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TAX ASPECTS OF DIVORCE AND SEPARATION AND THE INNOCENT SPOUSE RULES

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INTRODUCTION

The major tax legislation in 1984 and 1986 extensively changed federal income tax rules for divorce and separation. This paper surveys the background of these rules and examines the current state of the law regarding the tax aspects of divorce and separation.[1]

Prior to the Revenue Act of 1942, tax laws treated divorce primarily as a personal matter, not as an occasion for reporting income or deductions: those paying alimony were not allowed deductions for alimony payments, and persons receiving alimony were not required to report it as income.[2] Because alimony payments were not tax deductible, the increase in tax rates after World War II created a potentially disastrous situation. With the rising tax rates, an individual's combined alimony payments and federal tax liability possibly could have exceeded that person's income. In the 1942 Act, Congress mitigated this potential calamity by allowing payors to deduct, and requiring payees to include, alimony in their taxable income.[3] This treatment has prevailed under subsequent revisions to the Code. The 1942 Act did not, however, extend deduction of income treatment to child support or property settlement payments.

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1. References to the "Code" are to the Internal Revenue Code of 1939, 1954, or 1986, whichever is applicable, and references to "section" are to sections of those Codes. The term "divorce instrument" refers to either a written separation agreement, a divorce decree, or a judicial decree of separation and support order. Unless otherwise indicated, descriptions of Code provisions are to the law in effect after the 1986 Act. References to "the 1984 Act" are to Pub. L. No. 98-369, 98 Stat. 494. References to "the 1986 Act" are to Pub. L. No. 99-514, 100 Stat. 2085.

2. Gould v. Gould, 245 U.S. 151 (1917).

3. Revenue Act of 1942, Pub. L. No. 77-753, § 120, 56 Stat. 798, 816-17.

I. ALIMONY

A. *Generally*

Alimony is deductible by the payor[4] and included in the income of the payee.[5] Thus, the tax stakes are significant, and many issues concerning whether payments are properly classified as alimony have arisen over the years.

In its original 1942 form,[6] the Code provided that payments would only be alimony for tax purposes if paid incident to a divorce decree issued by a competent court.[7] At that time, community property was the only form of income-splitting generally available for married persons, making a restrictive rule appropriate to prevent abuse. The Revenue Act of 1948 expanded the forms of income splitting available by generally permitting spouses to file joint returns.[8] In the 1954 Code, the tax definition of alimony was broadened to include payments made pursuant to written separation agreements between spouses.[9]

Between 1954 and 1984 alimony was generally defined as periodic payments made to discharge the former spouse's support obligation.[10] Basing the definition of alimony on support obligations incorporated the relevant state domestic relations law into the alimony definition, because state, not federal law, determines the support obligation arising from marriage. Because states' support obligation laws differed, similar payments made in different states could be treated differently for tax purposes, depending upon a particular state's law. The original tax scheme was also complex and contained traps for the unwary. In the 1984 and 1986 Acts, Congress addressed these concerns.

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4. I.R.C. § 215(a) (1987).
5. I.R.C. § 61(a)(8) (1987).
6. Revenue Act of 1942, Pub. L. No. 77-753, § 120, 56 Stat. 798, 816-17.
7. *Id.*
8. Revenue Act of 1948, Pub. L. No. 80-471, §§ 301, 303, 62 Stat. 110, 114-15.
9. Internal Revenue Code of 1954, Pub. L. No. 83-591, § 71, 68A Stat. 3, 19.
10. Prior to the 1984 Act, § 71(a)(1) provided:

> (a) GENERAL RULE—
>
> (1) DECREE OF DIVORCE OR SEPARATE MAINTENANCE.—If a wife is divorced or legally separated from her husband under a decree of divorce or of separate maintenance, the wife's gross income includes periodic payments (whether or not made at regular intervals) received after such decree in discharge of . . . a legal obligation which, because of the marital or family relationship, is imposed on or incurred by the husband under the decree or under a written instrument incident to such divorce or separation.

Internal Revenue Code of 1954, Pub. L. No. 83-591, § 71, 68A Stat. 3, 19.

B. 1984 and 1986 Legislation and Current Law

1. Definition of Alimony

Under prior law, alimony was generally defined in terms of several factors. These factors included the legal origin of the payments (for example, whether payments were made pursuant to a divorce decree), the purpose of the payments (generally, alimony included only payments for the support needs of the payee spouse), and the objective characteristics of the payments (generally, a payment was not considered to be alimony if a principal sum could be determined).[11] The new rules change some of these details, but in many cases, the result will be the same.

Under the 1984 Act, alimony is defined rather objectively as a cash payment to or for the benefit of the payee spouse, which does not decrease too greatly in the first few years after the divorce; there is no obligation to continue payments after the death of the payee; payments are to be made in each of at least three years from the date of separation or divorce; and, as before the 1984 Act, the payments are made pursuant to a divorce decree or a *written* separation agreement.[12]

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11. Baker v. Commissioner, 17 T.C. 1610 (1952), *aff'd*, 205 F.2d 369 (2d Cir. 1953).

12. Tax Reform Act of 1984, Pub. L. No. 98-369, § 422(a), 98 Stat. 494, 795. The 1984 Act provided:

> (1) IN GENERAL—The term "alimony or separate maintenance payment" means any payment in cash if-
>
> (A) such payment is received by (or on behalf of) a spouse under a divorce or separation instrument,
>
> (B) the divorce or separation instrument does not designate such payment as a payment which is not includible in gross income under this section and not allowable as a deduction under section 215,
>
> (C) in the case of an individual legally separated from his spouse under a decree of divorce or of separate maintenance, the payee spouse and the payor spouse are not members of the same household at the time such payment is made, and
>
> (D) there is no liability to make any such payment for any period after the death of the payee spouse and there is no liability to make any payment (in cash or property) as a substitute for such payments after the death of the payee spouse (and the divorce or separation instrument states that there is no such liability).

Id. Originally the recapture period under the 1984 Act was six years. Section 1843(c) of the 1986 Act retroactively reduced this period to three years. Tax Reform Act of 1986, Pub. L. No. 99-514, § 1843(c), 100 Stat. 2085, 2853.

2. General Issues

The following issues need to be considered when determining whether payments made pursuant to a divorce or separation agreement constitute alimony for tax purposes.

a. "Incident"

Payments are characterized as alimony if they are paid "*under* a divorce or separation instrument."[13] The requisite instrument is defined as "a decree of divorce or separate maintenance or a written instrument incident to such a decree,"[14] or "a written separation agreement."[15] This language creates the following structure: before a divorce, assuming no resort to a court, payments will be considered alimony if they are made pursuant to a written (but not an oral) separation agreement or, if a court has issued a decree of separate maintenance, the payments must be made pursuant to a judicial separation and support order; payments made after a divorce will be considered alimony if they are made "under" a court divorce decree or a written agreement "incident" to the divorce.

This structure raises at least two questions, neither of which seems to have been addressed by the 1984 and 1986 Acts. First, whether payments are considered alimony when made pursuant to a written separation agreement which by its terms, or under state law, survives a court issued divorce decree and contains provisions that are different from (though not necessarily in conflict with) those in the divorce decree. Second, if the parties agree to changes in the payment terms, for example, the amount or the duration after the divorce decree is issued, what criteria must be met for the payments to be considered "incident" to or "under" the decree, so that they will be treated as alimony?

In regard to the first question, the regulations implementing the pre-1984 version of section 71 provided that payments under a pre-decree agreement which survived the decree are considered to be alimony.[16] There appear to be no changes in the language of section 71, or anything in the legislative history of the changes, which would alter this result.[17]

In regard to the second question, it should be noted that prior to

13. I.R.C. § 71(b)(1)(A) (1987) (emphasis added).
14. I.R.C. § 71(b)(2)(A) (1987).
15. I.R.C. § 71(b)(2)(B) (1987).
16. Treas. Reg. § 1.71-1(b)(2) (1983).
17. Temp. Treas. Reg. § 1.71-1T (Q & A 4) (1984) supports this conclusion.

the 1984 Act, under section 71(a)(1), a payment would be treated as alimony if it were paid pursuant to a divorce decree or "under a written instrument *incident* to such divorce or separation."[18] Under the 1984 Act amendments, the provision still states that a payment pursuant to a divorce decree is treated as alimony, but it also provides that payments made pursuant to an instrument written after the decree will be considered alimony only if the instrument is "incident to such a decree."[19]

It took much litigation to clarify the status of the "incident" language of the earlier version of section 71(a)(1), but at last the courts concluded that the matter to which the post-divorce written instrument must be "incident" was the *status* of being divorced.[20] Ultimately, the Internal Revenue Service agreed with this conclusion.[21] Unfortunately, Congress' choice of language in the 1984 Act, "incident to such a *decree*,"[22] strongly suggests that those cases are no longer controlling under the new version of section 71, since the statutory language speaks in terms of the very issue with which the courts and the Internal Revenue Service wrestled for so long. The safe answer for careful attorneys would be to insist that if any changes in the terms of a divorce decree are desired, the decree should be amended to help ensure that the changes will be taken into account for tax purposes.[23]

b. Indirect Payments

Before the 1984 Act, payments to third parties on behalf of, or at the behest of, the payee spouse were the object of extensive litigation.[24] Generally, these cases and rulings support the proposition

18. Internal Revenue Code of 1954, Pub. L. No. 83-591, § 71(a)(1), 68A Stat. 3, 19 (emphasis added).

19. Tax Reform Act of 1984, Pub. L. No. 98-369, § 422(a), 98 Stat. 494, 795 (codified at I.R.C. § 71(b)(2)(A)) (1987).

20. Hollander v. Commissioner, 248 F.2d 523 (9th Cir. 1957); Newton v. Pedrick, 212 F.2d 357 (2d Cir. 1954); Lerner v. Commissioner, 195 F.2d 296 (2d Cir. 1952); Cramer v. Commissioner, 36 T.C. 1136 (1961).

21. Rev. Rul. 58-451, 1958-2 C.B. 914; Rev. Rul. 60-140, 1960-1 C.B. 31.

22. I.R.C. § 71(b)(2)(A) (1987) (emphasis added).

23. It should be stressed that this is the "belt and suspenders" approach to the matter—there is nothing in the legislative history to suggest that Congress intended to overrule the cited cases or Revenue Rulings.

Also, Temp. Treas. Reg. § 1.71-1T (Q & A 4) (1984), states: "Are the instruments described in section 71(a) of prior law the same as divorce or separation instruments described in section 71(a), as amended by the Tax Reform Act of 1984? A-4: Yes."

24. *See, e.g.*, Gentry v. United States, 283 F.2d 702 (Ct. Cl. 1960); Blumenthal v. Commissioner, 183 F.2d 15 (3d Cir. 1950); Marinello v. Commissioner, 54 T.C. 577 (1970). *See also* Rev. Rul. 62-106, 1962-2 C.B. 21, 23, which held:

that payments which discharged the payee's legal obligations were indirectly received by the payee and could be considered alimony, if the payments bore some relation to support of the payee.[25]

The most troublesome areas were payment of the payee's legal fees connected with the divorce and housing costs for the payee after the divorce or separation. Payment of the payee's divorce related legal fees generally were disallowed as deductions on the ground that these payments were not "periodic."[26] It appears likely that the 1984 Act changed the law on this point, and such payments should now qualify as alimony.[27] Since the "periodic" requirement in the prior law was related, however, to disallowing alimony treatment for payments in the nature of property settlements, it is possible that payments for the payee's legal fees will be regarded as property settlement payments rather than alimony. Therefore, it seems that the safe approach under the new rules, as under the old, is to increase the regular alimony payments to provide the payee funds to satisfy legal bills, rather than the payor spouse directly paying these legal costs.

Housing costs continue to be troublesome because they sit on the boundary between alimony and property settlements. It is reasonably clear that cash payments for items such as mortgage payments, taxes, and utilities are considered alimony if they are for property which the payee spouse owns and occupies.[28] Rent should be treated the same as mortgage payments. Additionally, expendi-

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> [P]ayments by a husband of his wife's medical and dental expenses, pursuant to a decree of divorce or separate maintenance, or written instrument incident thereto, a written separation agreement, or decree for support, are periodic payments within the meaning of section 71 of the Code where (1) no principal sum is specified in the decree or instrument, or, (2) if specified, is either payable over more than a ten-year period or is subject to contingencies of death of either spouse, remarriage of the wife, or change in the economic status of either spouse.

Id. at 23.

25. *E.g.*, Lehman v. Commissioner, 17 T.C. 652 (1951), *aff'd*, 234 F.2d 958 (2d Cir. 1956) (payments made to ex-wife's mother were alimony); Lebeau v. Commissioner, 49 T.C.M. (P-H) 80,201 (1980) (payment of medical costs is considered alimony); Rev. Rul. 62-106, 1962-2 C.B. 21. *See also* Faber v. Commissioner, 264 F.2d 127 (3d Cir. 1959); Christiansen v. Commissioner, 60 T.C. 456 (1973) (payments to ex-wife for support of children not related to ex-husband are alimony because payments were for and on behalf of ex-wife).

26. Rose v. Commissioner, 40 T.C.M. (P-H) 71,147, *aff'd*, 459 F.2d 28 (6th Cir. 1972); Baer v. Commissioner, 16 T.C. 1418 (1951), *modified*, 196 F.2d 646 (8th Cir. 1952); Henson v. Commissioner, 48 T.C.M. (P-H) 79,110 (1979).

27. Section 71(b)(1)(A) treats cash payments "on behalf of" the former spouse as alimony, and section 71 contains no requirement of periodicity.

28. Temp. Treas. Reg. § 1.71-1T (Q & A 6) (1984).

tures for maintenance of a house which the payee spouse owns and occupies should be treated the same as mortgage payments, taxes, and utilities. However, if the payor owns an interest in the house occupied by the payee, at a minimum, an allocation should be required and only the percentage of the payments equal to the percentage which the payee spouse owns should be treated as alimony.[29] Even after the 1984 Act, if the payor owns the property in its entirety, it is likely that no part of the payor's costs will be treated as alimony.[30] The rationale for this is that the payments, at least in part, benefit the payor, not the payee (for example, because they include principal payments on the mortgage) and the rental value received by the payee spouse is not in cash.[31]

c. Insurance

Whether insurance payments are treated as alimony depends on which person owns the policy. If the payee spouse owns the policy, premium payments by the payor spouse should qualify as alimony.[32] Before the 1984 Act, a distinction was drawn between term and whole life insurance: only whole life insurance premiums were considered alimony.[33] After the 1984 Act, this distinction is of no consequence. If the payor retains ownership of the policy, however, whether it is term or whole life, premium payments are not considered alimony.[34]

d. Validity of Decree

The law is presently unclear when there are questions about the validity of the divorce decree, for example, if the court granting the divorce did not have jurisdiction or if two courts issued con-

29. Rev. Rul. 67-420, 1967-2 C.B. 63.

30. Fisher v. Commissioner, 39 T.C.M. (P-H) 70,255 (1970); Taylor v. Commissioner, 45 T.C. 120 (1965); Bradley v. Commissioner, 30 T.C. 701 (1958).

31. Section 71(b)(1) restricts alimony or separate maintenance payments to "payment[s] in cash." It is also possible to argue that these payments are in the nature of a property settlement, rather than alimony. Before the 1986 Act, the payor was entitled to the usual deductions for interest and property taxes, but the enactment of section 163(h) in 1986, limiting interest deductions for real estate loans, will probably eliminate this interest deduction. *See* I.R.C. § 163(h) (1987).

32. Temp. Treas. Reg. § 1.71-1T (Q & A 6) (1984).

33. Wright v. Commissioner, 543 F.2d 593 (7th Cir. 1976); Brodersen v. Commissioner, 57 T.C. 412 (1971).

34. Baker v. Commissioner, 17 T.C. 1610 (1952), *aff'd*, 205 F.2d 369 (2d Cir. 1953); Smith's Estate v. Commissioner, 208 F.2d 349 (3d Cir. 1953); Blumenthal v. Commissioner, 183 F.2d 15 (3d Cir. 1950); Ortmayer v. Commissioner, 28 T.C. 64 (1957); Fisher v. Commissioner, 25 T.C.M. (P-H) 56,098 (1956).

flicting decrees.[35] The Second and Third Circuits have taken the position that payments made under a divorce decree remain alimony, even if a court in another jurisdiction rules that the first decree is invalid.[36] In contrast, the Tax Court and the Internal Revenue Service take the position that a subsequent decision by a court having jurisdiction over the parties will be given effect for tax purposes, and if that later decision holds the earlier decision invalid, payments made pursuant to the first decision will not be considered alimony.[37] Presumably, a later decision in the same jurisdiction finding an earlier decision invalid, or modifying it, would be given effect for tax purposes by all authorities.[38]

e. Explicit Removal from Alimony Status

The 1984 Act added a useful provision, section 71(b)(1)(B), which permits the parties to remove any payment from alimony classification simply by explicitly so providing.[39] Judicious use of this provision could resolve the uncertainty in the law in many of the situations noted above. It must be stressed, however, that this

35. The Internal Revenue Service and the federal courts are not bound by the decisions of lower state courts as to the applicable state laws. Commissioner v. Bosch, 387 U.S. 456 (1967). It appears, however, that such residual authority would be used sparingly.

36. Estate of Borax v. Commissioner, 349 F.2d 666 (2d Cir. 1965); Wondsel v. Commissioner, 350 F.2d 339 (2d Cir. 1965); Feinberg v. Commissioner, 198 F.2d 260 (3d Cir. 1952).

37. Borax v. Commissioner, 40 T.C. 1001 (1964), *rev'd*, 349 F.2d 666 (2d Cir. 1965); Wondsel v. Commissioner, 33 T.C.M. (P-H) 64,213 (1964), *rev'd*, 350 F.2d 339 (2d Cir. 1965); Feinberg v. Commissioner, 16 T.C. 1485 (1951), *rev'd*, 198 F.2d 260 (3d Cir. 1952); Rev. Rul. 67-442, 1967-2 C.B. 65.

38. It is unclear whether the later decision in the *same* jurisdiction would be given retroactive effect. If the later decision is on appeal and is reversed, it seems clear that the earlier decision is nullified and would never be given effect. If, however, the later decision is based on a request to change the earlier decision, the result depends on the reason for the change. If, for example, the later process were initiated to correct or clarify language to conform to the original intent of the court or the parties, the later decision should be given retroactive effect. *See, e.g.*, Johnson v. Commissioner, 45 T.C. 530 (1966), *acq. in result*, 1968-2 C.B. 2; Rev. Rul. 71-416, 1971-1 C.B. 83. However, a decision based on a request to change the original decision should not be given retroactive effect. *See* Martin v. Commissioner, 42 T.C.M. (P-H) 73,228 (1973); Turkoglu v. Commissioner, 36 T.C. 552 (1961). In practice, it could be very difficult to distinguish the purpose for review, and presumably the Internal Revenue Service and the federal courts would not be bound by the way the parties or the state courts characterized their intent.

39. I.R.C. § 71(b)(1)(B) provides that certain payments may be classified as alimony if "the divorce or separation instrument does not designate such payment as a payment which is not includible in gross income under this section and not allowable as a deduction under section 215." *Id.*

new provision can be used only to *exclude* a payment from alimony classification; it cannot be used to classify a payment as alimony if section 71 would classify the payment differently, such as property settlement or child support payments.

f. Annulment

Arguably, payments made after a marriage annulment could not be alimony because the court-issued annulment decree renders the marriage void *ab initio* under state law. However, the federal courts and the Internal Revenue Service have not taken such a narrow view of the matter and have generally held that support payments pursuant to a judgment of annulment were alimony,[40] even in the case of a foreign court decree.[41]

g. Substance and Reality

It is easy to get carried away with the technical details of the Code and think that compliance with narrow language will blind the Internal Revenue Service and the courts to the reality of what is happening. While this result might occur occasionally, it is not the usual result. Therefore, a payment made about the same time as a divorce, does not become alimony, if the payment was clearly intended to satisfy another obligation. For example, if one spouse owed money to the other and paid the loan when they were divorced, the payment would not be considered alimony, or even a property settlement or child support, just because it was made when the couple divorced.[42]

C. *Distinguishing Alimony from Child Support*

Both alimony and child support are payments for support of the former spouse's family and are typically paid to the same person, the former spouse with whom the children live. Distinguishing the portion of payments intended as child support from that intended as alimony can be difficult. Presently, the Code continues to permit the parties and the divorce court to determine the amount paid for each purpose, but the 1984 Act made a major change in

40. *E.g.*, Newburger v. Commissioner, 61 T.C. 457 (1974); Reisman v. Commissioner, 49 T.C. 570 (1968); Rev. Rul. 59-130, 1959-1 C.B. 61.

41. Reighly v. Commissioner, 17 T.C. 344 (1957) (German decree); Parsons v. Commissioner, 20 T.C.M. (P-H) 51,297 (1951) (German decree); Rev. Rul. 57-113, 1957-1 C.B. 106 (Mexican decree, alimony treatment allowed even though questions raised as to validity of the decree, if parties believed in good faith it was valid).

42. *See, e.g.*, Thorsness v. United States, 260 F.2d 341 (7th Cir. 1958).

the way that this intent must be memorialized.[43]

The pre-1984 tax rule is found in *Commissioner v. Lester*.[44] In that case, the United States Supreme Court held that the language which the parties used in a divorce decree was insufficient to "fix" the portion of the payment allotted for child support when the decree provided that the total payment would be " 'reduced in a sum equal to one-sixth of the payments which would thereafter otherwise accrue' "[45] upon the death or marriage of each of the couple's three children. It was clear from the terms of the above language that the parties in *Lester* intended one-half of the husband's payments to be child support and one-half to be alimony, but the Court held that section 71 required the portion for child support to be explicitly labeled in words which left absolutely no room for doubt or alternative interpretation.[46] The primary concern of the Court was to interpret section 71 in a way that would permit as much certainty as possible in planning for the tax consequences of divorce and separation.[47]

Unfortunately, interpreting the word "fix" in section 71 to provide maximum certainty also made the rule very rigid, and the *Lester* interpretation created a major trap for the unwary. The books are full of cases in which divorce and separation instruments were deemed insufficiently exact in langauge to classify payments as child support, rather than alimony, to the great sorrow of the payee spouse.[48] The 1984 Act amended section 71 by adding section 71(c)(2) to eliminate this problem.[49]

New section 71(c)(2) generally provides that payments made pursuant to a divorce or separation instrument can be classified as child support if reasonable inferences can be drawn from the substance of the divorce or separation instrument that child support was intended. Such inferences can be drawn from changes in the total payments (in the nature of family support) connected with

43. Characterization of payments as child support eliminates taxation for the payee and deduction by the payor, the main issue, and it might also affect claims for dependency exemptions. *See* I.R.C. § 71(c) (1987).

44. 366 U.S. 299 (1961).

45. Commissioner v. Lester, 366 U.S. at 300 (quoting written agreement of husband and wife).

46. *Id.* at 301-03.

47. Also supporting this position is the argument that anything less left the payee spouse free to spend the money for purposes other than for support of the children.

48. Maytag v. Commissioner, 370 F.2d 914 (10th Cir. 1966), *cert. denied*, 388 U.S. 916 (1967); Guthrie v. United States, 264 F. Supp. 840 (W.D. Ark. 1967); Blakey v. Commissioner, 78 T.C. 963 (1982).

49. Tax Reform Act of 1984, Pub. L. No. 98-369, § 422(b), 98 Stat. 494, 796.

presumed changes in the support needs of the children. Under new section 71(c)(2), when the agreement provides for reduced payments after certain contingencies occur, such as the child "attaining a specified age, marrying, dying, leaving school, or a similar contingency,"[50] the implication is created that payments are child support, not alimony. The facts of *Lester* provide a good example of a situation in which this rule could be applied. If a court relied on reasonable inferences drawn from the circumstances surrounding the divorce, rather than just focusing on the language in the decree, *Lester* would be decided differently, with one-half of the payments considered to be child support.

Of course, a departure from the arid clarity of the *Lester* rule is not an unmixed blessing; it leaves an area of uncertainty which will not be clarified until the Internal Revenue Service or the federal courts determine whether a given payment is child support or alimony. The wise tax lawyer will still insist, therefore, that the amount intended as child support be explicitly labeled as such, in order to avoid any possibility for an "interpretation" which would result in classifying the payments as alimony.[51]

D. Distinguishing Alimony from Property Settlements

1. Generally

As noted above, the focus of the law prior to the 1984 Act was on the nature of the payor's support obligation under state law and whether the characteristics of the payments indicated they were related to the support needs of the payee.[52] This focus led to the requirement that payments be periodic and that the total amount of the payor's obligation not be fixed in advance because each of these characteristics seemed to buttress the inference that support payments were being made.[53] Also, prior to the 1984 Act, courts generally held that no total principal sum could be determined if

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50. I.R.C. § 71(c)(2)(A) (1987).

51. New section 71(c)(2), eliminating the *Lester* problem, was effective for divorce instruments executed after December 31, 1984. Thus, the character of payments under older instruments is not changed even though they are made after 1984. Payments under older instruments can be brought under the new rules if they are modified after 1984, if the modification specifically states that this change is the intent of the parties. Tax Reform Act of 1984, Pub. L. No. 98-369, § 422(e)(1), (2), 98 Stat. 494, 798.

52. *See supra* text accompanying notes 10-11.

53. *E.g.*, Salapatas v. Commissioner, 446 F.2d 79 (7th Cir. 1971); Baker v. Commissioner, 205 F.2d 369 (2d Cir. 1953); Martin v. Commissioner, 73 T.C. 255 (1979); Kent v. Commissioner, 61 T.C. 133 (1973).

contingencies existed which made the total of payments uncertain and that the death or remarriage of the payee spouse was such a contingency.[54] These restrictive criteria for alimony treatment led to the conclusion that the rental value of real estate owned by the payor and occupied by the payee was not alimony.[55]

The 1984 Act removed the "periodic" requirement from section 71 and loosened the requirements for characteristics which permit the inference of intended support. In its original 1984 form, the new section 71 required the relevant divorce instrument to explicitly state that any obligation to make the payments ceased at the death of the payee spouse.[56] This was softened retroactively by the 1986 Act to provide merely that the cessation of alimony payments must be the "bottom line," whether that result follows from the terms of the agreement or from the effect of state law.[57] This requirement is strengthened by another rule in section 71(b)(1)(D), that death of the payee cannot cause an increase in some other kind of payment, such as support for children.[58]

The "periodic" and "cease at death" (or remarriage) requirements, which were necessary to conclude that payments were considered alimony, still left a gray area between indefinite payments until death or remarriage, and periodic payments to be made for a definite but very lengthy period. On the one hand, these payments looked like a property settlement because a total obligation could readily be determined. On the other hand, the periodic and spread out nature of the payments made them appear to be tied to support needs. To resolve this ambiguity, section 71(c)(2) prior to the 1984 Act provided that payments of ten percent of the total obligation could be considered alimony if the payments were to be made for more than ten years from the date of the divorce instrument.[59]

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54. Baker v. Commissioner, 205 F.2d 369 (2d Cir. 1953).

55. Pappenheimer v. Allen, 164 F.2d 428 (5th Cir. 1947).

56. Tax Reform Act of 1984, Pub. L. No. 98-369, § 422(a), 98 Stat. 494, 795.

57. Tax Reform Act of 1986, Pub. L. No. 99-514, § 1843(b), 100 Stat. 2085, 2853 (amending I.R.C. § 71(b)(1)(D)).

58. It is interesting that the other portion of the common clause which ties payments to support needs of the payee, termination upon remarriage, is not included in the Code requirements. Neither provision was included explicitly in section 71 before the 1984 changes, so perhaps an inference could be drawn from the omission that continuation of payments after remarriage still results in alimony treatment. On the other hand, if state law provided that the obligation to make payments ceased upon remarriage, and the relevant divorce instrument did not provide to the contrary, presumably the Internal Revenue Service would argue that there was no continuing obligation and conclude that the payments were voluntary and could not be alimony.

59. Internal Revenue Code of 1954, Pub. L. No. 83-591, § 71(c)(2), 68A Stat. 3, 20.

This clear rule provided parties with a baseline for planning.

The 1984 and 1986 Acts continued this approach, but drastically shortened the time in which these payments could be made and changed the method for policing fluctuations in payments.[60] Under the 1984 Act, in its original form, the analog of old section 71(c)(2), new section 71(f), provided that payments would be considered alimony only if they were required to be made "in" at least the first six years from the date of the initial payments[61] and payments in one of those six years were not more than $10,000 less than payments in a prior year within the six year period.[62] For example, if the payments were $50,000 in year one, and $10,000 in year two, $30,000 of the decrease (the amount of the $40,000 decrease in excess of $10,000) would be treated as alimony initially (assuming it met the general requirements), but recharacterized as a property settlement payment in year two. Recharacterization is in the form of recapture:[63] the payor includes the recharacterized amount in income, and the payee deducts the same amount. Under the 1984 Act, recapture occurred in the year of the lower payments, not through a recalculation of the tax for the year of the higher payment and amended returns.[64]

The 1986 Act amends section 71(f) to provide that recapture will

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60. The apparent purpose of limiting alimony treatment under these rules to relatively constant payments made during the test period is to limit the reclassification of property settlements as alimony. Apparently, it has been the view of Congress, since the initial enactment of section 71(c)(2), that a feature which distinguishes alimony from property settlement payments is the general constancy of payments in the former, and the general fluctuation of payments in the latter. The 1984 and 1986 Acts continue to reflect this concern by focusing on sharp decreases in payments during the test periods created by these Acts. I.R.C. § 71(f) (1987).

61. Tax Reform Act of 1984, Pub. L. No. 98-369, § 422(a), 98 Stat. 494, 796 (creating § 71(f)(1)). This is a rather substantial change from the prior rule, which began counting the time period from the date of the relevant instrument and measured the period exactly from the execution of the instrument to the date of the last payment. The old rule created a trap for the unwary, because ten payments beginning with the execution of the instrument would span only a nine-year period. The new rule possibly has a similar problem, but it is a little easier to avoid, because it does not appear to make any difference at what point "in" the year a payment is made. *See* I.R.C. § 71(f)(1)-(4)(A) (1987).

62. Tax Reform Act of 1984, Pub. L. No. 98-369, § 422(a), 98 Stat. 494, 796 (creating I.R.C. § 71(f)(2)).

63. "Recapture" in the tax setting simply means an inclusion in income to offset an earlier deduction. *See* I.R.C. § 71(f) (1987).

64. Tax Reform Act of 1984, Pub. L. No. 98-369, § 422(a), 98 Stat. 494, 796. Exceptions from recapture are provided when payments are a definite percentage of income from a business or property, and the fluctuation results from changes beyond the control of the payor, and when the payments cease because of the death or remarriage of the payee. I.R.C. § 71(f)(5) (1987).

occur only during the first three years, and only if the payments during the first year exceed the average of the payments during the second and third years by more than $15,000.[65] Recapture also will occur if payments during the second year exceed the payments during the third year by more than $15,000.[66] In both cases, recaptured amounts are taken into account only for the third year of payments—even if there is recapture with respect to a decrease from year one to year two, the recaptured amounts are only reflected on the tax returns of the former spouse for the third year.[67]

Example. The starting point in the calculations is the relationship of the payments for years two and three: recapture will occur if the payments in year two are more than $15,000 greater than those for year three. Thus, for example, if the payments for year one were $60,000, for year two $30,000, and for year three $10,000, then $5,000 would be recaptured because the decrease in payments from year two to year three ($20,000) was $5,000 more than the permitted $15,000 decrease. The payor would deduct $30,000 in year two and $10,000 in year three for alimony payments during those years, but also would be required to add $5,000 of recapture income to year three's tax return. The payee spouse would include $30,000 in income in year two and $10,000 in year three for alimony payments during those years, but also would deduct $5,000 for recapture on year three's tax return. Since $5,000 has been recaptured for the decrease in payments from year two to year three, *for recapture computation purposes*, the payment for year two would thereafter be regarded as $25,000 (the original $30,000 less the $5,000 recaptured).

Next, the payments for year one are compared to the average (adjusted for year two or year three recapture) of the payments for years two and three: if the year one payments are more than $15,000 greater than the average for years two and three, that excess is recaptured in year three. For example, if the actual payments for year one were $60,000, for year two $30,000, and for year

65. Tax Reform Act of 1986, Pub. L. No. 99-514, § 1843(c), 100 Stat. 2085, 2853-54 (codified at I.R.C. § 71(f)(3) (1987)).

66. I.R.C. § 71(f)(4) (1987). The years after the third annual payment are disregarded—that is, no recapture occurs regardless of a decrease in payments from one of the first three years to the fourth or a later year.

67. There is quite a difference in the timing of recapture under the new rules compared to those of the 1984 Act. Under the 1984 Act, recapture could occur immediately in the year of decreased payments (*e.g.*, if payments in year two were small compared to those in year one, recapture would occur for year two). Tax Reform Act of 1984, Pub. L. No. 98-369, § 422(a), 98 Stat. 494, 796-97.

three $10,000, then $27,500 would be recaptured for the year one excess payment, in addition to the $5,000 recapture for the year two excess payment described above. The computation is: actual payments for year one are $60,000, average payments for years two and three are $17,500 ($25,000 [as adjusted] for year two plus $10,000 for year three equals $35,000, divided by two equals $17,500 average), excess of year one over years two-three average is $42,500 ($60,000 minus $17,500), less the permitted decrease of $15,000 is $27,500. Thus, with respect to the year one payment, the payor spouse would deduct $60,000 for year one and include $17,500 in income for year three. The payee spouse would include $60,000 in income for year one and would deduct $17,500 in year three as recapture.

Summarizing, the payor spouse would deduct $60,000 in year one, $30,000 in year two, and $10,000 in year three, but would include $22,500 ($5,000 from year two, $17,500 from year one) in income for year three as recapture. The payee spouse would include $60,000 in income for year one, $30,000 for year two, and $10,000 for year three, but also would deduct $22,500 in year three as recapture.[68]

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68. For comparison and archival purposes, the following is an example of the method of computation under the original rules of the 1984 Act: Computation of Recapture. [*Caveat*: This example does not reflect the retroactive decrease in the recapture period from six years to three years.]

The basic idea of the new rule appears to be that large payments in the early years after a divorce are a primary characteristic of a property settlement, but payment fluctuations of less than $10,000 are not significant. Thus, if in any of the first six years total annual payments are more than $10,000 greater than the total payments for a later year in this same six year period, some portion of the deduction for the earlier year payments will be recaptured (included in the income of the payor for the year of low payments), and an offset will be allowed through a deduction to the payee spouse for the year of low payments.

The key to understanding these rules is to realize that each year stands on its own, and that the same year's payments can be recaptured in part in each of several subsequent years.

For example, assume the payments were $50,000 in year one, $30,000 in year two, and $10,000 in years three through six. Assuming the payments otherwise qualified as alimony (proper origin of obligation, provision for no payments after death of payee, etc.), the payor would have a deduction of $50,000 for year one, and the payee would have income of $50,000 for year one. For year two, the starting point would be a deduction of $30,000 for the payor and income of $30,000 for the payee. A recapture computation must be made, however, because the payments in year two ($30,000) were more than $10,000 less than the payments in year one ($50,000)—the excess of year one payments over year two payments was, in fact, $20,000. Therefore, $10,000 is subtracted from year one payments to determine the recapture amount, leaving a decrease from year one (now $40,000) to year two ($50,000) of $10,000. The $10,000 is treated as income of the payor for year two, with the payee receiving a $10,000 deduction for year

2. *Effective Dates*

a. *Generally*

The effective date provisions of the 1986 Act create complexity and planning opportunities and appear to contain a serious technical error. Generally, the new rules apply to divorce decrees and agreements executed after December 31, 1986.[69] However, if a pre-1987 decree or agreement is modified after 1986, the parties can choose to come under the new rules by so stating in the modified instrument.[70] Thus, if recapture would have occurred under the $10,000 decrease rule of the 1984 Act, this could be avoided in some cases if the parties modified the relevant instrument after 1986 to provide that the $15,000 decrease rule would apply instead. Up to this point in the discussion the effective date rules are fairly simple; however, the complexity increases in the following section.

b. *Retroactive Amendment*

Section 1843(c)(3) of the 1986 Act retroactively amended section 71(f)(2) of the Code to change the 1984 Act recapture period from

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two. The net effect for year two is a net deduction of $20,000 for the payor ($30,000 paid less $10,000 recaptured) and income of $20,000 for the payee ($30,000 income less $10,000 recapture deduction).

In year three, only $10,000 is paid. Because this payment is more than $10,000 less than the $30,000 paid in year two, the same kind of computation is made—subtract $10,000 from year two, leaving $20,000, and recapture the excess of that $20,000 over the $10,000 for year three, making a $10,000 recapture, treated as described above. But even after recapturing $10,000 from year one because of the decrease from year one ($50,000) to year two ($30,000), the unrecaptured amount for year one ($40,000) is more than $10,000 greater than the amount for year three ($10,000), so an additional amount must be recaptured for the fluctuation between year one and year three. The manner in which this amount is computed is the same as before—subtract $10,000 from the payments for year one which have not already been recaptured, leaving $30,000 ($40,000 minus $10,000), and subtract the payments during year three from that amount, leaving $20,000 to be recaptured.

Mercifully, there would be no further recapture on these facts. The net effect is that the payor will pay $120,000 over the five-year period, but will be allowed total deductions of only $80,000. The payee will receive $120,000, but will have an aggregate net increase in income of only $80,000. The amount of recapture will approximate the excess of the large payments over the average of the payments for the entire six years. In this case, the average of the six years was $20,000 ($120,000/6); the payments for year one were $30,000 greater than that average, and the payments for year two were $10,000 greater, making a total of $40,000 in excessive amount. This $40,000 is the total that was recaptured in years two and three. The numbers probably will not be that tidy in most cases.

69. Tax Reform Act of 1986, Pub. L. No. 99-514, § 1843(c)(2), 100 Stat. 2085, 2854-55.

70. *Id.*

six years to three.[71] The effective date rules of the 1984 Act, like those of the 1986 Act, provided that pre-1985 instruments could be brought within the new rules if they were modified after 1984 and if the instrument provided that the new rules ($10,000 decrease recapture) would apply. Generally, the retroactive amendment changing the recapture period from six years to three years will not affect tax returns already filed under instruments executed after December 31, 1984, because the third year under such instruments cannot be earlier than 1987.[72] But if the parties had a pre-1985 instrument which was amended during 1985 or 1986, and in which the parties elected to come under the original 1984 Act rules, a readjustment of already reported tax liability could be required.

For example, if payments under a 1982 divorce agreement were modified in 1985, and the modified instrument provided that the original 1984 Act rules would apply, recapture might have been reported for 1985, and might have been due for 1986 under the original 1984 Act provisions. If payments under the original 1982 instrument began in 1982, the retroactive 1986 Act amendment would eliminate recapture for 1985 and 1986, because the six year period for possible recapture under the original 1984 Act rules has been shortened to three years (and thus would end in this case in 1984—a year for which there could be no recapture under these rules).

The change also creates at least two, and in some cases three, options for tax planning. First, a 1985 or 1986 divorce instrument can be modified after December 31, 1986, to use the new $15,000 decrease recapture rules or can be left alone and subjected to the $10,000 recapture rules (but only for the shorter three year period). Second, a pre-1985 instrument can be treated in one of three ways: (1) it can be modified during the last few months of 1986 to fall

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71. *Id.* at § 1843(c)(3), 100 Stat. 2085, 2855 (codified at I.R.C. § 71(f)(2) (1987)). Section 1843(c)(3) of the Act reads:

> TRANSITIONAL RULE. — In the case of any instrument to which the amendment made by paragraph (1) does not apply, paragraph (2) of section 71(f) of the Internal Revenue Code of 1954 (as in effect on the day before the date of the enactment of this Act) shall apply only with respect to the first 3 post-separation years.

Paragraph (1) of section 1843(c) in the 1986 Act substitutes a new subsection (f) in section 71 of the Code for that enacted by the 1984 Act. This new subsection (f) contains the three year $15,000 decrease recapture rules, which contain paragraph (2) referred to in the Transitional Rule. Old section 71(f)(2) contained the basic computational rule for recapture when payments decrease more than $10,000 from one year of payments to a succeeding year of payments.

72. Planning, of course, could be severely disrupted.

under the $10,000 decrease recapture rules; (2) it can be modified after December 31, 1986 to come under the new $15,000 decrease recapture rules; or (3) it can be left alone to be subject to old section 71(c).

Section 1843(c) of the 1986 Act appears to contain a serious technical error. As previously discussed, section 1843(c) retroactively amends section 71(f)(2) to provide that recapture, for instruments executed in 1985 and 1986 (and those altered during those years if the parties choose to have the 1984 Act rules apply), will occur only during the first three years of payments, rather than during the first six years under the original rule of the 1984 Act.[73] However, the 1986 Act retroactively amends only the computational portion of the 1984 rules. It does not change the basic statement in the 1984 provision of section 71(f)(1) that annual payments of more than $10,000 per year can be alimony only if the instrument provides that payments must be made in each of the six years beginning with the first year of payments.[74] Thus, section 1843(c) creates a significant anomaly on its face. According to the language of section 1843(c), instruments executed in 1985 and 1986 would still be governed by the 1984 provision of section 71(f)(1) and thus, to qualify as alimony, payments made pursuant to these agreements must be made in each of the six post-separation years. But, section 1843(c) imposes recapture only with respect to the payments made for the first three years. If Congress thought that only the first three years were important enough to impose a recapture rule, it is hard to understand why the provisions of the Code were amended in a way which left the six years of payments requirement intact. In all likelihood, this is a drafting oversight.

3. *Planning*

Obviously, when a set of mechanical rules is incorporated into a tax provision, planning is possible, indeed necessary. Two possibilities which immediately come to mind are the need for spreading payments evenly over a number of years in order to avoid recapture, if that is desired, and in situations in which the parties remain friendly, the possibility for the payor to shift income from one year to another through excessive payments in an earlier year

73. *See supra* notes 61-65, 71 and accompanying text.

74. *Compare* Tax Reform Act of 1984, Pub. L. No. 98-369, § 422(a), 98 Stat. 494, 796-97 *with* Tax Reform Act of 1986, Pub. L. No. 99-514, § 1843(c), 100 Stat. 2085, 2854-55.

(at the cost of increased income tax to the payee for the earlier year).

It should be noted that excess payments apparently need not be made pursuant to the terms of the agreement or decree—the rules apply to the amounts actually paid. The rules also contain an exception for cases in which the amount of the payments in a year is beyond the control of the payor, because these payments are based on a percentage of the income from a business or self-employment.[75] Other exceptions are provided for situations in which payments decrease for a year because of the death or remarriage of the payee[76] and when payments are made pursuant to legal authority other than a divorce or separation agreement (for example, an annulment).[77] Significantly, alimony treatment for payments is not allowed if the payor and payee are members of the same household.[78]

In addition to the exceptions and limitations outlined above, the parties can choose to exclude from alimony treatment payments which otherwise would qualify as alimony. This opportunity to exclude payments should permit some fine-tuning in appropriate cases.

4. Nagging Doubts

It is tempting to suppose that regardless of the intended purpose of payments, careful compliance with the time payment provisions of section 71(f) will insure payments are treated as alimony, if that is desired.[79] However, if there is strong evidence the parties intended to reach an agreement concerning the settlement of property rights, and only chose to *structure* the payments to look like alimony (or at least look like what section 71(f) treats as alimony), it is possible that the Internal Revenue Service or the courts would treat the payments in accord with the parties' original intent and classify the payments as a property settlement, rather than alimony.[80] The cautious tax advisor should keep this possibility in

75. I.R.C. § 71(f)(5)(C) (1987).
76. I.R.C. § 71(f)(5)(A) (1987).
77. I.R.C. § 71(f)(5)(B) (1987).
78. I.R.C. § 71(b)(1)(C) (1987).
79. If alimony treatment is *not* desired, the parties need merely say so. I.R.C. § 71(b)(1)(B) (1987).
80. *See* Bernatschke v. United States, 364 F.2d 400 (Ct. Cl. 1966). It is clear that the Internal Revenue Service and the courts are not bound by the labels placed on payments. Bardwell v. Commissioner, 318 F.2d 786 (10th Cir. 1963); Ryker v. Commissioner, 33 T.C. 924 (1960); Rev. Rul. 58-192, 1958-1 C.B. 34.

mind.

II. CHILD SUPPORT

A. *Generally*

Payments for child support are neither deductible by the payor, nor income to the payee.[81] From the point of view of the payor, this means that payments classified as child support are more expensive than those treated as alimony, while from the point of view of the payee, such nontaxable child support payments are worth more. Thus, the primary function of the rules in this area is to differentiate between alimony and child support. As noted previously, before the 1984 legislation, courts required that parties specifically identify which portion of support payments were to be allocated for child support.[82] Less specificity is required after the 1984 Act. When the payor makes support payments in an amount less than the total required under the terms of the instrument, however, the Code still treats the first dollars received by the payee spouse as child support to the extent of the amount so provided.[83]

B. *Dependency Exemptions*

The prior law on dependency exemptions caused considerable controversy between spouses and the Internal Revenue Service because, in part, the determination of the person eligible to claim the children as dependents was made with reference to the amount each spouse expended for care of the children.[84] The general starting point in regard to this issue was, and under section 151(c)(1) continues to be,[85] a presumption that the custodial spouse was entitled to claim children as dependents.

Prior law provided that if the noncustodial spouse paid more than $600 per year per child for support, and the custodial spouse agreed, the noncustodial spouse could claim the child as a dependent.[86] Even when the custodial spouse did not consent, if the noncustodial spouse furnished $1,200 for the support of a child during the year, and if that was more than one-half of the total amount

81. I.R.C. § 71(c)(1) (1987).
82. *See supra* notes 43-49 and accompanying text.
83. I.R.C. § 71(c)(3) (1987).
84. Internal Revenue Code of 1954, Pub. L. No. 83-591, § 152(c), 68A Stat 3, 44.
85. I.R.C. § 151(c)(1) (1987).
86. Internal Revenue Code of 1954, amended by, Pub. L. No. 90-78, 81 Stat. 191-92 (1967) (previously codified at 152(e)(2)(A)(i), (ii)).

expended for the child's support, the noncustodial spouse could claim the child as a dependent.[87]

These rules were eliminated in the 1984 Act.[88] Under the new rules, the custodial spouse can claim the children as dependents unless there is an agreement to the contrary.[89] If there is an agreement allowing the noncustodial spouse to claim the children as dependents, then the noncustodial spouse must file a copy of that agreement with his or her tax return.[90]

Often overlooked, until it was too late, were various collateral provisions that applied in unforeseen ways if dependency exemptions were shifted. Most, if not all, of these anomalies were eliminated by the 1984 Act. For example, the earned income[91] and child care credit[92] provisions were amended by the 1984 Act to allow the credit as though the custodial spouse were allowed to claim the children as dependents, even though there is an agreement to shift the dependency exemptions. In an unusually generous move, Congress also provided that *both* parents can deduct medical expenses for care of the child (but, of course, they both cannot deduct the same dollars).[93]

III. Property Settlements

A. *Generally*

Property settlements generally are not considered income to the payee and are not deductible by the payor. In situations in which property rather than money was transferred, gain or loss was recognized by the transferor spouse to the extent of the difference between the basis of the property transferred and its value at that time. This result, however, was changed in the 1984 Act. This section of the article addresses the possible gain and loss consequences of those transfers.

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87. Internal Revenue Code of 1954, amended by, Pub. L. No. 90-78, 81 Stat. 191-92 (1967) (previously codified at 152(e)(2)(B)(i), (ii)).

88. Tax Reform Act of 1984, Pub. L. No. 98-369, § 423(a), 98 Stat. 494, 799-80 (codified at I.R.C. § 152(e) (1987)).

89. I.R.C. § 152(e)(2)(A) (1987).

90. I.R.C. § 152(e)(2)(B) (1987).

91. Tax Reform Act of 1984, Pub. L. No. 98-369, § 423(c)(3), 98 Stat. 494, 801 (currently codified at I.R.C. § 32(c)(1) (1987)).

92. *Id.* at § 423(c)(4), 98 Stat. 494, 801 (currently codified at I.R.C. § 21(e)(5) (1987)).

93. *Id.* at § 423(b)(1), 98 Stat. 494, 800 (currently codified at I.R.C. § 213(d)(5) (1987)).

B. Gain or Loss

1. Prior Law

Before the 1984 Act, a property transfer from one spouse to another, pursuant to an instrument, was treated, under *United States v. Davis*,[94] as though there had been a sale. Thus, if the parties agreed to a property settlement under which one spouse transferred property worth $100,000 to the other, and if the property had a basis in the transferor's hands of $40,000, the transferor spouse would realize a $60,000 gain on the transfer. The compensation the transferor received for the property was deemed to be the transferee's release of marital rights. Under *Davis*, those marital rights were deemed to be worth the same as the property transferred for them. The transferee spouse, in such a case, did not realize any gain on the transfer of his or her marital rights and was deemed to be purchasing the property he or she received for a cost equal to the value of that property.[95]

Thus, under the former law, if the husband and wife agreed that as a property settlement the wife would transfer property with a basis of $100,000 and a fair market value of $300,000 to the husband, the wife would realize $200,000 gain on her transfer of the property to the husband, the husband would realize no gain upon his exchange of marital rights for the property, and the husband's basis in the property after the transfer would be $300,000. If the husband immediately sold the property for its $300,000 fair market value, he would realize no gain on the sale.

In the case of jointly held property, it was necessary to consider that both spouses already had an interest in the property, even though only one of them might have paid for it. For instance, if the husband paid $30,000 for a house and took title as a tenant by the entirety with his wife, and the house had appreciated in value to $80,000, and then the husband transferred his interest in the house as a divorce property settlement, he would realize a gain of $25,000. Under these facts, the husband transferred one-half the house to his wife when it was acquired and retained the other half for himself. He paid $30,000 for the house; therefore, his cost basis for the half of the house he retained was $15,000. In the property settlement, the husband transferred the retained half of the house to his wife. That retained half was worth $40,000 (half the total

94. 370 U.S. 65 (1962).
95. *See* Farid-Es-Sultaneh v. Commissioner, 160 F.2d 812 (2d Cir. 1947).

value of $80,000 for the whole house), therefore, the husband had a gain to the extent that the $40,000 value exceeded his $15,000 basis in the retained half. The wife's basis in the whole house after the transfer was $55,000. She acquired her first half as a gift when her husband purchased the property, and her basis in that half (under section 1015)[96] was the cost of her half to her husband, $15,000. She acquired her second half in the property settlement in exchange for the release of marital rights which were presumed worth the same as the property she received in exchange for them, $40,000. Therefore, her cost basis for the second half of the house was $40,000. When this amount was added to the existing basis for her first half of the house, she had a total basis of $55,000 for the house. Thus, if the wife sold the house for its presumed $80,000 fair market value, she would realize $25,000 of gain.

If one spouse received more than one-half of the total jointly held property, it was possible for divorcing couples to realize a gain on an unequal division of jointly held property. Under these circumstances, the separate property of the spouses was not taken into account. That is, even if the division was apparently equal, by counting the separate property as part of the pot, the division was not treated as equal for tax purposes if the jointly held property was not divided equally.[97]

2. *Current Law*

The 1984 and 1986 Acts extensively amended these tax rules concerning transfer of property between spouses. New section 1041 provides that no gain or loss is ever recognized on a transfer of property between spouses or former spouses (if related to the divorce), whether or not the transferee pays the transferor spouse.[98] Thus, the holding in *Davis* is no longer controlling. In order for a transfer to come within section 1041, the parties must be spouses at the time of the transfer or the transfer must be "incident" to a divorce.[99] The Code generally treats any transfer related to the cessation of marriage, and within one year after the effective date of the divorce, as "incident" to the divorce and, therefore, within section 1041.[100] The Treasury Department's temporary regulations

96. Internal Revenue Code of 1954, Pub. L. No. 83-591, § 1015, 68A Stat. 3, 298.
97. *See* Rev. Rul. 74-347, 1974-2 C.B. 26.
98. I.R.C. § 1041(a)(2) (1987).
99. I.R.C. § 1041(a) (1987).
100. I.R.C. § 1041(c)(1) (1987).

provide the negative side, that transfers more than six years after cessation of marriage are presumed not to be "incident" to the divorce.[101]

The 1986 Act added a "conforming amendment" to section 267,[102] which generally provides that the loss disallowance rules of section 267 for transactions between related persons shall not apply if a transfer is covered by section 1041.[103] Since section 1041 already expressly provided that losses as well as gains were not recognized in transfers between spouses, the likely purpose of new section 267(g) is to preclude the application of section 267(d).[104] For example, if a wife sold her husband property with a basis of $4,000 and a fair market value of $1,000, under section 1041(a), the wife would recognize no loss, and under section 1041(b), the husband would take, wife's basis in the property, $4,000, as his own. If section 267(d) were considered applicable, in addition to section 1041, when the husband sold the property for $6,000, his gain of $2,000 ($6,000 selling price less $4,000 basis) arguably would be excluded under section 267(d) because of the $3,000 loss disallowed to his wife on her transfer to him. The 1986 amendment appears to preclude this result, so that the husband would report a gain of $2,000.[105]

C. *Basis*

The *Davis* case essentially held that a transfer of property in connection with a divorce was a sale.[106] Thus, if the transferor purchased property for $40,000 and transferred it in a property settlement when it was worth $100,000, the transferor would realize a gain of $60,000. The transferee would then have a basis for the property equal to its fair market value, $100,000 in this example, so the transferee would realize no gain if the property were sold for $100,000. Under new section 1041, such a transfer is generally

101. Temp. Treas. Regs. § 1.1041-1T(b) (A-7) (1984).

102. Tax Reform Act of 1986, Pub. L. No. 99-514, § 1842(a), 100 Stat. 2085, 2852 (codified at I.R.C. § 267(g) (1987)).

103. I.R.C. § 267(g) (1987).

104. *Compare* I.R.C. § 267(g) (1987) *with* I.R.C. § 267(d) (1987).

105. The most likely reason for this provision seems to be a technical one: section 267(d) assumes that the transferee will take a cost basis in the property purchased from a relative. Because this is not the case with transfers between spouses, to exclude as much gain as the loss not allowed would be to give the transferee spouse a double benefit, the benefit of the transferor spouse's higher basis and an exclusion of the difference between that higher basis and the selling price.

106. 370 U.S. 65 (1962).

treated as a gift, and the transferor realizes no gain or loss.[107] The transferee, under the new rules, takes the transferor's basis in the property.[108]

Section 1041(b) contains a special provision for determining the basis of property received by one spouse from another and does not use Code section 1015[109]—the basis rules usually used for gifts. Under the new rule, the transferee spouse simply takes the adjusted basis of the transferor spouse. Under section 1015, a donee's basis generally is the same as the donor's basis, but for purposes of determining loss, the donee's basis is the fair market value of the property at the time of the gift, if that is less than the transferor's basis. For example, if a parent purchases property for $10,000 and gives it to his child when the property is worth $5,000, and if the child sells it for $5,000 or less, the child's loss is determined using a basis of $5,000. If the child sells it for more than $10,000, the basis is $10,000. If the child sells the property for more than $5,000 and less than $10,000, there is no gain or loss because of a technical anomaly. These reduced basis rules, which are applied for purposes of determining a loss when property is transferred as a gift, do not apply under the new rules for transfers between spouses, however. Thus, it is possible to pass losses between spouses and put the losses where they will provide the greatest tax benefit.

IV. Head of Household Filing Status

Section 1 of the Code provides different tax rates for taxpayers with differing personal situations.[110] For individuals, the tax rates, in order of increasing assessment, are: (1) married filing jointly;[111] (2) head of household;[112] (3) single individual;[113] and (4) married filing separately.[114] A taxpayer qualifies for the preferential "head of household" rates under section 2(b) if a household for a dependent child is maintained for at least half the year, the taxpayer is not married, and the taxpayer pays more than half the cost of maintaining the household.[115] Under section 2(c), a taxpayer is not

107. I.R.C. § 1041(b) (1987).
108. *Id.*
109. I.R.C. § 1015 (1987).
110. I.R.C. § 1 (1987).
111. I.R.C. § 1(a) (1987).
112. I.R.C. § 1(b) (1987).
113. I.R.C. § 1(c) (1987).
114. I.R.C. § 1(d) (1987).
115. I.R.C. § 2(b) (1987). A child is considered a dependent for this purpose even though the taxpayer has agreed, under section 152(e), to permit the noncustodial par-

considered married for purposes of the head of household tax category, despite the existence of a marital relationship, if, in addition to the requirements set forth in the preceding sentence, the other spouse does not live with the taxpayer during the last six months of the year, there is no court decree of separation, and a separate return is filed.[116]

V. The Innocent Spouse Rules

A. Generally

Since the Tax Reform Act of 1969, the tax law has contained a special provision, section 6013(e), to mitigate the liability of an "innocent" spouse who merely signs a joint return in ignorance of its contents and later finds that the return contained material misrepresentations.[117] This provision was quite limited before the 1984 Act, however, and did not protect the innocent spouse in many unfortunate situations. The 1984 Act substantially expanded the protection for innocent spouses and in many cases made it easier to obtain this protection. The new rules apply to all open taxable years under the 1954 and 1939 Codes, but a year closed under the statute of limitations may not be opened to take advantage of the relief made available by these changes.[118]

Probably the most significant change made by the 1984 Act was to include overstatements of deductions, credits, and the basis of property, as errors made by the noninnocent spouse which can invoke relief.[119] Before the 1984 Act, errors which invoked relief were limited to those concerning an omission of gross income. The availability of relief for overstatements of deductions, credits, and basis, however, is severely limited because it can be claimed only if the item is large in comparison to the innocent spouse's income.[120]

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ent to claim the child as a dependent. I.R.C. § 2(b)(1)(A)(i) (1987).

116. I.R.C. § 2(c) (1987). Section 2(c) incorporates the definition of "married" contained in section 7703. I.R.C. § 7703 (1987) (this definition was contained in section 143(b) before the Tax Reform Act of 1986).

117. I.R.C. § 6013(e) (1987).

118. Tax Reform Act of 1984, Pub. L. No. 98-369, § 424(a), 98 Stat. 494, 801-02 (codified at I.R.C. § 6013(e) (1987)).

119. I.R.C. § 6013(e)(2) (1987).

120. I.R.C. § 6013(e)(4) (1987).

B. Omissions of Gross Income

An omission of gross income can provide a basis for relief if the income item was "attributable" to the noninnocent spouse, and if the tax liability for the year was reduced at least $500 as a result of the omission.[121]

C. False Claims of Deductions, Credits, and Basis

Newly added provisions in the Act concerning false claims of deductions, credits, and basis are severely limited in the relief available to innocent spouses. As with omissions of gross income, the false claim must be substantial with reference to the tax liability for the year in which it was claimed, that is, it must have reduced tax liability for that year by at least $500.[122] Additionally, the item must be substantial in relation to the income of the innocent spouse at the time the Internal Revenue Service attempts to collect a deficiency.[123] When determining whether relief can be granted under the innocent spouse rules, the starting point is establishing the measuring year that will be used to decide whether the tax error is "substantial" for purposes of the tax Act. This is called the "preadjustment year," and is defined as the innocent spouse's last full tax year which ended before the Internal Revenue Service mailed a notice of deficiency regarding the tax liability for the year of the false claim.[124] For example, if the false claim was made for taxable year 1984, and the Internal Revenue Service did not mail a notice of deficiency contesting that item until June 1987, the measuring year of the innocent spouse would be 1986.

If the innocent spouse's adjusted gross income for the measuring year is $20,000 or less, relief is available only if the false claim reduced the tax liability in that year by more than ten percent of the adjusted gross income.[125] Alternatively, if the innocent spouse's adjusted gross income for the measuring year is more than $20,000, then relief is not available unless the false claim reduces tax liability by more than twenty-five percent of adjusted gross income for the measuring year.[126] For example, assume that the measuring year is determined to be 1987. If the innocent spouse's adjusted

121. I.R.C. § 6013(e)(3) (1987).
122. *Id.*
123. I.R.C. § 6013(e)(4) (1987).
124. I.R.C. § 6013(e)(4)(C) (1987).
125. I.R.C. § 6013(e)(4)(A) (1987).
126. I.R.C. § 6013(e)(4)(A), (B) (1987).

gross income for 1987 was $10,000, relief would be available only if the false claim reduced tax liability for 1984 by at least $1,000. If the innocent spouse's income for 1987 were $40,000, relief would be available only if the item reduced 1984 tax liability by at least $10,000. The amount of the innocent spouse's income for 1984 (and the amount of the noninnocent spouse's income for 1984 or any other year) would be irrelevant for purposes of the measuring year.

If, at the close of the measuring year, the innocent spouse is married to a different spouse than the one with whom a joint return was filed for the year of the false claim, the income of the new spouse is included in determining the adjusted gross income of the measuring year under the above described test.[127] For example, assuming the same facts as stated above, if the new spouse's adjusted gross income for 1987 were $30,000, then the income of the measuring year would be treated as $70,000 ($40,000 income of the innocent spouse plus $30,000 of the new spouse) for purposes of the test. The test figure would be twenty-five percent, and the false claim must have reduced the tax $17,500 (twenty-five percent of $70,000) for 1984 in order for relief to be available. The new spouse's income is counted, even if the innocent spouse and the new spouse do not file a joint return for the measuring year.

It should be stressed that these "unique" rules apply only to tax reductions which resulted from false claims of deductions, credits, or basis—the only substantiality test which must be met for omissions of gross income is the $500 tax reduction test.[128]

D. Absence of Knowledge by Innocent Spouse

Importantly, in order to obtain relief, the innocent spouse must show that he or she did not know, or have reason to know, that tax was understated because income was omitted or a false claim was made.[129]

E. Inequitability of Holding Innocent Spouse Liable

In addition to the objective requirements for relief, section 6013(e)(1)(D) requires that it be "inequitable" to hold the innocent spouse liable for the increased tax resulting from correction of the error. What circumstances will be considered "inequitable" have yet to be judicially determined and thus, the scope of relief is

127. I.R.C. § 6013(e)(4)(D) (1987).
128. I.R.C. § 6013(e)(3) (1987).
129. I.R.C. § 6013(e)(1)(C) (1987).

uncertain.

Conclusion

Since the Revenue Act of 1942 made alimony deductible by the payor spouse and includable as income of the payee spouse, significant adjustments to the general rule have been made in subsequent Code revisions. The Revenue Acts of 1984 and 1986 are illustrative of such change.

The changes in alimony characterization have affected other areas incident to divorce. These areas include child support, property settlement, tax treatment of a single parent, and rules concerning an innocent spouse's liability for joint deficient tax returns.

A wise tax lawyer should be cognizant not only of the changes, but also of the fact that decisions by the Internal Revenue Service and by the courts interpreting these changes are sparse. As a result, when possible, the careful attorney should comply with pre-1984 tax law and add the subsequent modifications.