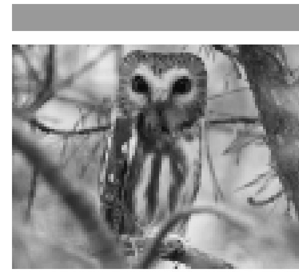

2000 Income Tax School

DIVORCE

INTRODUCTION

Numerous tax issues need to be considered when a client is divorcing, divorced, or separated. The issues covered in this chapter are

- Filing status—The importance of a divorce decree or separate maintenance order, choices available, rules, and ramifications of each filing status
- Exemptions—Who is a dependent, the importance of a dependency exemption, the custodial parent presumption, and how to overcome it, and the release of claim to exemption of a child (Form 8332)
- Alimony—What it is, what types of payments qualify, when payments are deductible, and the recapture of "front-end loaded" payments.
- Property settlements—What is a property settlement, transfers incident to divorce for nonrecognition of gain or loss, transfers to third parties, transfers to trusts, responsibilities of the transferor and transferee, when a gift tax return must be filed.
- Qualified domestic relations order (QDRO)—What it is and how it relates to the divorcing couple.

Divorce decrees entered into prior to 1985 are not covered in this chapter. The major differences between the rules discussed in this chapter and the rules that apply to decrees entered into prior to 1985 are how the dependency exemptions are allowed and how property settlements are treated. This chapter does not include special rules pertaining to the calculation of income and support unique to community property states (Arizona, California, Idaho, Louisiana, Nevada, New Mexico, Texas, Washington, Wisconsin, and optional in Alaska). Please reference IRS Publication 555 for further guidance.

FILING STATUS

State law governs marriage and divorce. Federal law does **not** govern marriage and divorce. It is a domestic affair governed by the family laws of the state of domicile. A taxpayer is **legally** married until the marriage is **legally** dissolved. However, some legally married persons can, under federal tax law, file as single individuals. For this reason there can be some confusion regarding a person's marital status for federal tax purposes. This section discusses the federal treatment of marital status. These federal tax options do not, however, alter the legal status of marriage in the state of legal residence.

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I.R.C. §7703: DETERMINATION OF MARITAL STATUS

This code section is designed to eliminate conflicts and provide a consistent basis nationwide that individuals can rely on to file accurate returns. The process of obtaining a divorce can extend over a period of years. However, for federal tax purposes, taxpayers are treated consistently regardless of the variations in state law. The Code provides guidance on the proper filing status of the taxpayers.

I.R.C. §7703(a) states the general rule:

1. The determination of whether an individual is married shall be made as of the **close** of the taxable year;
2. An individual legally separated from his spouse under a **decree of divorce** or **of separate maintenance** shall **not** be considered married.

It goes on in section (b) to address "certain married individuals living apart":

1. If an individual who is married (within the meaning of subsection (a)) and who files a separate return maintains as his home a household which constitutes for more than one-half of the taxable year **the principal place of abode of a child**, with respect to whom such individual is entitled to a deduction (exemption) for the taxable year and
2. Such individual furnishes over half the cost of maintaining such household during the taxable year, and
3. During the **last six months of the taxable year,** such individual's **spouse was not a member of such household,** then such individual **shall not be considered as married.**

This code section makes the following distinctions:

1. The filing status of an individual is determined at the **"close of the tax year."** For most individuals, this means on or before midnight, December 31.
2. More importantly, spouses can sever their marital property interests and support arrangements by a **legal separation decree** or **separate maintenance order**. With such a decree or order, they are treated for federal tax purposes as **unmarried.**

Practitioner Note. There is a distinction between "legal separation" and "living apart." The legal separation establishes a date for severing marital property interests, whereas living apart does not sever marital property interests. A legal separation does not mean that an actual distribution of marital assets has taken place; it simply means that, according to state and local law, a date has been determined for valuing marital property interests.

3. If there are two or more children, with one or more living with **each** spouse, each spouse may qualify as unmarried, provided the spouses did not live together for the last six months of the year.

FILING CHOICES FOR THE DIVORCING COUPLE

(1) Married Filing Jointly

Only legally married couples can file a joint return. The test is applied as of midnight December 31 for calendar year taxpayers (the last day of the tax year for fiscal year taxpayers). If a final divorce decree or separate maintenance order is not obtained by the end of the tax year, a joint return can be filed.

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Therefore, if they do not meet the requirement of living apart for the last six months of the year, the divorcing couple can choose either married filing jointly or married filing separate.

Generally speaking, married filing jointly will yield a lower "overall tax" for the couple. The importance of a decree of divorce or separate maintenance cannot be overemphasized. Until a divorce is "final," the best tax protection an individual can get is to obtain a legal separation order from the court. The IRS recognizes legal separation orders because they are considered to be "preparatory to the absolute dissolution of a marriage." The IRS considers an "agreement" to be only "temporary" and the dissolution of the marriage is not considered to be eminent.

Practitioner Note. Only court-approved orders or decrees can be considered when it comes to filing status.

Example 1. In the same year that Tony and Lois married, Lois moved out of the house and ceased all communications with him. For a period of 12 years, Lois moved from place to place, apparently to avoid any contact with Tony. At one point, Tony even filed a missing person report with the police to attempt to find her. He didn't file for divorce because he could not locate her and serve her with divorce papers. Tony filed his tax returns every year with a "Single" filing status. His returns were examined, and the IRS changed his "Single" filing status to the "Married Filing Separate" status.

Tony disagreed and went to tax court. The Tax Court upheld the IRS's position. Even though Tony had plenty of information to support the fact that he was abandoned, **he did not have a judicial decree or court order that altered his original marital status.** Until he obtained such a decree or order, he was required to file his returns with the marital status of "Married Filing Separate." In addition, he had to pay back taxes plus penalties plus interest, for three of the prior 12 years that he had filed single. (See *Hale v. Internal Revenue Service*, T.C. Memo 1982-527.)

Example 2. Jack and Jill were married for 10 blissful years. They were too busy with their careers during this time to have any children. In year 11 Jack decided to leave Jill. He moved out on June 15th, the day before Jill's birthday. Since Jack moved out, he has kept in contact with Jill, and they both have decided that this is going to be a friendly divorce. Therefore, neither party was in any hurry to immediately file for divorce or obtain any kind of written order from the court by December 31 of that year.

They have two choices of filing status. They can file as married filing joint return, or they can file separate returns using the married filing separate return status. Without a legal separation decree or separate maintenance order issued by December 31, they are still considered married for federal tax purposes.

Practitioner Note. To file a joint return, at least one of the taxpayers must be a U.S. citizen or resident alien at the end of the tax year. If either taxpayer is a nonresident alien at any time during the tax year, they can file a joint return only if they agree to treat the nonresident spouse as a resident of the United States. This means that the combined "world-wide income" is subject to U.S. income tax.

Signature. Both taxpayers must sign the return for it to be considered a joint return. In the throes of divorce, getting both to sign can be difficult. The various issues involved in divorce can detract from doing what is "tax best" for the married couple.

Joint and Individual Liability. The downside to married filing jointly is the concept of "joint and individual liability." Both taxpayers are individually responsible for the **total tax, penalty, and interest** assessed on a married filing joint return. This means that one spouse can be held liable for any amounts due even if the other spouse earned all the income.

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Example 3. Mike and Monica were married and filed a joint return. Mike was a self-employed motivational speaker and Monica was a nurse. They filed a joint return showing Monica's wages of $50,000 and Mike's Schedule C profit of $10,000. The IRS examined their return and determined that Mike omitted $20,000 of income on his Schedule C. The unreported income resulted in a $6,000 understatement of tax, plus penalties and interest. The IRS can collect the entire tax, penalty, and interest from **either** Mike or Monica.

Relief from Joint and Several Liability on Joint Returns (Expanded Innocent Spouse Relief). I.R.C. §6015 provides relief from the general rule that each spouse is jointly and severally liable for the taxes due on a joint tax return. In some cases, one spouse may be relieved of liability for tax, interest, and penalties for items of the other spouse that were incorrectly reported on a joint return. Relief can be requested no matter how small the liability by filing Form 8857. The provisions of IRC §6015 apply to tax liabilities arising **after July 22, 1998,** and tax liabilities arising on or before that date that **remain unpaid** as of that date. There are **three** kinds of relief available:

1. **Innocent spouse relief.** This method of relief can apply to all joint filers. Taxpayers must meet **all** of the following to qualify for innocent spouse relief:

> **Practitioner Note.** Innocent Spouse Relief applies only to deficiencies established during IRS examinations, including those initiated by service centers.

- **a.** The taxpayers filed a joint return that has an **understatement of tax** due to **erroneous items** of the spouse who is not seeking relief.
  - **i.** Understatement of tax is the excess of the amount of tax that should have been shown on the original return versus the actual tax shown on the return.
  - **ii.** Erroneous items are any items omitted from gross income and any claim of a deduction, credit, or basis, in an amount for which there is no basis of fact or law. For example,
    - A deduction claimed for an expense never paid or incurred,
    - Expenses that do not qualify as tax-deductible, such as payment of fines or payroll deposit penalties,
    - No factual argument can be made for the deduction claimed, such as claiming a $4,000 expense for security costs when the expense actually represents vet bills and foods cost of two dogs.
- **b.** At the time the spouse seeking relief signed the joint return he or she did not know, nor had a reason to know, that there was an understatement of tax.
- **c.** Taking into account all the facts and circumstances, it would be unfair to hold the spouse seeking relief liable for the understatement of tax. According to IRS Publication 971, two indicators that may be used are:
  - **i.** If the spouse seeking relief received any significant benefit from the understatement of tax
  - **ii.** The spouse seeking relief was later divorced from or deserted by his or her spouse.

> **Practitioner Note.** Innocent spouse relief does not apply to the tax shown on the joint return. See pages 424–28 in the 1999 *Farm Income Tax Book* for an example with a completed Form 8857 (Request for Innocent Spouse Relief).

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2. **Separate Liability**. This method can apply to all joint filers who are **divorced, widowed, legally separated, or have not lived together for the past twelve months.** Under this form of relief, the understatement of tax (plus interest and penalties) is allocated between the two individuals who filed a joint return. To request relief under the separate liability theory, taxpayers must have filed a joint return and met either of the following:

   a. The taxpayer seeking this relief is **no longer married to or is legally separated from** the spouse with whom he or she filed the joint return for which relief is requested. (Under this rule a taxpayer is no longer married if his or her spouse has died.)

   b. The taxpayer seeking this relief is **not** a member of the same household as the spouse with whom he or she filed the joint return **at any time** during the twelve-month period ending on the date he or she filed Form 8857.

The IRS will figure the separate liability and related penalties and interest after Form 8857 is filed with the required attachments. Taxpayers are not required to calculate this amount; however, they **can** calculate it using Worksheets provided in IRS Publication 971 (*Innocent Spouse Relief*). In short, it is a ratio of the part of the understatement generated by items attributable to the spouse requesting relief, divided by the total of all the items used to compute the understatement. For purposes of this allocation, an item giving rise to a deficiency on a joint return is allocated between the spouses in the same manner as it would have been if the spouses had filed separate returns.

Example 4. Stan and Lilly filed a **joint** 1996 tax return. Stan was an accountant with W-2 income of $50,000 and Lilly was a self-employed yoga instructor, reporting a Schedule C profit of $15,000. In September 1998, IRS examined the return and disallowed $10,000 of country club expenses deducted on Lilly's Schedule C. The entire $10,000 and related tax, penalty, and interest, is allocated to Lilly.

If an item is disallowed in its entirety solely because a separate return is filed, the disallowance is disregarded and the item is computed as if a joint return were filed, and the disallowance is then allocated appropriately between the spouses.

Example 5. Chick and Kathy timely filed a joint tax return for 1998. Chick received social security benefits of $6,000, but none of it was taxable because their total income was less than the $32,000 base amount for joint returns. In June 2000, Chick and Kathy received a deficiency notice from an IRS service center for off track gambling winnings that Chick did not report. 100% of the omitted gambling winnings are allocated to Chick.

Because of the amount of the winnings, 85% of Chick's social security became taxable ($5,100). If Chick had filed a separate return, the same $5,100 of social security benefits would have been taxable to him. However, the taxable amount of social security is an item that is taxable automatically by law based on a mathematical formula subject to different limits if one files married jointly or separately. Therefore, this item is allocated based on the "joint return rules," meaning **each** includes **half** of the $5,100 ($2,550) when calculating his or her separate tax liability.

3. **Equitable relief**. This final method of relief applies to all joint filers who do not qualify under the innocent spouse relief or separate liability theories. In order to qualify for equitable relief, a taxpayer must meet **all** of the following:

   a. The spouse seeking equitable relief is not eligible for **either** innocent spouse relief or separate liability relief.

   b. The spouses who filed the joint return did not transfer assets to one another as a part of a fraudulent scheme.

   c. The spouse seeking equitable relief did not receive assets from the other spouse for the main purpose of avoiding tax or the payment of tax.

   d. The spouse seeking equitable relief did not file the return with the intent to commit fraud.

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e. The spouse seeking equitable relief establishes that, taking into account all the facts and circumstances, it would be "unfair" to hold him or her liable for the underpayment.

Example 6. Frank and Cathy filed a joint tax return for 1998. The return showed a balance due of $10,000. Frank has constant cash flow problems because of a gambling habit. Cathy was very distraught over owing that much tax. She had the tax return reviewed by a tax preparer who advised her that the balance due was correct due to Frank's decreased withholding during 1998. It was dramatically less than previous years. Cathy accepted the explanation and signed the return on April 15, 1999.

She borrowed $5,000 from her father to pay half of the balance due. She enclosed her $5,000 check payable to the IRS with the signed 1998 joint return. Frank told Cathy he would borrow $5,000 from a bank to pay the remaining $5,000, but he failed to do so.

They were divorced in August 1999. IRS is attempting to collect the unpaid $5,000 tax, interest, and penalties from Cathy as she is employed and Frank has negative net worth. Since Cathy meets the conditions discussed in IRS Notice 98-61. She should file Form 8857 and request equitable relief.

Note. Per the facts for Example 6, IRS would very likely grant Cathy's request for equitable relief. See page 434 in the 1999 *Farm Income Tax Book* for more details on this issue.

> **Practitioner Note.** Separate liability and equitable relief applies to any tax liabilities that arose on or before **July 22, 1998** that remain **unpaid** as of that date.

(2) Married Filing Separately

The married filing separately status applies to any situation where no legal separation decree or separate maintenance order is in effect on the last day of the taxpayer's taxable year (provided that the taxpayer doesn't qualify as Head of Household–discussed later). An advantage of this status is that it can be elected without the consent or knowledge of the other spouse. The only special requirement is that the returns filed by the divorcing couple be consistent. In other words, they can't both claim the same exemptions and deductions. If one spouse itemizes, so must the other. This causes substantial procedural problems. The following chart taken from IRS Publication 504, *Divorced or Separated Individuals,* indicates itemized deductions that can be claimed on a separate return whether they are paid from one spouse's funds or from joint funds.

> **Practitioner Note.** If the taxpayers live in a community property state, these rules do not apply.

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Itemized Deduction	If you:	Then you can deduct on your separate return:
Medical expenses	Paid with funds deposited in a joint checking account in which you and your spouse have an equal interest	One-half of the total medical expenses, unless you can show that you alone paid the expenses
State income tax	File a separate state income tax return	The amount of state income tax you alone paid during the year
	File a joint state income tax return and you and your spouse are jointly and individually liable for the full amount of the state income tax	The amount of state income tax you alone paid during the year
	File a joint state income tax return and you are liable for only your own share of state income tax	The smaller of •The state income tax you paid alone during the year •The total state tax paid by you and your spouse during the year multiplied by your gross income divided by the combined gross income
Property tax	Paid on property held as tenants by the entirety	The amount of property tax that you alone paid
Mortgage interest	Paid on property held as tenants by the entirety	The amount of mortgage interest that you alone paid

Other important rules for the married filing separately status:

1. The taxpayer cannot take the credit for child and dependent care expenses in most cases
2. The taxpayer cannot take the earned income credit
3. The taxpayer cannot take the exclusion or credit for adoption expenses in most instances.
4. The taxpayer cannot take the credit for higher education expenses or the deduction for student loan interest.
5. The taxpayer cannot exclude the interest from qualified savings bonds used for higher education expenses.
6. If the taxpayer lived with his or her spouse at any time during the tax year
   - The taxpayer cannot claim the credit for the elderly or disabled.
   - The taxpayer will have to include in income up to 85% of any social security or equivalent railroad retirement benefits he or she received.
7. The taxpayer will become subject to the limit on the child tax credit, itemized deductions, and the phase out of the deduction for personal exemptions at income levels that are half of those for a joint return.
8. The taxpayer cannot convert amounts from a traditional IRA into a Roth IRA during a year for which he or she files a separate return.

Practitioner Note. Married taxpayers who file separately can amend their returns and file jointly within three years of the due date (not including extensions) of the separate returns. Married taxpayers cannot change from filing jointly to filing separately.

(3) Head of Household

A taxpayer can file as head of household only if he or she was unmarried or **considered unmarried** on the last day of his or her tax year. The taxpayer must have paid more than half the cost of keeping

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up or maintaining a home, and a **qualifying person** must have lived with the taxpayer in the home for more than half the year. The following are qualifying persons:

1. **Unmarried Children.** The taxpayer's unmarried child, grandchild, stepchild, foster child, or adopted child. The taxpayer must be able to claim an exemption deduction for a **foster child** in order for the foster child to be a qualifying person. In addition, the foster child must be a member of the taxpayer's household for the **entire year.**
2. **Married Children.** The taxpayer's married child, grandchild, stepchild, foster child, or adopted child for whom the taxpayer can claim an exemption deduction. The following exceptions apply:
   - **a.** The taxpayer allows the noncustodial parent to claim the exemption deduction, by written agreement **or**
   - **b.** The noncustodial parent provided at least $600 for the support of the dependent and claims the exemption deduction under a pre-1985 agreement.
3. **Other Relatives.** Any other relative for whom the taxpayer can claim an exemption deduction.

Practitioner Notes

1. A parent does not have to live with the taxpayer if the taxpayer paid more than half the cost of keeping up a home (including a retirement home) that was the main home of the parent for the entire year.
2. If a taxpayer can claim an exemption deduction for a person only because of a multiple support agreement, that person cannot be a qualifying person.

Married Living Apart: Considered Unmarried Rule

I.R.C. §7703(b) permits a legally married person "living apart" to file as head of household or married filing separately. There are definite advantages in doing so. There is no "must itemize" requirement as in the case of married filing separately, no cross-referencing the other spouse's social security number, and no joint and several liability feature. A taxpayer must meet the following **four** conditions in order to be **considered unmarried**:

1. He or she files a separate return.
2. He or she paid more than half the cost of keeping up his or her home for the tax year.
3. The taxpayer's spouse did not live in the taxpayer's home during the last 6 months of the year.
4. The home was, for more than **half the year,** the main home of the taxpayer's **child, stepchild, or adopted child;** or for the **entire year,** the main home for the taxpayer's **foster child.** However the taxpayer can still meet this test if he or she cannot claim an exemption deduction for the child only because
   - **a.** The taxpayer allows the noncustodial parent to claim the exemption deduction by written agreement, **or**
   - **b.** The noncustodial parent provided at least $600 for the support of the child and claims the exemption under a pre-1985 agreement.

Example 7. It is now two years since Jack (from Example 2) separated from Jill. She is living in an apartment with her one-year-old child. Jack is bitter and is not communicating or cooperating with Jill (there is yet no separation order or divorce order). Jack has been on a spending spree since the separation, buying

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sports cars, motorcycles, and a houseboat. Jack's financial position has deteriorated so much that he has had to permanently reside in the houseboat.

He "learns" from one of his "trustworthy" friends that although he has to file as married separate, he can itemize his deductions and consequently "force" Jill to itemize as well. Thrilled with his newly discovered knowledge, Jack comes to your office to have his return prepared. Usually Jack's tax information is a mess. But this year, his information is totaled and organized.

Jack's allowable itemized deductions are much larger than his standard deduction. Jack is pleased that his balance due for the current year is much smaller than in prior years. However, the fact that Jack itemizes does **not** affect Jill's return as **she is considered unmarried** under I.R.C. §7703(b). She maintained a home for more than half of the year for her child. Consequently, Jill is entitled to file as **head of household** and she does not have to itemize deductions.

Note. If Jill, itemizes, Jack is **required** to itemize also.

A person "living-apart" from his or her spouse **without** a qualifying person **must** file as married filing jointly or married filing separately.

There are other situations where an individual is "considered unmarried" under federal tax law (and, in some cases, state law as well). These situations are

1. **Legal separation decree.** This is a court decree whereby the spouses are mandated to live separately before all details of the marital dissolution process (especially the property settlement) are finalized. A legal separation is primarily sought in cases where no children are involved, or the children are now adults.
2. **Separate maintenance order.** This is the same thing as a separation decree except that minor children are involved. Usually this order is accompanied by a specific amount for spousal support as well as child support.

Practitioner Note. An **interlocutory decree of divorce** has only a temporary or provisional effect between the two divorcing parties in s**ome states.** The legal wording in such a decree may spell out issues such as legal separation, separate maintenance, child support, spousal support, property division, and so on. However, since the agreement is only **temporary** or provisional in nature, it is not considered "preparatory" to an absolute dissolution of marriage. If the agreement has the word "interlocutory" in it, it **may not** enable your client to be **considered unmarried** for federal tax purposes. State law controls.

(4) Single Filing Status

Spouses who are divorcing can avoid the "marriage penalty" by getting a court-ordered document such as a legal separation decree or separate maintenance order so that they can file as single taxpayers.

Observation. Taxpayers are penalized by married filing jointly **only** if the incomes of the two spouses are relatively equal. If one spouse has high income and the other little or no income, married filing jointly will reduce their tax liability compared to two single returns.

PERSONAL EXEMPTION DEDUCTIONS

Generally taxpayers can deduct $2,800 for each exemption in 2000. However, there are income limitations that phase out these deductions. The phase-out range is $96,700 to $157,950 for married filing separately and $193,400 to $315,900 for married filing jointly. For taxpayers with income that exceeds

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the top of the range, the deduction for an exemption is not an issue. The discussion in this section assumes that the taxpayer's income is below the bottom of the range and is able to take full advantage of the deduction for exemptions.

A taxpayer is allowed to claim a personal exemption deduction for the following:

1. The taxpayer (on a joint return, each taxpayer claims himself or herself)
2. The taxpayer's **spouse** if
   a. The taxpayer and his or her spouse do not file a joint tax return.
   b. The taxpayer's spouse has no gross income.
   c. The taxpayer's spouse cannot be claimed as a dependent of another taxpayer.
3. Each **dependent**

CLAIMING A CHILD AS A DEPENDENT

In many divorces, children are involved. This section focuses on the exemptions for them. The child must meet five tests to be claimed as a dependent.

(1) Member of Household or Relationship Test

To meet this test, the child must either:

a. Be related to the taxpayer or
b. Live with the taxpayer for the **entire year** as a member of the taxpayer's household

Related to the Taxpayer. The following individuals are considered as automatically meeting the "related to the taxpayer" portion of the test.

Child	Half-Brother	Son-in-law
Stepchild	Half-Sister	Daughter-in-law
Mother	Stepbrother	If related by blood:
Father	Stepsister	Uncle
Grandparent	Stepmother	Aunt
Great-Grandparent	Stepfather	Nephew
Brother	Mother-in-law	Niece
Sister	Father-in-law	
Grandchild	Brother-in-law	
Great-Grandchild	Sister-in-law	

Practitioner Note. Any relationship that has been established by marriage is not considered to have ended by death or divorce. See the following example.

Example 8. Jill was married to George. By a previous marriage, Jill had a son, Justin, whose father had died. George and Jill divorced five years ago. Once Justin graduated from high school, he moved in with George. Justin will still qualify as a dependent who is related to George since he was originally a **stepson** in a previous marriage.

Member of the Household. To qualify as a member of the taxpayer's household, the person who is **not** related to the taxpayer must have lived in the taxpayer's home for the **entire year** (except for temporary absences such as vacation or school). A person is not a member of the taxpayer's household if at any time during the tax year the relationship between the taxpayer and that person violates local law.

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Example 9. Henry and Kathy have one child, a 17-year-old daughter, Betty. The parents of Betty's best friend, Wilma, move out of the area in February 1999. Because it will be her senior year in the fall, Wilma comes to live with Henry and Kathy. She resides with them except for breaks in school, when she returns to her parents' new home. Henry and Kathy provide all the support for Wilma while she is with them. They **cannot** claim Wilma as a dependent for 1999 as she did **not live with them for the entire year.**

(2) Citizenship Test

To meet this test, the person must be a U.S. citizen or resident alien, or a resident of Canada or Mexico for some part of the calendar year in which the tax year begins.

Children usually are citizens or residents of the country of their parents. If the taxpayer was a U.S. citizen when his or her child was born, the child may be a U.S. citizen although the other parent was a nonresident alien and the child was born in a foreign country.

(3) Joint Return Test

Even if all the other exemption tests are met, a taxpayer cannot claim an exemption for anyone who files a joint return. However, this test does not apply if the dependent and his or her spouse file a joint return merely as a claim for refund, and no tax liability would exist for either spouse on a separate return.

(4) Gross Income Test

A taxpayer cannot claim an exemption for a person as a dependent if the person had gross income of $2,800 or more for 2000. Gross income in this case does not include nontaxable sources such as welfare benefits or nontaxable social security.

Special Rules for the Taxpayer's Children. The gross income test does not apply to a child if

- **a.** The child is under age 19 at the end of the year, **or**
- **b.** The child is a student during the year and is under age 24 at the end of the year.

Definition of a Student. During some part of **each of 5 calendar months** during the year (not necessarily consecutive), the person must be

- **a.** A full-time student at a school that has regular teaching staff and course of study, and a regularly enrolled body of students in attendance, **or**
- **b.** A student taking a full-time, on-farm training course given by a school described in (1) above, or a state, county, or local government

Practitioner Note. A full-time student is a person who is enrolled for the number of hours or courses the school considers to be full-time attendance. The term "school" includes elementary schools, junior and senior high schools, colleges, universities, and technical, trade, and mechanical schools. It does not include on-the-job training, correspondence schools, and night schools.

(5) Support Test

The taxpayer must provide more than half of a person's **total support** for the calendar year to meet the support test.

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EXEMPTION DEDUCTION FOR CHILDREN OF DIVORCING PARENTS

The exemption for a dependent child is all or nothing. There is no allocation of the exemption between divorcing parents; one or the other is entitled to claim the deduction, never both.

Determining whether a parent is allowed to claim the child as a dependent involves the understanding of the use of several terms. The term "**support**" pertains to financial care and welfare, whereas "**custody**" pertains to the actual physical housing and guidance. When one parent has physical custody and provides the entire support of a dependent child, clearly there is no question as to who is entitled to claim the exemption. The more common situation is to have a mix of support and custody between the parents.

Support. The parent, who pays **more than 50%** of the **total support** of a child for the calendar year, is entitled to the exemption deduction for that child.

Treasury Regulation §1.152-1(a)(2)(i)–Definition of total support:

> For purposes of determining whether or not an individual received, for a given calendar year, over half of his support from the taxpayer, there shall be taken into account the amount of support received from the taxpayer as compared to the entire amount of support which the individual received from all sources, including support which the individual himself supplied. The term "support" includes food, shelter, clothing, medical and dental care, education, and the like. Generally the amount of an item of support will be the amount of expense incurred by the one furnishing such items. If the item of support furnished to an individual is in the form of property or lodging, it will be necessary to measure the amount of such items of support in terms of its fair market value.

In other words, any expenditure actually made for the health, welfare, rearing, or development of a child into adulthood is considered support. Support includes all expenses (that are not illegal or extravagant) for children. What is deemed extravagant is based upon the financial capabilities of the parents.

Normally in a divorce situation, one of the child's parents is required to pay "support" to the other. All amounts paid for child support under a court order or divorce decree are treated for tax purposes as support payments. This is so regardless of how much money is actually spent for the child. The paying parent needs to prove only that he or she actually made the support payments on time and does not need to keep track of items of support incurred.

Practitioner Note. Payments for support **arrearages** are not considered support payments for tax purposes. Arrearages are considered "reimbursements" to the receiving spouse for support expenses previously incurred.

If the parent paying the court-ordered amount pays more than that amount, he or she must be able to specifically identify each item of support (example: receipts for Christmas gifts).

Total Support. As defined in the regulations, total support includes expenses incurred by others for the health, welfare, etc. of a child. It is not uncommon for a grandparent, aunt, uncle, or another third party (divorcing spouse's boyfriend or girlfriend), to contribute to the support of the child. This could be in the form of purchasing a particular toy, clothing, or even taking the child out for dinner. The point is that other individuals in addition to the natural parents also contribute to the "total support."

Where there are multiple contributors to the total support of a child, the person who actually pays more than 50% of the total support is the person entitled to the dependency exemption for the child. Unless the person paying support for the child is required to do so under a court order or divorce decree, he or she must be able to prove the amount of the expenditure and its purpose. In other words,

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the taxpayer must keep records on what was actually spent on the child in any given calendar year. The following example and table illustrate these points:

Example 10. Pat's parents are divorced, and he lives primarily with his mother. Pat's mother paid $2,600 for food consumed at home and $7,200 for other expenses for maintaining her home. One-half of these expenses are allocated to Pat's support. During this year, Pat wants to learn to play the guitar and begins to take lessons. He withdraws $200 from his savings account to buy a guitar. Also during the year, his grandparents took him on vacation and purchased some clothing for him. Pat's father is obligated, via a court order, to pay his mother $600 in monthly support. In the previous year, Pat's father failed to pay two months support payments and instead paid them this year. The following table summarizes these and other facts:

	Support Item	Paid by Dad	Paid by Mom	Paid by Grandparent	Paid by Child	Totals
1	Required Court Payment	$7,200				$7,200
2	Food	$510	$1,300			$1,810
3	Clothing	$200	$500	$125		$825
4	Medical		$100			$100
5	Educational		$25			$25
6	Housing-FMV		$3,600			$3,600
7	Furnishings		$15			$15
8	Utilities		$800			$800
9	Maintenance		$20			$20
10	Insurance		$75			$75
11	Transportation	$910	$1,200			$2,110
12	Recreation		$50		$200	$250
13	Vacation	$200		$300		$500
14	Religious		$50			$50
15	Miscellaneous		$100	$200		$300
	TOTALS	$9,020	$7,835	$625	$200	$17,680
	PERCENTAGES	51.02%	44.32%	3.54%	1.12%	100%

The table above illustrates several things. First, it should be noted who has to prove what. The father only needs to provide proof that he made the required support payments in order to be credited with the full $7,200. He must have other receipts to verify anything he did for Pat that was above and beyond the actual support payments to his mother. Pat's mother and grandparents must identify and prove any item of support they can claim to have paid over and above the support payments received.

The table also illustrates that part of Pat's "total support" can come from someone other than his parents. It also shows that support is not limited to certain expenditures, but that it is "all encompassing."

Practitioner Note. Note that the father's payment of the arrearage does not count in his column.

In this example, the father would be entitled to the dependency exemption for Pat since he paid more than 50% toward his **total support**. The mother would be entitled to file as "head of household" provided she did not live with Pat's father the last six months of the year and **maintained the household** where she and Pat lived.

Maintaining a Household. The next critical points are, what does maintaining a household mean for federal tax purposes, and what costs are considered part of it? In order to use the filing status of "Head of Household" one must maintain a household. This "maintaining" requirement is set out in I.R.C.

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§2(b): Definition of Head of Household. It states that an individual who is not married at the close of the taxable year and who maintains a home for more than half of the year, and it is the principle home of a child–[a son, stepson, daughter, or stepdaughter, or a descendant of a son or daughter of the taxpayer], can file as head of household.

The regulations under this section state that paying more than 50% of the cost of a household constitutes maintaining a household. Treas. Reg. §1.2-2(d) identifies what costs can be considered:

> The expenses of maintaining a household include property taxes, mortgage interest, rent, utility charges, upkeep and repairs, property insurance, and food consumed on the premises. Such expenses do not include the cost of clothing, education, medical treatment, vacations, life insurance, and transportation . . . or the value of services rendered in the household by the taxpayer or by a person qualifying the taxpayer as a head of household.

A problem in accounting for these costs is the allocation of them to the occupants of the household. This must be done to determine the "total support" of a dependent child. The solution is to simply list all the costs of maintaining the entire household and **total** them. Then **divide** each item and the total by the **number of occupants.** Then transfer this information to the previous chart where the "total support" from all sources for a dependent was computed.

Example 11. If the total cost of maintaining a household for a year was $12,000 and there were four occupants (a mother, stepfather, son, and a daughter), each occupant's share of household costs would equal $3,000. Provided that the mother paid at least $6,001 of these costs, she will be considered as "maintaining the household." It is important to note that if the mother has remarried, any support provided by the stepfather is treated as provided by the mother.

"**Total support**" and "**maintaining a household**" are two separate tests. Even if the taxpayer provides more than 50% of the cost of maintaining a household, he or she may not provide more than 50% of the total support of a dependent child.

Example 12. In Example 10, Pat's mother provides over 50% of the cost of maintaining her home and can claim head of household status. Pat's father pays over half of Pat's support and can claim him as a dependent.

Custodial Parent Presumption. For decrees entered **after 1984,** the custodial parent is **"presumed"** to have paid over half the total support of a dependent child. I.R.C. §152(e)(1) states:

Except as otherwise provided in this subsection, if

A. A child receives over **half** of his support during the calendar year **from his parents**–

- **i** Who are divorced or legally separated under a decree of divorce or separate maintenance,
- **ii.** Who are separated under a written separation agreement, or
- **iii.** Who live apart at all times during the last six months of the calendar year, and

B. Such child is in the **custody** of one or both of his parents for **more than half** of the calendar year, such child shall be treated, for purposes of subsection (a), as receiving over half of his support during the calendar year from the parent having custody for a greater portion of the calendar year.

It is important to note that this code section **does not require** that the custodial parent have custody for at least six months, but **only the greater portion** of the year.

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Example 13. The mother has custody of a child for three months. The father has the child for a total of four months. The balance of the year, the child was in the custody of her grandparents. During each period, the "custodial person" fully supported the child.

Question. Who is entitled to the dependency exemption?

Answer. In this case, the father is. During seven months of the year, both parents paid more than half of the child's total support. Also the child was in the custody of both parents for the greater portion of the year (seven months). The parent having custody for the **greater portion** of the year (four months in this case) is entitled to the dependency exemption for the child.

The essence of I.R.C. §152(e)(1) is that if both parents (in their combined efforts) provide support and a home for a child for more than six months of the year, the parent who does so for more than 50% of the combined time and support is entitled to the dependency exemption for the child.

Release of Claim to Exemption for a Child of Divorced or Separated Parents (Form 8332). I.R.C. §152(e)(2) allows the noncustodial parent to be treated as providing over half of a child's support if the custodial parent signs a statement releasing the dependency exemption of a child to the noncustodial parent. The noncustodial parent needs to attach the statement to his or her return.

To deal with such situations, the IRS created **Form 8332,** Release of Claim to Exemption for a Child of Divorced or Separated Parents. The form is to be attached to the return of the **noncustodial** parent. The form is designed to allow the **custodial** parent to **release** the exemption deduction of a child for the current year (Part I), a period of years, or for all future years (Part II). For each year that the noncustodial parent claims the child, this form must be attached. Should the custodial parent release the exemption for a period of years or all future years, IRS Publication 504 states that the original form should be attached to the first year, and then a copy of the form for each year thereafter.

Practitioner Note. A Form 8332 releasing the exemptions for all remaining years may be revoked if both parents agree. A written, signed agreement by both parents is required.

Practitioner Note. If the divorce decree or separation of maintenance is entered into **after 1984,** and it states that the noncustodial parent can claim the child **without regard to any condition**, such as payment of support, attach a copy of the following pages from the decree or agreement **instead** of Form 8332:

1. The cover page—write the other parent's social security number on this page.
2. The page that states you can claim the exemption for your child
3. The signature page with the other parent's signature and the date of agreement

Obtaining the Signature of the Custodial Parent. The burden is on the noncustodial parent to have the custodial parent sign and return Form 8832. If the custodial parent refuses to release the exemption by signing Form 8332, the noncustodial parent has no recourse. The determination of custody by the courts is a key factor in who is entitled to the exemptions of children of divorced parents. If the **actual** custody of a child changes from the custodial to the noncustodial parent, it is important that the state court amend the original divorce decree via a court order. See the ***Noah*** Tax Court Memo case (TCM 1998-384, 76 TCM 738) discussed on page 612 in the 1999 *Farm Income Tax Book* for details.

Other Important Reasons to Claim the Child as a Dependent. There are a number of reasons other than the dependency exemption for claiming a child as a dependent. The following is a summary of credits directly affected by the dependency exemption for a child:

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1. *Child Care Credit*–This credit is allowed only to the parent who had custody for the greater part of the year, regardless of who gets the dependency exemption for the child.
2. *Earned Income Credit*–This credit is allowed only to the custodial parent, regardless of who gets the dependency exemption for the child.
3. *Child Tax Credit*–The parent who claims the child as a dependent is entitled to this credit.
4. *Hope Scholarship Credit*–The parent who claims the child as a dependent is entitled to this credit.
5. *Lifetime Learning Credit*–The parent who claims the child as a dependent is entitled to this credit.

Note. See page 375 in the 1999 *Farm Income Tax Book* for other child exemption issues.

ALIMONY

A divorce may result in both a property settlement and alimony payments. Alimony is covered in I.R.C. §71–requiring alimony to be included in income, and I.R.C. §215–allowing alimony to be deducted. The following discussion is limited to divorce instruments entered into **after 1984.** Divorce decrees entered into prior to 1985 are governed by a different set of rules that are not covered here.

ALIMONY AS INCOME

Alimony is a payment to or for a spouse or former spouse under a divorce decree or separate maintenance agreement. I.R.C. §71 and regulations under it make the following important points:

1. Alimony is includible in gross income of the recipient.
2. No payments are treated as alimony if the spouses file a joint return.
3. Payment of alimony must be made in the form of cash. Cash includes checks and all other property that is generally considered to be the equivalent of cash.
4. "Interlocutory" or temporary agreements to pay, **prior** to the issuance of the **final** divorce decree, are treated as alimony. The only requirement is that these agreements be in writing. The agreements do not have to be an order issued by the court. Consequently, an agreement that includes "**alimony pendente lite**" will suffice.
5. Additional requirements found in Treas. Reg. §1.71(b)(1) state that alimony payments must be **periodic,** whether or not made at regular intervals, to be includible in gross income.
6. Payments are not treated as alimony if the spouses live together in the same household **while legally separated under a divorce decree or separation agreement.** A dwelling unit formerly shared by both spouses is not considered two separate households [Temp. Reg. §1.71-1T(b), Q&A-9].

Example 14. Danny and Margaret are in the process of getting divorced but are still residing in the same home. They are legally separated under a separate maintenance order requiring Danny to pay Margaret $1,000 per month in alimony. They do not have any children and the document is clear in identifying the payment as alimony. They jointly own a split-level house. The agreement was issued on July 4, 2000. Immediately on returning home from her lawyers, Margaret had all the locks on the upper level changed so Danny could not access them.

Each had separate entrances to the area of the house he or she occupied. Danny began his search for an apartment to rent, on December 4, 2000, he moved into new quarters. The payments from July 4, 2000 to December 4, 2000, are **not** includible in Margaret's income as alimony, or deductible as alimony by Danny (reference IRS Publication 504).

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Practitioner Note. Payments under a written separation agreement that is **not** incident to a decree of divorce or separate maintenance can be treated as alimony even if they are paid while the spouses are living in the same household. *Benham v. Commissioner*, T.C. Memo 2000-165.

7. If the payments specified in the agreement are **clearly identified that they are not to be considered alimony**, that agreement is effective for federal income tax purposes.

Observation. This provision gives divorcing parties a chance to effectively manage the tax costs of alimony if **the payer spouse is in a lower tax bracket than the payee spouse.** This can be accomplished if the parties can be convinced to view themselves as one economic unit.

8. To be treated as alimony, **the obligation to pay must terminate upon death** of the payee. There can be no obligation to pay, third parties, or to pay into a trust beyond the date of the payee's death.

Example 15. Julie and Bill are divorced in October of 1999. They have one daughter, age 8, who lives with Bill. The divorce decree states that Julie must pay Bill $30,000 per year for alimony for at least six years. The alimony payments stop upon the death of Bill or after the sixth year. The decree states that in the event Bill dies before the sixth year and their daughter is still living, Julie must pay $10,000 annually into a trust for their daughter until she reaches the age of majority. The trust income and corpus is to be used for the benefit of their daughter.

The additional payment requirement of the $10,000 after the death of Bill **implies** that the $30,000 annual payment made while Bill is alive includes the $10,000. Therefore, of the $30,000 paid each year to Bill, Julie can deduct only $20,000 as alimony and Bill only reports $20,000 of alimony income.

Example 16. Craig and Alice divorce in January of 2000. Alice agreed to pay Craig $500 per month ($6,000 annually) in alimony for 15 years or until the death of Craig. The divorce settlement includes a clause that requires Alice to pay the unpaid balance to Craig's estate in the event of Craig's death. If Craig were to die after 10 years, $30,000 ($6,000 × 15 years minus $6,000 × 10 years) would be payable to his estate. These facts indicate that the lump-sum payment to be made to Craig's estate is a substitute for the full annual requirement of $6,000 per year. Therefore, **none** of Julie's $6,000 annual payment to Craig is considered alimony.

9. **Periodic payments received from property transferred, in trust or otherwise, after a decree of divorce or of separate maintenance.** These payments are includible in the income of the spouse who receives the payments in the same manner as the income would have been taxed to the spouse who created the trust if the payments were not in satisfaction of an alimony obligation (I.R.C. §682).

Example 17. In order to meet an alimony or separate maintenance obligation of $500 per month, Peter purchases for the benefit of his wife, Sarah, a commercial annuity contract paying that amount. Sarah must report the **income portion** of each $500 payment as her income. Peter reports no income and gets no deduction. If the amount of alimony is to be reduced for contingencies involving children, then the amount of reduction will be treated as child support and not alimony.

10. Other miscellaneous payments that are not alimony include:
    a. Amounts paid for property settlement
    b. Payments for the upkeep of the payer's property
    c. Use of the payer's property

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Example 18. Richard and Carol were married for 30 years. After raising their family, Carol filed for divorce. A separate maintenance order was granted ordering Richard to pay Carol $700 per month in spousal support. In addition, the order allows Carol the right to live in their jointly owned house rent-free for a period of 5 years. Richard can deduct the actual cash payment of $700 per month, as alimony, and Carol must include a similar amount in income. The "economic loss" of the fair rental value of the jointly owned house is not considered alimony. However, see the following chart for required payment of home expenses by one spouse for the benefit of the other.

If you must pay all of the...	AND your home is...	THEN you can deduct and your spouse (or former spouse) must include as alimony	AND you can claim as an itemized deduction...
Mortgage payments (principal and interest)	Jointly owned	One-half of the total payments	One-half of the interest as interest expense (if the home is a qualified home)
Real estate taxes and home insurance	Held as tenants in common	One-half of the total payments	One-half of the real estate taxes and none of the home insurance
	Held as tenants by the entirety or in joint tenancy	None of the payments	All of the real estate taxes and none of the home insurance

ALIMONY DEDUCTION

I.R.C. §215 is the governing source pertaining to alimony deductions. However, this section refers to I.R.C. §71 for the definition of alimony. Some important points about claiming the deduction are as follows:

1. I.R.C. §215 allows an "individual" to deduct alimony payments made during the individual's tax year. The word "individual" has two important implications. First it is meant to mean either husband or wife, and secondly it clearly is intended to eliminate payments from nonhuman sources such as trusts, corporations, brokerage firms, insurance companies and the like as being deductible. **Therefore, payments must be made directly by the individual required to do so under the alimony agreement in order to be deductible.**

Example 19. Steve has been married to Beth for 10 years. Beth files for divorce on February 14, 2000. Steve is a self-employed contractor and a very prudent investor. Beth secures a separate maintenance order requiring Steve to pay her $1,500 per month for 10 years. If Steve allows a third party transferee such as an insurance company to issue the monthly $1,500 checks to Beth, the payments are **not deductible by him** as alimony. However, the payments **are includable by Beth** as taxable alimony.

2. The recipient of alimony is required to give the person who paid the alimony his or her social security number; otherwise they could be subject to a $50 penalty. The person paying alimony is required to identify the recipient's name and taxpayer identification number. Failure on the part of the payor to do this could result in the assessment of a $50 penalty.
3. Payments for child support are not alimony, and any shortfall in payments is taken out of alimony first.

Example 20. On January 3, 2000, a decree of divorce or separate maintenance requires that Bill pay Hilda a total of $600 per month, beginning January 15th and every month thereafter. Of this payment, $400 per month is **clearly designated** as child support, and $200 a month as alimony. Only the $200 per month is alimony income to Hilda and deductible by Bill. If Bill falls behind in his payments and

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pays only $400 per month, the full $400 is treated as child support and Bill gets no alimony deduction for that $400 payment.

4. Payments made directly to third parties on behalf of the payee spouse can qualify as alimony if they are made under the terms of a divorce or separate maintenance instrument or if they are made as a result of a request from the payee spouse **and** all of the following requirements are met:

a. The payments are in lieu of payments of alimony directly to the spouse.

b. The written request states that both spouses intend the payments to be treated as alimony.

c. The spouse receiving the alimony submits a written request to the payor before the payor files his or her return for the year in which the payments are made.

Payments made on behalf of the spouse for medical expenses, housing costs, rent, taxes, or tuition are examples of payments that qualify for alimony if the above requirements are met. **The payments are treated as received by the payee spouse when paid to the third party.** The payee spouse is treated as making the payment to the third party.

Example 21. Under a divorce decree, Claudia must pay her former spouse's medical and dental expenses. If the payments otherwise qualify (terminate upon death of the spouse, etc.) then Claudia can deduct these payments as alimony.

Practitioner Note. If an individual is required to pay alimony and has "nontaxable" sources of income and the alimony is paid from these nontaxable sources, the payee is **not** entitled to an alimony deduction. Similarly, the payments are not includible as income of the recipient (Rev. Rul. 62-187).

Life Insurance Premiums. Alimony can include payments made under the divorce decree or separation agreement for insurance on the payor spouse's life. These qualify as alimony so long as the payee spouse is the owner of the policy.

RECAPTURE OF ALIMONY

If the alimony payments decrease or terminate during the first three calendar years, the taxpayers may be subject to the recapture rule. If this rule applies, the payor must include alimony payments that were deducted years one and/or two in year three income. The payee spouse can deduct those year one and two payments from his or her year three income.

The three-year period starts with the first calendar year the payor spouse makes a payment qualifying as alimony. The second and third years are the next two calendar years, whether or not payments are made during those years. The reduction or termination of alimony payments could be a result of the original divorce or separation instrument. Other reasons for a reduction or termination of alimony payments that can require a recapture include:

1. A change in the divorce or separation instrument
2. A failure to make timely payments
3. A reduction in the payor's ability to provide support
4. A reduction in the payee's support needs

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When to Apply the Recapture Rule. The taxpayer is subject to the recapture rule in the third year if the alimony paid in **either** the second year or the third year **decreases by more than $15,000 from the prior year.** When calculating the decrease in alimony, do not include the following amounts:

1. Payments made under a temporary **support** order
2. Payments required over a period of at least 3 calendar years of a fixed part of your income from a business or property, or from compensation for employment or self-employment
3. Payments that decrease because of the death of either spouse or the remarriage of the spouse receiving the payments

Example 22. Donald Walden is required under his 1998 divorce decree to pay the ex-wife one lump sum alimony payment of $50,000 in 1998. No further payments are required. Following are the tax results for 1998–2000.

1998. Donald may deduct the full $50,000 as alimony and the ex-wife must include $50,000 as alimony income.

1999. No payments were required to be made and no alimony is required to be recaptured.

2000. Since 2000 is the third post separation year, **$35,000 is recaptured.** The amount recaptured is required to be included in Donald's income and is deductible by his ex-wife. The recapture amount is computed on the worksheet below.

Worksheet for Recapture of Alimony

Note. Do not enter less than zero on any line

1	Alimony paid in **2nd Year**		-0-	
2	Alimony paid in **3rd Year**	-0-		
3	Floor	$15,000		
4	Add lines 2 and 3		$15,000	
5	Subtract line 4 from line 1			-0-
6	Alimony paid in **1st Year**		50,000	
7	Adjusted alimony paid in **2nd Year** (line 1 less line 5)	-0-		
8	Alimony paid in **3rd Year**	-0-		
9	Add lines 7 and 8	-0-		
10	Divide line 9 by 2	-0-		
11	Floor	15,000		
12	Add lines 10 and 11		15,000	
13	Subtract line 12 from line 6			$35,000
14	**Recaptured alimony.** Add lines 5 and 13			**$35,000**

Donald reports the $35,000 alimony recapture on his 2000 Form 1040 (partially completed) which follows.

Income	7	Wages, salaries, tips, etc. Attach Form(s) W-2	7	
Attach Forms W-2 and W-2G here. Also attach Form(s) 1099-R if tax was	8a	**Taxable** interest. Attach Schedule B if required	8a	
	b	**Tax-exempt** interest. **Do not** include on line 8a [8b]		
	9	Ordinary dividends. Attach Schedule B if required	9	
	10	Taxable refunds, credits, or offsets of state and local income taxes (see page 22)	10	
	11	Alimony received recapture Walden 123 00 7654	11	35,000
	12	Business income or (loss). Attach Schedule C or C-EZ	12	

Including the Recapture in Income. Show the amount of alimony to be recaptured on line 11 of Form 1040 (Alimony Received). Cross out "received" and write, "recapture." On the dotted line next to the amount, enter the spouse's last name and social security number.

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Deducting the Recapture Amount. Show the amount of alimony to be recaptured on Form 1040, line 31a (Alimony Paid). Cross out "paid" and write, "recapture." In the space provided, enter the spouse's last name and social security number.

PROPERTY SETTLEMENTS

A property settlement is the division of the marital estate. This transfer of property from one spouse to the other is necessary to terminate the other spouse's rights to the property. The general rule is that no gain or loss is recognized on the transfer of property between spouses, or former spouses, if the transfer is incident to a divorce. If spouses sell property that is owned jointly to split the proceeds as part of their property settlement, each must report his or her share of the gain or loss on the sale.

Transfers between Spouses

No gain or loss is recognized on the transfer of property between spouses as part of the property settlement provided it was incident to the divorce. This rule applies even if the transfer was in exchange for cash, the release of marital rights, the assumption of liabilities, or other considerations. However this rule does not apply if the spouse who receives the property is a nonresident alien. Nor does it apply to certain transfers to a trust.

The term property includes all property whether real or personal; tangible or intangible; separate or community. It includes property acquired after the end of the marriage and transferred to a former spouse. It does not include services.

Example 23. Art transfers his interest in a medical savings account to his former spouse Bea under a divorce instrument. The transfer is not considered a taxable transfer. After the transfer, the account is treated as Bea's medical savings account.

Incident to a Divorce. A property transfer is considered incident to a divorce if the transfer:

1. Occurs **within one year** after the date the marriage ends
2. Is related to the ending of the marriage. To be related to the ending of the marriage, both of the following conditions must apply:
   a. The transfer is made under the original or modified divorce or separation instrument.
   b. The transfer occurs **within 6 years after** the date the marriage ends.

Unless the transfer takes place within this time frame, it is assumed that the transfer is not related to the end of the marriage. However, this presumption can be overridden if the taxpayer can establish that the transfer outside of this window was because of legal or business factors that prevented the transfer within the allowable time frame **and** the transfer took place shortly after the factors were resolved.

The additional six-year period was provided to avoid inflicting unwanted hardships on either party by forcing them to sell assets prematurely. Therefore, the IRS will very carefully scrutinize a claim for relief for a transfer outside the window. Transfers that are not incident to a divorce are considered gifts, and may consequently require the filing of a gift tax return.

Record Keeping Requirement. **I.R.C. §1041 and the related regulations require the transferor to provide sufficient records to enable the spouse receiving the property or interest to determine his or her adjusted basis and holding period on the date of transfer.** For example, if a taxpayer transferred investment credit property, he or she must provide sufficient records to determine the amount and period of recapture. The basis and holding period in the property received is the same as the transferor's basis. This applies for determining either gain or loss when the property is transferred later. It applies whether the basis of the property is less than, equal to, or greater than either its

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value at the time of the transfer or any consideration that was paid. It also applies even if the property's liabilities exceed its adjusted basis.

This rule applies to all property received after July 18, 1984, under a divorce or separation instrument in effect after that date. It also applies to all other property received after 1983 for which a taxpayer and his or her spouse made an I.R.C. §1041 election to apply this rule.

If property was transferred into a trust for the benefit of the spouse or former spouse and recognized gain on the transfer, then the basis to the transferee is increased by the amount of gain recognized.

In this situation, the burden is clearly upon the transferee upon disposition to prove adjusted basis and holding period. Obviously, if the transferee cannot verify adjusted basis and holding period, then the IRS will assume the worst and not allow any basis and will assume a holding period equal to the difference between the time of transfer and the date of disposition.

QUALIFIED DOMESTIC RELATIONS ORDER

A qualified domestic relations order (QDRO) is a judgment, decree, or court order (including an approved property settlement agreement) issued under a domestic relations law that satisfies all of the following:

1. Relates to the rights of someone other than a participant to receive benefits from a qualified retirement plan (such as most pension and profit-sharing plans) or a tax-sheltered annuity
2. Relates to payment of child support, alimony, or marital property rights to a spouse, or former spouse, child, or other dependent of the participant
3. Specifies the amount or portion of the participant's benefits to be paid to the participant's spouse, former spouse, child, or dependent

Benefits Paid to a Child or Dependent. Benefits paid under a QDRO to the plan participant's child or dependent are treated as paid to the participant.

Benefits Paid to a Spouse or Former Spouse. Benefits paid under a QDRO to the plan participant's spouse or former spouse generally must be included in the spouse's or former spouse's income. If the participant contributed to the retirement plan, a prorated share of the participant's cost is used to figure the taxable amount. The spouse or former spouse can use the special rules for lump-sum distributions if the benefits would have been treated as a lump-sum distribution had the participant received them. The most popular way of handling a distribution is a direct rollover to another qualified plan or individual retirement account. Generally this method defers the taxation of the funds until withdrawn by the spouse.

COST INCURRED TO GET A DIVORCE

Legal fees and court costs incurred in getting a divorce **cannot** be deducted. However, **legal fees paid for tax advice regarding the divorce and obtaining alimony may be deductible.** In addition, fees paid to appraisers, actuaries, and accountants for services in determining your correct tax or in helping get alimony may be deductible. The important thing to note is that t**he fees must be identified separately** in the bill. The taxpayer cannot "allocate" the total cost of the divorce to tax issues. **The amount and tax issue must be specifically identified in the bill.**

Example 24. The following billing descriptions illustrate the type of precise wording necessary to deduct the cost of services performed relative to a divorce.

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1. Analysis of Separate Maintenance Order to determine deductibility of payments made on behalf of the estranged spouse for income tax purposes
2. Review of Child Support Order to determine whether the child qualifies as a dependent and whether a waiver to release the dependent is required (Form 8332)
3. Review of the marital assets for tax consequences upon subsequent liquidation
4. Review of the marital assets proposed in the property settlement agreement to determine whether the ex-spouse has provided adequate basis information for income tax purposes
5. Planning regarding structuring the payment of alimony to ensure deductibility for income tax purposes
6. Analysis to determine the tax cost of receiving alimony
7. Appraisal cost incurred in conjunction with the determination of taxable gain on the liquidation of property received in a marital settlement
8. Expert witness fees for testimony regarding the tax cost of property settlement, alimony, or child support

These qualified fees are deductible on Schedule A (Form 1040) as miscellaneous deductions, subject to the 2% of adjusted gross income floor.

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