Virginia Society of Enrolled Agents

Your Practice and Your Divorcing Clients

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Learning Objectives

1) Understand when you need a signed conflict of interest statement
2) Make yourself a resource of information
3) Learn how to assist lawyers during the divorce to provide the best situation for the taxpayers
4) Determine when tax items need to be addressed
5) Translate between the lawyer and the tax code

Conflict of Interest

The conflict discussion in Circular 230 is pretty short so it is all included here.

> ***§ 10.29 Conflicting interests.***
>
> *(a) Except as provided by paragraph (b) of this section, a practitioner shall not represent a client before the Internal Revenue Service if the representation involves a conflict of interest. A conflict of interest exists if — (1) The representation of one client will be directly adverse to another client; or (2)There is a significant risk that the representation of one or more clients will be materially limited by the practitioner's responsibilities to another client, a former client or a third person, or by a personal interest of the practitioner.*
>
> *(b) Notwithstanding the existence of a conflict of interest under paragraph (a) of this section, the practitioner may represent a client if — (1) The practitioner reasonably believes that the practitioner will be able to provide competent and diligent representation to each affected client; (2) The representation is not prohibited by law; and (3) Each affected client waives the conflict of interest and gives informed consent, confirmed in writing by each affected client, at the time the existence of the conflict of interest is known by the practitioner. The confirmation may be made within a reasonable period of time after the informed consent, but in no event later than 30 days.*
>
> *(c) Copies of the written consents must be retained by the practitioner for at least 36 months from the date of the conclusion of the representation of the affected clients, and the written consents must be provided to any officer or employee of the Internal Revenue Service on request.*
>
> *(d) Effective/applicability date. This section is applicable on September 26, 2007.*

What happens when your married clients decide to divorce? You are immediately in a conflict situation, but you are also in the best position to help. Even if the couple claims they are cordial and want to file jointly, <u>immediately</u> get a Conflict of Interest Disclosure Letter signed by both of them. (A sample letter is in Appendix A.)

Pros of working with both spouses:

- Know if the other spouse itemized
- Know if the children were claimed by the other spouse

- Know if the carry overs (capital gains/losses, refunds, unclaimed passive losses, etc.) were claimed
- Know if joint assets were fully claimed, partially claimed, or not claimed
- Know any alimony claimed as a deduction aligns with alimony claimed as income (remember, even post 2018, some states allowed deductions of alimony)

Cons of working with both spouses:

- Allocations of carry overs and joint accounts likely to benefit one spouse over the other
- Itemizing likely to benefit one spouse over the other
- Easy to be caught in spousal disagreements
- Easy to be blamed for everything

Divorces range from shockingly cordial to deadly (literally) contentious. Even with a signed conflict of interest form, do NOT prepare tax returns for both spouses if there is significant contention. If any issues ever arise that prevents you from properly representing both or can be perceived as preventing you from proper representation, <u>immediately</u> disengage one or both spouses.

Despite all those cautions, you can be a valuable asset to both spouses.

Make yourself a resource of information

Divorcing couples are going through emotional times. Each year, you likely have a few clients that bring you "all" their tax documents but they've missed some. Publicly traded partnership K-1s are the most common. Have you had the following conversation with a client?

> Tax Pro: "Do you have your K-1?"
>
> Client: "What's a K-1?"
>
> Tax Pro: "Remember that you get a K-1 form from XYZ Gas Partnership of which you purchased a small ownership through your brokerage account? Last year, it arrived in late March after we filed your return and you had to amend."
>
> Client: "Oh yeah. I haven't gotten that. I'll have to ask."

If a client can't remember their partnership interest during a normal year, do you expect them to remember it during an emotional time like a divorce? Divorcing couples are legally required to share financial information.

In addition to provide tax law understanding, you have intimate knowledge of your clients' financial assets and expenses. With this knowledge, you have the ability to offer services beyond tax preparation. Here are some services you can provide:

- List of financial assets
- List of other properties (real estate)
- Areas of concern which need to be addressed in the divorce decree such as carry over tax issues
- Determining asset allocation to limit overall tax burdens
- Allocation of Affordable Care Act Premium Tax Credits
- Advise that clients file form 8822 with change of address

- Suggest they both sign form 8821 requiring the IRS send copies of letters to you or sign 2848 Power of Attorney so that you can monitor for any future issues

Assist lawyers during the divorce to provide the best situation for the taxpayers

The gut instinct of agreeable spouses is to split the assets evenly or, for contentious spouses, to get the most assets in the end. There are serious tax implications for not considering the taxes on each asset.

Example: Drew and Kelly own the following:

- $400,000 home with $80,000 mortgage, purchased for $150,000
- $10,000 in savings and checking accounts
- $50,000 in mutual funds and ETFs in Kelly's brokerage account
- $80,000 in Drew's 401K
- $5,000 in Kelly's business checking account (the couple contributed $10,000 to open Kelly's consulting business which just got started and has generated little income)
- Drew's $90,000/year income

Often one or both spouses wants the house, especially if there are children involved. It is important that people look at whether they can afford the house. There are realtors that focus on helping divorced people who realize they now own a home they can't afford to keep.

Let's say Kelly gets the house and then two years later realizes that it is unaffordable. Remember that the excludable gains are $250,000 for a single person. Now the home is worth $450,000 so there are taxable gains. If the home was sold immediately, all gains would be excluded.

It would be different if Kelly bought out Drew's half. Now the basis changes. If Drew remained as co-owner but didn't live there, then Drew may not meet the exclusion requirements of living in the house. The latter situation requires written agreements as part of the divorce settlement.

Selling the brokerage account will likely result in some capital gains. If this is done during the marriage, then the tax will be 15% on long-term gains. If Kelly's business is just starting and income is low, then Kelly could sell after the divorce and may be in the 0% long-term capital gains bracket.

There are also implications with retirement. If the couple is close to retirement, it is easier to estimate tax liability during retirement. It might be beneficial to give the Roth to the high income earner and the traditional IRA to the lower income earner.

Attorneys understand the requirement for a Qualified Domestic Relationship Order (QDRO) but not always all the details. For qualified retirement plans, like 401Ks and 403Bs, and pensions, only the owner is entitled to the money unless there is a survivor's benefit. A QDRO allows the spouse to receive money from the retirement plan according to the divorce agreement (see next paragraph). This includes receiving cash before retirement age without the 10% penalty, moving the money to the spouse's IRA, and/or receiving the money during retirement.

It is critical that the QDRO is provided to the financial institution managing the qualified retirement plan well before the divorce is finalized. The financial institution needs to confirm receipt and acceptance because the divorce decree cannot violate the retirement plan rules. For example, some pension plans do not allow lump sum distributions. If the divorce decree requires a lump sum payment to the spouse when the spouse turns 65, then the QDRO is not valid. Discovering this error after the divorce is too late. QDROs cannot be done once the divorce is finalized.

For clients with substantial assets, you can perform analysis on the finances to determine the best way to allocate assets for the most post-tax dollars.

Just because Tax Cut and Jobs Act of 2017 (TCJA) changed the alimony taxation rules does not mean alimony is no longer an issue. For alimony agreements initially in place before January 1, 2019, the alimony paid may still be deductible and the amount received may still be income. Even for alimony agreements in place after Dec. 31, 2018, there are some states that consider the alimony received as taxable.

There is a provision in section 71 of the IRC that allows an alimony agreement to be considered non-taxable and non-deductible. Some attorneys are using this to have the state tax filing match the post-TCJA federal filing. It might be worth analyzing your client's situation to determine if there is a benefit of adjusting the alimony and making it all treated like TCJA versus having the recipient pay the state tax and the payer deduct it.

You can also help divorce attorney by reviewing tax returns. Often there are things that we see that they might miss. You can do this for attorney's clients as well as your own.

Determine when tax items need to be addressed

And speaking of reviewing tax returns, those carry overs and other tax items need to be addressed. Some are obvious and some aren't.

If the investments are all Kelly's before and after the divorce, then Kelly gets the carry over capital losses. If the rental property goes to Drew, then Drew gets the carry over passive losses. If the assets were all acquired during the marriage, then maybe the losses should be viewed as an asset and included when determining the value of the assets as they are allocated.

The Affordable Care Act (ACA) allows allocation of credits and expenses to be decided by the taxpayers. If a couple has ACA insurance and gets divorced during the year, any premium credits need to be allocated between the returns. If in the example above, it is worth seeing who would get the higher allowed premium credits or if they should be divided between the spouses.

Sole proprietors can deduct health insurance (with limits) on Schedule 1. If the divorce requires the business owner to continue to provide the health insurance to the spouse, a portion of the health insurance costs are no longer deductible. This creates a tax increase for the sole proprietor. The spouse might be able to claim the deduction on Sch. A. Is it better to increase the alimony and have the spouse buy individual health insurance?

While Tax Cut and Jobs Act of 2017 (TCJA) reduced the number of returns that itemize, there are still taxable state refunds. The 1099-G forms usually come with the primary filers Social Security number, but that does not mean the income cannot be allocated between spouses.

Translate between the family law attorney and the tax code

Most people expect attorneys to know the law, but they specialize. Psychiatrists and heart surgeons are both medical doctors, but you would never ask your psychiatrists to perform open heart surgery and vice versa. Family law attorney are not tax attorneys. The good ones try to keep up with the tax law changes but, as we know, there are many intricacies to tax law.

In my experience, the two most common misunderstandings of the divorce decree and taxes seems to be involving children and filing jointly.

Filing jointly cannot be mandated in a divorce decree. This is an actual agreement that came to my office:

The parties shall file their state and federal income taxes jointly for calendar year 2020 every year thereafter and shall divide evenly any refunds received or taxes due. Commencing with the calendar year 2021 tax year, the parties shall file individually.

Legally, this means nothing. By signing the 1040, the taxpayer is declaring:

Under penalties of perjury, I declare that I have examined this return and accompanying schedules and statements, and to the best of my knowledge and belief, they are true, correct, and complete. Declaration of preparer (other than the taxpayer) is based on all information of which preparer has any knowledge.

Notice that the taxpayer is saying they are "complete" and the preparer is saying it is based on "all information" known about. This is an important distinction. While a spouse can say "I didn't know about my exes' unreported income," it becomes the burden on that spouse to prove lack of knowledge. The IRS assumes the spouse is aware.

The divorce decree is a civil contract. The tax return is signed under penalties of perjury. No civil contract can force someone to perjure themselves. But I continue to see this. Let your clients decide how comfortable they are with the information provided by their spouse. If there is a Sch. C, cryptocurrency, foreign assets, or likely hidden assets, I usually discourage joint filing.

The area of children is usually misunderstood by the taxpayers. Here is a portion of a divorce decree that I see often:

The Husband shall have the right to claim the child as a dependent on his income tax return in year 1 and every year thereafter until such time as the Wife earns $XX,000.00 in a calendar year. At that time, the parties will alternate claiming the child on their individual tax returns beginning with Wife.

Legally, this means nothing. Again, the divorce decree is a civil contract and the IRC is law. Many people believe that the above paragraph entitles the husband to file as head of household (HOH) and get the child tax credit (CTC). Neither of these are true.

The IRC (section 2b) defined HOH as an individual who is not married and has a qualifying child or dependent living with them over half the year. The individual can be married but living separately from the spouse for the last 6 months of the year or longer.

The IRC (section 24 and 152) explain that the CTC goes to the custodial parent of the qualifying child and that HOH goes to the custodial parent only. A qualifying child is:

- a son, daughter, grandchild, minor sibling, niece, or nephew;
- living in the same home as the taxpayer for more than half the year;
- is under 19 years old or under 24 years old and a full-time student or is permanently and totally disabled (section 22(e)(3));
- does not provide over half of their own support; and
- is not filing a joint return.

If the child lives with the wife except every other weekend and Wednesdays, then only the wife can be HOH regardless of the divorce decree.

ONLY if the wife provides a signed form 8332, can the husband claim CTC, regardless of the divorce decree.

There are several other situations where one spouse infers a different situation than the law. Several of my clients have a provision similar to this:

> *Should there be a deficiency assessment in connection with any joint tax returns, the party whose error or omission caused the deficiency shall pay the amount due with interest and penalties and all other expenses incurred in connection with deficiency assessment.*

When the client receives a letter from the IRS, he/she believes that showing the divorce decree to the IRS will result in the IRS going to the other spouse and leaving the client alone.

Appendix A: Conflict of Interest Disclosure Letter

Disclosure and Waiver of Potential Related-Party Conflict of Interest

The parties below are in the process of obtaining a Dissolution of Marriage and wish to retain Elizabeth Logan, EA (of Kozlog Enterprises) to prepare income tax returns and advise them regarding income tax planning opportunities.

This disclosure, signed by both parties, is verification that no disagreement currently exists in the settlement of the marital estate and that both parties understand that all information contained in, or used to prepare, joint tax returns is available to both parties at all times. Private information obtained after the dissolution is final will not be disclosed to a former spouse, or any other party, absent specific consent.

Both parties understand that because of differing or conflicting interests inherent in the dissolution process, any agreements reached by them may benefit one party over the other. Both parties wish to enter into this engagement even though their interests are or may become adverse, including in ways not presently known or anticipated.

Both parties have determined that the benefits of entering into this agreement outweigh any adverse implications or consequences of doing so. Each expressly and forever waives the conflict of interest that may arise during the performance of services.

Should an unanticipated conflict arise that jeopardizes the ability to provide competent and diligent representation to both parties, it will be disclosed and engagement with one or both of the parties may be terminated immediately.

I have read this agreement and fully understand it.

______________________________ ____________

Client Signature Date

______________________________ ____________

Client Signature Date