TAX CONSIDERATIONS AFFECTING DIVORCE

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I. INTRODUCTION

In a rational separation or divorce (as opposed to a vindictive one), maximizing the net after tax value of business and non-business assets benefits both parties. Asset transfers and payments from one party to the other should be designed to leave as little for the tax collector as possible. The value and the viability of any jointly owned business may depend on structuring the property settlement so that the business has sufficient capital to continue to operate profitably and generate income sufficient to acquire the departing spouse's interest. This may require continued joint ownership of the business or replacement of immediate payment for the departing owner's interest with payments over time via some sort of loan or trust arrangement. The designation of payments as alimony (deductible to the payor and taxable as income to the payee) or non-alimony (not deductible to payor and not taxable to payee) should take likely tax liability of both payor and payee into account. The same is true of division of assets that will have differing tax liabilities when those assets are sold.

The paper first examines the tax rules associated with alimony and non-alimony payments from one party to the other. It continues by discussing tax rules associated with transfer of assets between separating or divorcing parties. It explains why after tax values of assets to be divided should be used to determine how they are divided rather than before tax values.[1] While most transfers are tax free, subsequent disposition of the assets has well defined tax liabilities. Transferring assets with low basis to the lower tax bracket spouse and adjusting the value of assets transferred to share the tax savings can make both parties better off. It continues by explaining how division of a business can be structured to minimize harm to its viability and income producing capacity. A poorly designed sale of one spouse's ownership interest in a business, whether jointly owned by agreement, by law in community property states, or subject to equitable distribution between

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[1] I.R.C. § 1041(a); Treas. Reg. § 1.1041-1T(a) (2003).

parties in common law jurisdictions can produce unintended adverse consequences for both parties by damaging earnings on which payments for the business interest, alimony, and child support depend.[2]

II. RULES CONCERNING ALIMONY PAYMENTS

A. *General Definition of Alimony*

Alimony is any separate maintenance payment made in cash or cash equivalent includible in the gross income of the spouse or former spouse recipient (*payee*) and deductible to the spouse or former spouse paying it (*payor*).[3] Subject to one exception, an alimony payment must be made pursuant to a court order in the form of a decree of divorce,[4] decree of separate maintenance,[5] a written instrument incident to a decree,[6] a written separation agreement,[7] or some other instrument requiring one spouse to make payments for the support or maintenance of the other spouse (collectively referred to as a *divorce or settlement agreement*).[8] A divorce or settlement agreement need not be legally enforceable.[9] It need not specify that it is a divorce or settlement agreement as long as its intent is clear.[10] What alimony should be paid is based on the payee's after-tax income, not before-tax income.[11] The payee must include alimony in income in the year constructively received; payor can deduct alimony only in the year paid, even if the two years are different.[12] Payments not required by a divorce or settlement agreement do not qualify as alimony.[13] An individual is treated as legally separated and may file as a single taxpayer if a decree of divorce or separate maintenance "expressly and affirmatively provides that the parties live apart in the future."[14] Such spouses are not treated as married for tax

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[2] CAL. FAM. CODE §§ 751, 760, 761 (2016) (Community property); 23 PA. STAT. AND CONS. STAT. ANN. § 3502 (2016) (Equitable division of marital property).
[3] I.R.C. §§ 71(a), (b), 61(a)(8), 215(a), (b) (2016).
[4] *Id.* at § 71(b)(2)(A).
[5] *Id.*
[6] *Id.* at § 71(b)(2)(C).
[7] *Id.* at § 71(b)(2)(B),
[8] *Id.* at §§ 71(b)(1), (2); Treas. Reg. §§ 1.71-1(b)(1)(i), (b)(2) (1960).
[9] Jaklin v. Comm'r., 79 T.C. 340 (1982); Friedland v. Comm'r, T.C.M. (CCH) 1192 (1982).
[10] *Jaklin*, 79 T.C. 340.
[11] Treas. Reg. § 1.71-1T(a), Q&A (2) (1984).
[12] Burkes v. Comm'r, T.C.M. (CCH) 1772 (1998).
[13] Taylor v. Comm'r, 55 T.C. 1134 (1971).
[14] Capodanno v. Comm'r, 69 T.C. 638, 647 (1978), *aff'd*, 602 F.2d 64 (3d Cir. 1979) (quoting Boettiger v. Comm'r, 31 T.C. 477 (1958), *acq*., 1959-1 C.B. 3).

purposes.[15] The decree must mandate separation.[16] A voluntary separation agreement does not constitute legal separation.[17]

The exception to the general rule is that a married taxpayer is treated as a single head of household for tax purposes without a decree of divorce or separate maintenance under the abandoned spouse rule if he or she files a separate return, maintains a separate household for more than half of the tax year that is the principal abode of a child for whom the taxpayer is entitled to a dependent deduction (or would be entitled to the deduction but for releasing it to the non-custodial parent[18]) furnishes over half of the cost of maintaining the household, including expenditure of alimony received,[19] and whose spouse or former spouse is not a member of the household during the last 6 months of the tax year.[20]

B. *Rules Governing Whether Payments Qualify as Alimony*

To be alimony, payments must meet seven requirements; 1) payments must be made in cash, check, or a money order payable on demand[21](For example, transfer of a contract to a former spouse in exchange for a deed is not alimony),[22] 2) payment must be received pursuant to a divorce or settlement agreement,[23] 3) payor and payee must live in separate households when the payment is made,[24] 4) payments to a third party on behalf of payee must be evidenced in writing,[25] 5) the alimony obligation may not continue beyond the death of the payee,[26] 6) payor and payee may not file a joint tax

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[15] I.R.C. § 7703(a)(2) (2016). *See also* I.R.C. §§ 2(b)(2)(A), 6013(d)(2) (2016).
[16] *Id.* at §7703(a)(2). *See also*, *e.g.*, Boyer v. Comm'r, 732 F.2d 191 (D.C. Cir. 1984), *rev'g* 79 T.C. 143 (1982); Dunn v. Comm'r, 70 T.C. 715 (1978); Boettiger v. Comm'r, 31 T.C. 477 (1958), *acq.*, 1959-1 C.B. 3.
[17] *See*, *e.g.*, Kellner v. Comm'r, 468 F.2d 627 (2d Cir. 1972), *aff'g per curiam* 30 T.C.M. (CCH) 448 (1971); Johnson v. Comm'r, 42 T.C.M. (CCH) 605 (1981).
[18] I.R.C. § 7703(b)(1) (2016).
[19] *Id.* at § 7703(b)(2).
[20] *Id*. at § 7703(b)(3); Treas. Reg. §1.7703-1(a) (1997). *See also* I.R.C. §§ 1(a), 2(c), 63, 6012(a)(1)(A)(i) (2016) (addressing treatment of taxpayers as single and married). Divorce at the end of a year and re-marriage early the next is treated as if the divorces never occurred, Boyter v. Comm'r, 74 T.C. 989 (1980); Boyter v. Comm'r, 668 F.2d 1382 (4th Cir. 1981).
[21] I.R.C. § 71(b)(1) (2016); Treas. Reg. § 1.71-1T(b) Q&A (5) (1984).
[22] Lofstrom v. Comm'r, 125 T.C. 271 (2005).
[23] I.R.C. § 71(b)(1)(A) (2016).
[24] *Id.*at § 71(b)(1)(C); Hopkins v. Comm'r, 63 T.C.M. (CCH) 3113(1992); Chiosie v. Comm'r, 79 T.C.M. (CCH) 1812 (2000).
[25] Treas. Reg. § 1.71-1T(b), Q&A (6), (7) (1984).
[26] I.R.C. § 71(b)(1)(D) (2016). To qualify as alimony, there can be no obligation to pay alimony, in the form of additional cash or other property after payor*'s* death. I.R.C. § 71(b)(1), Notice 87-9, 1987-1 C.B. 421; Cologne v. Comm'r, 77 T.C.M. (CCH) 1728 (1999); Hoover v. Comm'r, 69 T.C.M. (CCH) 2466 (1995), *aff'd*, 102 F.3d 842 (6th Cir. 1996).

return,[27] 7) the divorce or settlement agreement may not designate the payment as child support or non-alimony.[28] Payee's attorney fees paid by payor are alimony only if they are explicitly described as such in the divorce or settlement agreement.[29] An agreement to pay expenses arising in the future does not qualify as alimony.[30] The general rules are subject to qualifications and limitations.

The rule that payee and payor must not be members of the same household at the time alimony is paid is subject to a one month grace period.[31] In addition, a temporary support agreement or pre-separation order may be alimony when payor and payee are members of the same household.[32] A divorce decree such as one that requires taxpayer's ex-wife to pay taxpayer $69,000 for property equalization, and taxpayer to pay wife $69,000 in spousal support constitute offsetting obligations and is a cash payment of alimony.[33]

Payments payor is required by a divorce or settlement agreement to make to a third party on behalf of payee, such as mortgage principal and interest payments, taxes, insurance, repairs to rent, mortgage, tax, or tuition liabilities, and repairs to payee's owned residence are alimony,[34] even if made into a joint checking account.[35] Similarly, payments payor deposits in a joint checking account that the divorce or settlement agreement describes as for shelter, transportation or personal expenses of payee are alimony.[36] However, payments to maintain payor's property that is used by payee is not alimony.[37] The limitation on miscellaneous itemized deductions does not apply to alimony.[38]

When payor makes a payment for a joint obligation or jointly owned asset of payor and payee, payee receives alimony income and payor receives a deduction on one half of the payment; the other half is payment of payor's own debt.[39] Similarly, one-half of payor's mortgage payments on a mortgage on which both former spouses are liable is deductible alimony; the other half

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[27] I.R.C. § 71(e) (2016).
[28] *Id*. at § 71(b)(1)(B); Treas. Reg. § 1.71-1T(b), Q&A (8) (1984).
[29] Sa'd v. Comm'r, 104 T.C.M. (CCH) 784 (2012).
[30] Preston v. Comm'r, 77 T.C.M. (CCH) 1437 (1999); *aff'd* 209 F.3d 1281 (2000).
[31] I.R.C. § 71(b)(1)(C) (2016).
[32] Treas. Reg. § 1.1041-1T, Q&A (9) (2003).
[33] Medlin v. Comm'r, 76 T.C.M. (CCH) 707 (1998); Randall v. Comm'r. Summary Opinion 2010-163 (2010).
[34] Treas. Reg. § 1.71-1T(b), Q&A (6) (1984); I.R.S. Priv. Ltr. Rul. 87-10-089 (Dec. 11, 1986).
[35] I.R.C. § 71 (2016); Medlin v. Comm'r, 76 T.C.M. (CCH) 707 (1998).
[36] Kean v. Comm'r, 86 T.C.M. (CCH) 392 (2003), *aff'd*, 407 F.3d 186 (3d Cir. 2005).
[37] Treas. Reg. § 1.71-1T(b), Q&A (6) (1984).
[38] The itemized deduction limitation is found at I.R.C. § 67 (2016). *See also* §§ 62(a)(10), 67(a) (2016).
[39] Old Colony Trust Co. v. Comm'r, 279 U.S. 716 (1929).

is payment of payor's debt.[40] Alimony can be stated as a percentage of payor's income.[41] A taxpayer may deduct alimony not reportable by a foreign payee if there is a tax treaty excluding the income from U.S. taxation, for example, alimony paid to a resident of Puerto Rico.[42]

Payment of obligations involving community property or joint interests may be treated as alimony if the periodic payments are in the nature of or in lieu of alimony;[43] however, the deduction is not allowed to an estate, trust, corporation or anyone other than payor.[44] Alimony does not include any payment made pursuant to a continuing liability over a period of not less than 3 years to pay fixed portions of income from a business, property, compensation for employment, or self-employment.[45] If a payee, pursuant to the divorce or settlement agreement, receives income from a trust that would otherwise be included in the income of the payor spouse, the income is included as gross income of the payee;[46] however, the rule does not apply if the payments are for child support.[47] For example if, pursuant to the terms of a divorce or settlement agreement, payor transferred securities in trust for the benefit of payee to discharge all support obligations, the periodic payments made by the trust to payee must be included in payee's income.[48] They are not included in payor's income and are not a deduction from payor's income.[49]

Payments used to repurchase an interest in property payor previously transferred to payee in discharge of his or her obligation under a divorce or settlement agreement are not alimony.[50] Payments made to repurchase previously transferred property are not alimony and are not deductible to payor or included in payee's gross income.[51] If husband and wife transfer jointly owned securities to a trust to pay an annuity to one spouse, the full amount of the portion of the annuity received by the payee spouse attributable to the other spouse's interest in the securities is taxable to the

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[40] Rev. Rul. 67-420, 1967 C.B. 63; Treas. Reg. § 1.71-1T(b), Q&A (6) (1984); Taylor v. Comm'r, 45 T.C. 120 (1965); Simpson v. Comm'r, 78 T.C.M. (CCH) 191 (1999); Zampini v. Comm'r, 62 T.C.M. (CCH) 475 (1991); Zinsmeister v. Comm'r, 80 T.C.M. (CCH) 774 (2000).
[41] I.R.C. § 71(b) (2016); Friedland v. Comm'r, 44 T.C.M. (CCH) 1192 (1982).
[42] Rev.Rul 56-585, 1956-2 C.B. 166; I.R.C. § 933 (2016); Lunding v. N.Y. Tax Appeals Tribunal, 522 U.S. 287 (1998).
[43] I.R.C. §§ 215, 71 (2016); Treas. Reg. § 1.215-1(a) (1960).
[44] Treas. Reg. § 1.215-1(b) (1960).
[45] I.R.C. § 71(f)(5) (2016).
[46] *Id.* at § 682.
[47] *Id.* at § 682(a).
[48] *Id.* at § 71.
[49] *Id.* at § 215; Treas. Reg. § 1.215-1(c), Ex. (1) (1960).
[50] I.R.C. §§ 71(a)(1), (2) (2016).
[51] *See* I.R.C. §§ 71(d), or 682 (2016); Treas. Reg. § 1.215-1(b) (1960).

payee;[52] the portion of the annuity payment attributable to the payee's own interest is taxable to only to the extent it is out of trust income.[53]

C. *Terms in an Ante-Nuptial Agreement Constitute Alimony Only if Referenced in a Divorce or Settlement Agreement*

An ante-nuptial agreement that provides that in consideration of payee's relinquishment of all marital rights and to provide for payee's support and household expenses payor promises to pay payee a monthly amount during payee's lifetime is enforceable as a contract. However, if the divorce or settlement agreement neither references the terms of the ante-nuptial agreement nor restates payor's obligation to provide support the payments are not alimony.[54] A written divorce or settlement agreement referencing the terms of the ante-nuptial agreement would cause the payments to be treated as alimony.[55]

D. *Payment of Life Insurance Premiums on Payor's Life for a Policy Owned by Payee as an Irrevocable Beneficiary Is Alimony*

Payment of premiums on life insurance is alimony if payee irrevocably owns the life insurance policy on payor's life, is the beneficiary of the policy, and the policy is mandated by a divorce or settlement agreement.[56] Payments that fund both the death benefit and the accumulation of cash value are alimony.[57] However, just naming a spouse as beneficiary of a life insurance policy is not enough for payor to claim premium payments as alimony.[58] Partial relinquishment of control is not enough.[59] Premiums on policies assigned to children do not qualify as alimony.[60]

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[52] I.R.C. §§ 71(a)(1), (2) (2016).
[53] Treas. Reg. § 1.71-1(c)(4) (1960).
[54] I.R.C. § 71(a) (2016).
[55] *Id.* at § 71(a)(2); Treas. Reg. § 1.71-1(b)(6), Ex. (2) (1960).
[56] Treas. Reg. § 1.71-1(c)(2) (1960); Treas. Reg. § 1.71-1(b), Q&A (6) (1960); Rev. Rul. 70-218, 1970-1 C.B. 19. If the divorce or settlement agreement does not include a requirement that payor pay for life insurance a requirement that payee be irrevocable beneficiary, the payments are not alimony Griffith v. U.S., 360 F.2d 210, (1966); Rev. Rul. 57-125, 1957-1 C.B. 27.
[57] Treas. Reg. § 1.71-1(c)(2) (1960); Treas. Reg. § 1.71-1(b), Q&A (6) (1960); Rev. Rul. 70-218, 1970-1 C.B. 19; Hyde v. Comm'r, 36 T.C. 507 (1961), *aff'd*, 301 F.2d 279 (2d Cir. 1962); Stewart v. Commissioner, 9 TC 882 (1961); Carmichael v. Comm'r, 14 T.C. 1356 (1950); Treas. Reg. § 1.71-1(c)(2) (1960); Treas. Reg. § 1.71-1(b), Q&A (6) (1960); Rev. Rul. 70-218, 1970-1 C.B. 19.
[58] Griffith v. Comm'r, 35 T.C. 882 (1961); Cole v. Comm'r, 30 T.C.M. (CCH) 308 (1971).
[59] Weil v. Comm'r, 240 F.2d 584, (1957), *aff'g* 22 T.C. 612 (1955).
[60] Rev. Rul. 70-218, 1970-1 C.B. 19.

Payment for life insurance structures that make up for loss of alimony in the event of payor's death can be alimony. For example, where a divorce or settlement agreement required payor to purchase a life insurance policy as security in the event payor died prior to completion of 11 years of alimony payments mandated by the decree, payee owned the policy, would receive the portion of the death benefit that equaled the remaining unpaid alimony, and the remainder of the benefits went to the children, the payments were alimony.[61] A provision designating children as contingent beneficiaries if payee predeceases payor does not prevent deduction of premiums as alimony.[62]

III. CHILD SUPPORT PAYMENTS DO NOT QUALIFY AS ALIMONY

A. *Child Support Payments Are Not Alimony*

Child support payments imposed by a divorce or settlement agreement are not alimony and therefore are not deducted by the payor or income to the payee.[63] Payments in the divorce or settlement agreement[64] are child support payments if they are specified 1) as child support in the agreement,[65] 2) contain a child-related contingency in the agreement,[66] 3) are paid at a time tied to a child's birthday,[67] or 4) on the occurrence of a child-related contingency.[68]

Payor's payments to payee that are designated as child support or to pay for children's expenses are non-deductible child support and are not income to the payee.[69] In addition, any amount specified in a divorce or settlement agreement that will be reduced on the occurrence of a contingency relating to a child, such as a child attaining a specified age, marrying, dying, or leaving school is child support.[70] However, payments not specifically allocated to child support used for both spousal support and child support, such as payment of rent, are deductible as alimony in their entirety.[71] If payor fails to

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[61] Stevens v. Comm'r, 439 F.2d 69, 71 (1971).
[62] Rev. Rul. 70-218, 1970-1 C.B. 19.
[63] I.R.C. § 71(2016).
[64] *Id.* at §71(c)(1).
[65] *Id.* at § 71(c)(1).
[66] *Id.* at §71(c)(2)(A).
[67] *Id.* at §71(c)(2)(B).
[68] *Id*. The I.R.C. says that the contingencies apply only to the fact patterns in the regulations. Treas. Reg. § 1.71-1T(c), Q&A (18) (1984); *See also* Ambrose v. Comm'r, 71 T.C.M. (CCH) 2428(1996); Heller v. Comm'r, 68 T.C.M. (CCH) 538 (1994).
[69] I.R.C. § 71(c)(1) (2016).
[70] *Id.* at § 71(c)(2); Treas. Reg. §§ 1.71-1T(c), Q&A (16) (18) (1960).
[71] Richardson v. Comm'r, 125 F.3d 551 (7th Cir. 1997), *aff'g* 70 T.C.M. (CCH) 1390 (1995).

pay all alimony and child support specified in a divorce or settlement agreement payments are treated first as child support until that obligation is satisfied.

B. *Additional Tax Considerations Associated with Child Care*

1. The Custodial Parent Receives the Dependency Exemption Unless He or She Releases the Dependency Exemption to the Non-Custodial Parent

The child of divorced or legally separated spouses qualifies as a dependent for a calendar year if; 1) the child receives over half of his support during the calendar year from the parents,[72] 2) the child's parents are divorced or legally separated under a divorce or settlement agreement, or live apart for the last six months of the calendar year,[73] and 3) the child is in the custody of one or both parents for over half the calendar year.[74] If a child provides more than one-half of his or her own support, the child cannot be claimed as a dependent by either parent.[75]

The custodial parent receives the dependent exemption for a child unless that parent releases his or her claim in a written declaration that states that he or she will not claim that child as a dependent for the tax year, and the noncustodial parent attaches that written declaration to his or her return for the tax year.[76] The custodial parent is the parent with whom the child resides for the greater number of nights during the calendar year.[77] The dependency exemption rules are separate from the "same principal pace of abode as taxpayer" rule,[78] and the tie-breaking rules.[79] Neither relations of son-in-law nor father-in-law are affected by divorce or death for purposes of qualifying for a dependency exemption.[80] Child support is not subject to gift tax during a child's minority so long as it is covered by a divorce or settlement

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[72] I.R.C. § 152(e)(1)(A) (2016).
[73] *Id.*
[74] *Id.* at § 152(e)(1)(B).
[75] *Id.* at § 152(d).
[76] *Id.* at §§ 152(e)(1), (2); Treas. Reg. § 1.152-4(b) (as amended in 2008); Armstrong v. Comm'r 745 F.3d 890, (8th Cir. 2014).
[77] I.R.C. § 152(e)(4)(A) (2016); Treas. Reg. § 1.152-4(d) (as amended in 2008).
[78] I.R.C. § 152(c)(1)(B) (2016) (Under residence test the exemption goes to the parent with whom the child resides for the longer period of time in the year).
[79] I.R.C. § 152(c)(4) (2016); Treas. Reg. § 1.152-4(a) (as amended in 2008). §152(c)(4) (tie-breaking rules used to determine which taxpayer is entitled to claim the dependency exemption when more than one party qualifies for the exemption).
[80] Treas. Reg. § 1.152-2(d) (1973).

agreement.[81] Transfers directly to a school for tuition, and direct payment of medical expenses are never subject to gift tax.[82]

2. Rules for Determining Who May Claim the Dependent Care Credit

The dependent care credit is available to low income parents as reimbursement for child care.[83] Married couples may only claim a dependent care credit on a joint return;[84] Legally separated or divorced parents may claim the credit on a head of household or single return, if the child is under age 13, receives more than half of his or her support from parents, and is in custody of one or both parents for more than half of the calendar year.[85] The parent having the longer custody period is entitled to the dependent care credit.[86] The parent claiming the credit need not be able to claim the child as a dependent or may have released the dependency exception to the other parent.[87]

A taxpayer other than a child's parent may claim the child care credit if the taxpayer meets the requirements described above, neither parent claims the credit and the taxpayer's adjusted gross income is higher than the adjusted gross incomes of each of the individual's parents.[88] A child can be a taxpayer's dependent under the qualifying relative tests of I.R.C. §152(d) if the child's gross income for the year is less than the exemption amount,[89] the child receives over one-half of his or her support from the taxpayer,[90] and the child is not the qualifying child of another taxpayer.[91] Education scholarships are not counted in computing a child's income.[92]

If there is a dispute over who may claim the deduction, the parent with whom the child resided for the longer period, receives the exemption.[93] If the child resided with both parents an equal time, the parent with the higher income receives the exemption.[94]

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[81] I.R.C. § 2516(2) (2016); Rev. Rul. 79-118, 1979-1 C.B. 315.
[82] I.R.C. § 2523(e) (2016); Treas. Reg. § 25.2503-6(b)(3) (1984).
[83] Working Families Tax Relief Act, Pub. L. No. 108-311, §§201, 203, 208, 118 Stat 1166, 1169-76, 1178 (2004).
[84] I.R.C. § 21(e)(2) (2016); Treas. Reg. § 1.21-3(a) (2007).
[85] I.R.C. §21(b)(1)(A) (2016) (reference to §152(a)(1) defining a qualifying child)).
[86] I.R.C. § 152(c) (2016); Treas. Reg. § 1.21-1(b)(1) (as amended in 2007).
[87] I.R.C. § 21(e)(5) (2016); Treas. Reg. § 1.21-1(b)(5) (as amended in 2007).
[88] I.R.C. § 152(c)(4)(C) (2016).
[89] *Id.* at § 152(d)(1)(B).
[90] *Id.* at § 152(d)(1)(C).
[91] *Id.* at § 152(d)(1)(D).
[92] *Id.* at §152(f)(5).
[93] *Id.* at § 152(c)(4)(B)(i).
[94] *Id.* at § 152(c)(4)(B)(ii); Treas. Reg. § 1.152-4(a) (as amended in 2008); I.R.S. Notice 2006-86, 2006-2 C.B. 680.

3. Lifetime Learning Credit and American Opportunity Tax Credit

Individual taxpayers may claim the Hope Scholarship Credit and the Lifetime Learning Credit, for higher education tuition and related expenses.[95] The Hope Scholarship credit is a nonrefundable tax credit for those enrolled at least half time in the first two years of a postsecondary degree or certificate program at an eligible educational institution.[96] Qualified tuition and related expenses includes tuition and fees for taxpayer, spouse, and those dependents for whom the taxpayer is allowed a deduction.[97] The Hope Scholarship and Lifetime Learning Credits are phased out at modified Adjusted Gross Income over $40,000 for single taxpayers, $80,000 for those filing joint returns.[98] The Lifetime Learning Credit is a tax credit of 20% of up to $10,000 in qualifying costs for undergraduate and graduate studies as well as for courses to acquire or improve job skills.[99] The Hope Credit allows a $2,500 credit per eligible student per year.[100] It may be taken for four years of post-secondary education.[101] The credit is phased out at $80,000 for a single taxpayer, $160,000 for joint return filers.[102] Forty percent of the credit is refundable.[103] Qualified tuition and related expenses must be incurred on behalf of a dependent for whom the taxpayer is allowed a deduction.[104] The qualified expenses paid by the student are treated as paid by the taxpayer to whom the deduction is allowed.[105]

C. *Exceptions to the General Rules on Who May Take Deductions.*

If no single taxpayer provides more than half of a child's support parents may enter into a multiple support agreement.[106] If a grandparent contributes 40 percent of the child's support, each parent contributes 30 percent, and the parties agree, any one of the three may take the deduction.[107]

There are six provisions that permit a non-custodial parent to treat a child as a dependent, 1) medical expense reimbursements under employer-

[95] 2012 American Taxpayer Relief Act of 2012, Pub. L. No. 112-240 §103(a), 126 Stat 2313, 2319 (2012) (codified as amended at I.R.C. § 25A(i) (2016)).
[96] I.R.C. § 25A(b)(2016).
[97] *Id.* at §§ 151, 25A(f)(1)(A); Treas. Reg. § 1.25A-2(d)(2)(ii) (2002).
[98] I.R.C. § 25A(d) (2016).
[99] *Id.* at § 25A(c).
[100] *Id.* at § 25A(i)(1).
[101] *Id.* at § 25A(i)(2).
[102] *Id.* at § 25A(i)(4).
[103] *Id.* at § 25A(i)(5).
[104] *Id.* at §§ 151, 25A(f).
[105] *Id.* at § 151; Treas. Reg. §§1.25A-5(a), (b) (2003).
[106] I.R.C. §152(e)(5) (2016).
[107] I.R.C. § 152(d)(3) (2016).

provided health insurance,[108] 2) certain fringe benefits provided by employers,[109] 3) deduction for uncompensated medical or dental expenses,[110] 4) employer-provided health care or accident coverage,[111] 5) deductions for payments to an Archer Medical Savings Account,[112] 6) deduction for a health savings account.[113]

IV. OTHER PAYMENTS THAT DO NOT QUALIFY AS ALIMONY

A. *Payments Not Qualifying as Alimony Whether Required by the Divorce or Settlement Agreement or Not*

Payments, whether or not required under a final divorce or settlement agreement, including car expenses, legal fees, and car financing payments that would survive payee's death are not alimony.[114] A transfer of a third-party debt instrument to payee does not qualify as alimony.[115] The value of a contract-for-deed transferred to payee for a release of past and future alimony claims represents a debt instrument. It is a contract payment obligation does not expire on payee's death and is, therefore, not alimony.[116] Payments to maintain property owned by payor and used by payee are not alimony, even if made pursuant to the divorce or settlement agreement.[117]

B. *Payments Attributable to Property Originally Owned by the Other Spouse Are Not Alimony*

Generally, gross income of the payee provided pursuant to a divorce or settlement agreement includes payments attributable to property transferred, in trust or otherwise pursuant to a divorce or settlement agreement.[118] Subject to the exception below, whether the payment is from property in trust, an endowment, or an annuity contract, the full amount received by payee is included in payee's income; the amount is neither included in transferor's

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[108] *Id.* at. § 105(b).
[109] *Id.* at § 131(h)(2)(b).
[110] *Id.* at § 213(d)(5).
[111] *Id.* at § 106(a); Rev. Proc. 2008-48, 2008-36 I.R.B. 586.
[112] I.R.C. § 220(d)(2) (2016); Rev. Proc. 2008-48, 2008-36 I.R.B. 586.
[113] I.R.C. § 223(d)(2) (2016); Treas. Reg. § 1.152-4(g) (as amended in 2008); Rev. Proc. 2008-48, 2008-36 I.R.B. 586.
[114] Preston v. Comm'r, 77 T.C.M. (CCH) 1437 (1999), *aff'd*, 209 F.3d 1281 (11th Cir. 2000).
[115] Treas. Reg. § 1.71-1T(b), Q&A (5) (1984).
[116] LaBozetta v. Comm'r, TC Summary Opinion 2006-122.
[117] Treas. Reg. § 1.71-1T(b), Q&A (8) (1984).
[118] I.R.C. § 71(a)(1) (2016); Treas. Reg. § 1.71-1(b)(1)(i), (ii) (1960).

income nor deductible by transferor[119] regardless of whether such amount is paid out of income or principal of the property.[120]

The general rule does not apply to that part of any periodic payment attributable to the portion of any interest in property transferred in discharge of the payor's obligation under a divorce or settlement agreement that originally belonged to the payee, such as a joint interest or a community property interest.[121] Thus, when husband and wife transfer to a trust securities they had owned jointly, to pay an annuity to payee, the part of the principal as well as interest that is paid out and that was attributable to the non-income recipient's prior interest in the securities is taxed to the recipient. The portion of the annuity attributable to the income recipient's prior interest in the securities transferred is only taxable to the extent of trust income, not payments out of principal.[122]

C. *Installment Payments Discharging an Obligation*

Installment payments discharging a part of an obligation in a divorce or settlement agreement, which is in terms of money or property paid over less than 10 years are considered "periodic payments;" they are excluded from payee's income only if the conditions specified in the Treasury regulations are met.[123] Where such principal sum, under the divorce or settlement agreement, is to be paid over more than 10 years, the installment payment is considered a periodic payment subject to I.R.C. § 71(a) so long as the installment payments during the wife's taxable year do not exceed 10 percent of the principal sum.[124]

Where the payments end 10 years or less from the date of the divorce or settlement agreement, such payments are considered periodic payments if they are "subject to any one or more of the contingencies of death of either spouse, remarriage of the wife, or change in the economic status of either spouse, … and are in the nature of alimony or an allowance for support."[125] If the requirements are met under applicable state statute they need not be

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[119] I.R.C. § 72(k) (2016); Treas. Reg. § 1.71-1(c)(2) (1960).
[120] Treas. Reg. §§ 1.71-1(c)(2), (c)(3) (1960).
[121] I.R.C. § 71(a)(1), (2) (2016); Treas. Reg. § 1.71-1(c)(4) (1960).
[122] Treas. Reg. § 1.71-1(c)(4) (1960). (Transfer to payee made before execution of a divorce or settlement agreement to avoid I.R.C. §§ 71(a)(1), (2) (2016), results of taxation of the full amount received by the payee).
[123] Treas. Reg. § 1.71-1(d)(1) (1960). I.R.C. § 71(a) specifies, "gross income includes amounts received as alimony or separate maintenance payments." It does not apply under this section of the regulations unless the provisions of Treas. Reg. §§1.71-1(3)(i)(a) and (b) are met.
[124] Treas. Reg. § 1.71-1(d)(2) (1960).
[125] I.R.C. § 71(a) (2016); Treas. Reg. §§1.71-1(d)(3)(i)(a), (b) (1960).

included in the divorce or settlement agreement.[126] The aggregate amount of the payments may be explicitly stated in the divorce or settlement agreement, may be calculated as specified,[127] or may be determined actuarially.[128] Where payments are to be paid over a period ending more than ten years from the date of the divorce or settlement agreement and meet one of the above conditions, such payments are periodic payments under I.R.C. § 71 without regard to the requirement the annual payments not exceed 10 percent.[129]

For example, if, under the terms of a written instrument, H is required to make payments to W which are in the nature of alimony, in the amount of $100 a month for nine years. The instrument provides that if H or W dies the payments are to cease. The payments are periodic[130] if the written instrument explicitly provides that H is to pay W the sum of $10,800 in monthly payments of $100 over a period of nine years. The payments are still periodic.[131] However, if the monthly payments are not subject to any of the contingencies of death of H or W, remarriage of W, or change in the economic status of H or W under the terms of the divorce or settlement agreement or under local law the payments are not periodic.[132] These rules do not apply to periodic payments the divorce or settlement agreement specifies are payable for the support of minor children.[133]

D. *Excess Front-Loading of Payments Are Not Counted as Alimony*

Excess alimony payments equal to the sum of the first and second year excess alimony payments are recaptured in the third post separation year, are included in payor's taxable income, and are excluded from payee's taxable income.[134] Excess alimony payments are defined as:

> …[P]ayments for the first post-separation year is the excess of the amount of the alimony payments paid by the payor during the first post-separation year, over the sum of the average of the alimony paid by the payor during the second post-separation year, reduced by the excess payments for the second post-separation year and the alimony paid by the payor during the 3rd post-separation year, plus

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[126] Treas. Reg. §1.71-1(d)(3)(ii)(a) (1960).
[127] *Id.* at §1.71-1(d)(3)(ii)(b).
[128] *Id.* at §1.71-1(d)(3)(ii)(c).
[129] *Id.* at §1.71-1(d)(2).
[130] *Id.* at § 1.71-1 (d)(5), Ex. (1).
[131] *Id.* at § 1.71-1(d)(5), Ex. (2).
[132] *Id.* at § 1.71-1(d)(5), Ex. (3).
[133] *Id.* at § 1.71-1(e).
[134] I.R.C. §§ 71(f)(1), (4) (2016).

> $15,000.[135] The excess payments for the second post-separation year are the excess of the alimony payments paid by the payor during the 2nd post-separation year, over the sum of the alimony paid by the payor during the 3rd post-separation year, plus $15,000.[136]

No recapture is required under four circumstances; 1) payments end because either spouse dies during the first, second, or third post-separation year,[137] 2) payments end because the payee remarries during the first, second, or third post-separation year,[138] 3) support payments are made pursuant to I.R.C. § 71(b)(2)(C) (e.g. pendente lite or temporary support),[139] and 4) payments are tied to an obligation to pay a fixed portion of the *payor* spouse's income from a business, property, or from compensation for employment or self-employment.[140]

For example, if H makes alimony payments to W over a 10-year period as follows: $60,000 in 1996, $45,000 in 1997, and $10,000 annually in 1998-2007, the excess payments computation is as follows: Step 1, $45,000 - (10,000 + $15,000) = $20,000 (2nd year excess payments); step 2, $60,000 - [[($45,000 - $20,000) + $10,000]/2 + $15,000] = $27,500 (1st year excess payments); step 3, $20,000 (2nd year excess payments) + $27,500 (1st year excess payments) = $47,500 (total excess payments subject to recapture by the payor and allowable as a deduction to the payee in the third post-separation year).[141]

V. PERIODIC PAYMENTS MADE IN TRUSTS MAY BE IN THE NATURE OF OR IN LIEU OF ALIMONY

Placing a business in a trust from which income is paid to separating or divorcing spouses may preserve the earning power, and; thus, the viability of the business. Release of future support rights of a spouse or minor children in exchange for a beneficial interest in a trust may be adequate consideration for establishing the trust.[142] In addition, transfer of a beneficial interest to adult

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[135] *Id.* at § 71 (f)(3).
[136] *Id.* at § 71 (f)(4).
[137] *Id.* at §§ 71(f)(5)(A)(i), (ii).
[138] *Id.* at §§ 71(f)(5)(A)(i), (ii).
[139] *Id.* at § 71(f)(5)(B).
[140] *Id.* at § 71(f)(5)(C).
[141] CINDY L. WOFFORD, DIVORCE AND SEPARATION 34-35 (BNA 2d ed. 2015).
[142] *See* Estate of O'Nan Est. v. Comm'r, 47 T.C. 648 (1967), *acq.*, 1967-2 C.B. 3. The interest must be a substitute for the transferor's support obligation. If not, the transfer is not for adequate consideration. I.R.S. Tech. Adv. Mem. 85-26-003 (1985).

children is not supported by adequate consideration[143] unless the interest transferred was in return for the payee spouse releasing his or her support claims against the other spouse.[144]

However, establishing a trust can create unintended consequence with respect to both gift taxes and estate taxes. If the value of support rights released does not exceed the value of the trust established in exchange for releasing support claims, the transfer is incomplete to the extent of the difference and the transferring spouse retains a beneficial interest. The excess is treated as an incomplete gift subject to inclusion in the transferor's taxable estate at date of death values.[145] The problem is avoided if a payment of cash or transfer of property is the result of a court decree or judgment because it is involuntary and, therefore, is for consideration in money or money's worth for purposes of establishing a completed transfer under I.R.C. §§ 2036, 2037, 2038.[146]

Trust income to which a divorced or separated spouse is entitled is included in the gross income of the recipient not in the income of the settlor who set up the trust.[147] Whether a payment is made from trust corpus or by payor directly to payee affects whether the payment is treated as alimony. If a divorce or settlement agreement requires payor to establish a trust that pays payee $5,000 in income a year for the remainder of payee's life and make up any shortfall from either trust principal or payment by payor how the shortfall is paid determines whether making up the shortfall is treated as alimony. If the trust income is $4,000 to payee and $1,000 from trust corpus, payee includes $5,000 in income; payor cannot deduct any of the payment as alimony (nor does payor include the payment in income). If payor pays the additional $1,000 required by the divorce or settlement agreement to payee instead of trustee paying it out of corpus, payor becomes entitled to deduct the $1,000 payment as alimony and payee must treat the $1,000 as income.[148]

The structure of the trust is subject to the special valuation rules applicable to a transfer of property in trust when the transferor spouse (settlor) or another family member retains an interest in or power over the transferred property and the transfer benefits a family member.[149] For example, assume H transfers property to an irrevocable trust under which all trust income is payable to H or his estate for 10 years, after which the trust

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[143] *See e.g.*, Estate of Keller v. Comm'r, 44 T.C. 851 (1965).
[144] *See* Rev. Rul. 77-314, 1977-2 C.B. 349 (I.R.C. §2516 (2016) ruling).
[145] I.R.C. §§ 2036, 2037, 2038 (2016); Estate of Davis v. Comm'r, 440 F.2d 896 (3d Cir. 1971), *rev'g* 51 T.C. 269 (1968).
[146] Harris v. Comm'r, 340 U.S. 106 (1950); Comm'r v. Estate of Watson, 216 F.2d 941 (2d Cir. 1954).
[147] I.R.C. § 682(a) (2016).
[148] *Id.* at § 215; Treas. Reg. § 1.215-1(c), Ex. (2) (1960).
[149] I.R.C. §§ 2702(e), 2704(c)(2) (2016).

terminates and the remaining trust estate is payable to H's daughter, D, or D's estate. H has made a gift of the remainder interest to a family member. Because of I.R.C. § 2702, the value of H's retained interest is zero unless it is a qualified interest.[150]

A retained qualified interest is an interest consisting of a right to, 1) an annuity interest equal to a fixed amount or fixed percentage of the original trust principal;[151] 2) a unitrust interest, which is a fixed percentage of the fair market value of the trust principal;[152] or 3) a non-contingent remainder interest after an annuity interest or unitrust interest ceases.[153] For example, a right to receive $5,000 per year for 10 years would be a qualified interest because it is an annuity interest.[154] If the retained interest is a qualified interest its present value is valued using the code's valuation tables.[155] A retained interest is one held before and after the transfer in trust, such as the right to income for a period of years, or a right to revoke or alter the terms of the trust.[156]

A member of the family includes spouse, children, lineal descendants, in-laws, but not a former spouse.[157] As a result, a trust set up before divorce or separation remains valid; however, if a settlor has retained an interest in a trust set up after divorce or separation, I.R.C. §2702 does not apply, the general rules do.[158]

The I.R.C. § 2702(a) special valuation rules do not apply to a transfer in trust for the benefit of the spouse or former spouse if it is incident to divorce in a transaction within the scope of the adequate consideration rules of I.R.C. §2516 if all remaining interests in the trust are retained by the other spouse or former spouse.[159] For example, before their divorce, settlor and beneficiary enter into a marital agreement under which, in exchange for the release of beneficiary's marital and support rights, settlor transfers $1,000,000 into a trust, the income of which is paid to W for 10 years or until she dies. It then terminates and the remainder interest goes to settlor or settlor's estate. Although settlor has retained an interest in a trust established for the benefit of a family member, I.R.C. § 2702 does not apply since only beneficiary spouse or former spouse and settlor spouse or former spouse have an interest

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[150] *Id.* at § 2702(a)(2)(A).
[151] *Id.* at § 2702(b)(1).
[152] *Id.* at §2702(b)(2),
[153] *Id.* at § 2702(b)(3); *see* Treas. Reg. §§ 25.2702-2(a)(5)-(8) (2005).
[154] I.R.C. 2702(b)(1) (2016).
[155] *Id.* at §2702(a)(2)(B). The valuation tables are found at I.R.C. § 7520 (2016).
[156] Treas. Reg. § 25.2702-2(a)(3) (2005).
[157] I.R.C. §§ 2702(e), 2704(c)(2) (2016).
[158] *Id.* at § 2702(b)(3).
[159] The basis remains unchanged, Treas. Reg. § 25.2516-1 (1983); Treas. Reg. § 25.2516-2 (2016); *see also* Treas. Reg. § 25.2702-1(c)(7) (1998).

in the trust estate after the transfer. There are no gift tax consequences. The result would not be the same if, on the termination of beneficiary's interest in the trust, the trust corpus were distributable to the children of beneficiary and settlor rather than to settlor.[160]

Individuals who have made gifts must file a gift tax return.[161] A transferor transferring assets under a divorce or settlement agreement[162] must file a copy of the agreement and a certified copy of the gift tax return for the calendar period the agreement is effective and, when granted, a certified copy of the divorce decree.[163]

VI. GAIN AND LOSS ON PROPERTY TRANSFERS INCIDENT TO SEPARATION AND DIVORCE

Where a business is jointly owned, or is subject to equitable distribution, funds required for continued operation of the business may prevent the payor from making a cash payment for a departing spouse's interest. In other words, the transfer may require financing to allow for sufficient capital for the business to continue to operate. The following discussion of asset transfers starts by explaining the basic principles of division of marital assets and continues by discussing how ownership transfers can be financed over time with imputed or specified interest included in the value of the transfer to reflect the time value of money.

A. *Gain or Loss on Asset Transfers Incident to Divorce*

No gain or loss is recognized on transfer of property from an individual to or, in most cases, in trust for the benefit of a spouse, either during marriage or incident to divorce.[164] At transfer of property, the basis of the property is the adjusted basis of the transferor.[165] If the transferor keeps the property and transfers cash, the basis remains with the transferor.

A transfer of property is incident to divorce if it occurs; 1) within one year after the date on which the marriage ceases, pursuant to a divorce or settlement agreement,[166] 2) within 6 years of cessation of marriage or separation and is related to the marriage or separation,[167] or 3) is otherwise

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[160] Treas. Reg. § 25.2702-4(d) Ex. (5) (1992).
[161] I.R.C. § 6019 (2016).
[162] *Id.* at § 2516.
[163] *Id.* at § 6075(b)(1).
[164] *Id.* at § 1041(a); Treas. Reg. § 1.1041-1T(a) (2003).
[165] I.R.C. § 1041(b) (2016).
[166] *Id.* at § 71(b)(2).
[167] *Id.* at § 1041(c)(1).

shown to be related to the divorce.[168] The transfer is conclusively presumed to be pursuant to a divorce or settlement agreement if the transfer occurs within six months; it is subject to a rebuttable presumption that the transfer is not related to the divorce or settlement agreement if it occurs after six months.[169] Transfers from a former spouse to a third party in satisfaction of a liability of the former spouse also receive non-recognition treatment.[170] If a transfer is within the scope of I.R.C. § 1041(a), the non-recognition rule applies even where the parties are acting at arms-length, and the transferee pays full consideration for the property.[171]

B. *Transfers Made Pursuant to Separation or Divorce Are for Adequate Consideration and Are Not Gifts for Gift and Estate Tax Purposes*

If a transfer is incident to divorce and is complete it is treated as made for adequate consideration.[172] The transfer is not a gift for gift tax purposes and the value of the transfer is not included in the transferor's estate tax base.[173] An I.R.C. § 1041 transfer is only treated like a gift for determining basis and tax on gain when it is sold by the recipient.[174] However, if a transfer is incomplete because the decedent retained an interest in or power over the transfer, the value of the property is included in the individual's estate at death and is subject to estate tax.[175]

The value of assets to be transferred from transferor to transferee pursuant to the divorce or settlement agreement is a claim against the estate of the deceased[176] to the extent the payee spouse gave adequate consideration

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[168] *Id.* at § 1041(c)(2).
[169] Treas. Reg. §1.1041-1T(b), Q&A (7) (2003).
[170] Treas. Reg. § 1.1041-1T(c), Q&A (9) (2003).
[171] Treas. Reg. §§ 1.1041T(a), Q&A (2), (d), Q&A (11) (2003). When I.R.C. § 1041 (2016) does not apply, gain on transfer of appreciated property titled in one spouse's name to the other spouse is taxable to the transferring spouse except to the extent it is partition of joint or community interests. United States v. Davis, 370 U.S. 65, 70-71 (1962); Yonadi v. Comm'r, 21 F.3d 1292 (3d Cir. 1994), Serianni v. Comm'r, 80 T.C. 1090 (1983), *aff'd*, 765 F.2d 1051 (11th Cir 1985).
[172] I.R.C. § 1041 (2016).
[173] *Id.* at § 2512(b); Treas. Reg. § 25.2512-1 (1992); Harris v. Comm'r, 340 U.S. 106 (1950); Comm'r v. Estte of Watson, 216 F.2d 941 (2d Cir. 1954); Estate of Keller v. Comm'r, 44 T.C. 851 (1965). *See also* Estate of Glen v. Comm'r, 45 T.C. 323 (1966) (wife's release of a claim to a vested one-third share of her husband's personal property upon divorce in exchange for her husband funding certain trusts for her benefit and that of their child was adequate consideration for the husband's transfer in trust to the extent of the value of the personal property rights released).
[174] I.R.C. §§ 2501(a)(1), 2502(c) (2016).
[175] *Id.* at §§ 2001(b), 2036, 2037, 2038.
[176] *Id.* at § 2053(b).

for the property under the divorce or settlement agreement.[177] If the value of a transfer is no greater than the present value of the life estate provided for in the divorce or settlement agreement, the transfer is supported by adequate consideration.[178] Any additional amount is a taxable gift.[179] Thus, if payor must pay payee an annual amount for X years in exchange for support and marital rights and payor dies, the present value of the total remaining payments may be deducted as an expense of the estate.[180]

C. *Treatment of Interest on Installment Obligations*

If there is a direct transfer of an installment obligation between spouses incident to divorce, the obligation in the hands of the transferee spouse has the same basis and other characteristics it had in the hands of the transferor spouse.[181] When a divorcing spouse buys out the other spouse's ownership in joint property, stated interest payments received by selling spouse on installment payments of principal and interest received in exchange for the property are taxable income to the seller spouse.[182] Similarly, the stated interest component of installment payments for the value of an ex-spouse's equitable interest in transferor spouse's law practice is interest income to the ex-spouse for delay in the receipt of payment.[183] However, if interest is imputed and not separately stated, I.R.C. § 1264 does not result in taxation of imputed interest on a note in connection with an I.R.C. § 1041 transfer.[184] Thus, transfer payments to transferee by transferor for transferee spouse's share of the value of transferor spouse's dental practice that included principal and interest did not generate gain on principal;[185] however, the

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[177] Estate of Waters v. Comm'r, 48 F.3d 838 (4th Cir. 1995), *rev'g* 67 T.C.M. (CCH) 2837 (1994); Estate of Nesselrodt v. Comm'r, 51 T.C.M. (CCH) 1406 (1986).
[178] I.R.C. § 2053(c)(1) (2016).
[179] Estate of Scholl v. Comm'r, 88 T.C. 1265 (1987).
[180] Estate of Van Horne v. Comm'r, 720 F.2d 1114 (9th Cir. 1983), *cert. denied*, 466 U.S. 980 (1984); Estate of Nesselrodt v. Comm'r, 51 T.C.M. (CCH) 1406 (1986); Estate of Scholl v. Comm'r, 88 T.C. 1265 (1987).
[181] I.R.C. §§ 453(b), (g)(2) (2016).
[182] Gibbs v. Comm'r, 73 T.C.M. (CCH) 2669 (1997).
[183] Cipriano v. Comm'r, 81 T.C.M. (CCH) 1856 (2001).
[184] Craven v. United States, 215 F.3d 1201 (11th Cir. 2000) *aff'g* 70 F.Supp.2d 1323 ("W's transfer of her half of ownership to H [incident to divorce] fits within the terms outlined by I.R.C. § 1041 and … therefore qualif[ies] for non-recognition. … [W]we hold that I.R.C. § 1274 does not operate to tax the imputed interest on the corporation's note in connection to a transfer when such transfer is deemed to trigger the non-recognition provisions of § 1041."). I.R.C. §§ 483, 1272, 1273, 1274, or 7872 (2016); I.R.S. Priv. Ltr. Rul. 86-45-082 (Aug. 14, 1986) installment notes taken back in an I.R.C. § 1041 transfer are not subject to the imputed interest rules on deferred payments.
[185] I.R.C. § 453B(g)(2) (2016).

stated interest portion of payments was taxable income to transferee.[186] Stated interest on transfer of the marital home to one spouse on divorce, along with a ten year note payable with interest for transferor spouse's half interest in the property is income to the transferor and deductible interest to the transferee to the extent it is qualified residence interest or investment interest.[187]

D. *Interaction between I.R.C. § 1041 Property Transfer Incident to Divorce and I.R.C. §§ 401(a)(13B), 414(p), and 424(c) Anti-Assignment of Income Provisions*

The provisions preventing a taxpayer who earns income from transferring the right to receive income to another to shift the incidence of the tax on income[188] do not apply to transfers associated with non-statutory stock options or unfunded deferred compensation accounts. Rather, § 1041 applies and the transferor spouse does not recognize gain on the transfers.[189] The exception[190] does not apply if the transferor spouse's rights were not vested when the transfer occurred.[191] A settlement payment received by transferee from transferor to relinquish transferee's claim to transferor's military retirement pay is not included in her gross income because it is not an assignment of future rights to income.[192]

In contrast, division of contingent fees associated with transferor's provision of personal services in medical malpractice cases to transferee is taxable to the transferor former spouse as an assignment of income.[193] Similarly, where transferor assigned the proceeds of her half interest in a cemetery business to transferee, the transfer included pre-completion crypt deposits to transferee. The divorce or settlement agreement required transferee to sell the interest to a third party buyer. Under these facts the Tax Court held that the percentage of completion method of accounting[194] required transferor to accrue a share of the untaxed crypt sales under

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[186] Yankwich v. Comm'r, 83 T.C.M. (CCH) 1208 (2002).
[187] Treas. Reg. § 1.163-8T (1960) (tracing rules), I.R.S. Notice 88-74, 1988-2 C.B. 385.
[188] I.R.C. §§ 401(a)(13)(B), 414(p), 424(c) (2016).
[189] Rev. Rul. 2002-22, 2002-1 C.B. 849; Rev. Rul. 2004-60, 2004-1 C.B. 1051 (addressing application of FICA and FUTA tax on distribution of non-statutory stock options and non-qualified deferred compensation divided among spouses pursuant to spouse); I.R.S. Priv. Ltr. Rul. 2006-46-003 (Aug. 7, 2006).
[190] Rev. Rul. 2002-22, 2002-1 C.B. 849; Rev. Rul. 2004-60 2004-1 C.B. 1051.
[191] I.R.S. Priv. Ltr. Rul. 2010-16-031 (Jan. 15, 2010).
[192] Balding v. Comm'r, 98 T.C. 368, 370 (1992).
[193] Kochansky v. Comm'r, 67 T.C.M (CCH) 2665 (1994), *aff'd*, 92 F.3d 957 (9th Cir. 1996).
[194] I.R.C. § 446(b) (2016) (Secretary may choose a method that clearly reflects incomes); 293 (2016); Treas. Reg. §§ 1.451-5(b)(1)(ii), (f) 1960).

assignment of income principles; however, because I.R.C. § 1041 applied there was no gain on transfer to transferee.[195]

E. *Exceptions to the Non-Recognition of Gain or Loss Rules when Trusts Are Involved*

Placing a business into a trust from which former spouses each draw income is one alternative to sale of one party's interest to the other party or to the business. A trust structure can preserve capital required for the business to remain viable. There are; however, some constraints on transferring assets to a trust.

While a loss is not recognized on an asset transfer directly to a transferee it must be recognized on transfer to a trust where 1) liability exceeds basis,[196] 2) the transfer is of an installment obligation,[197] or 3) the transferee is a non-resident alien and the transfer is not covered by an exception in an applicable bilateral international tax treaty.[198] Under these exceptions the non-recognition rules[199] do not apply to the transfer of property in trust to the extent that the sum of liabilities assumed and the liabilities to which the property is subject is greater than the adjusted basis of the property.[200] Instead, the transferee's basis is equal to the transferor's basis which, when negative, is increased by the negative portion of basis on which the transferor is required to pay tax.[201]

For example, assume that pursuant to a divorce or settlement agreement, A transfers a beach house into a trust for the benefit of B in exchange for B agreeing to waive future support payments. Trustee assumes the remaining mortgage payments on the house. A's basis in the house is $20,000 and the mortgage balance is $25,000. A must recognize gain of $5,000 on the transfer and the trust receives a $25,000 basis in the property.[202] Had the transfer been directly from A to B, B would have assumed A's basis and no tax would have been due. Trusts created as grantor trusts do not have to recognize gain on liabilities in excess of basis, because the grantor is treated

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[195] Berger v. Comm'r, 71 T.C.M. (CCH) 2160 (1996).
[196] I.R.C. § 1041(e) (2016).
[197] *Id.* at § 453B(g).
[198] *Id.* at §§1041(d), (e); Berger v. Comm'r, 71 T.C.M. (CCH) 2160 (1996); David Ellis & Mark B. Baer, *The Tax Consequences of Dividing Marital Property*, 93 PRACT. TAX STRATEGIES 251, 253 (2014).
[199] I.R.C. § 1041(a) (2016).
[200] *Id.* at § 1041(e).
[201] *Id.* at §§ 1041(b), (e).
[202] I.R.S. Priv. Ltr. Rul. 92-30-021 (July 24, 1992).

as the owner of the assets for tax purposes; however, ownership would not have been transferred.[203]

If an insurance policy is transferred pursuant to a divorce or settlement agreement the cash value of the insurance policy received by a spouse will generally be excludable from income because the policy has a carryover basis and is not subject to the transfer for value rules.[204] Similarly, transfer of an installment obligation does not result in gain, and the transferee gets the same tax treatment that would have applied to the transferor.[205]

There is no recapture of depreciation at the time of a transfer incident to a divorce or settlement agreement because the transferee receives a carryover basis.[206] Transferor must provide transferee with sufficient records to identify adjusted basis, holding period, depreciation, and other tax attributes of the property transferred.[207]

F. *When Does Transfer of Assets Occur*

Property is transferred on the earlier of transfer of ownership benefits and obligations or transfer of title.[208] Either physical delivery or transfer of legal title effects transfer.[209] A facts and circumstances test determines when transfer occurs based on 1) the intent to transfer property, 2) who holds legal title, 3) who has equity in the property, 4) the obligation to transfer the property, 5) which party or parties have the right to possession, 6) who pays property taxes, 7) who bears risk of loss, and 8) who receives profits from operation, gain or loss on sale.[210]

G. *Gain on Sale of a Personal Residence by Separated or Divorced Individuals*

A homeowner(s) may exclude from taxable income gain from the sale of a home to a third party if the home owner(s) lived in the home for 2 of the previous 5 years; however, transfers between separating or divorcing spouses result in neither gain nor loss.[211] If the residence was held in a revocable living trust, the owners are treated as if they owned the house directly.[212] A

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[203] Rev. Rul. 85-13, 1985-1 C.B. 184; Treas. Reg. § 1.1041-1T(e) (2003).
[204] H.R. REP. NO. 98-861 (1984).
[205] *Id.*
[206] I.R.C. §§ 1041(b)(1), 1245(b)(1), 1250(d)(1) (2016).
[207] Treas. Reg. § 1.1041-1T(e), Q&A (14) (2003).
[208] Berger v. Comm'r, 71 T.C.M. (CCH) 2160 (1996); Deyoe v. Comm'r, 66 T.C. 904 (1976).
[209] Harrington v. Comm'r, 67 T.C.M, (CCH) 3060 (1994).
[210] Grodt & McKay Realty, Inc. v. Comm'r 77 T.C. 1221 (1981).
[211] I.R.C. § 121(a) (2016).
[212] *Id.* at §§ 671, 679.

single individual may exclude up to $250,000 of gain from tax and a married couple can exclude $500,000 on a joint return.[213] A former spouse may tack on the transferor's ownership period to his or her ownership period.[214] If the house is jointly owned and the couple separates or divorces, each can exclude $250,000 of gain; however, if a taxpayer first obtains ownership of the property from a spouse or former spouse on sale of the jointly owned property then sells the property, the maximum exclusion is only $250,000.[215] A taxpayer is treated as using the property as the taxpayer's principal residence when the taxpayer has an ownership interest in the property and the spouse or former spouse is granted use of the property under a divorce or settlement agreement as his or her principal residence.[216] Any depreciation expense previously deducted (or deductible) must be recaptured prior to computing the portion of gain that is non-taxable. Thus, for example, if prior depreciation totaled $25,000 before the owner sold the house for a gain of $150,000, owner would recognize $25,000 of recaptured depreciation[217] and $125,000 of excludible gain.[218]

H. *Transfers between Separating or Divorcing Spouses Are Not Subject to Recapture of Investment Tax Credits*

Property that had received an investment tax credit and is disposed of before the end of the credit recapture period is subject to recapture of the investment tax credit as an addition to the owner's tax liability in the recapture year.[219] A transfer pursuant to a divorce or settlement agreement is not considered a disposition for tax credit recapture purposes.[220]

I. *Neither Unstated Interest nor Original Issue Discount Rules on Non-Publicly Traded Debt Instruments Apply to Spouses Making Transfers Incident to Separation or Divorce*

Rules governing treatment of original issue discount do not apply to transfers between spouses or incident to divorce.[221] Similarly, the rules

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[213] Treas. Reg. § 1.121-2(a)(2) (2002).
[214] I.R.C. §§ 121(d)(3)(A), (B) (2016).
[215] Treas. Reg. § 1.121-4(b)(1) (2003).
[216] *Id.* at § 1.121-4(b)(2).
[217] I.R.C. § 150 (2016).
[218] *Id.* at § 121(d)(6); Treas. Reg. § 1.121-1(d)(2) (2002); *see also* Joanie Sompayrac & Caitlin Schroeder, *Tax issues That Can Arise in Even the Most Amicable Divorces*, 89 PRAC. TAX STRATEGIES 219, 221-2 (2012).
[219] I.R.C. § 50(a)(1) (2016).
[220] *Id.* at § 50(a)(5)(B).
[221] I.R.C. § 483 (2016); Treas. Reg. §1.483-1(c)(3)(i) (1994); Treas. Reg. § 1.483-2 (1994).

dealing with the determination of the issue price of a debt instrument without adequate stated interest do not apply to any debt instrument transferred between spouses or former spouses incident to divorce.[222]

J. *Distributions from 401(k), 403(b) and IRA Retirement Accounts*

Transfers of 401(k), 403(b), IRA, or Roth IRA ownership between spouses or former spouses pursuant to a divorce or settlement agreement that remain within the 401(k), 403(b), IRA, or Roth IRA are not considered withdrawals.[223] Mandatory and discretionary withdrawals follow the standard rules applicable to the post division owners.[224]

VII. CAPITAL, TAX, AND INTEREST EXPENDITURES FOR HOUSING

The tax rules governing separated or divorced couples payment of mortgage interest, tax, and other housing costs is governed by I.R.C. §§ 163(h)(3), (h)(4) (home mortgage interest), I.R.C. § 164 (property taxes), I.R.C. § 63(d) (deductions), and I.R.C.§ 71 (alimony). Capital expenditures are not deductible; they are added to basis.[225] Repair and maintenance are not deductible.[226]

A. *Deduction of Interest on a Personal Residence*

Secured debt is debt that "makes the interest of the debtor in the qualified residence specific security for payment of the debt … under which, in the event of default, the residence could be subjected to the satisfaction of the debt."[227] Secured home equity debt on a qualified residence,[228] or a second residence of the taxpayer is qualified residence interest and is

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[222] I.R.C. §1274 (2916); Treas. Reg. § 1.1274-1(b)(3)(iii) (1994). For example, an annuity agreement that is part of an I.R.C. §1041 property settlement is not subject to I.R.C. § 1274; I.R.S. Priv. Ltr. Rul. 96-44-053 (Aug. 1, 1996); Craven v. United States, 215 F.3d 1201 (11th Cir. 2000).

[223] I.R.C. §§ 408(d)(6), 408A(d)(4) (2016).

[224] *Id.*

[225] *Id.* at. § 263(a); Treas. Reg. §1.263(a)-2(d)(1) (as amended in 2014); Treas. Reg. §1.263(a)-3(d) (as amended in 2014); Treas. Reg. § 1.263(a)-2T(d)(1) (as amended in 2013); Del Vecchio v. Comm'r, 32 T.C.M, (CCH) 1153 (1973); Fisher v. Comm'r, 29 T.C.M. (CCH) 1135 (1970).

[226] I.R.C. § 262(a) (2016); Treas. Reg. §1.262-1(b) (as amended in 2014).

[227] Treas. Reg. §§ 1.163-10T(o)(1)(i), (ii) (1987). A debtor with no interest subject to foreclosure on default does not have acquisition or home equity debt within the meaning of I.R.C. §§163(h)(3)(B), (C) (2016).

[228] I.R.C. § 163(h)(3)(A) (2016).

deductible.[229] Deduction of interest is permitted on mortgages of up to $1,000,000 for married taxpayers filing joint returns and unmarried individuals and $500,000 each for married taxpayer filing a separate return.[230] Married taxpayers filing separate returns are treated as one taxpayer; thus, each may claim one of residence as a qualified residence.[231] Home equity indebtedness (as opposed to debt incurred acquiring a home) is deductible non-acquisition debt up to $100,000 for married taxpayers filing joint returns and unmarried individuals, and $50,000 for each married taxpayer filing separate return.[232] The loan must be secured by a qualified residence and loan plus acquisition debt must not exceed fair market value.[233]

When a taxpayer stops living in the marital home due to separation or divorce, it is no longer that taxpayer's principal residence.[234] However, since one may deduct mortgage interest on one's personal residence and on one other residence, as long as he or she continues to own the residence, mortgage interest on the residence remains deductible.[235] Once ownership is transferred to the other spouse or former spouse, the non-owning spouse or former spouse can no longer deduct the interest expense as a home mortgage deduction.[236] In a community property state, or when a house is titled as joint ownership with right of survivorship, half of the mortgage interest is attributable to each spouse.[237]

Because one need only own an interest in the qualified residence for interest to be deductible,[238] a non-occupant spouse who agrees or is ordered to pay the mortgage on the marital home and remains a co-owner may deduct the portion attributable to the payor's ownership interest in the property; the remainder is deductible alimony income to the payee and is offset by an income tax deduction to the extent attributable to payment of interest on a mortgage covering the payee's interest in the property.[239] If a former spouse or children use the residence without paying rent, the residence requirement

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[229] *Id.* Both acquisition and home equity debt is debt secured by a qualified residence or second residence, I.R.C. §§ 163(h)(3)(B) and (C). Whether a residence is a principal residence and whether there is taxable gain on sale are determined based on a facts and circumstances analysis. I.R.C. § 121 (2016); Treas. Reg. § 1.121-1(b) (2002).
[230] I.R.C. § 163(h)(3)(B)(ii) (2016).
[231] *Id.* at § 163(h)(4)(A)(ii).
[232] *Id.* at § 163(h)(3)(C)(ii)).
[233] *Id.* at § 163(h)(3)(C).
[234] *Id*.
[235] *Id.* at § 163(h)(4)(A)(i)(II). The definition at I.R.C. § 280A(d)(1) and I.R.C. § 163(h)(4)(A)(iii) says an owned dwelling is treated as *one other residence* notwithstanding I.R.C. § 280A(d)(1) if it is not rented during the taxable year.
[236] Treas. Reg. §1.163-10T(j) (1987).
[237] Keeter v. U.S., 957 F.Supp. 1160 (E.D. Cal. 1997).
[238] Treas. Reg. §1.163-10T(o)(1) (1987).
[239] *Id.*

is satisfied and one can argue that the interest is deductible if the payor is liable under a mortgage.[240]

B. *Deduction of Property Taxes*

Owner's real property state and local taxes are deductible.[241] Married taxpayers, whether filing joint returns or separate returns, and single taxpayers may deduct whatever property taxes they pay.[242] If a property is titled as joint tenancy or as tenancy in common, each spouse or former spouse may deduct payment of one-half of the property tax.[243] Housing costs are treated as alimony if they are paid pursuant to a written divorce or settlement agreement and end at payee's death.[244] If a former spouse pays all property taxes on a jointly owned house half may be deducted as a property tax payment by the payor and half is treated as alimony (which is income to the other party offset by deduction of the tax payment).[245]

VIII. PROPERTY TRANSFERS TO THIRD PARTIES

Gain on transfer of a business interest to a third party pursuant to a divorce or separation agreement may be taxed to the party giving up his or her interest in the business (transferor) or the non-transferor depending on who will incur the lower tax liability. How the parties draft the divorce or settlement agreement and transfer documents determines who is liable for whatever tax is due. The transfer of the assets between the separating or divorcing spouses is subject to I.R.C. § 1041 divorce and separation rules if, 1) required by the divorce or settlement agreement, 2) pursuant to a written request of the other spouse or former spouse, or 3) where the transferor receives from the other spouse or former spouse a written ratification of the transfer saying it was intended as transfer to the non-transferring spouse or former spouse prior to the transfer to the third party and prior to the transferor filing his or her tax return for the tax year of transfer.[246] If the transfer to a third party is first transferred from the transferor spouse to the other spouse or former spouse, the transferee spouse is liable for the tax

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[240] I.R.C. § 163(h)(4)(A)(i)(II) (2016).
[241] *Id.* at §§ 164(a), 63(d).
[242] Rev. Rul. 62-38, 1962-1 C.B. 15 (divorce decree requiring payment of real estate tax is not alimony; it is deductible by the payor under I.R.C. § 164); Zampini v. Comm'r, 62 T.C.M, (CCH) 475 (1991).
[243] I.R.C. §§ 163, 164 (2016); Rev. Rul. 62-39, 1962-1 C.B. 17.
[244] I.R.C. §§ 71(b)(1)(A), (D) (2016).
[245] *Id*.
[246] Treas. Reg. § 1.1041-1T(c) (2003).

consequences of the transfer to a third party; if the transferor transfers it to the third party and the proceeds are transferred to the transferor the transferor is liable for the tax consequences.[247]

IX. STOCK REDEMPTIONS IN PROPERTY SETTLEMENTS OF SEPARATING OR DIVORCING SPOUSES OWNING A BUSINESS

Liquidation of a business held as community property, in joint ownership, or ownership subject to equitable distribution can result in sale of the departing owner's interest, continued direct ownership by both owners after separation or divorce, or placing the business in a trust from which each party draws income. The second and third alternatives do not disturb the capital structure of the business. If there are inadequate funds for the business to acquire the departing spouse's interest assuming debt may be the only alternative to continued ownership and sharing of profits. Even if it is not, retaining that structure may increase chances for viability or increase earnings for both parties relative to a liquidation alternative. The goal in a rational separation or divorce should be to maximize the value of each of the spouses' long term financial interest.

A. *The Difference between a Stock Redemption and a Dividend*

While a transfer of a stock or any ownership interest in a business incident to divorce is not a taxable event, the sale of the stock or other business interest is. For a C corporation, stock is treated as redeemed by the corporation[248] if the corporation acquires its stock from a shareholder in exchange for money or other property.[249] Such a stock redemption can be either a dividend or a purchase of part or all of an owner's interest in the business. When distribution of property to a shareholder by a corporation is a dividend, the dollar value of the property is included in shareholder's gross income and taxed accordingly.[250] If a distribution is a purchase of an ownership interest, rather than a dividend, the payment is taxed differently. Purchase of an ownership interest from seller first reduces the departing shareholder's adjusted basis of the stock.[251] To the extent the value of

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[247] I.R.C. §§ 1001 (a)-(c) (2016).
[248] *Id.* at § 301.
[249] For purposes of corporate stock redemptions, property means money, securities, and any other property, except stock in the corporation making the distribution, I.R.C. § 317 (2016).
[250] I.R.C. § 301(c)(1) (2016).
[251] *Id.* at §301(c)(2).

property received exceeds the adjusted basis of the stock the difference is treated as gain from the sale or exchange of property.[252]

A redemption is a purchase rather than payment of a dividend if the redemption 1) is a distribution that is not essentially equivalent to a dividend, 2) is substantially disproportionate with respect to the shareholder, 3) is a complete redemption of all of the stock of the corporation owned by the shareholder, 4) is held by a shareholder who is not a corporation, or 5) is a distribution in redemption of stock of a publicly offered regulated investment company.[253] Thus, redemption of a business interest in a corporation may be accompanied by no current tax liability other than reduction in basis. However, redeeming a departing spouse's ownership interest would reduce the capital invested in the business.

B. *Tax Treatment of C Corporation Stock Redemptions*

A divorce or settlement agreement or other written agreement that supersedes any other instrument or agreement concerning the purchase, sale, redemption, or other disposition of the stock subject to redemption determines whether the redemption should be treated as a redemption distribution to the transferor spouse or to the non-transferor spouse.[254]

The default rule for stock redemptions associated with separation or divorce is that if a corporation redeems stock owned by the spouse giving up his or her interest in the stock, and the transferor spouse's receipt of property for the redeemed stock is not treated as a constructive distribution to the non-transferor spouse, the form of the stock redemption will be respected for federal income tax purposes.[255] Thus, if the transferor spouse is treated as receiving a distribution from the corporation in redemption of the transferor spouse's stock, the I.R.C. § 1041 non-recognition rule does not apply.[256] This normally means that the transferor spouse is taxed on any gain. However, when the transferring spouse's receipt of the redemption proceeds from the redeeming corporation is treated under general tax principles as a constructive distribution to the non-transferring spouse (for example, where he or she had a primary and unconditional obligation to purchase the stock from the transferring spouse),[257] the stock is deemed to be transferred by the

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[252] *Id.* at § 301(c)(3).
[253] *Id.* at § 302(b).
[254] Treas. Reg. § 1.1041-2(c) (2003).
[255] *Id.* at § 1.1041-2(a)(1).
[256] *Id.* at § 1.1041-2(b)(1).
[257] *Id.* at § 1.1041-2(a)(2).

transferor spouse to the non-transferring spouse who then transfers the stock to the corporation.[258]

For example, assume Corporation X has 100 shares owned half by each of the divorcing spouses, wife is required to purchase husband's shares, and husband is required to sell his shares to wife in exchange for $100,000. Corporation X redeems husband's shares for $100,000. If wife has a primary and unconditional obligation to purchase husband's stock the stock redemption is a constructive distribution to wife. If the divorce instrument does not require husband and wife to report the transaction on their income tax returns in a manner that would result in a deemed redemption distribution to husband, he will be treated as if he transferred his stock to wife in a transfer to which the I.R.C. § 1041 non-recognition rule applies. Wife will be treated as transferring the stock she is deemed to have received from husband to Corporation X in exchange for $100,000 in an exchange to which the §1041 non-recognition rule does not apply and she will be taxed on the proceeds.[259]

If instead, the divorce instrument provides, "husband and wife agree that the redemption will be treated for federal income tax purposes as a redemption distribution to husband" and the divorce instrument also provides that it "supersedes all other instruments or agreements concerning the purchase, sale, redemption, or other disposition of the stock that is the subject of the redemption," the tax consequences of the redemption will be determined in accordance with its form as a redemption of husband's shares by Corporation X and will not be treated as resulting in a constructive distribution to wife.[260] The husband would be liable for any tax due.

If instead, the divorce instrument requires husband to sell his shares to Corporation X in exchange for a note and wife guarantees X's payment of the note, under applicable tax law, wife does not have a primary and unconditional obligation to purchase husband's stock; and the divorce instrument does not require them to file their federal income tax returns in a manner that reflects that husband transferred the redeemed stock to wife in exchange for the redemption proceeds. If Corporation X redeems the stock from wife in exchange for the redemption proceeds; the stock redemption does not result in a constructive distribution to wife because she does not have a primary and unconditional obligation to purchase husband's stock. Accordingly, the tax consequences of the redemption will be treated as a redemption of husband's shares by Corporation X.[261]

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[258] I.R.C. § 302 (2016).
[259] Treas. Reg. § 1.1041-2(d), Ex. (1) (2003).
[260] *Id.* at § 1.1041-2(d), Ex. 2.
[261] *Id.* at § 1.1041-2(d), Ex. 3.

C. *Tax Imposed on Redemption of Stock by an S Corporation*

Redemption of stock by an S corporation that has no accumulated earnings and profits is not included in gross income to the extent of the adjusted basis of the stock; the redemption is treated as gain from the sale or exchange of property to the extent the distribution exceeds basis.[262] If the S corporation has earnings and profits, the portion which does not exceed the accumulated adjustments account is not included in gross income to the extent of its adjusted basis; it is treated as gain from sale or exchange to the extent it exceeds basis.[263] The remainder of the distribution is treated as a dividend to the extent it does not exceed the S corporation's accumulated earnings and profits.[264] Amounts in excess of accumulated earnings and profits are treated as gain on the sale of property.[265]

X. COSTS ASSOCIATED WITH CONTINUING HEALTH CARE FOR A FORMER SPOUSE

A. *Group Health Plan Continuation under the Consolidated Omnibus Budget Reconciliation Act (COBRA) Incident to Divorce or Separation*

An employee's group health plan is required to provide that if a qualified beneficiary loses coverage because of a qualifying event, the party losing coverage may elect continuation of coverage for a year under COBRA within at least 60 days of the qualifying event.[266] Qualified beneficiaries include the covered employee, employee's divorced or legally separated spouse, and dependent children.[267]

B. *Medical Expenses a Taxpayer May Deduct*

In addition to deducting one's own medical expenses, payor may deduct those of his or her spouse and dependents as of the date the service was rendered subject to the threshold levels for deduction.[268] The children of divorced or separated parents are dependents of both parents for purposes of

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[262] I.R.C. §§ 1368(a), (b) (2016).
[263] *Id.* at § 1368(c)(1).
[264] *Id.* at § 1368(c)(2).
[265] *Id.* at § 1368(c)(3).
[266] *Id.* at § 4980B(f)(1).
[267] *Id.* at § 4980B(g)(1).
[268] *Id.* at § 213(a).

deducting medical expenses; thus, the parent paying the medical expense may deduct the expense.[269]

C. *Allocation of Premium Tax Credit for Health Insurance Purchased on Patient Protection and Affordable Care Act Insurance Exchanges*

The provisions of the Patient Protection and Affordable Care Act,[270] and the Health Care and Education Reconciliation Act of 2010,[271] (collectively, the Affordable Care Act) provide subsidies for those purchasing insurance on individual state or federal exchanges who earn less than statutorily defined levels of income.[272] Many taxpayers are allowed a refundable credit[273] for Affordable Care Act health insurance purchased on an exchange.[274]

IRS regulations explain when separated and divorced taxpayers may claim the premium credit on separate returns.[275] If a taxpayer enrolls an individual in a qualified health plan, but a different taxpayer claims a personal exemption deduction for the enrollee (the *shifting enrollee*), both premiums and advance credit payments for the plan, in which the shifting enrollee was enrolled are allocated between the enrolling taxpayer and the claiming taxpayer using an allocation percentage.[276] The claiming taxpayer is allocated a portion of the premiums and credits for the plan in which the enrollee was enrolled equal to the premiums and credits times the allocation percentage; the enrolling taxpayer is allocated the remainder of the premiums and credits.[277] The enrolling taxpayer and claiming taxpayer may agree on any allocation percentage between 0 and 100 percent.[278] If the claiming taxpayer and enrolling taxpayer do not agree, the allocation percentage is equal to the number of shifting enrollees divided by the total number of individuals enrolled by the enrolling taxpayer in the same qualified health plan as the shifting enrollees.[279]

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[269] *Id.* at §§ 152(e), 213(d)(5).
[270] Patient Protection and Affordable Care Act, Pub. L. No. 111-148, 124 Stat. 119 (2010).
[271] Health Care and Education Reconciliation Act of 2010, Pub. L. No. 111-152, 124 Stat. 1029 (2010).
[272] *Id*.
[273] I.R.C. § 162(1) (2016).
[274] I.R.C. § 36B(f)(2) (2016); Treasury Department Rule: Rules Regarding the Premium Insurance Tax Credit, 79 R 43622, (7-28-2014); Treas. Reg. §§ 1.36B-4(a)(1),(a)(3), (c) (as amended in 2014) (refundable credit for coverage under a qualified health plan); Treas. Reg. § 1.162-1T(a)(2).
[275] I.R.C. § 36B (2016); Treas. Reg. § 1.36B-2(c)(4) (as amended in 2015).
[276] Treas. Reg. § 1.36B-3T(g) (as amended in 2014).
[277] Treas. Reg. § 1.36B-4T(a)(1)(ii) (as amended in 2014).
[278] *Id.* at § 1.36-4T(a)(4)(iii), Ex. (10).
[279] *Id.* at § 1.36B-4T(a)(4)(iii), Ex. (11).

The following examples illustrate the process. Assume taxpayers G and H are divorced and have two children, J and K. G enrolls herself, J, and K in a qualified health plan for 2014 for an annual premium of $13,000. G receives advance credit payments for a family of three, based on an annual benchmark plan premium of $12,000 (the benchmark premium plan rate) and projected 2014 household income of $58,590, (300 percent of the Federal poverty line for a family of three, applicable percentage 9.5). G's advance credit payments for 2014 are $6,434 ($12,000 benchmark plan premium less $5,566 contribution amount (determined by multiplying household income of $58,590 by the applicable percentage of 9.5).

K lives with H for more than half of 2014 and H claims K as a dependent for 2014. G and H agree to an allocation percentage[280] of 20 percent. Under the agreement, H is allocated 20 percent of the items to be allocated and G is allocated the remainder of those items. If H is eligible for a premium tax credit, H takes into account $2,600 of the premiums for the plan in which K was enrolled ($13,000 x .20) and $2,400 of G's benchmark plan premium ($12,000 x .20) of the advance credit payments for K's coverage. In addition, H is responsible for reconciling $1,287 ($6,434 x .20) of the advance credit payments for K's coverage.

G's family size for 2014 includes only G and J and G's household income of $58,900 is 380 percent of the Federal poverty line of a family of 2 (applicable percentage 9.5). G's benchmark plan premium for the plan covering G and J, benchmark plan premium for 2014 is $9,600 (which is the benchmark premium for the plan covering G, J, and K ($12,000) minus the amount allocated to H (2,400). Consequently, G's premium tax credit is $4,004 (G's benchmark plan premium of $9,600 minus G's contribution amount of ($5,596 x .095)). G has an excess advance payment of $1,143 (the excess of the advance credit payments of $5,147 ($6,434 - $1,287 allocated to H) over the premium tax credit of $4,004).[281]

If G and H do not agree on an allocation percentage[282] the allocation percentage is 33 percent, computed as follows: The number of shifting enrollees, which is 1, K, divided by the number of individuals enrolled by the enrolling taxpayer on the same qualified health plan as the shifting enrollee, which is 3, G, J, and K. H is allocated 33 percent of the items to be allocated and G is allocated the remainder of those items.[283]

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[280] Treas. Reg. § 1.36B-4T(a)(1)(ii)(B)(2) (2014).
[281] *Id.* at. § 1.36B-4T(a)(1)(iii), Ex. (10).
[282] *Id.* at § 1.36B-4T(a)(1)(ii)(B)(2).
[283] *Id.* at § 1.36B-4T(a)(1)(iii), Ex. (11).

XI. RELIEF FROM JOINT TAX LIABILITY AVAILABLE TO SEPARATING AND DIVORCING SPOUSES

If married persons file a separate return, each spouse is liable only for his or her own tax liability; however, if they file a joint return, each spouse is jointly and severally liable for all tax and penalties due except with respect to penalties for civil fraud.[284] There are three avenues for relief from liability incurred by filing joint returns for married, separated, or divorced spouses; innocent spouse relief, limitation of liability, and equitable relief.[285] Apportionment of relief can be provided if the innocent spouse had knowledge of part, but not all of the understatement of the tax liability.[286] In addition, the I.R.S. policy concerning the effect of unrecorded real property deeds arising in divorce cases on a later-arising federal tax lien is that once a conveyance divests a taxpayer of a property interests a Federal tax lien does not attach to the property.[287]

A. *Spousal Relief*

To use the innocent spouse relief rules[288] the innocent spouse must show that a joint return was filed, the understatement was due to the other spouse's erroneous statement, the spouse seeking relief had neither knowledge nor reason to know of the understatement, and that holding the innocent spouse responsible would be inequitable.[289] Innocent spouse relief is only available for income tax. One cannot secure innocent spouse relief after previously entering into an offer in compromise, or closing agreement disposing of the liability, or as part of a scheme to defraud the I.R.S.[290] Community property laws are ignored in considering the extent of innocent spouse relief.[291] The I.R.S. must send a notice of request for innocent spouse relief to the other spouse or former spouse.[292]

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[284] I.R.C. §§ 6013(d)(1), (3) (2016).
[285] Ron Youde, *A Call for IRS Guidance in Drafting Tax Liability Divorce Clauses in Anticipation of Innocent Spouse Litigation*, 52 DRAKE L. REV. 363 (2004).
[286] I.R.C. §6015(b)(2) (2016) (guidance on equitable relief); Rev Proc. 2013-34, IRB 2013-43, 397, Section 4.01.
[287] *See* William D. Elliott, *Tax Practice: Unrecorded Conveyances and Federal Tax Liens*, TAXES – THE TAX MAGAZINE, Oct. 20, 2014, at 37.
[288] I.R.C. § 6015(a)(1) (2016).
[289] *Id.* at §§ 6015(b)(1), (3).
[290] Treas. Reg. §§ 1.6015-1(a)(3), (c), (d) (2002).
[291] *Id.* at § 1.6015-1(g).
[292] Treas. Reg. § 1.6015-6(a)(1) (2002).

B. *Limitation of Liability*

A spouse legally separated from or divorced from the other spouse and not living in the same household during the preceding 12 month period may file a separate liability election to limit liability for unpaid taxes associated with understatements.[293] Refunds are not permitted under this approach.[294] Such an election is invalid if the IRS demonstrates the parties committed fraud.[295] Relief is limited to the portion of the deficiency allocated to the spouse claiming relief.[296]

C. *Equitable Relief*

A spouse or former spouse may seek equitable relief from the I.R.S. for tax liability or seek a refund.[297] The spouse must file a separate request for equitable relief[298] and demonstrate that he or she has; 1) filed a joint return, 2) other forms of relief are not available,[299] 3) the request is timely filed, 4) no assets were transferred to the requesting spouse, 5) the requesting spouse did not knowingly file a fraudulent joint return, and 6) the liability involved is attributable to the non-requesting spouse.[300] The standard for initiating review is that the spouse requesting relief did not know of the understatement or deficiency. There is also a limited possibility the I.R.S. will agree to a collection alternative to seek recovery from the other spouse.[301] The I.R.S. is free to weigh the facts and circumstances and make a subjective determination of whether relief is available and, if so, what relief should be granted.[302]

XII. DEDUCTIBILITY OF COUNSEL FEES

Attorney fees associated with obtaining a divorce are non-deductible personal expenses.[303] Fees associated with collection of income and tax

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[293] I.R.C. § 6015(a)(2) (2016).
[294] Treas. Reg. § 1.6015-3(c)(1) (2002).
[295] I.R.C. § 6015(c)(3)(a) (2016).
[296] *Id.* at §§ 6015(c)(1), (d)(3)(A).
[297] *Id.* at § 6015(f); Treas. Reg. § 1.6015-4 (2002).
[298] I.R.S. FORM 8857: REQUREST FOR INNOCENT SPOUSE RELIEF, (2014), https://www.irs.gov/pub/irs-access/f8857_accessible.pdf; Treas. Reg. § 1.6015-5(a) (2002).
[299] I.R.C. §§ 6015(b), 6015(c)(3) (2016).
[300] *Id.* at. § 6015; Treas. Reg. § 1.6015-5(a) (2002).
[301] I.R.C. § 6015 (2016); Welch v. Comm'r, 290 U.S. 111 (1933).
[302] I.R.C. § 6015 (2016).
[303] United States v. Gilmore, 372 U.S. 39 (1963); I.R.C. § 262(a) (2016); Treas. Reg. § 1.262-1(b)(7) (as amended in 2014); United States v. Patrick, 372 U.S. 53 (1963).

advice (even though associated with a divorce) may be deductible[304] as itemized expenses.[305] Taxpayers may deduct ordinary and necessary expenses for the production or collection of income.[306] These expenses include counsel fees associated with the determination and collection of alimony.[307] They also include costs of recovering alimony arrearages or business profits, and to increase alimony payments.[308] Counsel fees to try to reduce or avoid alimony are not deductible.[309] Taxpayers are permitted to deduct ordinary and necessary expenses paid or incurred during the taxable year for the determination, collection, or refund of any tax.[310] Deductible expenses must be substantiated as ordinary and necessary by the attorney who identifies the time spent performing collection of income items and tax advice.[311]

XIII. TREATMENT OF INCOME IN COMMUNITY PROPERTY STATES

Ending the community in a community property state causes income to be taxed solely to the spouse who earns or receives it.[312] In the Fifth and Ninth Circuits spouses may agree in writing to dissolve the community and treat income as separately acquired prior to divorce.[313] Absent an express agreement to dissolve the community, a divorce or separation agreement imposed or approved by a court or a final divorce ends the community.[314]

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[304] I.R.C. §§ 212(1), (3) (2016).
[305] *Id.* at §§211, 212, 63(d).
[306] *Id.* at §212(1); Treas. Reg. §1.212-1(a)(1)(i) (1975); Young v. Comm'r, 113 T.C. 152 (1999), *aff'd*, 240 F.3d 369 (4th Cir. 2001).
[307] Hesse v. Comm'r, 60 T.C. 685 (1973), *aff'd*, 511 F.2d 1393 (3d. Cir. 1975) (unreported), *acq*., 1974-2 C.B. 1; Wild v. Comm'r, 42 T.C. 706 (1964), *acq*., 1967-2 C.B. 1; Elliott v. Comm'r, 40 T.C. 304 (1963), *acq.*, 1964-1 C.B. 3.
[308] Dalton v. Comm'r, 34 T.C. 879 (1960); Gale v. Comm'r, 13 T.C. 661 (1949), *aff'd*, 191 F.2d 79 (2d Cir. 1951) (aff'd on other grounds); Hahn v. Comm'r, 35 T.C.M. (CCH) 509 (1976); Harris v. U.S., 275 F.2d 238 (9th Cir. 1960) (fees allocable to capital assets added to the basis of the underlying asset); Glassman v. Comm'r, 74 T.C.M. (CCH) 1106 (1997) (legal fees to correct miscalculation former wife's share of husband's qualified pension plan deductible under I.R.C. § 212, not added to her basis in plan benefits).
[309] Hunter v. U.S., 219 F.2d 69 (2d Cir. 1955), *aff'g* 123 F. Supp. 763 (E.D.N.Y. 1954); Sunderland v. Comm'r, 36 T.C.M. (CCH) 512 (1977); Melat v. Comm'r, 65 T.C.M. (CCH) 2868 (1993).
[310] I.R.C. § 212(3) (2016); Rev. Rul. 72-545, 1972-2 C.B. 179.
[311] Rev. Rul. 72-545, 1972-2 C.B. 179 (describing how to allocate fees).
[312] I.R.C. § 66 (2106); Treas. Reg. §1.66-1 (2003).
[313] Estate of Vogel v. Comm'r, 278 F.2d 548 (9th Cir. 1960), *aff'g* 30 T.C. 125 (1958); Jones v. Comm'r, 31 B.T.A. 55 (1934), *aff'd*, 82 F.2d 329 (5th Cir. 1936); Coburn v. Collins, 244 S.W.2d 526 (Tex. Civ. App. 1951); *see also* Abrams v. Comm'r, 57 T.C.M. (CCH) 1433 (1989).
[314] Ketcham v. Comm'r, 45 T.C.M. (CCH) 8 (1982).

The IRS allocates community income to each spouse if they 1) are married at any time during a calendar year,[315] 2) live apart at all times during the year,[316] 3) do not file a joint tax return for that year,[317] 4) one or both of them have earned income[318] for the year which is community income,[319] and 5) no earned income is transferred between them during the year.[320] Transfers between spouses for the benefit of the children are not considered transfers of community income.[321] Once the conditions for are met for ending the community, income is allocated to the respective parties as though it were allocated between non-resident alien former spouses.[322]

Community income is allocated as follows; 1) earned income (other than trade or business income and a partner's distributive share of partnership income) to the spouse who rendered the personal services,[323] 2) trade or business income[324] to the spouse carrying on the trade or business; if operated jointly, then based on their respective distributive shares,[325] 3) a partnership's distributive share to the partner,[326] 4) income from separate property is income of the owner of the property,[327] and 5) all other community property income is treated as provided in the applicable state community property law.[328]

XIV. CONCLUSION

For those who choose to address separation or divorce and division of property and payment of alimony rationally, planning can minimize the portion of funds paid in taxes. Good planning can maximize the likelihood of long run survival of a business in which both separating spouses have an ownership interest. Survival of the business, in turn, can provide continued income to pay alimony and child support in addition to maximizing the value of assets for both parties. Not planning for the long run survival of a business and maximization of asset value to the two parties is at best unfortunate, and

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[315] I.R.C. § 66(a)(1) (2016).
[316] *Id.* at § 66(a)(2)(A).
[317] *Id.* at § 66(a)(2)(B).
[318] *Id.* at §§ 66(d)(1), 911(d)(2) (compensation for personal services).
[319] *Id.* at § 66(a)(3).
[320] *Id.* at § 66(a)(4).
[321] *Id.* Treas. Reg. § 1.66-2(c) (2003); Easter v. Comm'r, 63 T.C.M. (CCH) 2590 (1992) (child support treated as payments for payee's own support).
[322] I.R.C. § 879(a) (2016); Treas. Reg. § 1.66-2(a) (2003).
[323] I.R.C. § 879(a)(1) (2016).
[324] *Id.* at § 162; Treas. Reg. § 1.1402(a)-1(c) (as amended in 1974).
[325] I.R.C. §§879(a), 1402(a)(5)(A) (2016).
[326] *Id.* at §§ 879(a)(2), 1402(a)(5)(B).
[327] *Id.* at §879(a)(3).
[328] *Id.* at § 879(a)(4).

at worst can lead to a substantially lower standard of living for both the separating spouses and their dependents.