TAX TRENDS AND DEVELOPMENTS

Strategy for Allocating the Property Tax Deduction in Year of Divorce to Minimize Effect of New Limits on Deducting Taxes

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The 2017 Tax Cuts and Jobs Act limits the annual itemized deduction for state and local taxes to $10,000. Such taxes include (1) state and local income tax, sales tax, and property tax.

The $10,000 cap does not apply to taxes on land used for farming or a rental property. It does, however, apply to second homes – e.g. a cabin up north – and to investment property.

In the year of divorce, for which each party will file a separate tax return, it is common for real property taxes to have been paid from a joint account before date of divorce. Under federal tax law, payments made from a joint account in which both spouses have an equal interest are presumed made equally by them.

That presumption can be rebutted by evidence that funding of the account was other than equal.

Example

- Assume that H, the higher earning spouse, contributed 80% to the account and W 20%. The property tax deduction is allocated accordingly.
- But as the higher earner, H will have higher state (and possibly local) income taxes.
- Depending on the amount of these taxes relative to the $10,000 cap, it may be advisable to split the deduction 50:50 even though H provided substantially more funds to the account.
- This also provides W with 50% vs. 20% of the tax deduction if she itemizes deductions on her tax return.

Observations

So, as a practical matter, the parties have some flexibility on the allocation of the property tax deduction. Factors to consider are:

- Amount of other taxes of each party relative to the $10,000 limit.
- Funding of the joint account from which taxes were paid prior to the divorce.
- Whether either party will likely use the increased standard deduction.

It is often advisable to provide for the allocation in the property settlement agreement to avoid post-divorce problems at tax return preparation time.

The following summarizes some general aspects of payments of mortgage interest and property taxes in a divorce context. It is drawn from the author's Taxation Chapter in ICLE's *Michigan Family Law.*

Payments Made in a Divorce Context

The deductibility of mortgage interest, property taxes, utilities, maintenance, etc., in a divorce context depends on the following:

- ownership of the home
- use of the home as a personal residence
- liability on the mortgage loan
- whether payments are made pursuant to a qualifying divorce or separation instrument.

Ownership. While some homes may be owned individually by one of the spouses during marriage, it is more common that a marital residence is owned by the spouses as tenants by the entireties, a form of ownership that is not severable and that provides survivorship rights for each party. A tenancy by the entireties is converted to a tenancy in common incident to divorce under Michigan law unless an alternative provision is made in the governing divorce instrument. MCL 552.102. Tenants in common do not have survivorship rights but do have a severable half interest in the home. It is not unusual for one of the parties to be awarded the family residence, often the custodial parent in cases involving minor children. It is also common for such a home to be owned as tenants in common subject to sale when the youngest child reaches the age of majority or graduates from high school.

As explained below, the form of ownership may affect the deductibility of payments related to the residence.

Use of the Home as a Qualifying Residence. IRC 163(h) permits the deduction of home mortgage interest, or "qualified residence interest," on a taxpayer's principal residence and a second qualifying home used by the taxpayer as a residence. If a noncustodial parent vacates the family residence and lives elsewhere, he or she may select the family residence as an "other residence" provided he or she uses the home for personal purposes for at least 14 days during the year. In this regard, the use of the home by a taxpayer's child—again, for as little as 14 days—is attributed to the taxpayer. IRC 280A(d)(1).

IRC 164(a) allows a taxpayer to deduct property taxes that he or she (1) pays and (2) is personally obligated to pay. The obligation to pay generally tracks with ownership.

Liability on the Mortgage Loan. Spouses who own their marital residence as tenants by the entireties usually have joint and several liability on the mortgage loan on which the home is pledged. It is also not uncommon for both parties to remain jointly and severally obligated on the loan after the divorce since lending institutions often will not release one party from the debt even if the other has been assigned full responsibility for its payment in the divorce settlement.

About the Author

__Joe Cunningham__ has over 25 years of experience specializing in financial and tax aspects of divorce, including business valuation, valuing and dividing retirement benefits, and developing settlement proposals. He has lectured extensively for ICLE, the Family Law Section, and the MACPA. Joe is also the author of numerous journal articles and chapters in family law treatises. His office is in Troy, though his practice is statewide.

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