Seven Shades of Gray

What Family Lawyers Cannot Afford to Miss
with Bonus Shades on Retirement Division and Estate Portability

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Introduction

In family law, tax considerations are often the silent third party in every negotiation, settlement, and judgment. Understanding the subtle ways federal and state tax laws interact with divorce, custody, and property division is essential to delivering equitable outcomes for clients. This handout summarizes nine critical 'Shades of Gray'—the tax intersections every North Carolina family lawyer must recognize.

Shade One: Dependency Exemption & Child Tax Credit

The personal exemption remains at zero under the One Big Beautiful Bill Act (OBBBA), yet entitlement to claim the exemption still determines eligibility for the Child Tax Credit (CTC). For 2025, the credit is $2,000 per qualifying child under 17, phasing out at $200,000 (single) or $400,000 (joint). A valid Form 8332 is required for a non-custodial parent to claim the child. In North Carolina, courts may allocate the exemption 'as justice and the child's best interests require.'

Practice Pointer: Ensure decrees and settlement agreements use IRS terminology and specify responsibility for tax forms and filings.

Must have the dependency exemption to claim the Child Tax Credit. The dependency exemption can be transferred with Form 8332 for purposes of the Child Tax Credit.

Shade Two: Child and Dependent Care Credit

This one is tricky!

This credit assists working parents with child-care expenses of a child under age 13 or a dependent with disabilities. It equals 20–35% of up to $3,000 for one child or $6,000 for two or more. Only the custodial parent may claim the credit, even if the other parent claims the dependency exemption. Even if the non-custodial parent pays the day care directly, they (even with Form 8332) cannot claim the Child and Dependent Care Credit.

Under the NC Child Support Guidelines, adjustments can be made if the non-custodial parent is entitled to the credit.

Child Care Costs under 2023 NC Child Support Guidelines: "The court may also consider actual childcare tax credits received by a parent as a basis for deviation."

Parents have fifty-fifty Custody: Well, 365 does not really divide by two, so one parent may have more overnights. The one with more than half is the only one who can claim the CDCC.

Practice Pointer: The Agreement or Court Order cannot change the outcome. The custodial parent (more overnights) wins under federal preemption.

Study IRS Form 2441

Shade Three: Head of Household & Earned Income Credit

The IRS looks to the 'nights test'—where the child slept more than half the year—to determine the custodial parent. That parent may claim Head of Household status and the Earned Income Credit (EIC). For 2025, the EIC ranges from $649 (no children) to $8,046 (three or more children). Both parents cannot claim HOH or EIC simultaneously; doing so triggers audits.

Practice Pointer: Ensure decrees and settlement agreements use IRS terminology and specify responsibility for tax forms and filings.

Shade Four: College Costs, 529 Plans & Education Credits

529 Plans grow tax-free if used for qualified education expenses, but control remains with the account owner. During equitable distribution, determine ownership and beneficiary. The American Opportunity Credit (up to $2,500) and Lifetime Learning Credit (up to $2,000) require the taxpayer to be entitled to the dependency exemption. Coordination between tuition payments, 529 withdrawals, and credit claims prevents duplication.

Shade Five: The Spousal Support Tax Trap

Alimony finalized after December 31, 2018, is no longer deductible by the payor or taxable to the recipient. Old orders remain deductible/taxable unless modified and opted into new law. Lawyers must avoid 'neutral' language that ignores hidden tax burdens and consider gross-up clauses or property offsets to equalize outcomes.

Shade Six: Death, Taxes, and the Divorce Decree

Under N.C.G.S. §50-16.9(b), alimony ends at death unless otherwise stated. To ensure continuation, provide for life insurance or other security mechanisms. QDROs allow tax-deferred division of retirement accounts. Divorce revokes testamentary bequests but not beneficiary designations—ERISA plans still pay named beneficiaries. Clients must update wills and accounts post-divorce.

Practice Pointer: Ensure beneficiaries' designations are actually changed post-divorce.

Shade Seven: The $500,000 Real Estate Trap

Under IRC §121, taxpayers may exclude $250,000 (single) or $500,000 (joint) of gain on sale of a principal residence. After divorce, each spouse qualifies individually, risking loss of half the exclusion. Section 121(d)(3)(B) allows a non-occupant spouse to count the occupant's use if occupancy is granted by a divorce instrument—language that should always be included.

Bonus Shade One: Retirement Division under SECURE Act 2.0

The SECURE 2.0 Act (2022) raised the RMD age to 73 (eventually 75), expanded Roth catchups, and increased QLAC limits to $200,000. Family lawyers must ensure QDROs reflect current plan rules and distinguish between pre-tax and Roth balances. Plan administrators now have enhanced notice obligations regarding domestic-relations orders.

Bonus Shade Two: Portability & Prenuptial Power

For 2025, the federal estate and gift tax exclusion is $13.99 million per person (≈$28 million per couple). Portability allows a surviving spouse to use a deceased spouse's unused exclusion via Form 706. Premarital agreements can require, waive, or allocate the portability election and related expenses. Portability does not apply to the GST exemption, so high-net-worth clients still need trusts.

Summary and Takeaways

Tax issues permeate every stage of family law practice—from child support to death benefits. A clear understanding of tax allocation, documentation, and timing can protect clients and prevent malpractice exposure. In every case, align your drafting with IRS definitions, North Carolina statutory requirements, and federal timing rules.

Checklist for Family Lawyers:

- **Confirm dependency and tax credit allocations.**
- **Require Form 8332 where applicable.**
- **Verify child care and education credits align with custody.**
- **Distinguish alimony vs. property payments.**
- **Secure support obligations with life insurance.**
- **Include exclusive occupancy clauses for home sales.**
- **Update QDRO templates for SECURE 2.0.**
- **Advise clients on estate plan and beneficiary updates.**
- **Address portability and estate tax clauses in prenups.**