Chapter 2: Divorce

Corrections were made to this workbook through January of 2013. No subsequent modifications were made.

While a divorce proceeding may involve several important issues, the impact of tax law on the parties to a divorce is an area of importance that continuously evolves legislatively and judicially. Proper tax advice should be obtained as soon as possible within the course of a divorce to help prevent unwanted tax consequences to the divorcing spouses.

In addition, there are various tax attributes of the parties that are viewed as marital assets. Early and prudent tax advice will uncover these additional "tax marital assets" and ensure that the parties maximize the value of these assets under applicable Code provisions. Early advice can also prevent unforeseen tax consequences from frustrating the intention of the parties or the divorce court.

TAX RETURN ISSUES

FILING STATUS

The IRS acknowledges that state law controls whether an individual is considered married.[1] Only persons considered married may file joint returns.[2] Marital status is determined on the **last day of the tax year.** Spouses must have the same tax year in order to qualify for filing a joint return.[3] However, a joint return can be filed if a difference in tax years exists because one or both spouses died.[4] Therefore, a joint return may still be filed if a spouse's death occurs prior to the time a divorce is finalized.

In the year a spouse dies, if the surviving spouse remarries before the end of that tax year, the surviving spouse can file jointly with the new spouse but cannot file jointly with the deceased former spouse. The deceased former spouse's filing status is MFS. If a spouse's death occurs, marital status on the date of death determines whether joint filing status is appropriate.[5] In addition, both spouses must be U.S. citizens or U.S residents to file jointly.[6]

Note. A couple in a **common-law marriage** is considered married under tax rules and **can** file jointly as long as their common-law marriage began in a state recognizing common-law marriages[7] or if they live in one of these states at the end of the tax year. Although there is common-law marriage in these states, there is no such thing as a "common-law divorce." Common-law couples must use the same formal divorce procedures in their state that married couples must use to obtain a divorce.

1. Rev. Rul. 58-56, 1958-1 CB 60.
2. IRC §6013(a).
3. IRC §6013(a)(2).
4. Ibid.
5. IRC §6013(d)(1)(B).
6. IRC §6013(a)(1).
7. These states are: Alabama, Colorado, Georgia, Idaho, Iowa, Kansas, New Hampshire (for inheritance purposes only), Ohio, Oklahoma, Pennsylvania, Rhode Island, South Carolina, Texas, Utah and the District of Columbia. These laws vary from state to state. The laws of each state should be referenced for specific limitations or dates that may be relevant to specific situations.

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Separation, Divorce, and Filing Status

A married couple can file jointly even though the spouses did not live together during part or all of the tax year. However, spouses legally separated under a decree of separate maintenance are not considered married and cannot file jointly. Divorced spouses are no longer considered married once the divorce is **final.** If the divorce decree is **interlocutory,** the spouses are considered married until the decree is final.

An "interlocutory" divorce decree (sometimes called a "judgment nisi"), is a decree that is issued by the court but is considered incomplete or temporary until after the expiration of a period of time (such as 30, 60, or 90 days), when it automatically becomes final. Many state courts use judgments nisi for divorce. During the waiting (nisi) period after entry of the judgment for divorce, the spouses are still considered married and are officially divorced only after the expiration of the nisi period.

> **Example 1.** Phil and Dolores, a married couple, have the same calendar tax year. They file for divorce in January 2012. A final decree of divorce is issued by the court on December 15, 2012. On the last day of their respective tax years, December 31, 2012, Phil and Dolores are not married. They ceased being married on December 15, 2012. They cannot file MFJ for the 2012 tax year.

> **Example 2.** Use the same facts as **Example 1,** except the final divorce decree is issued February 23, 2013. Because Phil and Dolores are still considered married until the final decree and therefore are still married on December 31, 2012, they may file MFJ for the 2012 tax year.

> **Example 3.** Use the same facts as **Example 1,** except the court order issued on December 15, 2012, is a judgment nisi with a 30-day nisi period. Phil and Dolores are still considered married on December 31, 2012, and can file jointly for the 2012 tax year.

Invalid Divorce Judgment. If a state court later finds a final divorce judgment invalid, the IRS will disregard the divorce.[8] However, there is a split of authority among tax cases in federal courts involving invalid divorce decrees. The 2nd Circuit[9] decided it would not recognize a state court's determination that a divorce is invalid. The 9th Circuit, however, ruled that such a determination by a state court must be recognized.[10] The IRS indicated that a foreign jurisdiction divorce for the sole purpose of avoiding the "marriage penalty" is not recognized. If a divorce becomes effective at the end of a tax year with a subsequent remarriage at the beginning of the following tax year, intent to avoid tax may be inferred.[11]

Appeal of Divorce Judgment. State law determines whether a divorce decree remains final if it is appealed. If an appeal makes the divorce judgment interlocutory, the spouses are considered married until the divorce judgment is final after the appeal is resolved. The 4th Circuit held that a joint return could not be filed in a year in which a Maryland divorce was appealed because the divorce remained final despite the appeal.[12] However, in states where an appeal delays finality, a joint return may be permitted.

Annulment. When spouses filed a joint return and a state court, holding that there never was a valid marriage, annulled the marriage in the following year, the IRS required amended returns using the single filing status.[13] Amended returns are required for all tax years affected by the annulment that are not closed by the statute of limitations. In addition, the Tax Court held that a taxpayer whose marriage was annulled had a right to amend returns from joint to single status.[14]

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8. Rev. Rul. 67-442, 1967-2 CB 65.
9. *Est. of H. Borax v. Comm'r*, 349 F.2d 666 (Jul. 30, 1965), *cert. denied*, 383 U.S. 935; *H.E. Wondsel v. Comm'r*, 350 F.2d 339 (Aug. 2, 1965), *cert. denied*, 383 US 935.
10. *H.K. Lee v. Comm'r*, 550 F.2d 1201 (Mar. 29, 1977).
11. Rev. Rul. 76-255, 1976-2 CB 40.
12. *K.T. Sullivan v. Comm'r,* 256 F.2d 664 (4th Cir. 1958); Rev. Rul 79-330, 1979-2 CB 391.
13. Rev. Rul. 67-442, 1967-2 CB 65.
14. *W.R. Wilson v. Comm'r,* TC Memo 1976-285 (Sep. 8, 1976).

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Filing Status after Divorce

After a divorce is finalized, the taxpayer may have the option of choosing single or head of household (HoH) status. However, if the divorced taxpayer remarries, that taxpayer may jointly file with the new spouse if the taxpayer and new spouse are married on or before December 31 of the tax year.

> **Note.** A taxpayer may qualify to file as HoH even before the divorce is final. For more information on the requirements to file HoH, see 2012 Volume A, Chapter 3: Individual Taxpayer Topics, as well as IRS Pub. 17, *Your Federal Income Tax (For Individuals)*.

DEPENDENCY EXEMPTION

Custodial Parent

A custodial parent may claim a dependency exemption for a child. The custodial parent is the parent in whose home the child sleeps for the greater number of nights during the year. This is the case even if that parent is not present in the home when the child is there. Overnight stays with the parent that occur outside that parent's home count as nights with that parent. If the child spends an equal number of nights with each parent during the year, the custodial parent is the parent with the higher adjusted gross income. Neither parent is considered a custodial parent of a child that has attained the age of majority under state law.[15]

Special Rule for Parents Working Nights. A child may spend days instead of nights with a parent due to the parent's nighttime work schedule. In this case, days are counted instead of nights. The parent with whom the child spends the greater number of days is the custodial parent. However, on school days, the child is deemed to reside at the primary residence that is registered with the child's school.

Transferring the Dependent Child Exemption

IRC §152(e) provides for the transfer of the dependent child exemption from the custodial to the noncustodial parent. This can only be accomplished if **all four** of the following requirements for §152(e) are satisfied.

1. The parents:
   a. Are either divorced or legally separated under a decree of divorce or separate maintenance,
   b. Are separated under a written separation agreement, or
   c. Lived apart at all times for the last six months of the year, whether married or not.[16]
2. The parents provide over half of the child's support for the year.[17]
3. One or both parents had legal custody of the child under state law for more than half of the year.[18]
4. The custodial parent provides **qualifying documentation** to waive the claim to the dependent child's exemption and transfer the right of that claim to the noncustodial parent.

15. Treas. Reg. §1.152-4(d).
16. IRC §§152(e)(1)(A)(i)–(iii); Treas. Reg. §§1.152-4(b)(2)(i)(A)–(C).
17. IRC §152(e)(1)(A); Treas. Reg. §1.152-4(b)(2)(i).
18. Treas. Reg. §1.152-4(c).

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"Qualifying documentation" is one of the following.

1. The custodial parent's **written waiver** of the dependent child's exemption that:

   a. Is unconditional,

   b. Is signed by the custodial parent,

   c. Names the **noncustodial parent** to whom the exemption claim is being transferred,

   d. Specifies the **tax year(s)** that it is effective, and

   e. Is provided on IRS **Form 8332,** *Release/Revocation of Release of Claim to Exemption for Child by Custodial Parent.* A document similar to Form 8332 that provides the same information and is used for the same sole purpose is also sufficient. A court order, decree, or separation agreement generally does not suffice for this purpose.[19]

2. If the noncustodial parent provides at least $600 for the support of the child during the year, a **pre-1985** divorce decree, separate maintenance agreement, or other written agreement indicating that the noncustodial parent is entitled to claim the child dependency exemption will suffice.[20]

The qualifying documentation must be attached to the noncustodial parent's tax return each year that the noncustodial parent claims the dependent child exemption.[21]

Alternate Documentation. Although the regulations specifically indicate that a court order, decree, or separation agreement will not suffice as the written waiver,[22] IRS Pub. 504, *Divorced or Separated Individuals,* indicates that under certain circumstances, such alternate documentation may be submitted which **will** suffice. This alternate documentation rule can **only** be used for parents having a **divorce decree or separation agreement dated anytime during 1985 through 2008, inclusively.** IRS Pub. 504 states that the noncustodial parent's tax return can be accompanied by the relevant pages of the decree or agreement stating the following.

- The noncustodial parent can claim the dependent child exemption without condition.
- The custodial parent will not claim the exemption for the child.
- The particular taxation years that the noncustodial parent is entitled to claim the exemption are listed.

The relevant pages indicating the above information along with the following additional pages may be attached to the noncustodial parent's tax return to support the claim.

- The signature page showing the custodial parent's signature and the date of the decree or agreement
- The cover page showing the custodial parent's social security number

Note. The following examples assume that the child in each example meets the requirements of a "qualifying child" for purposes of the dependency exemption. These requirements are found in IRC §152(c). Moreover, these examples assume that the parents provide over half of the child's support unless otherwise specified.

19. Treas. Regs. §§1.152-4(b)(3)(i) and 1.152-4 (e)(1)(i)–(ii).

20. Treas. Reg. §1.152-4(b)(3)(ii).

21. Treas. Reg. §1.152-4(e)(2).

22. Treas. Reg. §1.152-4(e)(1)(ii).

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Example 4. John and Linda are the divorced parents of their 3-year old daughter, Gracie. Their divorce was final on November 29, 2011, but they lived apart since March 15, 2011, when John moved into a new apartment. Gracie stayed with Linda in the matrimonial home and John visited Gracie there regularly. Under the terms of the divorce decree, Linda's brother, Steve (Gracie's uncle), has custody of Gracie from January 1, 2012, to July 4, 2012.

Both parents had legal custody of Gracie under state law for more than half of the year and John and Linda provided over half of Gracie's support during 2011. Because Gracie spent nights solely with Linda since the March 15, 2011, separation date, Linda is the custodial parent for purposes of claiming the dependent child exemption for 2011. These facts provide Linda with the ability to invoke IRC §152(e) and transfer her right to claim a 2011 dependency exemption for Gracie to John. She can accomplish this by completing and forwarding to John the following Form 8332 for 2011 (or a similar statement), which John can attach to his tax return.

Note. Even though Linda released the exemption to John for 2011, she may still claim HoH, the earned income credit (EIC), and the dependent child care credit if otherwise qualified. However, John can claim the child tax and education credits if applicable, because these credits are tied to the exemption.

Form **8332**
(Rev. January 2010)
Department of the Treasury
Internal Revenue Service

Release/Revocation of Release of Claim to Exemption for Child by Custodial Parent

▶ **Attach a separate form for each child.**

OMB No. 1545-0074
Attachment Sequence No. **115**

Name of noncustodial parent: **John Corbett**
Noncustodial parent's social security number (SSN) ▶ **444 | 44 | 4444**

Part I **Release of Claim to Exemption for Current Year**

I agree not to claim an exemption for **Gracie Anne Corbett**
Name of child

for the tax year 20**11**.

Linda Corbett
Signature of custodial parent releasing claim to exemption

555 | 55 | 5555
Custodial parent's SSN

Date

Note. If you choose not to claim an exemption for this child for future tax years, also complete Part II.

Part II **Release of Claim to Exemption for Future Years** (If completed, see **Noncustodial Parent** on page 2.)

I agree not to claim an exemption for ______
Name of child

for the tax year(s) ______ .
(Specify. See instructions.)

Signature of custodial parent releasing claim to exemption | Custodial parent's SSN | Date

Part III **Revocation of Release of Claim to Exemption for Future Year(s)**

I revoke the release of claim to an exemption for ______
Name of child

for the tax year(s) ______ .
(Specify. See instructions.)

Signature of custodial parent revoking the release of claim to exemption | Custodial parent's SSN | Date

Note. Linda could also complete Form 8332, Part II, and specify either particular tax years or indicate the form is for "all future years." Part III is used for the revocation of a previously completed Form 8332 (discussed later).

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For 2012, because Gracie was in the custody of her uncle Steve for more than half of the year, neither John nor Linda had custody of Gracie for more than half the year. Therefore, the dependent child exemption **transfer provision of IRC §152(e) cannot be used.** However, if Gracie is a "qualifying child" under §152(c) or "qualifying relative" under §152(d) of John, Linda, or Steve, that person can claim the 2012 exemption for Gracie. John or Linda may be able to claim an exemption for Gracie as a qualifying relative or Steve may be able to claim Gracie as a qualifying child for 2012.

Example 5. Frank and Frances are the parents of their 17-year old son, Alfredo. Frank and Frances finalized their divorce on January 11, 2011, and have lived apart since the divorce. The court granted Frank's mother, Norma, custody of Alfredo for the first three months of 2011. From April 1 through December 31, Frank and Frances had joint custody. Beginning April 1, Alfredo resided 190 nights with Frank and 85 nights with Frances. Alfredo is a qualifying child and Frank and Frances provide over half his support. Because one or both parents had custody of Alfredo for more than half of the year (April 1 through December 31), the requirements of §152(e) are met. Alfredo lived with Frank for the greater number of nights, which means Frank is the custodial parent. Frank can complete and sign a Form 8332 (or similar statement) releasing his right to claim an exemption for Alfredo, giving that right to Frances.

Example 6. Use the same facts as **Example 5,** except on April 6, 2011, Frank leaves the country for military duty and Alfredo lives with Frank's mother while Frank is away. Alfredo spends the same 85 nights with Frances as in **Example 5.** Frank does not return until the middle of 2012. From April 6 to December 31, 2011, Alfredo would have resided with Frank had it not been for Frank's temporary absence. The nights Alfredo spent with Frank's mother during Frank's absence count as nights with Frank. The result is the same as in **Example 5.**

Example 7. Use the same facts as **Example 5.** In 2012, Alfredo lives with Frank during the entire tax year. Alfredo attains age 18 on September 28, 2012. Under state law, Alfredo is emancipated as of September 28, 2012. After his 18th birthday, neither parent can be the custodial parent of Alfredo. However, because Frank had custody of Alfredo for more than half of the year prior to Alfredo's 18th birthday, Frank can use §152(e) to transfer the exemption to Frances as long as all the other requirements are met.

Example 8. Use the same facts as **Example 7,** except Alfredo's 18th birthday is on March 12, 2012. Frank did not have custody of Alfredo for more than half of the year because Alfredo was emancipated[23] on his birthday. Frank is **not considered a custodial parent** and cannot use §152(e).

Note. The emancipated child rules can have significant tax consequences, especially if the child is a student with qualified higher education expenses. It may be that Treas. Reg. §1.152-4, which established this rule, is inconsistent with congressional intent. See pages 102–105 of the 2011 *University of Illinois Federal Tax Fundamentals* workbook, for a detailed discussion of this issue.

ALLOCATION OF TAX BENEFITS BETWEEN DIVORCED PARENTS

When the custodial parent transfers the right to claim the child's dependency exemption to the noncustodial parent, the right to claim the following additional benefits is also transferred.

- The child tax credit
- Any education credits for the child's education expenses

A custodial parent who transfers the dependency exemption is still considered as meeting the qualifying child requirement for purposes of filing as HoH and can still claim a dependent care credit. In addition, the EIC can be claimed only by the custodial parent, regardless of any transfer of the child's exemption to the noncustodial parent.[24]

23. See Example 6 of Treas. Reg. §1.152-4.

24. IRC §§32(c)(3)(A) and 152(e).

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Medical Expense Deduction by Either Parent

If all the §152(e) requirements are met, a noncustodial parent can claim the following items even if they have not been given the right to claim the child's exemption from the custodial parent.

- A §105(b) income exclusion for medical expense reimbursement in connection with medical expenses incurred for the child
- An income exclusion for accident or health plan contributions for the child by an employer under §106(a) and Treas. Reg. §1.106-1
- A fringe benefit income exclusion for no-additional-cost services or qualified employee discounts under §132(a) when the child's use of these benefits is considered to be use by the taxpayer parent under §132(h)(2)
- The deduction of medical expenses of the child under §213(a)
- Income exclusions for Archer medical savings accounts and health savings accounts under §§220(f)(1) and 223(f)(1) if the distribution is used to pay qualified medical expenses of the child

The child is considered a dependent of **both** parents in connection with the above claims.[25]

TAX LIABILITY

MFJ taxpayers are jointly and severally liable for the taxes owed on a joint return.[26] The couple remains jointly and severally liable for all taxes on joint returns filed for all tax years ending before the finalization of a divorce. Pre-divorce returns filed separately and all post-divorce tax returns result in individual liability for each divorced spouse. To determine the extent of joint tax liability, it is essential to determine the extent of the tax liability that arises from any pre-divorce joint returns that have been filed.

Example 9. Bill filed for divorce from Betty in September 2009. In October 2009, Bill sold some GM stock at a substantial gain. This resulted in substantial additional tax liability for 2009. Bill and Betty decided to file MFJ for 2009 despite their pending divorce. Their divorce was finalized in state court on November 6, 2010. They also had an unpaid tax liability for 2007 and 2008. They file tax returns with the following tax liabilities.

Tax Year	Filing Status Used	Joint Tax Liability	Bill's Individual Tax Liability	Betty's Individual Tax Liability
2007	MFJ	$ 6,000 (unpaid)		
2008	MFJ	4,200 (unpaid)		
2009	MFJ	17,400		
2010	Single (both)		$5,000	$1,100
2011	Single (both)		1,400	1,560

Because Bill and Betty filed MFJ for the 2009 tax year, they are **both** jointly and severally liable for the 2009 taxes as well as for the unpaid balances for 2007 and 2008. This means that both Betty and Bill are liable for the entire $17,400 balance owed for 2009 and for the unpaid balances for 2007 and 2008 of $6,000 and $4,200 respectively.

Example 10. Use the same facts as **Example 9,** except Bill and Betty decide to file MFS for the 2009 taxation year. Bill's sale of GM stock is reported exclusively on his return. Bill is solely liable for the tax liability on the stock sale gain. For 2009, Betty is liable for only the amount of tax reported on her MFS return. Betty remains jointly and severally liable for the 2007 and 2008 unpaid balances because she filed MFJ with Bill for those years.

25. Rev. Proc. 2008-48, 2008-2 CB 586.

26. IRC §6013(d)(3); Treas. Reg. §1.6013-4(b).

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Requirements of a Joint Tax Return

A divorced spouse cannot be held jointly and severally liable unless a joint return is filed with a former spouse. Regardless of whether both signatures are on a return as required by regulations for the filing of a joint return,[27] courts hold that **intent** to file jointly is a necessary aspect of a joint return. A signature on a joint return does not, by itself, conclusively establish the necessary intent. Consider the following cases.

- A return signed by both spouses did not constitute a joint return. Because the wife helped complete the return, she believed she had to sign it. She did not intend for a joint return to be filed, her name was not indicated as spouse at the top of the return, and she gained no advantage from filing the return jointly.[28]
- Returns filed separately by a married couple because of poor accounting advice were treated as one joint return. The court held that the couple was not bound by an intentional election because the couple did not understand their choice to file separate or joint returns and they relied solely on the accountant's advice.[29]

If only one spouse signs the return or if one spouse signs for the other without their consent, courts may find that a joint return exists because of the **tacit consent** of the nonsigning spouse.[30] Tacit consent can be found in cases with a nonsigning spouse who did not file a separate return, knowing that the other spouse is filing a return.[31] A nonsigning spouse who is familiar with the obligation to file an annual return and who permits their own income to be reported on a joint return may also have tacitly consented to the filing of that return.[32]

IRS-Prepared Returns. The IRS can prepare a return for a taxpayer who fails to file a return but agrees to provide the information needed for its preparation.[33] An IRS-prepared document constitutes a joint return if it is based on information from a married couple who intended to file a joint return and signed the document under penalty of perjury.[34] However, if the return is prepared by the IRS based on information provided by third parties, it does not constitute a return because it is not signed under penalty of perjury.[35] A signature under penalty of perjury is a requirement for a valid return.[36]

If a taxpayer's name is signed to a return, the IRS presumes that the taxpayer in fact signed it.[37] However, this presumption is rebuttable.[38]

Duress. A joint return does not exist if one spouse demonstrates to the IRS that their signature on the return was obtained under duress.[39] Accordingly, a spouse that signs under duress is not jointly and severally liable for the tax shown on the return. The IRS recomputes the return for the spouse that signed voluntarily by using the MFS status. This recomputed return reflects only the income and tax liability of that spouse.

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27. Treas. Reg. §1.6013-1(a)(2).

28. *V.C. Payne v. U.S.*, 247 F.2d 481 (8th Cir. 1957), *cert. denied,* 355 US 923.

29. *R.A. Kiesling v. U.S.*, 171 F.Supp 314 (S.D. Tex., 1958).

30. See *M. Heim v. Comm'r*, 251 F.2d 44 (8th Cir. 1958); *M.S. Howell v. Comm'r*, 10 TC 859 (May 17, 1948) *aff'd per curiam* 175 F.2d 240 (6th Cir. 1949); *W.L. Kann v. Comm'r,* 210 F.2d 247 (3rd Cir. 1954), *cert. denied,* 347 US 967.

31. *H. Klayman v. Comm'r*, TC Memo 1979-408 (Sep. 27, 1979).

32. *M.W. Streit v. Comm'r*, TC Memo 1989-265 (Jun. 1, 1989).

33. IRC §6020(a).

34. Ibid.

35. IRC §§6020(b)and 6065; Rev. Rul. 2005-59, 2005-37 IRB 505.

36. IRC §6065.

37. IRC §6064.

38. Service Center Advice 1998-021 (Sep. 9, 1998); *V. Hennen v. Comm'r*, 35 TC 747 (1961).

39. Treas. Reg. §1.6013-4(d).

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DIVISION OF PROPERTY

Many people involved in a divorce think of their assets merely in terms of value. However, many assets carry intrinsic tax consequences that should be considered when dividing the property. For example, the tax consequences are significantly different when selling depreciated rental property versus selling a main home. The tax effects are also profoundly different when redeeming CDs versus taking distributions from IRAs.

NONRECOGNITION RULES

Three basic rules apply to the transfer of property between spouses or incident to a divorce. These nonrecognition rules apply to **outright transfers** or **transfers in trust** incident to a divorce.[40]

1. For transfers prior to the finalization of the divorce, no gain or loss is recognized on the transfer of property between spouses.[41]
2. For transfers after the divorce is finalized, no gain or loss is recognized on the transfer of property between former spouses if the transfer is **incident to the divorce.**[42]
3. The transfer is treated as a gift and the spouse receiving the property takes the same basis that the transferor spouse had immediately before the transfer.[43]

A transfer is "incident to the divorce" if it occurs **within one year** after the ending date of the marriage or if it is made under a qualifying divorce or separation agreement not more than six years from that date.[44]

The transfer must be a transfer of property. What constitutes "property" is a question of state law. Property generally includes **all** property, including real and personal property and tangible and intangible property.[45]

The nonrecognition rules also apply to any indebtedness that is discharged incident to the divorce.[46] In addition, these nonrecognition rules are applicable to property that was not owned by either spouse during the marriage.

Example 11. Ken and Nikki finalized their divorce on December 31, 2011. Rather than selling their house and dividing the proceeds after the divorce, Nikki decides to purchase a second house with a value of approximately half of the home and transfers it to Ken before December 31, 2012. The nonrecognition rules prevent the triggering of any capital gain or loss to Nikki upon the transfer and Nikki receives a carryover basis from Ken's half of the matrimonial home. Ken's basis in the new house received from Nikki also has a carryover basis equal to the amount Nikki paid for the house.

Example 12. Adam and Adriana finalized their divorce in 2003. At the time of their divorce, Adam, an inventor, was involved in patent infringement litigation. Their divorce decree ordered Adam to pay Adriana a percentage of any damage award Adam receives from the litigation. Eight years after the divorce, Adam wins his lawsuit and obtains a damage award. He immediately pays Adriana her portion. The transfer of funds to Adriana is considered a transfer of property incident to a divorce and is accorded **nonrecognition** treatment despite the transfer occurring eight years later.[47]

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40. IRC §1041(a).
41. IRC §1041(a)(1).
42. IRC §1041(a)(2).
43. IRC §1041(b).
44. IRC §1041(c); Temp. Treas. Reg. §1.1041-1T(b).
45. IRC §1041(c); Temp. Treas. Reg. §1.1041-1T(a).
46. House Committee Report, PL 98-369 (1984).
47. This example is based on Ltr. Rul. 9143050 (Jul. 26, 1991).

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Note. Under the **assignment of income doctrine** (discussed later in this chapter), the nonrecognition rules apply to gains and losses but not income. Under the assignment of income doctrine, Adam in **Example 12** pays any applicable income tax on the entire damage award because the income is attributable to Adam and is a result of his actions and efforts, not those of Adriana.

Community Property States

While living in a community property jurisdiction, all property acquired by husband and wife during the marriage is considered **community property.**[48] Although some aspects of community property law differ among the community property states, each spouse generally has a one-half share in the community property marital estate upon divorce. Typically under community property law, property that is brought into the marriage or inherited by a spouse is not considered community property. Rather, it is separate property of one spouse and does not form part of the marital estate to be divided equally between the spouses.

The nonrecognition rules apply whether the property transferred is separately owned by a spouse or is divided under a state's community property laws.[49]

Spouses living in community property states who file separately must report their respective half of income and deductions in connection with community property in addition to their own separate income and deductions.[50] A taxpayer may request relief from community property laws if community property treatment would be inequitable. This relief is requested under the innocent spouse provisions, discussed later in this chapter.

Nonrecognition Basis Rules

The nonrecognition rules treat a transfer of property incident to divorce as a **gift.** For subsequent dispositions, the carryover basis rule associated with the above nonrecognition rules **differs** somewhat from that for gifting. For calculating a **gain,** divorce nonrecognition and gifting basis rules use the transferor's basis. For calculating a **loss,** however, gifting basis rules use the **lesser of** the transferor's (donor's) basis **or** the fair market value (FMV) on the date of the transfer.[51] **The divorce nonrecognition rules use the transferor's basis in calculating a loss.**[52]

Example 13. Gertrude received some Ford Motor Company stock as a gift from her friend Harvey in 2009. On the date the gift was made, the stock had an FMV of $70,000. Harvey's basis in the stock was $100,000. Gertrude sells the Ford stock in 2012 for $60,000. The appropriate basis to use to calculate Gertrude's loss on the sale of the stock is the lesser of Harvey's basis or the FMV of the stock on the date the gift was made (which is $70,000).Therefore, Gertrude uses a basis of $70,000 to calculate her loss. Gertrude's loss is $10,000 ($60,000 sale price − $70,000 basis).

Example 14. Use the same facts as **Example 13,** except Harvey is Gertrude's former husband and she receives the stock in accordance with the terms of their divorce decree. The appropriate basis to use in calculating Gertrude's loss is $100,000, which is the carryover basis from Harvey. Gertrude's loss is therefore $40,000 ($60,000 sale price − $100,000 basis).

48. The community property states are Arizona, California, Idaho, Louisiana, Nevada, New Mexico, Texas, Washington, and Wisconsin.

49. Temp. Treas. Reg. §1.1041-1T(d).

50. IRS Pub. 555, *Community Property*.

51. IRC §1015(a).

52. Temp. Treas. Reg. §1.1041-1T(d).

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Debt in Excess of Basis

The property settlement may involve the transfer of property subject to a liability. As a general tax rule, if property with a cost basis less than its associated liabilities is transferred, the transferor must recognize gain in the amount of the excess of the liabilities over the basis in the property.[53] However, under the divorce nonrecognition rules, **no such gain or loss is recognized** on a transfer of property incident to a divorce.[54] The transferee spouse takes the transferor spouse's basis in the property with no step-up in basis for the assumed liability.

> **Example 15.** Guy owns a rental home on which he has claimed depreciation. His adjusted basis in the building is $100,000. The property is subject to a $130,000 mortgage. He transfers this property to his wife Gail incident to their pending divorce. Guy does not recognize $30,000 of gain on the transfer. Gail has a carryover basis of $100,000 in the property.

> **Example 16.** Use the same facts as **Example 15.** Upon receiving the rental home from Guy, Gail immediately sells the property. The sale price is $120,000. Gail recognizes gain of $20,000 ($120,000 − $100,000). Guy's holding period for the rental home was passed to Gail when he transferred the property to her.[55] If Guy's holding period and Gail's holding period total more than one year, Gail's $20,000 gain is long term. However, the portion of the gain attributable to depreciation is generally subject to a top tax rate of 25%.
>
> The $120,000 sale proceeds are used to extinguish all but $10,000 of the mortgage, which is paid by Gail. This $10,000 payment has no tax consequences to Gail. However, if the remaining $10,000 were forgiven by the bank (through a short sale or other cancellation of debt), Gail may have $10,000 of cancellation of debt income (CODI) which may be taxable.

Transfers in Trust. A transfer of property to a spouse or former spouse incident to divorce may be outright or in trust. One or both spouses may prefer to use a trust if there is a desire to ensure the property or income from the property passes to children or other beneficiaries after the death of one or both divorced spouses.

As a general rule, transfers in trust fall under IRC §1041(e), and do not result in any recognition of gain or loss to the transferor. However, there are exceptions to this general rule.

Gain or loss is recognized with:

1. A transfer of an installment obligation to a trust (described below),[56] or
2. A transfer of property in trust with debt in excess of basis.

For transfers in trust, if the liability to which the property is subject plus any additional liabilities assumed by the transferee exceed the basis in the property, this excess is the amount of gain that must be recognized.[57]

> **Example 17.** Use the same facts as **Example 15,** except instead of Guy transferring the property directly to Gail, the property is transferred to a trust for the benefit of Gail. Even though the transfer is still incident to a divorce, Guy is required to recognize $30,000 of gain on the transfer to the trust. Gail receives the trust property with a $100,000 carryover basis increased by the $30,000 gain that Guy must recognize. Therefore, her basis in the trust property is $130,000.

> **Note.** If the transferor spouse has unused capital losses, a transfer in trust is a way of passing on increased basis to a transferee spouse without adverse tax ramifications to the transferor spouse. This strategy may be useful in the property settlement negotiations between the parties.

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53. *Crane v. Comm'r*, 33 U.S. 1 (1947); *Comm'r v. Tufts*, 461 U.S. 300 (1983).
54. IRC §1041(a) and Temp. Treas. Reg. §1.1041-1T(d).
55. Treas. Reg. §1.1250-3(a)(3)(ii).
56. IRC §453B(g).
57. Ibid.

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> **Caution.** Debt in excess of the basis of property is calculated using an aggregate method, not an asset-by-asset method.[58]

Transfer of Installment Obligations

As a general rule, gain or loss is recognized on the transfer of an installment obligation.[59] However, the transfer of an installment obligation incident to divorce falls under the nonrecognition rules **and no gain or loss is recognized.**[60] The transferee spouse steps into the transferor spouse's shoes in connection with the tax treatment of the installment arrangement.

Exception for Transfers in Trust. A transfer **in trust** of an installment obligation is specifically excluded from the nonrecognition rules even if the transfer is incident to a divorce.[61] Accordingly, if an installment obligation is transferred in trust to a spouse or former spouse incident to divorce, nonrecognition treatment is not available.

Additional Exceptions to Nonrecognition Treatment

There are some other areas in which the nonrecognition rules do not apply.

Income. Generally, the nonrecognition rules apply to gains and losses but not to **income.** Most cases involving income are determined by the **assignment of income doctrine,** wherein income is taxed to the individual who either earns that income or who owns the property that generates the income. This doctrine was developed to prevent a taxpayer from assigning income to another person to avoid tax.

Amounts that are specifically designated as interest income in property settlements between spouses are generally treated as interest income.

> **Example 18.** As part of Tim and Annette's divorce settlement, Annette agrees to accept installment payments from Tim to obtain her share of the value of the marital property. Tim is paying Annette her half of the value of the marital property in equal monthly installments over two years at an interest rate of 5%.
>
> Annette does not recognize income on the portion of each payment that represents Tim's principal obligation. The principal amount is a transfer of property covered by the nonrecogition rules. However, the 5% interest Tim pays on each installment is taxable interest income to Annette.[62]

Even though the nonrecognition rules do not apply to income, they generally **do** apply to the transfer of **rights to receive** income, such as with a transfer of an interest in a trust or annuity, a nonqualified stock option, and deferred compensation.

Moreover, the imputed interest rules do not apply to debt issued between spouses incident to their divorce.[63]

> **Note.** A detailed discussion of the imputed interest rules and the tax treatment of below market-rate loans can be found in 2012 Volume C, Chapter 8: Investment Income.

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58. IRC §1041(e).
59. IRC §453B(a).
60. IRC §453B(g).
61. Ibid.
62. Based on *L. Gibbs v. Comm'r*, TC Memo 1997-196 (Apr. 29, 1997).
63. Treas. Reg. §1.1274-1(b)(3)(iii).

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Deductibility of Interest. The IRS has argued that any interest paid in connection with a nonrecognition transfer incident to divorce constitutes nondeductible personal interest. However, the Tax Court has held that the interest can be deductible, irrespective of the fact that it is paid in connection with a nonrecognition transfer. Therefore, qualified residence interest, passive activity interest, or investment interest is deductible when the interest is pursuant to a nonrecognition transfer between spouses.[64]

Transfer of Services. While the nonrecognition rules embrace a rather broad definition of property, services do not constitute property and are never included.[65]

> **Example 19.** Albert and Noreen are divorced. For the year following the finalization of their divorce, Noreen continues to be Albert's physician. Noreen is taxed on any fees she earns from Albert because the performance of physician services is not a transfer of property. The nonrecognition rules do not apply.

Nonresident Alien Spouse. The nonrecognition rules do not apply if the spouse or former spouse receiving the transferred property is a nonresident alien.[66] In such cases, gains and losses are recognized.

CARRYFORWARD RULES

Federal tax law determines who gets the future benefits of loss carryforwards after a divorce. However, the future tax savings related to loss carryforwards have a value that should be considered as part of the total value of marital assets. It is generally accepted that "equitable distribution of marital property" must take into account "the tax consequences of the property division upon the respective economic circumstances of the parties."[67] However, it may be difficult to value these losses, because the future tax consequences vary depending on the taxpayers' situation each year.

The following loss carryforwards should be included in this type of analysis.

- Capital loss carryforwards
- Net operating losses
- Charitable contribution carryforwards
- Passive activity losses
- S corporation losses
- Investment interest expense carryforward

Capital Loss Carryforward Amounts

For each tax year, capital losses are allowed to the extent of capital gains, plus an additional $3,000 for a married couple filing jointly.[68] To the extent that capital losses exceed the gains by more than $3,000, the excess can be carried forward and used in future years. Capital losses carry forward indefinitely until exhausted.

Treas. Reg. §1.1212-1 addresses the spousal allocation of capital losses when the spouses file jointly and thereafter file separate returns, such as in a divorce situation. The capital loss carryover is allocated to the spouses based on their individual net capital losses for the preceding year.[69] Short- and long-term capital losses are aggregated into separate categories, with allocations of each calculated separately. Short- and long-term losses retain their character once allocated to the appropriate spouse.

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64. *J.L. Seymour v. Comm'r*, 109 TC 279 (1997).
65. Temp. Treas. Reg. §1.1041-1T(a).
66. IRC §1041(d).
67. 750 ILCS 5/503.
68. IRC §1211(b)(1).
69. Treas. Reg. §1.1212-1(c)(iv).

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Example 20. Henry and Catherine file **jointly** for the **2011** tax year. They owned separate brokerage accounts. They divorce in 2012. The following amounts of capital gains and losses were incurred by the spouses in 2011 or carried forward to 2011 from prior years by the spouses.

	Henry	+	Catherine	=	Joint Gains and Losses
Long-term gain	$7,000		$10,000		$17,000
Long-term loss	(3,000)		(22,000)		(25,000)
Net long-term loss carryover					($ 8,000)
Short-term gain	$6,000		$ 4,000		$10,000
Short-term loss	(9,000)		(3,000)		(12,000)
Net short-term loss carryover					($ 2,000)

On Henry and Catherine's 2011 joint return, they had net capital losses available to carry forward to 2012 of $10,000 ($8,000 long-term loss + $2,000 short-term loss).

Long-Term Carryover. Catherine had $12,000 in net long-term losses for 2011 of which $4,000 was used to offset Henry's long-term gain after he used his $3,000 in long-term losses. This leaves **Catherine** with an **$8,000 long-term loss carryover** ($12,000 − $4,000) for 2012 on her separate return.

Short-Term Carryover. Henry has $3,000 of short-term losses available after offsetting his $6,000 short-term gain. The short-term loss is used to offset the remaining $1,000 of short-term gain Catherine has after fully utilizing her $3,000 short-term loss against her $4,000 short-term gain. This leaves **Henry** with a **$2,000 short-term loss carryover** ($3,000 – $1,000) to 2012.

Net Operating Losses

When spouses file jointly, one or both spouses may have net operating losses (NOLs). When spouses file jointly, spousal incomes are combined and NOL amounts can be claimed collectively.[70] After divorce, **each spouse's respective NOL** amounts, based on each spouse's separate business income and deductions that were reported on the joint return, **follow that spouse.** An NOL of a divorced spouse can only be used against their own income, whether the NOL is carried back to a year that had a joint return filed with the former spouse or carried forward and used on a joint return with a new spouse. Once the spouses cease filing jointly and begin filing separately, it is necessary to complete a separate income and deduction analysis to determine the NOL amount attributable to each spouse that can be claimed on their respective separate returns.

Accordingly, only the spouse who had the loss can take the NOL deduction. An NOL carryback from a separate filing year to a joint filing year is limited to the income of that respective spouse.

Example 21. Myron and Myrna are spouses who each have their own separate business. Both businesses are operated as sole proprietorships. For the **2010** tax year, Myron and Myrna filed their **last joint tax return** before their divorce. The first page of their joint 2010 return follows.

70. Treas. Reg. §1.172-7(c).

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For Example 21

Form **1040** Department of the Treasury—Internal Revenue Service
U.S. Individual Income Tax Return 2010 (99) IRS Use Only—Do not write or staple in this space.

For the year Jan. 1–Dec. 31, 2010, or other tax year beginning , 2010, ending , 20 OMB No. 1545-0074

Name, Address, and SSN

See separate instructions.

PRINT CLEARLY

Your first name and initial	Last name	Your social security number
Myron	Cohen	987 65 4321
If a joint return, spouse's first name and initial	Last name	Spouse's social security number
Myrna	Cohen	987 65 4322
Home address (number and street). If you have a P.O. box, see instructions.	Apt. no.	Make sure the SSN(s) above and on line 6c are correct.
338 Van Ness Street		
City, town or post office, state, and ZIP code. If you have a foreign address, see instructions.		Checking a box below will not change your tax or refund.
Newburgh, NY 12550		

Presidential Election Campaign ▶ Check here if you, or your spouse if filing jointly, want $3 to go to this fund ▶ ☐ You ☐ Spouse

Filing Status

Check only one box.

1 ☐ Single
2 ☑ Married filing jointly (even if only one had income)
3 ☐ Married filing separately. Enter spouse's SSN above and full name here. ▶
4 ☐ Head of household (with qualifying person). (See instructions.) If the qualifying person is a child but not your dependent, enter this child's name here. ▶
5 ☐ Qualifying widow(er) with dependent child

Exemptions

6a ☑ **Yourself.** If someone can claim you as a dependent, **do not** check box 6a
b ☑ **Spouse**

Boxes checked on 6a and 6b: 2

c **Dependents:**

(1) First name Last name	(2) Dependent's social security number	(3) Dependent's relationship to you	(4) ✓ if child under age 17 qualifying for child tax credit (see page 15)
			☐
			☐
			☐
			☐

If more than four dependents, see instructions and check here ▶ ☐

No. of children on 6c who:
• lived with you
• did not live with you due to divorce or separation (see instructions)
Dependents on 6c not entered above

d Total number of exemptions claimed — Add numbers on lines above ▶ 2

Income

Attach Form(s) W-2 here. Also attach Forms W-2G and 1099-R if tax was withheld.

If you did not get a W-2, see page 20.

Enclose, but do not attach, any payment. Also, please use Form 1040-V.

7	Wages, salaries, tips, etc. Attach Form(s) W-2	7	62,000
8a	**Taxable** interest. Attach Schedule B if required	8a	
b	**Tax-exempt** interest. **Do not** include on line 8a — 8b		
9a	Ordinary dividends. Attach Schedule B if required	9a	
b	Qualified dividends — 9b		
10	Taxable refunds, credits, or offsets of state and local income taxes	10	
11	Alimony received	11	
12	Business income or (loss). Attach Schedule C or C-EZ	12	(160,000)
13	Capital gain or (loss). Attach Schedule D if required. If not required, check here ▶ ☐	13	
14	Other gains or (losses). Attach Form 4797	14	
15a	IRA distributions 15a — b Taxable amount	15b	
16a	Pensions and annuities 16a — b Taxable amount	16b	
17	Rental real estate, royalties, partnerships, S corporations, trusts, etc. Attach Schedule E	17	
18	Farm income or (loss). Attach Schedule F	18	
19	Unemployment compensation	19	
20a	Social security benefits 20a — b Taxable amount	20b	
21	Other income. List type and amount	21	
22	Combine the amounts in the far right column for lines 7 through 21. This is your **total income** ▶	22	(98,000)

Adjusted Gross Income

23	Educator expenses	23			
24	Certain business expenses of reservists, performing artists, and fee-basis government officials. Attach Form 2106 or 2106-EZ	24			
25	Health savings account deduction. Attach Form 8889	25			
26	Moving expenses. Attach Form 3903	26			
27	One-half of self-employment tax. Attach Schedule SE	27			
28	Self-employed SEP, SIMPLE, and qualified plans	28			
29	Self-employed health insurance deduction	29			
30	Penalty on early withdrawal of savings	30			
31a	Alimony paid b Recipient's SSN ▶	31a			
32	IRA deduction	32			
33	Student loan interest deduction	33			
34	Tuition and fees. Attach Form 8917	34			
35	Domestic production activities deduction. Attach Form 8903	35			
36	Add lines 23 through 31a and 32 through 35			36	0
37	Subtract line 36 from line 22. This is your **adjusted gross income** ▶			37	(98,000)

For Disclosure, Privacy Act, and Paperwork Reduction Act Notice, see separate instructions. Cat. No. 11320B Form **1040** (2010)

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Myron and Myrna finalize their divorce in early 2011. During 2010, both businesses had losses for the first time. Closer inspection of their 2010 joint return and the accompanying Schedules C for each spouse's business indicates the following separate amounts applicable to each spouse.

	Myron	Myrna	Joint Return Amount
Wages	$40,000	$ 22,000	$ 62,000
Net business loss	(60,000)	(100,000)	(160,000)
NOLs carried forward to 2011	($20,000)	($ 78,000)	($ 98,000)

Post-divorce, each spouse retains their own separate respective NOL amount. Accordingly, after the divorce is finalized, Myrna has a $78,000 NOL carryforward. Later in 2011, Myrna remarries. In 2011, her business is profitable. She files jointly with her new husband, Lance, in 2011. Myrna and Lance have the following 2011 incomes.

	Myrna	Lance
Net business income	$48,000	$340,000
Wages	0	30,000

On the 2011 joint tax return, Myrna can only use $48,000 of her $78,000 NOL carryforward. She cannot use any of her remaining NOL carryforward to offset Lance's 2011 income.[71] Only losses generated by Myrna while married to Lance can be used against Lance's income on their jointly filed returns.

Note. Under the general NOL carryover rules, an NOL generally must be carried back to the two prior years before being carried forward. The taxpayer may elect to waive the carryback period.[72] The election must be filed by the return due date (including extensions) for the year in which the NOL occurred, or within six months of the due date on an amended return, excluding extensions. Different rules apply to eligible losses,[73] farming losses,[74] qualified disaster losses,[75] or a specified liability loss.[76]

If Myrna wishes to carry back her NOL to a year in which she filed jointly with Myron (or if she did not file the election in time to waive the carryback period for her 2010 NOL), the NOL amount she is able to use is limited by the amount of her own income for that carryback year.

Caution. Practitioners should review IRS Pub. 536, *Net Operating Losses,* and Rev. Rul. 60-216, for rules about handling NOLs for their client's specific situations.[77]

71. *A.E. Calvin v. U.S.*, 354 F.2d 202 (10th Cir. 1965).
72. IRC §172(b)(3).
73. IRC §172(b)(1)(F).
74. IRC §172(b)(1)(G).
75. IRC §172(b)(1)(J).
76. IRC §172(f).
77. Treas. Reg. §1.172-3(d); Rev. Rul. 60-216, 1960-1 CB 126; *A.E. Calvin v. U.S.,* 354 F.2d 202 (10th Cir. 1965).

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Refund Limitation. When a divorced taxpayer carries back an NOL against a previous year's joint return that was filed with a former spouse, the divorced taxpayer's refund is limited to their own tax liability. This liability is calculated using MFS tax rates as follows.

- Calculate the tax in the carryback year for each spouse as if they had filed MFS instead of MFJ.
- Compute each spouse's percentage of the total tax from the two MFS returns.
- Multiply the recomputed tax on the joint return after the NOL carryback by the taxpayer's percentage of the total MFS tax. The result is the taxpayer's share of the joint tax liability.

Only the amount of taxes attributable to the spouse who carries back the NOL (the NOL spouse) can be refunded. Unless there is an agreement or clear evidence of each spouse's contributions toward the payment of the joint tax liability, the NOL spouse's contribution is calculated using the following formula.[78]

	Any tax withholding from the NOL spouse's income
+	The NOL spouse's share of any tax estimates
+	The NOL spouse's share of any balance paid
−	The NOL spouse's share of previous refunds
	The NOL spouse's contribution

Caution. For taxpayers in community property states, the IRS issued the following rulings that modify these calculations.

- Rev. Rul. 2004-71, 2004-2 CB 74 (Arizona and Wisconsin)
- Rev. Rul. 2004-72, 2004-2 CB 77 (California, Idaho, and Louisiana)
- Rev. Rul. 2004-73, 2004-2 CB 80 (Nevada, New Mexico, and Washington)
- Rev. Rul. 2004-74, 2004-2 CB 84 (Texas)

If any of the taxpayer's income or deduction is subject to **alternative minimum tax** (AMT) adjustments, the NOL must be first recomputed under AMT rules to arrive at the alternative tax NOL (ATNOL) before the carryback calculation is done. ATNOL is only adjusted for tax preferences when the preferences increase the amount of the NOL for regular tax purposes.[79]

Note. For more information about ATNOL, see Chapter 7 of the 2007 *University of Illinois Federal Tax Workbook.* This can be found at **www.TaxSchool.illinois.edu/taxbookarchive.**

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

79. IRC §56(d)(2)(A).

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Charitable Contribution Carryovers

Charitable contribution carryover amounts must be allocated between divorcing spouses who filed jointly while married.[80] The spouses must use the IRS allocation rules.[81] The charitable carryover amount is allocated based on the amount of carryover each spouse would have if MFS returns had been filed instead of MFJ returns.[82]

Because charitable contributions are subject to a 5-year carryover period, a carryover amount from the final joint return between spouses may be composed of charitable contributions carried forward from up to four prior tax years. Therefore, joint returns must be recomputed as separate returns for each tax year going back to the earliest year within that 4-year period in which a carryover amount existed.

Passive Activity Losses

The transfer of a passive activity incident to a divorce is treated as a gift.[83] Any suspended passive activity losses of the donor spouse are added to the donee spouse's basis in the transferred property[84] and are not deductible as passive losses in any tax year.[85]

Example 22. Sam and Belinda finalize their divorce in 2011. Sam is the sole owner of rental property that he inherited from his aunt. Because the property was inherited, it is not considered a marital asset. However, as part of their property settlement, Sam agrees to transfer the rental property to Belinda on December 31, 2011.

At the beginning of 2011, Sam had suspended passive activity losses of $42,000. Sam uses $25,000 of the suspended passive losses against the 2011 rental income he reports on his separate return. The following details apply.

Belinda's transferred basis under gift rules (IRC §1015(a))		$150,000
Suspended losses transferred:		
Suspended losses, December 31, 2011	$42,000	
Less: Amount used by Sam in 2011 tax year	(25,000)	
Total amount of suspended losses transferred	$17,000	17,000
Belinda's adjusted basis in the property		$167,000

The rental property is IRC §1250 property. Sam has no depreciation recapture on the transaction because dispositions of §1250 property by gift are not subject to depreciation recapture.[86] However, Belinda must take into account the allowed/allowable depreciation from all years the property was owned by either party if she sells the property.

Belinda must treat the additional basis from the suspended passive activity losses ($17,000) as an increase to the basis of the property. The property therefore has two elements under Treas. Reg. §1.1250-5. Belinda acquires Sam's holding period with respect to Sam's adjusted $150,000 basis in the property.[87] However, the holding period for the $17,000 increase to basis begins on the day she takes the property.

80. Treas. Reg. §1.170A-10(d)(4)(i).
81. Rev. Rul. 76-267, 1976-2 CB 71.
82. Treas. Reg. §1.170A-10(d)(4)(i).
83. IRC §1041(b).
84. IRC §469(j)(6)(A).
85. IRC §469(j)(6)(B).
86. IRC §§1245(b)(1) and 1250(d)(1).
87. Treas. Reg. §1.1250-3(a)(3)(i).

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S Corporation Losses Limited by Basis

2

S corporation loss carryover amounts are personal to the shareholder and are not transferable to another person.[88] However, an **exception** to this rule exists when shares are transferred to a spouse or former spouse incident to a divorce.[89]

Example 23. Roger owns all 100 shares in CaptureMagic, Inc., a calendar-year S corporation. For 2010, CaptureMagic has $400 in losses. Roger cannot deduct any of the $400 loss in 2010 because he has no stock or debt basis. Therefore, the $400 loss carries forward to 2011.

On July 1, 2011, Roger transfers 50 of his shares to his spouse, Bernadette, in connection with their pending divorce. In 2011, CaptureMagic has $200 in losses. This 2011 loss amount is allocated to Roger and Bernadette on a pro-rata basis. To do this, the loss is allocated in a per-day, per-share manner.[90]

The amount of the $200 loss for 2011 allocable to the first half of the year is $100 ($200 × 50%). This $100 loss is allocable to Roger because he was the sole shareholder for the first half of the year.

The $100 loss allocable to the second half of the year is split equally between Roger and Bernadette as equal shareholders. Therefore, for the second half of the year, Roger and Bernadette are each entitled to half of that $100 loss (or $50).

Total losses for 2011 are allocated between Roger and Bernadette as follows.

	Roger	+	Bernadette	=	Total Loss for 2011
First half of 2011	$100				
Second half of 2011	50		$50		
Total loss for 2011	$150		$50		$200

On his 2011 return, Roger can use his carryover loss from 2010 ($400) and his pro-rata share of the 2011 loss ($150) to the extent he has basis. Bernadette can use her pro-rata share of the 2011 loss ($50) to the extent she has any stock or debt basis at the end of 2011.

If any of the 2010 loss of $400 cannot be used by Roger in 2011, it is prorated between Roger and Bernadette based on their stock ownership at the beginning of 2012. Because each spouse owned 50% of the shares in CaptureMagic at the beginning of 2012, each spouse shares equally in the unused 2010 loss of $400. This provides an allocation of $200 to each spouse. The S corporation loss carryover available to each spouse at the beginning of 2012 is as follows.

	Roger	+	Bernadette	=	Total Loss for 2011
Prorated 2010 unused carryover	$200		$200		$400
Allocated 2011 loss amounts	150		50		200
Total available carryover, January 1, 2012	$350		$250		$600

88. Treas. Reg. §1.1366-2(a)(5)(i).

89. Treas. Reg. §1.1366-2(a)(5)(ii).

90. IRC §1377(a); Treas. Reg. §1.1377-1(a)(1).

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Example 24. Use the same facts as **Example 23,** except Roger acquires $160 of basis from a capital contribution during 2011 and can therefore deduct $160 of the $400 loss carryover from 2010. He claims this $160 loss on his 2011 tax return. This leaves $240 of the 2010 carryover to be allocated between the spouses based on the relative share ownership they have at the beginning of 2012 (50% ownership for each spouse). Their revised available loss carryover amounts at the beginning of 2012 are as follows.

	Roger	+	Bernadette	=	Total Loss for 2011
Prorated 2010 unused carryover	$120		$120		$240
Allocated 2011 loss amounts	150		50		200
Total available carryover, January 1, 2012	$270		$170		$440

Investment Interest Expense Carryovers

The IRS has not provided any guidance on the allocation of investment interest expense carryover amounts incident to a divorce. Logically, the interest expense carryover should be allocated in the same manner between spouses as the underlying debt that generates the interest expense.

When a divorce decree makes one spouse liable for a debt that was originally a joint debt, this does not obligate the lender to relieve the other spouse from liability on that debt.[91] Care should be taken to avoid undesirable results if one spouse receives the investment interest carryover amounts while both spouses remain liable to the lender on the debt. If the debt is later forgiven because one of the spouses defaulted, both spouses will have cancellation of debt income. However, only one spouse will have the benefit of the investment interest expense carryover to alleviate the additional tax liability.[92]

TAXATION OF FINANCIAL SUPPORT

ALIMONY AND SEPARATE MAINTENANCE

Generally, alimony and separate maintenance are payments received by an ex-spouse under the terms of a divorce or separation agreement that cease upon the death of the recipient spouse.

Qualified alimony or separate maintenance payments are included in the income of the recipient spouse and are deductible by the payor spouse.[93] Alimony or separate maintenance is "qualified" if it meets the following requirements.

1. **The payment must be made in cash.**[94] Checks or money orders payable on demand meet this requirement. A transfer of property, no matter how easily the property can be converted to cash, does not qualify. Transferred services do not qualify.
2. **The payment must be made to the spouse or former spouse.**[95] Additionally, payments made to a third party on behalf of the recipient spouse **in accordance with the terms of the divorce decree or separation instrument** also meet this requirement. Cash payments made to a third party at the written request, consent, or ratification of the recipient spouse qualify as alimony payments. The writing must state that the spouses intend to treat the payments as alimony. In addition, the notice must be received before filing the payor spouse's **first** income tax return for the tax year in which the payment is made.

Caution. The regulation's use of the word "first" appears to suggest that it may not be possible for the payor spouse to amend a filed return to deduct an amount that was ratified as alimony after the original return is filed.

91. See *Jensen v. Comm'r*, 99 TC Memo 1334 (Apr. 15, 2010), in which one spouse had cancellation of debt income from a debt for which the other spouse was responsible and which was subsequently forgiven by the bank.

92. Ibid.

93. IRC §§71 and 215; Temp. Treas. Reg. §1.71-1T(a).

94. IRC §71(b)(1); Temp. Treas. Reg. §1.71-1T(b).

95. Temp. Treas. Reg. §1.71-1T(b).

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Example 25. Fred makes regular alimony payments to Monica. Monica tells Fred to send her December 2011 alimony check to the Save the Whales Charitable Foundation. Fred makes the alimony payment by check to the charity at Monica's request. In January 2012, before Fred files his tax return, Monica confirms to Fred in a note that she agreed to this arrangement for her December alimony payment.

The Save the Whales payment for December 2011 is considered alimony. As long as it meets all the other requirements for qualified alimony, the December payment may be deducted by Fred along with the other 2011 alimony payments. In addition, it is included in Monica's income as taxable alimony for 2011. Monica is entitled to a charitable deduction if the foundation is a qualified charity.

3. **The payments must be made in accordance with a divorce or separation instrument.**[96] To qualify as alimony, the payments must be made pursuant to any type of written court order or decree, even if only temporary.[97] The written instrument need not be part of an actual divorce decree to qualify, but it must create a legal obligation to make payments to the other spouse for support or maintenance.[98] Payments made **without** any such written instrument or payments made in excess of those required by such an instrument are **not deductible** by the paying spouse.[99] For example, payments made pursuant to a judge's verbal order are not deductible because the required written instrument does not exist.[100]

4. **The spouses are legally separated under a divorce decree or separate maintenance agreement and are not members of the same household when the payment is made.**[101] However, if payments are made under a **temporary** support order or a written separation agreement, they qualify regardless of the spouses' living arrangements.

Example 26. Xavier and Zoe are married, but Zoe has obtained a temporary support order requiring Xavier to make payments to her for the next six months. During this time, Xavier and Zoe continue to live in the same household. Xavier's payments to Zoe may constitute qualified alimony as long as all other requirements are met.

Example 27. Use the same facts as **Example 26.** Immediately after the 6-month period of the temporary support order, Xavier and Zoe obtain a divorce decree and become officially divorced. The divorce decree requires Xavier to continue to make the same payments to Zoe. The payments do not qualify as alimony until the ex-spouses live in separate households. Even if Xavier and Zoe physically separate themselves within the same household, use separate bedrooms, bathrooms, and cooking facilities, or occupy the same household only part of the time, the payments do not qualify as alimony.[102]

5. **There must be no requirement that the payments continue after the recipient spouse's death.** If the paying spouse is required to make any payment in cash or property as a substitute for payments after the death of the recipient spouse, the payments made during the recipient spouse's lifetime do not constitute qualified alimony.[103] **Continuation of payments after the death of the recipient spouse disqualifies all pre-death payments.**[104] Making a substitute payment after the death disqualifies the amount of alimony for which the payment was a substitute.[105]

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96. Ibid.

97. Treas. Reg. §1.71-1(b)(3); Temp. Treas. Reg. §1.71-1T(a).

98. Ibid.

99. IRC §71(b)(1)(A).

100. *S.W. Jachym v. Comm'r*, TC Memo 1984-181 (Apr. 10, 1984*); N.T. Semel v. Comm'r*, TC Memo 1965-232 (Aug. 27, 1965).

101. IRC §71(b)(1)(C); Temp. Treas. Reg. §1.71-1T(b).

102. See *A. Washington v. Comm'r*, 77 TC 601 (1981) and *B.W. Coltman, Jr. v. Comm'r*, 980 F.2d 1134 (7th Cir. 1992).

103. IRC §71(b)(1)(D).

104. *R.E. Hoover v. Comm'r*, 102 F.3d.842 (6th Cir. 1996).

105. IRC §71(b)(1)(D); Temp. Treas. Reg. §1.71-1T(b).

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Example 28. Carl and Claire have a divorce decree that requires Carl to pay alimony of $20,000 per year to Claire. The payments are required until the earlier of the end of five years or Claire's death. However, the divorce decree requires that Carl pay $10,000 annually to a trust for the benefit of a qualified charity after Claire's death.

The $10,000 trust payments are a substitute for the $20,000 of annual alimony payments. Accordingly, $10,000 of the $20,000 annual alimony payments made to Claire is disqualified. Carl cannot deduct $10,000 of the $20,000 alimony he pays to Claire. This is true even if no substitute payments actually are made. Simply having the substitute provision in the divorce decree serves as a partial disqualification of the alimony paid.[106]

Example 29. Bob's divorce decree requires him to annually pay $40,000 of alimony to his former wife, Rebecca. The terms of the divorce decree require Bob to continue to make the same annual payments to a trust for the benefit of her brother if Rebecca passes away. All of Bob's alimony payments are disqualified.

6. **The divorce decree, separate maintenance agreement, or other relevant instrument must not provide for nondeductible and nonincludible alimony payments.** The spouses can agree in their divorce settlement that alimony that otherwise qualifies will be treated as disqualified alimony. An agreement to this effect disqualifies the alimony in accordance with the spouses' wishes. A clear and explicit directive in the written divorce instrument to this effect is necessary.[107] A statement indicating that the payor spouse is responsible for the taxes on the alimony payments does not amount to a disqualifying statement.[108]

Note. Spouses can agree to disqualify alimony that would otherwise qualify. However, they cannot simply agree to make alimony qualified that would otherwise be disqualified. Alimony must meet all the necessary requirements outlined in this section to be qualified.

7. **The amount intended as alimony in the divorce decree, separate maintenance agreement, or other relevant document must not be fixed as child support.** An amount specified in the instrument is treated as "fixed as child support" if:

   a. It is specifically designated for the support of the payor spouse's child,

   b. It is reduced on the occurrence of a contingency relating to a child, or

   c. It is reduced at a time that can clearly be associated with a contingency relating to a child.[109]

   Any amount fixed as child support does not qualify as alimony.[110] There is no requirement that the children be minors. Payments for the benefit of persons other than children do not constitute child support and may qualify as alimony if all requirements are met.

8. **The spouses do not file joint returns with each other.**[111]

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106. *J.R. Okerson v. Comm'r*, 123 TC 258 (2004).
107. *E.J. Richardson v. Comm'r*, 125 F.3d 551 (7th Cir. 1997).
108. *I.C. Jaffe v. Comm'r*, TC Memo 1999-196 (Jun. 17, 1999).
109. Temp. Treas. Reg. §1.71-1T(c).
110. IRC §71(c)(1); Temp. Treas. Reg. §1.71-1T(c).
111. IRC §71(e).

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A payment that meets all eight requirements automatically constitutes qualified alimony or separate maintenance and can be deducted by the payor spouse and must be included as income by the recipient spouse. However, these alimony payments are subject to excess front-loading rules (discussed in the next section).

> **Note.** The above requirements for qualified alimony are applicable to payments made under a divorce or separation agreement made or modified **after 1984.** For payments made under pre-1985 agreements, the requirements are different. See Temp. Treas. Reg. §1.71-1T(e) for effective dates regarding the written instruments and modification issues and Treas. Reg. §1.71-1 for the pre-1985 rules.

Excess Front-Loading Rules[112]

No gain or loss is recognized on transfers of property incident to a divorce. However, alimony payments may be deductible by the payor spouse and taxed to the recipient spouse. There may be an incentive to structure a property transfer that is incident to a divorce as alimony payments in order to provide the payor spouse with deductions or "shift" a tax burden from a payor spouse in a higher tax bracket to a recipient spouse in a lower tax bracket. The **excess front-loading (EFL)** rules exist to prevent this type of tax avoidance.

Post-Separation Years. The EFL rules cover the **first three "post-separation" years** (Year 1, Year 2, and Year 3) in which alimony payments are made. The first post-separation year is the first calendar year in which a **qualified** alimony or separate maintenance payment is made.

Example 30. Ralph must begin paying alimony to his former spouse, Marissa. Their divorce decree was finalized in late 2008. In accordance with the divorce decree, Ralph's first payment of alimony is on May 26, 2009. The payment is qualified alimony. Therefore, 2009 is the first post-separation year under the EFL rules.

Example 31. Use the same facts as **Example 30,** except after the divorce decree is finalized, Ralph and Marissa continue to live in the same household until October 2011. Because the alimony payments are not qualified until 2011, the first post-separation year is 2011 under the EFL rules.

Determination of Excess Payments and Recapture Amount. Under the EFL rules, payments that are too large in the first two years after separation or divorce are recaptured in the third year. The following two steps are used to determine if there are sufficient "excess payments" to trigger recapture.

Step 1. Qualified alimony payments in Year 2 are compared to those made in Year 3. The amount of Year 2 payments that exceed the amount of Year 3 payments plus $15,000 constitutes a **Year 2 excess payment.**

Step 2. Qualified alimony payments in Year 1 are compared to the average of Year 2 and Year 3 payments plus $15,000. Year 1 payments that exceed this Year 2 and Year 3 average, plus $15,000, are **Year 1 excess payments. Only that part of the Year 2 payments that is not subject to recapture in Step 1 is included in the total to be averaged.**

> **Note.** The $15,000 amount in each of the above two steps serves as an exemption amount.

The recapture amount is the sum of the Year 1 and Year 2 excess payments calculated in the two steps above. If there is any recapture, it is **recognized** by the spouses in **Year 3.** The result of the recapture is as follows:

- The payor spouse who deducted the recapture amount must **add that amount back into income** in Year 3, and
- The recipient spouse who reported the recapture amount as taxable income is entitled to a deduction for the recapture amount in Year 3.

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112. IRC §71(f).

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Example 32. Ted agrees to pay his former spouse, Jillian, qualified alimony in accordance with the following schedule.

	Calendar Year	Amount of Alimony
Year 1	2009	$75,000
Year 2	2010	50,000
Year 3	2011	20,000

Ted begins paying Jillian on March 2, 2009. The 2009 calendar year is the first post-separation year for purposes of the EFL rules. The recapture amount to be recognized in the 2011 tax year is calculated as follows.

Step 1: Compare Year 2 and Year 3 Payments			
Year 2 payments		$50,000	
Year 3 payments	$20,000		
Plus: $15,000 exemption	15,000		
	$35,000	(35,000)	
Year 2 excess payment		$15,000	$15,000
Step 2: Compare Year 1 and Year 2 Payments			
Year 1 payments		$75,000	
Year 2 amount not recaptured in Step 1 ($50,000 − $15,000)	$35,000		
Plus: Year 3 amount	20,000		
	$55,000		
Divided by number of years	÷ 2		
Average for Year 2 and Year 3	$27,500		
Plus: $15,000 exemption	15,000		
	$42,500	(42,500)	
Year 1 excess payment		$32,500	32,500
Total recapture recognized in Year 3			$47,500

In the 2011 tax year (Year 3), Ted must add $47,500 of recaptured alimony into his income. Jillian is entitled to an offsetting deduction of the same amount on her 2011 return. Ted and Jillian still report their 2011 alimony amounts on their 2011 returns ($20,000 deduction for alimony paid for Ted and $20,000 of alimony income for Jillian) in addition to showing this recapture amount.

To report the recapture amount, Ted reports $47,500 on Form 1040, line 11 ("Alimony received"). He should cross out the word "received" and enter the word "recapture" to properly identify the amount. On the dotted line next to the amount, he must enter Jillian's surname and social security number.

Jillian deducts this amount on her Form 1040, line 31a ("Alimony paid"). She should cross out the word "paid" and enter the word "recapture." In the space provided, Jillian must enter Ted's social security number.[113]

> **Note.** The recapture of alimony worksheets can be found in IRS Pub. 504, *Divorced or Separated Individuals.*

113. IRS Pub. 504, *Divorced or Separated Individuals*.

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Exceptions to the Excess Front-Loading Rules. There are three exceptions to the application of the EFL rules.[114]

1. Alimony payments stop due to the death of either party or the remarriage of the recipient spouse before the end of the third post-separation year.
2. Temporary support payments are received under a support decree that is not a written separation agreement or a decree of divorce or separate maintenance.
3. For at least 36 months, the alimony payments fluctuate because they are based on business, property, or self-employment earnings. The 36-month period for fluctuating alimony payments does not have to be the same 36 months that cover the three post-separation years under the EFL rules.

DIVISION OF RETIREMENT ASSETS

The basic nonrecognition rules can also apply to retirement assets that are transferred incident to divorce. However, there are other specific rules and regulations associated with the division of retirement assets that must be followed if retirement accounts are part of the divided marital property.

> **Note.** Placing an appropriate **value** on retirement assets can be difficult. Depending on the type of retirement plan, actuarial calculations and various financial assumptions must be used.

IRA ACCOUNTS

The transfer of individual retirement arrangement (IRA) assets incident to divorce may be tax-free to the spouses if two requirements are met:

1. The transfer is made under a **divorce or separation instrument,** and
2. There is a **transfer** of funds and not a distribution.

Divorce or Separation Instrument

A tax-free transfer of IRA assets to a spouse or former spouse requires a **divorce or separation instrument.**[115] Both individual retirement accounts and individual retirement annuities have this requirement. A "divorce or separation instrument" is defined as:

- A divorce or separate maintenance decree or written instrument incident to such a decree,
- A written separation agreement, or
- A decree requiring a spouse to make support or maintenance payments to the other spouse.[116]

A private separation agreement is **not** considered a "divorce or separation instrument" for purposes of these IRA transfer rules.[117]

114. IRC §71(f)(5).
115. IRC §408(d)(6).
116. IRC §71(b)(2).
117. Ltr. Rul. 9344027 (Aug. 9, 1993).

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The IRA assets transferred are considered to be the IRA assets of the recipient spouse after the transfer.[118] This means that the recipient spouse is not required to take distributions from the IRA assets received even if the spouse who originally owned the IRA assets was taking distributions. Moreover, the transfer itself is not considered an IRA distribution.[119]

Actual Transfer

The tax-exempt status of this type of IRA asset transaction between spouses or former spouses provided by the Code[120] requires a **transfer** of assets as opposed to a distribution or withdrawal.

Neither the Code nor the regulations provide guidance on the mechanics of a transfer of IRA assets incident to divorce. However, according to the IRS, there are two commonly used methods to transfer IRA assets to a spouse or former spouse.[121]

- Changing the name on the IRA
- Making a direct transfer of IRA assets

Example 33. Under the terms of their divorce decree, Latimer must transfer 100% of the funds in his IRA with Merryville National Bank to Ellen, his former wife. Latimer forwards a copy of the divorce decree to Merryville with instructions to transfer the IRA assets in his name to Ellen. Merryville establishes a new, temporary IRA in Ellen's name and transfers all of Latimer's IRA funds into Ellen's account. Ellen can choose to retain the account with Merryville or transfer her new IRA to another custodian or trustee. A valid transfer of IRA assets incident to divorce has taken place. Neither Latimer nor Ellen faces any adverse tax ramifications from this transfer.

Example 34. Use the same facts as **Example 33,** except Merryville simply changes the name on Latimer's IRA to Ellen as owner. Latimer's IRA has been transferred to Ellen. This is an alternate method for Latimer to transfer IRA funds to Ellen that can be used if 100% of the funds in the IRA are transferred to her.

Example 35. Use the same facts as **Example 33,** except Latimer is only required to transfer 30% of his IRA balance to Ellen. Latimer forwards instructions to transfer 30% of the account balance along with a copy of the divorce decree to Merryville. Merryville establishes a temporary IRA for Ellen and transfers 30% into that temporary account. A valid transfer of IRA assets incident to the divorce has taken place. Ellen can choose to continue to use Merryville as custodian or transfer her new IRA to a different custodian.

Example 36. Use the same facts as **Example 33.** Ellen establishes one or more custodians for her IRA assets. Latimer then forwards instructions, along with a copy of the divorce decree, to Merryville explaining how much of his IRA assets to transfer into the new account(s) that Ellen established. Merryville transfers the required funds directly to Ellen's custodians in this **direct transfer** (or trustee-to-trustee transfer) of IRA funds. A valid transfer of IRA assets has occurred.

> **Note.** A qualified domestic relations order (QDRO), discussed in the next section, is **not** required for the transfer of IRA assets incident to divorce. However, the IRA custodian or trustee requires documentation that the requested transfer is being accomplished incident to a divorce. A copy of the divorce decree or separate court order incident to the divorce decree specifying the required transfer is usually sufficient.

118. IRC §408(d)(6).
119. Treas. Reg. §1.408-4(g)(1).
120. IRC §408(d)(6).
121. IRS Pub. 590, *Individual Retirement Arrangements (IRAs)*.

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Observation. Although a "rollover" is a common method for an individual to transfer IRA assets from one account to another, no Code provision, regulation, or IRS publication specifically permits a rollover in connection with a transfer incident to a divorce.

Changing the name on the IRA funds as explained above or making a direct transfer serves to effect the valid transfer of IRA funds required by IRC §408(d)(6) in order for the transaction to be tax-free for both spouses.

An individual's withdrawal and use of the funds for the benefit of the spouse or former spouse does not constitute the type of "transfer" required for tax-free treatment. Such a withdrawal results in a taxable distribution and penalties if the account owner has not attained age 59½.

Example 37. Gordon and Agnes finalize their divorce in 2012. Their divorce decree requires Gordon to give Agnes the funds in his IRA. Gordon cashed out his IRA and received a check for $68,000. He endorsed the check over to Agnes. Even though Gordon never deposited the funds into his bank account and he endorsed the check directly to Agnes, the endorsement of the check does not constitute an appropriate transfer of funds for nonrecognition treatment. Gordon must include the $68,000 in income as a taxable IRA distribution.[122]

QUALIFIED RETIREMENT PLANS

A **qualified retirement plan** is a plan that is governed by the various requirements under **IRC §401(a)** and **the Employee Retirement Income Security Act of 1974 (ERISA).** These requirements are complex and involve setting minimum standards for a plan that is offered through an employer. An employer that offers a plan that meets these requirements can deduct employer contributions made to the plan. Earnings within a qualified plan are not taxed until withdrawn and paid to the employee. Some of the minimum standards include the following.

- Vesting of plan benefits
- Nondiscrimination rules for plan participants
- Plan retirement age
- Availability of benefits to a surviving spouse
- Prevention of plan participants from transferring or assigning an ownership interest in the plan ("anti-alienation and anti-assignment" provisions)

Some examples of qualified plans include traditional pension plans, §401(k) plans, employee stock ownership plans (ESOPs), and profit-sharing plans. IRAs offered by an employer, such as SEP IRAs and SIMPLE IRAs, are also qualified plans.

Qualified Domestic Relations Orders

Divorce property settlements frequently require the transfer of a spouse's ownership interest in a qualified plan to a spouse or former spouse. With the transfer of an ownership interest in a qualified plan, the transferring spouse needs to ensure the following.

- The ownership interest is transferred to the other spouse, making that spouse the new owner of the interest in accordance with the requirements set out in the divorce decree or other related document.
- Distributions from the transferred qualified plan are taxable to the other spouse who became the new owner as a result of the transfer.
- The transfer of the ownership interest in a qualified plan does not violate the "anti-alienation and anti-assignment" provisions[123] that are part of the qualified plan.

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122. This example is based on *Jones v. Comm'r*, TC Memo 2000-219 (Jul. 20, 2000). See also *Bunney v. Comm'r*, 114 TC 17 (2000).

123. IRC §401(a)(13).

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In order to ensure all the above factors are properly addressed within a transfer of a retirement plan interest, a **qualified domestic relations order (QDRO)** is used.

The QDRO is an exception to the anti-alienation rules for qualified plans under ERISA[124] and is therefore used as the method to transfer qualified plan benefits incident to divorce. In addition, while a §403(b) plan is not technically "qualified," it is treated the same as qualified plans under QDRO rules and can be transferred by a QDRO.[125]

A QDRO is a court order that recognizes or creates the rights of an **alternate payee** to some or all benefits payable under the terms of a qualified retirement plan. The alternate payee is the spouse or former spouse who receives the qualified plan interests from the **participant spouse** who originally owned that interest. A QDRO must include the following four items.

1. The name and last known mailing address of the participant and any alternate payees covered by the order
2. The amount or percentage of the participant's benefits that the plan must pay to the alternate payee or the method by which the appropriate amount or percentage is to be determined
3. The number of payments or period of time covered by the order
4. The specific plan(s) covered by the order

Moreover, a QDRO cannot require a plan to provide:

- An alternate payee with a type or form of benefit not otherwise provided by the plan,
- Increased benefits beyond those provided under the usual terms of the plan, or
- Payment of benefits to an alternate payee that must be paid to another alternate payee under a previously existing QDRO.[126]

A QDRO serves as the plan administrator's authorization to transfer benefits to the alternate payee. Major qualified plans have a "model QDRO" that attorneys can use as a starting point in drafting an appropriate QDRO for their clients in divorce cases. A QDRO covers any successor plans of the original qualified plan for which it was issued and also covers qualified plans of a successor employer.[127] In addition, although a QDRO attaches to the participant's plan benefits, it cannot reach benefits already vested in a new spouse of the participant.[128]

Example 38. Dean and Diana have finalized their divorce. Dean remarries and designates his new spouse, Roxanne, as beneficiary of the survivor benefits of his pension plan. Dean retires and begins receiving a joint and survivor annuity benefit.

Diana obtains a domestic relations order from a state court mandating that she be named as the annuity's alternate payee. This order is not a QDRO in connection with the survivor benefits. QDROs can only attach to benefits that are payable to a plan participant. Roxanne is not a plan participant; rather, she is a beneficiary with a vested interest.[129]

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124. ERISA §206(d)(3)(A).

125. IRC §414(p)(9).

126. IRC §414(p)(3).

127. Senate Committee Report to the Retirement Equity Act of 1984, PL 98-397 (1984); IRC §414(a).

128. *V.M. Hopkins v. AT&T Global Information Solutions Co*., 914 F. Supp. 1362 (DC W. Va. 1996), *aff'd* 105 F.3d 153 (4th Cir. 1997).

129. Ibid.

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Failure to Use a QDRO

A properly drafted QDRO clearly outlines the type and amount of plan benefits to be transferred to the alternate payee. In the absence of a QDRO, a former spouse can claim benefits greater than those intended in the transfer or can claim that there was no actual transfer of ownership as ordered by the court in the divorce proceedings. In addition, the participant can remain liable for taxes on the benefits paid to the other spouse. This can occur when a participant relies on a divorce decree for the transfer rather than obtaining a properly drafted QDRO.

Example 39. When Kyle and Karen divorced, their divorce decree awarded half the pre-tax value of Kyle's pension benefit to each spouse. However, the divorce decree did not qualify as a QDRO and did not give Karen any ownership interest in the pension benefits. Even though Kyle paid half of the lump-sum distributions he received from the pension plan to Karen, he remained liable for the tax on the whole amount.[130]

Example 40. Use the same facts as **Example 39,** except Kyle and Karen live in a community property state. Because the state divorce proceedings specifically recognize Karen's community property ownership interest in Kyle's pension plan benefits, Karen is liable for the tax on her half of the distributions paid to her by Kyle.[131]

FEDERAL GOVERNMENT PENSIONS

All federal government employees participate in either the Civil Service Retirement System (CSRS) or the Federal Employees Retirement System (FERS). The CSRS covers most employees first hired before 1984. FERS covers those employees hired after 1983 as well as employees who were hired earlier and elected to transfer their pension benefits from CSRS to FERS. These plans are administered by the Office of Personnel Management (OPM) and are not bound by the requirements of ERISA. Therefore, a QDRO cannot be used to divide federal pension plan benefits.

Any court order labeled as a QDRO or issued on a form for ERISA plans is not acceptable for processing unless the provisions within the court order expressly states that it applies to CSRS or FERS benefits and is drafted to conform to OPM's requirements. The court order must recognize that neither CSRS nor FERS are subject to the provisions of ERISA.

A similar court order, called a "qualified court order acceptable for processing" (QCOAP) is required by OPM before the division of any federal pension benefit under CSRS or FERS. Specific statutory language must exist in the order.

In addition, a state court order cannot be used to alter certain CSRS and FERS benefits, such as the eligibility for children's survivor benefits or the payment of accrued annuity amounts that exist at the participant's death. Federal law exclusively controls these benefits.[132]

MILITARY PENSIONS

The Uniformed Services Former Spouse Protection Act[133] (USFSPA) permits, but does not require, state courts to divide military pensions when determining property rights in a divorce or separation proceeding. The USFSPA provides a method for enforcement of state court orders at military pay centers. In addition, the USFSPA does not create a state property right if such a right does not initially exist under applicable state law.[134]

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130. See *In re M.D. Boudreau* (Bankr. M.D. Fla. 1995).

131. See *K.A. Weir v. Comm'r*, TC Memo 2001-184 (Jul. 23, 2001) for facts similar to *Boudreau, op. cit.*, but occurring within a community property state, which changed the outcome.

132. Additional details on the requirements of a QCOAP and the OPM procedure used to process them may be found in *A Handbook for Attorneys on Court-Ordered Retirement, Health Benefits and Life Insurance Under the Civil Service Retirement Benefits, Federal Employees Retirement Benefits, Federal Employees Health Benefits and Federal Employees Group Life Insurance Program* (2012 ed., U.S. Social Security Administration). This handbook is available online at www.opm.gov/retire/pubs/pamphlets/ri38-116.pdf.

133. 10 USC §1408.

134. 10 USC §1408(c)(2).

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A traditional pension plan receives and invests contributions allocable to each participant. The participant has an actual sum of money within the pension plan and options available regarding that amount. However, this is not the case with a military pension for servicemembers. Servicemembers receive retirement pay, which is a stream of income.

> **Note.** Military retirement pay represents reduced pay for reduced services. This is sometimes called "retainer pay."

Because the USFSPA gives states the ability to determine the rights of a spouse or former spouse to military retirement pay, the servicemember's state of residency must be determined before an appropriate division of retirement pay can be made. There are substantial differences among state courts in the valuation and calculation of the spousal share of military retirement pay benefits.

The servicemember's retirement pay can be divided in two different ways.

1. As a source of payment, such as a source of alimony and/or child support
2. As property, to be divided between spouses

To have military benefits used as a source of payment, generally the military pay center responsible for disbursing the servicemember's retirement pay must receive a certified court order that requires payments to be made to a spouse or former spouse.

In the case of a property division, the USFSPA limits payments made directly by the servicemember to 50% of "disposable retired pay" for all payments that constitute a division of property.[135] More than 50% of disposable pay may be paid under certain circumstances, such as garnishments for child support arrears. States vary on how this limitation is interpreted. State court orders are used in connection with a division of retirement pay, but USFSPA limitations must generally be adhered to.[136]

STATE PENSION SYSTEMS

Because each state's pension plan system is regulated under the respective state laws, states vary on how the state pension benefits are divided in a divorce or separation proceeding. Differences exist in areas such as the following.

- The limitations on what a court order can direct the pension system to do to divide a pension benefit
- Whether the court order must be a QDRO or if a nonqualified domestic relations order will suffice
- The particular procedure to use to direct the pension system to divide the pension benefit

Each state's statutes and case law impacts how a division of state pension benefits is accomplished.

> **Note**. As an example, Illinois requires a "Qualified Illinois Domestic Relations Order." Further details and requirements are available on the State Retirement Systems website at **www.state.il.us/srs.**

135. 10 USC §1408(e)(1).

136. *Division of Military Retirement Benefits in Divorce.* Willick, Marshal S. Oct. 2006. [www.willicklawgroup.com/get_file/id=317] Accessed on Apr. 24, 2012.

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NONQUALIFIED PLANS

Only administrators of qualified retirement plans can accept and process a QDRO. **QDROs cannot be used with nonqualified plans.** Nonqualified plans are not covered by ERISA. Examples of nonqualified plans include:

- Deferred compensation plans,
- Nonstatutory stock option plans,
- Supplemental employee retirement plans, and
- Executive bonus plans.

Rev. Rul. 2002-22 provides that the nonrecognition provisions under IRC §1041 apply to nonstatutory stock options and other nonqualified deferred compensation arrangements.[137] The revenue ruling also provides that the assignment of income doctrine does not apply with a nonqualified compensation transfer.[138]

> **Example 41.** Ian is employed by Integral Plastics Incorporated (IPI). Before Ian's divorce from Barbara, IPI issued nonstatutory stock options to him that were not taxable to him at the time they were granted. In addition, Ian has two unfunded nonqualified deferred compensation plans that provide him with the right to post-employment payments. At the time of the divorce, one of these accounts had a $100,000 balance and the other account had a $50,000 balance. Both of these balances were vested.
>
> Under the terms of their divorce settlement, Ian transferred the following to Barbara.
>
> - One-third of his stock options
> - The right to receive some of the deferred compensation payments from the two nonqualified deferred compensation accounts
>
> Four years after the divorce, Barbara exercises all the stock options she received. The FMV of the stock was greater than the exercise price. Moreover, Ian terminates his employment with IPI and Barbara receives payments from both of the nonqualified deferred compensation accounts.
>
> The transfers of the nonstatutory stock options and the rights in the two deferred compensation accounts constitute "**property**" under IRC §1041 and **nonrecognition** treatment applies to these transfers that were done incident to the divorce.
>
> Moreover, the **assignment of income doctrine** does not apply to Barbara's exercise of stock options. Ian therefore has no income inclusion from Barbara's exercise of the options or from her receipt of funds from the deferred compensation plans. Rather, Barbara is taxed on the exercise of the stock option as if she were the individual who performed the employment services with IPI. Barbara also includes the amounts received from the deferred compensation accounts in her income.[139]

The IRS noted that a different result might arise if the nonstatutory stock options or deferred compensation accounts are unvested or subject to substantial contingencies at the time of the transfer.[140]

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137. Rev. Rul. 2002-22, 2002-1 CB 849.

138. Ibid.

139. This example is based on the facts in Rev. Rul. 2002-22, 2002-1 CB 849.

140. Rev. Rul. 2002-22, 2002-1 CB 849.

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INNOCENT SPOUSE RELIEF

Statutory relief is available for spouses that have MFJ tax liability for amounts that are attributable to the other spouse. A spouse requesting relief (the "requesting spouse") has three available avenues for innocent spouse relief. The following table outlines these three types of relief, the statutory provisions that created them, and the primary guidance that exists for each.

Type of Relief	Code Section	Applicable Regulation
General relief for joint filers (general relief)	IRC §6015(b)	Treas. Reg. §1.6015-2
Separate liability relief (separate relief)	IRC §6015(c)	Treas. Reg. §1.6015-3
Equitable relief	IRC §6015(f)	Treas. Reg. §1.6015-4, Rev. Proc. 2003-61

Note. Additional guidance is provided by other regulations under IRC §6015 in addition to those noted above.

A requesting spouse must make a formal **election** to invoke general or separate relief.[141] An election is technically not required for equitable relief but equitable relief is requested using the same procedure as a request for general relief or separate liability relief.

ELECTION PROCEDURE

In order to request relief from a tax liability under one or more of the three types of relief, the requesting spouse must have filed a joint return and must complete one of the following.

- Form 8857, *Request for Innocent Spouse Relief*
- A written statement, signed under penalty of perjury, containing the same information as Form 8857[142]

The election for **general relief** or **separate liability relief** must be filed no later than **two years** from the date of the **first collection activity** against the requesting spouse for the joint tax liability.[143] A request for **equitable relief** can be made anytime within the limitation period for collection under IRC §6502 or for credit or refund of tax under IRC §6511.

While the election can be submitted before the commencement of collection activity,[144] such as in connection with an audit, examination, or demand for payment, the election cannot be made prematurely.[145] An election is **premature** if it is submitted for a tax year before the IRS sends notice of an audit or possible balance owed for that tax year.[146]

Note. The definition of "collection activity" is found in Treas. Reg. §1.6015-5(b)(2).

Once the requesting spouse makes the election, the nonrequesting spouse has notice and participation rights.

141. IRC §§6015(b) and (c).

142. Treas. Reg. §1.6015-5(a).

143. Treas. Reg. §1.6015-5(b)(1).

144. Treas. Reg. §1.6015-5(b)(3).

145. Treas. Reg. §1.6015-5(b)(5).

146. Ibid.

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GENERAL RELIEF FOR JOINT FILERS

The IRS may grant relief to a requesting spouse who makes a proper election if the following conditions are satisfied.

- A joint return was filed.
- The return has an understatement caused by the nonrequesting spouse.
- When the tax return was signed, the requesting spouse had neither **actual knowledge** nor any **reason to know** of the understatement.
- It is inequitable to hold the requesting spouse liable for the understatement.[147]

Actual Knowledge or Reason to Know Standard

The burden of proof lies with the requesting spouse to establish lack of **actual knowledge** or any **reason to know** of the understatement **when the joint return was signed.**[148]

Actual knowledge about omitted income exists if the requesting spouse knows that the nonrequesting spouse received the income.

Actual knowledge about an erroneous deduction exists if the requesting spouse knows the facts that make the particular expense not allowable as a deduction or credit. Actual knowledge about an inflated or fictitious deduction exists if the requesting spouse knows the expenditure was not incurred or not incurred to the extent claimed on the return. The IRS may rely on all the facts and circumstances in establishing actual knowledge on the part of the requesting party.[149]

Note. Further details on the definition of "actual knowledge" are found in Treas. Reg. §1.6015-3(c).

The requesting spouse has **reason to know** if a reasonable person in similar circumstances would have known of the understatement, based on all the facts and circumstances, including the following.

- The nature and amount of the understatement relative to other items on the return
- The financial circumstances of the spouses
- The requesting spouse's education, business experience, and participation in the activity that led to the understatement
- Whether the requesting spouse made reasonable inquiries about aspects of the return at the time of signature
- Whether the erroneous item on the return represented a divergence from the couple's past reporting practices[150]

Example 42. Steve and Inga file jointly for 2011. Steve knew that Inga inherited substantial funds from her deceased father. However, he did not know or have reason to know that Inga received and failed to report the taxable distributions from an inherited IRA account. Steve may be eligible for relief from the tax liability on the unreported IRA distributions.[151]

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147. Treas. Reg. §1.6015-2(a).

148. IRC §6015(b)(1)(C).

149. Treas. Reg. §1.6015-3(c)(2)(iv).

150. Treas. Reg. §1.6015-2(c).

151. Based on *D.R. Braden v. Comm'r*, TC Memo 2001-69 (Mar. 22, 2001).

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If a requesting spouse does not have actual or reasonable knowledge of an understatement earlier in the year but later learns of the understatement before the return is filed, the requirements necessary for relief are not met.[152] However, obtaining knowledge of the understatement after signing the joint return does not preclude relief from being granted.[153] Mere lack of knowledge of the tax consequences of a known error[154] or failure to read the return[155] before it is signed are not sufficient circumstances for relief.

Knowledge of Part of the Understatement

The requesting spouse may know or have reason to know about part of an understatement but not about the entire understatement. Relief can be granted only for the portion of the understatement of which there was no knowledge.[156]

> **Example 43.** Harvey and Wilma file jointly each year. Harvey understated their tax liability by $50,000 for 2011. Wilma knew that Harvey underreported some income from his plumbing business, which resulted in $10,000 of the understated tax liability. However, Wilma did not know that Harvey received and also failed to report other substantial income from a large contract that Harvey did not tell her about. Failure to report the contract income caused $40,000 of the understatement. While Wilma is not eligible for relief for the $10,000 portion of the understatement of which she had knowledge, she may still be eligible for relief for the $40,000 portion for which she had no knowledge.

SEPARATE LIABILITY RELIEF

A requesting spouse can elect separate liability relief from a tax deficiency if the following conditions are satisfied.

- At the time of the election, the spouses who filed jointly are divorced, legally separated, or have not lived together for at least 12 months.
- The spouses have not transferred assets between them as part of a fraudulent scheme.
- The requesting spouse signed the return without actual knowledge of the other spouse's tax issues that caused the deficiency (unless the signature was under duress).

The requesting spouse has the burden of proof in showing initial eligibility for the election for relief. If the IRS decides to deny the election on grounds that the requesting spouse had **actual knowledge** of the other spouse's tax issues, the IRS bears the burden of proof.[157]

Actual Knowledge Standard

Relief is granted unless the IRS proves, by a preponderance of the evidence, actual knowledge of the item causing a deficiency. The "reasonable knowledge" standard that also applies with a general joint relief election is inapplicable with an election for separate liability relief. Accordingly, what a reasonable person would have known is irrelevant under a separate relief election. However, the same actual knowledge standard that applies with general relief for joint filers also applies with separate relief.[158]

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152. See *H.I. Joss v. Comm'r*, 56 TC 378 (1971).

153. *L.E. Kistner v. Comm'r*, 18 F.3d 1521 (11th Cir. 1994); *B. Ianiello v. Comm'r*, TC Memo 1991-415 (Aug. 22, 1991).

154. *J. Hayman v. Comm'r*, 992 F.2d 1256 (2nd Cir. 1993); *H.L. Park v. Comm'r*, 25 F.3d 1289 (5th Cir. 1994).

155. *G. Erdahl v. Comm'r*, 930 F.2d 585 (8th Cir. 1991); *P.A. Price v. Comm'r*, 887 F.2d 959 (9th Cir. 1989).

156. Treas. Reg. §1.6015-2(e)(1).

157. IRC §6015(c)(2); Treas. Reg. §1.6015-3(d)(3).

158. Treas. Reg. §1.6015-3(c)(2); Treas. Reg. §1.6015-2(c).

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Example 44. Raymond's election for separate relief was successful for unreported income amounts that his former wife Hilda embezzled. Even though Raymond should have known about the unreported income because a substantial portion of it was deposited to their joint bank account and spent on household items, the IRS failed to show that Raymond had actual knowledge of the unreported income.[159]

Example 45. Ryan failed to report restaurant income. The IRS established that his former wife Erin had actual knowledge of the unreported income because she was directly involved with daily restaurant operations along with her other family members. Additionally, Erin studied accounting and earned a degree in business administration. She also signed two loan applications that showed restaurant income substantially in excess of the amount reported on the joint tax returns.[160]

Observation. To deny relief, the IRS must make a stronger showing under a separate relief election than for a general relief election. For a requesting spouse that had no actual knowledge but may have had reason to know about what caused the understatement, a separate relief election may provide a much stronger case because the IRS must show actual knowledge.

Allocating the Deficiency

Using the separate relief provision, a requesting spouse can elect to allocate a deficiency, thereby apportioning the deficiency between the two joint filers.

If relief is granted, any item that caused the deficiency is allocated between the spouses as if separate returns had been filed.[161] The requesting spouse is only liable for that portion of the deficiency attributable to the requesting spouse.[162] However, the requesting spouse has the burden of proof in connection with the apportionment of liability for the deficiency.[163]

Example 46. Dan and Isabella finalized their divorce in February 2009. They filed MFJ for a final time for 2008. Isabella received a substantial taxable IRA distribution in the form of two payments: a smaller payment she received in April 2008 and a much larger payment she received in October 2008. In August 2010, Dan and Isabella received a 30-day letter indicating a $100,000 deficiency for 2008 relating to Isabella's distributions received during that year. Twenty-five percent of the deficiency is attributable to the April payment and 75% of the deficiency is attributable to the October payment.

In 2010, Dan makes an election under the innocent spouse separate liability relief provision. Dan knew about the smaller April 2008 payment because Isabella deposited it in the joint bank account. Dan used these funds to pay household expenses and received bank statements in connection with this account. However, Dan had no knowledge of the larger October payment because Isabella received and invested these funds without telling Dan anything about this payment. Assuming Dan is not eligible for further relief under another innocent spouse provision, Dan remains jointly and severally liable for 25% of the deficiency that is attributable to the April payment of which he had actual knowledge. He may obtain relief from joint and several liability for the other 75% of the deficiency related to the October payment.

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159. Based on *M.G. Culver v. Comm'r*, 116 TC 189 (2001).

160. Based on *F. Entezam v. Comm'r*, TC Memo 2003-253 (Aug. 21, 2003).

161. IRC §6015(d)(3)(A).

162. IRC §6015(c)(1).

163. IRC §6015(c)(2).

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Disqualified Asset Transfers

If an asset is transferred to the requesting spouse from the other spouse with the principal purpose of avoiding tax or payment of tax, the transaction constitutes a disqualified asset transfer.[164] There is a **presumption** that any asset in such a transfer during the 12-month period preceding the date of either the first 30-day letter or notice of deficiency is the subject of a disqualified asset transfer. This presumption is rebuttable.[165]

> **Note.** This presumption **does not apply** to asset transfers under a divorce decree, separate maintenance decree, or written instrument incident to these decrees.

Example 47. Use the same facts as **Example 46,** except Isabella transfers $1,500 to Dan in April 2009, shortly after the divorce was finalized. When Dan elects relief from joint liability for the 2008 return, he indicates that the $1,500 transfer was not made for tax avoidance reasons. However, he does not provide the IRS with documentation for any alternative to explain the transfer of the $1,500 from Isabella. Because the $1,500 transfer took place within the year preceding the date of the 30-day letter, the presumption is that there was a tax avoidance purpose to the transfer. Dan did not successfully rebut that presumption. Therefore, he remains liable for not only $25,000 ($100,000 × 25%) of the tax liability due to his knowledge of Isabella's April distribution, but also for an additional $1,500 of tax liability, for a total of $26,500. The $1,500 value of the transfer is added to the amount for which Dan is otherwise liable.

Example 48. Use the same facts as **Example 47,** except Dan explains to the IRS that Isabella always made a $1,500 payment each year to Dan as a birthday gift. Despite the divorce, Isabella continued to make this payment to Dan in 2009. Isabella is not required to make this payment under the divorce decree or related document. Dan states these facts on his election for separate liability relief. Dan will likely have overcome the disqualified payment presumption, limiting his liability for the 2008 taxes to the $25,000 attributable to his knowledge of the April distribution received by Isabella.

Example 49. Use the same facts as **Example 47,** except Isabella is required to make the $1,500 payment to Dan under their divorce decree. The disqualified asset presumption therefore does not apply and Dan's liability for tax is limited to the $25,000 attributable to his knowledge of the April distribution Isabella received.

EQUITABLE RELIEF

Equitable innocent spouse relief requires the requesting spouse to meet **seven criteria.**

1. The tax liability is attributable to the nonrequesting spouse.
2. The requesting and nonrequesting spouses must have filed a joint return.
3. There is no fraudulent intent in connection with the filing of the joint return.
4. The requesting spouse does not qualify for either general relief or separate relief.
5. No assets were received from the nonrequesting spouse as part of a fraudulent scheme.
6. No disqualified assets were received from the nonrequesting spouse.
7. The request for equitable relief is timely.[166]

If these seven criteria are met, the requesting spouse may qualify for a "streamlined decision" (discussed later in this chapter).

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164. Treas. Reg. §1.6015-3(c)(3)(ii).

165. Treas. Reg. §1.6015-3(c)(3)(iii).

166. Treas. Reg. §1.6015-4(c); IRS Notice 2012-8, 2012-4 IRB 309.

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Timely Request

In 2011, the IRS announced that it will:[167]

- No longer apply the 2-year deadline for equitable relief requests that applies for general relief or separate relief elections,
- Accept reapplications for equitable relief if a previous application was denied due to the failure to initially apply before the 2-year deadline, and
- Not enforce the 2-year deadline in any pending litigation involving equitable relief.

Accordingly, a **timely** request is:

- Within the 10-year collections limitation period if the request is made for relief from an unpaid tax liability, or
- Within the 3-year limitation period for a credit or refund if the request is made for relief that would result in a credit or refund.[168]

Determination of Relief

Upon receiving an application for equitable relief, the IRS makes a determination about whether to grant relief after reviewing all the relevant facts and circumstances of the case. These factors include the following.

- Existence of economic hardship for the requesting spouse
- The requesting spouse's knowledge of, or reason to know about, the nonrequesting spouse's deficiency or underpayment
- Any significant benefit obtained from the deficiency or underpayment
- The nonrequesting spouse's legal obligation to pay the tax liability
- The spouses' compliance with tax laws
- The existence of any spousal abuse and mental or physical health problems.[169]

> **Note.** IRS Notice 2012-8 provides significant additional guidance on these factors. Other factors that are considered by the IRS and the relative importance of each vary from case to case depending on the circumstances of the requesting spouse and of the marriage.

Streamlined Determination. If all seven equitable relief criteria are met, the IRS provides a streamlined determination if the requesting spouse can meet three additional requirements.

1. The spouses are separated or no longer married for the 12-month period leading up to the request.
2. The requesting spouse did not know or have reason to know that the other spouse would not pay the tax shown on the joint return.
3. The requesting spouse will suffer economic hardship if relief is not granted.[170]

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167. IRS News Release IR-2011-80 (Jul. 25, 2011).
168. IRS Notice 2012-8, 2012-4 IRB 309.
169. Ibid.
170. Ibid.

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INJURED SPOUSE

A tax overpayment is typically refunded to the taxpayer. However, the IRS has statutory authority to apply a tax overpayment to certain other debts and obligations of the taxpayer.[171] A spouse who would have obtained a refund but for the other spouse's debts is an **injured spouse.** The injured spouse can apply to obtain the refund to which they were entitled. This may be useful for a divorced or divorcing spouse whose refund was used on a previous joint return filed with a former spouse to satisfy the former spouse's debts. The debts against which a tax overpayment can be applied are as follows.

- Unpaid federal taxes
- Debts owed to a federal agency
- Past-due child or parental support assigned to a state
- Past-due child support or parental support not assigned to a state
- Legally enforceable unpaid state income taxes

Note. Past-due child or parental support refers to an amount determined by state court order or other state administrative process that is owed for either a child or a parent with whom the child lives.[172] A past-due amount **"assigned to a state"** refers to support payments that the recipient has agreed to let the state receive and retain in exchange for one or more social program benefits offered by the state for the child and/or parent.

When there is a tax overpayment on a joint return, the IRS generally applies the entire tax overpayment against any of the debts listed above.[173] Accordingly, the entire overpayment can be applied against the debts of one spouse, using an overpayment that would otherwise have been refunded to the other spouse that had no such debts to satisfy.

A notice is sent to the affected taxpayer(s) if a tax overpayment is applied against one of the above debts.[174]

Note. A couple does not have to be divorced or divorcing for a spouse to apply for injured spouse relief. A married person can also use this provision.

PRIORITY RULES

When the taxpayer has two or more of the above debts, a tax overpayment is applied to them in the order in which they are listed.[175] If there is more than one debt of the same type, the overpayment is applied against the debts in the order in which they are accrued.[176]After satisfaction of all these debts, any excess overpayment is refunded to the taxpayer.[177] The taxpayer can also elect to have this refundable amount credited as estimated tax payments.[178]

171. IRC §6402.
172. Treas. Reg. §301.6402-5(b)(1). See Treas. Reg. §301.6402-5(b)(2) for additional details on what constitutes past-due support under these rules.
173. IRM 25.18.5.1 (2011).
174. [www.irs.gov/taxtopics/tc203.html] Accessed on Apr. 6, 2012.
175. Treas. Reg. §301.6402-6(g)(1).
176. Treas. Reg. §301.6402-6(g)(2).
177. Treas. Reg. §301.6402-6(g)(3).
178. Ibid.

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APPLYING FOR RELIEF

The apportioned share of an overpayment may be refunded to an injured spouse who applies for relief using Form 8379, *Injured Spouse Allocation*. This form may be filed:

- With a tax return before the overpayment is applied to a debt, or
- On its own, after notification that an overpayment was applied to a debt.

If the form is sent with a tax return, the term "injured spouse" should be conspicuously noted at the top left corner of the tax return to alert the IRS that there is a Form 8379 attached. The IRS processes the injured spouse request before applying any overpayment shown on the return to an existing debt.

If the form is sent by itself, the injured spouse must sign the form and both spouses' social security numbers must appear on the form in the same order that they appeared on the income tax return. The form is sent to the same IRS service center to which the tax return is filed.[179]

> **Note.** The IRS calculates the injured spouse's share of the overpayment. For an injured spouse in a community property state, the IRS divides the joint overpayment in accordance with state law.

APPORTIONMENT OF THE TAX OVERPAYMENT

The IRS established a method for apportioning the tax overpayment between spouses. This process is used to determine the amount of overpayment refundable to the injured spouse. The apportionment is based on the spouses' respective contributions to the payment of the taxes for the year, not on their respective incomes that gave rise to the tax liability.

The apportionment is accomplished in three steps.

Step 1. Determine each spouse's portion of the joint tax liability (JTL). Under the injured spouse rules, this is calculated using the **separate tax formula** below.

$$\text{Spouse's portion of JTL} = \frac{\text{Spouse's MFS tax liability}}{\text{Both spouses' MFS tax liabilities}} \times \text{JTL}$$

Step 2. Calculate each spouse's contribution to the payment of the JTL. Each spouse's tax withholding on wages and other income counts as a contribution toward the payment of the JTL for that spouse. If estimated payments are made, they are apportioned to each spouse using the following formula.

$$\text{Spouse's contribution} = \frac{\text{Spouse's MFS tax liability}}{\text{Both spouses' MFS tax liabilities}} \times \text{Estimated payments}$$

Step 3. Determine each spouse's share of the overpayment. This is calculated for each spouse by taking that spouse's amount calculated in Step 2 and subtracting the amount calculated in Step 1 from it. This is reflected in the following formula.

$$\text{Spouse's refund amount} = \begin{array}{c}\text{Spouse's share of contribution}\\\text{to payment of JTL}\end{array} - \text{Spouse's share of tax liability}$$

> **Note**. IRS Pub. 17 suggests that, outside of an injured spouse situation, divorced spouses may have the ability to specify the apportionment of the overpayment amount instead of using this apportionment method.

179. *Refund Offsets: For Unpaid Child Support, And Certain Federal, State, and Unemployment Compensation Debts* [www.irs.gov/taxtopics/tc203.html] Accessed on Apr. 6, 2012.

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Example 50. Ron and Shauna finalize their divorce in early 2012. Their 2011 tax return is the last joint tax return filed. Ron has $15,000 of unpaid federal taxes from a prior year. The relevant figures in connection with their 2011 MFJ tax return, along with applicable MFS amounts for each spouse, are as follows.

	Ron (MFS)	Shauna (MFS)	Joint Return as Filed
Wages	$40,000	$50,000	$90,000
Standard deduction	5,800	5,800	11,600
Exemptions	3,700	3,700	7,400
Taxable income	30,500	40,500	71,000
Tax liability	4,154	6,256	10,006
Federal tax withheld on wages	6,000	9,000	15,000

The 2011 joint tax return showed a total tax liability of $10,006 and an overpayment amount of $4,994. The IRS applied the entire $4,994 overpayment to Ron's unpaid $15,000 tax liability. Ron and Shauna would have received a refund of this overpayment had it not been for Ron's unpaid taxes. Some of this $4,994 refund is attributable to Shauna. After the divorce in 2012, Shauna applies for injured spouse relief in order to obtain a refund of the 2011 overpayment attributable to her.

To determine how much of the $4,994 is attributable to each spouse under the injured spouse rules, the following calculations must be made.

Step 1. Determine each spouse's portion of the JTL using the separate tax formula.

$$\begin{aligned}\textbf{Ron's portion of JTL} &= \frac{\textbf{Ron's MFS tax liability}}{\textbf{Both spouses' MFS tax liabilities}} \times \textbf{JTL}\\ &= \frac{\$4{,}154}{\$4{,}154 + \$6{,}256} \times \$10{,}006\\ &= \frac{\$4{,}154}{\$10{,}410} \times \$10{,}006\\ &= 0.399 \times \$10{,}006\\ &= \$3{,}992\end{aligned}$$

$$\begin{aligned}\textbf{Shauna's portion of JTL} &= \frac{\textbf{Shauna's MFS tax liability}}{\textbf{Both spouses' MFS tax liabilities}} \times \textbf{JTL}\\ &= \frac{\$6{,}256}{\$4{,}154 + \$6{,}256} \times \$10{,}006\\ &= \frac{\$6{,}256}{\$10{,}410} \times \$10{,}006\\ &= 0.601 \times \$10{,}006\\ &= \$6{,}014\end{aligned}$$

Each spouse's portion of the joint tax liability is therefore as follows.

Ron	$ 3,992
Shauna	6,014
Total joint tax liability	$10,006

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Step 2. Determine each spouse's contribution to the payment of the joint tax liability. In this case, Ron and Shauna have each contributed the amount of federal tax that was withheld from their wages. Therefore, Ron's contribution toward payment of the JTL is $6,000. Shauna's contribution is $9,000.

Step 3. Determine each spouse's share of the overpayment. This amount for each spouse is arrived at by taking each spouse's contribution toward payment of the JTL minus each spouse's respective share of the JTL. These calculations follow.

	Tax Payments Made	Apportioned Amount of JTL	Apportioned Amount of Overpayment
Ron	$ 6,000	$ 3,992	$2,008
Shauna	9,000	6,014	2,986
Total	$15,000	$10,006	$4,994

Shauna's apportioned amount of the 2011 overpayment is $2,986, which will be refunded to her if injured spouse relief is granted. Ron's $2,008 portion of the overpayment will be applied against his past tax debt.

Note. The outcome may be different for an injured spouse in a community property state. See the following revenue rulings for guidance in connection with community property states.

- Rev. Rul. 2004-71, 2004-2 CB 74 (Arizona and Wisconsin)
- Rev. Rul. 2004-72, 2004-2 CB 77 (California, Idaho, and Louisiana)
- Rev. Rul. 2004-73, 2004-2 CB 80 (Nevada, New Mexico, and Washington)
- Rev. Rul. 2004-74, 2004-2 CB 84 (Texas)

LEGAL FEES AND DIVORCE

BASIC RULES

Legal fees associated with **personal** matters are **not** deductible.[180] However, legal fees in connection with an income-producing activity or to establish or protect a source of taxable income for the taxpayer are generally deductible.[181] Legal costs incurred in the course of recovering investment property or income from property are deductible.[182] In order for legal costs to be deductible, they must be "ordinary and necessary." This means that the legal costs must bear a close relationship to the production of income and must be reasonable in amount.[183] To determine whether legal fees are personal or sufficiently related to the production of income, the "origin and character" test is used. The origin and character test considers the following two factors.

- The **origin of the claim**
- The **character of the controversy**

180. IRC §262.

181. IRC §212.

182. Treas. Reg. §1.212-1(k).

183. Treas. Reg. §1.212-1(d).

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The claim's origin and character is a factual determination made on the basis of the facts and circumstances of the litigation. The **most important factor** to consider is the **circumstances** from which the lawsuit originated. This includes an assessment of:

- The allegations made in the complaint;
- The issues that arise from the pleadings;
- The litigation's background, nature and purpose; and
- The facts surrounding the controversy.[184]

LEGAL FEES ASSOCIATED WITH DIVORCE

Generally, legal fees and other costs associated with obtaining a divorce, separation, or decree for support are not deductible by either spouse.[185] Legal costs in connection with a divorce action are viewed as personal in nature. However, the portion of the attorney's fees and other costs that are related to the production or collection of taxable income is deductible.[186]

Example 51. Gilmore deducted the cost of his successful divorce action against Wilma. Gilmore believed these legal costs were business-related and therefore deductible because if Wilma had been successful, Gilmore would have lost the controlling stock in his automobile dealership and his livelihood. In addition, if Gilmore was found guilty of Wilma's infidelity allegations, the automobile manufacturer may have exercised its right to cancel his dealer franchise.

The deduction was disallowed. Gilmore's reasoning for claiming the deduction is based on the possible consequences of the litigation, not its origin and character. The **origin and character** of Gilmore's litigation was one of divorce, which is **personal and nondeductible,** irrespective of any possible business consequences.[187]

Example 52. Brad and Amelia finalized their divorce in 2009. During their marriage, they were joint owners of a rental apartment building. Their divorce decree requires Brad to pay Amelia her one-half share of the rental income each month. Brad complies with the terms of the divorce decree for several months but, in early 2010, he discontinues making the required payments to Amelia.

Amelia hires an attorney to sue Brad to collect the unpaid income amounts. Amelia can deduct her legal fees because they were incurred to enforce the collection of taxable income.

> **Note.** While the Code and regulatory provisions in this area are straightforward, the contours of divorce legal fee deductibility and the application of the origin and character test have largely been drawn by case law. Accordingly, case law appears to provide the best guidance in this area.

184. *J.W. Lange v. Comm'r*, TC Memo 1998-161 (May 5, 1998); *V. Boagni, Jr. v. Comm'r*, 59 TC 708 (1973).

185. Treas. Reg. §1.262-1(b)(7).

186. Ibid.; IRC §212.

187. See. *U.S. v. Gilmore*, 372 US 39 (1963).

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Legal Fees Associated with Alimony

The portion(s) of divorce legal fees that are associated with **obtaining or collecting** taxable alimony **are deductible**[188] if they are paid by the spouse receiving the alimony. This includes the collection of both current[189] and back[190] alimony as long as it is taxable.[191] Such legal fees are viewed as related to the production or collection of income. However, if these legal fees are paid by the spouse who **pays** the alimony, the fees are **not** deductible.[192]

Legal fees incurred to **reduce** the amount of alimony payments being made are not deductible.[193]

Legal Fees and Child Support

Legal fees to obtain child support or to assert or defend the right to child support were held to be nondeductible.[194]

Legal Fees to Protect Business Interests

In a recent case, a married couple was not entitled to deduct fees related to the husband's divorce from his first wife but was allowed to deduct the portion of legal costs incurred to defend their interest in property and rental income held in the first wife's bankruptcy estate.[195]

Legal expenses paid by a corporation to defend a claim filed against it by a divorce litigant were considered deductible. The claim involved preserving corporate assets and resisting legal action that would interfere with the corporation's business activities.[196]

Legal Fees for Divorce Tax Counseling

The portion of legal fees allocable to tax counseling throughout a divorce proceeding are deductible.[197] Accordingly, fees charged for determining the tax consequences of property settlements and alimony payments are deductible.[198] The fee for tax advice for past or future tax years is deductible. However, a spouse may only deduct their own expenses and not those of the other spouse.[199]

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188. Treas. Reg. §1.262-1(b)(7); IRC §212(1).

189. *R.K. Wild v. Comm'r*, 42 TC 706 (1964).

190. *Est. of R. Edelman v. Comm'r*, 38 TC 972 (1962).

191. IRC §71.

192. *F.A. Sunderland v. Comm'r*, TC Memo 1977-116 (Apr. 21, 1977).

193. *G.G. Wolfson v. Comm'r,* 47 TC 290 (1966); IRC §71(e).

194. *D.A. Swenson v. Comm'r,* 43 TC 897 (1965); *C.B. McClendon v. Comm'r,* TC Memo 1986-416 (Sep. 4, 1986).

195. *T.P. Melcher Est.*, TC Memo 2009-210 (Sep. 15, 2009).

196. *R. Dolese et al. v. U.S.*, 605 F.2d 1146 (10th Cir. 1979).

197. *U.S. v. T.C. Davis*, 370 US 65 (1962).

198. *W.K. Carpenter v. U.S.*, 338 F.2d 366 (U.S. Ct Cl. 1964).

199. *U.S. v. T.C. Davis*, 370 US 65 (1962).

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DIVISIBILITY OF THE LEGAL FEES

Often, legal fees for divorce cover a variety of issues. Some of these issues may be in connection with the divorce decree or other items considered personal in nature and are therefore nondeductible. Some of the legal fees may be incurred for items related to the production or collection of income and therefore may be deductible. It is therefore necessary to **allocate** the legal fees into deductible and nondeductible amounts.

Most IRS and case law guidance regarding the allocation of legal fees into deductible and nondeductible amounts involves legal fee deductions for tax advice. The IRS takes the position that the allocation between tax and nontax matters must be done on a reasonable basis.[200] A reasonable basis for this allocation requires:

- That the taxpayer hire a firm that limits its practice to tax matters, or
- If both tax and nontax matters are addressed, the portion of the fee allocated to tax matters must be based on the time spent on the tax issues, the difficulty of the tax issues, and the amount of tax involved.[201]

Evidence of the amount customarily charged for the tax service is relevant. Absent evidence of this nature, the taxpayer's testimony may persuade a court to allow some of the deduction, but the need to approximate the amount is a factor that works against the taxpayer.[202]

> **Note.** When the divorce attorney's advice and fees require allocation between deductible and nondeductible amounts, an **itemized invoice** that delineates the deductible amounts likely suffices for documentation of the deduction. It is essential that the client request this in order to appropriately claim the deductible portion of the legal fees incurred.[203]

200. *U.S. v. T.C. Davis*, 370 US 65 (1962); *W.K. Carpenter v. U.S.,* 338 F.2d 366 (U.S. Ct Cl. 1964).

201. Rev. Rul. 72-545, 1972-2 CB 179.

202. *H.C. Goldaper v. Comm'r*, TC Memo 1977-343 (Sep. 29, 1977); *G.M. Cohan v. Comm'r*, 39 F.2d 540 (2nd Cir. 1930).

203. *H. Kellner v. Comm'r*, U.S. Ct. App., 2nd Cir. (Feb 3, 1977).

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