1985

# Divorce: A Taxing Experience

Charles Edward Falk

# DIVORCE: A TAXING EXPERIENCE

By Charles Edward Falk

CONTENTS



## *1.01 Introduction*

Among the many changes made by the Tax Reform Act ("TRA") of 1984 was an overhauling of the definition and treatment of alimony[1], and an equally radical change for certain spousal transfers. The new legislation reflects the uncertainties and frustrations that resulted from the former law. While the changes made to the Code are sweeping, the practitioner continues to face a demanding requirement that clients be thoroughly informed and counseled about the implications of any settlement or property transfer, and that any documents be carefully drawn so that the intended tax consequences are achieved.

[1] Unless otherwise provided, for purposes of this paper, the term "alimony" includes payments made for separate maintenance pursuant sec. (71) (a).

*2.01 Alimony*

*2.02 Reason for Change*

The only similarity between the law concerning the taxation of alimony before the TRA 1984 and the changes made by the Act is the Internal Revenue Code (the "Code") designation for includibility (section 71) and deductibility (section 215).

The motivation for change is provided in the General Explanation of the Act prepared by the Joint Committee on Taxation:

> The Congress believes that the prior law definition of alimony is not sufficiently objective. Differences in State laws create differences in Federal tax consequences and administrative difficulties for the IRS. The Congress believes that a uniform Federal standard should be set forth to determine what constitutes alimony for Federal tax purposes. This will make it easier for the Internal Revenue Service, the parties to a divorce, and the courts to apply the rules to the facts in any particular case and should lead to less litigation. The Act attempts to define alimony in a way that would conform to general notions of what type of payments constitute alimony as distinguished from property settlements and to prevent the deduction of large, one-time lump-sum property settlements.[2]

The change, however, is even more complete than set forth in the above quote.

*2.03 What is Alimony*

The Code provides that "gross income includes amounts received as alimony or separate maintenance payments."[3] The term "alimony or separate maintenance payment" means any payment received by or on behalf of a spouse, or a former spouse, of the payor under a divorce or separation instrument that meets all of the following requirements:[4]

> (a) The payment is in cash.
>
> (b) The payment is not designated as a payment which is excludible from the gross income of the payee and nondeductible by the payor.
>
> (c) In the case of spouses legally separated under a decree of divorce or separate maintenance, the spouses are not members of the same household at the time the payment is made.

---

[2] Joint Committee in Taxation, General Explanation, CCH Edition, p. 714.

[3] 71(a)

[4] Temp. Reg. ("TR") 1.71-1T, Q + A 2. The Treasury promulgated temporary regulations on August 30, 1984. They are in question and answer form.

(d) The payor has no liability to continue to make any payment after death of the payee (or to make any payment as a substitute for such payment) and the divorce or separation instrument states that there is no such liability.

(e) The payment is not treated as child support.

(f) To the extent that one or more annual payments exceed $10,000 during any of the 6-post-separation years, the payor is obligated to make annual payments in each of the post-separation years.

### *2.04 A Divorce or Separation Instrument ("DSI")*

The Code defines a DSI as:

(A) A decree of divorce or separate maintenance or a written instrument incident to such a decree. ("DDSM")

(B) A written separation agreement ("WSA"),

or

(C) A decree (not described in subparagraph (A) (requiring a spouse to make payments for the support or maintenance of the other spouse (71 (b) (2) (C)).[5]

### *2.05 Payments Must be in Cash*

A major departure from prior law is that payments will only qualify as alimony if they are made in cash.[6] Payments of cash to a third party on behalf of a spouse qualify, if the payments are made pursuant to a DSI. The regulations provide rent, mortgage, tax or tuition liabilities as examples of direct payments made to third parties.[7] Payments made to maintain property owned by the payor spouse but used by the payee spouse will qualify.[8] Premiums paid by the payor spouse for term or whole life insurance on the payor's life made under the terms of a DSI will qualify to the extent the payee spouse owns the policy.[9] A payee spouse may also make a written request that payments be made directly to a third party. These payments will qualify if the request states that the parties intend the payment to be treated as alimony under sec. 71, and must be received by the payor spouse prior to the filing of the payor spouse's first tax return for the taxable year in which the payment was made.[10] The regulations give a cash payment to a charitable organization as an example of this kind of payment.[11]

---

[5] 71(b) (2)
[6] 71(b) (1)
[7] TR. 2. 71-1T, Q + A 6
[8] Ibid
[9] Ibid
[10] TR. 1.71-1T, Q + A 7
[11] Ibid

*2.06 Designation of Payment*

Payment that would otherwise qualify as alimony, and be deductible by the payor and includible by the payee can be designated as excludible from gross income and not deductible.[12] Such designation must be made in the DSI. The statement must be made in the relevant instrument and a copy must be attached to the payee's first tax return for each year in which the designation applies.[13]

*2.07 Members of the Same Household*

The new law provides that payment made pursuant to a DDSM will only qualify as alimony if the parties are not members of the same household at the time such payment is made.[14] This requirement of living apart does not apply to payments made pursuant to a WSA or a 71(b) (2) (C) order.[15] A payment will nonetheless qualify if it is made while one spouse is preparing to depart and does depart not more than one minute after the date the payment is made.[16]

*2.08 Payor Liability to make Payments after Payee's Death*

One of the most crucial provisions of the new law is that the payor spouse must have no liability to make any payments, whether in cash or property, after the death of the payee spouse, or any payments as a substitute for those payments, and the DSI must *state* that there is no such liability.[17] A failure to make this statement in the agreement will cause the payments not to be treated as alimony, and will not be deductible by the payor nor excludible by the payee.[18] The temporary regulations are quite emphatic and specific on this point:[19]

> A is to pay B $10,000 in cash each year for a period of 10 years under a divorce or separation instrument which does not state that the payments will terminate upon the death of B. None of the payments will qualify as alimony or separate maintenance payments.

The fact that local law or an oral agreement provides that payments will terminate is of no consequence.[20] A requirement that substitute payments are to be made upon the death of the payee spouse will cause all payments (pre-death and post-death) to fail to qualify.[21] The regulations provide that payments will be considered substitute payments "to the extent that one or more payments are

---

[12] 71(b) (1) (B)

[13] If such a designation is intended, counsel should review TR. 1.71-1T, Q + A 8 for the requirements. While the parties may agree not to include or deduct payments otherwise qualifying, presumably no procedure is permitted to qualify non-qualifying payments.

[14] 71(b) (1) (c)

[15] T.R. 1.71-1T, Q + A 9

[16] Ibid

[17] 71(b) (1) (D)

[18] T.R. 1.71-1T, Q + A, 10 and 11

[19] Ibid, Q + A 11, example (1)

[20] Ibid, Q + A 12

[21] Ibid, Q + A 13

to begin to be made, increase in amount, or become accelerated in time as a result of the death of the payee spouse.''[22] The regulations do however, provide that such a determination will be made on a case by case basis.[23] The following example from the regulations is instructive on this point:

> Under the terms of a divorce decree, A is obligated to make annual alimony payments to B of $30,000, terminating on the earlier of the expiration of 15 years or the death of B. The divorce decree provides that if B dies before the expiration of the 15 year period, A will pay B's estate the difference between the total amount that A would have paid had B survived, minus the amount actually paid. For example, if B dies at the end of the 10th year in which payments are made, A will pay B's estate $150,000 ($450,000 − $300,000). These facts indicate that A's liability to make a lump sum payment to B's estate upon the death of B is a substitute for the full amount of each of the annual $30,000 payments to B. Accordingly, none of the annual $30,000 payments to B will qualify as alimony or separate maintenance payments. The result would be the same if the lump sum payable at B's death were discounted by an appropriate interest factor to account for the prepayment.[24]

*2.09 Payments Treated as Child Support*

As under prior law, payments for child support do not constitute alimony, and are not includible in the gross income of the recipient and are not deductible by the payor.[25] Unlike prior law, however, the degree of specificity with which such payments must be stated is reduced. Under prior law, the standard had been defined in *Commissioner v. Lester*,[26] where the Supreme Court required that the agreement ''specify or fix'' on amount designated as child support. The new law relaxes this requirement by permitting, as child support, payments which are reduced on the happening of a contingency. The code specifies two types of reductions:

> (1). On the happening of a contingency specified in the DSI relating to the child such as the attainment of a specified age, marrying, dying, leaving school, etc.
> (2). At a time which can be clearly associated with a contingency specified in (1)[27]

[22] Ibid, Q + A 14
[23] Ibid
[24] Ibid, example (2)
[25] 71(c); T.R. 1.71-1T, Q + A 15
[26] 366 U.S. 299 (1961)
[27] 71(c) (2)

The regulations provide that (2), above, will be applied to two situations:

> (1). Where payments are to be reduced no more than 6 months before or after the child attains the age of 18, 21 or local age of majority;
>
> (2). Where payments are to be reduced on two or more occasions which occur not more than one year before or after a different child of the payor spouse attains a certain age between 18 and 24 inclusive.[28]

Both of the above are rebuttable presumptions.[29] The regulations provide an interesting example of how (2), above, will be applied:

> A and B are divorced on July 1, 1985, when their children, C (born July 15, 1970) and D (born September 23, 1972), are 14 and 12, respectively. Under the divorce decree, A is to make alimony payments to B of $2,000 per month. Such payments are to be reduced to $1,500 per month on January 1, 1991 and to $1,000 per month on January 1, 1995. On January 1, 1991, the date of the first reduction in payments, C will be 20 years 5 months and 17 days old. On January 1, 1995, the date of the second reduction in payment, D will be 22 years 3 months and 9 days old. Each of the reductions in payments is to occur not more than one year before or after a different child of A attains the age of 21 years and 4 months. (Actually, the reductions are to occur not more than one year before or after C and D attain any of the ages 21 years 3 months and 9 days through 21 years 5 months and 17 days.) Accordingly, the reductions will be presumed to clearly be associated with the happening of a contingency relating to C and D. Unless this presumption is rebutted, payments under the divorce decree equal to the sum of the reductions ($1,000 per month) will be treated as fixed for the support of the children of A and therefore will not qualify as alimony or separate maintenance payments.[30]

If a part payment is made, the payment is first applied to child support.[31]

### *2.10 Front Loading*

The 1984 act added new rules concerning the "front loading" of payments.[32] The purpose of this rule is to deter taxpayers from making large early payments to obtain large tax breaks.

---

[28] T.R. 1.71-1T, Q + A 18
[29] Ibid
[30] Ibid, example in Q + A 18
[31] 71(c) (3)
[32] 71(f)

The first rule provides that any otherwise deductible payment in excess of $10,000 will not be deductible in excess of $10,000 unless a payment in each of the six "post separation years" is made.[33] The six post separation years are the six consecutive calendar years beginning with the first calendar year in which the payor makes an alimony or separate maintenance payment (except a payment under 71(b) (2) (C)).[34]

The second "front loading" rule is designed to reduce the fluctuation in the amount of the payments made during the six post separation years. In any of the six post separation years, if a payment is less than a payment made in a prior year, the prior year's payment is "recaptured" to the extent that the prior year's payment exceeds the present year's payment plus $10,000. Any amount recaptured is included in the income of the payor spouse and is deductible by the payee spouse.[35] Any amount recaptured reduces the prior year's payment for future calculations. The application of this rule may be illustrated by the following example:

Payor spouse H makes payments to payee spouse B as follows (payments in thousands):

| | 1985 | 1986 | 1987 | 1988 | 1989 | 1990 |
|---|---|---|---|---|---|---|
| Amount Paid | 30 | 25 | 20 | 15 | 10 | 5 |
| Potential Recapture | 20 | 15 | 10 | 5 | 0 | 0 |
| Amount Recaptured | | | | | | |
| 1985 | — | — | — | — | — | — |
| 1986 | 0 | — | — | — | — | — |
| 1987 | 0 | 0 | — | — | — | — |
| 1988 | 5 | 0 | 0 | — | — | — |
| 1989 | 5 | 5 | 0 | 0 | — | — |
| 1990 | 5 | 5 | 5 | 0 | 0 | — |
| Total Recaptured | 15 | 10 | 5 | 0 | 0 | 0 |

If H had no obligation to make payments in 1990, the rule requiring a payment in each of the six post separation years would have been violated, and only $10,000 (or less) would be permitted as a deduction in each year. For example, if no payment had been required in 1990, the amount so permitted would have been:

| | Payment | Amount Allowed |
|---|---|---|
| 1985 | 30 | 10 |
| 1986 | 25 | 10 |
| 1987 | 20 | 10 |
| 1988 | 15 | 10 |
| 1989 | 10 | 10 |

[33] 71(f) (i)
[34] 71(f) (4)
[35] 71(f) (2)

The code provides for these exceptions to the "recapture rule":

(1.) Payment made pursuant to a 71(b) (2) (C) order,[36]

(2.) Payments that are subject to a contingency not within the payor's control;[37]

(3.) Any year in which payment cease by reason of the death or remarriage of the payee spouse.[38]

*2.11 Effective Date*

Generally, the new law applies to a DSI executed after December 31, 1984. The regulations give the following summary:

> Generally, section 71, as amended, is effective with respect to divorce or separation instruments (as defined in section 71(b) (2)) executed after December 31, 1984. If a decree of divorce or separate maintenance executed after December 31, 1984, incorporates or adopts without change the terms of the alimony or separate maintenance payments under a divorce or separation instrument executed before January 1, 1985, such decree will be treated as executed before January 1, 1985. A change in the amount of alimony or separate maintenance payments or the time period over which such payments are to continue, or the addition or deletion of any contingencies or conditions relating to such payments is a change in the terms of the alimony or separate maintenance payments. For example, in November 1984, A and B executed a written separation agreement. In February, 1985, a decree of divorce is entered in substitution for the written separation agreement. The decree of divorce does not change the terms of the alimony A pays to B. The decree of divorce will be treated as executed before January 1, 1985 and hence alimony payments under the decree will be subject to the rules of section 71 prior to amendment by the Tax Reform Act of 1984. If the amount or time period of the alimony or separate maintenance payments are not specified in the pre-1985 separation agreement or if the decree of divorce changes the amount or term of such payments, the decree of divorce will not be treated as executed before January 1, 1985, and alimony payments under the decree will be subject to the rules of section 71, as amended by the Tax Reform Act of 1984.

[36] 71(f) (5) (b)
[37] 71(f) (5) (c)
[38] 71(f) (5) (a)

Section 71, as amended, also applies to any divorce or separation instrument executed (or treated as executed) before January 1, 1985 that has been modified on or after January 1, 1985, if such modification expressly provides that section 71, as amended by the Tax Reform Act of 1984, shall apply to the instrument as modified. In this case, section 71, as amended, is effective with respect to payments made after the date the instrument is modified.[39]

### *3.01 Spousal Transfers*

#### *3.02 Reason for Change*

One of the most dramatic changes made by the TRA of 1984 was the across the board exemption from income taxation of transfers between spouses and certain former spouses. The enactment of new section 1041 of the code effectively repeals the often cited and potentially disastrous *United States v. Davis*.[40] In that case, the Supreme Court held that a transfer by a husband to his wife of appreciated property in satisfaction of her marital rights resulted in the recognition of gain to the husband. In repealing this holding, the Joint Committee on Taxation stated:

> The Congress believes that, in general, it is inappropriate to tax transfers between spouses. This policy is already reflected in the Code rule that exempts marital gifts from the gift tax, and reflects the fact that a husband and wife are a single economic unit.
>
> The current rules governing transfers of property between spouses or former spouses incident to divorce have not worked well and have led to much controversy and litigation. Often the rules have proved a trap for the unwary as, for example, where the parties view property acquired during marriage (even though held in one spouse's name) as jointly owned, only to find that the equal division of the property upon divorce triggers recognition of gain.
>
> Furthermore, in divorce cases, the government often gets whipsawed. The transferor will not report any gain on the transfer, while the recipient spouse, when he or she sells, is entitled under the Davis rule to compute his or her gain or loss by reference to a basis equal to the fair market value of the property at the time received.
>
> The Congress believes that to correct these problems,

---

[39] T.R. 1.71, Q + A 26

[40] 370 U.S. 65 (1962)

> and make the tax laws as unintrusive as possible with respect to relations between spouses, the tax laws governing transfers between spouses and former spouses should be changed.[41]

As indicated, Sec. 1041 applies to all spousal transfers, not just those incident to a divorce.[42]

*3.03 How Transfers are Treated*

Section 1041(b) provides that transfers within the scope of 1041 are treated as gifts, and the transferee's basis is the adjusted basis of the transferor.

*3.04 What Transfers Quality*

Section 1041(a) applies to transfers to a spouse or to a former spouse, if the latter is incident to a divorce. Section 1041 is not a elective section, but applies if its provisions are met. Sham transactions and step transactions which do not technically fall with its provisions nonetheless qualify in appropriate circumstances.[43] Transfers to a nonresident alien do not qualify.[44]

While a transfer to a spouse is self explanatory, transfers to a former spouse are a little more complicated. The statute requires that the transfer be "incident to a divorce."[45] A transfer is deemed to be "incident to a divorce" if either:

(1). The transfer occurs not more than one year after the date on which the marriage ceases;[46]

(2). The transfer is related to the cessation of the marriage.[47]

A transfer is related to the cessation of the marriage if it is pursuant to a DSI (as defined in sec. 71), and the transfer occurs not more than 6 years after the date on which the marriage ceases.[48] This, however, is a rebuttable presumption, and may be defeated by showing that the transfer was made to effect the division of property at the time of the cessation of the marriage.[49] The regulations give as an example where legal or business impediments delayed the transfer.[50]

Transfers of property to a third party may qualify under sec. 1041 under either of the following situations:

1. Where the transfer is required by the DSI;

---

[41] The committee report indicates that taxpapyers often failed to report the gain from such transfers. The author once had a client who received a form 1099 from his former spouse. She indicated to her former husband that she "didn't want him to overlook the $400,000 plus gain!"

[42] T.R. 1.1041-1T(a), Q + A 2

[43] Ibid, Example 3

[44] Ibid, Q + A 3

[45] 1041(c); Annulments also qualify under Sec. 1041.

[46] 1041(c) (1)

[47] 1041(c) (2)

[48] T.R. 1.1041-1T(b), Q + A 7

[49] Ibid

[50] Ibid

2. Where the transfer is pursuant to the written request of the other (or former) spouse;
3. Where the transferor or spouse (or former spouse) receives from the other spouse a written consent or ratification of the transfer to the third party.[51]

*3.05 Liabilities and Other Ancillary Issues*

The thrust of sec. 1041 is to eliminate the recognition of gain from any transfer within its scope. In keeping with this spirit, the following should be considered:

A. No gain is recognized even where the transferor transfers property that is subject to liabilities that exceed the basis of the property.[52]

B. If the transferor transfers property that is subject to investment credit recapture, no recapture will occur. However, if the transferee fails to utilize this property in a qualifying manner (the property is disposed of or ceases to be sec. 38 property), the unearned credit will be recaptured.[53] For example, a husband transfers to his wife, pursuant to a DSI, an auto used in husband's business, on which H had received an investment tax credit one year ago. If wife uses the property for personal purposes, the wife will have to recapture 2/3 of the husband's prior credit.[54]

C. The transfer of an installment obligation is not considered a disposition.[55]

D. Given the interest that no gain should be recognized on any transfer within sec. 1041, judicial doctrines such as the assignment of income or tax benefit rule should not apply. This is also consistent with the exception for installment obligations discussed above.

E. The TRA of 1984 enlarged the time frame for the application of sec. 2516 as to gift tax consequences to a three year period beginning on the date 1 year before the agreement,[56] and added 2043(b) (2) and 2053(e) to allow certain transfers to constitute a full and adequate consideration in money or money's worth.[57]

*3.06 Notice and Recordkeeping Requirements*

The regulations require that the transferor supply the transferee with records sufficient to determine the adjusted basis and holding period of the property transferred, and, if the property is subject to investment credit recapture, records sufficient to determine the adjusted basis and holding period of the

---

[51] Ibid, Q + A 9

[52] Ibid, Q + A 12; The transferee is not permitted to "step up" the basis of the property to the amount of the liabilities.

[53] 47(e)

[54] This example assumes the auto is 3 year property. See T.R. 1.1041-1T(d), Q + A 13

[55] 453B(g)

[56] While sec. 1041 exempts the recognition of gain or loss for the income tax purposes, since the transfer is treated as a gift, the normal gift tax rules apply.

[57] Generally, marital rights are not considered "a full and adequate consideration in money or money's worth."

property transferred, and, if the property is subject to investment credit recapture, records sufficient to determine the amount and period of any potential liability.[58]

*3.07 Effective Date*

Generally, sec. 1041 applies to transfers after July 18, 1984.[59] However, sec. 1041 will not apply to transfers made pursuant to instruments entered into before July 18, 1984, unless both spouses agree.[60] Further, transfers after December 31, 1983, can qualify if both spouses agree.[61] If such elections apply, they must apply to all transfers.[62]

---

[58] T.R. 1.1041-1T(e), Q + A 14
[59] Ibid, Q + A 15
[60] Ibid; The regulations give directions how this election should be made. See T.R. 1041-1T(e), Q + A 18
[61] Ibid
[62] Ibid