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The Tax Consequences of Divorce

The Tax Reform Act of 1984 and the Retirement Equity Act of 1984

By Jon A. Booker, John C. Gardner and Virginia M. Moore

Prior to 1942 the tax laws offered no special treatment for alimony or separate maintenance payments. Such payments were not considered taxable to the payee spouse and were not deductible by the payor spouse. With substantial increases in the tax rates it became evident that the payor spouse would be placed in a very difficult economic position if relief were not granted. The Revenue Act of 1942 modified the general provisions applicable to alimony and separate maintenance payments to make them taxable to the payee and potentially deductible by the payor. Subsequent to 1942, the Internal Revenue Code developed a set of definite rules relating to the tax status of alimony and separate maintenance payments.[1]

Alimony and Separate Maintenance — Background

Between 1942 and January 1, 1985, for a payment to be considered deductible by the payor and taxable by the payee spouse it must be imposed by a divorce decree, separate maintenance agreement or written separation agreement and be periodic in nature. To be considered periodic the payments must be indefinite in amount or paid for an indefinite period of time or made over a period of more than ten years to discharge a "principal sum." In addition, a contingency such as death, remarriage or change in the economic status of either spouse would qualify the payments as periodic. In those cases where the payments were to be made for a period of time less than ten years and were not subject to a contingency, they were not considered to be alimony or separate maintenance and were nontaxable to the payee and nondeductible by the payor.[2]

Under the ten-year provision any part of the alimony in excess of ten percent of the principal sum was neither taxable to the payee nor deductible by the payor. The ten percent rule may not apply if there are contingencies specified on the divorce decree or agreement.[3]

Several special problems arose as a result of rules developed between 1942 and January 1, 1985. First, if a payor spouse made an initial lump sum payment, it was generally held to be nondeductible as alimony. If this same initial lump sum payment was subject to a contingency (and not payable immediately after the divorce), it might be considered alimony and therefore deductible by the payor spouse.[4] There was some question about the status of payments made by the payor spouse to a third party for the benefit of the payee spouse. For example, the deductibility of premiums on whole life insurance policies was permitted only if the payor spouse was not the owner of the policy and the obligation to make the payments resulted from a divorce decree or similar document. A payor spouse was entitled to deduct mortgage principal, interest, and taxes on a former residence if the title to the residence had been transferred to the payee spouse. These, and other similar payments, must have met the conditions previously outlined before they were considered to be alimony for tax purposes.[5]

Alimony and Separate Maintenance — Current Provisions

The provisions of the Tax Reform Act of 1984 for alimony and separate maintenance payments, as described in Code Section 71, are outlined in the Flowchart.[6] Block 1 indicates that for a payment to qualify as alimony and separate maintenance it must be in the form of cash and be received by, or on behalf of the payee, under the terms of a divorce or separate maintenance agreement. If the payment is not in the form of cash or is not received by or on behalf of the payee, the amount will not qualify as alimony and cannot be deducted by the payor.

Block 2 indicates that the payment must terminate no later than the death of the recipient. Payments that extend beyond the death of the payee are not considered alimony or separate maintenance. The divorce or written separation agreement must specifically provide that there is no liability to continue any payments beyond the death of the payee spouse nor liability to make a substitute cash or property settlement instead of the alimony of the deceased spouse. Payments made from the proceeds of insurance on the life of the payee are not considered alimony.

As shown in Block 3 of the flow chart, any payments in excess of $10,000 per year are to be made for at least six calendar years following the first payment required by the divorce agreement (six-year alimony rule). Payments that end due to the death or remarriage of the payee are not considered a violation of the six-year requirement (Block 4).[7]

For the payments to qualify as alimony or separate maintenance, the payee and payor must not file a joint tax return for the tax year being considered (Block 5). In addition, payments between parties legally separated under a divorce agreement cannot qualify as alimony or separate maintenance if they live in the same household (Block 6). However payments will qualify as alimony if one party is making arrangements to leave the household shortly (Block 10).

Under the revised provisions of the law there can be "recapture" of amounts previously treated as alimony if the payments in years 2-6 are $10,000 less than the payment made the previous year(s) (Block 7). The amount "recaptured" is included in the gross income of the payor and is deductible by the payee. For there to be any "recapture" amount, the current year's payment plus $10,000 must be compared to the payment made in the previous year. If the first year's payment is greater than the second year's payment plus $10,000, the recapture amount is equal to the difference between the two values. The recapture provisions do not apply to payments made under a temporary alimony agreement, or in years when the payee dies or remarries. In addition, recapture will not apply when there is liability to make a payment based on a set portion of one's income. The "six-year" alimony rule applies to these payments.

Generally, payments made for child support are not included in the gross income of the payee and are not deductible by the payor (Block 8). A new provision of the Act specifies that payment amounts that vary depending upon a contingency relating to the child shall be treated as child support, even though the written agreement does not specify an amount as child support. For example, if the total payment is reduced when the child reaches a given age, the amount of the reduction is treated as child support.

One of the most interesting changes in the Act deals with the election to treat qualifying alimony payments as non-alimony payments. Parties to the divorce or separation agreement can agree in writing to amounts that will not be included in the gross income of the payee and not deductible by the payor (Block 9). While this type of agreement is binding for tax purposes, there is nothing that prevents the agreement from being changed through amendment. This opens some avenues for tax planning that should not be overlooked.

The new alimony provisions are generally effective for tax years beginning after December 31, 1984. Additionally, prior divorce or separate maintenance agreements may be revised, if both parties agree, in order to be in compliance with the new tax rules. The Internal Revenue Service may also require payors and payees to furnish taxpayer identification numbers.

Property Transfers Between Spouses

Prior to the Tax Reform Act of 1984, property transfers between spouses, even transfers made in exchange for release of marital rights, resulted in taxable gain. Losses on transfers between spouses were disallowed. Gains were not generally recognized when the transfer was the result of a division of community or jointly held property incident to a divorce.[8]

One of the most interesting changes in the Act deals with the election to treat qualifying alimony payments as non-alimony payments.

Several states attempted to avoid these rules by statutory recognition of some form of marital rights in assets owned by spouses individually. These state statutes attempted to equate the transfer of an individual spouse's property with a division of community or jointly held property. Litigation arose out of these statutes and the required tax treatment was fraught with problems.[9]

The Tax Reform Act of 1984 overhauled the rules described above. The new law generally provides no recognition of gain or loss in transfers occurring after July 18, 1984, between spouses or former spouses incident to a divorce. The nonrecognition of gain applies to release of marital rights, as well as to transfers in exchange for cash, other property, or other forms of consideration. If the taxpayers agree, the new rules can be applicable to transfers made after December 31, 1983, even if these transfers resulted from property settlements or divorce decrees which were in effect before January 1, 1984. The new rule applies even to spousal transfers made during a marriage, unless the spouse is a nonresident alien. Transfer rules apply only to transfers to a former spouse if "incident to a divorce," which means that the transfer takes place within one year of the cessation of the marriage or that the transfer is related to the cessation of the marriage.[10]

The basis of the transferred property will carry over to the transferred spouse and be the same as the basis to the transferor. For example, if Mary purchases a farm for $100,000, and in the marital property settlement which is incident to the divorce, Bob receives the farm for the equivalent of $150,000, Mary is subject to no gain and Bob's basis for tax purposes is $100,000. The length of time Mary owned the property will be added to Bob's holding period to determine the appropriate holding period upon ultimate sale of the property.[11]

Transfer of an installment debt to a spouse before the Tax Reform Act of 1984 meant that the transferor must recognize the balance of the profit or loss from the note. According to the provision of the new law, the transfer will not impose the recognition of gain or loss to the transferor. The transferor will receive the same tax treatment as the transferee.[12]

Prior to the Tax Reform Act of 1984, any gain resulting from the sale of depreciable property by one spouse to the other was taxed as ordinary income rather than qualifying for the more favorable capital gains treatment. This rule is no longer appropriate because the new law does not require the recognition of taxable gain.[13]

Investment credit recapture provisions were automatically applicable to transfers between spouses before the Tax Reform Act of 1984. The law now specifies that no investment credit or depreciation will be recaptured if the property was used in a trade or business prior to the transfer and continues to be used in a trade or business after the transfer.[14]

Life Insurance and Annuity Contracts

The tax treatment of annuity or life insurance contracts transferred to meet alimony obligations has been changed under the new law. Prior law required that the recipient spouse include in gross income all payments received under annuity or life insurance contracts.[15]

Effective with transfers after July 18, 1984 (or post December 31, 1983 transfers), the recipient may reduce taxable income by the transferor's investment in an annuity contract, and may exclude from gross income the life insurance proceeds received upon the death of the former spouse.[16]

IRA For Divorced Individuals

Effective January 1, 1985, a divorced or legally separated individual may establish an IRA based on alimony payments received. Alimony is defined as compensation even though the payee has no other earned income. Before this revision, alimony was considered only in highly restricted situations.[17]

Dependency Exemption

Prior to January 1, 1985, the parent or step-parent having custody of a child for the major portion of the year was entitled to claim the dependent exemption for the child. This general rule applies unless the divorce decree awarded exemption to the noncustodial parent who provided a minimum of $600 support during the calendar year, or unless the noncustodial parent provided $1,200 support and the custodial parent was unable to prove a greater support provision.[18]

The Tax Reform Act of 1984 alters these prior tax provisions by enabling the custodial parent to claim the dependency exemption unless this right is waived. However, if the exemption was granted to the noncustodial parent under a divorce agreement executed before January 1, 1985, the agreement will prevail providing that the $600 minimum support provision is met and no amendment is made to the original agreement. These new rules are applicable only when more than half of the child's support is provided by his or her parents and the child is in the custody of the child's parents for more than half of the year. The new rules discussed above are not applicable when multiple support agreements are in effect. The custodial parent can release the dependency exemption to the noncustodial parent by signing a written statement that he or she will not claim the child as a dependent for a specified year or on a permanent basis. This statement must be attached to the claimant's return.[19]

Medical Costs of Dependent Child

The new tax law alters the former rule that only the taxpayer claiming the dependent exemption was entitled to deduct medical expenses associated with a dependent child. Under the new provisions, beginning December 31, 1984, a parent may deduct medical costs incurred in connection with a child regardless of the status of the dependency exemption.[20]

Child Care Credit

If a child is under the age of 15, or is mentally or physically incapable of caring for himself or herself, a parent may claim a credit for certain expenses of the dependent. Under prior law the parent who had custody for the longer period during the year generally was allowed the credit. After December 31, 1984, a custodial parent may qualify for the child care credit even though he or she waived the dependency exemption for the child.[21]

Earned Income Credit

Under the new law, a custodial parent who qualifies as an abandoned spouse or head of household is entitled to claim the earned income credit. The custodial parent may claim this credit even though the noncustodial parent is entitled to claim the dependent exemption for the child. This is a change from the previous law which required the custodial parent to have the dependent exemption for eligibility for the earned income credit. This change is effective after December 31, 1984.[22]

Head of Household Status

Under the new rules, even if a parent is not entitled to claim the dependency exemption for a married child residing in his or her home, the parent will generally qualify as the head of household for tax purposes. The provision is applicable unless a waiver or pre-1985 divorce decree provides otherwise. Also the new law requires that the child's principal residence with the parent claiming head of household be for only one-half of the taxable year rather than the entire year.[23]

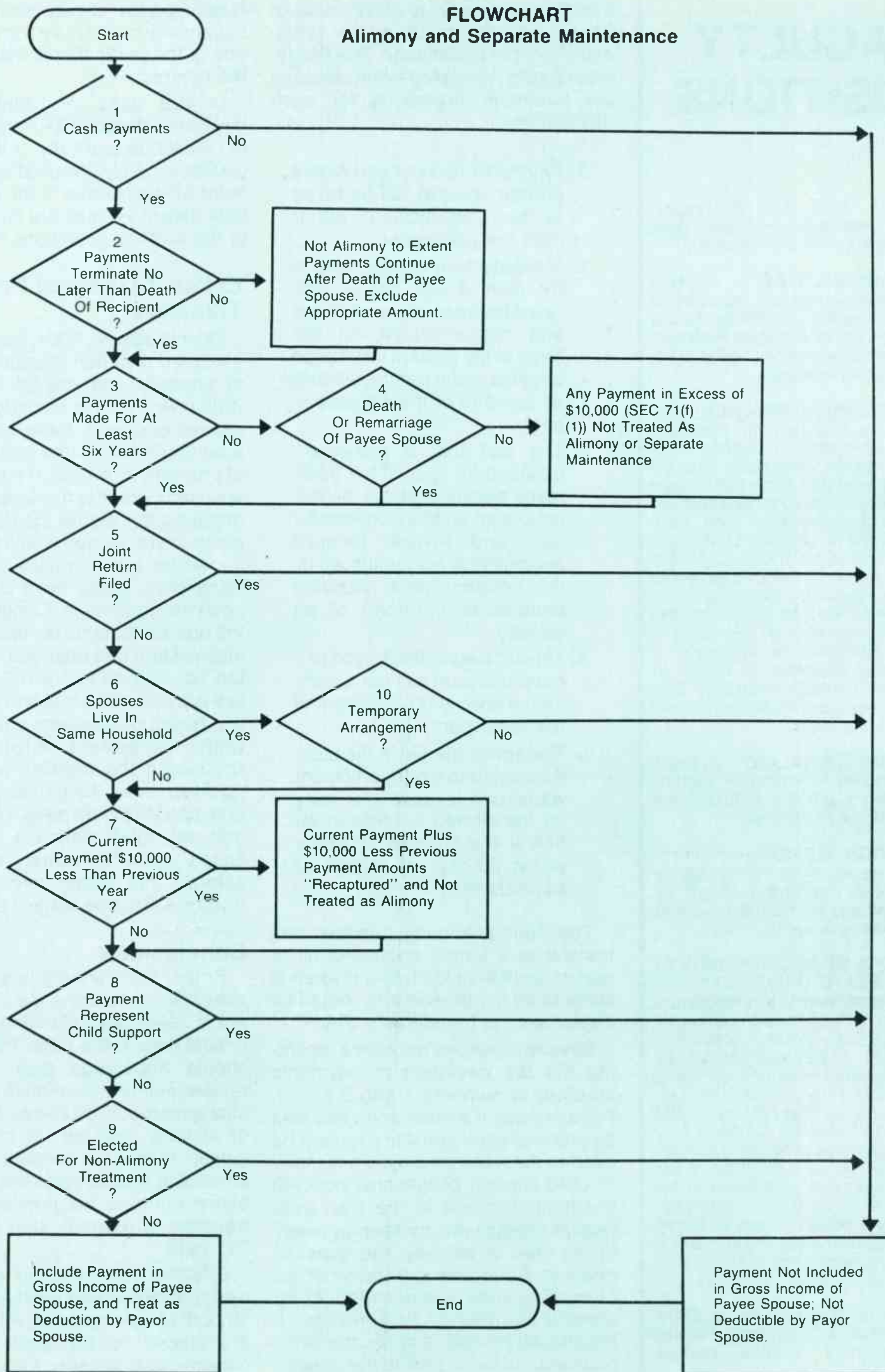
"Innocent Spouse" Rule

The new tax rules have provided additional relief for an innocent spouse filing a joint return in cases where there is a substantial understatement of tax (more than $500). In addition to relief from failure to report income, relief may now be granted when claims for deductions or credits for which there is no basis are erroneously made. Under prior tax law, no relief was available to an innocent spouse when the relief requested was for grossly erroneous deductions or claims for credit. The new law continues to require the innocent spouse to prove that he or she had no reason to know of a substantial understatement. It is effective for all open tax years under the 1939 and 1954 tax codes.[24]

Retirement Benefits

With few exceptions, the Employee Retirement Income Security Act (ERISA) and the Internal Revenue Code have required that any retirement plan covered by these statutes must specifically prohibit the assignment or alienation of the benefits provided by the plan and that ERISA provisions would supersede all state laws relevant to the retirement plan. This anti-assignment rule has been amended by the Retirement Equity Act of 1984, and the new provisions become effective January 1, 1985. In addition, the Internal Revenue Code was amended by the Retirement Equity Act of 1984, permitting transfer of retirement benefits when the transfer is made pursuant to a qualified state domestic relations order. State court orders assigning benefits under a retirement plan are now permitted. However, other assignments or transfers of benefits will violate the anti-assignment rule. Also, state courts may not order the transfer of assets held by a retirement plan unless the assets are available to the employee under the plan.[25]

As noted earlier, property transfers between parties to a divorce generally are not considered to be taxable. This rule should apply to transfers of interest in retirement plans resulting from a divorce proceeding. However,


FLOWCHART
Alimony and Separate Maintenance
Start
1 Cash Payments ?
No
Yes
2 Payments Terminate No Later Than Death Of Recipient ?
No
Not Alimony to Extent Payments Continue After Death of Payee Spouse. Exclude Appropriate Amount.
Yes
3 Payments Made For At Least Six Years ?
No
4 Death Or Remarriage Of Payee Spouse ?
No
Any Payment in Excess of $10,000 (SEC 71(f)(1)) Not Treated As Alimony or Separate Maintenance
Yes
Yes
5 Joint Return Filed ?
Yes
No
6 Spouses Live In Same Household ?
Yes
10 Temporary Arrangement ?
No
Yes
No
7 Current Payment $10,000 Less Than Previous Year ?
Yes
Current Payment Plus $10,000 Less Previous Payment Amounts "Recaptured" and Not Treated as Alimony
No
8 Payment Represent Child Support ?
Yes
No
9 Elected For Non-Alimony Treatment ?
Yes
No
Include Payment in Gross Income of Payee Spouse, and Treat as Deduction by Payor Spouse.
End
Payment Not Included in Gross Income of Payee Spouse; Not Deductible by Payor Spouse.

FACULTY POSITIONS

RANKS: Assistant Professor, Associate Professor, Professor, (also visiting appointments at all ranks)

RESPONSIBILITIES: Quality teaching and service are expected of faculty at all ranks; in addition, faculty holding the rank of Assistant Professor or above are expected to engage in ongoing scholarly research.

EDUCATION/EXPERIENCE: Appointment at the rank of Assistant, Associate, or Professor requires a Ph.D. or D.B.A. degree; candidates who will have completed all but the dissertation will also be considered for appointment at the Assistant Professor rank. Candidates having (1) both the LLM in taxation degree and the CPA or CMA certification, or (2) both the JD degree and a master's degree in accounting or taxation will be considered for appointment at a professorial rank. At the ranks of Associate Professor or Professor, a demonstrated performance record in teaching and research is required. Certification and professional experience at all ranks is desirable.

APPOINTMENTS/SALARY: Appointment will be for nine months, starting August, 1985 or January, 1986. Salaries are competitive at all ranks.

APPLICATION DETAILS: Applications will be accepted beginning immediately. Application deadline is March 15, 1985; if positions are not filled, application deadline is June 15, 1985.

THE SCHOOL OF ACCOUNTANCY AT WICHITA STATE UNIVERSITY: The School of Accountancy, a component of the College of Business Administration, replaced the Department of Accounting in May, 1981. The School offers an integrated five-year program leading to the degree of Master of Professional Accountancy, participates fully in the MBA program and continues to offer a four-year baccalaureate program in accounting. The School of Accountancy has over 500 majors and graduates over 100 professional accountants each year. Wichita State University has an enrollment of approximately 17,000, and is located in the largest economic, cultural and population center in Kansas.

CONTACT: Dr. Michael F. Foran, Director, School of Accountancy, Wichita State University, Wichita, Kansas 67208.

questions remain regarding the tax treatment applicable to distributions or benefit payment made by the retirement to a nonparticipant. The Retirement Equity Act provides the following tax treatment provisions for such distributions:

1. Payments to a nonparticipant (former spouse) will be taxed to the nonparticipant, rather than the participant;
2. Nondeductible contributions to the plan, if any, will be prorated between the participant and nonparticipant on the basis of the present value of all benefits of the participant and all benefits of the nonparticipant;
3. The fact that a participant qualified for special tax treatment because of his or her lump-sum distribution (capital gain and 10-year forward averaging) is not prejudiced by the nonparticipant receiving benefits in the form of an annuity;
4. The lump-sum distribution to a nonparticipant will not qualify for the special tax treatment of the participant;
5. The entire interest in the plan, if awarded to a nonparticipant within one taxable year, may be transferred tax-free to an IRA if the transfer is made within 60-days of receipt of payment.[26]

The Code previously provided that transfer to a former spouse of all or part of an IRA incident to a divorce is considered nontaxable and should be treated as the transferee's IRA.[27]

Several questions may arise regarding the tax treatment of payments received in numbers 1 and 2 above. For example, if a state court requires a portion of each pension payment be used to meet the employee's alimony or child support obligations, how will the nonparticipant in the plan treat receipt of payments for tax purposes? In the case of alimony, the question revolves around the application of two competing code sections (IRC 71 for alimony and IRC 72 for annuities). If the annuity provisions apply, the entire payment will be taxable to the nonparticipant former spouse. But if the alimony provisions apply, the nonparticipant will be entitled to reduce the taxable portion of each payment under the annuity contract by a prorated portion of the participant's investment in the contract.

In the case of child support payments, the code sections are again in conflict. Specifically, if the annuity provisions apply, the child support payment will be taxable to the nonparticipant parent in complete contradiction to the alimony provisions.[28]

Estate Taxes and Property Transfers

Prior to July 18, 1984, if spouses had executed a written document relating to property and marital rights, and within two years of such agreement a divorce occurred, there would be no federal gift tax on the actual transfer of property. However, if one of the ex-spouses died after the agreement was prepared but before the transfer took place, no deduction would be allowed for estate tax purposes against the decedent's estate for a claim based upon the agreement. Congress was of the opinion that this tax treatment was inconsistent and changed the rules in the Tax Reform Act of 1984. The new law provides for an estate tax deduction based on transfers arising from a written agreement between former spouses if the transfer would have qualified under the gift tax rules when both spouses were alive. The Act also provides that transfers of assets based upon a written agreement entered into within one year after divorce will not be subject to gift tax.[29]

Conclusions

Proper tax planning in a divorce is always important and the Tax Reform Act of 1984 makes planning even more critical than in the past. Tax advisors should encourage their clients to review their tax situation in light of the changes discussed above. In the case of alimony and certain other provisions, taxpayers should consider amending their divorce decree or applying the new tax provision to any transfers of property after December 31, 1983.

Effective tax planning requires a search for the lowest overall tax liability for both former spouses. All taxpayers are placed on the cash basis for alimony and all new rules must be followed to prevent recapture of income in future years. In addition, the

new law gives the former spouses flexibility in designating amounts that will be taxable as alimony.

Divorce negotiations should cover the tax status of a child. If the non-custodial parent is granted the dependency exemption, there will no longer be a loss to the custodial parent of benefits such as head of household status, the earned income credit, or child care credit. Moreover, the non-custodial parent will no longer have to maintain records of payments since the ony way that he or she can obtain the exemption is by agreement with the custodial parent.

Finally, the question of medical expense deductions will be important under the new law. Medical expenses may be deducted by either parent beginning January 1, 1985. Since these expenses must exceed five percent of adjusted gross income, payments for a particular year should be made by the parent whose total medical expenses will exceed the five percent and the Zero Bracket amount. Ω

NOTES

[1]Background information for this article is found in Mark A. Vogel, "Tax Problems of Divorce," 2 *Tax Law Journal* 61 (1983); additional information is in Mertens *Law of Federal Income Taxation;* all code sections will be referenced to the law prior to the Tax Reform Act of 1984 which is part of the Deficit Reduction Act of 1984. Code sections with the reference "as amended by" or "as added by" indicate new tax law changes.

[2]IRC 71(c) and IRC 215.

[3]IRC 71(c)(2).

[4]Rev Rule 73-392, 1973-2 CB. 18; Knowles v. U.S., 182 F. Supp 150 (D.C. Miss. 1960), aff'd per curiam 290 F.2d 584 (CA5, 1961); Reg 1.71-l(d)(3)(i)(a).

[5]*Mace v. Commissioner,* 64-2 USTC 9732 (D.C.Cal. 1964); *Isacson v. Commissioner,* 58 T.C. 659 (1972); Rev Rule 70-218, 1970-1 C.B.18; Rev Rule 62-106, 1962-2 C.B. 21. The law should be checked carefully for joint tenancies and tenancies in common. Rev Rule 67-420,1967-3 C.B. 63.

[6]IRC 71 as amended by §421.

[7]IRC 71 (f)(1).

[8]*U.S. v. Davis,* 370 U.S. 65; (1962).

[9]*The RIA Complete Analysis of the '84 Tax Reform Act.* (1984), p. 107. *Collins v. Commissioner,* 412 F. 2d 211 (CAIO, 1969); Kansas Stat. Ann. Sec 23-301; *Imel v. U.S.* 375 F. Supp. 1102 (D.C. Col, 1974).

[10]IRC 1041(a)(c) and (d) as added by '84 Act §421; H. Rept, p. 1492.

[11]IRC 1041(b) as added by '84 Act §421.

[12]IRC 453 B(g) as amended by '84 Act §421(b)(3).

[13]IRC 1239 as amended by '84 Act §421(b)(6).

[14]IRC 47(e) as amended by '84 Act §421(b)(7); IRC 1245 (b)(1) and 1250(d)(1).

[15]IRC 72(k) and IRC 101(e).

[16]IRC 72 as amended by '84 Act §421(b)(1); IRC 101 as amended by '84 Act §421(b)(2), §421(d)(2) and (d)(4).

[17]IRC 219(b) and (f)(1) as amended by '84 Act §529(b).

[18]IRC 152(e)(1), as amended by '84 Act.

[19]IRC 152(e)(1), (2), and (3), as amended by '84 Act §423(a).

[20]IRC 213 (d)(5) as amended by '84 Act §423(b)(1), §482(a), §423(b)(3).

[21]IRC 44A(f)(5) as amended by '84 Act §423(c)(4).

[22]IRC 43(c)(1)(A) as amended by '84 Act §423(c).

[23]IRC 2(b)(1)(a) as amended by '84 Act §421, §423(c)(2). See also IRC 143(b) as amended by '84 Act §423(c)(1).

[24]IRC6013(e) as amended by '84 Act §424(a).

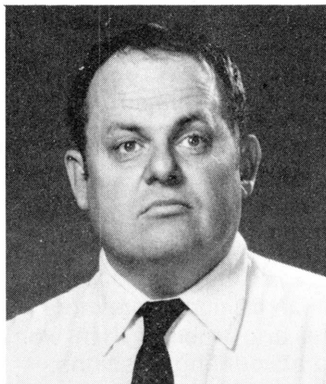
[25]*Explanation of Divorce Provisions, Tax Reform Act of 1984,* Commerce Clearing House, Inc. (1984), p. 17. (Hereinafter cited as *Explanation*); IRC 401(a)(3) and IRC 414 as amended by the Retirement Equity Act of 1984.

[26]*Explanation* at p. 18.

[27]IRC 408(d)(6).

[28]*Explanation,* pp. 25-26; IRC 71; IRC 72; IRC 401(a)(1), IRC 402(a)(1)

[29]IRC 2516; IRC 2516 as amended by '84 Act §425(b); IRC 2043(b) as amended by '84 Act §425(a).



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