NEED-TO-KNOW DIVORCE TAX LAW FOR LEGAL ASSISTANCE OFFICERS

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I. Introduction

On two occasions during the 1980s, Congress passed comprehensive tax legislation that dramatically changed the principles of divorce and sep-

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aration taxation. The first major enactment occurred when the Tax Reform Act of 1984 (TRA 1984)[2] was signed into law on 18 July 1984. The TRA 1984 completely overhauled the tax treatment of property transfers between spouses and between former spouses when the transfer is "incident to a divorce."[3] In addition, while preserving the fundamental precept of alimony deductibility by the payor spouse, TRA 1984 redefined alimony and created "front-loading" anti-abuse rules designed to prevent a payor from transferring property as deductible alimony.[4] The TRA 1984 also changed the eligibility requirements for several tax credits (namely, the child care credit and earned income credit), the child dependency exemption, and other related rules.[5]

Soon after attorneys, IRS auditors, and the judiciary mastered these new rules, Congress passed the Tax Reform Act of 1986 (TRA 1986).[6] The TRA 1986 revised the anti-front-loading rules to permit a larger dollar-amount fluctuation in alimony payments, shorten the period subject to recapture of "excessive" alimony payments, and make additional changes to the alimony provisions.[7] The 1986 overhaul of the marginal tax brackets,[8] the addition of a phase-out of personal and dependent exemptions through a surtax,[9] the repeal of the capital gains sixty percent deduction,[10] and other fundamental changes[11] have all had a major impact on how attorneys must approach settlement negotiations and the structuring of the parties' obligations in separation agreements or divorce proceedings. The attorney who understands these rules is in a strong position to provide his client with valuable tax advice and the opportunity for significant tax savings.

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2. Pub. L. 98-369, 98 Stat. 494 (1984).
3. *Id.* Sec. 421.
4. *Id.* Sec. 422.
5. *Id.*
6. Pub. L. 99-514, 100 Stat. 2085 (1986).
7. *Id.* Sec. 1843.
8. *Id.* Sec. 101.
9. *Id.* Sec. 103.
10. *Id.* Sec. 406.
11. *See, e.g.*, *id.* Sec. 104.

II. Alimony

A. Overview of General Rules Before 1985

Alimony or maintenance payments have been considered as taxable ordinary income to the receiving spouse and deductible by the paying spouse since 1942.[12] Under prior law, for a payment to be considered as alimony it had to meet the following four requirements: (1) the payment had to be "periodic;" (2) the payment had to be in discharge of a legal obligation of support imposed as a result of the family relationship; (3) the payment must have been made subsequent to the entry of a divorce decree or the execution of a separation agreement; and (4) the payment must have been required by the divorce decree or separation agreement.[13] Any amounts paid in excess of that required by the divorce decree or separation instrument were not considered deductible alimony payments.[14] This definition of alimony led to inconsistent results when determining whether alimony existed for federal tax purposes. State law determined whether a payment was "periodic" or whether the payment was based upon an obligation of support that originated out of the family relationship.[15] The inconsistent treatment among the states led to divergent results among taxpayers who were otherwise similarly situated. The TRA 1984 sought to eliminate this disparate treatment.[16]

B. Tax Reform Act of 1984 Overhauls Alimony Definition

The TRA 1984's substantial changes to the alimony provisions were the result of a conscious effort by Congress to reduce the importance of state law differences that caused similarly situated taxpayers to receive different tax consequences.[17] Alimony payments continued to remain deductible by the payor spouse and includable in the income of the payee

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12. The Revenue Act of 1942, Pub. L. 77-753, § 120, 56 Stat. 798, amended the Internal Revenue Code of 1939 by adding a new section 22 (providing for the taxation of alimony payments received) and section 23(c) (providing for the deduction of alimony payments by the payor spouse).

13. I.R.C. § 71(a)(1) (1982).

14. Van Vlaanderen v. Comm'r, 175 F.2d 389 (3d Cir. 1949); Ellis v. Comm'r, 60 T.C.M. (CCH) 593 (1990).

15. *See* Zampini v. Comm'r, 62 T.C.M. (CCH) 475 (1991 (including the cases cited therein).

16. Staff of the Joint Committee on Taxation, *General Explanation of the Revenue Provisions of the Tax Reform Act of 1984*, 98th Cong., 2d Sess. 715 (Comm. Print. 1985).

17. *See* H.R. REP. NO. 98-432, at 1495 (1984).

spouse.[18] The TRA 1984 definition of alimony can be broken into five components:

> 1. The payment must be in cash;[19]
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> 2. The payment must be received by (or on behalf of) the spouse under a divorce or separation instrument;[20]
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> 3. The divorce or separation instrument must not designate the payment as non-deductible by the payor and non-includable by the payee;[21]
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> 4. The spouses may not be members of the same household at the time the payment is made;[22] and
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> 5. The divorce or separation instrument must provide that there is no liability to make payments for any period after the death of the payee spouse and that there is no liability to make any payment (in cash or property) as a substitute payment for such payments after the death of the payee spouse.[23]

Congress later repealed two requirements from the pre-1985 alimony definition. Payments were no longer required to be "periodic" or made on account of the marital relationship imposed under local (namely, state) law.[24] In an effort to prevent divorce and separation agreements from abusing the new "mechanical" alimony rules by attempting to transfer property as alimony (commonly referred to as "excessive front-loading"), Congress also enacted minimum-term and recapture rules.[25] Under the minimum-term rule, alimony payments of more than $10,000 per calendar year were not deductible unless the payor was obligated to make payments for at least six post-separation calendar years.[26] The payments could ter-

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18. I.R.C. §§ 71(a), 215(a).
19. *Id.* § 71(b)(1).
20. *Id.* § 71(b)(1)(A).
21. *Id.* § 71(b)(1)(B).
22. *Id.* § 71(b)(1)(C).
23. *Id.* § 71(b)(1)(D); *see* Priv. Ltr. Rul. 85-51-012 (Sept. 19, 1985) (holding that if this requirement was not in the divorce or separation instrument, then the payments would be neither deductible by the payor spouse nor includable in payee spouse's gross income).
24. Pub. L. 99-514, 100 Stat. 2085, Sec. 1843 (1986).
25. I.R.C. § 71(f) (1982).
26. *Id.* § 71(f)(1) (before TRA 1986, which repealed this rule; § 1843(c)).

minate within the six-year period if one of the following three events occurred: (1) death of the payor spouse; (2) death of the payee spouse; or (3) remarriage of the payee spouse.[27] The purpose of the minimum-term rule was to ensure that deductible payments were only for purposes of support and not a mechanism to effect property settlements.[28]

In addition, if during any one of the first six post-separation calendar years the total of alimony payments made during the calendar decreases by more than $10,000 from any preceding year within the six post-separation calendar years, the difference in excess of $10,000 was "recaptured." The recapture provisions required the payor spouse to add this difference to his or her gross income. The payee spouse was then entitled to a corresponding deduction of the "recapture amount" from his or her gross income, because the amount recaptured had already been included in gross income during an earlier year as alimony income.[29] The purpose of the recapture provisions was to discourage "front-end loading" of alimony payments.

C. Tax Reform Act of 1986 Revised Alimony Provisions

The Tax Reform Act of 1986 made three changes to the alimony rules. First, Congress repealed the requirement that a divorce or separation instrument must specifically state that alimony payments must terminate upon the payee spouse's death.[30] The elimination of this express statement requirement was made retroactive to 1 January 1985.[31] It is important to realize that Congress only repealed the requirement to expressly provide that alimony payments must cease upon the payee's death in the divorce or separation instrument. The general prohibition that there must be no liability to make any alimony payment for any period subsequent to the payee's death remains in effect.[32] Therefore, a prudent attorney should include a specific provision in the divorce or separation instrument precluding alimony payments after the payee spouse dies. Since this 1986 revision, *Q&A 11* and *Q&A 12* of the Temporary Treasury Regulations[33]

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27. *Id.* § 71(f)(5) (before TRA 1986).

28. Staff on the Joint Committee on Taxation, *General Explanation of the Revenue Provisions of the Tax Reform Act of 1984*, 98th Cong., 2d Sess. 715 (Comm. Print. 1985).

29. *Id.* § 71(f) (before TRA 1986).

30. Tax Reform Act of 1986 § 1843(b) (amending I.R.C. § 71(b)(1)(D)); I.R.S. Notice 87-9, 1987-1 C.B. 421.

31. I.R.C. § 71(b)(1)(D); I.R.S. Notice 87-9, 1987-1 C.B. 421, 422; Tax Reform Act of 1986, § 1843(b).

32. *Id.*

remain unchanged. *Question 11* asks what the consequences would be if the divorce or separation instrument did not state that there was no liability to continue to make alimony payments for any period after the death of the payee spouse. The response was that if the instrument failed to include such a statement, none of the payments, regardless if they were made before or after the payee spouse's death, would qualify as alimony. It is also clear that *Answer 11* has no validity when state law does not require payments after the payee spouse dies. However, when state law does not contain this requirement, it would remain valid. Note that Section 20-109 of the Virginia Code provides that spousal support and maintenance (alimony) "shall terminate upon the death of the spouse receiving such support unless otherwise provided by stipulation or contract between the parties."[34]

Question 12 of the Temporary Treasury Regulations asks if a divorce or separation instrument will be treated as if it stated that there is no liability to make alimony payments after the payee spouse's death where such liability terminates under local (state) law. *Answer 12* provides that the divorce or separation agreement must state that liability to pay alimony will terminate upon the payee spouse's death. While *Answer 12* no longer states a requirement after the Tax Reform Act of 1986 revisions,[35] attorneys should still follow it and write a specific provision into divorce or separation instruments precluding alimony payments after the death of the payee spouse.

The TRA 1986's two other changes involving the alimony provisions concern the recapture rules. Congress revised the anti-front-loading rules to permit a wider fluctuation of payments, reduced the six-post-separation-year recapture period to three years, and increased the difference level triggering the recapture rules from $10,000 to $15,000.[36]

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33. Temp. Treas. Reg. § 1.71-1T(b), Q&A-11 (1984).
34. VA. CODE § 20-109 (2003).
35. *See*, e.g., Heller v. Comm'r, 103 F.3d 138 (9th Cir. 1996).
36. I.R.C. § 71(f).

III. Explanation of the Current Alimony Rules

A. General Requirements

Under TRA 1986, any payments that meet the statutory requirements of I.R.C. § 71 and *Temporary Treasury Regulation § 1.71-1T(a), Q&A-2* will be deductible by the payor spouse as alimony and taxable as income to the payee spouse.[37] An alimony or separation maintenance payment is any payment received by or on behalf of a spouse (which includes a former spouse for this purpose) of the payor under a divorce or separation instrument that meets all of the following requirements:

1. The payment is in cash;

2. The payment is not designated as a payment that is excludable from the gross income of the payee and non-deductible by the payor;

3. In the case of spouses legally separated under a decree of divorce or separate maintenance, the spouses are not members of the same household at the time the payment is made;

4. The payor has no liability to continue to make any payment after the death of the payee (or to make any payment as a substitute payment); and

5. The payment is not treated as child support.[38]

Internal Revenue Code § 71(e) requires each spouse to file his or her tax returns in a filing status other than married filing jointly to be able to use the provisions of I.R.C. §§ 71, 215.

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37. *Id.* §§ 71, 215; Temp. Treas. Reg. § 1.71-1T(a), Q&A-1, Q&A-2 (1984).

38. Temp. Treas. Reg. § 1.71-1T(a), Q&A-2 (1984). In light of the TRA 1986 revisions to Section 71 of the Internal Revenue Code, the temporary regulation's requirements on the minimum-term rule, and the $10,000 trigger level, as well as the requirement that the divorce or separation instrument explicitly state that the payor spouse has no liability for either payments or a substitute for such payment, are superseded and invalid. I.R.C. § 71(f).

B. Payment Must Be in Cash

Sections 71(b)(1) and 215(b) require alimony or separate maintenance payments to be made in cash. The Temporary Treasury Regulations include checks and money orders that are payable upon demand within the definition of cash.[39] Transfers of services or property, including a debt instrument of a third party or an annuity contract, execution of a debt instrument by the payor, or the use of property of the payor do not qualify as alimony or separate maintenance payments.[40] Cash payments made by the payor to a third party, if such payments are pursuant to the terms of the divorce or separation instrument, will qualify as a payment of cash that is received "on behalf of a spouse." Examples of such payments include cash payments of rent, mortgage, and tax and tuition liabilities of the payee spouse.[41] Premiums paid by the payor spouse for term or whole life insurance on the payor's life, if made under the terms of the divorce or separation instrument, will qualify as alimony payments on behalf of the payee spouse to the extent that the payee spouse is the owner of the policy.[42] In addition to alimony payments made to third parties under the terms of the divorce or separation instrument, a payor spouse may make a cash alimony payment to a third party if such payment is made at the written request of the payee spouse. The writing must specifically state that the parties intend the payment to be treated as an alimony payment. The payor spouse must receive this writing before filing of his or her first tax return for the taxable year in which the payment is made.[43]

If the payor spouse must make payments to maintain property owned by the payor spouse and used by the payee spouse (including mortgage payments, real estate taxes, and insurance premiums), such payments are not payments on behalf of a spouse even if the divorce or separation instrument requires them.[44] However, if for example, the payee spouse occupies the marital home and is a co-owner of that home, then payments by the non-occupying payor spouse for the mortgage, taxes, and insurance will be

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39. Temp. Treas. Reg. § 1.71-1T(b), Q&A-5 (1984).
40. *Id*.
41. *Id*. § 1.71-1T(b), Q&A-6.
42. *Id*.
43. *Id.* § 1.71-1T(b), Q&A-7.
44. *Id.* § 1.71-1T(b), Q&A-6.

deductible to the extent of the payee spouse's legal interest in the property.[45]

In *Tseng v. Commissioner*,[46] the Tax Court held that a husband could not deduct mortgage payments made pursuant to a divorce decree as alimony. The residence was titled solely in husband's name at the time these payments were made. The husband made payments to the holder of the mortgage on the marital home in lieu of making alimony payments to his former wife. Relying on *Temporary Treasury Regulation § 1.71-1T(b), Q&A-6*, the court refused to permit the husband to classify mortgage payments as alimony when the husband still had an ownership interest in the property.[47] Specifically, the regulation provides that any payments to maintain property owned by the payor spouse and used by the payee spouse (including mortgage payments) are not payments on behalf of a spouse, even if those payments are made pursuant to the terms of the divorce or separation instrument.[48]

In *Israel v. Commissioner*,[49] the Tax Court allowed a former husband to deduct rent payments on an apartment occupied by his ex-wife. Pursuant to the parties' property agreement, the husband was to make a number of different payments to his wife. Their agreement provided for a weekly alimony support payment and also called for the former husband to pay his former spouse's rent payments at a particular location as "additional maintenance." The separation agreement also called for a number of other lump sum maintenance payments and for certain child support payments. The Tax Court reviewed the statutory requirements of alimony as set forth in I.R.C. § 71 and held the following: (1) the payments were pursuant to a

45. Priv. Ltr. Rul. 87-10-089 (Dec. 11, 1986); *see* Zampini v. Comm'r, 62 T.C.M. (CCH) 475 (1991), in which the husband's payment of a mortgage for which the wife was also liable and which was secured by a residence owned by the husband and wife as tenant by the entirety, was treated as alimony to the extent of one-half of the principal portion of the payment, and as deductible interest to the extent of all of the interest portion of the payment. *Id.* at 482.

46. 67 T.C.M. (CCH) 2501 (1994), *aff'd*, 79 F.3d 1154 (9th Cir. 1996) (unpublished), *cert. denied*, 519 U.S. 820 (1996).

47. *Id.* at 2504.

48. *Id.*

49. 70 T.C.M. (CCH) 1037 (1995). *See also* Medlin v. Comm'r, 76 T.C.M. (CCH) 707 (1998) (holding that former husband's wholly-owned car dealership's cash payments for lease, insurance, and maintenance of ex-wife's car and reimbursement of medical insurance premiums were deductible as alimony and includible in ex-wife's income; payments were properly treated as made by former husband "on behalf of" the ex-wife and satisfied I.R.C. § 71(b)(1)(A)).

separation agreement; (2) the parties were legally separated rather than members of the same household; and (3) the former husband was not obligated to make payments after the former wife's death. On this basis, the former husband was permitted to deduct the rent payments as alimony.[50]

C. Payment Must Be Pursuant to a Divorce or Separation Instrument

Alimony payments must be made pursuant to a divorce or separation instrument for the benefit of the spouse. A divorce or separation instrument is defined as follows:

> 1. A decree of divorce or separate maintenance or written instrument incident to a divorce; or
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> 2. A written separation agreement; or
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> 3. Another type of decree requiring a spouse to make payments supporting the other spouse.[51] An example of this type of decree would be a temporary order to make support payments.[52]

The qualifying instruments described under the current law after the TRA 1986 revisions are the same as under the prior law.[53] Accordingly, a written instrument incident to a divorce that requires support could include a stipulation entered into pursuant to a divorce proceeding.[54] The primary concern leading to the writing requirement imposed by I.R.C. § 71(b)(2)(A) is to "ensure there is adequate proof of the existence of an obligation and the specific items thereof when a divorce has occurred."[55]

In *Mercurio v. Commissioner*,[56] the Tax Court held that a wife's willingness to sign a written stipulation regarding support payments would not satisfy the "writing requirement" for her husband's deduction of the pay-

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50. 70 T.C.M. (CCH) at 1039.

51. I.R.C. § 71(b)(2).

52. Priv. Ltr. Rul. 87-10-089 (Dec. 11, 1986).

53. Temp. Treas. Reg. § 1.71-1T(a), Q&A-4 (1984).

54. Priv. Ltr. Rul. 88-21-069 (Mar. 1, 1988).

55. Prince v. Comm'r, 66 T.C. 1058, 1067 (1976); *see also* Herring v. Comm'r, 66 T.C. 308, 311 (1976); Ellis v. Comm'r, 60 T.C.M. (CCH) 593, 594 (1990) (holding that husband who paid one-third of his salary to former spouse instead of the lower amount established in a written divorce decree was not entitled to deduct the excess payments as alimony); Abood v. Comm'r, 60 T.C.M. (CCH) 584, 586 (1990).

ments as alimony under I.R.C. § 215. The Mercurios separated in 1988, and Mr. Mercurio began to make monthly payments of $1,000 to his wife. Through a mediator, Mr. and Mrs. Mercurio orally agreed to spousal support. In September 1990, a marital separation agreement was drafted reflecting the parties' oral agreement of support. Mr. Mercurio did not agree to other portions of the written document, and the draft agreement was never executed.[57]

In a letter dated November 13, 1990 to Mrs. Mercurio's attorney, Mr. Mercurio's attorney proposed a stipulation stating that the payments the husband made to his wife in 1990 be deductible as support. Mrs. Mercurio's attorney responded with a letter dated December 13, 1990, expressing her willingness to sign the stipulation. Such a stipulation was filed with the court, along with judgment papers to perfect a dissolution of the Mercurios' marriage. The court did not enter a judgment during the calendar year 1990. The Tax Court held that the husband's unilateral statement that he was willing to pay certain sums for support would not constitute a written separation agreement. Furthermore, the Tax Court concluded that even if there was an agreement between the parties, the agreement must be reduced to writing before payments are deductible.[58]

D. Spouses Must Reside in Separate Households

Spouses who are legally separated under a decree of divorce or separate maintenance may not be members of the same household at the time payments are being made.[59] The IRS will not treat spouses as residing separately if they physically live in different locations in the former marital dwelling unit.[60] However, the spouses will not be treated as members of the same household where one spouse is preparing to leave the household and departs not more than one month after the date the payment is made.[61] If, on the other hand, spouses are *not* legally separated under a decree of divorce or separate maintenance, a payment made under a written separa-

56. 70 T.C.M. (CCH) 59 (1995); *see also* Ewell v. Comm'r, 71 T.C.M. (CCH) 3124 (1996) (holding that payments husband made to ex-wife before written separation agreement existed were not deductible as alimony except for one payment conceded by IRS; former wife's list of expenses, negotiation letters between attorneys, check negotiations, and the fact that payments were made did not constitute a written agreement).

57. *Id.* at 60.

58. *Id.*

59. I.R.C. § 71(b)(1)(C); Lyddan v. United States, 721 F.2d 873 (2d Cir. 1983); Washington v. Comm'r, 77 T.C. 601 (1981).

tion agreement or a decree described in I.R.C. § 71(b)(2)(C) may qualify as an alimony payment notwithstanding the fact that the spouses are still members of the same household at the time the payment is made.[62]

E. Payments Must Terminate Upon the Payee's Death

Alimony payments must stop upon the death of the payee, and there must be no liability for any kind of substitute payment.[63] Payments that are made simultaneously with the signing of an agreement, thus guaranteeing the payee spouse being alive, will not satisfy this requirement. In *Webb v. Commissioner*,[64] the husband was required to make two payments totaling $215,000 at the time the agreement was signed. These payments were in addition to other periodic payments required by the agreement, which qualified as deductible alimony payments and were not at issue. The husband made the two required payments and deducted them as alimony on his 1986 income tax return. The Tax Court denied the deduction. In so ruling, the court stated that the agreement created a liability that the wife's estate could have enforced should the two payments not have been made.[65]

The fact that the payments were made simultaneously with the execution of the agreement (creating the husband's liability to make the payments) was irrelevant. The agreement's creation of a "liability" that was enforceable by the wife's estate violated the requirement that payments

60. The requirement for spouses to reside in separate households is generally strictly construed. In Coltman v. Comm'r, 61 T.C.M. (CCH) 2207 (1991), the Tax Court held that a husband and wife were not "separated and living apart" when the husband resided several days per week in his former marital home and also spent considerable time residing in an apartment, in a condominium that he owned, and also at his girlfriend's home. When Mr. Coltman stayed in his former marital home, he resided in a separate bedroom from his wife, and they had virtually no contact throughout the day. The court ruled that despite the little contact between the husband and wife, the sharing of the entrances and other common areas of the house "under the same roof was not separate and living apart" for purposes of former I.R.C. § 71(a)(3), currently I.R.C. § 71(b)(1)(C). Accordingly, the alimony payments were not deductible by Mr. Coltman. *Id*. at 2214; *see also* Hopkins v. Comm'r, 63 T.C.M. (CCH) 3113 (1992). *But see* Sydnes v. Comm'r, 577 F.2d 60 (8th Cir. 1978).

61. Temp. Treas. Reg. § 1.71-1T(b), Q&A-9 (1984).

62. *Id*. *See*, *e.g.*, Benham v. Comm'r, 79 T.C.M. (CCH) 2054 (2000) (deciding a case in which taxpayers continued to reside in same household after executing separation agreement providing for temporary alimony; the Tax Court permitted a deduction for alimony paid prior to the parties' divorce).

63. I.R.C. § 71(b)(1)(D).

64. 60 T.C.M. (CCH) 1024 (1990).

65. *Id*. at 1027.

must terminate upon the payee's death.[66] The lesson is that form must prevail over substance when an attorney drafts an agreement for I.R.C. § 71 payments. The fact that compliance with the agreement creates a legal impossibility for the estate to make a valid claim appears to be irrelevant.

One way to overcome this problem would have been to draft the agreement to provide for the requirement that the two payments totaling $215,000 would be payable within a specified time after the execution of the agreement (for example, within six months), provided the wife is alive at the time of the payment. If the wife dies before receiving the payment, the obligation to make the payments would terminate. The estate would have no claim to seek collection of the $215,000. The wife must be willing to accept the risk that she will survive the relatively short time period to collect the money. A larger lump sum payment may entice her to accept this risk. Given the size of the lump sum payment, the alimony recapture provisions discussed in Paragraph 6.402 are likely to be applicable.[67]

In *Hoover v. Commissioner*,[68] the Tax Court held that failure to include terminate-at-death language in a final divorce decree converted payments that would have been deductible as alimony into a non-deductible property settlement. In October 1988, Mr. and Mrs. Hoover were granted a final decree of divorce in Ohio. Under a temporary order in effect before that time, Mrs. Hoover received payments of $10,000 from her husband in 1988. The parties agreed that the wife was ultimately to receive, among other things, a lump sum of "alimony as division of equity" that was to be paid in installments of no less than $3,000 per month until the whole amount was paid in full.[69] A preliminary draft of the divorce decree (which was separate from the temporary order noted above) provided that "all payments of alimony shall cease upon [Mrs. Hoover's] death, [or] remarriage."[70]

The actual final decree, however, did not contain the terminate-at-death language. The decree awarded the wife "alimony as division of

66. *Id.*

67. Author's comments. Furthermore, the court did not address the recapture provisions of I.R.C. § 71(f) that would have been applicable to these two payments if the court had concluded that the husband's obligation or liability to make the $215,000 payment did terminate upon wife's death. The recapture issue is moot given the court's interpretation of I.R.C. § 71(b)(1)(D).

68. 69 T.C.M. (CCH) 2466 (1995), *aff'd*, 102 F.3d 842 (6th Cir. 1996).

69. *Id.* at 2469.

70. *Id.* at 2467.

equity" in the amount of $521,640.[71] At that time, Ohio law permitted "alimony as division of equity" to refer to equitable distribution of marital property as well as support payments made to a former spouse.[72] The Hoover's divorce decree stated that this "alimony" was payable in installments of no less than $3,000 per month until the entire amount was paid in full.[73]

In 1988 and 1989, Mr. Hoover reported his payments of $36,000 and $36,200 respectively, as deductible alimony. Mrs. Hoover, on the other hand, treated the money as a non- taxable property settlement. The IRS assessed deficiencies against both Hoovers. In reviewing the final divorce decree, the court looked at all relevant factors. The parties' removal of the language from the draft decree providing that the payments would cease upon Mrs. Hoover's death or remarriage was weighed especially heavily against Mr. Hoover. During the trial, Mr. Hoover testified that he agreed to delete the language because his "tax preparer" told him the divorce decree did not have to include it. The Tax Court held that the payments did not satisfy the terminate-at-death requirement and therefore would not be treated as alimony under the Internal Revenue Code.[74]

In *Cunningham v. Commissioner*,[75] the Tax Court reached a conclusion similar to that in the *Hoover* case. In *Cunningham*, the property settlement provided that the husband was to pay to his wife an established amount for a period of 142 months. The language was silent as to whether these payments would terminate upon the death of Mrs. Cunningham. The taxpayers resided in North Carolina, and under that state's law, payments would terminate on death of either party if such payments otherwise qualified as alimony. The Tax Court stated that the Cunningham's divorce set-

71. *Id.*

72. *Id.* at 2469.

73. *Id.* at 2467.

74. *Id.* at 2469. Practice Point: The learning point from this decision is that if the parties had retained the terminate-at-death provision in the final decree, the payments in *Hoover* would have qualified as deductible alimony. Mr. Hoover's tax advisor was technically correct in stating that for tax purposes, the divorce decree need not specifically include the terminate-at-death language. Leaving such language out, however, opens the real possibility that the IRS will successfully deny the payor a deduction for alimony if state law does not specifically require support payments to cease upon the death of the payee spouse. To make sure the payor spouse receives deductible alimony treatment, the separation agreement or divorce decree should specify that otherwise qualifying payments will cease at the death of the payee spouse. When the parties do *not* seek to treat payments as alimony, the instrument should specify that payments are not to be treated as deductible alimony.

75. 68 T.C.M. (CCH) 801 (1994).

tlement agreement was not approved or adopted by any North Carolina court.

Several commentators who reviewed the *Cunningham* case are unsure whether the failure of a North Carolina court to approve or adopt the property agreement, in and of itself, should disqualify spousal support that otherwise appears to meet the requirements of I.R.C. § 71. In *Cunningham*, however, the Tax Court also noted that no evidence before it demonstrated whether the Cunningham's intended support payments were to terminate in the event of the former wife's death. If the Cunninghams did present such evidence, perhaps the Tax Court would have held that the arrangement met the terminate-at-death requirement and that the alimony payments were deductible by the payor spouse.[76]

In 1995, the IRS also issued a private letter ruling that a lump sum payment from a divorced spouse to the former spouse's attorneys under a divorce decree did not qualify as alimony because the divorce decree did not meet the "terminate-at-death" requirement of I.R.C. § 71(b)(1)(D). Apparently, the taxpayers had attempted to establish a "third party" payment, but neglected to include the terminate-at-death requirement in the separation agreement.[77]

In *Private Letter Ruling 9542001*, the IRS reviewed an Illinois court's judgment for dissolution of marriage. The divorce judgment called for the wife to pay her former spouse the sum of $2000 for maintenance. In a subsequent modification motion filed by the husband, the Illinois court modified the spousal support payments and included language that specifically provided that the maintenance payments would terminate upon the death of the husband or upon his remarriage or upon his reaching the age of sixty-two years. The wife subsequently paid her former husband's attorney fees and deducted those payments. The husband did not include the payment as income on his tax return. In concluding that the attorney fees payment did not qualify as alimony, the IRS stated that the payment did not meet the termination requirement under I.R.C. § 71(b)(1)(D) because the

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76. *Id.* at 809; *see also* Barrett v. United States, 878 F. Supp. 892 (S.D. Miss. 1995), *aff'd*, 74 F.3d 661 (5th Cir. 1996); Smith v. Comm'r, 75 T.C.M. (CCH) 2250 (1998); Human v. Comm'r, 75 T.C.M. (CCH) 1990 (1998); Riberia v. Comm'r, 70 T.C.M. (CCH) 1807 (1997), *aff'd* in unpub. opin. 98-1 U.S.T.C. (CCH) ¶ 50,260 (9th Cir. 1998), 1998 U.S. App. LEXIS 3030; Sroufe v. Comm'r, 69 T.C.M. (CCH) 2870 (1995); Heller v. Comm'r, 69 T.C.M. (CCH) 730 (1994); Pettet v. United States, 80 A.F.T.R. 2d 97-7987 (D.C.N.C. 1997).

77. Priv. Ltr. Rul. 9542001 (Oct. 10, 1995).

wife's liability did not terminate by operation of any specific language in the divorce decree nor by operation of any provision of Illinois law. That position, the IRS pointed out, was supported by the Tax Court's analysis in three recent cases addressing the same issue.[78]

In each of these three cases, the Tax Court focused on whether a liability was created that would have been enforceable by the payee spouse's estate had he or she died before the payments were actually made. To answer that inquiry, the Tax Court looked both at the terms of the agreement and at whether applicable state law would operate to terminate the obligation at some point. In all three cases, the IRS noted, the Tax Court held that the payments in question were not alimony because liability for the payments continued to exist even after death.[79]

In *Private Letter Ruling 9542001*, the IRS stated that the Illinois court documents did not indicate an intent by either party for the wife's liability for her former husband's attorney fees to cease on the occurrence of an event. Also, the IRS noted that there was no provision in Illinois law that would operate to terminate the wife's liability. The IRS followed the analysis in *Stokes*, *Webb*, and *Cunningham* and concluded that the wife's payment of her former husband's attorney fees did not meet the termination requirement because the former husband's estate would be able to enforce the obligation.[80]

More recently, in *Larry W. Human v. Commissioner*,[81] the Tax Court held that a man's obligation to make payments to a former wife under a divorce decree specifying the number and amount of each payment does not terminate on the payee's death under Georgia law; thus, the payments are not alimony under Section 71. Larry Human and his ex-wife obtained a divorce decree in 1990 that obligated him to make two lump sum pay-

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78. *Id.* (citing Cunningham v. Comm'r, 69 T.C.M. (CCH) 801 (1994); Stokes v. Comm'r, 68 T.C.M. (CCH) 705 (1994); Webb v. Comm'r, 60 T.C.M. (CCH) 1050 (1990)).

79. Priv. Ltr. Rul. 9542001 (Oct. 10, 1995).

80. *Id.* Courts that review separation agreements will notice that including language calling for the cessation of payments upon the death of the payee spouse will favor characterization of the payments as spousal support because the payee spouse is not in a position to pass any payment obligation on to his or her heirs or legatees. *See* Prater v. Comm'r, 55 F.3d 527 (10th Cir. 1995) (reversing the Tax Court decision, 66 T.C.M. (CCH) 471 (1993)).

81. 75 T.C.M. (CCH) 1990 (1998).

ments to her totaling $775,000. The decree classified the payments as alimony, but did not specify whether the payments terminated on her death.[82]

Human paid $970,000 to his ex-wife in 1992 and claimed a tax deduction for the full payment. The Service disallowed the deduction, and Human filed a Tax Court petition. The court found that under Georgia law, Human's obligation to make lump sum payments survived his ex-wife's death. Because the divorce decree specified the number and amount of each payment, and contained no other limitations, conditions, or statements of intent, explained the court, state law construes the obligation as one surviving the payee's death.[83]

The TRA 1986 retroactively eliminated the TRA 1984's requirement that the divorce or separation instrument must specifically state the termination of alimony payments upon the death of the payee spouse.[84] Should the payor spouse be required to make either alimony payments or a substitute payment following the death of a payee spouse, the consequences would be that none of the prior payments made by the payor spouse would qualify as deductible alimony.[85]

Neither the statute nor the temporary regulations define a substitute payment; however, guidance can be found in the temporary regulations. To the extent that one or more payments begin, increase in amount, or become accelerated in time as a result of the death of the payee spouse, such payments may be treated as a substitute for the continuation of payments terminating on the death of the payee spouse which would otherwise qualify as alimony payments. A "facts and circumstances" test is used to determine if payments are substitute payments.[86] The temporary regulations provide several examples, one of which is as follows:

> *Example*. Under the terms of a divorce decree, A is obligated to make annual alimony payments to B of $30,000, terminating on the earlier of the expiration of 15 years or the death of B. The divorce decree provides that if B dies before the expiration of the 15-year period, A will pay to B's estate the difference between the total amount that A would have paid had B survived, minus the amount actually paid. For example, if B dies at the end of the

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82. *Id.* at 1990.
83. *Id.* at 1991.
84. *See supra* §§ II B and C.
85. Temp. Treas. Reg. § 1.71-1T(b), Q&A-13 and Q&A-14 (1984).
86. *Id.* § 1.71-1T(b), Q&A-14.

> [tenth] year in which payments are made, A will pay to B's estate $150,000 ($450,000-$300,000). These facts indicate that A's liability to make a lump sum payment to B's estate upon the death of B is a substitute for the full amount of each of the annual $30,000 payments to B. Accordingly, none of the annual $30,000 payments to B will qualify as alimony or separate maintenance payments. The result would be the same if the lump sum payable at B's death were discounted by an appropriate interest factor to account for the prepayment.[87]

The IRS has also addressed a situation involving the establishment of a trust for children when the payee spouse dies. In this ruling, the husband was obligated to make spousal support payments to his former wife on a monthly basis until the year 2008. Should his ex-wife predecease him, the divorce decree required the ex-husband to establish a trust for their children. The trust would receive monthly payments, equal to the former spousal payments in amount and duration. The husband was required to make these payments to the trust until the year 2008. The payments to the ex-wife would stop upon her death. The IRS held that these payments to the trust were substitute payments. The IRS stated that the fact that the trust beneficiaries were adult children was irrelevant. Accordingly, none of the alimony payments made under the divorce decree would qualify as deductible alimony.[88]

A taxpayer can obtain the economic effect of a substituted payment in the event of the payee spouse's premature death by obtaining a life insurance policy on the life of the payee spouse. The payor can increase the alimony to the payee spouse by the amount of the premium payments.[89]

F. Payments Must Not Be Child Support

A payment made pursuant to a divorce or separation instrument that is fixed (or treated as fixed under special rules discussed later, in Paragraph III.B) as payable for the support of a child of the payor is not an alimony

87. *Id.* (ex. 2).
88. Priv. Ltr. Rul. 90-10-051 (Dec. 12, 1989).
89. *See* Temp. Treas. Reg. § 1.71-1 T(b), Q&A-6 (1984).

payment.[90] In other words, if a payment is classified and treated as child support, it will not qualify as alimony.

G. Payments Must Not Be Designated as Non-Deductible or Excludable

Payments that otherwise qualify as alimony are nevertheless not treated as alimony if the divorce or separation instrument designates all or some of the payments as not includable in the payee spouse's gross income and not deductible by the payor spouse.[91] This designation may be evidenced by a written separation agreement (as defined by I.R.C. § 71(b)(2)(B)) or another writing signed by both parties that designates the otherwise qualifying payments as non-deductible and excludable. This latter writing must refer to the written separation agreement to have effect.[92] An example of suitable language, if included in a divorce or separation agreement, follows:

> Non-Alimony Treatment. In accordance with Internal Revenue Code § 71(b)(1)(B), the parties expressly agree to designate payments under [indicate relevant paragraph(s) in document] as excludible and non-deductible payments for purposes of § 71 and § 215, respectively.

If the payor makes any payments pursuant to a temporary support order that the parties seek to "elect out" of alimony treatment, then such temporary support order or a subsequent order must specifically designate the payments as non-alimony.[93] The spouses have until the deadline for the filing of IRS Form 1040 to make the election of non-alimony treatment. The parties can apparently make the election on a year-by-year basis by regularly executing appropriate designation instruments that effectively "amend" their written separation agreement. The spouses must attach copies of the instrument containing the designation of non-alimony treatment to the first tax return (Form 1040) the payee spouse files for *each* year to which the designation applies.[94]

The purpose of the "election" out of alimony treatment is to permit the spouses to negotiate and work out the tax and non-tax economic aspects of

90. *Id.* § 1.71-1T(c), Q&A-15.
91. I.R.C. § 71(b)(2)(B); § 1.71-1T(b), Q&A-8.
92. *Id.* § 1.71-1T(b), Q&A-8.
93. *Id.*
94. *Id.*

a separation or divorce rather than having a judge mandate a result that neither spouse may want. The designation of non-alimony treatment is restricted to cash payments that otherwise would qualify for alimony treatment under I.R.C. § 71 and I.R.C. § 215. However, when spouses use these provisions with I.R.C. § 1041,[95] which concerns spousal transfers of property, they gain powerful tools to negotiate an arrangement that suits both parties economically while accommodating their tax concerns.

H. Excess Front-Loading of Alimony Payments—The Rule and Recapture Provisions

The deductibility of alimony payments from gross income by the payor spouse has always served as a temptation to disguise property settlement payments, which are not deductible, as alimony. To curb this temptation, TRA 1984 added I.R.C. § 71(f), which established a set of rules to prevent excessive front-loading of alimony payments by providing a minimum-term rule and a recapture rule.[96] Under the 1984 minimum-term rule, if alimony payments exceeded $10,000 annually, then these payments had to continue for a minimum of six calendar years following the parties' separation; otherwise, only the first $10,000 in payments each year would be deductible to the payor and includable in the payee's gross income.[97] The recapture rule would then require a recalculation and inclusion in income by the payor and deduction by the payee of previously paid alimony, to the extent that the amount of such payments during any of the six "post-separation" years fell short of the amount of payments during a prior year by more than $10,000.[98]

These 1984 excess front-loading rules led to some very confusing calculations. The TRA 1986 reduced the six-year minimum-term rule to three post-separation years. The "first post-separation year" means the first calendar year in which the payor spouse paid I.R.C. § 71(f)-qualifying alimony payments.[99] The first calendar year that follows the first post-separation year is called the "second post-separation year," and the second calendar year following the first post-separation year is known as the

95. *See infra* § V.

96. I.R.C. § 71(f)(1), (2); Temp. Treas. Reg. § 1.71-1T(c), (d), Q&A-18, Q&A-19 (1984).

97. *See* Temp. Treas. Reg. § 1.71-1T(d), Q&A-20, Q&A-23 (1984) (giving general guidance on how the minimum-term rule worked and an example).

98. *Id.* § 1.71-1T(d), Q&A-19.

99. I.R.C. § 71(f)(6).

"third post-separation year."[100] In addition, the TRA 1986 increased the safe harbor permitted excess payment amount to $15,000.[101]

Under these new recapture rules, alimony payments made in the first post-separation year that exceed the average of the alimony payments made in the second and third post-separation years by more than $15,000 are recaptured as ordinary income in the third post-separation year. The payee spouse must deduct this recapture amount from his or her gross income while the payor spouse must add the recapture amount in his or her gross income for the third post-separation year.[102] Only payments made in the first and second post-separation years are subject to recapture. The payments made in the third post-separation year and thereafter are not subject to recapture.

In the TRA 1986, Congress made the elimination of the six-year minimum-term rule and its replacement with a third-year recapture retroactive to 1 January 1985.[103] For divorce or separation instruments executed on or after 1 January 1987, there is no minimum payment term. The instrument need only be subject to the potential recapture in the third post-separation year of any excessive alimony payments that violate the new recapture provisions. The new recapture provisions will also apply to pre-1987 instruments if they are modified after 31 December 1986, and any such modification expressly provides that the TRA 1986 amendments shall apply.[104] The transition rule for all other instruments to which the minimum-term and recapture rules of TRA 1984 apply provides, in effect, that the $10,000 "safe harbor" will still control. However, the recapture period will only be for the first three post-separation years.[105]

I. Examples of the New Recapture Provisions

The recapture formula described in I.R.C. § 71(f) can be described as follows: the total recapture reported in post-separation year three is the

100. *Id*.
101. *Id.* § 71(f)(2)-(4).
102. *Id.* § 71(f)(1).
103. Pub. L. No. 99-514, § 1882(c)(2)(A), 100 Stat. 2085 (1986).
104. TRA 1986, § 1842(c)(2)(A)-(B).
105. *Id.* § 1842(c)(3).

sum of excess alimony payments made in years one and two, calculated as follows:

Excess Year 2 Payments
<u>+ Excess Year 1 Payments</u>
Total Year 3 Reportable Recapture

To calculate Year 1 and Year 2 excess, first calculate year two excess payments as follows:

Sum of All Year 2 Payments
<u>- Sum of All Year 3 Payments + $15,000</u>
Excess Year 2 Payments

Next, calculate year one excess payments as follows:

Sum of All Year 1 Payments
<u>-$15,000 + ([Year 2 Payments – Year 2 excess payments + Year 3 Payments] ÷ 2)</u>
Excess Year 1 Payments

In describing this three-part formula, the total amount of recapture that must be reported in the third post-separation year is the sum of excess payments made in the first and second post-separation years. Calculation of the amount of excess alimony in the second post-separation year is simply the amount of payments for year two that exceed the payments made in the third post-separation year by more than $15,000. Calculating the amount of excess alimony in the first post-separation year is a bit more complex. It is equal to the amount of payments made in year one that exceeds the average alimony payments made in the second post-separation year (less the excess already recaptured) and in the third post-separation year by more than $15,000.

Example 1. Payor makes payments totaling $70,000 in year one and payments totaling $35,000 in each of years two and three. The recapture of these previously deducted alimony payments is computed using the following steps, starting with calculating year two excess payments:

$$\begin{array}{c} \$70{,}000 \\ \underline{-\ (\$35{,}000 + \$15{,}000)} \\ \text{Year 2 Excess} = 0 \end{array}$$

The $20,000 must be included in the payor's gross income for the third post-separation year and is deductible from the payee's gross income for that same year.

Example 2. Payor is required to make a lump sum alimony payment of $50,000 in year one and no payments in year two or thereafter. The lump sum alimony payment is not required to be paid if the payee spouse should die before the payment must be made. The recapture of this payment is calculated as follows:

$$\text{Excess Payments in Year 2} = 0 - (0 + \$15{,}000) = 0$$
$$\text{Excess Payments in Year 1} = \$50{,}000 - (\$15{,}000 + (0 - 0) + 0) = \$35{,}000$$

Thus, the amount to be recaptured in year three is $35,000.

J. Exceptions to the Recapture Provisions

There are four significant exceptions to the excess front-loading recapture rules. If any of these exceptions occur, the recapture of any excess alimony in year three will not be required. First, if either spouse dies before the close of the third post-separation year and the alimony payments terminate because of this death,[106] then the recapture rules do not apply. Second, the recapture provisions do not apply to support payments that are made pursuant to the type of support decree defined by I.R.C. § 71(b)(2)(C).[107] An example of this would be a temporary support order. Third, the recapture provisions do not apply to alimony payments that vary in amount because they are determined by a fixed formula that is based upon the payor spouse's income from a business or from compensation from employment or self-employment. The period during which the payor spouse is obligated to make these fluctuating payments must be not less than three years.[108] In other words, these payments can fluctuate in

106. I.R.C. § 71(f)(5)(A); *see also* Temp. Treas. Reg. § 1.71-1T(d), Q&A-25 (1984).
107. *Id.* § 71(f)(5)(B); *see also* Temp. Treas. Reg. § 1.71-1T(d), Q&A-21, Q&A-25 (1984).

amount as long as the percentage used is fixed by a preexisting formula. The fourth exception is if payments terminate because the payee spouse remarries before the end of the third post-separation year.[109]

K. Planning[110]

Since recapture may only occur in the third post-separation year, the parties may completely avoid it if they can agree to spread out the payments in excess of three years or stay within the $15,000 safe-harbor level. For example, the parties can arrange for alimony payments to remain fairly stable during the first three post-separation years and then dramatically increase or decrease during the fourth year. Another approach would be to insure that the separation agreement includes a contingency in the payor's alimony payment obligation that will cause one of the recapture exceptions to apply. One example might be where it is evident that the payee spouse will remarry after the dissolution of the current marriage. In this situation, the payor can only pay large amounts of alimony during the first two years after separation, and the payee spouse must remarry after receiving the payments but before the close of the third post-separation year.

The increase of the safe harbor level to permit $15,000 in excess alimony payments before such payments would trigger the recapture provisions which permits the parties to deduct disguised property settlements made during the first two separation years. For example, assume the spouses are both gainfully employed but have a significant amount of property to transfer between them. If the payor spouse is in a higher marginal tax bracket, she may negotiate the transfer of a larger overall payment in exchange for structuring it as alimony payments designed to avoid recapture. The maximum amount of payments that can be designed to resemble alimony for tax purposes is $37,500, if the parties push such payments into the first two post-separation years. They may transfer up to $22,500 in year one and another $15,000 in year two, according to the following formula:

Step 1:Subtract $37,000 from the property settlement amount;

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108. I.R.C. § 71(f)(5)(C); *see also* Temp. Treas. Reg. § 1.71-1T(d), Q&A-25 (1984).

109. I.R.C. § 71(f)(5)(A); *see also* Temp. Treas. Reg. § 1.71-1T(d), Q&A-25 (1984).

110. This section depicts the author's suggestions on alternative strategies a legal assistance attorney may use to plan around or seek to avoid application of the alimony recapture provisions contained in I.R.C. § 71(f).

Step 2:Divide the difference by 3 to calculate the base payment amount;
Step 3:Add $22,500 to calculate the year one base payment;
Step 4:Add $15,000 to calculate the year two base payment.

Example: H would like to transfer $199,998 to W as a property settlement and have this settlement qualify as deductible alimony.

Step 1:Subtract $37,000 from the property settlement amount:
$199,998 – 37,500 = $162,498
Step 2:Divide the difference by 3 to calculate the base payment amount:
$162,498 / 3 = $54,166
Step 3:Add $22,500 to calculate the year one payment:
$54,166 + $22,500 = $76,666
Step 4:Add $15,000 to calculate the year two payment:
$54,166 + $15,000 = $69,166

For year three and subsequent years, the payment will be equal to the base payment amount, $54,166. None of these payments will be subject to recapture.

IV. Child Support

A. Pre-1985 Rules

Before the enactment of the TRA 1984, I.R.C. § 71(b) permitted the payor spouse to treat payments made to support minor children of the marriage as alimony by making a "unitary" payment that combined child support and alimony. The payor spouse was not otherwise permitted to deduct child support payments.[111] Litigation was the common result, in which courts repeatedly struggled with the definition of "child support," and specifically, whether payments pursuant to an agreement or a decree were expressly specified or "fixed" as established amounts for child support. The leading case defining the former I.R.C. § 71(b)'s requirement that child support had to be firmly expressed or fixed in the agreement or decree to be eligible for deductible alimony treatment was *Commissioner v. Lester*.[112] In *Lester*, the husband paid a monthly amount of "family" sup-

111. I.R.C. §§ 71(b), 215(b) (1982) (pre-TRA 1984 statute).
112. 366 U.S. 299 (1961).

port for his wife and three children, pursuant to a written divorce agreement. The agreement provided for a reduced amount of support if any of the children married, died, or became emancipated. The Commissioner argued that this reduction, triggered by one of the three contingencies relating to the children, effectively fixed the amount of child support contained in their agreement.[113] The Supreme Court disagreed and held that the language must be clear and specific.[114]

> The agreement must expressly specify or "fix" a sum certain or percentage of the payment for child support before any of the payment is excluded from the wife's income. The statutory requirement is strict and carefully worded. It does not say that "a sufficiently clear purpose" on the part of the parties is sufficient to shift the tax. It says that the "written instrument" must "fix" that "portion of the payment" which is to go to the support of the children. Otherwise, the wife must pay the tax on the whole payment. We are obligated to enforce this mandate of the Congress.[115]

To disqualify the child support part of a unitary award from alimony treatment, the designation had to be express and specific and could not be implied from other terms of the decree or agreement (for example, a contingency calling for a reduction of support upon a child reaching majority such as in *Lester*).[116]

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113. *Id*. at 300.

114. *Id*. at 303.

115. 366 U.S. at 303. The *Lester* decision interpreted sections 22(k) and 23(c) of the 1939 Internal Revenue Code, the predecessor provisions to sections 71(b) and 215(b) of the Internal Revenue Code of 1954 (before the enactment of TRA 1984). In *Revenue Ruling 62-53*, 1962-1 C.B. 41, the IRS ruled that the *Lester* holding is equally applicable to sections 71 and 215 of the 1954 Code.

B. Current Law (Post-1985)

The TRA 1984 specifically addressed the *Lester* decision by legislatively overruling its result.[117] The general treatment of child support as being non-includable in the payee's gross income and non-deductible from the payor's gross income remained unchanged. If any amount of support will be reduced upon the occurrence of a contingency relating to a child, or at a time that can clearly be associated with a contingency relating to a child, then "an amount equal to the amount of such reduction will be treated as an amount fixed as payable for the support of the children of the payor spouse."[118] This new definition provides an explanation of what will "fix" an amount as child support.

The Tax Court stated that the amount of child support must be fixed "by the terms of the instrument" under Section 71(c)(1). In *Lawton v. Commissioner*,[119] the Tax Court held that payments a woman received from her husband were alimony includible in her income because the divorce instrument did not fix a specific amount of the payments as support for their minor child. Judith Lawton was separated from her husband during 1994 and 1995. The Lawtons divorced in July 1995. Under the terms of a support order, Mr. Lawton made payments of $12,900 and $6950 in 1994 and 1995, respectively. The support order provided that these pay-

116. Nelson v. Comm'r, 32 T.C.M. (CCH) 356 (1973); Grummer v. Comm'r, 46 T.C. 674, 680 (1966) (finding that the *Lester* decision required the Tax Court to ignore the parole and other extrinsic evidence offered as irrelevant). The parties extensively litigated the question of what language fixed child support. For example, in *Nelson*, the husband was required to pay $475 to the wife each month until their daughter reached the age of twenty-one, at which time the agreement reduced the support to $332.50 per month, until their son reached twenty-one. In the event the wife died or remarried, however, the support obligation was to be $137.50 per child per month, until such child reached the age of twenty-one. Although the agreement describes the parties' apparent intention for the amount dedicated to child support, the Tax Court held that the entire amount constituted alimony. 31 T.C.M. (CCH) at 359-360. In *Talberth v. Comm'r*, 47 T.C. 326 (1966), a separation agreement required a husband to provide the wife with $7,200 annually, and also stated (for tax purposes) that $2,000 of this amount was for the wife and the remainder was to support their three children. A subsequent court judgment recorded the identical terms. A modification several years later reduced the amount of support allocated to the children, because one of the children reached the age of majority. The Tax Court held that this was not sufficient to fix an amount for child support after the *Lester* decision. *But see* West v. United States, 413 F.2d 294 (4th Cir. 1969); Comm'r v. Gotthelf, 407 F.2d 491 (2d Cir. 1969), *cert. denied*, 396 U.S. 828 (1969).

117. I.R.C. § 71(c) (2000).

118. *Id.* § 71(c)(2); Temp. Treas. Reg. § 1.71-1T(c), Q&A-16 (1984).

119. 78 T.C.M. (CCH) 153 (1999).

ments were "for support of spouse and one child." Mrs. Lawton did not report the amounts as income, and the IRS determined that the payments were alimony under Section 71. The Tax Court pointed out that the amount of child support must be fixed "by the terms of the instrument" under Section 71(c)(1). The court noted that the support order did not fix any specific amount for child support payments, instead making an "unallocated" award for spousal and child support. The Tax Court rejected Mrs. Lawton's assertion that the amounts were fixed under state law. The court reasoned that if Congress had intended that state law could fix the amount of child support payments, it would have changed the statutory language of Code Section 71(c).[120]

Section 71(c)(2) contains two alternative conditions that will fix an amount as child support. The first is a reduction in payments that occurs on the happening of a contingency relating to a child specified in the instrument, for example, the child attaining a specified age or income level, dying, marrying, leaving school, leaving the payee spouse's household, or gaining employment.[121]

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120. *Id.* at 156.

121. Temp. Treas. Reg. § 1.71-1T(c), Q&A-17 (1984). The Tax Court applied this alternative of fixing child support in *Fosberg v. Comm'r*, 64 T.C.M. (CCH) 1527 (1992). In *Fosberg*, the husband was ordered to pay his wife $175 per week as alimony until 31 December 1986. The alimony would then automatically be reduced to $150 per week until the earlier of his wife's death or remarriage or until the youngest child reached the age of eighteen. In a separate paragraph, the divorce decree ordered the husband to pay $75 per week per child as child support. The Tax Court held that because the alleged alimony payments were to be reduced when the child reached the age of eighteen, this constituted a "contingency involving a child" within the meaning of I.R.C. § 71(c)(2). Accordingly, the husband could not deduct the purported alimony payments. On substantially similar facts, the Tax Court reached the same result in *Hammond v. Comm'r*, 75 T.C.M. (CCH) 1745 (1998). In *Hammond*, the divorce judgment called for specified child support payments and also provided for $2000 monthly alimony payments until either the remarriage of Mrs. Hammond or until their child reached the age of eighteen. The latter "contingency" is precisely what the revised I.R.C. § 71(c)(2) was designed to prevent qualifying as deductible alimony. *See also* Simpson v. Comm'r, 78 T.C.M. (CCH) 191 (1999) (holding that a state's child support guidelines (Pennsylvania) did not operate to fix the child support portion of an unallocated award; reasoning that if Congress had intended that child support payments be fixed by operation of law, it could have amended the language of I.R.C. § 71(c)(1) to provide accordingly); Lawton v. Comm'r, 78 T.C.M. (CCH) 153 (1999) (holding that "child support" must be fixed "by the terms of the instrument" under I.R.C. § 71(c)(1); the amount to be fixed is not fixed by state law); Wells v. Comm'r, 75 T.C.M. (CCH) 1507 (1998).

The second alternative event that will permit the fixing of child support is the reduction of a payment at a time clearly "associated with" the happening of a contingency relating to the payor's child. There are two situations in which payments that would otherwise qualify as alimony will be presumed to be reduced at a time clearly associated with the happening of a contingency relating to a child. The first situation occurs when the payments are reduced within six months of the date the child is to attain the local age of majority.[122] The second situation is where the agreement provides for a reduction in payments on two or more occasions that occur not more than one year before or after a different child of the payor spouse attains any specific age between the ages of eighteen and twenty-four, inclusive. The age must be the same for each child, but need not be a whole number of years.[123]

The two situations described above are not conclusive; they merely create rebuttable presumptions. Either the IRS or the taxpayer may rebut them by showing that the parties chose the timing of the reduction of the payments to be independent of any contingencies relating to the payor's children.[124] In the first situation, when payments are reduced within six months of the child reaching the age of majority, the temporary regulations provide that if the reduction is a complete cessation of alimony during the sixth post-separation year or upon the expiration of a seventy-two-month period, the presumption is rebutted conclusively.[125] It is unclear whether the time period for this conclusive rebuttal of the presumption is still six years; since the IRS filed this temporary regulation, the TRA 1986 eliminated the six-year minimum-term rule. A three-year period may actually be adequate, or this portion of the regulation may simply no longer be valid. Other circumstances also support the rebuttal of the presumption, for example, evidence that the alimony payments will continue for a period

122. Temp. Treas. Reg. § 1.71-1T(c), Q&A-18 (1984).

123. *Id*.

124. *Id*.; *see* Hill v. Comm'r, 71 T.C.M. (CCH) 2759 (1996) (upholding the IRS's rebuttal of the presumption that payments terminating within six months of the child's eighteenth birthday was based on an independent date agreed by the parties unrelated to child reaching 18 years); *see also* Shepherd v. Comm'r, 79 T.C.M. (CCH) 2078 (2000) (concluding, based on the record, that the parties chose a termination date independent of any contingencies relating to the child).

125. *Id*.

customarily provided in the local jurisdiction, such as a period equal to one-half the duration of the marriage.[126]

The second situation that triggers the rebuttable presumption is when the agreement or divorce instrument calls for the reduction in payments on two or more occasions occurring within a year of the time a different child of the payor spouse attains a specific age between eighteen and twenty-four. The following examples show how the second situation works when the spouses have at least two children.

> ***Example 1:*** *A* and *B* are divorced on 1 July 1985, when their children, *C* (born 15 July 1970) and *D* (born 23 September 1972), are fourteen and twelve, respectively. Under the divorce decree, *A* is to make alimony payments of $2000 per month to *B*. Such payments are to be reduced to $1500 per month on 1 January 1991 and to $1000 per month on 1 January 1995. On 1 January 1991, the date of the first reduction in payments, *C* will be twenty years, five months, and seventeen days old. On 1 January 1996, the date of the second reduction in payments, *D* will be twenty-two years, three months, and nine days old. Each of the reductions in payments is to occur not more than one year before or after a different child of *A* attains the age of twenty-one years and four months. (Actually, the reductions are to occur not more than one year before or after *C* and *D* attain any of the ages of twenty-one years, three months, and nine days through twenty-one years, five months, and seventeen days.) Accordingly, the reductions will be presumed to clearly be associated with the happening of a contingency relating to *C* and *D*. Unless this presumption is rebutted, payments under the divorce decree equal to the sum of the reductions ($1000 per month) will be treated as fixed for the support of the children of *A* and, therefore, will not qualify as alimony or separate maintenance payments.[127]

> ***Example 2***. The husband and wife are divorced in 1986. They have two children, *A*, age sixteen, and *B*, age ten. The separation agreement requires the husband to pay his wife $2000 per month, reduces the payments to $1500 in 1985, and terminates them completely in 1999. The age of majority governing the state where the husband and wife reside is eighteen years. In

126. *Id.*
127. *Id.*

1985, child *A* will be twenty-five and *B* will be nineteen. Given that there is only one reduction in the separation agreement, the parties have avoided situation two. In addition, both children have passed the local age of majority for their state. Accordingly, all of the payments can be treated as alimony includable in the wife's gross income and deductible from the husband's gross income, assuming that the payments otherwise meet the alimony requirements.

A common problem arises when the parties want to structure payments so that they are subject to multiple reductions over several years without having a portion of the payments qualify as alimony. To accomplish this goal, the parties should do either of the following: (1) schedule the reductions so that they will occur before any child of the payor attains age seventeen, or after all children have reached the age of twenty-five; or (2) separate the reductions by a time period of at least two years, plus the difference in the ages between the payor's youngest and oldest children. The certainty and practicality of such a plan will depend on the financial condition of the parents, the number of children that need support, and the range of ages of the children.

The IRS has had several opportunities to consider various payment reductions in light of the temporary Treasury regulations that followed the enactment of the TRA 1984. The IRS ruled that when the agreement reduced payments to the payee spouse for two weeks out of the year when the child was visiting the payor spouse, the amount of such a reduction would fix the level of child support. The IRS used this reduction to prorate the payments into alimony and child support.[128]

In another ruling in 1988, the IRS was able to interpret whether several reductions in payments to a former spouse were "closely associated with the happening of a contingency relating to a child of the payor," enabling a portion of the payments to be fixed as child support.[129] In this case, the spouses divorced in January 1986. The payor's support obligation was $1000 per month from October 1985 (before the written agreement) until July 1992, when the payments would be reduced to $500 per month. The payments were set to terminate in December 1997. The parties had two children born in December 1973 and June 1976.[130] These

128. Priv. Ltr. Rul. 87-46-085 (Aug. 21, 1987).
129. Priv. Ltr. Rul. 88-20-052 (Feb. 19, 1988).
130. *Id.*

facts satisfy both sets of circumstances triggering the rebuttable presumption: the 1992 reduction would find both children under the age of eighteen by more than six months (thus, situation one applies); and the age of the youngest child at the time of the termination of payments in 1997 would be more than two years from the age of the first child at the time of the initial reduction scheduled for July 1992 (thus, situation two applies). Accordingly, the IRS held that the reductions of these payments were not associated with the happening of a contingency relating to the children of the payor. The IRS concluded that the payments qualified as alimony.[131]

The IRS also ruled that unallocated support payments reduced upon the eighteenth birthday of each of the taxpayer's children would be child support fixed by the divorce instrument. The facts in this ruling involved a former husband who was required to pay to his ex-wife "unallocated support" twice a month. The level of support was to be reduced on two separate dates that coincided with the eighteenth birthdays of two of the parties' children. The support payments would cease altogether when their third child attained the age of eighteen. Prior to the ruling request, the wife had been including these payments in her income as alimony.[132] The IRS held that the three support payment reductions were reduced at a time clearly associated with the happening of a contingency relating to the payor's child. The unallocated support payments were therefore fixed by the divorce instrument as child support, and would not be includable in the wife's income or be deductible by the husband. Language contained in the divorce instrument that the payments were alimony and includable in the ex-wife's income and deductible by the husband was not controlling for tax purposes. The IRS stated that when payments meet the statutory requirements for child support under I.R.C. § 71(c), it would disregard language in a divorce instrument indicating a contrary intent.[133]

In *Heller v. Commissioner*,[134] the Tax Court was faced with a situation that called for an offset arrangement. Pursuant to the Hellers' divorce instrument, Mrs. Heller received certain payments from her former husband. Some of the payments were designated as spousal support, but the remaining payments were designated as child support. The divorce instrument stated that in the event a court increased the amount of child support,

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131. *Id.*

132. Priv. Ltr. Rul. 92-51-033 (Sept. 21, 1992).

133. *Id.*; *see also* Hammond v. Comm'r, 75 T.C.M. (CCH) 1745 (1998) (holding that the termination of $2000 monthly payments on a child's eighteenth birthday were child support, despite the agreement labeling them as alimony).

134. 68 T.C.M. (CCH) 538 (1994).

the divorce instrument would also operate to reduce the amount of spousal support to offset the amount of the increased in child support. The divorce left no room to doubt the parties' intentions—to maintain Mr. Heller's total monthly obligation for spousal and child support at a fixed level for a specified period of time. Conversely, the agreement provided that if Mrs. Heller obtained an increase in child support before the end of the same time period, the court-ordered increase in child support would operate to reduce Mr. Heller's spousal support by an equal amount.[135]

In *Heller*, therefore, the Tax Court considered the question of whether a court-ordered increase in spousal support, as offset by the contractual reduction in child support, constituted a "contingency related to a child" under I.R.C. § 71(c)(2). The Tax Court first reviewed the legislative history that led to the adoption of I.R.C. § 71(c)(2).[136] By adding I.R.C. § 71(c)(2) in 1984, Congress effectively overruled the U.S. Supreme Court's decision in *Commissioner v. Lester*,[137] which held that an allocation would not be considered child support unless the agreement "specifically designated" it as such.[138] While I.R.C. § 71(c)(2) makes it more difficult to disguise child support as alimony, this section still allows taxpayers some freedom in structuring their divorce instruments.[139]

The statutory list of contingencies in I.R.C. § 71(c)(2) contemplates situations that call for the termination of a certain amount of support on account of an occurrence relating to a child. The Tax Court in *Heller* noted that the contingencies listed in the text of I.R.C. § 71(c)(2) and its implementing regulations are not exhaustive; however, any contingency relied upon to reject the expressed allocation in a divorce instrument should be similar to the exceptions listed in that section.[140]

In *Heller*, the parties to the divorce instrument specifically designated the amounts of spousal and child support. The payments designated as spousal support met all of the definitional requirements of I.R.C. § 71(b)(1). Therefore, in order to distinguish these payments from the alimony definition of I.R.C. § 71(b)(1), the IRS was required to demonstrate

135. *Id*. at 538, 540.

136. *See generally* STAFF OF JOINT COMMITTEE ON TAXATION, 99TH CONG., 1ST SESS., GENERAL EXPLANATION OF THE REVENUE PROVISIONS OF THE DEFICIT REDUCTION ACT OF 1984, at 713 (Jt. Comm. Print 1985).

137. 366 U.S. 299 (1961).

138. *Id.* at 306.

139. *See* I.R.C. § 71(c)(2).

140. 68 T.C.M. at 539.

that the spousal support provisions of the divorce instrument contained a contingency related to a child. The Hellers' divorce instrument allowed the parties to seek future modifications of child support. While any increase in child support would be offset by a corresponding decrease in spousal support, the Tax Court stated that it did not believe the ability to modify child support rose to the level of a contingency related to a child. The court noted that the temporary treasury regulations implementing I.R.C. § 71 contemplate agreements in which the amount of child support can fluctuate.[141]

C. Mixed Payments (Part Alimony, Part Child Support)

Divorce and separation instruments usually designate payments as either alimony or child support. If the payments the payor spouse actually makes are less than that required by the instrument, the IRS will classify any portion of the actual payments up to the amount of agreed child support as child support. The amount exceeding the agreed child support obligation will be treated as alimony.[142]

V. Transfers of Property Between Spouses and Former Spouses

A. Overview of General Rules Before 1985

Transfers of property in return for the transferee's interest in the marital property formerly required courts to examine state laws of ownership to determine what federal tax treatment was appropriate for the transaction. As might be expected, this resulted in different tax treatment for residents of different states despite the clear similarities between the transfers. At one extreme, a common law state would require a spouse to hold some type of title in the property for payments received to be attributable to the marital asset. At the opposite end of the spectrum, a community property state assumed that the spouse had a vested interest in any marital asset. Between these two extremes were states that provided spouses with some varying degree of equitable vested ownership interest in the marital assets. Accordingly, transfers of assets in connection with a divorce or separation

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141. *See* Temp. Treas. Reg. § 1.71-1T(c), Q&A-16.

142. I.R.C. § 71(c)(3); *see* Baron v. Comm'r, 56 T.C.M. (CCH) 1391 (1989); Blair v. Comm'r, 56 T.C.M. (CCH) 923 (1988).

produced different tax treatment for similar property transfers among similarly situated taxpayers.[143]

The leading case on the tax effects of marital property divisions was the Supreme Court decision in *United States v. Davis*.[144] In *Davis*, the Court held that when a spouse transfers property to the other spouse in satisfaction of the transferee's marital or support rights, the transfer results in the transferor spouse realizing a gain or loss on the transfer. The amount of gain or loss is the difference between the adjusted basis in the property and its fair market value on the date of transfer. In *Davis*, the husband agreed to transfer 1000 shares of DuPont stock in exchange for the wife releasing all claims and rights against him for her dower share of the family assets. The stock had appreciated greatly since its purchase by the husband.[145] The Supreme Court held that the transfer of stock in satisfaction of the release of inchoate marital rights by the wife was a taxable event. The Court held that the transfer was an "other disposition" under I.R.C. § 1001.[146]

The Court next considered how to determine the nature of the wife's property interests in the stock. The Court looked at the state law of Delaware, a common law state, and held that the wife had "no interest—passive or active—over the management or disposition of her husband's personal property."[147] Consequently, the Court was not merely dividing jointly owned property in a non-taxable transaction. Rather, the Court held that the transfer of stock required an immediate recognition of gain by the husband.[148] The wife received a basis in the stock equal to the money she paid plus the fair market value of property (other than money) given to the husband. The wife transferred no money for the stock. The release of her inchoate marital rights was valued as equal to the fair market value of the stock because the values "of the two properties exchanged in an arms-length transaction are either equal in fact, or are presumed to be equal."[149] The rationale of *Davis* is that the transferee spouse exchanges the release of inchoate marital rights under state law for the property transferred and that the value of those inchoate rights is deemed to be equal to the value of

143. *See* the discussion in *McIntosh v. Comm'r*, 85 T.C. 31 (1985), and the cases cited therein.

144. 370 U.S. 65 (1962).

145. *Id*. at 66-67.

146. *Id*. at 69.

147. *Id*. at 70.

148. *Id*. at 70-71.

149. *Id*. at 72.

the transferred property. The IRS has ruled that the spouse receiving the property received a basis in the asset equal to its fair market value.[150]

The rules established by *Davis* did not apply in the case of equal divisions of community property;[151] the IRS also ruled that they did not apply to the partition of jointly held property.[152]

B. Tax Reform Acts of 1984 and 1986 Overhaul Property Transfers Between Spouses and Former Spouses

Because of the varying tax consequences that resulted from the importance given state law, Congress believed a change was necessary.[153] Congress decided that it was inappropriate to tax transfers between spouses,[154] and that the law of property transfers incident to divorce created too much controversy and litigation.[155] The rules often proved a trap for the unwary if, for example, the parties viewed property acquired during marriage (even though held in one spouse's name) as jointly owned, only to find that the equal division of the property upon divorce triggered the recognition of a gain.[156] Congress also showed concern for the IRS, noting

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150. Rev. Rul. 67-221, 1967-2 C.B. 63; Field Service Advice 200005006 (Feb. 4, 2000). Field Service Advice *200005006* involved a situation in which the husband received awards of both incentive stock options and non-qualified stock options from his employer. Pursuant to the parties' divorce, the wife received half of the options in the divorce decree. After the divorce, the ex-wife exercised her options. The corporation issued the ex-husband a Form 1099, which he used to report the difference between the fair market value and the exercise price paid by his ex-wife. The ex-husband included this gain on his federal income tax return and filed a claim for a refund of the tax related to the gain. The IRS advised the parties that neither of them would be taxed under I.R.C. § 83 when the ex-wife exercised her options. The IRS stated that ex-husband's transfer of the options to his wife was an arms-length transaction, citing *United States v. Davis*, 370 U.S. 65 (1962). As a result of this decision, the IRS determined that the ex-husband received compensation income equal to the fair market value of the options when he transferred them to his ex-wife under the divorce decree. When the ex-wife subsequently exercised the options, there was no taxable event for her ex-husband under I.R.C. § 83, and there were no tax consequences for the ex-wife. The IRS did note, however, that the ex-wife would be taxed on any subsequent gain or loss on the sale of the underlying stock, which would then have a basis equal to the amount previously includable in the ex-husband's gross income. Field Service Advice 200005006 (Feb. 4, 2000).

151. H.R. REP. NO. 98-4170, at 1491 (1984).

152. Rev. Rul. 74-347, 1974-2 C.B. 26.

153. H.R. REP. NO. 98-4170, at 1491 (1984).

154. *Id.*

155. *Id.*

156. *Id.*

that the government frequently found itself caught between the parties' contradictory assertions. The transferor spouse frequently reported no gain on the transfer, while *Davis* entitled the transferee spouse to compute her gain or loss by reference to a basis equal to the fair market value of the property at the time of receipt.[157]

Mindful of these concerns, the TRA 1984 created a new I.R.C. § 1041, the effect of which was to legislatively reverse the portion of *Davis* relating to property transfers. The new section provided that an individual spouse does not recognize a gain or loss on a transfer of property to (or in trust for the benefit of) his spouse during the marriage or to "a former spouse, but only if the transfer is incident to the divorce."[158] Generally, new law treats the transfer as a gift. The transferor's adjusted basis carries over to the transferee and becomes the recipient's basis. This carry-over of the transferor's basis obtains (as contrasted with the result under the gift rules), even if the fair market value of the property at the time of the transfer is less than the transferor's adjusted basis.[159]

The TRA 1986 made a technical change to I.R.C. § 267, which generally disallows losses between related taxpayers. Section 1842(a) of the TRA 1986 created I.R.C. § 267(g), which requires coordination between sections 267 and 1041.[160] Section 1041 expressly prohibits recognizing both gains and losses in transfers between spouses.[161] Section 267(g) insures that I.R.C. § 267(d), which does permit a loss created by a transfer between related taxpayers to offset a subsequent gain caused by the sale or other disposition of the asset, does not apply.[162]

> ***Example:*** A husband sells 100 shares of stock to his wife for $5000. The husband's basis in the stock was $10,000. Under I.R.C. § 1041(b), the wife takes the husband's basis of $10,000, and the husband does not recognize any loss by virtue of I.R.C. § 1041(a). If I.R.C. § 267(d) were permitted to apply, in addition to I.R.C. § 1041, a subsequent sale of the stock by the wife for $14,000 would provide her with a gain of $4000 ($14,000 sale proceeds minus the $10,000 basis). Section 267(d) might have reduced this gain by offsetting it with the husband's previously

157. *Id*. at 1491-92.
158. I.R.C. § 1041(a); Temp. Treas. Reg. § 1.1041-1T, Q&A-1 (1984).
159. I.R.C. § 1041(b); *see also infra* § V.C.7.
160. I.R.C. § 267(g); *see also* Rev. Rul. 76-377, 1976-2 C.B. 89.
161. I.R.C. § 1041.
162. *Id*. § 267(g), (d).

disallowed loss of $5000, resulting from his original sale of the stock to his wife. Section 267(g), however, precludes this offset. The wife must report the full $4000 gain.

The TRA 1986 made two other important changes to I.R.C. § 1041. Both involved transfers of property in trust. First, if a spouse transfers an installment obligation to a trust established for the other spouse, the deferred gain on the installment obligation is accelerated and recognized.[163] Second, when a spouse transfers property subject to liabilities that exceed its basis to a trust established for a spouse, the transferor will recognize a gain for the difference between the amount of the liabilities and the basis.[164] The transferor will no realize such a gain, however, if the transferor transfers the property directly to the other spouse, exclusive of the trust.[165] For example, the IRS applied the I.R.C. § 1041 non-recognition rule to the transfer of a partnership interest when the transferring partner's share of partnership liability exceeded his basis in his partnership interest.[166]

C. Explanation of the Current Rules on Property Transfers Between Spouses and Former Spouses

1. General Requirements

Under I.R.C. § 1041, any transfer of property between spouses during the marriage or any property transfers after the marriage terminates, if such transfers are "incident to a divorce," are not taxable.[167] All such transfers are treated as gifts,[168] and the transferee's basis in the property shall be the adjusted basis of the transferor.[169]

Section 1041 applies to any transfer between spouses regardless of whether the transfer is a gift or a sale or exchange between spouses acting at arm's length.[170] No divorce or legal separation need be contemplated

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163. *Id.* § 453B(g).
164. *Id.* § 1041(e).
165. *Id*.
166. Priv. Ltr. Rul. 92-50-031 (Sept. 14 1992).
167. *Id*.
168. I.R.C. § 1041(b)(1).
169. *Id.* § 1041(b)(2).
170. Temp. Treas. Reg. § 1.1041-1T(a), Q&A-2 (1984).

between the spouses at the time of the transfer, nor does a divorce or legal separation ever have to occur.[171]

There is one exception to the tax-free transfer of property between spouses (or former spouses): if the transferee is a nonresident alien, then gain or loss will be recognized at the time the property is transferred to the nonresident alien spouse.[172] The purpose of this exception is presumably because either nonresident aliens frequently are not subject to U.S. taxes by virtue of tax treaties, or nonresident spouses (or former spouses) sometimes simply fail to report subsequent sales of the appreciated transferred property. Such tax avoidance is possible since nonresident aliens generally are not subject to U.S. taxes on property sales outside of the United States.[173]

Any transfers between former spouses must be "incident to the divorce" to qualify for tax-free treatment.[174] A transfer of property is "incident to the divorce" if it occurs within one year after the date on which the marriage ends or is related to the cessation of the marriage.[175] If the transfer occurs within one year after the date the marriage ends, the transfer does not need to be related to the cessation of the marriage to qualify for I.R.C. § 1041 treatment.[176] If the one-year "safe harbor" rule covering transfers made within one year after the marriage ends applies, the transfer may still be tax-free if the transfer is related to the cessation of the marriage. A transfer of property is treated as related to the cessation of the marriage if the transfer is pursuant to a divorce or separation instrument, and the transfer occurs within six years after the date the marriage ends.[177]

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171. *Id.*

172. I.R.C. § 1041(d); Temp. Treas. Reg. § 1.1041-1T(a), Q&A-3 (1984).

173. *See*, e.g., I.R.C. § 865(a)(2)(2002).

174. *Id.* § 1041(a)(2).

175. *Id.* § 1041(c); Temp. Treas. Reg. § 1.1041-1T(b), Q&A-6 (1984).

176. Temp. Treas. Reg. § 1.1041-1T(b), Q&A-6 (1984).

177. *Id.* § 1.1041-1T(b), Q&A-7; *see also* Priv. Ltr. Rul. 88-33-018 (May 20, 1988); Young v. Comm'r, 113 T.C. 152 (1999), *aff'd*, 240 F.3d 369 (4th Cir. 2001). In *Young*, the Tax Court held that a fifty-nine acre property Mr. Young conveyed to his ex-wife four years after their divorce, and because of his default on a $1.5 million promissory note given to ex-wife under property separation agreement, was "incident to divorce." *Id.* at 156. The court reasoned that it was "related to the cessation of the marriage," found that the promissory note was part of the property settlement, and found that the dispute leading to the land transfer resolved a dispute arising under the property settlement and completed the division of marital property. *Id.* at 156.

For purposes of this rule, a divorce or separation instrument includes a modification or amendment to such decree or instrument.[178]

Any transfer not pursuant to a divorce or separation instrument and any transfer occurring more than six years after the cessation of the marriage is presumed not to be related to the cessation of the marriage. A party may rebut this presumption only by showing that he made the transfer to effect the division of property owned by the former spouses at the time of the cessation of the marriage.[179] For example, evidence to rebut the presumption may include evidence that: (1) the transfer was not within the one and six-year periods because of factors that hampered an earlier transfer of the property, such as legal or business impediments to transfer or disputes concerning the value of the property owned at the time the marriage terminated; and (2) the parties effected the transfer promptly after removing the impediment to the transfer.[180]

The IRS has addressed this rebuttable presumption on several occasions. In *Private Letter Ruling 92-35-026*,[181] the husband and wife entered into a property settlement that required the husband to purchase the wife's entire interest in a business, and in certain realty held by the business, for a specified sum. The husband refused to purchase the business and real property under the agreement. The husband disputed the price, and the parties agreed to arbitrate the matter. They reached a tentative arbitration agreement, but the husband again refused to purchase the business and realty. The wife sued to enforce the transfer as set forth in their marital separation agreement. The former spouses settled, and the husband purchased the business and real estate. The transfer of property occurred more than six years after the date of their divorce. The IRS ruled that the wife's transfer of the business and related realty to her former husband qualified for non-recognition treatment as a transfer between former spouses incident to divorce under I.R.C. § 1041(a).[182] The IRS explained that the wife successfully rebutted the presumption of *Temporary Treasury Regulation § 1041(a)-1T(b), Q&A-7*, by showing that: (1) the parties transferred the property to accomplish the division of property the parties owned at the time of the divorce; and (2) the transfer did not occur within the six-year

178. Temp. Treas. Reg. § 1-1041-1T(b), Q&A – 7 (1984).
179. *Id.*
180. *Id.*
181. Priv. Ltr. Rul. 92-35-026 (May 29, 1992).
182. *Id.*

period because a dispute concerning the value of the property, which resulted in litigation, prevented an earlier transfer.[183]

In *Private Letter Ruling 91-23-053*,[184] the IRS ruled that a taxpayer's payment (in a community property state) of one-half of a business interest to his former spouse, in monthly installments lasting more than six years after the divorce, qualified as nontaxable transfers under I.R.C. § 1041. The IRS stated that while *Temporary Treasury Regulation § 1.1041-1T(b), Q&A-7* establishes a rebuttable presumption that payments more than six years after the end of the marriage are not related to the cessation of the marriage, in this case, it was clear that the payments were made to accomplish a division of property owned by the couple at the time of divorce.[185]

Private Letter Ruling 93-06-015[186] addressed an eight-year delay between the divorce and the transfer. The original judgment of divorce required that the parties' residence, which the former spouses owned jointly, be sold when the youngest child was emancipated, and that the parties divide the proceeds between them equally. Instead, eight years later, the parties amended the divorce instrument, and under that amendment, the husband sold the residence to the wife. The IRS concluded that this transaction was not made to effect a division of property between them. The original divorce judgment had already accomplished that. Instead, the IRS considered this to be an arms-length transfer between two individuals who were not married to each other.[187]

In *Private Letter Ruling 93-48-020*,[188] a marital settlement agreement between a husband and wife who were divorced on December 26, 1990 provided that the parties would sell certain property they held as tenants in common to a third party, unless the husband exercised his right of first refusal. The IRS concluded that the husband's purchase of the property would be a purchase pursuant to a divorce or separation instrument, and that I.R.C. § 1041(a)(1) would apply to any such sale if it took place before December 27, 1996.[189] For purposes of I.R.C. § 1041, annulments and

183. *Id*.
184. Priv. Ltr. Rul. 91-23-053 (Mar. 13, 1991).
185. *Id*.
186. Priv. Ltr. Rul. 93-06-015 (Nov. 13, 1992).
187. *Id*.
188. Priv. Ltr. Rul. 93-48-020 (Sept. 1, 1993).
189. *Id*.

cessations of marriage that are void ab initio for violations of state law constitute divorces.[190]

In addition to direct transfers between spouses or former spouses, I.R.C. § 1041 permits certain "indirect" transfers to third parties.[191] The temporary regulations authorize three situations in which third parties may receive property on behalf of spouses or former spouses without triggering a gain or loss to the transferring spouse: (1) when the divorce or separation instrument requires the transfer to the third party; (2) when the transfer to the third party is pursuant to the written request of the other spouse (or former spouse); and (3) when the transferor receives a written consent or ratification of the transfer to the third party from the other spouse (or former spouse).[192] With respect to the latter situation, the consent or ratification must state that the parties intend for the transfer to be treated as a transfer to the non-transferring spouse (or former spouse), subject to the rules of I.R.C. § 1041, and the transferor must receive the consent before the date of filing of the transferor's first tax return for the taxable year in which the transfer is made.[193] In each of these three situations, the tax laws will treat the transfer of property as if the non-transferring spouse (or former spouse) made it to the third party. This deemed transfer by the non-transferring spouse is not a transaction that qualifies for non-recognition of gain under I.R.C. § 1041.[194] Thus, the non-transferring spouse may have to recognize gain or loss as a result of the transfer.

2. Basis Considerations

As indicated earlier, I.R.C. § 1041 covers all transfers between spouses, and virtually all transfers between former spouses. The provisions of I.R.C. § 1041 are mandatory. The general rule of no gain or loss recognition on a transfer between spouses or former spouses is designed to cover any such transfer even when the transfer is in exchange for the release of marital rights or other consideration.[195] The general rule applies regardless of whether the transfer is of property separately owned by the transferor or is a division—whether equal or unequal—of community property.[196] Section 1041 may even govern transfers of property acquired

190. Temp. Treas. Reg. § 1.1041-1T(b), Q&A-8 (1984).
191. *Id.* § 1.1041-1T(b), Q&A.
192. *Id.* § 1.1041-1T(c), Q&A-9.
193. *Id.*
194. *Id.*
195. *Id.* § 1.1041-1T(d), Q&A-10.

by one or both former spouses after the marriage ceases if the acquisition satisfies the provision's other requirements.[197] The holding period "tacking rule" of I.R.C. § 1223 also applies to I.R.C. § 1041 transfers. A transferee who takes a carry-over basis in property is treated as having owned the property for as long as the transferor owned it.[198]

The spouse or former spouse who receives property under I.R.C. § 1041 recognizes no gain or loss upon receipt of the transferred property. In all cases, the basis of the transferred property in the hands of the transferee is the adjusted basis of such property in the hands of the transferor immediately before the transfer. Even if the transfer is a bona fide sale, the transferee spouse (or former spouse) does not acquire a basis in the transferred property equal to the transferee's cost (the fair market value).[199] This carry-over basis rule applies whether the adjusted basis of the transferred property is less than, equal to, or greater than its fair market value at the time of transfer—or the value of any consideration provided by the transferee—and applies for purposes of determining loss as well as gain upon the transferee spouse's subsequent disposition of the property.[200] Thus, this rule is different from the rule applied in I.R.C. § 1015(a) for determining the basis of property acquired by gift.[201]

The most frequently encountered application of this rule is when the parties negotiate the transfer of the marital residence. The home is typically one of the largest assets the husband and wife own, and usually has the most appreciation of any of their assets. Accordingly, one spouse will usually seek to purchase the other spouse's ownership interest in the home with cash, property, or a promissory note. Counsel must ensure that the transferee spouse is aware that buying his spouse's ownership interest in the home will not increase the basis of the property upon its subsequent sale by the transferee.

The Tax Court recently applied the new basis rules of I.R.C. § 1041 in *Godlewski v. Comm'r.*[202] This case involved the transfer of the marital

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196. *Id*.

197. *Id.* § 1.1041-1T(a), Q&A-5 (1984).

198. I.R.C. § 1223(2); *see also* Priv. Ltr. Rul. 87-19-007 (Feb. 2, 1987) (determining a wife's holding period in shares of business interests purchased from her husband in an I.R.C. § 1041 transfer by taking the husband's holding period in such property into account).

199. Temp. Treas. Reg. § 1.1041-1T(d), Q&A-11 (1984).

200. *Id*.

201. *Id*; *see supra* § II.B.

home from one spouse to the other, and the transferee's subsequent sale of the house. The Godlewskis purchased a house for $32,200 in 1973 and resided in it until the husband moved out due to marital difficulties in 1981. In 1984, the parties negotiated a property agreement in which the husband agreed to purchase his wife's ownership interest in the home for $18,000. The parties executed the property agreement after the effective date for making I.R.C. § 1041 applicable to spousal property transfers. In 1984, after the transfer of ownership, the husband sold the house for $64,000. He failed to report the purchase of his wife's interest in the house and his subsequent sale of the house in his income tax return. The IRS calculated the amount realized on the sale using the original basis of $32,200. Mr. Godlewski contended that he had the right to increase his basis in the home by $18,000 to reflect the amount he paid his former wife. The Tax Court disagreed with the taxpayer and held that both I.R.C. § 1041(b)(2) and *Temporary Treasury Regulation § 1.1041-1T(d)A-11* preclude the transferee spouse from increasing the basis of an asset, even in a bona fide sale, when I.R.C. § 1041 governs the transfer.[203]

Clients frequently encounter the same rule when they own a family business, and only one spouse wishes to continue operating it. If the transferee spouse purchases the other spouse's ownership interest in the business for cash or other property, the transferee will only be entitled to a basis equal to the transferor spouse's adjusted basis in the business. The tax laws will not permit any additional increase in the basis for the money or property used to purchase the transferor spouse's ownership interest.[204] It may be possible, however, to arrange a transfer outside of the I.R.C. § 1041 provisions. Section 1041 only covers transfers between spouses or former spouses if "incident to a divorce." A transaction between a spouse and a corporation wholly owned by the other spouse, or between two corporations, is not a sale between spouses subject to the rules of I.R.C. § 1041.[205] This creates a tax planning opportunity. If a taxable transaction can use a controlled corporation or other entity, thereby permitting a step-up in the basis of the purchased property to its cost (as opposed to a carry-over of the other spouse's adjusted basis), the parties may benefit from increased depreciation allowances and other tax benefits. Such a transaction is not

202. 90 T.C. 200 (1988).
203. *Id*. at 206.
204. *See* Priv. Ltr. Rul. 87-19-007 (Feb. 2, 1987).
205. Temp. Treas. Reg. § 1.1041-1T(a), Q&A-2, Example (3) (1984).

without risks, however; the IRS may seek to recharacterize the transfer using a common law principle such as the step transaction doctrine.[206]

3. Section 1041 Non-Recognition Has Broad Implications

The breadth of the non-recognition-of-gain rule of I.R.C. § 1041 means that it also overrides other normal gain recognition events. For example, the non-recognition treatment the tax laws afford to spouses overrides the gain that would normally be recognized when spouses or former spouses transfer property to each other that is subject to liabilities exceeding its adjusted basis.[207]

> ***Example:*** Assume that *Husband* (*H*) owns property having a fair market value of $10,000 and an adjusted basis of $1000. In contemplation of making a transfer of this property incident to a divorce from *Wife* (*W*), *H* borrows $5000 from a bank, using the property as security for the borrowing. *H* then transfers the property to *W* and *W* assumes, or takes the property subject to, the liability to pay the $5000 debt. Under I.R.C. § 1041, *H* recognizes no gain or loss upon the transfer of the property, and the adjusted basis of the property in the hands of *W* is $1000.[208]

The non-recognition of gain rule that applies when the property's liabilities exceed its adjusted basis will only apply if the transferee spouse owns the property after the transfer is completed. If the transferee spouse transfers property for which liabilities exceed basis to a trust for the transferee spouse, that spouse will immediately recognize a gain.[209] The amount of the gain recognized will be added to the trust's basis in the property. Counsel for transferee spouses who receive, for example, tax shelter properties for which the fair market value of the property is less than its associated liabilities, must exercise caution. "Burned out" tax shelters exist, in which accelerated depreciation deductions have reduced the basis of the property, which when coupled with tax credits taken and highly leveraged debt, place the projects well below economic viability. In many

206. *Id.*; *see also* Priv. Ltr. Rul. 88-42-072 (July 29, 1988) (holding that a promissory note transferred by a controlled corporation to the transferee spouse for the latter's ownership interests in several assets, including some of the corporation's stock, was within the non-recognition provisions of I.R.C. § 1041).

207. Temp. Treas. Reg. § 1.1041-1T(d), Q&A-12 (1984).

208. *Id.*

209. I.R.C. § 1041(e).

cases, the shelter may now produce taxable income that exceeds its cash flow. The transferee of such a property, upon subsequent disposition (or foreclosure) of the shelter, may experience depreciation recapture, tax credit recapture, and the recognition of "phantom income" resulting from the release of liabilities. Before a spouse or former spouse agrees to accept such a property, that spouse's counsel should ensure the client is "compensated" for any additional tax liability with other payments of cash or property.

The broad scope of I.R.C. §1041 will also serve to prevent property which has enjoyed the benefits of investment tax credits relating to the property from tax credit recapture gain, when the property transfer is governed by I.R.C. § 1041. The TRA 1984 added I.R.C. § 47(e), which states that as long as the transferee spouse continues to use the property in the trade or business that qualified it for the investment tax credit, the property transfer does not trigger investment tax credit recapture.[210] If, at the time of or after the transfer, however, the owner ceases to use the property for its qualifying use, the IRS will recapture the investment tax credit.[211]

Spouses also may arrange transfers of property to avoid depreciation recapture. Sections 1245 and 1250 of the I.R.C. will cause gain realized on certain sales or exchanges of real and personal property to be taxed as ordinary income, to the extent of certain portions of depreciation deductions that taxpayers have already claimed. Section 1041 treats transfers between spouses as gifts. The recapture provisions of I.R.C. § 1245 and I.R.C. § 1250 do not apply to transfers that are treated as gifts.[212] The transferee spouse, however, will take the property subject to the transferor's potential recapture. The transferee spouse will be required to recognize the depreciation recapture when he disposes of the property.[213]

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210. Temp. Treas. Reg. § 1.1041-1T(d), Q&A-13 (1984); Priv. Ltr. Rul. 87-19-007 (Feb. 2, 1987).

211. *Id*.

212. I.R.C. § 1245(b)(1), 1250(d)(1); Priv. Ltr. Rul. 87-19-007 (Feb. 2, 1987).

213. Treas. Reg. § 1.1245-2(a)(4), 1.1250-2(d)(3).

4. *Transfers of Installment Obligations Between Spouses*

Before the TRA 1984, if one spouse transferred an installment obligation to the other, either during the marriage or incident to a divorce, the transferee spouse was immediately required to recognize the remaining outstanding gain represented by the installment obligation instrument. The Tax Reform Act of 1984 added a new I.R.C. § 453B(g). This new provision expressly excludes transfers of installment obligations that qualify for non-recognition under I.R.C. § 1041. No gain is recognized on the transfer, and the transferee receives the same tax treatment that would have applied to the transferor.[214] However, if such installment obligation is transferred to a trust for the other spouse, the deferred gain on the installment obligation is recognized.[215]

5. *Record-Keeping Requirements Under I.R.C. § 1041*

At the time of the transfer, a transferor of property under I.R.C. § 1041 must supply the transferee with sufficient records to determine the adjusted basis and holding period of the property as of the date of transfer. If the transfer carries a potential liability for investment tax credit recapture, the transferor must also supply the transferee with sufficient records to determine the amount and period of such potential liability at the time of the transfer.[216] The transferee must preserve these records and keep them accessible.[217]

6. *Effective Dates*

In most cases, I.R.C. § 1041 applies to all transfers after 18 July 1984. Section 1041 will not, however, apply to transfers after 18 July 1984 made pursuant to a divorce or separation instrument that was in effect before 18 July 1984.[218] There are two exceptions to the 18 July 1984 effective-date

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214. I.R.C. § 453B(g).

215. *Id.* Section 1842(b) of the TRA 1986 amended I.R.C. § 453B(g) to preclude installment obligations transferred in trust from the gain deferral rules under section 453B(g). TRA 1986, § 453B(g).

216. Temp. Treas. Reg. § 1.1041-1T(e), Q&A-14 (1984).

217. *Id.*

218. *Id.* § 1.1041-1T(f), Q&A-15.

rule, and both exceptions require the concurrence of both spouses or former spouses:

> a. Section 1041 will apply to transfers of property made after 18 July 1984 under a divorce or separation instrument that is in effect before 18 July 1984 if both spouses (or former spouses) elect to have I.R.C. § 1041 apply to such transfers.[219]
> b. Section 1041 will apply to all transfers after 31 December 1983 if both spouses (or former spouses) elect to have I.R.C. § 1041 apply.[220]

Temporary Treasury Regulation § 1.1041-1T(g), A-18, provides a form that will permit a spouse or former spouse to make the election for I.R.C. § 1041 treatment for either of the exceptions.[221] The transferor must attach a copy of the form to his first filed income tax return for the taxable year in which the first transfer occurs. The transferor must attach a copy of the election form to each tax return for each subsequent taxable year in which he makes a transfer that is governed by the exception.[222]

In a 1987 letter ruling, the IRS permitted former spouses to elect I.R.C. § 1041 treatment after they modified a 1982 divorce decree to permit the transfer of the former marital home from one spouse to his former spouse. The former spouses had to show that the transfer was related to the cessation of the marriage, as required by I.R.C. § 1041(c)(2).[223]

In the case of either of the alternatives to elect I.R.C. § 1041 treatment, such an election will subject all property transfers to the provisions of I.R.C. § 1041. Partial elections are not allowed.[224] The election, once made, is irrevocable.[225]

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219. *Id.* § 1.1041-1T(f), Q&A-16 (1984).
220. *Id*.
221. *Id.* § 1.1041-1T(g), Q&A-18 (1984).
222. *Id*.
223. Priv. Ltr. Rul. 87-32-036 (May 12, 1987); *see also* Priv. Ltr. Rul. 89-49-085 (Sept. 14, 1989).
224. Temp. Treas. Reg. § 1.1041-1T(f), Q&A-17 (1984).
225. *Id*.

7. Gift and Estate Tax Considerations in Property Transfers

It may seem ironic to think of the possible imposition of a gift tax on property transfers between spouses or former spouses when pursuing a divorce. The donative intent one normally encounters when making a gift is rarely present in these situations. The Economic Recovery Tax Act of 1981[226] completely eliminated federal transfer taxes (gift and estate) for inter-spousal transfers by amending the marital deduction provisions to make the marital deduction unlimited for property transfers between spouses as long as they are married. Gift taxes could be imposed on transfers of property between former spouses, however. Such transfers of property between former spouses were subject to a gift tax unless the property was transferred for an adequate and full consideration in money or money's worth.[227]

Before the TRA 1984, I.R.C. § 2516 prevented the imposition of a gift tax on property transferred between two former spouses if the transfer was pursuant to a written agreement entered into not more than two years prior to a divorce. The written agreement had to be either in settlement of marital or property rights or provide a reasonable allowance for the support of the parties' minor children.[228] Transfers that were included within the coverage of I.R.C. § 2516 would treat the transfer of marital and property rights as being made for adequate and full consideration in money or "deemed consideration." In addition, the Supreme Court held in *Harris v. Commissioner*[229] that no gift taxes were applicable when property was transferred in satisfaction of the release of marital rights pursuant to a divorce decree or judgment. The IRS broadened the *Harris* decision to exclude gift taxes from situations in which a divorce decree or judgment required the transfer of property to discharge a transferee spouse's right to support.[230]

Problems with transfer taxes still existed, however. If two spouses made a property transfer pursuant to a written agreement, for example, but they did not divorce within two years after the date of the agreement, the tax implications of the transfer were not clear. In such situation, the transfer was a taxable gift unless it qualified for the unlimited marital deduc-

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226. Pub. L. No. 97-34, 95 Stat. 172 (1981).

227. I.R.C. §§ 2056, 2523 (for estate and gift taxes, respectively).

228. *Id.* § 2516 (before TRA 1984).

229. 340 U.S. 106 (1950).

230. Rev. Rul. 68-379, 1968-2 C.B. 414; Rev. Rul. 71-67, 1971-1 C.B. 271; Rev. Rul. 77-314, 1977-2 C.B. 349.

tion. Counsel also had to make factual inquiries to determine whether the transfer of property was a completed gift. Was the consideration given for the property adequate and full in cash (or cash equivalent)? Did a divorce decree incorporate the property transfer? Did the transfer qualify for the unlimited marital deduction?

The TRA 1984 made two changes to the transfer tax provisions involving property transfers between spouses. First, Congress broadened I.R.C. § 2516 to include certain post-divorce transfers if they are made pursuant to a written separation agreement entered into up to one year after the divorce,[231] in addition to the two years preceding the divorce—a total period of three years. Second, TRA 1984 made estate and gift tax laws the same when property transfers arise out of a divorce. Congress amended I.R.C. § 2043(b)(2) to include any transfer that qualified for I.R.C. § 2516; such transfers are now also considered made for adequate and full consideration in money and money's worth for estate tax purposes.[232] Such transfers would also qualify for an estate tax deduction. This amendment permits an estate tax deduction for property transfers completed as a result of a claim by a spouse or former spouse that arises under a written separation agreement, should such transfer meet the criteria of a gift under I.R.C. § 2516. This situation occurs when a spouse dies before completing all of the required transfers called for under the parties' written separation agreement. Section 2043(b)(2) prevents the imposition of an estate tax with respect to the property transfers that have not been completed as long as the estate executes the transfers that the written agreement requires. The revised sections 2043 and 2516 apply to transfers that occur after 18 July 1984.

D. Transfer of Retirement Benefits.

The division of a family's retirement benefits, which may frequently be the couple's most significant asset, requires an examination of both state law and federal tax law. Typically, a qualified pension, profit-sharing, or stock bonus plan is strictly defined and regulated by federal tax law. Principal among the federal regulatory and statutory control of qualified retirement plans is the Employment Retirement Income Security Act of 1974 (ERISA).[233] Under ERISA, qualified employee retirement plans were

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231. I.R.C. § 2516 (1982) (amended by TRA 1984, § 425(b)).
232. *Id.* § 2043(b)(2) (amended by TRA 1984, § 425(a)(1)).
233. 29 U.S.C. § 1144 (2000).

required to include spendthrift provisions that prohibited the assignment of vested accrued benefits to anyone other than the person who earned them. Before the Retirement Equity Act of 1984 (REA 1984),[234] retirement plans were generally prohibited from assigning retirement benefits to anyone other than the plan participant. Thus, court orders granting the spouse of a plan participant an interest in a portion of the vested benefits sometimes proved fruitless. Conflicts emerged as state courts began to define retirement benefits as marital property subject to division.

This same issue exists for non-ERISA government retirement programs such as military sponsored retirement plans. The appropriate tax treatment applicable to military retirement payments received by the former spouse of a retired service member generally hinges on whether the property is classified as community property under state law. For example, in a private letter ruling,[235] the IRS held that payments by the husband to the wife in exchange for the wife's relinquishment of claims on her ex-husband's military retirement plan under the Uniformed Services Former Spouse's Protection Act[236] should be treated as an assignment of the wife's future right to receive income and not as a tax-free transfer of property under I.R.C. § 1041(a)(2). The wife was required to report her receipt of the payments as ordinary income under I.R.C. § 61. The Tax Court has reached similar results in a recent case including the receipt of Air Force retirement benefits.[237]

In *Private Letter Ruling 8813023*[238], Mrs. Balding's marriage was dissolved in a community property state (California) in December 1981. At that time, the Supreme Court's ruling in *McCarty v. McCarty*[239] was in effect. *McCarty* held that a military spouse's retirement benefit was that spouse's separate property in community property states and therefore would not be subject to division as part of the community property.[240] Pursuant to *McCarty*, the divorce decree stated that the husband's military retirement plan was the separate property of Mr. Balding.[241] The Uniformed Services Former Spouse's Protection Act effectively overruled

234. *Id.* § 1001.

235. Priv. Ltr. Rul. 88-13-023 (Dec.29, 1987). This ruling was released prior to the enactment of the Uniformed Services Former Spouse's Protection Act.

236. Pub. L. No. 97-252, tit. X, 96 Stat. §§ 730-738 (1982).

237. Denbow v. Comm'r, 56 T.C.M. (CCH) 1397 (1989).

238. Priv. Ltr. Rul. 88-130-23 (Dec. 29, 1987).

239. 453 U.S. 210 (1981).

240. *Id*. at 223-224, 232

241. Priv. Ltr. Rul. 88-130-23 (Dec. 29, 1987).

McCarty, however.[242] Mrs. Balding moved to modify the divorce decree to recognize her interest in her husband's military retirement plan, and then agreed to relinquish her claims in exchange for three payments, of $15,000 in 1986, $14,000 in 1987, and $13,000 in 1988.[243]

In *Private Letter Ruling 8813023*, the IRS ruled that such payments would be taxable to Mrs. Balding. The IRS's rationale was that the payments should be treated as an assignment of Mrs. Balding's future right to receive income, not as a tax-free transfer of property under I.R.C. § 1041(a)(2). The IRS stated that Mrs. Balding would be required to report the three payments as ordinary income in the respective tax years.[244]

Mrs. Balding filed a petition with the Tax Court, which ruled in her favor in *Balding v. Commissioner*.[245] The Tax Court concluded that the cash payments to Mrs. Balding were "property" within the meaning of I.R.C. § 1041 and thus excludable, notwithstanding the IRS's argument that the assignment of income doctrine required taxation of the three payments.[246] In a footnote, the Tax Court expressly declined to rule whether the assignment of income doctrine might apply in future years in which Mrs. Balding actually received payments under the plan, but cited a law review article as authority for the argument that Mrs. Balding was not required, under the assignment of income doctrine, to report any portion of the retirement benefits she received as taxable income.[247]

Subsequent decisions in community property jurisdictions have decided that I.R.C. § 1041 does not apply to the division of retired military pensions because there is no transfer of property. In one such decision, *Fulgram v. Commissioner*,[248] the petitioner and her former husband divorced in Texas. Under divorce decree, the court awarded Mrs. Fulgram twenty percent of her husband's net military retirement pay (gross pension, veterans' compensation, and federal income tax withheld) as a property settlement. Mrs. Fulgham did not report any portion of the distribution and

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242. *See* 10 U.S.C. § 1408 (2000). (recognizing the fact that a military retirement program is similar in purpose and intent to private employer and government sponsored retirement programs which are treated as marital property for purposes of I.R.C. § 1041).

243. Priv. Ltr. Rul. 88-130-23 (Dec. 29, 1987).

244. *Id*.

245. 98 T.C. 368 (1992).

246. *Id*. at 370, 372-373.

247. *Id.* at 373 n.8 (citing Michael Asimow, *The Assault on Tax-Free Divorce: Carryover Basis and Assignment of Income*, 44 TAX L. REV. 65 (1988)).

248. T.C. Sum. Op. 2001-29 (Mar. 14, 2001), 2001 Tax Ct. Summary LEXIS 136.

received a notice of deficiency, dated 18 August 1999, for $1515. The petitioner disputed the deficiency determination and contended that the pension was taxable only with respect to her husband. She also contended that if she were responsible for the tax, she should get a twenty-percent credit for federal income tax withheld in the course of determining "net."[249] The Tax Court found that military retirement benefits earned during marriage are community property in Texas.[250] The payments are characterized as compensation for services that are earned over the course of employment, and under Texas law, a spouse's rights to her husband's military retirement benefits become vested at the time the couple earns such benefits.[251] The petitioner did not present any evidence that it was not community property. Because the petitioner had a vested interest in the retired military pension, she had to pay tax on that share of it when she received it.[252]

In a more recent California case, *Weir v. Commissioner*,[253] the Tax Court reached the same decision as in *Fulgram*, and distinguished itself from *Balding*. The petitioner argued that at the time of the divorce, her husband was ordered to make settlement payments to her in lieu of her community property interest in the military retirement benefits. The petitioner argued that she received cash settlement payments while her ex-husband received the benefits as his separate property.[254] While this appears similar to the facts in *Balding*, the Tax Court did not accept this argument and emphasized that the separation agreement and its addendum, both of which were incorporated into the interlocutory judgment of dissolution of marriage and the final judgment of dissolution of marriage, contained language that clearly identified her as having a "vested community interest" in the pension. The petitioner failed to persuade the Tax Court that the agreement language intended for the ex-husband to act as anything other than a collection agent on her behalf.[255]

Relatively few decisions explain I.R.C. § 1041 property transfers involving the military pension in equitable distribution law states, but a recent Oregon case suggests a likely outcome. In *Huggins v. Commissioner*,[256] a divorce decree, effective 18 January 1986, dissolved the peti-

249. 2001 Tax Ct. Summary LEXIS at 138-139.
250. *Id*. at 142.
251. *Id.* at 142-143.
252. *Id.*
253. 82 T.C.M. (CCH) 281 (2001).
254. *Id.*
255. *Id.*

tioner's marriage. The decree provided that the husband would pay the petitioner a sum of money equaling one-half of [the] monthly net amount, after deductions for federal and state taxes, of the U.S. Coast Guard retirement pension received by [the petitioner's former husband]. Payment to [the petitioner] shall not be included as taxable income to [the petitioner], nor shall such payments be deductible by [the petitioner husband].[257]

The decree further directed that the payments be made directly to the petitioner and continue until the mortgage on the marital home was paid, foreclosed upon, or sold.[258] The IRS argued that what the petitioner received was "simply a right to receive a future stream of income."[259] The Tax Court opined that under Oregon law, the retired military pension was property, and that the petitioner's husband was the recipient of the pension. Thus, the petitioner's husband remained fully taxable on his retired pay.[260]

Recently, the Tax Court was able to directly address the tax treatment of the military pension under the equitable distribution laws of Virginia. In *Pfister v. Commissioner*,[261] the Tax Court held that a former spouse of a retired service member awarded an ownership interest in a military pension as a division of military property or pursuant to a divorce settlement must include her proportionate share of the benefits in her gross income.[262]

Another issue pertaining to the tax treatment afforded to pension plans relates to the tax treatment applicable to payments an employee's spouse receives from deferred compensation plans. This issue was the subject of *IRS Letter Ruling 93-40-032*,[263] in which the IRS considered the

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256. T.C. Sum. Op. 2001-69 (May 14, 2001), 2001 Tax Ct. Summary LEXIS 173.

257. 2001 Tax Ct. Summary LEXIS at 174.

258. *Id.*

259. *Id*. at 175.

260. *Id*. at 183.

261. T.C. Memo 2002-198, 84 T.C.M. (CCH) 172 (2002).

262. *Id.* at 10. The Tax Court concluded that a Virginia divorce decree did transfer an ownership interest in a military pension. *See also* Newell v. Comm'r, T.C. Sum. Op. 2003-1 (Jan. 7, 2003); Witcher v. Comm'r, T.C. Memo 2002-184, 84 T.C.M. (CCH) 582 (2002). If not properly dated, there is a chance the pension payments or cash equivalents may be treated as alimony instead of property transfers. In *Baker v. Comm'r*, T.C. Memo 2000-164, 79 T.C.M. (CCH) 2050 (2000), an Alabama case, the divorce decree indicated that the payments were a "property settlement." *Id*. at 2051. Because the decree did not clearly designate that the payments were non-taxable under I.R.C. § 71 or non-deductible under I.R.C. § 215, the court considered the payments to alimony, and therefore includable in petitioner's income. *Id.* at 11.

263. Priv. Ltr. Rul. 93-40-032 (July 6, 1993).

tax treatment of payments under a deferred compensation plan that had been assigned to the employee's wife in a divorce decree. The employee, a baseball player, participated in his employer's deferred compensation plan, which permitted him to defer a portion of his salary. A divorce decree between the employee and his wife gave her a percentage of his interest in the deferred compensation plan. The decree provided that if the IRS determined that the employee was liable for taxes on payments to his wife made under the plan, that the wife was to reimburse him for his tax liability on such payments.[264]

Curiously, the IRS did not renew the position it took in *Private Letter Ruling 88-13-023*.[265] The theory of that ruling would have resulted in immediate taxation to the employee when the court assigned an interest in his deferred compensation plan to his wife.[266] If I.R.C. § 1041 does not protect an assignment of deferred compensation in satisfaction of marital rights, under the rationale of *United States v. Davis*,[267] the assignment should cause recognition of income in the same manner as an assignment of deferred compensation rights in exchange for a cash payment.

Instead, the IRS concluded that assignment of income principles require that the employee recognize income when his employer paid his wife amounts under his deferred compensation plan. This conclusion clarified that, despite I.R.C. § 1041's attempt to repeal *Davis*, important tax differences persist between marital settlements in common law and community property states. The non-employee spouse in a community property state has state law rights to his spouse's deferred compensation; no assignment is necessary. Accordingly, the assignment of income doctrine did not cause the employee spouse a tax liability attributable to the payments paid to and received by the non-employee spouse from the employee's deferred compensation plan.[268]

In some cases, it is difficult to distinguish between rights to future compensatory payments and rights to future payments for transferred or released property rights. The taxpayer in *Meisner v. United States*[269] faced this dilemma. Jennifer Meisner, the taxpayer, had been married to Randall Meisner, a former member of The Eagles. When Mr. Meisner left the

264. *Id*.
265. Priv. Ltr. Rul. 88-13-023 (Dec. 29, 1987).
266. *Id*.
267. 370 U.S. 65 (1962).
268. *See, e.g.*, Graham v. Comm'r, 72 T.C.M. (CCH) (1996).
269. 133 F.3d 654 (8th Cir. 1998).

group, he was entitled to performance and composer royalties under his termination agreement with The Eagles. The Meisners' property settlement agreement gave Mrs. Meisner an "undivided forty percent interest in the royalty contract."[270] If the basis for the termination contract was Mr. Meisner's performance of services for the Eagles, presumably he should have fared no differently than the baseball player in *Private Letter Ruling 93-40-032*.[271] The U.S. Court of Appeals for the Eighth Circuit, however concluded that Mrs. Meisner, not Mr. Meisner, should be taxed on the share of the royalties paid to her because Randall had retained no power or control over that share.[272] The court did not discuss whether the origin of the royalty payments was compensation for services or property.

The IRS's position on this issue presents a difficult problem for parties negotiating marital settlement agreements. In some cases, a significant portion of the parties' marital property will consist of various rights to deferred compensation that are not a part of a qualified pension plan. Assignment of these rights to a spouse under a marital settlement agreement may trigger the immediate recognition of income. Alternatively, an assignment may result in income recognition by the spouse who has assigned his rights under the plan, as his employer makes payments to his spouse. Until the IRS resolves this issue, attorneys should not assign these rights as part of a property settlement. If counsel cannot avoid an assignment, perhaps because other assets are not sufficient, the marital settlement agreement should contain a tax adjustment clause to compensate the transferring spouse for any unexpected tax liability.

To provide more certainty in the division of qualified retirement benefits between a plan participant and his spouse, the REA 1984 created a limited exception to the prohibition on the assignment of benefits. Section 401(a)(13)(B) of the I.R.C. permits an employee to assign future benefits of a qualified retirement plan to a non-participant spouse, pursuant to a "qualified domestic relations order" (QDRO). A QDRO assignment of benefits will not disqualify the plan because I.R.C. § 401(a)(13) recognizes

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270. *Id*. at 655.
271. Priv. Ltr. Rul. 93-40-032 (July 6, 1993).
272. 133 F.3d at 657.

the QDRO as an exception to the anti-alienation rules applicable to qualified retirement plans.[273]

For purposes of the QDRO rules, a "domestic relations order" is a judgment, decree, or order—including an approved property settlement—that relates to child support, alimony payments, or marital property rights, and is made pursuant to the state's domestic relations law.[274] A domestic relations order is a "qualified" order (and thus, a qualifying QDRO) if it meets the following requirements:

> 1. Creates or recognizes the right of an alternative payee (*i.e.*, a spouse, former spouse, child or other dependent of a plan participant) to receive all or a portion of the accrued benefits payable with respect to the participant; and
>
> 2. Specifies the following information:
>
> a. The name and last known mailing address of the plan participant and each alternate payee;
>
> b. The amount or percentage of the participant's benefits to be paid to each alternate payee;
>
> c. The number of payments or period to which such order applies; and
>
> d. Each plan to which such order applies.[275]

The QDRO cannot require a plan to provide any type or form of benefit, or any option not otherwise provided under the plan. It also cannot require a plan to pay the payee more benefits than the amount to which the participant is entitled. Lastly, the QDRO may not require a plan to pay any

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273. I.R.C. § 401(a)(13)(A) and (B).

274. *Id.* § 414(p)(1)(B). The anti-alienation rules have the effect of protecting qualified plan benefits from the participant's creditors. *See* Johnston v. Mayer, Trustee, 218 B.R. 813 (Bankr. E.D. Va. 1998).

275. I.R.C. § 414(p)(2).

benefits to a payee if another QDRO already requires the payment of those benefits to another, pre-existing payee.[276]

Although a QDRO cannot increase or modify the form of benefits, it is not bound by the elections or circumstances of the plan participant. Thus, a QDRO may require that payments to an alternate payee begin on or after the date on which the participant is first eligible to receive retirement benefits under the plan, regardless of whether the participant actually retires on that date.[277] Should the plan participant die before the date on which the QDRO requires payments to begin to the alternate payee, survivor benefits may be paid to the alternate payee if the QDRO requires.[278]

The TRA 1986 made several revisions to the QDRO provisions, primarily as they relate to government retirement plans and other plans to which the assignment or alienation restrictions do not apply.[279] In *Hawkins v. Commissioner*,[280] a husband and wife entered into a marital agreement, which provided that Mrs. Hawkins would receive $1,000,000 in cash from Mr. Hawkins' share of a pension plan. Mr. Hawkins paid Mrs. Hawkins the $1,000,000 in installment checks written on the pension plan bank account. Subsequently, Mr. Hawkins filed a nunc pro tunc motion for entry of a QDRO in state court. The state court denied the motion, holding that nothing in the marital agreement or the final decree specified the creation of a QDRO, or that Mrs. Hawkins would be designated as an alternate payee.[281]

The Tax Court held that the agreement did not constitute a valid QDRO. The divorce decree's reference to the pension plan as the source of the $1,000,000 in payments did not create any rights to benefits under the plan because the agreement did not refer to Mrs. Hawkins as the alternate payee, as I.R.C. § 414(p)(1)(A) requires. The agreement did not contain the other I.R.C. § 414(p)(2)(c) requirements concerning the number of payments or payment period, either. The Tax Court specifically rejected Mr. Hawkins' argument that the QDRO did not have to specify required

276. *Id.* § 414(p)(1)-(3).
277. *Id.* § 414(p)(4).
278. *Id*.
279. *See* TRA 1986. § 1898(c)(1)-(7).
280. 102 T.C. 61 (1994), *rev'd*, 86 F. 3d 982 (10th Cir. 1996).
281. *Id*. at 64-65.

facts when the plan administrator already knows them (commonly referred to as the "subjective knowledge standard").[282]

The U.S. Court of Appeals for the Tenth Circuit (Tenth Circuit) reversed, disagreeing with the Tax Court's conclusion that the marital agreement incorporated into the decree did not constitute a QDRO. The Tenth Circuit concluded that the issue of whether the agreement as incorporated into the decree constituted a QDRO was neither "actually litigated nor necessarily decided" in the divorce proceeding, and held that the parties should have litigated the issue in Tax Court.[283] Finding that the parties' agreement and decree included the information necessary to create a QDRO under I.R.C. § 414(p), the Tenth Circuit held that under I.R.C.§ 402(a)(1), Mrs. Hawkins, as the pension plan distributee, was liable for the tax on the entire distribution.[284]

To be a QDRO, an order must be entered *before* the plan makes a distribution to an alternate payee. It is not sufficient for an order to recognize the alternate payee's rights after the distribution.[285] In *Rodoni*, the Tax Court held that Mr. Rodoni's receipt of a lump sum distribution from his employer's terminated profit-sharing plan, which was subsequently transferred to Mrs. Rodoni's individual retirement account (IRA), did not qual-

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282. *Id.* at 76-77; *see also In re* Boudreau, 95-1 U.S.T.C. (CCH) ¶ A50, 115 (Bankr. M.D. Fla. 1995).

283. 86 F.3d at 987.

284. Hawkins v. United States, 86 F. 3d 982, 988 (10th Cir. 1996); *see also* Wilcox v. Williams, 50 F. Supp. 2d 951 (C.D. Cal. 1999) (treating a domestic relations order as a QDRO even though it did not conform to the strict requirements of a QDRO; holding that the intent of the order was clear). Practitioners must exercise particular care when complying with the statutory rules for drafting and entering QDROs. Failure to abide by the rules in I.R.C. § 414(p) could lead to unintentional and disastrous results for the client and subsequent heartache to the attorney, whom more senior partners may ultimately advise to "call the malpractice insurance carrier." Attorneys should always draft QDROs specifically to meet the requirements of I.R.C. § 414(p). Attention to detail is critical. A prudent counsel should consider showing a draft QDRO to the plan administrator before submitting it to the court, to ensure that it conforms to the particular retirement plan's provisions, as well as to the requirements of I.R.C. § 414(p) (for example, early withdrawal provisions). Plan administrators, particularly those from large employer plans, will usually provide sample QDROs that have been approved previously. Counsel should exercise extreme caution when using such samples, however; they may lack elections or provisions favorable to alternate payees, provisions the plan may authorize. The plan administrator frequently provides information that will make an attorney's job easier. It is not the role of the plan administrator, however, to inform counsel for the alternate payee about options and elections that may be more beneficial for the alternate payee.

285. *See* Rodoni v. Comm'r, 105 T.C. 29 (1995).

ify as a QDRO plan (and thus, taxable to Mrs. Rodoni). The parties executed the marital agreement providing Mrs. Rodoni with a portion of Mr. Rodoni's profit-sharing plan after receipt of the lump sum distribution. The Tax Court held that the domestic relations order judgment was not "qualified" before the payment of the distribution; it also did not specify payments, the period to which it applied, or the amount of benefits to be paid. Mrs. Rodoni could not roll over her receipt of the lump sum payment to her IRA tax-free. Her IRA was not an "eligible retirement plan" because the IRA was not established for the benefit of the employee—Mr. Rodoni.[286]

The primary emphasis of the REA 1984 and subsequent amendments is not to determine how benefits are to be allocated. State law will govern whether a non-employee spouse has any claim to the employee spouse's retirement benefits, and the extent of the claims. The provisions of the REA 1984 are primarily a mechanism to insure that once a court recognizes any claims, the court orders will be enforceable, and the plan will pay the alternate payee directly. Generally, the alternate payee will be taxed on distribution payments received in the same manner as if the participant received them.[287]

E. Treatment of Promissory Notes and Related Issues Under Section 1041

1. The Problem

In many property settlements, one spouse may not have sufficient liquid or readily divisible assets at the time of a transfer to "equalize" a property division. The situation is common when it is impractical or inadvisable to divide or liquidate certain large assets (for example, stock in a closely held family corporation). In such cases, the spouse retaining the business must often buy the other spouse's interest in the asset. In such cases, the transferee spouse or retaining spouse usually gives the transferor spouse a promissory note obligating him to make installment payments of the outstanding balance. The use of promissory notes raises multiple issues. For example, what basis will the note have? Must the promissory note pay interest? If the note must pay interest, is such interest property under I.R.C. § 1041? Is such interest deductible by the payor and includ-

286. *Id*. at 33.
287. I.R.C. §§ 402(e)(1)(A), 402(a), and 72.

able in the payee's gross income? If no interest is stated on the note, do the rules concerning imputed interest apply to the note?

2. *Treatment of Stated Interest and Imputed Interest*

If the promissory note provides for a stated amount of interest (for example, ten percent) payable on the outstanding balance due, is such interest income or property? In a more recent case, the Tax Court addressed the issue on the tax treatment of the interest received on an installment note executed between former spouses. In *Gibbs v. Commissioner*,[288] the payee (former wife) argued that the interest she received from her former husband on installment payments she received in exchange for her ownership interests in the marital residence, securities, and other marital property should be treated as property payments received which are excludible from income pursuant to I.R.C. §1041.[289] The Tax Court disagreed and noted that the interest and any nontaxable gain realized on the assets conveyed by the former wife are "two distinct items that give rise to separate federal income tax consequences, . . ."[290] The court held that I.R.C. §1041 did not apply to the interest portion of the payments the former wife received and such interest must be included in the former wife's gross income in the year received.[291] In a private letter ruling,[292] the IRS held that the parties must include the stated interest provided for in a property judgment in a wife's gross income at the time she receives such interest. Such a ruling carries a corollary that the husband would be entitled to deduct the interest payments, subject to the limitations of I.R.C. § 163(h), which governs personal interest deductions.[293]

The treatment of potential imputed interest presents a much clearer question. The imputed interest rules of I.R.C. sections 483, 1274, and 7872 concern themselves with requiring that interest be imputed (includable in the gross income of the payee and deductible by the payor) if the interest on an obligation is not equal to the applicable federal rate. Treasury income tax regulations provide that interest will not be imputed under I.R.C. § 483 (interest on certain deferred payments) and sections 1272 to

288. 73 T.C.M. (CCH) 2669 (1997).
289. *Id*. at 2671.
290. *Id*. at 2672
291. *Id*. at 2672-2673.
292. Priv. Ltr. Rul. 86-40-046 (July 8, 1986).
293. *See* I.R.C. § 163(h); Seymour v. Comm'r, 109 T.C. 270 (1997), Treas. Reg. §1.163-8T (tracing rules); IRS Notice 88-74, 1988-2 C.B. 385.

1274 (original issue discount), if the debt obligation arises out of a property transfer that qualifies for non-recognition under I.R.C. § 1041.[294] The IRS has also held that the rules for imputed interest on gift loans are inapplicable to note payments made in connection with an I.R.C. § 1041 property transfer.[295] This latter private letter ruling involved a promissory note by the husband and given to his wife pursuant to a separation agreement. The parties used this note to equalize the property division; it carried a variable interest rate ranging from 5.5% to 7.5%. The interest alone was payable monthly for ten years, followed by principal payments with amortized interest for the next ten years. The IRS held that neither I.R.C. § 483 nor I.R.C. § 1274 would apply to recharacterize principal payments as interest, and that I.R.C. § 7872 would not apply to any of the note payments.[296]

The tax treatment of accrued but unpaid interest that is transferred between spouses in I.R.C. § 1041 transactions remains unsettled. In *Revenue Ruling 87-112*,[297] the IRS took a restrictive approach in applying I.R.C. § 1041 to interest.[298] In this ruling, the IRS addressed the transfer of savings bonds between spouses. The husband transferred Series E and EE bonds to his wife, pursuant to a property agreement qualifying for I.R.C. § 1041 treatment. Typically, interest earned on bonds of these types is not reportable in the owner's income until he redeems or otherwise disposed of them—for example, by gift. The owner is taxed on the accrued interest when he redeems the bonds.[299] The IRS ruled that while I.R.C. § 1041 prevents gain recognition on the sale or exchange of property between spouses, it does not apply to income assignments pursuant to a divorce. The ruling required the husband (the transferee) to include all of the deferred income in his gross income in the year of transfer, stating that:

> Although § 1041(a) of the Code shields from recognition gain that would ordinarily be recognized on a sale or exchange of property, it does not shield from recognition income that is ordinarily recognized upon the assignment of that income to another taxpayer. Because the income at issue here is accrued but unrec-

294. Prop. Treas. Reg. § 1.483-1(c)(3); Prop. Treas. Reg. § 1.1274-1(b)(3)(iii); *see* Priv. Ltr. Rul. 86-45-082 (Aug. 14, 1986).

295. Priv. Ltr. Rul. 86-45-082 (Aug. 14, 1986); *see* I.R.C. § 7872.

296. *Id.*

297. 1987-2 C.B. 207.

298. Rev. Rul. 87-112, 1987-2 C.B. 207.

299. *Id.* Treas. Reg. § 1-454-1(a).

> ognized interest, rather than gain, § 1041(a) does not shield that income from recognition.[300]

The wife was thus entitled to an adjusted basis equal to the carryover basis in the bonds, plus an amount equal to the interest income that was includable to the husband as a result of the transfer. Interest accrued after the transfer would be includable in the wife's income.[301]

In a private letter ruling issued after *Revenue Ruling 87-112*, the IRS ruled that principal payments on a promissory note received by the wife were nontaxable under I.R.C. § 1041, even though such payments came from her husband's corporation. At the end of the ruling, however, the IRS stated the following: "We express no opinion on whether the entire principal payment is property subject to [I.R.C. § 1041] because the note may represent payment for a right to earned or accrued income that is subject to the assignment of income principle."[302] The letter ruling cited *Revenue Ruling 87-112* as authority for the comment.[303] Thus, to the extent assignment of income principles may be applicable to note payments or other assets transferred under I.R.C. § 1041, taxpayers can expect the IRS to seek to recognize income to the transferor at the time of transfer.

In *Seymour v. Commissioner*,[304] the Tax Court applied *Temporary Treasury Regulation § 163-8T* (the interest tracing rules) and held that interest paid on a $925,000 promissory note given by the husband to his wife, given as part of the property settlement in a divorce, should be allocated by the wife among the various property interests the wife transferred to her husband as part of the property settlement. Thus, to the extent the note's principal was in exchange for the wife's interest in corporate stock transferred to the husband, the interest was deductible as investment interest, subject to the limitations in I.R.C. § 163(d). To the extent the note was in exchange for the wife's interest in rental real estate, the interest was deductible, subject to the passive activity loss rules of I.R.C. § 469. Because the note was secured by the taxpayer's principal residence to the extent that it was in exchange for the wife's interest in the residence, interest was deductible as qualified residence interest under I.R.C. § 163(h)(3).[305] To the extent that the note was in exchange for the wife's

300. Rev. Rul. 87-112, at 208.
301. *Id.*
302. Priv. Ltr. Rul. 88-42-072 (July 29, 1988).
303. *Id*.
304. 109 T.C. 279 (1997); *see also* Redlark v. Comm'r, 114 F.3d 936 (9th Cir. 1998) (reversing the decision of the Tax Court below, 106 T.C. 31 (1996)).

interest in personal use property, such as home furnishings, however, the interest was nondeductible personal interest under I.R.C. § 163(h)(1). The divorce instrument's failure to allocate any amount of the note as a payment for any particular asset transferred to the husband did not affect the essential nature of the transaction.[306]

In another case, the Tax Court held that the interest portion of annual payments the wife received from her ex-husband in exchange for her property interest in a convenience store was not excludable as a transfer incident to divorce under I.R.C. § 1041.[307] Although the court noted that this result differed from the hypothetical result in the event a taxpayer received I.R.C. § 483 "unstated" interest, the court saw the problem as one of proof rather than principle.[308]

3. What Basis Will the Promissory Note Have?

It is not settled what basis, if any, a spouse's promissory note will have when he transfers it in exchange for property under I.R.C. § 1041. Typically, one's own promissory note has a basis of zero.[309] If this is the case, then the parties may lose the basis of the property that they exchange for the note, in which case, the transferor of the property would have no basis in the note she receives. For example, assume that a husband and wife own a home with a fair market value of $100,000. Next, assume that the parties enter into a written separation agreement in which the husband will give his wife a promissory note for $50,000 in exchange for the wife's relinquishment of all of her ownership rights in the home. The note provides for annual payments of $10,000 for five years. Presumably, this note will have a basis of $50,000 at the time the wife receives it. As she receives her annual payments, the wife recognizes no gain by virtue of I.R.C. § 1041.

Temporary Treasury Regulation § 1.1041-1T(d) leaves much uncertainty about the basis of a note a maker spouse gives to a holder spouse as part of a property settlement in a divorce. If the holder sells the note at the note's face value, it is unclear whether gain or loss will result. Also, once the individual issues the note to his or her spouse or former spouse, the tax

305. *See also* Notice 88-74, 1988-2 C.B. 385.
306. *Id*. at 289.
307. Gibbs v. Comm'r, 73 T.C.M. (CCH) 2669 (1997).
308. *Id*. at 26721.
309. United States v. Davis, 370 U.S. 65 (1962).

consequences of full or partial discharge of the indebtedness are not clear.[310] The IRS, however, has ruled that principal payments on an installment note transferred from one spouse to the other incident to a divorce are excluded from income as a transfer of "property" under I.R.C. § 1041.[311]

F. Miscellaneous Issues in Property Transfers Under I.R.C. § 1041

1. Services Are Not Property

Only transfers of property (whether real or personal, tangible or intangible) are governed by I.R.C. § 1041. Transfers of services are not subject to the rules of I.R.C. § 1041.[312]

2. Transfers of IRAs, Retirement Annuities, and Retirement Bonds

Section 408(d)(6) of the I.R.C. provides that a transfer of an IRA, retirement annuity, or retirement bond by one spouse to the other under a divorce or separation instrument will have no tax consequences. After the transfer of such account, annuity, or bond, the IRS will treat it as if it is maintained for the benefit of the transferee spouse.[313]

After December 31, 1984, the IRS considers alimony received by a payee spouse as "compensation" for the purpose of permitting the payee spouse to fund an IRA.[314] In some cases, it may be prudent to treat a por-

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310. *See generally* I.R.C. § 108 (containing statutory tax rules pertaining to income realized from discharge of indebtedness).

311. *See* Priv. Ltr. Rul. 92-35-026 (May 29, 1992); Priv. Ltr. Rul. 91-23-053 (Mar. 13, 1991). These private letter rulings suggest that the maker's basis in its own note could be an amount less than face value. Under these circumstances only, I.R.C. § 1041(a) would have to take effect to exclude the gain. Commentators have criticized the underlying logic of these rulings as faulty, arguing that the application of I.R.C. § 1041 should not be necessary if the face of the note and the basis in the note are the same, as no gain or loss should result in such a case. They argue that maker of a note should have a basis in his own note equivalent to the fact of the note. *See* Asimov, *The Assault on Tax Free Divorce: Carryover Basis and Assignment of Income*, 44 TAX L. REV. 65, 84-112 (1988).

312. Temp. Treas. Reg. § 1.1041-1T(a), Q&A-4 (1984).

313. I.R.C. § 408(d)(6).

314. *Id.* § 219(f)(1).

tion of a property settlement as alimony simply to qualify the payee spouse for IRA contributions eligibility.

3. *Transfer of Annuities*

Before Congress enacted the TRA 1984, if one spouse assigned the benefits of an annuity contract to the other spouse under a divorce or separation instrument, each annuity payment received by the transferee spouse would be fully taxable.[315] The exclusion rules of I.R.C. § 72(b), permitting a tax-free return of investment, would not apply to reduce the amount of annuity payments that a transferee spouse must report as gross income. As a result of the TRA 1984, however, Congress repealed I.R.C. § 71(k). An assignment of an annuity contract is now a non-taxable event under I.R.C. § 1041. Accordingly, the transferee spouse will step into the shoes of the transferor spouse who made the contributory investment into the contract. This result permits the transferee spouse to recover (that is, to exclude) the transferor's investment under the normal I.R.C. § 72 annuity rules, as if the transferee were the purchaser of the annuity.[316]

4. *Issues Relating to the Transfer of the Family Home*

a. *Residence Sales and Transfers Before 6 May 1997*

The Taxpayer Relief Act of 1997[317] (TRA 1997) repealed I.R.C. § 1034 and amended I.R.C. § 121. The former I.R.C. § 1034 still applies to sales and non-I.R.C. § 1041 transfers of personal residences before May 7, 1997.[318]

The former I.R.C. § 1034 allowed any gain realized upon the sale of a personal residence to be rolled over into a new personal residence within two years before or after the sale of the former residence. The gain was not recognized as long as the cost of the new residence exceeded the adjusted sale price of the former residence. Typically, both spouses jointly own a marital home, and each spouse must independently qualify for I.R.C. § 1034 treatment.[319] If one spouse is transferring the home to the

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315. I.R.C. § 72(k) (1982) (repealed by the TRA 1984).
316. Temp. Treas. Reg. § 1-1041-1T(d), Q&A-10 and Q&A-11 (1984).
317. Pub. L. No. 105-34, 788 Stat. 111 (1997).
318. *Id*. art. § 312(d); I.R.C. § 121(b)(3)(B).
319. Rev. Rul. 74-250, 1974-1 C.B. 202.

other, I.R.C. § 1041 will always prevent recognition of gain to the transferor spouse. If both parties remain joint owners of the home and one spouse vacates the home, however, the spouse who leaves the home and lives elsewhere may no longer qualify for non-recognition treatment under I.R.C. § 1034.

> ***Example:*** *H* and *W* jointly own a home that they purchased for \$100,000. In 1986, *H* leaves the home and moves into an apartment. The parties execute a property agreement that permits *W* to live in the home for ten years, at which time their only child will reach the age of nineteen. The parties will then sell the home, with the proceeds to be divided equally between *H* and *W*. Ten years pass, and the home sells for \$350,000. *W* is allowed to roll over her \$125,000 gain (one-half of \$350,000 minus one-half of the \$100,000 basis) into her new home, which she purchased for \$200,000 (or if *W* was fifty-five or older, she could exclude the entire gain by using the one-time exclusion under I.R.C. § 121). *H*, however, must recognize \$125,000 of gain, because the former residence no longer qualifies as his principal residence under I.R.C. § 1034 or I.R.C. § 121.

This result varies greatly with changes to the facts; counsel should similarly be alert to important facts that can change their clients' tax consequences. The spouse who remains in the house will enjoy the advantages of a subsequent rollover or exclusion of any gain upon the subsequent sale of the home. In addition, the homeowner will continue to have deductions for interest expenses and real estate taxes. Counsel for the transferor spouse should be aware of the potential loss of these tax advantages in the negotiating process.

The courts and the IRS have held that in certain situations, a taxpayer may temporarily leave his or her residence and subsequently sell the home without reoccupying it, and still claim a tax-free rollover of the gain. The key factor in this favorable result is establishing the taxpayer's intent to return to the home.[320] In *Trisko v. Commissioner*,[321] the taxpayer, a federal employee, accepted an overseas temporary assignment in Europe. He rented out his home, intending to return to it upon completion of his temporary assignment. When he returned several years later, however, he was unable to reoccupy the home because of the federal rent control regula-

320. *See* Trisko v. Comm'r, 29 T.C. 515 (1957), *acq.*, 1959-1 C.B. 5.
321. *Id.*

tions. Trisko sold the home and purchased a new one.[322] The Tax Court permitted the taxpayer to treat the former home as his primary residence and deferred recognition of any gain on the sale under Section 112 of the 1939 Code, the predecessor to I.R.C. § 1034.[323]

In *Barry v. Commissioner*,[324] an Army officer rented out his home when he was transferred to Germany, where he lived in government quarters. Barry intended to reoccupy the home and retire in the area. Upon returning, however, he retired from the Army, accepted a job in another state, and sold the home. The court permitted the taxpayer to treat the home as his primary residence and use the tax-free rollover provisions of I.R.C. § 1034.[325] While these cases and rulings involved the taxpayer's absence from his primary residence due to employment conditions, the courts have also permitted temporary absences due to market exigencies to qualify, and allowed I.R.C. § 1034 rollover treatment.[326]

The Tax Court applied a liberal interpretation of I.R.C. § 1034 in *Green v. Commissioner*.[327] In *Green*, the taxpayer purchased a home with her boyfriend in Los Angeles, California in 1975. The taxpayer's relationship with her boyfriend had become strained by the end of December 1979. Ms. Green obtained a job transfer to Baltimore. After two months in Baltimore, Ms. Green tried to obtain a transfer back to Los Angeles, but her employer refused. From 1980 to mid-1982, Ms. Green returned to the Los Angeles home periodically for periods ranging from two weeks to two months. She continued to vote and pay taxes in California. She also paid all mortgage, tax, and insurance payments on the home; her former boyfriend refused to do so. In June 1982, Ms. Green removed all of her belongings from the Los Angeles home. In August 1982, the ex-boyfriend married another woman and moved back into the Los Angeles residence. The next month, Ms. Green listed the property for sale with a real estate

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322. *Id*. at 517.

323. *Id*. at 519-520.

324. 30 T.C.M. (CCH) 757 (1971).

325. *See also* Rev. Rul. 78-146, 1978-1 C.B. 260.

326. *See* Bolaris v. Comm'r, 776 F.2d 1428 (9th Cir. 1985) (holding that the taxpayer was permitted to take full depreciation and rental expense deductions during the rental period until he subsequently sold the home); Clapham v. Comm'r, 63 T.C. 505 (1975), *acq.*, 1979-2 C.B. 1 (permitting a temporary absence where the owner rented the home after listing it for sale). *But see* Rogers v. Comm'r, 45 T.C.M. (CCH) 318 (1982).

327. 64 T.C.M. (CCH) 369 (1992).

agent. Although she found a qualified buyer, her ex-boyfriend refused to sell his interest in the house.[328]

Ultimately, the California Superior Court ordered the boyfriend to make the mortgage payments. Ms. Green treated these payments as rental to claim a net loss on the property from 1983 through 1986. The Superior Court ordered a partition of the property in July 1986, and the ex-boyfriend paid $262,500 to Ms. Green for her interest in the house. In April 1987, Ms. Green purchased a house in Baltimore for $135,000.[329] The Tax Court allowed Ms. Green to treat the Los Angeles house as her principal residence and to enjoy the rollover benefits of I.R.C. § 1034.[330]

The Tax Court placed particular emphasis on the facts that Ms. Green left her belongings in the house until mid-1982, that she immediately sought a transfer from Baltimore back to Los Angeles, and that she made frequent extended visits to the house. The court found that Ms. Green's absence from the house until June 1982 was temporary. Thus, she did not abandon the house as her primary residence. Ms. Green's treatment of the house as a rental property from 1983 to 1986 was not an abandonment of the residence. Her actions were consistent with an intent to reoccupy the house, pending the resolution of the action for partition. The court ordered the boyfriend to make the mortgage, tax, and insurance payments during the partition action.[331]

In *Snowa v. Commissioner*,[332] the U.S. Court of Appeals for the Fourth Circuit held that for purposes of former I.R.C. § 1034 principal residence rollover rules, a taxpayer may treat a spouse's payment for a replacement home as the taxpayer's own cost, even though the taxpayer sold the old home with a different spouse. The decision invalidates a treasury regulation that maintains a contrary view.

Mr. and Mrs. Spivey sold their jointly owned home for $380,000 in 1989; they were divorced at about the same time. Mrs. Spivey filed her 1989 income tax return as a single individual and reported one-half of the selling price ($190,000), the amount realized ($178,000) and the gain ($69,000) from the sale of the residence. Mrs. Spivey reported on IRS

328. *Id*. at 370.
329. *Id*.
330. *Id*. at 373.
331. *Id.* at 373 (citing Clapham v. Comm'r, 63 T.C. 505 (1975), *acq*., 1979-2 C.B.1).
332. 123 F.3d 190 (4th Cir. 1997) (reversing T.C. Memo 1995-336).

Form 2119 that she intended to replace the residence, and therefore did not recognize the gain in 1989.[333]

In 1991, Mrs. Spivey and her new husband purchased a home at a total cost of $180,000. On their 1991 income tax return, the former Mrs. Spivey (now Mrs. Snowa) and her new husband reported the new residence as a replacement property for the home Mrs. Snowa had sold in 1989. In an audit, the IRS determined that Mrs. Snowa's share of the cost of the new property purchased in 1991 was $90,000 (one-half of the total cost of $180,000), which was less than her share ($178,000) of the adjusted sales price of the former home. The IRS concluded, therefore, that Mrs. Snowa must recognize the gain on the sale of the prior residence 1989.[334]

The Tax Court held that Mrs. Snowa was not entitled to the benefit of I.R.C. § 1034 and must recognize the entire gain from the sale of her former residence in 1989. The Court noted that I.R.C. § 1034(g) provides a limited inter-spousal exception to the general requirement that the same taxpayer must own the new and old homes, and that the exception applies only if each of the taxpayers uses the old and new residences as his or her principal residence. The court quoted I.R.C. § 1034(g), noting that this statute consistently uses the phrase "taxpayer and his spouse," and that the exception applies only to the taxpayer and the *same* spouse who owned the old residence and who jointly consented to the requirements of I.R.C. § 1034(g).[335] The Tax Court also cited *Treasury Regulations § 1.1034-1(f)(1)*,[336] the instructions for *IRS Form 2119*[337] and *IRS Publication 523, Tax Information on Selling Your Home*,[338] to support its conclusion.[339]

Reversing the Tax Court, the U.S. Court of Appeals for the Fourth Circuit (Fourth Circuit) held that a taxpayer need not be married to the same spouse to take advantage of I.R.C. § 1034(g). It held that the statutory language was ambiguous, and that *Treasury Regulations § 1034-1(f)(1)* was an interpretative (rather than legislative) regulation that did not reasonably implement Congress's mandate to treat family finances as being run from a single pocketbook (according to the elective spousal consent procedure). True, the law directs the IRS to write regulations explain-

333. 70 T.C.M. (CCH) 163, 165 (1995).
334. *Id*.
335. *Id*. at 165-166.
336. *Id*. at 166
337. *Id*.
338. *Id*.
339. *Id*.

ing the elective spouse consent, but the manner of the consent was the gap in the I.R.C. provision that Congress impliedly wanted the IRS to fill. Congress did not leave a gap in the I.R.C. as to who qualifies as a spouse, and did not specifically direct the IRS to explain this requirement.[340] The Fourth Circuit cited the legislative history of I.R.C. § 1034[341] to support its conclusion that the IRS was to write permissive—not restrictive—regulations implementing spousal rollovers. The court held that same-spouse rule in *Treasury Regulations § 1034-1(f)(1)* did not implement the congressional mandate in a reasonable manner and was therefore invalid.[342]

b. Post-6 May 1997 Sales—Exclusion of Gain from Sale of Principal Residence

Article 312 of TRA 1997 amended I.R.C. § 121 to permit taxpayers to exclude $250,000 ($500,000 in the case of a joint return) of gain from the sale or exchange of their principal residence from income if they owned and used the residence as their principal residence for periods aggregating two years or more during the five-year period ending on the date of the home's sale or exchange. In order to obtain the $500,000 exclusion in the case of a joint return, taxpayers must meet the following conditions: (1) either spouse may meet the ownership requirements; (2) both spouses must meet the use requirements; and (3) neither spouse must be ineligible because of the sale or exchange of another principal residence within the two-year period ending on the date of the sale or exchange.[343] The IRS has stated it will not issue any advance rulings on whether a particular property qualifies as the taxpayer's principal residence.[344]

The exclusion is only available for a sale or exchange by the taxpayer if, during the two-year period ending on the date of the sale or exchange, the taxpayer had not claimed the exclusion of gain from the sale of principal residence for any other sale or exchange. If the reason for the sale or exchange is a change in place of employment, health, or, to the extent provided in regulations, unforeseen circumstances, however, the amount of

340. 123 F.3d 190, 195-197 (4th Cir. 1997).
341. *Id*. at 198-199.
342. *Id*. at 200.
343. I.R.C. § 121(b)(2).
344. Rev. Proc. 99-3, 1999-1 I.R.B. 103.

the exclusion will be the same ratio of the exclusion as the period of ownership and use after the sale or exchange bears to two years.[345]

In the case of a joint return, either spouse may meet the ownership and use requirements, but the exclusion will be limited to $250,000 if both spouses do not meet the use requirements. In the case of an unmarried individual whose spouse is deceased on the date of the sale or exchange of the property, the period such unmarried individual owned and used the property will include the period the deceased spouse owned and used the property before death.[346]

A period of ownership will include ownership by a spouse before a transfer, subject to I.R.C. § 1041(a), the provision for non-taxable inter-spousal sales or exchanges. During the period that a taxpayer's spouse or former spouse is granted use of the property under a divorce or separation instrument as defined in I.R.C. § 71(b)(2), the IRS will treat the taxpayer as using the property as his principal residence.[347] The exclusion will also apply to a taxpayer holding stock as a tenant-stockholder in a cooperative housing corporation, as defined in I.R.C. § 216.[348] The holding and use period of property acquired in an involuntary exchange under I.R.C. § 1033 will include the property that was sold or exchanged.[349]

The exclusion of income from the sale of the home will not apply to the portion of the property for which the taxpayer claimed depreciation (e.g., home office rules) with respect to periods after 6 May 1997.[350]

If a taxpayer becomes physically or mentally incapable of self-care, and the taxpayer owns and uses property as his principal residence during the five-year period ending on the date of the sale or exchange of the principal residence for periods aggregating at least one year, the IRS will treat the taxpayer as using the property as his principal residence at any time

345. I.R.C. § 121(c)(1) and (2).
346. *Id.* § 121(d).
347. *Id.* § 121 (d)(3).
348. *Id.* § 121 (d)(4).
349. *Id.* § 121(d)(5).
350. *Id.* § 121(d)(6).

during the five-year period in which he owns the property and resides in any licensed medical facility or nursing home.[351]

The exclusion also applies to the sale of a remainder interest in a principal residence to a person other than a related party, as defined under I.R.C. § 267(b) or 707(b).[352] The exclusion is not available to expatriates if I.R.C. § 877(a)(1) applies.[353] The section will also not apply to a sale or exchange with respect to which the taxpayer elects not to have the exclusion apply.[354]

The holding and use period for the taxpayer's principal residence includes the holding period for prior residences for which non-recognition treatment was applicable under I.R.C. § 1034.[355]

The changes to I.R.C. § 121 apply to sales and exchanges after 6 May 1997. One exception to this general rule is that a sale or exchange during the two-year period ending on 6 May 1999 will not be subject to the requirement that a previous sale or exchange not have taken place within two years of a subsequent sale or exchange.

c. Deductibility of Qualified Residence Interest

Another issue regarding the marital home involves the deductibility of qualified residence interest. The general rule is that acquisition indebtedness interest expenses for a personal residence (or a designated second residence) are fully deductible. The total amount of acquisition debt for which interest is deductible is limited to $1,000,000 for married taxpayers filing jointly ($500,000 for married persons filing separately). Total home equity (non-acquisition) debt is subject to a $100,000 limitation ($50,000 for married persons filing separate returns). In either case, the applicable loan must be secured by the personal residence (or designated second residence).[356] The debt (including all other debt secured by the home) must not exceed the lesser of the cost of the house[357] or its fair market value.[358]

351. *Id.* § 121(d)(7).
352. *Id.* § 121(d)(8).
353. *Id.* § 121 (e).
354. *Id.* § 121 (f).
355. *Id.* § 121(g).
356. *Id.* § 163(h)(3); *see also* Armacast v. Comm'r, T.C. Memo 1998-150 (1998).
357. *See* I.R.C. § 163(h)(5)(B)(ii)(I).
358. *See id.* § 163(h)(3).

Section 163(h)(3) also includes debt that is incurred in acquiring, constructing, or substantially improving the taxpayer's qualifying residence within the definition of "acquisition indebtedness." The debt must be secured by the personal residence (commonly referred to as qualified debt). For purposes of I.R.C. § 163, and without regard to the treatment of the transaction under I.R.C. § 1041, the IRS has concluded that debt incurred to acquire a spouse's (or former spouse's) interest in a residence incident to a divorce or legal separation is eligible for treatment as debt incurred in acquiring a residence.[359]

5. Stock Redemptions Incident to Divorce

Frequently, a spouse who is a controlling shareholder and intimately involved in the day-to-day operations of a closely held or family owned business wishes to retain control of the corporation after a divorce. The usual method to obtain this result is for the controlling shareholder spouse to transfer his or her property interests in other marital assets (for example, family residence, liquid investment assets, etc.) or items of "separately owned property" in exchange for the other spouse's entire property interest rights (direct stock ownership or other indirect equitable ownership rights) in the stock. Under I.R.C. § 1041, the spouse does not realize a taxable gain from the various property transfers. If the spouse wishing to remain in control of the corporation lacks sufficient assets to buy out the other spouse's corporate interest, he often will use a promissory note to make payments over a period of years.[360]

An alternative approach is to have the controlling shareholder spouse transfer a portion of his stock to the other spouse, followed by an immediate stock redemption of the latter spouse's entire stock interest in the corporation.

Unfortunately, recent IRS and court opinions have made it virtually impossible to predict the tax consequences of these redemptions. The focus of the uncertainty is the identity of the party whose interest is redeemed, and on whether the redemption of shares owned by one spouse satisfies an obligation of the other spouse. The IRS and the Tax Court appear to treat the redemption as a redemption by the spouse whose stock is actually redeemed.[361] The U.S. Court of Appeals for the Ninth Circuit

359. I.R.S. Notice 88-74, 1988-27 I.R.B. 27.

360. *See supra* § V.E. (use of promissory note).

apparently treats it as a transfer of the stock to the corporation on behalf of the spouse whose interest in the corporation continues and a payment by the corporation on behalf of that spouse.[362]

The IRS promulgated new regulations to address the difficulty in ascertaining whether stock transfers are "on behalf of" one spouse. On January 13, 2003, the IRS issued *Treasury Regulations* § 1.1041-2, clarifying the tax treatment of stock redemptions between spouses and former spouses incident to a divorce.[363]

Resolution of this issue will determine not only the identity of the taxpayer but also the amount and character of the income arising from the redemption. If the spouse whose interest in the corporation is terminated qualifies as the redeeming shareholder, he will generally be able to treat the redemption as a sale or exchange under I.R.C. § 302(a).[364] In contrast, if the spouse who will continue to own stock in the corporation qualifies as the redeeming shareholder, the IRS will treat her as though she received a distribution of property under I.R.C. § 301. To the extent the corporation has earnings and profits, the distribution is a dividend, and any excess will be considered a return of capital or a gain from the sale or exchange of property.[365]

Treatment as a sale or exchange entitles the taxpayer to offset his basis in a stock against the amount received. If the taxpayer has held the stock for at least eighteen months, sale or exchange treatment characterizes the income as long-term capital gain rather than ordinary income. If the taxpayer held the stock for more than one year but less than eighteen months, sale or exchange treatment characterizes the income as mid-term capital gain rather than ordinary income. The distinctions among long-term cap-

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361. *See, e.g.*, Arnes v. United States, 981 F.2d 456 (9th Cir. 1992); Tech. Adv. Mem. 90-46-004 (July 20, 1990).

362. *Id.*

363. Treas. Doc. 9035, 67 Fed. Reg. 1534 (Jan. 13, 2003).

364. A redemption is treated as a sale or exchange if the redeeming shareholder has completely terminated his or her interest in the corporation or in the case of certain disproportionate redemptions. I.R.C. § 302(b). If, however, the redemption occurs before the divorce or if other family members, such as children, continue to own shares in the corporation, the family attribution rules of I.R.C. section 318 may preclude satisfaction of this requirement. In some cases, section 318 attribution can be avoided by complying with Code section 302(c), which generally requires the termination of all interests in the corporation (including interests as an employee, director, or officer but excluding interests as a creditor) for ten years.

365. I.R.C. § 301(c).

ital gain treatment, mid-term capital gain treatment, and ordinary income or short-term capital gain treatment are significant. Ordinary income is now subject to tax rates as high as 39.1%; the top rate for mid-term capital gains is 28%; and the top rate for long-term capital gains is 15%.[366]

a. Redemption If Only One Spouse Owns Shares

If only one spouse owns shares in the closely held corporation, the spouse may need corporate-held funds to compensate the other spouse for her marital property interest in the shares or in other property. If the owner redeems a portion of his shares to obtain the necessary funds, the redemption is a distribution with the undesirable tax results described above.[367]

Suppose, instead, that the owner-spouse first transferred the shares to the other spouse and the corporation then redeemed the shares from the spouse. Outside the divorce context, the step-transaction doctrine would likely characterize this type of arrangement as a redemption from the original owner followed by the transfer of the redemption proceeds to the other spouse, but only if: (1) the transferee is legally obligated to surrender the stock for redemption;[368] or (2) there is an understanding that the recipient of the stock will have their stock redeemed by the corporation, and the original owner received something of value back from the transferee.[369]

The IRS seems to have carved out an exception to the step-transaction doctrine for redemption of shares that one spouse transfers to the other pursuant to a marital settlement agreement. In *Technical Advice Memorandum 90-46-004*,[370] the IRS took the position that a redemption was a redemption by the spouse whose shares were actually redeemed, despite the fact that she had received the shares pursuant to a divorce decree, which required her to offer the shares for redemption, by the corporation. The IRS recognized that the spouse's obligation to offer her shares for redemption would ordinarily require treating the original owner as the redeeming shareholder.[371] In this particular case, the husband was the

366. *Id.* § 1(h).

367. *See* I.R.C. §§ 301, 302.

368. *See*, *e.g.*, Rev. Rul. 69-608, 1969-2 C.B. 42. In this case, the corporation's earnings and profits will be reduced by the amount of the distribution. I.R.C. § 312(a).

369. *Cf.* Blake v. Comm'r, 697 F.2d 473 (2d Cir. 1982); Tech. Adv. Mem. 85-20-09 (Sept. 25, 1985).

370. Tech. Adv. Mem. 90-46-004 (July 20, 1990).

371. *Id.*

president and ninety-percent stockholder of a corporation. Members of the husband's family (other than his wife) owned the remaining ten percent of corporate stock. Pursuant to the parties' divorce decree, the husband transferred thirty-nine percent of the corporation's outstanding stock (from his ninety-percent ownership interest) to his ex-wife. Immediately thereafter, the corporation completely redeemed the ex-wife's shares of stock in the corporation. The divorce decree required the redemption, and the corporation funded it with a promissory note payable to the ex-wife. The husband guaranteed and collateralized the note. The IRS respected the structure of the transaction and ruled that the transfer of stock from the ex-husband to the ex-wife was incident to the divorce under I.R.C. § 1041. The ex-wife then transferred stock to the corporation, resulting in a taxable sale to the ex-wife. In reaching this result, the IRS relied on *Temporary Treasury Regulation § 1.1041-1T(c), Q&A-9*, which applies I.R.C. § 1041 to transfers of property to third parties (for example, corporations) on behalf of spouses (for example, the ex-wife). In such cases, the IRS considers the transfer of property as though made directly to the non-transferring spouse, and treats the non-transferring spouse as though she had immediately transferred the property to the third party. The same provision allows the parties to transfer the tax consequences of the transfer to the third party (the corporation) to the non-transferring spouse (the ex-wife), even though the non-transferring spouse was never an actual owner of the property (the stock). By agreeing to immediately redeem the stock, the ex-wife exercised sufficient "ownership" rights to be responsible for the tax consequences of the transfer to the corporation. The IRS indicated that, but for I.R.C. § 1041 and its regulations providing for no gain or loss on transfers between spouses, it would have characterized the transaction as a taxable redemption by the ex-husband, followed by a transfer of the redemption proceeds to the ex-wife under the divorce decree.[372]

The IRS justified its conclusion in *Technical Advice Memorandum 90-46-004* with a surprisingly broad reading of I.R.C. § 1041, stating the following:

> [Section 1041 provides] taxpayers a mechanism for determining which of the two spouses will pay the tax on the ultimate disposition of the asset. The spouses are thus free to negotiate between themselves whether the "owner" spouse will first sell the asset, recognize the gain or loss and then transfer to the transferee spouse the proceeds from that sale, or whether the owner

372. *Id.*

> spouse will first transfer the asset to the transferee spouse who will then recognize gain or loss upon its subsequent sale.[373]

In *Private Letter Ruling 94-27-009*,[374] the IRS stepped back from this broad reading of the statute. The marital settlement agreement described in the letter ruling required the spouse who owned the shares of a closely held corporation to transfer a portion of the shares to the other spouse. It also stated that the transferee spouse intended to negotiate the redemption of the newly acquired shares, but that there was no obligation to do so. In fact, immediately after the transferee spouse received the shares, the corporation redeemed them. The letter ruling concluded that the gain was attributable to the transferee spouse, but relied on the absence of any obligation on the part of the transferee spouse to offer her shares for redemption.[375]

b. Redemption If Both Spouses Own Shares

If both spouses own shares in the closely held corporation and agree to redeem the shares belonging to one of them, the step-transaction doctrine issue discussed above will not be a problem. Ordinarily, the redemption qualifies as a redemption of the shares of the spouse who is surrendering his or her shares. If, however, the redemption satisfies an obligation of the non-redeeming shareholder, that shareholder may have to report the redemption as a constructive dividend.[376]

Under long-established corporate income tax principles, when two shareholders own all of the shares of a corporation and the corporation redeems shares owned by one of them, the remaining shareholder is not

373. *Id.*

374. Priv. Letr. Rul. 94-27-009 (Apr. 6, 1994).

375. *Id*.

376. *See, e.g.*, Rev. Rul. 69-608, 1969-2 C.B. 42; *see also* Marvin A. Chirelstein, Optional Redemptions and Optional Dividends: Taxing the Repurchase of Common Shares, 78 YALE L.J. 739 (1969).

taxed on the transaction, despite the fact that he indirectly benefits from an increase in his proportional interest in the corporation.[377]

There is one principal exception to this general rule: if the redemption satisfies a primary, unconditional obligation of the non-redeeming spouse to purchase the redeemed shares, the IRS could treat the redemption as a constructive dividend to the non-redeeming spouse.[378]

(i) Marital Settlement Agreements that Obligate One Spouse to Purchase the Shares of the Other Spouse

Some marital settlement agreements obligate one spouse to purchase the shares of the other spouse. This kind of agreement was the focus of the Tax Court in *Hayes v. Commissioner*.[379] In *Hayes*, the spouses, Jimmy and Mary Hayes, each owned shares in a corporation that operated a McDonald's franchise. McDonald's required that the wife, who owned a minority interest in the corporation, dispose of her stock in order for the husband to retain the franchise. The spouses executed a separation agreement that required Jimmy to purchase Mary's interest in the corporation. Several months later, Mary and the corporation executed a redemption agreement. The corporation ultimately redeemed her shares.[380]

The Tax Court agreed with the IRS's position that the corporation's redemption of Mary's shares was a constructive dividend for the husband because it satisfied his primary and unconditional obligation to purchase his wife's shares.[381]

Although both spouses were before the Tax Court, *Hayes* does not resolve the issue of how the redeeming spouse is to be treated when the non-redeeming spouse receives a constructive dividend. Ordinarily, the treatment of one shareholder as having received a constructive dividend—

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377. *See, e.g.*, Edler v. Comm'r, 727 F.2d 857 (9th Cir. 1984) (affirming T.C. Memo. 1982-67); Holsey v. Comm'r, 258 F.2d 865 (3d Cir. 1958); Wall v. United States, 164 F.2d 462 (4th Cir. 1947); Rev. Rul 69-608, 1969-2 C.B. 42; *see generally* Michael B. Lang, *Dividends Essentially Equivalent to Redemptions: The Taxation of Bootstrap Acquisitions*, 41 TAX L. REV. 309 (1986); Marvin A. Chirelstein, *Optional Redemptions and Optional Dividends: Taxing the Repurchase of Common Shares*, 78 YALE L.J. 739 (1969).

378. *See, e.g.*, Sullivan v. United States, 363 F. 2d 724 (8th Cir. 1966); Rev. Rul 69-608, 1969-2 C.B. 42.

379. Hayes v. Comm'r, 101 T.C. 593 (1993).

380. *Id*. at 596-597.

381. *Id*. at 599.

because his other corporation satisfies his obligation to buy the shares of another shareholder—does not affect the tax consequences of the transaction to the other shareholder.[382]

The Tax Court was able to avoid deciding the issue because the IRS had conceded that if the court held one of the spouses liable for income tax on the transaction, the other spouse would not be liable. In dicta, however, the court stated that if the IRS treated the ex-husband as having received a constructive dividend, the ex-wife "would be shielded by [I.R.C. § 1041] from recognizing gain on the redemption."[383]

The opinion points to *Temporary Treasury Regulations § 1.1041-1T(c), Q&A-9* to support this conclusion. The temporary regulation provides that the transfer of property by one spouse to a third party on behalf of the other spouse is considered made to the non-transferring spouse instead of the third party. Section 1041 protects such a transfer from recognition. The non-transferring spouse is then treated as having transferred the property to the third party in a transaction that does not qualify for non-recognition treatment.[384]

In keeping with the temporary regulation, the Tax Court in *Hayes* treated the redeeming spouse (Mrs. Hayes) as having transferred the shares to the third party (the corporation) on behalf of the non-redeeming spouse (Mr. Hayes). In the Tax Court's view, I.R.C. § 1041 protected Mrs. Hayes's recharacterized transfer, but not Mr. Hayes's transfer.[385]

(ii) Marital Settlement Agreements that Obligate the Spouses to Cause the Corporation to Redeem the Shares of One of the Spouses

Some marital settlement agreements require that the spouse cause a closely held corporation in which both spouses hold shares to redeem the shares of one of the spouses. In *Arnes v. United States*, the U.S. Court of Appeals for the Ninth Circuit (Ninth Circuit) held that this type of agreement imposes an obligation on the non-redeeming spouse, and that the redeeming spouse's transfer of shares to the corporation under such a marital settlement agreement is a transfer on behalf of the non-redeeming

382. *Id*. at 597.
383. *Id*.
384. *Id*. at 598.
385. *See* discussion of this issue in Leandra Gassenheimer, *Redemptions Incident to Divorce*, 72 TAXES 651, 658 (Nov. 1994).

spouse within the meaning of *Temporary Treasury Regulations § 1.1041-1T(c), Q&A-9*, discussed above.[386]

Arnes involved a fact pattern similar to *Hayes*; John and Joanne Arnes each owned fifty percent of the shares of a corporation that operated a McDonald's franchise. As in the *Hayes* case, McDonald's would not permit continued ownership by both spouses after the divorce. John and Joann entered into an agreement that their corporation would redeem Joann's shares for a price paid partly in cash, to be paid over a number of years. John guaranteed the corporation's obligation.[387]

Unlike the husband in *Hayes*, however, John had no explicit primary, personal obligation to purchase Joann's shares. Nevertheless, the Ninth Circuit concluded that "John Arnes had an obligation to Joann Arnes that was relieved by [the corporation's] payment to Joann. That obligation was based in their divorce property settlement, which called for the redemption of Joann's stock."[388] Having determined that the corporation's purchase from Joann relieved John of an obligation, the Ninth Circuit concluded that Joann's transfer of shares to the corporation was a transfer on behalf of John that fell within the reach of *Temporary Treasury Regulations § 1.1041-1T(c), Q&A-9*. Under the temporary regulation, the court treated the transfer as a constructive transfer to Mr. Arnes. As such, I.R.C. § 1041 shielded Mrs. Arnes from recognition of gain.[389]

The linchpin of the Ninth Circuit's decision is its factual finding of the existence of John's obligation. It does not, however, explain the source of this obligation. John's guarantee of the payments to be made by the corporation is not sufficient to establish a primary, unconditional obligation. As discussed above, when a corporation is obligated to redeem the shares of one shareholder, the corporate obligation is not imputed to the remaining shareholder.[390]

In two subsequent cases, the Tax Court has refused to follow the Ninth Circuit's opinion in *Arnes*. In *Blatt v. Commissioner*,[391] the corpo-

386. Arnes v. United States, 981 F.2d 456 (9th Cir. 1992); *see also* Craven v. United States, 99-1 USTC ¶ 50,336 (N.D. Ga. Feb. 18, 1999), *aff'd*, 215 F.3d 1201 (11th Cir. 2000).

387. Arnes, 981 F.2d at 457.

388. *Id*. at 459.

389. *Id*. at 460.

390. *Id*. at 459-460.

391. Blatt v. Comm'r, 102 T.C. 77 (1994).

ration redeemed stock from an ex-wife pursuant to a court decree that ordered the husband and wife to cause their corporation to redeem the wife's shares. In *Arnes v. Commissioner*,[392] the Tax Court had before it the same set of facts that the Ninth Circuit dealt with in *Arnes*, except that both ex-spouses were before the Tax Court. Only the ex-wife was before the court in the Ninth Circuit's *Arnes* case. In its *Arnes* case, the Tax Court determined the liability of the husband. In both *Blatt* and *Arnes*, the Tax Court rejected the Ninth Circuit's conclusion. In both cases, it concluded that the husband did not have a primary obligation to acquire the wife's stock. As a result, the Tax Court treated the wife as having sold her shares to the corporation in a transaction not protected by I.R.C. § 1041.[393]

The split between the Tax Court and the Ninth Circuit causes an unfortunate level of uncertainty for divorcing parties with interests in closely held corporations. Until the issue is resolved, spouses who wish to arrange for redemption of corporate stock as part of a marital settlement should execute a separate agreement with their corporation in which it is clear that the corporation is obligated to purchase the shares. The obligation, if any, of the non-redeeming shareholder should be clearly limited to that of a guarantor of the primary corporate obligation.[394]

In *Pozzi v. United States*,[395] the U.S. District Court for the District of Oregon, following *Arnes*, held that monies paid by the husband to his former wife to relieve the husband of his obligation to convey the value of the stock in a closely held corporation to his ex-wife was incident to their divorce within the meaning of I.R.C. § 1041.[396] A full explanation of the facts is required to appreciate the court's holding.

Gertrude and Arthur Pozzi married in 1951. During their marriage, they acquired substantial marital assets, mostly in the form of stocks in

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392. Arnes v. Comm'r, 102 T.C. 522 (1994).

393. *Id*. at 530.

394. *See also* Gassenheimer, *supra* note 385; Alan L. Feld, *Divorce and Redemption*, 64 TAX NOTES 651 (1994); Geir, *Form, Substance, and Section 1041*, 60 TAX NOTES 519 (1993); Thomas Monaghan, *Corporate Redemption in the Context of Marital Dissolutions; I.R.C. Sec. 1041 and* Arnes v. United States, 68 WASH. L. REV. 923 (1993); Robert J. Preston & Richard K. Hart, *Spouse's Stock in a Divorce Can Be Redeemed Tax Free*, 78 J. TAX'N 360 (1993); William L. Raby, *If He Gets the Big Mac, Does She Pay the Tax? A Commentary on Stock Redemptions Pursuant to Divorce*, 62 TAX NOTES 347 (1994); William L. Raby, *Raby Revisits Stock Redemptions Incident to Divorce*, 62 TAX NOTES 1031 (1994).

395. Pozzi v. United States, 1993 U.S. Dist. LEXIS 14174 (D. Or. Oct. 4, 1993).

396. *Id*. at 14183-14184.

three closely held companies, the Arthur Pozzi Company, the Bend Millwork Company, and Florentco, Inc. On 23 October 1984, Arthur and Gertrude signed a property settlement agreement and a corporate stock agreement. The parties negotiated the two agreements together as a step toward the termination of their marriage. The design and purpose of the agreements was to provide for the equitable division of the property they had accumulated during their marriage, including the closely held interests of the Pozzis in the three corporations. The property settlement agreement and the corporate stock agreement required Arthur Pozzi to indemnify Gertrude Pozzi for her liability on all loans to the closely held corporations, and to cause the creditor banks to release Gertrude Pozzi from all personal guarantees relating to these loans. The corporate stock agreement also required Arthur Pozzi to cause the Arthur Pozzi Company and the Bend Millwork Company to pay Gertrude Pozzi cash for her shares when the divorce became final.[397]

The property settlement agreement and the corporate stock agreement required Arthur to pay Gertrude additional sums if, within three years of the divorce, it became known that the interest of Gertrude Pozzi in the Arthur Pozzi Company and the Bend Millwork Company had a greater value than originally relied on in the divorce negotiations. As to Florentco, Inc., the property settlement agreement stated that Gertrude Pozzi was to receive all shares of stock in Florentco, Inc., all of which were registered in Arthur Pozzi's name. In a side letter agreement, Florentco, Inc. was to purchase all of Arthur Pozzi's shares in Florentco, Inc.[398]

On November 27, 1984, the Pozzis divorced. The divorce decree incorporated the property settlement agreement and the corporate stock agreement. Arthur Pozzi made cash payments to Gertrude in January 1985 to cash out the interests of Gertrude Pozzi in the Arthur Pozzi Company and the Bend Millwork Company. Mr. Pozzi also obtained the required releases from the loan guarantees for the obligation of Gertrude Pozzi. On May 5, 1986, pursuant to an oral agreement that Arthur Pozzi made with Gertrude regarding the failure of Florentco, Inc. to honor the letter agreement of April 19, 1984, Arthur Pozzi made a direct cash payment to Gertrude in the amount of $87,142.46. On that same date, Arthur Pozzi made two direct cash payments to his former wife in the amount of $1,225,932.40 in connection Gertrude Pozzi's interest in the Arthur Pozzi

397. *Id*. at 14175-14176.
398. *Id*. at 14176.

Company, and a payment of $145,542 in connection Gertrude Pozzi's interest in the Bend Millwork Company.[399]

The court treated the two payments to Mrs. Pozzi in connection with her interests in the Arthur Pozzi Company and the Bend Millwork Company as incident to the Pozzis' divorce and covered by I.R.C. § 1041. The two payments were pursuant to the divorce decree to equalize valuations of the two companies.[400]

Gertrude Pozzi reported all three payments as capital gains on her 1986 tax return and paid all income taxes due for tax year 1986. Subsequently, she filed a refund claim with the IRS and sought a refund of $286,681, plus interest. The IRS disallowed the claim. The IRS conceded that the two cash payments to Mrs. Pozzi in exchange for her interests in the Arthur Pozzi Company and Bend Millwork Company were pursuant to I.R.C. § 1041. The IRS would not, however, concede that the 1986 payment of $87,142.46 in connection with Mrs. Pozzi's interest in Florentco, Inc. fell within the scope of I.R.C. § 1041.[401]

The court held that the $87,142.46 payment by Arthur Pozzi to Gertrude Pozzi relieved Mr. Pozzi of his obligation to convey the value of the stock in Florentco, Inc. to his wife to obtain the divorce. The court concluded that Mr. Pozzi made the payment directly to Mrs. Pozzi, that it was related to the cessation of their marriage, and that it was incident to their divorce. The court had little problem deciding that the transfer fit within the plain language of I.R.C. § 1041. In deciding to grant Gertrude a refund, the court relied heavily on the Ninth Circuit's decision in *Arnes*.[402]

(iii) Martial Settlement Agreements that Provide for One of the Spouses to Select Purchase or to Cause the Corporation to Redeem the Shares of One of the Spouses

In *Read v. Commissioner*,[403] the Tax Court recently held that a former spouse's transfer of stock back to the corporate issuer in accordance with an election by the ex-husband—an election granted in a divorce judgment that gave him the option to have the stock transferred for consideration to

399. *Id*. at 14177-14178.
400. *Id*.
401. *Id*. at 14180.
402. *Id*. at 14182-14183. (citing United States v. Arnes, 981 F.2d 456 (9th Cir. 1992)).
403. Read v. Comm'r, 114 T.C. 14 (2000).

either him, the corporation or the corporation's Employee Stock Option Plan (ESOP)—qualified for non-recognition under I.R.C. § 1041.[404]

Mr. and Mrs. Read owned all of the stock in a corporation. The Reads' divorce judgment ordered that Mrs. Read sell and convey her stock in the corporation to Mr. Read or, at her husband's election, to the corporation or its ESOP. The divorce judgment ordered that the husband, or the corporation (or its ESOP) would pay a stated amount of cash to the wife simultaneously with the sale and conveyance of the stock. The party paying for the stock would be the party that actually received the stock from the ex-wife. If the eventual purchaser did not make full payment on the stock, the husband, corporation, or corporation's ESOP (whichever party actually received the stock) would give Mrs. Read a promissory note bearing nine percent interest on any unpaid balance of the purchase price of the stock. Pursuant to the divorce judgment, husband elected that: (1) the sale and conveyance be made to the corporation; (2) that the corporation make the payment of cash to the wife; and (3) that the corporation issue a promissory note to wife for the balance of the purchase price.[405]

Mrs. Read did not report any income on the cash payment, arguing I.R.C. § 1041 applied to the transaction. She reported the interest on payments under the promissory note as interest income, however. Mr. Read did not report any income from the transactions. The corporation deducted the interest payments made to the former wife. The IRS determined that the principal payments to Mrs. Read constituted a long-term capital gain, that the principal and interest payments under the installment promissory note were constructive dividends to the husband, and that the interest payments under the installment promissory note were not deductible by the corporation.[406]

Mrs. Read argued that she was entitled to non-recognition tax treatment under I.R.C. § 1041(a) and *Treasury Regulations § 1.1041-1T(c), Q&A-9* (*Q&A-9*).[407] These provisions treat certain transfers to third parties as transfers of property by the transferring spouse directly to the non-transferring spouse, and qualify them for non-recognition treatment under I.R.C. § 1041 if the non-transferring spouse immediately transfers the property to the third party in a transaction that is not subject to I.R.C. §

404. *Id.* at 27-28.
405. *Id*. at 17-19.
406. *Id*. at 24.
407. *Id*. at 27-28.

1041. Mr. Read argued that I.R.C. § 1041(a) and *Q&A-9* did not apply because he never had an unconditional obligation to purchase his wife's stock. According to his argument, he had recognized no income, but his wife had recognized gain on the redemption of her stock. The Commissioner took the position that Mr. Read was a mere stakeholder. Although he issued deficiency notices to both taxpayers in the joined cases to avoid becoming embroiled in a dispute between the ex-spouses, the Commissioner argued that wife "has the better argument."[408]

In an eight-to-seven reviewed opinion by Judge Chiechi, the Tax Court agreed with the Commissioner and Mrs. Read. The court held that in cases involving corporate redemptions in divorce settings, the primary-and-unconditional-obligation standard that generally applies in "bootstrap-acquisitions"[409] is inappropriate for determining whether the transfer of property by the transferring spouse to a third party is on behalf of the non-transferring spouse within the meaning of *Q&A-9*. Applying the common, ordinary meaning of the phrase "on behalf of" in *Q&A-9*, the wife's transfer of her stock in the parties' closely held corporation was a transfer of property by wife to a third party on behalf of husband within the meaning of the regulation.[410] Thus, under I.R.C. § 1041(a), Mrs. Read did not recognize a gain and Mr. Read recognized a dividend. The majority reasoned that *Hayes v. Commissioner*[411] did not limit the treatment of a redemption of one divorcing spouse's stock as an I.R.C. § 1041 transfer by that spouse and a dividend to the non-redeeming spouse. It distinguished *Blatt v. Commissioner*,[412] a case in which the record did not establish that the corporation acted on behalf of the husband in redeeming the wife's stock. The majority attempted to distinguish *Arnes v. Commissioner*,[413] in which the ex-husband did not have an unconditional obligation to acquire his ex-wife's stock.[414]

Dissents by Judges Ruwe, Halpern, and Beghe made various arguments that the primary-and-unconditional-obligation standard that generally applies in bootstrap acquisitions was the appropriate standard, that nothing in *Q&A-9* indicated otherwise, and that the husband did not have

408. *Id*. at 25.

409. *See* Rev. Rul. 69-608, 1969-2 C.B. 42.

410. Temp. Treas. Reg. § 1-1041-1(d) Q&A-9 (1984) (stating "where the transfer to the third party is required by a divorce or separation instrument").

411. 101 T.C. 593 (1993).

412. 102 T.C. 77 (1994).

413. 102 T.C. 522 (1994).

414. *Id*. at 529-530.

a primary and unconditional obligation to purchase wife's stock.[415] A joint dissent by Judges Laro and Marvel argued that *Q&A-9* should never should apply to redemptions like those in any of these cases.[416]

In *Craven v. United States*,[417] the U.S. Court of Appeals for the Eleventh Circuit (Eleventh Circuit) held that a stock redemption for $4.8 million in future cash incident to a 1989 divorce was governed by I.R.C. § 1041; thus, the redeeming spouse does not recognize gain, nor (because I.R.C. § 1041 applies) does she have imputed an interest during the period before receiving cash.[418] The stock redemption agreement executed by the redeeming spouse and the corporation did not specify the amount of interest to accompany each payment, but did require the corporation would send the ex-wife *Form 1099-INT*,[419] specifying the amounts of interest imputed to her under I.R.C. § 1272. The Court of Appeals for the Ninth Circuit in *Cravens* followed the *Read* tax court's decision to find that the redemption was governed by I.R.C. § 1041, pursuant to *Q&A-9*.[420]

The apparent intention of the parties in 1989 was to structure the redemption as a taxable redemption by the redeeming spouse, and to make the gain taxable to the wife. The stock redemption agreement provided that because the payments under the note were without stated interest, the corporation would send the wife copies of *IRS Form 1099-INT* stating the amounts of interest imputed to her under I.R.C. § 1272. The corporation complied with this obligation. The parties, however, appear not to have contemplated an I.R.C. § 1041 transfer because under I.R.C. § 1.1274-1(b)(iii), the original issue discount rules do not apply to transactions covered by I.R.C. § 1041.[421]

The court followed the Ninth Circuit's decision in *Arnes v. United States*,[422] to apply I.R.C. § 1041 and provide non-recognition on redemption (pursuant to the divorce decree) of the ex-wife's forty-seven percent of stock in a corporation controlled by husband. The court reasoned that the purpose of the redemption was to effect a division of marital property, and thus, I.R.C. § 1041 applied to the wife. The opinion states that the

415. *Id*. at 531-550.
416. *Id*. at 549.
417. 215 F. 3d 1201 (11th Cir. 2000).
418. *Id*. at 1207-1208.
419. *See* U.S. Dep't of Treas., Internal Revenue Serv., IRS Form 1099-INT.
420. 215 F.3d at 1206-1207.
421. Treas. Reg. § 1-1274-1(b)(3)(iii).
422. 981 F.2d 456 (9th Cir. 1992).

question of proper treatment of the husband—whether the husband had a constructive dividend by reason of the redemption—was not before the court, and in any event, was not relevant to the proper treatment of the wife's redemption. The court held that I.R.C. § 1041 applied to the original issue discount (OID) component of the promissory note that the wife received in exchange for the redeemed stock.[423]

VI. Dependency Exemption for Children of Divorced or Separated Parents

A. Pre-TRA 1984

Before enactment of the TRA 1984, I.R.C. § 152(e)[424] established the general rule and exceptions to the rule governing the allocation of the dependency exemption in situations where the parents were divorced or separated. The general rule of I.R.C. § 152(e)(1) granted the exemption to the custodial parent if the parties met the following conditions: (1) one or both of the parents must have had custody of the child for more than one-half of the calendar year; (2) one or both of the parents must have provided more than one-half of the support for the child; and (3) the parents must be divorced or legally separated under a decree of divorce or separate maintenance, or separated under a written separation agreement.[425]

There were two exceptions to the general rule that permitted the non-custodial parent to claim the child as an exemption. The first exception required the non-custodial parent to provide at least $600 for the support of the child and the decree of divorce or separate maintenance, or a written agreement was required to allocate the exemption to the parent not having custody.[426] The second exception applied to situations in which the divorce decree or agreement remained silent about which parent was entitled to the exemption. In this circumstance, the non-custodial parent was entitled to the exemption if he or she provided at least $1200 or more of

423. *Id*.

424. I.R.C. § 152(e) (1982). This section predates amendment by the Tax Reform Act of 1984, Pub. L. 98-369, § 423(a), 98 Stat. 494 (1984). Congress originally added I.R.C. § 152(e) with Pub. L. 90-78, § 1(a), 81 Stat. 191, enacted on 31 Aug. 1967, and effective with respect to taxable years beginning after 31 Dec. 1966.

425. I.R.C. § 152(e).

426. *Id.* § 152(e)(2)(A).

support for the child, and if the custodial parent did not establish that he or she provided more support for the child during the calendar year.[427]

The express purpose of I.R.C. § 152(e) was to eliminate the uncertainty to taxpayers and ease the administrative burden on the IRS in the allocation of dependency exemptions in divorce and separation cases.[428] The IRS hoped that the presumption granting the dependency exemptions to the custodial parent, unless one of the two exceptions applied, would reduce litigation. Litigation involving dependency exemption claims persisted, however, because I.R.C. § 152(e) and its implementing rules did not "guarantee" the exemption to one parent. Section 152(e)(2)(B)(ii) would always permit the non-custodial parent to claim the exemption if he or she contributed over $1200 of support during the calendar year, and if the custodial parent could not clearly establish that he or she provided more than one-half of the child's support.[429] In addition, the tax regulations vaguely defined support as including "food, shelter, clothing, medical and dental care, education, and the like."[430] Accordingly, the courts were required to interpret and define qualifying expenditures for support and make fair market value determinations for support provided in kind.[431]

B. TRA 1984

1. General Rule

In 1984, Congress substantially revised I.R.C. § 152(e) in a conscious attempt to provide certainty in the area of dependency exemptions.[432] The TRA 1984 simplified the dependency exemption issue by always allocating the exemption to the custodial parent, unless the custodial parent signed a written declaration disclaiming the child as a dependent for a given tax year.[433] The "custodial parent rule" has several threshold requirements that must be satisfied. First, the child must receive over half of his support from the custodial parent during the calendar year.[434] For this purpose, I.R.C. §152(e)(5) specifically provides that payments by a new spouse of one of the divorced parents are treated as if made by the divorced parent. Second, the child's parents must either be divorced or legally separated under a decree of divorce or separate maintenance,[435]

427. *Id.* § 152(e)(2)(B).
428. Bridgett v. Comm'r, 31 T.C.M. (CCH) 798 (1972).
429. *See, e.g.*, Bodine v. Comm'r, 47 T.C.M. (CCH) 1337 (1984).
430. Treas. Reg. § 1.152-1(a)(2)(i).
431. Tharp v. Comm'r, 36 T.C.M. (CCH) 162 (1977).

separated under a written separation agreement,[436] or living apart at all times during the last six months of the calendar year.[437] Third, the child must be in the custody of one or both of the parents for more than one-half of the calendar year.[438] If these three threshold requirements are met, the custodial parent will receive the dependency exemption regardless of whether the non-custodial parent provided over one-half of the child's support for the calendar year. When determining which parent has custody for purposes of the dependency exemption, the most recent divorce or custody decree or (if none) a written separation agreement will govern. In the event either such a decree or agreement is ambiguous, or no such decree or agreement exists, or the decree or agreement awarded joint custody, then custody will be determined based on the length of time a parent has physical custody of the child. The parent who has the smallest portion of phys-

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432. The legislative history of the TRA 1984, Pub. L. No. 98-369, 98 Stat. 494 (1984), sets forth the following reasons for the change:

> The present rules governing the allocations of the dependency exemption are often subjective and present difficult problems of proof and substantiation. The Internal Revenue Service becomes involved in many disputes between parents who both claim the dependency exemption based on providing support over the applicable thresholds. The cost to the parties and the Government to resolve these disputes is relatively high and the Government generally has little tax revenue at stake in the outcome. The committee wishes to provide more certainty by allowing the custodial spouse the exemption unless the spouse waives his or her right to claim the exemption. Thus, dependency disputes between parents will be resolved without the involvement of the Internal Revenue Service.

H. REP. NO. 432, pt. II (1984), *reprinted in* 1985 U.S.C.C.A.N. 697, 1140.

433. I.R.C. § 152(e)(1).

434. *Id*.

435. *Id.* § 152(e)(1)(A)(i).

436. *Id.* § 152(e)(1)(A)(ii).

437. *Id.* § 152(e)(1)(A)(iii).

438. *Id.* § 152(e)(1)(B).

ical custody of the child over the calendar year is considered the custodial parent.[439]

These dependency exemption rules apply to all tax years beginning after 31 December 1984.[440]

> ***Example:*** *H* and *W* divorced on 30 June 1983. They have two minor children. The divorce decree was silent as to who was entitled to the dependency exemptions. The two children stayed with *H* in July and August and then resided with *W* for the remainder of 1983. In 1984, the children lived with *W* all year except for June, July, and August, when the children lived with *H*. In 1983, *H* paid *W* $300 per month in child support (a total of $1800 per child for the year) and $3600 per year per child in 1984. *W* could not prove that she provided more support in either year. Under the pre-TRA 1984 rules, *H* was entitled to both exemptions for the children in 1983 and 1984. In 1985, however, *W*, as the custodial parent by virtue of having the children for nine months during the year, would receive both dependency exemptions, regardless of whether she provided little or no support for the children.

In *Knight v. Commissioner*,[441] the Ninth Circuit upheld the constitutionality of the I.R.C. § 152(e) presumption of a custodial parent's entitlement to the dependency exemption. The Ninth Circuit held that the Tax Court properly rejected Mr. Knight's arguments that I.R.C. § 152(e) creates an unconstitutional, irrebuttable presumption; that it constitutes a bill of attainder; and that it violates the right to equal protection (because ex-spouses can deduct alimony payments but non-custodial parents cannot deduct child support). In reaching this decision, the Ninth Circuit noted that an irrebuttable presumption is not *per se* unconstitutional so long as it is rational. The Court noted that I.R.C. § 152(e) is rationally related to and advances a legitimate congressional purpose.[442]

2. *Exceptions to the General Rule*

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439. Treas. Reg. § 1.152-4(b).

440. Temp. Treas. Reg. § 1.152-4T(a), Q&A-6 (1984).

441. 74 A.F.T.R. 2d 94-5177 (9th Cir. 1994) (affirming T.C. Memo 1992-710 (1992)).

442. *Id.*

Three situations exist in which a non-custodial parent may take the dependency exemption for a child. First, the custodial parent may transfer the exemption to the non-custodial parent through a written declaration.[443] Second, if a "multiple support agreement" is in effect, it will always take precedence over the support test rules of I.R.C. § 152(e).[444] Lastly, when a pre-1985 instrument, as defined by I.R.C. § 152(e)(4)(B), is in effect and has not been modified to apply current rules of I.R.C. § 152(e)(2), the former rules may apply.[445] Each of these exceptions is discussed below.

a. Transfer of Exemption Through Written Declaration

While the custodial parent is generally entitled to the dependency exemption under I.R.C. § 152(e)(1), that parent may waive the right to the exemption by executing a written declaration stating that he or she will not claim such child as a dependent for the taxable year.[446] The non-custodial parent must attach this written declaration to the non-custodial parent's tax return for the year for which the waiver is effective.[447] The provision has some flexibility built into it. The written declaration does not have to be made on the official IRS form;[448] however, if the parties do not use the IRS form, the written declaration must provide the same substantive information the form contains.[449] The waiver of the exemption by the custodial parent may be for a single year or for a number of specified years, or it can be permanent.[450] When the waiver covers more than one year, the original release must be attached to the non-custodial parent's tax return and a copy of the release must be attached to the non-custodial parent's tax returns for each subsequent year in which he or she is claiming the exemption.[451] When negotiating a separation and property agreement, the parties should specifically provide how they will allocate the dependency exemption between them with respect to each of their children. Given the breadth of the temporary regulations implementing this exception, the separation agreement itself could then serve as the written declaration. Alternatively, the separation agreement could specify the allocations and then require the

443. I.R.C. § 152(e)(2).
444. *Id.* § 152(e)(3).
445. *Id.* § 152(e)(4).
446. *Id.* § 152(e)(2)(A).
447. *Id.* § 152(e)(2)(B); *see* Paulson v. Comm'r, 72 T.C.M. (CCH) 1600 (1996).
448. *See* U.S. Dep't of Treas., Internal Revenue Serv., IRS Form 8332.
449. Temp. Treas. Reg. § 1.152-4T(a), Q&A-3 (1984).
450. *Id.* § 1.152-4T(a), Q&A-4 .
451. *Id*.

custodial parent to complete the appropriate IRS form each year. If the custodial parent is concerned that the other parent will not pay the required child on time, the declaration can be renewable annually, contingent upon the timely payment of all child support payments.[452] There is no required minimum support to be paid by the non-custodial parent in order to claim the exemption if the custodial parent waives his or her right to claim the child under this exception.[453]

In *Nieto v. Commissioner*,[454] the Tax Court held that the non-custodial parent (husband) could not claim the dependency exemption for two children who lived with his former wife. In 1984, the parties were divorced and awarded joint legal custody of their three children. The husband was awarded physical custody of all three children. In 1986, however, the husband agreed to give his wife physical custody of his two sons, and both children lived with their mother for all twelve months of tax years 1987 and 1988. On audit, the IRS held that the husband did not have physical custody of the two boys during those two tax years and therefore was not entitled to the dependency exemptions for them, citing *Treasury Regulation § 1.152-4(b)*. The court noted that as the non-custodial parent of the two boys, the only way the former husband could claim the dependency exemptions for the two sons was by obtaining a written declaration from his ex-wife that she would not claim such exemptions, and by attaching the declaration to his income tax return. Because the husband did not do this, the court ruled he was not entitled to the dependency exemptions for the two boys for 1987 and 1988.[455]

b. Multiple Support Agreement

One of the foundation requirements of I.R.C. § 152(e)(1) and (2) is that one or both of the parents must provide over one-half of the support to the child during the calendar year to qualify for the dependency exemption. There may be situations where this does not exist. For example, several of the child's grandparents may provide over fifty percent of the child's support or a non-grantor trust may fund in excess of one-half of the support furnished to the child. In these situations, neither of the parents will be able to meet the fifty-percent funding threshold.[456] However, the depen-

452. H.R. REP. NO. 4170, at 1499 (1984).

453. I.R.C. § 152(e)(2).

454. 63 T.C.M. (CCH) 3050 (1992); *see Peck v. Comm'r*, 71 T.C.M. (CCH) 1933 (1996); *McCarthy v. Comm'r*, 70 T.C.M. (CCH) 1404 (1994).

455. *Id*. at 3052.

dent deduction may still be available if a multiple support agreement is in effect. Section 152(c) provides that a taxpayer shall be treated as having contributed over half of the support for a child during the calendar year if (i) no one person contributed over half of the child's support; (ii) the group collectively provided in excess of fifty percent of the child's support; (iii) the member of the group who will claim the dependency exemption contributed more than ten percent of the child's support; and (iv) the other members of the group who also contributed more than 10 percent of the child's support file a written declaration that they will not claim the child for the tax year.[457] The Treasury Department has issued IRS Form 2120 to accomplish the written declaration of waiver requirement. The taxpayer who seeks the dependency exemption must attach the Form 2120 waivers to his or her tax return and must otherwise be eligible to claim the child independently if he or she had provided in excess of fifty percent of the child's support.[458]

c. Pre-1985 Instruments

Only one of the support tests for determining which parent may properly claim a child in divorce or separation situations under I.R.C. § 152(e) survived the TRA 1984 overhaul of the dependency exemption. Section 152(e)(4) preserves the exemption for the non-custodial parent with respect to certain divorce or separation maintenance decrees or written agreements executed before 1 January 1985. The non-custodial parent will be entitled to retain the dependency exemption if the following criteria are met: (1) the decree, judgment, or written agreement must have been executed before 1 January 1985;[459] (2) the instrument must provide that the non-custodial parent is entitled to the exemption;[460] (3) the non-custodial parent must provide at least $600 for the child's support;[461] and (4) the decree, judgment, or agreement must not have been modified on or after 1

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456. In such case, the child may be entitled to use his or her own personal exemption to offset unearned income. *See* I.R.C. § 151(d)(3)(D), 63(c)(5).

457. Treas. Reg. § 1.152-3(a) (1957) (republished in T.D. 6500, filed Nov. 25, 1960; amended by T.D. 6663, filed July 10, 1963).

458. I.R.C. § 152(c)(2).

459. *Id.* § 152(e)(4)(B)(i).

460. *Id.* § 152(e)(4)(A)(i), (B)(ii).

461. *Id.* § 152(e)(4)(A)(ii).

January 1985 to expressly preclude the application of the I.R.C. § 152(e)(4) exception.[462]

If the non-custodial parent has remarried, the IRS will treat any support the spouse of the non-custodial parent furnished to the child as deemed support provided by the non-custodial parent.[463]

3. Relevance of the General Definition of Dependent

A scenario may arise in which the children of divorced parents are no longer considered dependents under state law. Many states treat a child as emancipated under state law when the child reaches the age of eighteen or nineteen.[464] What happens when the child is considered emancipated under state law but is also a full-time student? The Tax Court recently addressed this situation in *Kaechele v. Commissioner*.[465]

The issue in *Kaechele* was which parent was entitled to claim the dependency exemptions for their two daughters. The Kaecheles divorced in 1985. Their daughters were both full-time students in college and resided on their respective college campuses. During the summers and certain holidays, the daughters resided with their mother. The husband, however, provided more than one-half of their support. The Kaecheles' divorce decree did not provide either parent with custody, because at the

462. *Id.* § 152(e)(4)(B)(iii).

463. *Id.* § 152(e)(5).

464. *E.g.*, FLA. STAT. § 743.07(1) (2003) ("the disability of nonage is removed for all persons . . . who are eighteen years of age or older, . . ."); N.C.G.S. § 48A-2 (2003) (defining a minor as any person who has not reached the age of eighteen years); VA. CODE ANN. § 20-61 (2003) (explaining that it is the age of eighteen years, unless child is crippled or otherwise incapacitated).

465. 64 T.C.M. (CCH) 459 (1992); *see also* Rownd v. Comm'r, 68 T.C.M. (CCH) 738 (1994). In *Rownd*, the father paid for all college tuition, dormitory, and health care expenses for his nineteen-year-old son, who was a full-time student at the University of Georgia. This support constituted over half of the son's total support. The court held that the father was entitled to claim his son as a dependent under I.R.C. § 152(a). The court also held that I.R.C. § 152(e) no longer applied to the Rownds, because their child had already reached the age of majority. *Id.* at 739.

time of their divorce, both daughters had reached the age of majority under Ohio law.[466]

The Tax Court held that the support test rules for divorced parents in I.R.C. § 152(e) did not apply. The children did not reside with either parent for more than six months, as required by I.R.C. § 152(e)(1)(B). The children were not in the custody of either parent, because they were emancipated under Ohio law. The Tax Court concluded that the general rule of I.R.C. § 152(a) would control. Under I.R.C. § 152(a), the parent who provides more than one-half of the support for the child is entitled to the dependency exemption. The father was awarded the dependency exemptions for both of his daughters for the two tax years at issue.[467]

C. Revisions of the TRA 1986 and Revenue Reconciliation Acts of 1990 and 1993

The TRA 1986 did not change the support test rules of I.R.C. § 152(e); however, it did increase the dollar amount of the exemption. For 2003, the amount of each exemption was $3050.[468] For subsequent years, the exemption amount is adjusted for inflation.[469]

Counsel must be aware of the phase-out rules under I.R.C. § 151(d) and the impact they may have on negotiations over dependency exemptions. Once taxable income exceeds certain specified levels, the benefit of the exemptions begins to phase out. The benefits of personal exemptions

466. 64 T.C.M. (CCH) at 459-460.
467. *Id*. at 460.
468. I.R.C. § 151(d)(1)(C).
469. *Id.* § 151(d)(4).

are phased out if a taxpayer's adjusted gross income (AGI) exceeds certain thresholds.[470]

Filing Status	Threshold Amount (AGI)
Unmarried	$139,500
Head of Household	$174,400
Married Filing Jointly	$209,250
Married Filing Separately	$104,625

When the taxpayer's adjusted gross income exceeds the applicable threshold amount, the personal dependency deduction is reduced by two percent for each $2500 (or fraction thereof) by which the adjusted gross income exceeds the threshold amount.[471] The result of the personal dependent deduction phase out rules will be to completely eliminate the tax benefit gained from taking the deduction whenever a taxpayer's adjusted gross income exceeds the applicable threshold amount by more than $122,500. These phase out rules will be adjusted for inflation (cost-of-living adjustment).[472]

> ***Example:*** *Husband(H)* and *Wife(W)* divorced in 1997. The court awarded *W* custody of their only child, *A*. *W* has waived her right to claim the child as a dependent in a written document that qualifies under I.R.C. § 152(e)(2) transferring the exemption to *H*. In 2000, *H* remarries and his new spouse has no taxable income. *H* and his new bride have an adjusted gross income of $230,800 and they will claim three exemptions (himself, his new spouse, and *A*). Assume each personal exemption adjusted for inflation is $3050. The exemption deduction before reduction is $9150 (3 x $3050). The actual deduction permitted is calculated as follows:

H and new spouse's AGI	$230,800
Less:	
Applicable threshold	($209,250)
Excess amount subject	

470. *Id.* § 151(d)(3)(C). The phase-out of personal exemptions for certain taxpayers were originally set to expire in 1997. The 1993 Act eliminated the sunset provision. The phase-out of personal exemptions is now permanent. Pub. L. 103-66, § 13205, 107 Stat. 312 (1993). The threshold amounts are adjusted for inflation. I.R.C. § 151(d)(4).

471. *Id.* § 151(d)(3)(A), (B).

472. *Id.* § 151(d)(4); *see* Rev. Proc. 2002-70, 2002-46 I.R.B. 845.

to reduction $ 21,550
Excess amount: 21,550 / 2500 = 9
Reduction percentage: 9 x 2% = 18%

Permitted personal exemption
deduction: Unreduced deduction - (Unreduced
deduction x Reduction percentage)

$9150 - ($9150 x 18%)
$9150 - $1647 = $7503

H can take a personal exemption deduction of $7503. The phase-out rules reduced the tax benefit of the personal exemption deduction by $1647.

When representing taxpayers with high levels of taxable income, attorneys should remember that the phase-out rules on exemptions may reverse the tradition of giving the higher income spouse the dependency exemption. It does not help to negotiate for the child dependency exemption for a taxpayer who has a high level of taxable income when receipt of the additional exemption does little to reduce his or her total tax liability.

VII. Collateral Income Tax Considerations Relating to Children

A. Medical Expense Deduction

Before the TRA 1984, the medical expense deduction was only available to the parent who was entitled to claim the dependency exemption for the child who received the benefits of the medical expenditures. Section 213(a) provided a deduction for medical care and treatment expenses incurred by the taxpayer, the taxpayer's spouse, and any dependent as defined under I.R.C. § 152, to the extent such expenses were above a "percentage floor" (currently 7.5%).[473] The interrelation of I.R.C. § 213(a) and I.R.C. § 152 necessarily precluded the non-custodial parent from deducting any qualified medical expenses he or she incurred on behalf of the child. This could lead to a very inequitable result in which a non-custodial parent with a high taxable income could spend a large amount of money to treat the child for a medical problem and receive no tax benefit. The TRA 1984 rectified this problem by enacting a new I.R.C. § 213(d)(5), which

473. I.R.C. § 213(a).

permits both parents to treat a child as a dependent for purposes of the medical expense deduction.[474]

A prerequisite to taking the medical expense deduction for expenses incurred on behalf of a child is that one of the two parents must be able to claim the child as a dependent under the custodial parent rule or one of the exceptions listed in I.R.C. § 152(e). This requirement ensures that one or both of the parents provide over one-half of the child's support.[475] If the parent is entitled to the dependency exemption by virtue of a multiple support agreement, then only the parent taking the dependency exemption can claim the medical expense deduction for medical care and treatment for the child during that year.[476]

B. Child Care Credit Availability

A tax credit is available for a portion of the qualifying child or dependent care expenses a parent incurs, if the parent is eligible to claim the dependency exemption for that child.[477] The child must be under the age of thirteen, unless the child is physically or mentally incapable of caring for himself.[478] The ceiling dollar amount on employment-related expenses[479] to which the child care credit applies is $3000 for one child or dependent and $6000 for two or more children or dependents.[480] The credit itself is equal to thirty-five percent of the qualified employment-related expenses for taxpayers who have an adjusted gross income of $15,000 or less. The credit is reduced by one percent for each $2000 of adjusted gross income (or fraction thereof) over $15,000, until the credit percentage rate is reduced to a minimum of twenty percent when a taxpayer's adjusted gross income is more than $43,000).[481]

The key to the child care credit for divorced or separated parents is that only the custodial parent is eligible to take the child care credit.[482]

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474. Pub. L. No. 98-369, § 423(b), 98 Stat. 494 (1984); *see also* Temp. Treas. Reg. § 1.152-4T(a), Q&A-5 (1984).

475. I.R.C. § 152(e).

476. *See id.* § 152(c) (governing the conditions for claiming the dependency exemption when no single person provides over one-half of the child's support).

477. *See id.* § 21(a), (e)(5).

478. *Id.*

479. *See id.* § 21(b) (listing the statutory requirements for a valid employment-related expense for purposes of qualifying for the child care credit).

480. *Id.* § 21(c)(1), (c)(2).

Therefore, the custodial parent must ensure that he meets the custodial parent requirements of I.R.C. § 152(e)(1) to be able to take the credit. In situations in which the non-custodial parent provides more support for the child, the custodial parent is the one who may attempt to qualify for the credit.[483] Only the custodial parent may claim the child care credit, even when the custodial parent has executed a valid written document under I.R.C. § 152(e)(2) transferring the dependency exemption to the non-custodial parent, or when there was a pre-1985 instrument as defined by I.R.C. § 152(e)(4), granting the dependency exemption to the non-custodial parent.[484]

Another problem in determining eligibility for the child care credit occurs when the parents are separated but not divorced. When the parents are still married (albeit separated under a written separation agreement) at the close of the tax year, the credit is allowed only if the parents agree to file a joint tax return for the year.[485] If they file separately, neither parent is eligible to claim the credit. If one parent has abandoned the other spouse for at least the last six months of the tax year, however, then the parent who maintains a household that is the child's principal home for more than one-half of the tax year and furnishes more than one-half of the cost of maintaining the household during the same period will be considered not married for purposes of the child care credit and can file separately.[486]

C. Child Tax Credit

The Taxpayer Relief Act of 1997 (TRA 1997)[487] added I.R.C. § 24 and amended I.R.C. sections 31,501(c) and 6213(g), creating a $1000

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481. *Id.* § 21(a)(2). Note that I.R.C. § 21 was formerly I.R.C. § 44A until the TRA 1984 redesignated it. Section 1.44A still lists the Treasury Regulations, which refer to the old child care credit, which had a number of differences with respect to child age limits and the rules that governed who was entitled to claim it when the parents were divorced or separated. However, for definitions of what constitutes a qualified employment-related expense, physical or mental incapacity, types of care, and other related items, these regulations should still be useful. Pub. L. No. 98-369, art. § 474(m)(1), 98 Stat. 494 (1984).

482. I.R.C. § 21(e)(5).

483. *Id.*

484. *Id.* § 21(e)(5); *see also* Treas. Reg. § 1.44A-1(b)(2) (1984).

485. I.R.C. § 21(e)(2).

486. I.R.C. § 21(e)(4).

487. Pub. Law No. 105-34, § 101, 788 Stat. 111. The maximum credit per child will be $700 for the years 2005-2008, $800 for 2009, $1000 for 2010, and $500 after year 2010. I.R.C. §24(a)(2).

income tax credit for each of the taxpayer's qualifying children. The amount of credit decreases by $50 for each $1000 (or fraction thereof) of modified adjusted gross income in excess of a threshold amount, as follows: (1) $110,000 for joint return filers; (2) $75,000 for single return filers; and (3) $55,000 for a married individual filing a separate return. These amounts are not indexed for inflation.[488]

Modified adjusted gross income is adjusted gross income increased by amounts excluded under I.R.C. sections 911, 931 or 933, including foreign source income, housing costs of individuals living abroad, and income from sources within Guam, American Samoa, the Mariana Islands, or Puerto Rico.[489]A qualifying child is the taxpayer's child, stepchild, or foster child who is under age 17, a dependent of the taxpayer for whom the taxpayer is allowed a personal exemption deduction, and not a non-resident alien.[490] The taxpayer must include the name and taxpayer identification number for each qualifying child on the return.[491]

If the taxpayer's income tax liability is less than the taxpayer's allowable credit, the Act allows for a refundable credit, referred to as a supplemental credit, which is limited by the amount that the sum of the taxpayer's share of Federal Insurance Contributions Act (FICA) and one-half of the taxpayer's Self-Employment Contributions Act of 1954 (SECA) exceeds the taxpayer's refundable earned income credit.[492] In addition, a taxpayer with more than two children may be entitled to a refundable tax credit in excess of the supplemental credit.[493]

D. Earned Income Tax Credit

The earned income tax credit is designed to help low-income taxpayers who have earned income, meet modified adjusted gross income thresholds, and do not have more than a certain amount of disqualified income for purposes of individuals having excess investment income.[494] Individuals who have at least one qualifying child for the taxable year are usually eligible,[495] as are those who meet the four following conditions:[496] (1) the

488. I.R.C. § 24(b).
489. *Id*.
490. *Id.* § 24(c).
491. *Id.* § 24(e).
492. *Id.* § 24(d); *see also id.* §§ 3101, 1401.
493. *Id.* § 24(d).
494. *Id.* §§ 32(a), 32(i).

individual must not have a qualifying child for the taxable year;[497] (2) the individual's place of abode must be in the United States for more than one-half of the taxable year;[498] (3) the individual must be between the age of twenty-five and sixty-four years at the close of the tax year;[499] and (4) the individual must not be someone for whom another taxpayer is allowed a dependency exemption for the same taxable year.[500]

An individual is a qualifying child of a taxpayer for a taxable year if he meets the relationship, abode, and age requirements.[501] A qualifying child will not be taken into account in computing the earned income credit unless the taxpayer includes the name, age, and social security number of the qualifying child on the tax return for the taxable year.[502] A person meets the relationship requirement if he or she is the son or daughter of the taxpayer, a descendant of a son or daughter of the taxpayer, a stepson or stepdaughter of the taxpayer, a descendant of such stepchild, or an eligible foster child of the taxpayer.[503] For the tax year 2002 and thereafter, a person also meets the relationship requirement if he or she is a sibling, step-sibling, descendant of a sibling, or descendant of a step-siblings, if the taxpayer cares for that person as the taxpayer would care for his own children.[504]

The abode requirement is satisfied if the individual has the same principal place of abode as the taxpayer for more than one-half of the taxpayer's taxable year.[505]

The age requirement is satisfied if the individual meets any one of the following alternative criteria: (1) the individual is under the age of nineteen as of the close of tax year;[506] (2) the individual is a student under age twenty-four at the end of the tax year;[507] or (3) the individual is perma-

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495. *Id.* § 32(c)(1)(A)(i).
496. *Id.* § 32(c)(1)(A)(ii).
497. *Id.*
498. *Id.* § 32(c)(1)(A)(ii)(I).
499. *Id.* § 32(c)(1)(A)(ii)(II). If the individual is married then either the individual or the spouse must meet this condition. *Id.*
500. *Id.* § 32(c)(1)(A)(ii)(III).
501. *Id.* § 32(c)(3)(A).
502. *Id.* § 32(c)(3)(D).
503. *Id.* § 32(c)(3)(B)(i)(I)-(III). An individual must meet five conditions to qualify as an eligible foster child. *Id.* § 32(c)(3)(B)(iii), (E).
504. *Id.* § 32(c)(3)(B)(i)(II).
505. *Id.* § 32(c)(3)(A)(ii); Wooten v. Comm'r, 79 T.C.M. (CCH) (2000).
506. I.R.C. § 32(c)(3)(C)(i).

nently and totally disabled at any time during the tax year.[508] A person who meets the definition of a qualifying child must also have a taxpayer identification number (TIN),[509] usually the same as the child's social security number.[510]

The credit is based on earned income, which includes all wages, salaries, tips, and other employee compensation, plus the amount of the taxpayer's net earnings from self-employment. Beginning with the 2003 tax year, combat zone pay excluded from income is not treated as earned income.[511] Basic Allowance for Housing (BAH) and the Basic Allowance for Subsistence (BAS) are also excluded from earned income.[512]

The amount of earned income tax credit is phased out as a taxpayer's earned income increases. These phase-out limitations are adjusted for inflation.[513]

After taking into account the required inflation adjustments, the earned income limitation amount for 2003 is $7490 for eligible individuals with one qualifying child, $10,510 for eligible individuals with two or more qualifying children, and $4990 for eligible individuals with no qualifying children.[514] For 2003, the maximum earned income credit for eligible individuals with one qualifying child is $2547, with two or more qualifying children $4203, and with no qualifying children, $382.

Taxpayers who qualify for the earned income tax credit may do so when they prepare and file their tax returns. However, taxpayers who have at least one qualifying child may receive up to sixty percent of the earned income tax credit through advance payments. The advance payment option requires the taxpayer to certify that he has one or more qualifying

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507. *Id.* § 32(c)(3)(C)(ii).

508. *Id.* § 32(c)(3)(C)(iii).

509. *Id.* § 32(c)(3)(D)(i).

510. *Id.* § 32(m).

511. IRS Notice 2003-21, 2003-17 I.R.B. 817, Q&A-37.

512. *Id.* This new release by the IRS implements a significant change from prior law implemented by the 2001 Tax Relief Act, Pub. L. No. 107-16, § 901, 115 Stat. 38. Pre-2002 law, which will also apply after 2010, included the value of military quarters and subsistence allowances as earned income for purpose of computing the earned income tax credit. *See* Neff v. United States, No. 97-750T, 1999 WL 333410 (Ct. Fed. Cl. May 25, 1999).

513. I.R.C. § 32(i): Rev. Proc. 2002-70, 2002-46 I.R.B. 845.

514. Rev. Proc. 2002-70, 2002-46 I.R.B. 845.

children for the taxable year.[515] The taxpayer certification is made on *IRS Form W-5*.[516]

E. Filing Status

The following are the four filing categories for individual taxpayers: (1) married filing a joint return (and surviving spouses);[517] (2) head of household;[518] (3) unmarried (other than surviving spouses and head of households);[519] and (4) married filing separate returns.[520]

These options are relatively straightforward. Married taxpayers may file jointly with their spouses, or they may file separately. A taxpayer who is not married on the last day of the calendar year may file as a single taxpayer, but should remember that he may also qualify for the head of household filing status, which is usually more favorable.

Internal Revenue Code § 7703 defines whether a taxpayer will be considered married for tax purposes.[521] If a decree of divorce or separate maintenance exists between the taxpayer and another on the last day of the taxable year, the taxpayer will not be considered married.[522] Nevertheless, a married taxpayer may qualify as an unmarried taxpayer under what is commonly referred to as the "abandoned spouse" rule.[523] In order to satisfy this rule, the spouse does not have to be abandoned, only living apart from the other spouse for at least the last six months of the taxable year.[524] The "abandoned" spouse who meets the other requirements of the filing status may file as an unmarried taxpayer under I.R.C. § 1(c), or as a head of household.[525]

In general, for a parent to qualify as a head of household, he or she must meet the following criteria: (1) be divorced or legally separated;[526]

515. I.R.C. § 32(g).
516. *See* U.S. Dept. of Treas., Internal Revenue Serv., IRS Form W-5.
517. I.R.C. § 1(a).
518. *Id.* § 1(b).
519. *Id.* § 1(c).
520. *Id.* § 1(d).
521. *Id.* § 1(a).
522. *Id.* § 7703(a).
523. *Id.* § 7703(b).
524. *Id*.
525. *Id.* § 1(b) and (c).
526. *Id.* § 2(b).

(2) provide for more than one-half of the cost of maintaining the household during the taxable year; and (3) maintain a home that constitutes the child's principal place of abode for more than one-half of the taxable years. Generally, the child must also qualify as a dependent of the parent. After passage of the TRA 1984, the requirements to qualify for head of household filing status changed. It is no longer necessary for a divorced parent to claim the child as a dependent on the tax return to be entitled to file a tax return as head of household and take advantage of the more favorable tax rates.[527] The parent is free to transfer the dependency exemption to the non-custodial parent in a written declaration under I.R.C. § 152(e)(2), or the dependency exemption may already have been awarded to the non-custodial parent in a pre-1985 instrument.[528]

The head of household rules are slightly different when the parents are still married but not residing together. The parent must do the following: (1) separately file a return; (2) maintain a household that serves as the child's principal place of abode for more than one-half of the taxable year; (3) provide more than one-half the cost of maintaining the household during the taxable year; (4) be entitled to the dependency exemption for the child, or have transferred the exemption to the other parent (or the child may qualify as a dependent exemption for the non-custodial parent under a pre-1985 instrument); and (5) reside separately from the spouse for at least the last six months of the taxable year.[529]

F. Deductibility of Legal Fees

A spouse is not usually permitted to deduct attorney fees incurred in connection with a divorce or separation. The IRS considers legal fees to be personal, like other nondeductible personal, living, or family expenses.[530] In *United States v. Gilmore*,[531] an ex-husband attempted to deduct eighty percent of the legal fees he incurred over two tax years in his bitterly contested divorce. The husband was the president and controlling shareholder of three car dealerships. In the proceeding, Mr. Gilmore argued that the legal fees were incurred to conserve his income-producing property and protect his business reputation from his wife's accusations of marital infidelity. He argued that they were deductible under the predeces-

527. *Id*.
528. *Id.* § 152(e)(4).
529. *Id.* §§ 2(b), 7703(b).
530. United States v. Gilmore, 372 U.S. 39 (1963); I.R.C. § 262(a).
531. 372 U.S. 39 (1963).

sor to I.R.C. § 212(2). The U.S. Supreme Court held that none of the legal expenses were deductible. The Court reasoned that it is not appropriate to look at the consequences that might result to the income-producing properties, but rather at whether the claim originates with the taxpayer's profit-seeking activities.[532] The Court ruled that the taxpayer's claim "originated"[533] out of marital difficulties, which were personal and not business related. This is referred to as the "origin of the claim" doctrine.[534]

There are exceptions to the general rule that legal fees paid to an attorney are not deductible. Such exceptions usually involve one of the subparts of I.R.C. § 212. Although *Gilmore* has curtailed the use of I.R.C. § 212(2)[535] to deduct fees incurred during a divorce or legal separation, taxpayers have had more success under either I.R.C. § 212(1) or I.R.C. § 212(3).[536]

1. Production or Collection of Income—I.R.C. § 212(1)

Section 212(1) allows a deduction for expenses incurred for the production or collection of income. The IRS has allowed deductions under this provision in proceedings in which taxpayers incurred legal fees to obtain or increase alimony. In *Wild v. Commissioner*,[537] the Tax Court permitted a wife to deduct $6000 out of a $10,000 legal bill when her attorney had allocated the $6000 had been allocated by her attorney as representing the amount attributable to obtaining monthly alimony payments. The court ruled that the costs to the wife to produce the alimony were deductible under I.R.C. § 212(1).[538] The tax regulations now recognize this prin-

532. *Id*. at 48.

533. *Id*. at 49.

534. *Id*.

535. Internal Revenue Code § 212(2) permits a deduction for ordinary and necessary expenses paid or incurred "for the management, conservation, or maintenance of property held for the production of income." I.R.C. § 212(2).

536. *See, e.g.,* Hesse v. Comm'r, 60 T.C. 685 (1973), *aff'd* in unpub. opin., 511 F.2d 1393 (3d Cir. 1975), *acq.* 1974-2 C.B. 2; Rev. Rul. 72-545, 1972-2 C.B. 179.

537. 42 T.C. 706 (1964), *acq.*, 1967-2 C.B. 4.

538. *Id*. at 711; *see also* Hesse v. Comm'r, 60 T.C. 685 (1973), *aff'd*, 511 F.2d 1393 (3d Cir. 1975), *cert. denied*, 423 U.S. 834 (1975); Schafler v. Comm'r, 75 T.C.M. (CCH) 1897 (1998).

ciple.[539] A spouse may also deduct legal fees incurred to collect alimony arrearages.[540]

On the reverse side, the party defending against an award or collection of alimony cannot deduct his or her legal fees. In *Hunter v. United States*,[541] the U.S. Court of Appeals for the Second Circuit (Second Circuit) stated that "production of income" as that term is used in I.R.C. § 212(1) refers to the creation of additional income, not to reducing a liability.[542] Reducing a tax-deductible alimony obligation does not create an amount of income includable in gross income, although the net effect may be to increase a payor's taxable income level.[543]

2. Determination, Collection, or Refund of Any Tax: Tax Advice—I.R.C. § 212(3))

Section 212(3) permits a deduction for all ordinary and necessary expenses paid or incurred during the taxable year in connection with the determination, collection, or refund of any tax.[544] The regulations under I.R.C. § 212(3) include expenses for tax counsel, preparation of tax returns, and fees incurred in connection with any proceedings involving the determination of tax liability or contesting a person's tax liability.[545] Courts have allowed deductions for tax advice concerning the rights to claim dependency exemptions; characterization and treatment of alimony obligations; property transfers in connection with divorce; and income, estate, and gift tax consequences to a taxpayer who establishes a trust to discharge the alimony obligation.[546]

For legal fees incurred with respect to a divorce to be deductible, the attorney must determine what portion of the fees is allocable to tax advice, as opposed to the non-deductible advice and services. The allocation should be reasonable and one that can be substantiated.[547] In *Revenue Rul-*

539. Treas. Reg. § 1.262-1(b)(7) (1993).

540. Elliott v. Comm'r, 40 T.C. 304 (1963), *acq*., 1964-1 C.B. 4; *see* Treas. Reg. § 1.262-1(b)(7) (1993).

541. 219 F.2d 69 (2d Cir. 1955).

542. *Id*. at 70.

543. *See* Sunderland v. Comm'r, 36 T.C.M. (CCH) 512 (1977).

544. I.R.C. § 212(3).

545. Treas. Reg. § 1.212-1(k) (1993).

546. *See* United States v. Davis, 370 U.S. 65 (1962); Carpenter v. United States, 338 F.2d 366 (Ct. Cl. 1964); Rev. Rul. 72-545, 1972-2 C.B. 179.

ing 72-545,[548] the IRS suggested that the allocation should be based on time attributable to tax-related advice, plus other factors such as the fee customarily charged in the locality for similar services, the amount of taxes involved, and the difficulty of the tax questions presented. If the taxpayer is unable to document his allocation with records such as time sheets, diaries, or other evidence of time spent on tax advice, the IRS or courts may refuse to permit the deduction. In *Hall v. United States*,[549] a taxpayer (the ex-husband) paid a law firm legal fees of $15,000. Three attorneys from the firm worked on the case, including a tax lawyer who testified that he spent approximately twenty to twenty-five hours on tax matters with a billing rate of $100 per hour. The attorney kept no time sheets, logs, or diaries to evidence his time. During the tax year in question, the taxpayer paid $7000 in legal fees. The court refused to allow the taxpayer to deduct any part of the legal fees paid to the law firm because the taxpayer failed to prove, by a preponderance of the evidence, that any part of the legal fee was for tax advice.[550]

The obvious lesson of *Hall* is that the attorney should prepare an itemized bill showing exactly what portion of the fee is tax deductible. If the attorney charges for his services by the hour, it should not be difficult to substantiate the deduction if the IRS questions it later. If the attorney charges a set legal fee based on the attorney's experience, knowledge, difficulty of issues, and other similar factors, the attorney should divide the bill into the various deductible and non-deductible areas.[551] The deductible tax-related legal fees are treated as itemized deductions.[552] They are reported as miscellaneous deductions on *IRS Form 1040, Schedule A*, and as such, are subject to the two- percent floor.[553] The taxpayer may not deduct legal fees unless he itemizes his deductions.[554]

The deduction of tax-related legal fees is permitted only to the spouse who incurs the expense on his or her own behalf. When one spouse pays the other spouse's legal fees, the payor spouse will not be allowed to

547. *See* Merians v. Comm'r, 60 T.C. 187 (1973).

548. Rev. Rul. 72-545, 1972-2 C.B. 179, situations 2, 3.

549. 78-1 U.S. Tax. Cas. (CCH) 83,086 (Ct. Cl. 1977).

550. *Id*. at 83,091.

551. *See* Goldaper v. Comm'r, 36 T.C.M. (CCH) 1381 (1977); Mirsky v. Comm'r, 56 T.C. 664 (1971). These cases are examples of what can happen if the attorney does not allocate fees—the court is left to make the allocation itself.

552. I.R.C. § 63(d).

553. *Id.* § 67(a), (b).

554. *Id.* § 67 (b).

deduct the payee spouse's tax-related legal fees.[555] Counsel who represent a spouse who is paying the other spouse's legal fees should consider treating the payment as alimony. Since the TRA 1984 repealed the "periodic payment" requirement for alimony, it is much easier to structure the payment of the other spouse's legal fees as alimony.[556] When negotiating the alimony payment obligation, the payee spouse's expected attorney fees can be incorporated into the payment schedule. If the fees are expected to be high, they should be spread out over several years to ensure the payor does not violate the rules by "front-end loading" of cash payments in the first three years following the divorce, which could trigger the recapture provisions.[557] If this option is used, the attorney for the payor should, of course, ensure that the agreement or decree requires that the payee spouse is responsible for paying his or her own attorney fees. In the alternative, the temporary regulations permit a payor spouse to make a cash payment to a third party on behalf of a spouse and such payment will qualify as alimony if it is pursuant to a divorce, separation agreement, or a written request for such payment by the payee spouse.[558] This method will ensure payment and ensure that the payment qualifies as deductible alimony to the payor spouse.

Another approach would be for the payor spouse to transfer appreciated property to the payee spouse. Such transfer would be income-tax free[559] as well as gift-tax free.[560] The payee spouse takes over the transferor's basis. The parties may add the legal fees for the transfer to the transferor's basis, thereby increasing the basis to the payee upon receipt of the property, if the legal fees are not deductible by the transferor spouse.[561] The gain that is realized and recognized by the payee (transferee) spouse can be at least partially offset by a deduction for the allocation of tax-advice related legal fees incurred by the transferee spouse.[562] Each of these alternatives will require close scrutiny in light of each party's respective marginal tax rates and the ability of the payee spouse to itemize.

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555. United States v. Davis, 370 U.S. 65, 74 (1962).
556. *See generally* I.R.C. § 71(b) (containing the applicable requirements).
557. I.R.C. § 71(b)(1), (f).
558. Temp. Treas. Reg. § 1.71-1T(b), Q&A-6, Q&A-7 (1984).
559. I.R.C. § 1041(a).
560. *Id.* § 2516.
561. *Id.* §§ 212(2), 1041(b); Treas. Reg. § 1.212-1(k).
562. I.R.C. § 212(1).

G. Entitlement to Tax Refunds

Property settlement agreements sometimes state which party will be responsible for paying any unpaid income tax liabilities and which party will receive any tax refunds with respect to prior and future year joint returns. These allocations are binding on the parties, but do not bind the IRS. The IRS may seek payment from either party, regardless of the property settlement terms. The typical scenario involves a husband and wife who file a joint tax return during a year when they are entitled to a refund. If the parties are divorced or separated before the refund check arrives, both spouses may claim entitlement to the refund.

1. Applicable Law

An overpayment is the property of the spouse whose income and tax payments created the overpayment.[563] Court decisions have consistently held that a husband and wife who file a joint return do not have a joint interest in an overpayment; each spouse or former spouse has a separate interest.[564] For example, if one spouse goes bankrupt, only his share of the refund goes to the trustee in bankruptcy.[565] If one spouse dies, his share of the refund goes to his estate, not to the surviving spouse.[566]

The Tax Court has held on several occasions that filing a joint return does not have the effect of converting the income of one spouse into the income of the other.[567] Spouses who file joint returns do not have a joint interest in an overpayment; filing a joint return does not convert the income and tax payments of one spouse into the income and tax payments of the other spouse. In other words, a joint income tax return does not give

563. Rev. Rul. 74-611, 1974-2 C.B. 399.

564. *See* Maragon v. United States, 153 F. Supp. 365 (Ct. Cl. 1957).

565. *In re* Wetteroff, 324 F.Supp. 1365 (E.D. Mo. 1971), *aff'd*, 453 F.2d 544 (8th Cir. 1972).

566. Estate Tax Reg. § 20.2053-6(f); McClure v. United States, 288 F.2d 190 (Ct. Cl. 1961).

567. *See* Dolan v. Comm'r, 44 T.C. 420 (1965); Coerver v. Comm'r, 36 T.C. 252 (1961), *aff'd per curium*, 297 F.2d 837 (3d Cir. 1962).

a spouse a property interest in the other spouse's income tax overpayment.[568]

Occasionally, the IRS will apply one spouse's overpayment to the separate debt of the other spouse. If this occurs, the non-debtor spouse can recover his share of the refunds erroneously applied to the other spouse's debt by filing an amended tax return for the tax year in question with *IRS Form 8379*.[569]

2. *Allocation Formula*

In *Revenue Ruling 80-7*,[570] the IRS established a two-step formula to calculate each spouse's interest in a refund or overpayment. In step one, one determines each spouse's allocable percentage of the joint tax liability on the return by multiplying the joint tax liability by a "separate share" fraction, computed as follows: (1) the amount of tax the spouse would have paid if he had filed a separate return computed using married filing separately rates; (2) divide this sum by the sum of the husband's separate tax plus the wife's separate tax. To compute the separate share fraction, one must recalculate the taxes for the taxable year on two separate returns for the husband and the wife.[571] In step two, one determines a spouse's share of a joint refund or other overpayment. To calculate this share, one subtracts the spouse's percentage of the joint tax liability, as calculated in step one, above, from his or her actual contributions toward the payment of the joint liability. A spouse's contribution includes his or her withholding and estimated tax credits during the tax year.[572]

The following examples will illustrate the Allocation Formula rules:

> ***Example:*** *H* and *W* filed a joint return. *H*'s income for the year was $100,000. *W*'s income was $25,000. They used the $7950 standard deduction and claimed $6100 in personal exemptions. They had no other deductions. Their joint tax liability on $110,950 of taxable income was $23,858. Had they filed separate returns, *H*'s taxable income would have been $92,975, with

568. Dolan v. Comm'r, 44 T.C. 420 (1965); Rev. Rul. 74-611, 1974-2 C.B. 399.

569. U.S. Dep't of Treas., IRS Form 8379, Innocent Spouse Claim and Allocation.

570. 1980-1 C.B. 296. *But see* Rev. Rul. 85-70, 1985-1 C.B. 361 (expressing a different allocation formula for certain community property credits).

571. Rev. Rul. 80-7, 1980-1 C.B. 296.

572. *Id.*

a tax liability of $23,307, and *W*'s taxable income would have been $17,975, with a $2396 tax liability. *H*'s share of the joint tax liability is 91%; *W*'s share is 9% percent. Therefore, *H*'s portion of the joint tax liability is $21,711 (91% percent x $23,858), and *W*'s portion of the joint tax liability is $2147 (9% x $23,858).

Although *H* provided 80% of the income and *W* provided 20%, the allocable share of the joint tax liability is different, because each spouse is entitled to use a $3050 personal exemption and half of the standard deduction ($7950).

Example: Using the facts in the example above, *H* had $22,000 withheld during the year and *W* had $3000 in withholding. Their total tax payments were $25,000 and their refund is $1142. *H* is entitled to $289 of the refund ($22,000 withheld - $21,711 separate tax liability). *W* is entitled to the remaining $853 ($3000 withheld - $2147 separate tax liability).

Example: Using the facts in example (1) above *H* had $21,000 and *W*'s withholding was $4000. Their total tax payments were $25,000 and their refund is only $1142. *W* is entitled to the entire $1142 refund.

As illustrated in the example above, $1000 of *W*'s tax payments was used to satisfy *H*'s tax liability. Unless this is specifically addressed by a clause in the divorce decree, *W* is not entitled to any indemnification from *H* for the $1000.

H. Innocent Spouse, Separate Liability and Equitable Tax Relief

1. Overview of General Rules Before 1998

Section 6013(a) authorizes a joint return for a husband and wife.[573] In general, a husband and wife are jointly and severally liable for any tax for a tax year in which they filed a joint return.[574] Under recently adopted regulations, if one spouse signed the return under duress, the return does not constitute a joint return.[575] In order to alleviate the burden on a spouse who

573. I.R.C. § 6013(a).
574. *Id.* § 6013(d)(3).
575. Treas. Reg. § 1.6013-4(d).

did not engage in the activity giving rise to an understatement of tax, and who was unaware of the understatement, Congress enacted an "innocent spouse" exception to joint and several liability.[576] Former I.R.C. § 6013(e) provided the innocent spouse exception until 1998, when Congress repealed it and re-codified portions of the statute as I.R.C. § 6015.[577]

Former I.R.C. § 6013(e) had the following four main requirements: (1) the spouses must have filed a joint return for the taxable year; (2) the return must have contained a substantial understatement of tax attributable to grossly erroneous items of one spouse; (3) the other spouse must have established that in signing the return, he did not know—and had no reason to know—that there was such a substantial understatement; and (4) taking into account all the facts and circumstances, it was inequitable to hold the other spouse liable.[578] "Grossly erroneous items" meant any unreported item of gross income and any claim of a deduction, credit, or basis in an amount for which there was "no basis in fact or law."[579] Taxpayers had a difficult time proving the presence of "grossly erroneous items" in erroneous deduction cases.[580] Furthermore, even if a taxpayer did not have actual knowledge that a deduction claimed on a return would give rise to a substantial understatement, a taxpayer who had reason to know of such an understatement was not entitled to innocent spouse relief under former I.R.C. § 6013(e).[581]

2. *Current Rules For Innocent Spouse, Separate Liability, and Equitable Tax Relief*

The 1998 IRS Reform Act[582] created I.R.C. § 6015. This new statute contains the following three exceptions to joint and several liability for tax arising from a joint tax return: (1) innocent spouse relief;[583] (2) election for separate liability;[584] and (3) equitable tax relief.[585] The IRS makes its

576. Former I.R.C. § 6013)(e)(1998).

577. I.R.C. § 6015.

578. *Id.* § 6013(e)(1) (1998); Pub. L. No. 105-206, § 3201(e)(1), 112 Stat. 685 (1998).

579. I.R.C. § 6013(e)(2) (1998).

580. *See* Crowley v. Comm'r, 66 T.C.M. (CCH) 1180 (1993); Anthony v. Comm'r, 63 T.C.M. (CCH) 2294 (1992); Neary v. Comm'r, 50 T.C.M. (CCH) 4 (1985).

581. I.R.C. § 6013(e)(1)(C) (1998).

582. Pub. L. No. 105-206, 112 Stat. 685 (1998) *amended*, Tax Extension Act of 1998, Pub. L. No. 105-277, 112 Stat. 2681-906 (1998); Community Renewal Act of 2000, Pub. L. No. 106-554, 114 Stat. 2763 (2000).

583. I.R.C. § 6015(b).

determinations under this section without regard to community property laws.[586]

a. Innocent Spouse Rules—I.R.C. § 6015(b)

To qualify for innocent spouse relief, the requesting spouse must satisfy each of the following elements: (1) the requesting spouse must have filed a joint return on which there is an understatement of tax due to an erroneous item of the non-requesting spouse;[587] (2) the requesting spouse must not have known or had reason to know about the understatement at the time of signing the return;[588] (3) taking into account all the facts and circumstances, holding the requesting spouse liable for the additional tax must be inequitable;[589] and (4) the requesting spouse must make a valid election for I.R.C. § 6015(b) relief.[590]

Section 6015(b) is silent about the burden of proof, except that it requires that the requesting spouse to establish his lack of knowledge of the understatement. Cases applying former I.R.C. § 6013(e) uniformly held that the requesting spouse had the burden of proving each element of the innocent spouse defense by a preponderance of the evidence.[591]

The understatement of tax must be attributable to an "erroneous item" of the non-requesting spouse.[592] Section 6015 does not expressly define "erroneous item," but the regulations provide definitions of both "item" and "erroneous item." *Treasury Regulation § 1.6015-1(h)(3)* defines "item" as that which is required to be separately listed on an individual return or attachments to the return.[593] *Treasury Regulation § 1.6015-1(h)(4)* defines "erroneous item" as an item resulting in an understatement

584. *Id.* § 6015(c).
585. *Id.* § 6015(f).
586. *Id.* § 6015(a).
587. *Id.* § 6015(b)(1)(A),(B); Treas. Reg. § 1.6015-2(a)(1)-(2).
588. I.R.C. § 6015(b)(1)(c); Treas. Reg. § 1.6015-2(a)(3).
589. I.R.C. § 6015(b)(1)(D); Treas. Reg. § 1.6015-2(a)(4).
590. I.R.C. § 6015(b)(1)(E); Treas. Reg. § 1.6015-2a, - 1(h)(5).
591. *See* Stephens v. Comm'r, 872 F.2d 1499 (11th Cir. 1989); Purcell v. Comm'r, 826 F.2d 470, 473 (6th Cir. 1987).
592. I.R.C. § 6015(b)(1)(B); Treas. Reg. § 1.6015-2(a)(2).
593. Treas. Reg. § 1.6015-(h)(3).

or deficiency, such as unreported gross income or a deduction, credit, or basis improperly characterized or reported on the tax return.[594]

The most-litigated issue under the innocent spouse relief provisions is whether the spouse seeking the innocent spouse relief had reason to know about the understatement of tax.[595] A review of the reported cases shows courts have analyzed this issue in a multitude of ways, depending on the particular facts of each case.[596] Mere knowledge of the underlying transaction is sufficient to justify denying innocent spouse relief.[597]

b. Separate Tax Liability for Divorced and Separated Taxpayers—I.R.C. § 6015(c)

Section 6015(c) allows a spouse to elect to limit his liability for any deficiency arising from a joint return to that portion of the deficiency attributable to errors allocable to that spouse.[598] The election applies to both income taxes and self-employment taxes.[599] Section 6015(c) applies only to deficiencies of tax arising with respect to a joint return, not liabilities for unpaid taxes reported on the return.[600]

To elect separate liability under I.R.C. § 6015(c), a requesting spouse must satisfy the following requirements: (1) at the time of making the election, the requesting spouse is no longer married to or is legally separated from the other spouse, and has not been a member of the same household as the other spouse for the last twelve months;[601] (2) before making the election, the requesting spouse and the other spouse must not have transferred assets between themselves as part of a fraudulent scheme;[602] (3) at the time of signing the tax return, the requesting spouse must not have had

594. *Id.* § 1.6015-1(h)(4).

595. *See, e.g.*, Cheshire v. Comm'r, 115 T.C. 183 (2000), *aff'd* 282 F.3d 326 (5th Cir. 2002), *cert. denied* 537 U.S. 881 (2002); Grossman v. Comm'r, 182 F.3d 275 (4th Cir. 1999); Buchine v. Comm'r, 2c F.3d 173 (5th Cir. 1994); Altman v. Comm'r, 475 F. 2d 876 (2d Cir. 1973).

596. *See supra* note 595; I.R.C. § 6015(b)(1).

597. *See* Erdahl v. Comm'r, 930 F.2d 585, 589 (8th Cir. 1991); Cheshire v. Comm'r, 115 T.C. at 183.

598. I.R.C. § 6015(c)(1); Treas. Reg. § 1,6015-3(a), (d).

599. *See* S. Rep. No. 174, at 56 (1998).

600. I.R.C. § 6015(a) and (c)(1).

601. *Id.* § 6015(c)(3)(A)(i)(I)-(II); Treas. Reg. § 1.6015-3(a).

602. I.R.C. § 6015(c)(3)(A)(ii); Treas. Reg. § 1.6015-1(d).

actual knowledge of the item giving rise to the deficiency;[603] and (4) the requesting spouse makes a timely election for I.R.C. § 6015(c) relief.[604]

Practitioners must remember that when making a request for separate tax liability under I.R.C. § 6015(c), the election will not apply to any item of the other spouse with respect to which the electing spouse had actual knowledge. The knowledge referred to in I.R.C. § 6015(c) is knowledge of the item, not its tax consequences.[605] Unlike I.R.C. § 6015(b) (innocent spouse relief, discussed above), I.R.C. § 6015(c) does not have a constructive knowledge provision.[606] The IRS cannot infer actual knowledge from the requesting spouse's reason to know of the erroneous item.[607]

c. Equitable Relief—I.R.C. § 6015(f)

The 1998 IRS Reform Act added a third new liability relief provision called "Equitable Relief," at I.R.C. § 6015(f).[608] Section 6015(f) provides a last-resort equitable relief provision authorizing the IRS to relieve a spouse from liability for a deficiency arising with respect to a joint tax return or any unpaid tax properly reported on the return if, "taking into account all the facts and circumstances it is [in]equitable to hold the individual liable" for all or a portion of such deficiency or unpaid tax,[609] and relief is not available under the other two subsections of I.R.C. § 6015.[610] Relief under I.R.C. § 6015(f) is discretionary on the part of the IRS.[611]

In *Revenue Procedure 2000-15*,[612] the IRS provided guidance for taxpayers seeking equitable relief under I.R.C. § 6015(f). The procedure provides a requesting spouse with various threshold conditions to be eligible for relief from tax liability arising from a joint tax return under I.R.C. § 6015(f). The requesting party must meet the following threshold requirements under *Revenue Procedure 2000-15*: (1) relief must not be available

603. I.R.C. § 6015(c)(3)(C); Treas. Reg. § 1.6015-3(c)(2). This limitation does not apply if the requesting spouse can demonstrate he signed the tax return under duress. I.R.C. § 6015(c)(3)(C); *see* Treas. Reg. § 1.6015-1(b) (citing Treas. Reg. § 1.6013-4(d)).

604. I.R.C. § 6015(c)(3)(B).

605. Treas. Reg. § 1.6015-3(c)(4), ex. 2.

606. *Id.* § 1.6015-2(c).

607. *Id.* § 1.6015-3(c)(2).

608. Pub. L. No. 105-206, § 3201(a), 112 Stat. 685 (1998).

609. I.R.C. § 6015(f)(1); Treas. Reg. § 1.6015-4(a).

610. I.R.C. § 6015(f)(2).

611. *Id.* § 6015(f).

612. 2000-1 C.B. 447.

under I.R.C. § 6015(b) or (c);[613] (2) the requesting spouse must make a valid election for I.R.C. § 6015(f) relief;[614] (3) the spouses filing the joint return must not have transferred any assets to each other as part of a fraudulent scheme;[615] (4) liability for which relief is requested must remain unpaid at the time of the request, or if paid, must either have been paid after July 22, 1998 as part of an installment agreement which is not in default,[616] or have been paid between July 2, 1998 and April 14, 1999;[617] (5) the requesting spouse must not have filed the joint tax return with fraudulent intent;[618] and (6) the non-requesting spouse must not have transferred any disqualified assets transferred to the requesting spouse.[619]

Except to say that "disqualified assets" has the same meaning as under I.R.C. § 6015(c)(4)(B), and to clarify that a transfer of a disqualified asset only precludes relief to the extent of the value of the asset, the revenue procedure does not elaborate on these requirements, [620] but it lists circumstances, under which the IRS will ordinarily grant equitable relief,[621] in addition to factors the IRS will consider in determining whether relief is appropriate in other cases.[622]

d. "Ordinarily" Qualifying Circumstances—A Safe Harbor

As stated above, the requesting spouse must satisfy the above threshold requirements to be considered for equitable relief. According to *Revenue Procedure 2000-15*,[623] a spouse who meets the threshold requirements and also meets the following criteria will ordinarily obtain relief: (1) the tax due as reported on the return must have been unpaid at the time of filing;[624] (2) at the time the taxpayer requests the relief, the

613. Rev. Proc. 2000-15, § 4.01.

614. *Id.* § 5.

615. Rev. Proc. 2000-15, § 4.01.

616. *See* I.R.C. § 6159(b)(4) (governing IRS installment agreements).

617. Rev. Proc. 2000-15, § 4.01. In *Field Service Advice 2002-13-006*, the IRS Chief Counsel's Office advised that the IRS did not abuse its discretion in creating a "window period" between 22 July 1998 and 15 April 1999. Field Serv. Advice 2002-13-006 (October 23, 2001).

618. *Id.*

619. *Id.*

620. *Id.*

621. *Id.*

622. *Id.*

623. 2001-C.B. 447.

624. *Id.* § 4.02.

requesting spouse must no longer be married to the non-requesting spouse, or be legally separated from him, or must not have been a member of the same household for the previous twelve months;[625] (3) at the time the return was signed, the requesting spouse must not have known or had reason to know that the tax would not be paid, and must show that it was reasonable for the requesting spouse to believe that the non-requesting spouse would not pay the reported liability;[626] (4) the requesting spouse must show that she would suffer economic hardship if the IRS does not grant relief from liability;[627] and (5) the tax liability must be attributable to the non-requesting spouse.[628]

e. Other Relevant Factors

According to *Revenue Procedure 2000-15*, a requesting spouse satisfying the threshold requirements but whose circumstances do not fall within the above safe harbor test may still be entitled to equitable relief.[629] *Revenue Procedure 2000-15* lists a number of factors that the IRS will take account in making its determination, and notes that these listed factors are not intended to be exhaustive. A summary of the factors are as follows:

(i) Factors Weighing in Favor of Relief

a) Marital Status. The requesting spouse is legally separated from, living apart from, or divorced from the nonrequesting spouse;
(b) Economic Hardship. The requesting spouse would suffer economic hardship if relief is not granted;
(c) Abuse. The requesting spouse was abused by his or her spouse but such abuse did not constitute duress;

625. *Id.*.
626. *Id.* § 4.02(b).
627. *Id.* § 4.02(c). The determination of economic hardship is made by the Commissioner of the Internal Revenue Service, or delegate, based on rules similar to those provided in Treasury Regulation § 301.6343-1(b)(4), describing circumstances under which the IRS will release a levy. *Id.*
628. Rev. Proc. 2000-15, § 4.02. The IRS derived these criteria from language in the 1998 Conference Report. H.R. CONF. REP. NO. 599, at 254 (1998). Discussing the scope of I.R.C. § 6015(f), the 1998 Conference Report states: "The conferees intend that equitable relief be available to a spouse that does not know, and has no reason to know, that funds intended for the payment of tax were instead taken by the other spouse for such other spouse's benefit." *Id.*
629. Rev. Proc. 2000-15, § 4.0.

(d) No knowledge or reason to know. The non-requesting spouse has a legal obligation pursuant to a divorce decree or agreement to pay the outstanding liability, and the requesting spouse had no knowledge or reason to know that the non-requesting spouse would not pay the liability as required by the divorce decree or agreement.

(e) Attributable to non-requesting spouse. The divorce instrument obligates the nonrequesting spouse to pay the liability for which relief is sought.[630]

. . . .

(ii) Factors Weighing Against Relief

(a) The liability for which relief is sought is attributable to the requesting spouse;
(b) The requesting spouse knew or had reason to know of the unpaid liability or deficiency (although, according to the revenue procedure, in extreme cases, knowledge will not preclude relief);
(c) The requesting spouse received a significant benefit (beyond normal support) from the unpaid liability or items giving rise to the deficiency, such as described in former Regs. § 1.6013-5(b) (listing factors relevant in determining whether it would be inequitable to hold a relief-seeking spouse liable for tax under the former § 6013(e));
(d) The divorce instrument obligates the requesting spouse to pay the liability for which relief is sought;
(e) The requesting spouse will not experience economic hardship if relief is not granted;
(f) The requesting spouse has not made a good faith effort to comply with federal income tax laws in the tax years following the tax year or years to which the request relief relates.[631]

f. Making an Election for Relief Under I.R.C. § 6015

Section 6015(b)(1)(E) expressly provides that a spouse seeking relief from liability on a joint tax return must file an election-for-relief form approved by the IRS within the statutory time period. The IRS revised

630. *Id.* § 4.03(1).
631. *Id.* § 4.03(2).

Form 8857,[632] the form previously used for requesting innocent spouse relief under former I.R.C. § 6013, to make it usable for making elections and requests for relief under all three I.R.C. § 6015 relief categories.[633]

Section 6015(a) expressly states that an individual may elect to seek relief under § 6015(b),[634] and, if eligible, to elect separate liability under § 6015(c).[635] Form 8857 also advises that the IRS will automatically consider whether a taxpayer ineligible for relief under § 6015(b) or (c) qualifies for equitable relief under § 6015(f).[636]

The earliest date for filing any election is the first date the IRS asserts the deficiency.[637] For liabilities arising after 22 July 1998, the last date for filing an election is two years after the date the IRS commenced collection activities against the taxpayer with respect to the liability.[638]

Section 6015(b)(2)[639] directs the IRS to prescribe regulations designed to give the non-requesting spouse notice of and an opportunity to participate in the requesting spouse's I.R.C. § 6015 administrative proceeding. The implementing regulations specify that, upon receipt of a requesting spouse's application using *IRS Form 8857*, the IRS must send a notice to the last known address of the non-requesting spouse informing him or her of the election.[640] The IRS must give the non-requesting spouse an opportunity to submit information relevant to its determination[641] and must notify him or her of its final determination.[642]

In *Revenue Procedure 2003-19*,[643] the IRS published rules under which a non-requesting spouse may administratively appeal a preliminary determination granting full or partial relief from joint liability to the requesting spouse.[644] The revenue procedure, which significantly expands

632. U.S. Dept. of Treas., IRS Form 8857, Request for Innocent Spouse Relief (Rev. May 2002).
633. *Id*.
634. I.R.C. § 6015(a)(1).
635. *Id.* § 6015(a)(2).
636. *See* U.S. Dep't of Treasury, Internal Revenue Service, Form 8857, paras. 3-5.
637. Pub. L. No. 106-554, 114 Stat. 2763 (2000)(amending I.R.C. § 6015(c)(3)(B)).
638. *Id.* § 6015(b)(1)(E).
639. I.R.C. § 6015(b)(2).
640. Treas. Reg. § 1.6015-6(a)(1).
641. *Id.*
642. Treas. Reg. § 1.6015-6(a)(2).
643. 2003-5 I.R.B. 371.
644. Rev. Proc. 2003-19, 2003-1 C.B. 371.

the due process rights of non-requesting spouses, specifies the procedures that the IRS will follow after making a preliminary decision regarding a claim for relief, and the time and manner for protesting a determination to grant relief. Under the new rules, the non-requesting spouse may request an appeals conference both to challenge a preliminary grant of relief and to protest a proposed increase in the recommended relief resulting from the requesting spouse's appeal of the preliminary determination.[645] *Revenue Procedure 2003-19* is effective for claims for relief filed on or after 1 April 2003, and for claims filed before that date for which the IRS has issued no preliminary determination as of 1 April 2003.[646]

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645. *Id.*
646. *Id.*

By Order of the Secretary of the Army:

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