US TAX: 5 POTENTIAL DIVORCE PITFALLS

The United States is one of the few countries in the world that taxes its citizens and US green card holders on a worldwide basis even if they have left the country and don't plan to return.

From a US tax perspective every penny is subject to US tax no matter where in the world it was earned or received and there is likely to be a requirement to file a US income tax return by all US citizens and green card holders who derived more than a very modest level of income during the year. Even if a US citizen or green card holder received no income in the year, there are various other reasons why the IRS may still require a filing from them such as holding more than $10,000 in a foreign bank account or investment account (including certain pension plans) at any point during the year, receiving a gift of more than $100,000 from a non-US person during the year, or holding a controlling interest or acquiring a significant interest in a foreign corporation.

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Fortunately, the country where the income is derived or where the individual actually lives usually has the primary right to tax it. This means the IRS will generally accept either a foreign tax credit for the tax suffered on most types of income in the source jurisdiction, or will for some types of income, exempt the income from US tax depending on the taxpayer's situation and what the US double tax treaty with the relevant country says.

However, that doesn't mean there aren't some traps out there which are avoidable particularly when going through a divorce. Here we look at the ones that we see most often in cases of divorce:

1. GIVING UP CITIZENSHIP OR US GREEN CARD

Going through a divorce often forces a person to re-evaluate their life and think about where they see their future. If that future is not likely to involve living in the US, the individual concerned may wish to consider giving up their US citizenship or green card.

Depending on their circumstances, a US citizen or long term green card holder may be better off doing this before acquiring any additional assets in the divorce to try to keep their net worth under the $2 million threshold which can be a trigger for an exit tax when expatriating.

2. PRIMARY RESIDENCE

Unlike in UK tax, the exclusion against US tax on the capital gain realised from sale of a home is capped at $250,000 per taxpayer provided the taxpayer meets the necessary conditions.

This can present issues if a US taxpayer is transferring a share of the former matrimonial home to their non-US taxpayer spouse in a divorce as the transfer is potentially subject to US tax. It can also represent a future US tax cost for a US taxpayer receiving appreciated property from the divorce. These rules are equally applicable to a transfer of investment assets, not just the primary residence

There is also a further complication where a transfer concerns non-US property as the gain has to be calculated with reference to US Dollar values on acquisition and disposal. This can result in unexpected gain in US Dollar terms due to exchange rate movements.

TIMING ISSUES CAN RESULT IN A FORM OF DOUBLE TAXATION...

It is also worth noting that there is a US provision which taxes a deemed gain on repayment of a mortgage in non-US currency. If the amount of debt repaid in US Dollars terms is worth less than the US Dollar value when it was taken out, a gain is deemed to have arisen taxable at ordinary income rates. This is unfortunate as the individual will have seen no financial benefit from the exchange rate movement.

3. TIMING ISSUES

There are various different scenarios in which a transfer of property occurring during a divorce will result in the recognition of a gain or loss for the transferor and adjustment to the receiver's cost basis in one jurisdiction, and be recognised as a nil gain/nil loss transfer with no adjustment to the recipient's cost basis in the other jurisdiction.

For example, if a non-US taxpayer transfers an asset to their US taxpayer spouse which has appreciated in value after 5 April following the breakdown of the marriage, the transfer would result in a no gain/no loss transfer for US tax purposes, with the US taxpayer spouse acquiring the original cost basis. However, for UK tax purposes, this transfer would create a taxable capital gain on disposal for the transferor and provide the US taxpayer spouse with a step up in basis to the market value on transfer. The US taxpayer spouse may then end up paying US tax when they dispose of the asset on the part of the gain already taxed in the UK on the non-US taxpayer spouse. In this situation it would be very difficult to claim relief for double taxation as no single taxpayer has been taxed twice on the same gain.

Timing issues can result in a form of double taxation which it is often difficult to obtain relief for so it is important they are identified and taken into account before transfers are made and if possible, avoided.

NON US PENSION SCHEMES ARE NON-QUALIFYING SCHEMES FOR PURPOSES OF THE INTERNAL REVENUE CODE.

4. PENSIONS AND DEFERRED INCOME SCHEMES

The tax rules relating to US based pension schemes are well regulated and generally do not give rise to any taxation on the transfer of all or part of a pension by one spouse to another. The typical complication which arises here is in determining whether a pension sharing order from a UK court will be sufficient or if a special court order known as a qualified domestic relations order (QDRO) might be required to achieve a transfer.

Overseas pension schemes held by US taxpayers present potential complications. All non-US pension schemes are non-qualifying schemes for purposes of the Internal Revenue Code. Therefore, the provisions that would provide an exemption from tax on transfer in divorce for a US scheme do not apply. A pension sharing order from a UK court would constitute a disposition of the pension for US tax purposes, potentially resulting in US tax. The circumstances of every individual has to be carefully considered as the historic US tax treatment of the overseas pension in the hands of the owner will determine the potential for tax on transfer. If there is a tax treaty between the US and the country in question, then there may be relief available that allows for continued deferral of taxation.

WHILE THE UK DOES NOT TAX MAINTENANCE AWARDS, THE US TAKES A DIFFERENT VIEW.

Deferred income schemes including stock based incentive compensation, whether in the US or overseas are particularly complex matters. There is no general rule that fits all here, but the overriding assumption to begin with should be that a transfer on divorce results in the taxation of the income. There is the added complication of who should be liable for the tax on the income, since the income has been earned by one party, but may be received by the other. There have been rulings where the Internal Revenue Service have allowed continued deferral or tax in the hands of the recipient when paid.

5. ALIMONY

This point isn't a trap to be wary of but is something to consider.

Generally speaking, while the UK does not tax maintenance awards, the US takes a different view and any payment excluding child support can be considered to be alimony and subject to US tax with a deduction available to the payor. However it is possible to opt out of this treatment by including appropriate phrasing in the consent order or if the circumstances fit, the UK/US double tax treaty and potentially other treaties can be used to get to a position where the payor receives a deduction and the receiver avoids tax on alimony payments.

If you would like to discuss any of the above issues or the UK or US tax implications of any other aspect of a divorce, please get in touch.

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