Chapter 5: Divorce

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Please note. Corrections were made to this workbook through January of 2019. No subsequent modifications were made. For clarification about acronyms used throughout this chapter, see the Acronym Glossary at the end of the Index.

For your convenience, in-text website links are also provided as short URLs. Anywhere you see **uofi.tax/xxx**, the link points to the address immediately following in brackets.

About the Author

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While a divorce proceeding may involve several important issues, the impact of tax law on the parties to a divorce is an area that continuously evolves legislatively and judicially. **Tax professionals can help divorcing couples prevent unfavorable tax consequences when they are involved early in divorce planning discussions.** However, beware of the potential for conflicts of interest.

TAX RETURN ISSUES

FILING STATUS

The IRS acknowledges that state law controls whether an individual is considered married.[1] Only persons considered married are allowed to file joint returns.[2] Marital status is determined on the last day of the tax year.[3] Spouses must have the same tax year in order to qualify for filing a joint return.[4] However, a joint return can be filed if a difference in tax years exists because one or both spouses died.[5] Therefore, a joint return can be filed if a spouse's death occurred prior to the time a divorce is finalized.

If a spouse's death occurs, marital status on the date of death determines whether joint filing status is appropriate.[6] 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 married filing separately (MFS).[7] Generally, both spouses must be U.S. citizens or U.S. residents to file jointly.[8]

Note. A couple in a common-law marriage is considered married under tax rules. As such, they can file jointly as long as their common-law marriage began in a state recognizing common-law marriages or if they live in one of these states at the end of the tax year.[9] Although common-law marriage is recognized 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.[10]

Same-Sex Marriage

For federal tax purposes, same-sex marriages are treated the same as opposite-sex marriages. However, persons who have entered into a registered domestic partnership, civil union, or other similar relationship that is **not considered** a marriage under state laws are not considered married for federal tax purposes.[11]

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1. Rev. Rul. 58-66, 1958-1 CB 60.
2. IRC §6013(a).
3. IRC §6013(d)(1)(A).
4. IRC §6013(a)(2).
5. Ibid.
6. IRC §6013(d)(1)(B).
7. *Filing Status.* IRS. [apps.irs.gov/app/vita/content/globalmedia/4491_filing_status.pdf] Accessed on Oct. 4, 2017.
8. IRC §6013(a)(1), but for exceptions see §§6013(g) and (h).
9. *Filing Status.* IRS. [apps.irs.gov/app/vita/content/globalmedia/4491_filing_status.pdf] Accessed on Oct. 4, 2017.
10. *How do we end a common law marriage?* NOLO. [www.nolo.com/legal-encyclopedia/question-end-common-law-marriage-28053.html] Accessed on Oct. 4, 2017.
11. IRS Pub. 504, *Divorced or Separated Individuals.*

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. In addition, when a married couple lives apart for the last six months of the year, the custodial parent of a dependent child can file as head of household (HoH) and the other spouse can file MFS. 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.[12]

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.[13] 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. Michael and Juanita, a married couple, have the same calendar tax year. They filed for divorce in January 2017. The court issued a final decree of divorce on December 15, 2017. On the last day of their respective tax years, December 31, 2017, Michael and Juanita were not married. They ceased being married on December 15, 2017. They cannot file a joint return for the 2017 tax year.

Example 2. Use the same facts as **Example 1,** except the final divorce decree was issued February 23, 2018. Because Michael and Juanita are considered married until the final decree and are therefore still married on December 31, 2017, they may file a joint return for the 2017 tax year.

Example 3. Use the same facts as **Example 1,** except the court order issued on December 15, 2017, is a judgment nisi with a 30-day nisi period. Michael and Juanita are considered married on December 31, 2017, and may file jointly for the 2017 tax year.

Invalid Divorce Judgment. If a state court later finds a final divorce judgment invalid, the IRS disregards the divorce.[14] However, there is a split of authority among tax cases in federal courts involving invalid divorce decrees. The Second Circuit[15] decided it would not recognize a state court's determination that a divorce was invalid. The Ninth Circuit, however, ruled that such a determination by a state court must be recognized.[16] The IRS indicated that a foreign jurisdiction divorce for the sole purpose of tax avoidance 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.[17]

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 Fourth 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.[18] However, in states where an appeal delays finality, a joint return may be permitted.

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12. Ibid.
13. *Interlocutory Decree.* Encyclopedia Britannica. [www.britannica.com/topic/interlocutory-decree] Accessed on Oct. 4, 2017.
14. Rev. Rul. 67-442, 1967-2 CB 65.
15. *Est. of H. Borax v. Comm'r*, 349 F.2d 666 (2nd Cir. 1965); *H.E. Wondsel v. Comm'r,* 350 F.2d 339 (2nd Cir. 1965), *cert. denied,* 383 U.S. 935.
16. *H.K. Lee and Louise Geise v. Comm'r,* 550 F.2d 1201 (9th Cir. 1977).
17. Rev. Rul. 76-255, 1976-2 CB 40.
18. *K.T. Sullivan v. Comm'r,* 256 F.2d 664 (4th Cir. 1958).

Annulment. A taxpayer who obtains a decree of annulment (which holds that no valid marriage ever existed) must file amended returns for all tax years affected by the annulment that are not closed by the statute of limitations. The taxpayer generally must use the single filing status on the amended returns, unless they meet the requirements to file as HoH.[19]

Itemized Deductions on Separate Returns. If spouses file MFS and one of them itemizes deductions, the other spouse **must** also itemize. In this situation, the standard deduction amount is zero for the non-itemizing spouse.

Taxpayers who file using the MFS status may be able to claim itemized deductions on their separate return for certain expenses they paid separately or jointly with their spouse. The following table from IRS Pub. 504, *Divorced or Separated Individuals,* shows which deductions can be claimed on a separate return.

IF you paid ...	AND you ...	THEN you can deduct on your separate federal return...
medical expenses	paid with funds deposited in a joint checking account in which you and your spouse have an equal interest	half of the total medical expenses, subject to certain limits, unless you can show that you alone paid the expenses.
state income tax	file a separate state income tax return	the state income tax you alone paid during the year.
	file a joint state income tax return and you and your spouse are jointly and individually liable for the full amount of the state income tax	the state income tax you alone paid during the year.
	file a joint state income tax return and you are liable for only your own share of state income tax	the smaller of: • the state income tax you alone paid during the year, or • the total state income tax you and your spouse paid during the year multiplied by the following fraction. The numerator is your gross income and the denominator is your combined gross income.
property tax	paid the tax on property held as **tenants by the entirety**	the property tax you alone paid.
mortgage interest	paid the interest on a qualified home[a] held as **tenants by the entirety**	the mortgage interest you alone paid.
casualty loss	have a casualty loss on a home you own as **tenants by the entirety**	half of the loss, subject to the deduction limits. Neither spouse may report the total casualty loss.

[a] For more information on a qualified home and deductible mortgage interest, see Pub. 936, *Home Mortgage Interest Deduction.*

Note. Beginning with the 2018 tax year, provisions in the Tax Cuts and Jobs Act (TCJA) affect various categories of itemized deductions. For more information, see the 2018 *University of Illinois Federal Tax Workbook,* Volume A, Chapter 1: New Legislation — Individual Concerns.

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

Other Issues Applicable to Separate Returns. The following special rules apply to married couples who file separate returns.[20]

- The tax rate is generally higher than it would be on a joint return.
- The exemption amount for calculating the alternative minimum tax (AMT) is half that allowed on a joint return.
- The taxpayer cannot take the credit for child and dependent care expenses in most cases.
- The taxpayer cannot take the earned income credit.
- In most cases, the taxpayer cannot take the exclusion or credit for adoption expenses.
- The taxpayer cannot exclude the interest from qualified savings bonds used for higher education expenses.
- If the taxpayer lived with their spouse any day during the year:
  - They cannot claim the credit for the elderly or the disabled, and
  - They must include in income a higher percentage of any social security or equivalent railroad retirement benefits they received.
- The following credits and deductions are reduced at income levels that are half of those for a joint return.
  - Child tax credit
  - Retirement savings contributions credit
- The capital loss deduction limit is $1,500 (instead of $3,000 on a joint return).
- If the taxpayer's spouse itemizes deductions, the taxpayer cannot claim the standard deduction. If the taxpayer can claim the standard deduction, the basic standard deduction is half of the amount allowed on a joint return.
- The taxpayer cannot take the American opportunity credit, the lifetime learning credit, or the deduction for student loan interest.

Filing Status after Divorce. After a divorce is finalized, the taxpayer may have the option of choosing single or 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.[21]

> **Note.** A taxpayer may qualify to file as HoH even before the divorce is final. For more information on the requirements to file as HoH, see IRS Pub. 17, *Your Federal Income Tax (For Individuals)*, and IRS Pub. 504.

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

21. *Filing Status.* IRS. [apps.irs.gov/app/vita/content/globalmedia/4491_filing_status.pdf] Accessed on Oct. 5, 2017.

Healthcare Insurance Considerations

Under the Affordable Care Act (ACA),[22] individuals must have qualifying healthcare coverage, unless they qualify for an exemption. A divorce or separation may impact an individual's responsibilities under the ACA in the following ways.[23]

- **Special Marketplace enrollment period** — Losing coverage because of a divorce is considered a qualifying life event that allows the divorced individual to enroll in health coverage through the health insurance Marketplace during a special enrollment period.
- **Changes in circumstances** — Certain individuals who purchase health insurance coverage through the Marketplace may get advance payments of the premium tax credit. These individuals should report changes in circumstances to the Marketplace. Such changes include a change in marital status, a name change, and a change in income or family size. Reporting such changes helps ensure that the individual gets the proper type and amount of financial assistance.
- **Shared policy allocation** — An individual who obtains a divorce or legal separation during the year and is enrolled in the same qualified health plan must allocate policy amounts with the former spouse on their separate tax returns to calculate their premium tax credit and reconcile any advance payments of the credit. The instructions for Form 8962, *Premium Tax Credit (PTC),* contain instructions for making this allocation.

> **Note.** Effective January 1, 2019, the tax imposed on individuals who do not maintain qualifying health insurance is reduced to zero. This is one of the changes implemented under the TCJA, which was signed into law on December 22, 2017. For more information, see the 2018 *University of Illinois Federal Tax Workbook,* Volume A, Chapter 1: New Legislation — Individual Concerns.

DEPENDENCY EXEMPTION

Custodial Parent

A custodial parent may claim a dependency exemption for a child. For the 2017 tax year, the personal exemption amount was $4,050.[24] However, under the TCJA, the personal exemption amount is reduced to zero for tax years beginning after December 31, 2017, and before January 1, 2026.[25] IRC §151(d)(5)(B) states that, "For purposes of any other provision of this title, the reduction of the exemption amount to zero… shall not be taken into account in determining whether a deduction is allowed or allowable, or whether a taxpayer is entitled to a deduction, under this section." This means that if a taxpayer is required to qualify for a child's dependency exemption for purposes of any other Code provision (e.g., the child tax credit), they are still required to do so, even though the dependency exemption is reduced to zero.[26]

The custodial parent is the parent in whose home the child resides 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. A child is treated as residing with neither parent if the child is emancipated under state law.[27]

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22. PL 111-148 (Mar. 23, 2010).

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

24. Rev. Proc. 2016-55, 2016-45 IRB 707.

25. IRC §151(d)(5).

26. *Children's Dependency Exemptions Eliminated by New Tax Law.* Vertz, Brian. Jan. 30, 2018. Pollock Begg Komar Glasser & Vertz LLC. [familylawtaxalert.com/childrens-dependency-exemptions-eliminated-by-new-tax-law/] Accessed on Mar. 14, 2018.

27. Treas. Reg. §1.152-4(d).

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.[28]

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.[29]
2. The parents provide over half of the child's support for the year.[30]
3. One or both parents had custody of the child for more than half of the year.[31]
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.[32]

"Qualifying documentation" includes one of the following.

1. The custodial parent's **written waiver** of the dependent child's exemption that satisfies the following requirements[33]
   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
   e. Is provided on **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.)
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[34]

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28. Treas. Reg. §1.152-4(d)(5).
29. IRC §§152(e)(1)(A)(i)–(iii).
30. IRC §152(e)(1)(A); Treas. Reg. §1.152-4(b)(2)(i).
31. IRC §152(e)(1)(B).
32. IRC §152(e)(2).
33. Treas. Regs. §§1.152-4(b)(3)(i) and 1.152-4(e)(1)(i)–(ii).
34. Treas. Reg. §1.152-4(b)(3)(ii).

The noncustodial parent must attach the qualifying documentation to their tax return each year that the noncustodial parent claims the dependent child exemption.[35]

Alternate Documentation. Although the regulations specifically indicate that a court order, decree, or separation agreement will not suffice as the written waiver,[36] 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 that went into effect after 1984 and before 2009.** 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.

- That the noncustodial parent can claim the dependent child exemption without condition
- That the custodial parent will not claim the exemption for the child
- The particular tax years that the noncustodial parent is entitled to claim the exemption

The relevant pages indicating the above information along with the following additional pages must 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 (SSN)

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.

Example 4. Jason and Lana are the divorced parents of their 3-year old daughter, Gia. Their divorce was final on November 29, 2016. They lived apart since March 15, 2016, when Jason moved into a new apartment. Gia stayed with Lana in the matrimonial home. Under the terms of the divorce decree, Lana's brother, Simon (Gia's uncle), has custody of Gia from January 1, 2017, to July 4, 2017.

During 2016, both parents had legal custody of Gia for more than half of the year and Jason and Lana provided over half of Gia's support. Because Gia spent nights solely with Lana since the March 15, 2016, separation date, Lana was the custodial parent for purposes of claiming the dependent child exemption for 2016. Lana invoked IRC §152(e) and transferred her right to claim a 2016 dependency exemption for Gia to Jason. She accomplished this by completing and forwarding to Jason the following Form 8332 for 2016, which Jason attached to his tax return.

35. Treas. Reg. §1.152-4(e)(2).

36. Treas. Reg. §1.152-4(e)(1)(ii).

For Example 4

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: **Jason Mills**
Noncustodial parent's social security number (SSN) ▶ **999 88 7777**

Part I Release of Claim to Exemption for Current Year

I agree not to claim an exemption for **Gia Mills**
Name of child

for the tax year 20**16**.

Lana Mills — Signature of custodial parent releasing claim to exemption
777 88 9999 — 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. Even though Lana released the exemption to Jason for 2016, she was still allowed to use the HoH filing status and claim the earned income credit (EIC) and the dependent child care credit if otherwise qualified. However, Jason could claim the child tax and education credits, if applicable, because these credits are tied to the exemption.[37]

Note. Lana 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).[38]

For 2017, because Gia was in the custody of her uncle Simon for more than half of the year, neither Jason nor Lana had custody of Gia for more than half the year. Therefore, the dependent child exemption **transfer provision of IRC §152(e) cannot be used.** If Gia is a "qualifying child" under §152(c) or "qualifying relative" under §152(d) of Jason, Lana, or Simon, that person can claim the 2017 exemption for Gia. Jason or Lana may be able to claim an exemption for Gia as a qualifying relative or Simon may be able to claim Gia as a qualifying child for 2017.

37. IRS Pub. 504, *Divorced or Separated Individuals; Education Credits — AOTC and LLC.* Mar. 13, 2018. IRS. [www.irs.gov/credits-deductions/individuals/education-credits-aotc-llc] Accessed on Mar. 20, 2018.

38. Instructions for Form 8332.

Example 5. Felipe and Greta are the parents of Adam, who is 17. Felipe and Greta finalized their divorce on January 11, 2016, and have lived apart since the divorce. The court granted Felipe's mother, Marilee, custody of Adam for the first three months of 2016. From April 1 through December 31, Felipe and Greta had joint custody. Beginning April 1, Adam resided 190 nights with Felipe and 85 nights with Greta. Adam was a qualifying child and Felipe and Greta provided over half his support. Because one or both parents had custody of Adam for more than half of the year (April 1 through December 31), the requirements of §152(e) are met. Adam lived with Felipe for the greater number of nights, which means Felipe was the custodial parent. Felipe could complete and sign a Form 8332 (or similar statement) releasing his right to claim an exemption for Adam, giving that right to Greta.

Example 6. Use the same facts as **Example 5.** In 2017, Adam lived with Felipe during the entire tax year. Adam attained age 18 on September 28, 2017. Under state law, Adam was emancipated as of September 28, 2017. After his 18th birthday, neither parent can be the custodial parent of Adam. However, because Felipe had custody of Adam for more than half of the year prior to Adam's 18th birthday, Felipe could use §152(e) to transfer the exemption to Greta as long as all the other requirements are met.

Example 7. Use the same facts as **Example 6,** except Adam's 18th birthday was on March 12, 2017. Felipe did not have custody of Adam for more than half of the year because Adam was emancipated[39] on his birthday. Felipe was not considered a custodial parent and could not 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. For a detailed discussion of this issue, see the 2011 *University of Illinois Federal Tax Fundamentals,* Chapter 3: Filing Status and Dependency Exemptions. This can be found at **uofi.tax/arc** [taxschool.illinois.edu/taxbookarchive].

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 child tax credit is also transferred.[40] In addition, many other tax benefits (e.g., education credits) cannot be used unless the taxpayer claims the dependency exemption.[41] As mentioned earlier, the requirement for the parent to qualify for the dependency exemption to claim certain tax benefits still applies to tax years beginning after December 31, 2017, and before January 1, 2026, even though the dependency exemption is reduced to zero for those years.

A custodial parent who transfers the dependency exemption still meets 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.[42]

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

40. IRS Notice 2006-86, 2006-41 IRB 680.

41. See IRS Pub. 970, *Tax Benefits for Education.*

42. IRS Notice 2006-86, 2006-41 IRB 680.

Medical Expense Deduction by Either Parent[43]

If a noncustodial parent meets all the §152(e) requirements, they 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 the child's medical expenses 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 the child's qualified medical expenses

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

TAX LIABILITY

Married taxpayers filing jointly (MFJ) are jointly and severally liable for the taxes owed on a joint return.[44] 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 were filed.

Example 8. Brett filed for divorce from Mandy in September 2015. In October 2015, Brett sold some GM stock at a gain, which resulted in substantial additional tax liability for 2015. Brett and Mandy decided to file MFJ for 2015 despite their pending divorce. Their divorce was finalized on November 6, 2016. They also had an unpaid tax liability for 2013 and 2014. They filed tax returns with the following tax liabilities.

Tax Year	Filing Status Used	Joint Tax Liability	Brett's Individual Tax Liability	Mandy's Individual Tax Liability
2013	MFJ	$ 6,000 (unpaid)		
2014	MFJ	4,200 (unpaid)		
2015	MFJ	17,400		
2016	Single (both)		$5,000	$1,100
2017	Single (both)		1,400	1,560

Because Brett and Mandy filed MFJ for the 2015 tax year, they are **both** jointly and severally liable for the 2015 taxes as well as for the 2013 and 2014 unpaid balances. This means that both Brett and Mandy are liable for the entire $17,400 balance owed for 2015 and for the unpaid balances for 2013 and 2014 of $6,000 and $4,200, respectively.

Example 9. Use the same facts as **Example 8,** except Brett and Mandy decide to file MFS for the 2015 tax year. Brett reports the sale of GM stock on his return, and he is solely liable for the tax liability on the gain. For 2015, Mandy is liable only for the tax amount reported on her MFS return. She remains jointly and severally liable for the 2013 and 2014 unpaid balances because she filed MFJ with Brett for those years.

43. Rev. Proc. 2008-48, 2008-36 IRB 586.

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

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,[45] 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.

- In *V.C. Payne,* 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.[46]
- In *R.A. Kiesling,* 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.[47]

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.[48] 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.[49] 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.[50]

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.[51] 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.[52] However, if the IRS prepares the return based on information provided by third parties, the return is not considered a valid joint return because it is not signed under penalty of perjury.[53] A signature under penalty of perjury is a requirement for a valid joint return.[54]

If a taxpayer's name is signed to a return, the IRS presumes that the taxpayer in fact signed it.[55] However, this presumption is rebuttable.[56]

Duress.[57] A joint return does not exist if one spouse demonstrates to the IRS that they signed the return under duress. **Accordingly, a spouse who signs under duress is not jointly and severally liable for the tax shown on the return.** The IRS recomputes the return for the spouse who signed voluntarily by using the MFS status. This recomputed return reflects only the income and tax liability of that spouse.

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45. Treas. Reg. §1.6013-1(a)(2).
46. *V.C. Payne v. U.S.,* 247 F.2d 481 (8th Cir. 1957).
47. *R.A. Kiesling v. U.S.,* 171 F.Supp 314 (S.D. Tex. 1958).
48. 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. 1953).
49. *H. Klayman v. Comm'r,* TC Memo 1979-408 (Sep. 27, 1979).
50. *M.W. Streit v. Comm'r,* TC Memo 1989-265 (Jun. 1, 1989).
51. IRC §6020(a).
52. Ibid.
53. IRC §§6020(b) and 6065; Rev. Rul. 2005-59, 2005-37 IRB 505.
54. IRC §6065.
55. IRC §6064.
56. Service Center Advice 1998-021 (Sep. 9, 1998); *V. Hennen v. Comm'r,* 35 TC 747 (1961).
57. Treas. Reg. §1.6013-4(d).

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 certificates of deposit versus taking distributions from individual retirement arrangements (IRA).

NONRECOGNITION RULES

Three basic nonrecognition 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.[58]

1. For transfers prior to the finalization of the divorce, no gain or loss is recognized on the transfer of property between spouses.[59]
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.[60]
3. The transfer is treated as a gift for income tax purposes. The spouse receiving the property takes the same basis as the transferor spouse even if the property is business property for which the receiving spouse paid the transferor spouse.[61] The receiving spouse also acquires the transferring spouse's holding period in the property.[62]

A transfer is conclusively "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 instrument and the transfer occurs not more than six years after the date on which the marriage ends.[63] Any transfer not made under a divorce or separation instrument and any transfer occurring more than six years after the end of the marriage is presumed to not be related to the end of the marriage. This presumption can be rebutted by showing that the transfer was made to effect the division of the property owned by the former spouses at the time the marriage ended.[64]

The transfer **must** be a transfer of property. Property generally includes **all** property, including real and personal property and tangible and intangible property.[65] In addition, these nonrecognition rules are applicable to property that was not owned by either spouse during the marriage.[66]

Example 10. Kendall and Zach finalized their divorce on December 31, 2017. Rather than selling their house and dividing the proceeds after the divorce, Zach decides to purchase a second house with a value of approximately half of the home and transfers it to Kendall before December 31, 2018. The nonrecognition rules prevent the triggering of any capital gain or loss to Zach upon the transfer and Zach receives a carryover basis from Kendall's half of the matrimonial home. Kendall's basis in the new house received from Zach also has a carryover basis equal to the amount Zach paid for the house.

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58. IRC §1041(a).
59. IRC §1041(a)(1).
60. IRC §1041(a)(2).
61. IRC §1041(b).
62. Treas. Reg. §1.1250-3(a)(3)(ii).
63. IRC §1041(c); Temp. Treas. Reg. §1.1041-1T(b).
64. Temp. Treas. Reg. §1.1041-1T(b).
65. IRC §1041(c); Temp. Treas. Reg. §1.1041-1T(a).
66. Temp. Treas. Reg. §1.1041-1T(a).

Example 11. Alphonse and Jessica finalized their divorce in 2013. At the time of their divorce, Alphonse, an inventor, was involved in patent infringement litigation. Their divorce decree ordered Alphonse to pay Jessica a percentage of any damage award Alphonse receives from the litigation. Five years after the divorce, Alphonse wins his lawsuit and obtains a damage award. He immediately pays Jessica her portion. The transfer of funds to Jessica is considered a transfer of property incident to a divorce and is accorded **nonrecognition** treatment.[67]

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, Alphonse in **Example 11** pays any applicable income tax on the entire damage award because the income is attributable to him and is a result of his actions and efforts, not those of Jessica.

Community Property States

While living in a community property jurisdiction, all property acquired by either spouse during the marriage is considered community property.[68] Although some aspects of community property law differ between the community property states, each spouse generally has a one-half share in the community property marital estate upon divorce.

The nonrecognition rules apply regardless of whether the property transferred is separately owned by a spouse or is divided under a state's community property laws.[69]

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.[70] 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,[71] discussed later in this chapter.

Nonrecognition Basis Rules

The nonrecognition rules treat a transfer of property incident to divorce as a **gift** for income tax purposes only. For subsequent dispositions, the carryover basis rule associated with the nonrecognition rules **differs** somewhat from that for gifting. For calculating a **gain,** divorce nonrecognition and gifting rules both use the transferor's basis. For calculating a **loss,** however, gifting rules use the **lesser of** the transferor's (donor's) basis or the fair market value (FMV) on the date of the transfer.[72] **The divorce nonrecognition rules use the transferor's basis for calculating a loss.**[73]

Example 12. Hannah received some Fordham Motor Company stock as a gift from her friend Joe in 2014. On the date the gift was made, the stock had an FMV of $70,000. Joe's basis in the stock was $100,000. Hannah sells the Fordham stock in 2018 for $60,000. The appropriate amount to use to calculate Hannah's loss on the sale of the stock is the lesser of Joe's basis or the FMV of the stock on the date the gift was made, which is $70,000. Therefore, Hannah uses the $70,000 FMV to calculate her loss. Hannah's loss is $10,000 ($60,000 sale price − $70,000 FMV).

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67. This example is based on Ltr. Rul. 9143050 (Jul. 26, 1991).

68. The community property states are Arizona, California, Idaho, Louisiana, Nevada, New Mexico, Texas, Washington, and Wisconsin. See IRS Pub. 555, *Community Property.*

69. Temp. Treas. Reg. §1.1041-1T(d).

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

71. Ibid.

72. IRC §1015(a).

73. Temp. Treas. Reg. §1.1041-1T(d).

Example 13. Use the same facts as **Example 12,** except Joe is Hannah's former husband and she receives the stock in accordance with the terms of their divorce decree. The appropriate basis to use in calculating Hannah's loss is $100,000, which is the carryover basis from Joe. Hannah's loss is therefore $40,000 ($60,000 sale price − $100,000 basis).

Debt in Excess of Basis

A 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.[74] However, under the divorce nonrecognition rules, **no such gain or loss is recognized** on a transfer of property incident to a divorce.[75] The transferee spouse takes the transferor spouse's basis in the property with no step-up in basis for the assumed liability.[76]

Example 14. Buddy owns a **rental home** on which he 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 Jennifer incident to their pending divorce. Buddy does not recognize $30,000 of gain on the transfer. Jennifer has a carryover basis of $100,000 in the property.

Example 15. Use the same facts as **Example 14.** Upon receiving the rental home from Buddy, Jennifer immediately sells the property. The sale price is $120,000. Jennifer recognizes gain of $20,000 ($120,000 − $100,000). Buddy's holding period for the rental home passes to Jennifer when he transferred the property to her.[77] If Buddy's holding period and Jennifer's holding period total more than one year, Jennifer's $20,000 gain is long term.

Jennifer uses the $120,000 sale proceeds to extinguish all but $10,000 of the mortgage, which she pays. She has no tax consequences as a result of the additional $10,000 payment.

Transfers in Trust. Property may be transferred to a spouse or former spouse incident to divorce outright or in trust. One or both spouses may prefer to use a trust if they have 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.

Generally, 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.[78] Gain or loss is recognized with:

1. A transfer of an installment obligation to a trust, or
2. A transfer of property in trust with debt in excess of basis.[79]

For transfers in trust, if the liability to which the property is subject plus any additional liabilities assumed by the transferee exceeds the basis in the property, this excess is the amount of gain that the **transferor** must recognize. The trust's basis in the property is increased by the recognized gain.[80]

Example 16. Use the same facts as **Example 14,** except instead of Buddy transferring the property directly to Jennifer, the property is transferred to a trust for the benefit of Jennifer. Even though the transfer is still incident to a divorce, Buddy is required to recognize $30,000 of gain ($130,000 mortgage − $100,000 basis) on the transfer to the trust. The trust's basis in the property is the $100,000 carryover basis increased by the $30,000 gain that Buddy must recognize. Therefore, the trust's basis is $130,000.

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74. *Crane v. Comm'r*, 331 U.S. 1 (1947); *Comm'r v. Tufts*, 461 U.S. 300 (1983).
75. IRC §1041(a) and Temp. Treas. Reg. §1.1041-1T(d).
76. Temp. Treas. Reg. §1.1041-1T(d).
77. Treas. Reg. §1.1250-3(a)(3)(ii).
78. IRS Pub. 504, *Divorced or Separated Individuals*.
79. IRC §453B(g); IRS Pub. 504, *Divorced or Separated Individuals.*
80. IRS Pub. 504, *Divorced or Separated Individuals.*

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.**[81] 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 prevents a taxpayer from assigning income to another person to avoid tax.[82]

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

> **Example 17.** As part of Roderick and Lynnette's divorce settlement, Lynnette agrees to accept installment payments from Roderick to obtain her share of the value of the marital property. Roderick pays Lynnette her half of the value of the marital property in equal monthly installments over two years at an interest rate of 5%.
>
> Lynnette does not recognize income on the portion of each payment that represents Roderick's principal obligation. The principal amount is a transfer of property covered by the nonrecogition rules. However, the 5% interest Roderick pays on each installment is taxable interest income to Lynnette.[83]

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.[84]

Moreover, the imputed interest rules do not apply to debt issued between spouses incident to their divorce.[85]

> **Note.** A detailed discussion of the imputed interest rules and the tax treatment of below market-rate loans can be found in the 2017 *University of Illinois Federal Tax Workbook,* Volume A, Chapter 1: Investments.

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 held that the interest tracing rules[86] apply in determining the deductibility of interest by the transferor even in the case of transfers incident to divorce under §1041. Therefore, qualified residence interest, passive activity interest, or investment interest is deductible when the interest is pursuant to a nonrecognition transfer between spouses.[87]

Transfer of Services. Although the nonrecognition rules embrace a rather broad definition of property, services do not constitute property and are never included.[88]

> **Example 18.** Wallace and Nancy are divorced. For the year following the finalization of their divorce, Nancy continues to be Wallace's physician. Nancy is taxed on any fees she earns from Wallace 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.[89] In such cases, gains and losses are recognized.

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81. Rev. Rul. 87-112, 1987-2 CB 207.
82. See, e.g., *U.S. v. G.R. Shafto,* 246 F.2d 338 (1957).
83. Based on *L. Gibbs v. Comm'r*, TC Memo 1997-196 (Apr. 29, 1997).
84. Rev. Rul. 2002-22, 2002-1 CB 849.
85. Treas. Reg. §1.1274-1(b)(3)(iii).
86. Temp. Treas. Reg. §1.163-8T.
87. *J.L. Seymour v. Comm'r*, 109 TC 279 (1997).
88. Temp. Treas. Reg. §1.1041-1T(a).
89. IRC §1041(d).

CARRYFORWARD RULES

Federal tax law determines who gets the future benefits of loss carryforwards after a divorce. The future tax savings related to loss carryforwards have a value that should be considered as part of the total value of marital assets. 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 up to $3,000 ($1,500 MFS).[90] To the extent that capital losses exceed the gains by more than $3,000, the taxpayer can carry the excess forward and use it 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.[91] 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.

Example 19. Hector and Andrea file **jointly** for the **2017** tax year. They own separate brokerage accounts. They divorce in 2018. The following amounts of capital gains and losses were incurred by the spouses in 2017 or carried forward to 2017 from prior years.

	Hector	+	Andrea	=	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 gain/(loss)	$4,000		($12,000)		($ 8,000)
Short-term gain	$6,000		$ 4,000		$10,000
Short-term loss	(9,000)		(3,000)		(12,000)
Net short-term gain/(loss)	($3,000)		$ 1,000		($ 2,000)

On Hector and Andrea's 2017 joint return, they had net capital losses available to carry forward to 2018 of $10,000 ($8,000 long-term loss + $2,000 short-term loss).

90. IRC §1211(b)(1).

91. Treas. Reg. §1.1212-1(c)(iv).

Long-Term Carryover. Andrea had $12,000 in net long-term losses for 2017, of which $4,000 was used to offset Hector's long-term gain after he used his $3,000 in long-term losses. This leaves **Andrea** with an **$8,000 long-term loss carryover** ($12,000 − $4,000) for 2018 on her separate return.

Short-Term Carryover. Hector 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 Andrea has after fully utilizing her $3,000 short-term loss against her $4,000 short-term gain. This leaves **Hector** with a **$2,000 short-term loss carryover** ($3,000 – $1,000) to 2018.

Note. Taxpayers frequently have joint brokerage accounts. When they do, the capital loss carryforward is split 50/50.

Net Operating Losses

Tax Years Beginning Before 2018. 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.[92] After a 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.** A divorced spouse can only use an NOL against their own income, whether the NOL is carried back to a year in which they filed a joint return with the former spouse or carried forward and used on their individual return or on a joint return with a new spouse.[93] 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 they can claim 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.[94]

Example 20. Merrick and Avery are spouses who each have their own separate businesses. Both businesses are operated as sole proprietorships. For the **2016** tax year, Merrick and Avery filed their **last joint tax return** before their divorce. The first page of their joint 2016 return follows.

92. Treas. Reg. §1.172-7(c).

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

94. Ibid.

For Example 20

Form **1040** Department of the Treasury—Internal Revenue Service (99)
U.S. Individual Income Tax Return **2016** OMB No. 1545-0074 IRS Use Only—Do not write or staple in this space.

For the year Jan. 1–Dec. 31, 2016, or other tax year beginning , 2016, ending , 20 See separate instructions.

Your first name and initial	Last name	Your social security number
Merrick	Laurel	333 22 1111
If a joint return, spouse's first name and initial	Last name	Spouse's social security number
Avery	Laurel	333 22 1110
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.
352 High Street		
City, town or post office, state, and ZIP code. If you have a foreign address, also complete spaces below (see instructions).		Presidential Election Campaign
Minneapolis, MN 55111		Check here if you, or your spouse if filing jointly, want $3 to go to this fund. Checking a box below will not change your tax or refund. ☐ You ☐ Spouse
Foreign country name	Foreign province/state/county	Foreign postal code

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 instructions)
			☐
			☐
			☐
			☐

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 instructions.

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	Deductible part 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 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** (2016)

5

During 2016, both businesses had losses for the first time. Closer inspection of their 2016 joint return and the accompanying Schedules C for each spouse's business indicates the following separate amounts applicable to each spouse.

	Merrick	Avery	Joint Return Amount
Wages	$40,000	$ 22,000	$ 62,000
Net business loss	(60,000)	(100,000)	(160,000)
NOLs carried forward to 2017	($20,000)	($ 78,000)	($ 98,000)

Merrick and Avery finalize their divorce in early 2017. Post-divorce, each spouse retains their own respective NOL amount. Accordingly, after the divorce is finalized, Avery has a $78,000 NOL carryforward. Later in 2017, Avery remarries. In 2017, her business is profitable. She files jointly with her new husband, Lester, in 2017. Avery and Lester have the following 2017 incomes.

	Avery	Lester
Net business income	$48,000	$340,000
Wages	0	30,000

On the 2017 joint tax return, Avery can only use $48,000 of her $78,000 NOL carryforward. She cannot use any of her remaining NOL carryforward to offset Lester's 2017 income.[95] Only losses generated by Avery while she is married to Lester can be used against Lester's income on their jointly filed returns.

Note. Under the general NOL carryover rules applicable to tax years beginning before 2018, 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.[96] 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, farming losses, qualified disaster losses, and specified liability losses.[97] The rules that apply to tax years beginning after 2017 are discussed later.

If Avery wishes to carry back her NOL to a year in which she filed jointly with Merrick (or if she did not file the election in time to waive the carryback period for her 2016 NOL), the NOL amount she can use is limited by the amount of her own income for that carryback year.

Caution. Practitioners should review IRS Pub. 536, *Net Operating Losses (NOLs) for Individuals, Estates, and Trusts,* for rules about handling NOLs for their client's specific situations.

95. See *A.E. Calvin v. U.S.*, 354 F.2d 202 (10th Cir. 1965).

96. IRC §172(b)(3).

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

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. The divorced taxpayer can claim a refund for the difference between their share of the recalculated tax and their contribution toward the tax paid on the joint return. The refund cannot be more than the joint overpayment. The divorced taxpayer's liability is calculated using MFS tax rates as follows.[98]

- 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.[99]

	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 AMT adjustments, the NOL must be first recomputed under AMT rules to arrive at the alternative tax NOL (ATNOL) before the carryback amount is calculated. ATNOL is only adjusted for tax preferences when the preferences increase the amount of the NOL for regular tax purposes.[100]

Note. For more information on the ATNOL, see the 2014 *University of Illinois Federal Tax Workbook,* Volume C, Chapter 2: Net Operating Losses. This can be found at **uofi.tax/arc** [taxschool.illinois.edu/taxbookarchive].

98. Ibid.

99. Ibid.

100. IRC §56(d)(2)(A).

Tax Years Beginning After 2017. The TCJA changes the rules for NOL deductions for tax years beginning after 2017. Under these rules, **the NOL deduction for tax years beginning after December 31, 2017, is limited to 80% of taxable income determined without regard to the deduction.**[101] Losses attributable to tax years beginning before January 1, 2018, are not subject to the 80% limitation. In addition, the TCJA generally repeals the 2-year carryback period and special carryback provisions for certain losses.[102]

Example 21. Garrett and Kara are spouses who each have their own separate businesses. Both businesses are operated as sole proprietorships. For the **2018** tax year, Garrett and Kara filed their **last joint tax return** before their divorce.

Garrett and Kara finalize their divorce in early 2019. During 2018, both businesses had losses for the first time. Their 2018 joint return and the accompanying Schedules C for each spouse's business indicates the following separate amounts applicable to each spouse.

	Garrett	Kara	Joint Return Amount
Wages	$40,000	$ 22,000	$ 62,000
Net business loss	(60,000)	(100,000)	(160,000)
NOLs carried forward to 2019	($20,000)	($ 78,000)	($ 98,000)

Post-divorce, each spouse retains their own respective NOL amount. Accordingly, after the divorce is finalized, Kara has a $78,000 NOL carryforward. Later in 2019, Kara remarries. In 2019, her business is profitable. She files jointly with her new husband, Mitch, and they take the standard deduction. Kara and Mitch have the following 2019 incomes.

	Kara	Mitch
Net business income	$48,000	$340,000
Wages	0	30,000

On the 2019 joint tax return, Kara's NOL deduction is limited to 80% of her taxable income, or $28,800 (($48,000 net business income – $12,000 standard deduction) × 80%). She cannot use any of her remaining NOL carryforward to offset Mitch's 2019 income. Only losses generated by Kara while she is married to Mitch can be used against Mitch's income on their jointly filed returns.

Note. For more information about the NOL deduction under the TCJA, see the 2018 *University of Illinois Federal Tax Workbook,* Volume B, Chapter 1: New Legislation — Business Concerns.

101. IRC §172(a), as amended by the TCJA.

102. IRC §172(b), as amended by the TCJA.

Charitable Contribution Carryovers

Charitable contribution carryover amounts must be allocated between divorcing spouses who filed jointly while married.[103] The spouses must use the IRS allocation rules.[104] The charitable carryover amount is allocated based on the amount of carryover each spouse would have if they filed MFS returns instead of MFJ returns.[105]

Because charitable contributions are subject to a 5-year carryover period,[106] a carryover amount from a couple's final joint return 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.[107] Any suspended passive activity losses of the donor spouse are added to the donee spouse's basis in the transferred property[108] and are not deductible as passive losses in any tax year.[109]

Example 22. Seth and Brianne finalized their divorce on November 1, 2017. Seth is the sole owner of rental property that he inherited from his aunt. Because he inherited the property, it is not considered a marital asset. However, as part of their property settlement, Seth agreed to transfer the rental property to Brianne on December 31, 2017.

At the beginning of 2017, Seth had suspended passive activity losses of $42,000. The following details apply.

Brianne's transferred basis under gift rules (IRC §1015(a))	$150,000
Suspended losses transferred, January 1, 2017	42,000
Brianne's adjusted basis in the property	$192,000

Brianne must treat the $42,000 of suspended passive activity losses transferred to her as an increase to the property's basis. If Seth has positive rental income for 2017, he must report it with no allowance for suspended losses from previous years.

S Corporation Losses Limited by Basis

S corporation loss carryover amounts are personal to the shareholder and are generally not transferable to another person.[110] However, an **exception** to this rule applies when shares are transferred to a spouse or former spouse incident to a divorce. If a shareholder transfers S corporation stock to a spouse or former spouse incident to a divorce, any loss or deduction with respect to the transferred stock that is disallowed to the transferring shareholder because of insufficient basis is treated as incurred by the corporation in the following tax year with respect to the transferee spouse or former spouse. The amount of the loss or deduction relating to the transferred stock is determined by prorating the losses or deductions disallowed for the year of the transfer between the transferor and the spouse or former spouse based on their stock ownership at the beginning of the next tax year.[111]

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103. Treas. Reg. §1.170A-10(d)(4)(i).
104. Rev. Rul. 76-267, 1976-2 CB 71.
105. Treas. Reg. §1.170A-10(d)(4)(i).
106. IRS Pub. 526, *Charitable Contributions.*
107. IRC §1041(b).
108. IRC §469(j)(6)(A).
109. IRC §469(j)(6)(B).
110. Treas. Reg. §1.1366-2(a)(6)(i).
111. Treas. Reg. §1.1366-2(a)(6)(ii).

Example 23. Jeffery owned all 100 shares in FreeFalling, Inc., a calendar-year S corporation. For 2016, FreeFalling had $400 in losses. Jeffery could not deduct any of the $400 loss in 2016 because he had no stock or debt basis. Therefore, the $400 loss carried forward to 2017.

On July 1, 2017, Jeffery transferred 50 of his shares to his spouse, Brandi, in connection with their pending divorce. In 2017, FreeFalling had $200 in losses. This 2017 loss amount is allocated to Jeffery and Brandi based on per-day, per-share ownership.[112] The amount of the $200 loss for 2017 allocable to the first half of the year is $100 ($200 × 50%). This $100 loss is allocable to Jeffery because he was the sole shareholder for the first half of the year.

The $100 loss allocable to the second half of the year was split equally between Jeffery and Brandi as equal shareholders. Therefore, for the second half of the year, Jeffery and Brandi were each entitled to half of that $100 loss (or $50).

Total losses for 2017 were allocated between Jeffery and Brandi as follows.

	Jeffery	+	Brandi	=	Total 2017 Loss
First half of 2017	$100				$100
Second half of 2017	50		$50		100
Total loss for 2017	$150		$50		$200

On his 2017 return, Jeffery can use his carryover loss from 2016 ($400) and his pro-rata share of the 2017 loss ($150) to the extent he has basis. Brandi can use her pro-rata share of the 2017 loss ($50) to the extent she has any stock or debt basis at the end of 2017.

If Jeffery cannot use any of the 2016 loss of $400 in 2017, it is prorated between Jeffery and Brandi based on their stock ownership at the beginning of 2018. Because each spouse owned 50% of the shares in FreeFalling at the beginning of 2018, each spouse shares equally in the unused 2016 loss of $400. This provides an allocation of $200 to each spouse. Likewise, Jeffery's loss for the first half of 2017 with respect to the transferred stock that is disallowed because of insufficient basis is treated as incurred by the corporation at the beginning of 2018.

The loss amount is determined by prorating the losses or deductions disallowed for the year of the transfer between Jeffery and Brandi based on their stock ownership at the beginning of 2018. Therefore, Jeffery's disallowed loss for the first half of 2017 is prorated equally between him and Brandi based on their equal ownership at the beginning of 2018. The S corporation loss carryover available to each spouse at the beginning of 2018 is as follows.[113]

	Jeffery	+	Brandi	=	Total 2017 Loss
Prorated 2016 unused carryover	$200		$200		$400
Allocated 2017 loss amounts (1/1/2017–6/30/2017)	50		50		100
Allocated 2017 loss amounts (7/1/2017–12/31/2017)	50		50		100
Total available carryover, January 1, 2018	$300		$300		$600

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

113. IRC §1366(d)(2).

Example 24. Use the same facts as **Example 23,** except Jeffery obtained $160 of basis from a capital contribution during 2017 and can therefore deduct $160 of the $400 loss carryover from 2016. He claims this $160 loss on his 2017 tax return. This leaves $240 of the 2016 carryover to be allocated between the spouses based on the relative share ownership they have at the beginning of 2018 (50% ownership for each spouse). Their revised available loss carryover amounts at the beginning of 2018 are as follows.

	Jeffery	+	Brandi	=	Total 2017 Loss
Prorated 2016 unused carryover	$120		$120		$240
Allocated 2017 loss amounts	100		100		200
Total available carryover, January 1, 2018	$220		$220		$440

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Investment Interest Expense Carryovers

The IRS has not provided 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.

SALE OF HOME

Under IRC §121, single individuals can exclude up to $250,000 of gain if **all** of the following apply.[114]

- The taxpayer **owned** and **used** the home as a principal residence for at least two years during the 5-year period ending on the date of sale. The time of usage does not need to be continuous, nor does it have to occur at the same time as ownership.
- During the 2-year period ending on the date of sale, the taxpayer did not exclude a gain on the sale of another home.
- The taxpayer did not acquire the home through a like-kind exchange during the past five years.

Married couples filing MFJ can exclude up to $500,000 of gain, provided:[115]

- One spouse meets the ownership test and both spouses meet the use test, and
- Neither spouse claimed a §121 exclusion within the prior two years.

Special provisions relating to divorce allow the nonoccupant spouse who owns a home to meet the use test if the occupant spouse or former spouse is allowed to use the home under a divorce decree or separation instrument and uses the home as a principal residence. For property transferred from a spouse or former spouse, the ownership of the transferee includes the period of ownership of the transferor spouse.[116]

114. IRS Pub. 523, *Selling Your Home.*

115. Ibid; IRC §121(b).

116. IRS Pub. 523, *Selling Your Home;* IRC §121(d)(3).

ALIMONY AND SEPARATE MAINTENANCE

TAX YEARS BEGINNING BEFORE 2019

Generally, alimony and separate maintenance are payments received by an ex-spouse under the terms of a divorce or separation agreement. **Qualified** alimony or separate maintenance payments are included in the income of the recipient spouse and are deductible by the payor spouse.[117] Alimony or separate maintenance is "qualified" if it meets the following requirements.

1. The payment must be made in cash. 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 also do not qualify.[118]
2. The payment must be made to the spouse or former spouse. 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 written request, consent, or ratification must state that the spouses intend to treat the payments as alimony. In addition, the request, consent, or ratification must be received by the payor spouse before the payor spouse's **first income tax return** is filed for the tax year in which the payment was made.[119]

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.

Example 25. Nelson makes regular alimony payments to Maisie. Maisie told Nelson to send her December 2017 alimony check to the Save the Penguins Charitable Foundation. Nelson made the alimony payment by check to the charity at Maisie's request. In January 2018, before Nelson filed his tax return, Maisie confirmed to Nelson in a written statement that she agreed to this arrangement for her December alimony payment.

The Save the Penguins payment for December 2017 is considered alimony. As long as it meets all the other requirements for qualified alimony, Nelson may deduct the December payment along with the other 2017 alimony payments. In addition, it is included in Maisie's income as taxable alimony for 2017. Maisie is entitled to a charitable deduction if the Save the Penguins Foundation is a qualified charity.

3. The payments must be made in accordance with a divorce or separation instrument.[120] To qualify as alimony, the payments must be made pursuant to a written instrument, even if only temporary.[121] 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.[122] Payments made pursuant to a judge's verbal order are not deductible because the required written instrument does not exist.[123]

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

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

119. Temp. Treas. Reg. §1.71-1T(b).

120. Ibid.

121. Treas. Reg. §1.71-1(b).

122. Ibid.

123. *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).

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.[124] 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. John and Cynthia are married, but Cynthia has obtained a temporary support order requiring John to make payments to her for the next six months. During this time, John and Cynthia continue to live in the same household. John's payments to Cynthia 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, John and Cynthia obtain a divorce decree and become officially divorced. The divorce decree requires John to continue to make the same payments to Cynthia. The payments do not qualify as alimony until the **ex-spouses live in separate households.** Even if John and Cynthia 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.**[125]

5. There must be no requirement that the payments continue after the recipient spouse's death. If the payor 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.[126] Continuation of payments after the death of the recipient spouse disqualifies all pre-death payments.[127] An obligation to make a substitute payment after the recipient spouse's death disqualifies the amount of alimony for which the payment was a substitute.[128]

Example 28. Eric and Pattie have a divorce decree that requires Eric to pay alimony of $20,000 per year to Pattie. The payments are required until the earlier of the end of five years or Pattie's death. However, in the event that Pattie dies before the end of the 5-year period, the divorce decree requires that Eric pay $10,000 annually to a trust for the benefit of a qualified charity after Pattie's death.

The obligation to make the $10,000 trust payments disqualifies part of the $20,000 of annual alimony payments. Accordingly, $10,000 of the $20,000 annual alimony payments made to Pattie is disqualified. Eric cannot deduct $10,000 of the $20,000 alimony he pays to Pattie. This is true even if Eric does not actually make any substitute payments. Simply having the substitute provision in the divorce decree serves as a partial disqualification of the alimony paid.[129]

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

6. The payments are not designated as something other than alimony. The spouses can designate that otherwise qualifying payments are not alimony. They do this by including a provision in the divorce or separation agreement that states the payments are not deductible as alimony by the payor spouse and are excludable from the payee spouse's income. The payee spouse can exclude the payments from income only if the payee attaches a copy of the instrument designating that the payments are not alimony to their return. The copy must be attached to the return each year that the designation applies.[130]

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124. Temp. Treas. Reg. §1.71-1T(b); IRS Pub. 504, *Divorced or Separated Individuals.*

125. 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).

126. IRC §71(b)(1)(D).

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

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

129. *J.R. Okerson v. Comm'r*, 123 TC 258 (2004).

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

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.[131]

   Any amount fixed as child support does not qualify as alimony.[132]

8. The spouses do not file joint returns with each other.[133]

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 next).

> **Note.** The above requirements for qualified alimony are applicable to payments made under a divorce or separation agreement made or modified **after 1984 and before 2019.** Different requirements apply to payments made under pre-1985 agreements. 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. The rules for divorces occurring after 2018 are discussed later.

Excess Front-Loading Rules[134]

As mentioned earlier, no gain or loss is recognized on transfers of property incident to a divorce. However, for tax years beginning before 2019, alimony payments may be deductible by the payor spouse and taxable 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 the payor spouse made a **qualified** alimony or separate maintenance payment (defined earlier) to the payee spouse.

Example 30. Leonard must begin paying alimony to his former spouse, Marianne. Their divorce decree was finalized in late 2014. In accordance with the divorce decree, Leonard's first qualified alimony payment is on May 26, 2015. Therefore, 2015 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, Leonard and Marianne continued to live in the same household until October 2016. Because the alimony payments are not qualified until 2016, the first post-separation year is 2016 under the EFL rules.

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131. Temp. Treas. Reg. §1.71-1T(c).

132. IRC §71(c)(1); Temp. Treas. Reg. §1.71-1T(c).

133. IRC §71(e).

134. IRC §71(f).

Determination of Excess Payments and Recapture Amount. Under the EFL rules, excess payments 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 preceding two steps. 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.
- The recipient spouse who reported the recapture amount as taxable income is entitled to deduct the recapture amount in Year 3.

Reporting the Recapture.[135] To report the recapture amount, the payor spouse shows it on Form 1040, *U.S. Individual Income Tax Return,* line 11 ("alimony received"). The payor spouse should cross out the word "received" and enter the word "recapture" to properly identify the amount. On the dotted line next to the amount, the recipient spouse's last name and SSN should be entered.

If the recipient spouse can deduct a recapture amount, they should show it on Form 1040, line 31a ("alimony paid"). The recipient spouse should cross out "paid" and enter "recapture." The payee spouse's SSN should be entered on line 31b ("recipient's SSN").

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

Example 32. Glen agreed to pay his former spouse, Billie Jean, qualified alimony in accordance with the following schedule.

	Calendar Year	Amount of Alimony
Year 1	2015	$75,000
Year 2	2016	50,000
Year 3	2017	20,000

Glen began paying alimony to Billie Jean on March 2, 2015. The 2015 calendar year is the first post-separation year for purposes of the EFL rules. The recapture amount to be recognized in the 2017 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 2017 tax year (Year 3), Glen must add $47,500 of recaptured alimony into his income. Billie Jean is entitled to an offsetting deduction of the same amount on her 2017 return. Glen and Billie Jean still report their 2017 alimony amounts on their 2017 returns ($20,000 deduction for alimony paid for Glen and $20,000 of alimony income for Billie Jean) in addition to showing this recapture amount.

To report the recapture amount, Glen's tax preparer reports $47,500 on Form 1040, line 11. His tax preparer crosses out the word "received" and enters the word "recapture" to properly identify the amount. Billie Jean's surname and SSN is entered on the dotted line next to the amount.

Billie Jean deducts this amount on her Form 1040, line 31a. Her tax preparer crosses out the word "paid" and enters the word "recapture." In the space provided on line 31b, Glen's SSN is entered.

> **Note.** Worksheets to calculate the alimony recapture amount can be found in IRS Pub. 504, *Divorced or Separated Individuals.*

Exceptions to the Excess Front-Loading Rules. The following amounts should not be included when calculating the recapture amount.[136]

1. Payments that decrease due to the death of either party or the remarriage of the recipient spouse before the end of the third post-separation year
2. Payments that are received under a temporary support decree
3. Payments required over a period of at least three calendar years that vary because they are a fixed part of income from a business or property or from compensation for employment or self employment

Payments for Jointly Owned Home[137]

If a divorce or separation agreement states that one spouse must pay expenses for a home jointly owned with a spouse or former spouse, some of the payments may be alimony. The following table from IRS Pub. 504 shows how such payments are treated.

IF you must pay all of the ...	AND your home is ...	THEN you can deduct and your spouse (or former spouse) must include as alimony ...	AND you can claim as an itemized deduction ...
mortgage payments (principal and interest)	jointly owned	half of the total payments	half of the interest as interest expense (if the home is a qualified home).[a]
real estate taxes and home insurance	held as tenants in common	half of the total payments	half of the real estate taxes[b] and none of the home insurance.
	held as tenants by the entirety or in joint tenancy	none of the payments	all of the real estate taxes and none of the home insurance.

[a] Your spouse (or former spouse) can deduct the other half of the interest if the home is a qualified home.
[b] Your spouse (or former spouse) can deduct the other half of the real estate taxes.

TAX YEARS BEGINNING AFTER 2018

The TCJA **repeals the deduction** for alimony and separate maintenance payments by the payor spouse and the **inclusion in income** by the recipient spouse for the following situations.[138]

- Divorce or separation instruments executed after December 31, 2018
- Pre-January 1, 2019 agreements modified after December 31, 2018, **if the modification expressly provides that the repeal applies**

Example 33. Selena and Abel are divorced on February 5, 2019. Under the terms of the divorce, Selena is required to pay alimony of $5,000 to Abel each month. Selena cannot deduct any portion of the alimony payments, and Abel does not include any of the payments in his income.

136. IRC §71(f)(5); IRS Pub. 504, *Divorced or Separated Individuals.*

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

138. TCJA §11051.

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 traditional IRA assets incident to divorce may be tax-free to the spouses if two requirements are met.[139]

1. The transfer is made under a **divorce or separation instrument.**
2. There is a **transfer** of the interest in the IRA 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.[140] This is required for both individual retirement accounts and individual retirement annuities. 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.[141]

The IRA assets transferred are considered the IRA assets of the recipient spouse after the transfer.[142] 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, unless they meet the RMD rules. Moreover, the transfer itself is not considered an IRA distribution.[143]

Actual Transfer

The tax-exempt status of this type of IRA asset transaction between spouses or former spouses provided by the Code[144] requires a **transfer** of assets as opposed to a distribution or withdrawal.

According to the IRS, there are two commonly used methods to transfer IRA assets to a spouse or former spouse.[145]

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

Making a direct transfer or changing the name on the IRA 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.

139. IRS Pub. 504, *Divorced or Separated Individuals.*
140. IRC §408(d)(6).
141. IRC §71(b)(2).
142. IRC §408(d)(6).
143. Treas. Reg. §1.408-4(g)(1).
144. IRC §408(d)(6).
145. IRS Pub. 590-A, *Contributions to Individual Retirement Arrangements (IRAs).*

Direct Transfer.[146] A direct transfer is accomplished when the transferor-spouse directs the trustee of the traditional IRA to transfer the affected assets directly to the trustee of a new or existing traditional IRA set up in the name of the transferee-spouse (or former spouse).

If the transferee-spouse is allowed to keep their portion of the IRA assets in the transferor-spouse's existing IRA, the transferor-spouse can direct the trustee to transfer the assets the transferor-spouse is permitted to keep directly to a new or existing traditional IRA set up in the transferor-spouse's name. The name on the IRA that holds the transferee-spouse's portion of the assets is changed to show the new ownership.

Example 34. Under the terms of their divorce decree, David must transfer 100% of the funds in his IRA with Community Bank to Angie, his former wife. David forwards a copy of the divorce decree to Community Bank with instructions to transfer the IRA assets in his name to Angie. Community Bank establishes a new, temporary IRA in Angie's name and transfers all of David's IRA funds into Angie's account. Angie can choose to retain the account with Community Bank or transfer her new IRA to another custodian or trustee. A valid transfer of IRA assets incident to divorce has taken place. Neither David nor Angie faces any adverse tax ramifications from this transfer.

Example 35. Use the same facts as **Example 34,** except David is only required to transfer 30% of his IRA balance to Angie. David forwards a copy of the divorce decree and instructions to transfer 30% of the account balance to Community Bank. Community Bank establishes a temporary IRA for Angie and transfers 30% into that temporary account. A valid transfer of IRA assets incident to the divorce has taken place. Angie can choose to continue to use Community Bank as custodian or transfer her new IRA to a different custodian.

Changing the Name on the IRA.[147] If all the IRA assets are to be transferred, the transfer can be accomplished by changing the name on the IRA from the transferor-spouse (or former spouse) to the name of the transferee-spouse.

Example 36. Use the same facts as **Example 34,** except Community Bank simply changed the name on David's IRA to Angie as owner. David's IRA has been transferred to Angie.

Distribution. 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.[148]

Example 37. Maurice and Yvonne finalize their divorce in 2018. Their divorce decree requires Maurice to give Yvonne the funds in his IRA. Maurice cashed out his IRA and received a check for $68,000. He endorsed the check over to Yvonne. Even though Maurice never deposited the funds into his bank account and he endorsed the check directly to Yvonne, the endorsement of the check does not constitute a valid transfer of funds that qualifies for nonrecognition treatment. Maurice must include the $68,000 in income as a taxable IRA distribution.[149]

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). Some examples of qualified plans include §401(k) plans, employee stock ownership plans (ESOPs), and profit-sharing plans.

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146. Ibid.

147. Ibid.

148. See, e.g., *Summers v. Comm'r,* TC Memo 2017-125 (Jun. 26, 2017); *Bunney v. Comm'r,* 114 TC 259 (Apr. 10, 2000).

149. This example is based on *Jones v. Comm'r*, TC Memo 2000-219 (Jul. 20, 2000).

Qualified Domestic Relations Order

ERISA created the term **qualified domestic relations order** (QDRO) to describe a court order that summarizes the division of retirement benefits under ERISA plans.[150] A QDRO is a judgment, decree, or court order issued under a state's domestic relations law that:[151]

- Recognizes the existence of an alternate payee's right, or assigns to an alternate payee the right, to receive all or part of the benefits of a qualified retirement plan or a tax-sheltered annuity;
- Relates to payment of child support, alimony, or marital property rights to a spouse, former spouse, child, or other dependent of the participant; and
- Specifies certain information, including the amount or part of the participant's benefits to be paid to the participant's spouse, former spouse, child, or other dependent.

A QDRO serves as the plan administrator's authorization to transfer benefits to the alternate payee.

Benefits Paid to a Child or Other Dependent.[152] For tax purposes, benefits paid under a QDRO to a child or other dependent are treated as paid to the participant.

Benefits Paid to a Spouse or Former Spouse.[153] Benefits paid under a QDRO to the plan participant's spouse or former spouse generally must be included in the spouse's or former spouse's income. If the participant contributed to the retirement plan, a prorated share of the participant's investment is used to calculate the taxable amount. There is no 10% early distribution penalty if the spouse is under age 59½.

If the benefits would have been treated as a lump-sum distribution if the participant received them, the spouse or former spouse can use the special rules for lump-sum distributions. The special rules for lump-sum distributions are explained in IRS Pub. 575, *Pension and Annuity Income.*

FEDERAL GOVERNMENT PENSIONS[154]

Most federal government employees participate in either the Civil Service Retirement System (CSRS) or the Federal Employees Retirement System (FERS). The CSRS covers most employees hired before 1984. The FERS generally covers 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 U.S. 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.

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.

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150. *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.* Jul. 1997. OPM. [archive.opm.gov/retire/pubs/pamphlets/ri38-116.pdf] Accessed on Oct. 20, 2017.

151. IRS Pub. 504, *Divorced or Separated Individuals;* IRC §414(p).

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

153. Ibid.

154. *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.* Jul. 1997. OPM. [archive.opm.gov/retire/pubs/pamphlets/ri38-116.pdf] Accessed on Oct. 20, 2017.

MILITARY PENSIONS

The Uniformed Services Former Spouses' Protection Act (USFSPA) permits, but does not require, state courts to divide military pensions when determining property rights in a divorce or separation proceeding.[155] In addition, it allows direct payments by the uniformed services of up to 50% of a military member's (or former member's) disposable retired pay to the former spouse if the settlement complies with the USFSPA.[156]

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 military members. Members receive military retired pay, which is a stream of income.[157]

The military member's retirement pay can be divided in two different ways.[158]

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 military member's retirement pay must receive a certified court order that requires payments to be made to a spouse or former spouse.[159]

In the case of a property division, the USFSPA limits payments made on behalf of a military member to 50% of "disposable retired pay" for all payments that constitute a division of property.[160] More than 50% of disposable pay may be paid under certain circumstances, such as garnishments for child support arrears.[161]

NONQUALIFIED PLANS

Only administrators of qualified retirement plans can accept and process a QDRO. **QDROs cannot be used with nonqualified plans.**[162] Nonqualified plans are not covered by ERISA.

Rev. Rul. 2002-22 provides that the nonrecognition provisions under IRC §1041 apply to nonstatutory stock options and other nonqualified deferred compensation arrangements.[163] The revenue ruling also provides that the assignment of income doctrine does not apply to a nonqualified compensation transfer.[164]

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155. *Military Benefits for Former Spouses: Legislation and Policy Issues.* Kamarck, Kristy, N. Nov. 30, 2017. Congressional Research Service. [fas.org/sgp/crs/misc/RL31663.pdf] Accessed on Mar. 27, 2018.

156. Ibid.

157. Ibid; 10 USC §1408(c).

158. 10 USC §1408(d).

159. Ibid.

160. 10 USC §1408(e)(1).

161. 10 USC §§1408(d)(5)–(6).

162. See IRS Pub. 504, *Divorced or Separated Individuals.*

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

164. Ibid.

Example 38. Wendell is employed by Graduated Plastics Incorporated (GPI). Before Wendell's divorce from Barbara, GPI issued nonstatutory stock options to him that were not taxable to him at the time they were granted. In addition, Wendell 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, Wendell 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 exercised all the stock options she received. The FMV of the stock was greater than the exercise price. Wendell subsequently terminated his employment with GPI, 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. **Nonrecognition** treatment applies to these transfers that were incident to the divorce.

Moreover, the **assignment of income doctrine** does not apply to Barbara's exercise of stock options. Wendell therefore does not include any amount in income as a result of 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 GPI. Barbara also includes the amounts received from the deferred compensation accounts in her income.[165]

The IRS noted that a result different from those obtained in the preceding example might occur if the nonstatutory stock options or deferred compensation accounts are unvested or subject to substantial contingencies at the time of the transfer.[166]

INNOCENT SPOUSE RELIEF

Statutory relief is available for spouses who 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.[167] 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

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

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

167. *Topic Number: 205 — Innocent Spouse Relief (Including Separation of Liability and Equitable Relief).* Sep. 21, 2017. IRS. [www.irs.gov/taxtopics/tc200/tc205] Accessed on Oct. 23, 2017.

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.[168]

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

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. A request for **equitable relief** can be made any time within the limitation period for collection under IRC §6502 or for credit or refund of tax under IRC §6511.[169]

Although the election can be submitted before the commencement of collection activity[170] (such as in connection with an audit, examination, or demand for payment), the election cannot be made prematurely.[171] 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.[172]

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

After the requesting spouse makes the election, the nonrequesting spouse is notified.[173]

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.[174]

- A joint return was filed.
- The return has an understatement caused by erroneous items of 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 deficiency attributable to the understatement.

Actual Knowledge or Reason to Know Standard

The requesting spouse must establish that they lacked actual knowledge and had no **reason to know** of the understatement **when they signed the joint return.**[175]

168. Ibid; Treas. Reg. §1.6015-5(a).

169. *Topic Number: 205 — Innocent Spouse Relief (Including Separation of Liability and Equitable Relief).* Sep. 21, 2017. IRS. [www.irs.gov/taxtopics/tc200/tc205] Accessed on Oct. 23, 2017.

170. Treas. Reg. §1.6015-5(b)(3).

171. Treas. Reg. §1.6015-5(b)(5).

172. Ibid.

173. *Topic Number: 205 — Innocent Spouse Relief (Including Separation of Liability and Equitable Relief).* Sep. 21, 2017. IRS. [www.irs.gov/taxtopics/tc200/tc205] Accessed on Oct. 23, 2017.

174. Treas. Reg. §1.6015-2(a).

175. IRC §6015(b)(1)(C).

Actual knowledge about omitted income exists if the requesting spouse knows that the nonrequesting spouse received the income. Actual knowledge about an erroneous deduction or credit 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 determining actual knowledge on the part of the requesting party.[176]

Note. For further details about the definition of "actual knowledge," see 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.[177]

- 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

Example 39. Sharon and Otis filed jointly for 2017. Sharon knew that Otis inherited substantial funds from his deceased father. However, she did not know or have reason to know that Otis received and failed to report the taxable distributions from an inherited IRA. Sharon may be eligible for relief from the tax liability on the unreported IRA distributions.[178]

Obtaining knowledge of an understatement after the requesting spouse signs the joint return does not preclude relief from being granted.[179] Mere lack of knowledge of the tax consequences of a known error[180] or failure to read the return[181] 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.[182]

Example 40. Gregg and Stacey file jointly each year. Gregg understated their tax liability by $50,000 for 2017. Stacey knew that Gregg underreported some income from his plumbing business, which resulted in $10,000 of the understated tax liability. However, Stacey did not know that Gregg also received and failed to report substantial income from a large contract that Gregg did not tell her about. Failure to report the contract income caused $40,000 of the understatement. Although Stacey 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.

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176. Treas. Regs. §§1.6015-2(c) and 1.6015-3(c)(2)(iv).
177. Treas. Reg. §1.6015-2(c).
178. Based on *D.R. Braden v. Comm'r* , TC Memo 2001-69 (Mar. 22, 2001).
179. *B. Ianiello v. Comm'r*, TC Memo 1991-415 (Aug. 22, 1991).
180. *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).
181. *G. Erdahl v. Comm'r*, 930 F.2d 585 (8th Cir. 1991).
182. Treas. Reg. §1.6015-2(e)(1).

SEPARATE LIABILITY RELIEF

A requesting spouse can elect separate liability relief from a tax deficiency if the following conditions are satisfied.[183]

- At the time of the election, the spouses (or former 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 denies the election on the grounds that the requesting spouse had **actual knowledge** of the other spouse's tax issues, the IRS bears the burden of proof.[184]

Actual Knowledge Standard

Relief will not be granted if the IRS proves, by a preponderance of the evidence, that the requesting spouse had actual knowledge of the item causing a deficiency. The "reason to know" 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 to general relief for joint filers also applies to separate relief.[185]

Example 41. Morrison's election for separate relief was successful for unreported income amounts that his former wife Alexa embezzled. Even though Morrison should have known about the unreported income because Alexa deposited a substantial portion of the embezzled funds to their joint bank account and spent the money on household items, the IRS failed to show that Morrison had actual knowledge of the unreported income.[186]

Example 42. Anthony failed to report restaurant income. The IRS established that his former wife, Rachel, had actual knowledge of the unreported income because she was directly involved with daily restaurant operations along with her other family members. Additionally, Rachel 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.[187]

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.

183. IRC §6015(c)(3).

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

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

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

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

Allocating the Deficiency

If separate relief is granted, any item that caused the deficiency is allocated between the spouses as if separate returns had been filed.[188] The requesting spouse is only liable for that portion of the deficiency attributable to the requesting spouse.[189] However, the requesting spouse has the burden of proof in connection with the apportionment of liability for the deficiency.[190]

Example 43. Bruce and Julianne finalized their divorce in February 2017. They filed MFJ for the last time for 2016. Julianne received a substantial taxable IRA distribution in two payments — a smaller payment in April 2016 and a much larger payment in October 2016. In March 2018, Bruce and Julianne received a 30-day letter indicating a $100,000 deficiency for 2016 relating to Julianne's IRA distributions 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 2018, Bruce made an election under the separate liability relief provision. Bruce knew about the smaller April 2016 payment because Julianne deposited it in the joint bank account. Bruce used these funds to pay household expenses and received bank statements in connection with this account. However, he had no knowledge of the larger October payment because Julianne received and invested these funds without telling Bruce anything about this payment. Assuming Bruce is not eligible for further relief under another innocent spouse provision, he 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.

Disqualified Asset Transfers

If a nonrequesting spouse transfers an asset to the requesting spouse with the principal purpose of avoiding tax or payment of tax, the transaction constitutes a disqualified asset transfer.[191] There is a **presumption** that any asset transferred during the 12-month period preceding the date of the first IRS letter regarding the proposed deficiency is the subject of a disqualified asset transfer. The presumption also applies to any asset transferred from the nonrequesting spouse to the requesting spouse after the first letter of proposed deficiency is mailed. This presumption is rebuttable by establishing that the principal purpose of the transfer was not the avoidance of tax or the payment of tax. The presumption does not apply if the requesting spouse establishes that the asset was transferred under a decree of divorce or separate maintenance or a written instrument incident to such a decree.[192]

The portion of the deficiency for which a requesting spouse is liable is increased (up to the total amount of the deficiency) by the value of a disqualified asset transferred to the requesting spouse.[193]

Example 44. Use the same facts as **Example 43,** except Julianne transferred $1,500 to Bruce in April 2017, shortly after the divorce was finalized. When Bruce elects relief from joint liability for the 2016 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 Julianne. 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. Bruce 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 Julianne'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 Bruce is otherwise liable.

188. IRC §6015(d)(3)(A).

189. IRC §6015(c)(1).

190. IRC §6015(c)(2).

191. Treas. Reg. §1.6015-3(c)(3)(ii).

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

193. Treas. Reg. §1.6015-3(c)(3)(i).

Example 45. Use the same facts as **Example 44,** except Bruce explains to the IRS that Julianne always made a $1,500 payment each year to Bruce as a birthday gift. Despite the divorce, Julianne continued to make this payment to Bruce in 2017. Julianne is not required to make this payment under the divorce decree or related document. Bruce states these facts on his election for separate liability relief. He will likely have overcome the disqualified payment presumption, limiting his liability for the 2016 taxes to the $25,000 attributable to his knowledge of the April distribution received by Julianne.

Example 46. Use the same facts as **Example 44,** except Julianne is required to make the $1,500 payment to Bruce under their divorce decree. The disqualified asset presumption therefore does not apply and Bruce's liability for tax is limited to the $25,000 attributable to his knowledge of the April distribution Julianne received.

EQUITABLE RELIEF[194]

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

1. The tax liability from which the requesting spouse seeks relief is attributable to the nonrequesting spouse.
2. The requesting and nonrequesting spouses filed a joint return.
3. The requesting spouse did not knowingly participate in the filing of a fraudulent joint return.
4. The requesting spouse does not qualify for either general relief or separate liability relief.
5. No assets were transferred between the spouses as part of a fraudulent scheme.
6. The requesting spouse did not receive disqualified assets from the nonrequesting spouse.
7. The request for equitable relief is timely.

If the requesting spouse meets these seven criteria, they may qualify for a **streamlined decision** (discussed later in this chapter).

Timely Request

A **timely** request for purposes of equitable relief 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.

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, the nonrequesting spouse's deficiency or underpayment
- Any significant benefit the requesting spouse obtained from the deficiency or underpayment
- Whether either spouse has a legal obligation to pay the tax liability
- The requesting spouse's compliance with tax laws in years subsequent to the tax year for which relief is sought
- The requesting spouse's mental or physical health problems

Note. IRS Notice 2012-8 and IRS Pub. 971, *Innocent Spouse Relief,* provide additional guidance on these factors.

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194. IRS Notice 2012-8, 2012-4 IRB 309.

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 legally separated, no longer married, or have not been members of the same household for the 12-month period preceding the request.
2. The requesting spouse did not know or have reason to know that the other spouse would not pay the underpaid tax reported on the joint return.
3. The requesting spouse will suffer economic hardship if relief is not granted.

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.[195] 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.[196] This may be useful for a divorced or divorcing spouse whose refund on a previous joint return was applied against the former spouse's debts. The debts against which a tax overpayment can be applied are as follows.[197]

- Unpaid federal taxes
- Debts owed to a federal agency
- Past-due child support or support of a child and the parent with whom the child is living
- Legally enforceable unpaid state income taxes
- Unpaid unemployment compensation obligations

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.[198] 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.

> **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.

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:[199]

- With an original or amended joint 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 joint tax return, the term "injured spouse" should be conspicuously noted at the top left corner of the first page 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.

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195. IRC §6402.
196. IRM 25.18.5.1 (2017).
197. Ibid; IRC §6402; Social Security Act §464(c).
198. IRM 25.18.5.1 (2017).
199. Instructions for Form 8379.

If the form is sent separately, the injured spouse must sign the form and both spouses' SSNs must appear on the form in the same order that they appeared on the income tax return. The requesting spouse should attach copies of all Forms W-2, *Wage and Tax Statement,* and W-2G, *Certain Gambling Winnings* for both spouses, as well as any Forms 1099 that show federal income tax withholding. The form is sent to the same IRS service center to which the original tax return was sent.[200]

> **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.[201]

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 following **separate tax formula.**[202]

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

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. Estimated tax payments can be allocated in any way agreed to by both spouses. If the spouses cannot agree, the estimated payments are apportioned to each spouse using the following formula.[203]

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

Step 3. Determine each spouse's share of the overpayment. This is calculated for each spouse by taking the amount calculated in Step 2 for that spouse and subtracting the amount calculated in Step 1 from it. This is reflected in the following formula.[204]

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

> **Note.** The instructions for Form 8379 contain more detailed instructions for allocating a tax overpayment.

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200. Ibid; *Topic Number: 203 — Refund Offsets: For Unpaid Child Support, Certain Federal and State Debts, and Unemployment Compensation Debts.* Mar. 13, 2018. IRS. [www.irs.gov/taxtopics/tc203.html] Accessed on Mar. 27, 2018.

201. Instructions for Form 8379.

202. IRM 25.18.5.3 (2011).

203. IRM 25.18.5.8 (2011); Instructions for Form 8379.

204. IRM 25.18.5.3 (2011).

Example 47. Marvin and Janis finalized their divorce in early 2018. Their 2017 tax return is their last joint tax return filed. Marvin has $15,000 of unpaid federal taxes from a prior year. The relevant figures in connection with their 2017 MFJ tax return, along with applicable MFS amounts for each spouse, are as follows.

	Marvin (MFS)	Janis (MFS)	Joint Return as Filed
Wages	$40,000	$50,000	$90,000
Standard deduction	(6,350)	(6,350)	(12,700)
Exemptions	(4,050)	(4,050)	(8,100)
Taxable income	$29,600	$39,600	$69,200
Tax liability	3,974	5,639	9,448
Federal tax withheld on wages	5,000	7,000	12,000

The 2017 joint tax return showed a total tax liability of $9,448 and an overpayment of $2,552 ($12,000 − $9,448). The IRS applied the entire overpayment to Marvin's unpaid $15,000 tax liability. Marvin and Janis would have received a refund of the $2,552 overpayment had it not been for Marvin's unpaid taxes. Some of this overpayment is attributable to Janis. After the divorce in 2018, Janis applied for injured spouse relief in order to obtain a refund of the 2017 overpayment attributable to her.

To determine how much of the $2,552 overpayment 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.

$$\text{Marvin's portion of JTL} = \frac{\text{Marvin's MFS tax liability}}{\text{Both spouses' MFS tax liabilities}} \times \text{JTL}$$
$$= \frac{\$3{,}974}{\$3{,}974 + \$5{,}639} \times \$9{,}448$$
$$= \frac{\$3{,}974}{\$9{,}613} \times \$9{,}448$$
$$= 0.413 \times \$9{,}448$$
$$= \$3{,}902$$

$$\text{Janis's portion of JTL} = \frac{\text{Janis's MFS tax liability}}{\text{Both spouses' MFS tax liabilities}} \times \text{JTL}$$
$$= \frac{\$5{,}639}{\$3{,}974 + \$5{,}639} \times \$9{,}448$$
$$= \frac{\$5{,}639}{\$9{,}613} \times \$9{,}448$$
$$= 0.587 \times \$9{,}448$$
$$= \$5{,}546$$

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

Marvin	$3,902
Janis	5,546
Total joint tax liability	$9,448

Step 2. Determine each spouse's contribution to the payment of the joint tax liability. In this case, Marvin and Janis have each contributed the amount of federal tax that was withheld from their wages. Therefore, Marvin's contribution toward payment of the JTL is $5,000. Janis's contribution is $7,000.

Step 3. Determine each spouse's share of the overpayment. This amount for each spouse is calculated 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
Marvin	$ 5,000	$3,902	$1,098
Janis	7,000	5,546	1,454
Total	$12,000	$9,448	$2,552

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Janis's apportioned amount of the 2017 overpayment is $1,454, which will be refunded to her if injured spouse relief is granted. Marvin's $1,098 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

RULES FOR TAX YEARS BEFORE 2018

Legal fees associated with personal matters are not deductible.[205] However, for tax years beginning before January 1, 2018, legal fees in connection with an **income-producing activity or to establish or protect a source of taxable income** for the taxpayer were generally deductible as a miscellaneous itemized deduction subject to the 2% of AGI limitation.[206] Legal costs incurred in the course of **recovering investment property or income from property** were also deductible as a miscellaneous itemized deduction subject to the 2% floor.[207] 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 a reasonable amount.[208] The test of deductibility of legal fees is the origin and character of the claim with which the expense was incurred, not its potential consequences.[209]

205. IRC §262.

206. IRC §212; IRS Pub. 529, *Miscellaneous Deductions.*

207. Treas. Reg. §1.212-1(k); IRS Pub. 529, *Miscellaneous Deductions.*

208. Treas. Reg. §1.212-1(d).

209. *U.S. v. D. Gilmore et al.,* 372 U.S. 39 (1963).

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 issues involved,
- The nature and objectives of the litigation,
- The defenses asserted,
- The purpose for which the claimed deductions were expended,
- The background of the litigation, and
- All facts pertaining to the controversy.[210]

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.[211] Legal costs in connection with a divorce action are viewed as personal in nature. However, for tax years beginning before 2018, the portion of the attorney's fees and other costs that were related to the **production or collection of taxable** income was deductible as a miscellaneous itemized deduction subject to the 2% floor.[212]

Example 48. Miles deducted the cost of his divorce action against Cicely. Miles believed these legal costs were business-related and therefore deductible because, if Cicely had been successful, Miles would have lost the controlling stock in his automobile dealership and his livelihood. In addition, if Miles was found guilty of Cicely's infidelity allegations, the automobile manufacturer may have exercised its right to cancel his dealer franchise.

The deduction was disallowed. Miles'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 Miles's litigation was one of divorce, which is **personal and nondeductible,** irrespective of any possible business consequences.[213]

Example 49. Wynton and Candace finalized their divorce in 2016. During their marriage, they were joint owners of a rental apartment building. Their divorce decree requires Wynton to pay Candace her half share of the rental income each month. Wynton complied with the terms of the divorce decree for several months but, in early 2017, he discontinued making the required payments to Candace.

Candace hired an attorney to sue Wynton to collect the unpaid income. Candace can deduct her legal fees because they were incurred to enforce the collection of taxable income.

Legal Fees Associated with Alimony. For tax years beginning before 2018, the portion(s) of divorce legal fees that are associated with **obtaining or collecting taxable** alimony **were deductible**[214] as a miscellaneous itemized deduction if they are paid by the spouse receiving the alimony. Such legal fees are viewed as related to the production or collection of income. However, if these legal fees were paid by the spouse who **paid** the alimony, the fees were **not** deductible.[215] Similarly, legal fees incurred to reduce the amount of alimony payments being made are not deductible.[216]

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210. *V. Boagni, Jr. v. Comm'r*, 59 TC 708 (1973).

211. Treas. Reg. §1.262-1(b)(7).

212. Ibid; IRS Pub. 529, *Miscellaneous Deductions.*

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

214. Treas. Reg. §1.262-1(b)(7); *R.K. Wild v. Comm'r*, 42 TC 706 (1964).

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

216. Ibid.

Legal Fees and Child Support. Legal fees to obtain child support or to assert or defend the right to child support are nondeductible.[217] Such fees are considered personal in nature and are not incurred in the production of income because child support received is not taxable income.

Legal Fees to Protect Business Interests. In a 2009 case,[218] 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.

Legal Fees for Divorce Tax Counseling. The portion of legal fees allocable to tax counseling throughout a divorce proceeding was deductible as a miscellaneous itemized deduction subject to the 2% floor for tax years beginning prior to 2018. Accordingly, fees charged for determining the tax consequences of property settlements and alimony payments were deductible.[219] However, a spouse could only deduct their own expenses and not those paid on behalf of the other spouse.[220]

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 as a miscellaneous itemized deduction subject to the 2% of AGI floor for tax years beginning before 2018. It is therefore necessary to **allocate** the legal fees into deductible and nondeductible portions.

The IRS takes the position that the allocation between tax and nontax matters must be done on a reasonable basis.[221] A reasonable basis for this allocation exists in the following situations.[222]

- The taxpayer hires a firm that limits its practice to tax matters.
- Both tax and nontax matters are addressed, but the portion of the fee allocated to tax matters is based on the time spent on the tax issues, the difficulty of the tax issues, and the amount of tax involved.
- Both tax and nontax matters are addressed, but the portion of the fee allocated to tax matters is based on the time attributable to each, the fee customarily charged in the locality for similar services, and the results obtained in the divorce negotiations.

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217. *D.A. Swenson v. Comm'r,* 43 TC 897 (1965); *C.B. McClendon v. Comm'r,* TC Memo 1986-416 (Sep. 4, 1986).
218. *Estate of T.P. Melcher v. Comm'r*, TC Memo 2009-210 (Sep. 15, 2009).
219. *W.K. Carpenter v. U.S.*, 338 F.2d 366 (Cl. Ct. 1964).
220. *U.S. v. T.C. Davis*, 370 U.S. 65 (1962).
221. *W.K. Carpenter v. U.S.,* 338 F.2d 366 (Cl. Ct. 1964).
222. Rev. Rul. 72-545, 1972-2 CB 179.

RULES FOR TAX YEARS AFTER 2017

Under the TCJA, **all** miscellaneous itemized deductions **subject to the 2% of AGI floor** are suspended for years beginning after December 31, 2017, through December 31, 2025.[223] Therefore, during these years, no deductions are allowed for the following legal expenses.

- Legal fees in connection with an income-producing activity or to establish or protect a source of taxable income for the taxpayer
- Legal costs incurred in the course of recovering investment property or income from property
- The portion of the attorney's fees and other costs incurred in a divorce action that was related to the production or collection of **taxable** income
- The portion of legal fees allocable to tax counseling throughout a divorce proceeding
- The portion of divorce legal fees associated with **obtaining or collecting** alimony

Note. In addition to suspending miscellaneous itemized deductions for the 2018–2025 tax years, the TCJA repeals the deduction for alimony and separate maintenance payments by the payor spouse and the inclusion in income by the recipient spouse for divorces finalized after December 31, 2018. For more information, see the 2018 *University of Illinois Federal Tax Workbook,* Volume A, Chapter 1: New Legislation — Individual Concerns.

Note. For information about the deductibility of legal fees incurred in resolving tax issues related to business profit or loss, unlawful discrimination, and whistleblower claims, see the 2017 *University of Illinois Federal Tax Workbook,* Volume B, Chapter 2: Individual Taxpayer Issues.

223. IRC §67(g).