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Divorce Tax Law after '84 Reform More Predictable but Still Complex

by Professor Wendy G. Shaller
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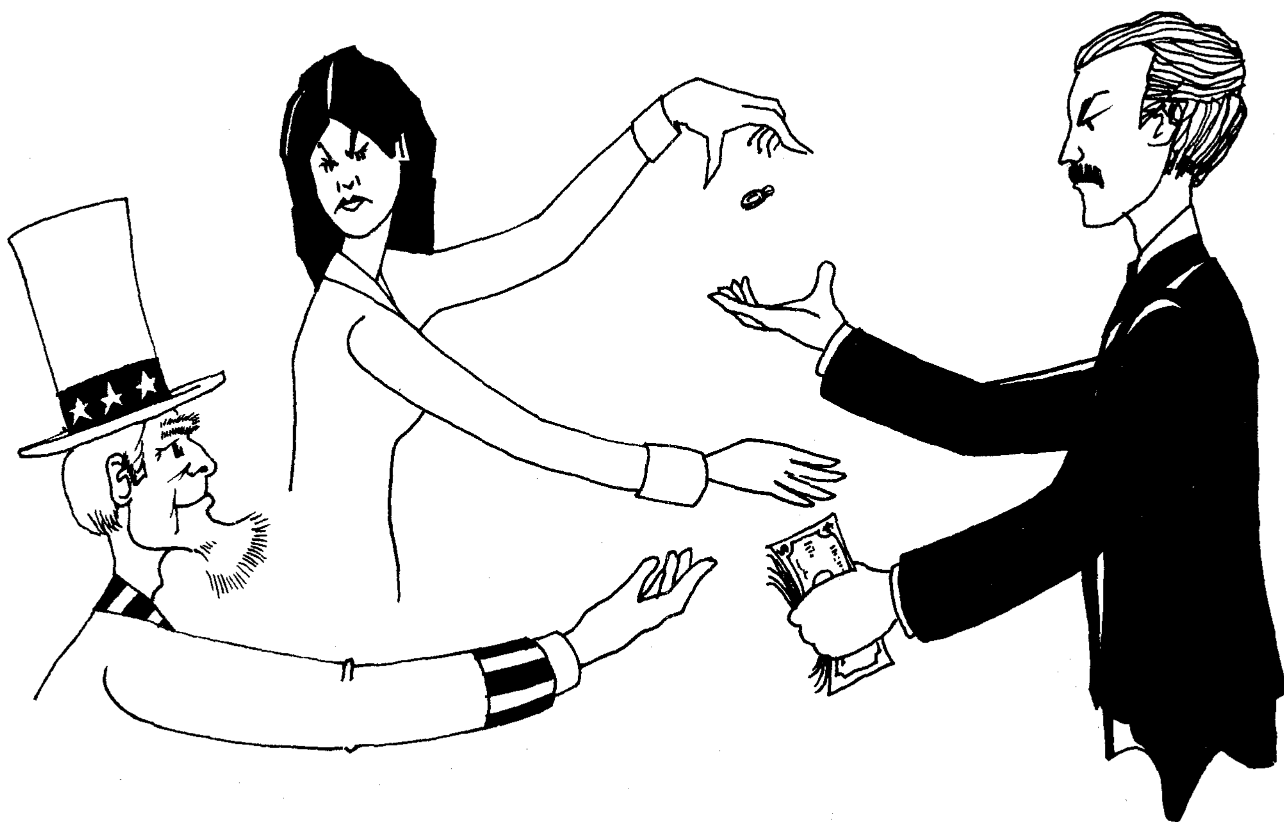

For many years, the tax law related to divorce has been plagued by complexity and uncertainty. Much of the confusion has been caused by attempts of the courts to respect the economic circumstances of the parties and differences in state law in characterizing divorce-related payments as alimony *vel non* for federal income tax purposes. Experience with former I.R.C. § 71 (which required a recipient to include alimony-like payments in income) and complementary § 215 (which allowed a paying spouse to deduct such payments) has demonstrated that tax law provisions related to divorce are singularly inappropriate places for complexity. The Tax Reform Act of 1984[1] has now made the characterization of divorce related payments a much more mechanical process. The Act has also made several other changes that affect payments and property transfers among the parties to a divorce. This article will discuss those changes.

A New Definition of Alimony

Prior law provided generally that payments pursuant to a divorce or separation agreement, decree or instrument which represented an obligation of support for a spouse (rather than a child) were deductible from the gross income of the paying spouse and includable for the recipient if they were periodic.[2] The periodic requirement provided as a general rule that the payments had to be for an indefinite duration rather than installments of a fixed amount.[3] If the divorce decree or agreement fixed a definite total of payments and such a sum was payable over a period of longer than ten years, the payments, though not indefinite, were deemed to be periodic. If such payments could be terminated or modified within a fixed period of less than ten years by the happening of contingencies, such as the death or change in economic circumstances of the parties, the payments could also be regarded as peri-

odic.[4] Although the statute did not explicitly so provide, payments which represented a property settlement, of whatever form or duration, were not deductible by the payor or income to the recipient.[5] Under the old law, many courts looked behind labels in divorce agreements in characterizing payments for tax purposes.[6] They looked to factors such as the net worth of the parties, the need of the recipient for support and the negotiations of the parties. This approach was the greatest cause of unpredictability under prior law. The prior law applies to payments under divorce or separation instruments executed before January 1, 1985 and instruments after that date which adopt pre-1985 instruments without change. If pre-1985 instruments are subsequently modified with respect to the amount or time period of payments of alimony or to provide that the new provisions are to be applied, new section 71 applies.[7]

Section 71, as amended, not only provides for inclusion of alimony or separate maintenance payments but it also provides, for the first time, a definition of alimony for federal income tax purposes. While there is an attempt to define alimony in a fashion which includes the essentials of what is commonly understood as representative of a support obligation, it is a definition which can be applied with more mechanical precision than the support obligation and periodic payment requirements of prior law. First, to be deductible such payments must be in cash, must be to a spouse or a third party on behalf of a spouse and must be made pursuant to a divorce or separation instrument.[8] Second, such payments must not be designated under the instrument as not includable in gross income under § 71 and deductible under §215.[9] Third, in the case of individuals who are legally separated under a decree of divorce or separate maintenance, the payee and payor must not be members of the same household.[10] Finally, there must be no liability to make such payments after the death of the payee spouse or liability to make any substitute payments after the payee spouse's death. Furthermore, the divorce instrument must state that there is no such liability.[11] Divorce or separation instrument is defined much as it was under prior law: a decree of divorce or separation or a written instrument incident to such decree, a written instrument or a decree requiring a spouse to make payments for the support and maintenance of the other spouse, such as a decree *pendente lite.*[12]

If the above mentioned requirements are satisfied, the payments are alimony for federal income tax purposes regardless of the circumstances of the parties or their rights under state law. Conversely, if the parties designate the payments as not includable in the recipient's income under § 71 or deductible by the payor under § 215, they are so treated for tax purposes even when the circumstances of the parties indicate that the payments could not represent a property settlement. The requirement that there be no payment after death of the payee and the restrictions on excess front-loading (discussed below) tend to require that a recipient include only payments which represent a support obligation.

There is some explanation of these requirements in the House Ways and Means Committee report.[13] In addition, last August, the IRS issued temporary regulations which also provide some assistance in construing the statute. Concerning the requirement that the payments be in cash to or on behalf of a payee spouse, the House report states that a cash payment may be made to a third party for benefit of the payee.[14] The temporary regulations provide that alimony treatment may be extended to payments of rent, mortgage indebtedness or tuition on behalf of a spouse.[15] As under prior law, a paying spouse may not deduct mortgage payments on property which he or she owns and may deduct payment of life insurance premiums only to the extent the other spouse owns the policy.[16]

An interesting question is whether a payment by one spouse to the other spouse's attorney for legal fees in connection with the divorce would be treated as alimony under the new law. It would clearly be for the benefit of the spouse whose attorney is paid. On the other hand, such a payment would still represent an outlay for legal fees in a personal context, nondeductible under *United States v. Gilmore*, 372 U.S. 39 (1963).

As to the requirement that to be alimony such payments must not be designated as not includable under § 71 or deductible under § 215, the House report provides that the parties may avoid application of these sections by a clearly designated written agreement.[17] The language of the statute, however, does not appear to prevent a judge in a divorce suit from ordering in a decree that payments not be includable by the recipient or deductible by the payor.

Regarding the requirement that the spouses not be members of the same household, the House report provides that the parties to a divorce are not to be treated as members of the same household where the taxpayer is preparing to depart shortly from the household of the other spouse.[18] The temporary regulations provide that the departure of one of the spouses from the household must be within one month after the date the payment is made.[19] Moreover, the regulations provide that a dwelling unit formerly used by the spouses may not be regarded as two separate households even if they physically separate themselves.[20]

With respect to the requirement that payments must not continue after the payee's death and that no substitute may be provided, the House report provides that while an additional amount of child support after a payee's death would be a proscribed substitute payment, amounts payable under a life insurance contract on the payee's life would not be.[21] The temporary regulations provide that the divorce instrument must state that there is no liability to make payments after the death of the payee spouse. It is not sufficient that local law would so provide.[22] It is not necessary, according to the regulations, that the instrument provide that there is no liability to make a substitute payment.[23] The regulations provide an example of how this requirement would work. If under a divorce instrument one spouse is required to pay $30,000 per year to the other during her life and then $10,000 per year in the event of the payee's death to a trust for the support of their children, $20,000 per year during the payee's life would be regarded as alimony.[24]

Limitations on "Front-Loading"

Revised § 71 strives to deter characterization of property transfers as alimony and distortion of income through its excess front-loading provisions. There are two such provisions: a minimum term provision and a recapture provision. These two provisions probably bring the greatest degree of complexity to the new law.

Under the minimum term provisions, a paying spouse may treat payments as alimony to the extent they exceed $10,000 only if alimony payments under the divorce instrument are to be made in each of the six post separation years.[25] The six post separation years are the first calendar year in which an alimony payment (other than payments under a temporary support order) is made and the five following calendar years.[26] If payments are not to be made in each of the six post separation years, they are treated as alimony only up to $10,000 in any one year. However, this rule does not apply if the payments are terminated in the post separation years upon the death of either spouse or upon remarriage of the payee.[27]

Under the recapture rule, if payments in any of the last five post separation years are exceeded by the alimony payments of any

previous post separation year by more than $10,000, such excess over $10,000 must be taken into income by the paying spouse and may be deducted by the recipient.[28] Again, this rule does not apply with respect to payments under a temporary support order according to temporary regulations.[29] The rule is not applicable if the variation in the payments is caused by termination of the payments at the death of either spouse, the remarriage of the payee, or if the amount of the payments is a fixed percentage of the income of a business or property or of the income from employment or self-employment of the payor.[30]

The operation of the recapture rule may be illustrated as follows: Assume that A is required to make payments of $50,000 per year to B, A's former spouse, in each of the six years after divorce. In year 1, A pays B $50,000 but in years 2 and 3 A pays only $30,000 and $10,000 respectively. In year 2, A must recapture, or include as income, $10,000, the amount by which the excess paid in year 1 over year 2 exceeds $10,000. After recapture, the amount paid in year 1 is deemed to be $40,000. In year 3, A must look at both years 1 and 2. Payments in year 1, now deemed to be $40,000, exceed those in year 3 by $30,000, or $20,000 in excess of $10,000. Thus $20,000 is recaptured as to year 1. Payments in year 2, $30,000, exceed those in year 3 by $20,000; thus, $10,000 is recaptured as to year 2.

Complicated as these rules may appear at first, their practical significance is clear. From the point of view of the paying spouse, widespread variations in the amounts paid or payable under a divorce instrument are not a good idea. It is quite possible that harsh application of the recapture rules will serve as a stronger inducement to *make* the payments provided for in divorce instruments than the often ineffectual contempt power of domestic relations courts.

Alimony Trusts

Section 71, as revised, no longer provides for inclusion of the income of an alimony trust to the recipient of such income. Revised § 682 now does so, however. Under § 682, such trust income is not includable in the other spouse's income. Under § 215, the "payor" does not receive a deduction for payments from an alimony trust which are includable in the recipient's income.

Transfer of Property

Under prior law, when a spouse transferred appreciated property to his or her "ex" as part of a property settlement, the transferor had to recognize a gain.[31] For example, if a husband transferred a house which he had purchased for $50,000, if that house had increased in value to $75,000 at the time of the transfer, he would have to report a $25,000 gain as income (although the gain, if long term capital gain, would only be included as income at 40% of the gain – here $10,000). The transferee's basis in the property was $75,000 so that when the property was later sold at $80,000, the transferee had only a $5,000 gain. If, however, the parties lived in community property law jurisdictions, or the property was jointly owned, the transferor was viewed as merely distributing property already half-owned by one of the spouses and the above rule did not apply.[32]

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Because gifts between spouses since 1981 are not subject to gift taxes,[33] because of the disparate treatment given such transfers in community and common law states, and because it was often the IRS who lost revenue when the transferor failed to report any gain at the time of the transfer, Congress changed the law regarding transfers of property between spouses incident to a divorce effective for transfers after July 18, 1984.[34]

The new law provides for a carry-over basis on transfers incident to a divorce and that no gain is recognized until the transferee disposes of the property.[35] According to the temporary regulations, even if the transfer is a bona fide sale, there is still a carry-over basis.[36] Under the 1984 Act, applying the facts in the above example, the transferor reports no gain on the transfer of the house; however, the transferee's basis in the property is $50,000 so that if he/she then sells the property for $80,000, he/she will have to recognize a $30,000 gain instead of merely the $5,000 gain under prior law. A transfer occurring within one year after a marriage ends, or if the transfer is related to the end of a marriage, will be treated as being incident to a divorce; therefore, even property acquired after a divorce could be governed by these new rules. The new law also applies to transfers made after 1983 but on or before July 18, 1984, where both parties so elect.[37] However, the law does not apply where the transferee spouse is a nonresident alien.[38]

Although the transferee spouse will generally be in a lower tax bracket so that the aggregate tax on the gain will be less than it would have been under prior law, it is the transferee spouse who will be liable for the entire amount of gain. Since the transferee spouse is encumbered with paying the tax on appreciation occurring both before and after the divorce, he or she should make certain that these future tax consequences are taken into account when determining which property he or she will receive. Moreover, since some of that gain may be recaptured as ordinary income instead of being taxed at the more favorable capital gains rates,[39] this effect too must now be considered during divorce negotiations.

Finally, under the new law, it is irrelevant that the basis at the time of the transfer is greater than the property's fair market value. Unlike other "gifts" which, in order to determine loss, apply the fair market value at the time of the gift, transfers between spouses or ex-spouses retain the transferor's basis for purposes of determining loss as well as gain when the property is later sold by the transferee.[40]

Child Support

Under prior law, the Supreme Court, in *Commissioner v. Lester*,[41] strictly interpreted the rule that payments not specifically "fixed" as child support by a decree, instrument, or agreement were treated as alimony. In *Lester*, the agreement provided that if any of the taxpayer's three children married, became emancipated or died, the payments would be reduced by one-sixth of the payments which would otherwise have been due. While the Court could have inferred that one-half of the taxpayer's payments constituted child support and the other half alimony, it narrowly read the statute regarding child support to require that the agreement explicitly state a specific amount or percentage of the payments as child support in order to be characterized as child support. Significantly, child support, unlike alimony, is not income to the recipient nor deductible by the payor spouse.[42]

Under the new legislation, where an

amount stated by the instrument is to be reduced when a contingency occurs in relation to a child (e.g., reaching a specific age, marrying, dying, leaving school), or at a time clearly associated with a contingency occurring to the payor's child, the reduction will be deemed to be an amount "fixed" as child support.[43] Thus, in a *Lester* situation, under current law, the amounts would be characterized as child support. The temporary regulations[44] specify two situations in which payments otherwise considered to be alimony will be presumed to be reduced at a time clearly associated with a contingency occurring to the payor's child: (1) where payments are to be reduced no more than six months pre-or-post the child's attaining the age of majority and (2) where payments are reduced on two or three occasions occurring not more than one year before or after a different child of the payor spouse attains a certain age between the ages of eighteen to twenty-four. The second situation may be demonstrated as follows. Assume that payee receives $2,000 per month which is to be reduced to $1,500 on January 1, 1991 when one child reaches 20 years, 5 months, 17 days old and to $1,000 on January 1, 1995, when his sibling who is approximately two years younger reaches 22 years, 3 months and 9 days. Since each reduction occurs not more than one year before or after different children attain age 21 years, 4 months, the presumption will apply. However, if it can be shown that the reductions were timed to occur when they did for independent reasons, the payments could still constitute alimony.

Dependency Exemptions

Under prior law, in the case of divorced or separated parents, the custodial parent (the one with custody for more than one-half of the year) was entitled to claim an exemption for each dependent child unless either (1) the noncustodial parent paid at least $600 for each child's support *and* the parents had a decree or written agreement providing that the noncustodial parent was entitled to claim the dependency exemption; or (2) the noncustodial parent provided at least $1,200 for each child's support *and* the custodial parent did not clearly establish he provided more support during the year than the noncustodial parent.[45]

Again, because of the great number of controversies arising particularly under the second exception, the 1984 Act changes provide for greater simplicity and certainty. Essentially, effective for years beginning in 1985, the custodial parent is entitled to claim the exemption[46] for each dependent child unless the custodial parent signs a written waiver stating that he/she will not claim the child as a dependent; the noncustodial parent must attach the declaration to his/her tax return each year.[47] The new law provides that the custodial parent may make an annual or a permanent declaration of a waiver. He/she may also specify that the declaration relate to several tax years.[48] In order to provide an incentive for the noncustodial parent to continue making support payments, however, the custodial parent may prefer to make this waiver on an annual basis. Where the waiver is a permanent one, the noncustodial parent must still attach a copy of the waiver to each subsequent year's return.[49] The new law also provides that any support furnished by the spouse of a remarried parent will be deemed to be a contribution by that parent.[50]

The new provisions extend their application not only to parents who are divorced or separated under a written agreement but also to parents who are living apart for the last six months of the year.[51] With respect to any decree or written agreement executed before 1985 which stated that the noncustodial parent was entitled to the dependency exemption(s), however, prior law will continue to apply unless the parties modify their agreement expressly stating that the new law will control.[52] Also, under both prior and current law, these provisions do not apply to multiple support agreements.[53]

Although a parent may be unable to claim his/her child as a dependent under the new rules, he/she may still be entitled to claim a medical expense deduction[54] or an income exclusion for medical expenses paid by an employer[55] and/or a child care credit for expenses actually paid by him/her.[56] Similarly, that parent may be able to claim an earned income credit[57] and/or file as head of household[58] even though he/she has filed a waiver or cannot claim the child as a dependent under a pre-1985 divorce or settlement agreement. It must be noted, however, that a child may not be classified as a dependent under either prior or current law if he/she has gross income above $1,000 unless he/she is under 19 years old or a student.[59]

Conclusion

Most tax legislation is described by Congress with euphemistic terms such as "reform," "simplification" or "equity." In the field of domestic relations taxation, the Tax Reform Act may not have made the law any simpler. Nevertheless, it is quite likely that domestic relations counsel will be able to predict the tax consequences of divorce agreements and decrees with more confidence. That must undeniably be regarded as reform.

Notes

[1]P.L. 98-369, 98 Stat. 494 (1984).
[2]Ch. 736, § 71, 68A Stat. 19 (1954).
[3]Treas. Reg. 1.71-1(d)(1) (1960).
[4]*Id.*, at 1.71-(d)(3)(i).
[5]*Id.*, at 1.71-1(c)(4).
[6]*See, e.g.*, *Bardwell v. Commissioner*, 318 F.2d 786 (10th Cir. 1963).
[7]Temp. Reg. § 1.71-1T, Q-26 (1984).
[8]I.R.C. § 71(b)(1)(A). The payment must be in cash, money order or some form payable on demand. Temp. Reg. § 1.71-1T, Q-5 (1984).
[9]I.R.C. § 71(b)(1)(B).
[10]I.R.C. § 71(b)(1)(C).
[11]I.R.C. § 71(b)(1)(D).
[12]I.R.C. § 71(b)(2).
[13]H.R. Rep. No. 98-432, 98th Cong., 2d Sess. 1494-98 (1984), *reprinted in* 1984 U.S. CODE CONG. & AD. NEWS 1136-39.
[14]*Id.*, at 1496, *reprinted in* 1984 U.S. CODE CONG. & AD. NEWS at 1138.
[15]Temp. Reg. 1.71-1T, Q-6 (1984).
[16]*Id.*
[17]H.R. Rep. No. 98-432, at 1496, *reprinted in* 1984 U.S. CODE CONG. & AD. NEWS at 1138.
[18]*Id.*
[19]Temp. Reg. 1.71-1T, Q-9 (1984).
[20]*Id.*
[21]H.R. Rep. No. 98-432, at 1496, *reprinted in* 1984 U.S. CODE CONG. & AD. NEWS at 1138.
[22]Temp. Reg. § 1.71-1T, Q-12 (1984).
[23]*Id.*, at Q-13.
[24]*Id.*, at Q-14, Example 1.
[25]I.R.C. § 71(f)(1).
[26]I.R.C. § 71(f)(4)(A).
[27]I.R.C. § 71(f)(1).
[28]I.R.C. § 71(f)(2).
[29]Temp. Reg. § 1.71-1T, Q-25.
[30]I.R.C. § 71(f)(1).
[31]*United States v. Davis*, 370 U.S. 65 (1970).
[32]*See, e.g.*, *Imel v. Commissioner*, 523 F.2d 853 (10th Cir. 1975).
[33]I.R.C. § 2523(a).
[34]I.R.C. § 1041.
[35]I.R.C. § 1041(a)(2).
[36]Temp. Reg. § 1.1041-1T, Q-2 (1984).
[37]*Id.*, Q-15.
[38]I.R.C. § 1041(d).
[39]*See*, I.R.C. §§ 1245, 1250.
[40]Temp. Reg. § 1.1041-1T, Q11 (1984).
[41]366 U.S. 299 (1961).
[42]I.R.C. § 71(c).
[43]I.R.C. § 71(c)(2).
[44]Temp. Reg. § 1.71-1T, Q-18 (1984).
[45]Ch. 736, § 71(e), 68A Stat. 43 (1954).
[46]I.R.C. § 152(e)(1)(B).
[47]I.R.C. § 152(e)(2).
[48]Temp. Reg. § 1.152-4T, Q-4 (1984).
[49]*Id.*
[50]I.R.C. § 152(e)(5).
[51]I.R.C. § 152(e)(1)(A)(iii).
[52]I.R.C. § 152(e)(4).
[53]I.R.C. § 152(e)(3).
[54]I.R.C. § 213(d)(5).
[55]I.R.C. § 105(b).
[56]I.R.C. § 21(e)(5). A custodial parent who does not receive a dependency exemption under § 152(e)(2) or (4) may nevertheless be entitled to claim child care credit.
[57]I.R.C. § 32(c)(1)(A)(i).
[58]I.R.C. § 2(b)(1)(A)(i).
[59]I.R.C. § 151(e)(1)(B).

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