



TAX ISSUES IN DIVORCE

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Introduction to Tax and Divorce

1. Many Issues in Divorce Have Tax Consequences
2. Important to Discuss Tax Issues with Client
3. Know Your Limitations in the Area of Tax Law
4. Consult with Tax Experts who can Advise

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IRS PUBLICATION 504

IRS Publication 504 – Divorced or Separated Individuals

- Great resource for family law attorneys
- Provides examples
- Explains common tax issues that arise in divorce

See list of resources at end of written materials

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I. TAX CUT AND JOBS ACT OF 2017

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TAX CUT AND JOBS ACT OF 2017

Key Changes for Family Law Attorneys

- Lower individual income tax rates
- Spousal Support will no longer be tax deductible
- Higher standard deduction
- Elimination of the personal exemption
- Expanded Child Tax Credit – Tax Credit for non-child dependents

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ONE BIG BEAUTIFUL BILL

- Lower individual income tax rates. Federal tax rates for 2025 are between 10% and 37%. In 2025, a single tax filer can have an annual income of \$103,350 before they enter the 24% tax bracket- compared to \$46,950 before being in the 25% tax bracket in 2017.

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- Spousal Support is no longer be tax deductible. Spousal support is not tax deductible to the payor or taxable to the recipient for those decrees entered after December 31, 2018.

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- Higher standard deduction. The standard deduction has more doubled and increased to \$15,000 for an individual and \$30,000 for a married couple filing jointly for 2025.

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- Elimination of the personal exemption. There is no personal exemption (including dependency exemption).

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- Expanded Child Tax Credit. The child tax credit is increased to \$2,200 per qualifying child under age 17. In addition, \$1,700 is refundable in 2025 – meaning a taxpayer could still receive up to \$1,700 per child even if they did not pay any federal income taxes.



ONE BIG BEAUTIFUL BILL

- Tax Credit for Non-Child dependents. The 2017 Tax Bill added an additional tax credit of \$500 for other dependents such as children age 17 and over and/or other qualified dependents that may reside with the tax payer.



II. FILING STATUS

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FILING STATUS

1. Single
2. Married Filing Jointly
3. Head of Household
4. Married Filing Separately
5. Qualified Widow(er) with Dependent Child

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FILING JOINTLY OR SEPARATELY

- Joint and Several Liability. Both spouses may be held responsible, jointly and individually, for the tax and any interest or penalty due on a joint return.
- A hold harmless provision in the decree, however, could be enforced through the divorce court.



FILING JOINTLY OR SEPARATELY

- Married Filing Jointly. A husband and wife can file a joint tax return provided that a final decree of divorce or separate maintenance has not been filed on the last day of the tax year.
- Depending on facts and circumstances, a client may want to wait until after December 31 st to file the final divorce or separation decree, depending on whether they want to file jointly with their spouse or single.



REFUSAL TO FILE JOINTLY

- Filing Status of Married Filed Separate. If the spouse's elect to file separate returns, each spouse should only report their own income, exemptions, deductions, and credits on their individual return. The spouses can file a separate return even if only one of them had income.



REFUSAL TO FILE JOINTLY

- Married Filing Separate in Community Property States. If married spouses file separate returns, they each must report half of any income described by state law as community income and all of their separate income. Each of the spouses can claim credit for half the income tax withheld from community income.



REFUSAL TO FILE JOINTLY

- Amending Separate to Joint. If a spouse has filed a separate return, they have up to three (3) years after the tax due date to file an amended joint return to change their filing status.
- If the parties have already filed a joint return they cannot amend their return and change their filing status to separate. See IRS Publication 504.



RELIEF FROM JOINT LIABILITY

In some cases, a spouse MAY be relieved of the tax, interest, and penalties on a joint return. A taxpayer can ask for relief no matter how small the liability.

- 1) Innocent spouse relief - § 6015(b)
- 2) Separation of liability, which applies to joint filers who are divorced, widowed, legally separated, or who haven't lived together for the 12 months ending on the date election of this relief is filed - § 6015(c)
- 3) Equitable relief - § 6015(f)

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INNOCENT SPOUSE - §6015(b)

- Innocent Spouse Relief, Form 8857. There may be circumstances that a taxpayer can seek relief from the payment of income tax, interest and penalties by claiming "Innocent Spouse." To file this claim, the individual needs to fill out IRS Form 8857. The individual claiming innocent spouse is not responsible for calculating the amount of tax that may be relieved, as the IRS will perform this calculation.



INNOCENT SPOUSE - § 6015(b)

1. The taxpayer filed a joint return which has an understatement of tax due to erroneous items of your spouse (or former spouse).
2. The taxpayer establishes that at the time he or she signed the joint return they did not know, and had no reason to know, that there was an understatement of tax.
3. Taking into account all the facts and circumstances, it would be unfair to hold the taxpayer liable for the understatement of tax.
4. A request for innocent spouse relief will not be granted if the IRS proves that the taxpayer and their spouse (or former spouse) transferred property to one another as part of a fraudulent scheme.

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INNOCENT SPOUSE - § 6015 (b)

- If innocent spouse relief is granted, the IRS can only collect the tax, interest and penalties from the other spouse.

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RELIEF FROM LIABILITY - § 6015(c)

- For the “innocent spouse” to be denied relief under IRC § 6015(c) and held liable for the tax on an item otherwise allocable to the other spouse, the Internal Revenue Service must show that person to have actual knowledge of the item at the time he or she signed the joint return. IRC § 6015(c)(3)(C). If the electing spouse can show that the return was signed under duress, the deficiency will be allocated to the “bad” spouse.

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EQUITABLE RELIEF - § 6015(f)

- The third type of innocent spouse relief is equitable relief under IRC §6015(f). If, taking into account all of the facts and circumstances, it is inequitable to hold the individuals liable, and relief is not available under IRC § 6015(b) and (c), the IRS may relieve that person of liability.

EQUITABLE RELIEF - § 6015(f)

- The prior two-year statute of limitation to file for requesting equitable relief was eliminated by IRS Notice 2011-70. The deadline to request equitable relief has now been extended to the period of limitation on collection of taxes as set forth IRC 6502, which is generally 10 years after the assessment of any tax imposed or, for any credit or refund of tax, within the period of limitation set forth in IRC § 6511.



EQUITABLE RELIEF - § 6015(f)

- The two most often cited factors for determining whether it would be inequitable to hold a requesting spouse liable for a deficiency are whether: (1) The requesting spouse received significant benefit, *Pietromonaco v. Commissioner*, 3 F.3d 1342, 1347 (9th Cir. 1993); and (2) the failure to report the correct tax liability results from the non-requesting spouse's concealment, overreaching, or other wrongdoing, *Alt v. Commissioner*, 119 T.C. at 314." *Seamons v. Commissioner*, T.C. Summ. Op. 2008-92.



III. TAXATION OF ASSETS TRANSFERRED IN DIVORCE

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TAXATION OF ASSETS TRANSFERRED IN DIVORCE

- Tax Basis
- Transfer of Tax Basis
- Tax Free Transfer of Assets
- Capital Gains

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TAX BASIS OF ASSETS

- Gain from the Sale of Asset - Generally. Internal Revenue Code § 1001(a) provides that the gain from the sale or other disposition of property shall be the excess of the amount realized over the adjusted basis, and the loss shall be the excess of the adjusted basis over the amount realized.



TAX BASIS OF ASSETS

- Basis Explained. "Basis is defined in § 1012 as the taxpayer's cost in acquiring the property except as otherwise provided in the Code. A taxpayer's original "basis" is then "adjusted" under § 1016.

Amount Realized	Adjusted Basis
- Adjusted Basis	- Amount Realized
= Realized Gain	= Realized Loss



TRANSFER OF ASSETS

- Transfer of Tax Basis. Where there is a transfer of property between spouses or a transfer incident to divorce, §1041(b) states that the property will be treated as if the person who receives the property (the transferee) has acquired it by gift.
- The transferee's basis in the property shall be the adjusted basis of the transferor at the time of the transfer.



TRANSFER OF ASSETS

- Example. If the wife were to give the husband an asset worth \$10,000 in which the wife has a basis of \$5,000, the husband will include nothing in his gross income but the husband's basis in the asset will be \$5,000.
- *Note: Section 1014 applies to property acquired from a decedent. Under §1014(a), property received from a decedent shall have the basis to the recipient equal to the value of the property as of the decedent's death. This is commonly referred to as a stepped up basis.*



TAX FREE TRANSFER OF ASSETS

- No Tax on Transfer of Assets Incident to Divorce. Internal Revenue Code § 1041(a) provides that no gain or loss shall be recognized on a transfer of property from an individual to a spouse; OR a transfer of property to a former spouse if the transfer is incident to the divorce.



TAX FREE TRANSFER OF ASSETS

- “Incident to Divorce” Defined. Treasury Regulation 1.1041-1T(b) states that a transfer is “related to” the cessation of the marriage when the transfer is required under the divorce or separation instrument, and the transfer takes place within six years from the date of the divorce.”
- If the transfer is not made pursuant to a divorce or separation instrument, or occurs more than six years after cessation of the marriage, it is presumed to be unrelated to cessation of the marriage. See Treas. Regs. § 1.1041-1T, A-7; Ltr.Rul. 9306015.

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TAX FREE TRANSFER OF ASSETS

- §1041 Does Not Apply to Unmarried Individuals. Although § 1041 is not available to couples who have cohabited and not married or registered as domestic partners, there are still quasi-community property rights that may apply. See *Gromley v. Robertson*, 120 Wash. App 31 (2004). The issue for unmarried individuals will turn to “*for what was the payment received.*” See T.C, Memo. 1999-62. If the property settlement agreement or decree clearly state that transfer of property represents the receiving spouse’s community interest in property acquired during the relationship, the property will be treated as a gift and the basis in the property will equal to the basis immediately prior to the transfer.

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HYPOTHETICAL

“The Wife is awarded \$720,000 in stock to be transferred from the Husband’s Charles Schwab brokerage account ending #1234 within 30 days of signing this agreement; using a valuation date as of the date of transfer; the transfer in stock shall be pro rata from the investments in the account so as to equitably apportion any latent capital gain tax liability.”

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HYPOTHETICAL

- Transfer prior to final divorce order?
- Enforcement?
- Change in stock price?
- Proposed solution may be specific number of shares
- 30 days from entry of decree of signing CR2A?



CAPITAL GAINS

- Capital Assets. A capital asset is defined by the IRS in § 1221 of the Internal Revenue Code. The definition of a capital asset is set forth in § 1221(a) – which lists eight examples of assets that do not qualify as capital asset. Anything not described in § 1221(a) is a capital asset.
- Capital gains and losses are classified as long-term or short-term (capital assets held for less than a year).



2025 Federal Income Tax Rates			
Rate	Single	Married Filing Joint	Heads of Households
10%	\$0 to \$11,925	\$0 to \$23,850	\$0 to \$17,000
12%	\$11,925 to \$48,475	\$23,850 to \$96,950	\$17,000 to \$64,850
22%	\$48,475 to \$103,350	\$96,950 to \$206,700	\$64,850 to \$103,350
24%	\$104,350 to \$197,300	\$206,700 to \$394,600	\$103,350 to \$197,300
32%	\$197,300 to \$250,525	\$394,600 to \$501,050	\$197,300 to \$250,500
35%	\$250,525 to \$626,350	\$501,050 to \$751,600	\$250,500 to \$626,350
37%	\$626,350 or more	\$751,600 or more	\$626,350 or more
2024 Long Term Capital Gains Tax Rates			
Rate	Single	Married Filing Joint	Heads of Households
0%	\$0 to \$48,350	\$0 to \$96,700	\$0 to \$64,750
15%	\$48,351 to \$533,400	\$96,701 to \$600,050	\$64,751 to \$566,700
20%	\$533,401+	\$600,051+	\$566,701+



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CAPITAL GAINS

- Capital Carry-Forward. If a taxpayer's capital losses exceed their capital gains, the amount of the excess loss that can be claimed is the lesser of \$3,000 if married filing jointly or single (\$1,500 if married filing separately) or the total net loss as shown on line 16 of the Form 1040, Schedule D. If the net capital loss is more than this limit, the taxpayer can carry the loss forward to later years.



CAPITAL CARRY-FORWARD

- Example. If a taxpayer has a \$10,000 capital loss and no gains, she can use \$3,000 (\$1,500 if married filing separately) of the capital loss to deduct against her ordinary income. If the taxpayer's ordinary income is \$60,000, she will get to deduct the \$3,000 of capital loss and will only pay tax on \$57,000 of ordinary income. The remaining \$7,000 of unused capital loss will carry over to the next year.



CAPITAL GAINS

- Allocating Capital Losses in a Divorce. If separate returns are filed after a net capital loss was reported on a joint return, the carryover is allocated to each taxpayer based on their individual net long-term and short-term capital losses for the preceding taxable year. See IRC § 1212.
- If incurred in a community activity, the losses are split equally on separate returns. Therefore, each spouse may carry forward his or her half of the loss to post dissolution income. (See Treas Regs. § 1.1727; *Rose v. Commr.*, TC Memo. 1973-207.)

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CAPITAL GAINS

- No capital loss for personal property. Gain from the sale of an individual's household furnishings, automobiles, etc. is generally taxed at the capital gain rates. However, loss from the sale is not recognized unless the property was held for the production of income. Treasury Reg. § 1.262-1(b)(4).



CAPITAL GAINS

- Net Operating Loss from a Business. In the event of a net operating loss from the operation of a business, the loss may be carried back to the prior two years (by amending the tax returns for the prior years) or carried over to the succeeding 20 years as a net operating loss deduction. I.R.C. § 172.
- If the spouses filed a joint tax return for each year involved in figuring NOL carrybacks and carryforwards, the NOL is treated as a joint NOL. See IRS Publ. 536, p. 10. Each spouse may carryover to his or her separate return his or her share of the joint NOL. *Huckle v. Commissioner*, T.C. Memo 1968-45.



PRACTICE TIP

In many circumstances where the marital community owned a business, depending on whether the business is profitable or not, there may be tax carryovers that can be used to reduce your client's overall tax liability in the future. Also, do not assume that just because your client's business was operating in the black that there were not prior years that the business may have taken a loss. If so, those tax loss carryovers can be divided by the Court in the divorce proceeding. It is important to recognize a tax carryover as an asset to be distributed between the parties as a credit towards future tax payment.

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GIFTS

The annual exclusion amount is increased to \$19,000 for 2025. Therefore, an individual may give up to \$19,000 to as many individuals as he or she chooses, without being subject to a gift tax. The individual may do this every year. His or her spouse may do this as well, for a combined gift tax annual exclusion of \$38,000 to as many individuals as they choose.

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IV. TAX ON SALE OF MARITAL HOME

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TAX ON SALE OF MARITAL HOME

- Internal Revenue Code § 121
- Qualifying Personal Residence

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I.R.C. § 121

- Internal Revenue Code Section 121. I.R.C § 121(b) provides that an individual may exclude from income up to \$250,000.00 of gain (\$500,000.00 if sold as husband and wife on a joint return) that is realized from the sale of a primary residence.



SALE OF PRIMARY RESIDENCE

- As a general rule the gain will only be exempt from tax if the home was used as primary residence for an aggregate of two years over the past five years.
- Unless the value of the home has increased at least \$250,000.00 from the date the home was purchased (or \$500,000.00 if sold together as husband and wife), excluding any adjustments in basis, there will be no taxable gain on the sale of personal residence.

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SALE OF PRIMARY RESIDENCE

- Example. Harry and Wendy are married and have owned their home for the minimum two years. They bought the home for \$200,000 and made \$25,000 worth of repairs and improvements. They have contracted with a buyer to sell it for \$350,000. What are the tax consequences?



SALE OF PRIMARY RESIDENCE

Original Purchase Price	\$200,000
Plus Improvements	\$ 25,000
Equals Adjusted Basis	\$225,000
Sales Price	\$350,000
Less Adjusted Basis	\$225,000
Less Selling Expenses	\$ 15,000
Equals Realized Gain	\$110,000

Given the realized gain is less than the \$500,000 exclusion, there is no recognized gain or tax due on the sale. If the realized gain is above the exclusion, the federal long term capital gains rate would apply.

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V. TAX IMPACT OF DIVIDING RETIREMENT ACCOUNTS

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TAX IMPACT OF DIVIDING RETIREMENT ACCOUNTS

- ERISA Qualified Plans
- Early Withdrawal Penalties
- Important Practice Tip

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ERISA QUALIFIED PLANS

- The term “qualified” plan is unique to the Internal Revenue Code and the Code sets forth certain requirements that must be met for a plan to qualify for special tax treatment.

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ERISA QUALIFIED PLANS

- Qualified plans include any pension or profit sharing plan under 401(a), annuity plan under 403, an eligible deferred compensation plan under 457(b), a qualified governmental excess benefit arrangement under 415(m), a SIMPLE or SEP IRA, and certain trusts under 501(c)(18).



ERISA QUALIFIED PLANS

- Normally, there is no tax consequence associated with the transfer of an *ERISA governed* retirement account between spouses incident to a divorce, provided the transfer is effectuated through a Qualified Domestic Relations Order (QDRO).



ERISA QUALIFIED PLANS

- Not all tax deferred retirement accounts require a QDRO to transfer between spouses (e.g. Thrift Savings Plans, military pensions, Individual Retirement accounts).
- There are three types of IRAs that are not covered under ERISA: traditional, Roth and education.



EARLY WITHDRAWAL PENALTY

Normally, there is a 20% withholding of a lump sum cash-out to a spouse or former spouse from a defined contribution plan subject to ERISA. Although I.R.C. § 72(t) provides that there is also a 10% penalty associated with the liquidation of a § 72(t)(2)(C) specifically provides that qualified retirement plan as defined in § 4974(c), distributions pursuant to a QDRO are not subject to the penalty that generally applies to retirement benefits distributed prior to the recipient reaching the age of 59½.

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PRACTICE TIP

Unlike the exception to the early withdrawal penalty for the liquidation of a qualified retirement plan pursuant to a QDRO, there is no exception to the early withdrawal penalty enumerated in I.R.C. § 72(t)(3)(A) for the early distribution of an IRA. Therefore, a spouse or former spouse who has an option to liquidate an ERISA qualified plan versus a non ERISA qualified IRA (Traditional, Roth and Educational) should choose the ERISA qualified plan to avoid the additional 10% early withdrawal penalty.

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VI. TAXATION OF SPOUSAL MAINTENANCE

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TAXATION OF SPOUSAL MAINTENANCE

- I.R.C. § 71(a) and § 215
- Undifferentiated Support – why?

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SPOUSAL MAINTENANCE

- Decree entered AFTER to 12/31/18. No deduction is allowed for alimony or separate maintenance payments, and such payments are not includible in the recipient spouse's gross income, if made under a divorce or separation agreement (1) executed after December 31, 2018, or (2) executed on or before December 31, 2018 but modified after December 31, 2018 if the modification expressly provides that the amendments made by the Tax Cut and Jobs Acts of 2017 apply to such modification.



UNDIFFERENTIATED SUPPORT

- Undifferentiated Support. Child support payments are neither taxable to the individual who receives the support or deductible by the individual who pays the support.
- An order that does not specify the type of support being provided or an “undifferentiated” or “unallocated” support order will be deemed by the IRS as spousal support because it does not “fix” an amount for child support pursuant to I.R.C. Section 71(c). See *Lawton v. Commissioner*, T.C. Memo 1999-243.



HYPOTHETICAL

“The Husband’s spousal support obligation shall begin on X (date), and on the following terms: \$9,000 a month plus 15% of the Husband's net Google Restricted Stock Units after mandatory and standard deductions for a period of 42 months. The net RSUs shall be paid to the Wife within five business days after the funds are available.”

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HYPOTHETICAL

- What the benefit to requested undifferentiated family support?
- What are the potential issues in a “family support” order?



DEPENDENCY EXEMPTIONS

- Why the designation of the dependent child is still important. Generally, only one person may claim all the child-related tax benefits for a child, such as the child tax credit.



DEPENDENCY EXEMPTIONS

- Dependency Exemption. The dependency exemption for a child will be awarded to the parent who has physical custody of the child for the greater number of overnights during the calendar year. If the child spends an equal amount of time with both parents, the parent with the higher adjusted gross income will be allowed to claim the dependency exemption provided the child is otherwise eligible to be claimed as a dependent.

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DEPENDENCY EXEMPTIONS

- Noncustodial Parent May Claim Exemption. The noncustodial parent can claim the exemption for a child if the custodial parent formally releases the exemption via IRS Form 8332. The child still must meet the IRS qualifications of a dependent.
- The waiver does not have to be permanent and can be revoked at a later date by the custodial parent.



DEPENDENCY EXEMPTIONS

- IRS FORM 8332 (revised 10/2018) states “The deduction for personal exemptions is suspended for tax years 2018 through 2025 by the Tax Cuts and Jobs Act. Although the exemption amount is zero, eligibility to claim an exemption may make you eligible for other tax benefits. See Pub. 501 for details. Although taxpayers can’t claim a deduction for exemptions, eligibility to claim an exemption for a child remains important for determining who may claim the child tax credit, the additional child tax credit, and the credit for other dependents, as well as other tax benefits. See the instructions and Pub. 501 for details.”

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DEPENDENT CARE CREDIT

- Custodial Parent Only. The noncustodial parent can not treat the child as a qualifying person even if that parent is entitled to claim the child as a dependent under the special rules for a child of divorced or separated parents. See IRS Publication 503.



VII. ADDITIONAL TAX RESOURCES

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ADDITIONAL TAX RESOURCES

- Internal Revenue Code and Treasury Regulations
- U.S. Master Tax Guide
- Frumkes on Divorce Taxation
- Department of Labor's publication on Qualified Domestic Relations Orders

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QUESTIONS

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