DIVORCE AND SEPARATION: TAX ISSUES

By:

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CHAPTER I – ALIMONY PAYMENTS - Code Section 71

A. The Nature and Definition of Alimony.

Alimony is a payment to or for a spouse or former spouse made under a divorce or separation instrument. Alimony is deductible by the payor and includible in the income of the payee spouse or former spouse. Code Sections 71(a) and 215(a). References to “spouse” and “former spouse” may be used interchangeably. Code Section 71(d).

1. Alimony income and the alimony deduction are reported on IRS Form 1040 for federal income tax purposes. State laws should be checked (particularly those states with an “independent” income tax system that does not “piggyback” the Federal system) to determine if alimony is deductible by the payor and includible as income by the payee.

2. Alimony is an “above the line deduction”, i.e. it is deductible whether or not the payor itemizes deductions. It is not a miscellaneous itemized deduction. Code Sections 62(a)(10); 67(a).

3. Alimony payments do not, however, generate a net operating loss deduction, since it is a nonbusiness expense. Monfore v. Commissioner, TC Memo 1988-197; Code Section 172(d)(4).

4. As a general rule, there is no requirement for the payor spouse to withhold income taxes on alimony payments. An exception to this general rule applies in the case of alimony payments to a nonresident alien, since such payments are deemed United States source income. Where withholding applies, the rate is 30%. Code Section 1441(a); Rev. Rul. 69-108, 1969-1 C.B. 192. It is possible that a tax treaty with the home country of the payee may negate the withholding requirement.
5. Since alimony constitutes taxable income to the payee spouse, such spouse should be sure to include any alimony received in his or her tax calculation for purposes of determining liability for estimated taxes. Code Section 6654. Alimony is not considered income from self-employment, so that social security and Medicare taxes are not applied to it.

6. Since alimony is treated as earned income, the divorced recipient spouse may separately create an IRA and contribute to the IRA (subject to the IRA contribution limitations) based on the amount of alimony received. Code Section 219(b)(4).

7. The payee spouse must provide his or her social security number to the payor spouse, and the payor spouse is required to indicate the name and social security number of the payee spouse on the first tax return on which the payor spouse claims an income tax deduction for alimony payments made. Code Section 215(c); Reg.1.215-1T, Q&A 1. There is a $50 penalty imposed on any party who fails to comply with these rules. Code Sections 6723 and 6724(d)(3)(C).

B. **General Requirements for a Payment to Be Deemed Alimony.**

In order to be considered alimony, a payment must meet certain specific requirements. The payments do not have to be fixed, nor a specific amount, nor must they be periodic in nature. It is not required that the payments constitute support of a spouse.

C. **Seven Specific Requirements for a Payment to be Deemed Alimony.**

There are seven criteria for a finding that a payment constitutes alimony. If these criteria are satisfied, a payment will be classified as alimony, regardless of the parties’ designation of such payment, regardless of whether or not it is specifically designated as satisfying a support obligation, and regardless of how the payment may be classified under state law.

1. The payment is made in cash. Code Sections 71(b)(1); 215(b).

   a. Cash payments, including checks and money orders payable on demand, qualify as alimony and separate maintenance payments. A lump sum payment may qualify as alimony. The payment must be
received by or on behalf of the payee spouse.

b. Transfers of services or property, the execution of a promissory note, or other debt instrument, or allowing the payee to use property of the payor do not qualify as cash payments of alimony. Delivery of a third party’s debt instrument or an annuity contract do not constitute cash payments of alimony. Reg. 1.71-1T(b) Q&A 5.

c. Alimony may be found to have been constructively received by the recipient spouse when wages of the payor spouse are garnished and placed into a trust account for the recipient’s benefit. Burkes v. Commissioner, TC Memo 1998-61.

2. The payment must be received by or on behalf of a spouse pursuant to a “qualifying instrument”, namely a divorce decree, decree of separate maintenance, or a written separation agreement. Code Section 71(b)(1)(A), (b)(2).

a. A divorce or separation instrument is a decree (aka a judgment) of divorce or separate maintenance or a written instrument incident to such a decree; or a written separation agreement; or any other decree requiring a spouse to make payments for the support or maintenance of the other spouse (such as a temporary and pendente lite order of support) Code Section 71(b)(2)(A)-(C). Brooks v. Commissioner, TC Memo 1983-304.

b. The payment must be made under the instrument. When a payment is made prior to the execution of a divorce or separation instrument, it will not be treated as a payment made under the instrument. Payment should be made after execution of a divorce or separate maintenance decree or a written separation agreement. The decree must be “final”. Code Section 71(b)(2)(A). State law will determine when an order or decree is considered “final”. Jachym v. Commissioner, TC Memo 1984-182. Temporary support payments made and accepted (absent a formal order) while other issues are disputed and no agreement is final will not be characterized as “alimony”. Nemeth v. Commissioner, TC Memo 1982-646.

c. Cash payments to a third party on behalf of the payee spouse under the terms of a divorce or separation agreement can qualify as a cash
payment to the spouse. For example, if the divorce or separation agreement requires that the payor spouse pay the payee spouse’s mortgage, rent, real estate taxes, (where the payee spouse owns the property), life insurance premiums (only where the payee spouse owns the policy) or tuition obligations, such payments will qualify as alimony or maintenance payments. Reg. 1.71-1T(b), Q&A 6.

Where the payee spouse owns the residence, and the payor spouse pays the mortgage, property taxes, repairs and insurance, such payments will qualify as alimony if all of the Section 71 requirements are satisfied. This will enable the payor spouse to deduct the payments as alimony paid, and require the payee spouse to include the payments in income as alimony received. The payee spouse may then deduct the mortgage interest and real estate taxes paid on spouse’s behalf, provided the payee spouse itemizes deductions, and further provided that the interest constitutes qualified residential interest. Rev. Rul 62-39, 1962-1 CB 17.

**Planning Point:** If the parties intend that one will make the mortgage payments on behalf of the other, the divorce instrument should always specify that the payment is intended to be treated as alimony, and that the obligation to make such payments terminates on the death of the payee spouse.

**Planning Point:** If the payor spouse wants to deduct the payment of a life insurance premium, the life insurance policy must be transferred to the payee spouse who then becomes the policy owner, allowing the payment to be treated as alimony.

d. Cash payments made to a third party at the written request, consent, or ratification of a spouse qualify as alimony, provided the payments are in lieu of payments of alimony directly to the spouse; are intended by both spouses, per the written request, to be treated as alimony; and the written request is received from the spouse before the payor spouse files an income tax return for the year the payment is made. Reg. 1.71-1T(b),Q&A 7; PLR 8710089. For example, if the payee spouse has the payor make a contribution to a charity at the payee’s request, the payor may treat the payment as an alimony payment. In such a case, the payee spouse should be able to claim a charitable deduction for the payment.
Note: Where payments are made to maintain property owned by the payor spouse and used by the payee spouse, (such as mortgage payments, real estate tax payments and life insurance premium payments where the payor spouse maintains ownership of the policy) such payments do not qualify as payments of alimony or separate maintenance, even if they are made in connection with the terms of a divorce or separation instrument. All of such payments are considered as made on behalf of and for the benefit of the payor spouse. Reg. 1.71-1T(b), Q&A 6. Leventhal v. Commissioner, TC Memo 2000-92.

However, where one spouse is in sole and exclusive possession of property, the entire amount of utility charges paid by the non-occupying spouse may be treated as alimony or separate maintenance payments, if otherwise qualified under the above rules. Rev. Rul. 62-39, 1962-1 CB 17. This characterization will require the occupant spouse to treat the utility payments as income. Utility payments as alimony have been upheld where one spouse was contractually obligated to make the payments, Simpson v. Commissioner, TC Memo 1999-251, and where the payor spouse, as joint owner, would be required to continue utility payments even if the payee spouse died. Cologne v. Commissioner, TC Memo 1999-102.

Note Further: In such a case, where the payor’s payment does not constitute a payment of alimony, it may still be deductible (if otherwise qualified) as an itemized deduction. Where the payment involves interest, it will be deductible by the payor if it constitutes qualified residence interest. Code Section 163(h). In order to so qualify, the residence must be either the taxpayer’s principal residence, or “one other residence of the taxpayer”. This suggests that in order to be entitled to claim a mortgage interest deduction, the taxpayer must at least have an ownership interest in the residential property. Code Section 163(h)(4)(A)(i)(II).

Where the payment involves real estate taxes, if the payor spouse owns an interest in the property, even if the interest is less than 100%, such spouse will be entitled to deduct the entire amount of such taxes paid. Code Section 164. A number of cases have held that a joint obligor may deduct both interest and real estate taxes paid from his or

e. Where the property constitutes jointly-owned residential property, one-half of the total amount of mortgage payments, including both principal and interest, may be treated as alimony, and one-half of the interest may be deducted as mortgage interest, if it is qualified residential interest. With respect to real estate taxes and home owner insurance, none of the payments are deductible as alimony, but all of the real estate taxes (and none of the home owner insurance) are available as itemized deductions. Rev. Rul. 67-420, 1967-2 CB 63.

**Planning Point:** The discussion of housing costs suggests that the parties try for a flexible result. If the payor spouse can deduct payments for mortgage principal and interest as alimony (all or part, depending on the ownership of the residence) the payee spouse may accept the alimony characterization and claim at least a partially offsetting interest deduction. Alternatively, where the payor spouse is an owner of the property, the interest deduction should be available in full, along with the property tax deduction, so that the remaining issues for negotiation will be the principal payments on the mortgage as well as utilities and other maintenance expenses.

f. Where a cash payment is made to satisfy an arrearage of alimony payments otherwise due, such payment retains the character of the originally due payment, and is deductible by the payor in the year of payment, and includible by the payee in the year of receipt. Olsier v. Commissioner, 751 F.2d 1168 (11th Cir. 1985); Coleman v. Commissioner, TC Memo 1988-442; Davis v. Commissioner, 41 TC 815 (1964).

3. The parties do not designate that the payment is not alimony; i.e. the divorce or separation agreement does not designate the payment as nondeductible by the payor or excludable from the payee’s income. Code Section 71(b)(1)(B) allows the parties to affirmatively agree that an otherwise qualifying payment is not alimony or separate maintenance, and accordingly is not deductible by the payor or includible by the payee. A court may order that the payments are nondeductible/nontaxable.
a. The decree must make the tax effect known directly or expressly. Absent such an express statement, the payments will be held to be alimony. Richardson v. Commissioner, 125 F.3d 551 (7th Cir. 1997). Even stating in a court order that one party would be responsible for income taxes was not a sufficient non-alimony designation. Jaffe v. Commissioner, TC Memo 1999-196.

b. Unless there is an explicit mention of the tax consequences, the IRS will rule that the payments are alimony. PLR 200141036.

c. The payee spouse must attach a copy of the instrument designating the payments as not constituting alimony to his or her income tax return for each year that such a designation applies. Reg. 1.71-1T(b) Q&A 8.

In order to negate alimony treatment, it is advisable to include a clear, explicit, express direction that the support (or other payments) are not to be treated as alimony.

Example: A sample clause that would satisfy this requirement and be viewed as an election out of alimony treatment could read as follows: “The parties hereby expressly agree and hereby designate all payments made and required to be made under [the Section of the Agreement calling for regular payments to the payee spouse] to be deemed excludable as alimony and deemed non-deductible payments for purposes of Sections 71 and 215 respectively of the Internal Revenue Code of 1986, as amended, in accordance with the provisions of Code Section 71(b)(1)(B).” See Maloney v. Commissioner, TC Memo 2000-214; PLR 9610019.

4. The divorced or legally separated spouses must reside in separate households when the payment is made. Code Section 71(b)(1)(C). A formerly shared home is considered one household, even if the parties are physically separated within the home. Persons will not be treated as members of the same household if one is preparing to leave the household and does leave no later than one month after the date of the payment. Reg. 1.71-1T(b), Q&A 9; Coltman v. Commissioner, 980 F. 2d 1134 (7th Cir. 1992).
Note: This requirement only applies to divorced or legally separated spouses. If the spouses are not divorced or legally separated under a decree of divorce or separate maintenance, payments made pursuant to a written separation agreement or support order may still qualify as alimony even if the parties reside in the same household. This distinction may be significant in those states where separation for a specific period of time is grounds for a divorce, and time spent living under the same roof separate and apart counts toward such time requirements. Reg. 1.71-1T(b) Q&A 9; Benham v. Commissioner, TC Memo 2000-165.

5. The payor is not liable to make any payment for any period after the death of the payee spouse, and there is no liability to make any payment (whether in cash or in property) as a substitute for such payments after the death of the payee spouse. Code Section 71(b)(1)(D); Stokes v. Commissioner, TC Memo 1994-456.

a. Alimony payments must end at the death of the payee spouse. A provision requiring payments to continue after the death of the payee will taint all payments, including those made both before and after death. A required payment to the payee’s estate will taint any other payments designated as alimony, since a payment to the payee’s estate is considered a payment after death. Reg. 1.71-1T(b) Q&A 13.

b. The divorce or separation instrument does not have to expressly state that the payments cease upon the death of the payee spouse if, for example, the liability for continued payments would end under state law. However, allowing the instrument to be silent on the issue of termination of the obligation at death may not be a good idea. Cases indicate that courts may interpret obligations as continuing beyond the lifetime of the payee, thus damaging the payor’s expected income tax treatment of alimony payments. Webb v. Commissioner, TC Memo 1990-540; Rosenthal v. Commissioner, TC Memo 1995-603. It is strongly recommended that in order to avoid any ambiguity, the applicable divorce instrument should contain a provision stating that all alimony payments terminate upon the death of the payee spouse.

Planning Suggestion: If the payee spouse is concerned that death may result in a shortfall of expected or desired payments, the payee spouse should consider acquiring a life insurance policy on his or her life. Premium payments for this policy could be made by the payor.
spouse, and could constitute payments of alimony by such spouse.

c. An agreement may provide that payments are to continue to the payee spouse after the death of the payor spouse. The estate of the payor spouse is not entitled to an alimony income tax deduction for such payments. However, such post-death payments from the payor spouse’s estate are considered distributions to an estate beneficiary subject to the estate income tax distribution rules. Code Section 682(b). Accordingly, if the payor spouse’s estate has distributable net income, the estate can deduct the distribution, and the payee would be required to include the payment in income as a distribution of income received from the estate.

d. If the divorce agreement contains a provision requiring a reduction of alimony payments either in the event of the death of the payor spouse, or in the event of the remarriage of the payee spouse, such provisions will not preclude the deduction of ongoing reduced payments as alimony, nor will they jeopardize the original larger payments from alimony treatment.

6. The parties must file separate income tax returns. Code Section 71(e). The payor must include the payee’s social security number on his or her first tax return for the taxable year in which the payment is made. The payee is required to furnish this number to the payor. Code Section 215(c); Reg. 1.215-1T, Q&A 1. Alimony payments will not be recognized if the payor and payee file a joint return.

7. The payment must not be a payment for child support. Code Section 71(c). (Note: child support payments are discussed in further detail in Chapter III, below)

a. Payments made under the terms of a divorce or separation agreement that are specifically designated or treated as made for the support of a child of the payor spouse are not alimony or separate maintenance payments. In such a case, the payment is not deductible by the payor, and not included in the income of the payee. Reg. 1.71-1T(b), Q&A 15.

b. When a payor having both an alimony obligation and a child support obligation makes a payment that is less than the amount otherwise
specified as due under the agreement, the payment is first applied to the child support obligation, and then to the alimony obligation. Code Section 71(c)(3); Bacon v. Commissioner, 56 T.C.M. 1391 (1989).

CHAPTER II – RECAPTURE OF ALIMONY AND SEPARATE MAINTENANCE PAYMENTS - Code Section 71(f)

A. Purpose of Recapture.

The alimony recapture rule exists to prevent taxpayers from “disguising” otherwise nondeductible property settlement payments as alimony payments by attempting to “front-load” and deduct property settlement payments that are purportedly characterized as alimony.

B. How the Recapture Rules Work.

1. If the payor’s alimony payments decrease or terminate during the first three calendar years in which payments are made, the alimony recapture rule may be applicable.

   a. If total alimony payments deducted in year one exceed the average annual payments made in years two and three by more than $15,000, the excess deduction is recaptured in the payor’s gross income in the third year.

   b. If payments in the second year exceed payments in the third year by more than $15,000, the excess deduction is recaptured in the payor’s gross income in the third year.

2. The first calendar year in which the payor spouse makes alimony payments to the payee spouse is called the “first post-separation year”. The first calendar year following the first post-separation year is referred to as the second post-separation year, and the second calendar year following the first post-separation year is referred to as the third post-separation year. These rules will apply whether or not alimony payments are actually made in the second or third post-separation years. Code Section 71(f)(6).

3. Recapture will apply with respect to excess amounts of alimony payments made in the first and the second post-separation years.
“Recapture” means that the amount of a payment deemed to constitute “excess alimony” will be recharacterized as a property settlement. The excess alimony payment will be included in the taxable income of the payor spouse and will be deducted in computing the adjusted gross income of the payee spouse, all in the third post-separation year. Note that the recapture rules operate on a three calendar year basis.

4. Only payments made in the first and second post-separation years are subject to recapture. Payments made in the third post-separation year and subsequent years are not subject to recapture.

5. The law provides a “safe harbor” threshold of $15,000 per year. Payments of alimony of up to $15,000 per year may be made without being subject to the recapture rules.

6. However, the recapture rules will apply in the third post-separation year if the alimony paid in the third year decreases by more than $15,000 from the second year, or the alimony paid in the second and third year’s decreases significantly from the alimony paid in the first year.

C. A Two-Step Process to Determine Excess Alimony Payments:

1. **Step One**: Compare the aggregate amount of alimony payments in the third post-separation year to the aggregate alimony payments made in the second post-separation year. If the payments in the second post-separation year exceed the aggregate payments in the third post-separation year by more than $15,000, the excess over $15,000 is subject to recapture in the third post-separation year. Code Section 71(f)(4).

2. **Step Two**: Compare the aggregate amount of alimony payments made in the first post-separation year to the average of the aggregate amount of the non-excessive alimony payments made in the second post-separation year and the alimony payments made in the third post-separation year. If the payments in the first post-separation year exceed the average of the non-excessive payments in the second post-separation year plus the payments made in the third post-separation year by more than $15,000, the excess over $15,000 is subject to recapture in the third post-separation year. Code Section 71(f)(3).

**Example**: Assume the alimony payor makes payments of $50,000 in the
first post-separation year, $20,000 in the second post-separation year and nothing in the third post-separation year. As the payments are made in the first and second post-separation years, they are deducted by the payor and included in the income of the payee. In these years, no recapture calculation is made and nothing is, in fact, recaptured. Recall the requirement that recapture of excess alimony works on a three calendar year basis. Code Section 71(f).

In the third post-separation year, the test is made to determine if recapture is applicable. In the above Example, recapture is applicable. Applying Step One above, the amount of the second post-separation year payment subject to recapture is $5,000. This is the amount by which the second post-separation year payment ($20,000) exceeds $15,000 plus the amount of the third post-separation year payment (zero).

Applying Step Two above (also in the third post-separation year) the recapture amount with respect to the payment made in the first post-separation year is $27,500. This is the amount by which the first post-separation year payment ($50,000) exceeds $15,000 plus the average of the non-recaptured payments made in the second and third post-separation years (i.e. $7,500, representing the average of $15,000 [the amount of the second post-separation year payment not previously recaptured] and zero). Accordingly, $50,000 less $15,000 less $7,500 results in a recapture amount in year the third post-separation year of $27,500.

The result of the application of the alimony recapture rules as illustrated by this Example is that out of $70,000 paid by the payor, only $37,500 is deductible.

D. **Exceptions to the Alimony Recapture Rules.**

1. Payments in the three post-separation years are under $15,000 per year.

2. No recapture is required if either spouse dies before the end of the third post-separation year, and the alimony payments cease as the result of such death. Code Section 71(f)(5)(A)(i), (ii).

3. No recapture is required if the payee spouse remarries before the end of the third post-separation year, and the alimony payments cease as the result of such remarriage. Code Section 71(f)(5)(A)(i),(ii).
4. The recapture rules do not apply to support payments made pursuant to a court order for temporary or pendente lite support. Code Section 71(b)(2)(C).

5. The recapture rules do not apply to payments made pursuant to a continuing liability over the period of at least the first three post-separation years to pay a fixed portion of the income derived by the payor spouse from a business or rental property, or from compensation for employment or self-employment. Code Section 71(f)(5)(C). This rule enables the parties to agree on a fixed, pre-existing formula under which the actual payments may vary from year to year with the payor’s income consistent with the agreed-upon formula. Note, however, that in order for a variable payment agreement to be exempt from the excess alimony recapture rules, such agreement must be effective for at least three years.

E. **Planning to Avoid the Alimony Recapture Rules.**

1. Recapture will be avoided if equal payments of alimony are made over at least three years.

2. Recapture will be avoided if payments increase over the three-year period. Accordingly, adjustments (increases) can be made for inflation without triggering the alimony recapture rules.

3. Recapture will be avoided if the payments are structured to avoid triggering recapture, even if such payments are unequal and contain some “front-loading” so long as the mechanics of the recapture rule and the $15,000 safe harbor are observed. For example, a payor can make deductible alimony payments of $37,500 in 2011, $30,000 in 2012 and $15,000 in 2013 without triggering the recapture rules.

4. Recapture will be avoided if the agreement provides that the obligation of the payor spouse to make payments of alimony terminates upon the death of the payee spouse, and the payee spouse in fact dies during the three year “testing” period.

**CHAPTER III - CHILD SUPPORT ISSUES**

Generally, the issue here arises from a tension between the payor’s desire to
characterize his or her payment as an income tax deductible payment of alimony, while the payee prefers to treat the payment as an income tax-free receipt of a child support payment.


Payments that are specifically designated as child support or treated as specifically designated as child support under a divorce or separation instrument are not alimony, and are not includible in the recipient’s gross income. Code Section 71(c) excludes from the definition of alimony cash payments which constitute child support. To avoid ambiguity, the divorce instrument should clearly and unambiguously identify (“fix”) the payment as child support. The presumption for an unallocated award is that it has not been “fixed” as a payment for child support. *Simpson v. Commissioner*, TC Memo 1999-251.


Payments made for child support are not deductible by the payor spouse and are not taxable income to either the payee spouse or to the child.

C. Payments “Fixed” as Child Support.

A payment or portion of a payment is treated as specifically designated or “fixed” for child support if the divorce or separation instrument specifically designates an amount of money or a percentage of a payment as being made for the child of the payor. Code Section 71(c)(1).

1. The concept of a “fixed” payment refers to a clearly determinable payment for child support, rather than a specific amount. This rule allows the actual amount of a payment to vary from year to year without losing its essential qualification as a child support payment. Reg. 1.71-1T(c). An example of this rule would be a direction to pay educational or medical expenses for a child. While the amount of the payment may vary from year to year, the characterization of the expense clearly fits it within the child support classification. *Sperling v. Commissioner*, 726 F. 2d 948 (2nd Cir. 1984).

2. A payment may be treated as constituting child support even if the parent does not have a legal obligation under state law to support the child. Code
Section 71(c). A payment may constitute child support even if the child has reached the state law age of majority.

D. **Designated Payments; Contingent Payments.**

A payment will be considered to be a child support payment if the payment is designated as such, or if the payment (even if initially characterized by the payor as alimony) is reduced on the happening of a contingency relating to the child specified in the divorce instrument. A contingency relates to a child if it depends on any event relating to that child. Code Section 71(c)(2)(A). It does not matter whether that event is certain or likely to occur. The amount equal to the reduction will be treated as child support. Included among the contingencies relating to a child are: (Code Section 71(c)(2)(B); Temp. Reg. 1.71-1T(c), Q&A 17.)

1. Dying  
2. Becoming employed  
3. Leaving school  
4. Leaving the household of the custodial parent  
5. Marrying  
6. Attaining a specified age or level of income.

**Example:** A payment designated as “alimony” terminated upon the 18th birthday of a child. Despite the designation, the payment was treated as a child support payment. Hammond v. Commissioner, TC Memo 1998-53

E. **Allocation of Payments to Alimony and Child Support.**

In a situation where the operative divorce instrument calls for payments of both alimony and child support, and the payor pays less than the entire amount required, the payment is first allocated to child support until that requirement is satisfied in full. Code Section 71(c)(3).

F. **Recharacterized Payments.**

If a payment is recharacterized as child support, defeating an attempted characterization of it as alimony, an amount equal to the reduction in alimony is treated as child support from the outset, causing both the payor and payee spouse to possibly be required to amend a number of their income tax returns.
G. **Strict Construction of Contingencies and Ambiguities.**

The rules addressing contingencies relating to a child have thus far been construed strictly. A payment reduction will not be treated as being clearly associated with the happening of a contingency relating to a child of the payor unless one of the factual situations described above is present. Accordingly, payments of unallocated family support may still be taxable to the payee spouse as alimony unless child support is “fixed” with some specificity. Reg. 1.71-1T(c), Q&A 18; Commissioner v. Lester, 366 U.S. 299 (1961); Heller v. Commissioner, TC Memo 1994-423 (holding that the ability of a court to modify child support does not, by itself, constitute a contingency relating to a child); Ambrose v. Commissioner, TC Memo 1996-128 (holding that unallocated family support payments were taxable alimony to the payee spouse).

H. **Seizure of Refund to Satisfy Delinquent Child Support Obligation.**

The IRS may seize an income tax refund to pay a parent’s delinquent child support obligation. Code Sections 6305 and 6402(c); Reg. 301.6305-1(b)(4)(iii). If the parent is filing a joint return, the non-obligated spouse may file a claim as an injured spouse to avoid having the portion of the refund attributed to his or her income from being seized. In order to do so, the non-obligated spouse must write “Injured Spouse” in the upper left corner of Form 1040 and attach Form 8379 “Injured Spouse Allocation”. The IRS will then determine how much of the refund to which the non-obligated spouse is entitled. Rev. Rul. 80-7, 1980-1 CB 296.

**CHAPTER IV - PROPERTY SETTLEMENT ISSUES IN DIVORCE AND SEPARATION**

A. **Introduction.**

The transfers and payments between spouses and former spouses generally fall into three categories, namely payments for alimony, payments for child support, and property settlements. As indicated in the discussion above, how the parties characterize a payment is not necessarily determinative of its tax treatment. Note that transfers of property between spouses may never qualify as alimony, since alimony may only be payable in cash. Code Section 71(b)(1).
B. **Pre-1984 Act Rules.**

For many years, the governing tax rule for transfers of property in the matrimonial area was the basic rule governing sales and exchanges of property, i.e. that a transfer of property incident to divorce was a sale or exchange of property made in consideration of the relinquishment of valuable marital property rights, and a taxable event. The transferor of property was required to recognize gain on the difference between his or her basis in the transferred property and the fair market value of the property. The transferee took as his or her income tax basis the fair market value of the transferred property on the date of its transfer. Code Section 1001; United States v. Davis, 370 U.S. 65 (1962). The Davis rule lead to great amounts of litigation, with the parties contesting whether under state law there was a division of property between co-owners (which would have resulted in a non-taxable event with a carryover income tax basis) or a sale. See McIntosh v. Commissioner, 85 TC 31 (1985).

C. **Current Rules - Code Section 1041.**

The Davis rule was drastically changed by the 1984 Act which introduced Code Section 1041. This Section provides that the transfer of property outright or in trust between spouses or former spouses incident to divorce is not a taxable event. Accordingly, the transferor spouse will recognize neither gain nor loss on the transfer. Code Section 1041(a)(1) and (2); Reg. 1.1041-1T, Q&A 10. This nonrecognition rule applies even if the parties are acting at arms’ length and if the transferee pays full consideration for the property, whether in cash, in exchange for the release of marital rights, or by the assumption of liabilities. Reg. 1.1041-1T(a), Q&A 2; Reg. 1.1041-1T(d), Q&A 11. Similarly, the transferee spouse does not pay income tax on the value of the property received.

1. For purposes of this rule, “property” includes all property, whether real or personal, tangible or intangible, or separate or community.

2. The rule applies to property acquired before, during or after the end of a marriage and transferred to a former spouse. It applies regardless of whether the transfer is of property separately owned by the transferor, or is a division (whether equal or unequal) of marital property or community property. Reg. 1.1041-1T(a), Q&A 5; 1.1041-1T(d), Q&A
10. It does not, however, apply to services. If the transferor spouse performs valuable services for or on behalf of the payee spouse, arguably gain would be recognized by the payee spouse. Reg. 1.1041-1T(a), Q&A 4.

Planning Point: The purpose of Code Section 1041 is to create a regime of standardized tax treatment for transfers made between spouses and former spouses incident to divorce. As will be seen in the following discussion, the results of applying Code Section 1041 in certain circumstances (such as where the transferee spouse may have furnished consideration which is ignored under Section 1041) may appear to be - and actually be - inequitable. These situations should be understood and acknowledged by the parties and dealt with in the total property settlement between the parties.

Note: If property is transferred prior to marriage, it is not covered by Section 1041. Accordingly, if pursuant to a prenuptial agreement, and prior to the marriage, appreciated or depreciated property is transferred in exchange for the release of marital rights, such a transfer will not be viewed as a gift for income tax purposes, or as a non-taxable event under Section 1041. Rather, the transfer will be treated as a taxable sale, with the transferor recognizing gain or loss, and the transferee taking a fair market value basis in the transferred property. Farid-es-Sultaneh v. Commissioner, 160 F. 2d 812 (2nd Cir. 1947). However, if an obligation arises under a prenuptial agreement but the transfer of property to satisfy the obligation takes place during or subsequent to the marriage, the rules of Code Section 1041 apply to the transfer.

D. Basis Rules - Analogy to a Gift.

When property is subject to the rules of Code Section 1041(a), the property is treated as if it had been acquired by the transferee by gift. The transferee’s basis in the transferred property carries over from the transferor - i.e. the transferee takes the transferor’s basis in the property immediately prior to the transfer. Code Section 1041(b)(2).

1. This rule applies whether the property’s adjusted basis is less than, equal to, or greater than either the property’s value at the time of the transfer, and ignores any consideration paid for the property by the transferee. Reg. 1.1041-1T(d), Q&A 11; Godlewski v. Commissioner, 90 TC 200 (1988).
2. If Code Section 1041 is applicable, even if the transfer is a bona fide sale, the transferee spouse must take a carryover basis. Reg. 1.1041-1T(d), Q&A 11. This rule applies where the transferee spouse makes a required payment to the transferor spouse for the transfer of title to the property to the transferee spouse. Reg. 1.1041-1T(a), Q&A 2. The payment by the transferee is ignored in calculating the transferee’s carryover basis from the transferor.

3. This rule even applies if the liabilities associated with the property at the time of its transfer exceed its adjusted basis. Reg. 1.1041-1T(d), Q&A 11,12. The mandatory nonrecognition treatment and carryover basis rules of Code Section 1041 also supersede the partnership rule of Code Section 752 when there is a transfer of a partnership interest, and the transferor’s share of partnership liabilities exceeds his or her basis in the partnership interest. PLR 9250031.

Example: Zoe owns property valued at $20,000 that has a cost basis to her of $2,000. Zoe and Andy are getting divorced. Zoe borrows $10,000 from a bank, using the property as collateral. Zoe then transfers the property to Andy, with Andy assuming the liability to pay the $10,000 debt. Under Section 1041, neither Zoe nor Andy recognizes any gain or loss upon the transfer of the property, and the adjusted basis of the property in Andy’s hands is $2,000. Reg. 1.1041-1T(d), Q&A-12.

Note: The basis rule mandated by Code Section 1041 is different than the general rule that determines the basis of property acquired by gift. Code Section 1015(a) provides that in the “true gift” context, the transferee takes a basis equal to the lesser of the fair market value of the transferred property or the transferor’s adjusted basis for purposes of calculating loss on a subsequent sale. In the Section 1041 context, the carryover basis from the transferor applies for purposes of determining loss as well as gain when the transferee subsequently disposes of the transferred asset. Since the transferor spouse recognizes no loss on the transfer of depreciated property, the transferee spouse obtains the adjusted basis of the transferor in the transferred asset, even if the carryover basis exceeds the fair market value of the asset at the time of transfer. Code Sections 1015(e) and 1041(b)(2). However, in the case of an asset subject to the passive activity loss rules (such as a rental property), the accumulated suspended losses are added to the basis of a gifted interest, but such losses are never allowed as a
deduction. Code Section 469(j)(6).

4. There are several circumstances where the transferor will be required to recognize gain. Where this occurs, the transferee’s basis will be adjusted to take into account gain recognized by the transferor. These circumstances (discussed further below) include transfers to trusts of installment obligations, transfers to trusts where the adjusted basis of the property transferred is exceeded by the sum of the liabilities assumed and the amount of liabilities to which the property is subject, Code Section 1041(e), and transfers of U.S. Savings Bonds bearing accrued interest. Where gain is required to be recognized, the amount of such recognized gain is added to the transferee’s carryover basis in the asset received. Code Section 1041(e).

5. The transferor spouse is required to provide the transferee spouse with records sufficient to determine his or her adjusted basis and holding period in the transferred property. Reg. 1.1041-1T(e), Q&A 14.

Example: Pursuant to a divorce, Husband transfers securities to Wife valued at $25,000 for which Husband paid $10,000. Wife takes a basis in the stock of $10,000. Accordingly, there is a “built-in gain” of $15,000 in the stock when/if Wife sells it. The potential income tax liability on this built-in gain should be taken into account by the parties in negotiating the settlement.
E. **Holding Period.**

For income tax holding period purposes, the transferee of any carryover basis property is permitted to include the holding period during which the transferor held the property. Code Sections 1041(b)(2) and 1223(2); PLR 8719007.

F. **Transfers of Property Incident to a Divorce.**

Code Section 1041 applies to all transfers of property between spouses. There is no requirement that a divorce or separation ever occur for this Code Section to apply. In order for Code Section 1041 to apply to a property transfer between former spouses, the transfer must be “incident to the divorce”. In order for a transfer to be considered “incident to a divorce” one of the two following conditions must be satisfied:

1. The transfer occurs not more than one year after the date on which the marriage ceases (whether or not made pursuant to a divorce or separation instrument, and regardless of whether the marriage ends by divorce, annulment, or as the result of the violation of state law), Code Section 1041(c)(1); or

2. The transfer is related to the cessation of the marriage. Code Section 1041(c)(2). A property transfer is treated as related to the cessation of the marriage if both of the following conditions apply, namely:

   a. The transfer is made pursuant to a divorce or separation instrument described in Code Section 71(b)(2), (including a modification or amendment of such decree or instrument) [Note: a transfer occurring within one year of the date of cessation of the marriage need not be made pursuant to a divorce or separation instrument. Code Section 1041(c)(1)] and

   b. The transfer occurs not more than six years after the date of cessation of the marriage. Reg. 1.1041-1T(b), Q&A 7. PLR 9306015. The Regulations include in the term “cessation of the marriage” events such as annulments and voided marriages. Reg. 1.1041-1T(b), Q&A 8.

3. If these conditions are not met, i.e. the transfer is not made pursuant to a
divorce or separation instrument - unless made within one year after the date of cessation of the marriage - or the transfer is made more than six years after the date of cessation of the marriage, the transfer is presumed to be not related to the cessation of the marriage. See, e.g. PLR 9306015.

a. This presumption may be rebutted only by showing that the transfer was made to accomplish the division of property owned by the former spouses at the time of the cessation of the marriage.

b. For example, the presumption may be rebutted by demonstrating that the transfer was not made within the prescribed six year period because of factors interfering with the earlier transfer of the property, such as business or legal disputes hindering transfer, or disputes as to the value of the property at the time of cessation of the marriage, and by further demonstrating that the transfer was accomplished promptly after these factors were resolved. Reg. 1.1041-1T(b), Q&A 7; PLRs 9235026, 9644053 (protracted litigation over value and purchase price) and 200221021(compelling business reasons).

G. **Transfers to Third Parties on Behalf of a Spouse.**

The rules of Code Section 1041 only apply to transfers between spouses and former spouses. However, a transfer to a third party “on behalf of” a spouse or former spouse may allow the transferor to be treated under Code Section 1041 if:

1. The transfer to the third party is required by a divorce or separation instrument; or

2. The transfer to the third party is pursuant to the written request of the transferee spouse; or

3. The transferor receives from the transferee spouse a written consent or ratification of the transfer to the third party. The consent or ratification must state that the parties intend the transfer to be treated as a transfer to the transferee spouse subject to the rules of Code Section 1041. The writing must be received by the transferor spouse prior to the date of filing the transferor’s first income tax return for the taxable year in which the transfer was made. Reg. 1.1041-1T(c), Q&A 9.
Note: In a circumstance where this third party transfer situation exists, the transfer of property is treated as made directly to the transferee spouse, and such spouse is further treated as immediately transferring the property to the third party. The “deemed transfer” from the transferee spouse to the third party is not a transaction that qualifies for nonrecognition of gain treatment under Code Section 1041. Similarly, if there is a sale of marital property to a third party resulting in a division of the sale proceeds between the spouses, this is not viewed as a “transfer of marital property incident to a divorce”, and is treated as any similar transaction not governed by Code Section 1041 would be. Berger v. Commissioner, TC Memo 1996-76.

Example: Husband and wife could not agree on which of them should receive a sculpture they owned together. The divorce decree ordered the sale of the piece and the division of the proceeds. This would not be covered by Section 1041, and the parties would report gain or loss on the sale as would be the case in any non-divorce context.

Example: Wife owed her professional advisors $25,000 for services rendered. The divorce decree ordered husband to transfer securities to wife to enable her to satisfy her obligation. Husband’s transfer to wife is covered by Section 1041. He realizes neither gain nor loss on the transfer of the securities to wife, regardless of whether they had appreciated or declined in value. When wife either sells the securities and transfers cash to the advisors, or transfers them in kind, she is treated as having made a sale, and will realize gain or loss, depending on the carryover basis of the securities in her hands.

H. Redemption of Stock in a Closely-Held Business.

1. The Section 1041 Regulations (1.1041-2) provide clear rules that someone must recognize taxable income on the distribution of funds in connection with a stock redemption pursuant to a divorce.

   a. The rule of Reg. 1.1041-2(a)(1) prevents the application of Code Section 1041 to the spouse whose interest is redeemed (assume W). This provision applies when the other spouse (assume H) does not have a primary and unconditional obligation to purchase the stock of the redeeming spouse. Where this is the case, the form of the stock redemption will be respected for income tax purposes, and Code Section 1041 will not apply. In such a situation, the redeeming spouse
(W) will be subject to the rules of Code Section 302 applicable to distributions in redemption of stock.

b. The rule of Reg. 1.1041-2(a)(2) applies the nonrecognition rules of Code Section 1041 to the redeeming spouse (W) and applies the constructive distribution rules to the other spouse (H). Where the other spouse (H) has a primary and unconditional obligation to purchase the redeeming spouse’s (W’s) interest in the corporation, the other spouse (H) will be deemed to have received the distribution from the corporation and then to have transferred the distribution to the redeeming spouse (W). Here, the redeeming spouse (W) will not be subject to income tax on the redemption, but the other spouse (H) will be subject to Code Sections 301 and 302 to determine the tax consequences of the deemed distribution. The Regulation provides that any property actually received by the redeeming spouse from the corporation in respect of the redeemed stock is first deemed to be transferred by the corporation to the other spouse in redemption of that spouse’s stock and then transferred by that spouse to the redeeming spouse.

c. The key determination of whether one spouse has a primary and unconditional obligation to purchase the ownership interest of the other spouse is a question of fact. Where this is established clearly in the divorce agreement, there will be no issue as to the tax consequences. However, Reg. 1.1041-2(c) permits the parties to elect which of them will be subject to tax on the redemption. The parties may elect to have the redeeming spouse be subject to a redemption distribution, or elect to have the other spouse be subject to a constructive dividend distribution.

d. Ideally, a number of planning opportunities arise here, since the agreement as to the tax consequences can be separate from the divorce agreement. It can be executed as late as the timely filing due date, including extensions, of the tax return of the spouse recognizing the distribution for the tax year that includes the date of the stock redemption. Reg. 1.1041-2(c)(3). This gives the parties the opportunity to address the tax benefits and burdens to each party. Less than ideally, these new Regulations require the spouses to be aware of this potential tax issue and address it through negotiations as to which of them will be subject to taxation - something that may be a
great deal to expect in the context of a divorce.

**Planning Point:** To avoid some of the uncertainty surrounding the tax treatment of divorce-related stock redemptions, consider having one spouse purchase the stock held by the other spouse directly. (Avoid an actual corporate redemption) Under Code Section 1041, the selling spouse will recognize no gain. The purchasing spouse acquires the seller’s basis in the shares, and the gain is deferred until the stock is sold. When they determine the purchase price for the shares, the parties can take into account the eventual tax consequences to the purchasing spouse.

I. **Transfers of Property into Trusts.**

Transfers in trust are frequently utilized in the context of divorce and separation. A trust provides the recipient spouse with a regular source of funds, rather than the payor spouse’s unfunded promise to make alimony payments. Most transfers in trust fall under the rules of Code Section 1041(e) and do not result in the recognition of any gain or loss to the transferor.

1. The transfer is treated as if the transferee spouse received the beneficial interest in the trust as a gift from the transferor spouse. The trust obtains a carryover basis in the transferred property. The transferor’s transfer to the trust is generally protected from gift tax liability by Code Section 2516.

2. For income tax purposes, Code Section 682 applies to trusts involved in a divorce or separation, not Code Section 71.

   a. Code Section 682 applies if the transferor and transferee are divorced, have a written separation agreement, or are legally separated.

   b. Code Section 682 provides that the transferee spouse is taxed as a trust beneficiary, and not as the recipient of alimony, on the amount of any trust income that the transferee spouse is entitled to receive. But for this provision, such trust income would otherwise have been taxable to the transferor spouse under the grantor trust rules of Code Sections 671-679 (as payments used to satisfy the grantor’s support obligation).
c. Since the recipient spouse is not receiving alimony, the transferor spouse is not entitled to an income tax deduction when the trust is created.

d. Code Section 682 does not apply to the portion of any income of a trust fixed as child support payments under a divorce decree, written separation agreement or the trust instrument. Child support payments made from a trust are considered payments for support, and the income attributable to them is taxed to the transferor spouse. Accordingly, the rules of Code Section 682 tax the grantor spouse on trust income fixed as child support, and the beneficiary spouse is taxed on the balance of the trust income payable to him or her. If trust income in a given tax year is insufficient to make the required distributions for support of the spouse and for child support, income distributions are deemed to be applied first to child support. Code Section 682(a).

3. Note that the use of a trust avoids most of the alimony restrictions contained in Code Section 71.

   a. While payments of alimony may not continue after the death of the payee spouse, a trust may be designed to continue payments to the estate of the payee spouse, or to his or her beneficiaries.

   b. While a decrease in alimony payments made during the first three payment years may lead to the recapture of alimony payments, a trust may make decreasing payments to a spouse without any concern for recapture.

   c. A trust may provide lifetime support for a divorced spouse, or it may provide for payments for a fixed period of time, followed by a reversion to the transferor spouse (or such person’s estate) or a payment to the transferor’s children.

J. **Special Types of Property Transfer Issues Considered.**

   There are a number of special rules relating to the type of property transferred or to the tax characteristics of certain property. These rules are discussed below.
1. **Recapture of Depreciation, Investment Tax Credits.** The transfer of property incident to divorce will not result in the recognition of depreciation or investment tax credit recapture, (even if the property is Section 1245 or Section 1250 property), since no gain or loss, including depreciation recapture, is triggered by Code Section 1041, since the transfer is treated in the same manner as a disposition by gift. PLR 8719007.

2. **Installment Obligations.** Except in the case of a transfer to a trust, the transfer of an installment obligation will not be treated as a disposition of the obligation, and will not cause acceleration of gain to the transferor spouse. Code Section 453B(g). The same tax treatment as would have applied to the transferor spouse will be applied to the transferee spouse. Code Section 453B(g)(2).

3. **United States Savings Bonds.** The transfer of Series E and EE United States Savings Bonds will be taxable to the transferor spouse to the extent of untaxed accrued interest inherent in the bonds at the time of the transfer. An assignment of income theory is applied here. Code Section 454; Rev. Rul. 87-112, 1987-2 C.B. 207. The transferee spouse will take a basis in the transferred bonds equal to the transferor spouse’s basis plus the amount of income recognized by the transferor. Reg. 1.454-1(a). Note that Code Section 1041 is not applicable here since Section 1041 shields gain from recognition, not income.

4. **S Corporation Shares.** Where S corporation stock is transferred pursuant to a divorce, any suspended losses incurred by the transferor are transferred to the transferee. Code Section 1366(d)(2)(B).

5. **Passive Activity Property.** Where the transferor spouse transfers his or her entire interest in a passive activity to a transferee spouse incident to divorce, the transfer will not trigger a deduction for suspended losses by the transferor spouse. Instead, Code Section 469(j)(6) provides that in the case of a disposition of any interest in a passive activity by gift, the basis of such interest immediately before the transfer is to be increased by the amount of any passive activity losses allocable to such interest with respect to which a deduction has not been allowed, thereby indirectly permitting the transferee spouse to use the losses as a result of an increase in basis.
6. **Life Insurance Policies.** Transfer of a life insurance policy pursuant to divorce, even though made for consideration, does not trigger the transfer for value rule of Code Section 101(a)(2), since Code Section 1041 gives the transferee spouse a carryover basis in the property and negates the operation of the transfer for value rule.

7. **Interests in IRAs.** Transfers of interests in an IRA to a spouse or former spouse are treated as nontaxable transfers provided that the transfer is pursuant to a decree of divorce or separate maintenance or a written instrument incident to such a decree. Code Section 71(b)(2)(A). Note that a transfer in accordance with a written separation agreement is not sufficient to achieve a nontaxable transfer of an IRA. FSA 199935005; PLR 9344027. Once transferred under a divorce or separation agreement, the participant’s interest in the IRA is treated as owned by and taxable to the transferee spouse. Code Section 408(d)(6); Reg. 1.408-4(g)(1). Where a spouse takes a distribution from an IRA and pays it to the other spouse pursuant to a divorce, such a transfer has been held to not constitute the transfer of an “interest” in the IRA, so that the withdrawal is taxable to the IRA owner. Bunney v. Commissioner, 114 TC 259 (2000) (Must transfer an interest in an IRA, not the proceeds, to shift the tax burden); Czepiel v. Commissioner, TC Memo 1999-289; aff’d 86 AFTR2d 2000-7304 (1st Cir. 2000).

**Planning Point:** In order to avoid income taxation on the transferor where some, but not all of the value of the IRA must be transferred, consider dividing one large IRA into two or more smaller ones, and then transferring the interest in one or more entire IRAs to satisfy the transferor’s obligation to the transferee spouse. Make certain that the transfer may occur after the divorce is final in order to avoid being “caught” in the written separation agreement vs. final decree controversy.

8. **Interests in Qualified Retirement Plans.** As a general rule, the ERISA rules prohibit the transfer (“alienation”) of qualified retirement plans. However, in order to facilitate matrimonial settlements where qualified plans are involved, transfers of interests in qualified retirement plans may be made when they are in the form of a Qualified Domestic Relations Order (QDRO) that satisfies the requirements of ERISA. Code Sections 401(a)(13)(A) and 414(p). The transferee spouse is referred to as an “alternate payee” of the qualified plan. If the plan terms permit, a QDRO may provide for the payment of plan benefits that would be
payable to the plan participant to an alternate payee at any time. A QDRO may be written to direct payments to an alternate payee prior to the time that the plan could make payments to a participant, Reg. 1.401(a)-13(g)(3), or at the earliest retirement age permitted under the plan. Code Section 414(p)(4).

a. A “qualified domestic relations order” includes a judgment, decree, or order, including an order approving a property settlement agreement, that relates to the provision of child support, alimony payments or marital property rights to an alternate payee, who may be a spouse, former spouse, child, or other dependent of the participant which is made pursuant to a state domestic relations or community property law. Code Sections 414(p)(8) and 414(p)(1)(B)(ii).

b. A QDRO must create or recognize the existence of an alternate payee’s right to, or assign to an alternate payee the right to receive all or a portion of the benefits payable to a participant. It must clearly and fully specify the amount or percentage of benefits to be paid to each alternate payee, or the formula by which such amount or percentage is to be determined, along with the number of payments or the period over which payments are to be made. If an order is not a QDRO, the distribution will generally be taxable to the employee, not to the alternate payee. Code Sections 414(p)(1)(A)(i) and (ii) and 414(p)(2)(A)-(C). Hawkins v. Commissioner, 86 F. 3d 982 (10th Cir. 1996).

i. Tax liability shifts to the alternate payee only if the payee is a spouse or former spouse. Code Section 402(e)(1)(A).

ii. Amounts paid pursuant to a QDRO to a child or other dependent will be taxed to the plan participant. Stahl v. Commissioner, TC Memo 2001-22.

c. The transferee spouse can have the plan benefits described in a QDRO paid in a direct rollover to an IRA or to another qualified employer plan. The 10% penalty tax imposed on early plan distributions is not applied to a QDRO. Code Section 72(t)(2)(C).

d. Note that courts have been firm in finding that ERISA preempts state
statutes, so that the ERISA rules, designating the QDRO as the only mechanism by which a former spouse can preserve his or her rights to qualified plan survivor benefits upon the plan participant’s death, are the exclusive recourse for a spouse’s protection. Egelhoff v. Egelhoff, 121 S. Ct. 1322 (2001). In short, if a matrimonial agreement does not contain a QDRO making specific reference to retirement plan benefits, the non-employee spouse will be denied recovery of any share of such benefits.

e. If a former spouse is the named beneficiary of a qualified plan when the participant dies, and the matrimonial agreement and divorce decree provided for the spouse’s waiver of the plan rights, but no QDRO was created, and no beneficiary change was filed, the naming of the spouse as the plan beneficiary controls the disposition of the plan proceeds, and the divorce decree is properly ignored. Kennedy v. Plan Adm’r for DuPont Savings & Inv. Plan, 129 S. Ct. 865 (2009).

K. Disposition of the Marital Residence.

Many matrimonial cases involve the disposition of the principal residence owned by the parties.

1. The transfer of a principal residence between the spouses is governed by Code Section 1041. Neither party recognizes gain or loss on the transfer, and the transferee spouse takes the cost basis of the transferor’s interest in the property, and adds it to his or her own basis in such property, if any. This carry over basis rule applies whether the home was originally owned by the couple as tenants by the entirety, joint tenants with right of survivorship, tenants in common, community property, or by one spouse only. It also applies even if the transferee pays any consideration to the transferor spouse.

2. Transfers of a principal residence between former spouses not incident to divorce, and transfers of the residence to third parties are governed by the rules of Code Section 121. These rules allow qualifying taxpayers to exclude from gross income gain of up to $250,000 ($500,000 for qualifying joint filers) realized on the qualified sale or exchange of a principal residence once every two years. In order to qualify for the exclusion of gain under Code Section 121, the following requirements
must be satisfied:

a. The taxpayer (or, if married taxpayers are filing a joint return in the year of sale, either the taxpayer or the taxpayer’s spouse) has owned and both spouses have used the home as his or her principal residence for periods aggregating two of the five years immediately prior to the sale or exchange - the periods need not be continuous; Code Sections 121(a) and 121(d)(1); and

b. The taxpayer has not excluded gain under Section 121 with respect to a sale occurring within the two years immediately preceding the current sale. Code Section 121(b)(3)(A).

Accordingly, as a general rule, the spouse who remains in the family home will have the benefit of the Section 121 exclusion provisions if he or she elects to sell the house.

3. If the selling spouse is holding property obtained from a spouse or former spouse that was transferred in a transaction qualifying under Code Section 1041, the period of ownership for such seller includes the period during which his or her spouse or former spouse owned the property Code Section 121(d)(3)(A); and

4. If a spouse or former spouse is granted use of the home under a divorce instrument described in Code Section 71(b)(2), such spouse’s use of the property as his or her principal residence during the period of occupancy allowed by the divorce instrument is imputed to the other spouse [Code Section 121(d)(3)(B)]

CHAPTER VII - HOW TO HANDLE THE DEPENDENCY EXEMPTION

A. General Rules.

As a general rule, a taxpayer is permitted to deduct an amount each year as a personal exemption for him or herself and for his or her dependents. The amount of the allowable exemption is adjusted annually for inflation. Code Section 151(d)(4). The exemption amount is $3,900 for 2013.

B. Claiming the Dependency Exemption.

In the context of separation and divorce, where a joint return is not being
filed by the divorcing parents, only one parent may claim an exemption for each child. Code Section 152(e) contains a special rule which allocates the dependency exemption for a child of divorced and certain separated taxpayers. If Code Section 152(e)(1) applies, a child will be treated as having received over one-half of his or her support from the parent having custody of the child for the greater portion of that calendar year. Such parent, known as the “custodial parent”, will be entitled to claim the child as a dependent for that year, even if the noncustodial parent actually provides over half of the child’s support during the year. This rule will apply unless the custodial parent allows the dependency exemption to be claimed by the non-custodial parent.

1. For purposes of this rule, “custody” refers to physical custody. Code Section 152(e); Reg. 1.152-4(c).

2. The custodial parent is deemed to be the one having physical custody of the child for the greater part of the calendar year. The test is based on the number of days of custody - not on the amount of support provided. Reg. 1.152-4(b). It is a “time” test – based on the number of nights that a child resides with a particular parent, rather than on the terms of the matrimonial agreement or divorce decree. Final Regulations issued in 2008 (TD 9408) use the “counting nights” test as a “bright line” to determine which parent has custody for the greater part of the year. For purposes of Code Section 152(e), a child resides for a night with a parent if the child sleeps:

   a. At the residence of the parent, whether or not the parent is present;
   
   or
   
   b. In the parent’s company when the child does not sleep at the parent’s residence.

**Note:** The Regulations provide rules that do not penalize a parent for absences caused by military service, business trips, hospital stays, etc.

3. Special problems may arise in circumstances where there is a shared custody arrangement allowing the children to divide their time equally with both parents, or in circumstances where the children actually spend more time with the noncustodial parent, despite the terms of the matrimonial agreement. Physical custody – “counting nights” - has
C. **Release of Claim to Dependency Exemption.**

Notwithstanding the rule providing that the parent with the greater amount of physical custody (the “over-night” rule) is entitled to the dependency exemption, such parent may agree to release that exemption to the other parent. In order to be eligible for this release, the following criteria must apply:

1. The parents are divorced or legally separated under a decree of divorce or separate maintenance, or are separated under a written separation agreement; or the parents lived apart at all times during the last six months of the calendar year. Code Section 152(e)(1)(A)(i) through (iii).

2. One or both parents provide more than half of the child’s total support for the calendar year. Code Section 152(e)(1)(A). (Support is determined by calculating the entire amount of support the child received from all sources, including his or her own funds). A payment of alimony is not treated as a payment for the support of a dependent. Code Section 152(b)(4).

3. One or both parents have custody of the child for more than half of the calendar year. Code Section 152(e)(1)(B). Note that if both parents fail to meet the one half of the year custody test, Section 152(e) does not apply, and the person contributing more than half of the child’s support (absent a multiple support agreement, discussed below) may claim the child as a dependent, provided the other dependency exemption tests described above are met.

4. The custodial parent signs a written declaration (IRS Form 8332) constituting an unconditional release that the custodial parent waives the right to claim the child as a dependent for any taxable year commencing with the year in which the declaration is executed. In such a case, the noncustodial parent must attach the written declaration to his or her tax return for each year the noncustodial parent is claiming the exemption. Code Section 152(e)(2); Reg. 1.152-4T(a), Q&A 3.

   a. The exemption may be released for one year, for a number of specified years, or for all future years, depending on the language of
the written declaration. A specific year or series of years must be specified for this release to be effective. Reg. 1.152-4T(a), Q&A 4; Reg. 1.152-4(f) Ex. 7.

b. If the exemption is released for more than one year, a copy of the original release must be attached to the tax return filed by the noncustodial parent for each succeeding year for which he or she claims the dependency exemption. Reg. 1.152-4T(a), Q&A 4. Failure to file a declaration will preclude the availability of the deduction.

c. If there are conditions imposed on the custodial parent’s release of the right to the dependency exemption, such conditions will be respected, and the dependency deduction denied to the noncustodial parent if the conditions are not met. Flatt v. Commissioner, TC Memo 1986-495 (failure to maintain a life insurance policy).

d. The IRS strictly interprets the requirement that an actual Form 8332 or a written declaration conforming to the substance of the Form must be attached to the return of the noncustodial parent. Attachments that do not contain the detail required by Form 8332 have been rejected as insufficient substitutes. Reg. 1.152-4T(a), Q&A 3; White v. Commissioner, TC Memo 1996-438; Miller v. Commissioner, 114 TC 184 (2000). The final regulations provide that a court order or decree or a separation agreement may not substitute for this declaration.

e. The spouse signing Form 8332 to release the dependency exemption must have custody of the child at the time the release is signed for it to be effective. FSA 200211004.

f. If the custodial parent attempts to revoke a multi-year Form 8332, such revocation will not be effective unless the noncustodial parent does not claim the child as a dependent. CCA 200007031.

Note: Waiver of the dependency exemption will also result in the release of the child tax credit (Code Section 24 – allowing a $1000 credit for each child under age 17 for whom the taxpayer claims the dependency exemption) and the American Opportunity Credit, the Hope Scholarship Credit and the Lifetime Learning Credit (Code Section 25A – which also
follow the dependency exemption). It will not cause the custodial spouse to lose eligibility for other tax benefits, such as the dependent care credit (Code Section 21 – providing for an income tax credit equal to a specified percentage of employment-related expenses incurred in caring for qualified individuals), the earned income credit, or eligibility for head of household status.

5. The parties may enter into a multiple support agreement. Code Section 152(c). This is an exception to the general support test. This may arise where two or more people together pay over one-half the support of a child, but no one person alone pays more than one-half. (For example, a child lives with her grandparents. Her divorced parents each provide 35% of her support, and her grandparents provide 30%. Neither parent has custody, and neither provides more than half the child’s support. A multiple support agreement could allow either parent or the grandparents to claim the dependency exemption). In such circumstances, one of the payors may be treated as paying over one-half of the support of a child and may claim the child as a dependent if:

a. The taxpayer paid over 10% of the total support;

b. If not for the support test, the taxpayer could satisfy the requirements for the dependency exemption with respect to the child;

c. The claimant attached to his or her return a Form 2120, Multiple Support Declaration, signed by every other person meeting the requirements of 3 a and b, above. Those persons signing Form 2120 agree by signing the Form that they will not claim the dependency exemption for that year. Code Section 152(c)(1) through(4).

D. Medical Expense Benefits and Deductions.

With respect to eligibility of the child for medical benefits or payments of medical expenses on behalf of a child of divorced or separated parents, either parent may claim the child for purposes of benefit eligibility and for the deduction for medical expenses paid on behalf of such child, regardless of which parent is entitled to claim the dependency exemption for the child. Code Section 213(d)(5); Reg. 1.152-4T(a), Q&A 5. Rev. Proc. 2008-48. This includes medical expense deductions and reimbursements, employer-provided health insurance, fringe benefit exclusions and exclusions from
CHAPTER VI - FILING STATUS ISSUES FOR DIVORCED AND SEPARATED TAXPAYERS

A. Marital Status.

1. Marital status for the entire tax year is determined on the last day of the taxable year (which is December 31 for calendar year taxpayers, and a person’s date of death if he or she dies during the year). Code Section 7703(a)(1).

2. State law is generally applied to determine the validity and finality of a divorce. Domestic divorces must generally (absent fraud or lack of jurisdiction of the court granting the divorce) be recognized by every state under the full faith and credit clause of Article IV of the U.S. Constitution. A divorce that takes place in another jurisdiction (including an offshore jurisdiction) is considered to be valid unless declared invalid by a court. Rev. Rul. 67-442, 1967-2 CB 65.

3. Spouses who are legally separated under a final decree of divorce or separate maintenance are not considered married for tax purposes. Code Section 7703(a)(2).

   a. This does not include a voluntary separation under a voluntary separation agreement. It does not include a decree of support or temporary alimony absent an order of legal separation. In these latter situations, the parties are still considered to be married. Keller v. Commissioner, 468 F. 2d 627 (2nd Cir. 1972); Boyer v. Commissioner, 732 F. 2d 191 (D.C. Cir. 1984); Johnson v. Commissioner, TC Memo 1980-9. An interlocutory decree is not a final decree.

   b. An individual is legally separated under a decree if the decree expressly and affirmatively provides that the parties live apart in the future. Capetown v. Commissioner, 602 F. 2d 64 (3rd Cir. 1978).

B. Income Tax Return Filing Alternatives

1. Introduction. In the context of divorce, the filing status of an individual
is subject to a number of rules that will determine which filing status may or may not be available.

2. **Married Filing Jointly.**

a. A joint return may only be filed by those taxpayers who are married at the close of a tax year. Code Section 6013(a). Taxpayers living together in a common law marriage that is recognized by the state law of their domicile or the state where the marriage began, are treated as married. Rev. Rul. 58-66, 1958-1 CB 60. Same sex, married individuals can file jointly for federal income tax purposes if they married in a state that recognizes same sex marriages. Taxpayers are not considered to be married when they are legally separated under a decree of divorce or separate maintenance. Code Section 6013(d)(2). A joint return may be filed by married persons living apart from each other, so long as they are not legally separated. Reg. 1.6013-4(a).

b. Joint return filing subjects both filers to joint and several liability for all taxes, interest and penalties due in connection with the return, regardless of each spouse’s share of the taxable income. The IRS may attempt to collect all of any balance due from either spouse, notwithstanding any agreement between the spouses as to which will be responsible for IRS obligations. Code Section 6013(d)(3); Pesch v. Commissioner, 78 TC 100 (1982). Its collection efforts and success with one taxpayer must be disclosed to the other taxpayer. In the context of an impending divorce, the parties should be cautious in taking the risk of subjecting themselves to a liability that may be difficult to resolve in the future when their lives and assets have become separated. Signing returns and receiving and disposing of refunds may also pose practical problems. The filing of a joint return does not have the effect of converting the income of one spouse into the income of the other. Dolan v. Commissioner, 44 TC 420 (1965).

c. Joint return filing precludes deducting a payment to the recipient as alimony, and permits the recipient to not include the payment as income. Code Section 71(e). The parties should evaluate their relative marginal tax brackets to determine the advantages and disadvantages of inclusion/deduction in the absence of a joint return vs. a joint return filing.
d. A spouse who believes the other joint filing spouse has understated income or otherwise misrepresented items on the joint return may file for innocent spouse relief by filing Form 8857. The Form should be filed as soon as the “innocent” spouse is aware of a problem, but in any event not more than two years after an IRS Notice trying to collect tax from an innocent spouse.

3. **Married Filing Separately.**

   a. If persons are legally married and do not file a joint return, and if neither of them qualifies as “unmarried”, each of the spouses must file a separate return and use the married filing separately tax rates. Code Section 1(d). This filing status becomes more costly to the parties as the disparity in their incomes increases.

   b. Spouses who file their returns as married filing separately are not responsible for the tax liabilities of the other spouse. Code Section 6013(d)(3).

   c. A spouse who makes an alimony payment prior to divorce must file a separate return to deduct the alimony payments made during the year. Code Sections 71(e), 215.

   d. If one spouse filing as married filing separately itemizes deductions, the other must do so as well - unless the non-itemizer qualifies for head of household status, in which case the standard deduction may be claimed.

   e. Where separate returns are filed, each spouse is entitled to deduct the state income tax, property tax and mortgage interest that he or she alone paid. If a casualty loss is suffered on property owned jointly, each spouse can deduct half of the loss. Neither may deduct the entire loss. (IRS Publication 504).

4. **Head of Household.**

   a. A taxpayer who is unmarried must file either as an unmarried (single) individual or as a head of household. Persons filing as head of household are subject to tax rates that are lower than those paid by
single taxpayers, and by married persons filing separately, but higher than those imposed upon filers of joint returns. The persons eligible to file as head of household are generally divorced or single parents, or persons who are still married but who are separated awaiting a final divorce determination and who have minor children.

b. In addition to the advantage of lower marginal rates than single filers, the head of household filer is allowed to claim a larger standard deduction than single filers or married persons filing separately. The head of household filer is permitted to either itemize or claim the standard deduction, regardless of what his or her spouse elects to do. Code Sections 63(c)(2)(B), 63(c)(6) and 63(g).

c. A person filing as head of the household may be able to claim earned income credits and child care credits unavailable on the return of a married person filing separately.

d. If certain qualifications are met, a person may file his or her income tax returns as a head of household, rather than as a single individual.

e. The person must be a U.S. citizen or resident for the entire year and must be considered not married on the last day of his or her taxable year. Code Sections 2(b)(1) and 7703(b); Reg. 1.2-2(b)(1). This will result if:

   i. He or she is single, or is legally divorced or separated under a decree of divorce or separation; or

   ii. The taxpayer is married but lives apart from his or her spouse during the last six months of the taxable year, files a separate tax return and maintains a household (i.e. furnishes over half the cost of the household) during the entire taxable year that was the principal place of abode of a child (for whom the taxpayer is entitled to a dependency deduction, even if the right to claim the deduction has been transferred to the other spouse), for more than one-half of the taxable year. Code Sections 2(b)(1), (c) and 7703(b).

f. The taxpayer furnishes over half the cost of maintaining the household for the year, and a “qualifying person” (unmarried child,
grandchild, foster child, adopted child who need not be the taxpayer’s dependent) must have lived with the taxpayer for more than one-half of the year.

i. If the taxpayer receives alimony payments from his or her spouse and uses such payments to maintain the household, the taxpayer spouse will be considered as having furnished this amount, not the payor spouse.

ii. The costs of maintaining the home include such items as rent, mortgage interest, property taxes, utility charges, maintenance and repairs, property insurance and food. Items such as education expenses, clothing, vacations, medical expenses, life insurance and transportation are not included as such maintenance costs. Reg. 1.2-2(d).

g. The taxpayer claiming head of household status is not required to have custody of a child to be eligible to claim this filing status. Nevertheless, the time spent by a child at the parent’s home is relevant to determine whether such home constitutes the principal residence of the child for more than one-half of the taxable year. It is helpful for the parent seeking to claim or maintain head of household status to maintain a log indicating the presence of the child in the parent’s residence. Temporary absences may be relevant in making this determination, but should not be an issue where they are routine and not an indication of another place of residence of the child. Reg. 1.2-2(c)(1).

h. Note that the manner in which payments are made by one spouse to or on behalf of another may impact on the ability of the payee spouse to claim head of household status. In light of the requirement that a person must furnish more than one half of the cost of maintaining the household, consider having the payor spouse pay housing costs directly to the payee as either alimony or child support payments. This will enable the payee to pay such costs, and count them as household expense payments. If the payor pays such expenses directly to third parties, these costs may not be added to the payee’s costs of maintaining the household, and could jeopardize the claim for head of household status.