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White Paper

Divorce and Tax Planning

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Divorce and Tax Planning

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Alimony: Tax Planning

What is alimony?

Generally, alimony is a support payment made to a former (or separated) spouse under a divorce decree (or separation instrument) in an attempt to maintain the predivorce lifestyle. Alimony is determined by state law and is sometimes called maintenance. It is based on one party's need and the other party's ability to pay. If you're contemplating a separation or divorce, you should understand the tax treatment of alimony.

What is the basis for receiving alimony?

Deciding whether a spouse should receive alimony (and, if so, how much) is based on certain criteria that can vary from state to state. Alimony essentially allows one spouse with limited means to benefit from the earning power (acquired during the marriage) of the other spouse. In a long-term marriage, for example, often the wife has not worked outside the home or perhaps has spent many years at home caring for the children. As a couple, she and her husband may have decided that she would be responsible for caring for the children and/or running the household. These responsibilities limit her ability to build a career and can leave her in dire straits if the marriage ends.

Alimony is awarded based on any of the following criteria:

- **Need**--One of the most important reasons for alimony is that the recipient-spouse needs enough money to take care of basic needs, such as food, shelter, clothing, and utilities. Obviously, the state has an interest in keeping residents off of public assistance, and although child support is a separate issue,

courts will certainly consider the existence of minor children when considering a spouse's financial need for alimony. In considering the appropriateness of alimony, courts will evaluate a prospective recipient's current sources of income, such as wages or salary, earnings from property received in the property division, and earnings from separate property (such as a trust fund).

- **Ability to pay**--The next consideration is whether the payor spouse can afford to pay what is needed and still have enough money left over to live on or to support a lifestyle somewhat similar to his or her previous one. The needs of both spouses are important.
- **Prior lifestyle**--Because courts will also consider how the spouses were accustomed to living during their marriage, it's clear that alimony isn't based simply on need. For example, if John is a Hollywood star earning \$3 million per year, he'll have a hard time convincing a judge that his former spouse, Mary, should only be paid \$35,000 per year in alimony.
- **Length of marriage**--A marriage that lasts for only a year or two may not qualify for alimony, but a 30-year marriage probably will. This is because a longer marriage will illustrate more sacrifice and dependency of the spouses and will likely involve the sacrifice of one career for management of the home and/or child rearing.
- **Age and health**--Courts will also look at the respective ages and health of the spouses when determining alimony. A judge will want to know whether either party is disabled or retired. If retired, what sources of income exist? If both parties are young, able-bodied, and college-educated, alimony might not be awarded. However, if one spouse is a 58-year-old homemaker with health problems, it might be difficult (if not impossible) for him or her to find adequate employment. In such a case, an award of permanent alimony might be appropriate.
- **Contribution to education**--The courts will also consider whether a spouse contributed to the education, training, or career advancement of the other spouse. Often, one spouse will work while the other pursues a college or graduate degree. When the degreed spouse obtains a well-paying position, the working spouse might stay home to care for the children or may continue to work in a low-paying job.

What types of alimony exist?

Alimony may be classified as rehabilitative, permanent, modifiable, or nonmodifiable.

- **Rehabilitative**--Rehabilitative alimony may be defined as a temporary financial award to help a spouse until such time as he or she can become self-sufficient. If one party was the primary breadwinner for the couple, it's unrealistic to expect that the other spouse could automatically earn the same amount

of money after the divorce. Rehabilitative alimony can help a former spouse get a college degree or take courses to update old skills. Ideally, the payments would continue while the spouse gained some working experience. Note that some states do not allow for rehabilitative alimony.

- **Permanent**--As was mentioned earlier, permanent alimony may be appropriate when the spouses are older and one party has sacrificed career for family. That party simply doesn't have the ability to get hired late in life (with no experience) in a lucrative position. Permanent alimony may also be appropriate when the recipient spouse is disabled or has health problems.
- **Modifiable**--Modifiable alimony simply means that the alimony award can be changed (i.e., increased, decreased, or terminated). A change of circumstances can warrant a change in alimony. For example, the payor spouse may become unemployed, or the recipient-spouse may suddenly become disabled or ill and unable to seek employment. Additionally, the recipient-spouse might win the lottery or receive an inheritance. After the divorce is finalized and an order of support has been made, a modifiable arrangement will allow either spouse to go back into court to ask for a modification.
- **Nonmodifiable**--Nonmodifiable alimony is not often used, since it is difficult to predict the future. Still, its value is that it provides some security or peace of mind for the recipient. If the divorce decree states that the wife is entitled to ten years of nonmodifiable alimony, for instance, she knows she can count on that money and will continue to receive it, even if she gets remarried.

Do relocation and/or remarriage affect alimony?

Relocation of one or both of the spouses doesn't affect alimony. If you obtained a judgment in one state and have since moved to another state, state laws allow you to file the judgment in the second state and enforce it there. However, if the recipient-spouse gets a roommate or shares rent with someone else, the payor spouse might be able to get a reduction in monthly alimony payments. The presumption is that you need less financial support, since your rent has been lowered.

Unlike relocation, remarriage most certainly affects alimony. In fact, remarriage of the recipient-spouse will usually cause a termination of the payor's alimony obligation (unless alimony is nonmodifiable). The written agreement between the parties will specify the conditions that will terminate the alimony.

When can alimony be terminated?

Alimony will cease upon the death of the payor or recipient. Alimony can also be terminated on the conditions agreed upon by the parties.

Is it possible to guarantee alimony payments?

Because alimony terminates on the death of the payor, it's advisable for the recipient to take measures to ensure a continued income stream in the event of the payor's death. This can be accomplished by using such tools as life insurance, disability insurance, and annuities.

- Life insurance--You can stipulate in the divorce decree that life insurance will be carried on the life of the payor to replace alimony in the event of his or her death. If you're going to purchase a new policy, be sure you do it before the divorce is final. This is because health and insurability aren't predictable.

The recipient-spouse should either own the life insurance policy or be an irrevocable beneficiary in order to ensure payment of the premiums and to create favorable tax treatment for the payor of the premiums. Regarding the tax aspect, the insurance premiums will be construed as alimony (i.e., they'll be tax-deductible to the payor and income to the recipient) if the beneficiary-spouse owns the policy (or is an irrevocable beneficiary) and the premiums are made under a legal obligation imposed by the divorce decree.

- Disability insurance--While a former spouse can't own a disability policy on his or her ex-husband or ex-wife, the former spouse can pay the premiums on the policy to ensure that it stays in force. Disability insurance can be an important consideration.

Example(s): Assume John agreed to pay his ex-wife, Mary, \$2,000-per-month alimony, based on his \$7,000-per-month salary. John suffers an accident and becomes disabled. If he has no disability insurance and no salary, he can go back to court to get his alimony obligation modified. However, if he had appropriate disability insurance, it's possible that he might receive \$5,000 per month tax free and could continue paying alimony.

- Annuities--The payor spouse can also choose to buy an annuity that pays a monthly sum equal to the alimony payment. For example, the payor spouse can buy a \$200,000 annuity that pays out \$700 per month (the agreed-upon alimony amount) in interest only. If the payments are interest only, they are taxable to the payor spouse as income and are also deductible as alimony. The payments will be treated as income to the recipient spouse.

How is unpaid alimony collected?

Unfortunately, an award of alimony doesn't guarantee the actual receipt of alimony. There are a number of methods for enforcing alimony orders, including contempt of court proceedings, garnishment of wages, and the placement of liens on property. (In those cases where a spousal award contains both a child support portion and an alimony portion, see Child Support for additional methods of collecting past due amounts.)

- Contempt of court--If a judge orders a spouse to pay a particular amount of periodic alimony and that order is ignored, the recipient spouse can file an action, asking that the other party be held in contempt. A hearing will be scheduled, and if the delinquent spouse fails to attend, a warrant may be issued for his or her arrest. The payor spouse can be jailed, or the judge may order him or her to make future payments in a timely manner and to pay the arrearage according to a set schedule. The judge can also order that the payor spouse's wages be garnished or can place a lien on his or her property. The judge may also order the payor spouse to pay the legal fees of the recipient spouse.
- Wage garnishment--With this method, a portion of the payor spouse's wages is removed from his or her paycheck at the source and delivered to the recipient spouse (or to the court). To garnish wages, the recipient-spouse obtains authorization from the court to seize a percentage of wages. Typically, a sheriff notifies the payor-spouse's employer of the garnishment. Once the employer has been instructed to garnish wages, the employee will be informed.

Of course, the payor spouse can request a court hearing to oppose the garnishment, presenting a number of objections. For example, he or she can assert that the amount owed was calculated incorrectly or that the amount to be deducted will leave him or her with an insufficient amount to live on.

- Property liens--In some states, a spouse who's owed alimony can ask the court to grant a lien on the real or personal property of the payor spouse. For example, a real estate attachment may prevent

the property owner from refinancing or selling his or her house until the lien has been paid off. Sometimes, the recipient-spouse can even force a sale of this property to satisfy the lien.

What are the tax ramifications of alimony?

Simply stated, alimony is taxable income to the one who receives it and tax-deductible to the one who pays it. But to be considered alimony under present tax rules, the payments must meet all of the following requirements:

- All payments must be made in cash, check, or money order (alimony payments must take the appropriate form; transfers of services or property don't qualify as alimony)
- There must exist a written court order or separation agreement

Example(s): John is ordered to pay Mary \$800 per month in alimony for seven years. Three years after their divorce, Mary loses her job and convinces John to increase her alimony for six months so she can find a new position. John sends her an extra \$200 per month for the next six months. At tax time, John tries to deduct this extra money as alimony. However, the IRS will disagree. Since the extra payments were not made under the terms of a divorce or separation instrument, John can't deduct the extra money as alimony.

- The couple can't opt out of alimony tax treatment by agreement after the fact--If a recipient of alimony payments doesn't wish to report the money as taxable income and the payor spouse agrees not to take a tax deduction, it doesn't matter; the payments are still taxable to the recipient and deductible by the payor. However, in the divorce decree itself, spouses may designate payments as "not alimony" even though the payments would otherwise qualify as alimony. Such payments are not taxable to the recipient or deductible by the payor.
- The divorced couple can't stay in the same household--Sometimes, a couple gets divorced but neither party can afford to move out. Consequently, they might agree to live together. If alimony is paid, the payor will not be able to deduct it on his or her federal income tax return and the recipient will not include it in income. Living in the same household prevents this tax treatment.
- The obligation to pay alimony must end at death of spouse--The obligation to make payments ceases upon the death of the payor or the recipient.

- The former spouses may not file a joint tax return--Many couples mistakenly file a joint return for the year they get divorced; this is incorrect. Filing status will be determined by their marital status on the last day of the year (December 31).
- If any portion of the payment is considered to be child support, that portion can't be treated as alimony. Sometimes an order for spousal support will not use the words "child support," but a portion of the payment can be inferred to be child support nevertheless. For more information, see Child Support.

Note: Different rules may apply if your divorce was finalized before 1985. For more information about previous rules, contact an attorney.

What are the recapture rules?

The tax deductibility of alimony may encourage the spouses to disguise property settlement payments as alimony, so, the law provides alimony recapture rules. Alimony recapture is calculated by looking only at the first three calendar years during which deductible alimony was claimed. Therefore, any alimony payments made after the third calendar year are not subject to the recapture rules.

Alimony recapture rules require deductible alimony payments during the first three years to be structured so that payments are substantially equal. However, alimony payments of less than \$15,000 per year aren't subject to the recapture rules. The goal is to prevent "front-loading" of alimony. Deductible alimony payments will be recharacterized as nondeductible property settlement payments to the extent that payments made during the first two years are excessively front-loaded. In other words, high sums of alimony are paid during the first two years.

There are four exceptions to the recapture rules. The recapture doesn't apply:

- If either spouse dies during the first three years and the payments cease by reason of that death
- If the recipient-spouse remarries during the first three years and payments cease by reason of the remarriage
- To temporary support payments made pursuant to a court order

- To payments that fluctuate for reasons not in control of the payor spouse

Example(s): Ray agrees to pay Dorothy 25 percent of the net income from his farm each year for three years. In the first year, his net income is \$120,000, so Dorothy gets \$30,000. In the second year, severe weather wipes out many crops, and the net income is only \$32,000, so Dorothy gets \$8,000. In the third year, the farm suffers a loss rather than net income, so Dorothy gets nothing. In this case, no recapture will be required.

For more information about the recapture rules, contact an attorney or accountant.

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Child Support: Tax Planning

What is child support and who is responsible for paying it?

Every parent is obligated to financially support his or her children, providing such necessities as food, clothing, shelter, etc. Divorce doesn't cause this obligation to cease. When a divorce occurs, the

noncustodial parent is usually ordered to pay some child support to the custodial parent; the rest of the child's expenses are paid by the custodial parent.

Child support may end at the child's 18th birthday, although some states set a cutoff at 21 years of age if the child is principally dependent on one parent (absent an agreement between the parties for a higher age). Also, some courts may order that child support continue until the child has graduated from college.

Tip: Some courts may also order child support to continue if the child has significant special needs.

How do you determine the amount of child support?

The amount of child support that the noncustodial parent pays to the custodial parent can be simply a matter of agreement between the parents or it can be ordered by a judge. All states now have child support guidelines that help the court decide the amount of child support to be paid. However, there can exist considerable variation among states regarding the precise formula used to determine child support. Judges will carefully review agreements by the parents to ensure that the best interests of the child (or children) are kept in mind.

Often, the support obligation of each parent is based on the ratio of each parent's income, the percentage of time the child spends with each parent, the number of children, and the amount of alimony paid (if any). A child support worksheet is provided by the court to determine the amount. To complete a typical worksheet, each parent must determine his or her weekly (or monthly) available income (gross income minus taxes, Social Security, and other mandatory deductions). Optional deductions (like contributions to a 401(k) plan) aren't deducted.

When both parents are working, one method of determining support assigns a percentage of child-rearing costs to each parent based on his or her proportionate contribution to household income. When only one parent is employed, the amount of child support is assigned after determining the basic living expenses necessary for that parent.

Example(s): Assume Mary and John have two children and are seeking a divorce. Mary will have custody of the kids. Mary grosses \$900 per month and John grosses \$4,300, for a combined total of \$5,200. Thus, John earns 83 percent and Mary earns 17 percent of the total. Their particular state mandates that a household with two children should provide \$983 per month to maintain two children. Since 83 percent of \$983 is \$813, John owes Mary \$813 per month in child support.

Because there are a number of methods for determining the amount of child support to be paid, it is necessary for you to consult with the child support guidelines and worksheets provided by your own state. You should be able to obtain a worksheet at the probate court for your county.

Can you modify a child support order?

Child support orders can be modified by a court even after a divorce has been finalized. The basis for modifying a child support order is that there has been a substantial change in circumstances for one or both parties. For example, perhaps the father lost his job after the divorce or the mother got a big raise or won the lottery. In general, a substantial change in circumstances may be defined as any change that significantly increases living expenses or increases (decreases) the income of a parent. Of course, a modification can also be sought if one parent fraudulently failed to disclose all of his assets and income when the child support worksheet was completed.

Your request for modification of child support will be either contested or uncontested. Courts often provide a standard form for modifying child support--you fill in all relevant information (including how circumstances have changed) and check off a box to indicate whether the matter is contested. In an uncontested case, the parents will voluntarily agree so there will be no opposition motion or pleading filed. In a contested matter, you will have to take your dispute to court. Keep in mind that once a court sets a support order, only a court can modify it. If you make an informal modification and your ex-spouse changes his or her mind, you won't have any protection regarding an arrearage.

Who pays for the child's medical expenses, education, and other incidentals?

The provisions of your child support agreement must be specific and free of ambiguities in order to prevent disagreement at a later date. Try to anticipate future expenses. For example, dental bills can normally be expensive for children since braces are often needed. Medical insurance is also vital. In some families, a college education is expected and viewed as a necessity. Finally, paying for day care or other forms of child care when both parents work is also a significant expense and should be considered in any agreement.

If one parent is working and the other stays at home to care for the children, it's probably advisable to provide in the child support agreement that the working parent maintain health and dental insurance for the children on his employer plan. For high-net-worth families, the agreement might provide that the party with the higher income completely subsidize college education for the child (or children). On the other hand, perhaps each party will agree to pay a percentage of the college costs. Other questions you might want to consider include:

- Who will be responsible for repaying student loans
- Who will be responsible for subsidizing graduate school (if any)
- Who will pay for SAT preparation courses

Naturally, if the parents can't reach an agreement on these incidentals, it will be up to the judge to decide. Few, if any, states require payment for graduate school.

Finally, you should consider the issue of insurance--both life and disability insurance. A child support agreement will do you little good if the noncustodial parent dies or becomes severely disabled and unable to work. The settlement agreement can require the parent paying child support to purchase life and disability insurance to protect the income stream. If you suspect that the premiums won't be paid, you (the spouse receiving support) can own the policies and pay the premiums.

How is unpaid child support collected?

Unfortunately, an award of child support doesn't guarantee the actual receipt of support. There are a number of methods for enforcing child support orders, including garnishment of wages, interception of tax refunds, commencement of contempt of court proceedings, public humiliation, the placement of liens on property, and the denial of state licenses. For more information, see *Divorce and Risk Management*.

Wage garnishment

The most common method of collecting a judgment for child support is a wage garnishment. Here, a portion of the noncustodial parent's wages is removed from his or her paycheck at the source and delivered to you; with unpaid child support, up to 50 percent of net wages can be taken. To garnish wages, the custodial parent obtains authorization from the court to seize a percentage of the noncustodial parent's wages. Typically, a sheriff notifies that parent and his or her employer of the garnishment. Once the employer has been told to garnish wages, the employee will be informed.

Of course, the noncustodial parent can request a court hearing to oppose the garnishment and present a number of objections. For example, he or she can assert that you incorrectly computed the amount owed or that the amount to be taken will leave him or her with an insufficient amount to live on.

Intercepted tax refunds

Federal and state income tax refunds may be intercepted by the IRS and state departments of revenue and forwarded to your district attorney's office (or other state office charged with overseeing child support enforcement). The appropriate office will see that you get the money.

Before a refund is intercepted, the debtor will receive a written intercept notice, notifying him or her of a chance to request a hearing to object to the intercept. Relevant grounds for an objection include that the amount of the back support has already been paid or that the notice requests more than what is owed.

If the payer spouse is remarried and files a joint tax return, and that spouse's refund is intercepted, his or her new spouse's share of the federal refund can generally be returned. The new spouse should file

IRS Form 8379 (Injured Spouse Claim and Allocation) and attach it to the tax return. For more information, see Tax Planning for Marriage and Divorce.

Contempt of court

If a judge orders a parent to pay a particular amount of periodic child support and the parent doesn't pay, the parent who's owed the child support can file an action before the court to ask that the other party be held in contempt. A hearing will be scheduled, and if the delinquent spouse fails to attend, a warrant may be issued for his or her arrest. The delinquent party can be jailed, or the judge may order him or her to make future payments in a timely manner and to pay the arrearage as well according to a set schedule. The judge can also order the delinquent spouse's wages withheld, place a lien on his or her property, or order him or her to post a bond. In addition, the judge can order the delinquent spouse to pay the opposing party's legal fees.

Public humiliation

In recent years, states have come up with more creative ways to obtain back child support. For example, most state child-support enforcement agencies now publish a "Most Wanted" list of parents who owe substantial child support, posting photographs and amounts owed.

Property liens

In some states, a custodial parent who is owed child support money can ask the court to grant a lien on the payer spouse's real or personal property. A real estate attachment, for example, may prevent him or her from refinancing or selling the house until the lien has been paid off. Sometimes the custodial parent can force a sale of the payer spouse's property to satisfy the lien.

Denial of state license

In a number of states, the debtor-parent's professional license (e.g., doctor's license, attorney's license, etc.) will not be renewed by the state if substantial back child support is owed. Some states will even fail to renew driver's licenses.

Can relocation and/or remarriage affect a child support order?

Relocation of the parties and/or remarriage don't affect child support orders. The natural parents of a child continue to be responsible for support of the child, even if the custodial parent remarries. However, if the custodial parent moves out of state with the children, a noncustodial parent's increased transportation costs to visit with his or her children may constitute a substantial change in circumstances and warrant a decrease in child support.

Regarding arrearages in child support payments, even if a judgment was obtained in one state and the payer spouse has since moved to another state, state laws allow the custodial parent to file the judgment in the second state and enforce it there.

What are the tax ramifications of child support?

Briefly put, child support is not taxable to the one who receives it, nor is it deductible to the one who pays it.

Is it child support?

For payments to be classified as child support, the divorce decree or separation agreement must:

- Fix a sum that is payable for the support of a child (this can be either a dollar amount or a specific fraction of a payment). For example: Husband will pay \$500 per month child support to Wife.

- Provide that the amount payable by the payer spouse to the receiving spouse will be reduced in the event of some contingency relating to a child (such as the child's marrying, dying, leaving school or reaching a designated age). For example, Husband will pay \$500 per month child support to Wife until child reaches age 18.

OR

- Provide that the amount payable by the payer spouse to the receiving spouse will be reduced at a time that can clearly be "associated with" a contingency relating to a child.

Example(s): Husband agrees to pay Wife \$2,500 per month until she dies. (The words "child support" are not specifically mentioned.) Wife has custody of the couple's child, Justin, who was born on October 20, 1990. The divorce agreement states that on January 1, 2009, Husband's required payment to Wife will decrease to \$1,700 per month. Because Justin will turn 18 years old within six months of the date on which the payment is scheduled to decrease, the payment reduction is assumed to relate to Justin's reaching 18 years old. Therefore, the \$800 per month reduction is treated as child support unless the parties can rebut this presumption.

In this example, part of the husband's payment is characterized as alimony and part as child support. For information about alimony, see Alimony.

Who can claim an exemption for the child as a dependent on the federal income tax return?

The general rule is that unless otherwise specified, the dependency exemption usually goes to the parent who has physical custody of the child for the greater part of the calendar year (i.e., the custodial parent), regardless of how much support was provided by each parent.

Example(s): Frank and Liz separated in May. Their daughter, Carol, lived with Liz for the rest of the year, and Frank provided all the support for Liz and Carol that year. Because Carol lived with Liz longer than she lived with Frank, Liz may claim the dependency exemption, even though she made no actual financial contribution toward Carol's support.

However, there are circumstances when the noncustodial parent can claim the dependency exemption instead of the custodial parent. To do so, the noncustodial parent must meet one of the following conditions:

- The custodial parent must sign a written declaration that he or she will not claim the exemption for the child for the tax year, and the noncustodial parent must attach this declaration (IRS Form 8332) to his or her tax return, or
- A qualified pre-1985 instrument between the parents must provide that the noncustodial parent can claim the child as a dependent (the noncustodial parent must also have provided at least \$600 for the support of the child during the year).

Note: Once the minor child reaches majority age under state law, the exemption goes to the parent who actually provides more than 50 percent of the child's support.

Child-care credit

A custodial parent who pays child-care expenses so that he or she can work may be eligible for a tax credit for a portion of those expenses--up to 35 percent, depending on income. The qualifying expenses on which that percentage is based are limited to \$3,000 for one qualifying dependent, or \$6,000 if there is more than one dependent. For additional details, see Child and Dependent Care Credit.

Only the custodial parent is entitled to claim both the child and the dependent care credit. This is true even if the custodial parent does not claim the dependency exemption for the child. A noncustodial parent may not claim a child-care credit for expenses incurred even if that parent is entitled to claim the exemption for the child.

Example(s): Assume John and Mary have a son, Benny, who lives with Mary four days a week and with John three days a week. John and Mary are both singers and work outside the home. Each parent pays half of the \$4,000 per year that it costs to keep Benny in day care during the week. Mary is entitled to claim a child-care credit for her share of the day-care expenses. She's considered the custodial parent because Benny spends a greater portion of time with her than with his father.

Head of household filing status

The head of household filing status is available for those who are unmarried (or treated as unmarried for tax purposes) at the end of the calendar year, who provide more than half the cost of maintaining the household, and whose household is the principal home of at least one qualifying person for more than half of the year. (A qualifying person is their child or any other person who qualifies as their dependent.)

Example(s): John and Sue have an eight-year-old son, Tim. John and Sue obtained a divorce on January 1, 2006, and Sue was awarded custody of Tim. Tim lived with Sue throughout the year. When Sue files her 2006 tax return, she can claim head of household filing status.

The head of household filing status is also available to a married (separated) taxpayer under certain circumstances. The taxpayer must meet all of the following tests:

- The taxpayer's spouse did not live in the taxpayer's household at any time during the last six months of the calendar year
- The taxpayer files a separate return for the year
- The taxpayer maintains his or her home as a household that was the main home for a child stepchild, or adopted child for more than half of the year (a foster child must be a member of the household for the entire year)
- The taxpayer is entitled to claim the child as a dependent
- The taxpayer provides more than 50 percent of the cost of maintaining the household

For more information, see Head of Household.

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Dependency Exemptions: Divorce

What is a child dependency exemption?

If a separated or divorcing couple has children, an important tax decision involves assignment of the child dependency exemption. Exemptions are fixed amounts that you subtract from your adjusted gross income (AGI) to calculate taxable income. In 2008, you can deduct \$3,500 for each exemption you claim (up from \$3,400 in 2007). Along with personal exemptions, you're generally allowed one exemption for each person you can claim as a dependent. To claim a dependency exemption, you must first have a "qualifying child" or a "qualifying relative." In making this determination, special rules apply to separated or divorced parents. For purposes of this discussion, it is assumed that the child is a "qualifying child" of one or both parents and not a "qualifying relative."

For more information on the dependency exemption, including the tests to determine who is a "qualifying child" or a "qualifying relative," see Deductions: Personal Exemptions and Dependents, as well as IRS Publication 501 entitled Exemptions, Standard Deduction, and Filing Information.

Who can claim the child dependency exemption?

Assuming you have a child who is under age 19 at the end of the year (or a full-time student under age 24 at the end of the year, or a child who is permanently and totally disabled at any time during the year, regardless of age), the general rule for separated or divorced parents is that the custodial parent (the one with whom the child lived for the greater part of the year) is typically the one who claims the dependency exemption, regardless of how much support was provided by each parent.

Example(s): Frank and Liz separated in May. Their daughter, Carol, lived with Liz for the rest of the year, but Frank provided all the financial support for Liz and Carol that year. Because Carol lived with Liz longer than she lived with Frank, Liz may claim the dependency exemption, despite the fact that she made no actual financial contribution toward Carol's support.

What are the exceptions to the general rule?

There are exceptions to the general rule that the custodial parent is the one who claims the dependency exemption. Specifically, a child will be treated as the "qualifying child" of the noncustodial parent if one of the following conditions is met:

- The custodial parent must sign a written declaration that he or she will not claim the exemption for the child for the tax year, and the noncustodial parent must attach this declaration (IRS Form 8332) to his or her tax return, or
- A qualified pre-1985 instrument between the parents must provide that the noncustodial parent can claim the child as a dependent (the noncustodial parent must also have provided at least \$600 for the support of the child during the year).

Does the child dependency exemption affect your ability to claim the child-care credit?

A custodial parent who pays dependent child care expenses so that he or she can work may be eligible for a tax credit for a portion of those expenses--up to 35 percent, depending on income. The qualifying expenses on which that percentage is based are limited to \$3,000 for one qualifying dependent, or

\$6,000 if there is more than one qualifying dependent. To claim this credit, the parent must maintain a household that is the home of at least one dependent, and the day-care expenses must be paid to someone who's not claimed as a dependent. For more information, see Child and Dependent Care Tax Credit.

Only the custodial parent is entitled to claim the child and the dependent care credit. This is true even if the custodial parent doesn't claim the dependency exemption for the child. A noncustodial parent may not claim a child care credit for expenses incurred even if that parent is entitled to claim the exemption for the child.

Example(s): Assume John and Mary have a son, Benny, who lives with Mary four days a week and with John three days a week. John and Mary are both singers and work outside the home. Each parent pays half of the \$4,000 per year that it costs to keep Benny in day care during the week. Mary is entitled to claim a child-care credit for her share of the day-care expenses; John is not entitled to claim his portion. She is considered the custodial parent because Benny spends a greater portion of time with her than with his father.

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State, national and international laws vary, as do individual circumstances; so always consult a qualified investment advisor, attorney, CPA, or insurance agent on all investment, legal, tax, or insurance matters.

The effectiveness of any of the strategies described will depend on your individual situation and on a number of other factors. After reviewing your personal situation, we may recommend that you not use any strategy in this document but instead consider various other strategies available through our practice.

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