

Divorce Mediation: Reviewing Your Clients' Personal Tax Returns

by Anju D. Jessani, MBA, APM

Having taught in NJAPM's 40-hour class for the past five years, I have noticed a common pattern when the issue of clients' personal tax returns comes up — one of fear and loathing. However, if you had some clues on what to look for, that reaction could change. Just like the home inspector, the divorce mediator can benefit from a check list. While this article is not intended to take the place of tax advice of a CPA, I hope it will give a new mediator a little more confidence when reviewing returns. It helps to read and understand your own tax return so take the time to do that and reviewing your clients' returns will seem a little less daunting.

It would be helpful to have hard-copy of Form 1040 and Schedules A, B, C, D and E to cross-reference as you read this article. You can access and print these forms from the IRS website: www.irs.gov.

Form 1040, Page 1

Filing Status: Most of your divorcing clients will have filed married filing jointly. However, if they have lived apart for six months and filed separate returns, the custodial parent is entitled to file as head of household. The other parent can file as married filing separately while married, and single after the divorce. Refer them to an accountant immediately if they have been filing as single during the marriage.

Exemptions: If you see a name other than the children or dependants the clients have spoken about, be sure to ask about that relationship. As an example, there may be children from another marriage that the clients have not mentioned to you.

Line 7, Wages, Salaries, etc.: Does the information match what the clients told you about their compensation? You should know that if the clients are contributing to a retire-

ment savings plan, Line 7 will be net of those employee contributions. You would need to look at Medicare Wages on their W-2 statements for the income number for child support calculations. Also, as line 7 reflects the combined income of the parties, you also need the W-2 statements to verify individual incomes.

If your client has a W-2 statement and is the owner of his/her own business, review the business tax return to see if profits are being retained in the business.

Line 8a and Line 9a, Taxable Interest & Ordinary Dividends: Both lines indicate that assets exist that produce this income. If either category is greater than \$1,500, you are required to complete a Schedule B; make sure you get a copy if income thresholds are exceeded.

Line 13, Capital Gain or Loss: If you see either a positive or negative number, make sure you receive Schedule D. If the negative number is \$3,000, which is the maximum loss you can take in one year, there are probably more losses that can be carried into future years on Schedule D.

Line 15a and Line 16a, IRA Distributions. Are clients rolling over plans, liquidating plans or receiving pension income?

Adjusted Gross Income: Review adjustments to total income. As an example, a self-employed person may be contributing substantial amounts to a SEP IRA or a previously married party may be paying alimony.

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Taxes and Credits: If the clients are taking the standardized deduction, you are probably dealing with a pretty "standard" return. However, if they itemize, make sure you get a copy of their Schedule A.

If there are any educational credits, see if they apply to either of the parties.

Other Taxes: Self-employed tax should be reported here. If one party is a W-2 wage earner who over withholds, the self-employed party may not be aware of this tax—and may be in for a rude surprise after the divorce, when they need to make quarterly payments. Suggest that going forward, they should consult with their accountant regarding how to do this, if this has not been their practice. If the clients had penalties on early liquidation of IRAs and pensions, the tax will also be reported here.

Line 71, Total (Tax) Payments: Does the client over withhold or under withhold? If they consistently receive a refund, then their cash flow from the paycheck does not reflect their annual refund (and vice versa). This can be helpful information when assisting the clients with their budgets.

Line 72 — Line 74, Refunds: If the refund went to a bank account, whose account is this? If the refund was mailed, did both parties sign the check that was received? If the parties were eligible for a refund, they may have applied the credit towards next year's estimated tax. It doesn't happen often, but be sure to look for it, as that prepaid tax is a marital asset subject to distribution.

Preparer's Name and Phone Number: Take note of this information, and if there is something on the tax return that your clients can't answer, ask permission to speak to the accountant.

Schedule A, Itemized Deductions

Medical Expenses: If the clients report significant medical expenses, ask why? It might be that one or both parties have a medical condition

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that could be a factor in the divorce, or that there a child with special needs.

Taxes You Paid: If the clients are renters and you see real estate taxes paid or another inconsistency, ask questions.

Gifts to Charity: There are people who tithe. If these gifts seem higher than you might expect, ask questions about lifestyle.

Other: Are there any unusual deductions that raise questions? Don't be afraid to ask?

Schedule B, Interest and Dividends

Interest: \$10,000 invested at 3% interest annually would yield \$300. If you see \$9,000 in interest income, one could start with the assumption that there might \$300,000 in assets producing this income. As payers of interest are listed (e.g., Bank of America), make sure you receive an account statement for every payer and continue to ask questions.

Ordinary Dividends: Some stocks and mutual funds pay dividends and others do not. As with interest income, make sure you receive a statement for every source of dividend income. Even, if you don't see dividend income, don't assume there isn't a portfolio of stocks.

Schedule C, Profit or Loss from Business

Income: If your clients are contractors, musicians, realtors, performing artists, or other specialist, they may have 1099 forms documenting their income. On the other hand, if they say they were a private mediator, their primary documentation might include client invoices. Ask for the 1099s.

Part II, Expenses: In calculating child support, be aware that some expenses that are allowed by the IRS, are not allowable expenses for the purpose of income for child support

calculations in New Jersey. As related to Schedule C, these include various components of depreciation expenses, home office expenses, entertainment, and car and truck expenses.

Take note of the caveat in the child support guidelines: "In general, income and expenses from self-employment or the operation of a business should be carefully reviewed to determine an appropriate level of gross income that is available to the parent to pay a child support obligation. In most cases, this amount will differ from the determination of business income for tax purposes.

Schedule D, Capital Gains and Losses

Part I, Short-Term Capital Gains and Losses: With market volatility, I grow concerned when I see a large volume of trades, especially if one of the parties is unaware of trade activity. Ask questions, and consider asking the clients to confer with their attorneys about how to manage their assets as they go through their divorce so as to preserve principal, especially if the parties have different risk profiles.

Part II, Long-Term Capital Gains and Losses. If you see a large long-term sales price amounts, ask where that money is now invested. These are sales of assets held for more than one year, so as a starting point, I would be looking for a stock and or bond portfolio of at least this value.

Part III, Summary: If the parties have more losses than gains, including losses from prior years, they will be able to use these losses to either offset future gains, or take a loss of \$3,000 a year against other income. Look

at line 16, subtract the \$3,000 they took on their taxes in the past year, and you are left with their tax loss carry forwards. These can be divided by the parties in a divorce, and have real value. Don't overlook them.

Schedule E: Supplemental Income and Loss

Part I, Income or Loss from Rental Real Estate and Royalties: What you usually see on this schedule is rental real estate property. This part of the schedule provides the address for each property, which can be helpful. Be aware that a property may have positive cash flow yet show a loss because of depreciation. If you see royalties.... then future royalties for the referenced work may be subject to distribution. There may also be work that was created during the marriage that may not currently produce royalties, but might in the future. Ask questions.

Part II, Income or Loss from Partnerships and S Corporations: You might also see income from real estate held in an LLC or partnership. Ask for the tax return for each entity listed on this section if you see significant income. Note that some investments that you can buy from any stock broker operate as limited partnerships such as the United States Oil Fund. So, don't let your imagination get away from you when you review this section.

Conclusions

If you have a hot tip regarding reading tax returns, please let me know. ICLE sponsors a four-hour continuing education class on reading a personal tax return that I recommend.

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