From the desk of
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Filing Status During Divorce

The question that commonly comes up in divorce matters is what filing status a couple should consider in filing their tax returns during the process of divorce.

Generally this answer is determined by a number of factors but the overriding issue is what the Internal Revenue Service allows, and this can get rather technical depending upon the circumstances.

Generally what a couple should avoid is letting the government win in terms of taxes when they are at odd ends with each other.

While this seems easily said many couples are so polarized during the divorce process they lose sight of their overall objective of ending the marriage, and engage in behavior that is detrimental to their overall best interests.

In such situations it is important that the attorneys involved engage both parties along with their accountants in assisting both parties to find the appropriate solution without the government necessarily becoming the winner in an otherwise adversarial situation. Many times the parties are at such odds that this aspect of the divorce becomes more of a tactical arena for spite rather than logic where more objectiveness will generally find a middle ground that benefits both parties.

Unless there are criminal, or tax evasion issues, or ongoing tax liabilities originating currently by one party to the marriage, or from prior years relating to one or both spouses' a cooperative approach should be considered. Unless there are substantive reasons to file separately, or other reasons to avoid filing together the tax assessed will be in most situations lower if the couple files what is technically termed Married Filing Jointly (MFJ).

It must be remembered that when filing MFJ each spouse assumes complete liability for the tax assessed for that return. Only when each spouse files Married Filing Separately (MFS) does each spouse separate their tax liability from the other.

Married Filing Jointly (MFJ) is an election. Both spouses by filing together although there is no requirement to do so, in effect have made the election to file a jointly filed tax return, and thereby while enjoying generally lower taxes also have elected to both be personally responsible for the tax owed whether paid by the other party or not.

There is a requirement for each spouse to file their own tax return each year whether together or separately if there is a requirement to file.

In a community property state such as California a highly misunderstood issue is that the non-earning spouse is required to file a tax return allocating up to half of the other spouses' earnings and half of the deductions, or file jointly with the earning spouse, either way satisfying their tax filing requirement.

A married couple can elect by filing their return together if they are not legally separated under a decree of divorce or separate maintenance on the last day of the tax year.

In those situations where a couple are not living together as of the last day of the tax year they may still continue to file jointly if they are not legally separated under a decree of divorce or separate maintenance. Spouses who are not separated under an interlocutory decree of divorce are considered under tax law husband and wife and may still elect to file jointly until such decree becomes final.

One of the most misunderstood provisions in the tax code is the MFS process, especially in a community property state such as California.

Should one or both spouses elect to file separately during any year that they cohabitated they individually must allocate half of the total earnings of both spouses to each tax return no matter who earned the income. The same relates to the deductible expenses and deductions unless there exists a prenuptial, or post nuptial agreement, or there exists agreed upon separate property where earnings and deductions inured. Such an agreement again must be in writing.

In some marriages there are situations where one spouse may have owned a business, engaged in a career, or own an income earning asset that is covered in a prenuptial agreement which has not subsequently been commingled where those earnings are reported separately, and will continue to be reported as such during the divorce process period. Lacking such, both parties if they lived together during the year must allocate the appropriate earnings and deductions to each tax return no matter who earned or incurred the expenses.

Many tax professionals make the mistake of filing returns that reflect only the earnings and deductions of the separated spouse not making the allocations of earnings and deductions as required in a community property state.

The allocations generally are based upon that period that the couple cohabitated during the year. The resulting tax generally will be higher than if the couple filed their returns together electing MFJ status, therefore these approaches should be analyzed very carefully, and to the extent there is a benefit to the couple if they choose to file together the potential savings can and should be considered in the marriage settlement agreement or during the period that the divorce process is still ongoing rather than the government being the winner.

If a couple has filed separately and it is found later that it is more beneficial as to an overall tax position to amend the tax returns to that of Married Filing Jointly the couple may do so within three years of the filing of the original returns. The reverse is not true. Once a MFJ return is filed a couple may not thereafter file separate returns for that same tax year unless done so by the annual deadline for filing that return, generally April 15. Before amending from a Separate (MFS) status to a Jointly filed (MFJ) return to obtain a lower tax liability, this should be given strong consideration as to both parties who have completely separated any joint liability for that tax year as to any and all taxes that result from the Separate filing.

Amending to an MFJ filing will incur complete and total liability for each party once filed. This can come back to haunt one later where unpaid liabilities exist, and further if the other spouse files bankruptcy and is dismissed of those liabilities, the other spouse continues to remain fully liable. Remember, these choices are elections, and to the extent that these elections benefit the taxpayers either jointly or individually, the IRS will hold your choice as final in most situations.

It should also be noted that the election to file MFJ or MFS is an annual election.

While the complications in divorce are myriad the financial and tax problems exponentially increase as the divorce process continues and are not readily resolved, and those that span many years involve other questions as to filing status and choice. In those situations if the spouses have been separated for more than a year while both individuals have maintained separate households both parties can continue to elect to file together if a separate maintenance order or final interlocutory decree has not been issued.

With the assistance of the accountants for both parties computing the benefit to each party if the election to file jointly continues those benefits should clearly be considered in the overall settlement process, or at least in part.

The problem that arises in long drawn out proceedings over multiple years is that parties who are separated is that financial information is less likely to be voluntarily forthcoming and more difficult to determine the overall benefits. In many cases the

former spouses may not want the other spouse to continue to be aware of the others' finances. In those rare long term divorce proceedings cases the MFJ status maybe improbable but should be considered if there is benefit. The analysis can be done by an independent third party accountant that can be engaged to determine if there is in fact a benefit without disclosing certain financial information to the parties if a clearly written engagement is agreed to beforehand.

This can be tricky, but if the benefit is large enough the independent accountant can report accordingly. The parties can then determine what they may or may not want to do as to filing status. That accountant can also determine the mutual benefit and if sufficient, the parties should consider the process. This obviously applies to large case matters.

In those situations where the former spouses lived independent of each other for the entire year, and they choose to file separately, and it only takes one spouse to make that decision which is binding on the other, then earnings and deductions that are earned or paid by any given spouse can and should be reported only by the earning spouse, again assuming that the parties did not live together during the tax year.

The analysis for filing separately or jointly should also include the legal fees relating to each party. Legal fees paid in relationship to a divorce are not deductible to the party resisting the monetary demands of the other spouse, while those legal and accounting fees properly attributable to the obtaining, producing, or collection of spousal support are deductible. All other legal, accounting, and expert assistance in relationship to the divorce process are not deductible. These factors should be considered by both parties in their decision to file separately or together. If the choice is to file jointly, none of the professional fees in connection to the divorce proceedings are deductible no matter what the purpose.

Once a final court order establishing separate status is issued, or legal separation, both parties are required to file separately making the appropriate allocations for the periods before and after the court order for the year as MFJ is no longer available as of the date of the order.

Depending upon whether there are children, and fulfilling the criteria for maintaining a home and more than 50% of the support, Head of Household might be an option as to filing status, otherwise, the choices are Married Filing Separately, or if the parties lived separately all year long, then the Single status in some cases maybe the appropriate filing status depending upon the tax results. How one spouse files after that point does not dictate how the other files.

The option as to filing status of Head of Household one must be considered to be unmarried which is determined upon the marital status as of the last day of the tax year. A married taxpayer will be considered unmarried and eligible to file as Head of Household if the taxpayer's spouse was not part of the household for the six months prior to the last day of the year, and if the household is the principle household of at

least one child for whom the taxpayer is entitled to the dependency exemption for that child. Further, a taxpayer is considered unmarried if he or she is legally separated from his or her spouse under a decree of divorce, or separate maintenance agreement as of the last day of the tax year. A taxpayer under an interlocutory decree of divorce is not legally separate for this filing status, and therefore would not be eligible for filing Head of Household.

California tax law conforms with the federal rules with the exception of separate allocations that there must be the intention not to resume the marriage where under California law both parties must until a separation order is issued must allocate earnings equitably between the spouses. Under Internal Revenue Code Section (IRC) 66 which provides that while a person is living separately from his or her spouse earned income and accumulations while living apart for the entire year and files a separate return shall treat his or her earned income as his or her separate income. California law contains no such provision. In some instances where the intention is not determinable California Law will apply, but as a practical approach this maybe a mute issue unless the parties reconcile.

The tax rates are generally the most beneficial with the utilization of the Married Filing Jointly status but must be weighed against such issues of ongoing joint tax liability of both parties, tax compliance of both parties, and the need for separation of financial interests of the parties. These issues should be jointly considered and determined by the attorneys and accountants representing the clients. In some instances if the marital estate is large and complex enough consideration should be given to engaging a competent independent CPA for an objective tax evaluation. The tax consideration while important is not always governing.

Married Filing Separately can produce in some instances relatively strange results that may or may not be desirable depending upon the requirement in a community property state such as California lacking a prenuptial agreement that had been adhered to during the marriage in relationship to the tax filings during marriage period as to split earnings and deductions between the spouses for the period they cohabitated. For tax years subsequent to any cohabitation year this issue becomes less complex but may result in higher taxes that could be avoided with proper planning, guidance, and cooperation on this point. Head of Household for the parties that qualify, and in a multiple child family may work for both taxpayers with some advance planning, this alternative maybe the lesser of the better choices between filing jointly but may again with the proper planning gain each individual sufficient tax efficiency to be satisfactory.

Bottom line, while cooperation is not always evident in divorce proceedings, it is best that at least on when it relates to tax matters that the parties cooperate for their own best interest, and with sufficient guidance certain offsets in other areas of the proceeding could be considered with cooperation on this issue.

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