is extremely important because of the community aspect of their income.

### **If someone's divorce will be final before the end of the year, should they sign one last joint tax return with their soon-to-be ex? If not, what are their options and what are the pros and cons of these options?**

**Feder:** The Internal Revenue Service looks at December 31<sup>st</sup>, so if you're married on that day then you have permission to file a joint return. You could also file married separate. If you're divorced on December 31<sup>st</sup>, you cannot file a joint return. You each must file individual returns and may be able to claim head of household status if you have a qualifying dependent, such as a child. Otherwise, you file as single taxpayers as if you were unmarried for the whole year. Your options are limited to either filing as single taxpayers or one party may be able to claim head of household status, which has advantages such as lower rates to be applied against your income as well as a higher standard deduction amount from your income.

### **If one spouse earned all the household income during the marriage and they have prepared a joint tax return, should the other spouse sign it? Are there any risks or benefits to doing so?**

**Feder:** The first benefit of filing a joint return is that your income taxes are going to be lower. In New Mexico, because we are community property state, if you file a joint return with a spouse then you are able to have the non-working spouse's income treated as if they had earned half the income. You get to use the progressive rates of the income tax table and generally that will reduce taxes.

When you're dealing with a joint return, you're assuming the liability of both parties to a joint return or jointly and separately liable for the complete amount of unreported tax or unpaid tax to the Internal Revenue Service - that is a tremendous risk of filing a joint return. If you generally just file a W-2 for income and maybe some small interest from savings accounts or checking accounts, then you will not have much difficulty because there is no hidden income.

If you have business income, then we would suggest filing married separate. By filing married jointly, if the wage earner is hiding or not reporting income, the other spouse is liable on that income and likely not able to discover it until the Internal Revenue Service intervenes, at which point lawyers and tax accountants become involved. If you don't know about the income, you can try to claim you're an innocent spouse or other forms of equitable relief the Internal Revenue Service could grant. However, it's doubtful that they will grant it unless it's obvious you did not know the income could have come in.

Filing a joint return with a spouse will generally reduce both parties' taxes. If it's wage income, it's well assured you know what the income is. You will be able to take the advantage of the progressive tax rates the Internal Revenue Service offers.

**Are there any tax or financial consequences to keeping the marital home when dividing property during divorce?**

**Feder:** There are some concerns if it's a highly appreciated home. Prior to 2007, we were running into cases where homes were bought for \$70,000 in 1960 and selling for \$900,000 today. The Internal Revenue Code provides that each party is able to exempt \$250,000 of gain on a residence. If one party decides to keep the residence and it has more than \$250,000 in gain reflected in its value, then that party's going to be paid upon the sale of the house and they're going to pay a capital gains tax.

Most homes are covered by mortgages in joint names. Upon the divorce, the courts have a tendency to say the former community credit needs to be terminated and the person who wants to receive the house will have to refinance to get the former spouse off the mortgage. Their credit is not affected by the continuation of the mortgage.

However, the person who is willing to sell the house - to trade their equity in the house for other assets - should be concerned. If the other spouse is keeping the home and they do not insist upon the house being refinanced, then this payment will affect the former spouse's income. With the tough regulations and financing requirements that have occurred since 2007, it's unlikely that the spouse who is not the homeowner will be able to obtain a new mortgage because it will affect their ability to get favorable rates and credit to purchase a new home.

The other financial consequence of fighting to keep the house is that you cannot keep the house and eat it. When parties are getting divorced, New Mexico law requires the community estate to be divided equally between them. If somebody receives cash and the other person receives the house, there's a disadvantage to the homeowner, because they can't eat it - they don't have the same financial resources behind them, because they're tied up in the house.

**It seems clear the custodial parent should take most of the tax reductions pertaining to children, but can the non-custodial parent deduct any expenses, such as medical expenses they incurred for a child, on their tax return?**

**Feder:** There are certain tax benefits relating to children that can only be taken by the custodial parent, the main one being childcare tax credit. Although it's not a huge amount, it can only be claimed by the custodial parent. For medical expenses, the parent who paid the medical expense is the one who can claim the deduction if they meet the threshold, which is 10% of adjusted gross income. Unless you have a very ill child, medical expenses are not a tax advantage.

If some of the credits are tied up with the exemption of the custodial parents as defined by federal law rather than state law, then the federal law discount stays. Do one or both of the parties have a child for more than six months of the year? If they do, then which parent has more time than the other with the child? It's not what the decree says, but in reality, that's the parent who can claim the tax exemption. However, there is a right to waive it.

The New Mexico Supreme Court ruled in the Macias case that the court can award the exemption. It's a practical matter of who has the higher income up to a certain level that it can be advantageous to the family unit. The former marital unit would be advantaged because if one spouse is in a 25% tax bracket and the other is in a 10% tax bracket, they can receive 15% on approximately \$4,000 - or \$600 in additional income within that family unit for food, shelter, entertainment, and other items related to the child. With the exemption goes certain other credits, such as the child credit of \$1,000 allowed per child.

There are other advantages to the exemption. To have the wealthy pay more in taxes, certain items are reduced as income goes up, including the exemption. At a certain threshold they have what's called a phase out. For every \$2,500 you earn greater than the base, you lose a percentage of the child exemption. It's the same thing with itemized deductions; once you reach a certain income threshold, you start to lose your itemized deductions.

If you have a neurosurgeon making \$800,000 a year, it doesn't make any sense for them to claim the exemption because it wouldn't exist for them. It would be better to give it to the parent who may not be working or has limited income or spousal support so they can take advantage of the deductions for those items.

**Since spousal support is deductible to the payor, is there any way to prevent someone from declaring that all payments to their ex, including child support, are spousal support in order to save the taxes?**

**Feder:** Absolutely. When they passed Section 21 of the Internal Revenue Code in 1984 - the domestic relations reform act - they knew people were going to try to deduct child support. Not all alimony is deductible. You have to meet the requirements of Section 71, which exempts child support.

The federal government also requires the states to have guidelines for welfare. All states in the country have some form of guidelines. If the Internal Revenue Service wants to become extremely aggressive, they can say it is your

obligation under state guidelines and the federal government requires the guidelines to be mandatory. They could start to attack what the taxpayer paid and end up disallowing the full amount from any of the alimony.

Secondly, even though alimony is deductible, the payee pays income tax on it. If there is a child support element, they don't want to pay taxes on child support. Child support is neither deductible by the payor nor income to the payee. Can you declare it? Yes. Are you likely to be facing penalties in interest? Unless you have an extremely well compensated former spouse who happens to like you still, then you're going to face penalties, interest, and other sanctions from the Internal Revenue Service because the recipient spouse is unlikely to report it. When you deduct alimony, you have to report the recipient's Social Security number. The computer checks to see if those numbers match and spits them out if it doesn't like what it sees. You are asking for trouble if you try to deduct child support.

### **What if one spouse files for bankruptcy? Will this affect his or her obligation to pay child or spousal support?**

**Feder:** Under the tax bankruptcy format, any obligation that arises under a divorce decree is not dischargeable in bankruptcy. There might be certain limited exceptions, but that's something a bankruptcy attorney should be asked about because it has become such a specialized area. Most family lawyers do not practice bankruptcy. They all have a general knowledge of it, but will refer to the specialist who knows the ins and outs of bankruptcy court, which is its own entity separate from state courts.

### **In the case where two spouses own a business together, how will a judge split it during divorce?**

**Feder:** First, they must have the business valued. One party can be willing to take the business and pay the former spouse for their share in cash or in other property. The difficulty for the person taking the business is that those payments are not deductible and it doesn't give them a basis in the business. Most small businesses have very little equity or basis in the business, so the person retaining the business may have a zero base when they want to sell it. If they sell it for \$100, they're going to pay taxes on \$100. Meanwhile, they've already paid \$50 to their spouse for their one half of the interest.

The person who receives the business is not going to receive 50% of it, but they're going to take all the tax consequences. They have to weigh whether the future income they can earn is sufficient to overcome the tax disadvantage of owning the business and having all the gain tied up in it taxed to them alone instead of to their spouse.

The court could also order the business sold. The problem is that when you sell a business, it's unlikely to bring in its fair market value. You end up with one or two unemployed spouses, because they're not likely to continue in the business if they sell it. I have a current case where the judge also wanted to know the liquidation value for the business, which brings in the least value to the business.

There are certain ways you can handle it tax-wise, but it requires an agreement between the parties. A judge cannot order it, but the parties could agree that if the business is worth a half a million dollars and each spouse is entitled to \$250,000, one party may take the business and make the payments to the other spouse tax deductible so the other

spouse will pay it. The savings of not having to pay \$250,000 in post-tax dollars to their former spouse, which might cost that taxpayer \$400,000 in pre-tax dollars, means they might say, "I will pay \$300,000, but I can deduct it and you will pay the taxes when you receive the payments." If it's timed properly, then the spouse who's receiving payments, being in a lower tax bracket, can end up receiving the \$250,000 and paying \$50,000 in taxes, but the former spouse will save \$50,000.

One of the biggest problems when the court divides the businesses is how to fund the buyout. The business owner has to pay the spouse and pay taxes on that amount. There's a disadvantage because they may take too much money out of the business and literally kill the golden goose.

**Many people worry their spouse will try to hide assets during the divorce process. How can someone be sure this isn't happening and they're going to get their fair share?**

**Feder:** When there's a suspicion of hidden assets, we recommend that our client hire a forensic accountant to start reviewing tax returns and other information that the person will have available to them to see if there truly are hidden assets - at least those that are discoverable.

If somebody has \$50,000 in a Swiss bank account, it's almost impossible to find that information because it's not going to be reported on a tax return. If someone is going to hide money, they're going to hide it from the government as well as from their spouse.

The 1040 tax form is designed to tell the federal government what you own. If you have property taxes of \$6,000 and the home property tax is only \$3,000, a forensic accountant will come in and ask the logical question: what else are you paying property tax on? The property taxes do not equal what you're reporting you own. Forensic accountants are good at finding hard assets. It's very hard to find hidden cash unless it's in an American bank and the interest is being reported.

You run into a different problem if one spouse says, "I know my ex has a Swiss bank account." The person will testify there is money hiding and they want their half of it. Certain judges will say, "Fine, but I'm taking this transcript and sending it to the IRS. You knew you were hiding money; you weren't paying your taxes. I pay my taxes; you need to pay your taxes." Sometimes when a party has a suspicion about hidden assets, they get into problems for admitting under oath that they knew there were assets and they weren't reporting the income. It's a catch-22.

**What is the difference between marital and separate property?**

**Feder:** In New Mexico, community property is defined as property that is not separate property. Separate property is relatively easy to identify: it's property owned by either spouse before marriage or received after entering a divorce decree. It's property that the parties designate between themselves in writing to be separate or it's property they receive by gift, inheritance, devise, or descent during the marriage.

The hard part in going between community and separate property is that New Mexico separate property also includes the rent, issues, and profits from separate property - rents dealing with real estate investments, issues dealing with cattle and agriculture, and

the profits dealing with stock investments. Property acquired during marriage in New Mexico is presumed to be community property unless you can show it's separate property.

In other words, if you receive \$10,000 in inheritance, all you would have to show is that you received \$10,000 as inheritance and you broke the bubble that presumed it was community property during the marriage. The other difficult area between community and separate property is looking at how the parties handled the property during the marriage. If the husband had \$10,000 in his checking account where he puts his wages, and five years later the parties are getting divorced, he might try to say, "I had \$10,000 in separate property in that account that before we got married and I want it back." It's the duty of the person who is claiming separate property to trace the separate property. The party would have to show that the account never went below \$10,000 and they never intended to make a gift.

Parties do prenuptial agreements outlining separate property and everyone would agree by law that it is separate, but unless they keep it segregated, it may lose its separate property character to a process called transmutation. A house is an easy situation because you still own the house, but it can be very hard to trace when dealing with fungible goods like cash or wages.

**Let's say one spouse took \$50,000 earned before marriage from her mutual fund account and used it to buy a vacation property with her spouse. They sell that property 10 years later and she takes that \$50,000 from the proceeds and puts it back into the mutual fund account that she has kept solely in her name for the marriage. What happens when they get divorced? Is the entire mutual fund still her separate property or is the \$50,000 considered separate property?**

**Feder:** I'm going to make a presumption that the vacation property they bought went up in value. If it went up \$50,000 in value, they can trace it. They took \$50,000 of separate funds, put it into the property, and when it sold they took their \$50,000 back - they have traced the source of funds. It's likely the other spouse will say it was a gift. The courts will look at what type of property it was. If it was a vacation home, they may not find it was a gift. If they took \$50,000 and bought a marital home together in joint names, then the court can say, "When you put the \$50,000 in the house, you intended to give to the community." It's going to be based upon the testimony of the parties and what type of asset it is. If it's a boat or something of that nature, they may be much more immutable to find it is separate property, because it's not a basic property like a house.

In your example, she can trace the \$50,000 check into the vacation property from her mutual fund written to the company that sold them the property, so she's likely to be able to take the \$50,000 and keep her separate property interest.

**If one spouse receives annual bonuses that he puts into a savings account in his name only during the marriage, are these funds considered community or separate property?**

**Feder:** They would be community property, because they are from his labors and efforts. They were earned from bonuses. Title in and of itself is only some evidence of ownership in New Mexico. You would look at the source of the funds, so it belongs to the community since it was earned through his labor. The next question is once he puts

his bonus into a separate fund, do those so funds become mingled? The funds that were originally there would be transmuted into community property. He may think he is preserving the funds as his own, but all the funds he had in that account end up becoming marital or community property.

**How can someone protect their credit rating as they go through a divorce?**

**Feder:** If you're a higher income person and credit is more important, ensure the bills get paid as part of the divorce process. We have what's called interim division of income in New Mexico. The community income is thrown into a pot and fixed bills are paid off the top, including minimum credit card payments, car payments, utility payments, life insurance, and car insurance - the normal necessary expenses. What's left of the community income is then split equally.

If you want to protect your client's credit rating, then on his or her side of the ledger include all of the minimum payments for the credit card debts and the house payment, and hopefully your client will pay them in a timely manner. Quite often the other side has a choice between enjoying a great sale over at Dillard's or making the credit card payment; or between taking a girlfriend to Las Vegas or making the house payment. What are they going to do? They may make the payment.

To protect credit, you should try to have your client make the payments that need to be made - at least during the interim between the filing of the divorce and the final decree. It's important that they take responsibility while also protecting their own credit.

**For more information about Jon and his firm, please visit [www.atkinsonkelsey.com](http://www.atkinsonkelsey.com).**