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The Hidden Costs of Divorce

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With an average price tag of $15,000 to $30,000, the impact from divorce can be not only emotional, but financial. However, for many couples, legal fees and filing costs are only the beginning. October's Wealth Management Insights examines some of the lesser-known financial implications of getting unhitched.

Deducting child support payments from your taxable income is considered tax fraud.

What you should know:

1. Timing is everything.

- 10 is often the magic number. A marriage that lasts beyond 10 years may entitle an ex-spouse for spousal Social Security benefits and, depending on the state, extended alimony. If one spouse is in the military, a 10-year marriage may also entitle an "ex" to military benefits and a portion of his or her pension.
- You can file for spousal Social Security benefits independent of when your ex-spouse files – if certain conditions are met. The duration of the marriage, the recency of the divorce and the ex-spouse's age and Social Security eligibility all come into play.
- If splitting up also means selling the house, remember that when you do it matters. A couple can exclude up to $500,000 from the sale of their house on their returns if the house is sold ahead of the divorce filing. If the property is instead transferred to one spouse and sold later, that tax exclusion drops to $250,000.

2. How assets are divvied up can have financial repercussions – both positive and negative.

- Remember that different accounts can have different tax treatments. If a retirement and a taxable account each has $250,000, you may consider giving the retirement account to one spouse and the taxable account to the other. Before you do, know that withdrawals from the retirement account will be taxed at ordinary rates, while withdrawals from the taxable account will be taxed at (typically) lower capital gains rates – and then, only the profits.

- It's common to see a drop in income following a divorce. Although the reduced income may create its own challenges, it's often accompanied by a resulting drop in tax bracket – presenting a divorcing spouse with a traditional IRA a once-in-a-lifetime opportunity to save on a Roth IRA conversion.
- A house that's decreased in value over time can complicate even an amicable split. Short selling is one option, though selling your house for less than it's worth can wreck your credit and drive up your tax bill.
- Most 401(k)s allow you to borrow against your balance, but they typically require the loan be repaid within five years. There are no loans against IRA balances, but the IRS does allow a few narrow exceptions to the 10% penalty, such as for a severe disability.

3. Despite their similarities, the IRS treats child support and alimony very differently.

- Child support payments are considered tax-neutral: they need not be reported as income and cannot be deducted from taxable income.
- Alimony payments, on the other hand, constitute a taxable event. According to IRS Topic 452, the paying spouse may deduct alimony payments from his or her taxable income, and the recipient must report these payments as income.
- However, not all forms of alimony are deductible. If alimony is "paid" through services rendered or noncash assets such as property, the IRS does not consider it alimony – even if such payments are authorized under a divorce settlement.

What you should do now:

Addressing the financial impact of a divorce requires financial expertise and objectivity – two things that may be in short supply when a marriage is dissolving. Your Baird Financial Advisor can help you protect your future and make the best of what can be a trying situation. ■