

Chapter 1: Divorce

Introduction 1	Sale of Personal Residence 18
What Constitutes a Marriage..... 1	Transfer of Other Assets..... 19
Income Tax Considerations 3	Retirement Accounts..... 22
Dependency 8	Allocations..... 23
Property Settlements 9	Amended Returns..... 28
Alimony 11	Special Treatment of Community Property Laws... 28

Corrections were made to this workbook through January of 2007. No subsequent modifications were made.

INTRODUCTION

The annual divorce rate in the United States is declining, but at a relatively slow rate. It is currently estimated that 40% or more of all marriages will end in divorce. This number is down from 50% a few years ago. It is likely most tax professionals will prepare a tax return of a divorced individual.

Jay L. Zagorsky, Sociology Researcher at The Ohio State University, reports in his recent study of 9,000 people that divorce reduces a person’s wealth by approximately 77% when compared to a single person. He also found that marriage almost doubles (93%) comparative wealth. In addition, he found a person’s wealth begins to decline long before the divorce becomes final.¹ Zagorsky found the change in wealth was a function of more than the split of assets resulting from the divorce.

While the divorce is technically between the two separating spouses, there is a third party to the divorce. Without proper planning, that party may take a large share of the marital assets. That party is the Internal Revenue Service.

On the surface, property transfers between spouses caused by a divorce are income tax free.² The taxability issue arises when the transferred property is liquidated. This and other taxation issues are discussed in this chapter.

Once the decision is made to divorce, financial decisions should be made with the same diligence given to ending a business venture. This means removing emotions from the property settlement. As discussed later, an equal settlement is not necessarily an equitable settlement.

WHAT CONSTITUTES A MARRIAGE

LEGAL VERSUS COMMON LAW

Whether a marriage is recognized for tax purposes depends on state law. If taxpayers are married in compliance with the laws of the state in which they were married, then the marriage is recognized for tax purposes, even if they later reside in another state.³

¹ Jay L. Zagorsky, *Marriage and Divorce’s Impact on Wealth*; *Journal of Sociology*, © 2005 The Australian Sociological Association, Volume 41(4):406–424, December 2005

² IRC §1041(a)

³ Rev. Rule 58-66, January 1, 1958

2006 Workbook

Taxpayers are not considered married if they enter into a marriage that is void under applicable state law. However, in one case, taxpayers who were married in Fiji but failed to establish that their marriage was void under the laws of Fiji, or under the laws of New Jersey where they resided, were not entitled to file as nonmarried individuals.⁴ If local law recognizes common-law marriage, taxpayers with a common-law marriage are considered married for tax purposes, even if they later move to a state that does not recognize common-law marriage.

Black's Law Dictionary defines common-law marriage as:

Generally a non-ceremonial relationship that requires "a positive mutual agreement, permanent and exclusive of all others, to enter into a marriage relationship, cohabitation sufficient to warrant a fulfillment of necessary relationship of man and wife, and an assumption of marital duties and obligations."

The general elements found in determining whether there is a common-law marriage are: "Cohabitation and holding out." Holding out entails the couple telling the world that they are husband and wife through their conduct, such as the woman's assumption of the man's surname, filing a joint federal return, and so on. That means that mere cohabitation can never, by itself, rise to the level of constituting a marriage.⁵

The U.S. Constitution requires that every state accord "full faith and credit" to the laws of its sister states. Therefore, a common-law marriage that is validly contracted in a state where such marriages are legal are valid even in states where such marriages cannot be contracted and may be contrary to public policy.

The following states currently recognize common-law marriages:⁶

- Alabama
- Colorado
- District of Columbia
- Georgia (if created before January 1997)
- Idaho (if created before January 1996)
- Iowa
- Kansas
- Montana
- New Hampshire (for inheritance purposes only)
- Ohio (if created before October 1991)
- Oklahoma (possibly; only if created before November 1, 1998. Oklahoma's laws and court decisions may be in conflict about whether common-law marriages formed in that state after November 1, 1998 are recognized.)
- Pennsylvania (if created before September 2003)
- Rhode Island
- South Carolina
- Texas
- Utah

⁴ *U.S. L. Thorne McCarty and Mary Lynne Robertson v. U.S.*, New Jersey U.S. District Court, No. 01-4942 (SRC), January 29, 2004

⁵ Same-sex marriages are not recognized. Consequently, there are no common-law same-sex marriages.

⁶ State laws can change. Therefore, readers are encouraged to check with the specific state before relying on the list.

Example 1. Donald and Marsha lived together in Georgia from 1990 until 2005 when they moved to Illinois so Donald could take a new job. During their residence in Georgia, they were never married, even though they both used the same last name of “Singleton.” In order to simplify their tax filing, they filed their tax returns as married filing jointly. Even their best friends believed the Singletons were married.

While working as the night manager at the local convenience store, Marsha fell madly in love with Officer Smith, who came in each night for a donut and coffee. Shortly thereafter, Marsha moved in with Officer Smith. Marsha and Officer Smith decided to marry, but they had to postpone the wedding until Marsha obtained a divorce from Donald. Even though Illinois does not recognize a common-law marriage, Georgia does. Consequently Illinois must acknowledge the marriage.

DIVORCE CONTRACTS

Generally, state law determines whether a marriage or divorce is valid. A valid divorce in one jurisdiction may not be valid in another jurisdiction. The question of validity often arises when the divorce is obtained in an offshore jurisdiction or foreign country.

The tax court held that an individual is considered legally separated under a divorce decree if the decree expressly and affirmatively provides that the parties live apart in the future.⁷

There is no such thing as “common-law divorce.” Once parties are married, regardless of the manner in which their marriage is contracted, they are married and can only be divorced by appropriate means. In all 50 states, that is only by court order. There is an exception in Texas which allows a common-law marriage to dissolve if the parties are separated for two years.

The divorce decree is a legally binding document that usually determines how income, expenses, debts, and property are divided. It may also address dependency issues, as well as alimony and child support. Tax implications are governed by the Internal Revenue Code. In cases where state law is different from federal law, the IRS sides with federal law. Even judges’ opinions can be overridden by the IRS.

INCOME TAX CONSIDERATIONS

CHOICE OF FILING STATUS

A taxpayer’s filing status is determined by her marital status.⁸ This determination is made on the last date of the taxable year. If an individual is legally separated from a spouse under a final divorce decree or separate maintenance, the individual is not considered married.⁹ If a taxpayer is still legally married as of the last day of the tax year, she may choose one of the following filing statuses:¹⁰

- Married filing jointly
- Married filing separately
- Head of household (if certain tests are met)

If a taxpayer is legally divorced or separated under a separate maintenance agreement, she may choose one of the following filing statuses:

- Single
- Head of household (if certain tests are met)

⁷ *R.T. Capodanno v. Commr.*, 69 TC 638, January 31, 1978

⁸ IRC §7703

⁹ IRC §7703(a)(1)

¹⁰ IRC §7703(b)(1)–(3)

2006 Workbook

To file as **head of household**, the taxpayer may be considered unmarried for tax purposes only if **all four** of the following requirements are met:

1. A separate return is filed.
2. The taxpayer paid more than half the cost of maintaining a home for the year.
3. The taxpayer did not live with the spouse at any time during the last six months of the year.
4. The taxpayer's home was, for more than half of the year, the main home for a "qualifying child"¹¹ for whom the taxpayer is entitled to claim a dependency deduction. This is the case even if the custodial parent allows the other parent to claim the exemption for the child.

If a marriage is legally annulled, no valid marriage is considered to have existed under state law. For any open year, the taxpayer must amend any jointly filed returns to reflect her single status.¹² The statute of limitations for a refund is three years from the due date of the return, or two years from the date the tax was paid, whichever is later.

TAX LIABILITY

Taxpayers filing a joint return are jointly and severally liable for any income tax, related penalties, interest, or deficiency regardless of the separate taxable income of each spouse. Generally, the IRS can collect from either spouse regardless of what is stated in the divorce decree.

Innocent Spouse

In some cases, a spouse may sign a joint tax return without knowing the estranged spouse has omitted income or claimed erroneous deductions or credits. The unknowing spouse may elect to seek relief from joint and several liability under the innocent spouse procedures in these situations.¹³ An individual is relieved of liability for tax (including penalty, interest and other amounts) for a tax year to the extent the liability is attributable to an understatement of income due to erroneous items of the other spouse.¹⁴

This election is made on Form 8857, *Request for Innocent Spouse Relief*, if all the following items are present:

1. A joint return was filed for the tax year.
2. There is an understatement of tax on the return that is attributable to erroneous items of the other spouse.
3. The innocent spouse establishes that, in signing the return, she did not know and had no reason to know of the understatement.
4. Taking into account all the facts and circumstances, it would be inequitable to hold the innocent spouse liable for the deficiency.
5. The innocent spouse elects the relief in the format that the IRS prescribes no later than two years after the IRS has begun collection activities with respect to that spouse. This two-year period does not expire earlier than two years after the date of the first collection activity after July 22, 1998.

Example 2. In 2006, Marsha from **Example 1** received an IRS notice that the 2004 tax return she filed with Donald failed to report \$10,000 of gambling earnings. Marsha had no idea that Donald went to the casinos while she was at work. When she investigated, she found Donald was giving his winnings to a girlfriend. By the time the IRS notified Marsha of the deficiency, Donald had filed bankruptcy and was unable to work because of a terminal illness.

¹¹ IRC §152(f)(1)

¹² Rev. Rul. 75-255, January 1, 1975

¹³ IRC §6015(a)(1)

¹⁴ IRC §6015(b)(1)

Marsha does not have the money to pay the tax liability, but her new husband has a substantial savings account. After discussing the tax liability with Officer Smith's accountant, Marsha determines she qualifies for innocent spouse treatment. She files the following Form 8857.

Form <b style="font-size: 24px;">8857 (Rev. February 2004) Department of the Treasury Internal Revenue Service	Request for Innocent Spouse Relief (And Separation of Liability and Equitable Relief) ▶ Do not file with your tax return. ▶ See instructions.	OMB No. 1545-1596
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Do not file this form if:

- You did not file a joint return for the year(s) for which you are requesting relief. However, if you lived in a community property state, see instructions.
- All or part of your overpayment was (or is expected to be) applied against your spouse's past-due debt (such as child support). Instead, file **Form 8379**, Injured Spouse Claim and Allocation, to apply to have your share of the overpayment refunded to you.



To see if you may qualify for **Innocent Spouse Relief**, go to www.irs.gov, click on "Individuals," "Innocent Spouses," and "Explore if you are an Eligible Innocent Spouse"; or see **Pub. 971**, *Innocent Spouse Relief*.

Part I	Your current name (see instructions) Marsha Trooper	Your social security number 111 : 11 : 1111
See Spousal Notification in the instructions.	Your current home address (number and street). If a P.O. box, see instructions. 21 Suspect Lane	Apt. no.
	City, town or post office, state, and ZIP code. If a foreign address, see instructions. Leavenworth, KS 66048	Daytime phone number (555) 555-5555
	If you have been a victim of domestic abuse and fear that filing a claim for innocent spouse relief will result in retaliation, check here <input type="checkbox"/>	

Part II	1 Enter the year(s) for which you are requesting relief from liability of tax ▶ 2004 2 Information about the person to whom you were married as of the end of the year(s) on line 1. Name Donald Singleton Social security number 111 : 11 : 1112 Current home address (number and street). If a P.O. box, see instructions. 31 Shady Lane Apt. no. City, town or post office, state, and ZIP code. If a foreign address, see instructions. Gamble, GA 22222 Daytime phone number (555) 555-5556
	3 Do you have an Understatement of Tax (that is, the IRS has determined there is a difference between the tax shown on your return and the tax that should have been shown)? <input checked="" type="checkbox"/> Yes. Go to Part III. <input type="checkbox"/> No. Go to Part V.

Part III	4 Are you divorced from the person listed on line 2 or has that person died? <input checked="" type="checkbox"/> Yes. Go to line 7. <input type="checkbox"/> No. Go to line 5. 5 Are you legally separated from the person listed on line 2? <input type="checkbox"/> Yes. Go to line 7. <input type="checkbox"/> No. Go to line 6. 6 Have you lived apart from the person listed on line 2 at all times during the 12-month period prior to filing this form? <input type="checkbox"/> Yes. Go to line 7. <input type="checkbox"/> No. Go to Part IV. 7 If line 4, 5, or 6 is Yes , you may request Separation of Liability by attaching a statement (see instructions). Check here ▶ <input type="checkbox"/> and go to Part IV.
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Part IV	8 Is the understatement of tax due to the Erroneous Items of your spouse (see instructions)? <input checked="" type="checkbox"/> Yes. You may request Innocent Spouse Relief by attaching a statement (see instructions). Go to Part V. <input type="checkbox"/> No. You may request Equitable Relief for the understatement of tax. Check Yes in Part V.
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Part V	9 Do you have an Underpayment of Tax (that is, tax that is properly shown on your return but not paid) or another tax liability that qualifies for Equitable Relief (see instructions)? <input type="checkbox"/> Yes. You may request Equitable Relief by attaching a statement (see instructions). <input checked="" type="checkbox"/> No. You cannot file this form unless line 3 is Yes .
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Under penalties of perjury, I declare that I have examined this form and any accompanying schedules and statements, and to the best of my knowledge and belief, they are true, correct, and complete. Declaration of preparer (other than taxpayer) is based on all information of which preparer has any knowledge.

Sign Here Keep a copy for your records. ▶	Your signature	Date
Paid Preparer's Use Only	Preparer's signature ▶	Date
	Firm's name (or yours if self-employed), address, and ZIP code ▶	Check if self-employed <input type="checkbox"/>
		EIN : _____ Phone no. () _____

2006 Workbook

Attachment to Form 8857

Marsha Trooper

111-11-1111

The purpose of the Form 8857 is to elect innocent spouse treatment regarding the \$1,500 of income tax assessed on the 2004 income tax I jointly filed with Donald Singleton (111-11-1112).

The tax resulted from an unreported W-2-G received from Midnight Casino. The W-2-G reported \$10,000 of gambling winnings.

I had no reason to know about the gambling winnings. I did not know Donald went to the casino while I was at work. He never mentioned he gambled or that he had any winnings. None of the winnings were ever deposited in our joint bank account. I recently found Donald spent his winnings on his girlfriend, who was unknown to me.

Any tax liability should be paid by Donald. I do not have enough income to pay this liability and if a lien is placed on my meager earnings from the convenience store, I will lose my job.

I would appreciate your honoring this Form 8857 request.

An otherwise innocent spouse may be relieved of liability for the portion of tax attributable to the understatement that she did not know or have reason to know about. However, if she fails to establish that she did not know or have reason to know of the understatement, she must establish that she did not know or have reason to know of its extent.¹⁵

The innocent spouse may also petition the Tax Court to review her case. The petition must be filed at any time after the earlier of the IRS's mailing of a notice of final determination or six months after the Form 8857 is filed with the IRS.

Equitable Relief Rules. If relief is not available to a jointly filing taxpayer under the innocent spouse rules, the IRS may relieve the taxpayer of the liability for unpaid taxes under the equitable relief rules. This relief may be given if it would be inequitable to hold the taxpayer liable taking into account all facts and circumstances. **Equitable relief** applies only to the tax liability shown on the return before any adjustment to the return, and is only available to the extent the unpaid tax is attributable to the spouse not requesting relief.¹⁶

Note. The IRS has the authority under IRC §6015(f) to grant equitable relief for "any unpaid tax." Therefore, a tax deficiency is not required. However, if the IRS denies equitable relief for "any unpaid tax" which does not involve the assessment of additional tax, the spouse requesting equitable relief does not have the right to contest the denial by IRS at Tax Court. That legal dispute was settled by the 9th Circuit Court of Appeals in the *Ewing* decision. See pages 604-05 for an analysis of the *Ewing* case."

Injured Spouse

Although the injured spouse rules are not directly tied to divorce taxation, they often come into play because of a divorce.¹⁷ When husband and wife file a joint return, each normally has a separate interest in the jointly reported income and in any overpayment.¹⁸ Therefore, if a taxpayer remarries and the new spouse has a debt, such as unpaid child support, the nonobligated spouse can notify the IRS so that his portion of any tax refund is not applied to the debt.¹⁹

¹⁵ IRC §6015(b)(2)

¹⁶ IRC §6015(f)

¹⁷ IRC §6402(a)

¹⁸ FSA 200144030, October 1, 2001

¹⁹ Ibid

2006 Workbook

To make a request for the IRS to allocate an overpayment, the injured spouse must file Form 8379, *Injured Spouse Allocation*. The form is attached to a joint return when an overpayment is expected to be applied to a past-due liability of the other spouse.

Example 3. Fred and Shirley file a joint tax return for 2005. Fred is delinquent on child support payments to his former wife. Fred expects the IRS to allocate any refund to the past-due support. Therefore, when Fred and Shirley file their taxes, they attach Form 8379 to their Form 1040 to prevent the IRS from attaching her share of any refund due.

Form 8379 (Rev. January 2006) Department of the Treasury Internal Revenue Service	<h2 style="margin: 0;">Injured Spouse Allocation</h2> <p style="margin: 0;">▶ See instructions.</p>	OMB No. 1545-0074 Attachment Sequence No. 104
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Part I Information About the Joint Tax Return for Which This Form Is Filed

1 Enter the following information exactly as it is shown on the tax return for which you are filing this form. The spouse's name and social security number shown first on that tax return must also be shown first below.

First name, initial, and last name shown first on the return Fred L Newlywed	Social security number shown first 111 : 11 : 1111	If Injured Spouse, check here ▶ <input type="checkbox"/>
First name, initial, and last name shown second on the return Shirley A Newlywed	Social security number shown second 111 : 11 : 1112	If Injured Spouse, check here ▶ <input checked="" type="checkbox"/>

Note. If you are filing Form 8379 with your tax return, skip to line 5.

2 Enter the tax year for which you are filing this form (for example, 2004) ▶ _____

3 _____
 Current home address _____ City _____ State _____ ZIP code _____

4 Is the address on your joint return different from the address shown above? **Yes** **No**

5 Check this box only if you are divorced or separated from the spouse with whom you filed the joint return and you want your refund issued in your name only

6 Was your main home in a community property state (Arizona, California, Idaho, Louisiana, Nevada, New Mexico, Texas, Washington, or Wisconsin) at any time during the year entered on line 2? **Yes** **No**
 If "Yes," which community property state(s)? _____

Note. Overpayments affected by state community property laws will be allocated by the IRS according to those laws.

Part II Allocation Between Spouses of Items on the Joint Tax Return (see instructions)

Allocated Items	(a) Amount shown on joint return	(b) Allocated to injured spouse	(c) Allocated to other spouse
7 Income: a. Wages	145,000	100,000	45,000
b. All other income	32,000	16,000	16,000
8 Adjustments to income	6,000	5,000	1,000
9 Standard deduction or Itemized deductions	10,000	5,000	5,000
10 Number of exemptions	2	1	1
11 Credits (do not include any earned income credit)	0	0	0
12 Other taxes	0	0	0
13 Federal income tax withheld	13,000	9,500	3,500
14 Payments			

Part III Signature. Complete this part only if you are filing Form 8379 by itself and not with your tax return.

Under penalties of perjury, I declare that I have examined this form and any accompanying schedules or statements and to the best of my knowledge and belief, they are true, correct, and complete. Declaration of preparer (other than taxpayer) is based on all information of which preparer has any knowledge.

Keep a copy of this form for your records	Injured spouse's signature _____	Date _____	Phone number (optional) () _____
Paid Preparer's Use Only	Preparer's signature ▶ _____	Date _____	Preparer's SSN or PTIN _____
	Firm's name (or yours if self-employed), address, and ZIP code ▶ _____	Check if self-employed <input type="checkbox"/>	EIN : _____ Phone no. () _____

2006 Workbook

PRE-DIVORCE AND ESTIMATED TAX PAYMENTS

Any refund attributed to a joint return filed prior to the divorce is considered the property of both taxpayers even if received after the divorce is final. The IRS will make the total refund payable to both taxpayers shown on the jointly filed tax return. Because both taxpayers must sign the refund check, each individual is considered notified that he may be entitled to a portion of the refund.

The IRS has a responsibility to issue any refund to the taxpayer who made the overpayment. One spouse cannot be credited with the entire refund amount. Consequently, if the IRS pays the entire refund to only one of the taxpayers, and the other spouse demonstrates a separate interest in the refund, the IRS is liable to that taxpayer for the amount of the separate amount. The IRS issues a refund to the injured spouse and then attempts to recover the excess payment from the other party.

The rules require that the other spouse:

- Not be legally obligated to pay the past-due amount,
- Report income such as wages, taxable interest, etc. on the joint return, and
- Make and report payments, such as federal income tax withheld from wages or estimated tax payments, or claim the earned income credit or other refundable credit on the joint return.

In a 2003 Ohio case, the wife paid the entire tax liability from her trust account prior to her divorce. An excess payment of \$299,536 was credited toward the subsequent year's return. The taxpayers were divorced during the subsequent year. When her former husband filed his tax return, the IRS applied the entire estimate to his income tax of \$1,275 and refunded the excess to him. When the wife filed her return and claimed the refund, the IRS responded it had already refunded the excess. Her former husband would not reimburse her for the refund nor would he repay the IRS. The IRS finally gave the wife credit and went to court to receive payment from the husband.²⁰

DEPENDENCY

CHILDREN OF DIVORCED OR LEGALLY SEPARATED PARENTS

The Working Families Tax Relief Act of 2004 made changes to the definition of a "dependent" in some situations. Specifically, the act gave a new definition to a "qualifying child." The act also removed the restriction that a noncustodial parent must have a signed Form 8332, *Release of Claim to Exemption for Child of Divorced or Separated Parents*. Instead, he could attach a copy of the signed divorce decree showing the noncustodial parent can claim the dependency exemption.

Late in 2005, Congress issued a technical correction in the Gulf Opportunity Zone Act requiring a signed, written declaration if the custodial parent wishes to release the dependency exemption and the child tax credit to the noncustodial parent. While a signed statement other than Form 8332 may be used, the IRS form is suggested because it meets all the requirements. These requirements include the following:

- Names of the child(ren) for whom the exemption claims were released
- Year or years for which the exemption is released
- Custodial parent's signature confirming consent
- Custodial parent's social security number
- Date of the signature
- Name and social security number of the parent claiming the exemption

²⁰ *U.S. v. MacPhail, et al.*, Cite as 93 AFTR 2d 2004-1178, February 27, 2004

The release waiver only affects the dependency exemption and the child credit. It does not affect the other credits relating to a dependent child, for example EITC and dependent care.

Note. A detailed discussion of the technical correction can be found in Chapter 2, “Individual Taxpayer Problems,” page 31.

PROPERTY SETTLEMENTS

A divorce usually ends with a division of the couple’s assets. This is called a **property settlement**. Property settlements are neither taxable to the recipient nor deductible by the payor.²¹ This is true even if the spouse receiving the property had no interest in the property prior to the divorce. The transfer of property between spouses incident to divorce is treated the same as if they gifted the property. The recipient spouse receives the payor spouse’s basis in the property.²² Even if the property is transferred in a bona fide sale, between spouses, at its fair market value (FMV), which is higher than the property’s basis, the transfer has no tax consequences. If transfer fees are paid, they do **not** add to the basis of the property.²³

Transfers of property between spouses are not considered a gift, and no gift return is required, if all of the following apply:

- The couple has a written property settlement agreement.
- The agreement is entered into two years prior to the divorce or one year after the divorce.
- The property is transferred as specified in the written agreement.

The term **property** means all property including real, personal, intangible, tangible, community or separate.

A transfer is considered incident to a divorce in the following situations:

- The transfer is related to the marital termination or occurs within one year after the divorce or legal separation is final.
- The transfer is related to marital termination if it is required by a divorce or separation instrument and the transfer occurs within six years after the divorce or legal separation is final.

BASIS ISSUES

As discussed above, basis becomes a major issue when deciding how to split property. While the FMV of the assets each couple receives may be the same, the tax consequences on a subsequent sale can vary considerably.

²¹ IRC §1041(a)(2)

²² IRC §1031(b)(2)

²³ *Michael J. Godlewski v. Commr*, 90 TC 200, February 9, 1988

2006 Workbook

Example 4. Tom and Nicole decide to end their 10-year marriage. They agree the assets should be shared equally. The attorneys asked them to list their assets, the FMV of the assets, and who would receive each. The list is as follows:

Asset	FMV	Tom	Nicole
Cash in bank	\$ 34,850	\$ 32,875	\$ 1,975
Fidelity mutual fund	126,800	126,800	
Universal Pictures stock	375,000	375,000	
Merrill Lynch account	25,343,800	25,343,800	
Tom's 401(k) account	1,753,000	1,753,000	
Nicole's 401(k) account	1,500,000		1,500,000
Nicole's IRA	253,000		253,000
Nicole's 1996 Chevy Caprice Classic wagon	6,500		6,500
Nicole's 2005 Jaguar XK8	79,000		79,000
Tom's 2003 Ferrari F60 Enzo	1,290,000	1,290,000	
Household goods	25,000	12,500	12,500
Residence in Beverly Hills	43,000,000		43,000,000
Vacation house in Nice	16,000,000	16,000,000	
Credit card debt	(82,000)	(81,500)	(500)
Net assets	\$89,704,950	\$44,852,475	\$44,852,475

Example 5. The year following Tom's divorce, he went to his CPA to have his tax return prepared. His CPA advised him that he could no longer represent Tom because he was representing Nicole and it would be a conflict of interest. Tom found a new preparer. The new preparer asked for a copy of the divorce settlement.

After reviewing the settlement, the new accountant asked for basis information, which Tom provided. The accountant explained to Tom that he did not receive an equal settlement. If Tom sells his assets, he will report \$23,122,100 (\$44,852,475 – \$21,730,375) more gain than Nicole. In addition, because the Beverly Hills residence is Nicole's personal residence, she can utilize IRC § 121 to exclude part of the gain. The basis information follows:

Asset	FMV	FMV		Basis	
		Tom	Nicole	Tom	Nicole
Cash in bank	\$ 34,850	\$ 32,875	\$ 1,975	\$ 32,875	\$ 1,975
Fidelity mutual fund	126,800	126,800		35,000	
Universal Pictures stock	375,000	375,000		50,000	
Merrill Lynch account	25,343,800	25,343,800		13,500,000	
Tom's 401(k) account	1,753,000	1,753,000		0	
Nicole's 401(k) account	1,500,000		1,500,000		0
Nicole's IRA	253,000		253,000		0
Nicole's 1996 Chevy Caprice Classic wagon	6,500		6,500		6,500
Nicole's 2005 Jaguar XK8	79,000		79,000		79,000
Tom's 2003 Ferrari F60 Enzo	1,290,000	1,290,000		1,100,000	0
Household goods	25,000	12,500	12,500	12,500	12,500
Residence in Beverly Hills	43,000,000		43,000,000		39,000,000
Vacation house in Nice	16,000,000	16,000,000		7,000,000	
Credit card debt	(82,000)	(81,500)	(500)		
Net assets	\$89,704,950	\$44,852,475	\$44,852,475	\$21,730,375	\$39,099,975

Observation. If a taxpayer incurs debt in order to purchase the spouse's interest in the personal residence, the interest on the debt qualifies as interest on debt to acquire a personal residence.²⁴

TIMING ISSUES

Transfers of property occurring more than six years after the cessation of marriage, but **not** included in the divorce or separation agreement, are presumed **not** to be related to the divorce. The presumption can be challenged if the couple can show the transfer was made to divide property owned by them when the marriage ended. If the transfer was delayed because of legal or business reasons or valuation issues, they may relate to the divorce even if made outside of the six-year period. However, these transfers should occur immediately after the impediment is removed.²⁵

Example 6. George Barrister specializes in personal injury lawsuits. While in the middle of a large medical malpractice case, he and his wife Gotcha filed for divorce. A part of the property settlement called for Barrister to give Gotcha one half of the contingency fee Barrister would receive if he were successful in the malpractice case. The lawsuit was finalized; Barrister was successful and received a \$1 million contingency fee. However, he did not receive the fee until eight years after his divorce became final. Barrister immediately paid his former wife her share or \$500,000. This amount is neither deductible to Barrister nor taxable to Gotcha.

Example 7. What Barrister did not realize when agreeing to the property settlement was that he must include the entire \$1 million fee in his income in the year received. Income is taxable to the person who earns it. This is based on a long-standing precedent.²⁶

ALIMONY

A divorce decree or separate maintenance decree may require one party to a divorce to make payments to the other. Normally, these payments are taxable to the receiving individual²⁷ and deductible to the payor.²⁸ If the payments are structured properly, they need not be taxable or deductible.

An alimony or separate maintenance payment is any payment received by or on behalf of a spouse (or former spouse) of the payor under a divorce or separate maintenance instrument that meets all of the following requirements:²⁹

1. The payment is made in cash. Cash includes checks and money orders, but excludes transfers of services or property. Debt instruments and annuity contracts are also excluded. In addition, the execution of a debt instrument by the payor and use of the payor's property are excluded.
2. The payment is not designated as a payment which is excludible from the gross income of the payee and nondeductible 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.

²⁴ IRC §163(h)(3)(A)

²⁵ Temp. Treas. Reg. §1.1041-1T(b) Q&A 7

²⁶ *Lucas v. Earl*, 2 USTC ¶496, 282 U.S. 111, 50 S. Ct. 241, March 17, 1930

²⁷ IRC §71

²⁸ IRC §215

²⁹ *Ray v. Commr.*, TC Summary Opinion 2006-110, July 17, 2006

2006 Workbook

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 for such payment) and the divorce or separation instrument states that there is no such liability.
5. The spouses cannot file a joint return with each other.³⁰
6. The payment is not treated as child support.
7. To the extent that one or more annual payments exceed \$10,000 during any of the six post-separation years, the payor is obligated to make annual payments in each of the six post-separation years.

Prior to the Tax Reform Act of 1984, alimony or separate maintenance payments had to be “periodic” to qualify as alimony. In addition, they had to be made in discharge of a legal obligation arising out of a marital or family relationship. The 1984 act removed both of these qualifications.

AVOIDING TAX CONSEQUENCES

The spouses may designate that payments otherwise qualifying as alimony or separate maintenance payments are nondeductible by the payor and excludible from gross income by the payee. This is done by stating it in the divorce decree. If the spouses execute a written separation agreement, any document signed by both spouses which designates otherwise qualifying alimony or separate maintenance payments as nondeductible and excludible and which refers to the written separation agreement is treated as a written separation agreement (and thus a divorce or separation instrument). If the spouses are subject to temporary support orders,³¹ the designation of otherwise qualifying alimony or separate payments as nondeductible and excludible must be made in the original or a subsequent temporary support order. A copy of the instrument containing the designation of payments as **not** alimony or separate maintenance payments **must** be attached to the payee's first filed tax return (Form 1040) and for each subsequent year in which the designation applies.

Times when the non-alimony designation may be helpful include the following instances:

- The payor is unable to use the alimony deduction because of business or other losses.
- The recipient spouse is in a higher tax bracket than the payor spouse.
- The recipient sold property to the former spouse and does not want payments of the purchase price included as alimony.
- The payor wants to avoid the alimony recapture rules in a future year.
- The recipient wants the payments taxed under trust or annuity rules.

Note. The designation of alimony payments as nondeductible is not an all-or-nothing rule. The payments can be designated as partially deductible. The payment designation may be changed in future years.

If alimony or separate maintenance payments are taxable to one spouse, the payments are deductible to the other. These payments qualify as earned income for purposes of making an IRA contribution, but do not qualify as earned income for the earned income credit. This may be especially helpful to the spouse who has no other source of earned income.³² The couple may want to reduce annual payments and stretch them over more years to allow a longer time period for making IRA contributions. The payor can reduce the amount of nondeductible alimony and make the IRA limitation amount taxable/deductible. As long as the recipient spouse made the IRA contribution, the alimony payment is directly offset by the IRA contribution.

³⁰ IRC §71(e)

³¹ IRC §71(b)(2)(C)

³² IRC §219(f)

Example 8. Lance and Melinda are negotiating the terms of their divorce. They tentatively agree to a property settlement of \$400,000 paid over five years. Lance is in a 33% marginal tax bracket. Melinda has no earned income and does not plan to seek employment. If the couple agreed to reclassify \$4,000 of the annual property payment settlement as taxable alimony, Melinda could contribute \$20,000 to an IRA over the five-year period and Lance would receive a \$6,600 tax benefit over the same time period ($\$4,000 \times 5 \times 33\%$). Stretching the payments even further would compound the benefits to both parties.

THIRD PARTY PAYMENTS

Cash payments to a third party on behalf of the taxpayer's spouse under the terms of a divorce or separation instrument may be alimony if the payments otherwise qualify. These may include payments for the spouse's medical expenses, housing cost, taxes, tuition, and so on.

The payments are in lieu of alimony paid directly to the spouse if both of the following are true:

- The written request states that both spouses intend the payment to be treated as alimony.
- The written request from the payee spouse is received by the payor spouse before the return is filed.

Life insurance premiums that a taxpayer must pay under the divorce decree or separation instrument for insurance on his own life are deductible alimony to the extent the other spouse owns the policy.³³

Cash payments of rent, mortgage, tax, or tuition liabilities of the payee spouse made under the terms of the instrument can qualify as alimony. If the payments qualify as alimony, they are taxable to the payee spouse. However, any payments to maintain property owned by the payor spouse and used by the payee spouse do not qualify as alimony.³⁴

The payor spouse may make a cash payment to a charitable organization if the payment is under the written request, consent, or ratification of the payee spouse. The request, consent, or ratification must state that the parties intend the payment to be treated as an alimony or separate maintenance payment to the payee spouse subject to the rules of IRC §71. In addition, it must be received by the payor spouse prior to the date of filing of the payor's tax return for the year in which the payment was made.

SEPARATE HOUSEHOLDS

Generally, a payment made at the time when the payor and payee spouses are members of the same household cannot qualify as an alimony or separate maintenance payment if the spouses are legally separated under a divorce or separate maintenance decree. A dwelling unit formerly shared by both spouses is not considered as two separate households even if the spouses physically separate themselves within the dwelling unit. The spouses are not treated as members of the same household if one spouse is preparing to depart from the household of the other spouse, and departs not more than one month after the date the payment is made.³⁵ If the spouses are not legally separated under a divorce or separate maintenance decree, a payment under a written separation agreement or a decree may qualify as an alimony or separate maintenance payment notwithstanding that the payor and payee are members of the same household at the time the payment is made.

The Tax Court ruled that payments an attorney made to his spouse, while living in the same residence, qualified as alimony. The decision was based on the fact the payments were a part of a written separation agreement and the couple was not legally separated at the time of the payments.³⁶

In another case, the Tax Court ruled the payments did not qualify as alimony even though the taxpayers used separate bedrooms, bathrooms, and kitchens and were located on separate floors.³⁷

³³ Temp. Treas. Reg. §1.71-1T(b), Q&A 6

³⁴ Temp. Treas. Reg. §1.71-1T(b), Q&A 6

³⁵ Temp. Treas. Reg. §1.71-1T(b), Q&A 9

³⁶ *T.B. Benham v Commr.*, TC Memo 2000-165, May 22, 2000

³⁷ *Alexander Washington v Commr.*, 77 TC 601, September 11, 1981

2006 Workbook

JOINTLY-OWNED PROPERTY

Payments or portions of payments made related to jointly-owned property can **qualify as alimony** if the divorce decree obligates the payor spouse to:

- Make all the mortgage payments on a jointly-owned home. In this case, half of the amounts paid (both principal and interest) can qualify as alimony.
- Pay all the property tax or insurance, and the property is owned as tenants in common. In this case, half of the amounts paid can qualify as alimony. Taxpayers are each considered to own one half of tenants-in-common property.

If the payor spouse is required to pay all the property tax or insurance, and the house is owned jointly with right of survivorship or tenants by the entirety, then none of the taxes or insurance qualify as alimony.

Note. Payments of real estate tax and interest which do not qualify as alimony may still qualify as itemized deductions.

INTEREST DEDUCTION

If the payor/divorced spouse does not reside in the residence on which he is paying interest, it may be deducted as investment interest. However, if the nonoccupant spouse making the payments has a child who lives in the home with the occupant spouse, the home can qualify as a second residence of the nonoccupant spouse. Use of the home by the children constitutes personal use by the nonoccupant spouse.³⁸

LUMP-SUM ALIMONY

The terms of the divorce decree or separate maintenance instrument may allow for a payment of alimony in a lump sum. The payor spouse is allowed a deduction and the payee spouse must report the lump sum as income.³⁹ Prior to 1985, qualified alimony payments were required to be paid in periodic installments. After enactment of the Deficit Reduction Act of 1984, lump sum payments qualify as alimony if the provisions previously discussed are present.

Payments of delinquent alimony made to satisfy the payor's past and future obligations are treated as a payment of back alimony to the extent of the past-due payments. Neither the payor nor the recipient can allocate the delinquent payments to the year the alimony was due.⁴⁰ Unless specified with the payment, the IRS allocates the payment first to past-due alimony and any balance to future alimony. If the payment consists of both past-due alimony and past-due child support, the IRS allocates to the past-due child support first.

Example 9. Zoe was ordered to pay Chris \$500 per month in child support and \$600 per month in alimony with the first payment expected in March 2004. Zoe made no payments until June 2006, when she made a \$20,000 payment. She did not allocate the payment. Under the rules, the IRS allocates \$14,000 ($28 \times \500) to child support and \$6,000 ($\$20,000 - \$14,000$) to alimony. The alimony is deductible to Zoe and taxable to Chris in 2006.

³⁸ IRC §280A(d)

³⁹ Ltr. Rul. 200329003, March 20, 2004

⁴⁰ *Caroline M. Coleman v Commr.*, TC Memo 1988-442, September 15, 1988

RECAPTURE

To ensure that payments deducted as alimony are not disguised property settlement payments, the IRS has front-loading rules. These rules cause excess payments to be taxed as alimony. If alimony payments decrease or terminate during the first three calendar years, the payor spouse may be subject to the recapture rule.⁴¹ If this rule applies, the payor must include the recapture amount in income in the third year.⁴² The payee spouse is allowed a deduction for the recapture amount.

This rule is applied when alimony paid in the second or third year decreases by more than \$15,000 from the prior year. This rule does **not** apply under any of these conditions:

- Payments are made under a temporary support order.
- Payments fluctuate because they are based on a fixed percentage of income from a business, property, or compensation from employment or self-employment.
- Payments decrease because of the death of either spouse, or the remarriage of the payee spouse.

Determining the amount to recapture is a three-step process which occurs in the third post-separation year.

1. Compare the payments made in the second post-separation year with payments made in the third post-separation year. If the second-year payments are greater than the third year by more than \$15,000, the excess payments are subject to recapture.
2. Compare the payments made in the first post-separation year with the average of the payments made in the second and third post-separation years plus \$15,000. Only those payments not recaptured in Step 1 are included in the average. Any excess is also recaptured in year three.
3. Combine the results of Step 1 and Step 2. This amount is recaptured as income by the payor and is deductible by the recipient.

The recaptured alimony is reported on Form 1040, line 11. Cross out the word “received” and write in the word “recaptured.” On the dotted line next to the amount, enter the spouse’s last name and social security number.⁴³

To deduct the recapture amount on line 31a, cross out “paid” and write in “recaptured.” In the space provided, enter the spouse’s social security number.⁴⁴

⁴¹ IRC §71(f)(1)

⁴² IRC §71(f)(1)(B)

⁴³ IRS Pub. 504, *Divorced or Separated Individuals*, p. 15

⁴⁴ Ibid

2006 Workbook

Example 10. Hans and Juliet are divorced in 2003. Hans agrees to pay alimony of \$100,000 over the three years. He makes the following payments. The payments are deductible to Hans and reportable as income by Juliet in the year paid:

Year	Payment
Year 1 (2003)	\$70,000
Year 2 (2004)	25,000
Year 3 (2005)	5,000
Step 1	
Year 2 excess payment = Year 2 payments – (Year 3 payments + \$15,000)	
Year 2 excess payment = \$25,000 – (\$5,000 + \$15,000). If amount is less than 0 there is no excess payment in Year 2.	5,000
Step 2	
Year 1 excess payment = Year 1 payment – [average of (Year 2 payment – recaptured payment) and Year 3 payment] + \$15,000	
Year 1 excess payment = \$70,000 – {[((\$25,000 – \$5,000) + \$5,000) ÷ 2] + \$15,000}	
If amount is less than 0 there is no excess payment in Year 2.	42,500
Total excess payments	\$47,500
Recapture reported on Year 3 return = (Year 3 payment – Year 1 recapture)	
Year 3 net income/deduction = (\$5,000 – \$47,500)	(42,500)
Hans reports the net amount as income in Year 3 and Juliet reports the net amount as a deduction.	

Over the 3-year period, Hans has a total deduction of \$52,500 (\$70,000 + \$25,000 + \$5,000 – \$47,500).

Example 11. Use the same facts as **Example 11**, except Hans made the payments as follows:

Year	Payment
Year 1 (2003)	\$45,000
Year 2 (2004)	35,000
Year 3 (2005)	20,000
Step 1	
Year 2 excess payment = Year 2 payments – (Year 3 payments + \$15,000)	
Year 2 excess payment = \$35,000 – (\$20,000 + \$15,000)	
If amount is less than 0 there is no excess payment in Year 2.	0
Step 2	
Year 1 excess payment = Year 1 payment – [average of (Year 2 payment – recaptured payment) and Year 3 payment] + \$15,000	
Year 1 excess payment = \$45,000 – {[((\$35,000 – \$0) + \$20,000) ÷ 2] + \$15,000}	
If amount is less than 0 there is no excess payment in Year 2.	2,500
Total excess payments	\$ 2,500
Recapture reported on Year 3 return = (Year 3 payment – Year 1 recapture)	
Year 3 net income/deduction = (\$20,000 – \$2,500)	17,500
Hans reports the net amount as an alimony deduction in Year 3 and Juliet reports the net amount as income.	

Over the 3-year period, Hans has a total deduction of \$97,500 (\$45,000 + \$35,000 + \$20,000 – \$2,500).

DEEMED CHILD SUPPORT

A divorce or separation agreement may require payments for the support of the taxpayer's children. These payments are fixed or treated as fixed when they are tied to certain contingencies related to the child. Child support payments are **neither** deductible to the payor nor taxable to the recipient. Taxpayers sometimes attempt to disguise child support payments as alimony payments.

Even though the divorce or separation decree calls a payment "alimony," the IRS may deem the payment to be child support if certain conditions are met. Generally, this occurs when the alimony payment is reduced as a result of a contingency related to a child. The contingencies may include the child:

- Attaining a specific age,
- Dying,
- Leaving school due to graduation or other reasons,
- Leaving the household of the spouse,
- Marrying,
- Reaching a specified income level, or
- Obtaining employment.

There are two tests for determining whether there is a contingency relating to the child. If either test is met, the payments are treated as child support for tax purposes.

1. Payments are reduced within six months before or after a child has attained the age of 18, 21, or the local age of majority.
2. Payments are reduced on two or more occasions, which occur not more than one year before or after a different child of the payor spouse attains a certain age between the ages of 18 and 24, inclusive.

Example 12. Ricky and Lucy's divorce decree specifies that Ricky must pay Lucy \$5,000 per month alimony until Little Ricky attains age 21 or gets married. Payments are then reduced to \$3,000 per month; the IRS deems \$2,000 of the monthly payment as child support.

If total payments are less than the total of the child support and alimony a taxpayer is required to pay, the IRS allocates the payments to child support until they are paid in full. Thereafter, the IRS allocates any payment to alimony.

Interestingly, the rules do not work in reverse. If payments are designated as alimony, but are subject to increase in the event of a specific occurrence, the additional payments still qualify as alimony.

Example 13. Jill's divorce decree specifies she must pay Jack \$1,000 per month in alimony for life. If their son, Tommy, moves in with Jack before Tommy is age 18, Jill must pay an additional \$500 per month from the time Tommy moves in until he reaches age 18. This additional \$500 is deemed to be alimony and is deductible to Jill and taxable to Jack.

Observation. The additional \$500 per month would qualify as child support if the divorce decree is modified to expressly state the additional amount is child support.

Any advance payments of money designated as child support in the divorce decree or support agreement qualifies as child support.

2006 Workbook

Example 14. The court ordered Britney to pay Kevin \$25,000 per month for life. The divorce decree designated \$4,000 as child support until the child reaches age 18. Therefore, \$21,000 per month is treated as alimony until the child becomes 18. Thereafter, the entire \$25,000 per month is treated as alimony.

Note. It does not matter if the court designates a specific dollar amount or a percentage of the total as child support.

As previously discussed, payments terminating within six months before a child becomes age 18, 21, or the age of majority are considered child support payments. However, if the payer can show that the termination was due to circumstances other than the child's birthday, it may still be considered as alimony. In order to rebut the IRS's deemed child support argument, the taxpayer must show that the timing was purely coincidental to the child's birthday.

Note. Interest charged by a state agency and paid to the recipient does not qualify as child support and constitutes taxable income.⁴⁵ The interest is not deductible to the payer because it is assessed at a later time and is not designated as child support.

SALE OF PERSONAL RESIDENCE

QUALIFICATION FOR IRC §121 EXCLUSION

IRC §121 provides for an exclusion of \$250,000/\$500,000 gain, depending on filing status, from the sale of a personal residence if certain conditions are met. For sales of a personal residence after May 6, 1997, the gain may be excluded if the taxpayer:

1. Owned the home for two out of the last five years,
2. Used the home as his principal residence two out of the last five years, and
3. Did not use the §121 exclusion during the last two years.

Observation. The two-out-of-the-last-five-year rule is not required in the case of unforeseen circumstances. Divorce is considered an unforeseen circumstance.

EXCEPTIONS FOR FORMER SPOUSES

A spouse who vacates the personal residence prior to its sale but maintains ownership can still satisfy the two-out-of-the-last-five-year rule for use if the spouse or former spouse is granted use of the property under a divorce or separation instrument and that former spouse meets the use test.

Example 15. Don and Kay's divorce is final in 1998. The divorce decree allows Kay to live in the home with the children until the last child graduates from high school. At that time, the house must be sold and the proceeds split between Don and Kay. The house is sold in 2006. Even though Don has not lived in the house two out of the last five years, he is still entitled to the benefits of §121 because Kay remained in the residence the entire time.

A spouse who receives a personal residence as part of a property settlement incident to a divorce includes the former spouse's holding period for the ownership test but the use test must be met separately.⁴⁶

⁴⁵ CCA 200444026, September 22, 2004

⁴⁶ Treas. Reg. §1.121-4(b)(1)

Example 16. On January 15, 2005, Doug and Melissa marry and move into Doug's house, which he has owned since 1991. The marriage does not work out and the couple divorce in 2006. The divorce decree gives the house to Melissa and other property to Doug. Doug's basis in the house is \$85,000. Melissa immediately remarries and moves into her new husband's home on January 20, 2006. She sells Doug's house for \$240,000.

Sale price	\$240,000
Adjusted basis	<u>85,000</u>
Gain realized	\$155,000
§121 exclusion = $370/730 \times \$250,000 =$	<u>(126,712)</u>
Gain recognized	\$ 28,288

Melissa gets the benefit of Doug's holding period, but is not entitled to the statutory §121 exclusion since she didn't live in the house for two years. However, Melissa could qualify for the reduced §121 exclusion because divorce could be treated as an unforeseen circumstance.

QUIT CLAIM DEED

Property may be transferred by a quit claim deed. This type of deed is used when a person who owns the property, or a part of the property, transfers his interest in the property. The person making the transfer makes no guarantees about the title. The transfer is considered incident to the divorce and there is no taxable event. This is true even if one spouse is buying out the other spouse. Any transfer incidental to divorce is a nontaxable event.

TRANSFER OF OTHER ASSETS

STOCKS AND BONDS

When a taxpayer transfers stocks and/or bonds to his spouse or former spouse, incident to a divorce, the taxpayer must give the spouse sufficient records to determine the adjusted basis and holding period of the asset on the date of transfer. This includes any information relating to recapture provisions as well.

While transfers incident to divorce are generally treated the same as gifts, there is a distinct difference. When property is gifted and the basis of the property is higher than the FMV, the recipient's basis is the FMV. However, if the recipient then sells the gifted property at a gain, the gain is reduced, but only to the extent of the excess of basis over FMV at the time of the gift.

Example 17. Luke gifts his son, Adam, stock with an FMV of \$10,000 and a basis of \$12,000. Adam's basis in the stock is \$10,000 for purposes of a sale. Adam later sells the stock for \$11,000. Adam uses a basis of \$11,000 and does not report any gain on the sale.

Example 18. Instead of gifting the stock to Adam, Luke transfers the stock to his spouse Clare as part of their divorce settlement. Clare's basis in the stock is \$12,000. Therefore, if she sells the stock for \$11,000, she reports a \$1,000 capital loss.

2006 Workbook

PASS-THROUGH ENTITY

Like other property, the basis of an interest in a pass-through entity, such as a partnership or S corporation, transfers to the recipient spouse if the transfer is incident to a divorce. Generally, if a shareholder in an S corporation transfers his shares to another person, any suspended losses or deductions are irrevocably lost.⁴⁷ However, if the transfer is to a spouse or former spouse and the transfer is incident to a divorce, the loss transfers with the ownership interest. The suspended loss or deduction is treated as if it is incurred in the succeeding year for the recipient.⁴⁸

Note. This is a recent change enacted by the American Jobs Creation Act of 2004.⁴⁹ The Gulf Opportunity Zone Act of 2005 clarified that the change is effective for transactions occurring after December 31, 2004.

Example 19. Justin and Regan are the sole shareholders of Just in Time, Inc., an S corporation. They each own 100 shares of the corporation. The corporation was not successful and each shareholder has \$75,000 of suspended losses. Justin believes the corporation will be successful in the future and receives Regan's 100 shares as part of the divorce settlement. Regan's suspended loss of \$75,000 transfers to Justin along with her shares.

Example 20. Use the same facts as **Example 20**, except Regan refuses to transfer the shares to Justin, but gives them to a neighbor. In this case, the losses are lost forever even if the corporation becomes profitable.

REAL ESTATE/RENTAL PROPERTY

If a passive activity is transferred, the basis is increased by the amount of any suspended losses allocable to the property. If the property is owned one-half by each spouse, one-half of the property receives a basis adjustment and the balance of the passive activity loss carries forward for the recipient spouse.

Depreciation continues in the same manner and method being used prior to the transfer. All IRC §§1245 and 1250 recapture provisions transfer with the property.

Example 21. Tom and Sue jointly own a commercial building. They have suspended losses of \$100,000 on the building. Sue receives Tom's one-half interest in the building in the property settlement. Sue receives Tom's basis in his half of the property, plus his share of the suspended losses, which adds to the basis. She depreciates this "fresh start" basis using the appropriate life and method for the property. Sue continues to depreciate her original interest using its existing life and method. She also continues to carry \$50,000 as her share of the suspended loss. Sue shows the building on her depreciation schedule as if it were two different assets.

SERIES E, EE, AND I BONDS

Deferred or accrued interest on E, EE, and I bonds must be included in the transferor spouse's gross income in the year of the transfer incident to divorce.⁵⁰ Because the transferor must report income to the extent of the interest, this amount is added to the basis of the bond. Therefore, the bond's basis for the recipient is the original cost of the bond plus the interest.

Example 22. Prior to Jennifer's marriage to Brian, she purchases a Series E bond for \$950. Jennifer does not elect to report the interest on the bond annually. At the time of her divorce, the bond accrued \$120 of interest. Jennifer transfers the bond to Brian in the property settlement. Jennifer must report the \$120 of accrued interest on her tax return in the year of the transfer. Brian's basis in the bond is \$1,070 (\$950 + \$120).

⁴⁷ IRC §1041(a)

⁴⁸ IRC §1366(d)(2)

⁴⁹ P.L. 108-357

⁵⁰ Rev. Rul. 87-112, November 2, 1987

STOCK OPTIONS

No gain or loss is recognized when stock, which otherwise qualifies for nonrecognition, transfers between spouses incident to a divorce. This is true even if the stock was acquired through a statutory stock option plan such as an employee stock purchase plan or an incentive stock option plan. It also applies to formerly available plans such as a restricted stock option plan and a qualified stock option plan. Even though the stock is transferred to the spouse or former spouse, it retains any restrictions that applied to the original owner.

Nonrecognition only applies to gains and losses, not income. However, the IRS determined the assignment of income doctrine does not apply to nonstatutory stock option and deferred compensation plans. Income is not recognized until the option is exercised or the income received. The recipient spouse is then treated the same as if he were the employee who received the option or compensation.⁵¹

The same treatment applies to a statutory stock option as it becomes a disqualified statutory option plan at the time of transfer. Nonrecognition treatment does not apply to plans which are not vested at the time of transfer.

Example 23. Scott and Elizabeth were divorced in 2002. Scott is employed by PDQ Corp. and was issued a nonstatutory stock option as part of his deferred compensation. Because the option did not have a readily discernible FMV at the time it was granted, no amount was included in Scott's gross income when it was granted.

PDQ maintains two unfunded deferred compensation plans under which Scott earns the right to receive post-employment payments. Under one of the plans, Scott is entitled to payments based on the balance of his individual account. At the time of the divorce, Scott's account balance was \$100,000 under that plan. Under the second plan, Scott is entitled to receive a single sum or periodic payments following separation from service based on a formula reflecting his years of service and compensation history. At the time of the divorce, Scott had \$50,000 under that plan. Scott's contractual right to the benefits of both plans is not contingent on Scott's performance of future services for PDQ.

Under state law in the state where Scott and Elizabeth live, stock options and unfunded deferred compensation rights earned by a spouse during their marriage are marital property subject to equitable division between the spouses in event of a divorce. Scott transferred to Elizabeth one-third of the nonstatutory stock options and the right to receive deferred compensation from PDQ under the account balance plan. This was based on \$75,000 of Scott's account balance under that plan at the time of the divorce, and the right to receive a single sum payment of \$25,000 from PDQ under the deferred compensation plan upon Scott's termination of employment with PDQ.

In 2006, Scott exercises all of the stock options and receives PDQ stock with an FMV in excess of the exercise price of the options. In 2011, Scott terminates employment with PDQ, and Elizabeth receives a single sum payment of \$150,000 from the account balance plan and a single sum payment of \$25,000 from the other deferred compensation plan.

The assignment-of-income doctrine does not apply to these transfers. Scott does not recognize income when Elizabeth exercises the stock options in 2006 or the payment of the deferred income in 2011. When Elizabeth exercises the stock options in 2006, she must include the proceeds in income as if she were the employee who performed the services. She must also include the amount realized from payments of deferred compensation in income in the year payments are paid or made available to her. The same conclusions apply if Scott and Elizabeth resided in a community property state and all or some of the income rights constituted community property that was divided as part of the divorce.

⁵¹ Rev. Rul. 2002-22, May 8, 2002

2006 Workbook

ANNUITIES

In some divorces, a taxpayer transfers an existing annuity or purchases an annuity for the former spouse as part of the alimony obligation. The transfer does not have any tax consequences. The recipient spouse must recognize income when payments begin. He can exclude from income a portion of every payment to the extent of the transferor's investment in the annuity.

Because part of the payments are excluded from income, this type of arrangement is beneficial to the recipient spouse. The payor spouse may deduct the portion of the annuity that is taxable to the recipient.

Note. If a taxpayer wants the annuity rules to apply, the divorce or separation agreement should indicate the annuity rules apply to payments.

RETIREMENT ACCOUNTS

QUALIFIED PLANS

A qualified domestic relations order (QDRO) is a judgment, decree, or court order which creates or recognizes the existence of an alternate payee's right to, or assigns to an alternate payee the right to receive all or part of the benefits of a qualified plan.

The QDRO must clearly identify all of the following:

1. The name and last known mailing address of the participant and the name and mailing address of each alternate payee covered by the order.
2. The amount or percentage of the participant's benefits to be paid by the plan to each alternate payee, or the manner in which the amount or percentage is to be determined.
3. The number of payments or the period to which the order applies.
4. Each plan to which the QDRO applies.

The QDRO may require that the payment be made at any time. If the payee is a spouse or former spouse of the plan participant, the alternate payee is taxed as if she were the distributee of the plan. If the alternate payee is a child or other dependent of the participant, the distribution is deemed a distribution to the plan participant and taxed to the plan participant.

The 10% early-distribution penalty does not apply to any distribution to an alternate payee under a QDRO regardless of the alternate payee's age at the time of the distribution.

The alternate payee may be eligible to roll over, or timely transfer to an IRA, all or a portion of a distribution under a QDRO. However, a trustee-to-trustee transfer is necessary to avoid the 20% withholding on the transfer.⁵²

Example 24. Robert and Angela agree that \$500 per month of Angela's 401(k) plan will be paid to Robert for the support of their child. Because the payment is for the benefit of a child, the monthly payment of \$500 is included as income on Angela's tax return. If no exceptions under §72(t) apply, she will also be subject to the 10% penalty.

⁵² IRC §402(e)(1)(B)

Example 25. Assume in **Example 24** that \$30,000 of the 401(k) plan is distributed to Robert as part of the property settlement. This is included as income on Robert's tax return; however, it is not subject to the 10% early-distribution penalty even if Robert is under age 59½ at the time of the distribution.

Note. The Pension Protection Act of 2006 requires the IRS to issue regulations for situations where a second QDRO is issued.

IRAs

The transfer of an individual's interest in an IRA to his spouse or former spouse under a divorce or separation instrument isn't a taxable transfer. The individual's interest at the time of the transfer is treated as an IRA of the individual's spouse, and not of the individual. After the transfer, the IRA is treated as maintained for the benefit of the spouse.

In a court case, the withdrawal of funds from an IRA to pay the amount of cash awarded to the IRA owner's ex-spouse in their divorce decree was held to be a taxable transfer. The withdrawal and payment to the ex-spouse wasn't a transfer of an interest in the IRA under the divorce decree because the taxpayer withdrew cash from the IRA rather than transfer the IRA account to the former spouse.⁵³

Once the funds are transferred to the former spouse, they are considered to be the IRA funds of the former spouse and all applicable penalties and taxes apply as if the former spouse were the original owner.

ALLOCATIONS

CAPITAL LOSS CARRYFORWARD

Capital loss carryforwards must be allocated upon the separate capital gains and losses of each spouse.⁵⁴ Gains and losses on jointly-owned or community property are generally divided equally between the spouses.

CHARITABLE CONTRIBUTIONS CARRYFORWARD

Charitable contribution carryforwards must be apportioned between spouses in the ratio of what separate carryforwards would be if the spouses filed separate returns for the year(s) the excess contribution arose.⁵⁵

NET OPERATING LOSS CARRYFORWARD

Net operating loss (NOL) carryforwards are required to be allocated between spouses in the ratio of what separate NOL operating loss carryforwards would be with each spouse separately computing income and deductions.⁵⁶

An interesting situation occurs when a taxpayer files an individual return in a year subsequent to a divorce, incurs an NOL, and carries the loss back to a year in which he was married. The loss can only be applied to the taxpayer's separate income. After the NOL is deducted against the taxpayer's separate income, the joint tax rates apply to the remaining taxable income.

If the taxpayer was not married in the NOL year (or was married to a different spouse), and in the carryback year she was married and filed a joint return, her refund for the overpaid joint tax may be limited. She can claim a refund for the difference between her share of the refigured tax and her contribution toward the tax paid on the joint return. The refund cannot be more than the joint overpayment. She must attach a statement showing how she computed the refund.

⁵³ *Norma A. Cohen v. Commr.*, TC Memo 2004-227, October 7, 2004

⁵⁴ Treas. Reg. §1.1212-1(c)(1)(iv)

⁵⁵ Treas. Reg. §1.170A-10(d)(4)

⁵⁶ Treas. Reg. §1.172-1(D)

2006 Workbook

There are five steps for figuring her share of the refigured joint tax liability:

1. Figure her total tax as though she had filed as married filing separately.
2. Figure her spouse's total tax as though her spouse had also filed as married filing separately.
3. Add the amounts in (1) and (2).
4. Divide the amount in (1) by the amount in (3).
5. Multiply the refigured tax on her joint return by the amount figured in (4). This is her share of the joint tax liability.

Unless she has an agreement or clear evidence of each spouse's contributions toward the payment of the joint tax liability, figure her contribution by adding the tax withheld on her wages and her share of joint estimated tax payments or tax paid with the return. If the original return for the carryback year resulted in an overpayment, reduce her contribution by her share of the tax refund. Figure her share of a joint payment or refund by the same method used in figuring her share of the joint tax liability. Use her taxable income as originally reported on the joint return in steps (1) and (2) above, and substitute the joint payment or refund for the refigured joint tax in step (5).⁵⁷

S CORPORATION SUSPENDED LOSS

Losses from an S corporation that are limited as a result of the shareholder's basis stay with the shareholder that held the stock at the time the loss was incurred. Suspended losses are treated as incurred by the corporation in the next taxable year for that shareholder.⁵⁸

For transfers prior to January 1, 2005, if the stock held by one spouse is transferred to the other spouse, the transferee spouse takes the basis of the transferor spouse. A suspended loss, limited to the basis of the stock, is not deductible by the transferee spouse.⁵⁹

Note. See discussion on page 20 regarding the change made by the American Jobs Creation Act of 2004.

GENERAL BUSINESS CREDITS CARRYFORWARD

General business credits and investment credits follow the property that generated the credit.⁶⁰

ESTIMATED TAX PAYMENTS

If taxpayers pay their estimated tax based on a jointly filed return, but subsequently decide to file separately, they may split the estimated payments in any manner they choose. For example, one taxpayer could take credit for the entire estimated payment or any part thereof.

Unfortunately, at the time of the divorce, the taxpayers may not be able to agree on the split. In this case, they must split the payments based on each person's individual tax liability reported on their separately filed return.⁶¹ This division can result in inequitable results as shown in the example on the following page.

⁵⁷ IRS Pub. 536, *Net Operating Losses (NOLs) for Individuals, Estates and Trusts*

⁵⁸ IRC §1366(d)(2)

⁵⁹ Ltr. Rul. 9552001, August 3, 1995

⁶⁰ Ltr. Rul. 8828032, April 14, 1988

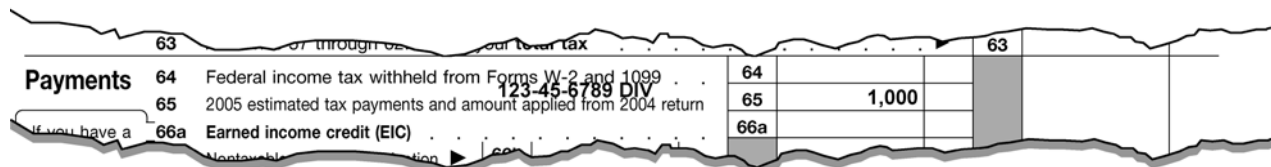
⁶¹ IRS Pub. 17, *Your Federal Income Tax*

Example 26. Mark and Karen were married eight years. Karen is an executive for an advertising agency and Mark is a self-employed farmer. Karen typically has enough withholding tax to cover her share of the tax liability. Mark, on the other hand, makes quarterly estimated payments, which total \$3,000 in 2005. When it is time to file their 2005 income tax return, they are in the middle of a bitter divorce. Karen refuses to file a joint return with Mark. While the estimated payments were made from the farm checking account, Karen believes she is entitled to her share of the payments. Because they cannot agree, the IRS prorates the payments according to each person's income tax as shown below.

	Mark	Karen
Wages		\$140,000
Taxable interest	\$ 750	750
Ordinary dividends	188	187
Farm income	20,000	
Total income	\$20,938	\$140,937
One-half SE tax	(1,413)	
Federal AGI	\$19,525	\$140,937
Standard deduction	(5,000)	(5,000)
Exemption	(3,200)	(1,536)
Taxable income	\$11,325	\$134,401
Tax	1,313	34,614
Percentage of total tax	3.65%	96.35%
Withholding		(\$ 31,500)
Estimated payment allocation	(\$ 110)	(\$ 2,890)
Balance of taxes due	\$ 1,203	\$ 224

Observation. If Mark and Karen filed a joint return, they would reduce their tax liability by \$5,907.

If any of the joint payments are claimed on the separate tax return, the former spouse's social security number (SSN) must be entered in the space provided on the front of Form 1040 or Form 1040A. If the person claiming the estimated payment divorces and remarries during the year, the current spouse's SSN is entered in the space on the front, and the former spouse's SSN, followed by "DIV," is written to the left of line 65, Form 1040, or line 40, Form 1040A.



ESTIMATED TAX PENALTIES

If the taxpayers file separate returns, any estimated penalties are based on the return filed. If a joint return is filed and an estimated penalty is assessed after the divorce, both taxpayers have joint and several liability for any balance due.

2006 Workbook

TAX REFUNDS

If a joint return is filed, each spouse has a separate interest in any refund.⁶²

Example 27. Patricia and Tim were married in 2005 and filed a joint tax return. The entire tax on the joint return was paid from withholdings from Pat's W-2 wages. In addition, the return reported an overpayment of \$7,000. Prior to the marriage, Tim filed as single in 2003 and 2004. He has an unpaid federal tax liability of \$8,500 in those two years. The IRS cannot apply the \$7,000 refund from 2005 against Tim's unpaid taxes.

SEPARATE RETURN ITEMIZED DEDUCTIONS

If the taxpayers are married filing separate tax returns and one decides to itemize his personal deductions, both must itemize. The itemized deductions consist of those the taxpayer paid separately and a portion of those paid jointly. The following table from IRS Pub. 504, *Divorced or Separated Individuals*, shows how the deductions are split.

Itemized Deductions on Separate Returns

*This table shows itemized deductions you can claim on your separate return whether you paid the expenses separately with your own funds or jointly with your spouse. **Caution:** If you live in a community property state, these rules do not apply. See Community Property.*

IF you paid ...	AND you ...	THEN you can deduct on your separate federal return ...
medical expenses	paid with funds deposited in a joint checking account in which you and your spouse have an equal interest	half of the total medical expenses, subject to the limits, unless you can show that you alone paid the expenses.
state income tax	file a separate state income tax return	the 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 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: <ul style="list-style-type: none"> • the state income tax you alone paid during the year, or • the total state income tax you and your spouse paid during the year multiplied by the following fraction. The numerator is your gross income and the denominator is your combined gross income.
property tax	paid the tax on property held as tenants by the entirety	the property tax you alone paid.
mortgage interest	paid the interest on a qualified home held as tenants by the entirety	the mortgage interest you alone paid.
casualty loss	have a casualty loss on a home you own as tenants by the entirety	half of the loss, subject to the deduction limits. Neither spouse may report the total casualty loss.

The following rules also apply if filing separately:

1. Tax rates increase at income levels that are lower than those for a joint return filer.
2. The exemption amount for figuring the alternative minimum tax is half of that allowed a joint return filer.
3. The separate filer loses the credit for child and dependent care expenses in most cases.
4. The separate filer loses the earned income credit.
5. The separate filer loses the exclusion or credit for adoption expenses in most instances.

⁶² Rev. Rul. 74-611, January 1, 1974

6. The separate filer loses the credit for higher education expenses (Hope and lifetime learning credits), the deduction for student loan interest, or the deduction for tuition and fees.
7. The separate filer excludes the interest from qualified savings bonds that are used for higher education expenses.
8. If the taxpayer lived with her spouse at any time during the tax year:
 - She cannot claim the credit for the elderly or the disabled,
 - She must include in income up to 85% of any social security or equivalent railroad retirement benefits received, and
 - She cannot roll over amounts from a traditional IRA into a Roth IRA.
9. Married filing separately imposes more strict income limits that reduce the child tax credit, retirement savings contributions credit, itemized deductions, and amounts she can claim for exemptions. These limits are half of those allowed a joint return filer.
10. The separate filer's capital loss deduction limit is \$1,500 (instead of \$3,000 on a joint return).
11. The basic standard deduction, if allowable, is half of that allowed a joint return filer.

PAYMENT OF KIDDIE TAX

Divorce can create problems when there are children under the age of 18. The child's parents may disagree about who pays the "kiddie tax." This can occur either during the divorce process or after the divorce is final. This is important since the kiddie tax (on the child's investment income in excess of \$1,700 in 2006) is based on the parent's marginal tax rate. The child must complete Form 8615, *Tax for Children Under Age 18 With Investment Income of More Than \$1,700*, and attach it to the child's return.

If the parents are divorced, filing separately, or lived apart the last six months of the year, the income of the custodial parent is used in the calculation. If the custodial parent remarried and files a joint return with a new spouse, the top tax rate on the joint return is used. If the divorce is not final, the tax rate of the parent with the highest income is used. If the parent files an amended return later reporting a higher income, the kiddie tax must be recalculated. The responsibility of filing the child's return falls upon the custodial parent.

If the parent or sibling information needed to complete Form 8615 cannot be obtained before the due date of the child's tax return, the parental or sibling information may be estimated. "Estimate" must be written next to the applicable lines. When correct information is obtained, the child's return should be amended.⁶³

Note. The Pension Protection Act of 2006 increases the age limit for the kiddie tax from age 14 to age 18. This is discussed in Chapter 14, "New Legislation."

SIGNING A JOINT RETURN

Although a high-income taxpayer may want the spouse to sign a joint tax return, there are no requirements that he sign. He cannot even be forced to sign by court order. However, there are court cases which address this situation.

If one spouse demands payment for signing a joint return, one case suggests that if the nonsigning spouse has no income, and has always signed a joint return, and there is no reason to believe the return is fraudulent then, the filing spouse may still file a joint return. The joint return does not have the other spouse's signature.⁶⁴

If the nonsigning spouse has already filed as married filing separate, nothing can be done.⁶⁵

⁶³ IRS Announcement 88-70, April 13, 1988

⁶⁴ *Vincent Riportella v. Commr.*, TC Memo 1981-463, August 26, 1981

⁶⁵ *J. Michael Springmann v. Commr.*, TC Memo 1987-474, September 21, 1987

2006 Workbook

AMENDED RETURNS

The IRS ruled that it accepts a claim for refund or credit filed by a divorced taxpayer on a Form 1040X for a joint return if the Form 1040X is signed by only one of the spouses. The IRS issues a refund check in the name of the taxpayer who filed the Form 1040X. However, the amount of the individual taxpayer's refund is determined by recomputing the taxpayer's share of the joint liability and subtracting that amount from the taxpayer's contribution toward the joint liability. This is done using the IRS allocation method based on separate return liability amounts. The amount of the refund is limited to the amount of the joint overpayment.

SPECIAL TREATMENT OF COMMUNITY PROPERTY LAWS

Married taxpayers who reside in a community property state are subject to special rules for determining taxable income. Taxpayers residing in a community property state during any part of the tax year may have community income. Any income earned by either spouse is considered community income. Income from investments purchased before marriage or income from inherited property is considered separate property. Married spouses filing separate returns must report one-half of any income described as community income under state law. Each spouse may also claim one-half of the income tax withheld from community income.

The following states are community property states:

- Arizona
- California
- Idaho
- Louisiana
- Nevada
- New Mexico
- Texas
- Washington
- Wisconsin

In some states, a husband and wife may enter into an agreement that affects the status of property or income as community or separate property. Different states have different rules.

COMMUNITY INCOME

IRC §66, *Treatment of Community Income*, applies if:

- Two individuals are married to each other at any time during a calendar year,
- Live apart at all times during the calendar year, and
- Do not file a joint return with each other for a taxable year beginning or ending in the calendar year.

One or both of the individuals must have earned income for the calendar year that is community income; and no portion of the earned income is transferred (directly or indirectly) between the individuals before the close of the calendar year. If this is the case, any community income of the individuals for the calendar year is reported in the manner below:

- Earned income other than trade or business income and a partner's distributive share of partnership income, is treated as the income of the spouse who rendered the personal services.
- Trade or business income, and a partner's distributive share of partnership income, is treated as income of the spouse carrying on the trade or business. If the trade or business is operated jointly, each spouse is entitled to their respective share.
- Community income not described above which is derived from the separate property (as determined under the applicable community property law) of one spouse is treated as the income of that spouse.
- All other such community income is treated as provided in the applicable community property law.

Earned Income

Earned income that is not trade, business, or partnership income is treated as the income of the spouse who performed the services to earn the income.

Trade or Business Income

Income and related deductions from a trade or business that is not a partnership are treated as those of the spouse carrying on the trade or business. If capital investment and personal services both produce business income, all of the income is treated as trade or business income.

Partnership Income or Loss

Income or loss from a trade or business carried on by a partnership is treated as the income or loss of the spouse who is the partner.

Separate Property Income

Income from the separate property of one spouse is treated as the income of that spouse.

Social Security Benefits

Social security and equivalent railroad benefits are treated as the income of the spouse who receives the benefits.

All other community income — such as dividends, interest, rents, royalties, or gains — are treated as provided under that state's community property laws.

ENDING THE COMMUNITY

When the marital community ends, the community assets are divided between the spouses and the income received after the division is taxable to the spouse that receives the property.

An absolute decree of divorce or annulment ends the community in all community property states. A decree of legal separation or of separate maintenance may or may not end the community.

The tax professional should check with state laws binding the taxpayer to determine when the community ends.

2006 Workbook

INNOCENT SPOUSE RELIEF IN COMMUNITY PROPERTY STATES

If the taxpayers were married and filed a separate return in a community property state and are now liable for an underpayment or understatement of tax, the innocent spouse has two relief options.

He is not responsible for the tax related to an item of community income if all of the following conditions exist:

- The taxpayer did not file a joint return for the tax year.
- The taxpayer did not include the item in gross income on his separate return.
- The item was income that belonged to the taxpayer's spouse or former spouse.
- The taxpayer establishes that he did not know of, and had no reason to know of, that item.
- Under all facts and circumstances, it would not be fair to include the item in gross income.

If this applies, then the taxpayer writes "Innocent Spouse Relief under Code Sec. 66(c)" across the top of Form 8857, *Request for Innocent Spouse Relief*, and completes Parts I, II and IV. A statement is attached to the form explaining why the taxpayer qualifies for relief.

If the taxpayer does not qualify for the relief and is liable for an underpayment or understatement of tax which, in the taxpayer's opinion, should be paid only by the spouse or former spouse, the taxpayer may request equitable relief. His request must state that it would be inequitable to hold the taxpayer responsible for the tax and explain the reason.