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42nd WILLIAM & MARY TAX CONFERENCE

AN EMPHASIS ON TAX PLANNING FOR INDIVIDUALS

WILLIAMSBURG, VIRGINIA

DECEMBER 6 - 7, 1996

TAX ISSUES IN DIVORCE

MARJORIE A. O'CONNELL, ESQ.

O'Connell & Associates
1730 Rhode Island Avenue, N.W.
Suite 809
Washington, DC 20036
U.S.A.

DIVORCE TAXATION COURSE BOOK

NEW OPPORTUNITIES--NEW OBSTACLES

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Washington, D.C. 20036

Printed in U.S.A.

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CONFERENCE OUTLINE

ALIMONY PAYMENTS: OVERVIEW OF THE NEW RULES

I. Law Before The DRTRA

II. Reasons For Change: Cash For Property Or For Support, Dependency Controversies

III. Basic Alimony Rules Under The DRTRA As Amended by TRA 86

ALIMONY PAYMENTS: DETAILED EXPLANATION OF NEW RULES

I. Payments In Cash

II. Divorce Or Separation Instrument Benefiting A Spouse

III. Separate Households When The Spouses Are Legally Separated Or Divorced

IV. Payments Must End At The Payee's Death

V. Payments For Child Support: _Lester_ Repealed

VI. Parties Elect Excludible/Nondeductible Treatment

VII. Recomputation Of Prior Years' Deductions Under TRA 86

VIII. Transition Rules For 1985 And 1986

IX. Deductions For Alimony Payments

X. Effective Date For Alimony Changes

DEPENDENCY EXEMPTIONS FOR CHILDREN OF DIVORCED OR SEPARATED PARENTS

I. Law Before The DRTRA

II. DRTRA Provisions For Dependency Exemptions

III. Exceptions To DRTRA Rules And Transitional Rules

MEDICAL EXPENSE DEDUCTIONS AND SEPARATED SPOUSE PROVISIONS

I. Medical Expense Deductions For Children Of Divorced Or Separated Parents

II. Uniform Treatment For Separated Spouses

III. Effective Dates

TRUSTS IN DIVORCE OR SEPARATION

I. Law Before The DRTRA

II. Changes Made By The DRTRA

III. Role Of Trusts In Support Packages

IV. Effective Dates

PROPERTY TRANSFERS AND DIVISIONS

I. Law Before The DRTRA

II. New Property Transfer Law

III. Special Marital Assets

IV. Effective Dates For the Nonrecognition Rules

GIFT AND ESTATE TAXES IN DIVORCE

I. Law Before The DRTRA

II. Gift Tax Exemption Covers Agreement Made One Year After The Divorce

III. Broader Estate Tax Deduction

IV. Effective Dates On Enactment

SEPARATE RETURNS IN COMMUNITY PROPERTY STATES

I. Law Before The DRTRA

II. DRTRA Changes

III. Interplay of Section 66(a) and Section 66(c)

IV. Effective Dates

INNOCENT SPOUSE TREATMENT ON JOINT RETURNS

I. Law Before The DRTRA

II. New Innocent Spouse Law

III. Effective Date

TABLE OF CONTENTS

ALIMONY PAYMENTS: OVERVIEW OF THE NEW RULES 1

I. Law Before the DRTRA 1

A. General Rules 1

B. Support Obligation 1

C. Written Instrument 2

D. Periodic Payments 3

E. Payments Fixed As Child Support Are Not Alimony 5

II. Reasons For Change: Cash For Property Or For Support, Dependency Controversies 6

III. Basic Alimony Rules Under The DRTRA As Amended by TRA 86 8

A. Payments In Cash 8

B. Divorce Or Separation Instrument 8

C. Separate Households 9

D. Payments End At Payee's Death 9

E. Payments Are Not For Child Support 9

F. Parties Elect Excludible/Nondeductible Treatment 10

G. New TRA 86 Alimony Recomputation Rules 10

H. Transition Rules For 1985 And 1986 12

ALIMONY PAYMENTS: DETAILED EXPLANATION OF NEW RULES 18

I. Payments In Cash 18

II. Divorce Or Separation Instrument Benefiting A Spouse 20

III. Separate Households When The Spouses Are Legally Separated Or Divorced 21

IV. Payments Must End At The Payee's Death 23

V. Payments For Child Support: Lester Repealed 25

A. General Rules 25

B. Reductions That Fix Child Support 26

C. Clearly Associated Contingencies 27

D. How To Draft Unallocated Support Agreements 32

VI. Parties Elect Excludible/Nondeductible Treatment 36

VII. Recomputation Of Prior Years' Deductions Under TRA 86 37

A. Overview Of TRA 86 Recomputation 38

B. Third Year Payments Are Crucial 43

C. Three Exceptions To Recomputation Rules 45

D. Drafting Under Recomputation Rules 50

VIII. Transition Rules For 1985 And 1986 52

A. Payments More Than $10,000 Must Be Paid In Six Calendar Years 52

B. Recomputation Under Post-DRTRA/Pre-TRA 86 Law 59

IX. Deductions For Alimony Payments 66

A. Identification Numbers For Payees And Payors 66

B. Penalty For Failure To Furnish TIN's 67

C. Effective Date 68

X. Effective Date For Alimony Changes 68

A. 1987 And Later Agreements 68

B. Agreements Executed In 1985 And 1986 71

C. Old Agreements 72

DEPENDENCY EXEMPTIONS FOR CHILDREN OF DIVORCED OR SEPARATED PARENTS 73

I. Law Before The DRTRA 73

A. Allocation To Noncustodial Parent 73

B. $1,200 Support From Noncustodial Parent 74

C. Custodial Parent In Other Cases 74

II. DRTRA Provisions For Dependency Exemptions 75

A. More Than Half Of Support For Child From Parents 76

B. Parents Who Are Divorced Or Separated 76

C. Parents Have Custody More Than Half Of Year 77

D. Custodial Parent Gets Dependency Exemption 78

E. Custodial Parent Releases Claim 78

III. Exceptions To DRTRA Rules And Transitional Rules 80

A. Qualified Pre-1985 Instrument 81

B. Modification Of Pre-1985 Instrument 81

C. Multiple-Support Exception 82

D. Effective Date 82

MEDICAL EXPENSE DEDUCTIONS AND SEPARATED SPOUSE PROVISIONS 83

I. Medical Expenses Deductions For Children Of Divorced Or Separated Parents 83

A. Law Before The DRTRA 83

B. DRTRA Changes: Decoupling 83

II. Uniform Treatment For Separated Spouses 84

A. Law Before The DRTRA 84

B. DRTRA Changes 85

III. Effective Dates 88

TRUSTS IN DIVORCE OR SEPARATION 88

I. Law Before The DRTRA 88

II. Changes Made By The DRTRA 90

A. Statutory Changes: Separating Section 71 And Section 682 90

B. Overview Of New Section 682 91

III. Role Of Trusts In Support Packages 93

A. Pre-TRA 86 Short-Term Alimony 94

B. Payments Past Payee's Death 94

C. Decreasing Payments 95

D. Child Support Under The Lester Rule 95

IV. Effective Dates 96

PROPERTY TRANSFERS AND DIVISIONS 97

I. Law Before The DRTRA 97

A. Property For Marital Rights 97

B. Property For Property Or Cash 98

C. Problems With Prior Law 99

II. New Property Transfer Law 100

A. Qualifying Transfers 101

B. Nonrecognition For Transferor 104

C. Carryover Basis To Recipient 105

D. Exceptions For Some Transfers To Trusts 109

E. Transfers To Third Parties 111

F. Transferor Must Provide Records About Basis 114

G. Property Or Support Payments 114

III. Special Marital Assets 116

A. Marital Home 116

B. Insurance 119

C. Annuities 120

D. Corporations 121

E. Partnerships 126

F. Proprietorships And Investment Property 127

IV. Effective Dates For The Nonrecognition Rules 134

GIFT AND ESTATE TAXES IN DIVORCE 136

I. Law Before The DRTRA 136

II. Gift Tax Exemption Covers Agreements Made Two Years Before And One Year After The Divorce 138

III. Broader Estate Tax Deduction Covers Section 2516 Transfers 139

IV. Effective Dates On Enactment 140

SEPARATE RETURNS IN COMMUNITY PROPERTY STATES 141

I. Law Before The DRTRA 141

II. DRTRA Changes 142

A. No Joint Return 143

B. Item Not Included In Gross Income 143

C. No Knowledge 145

D. Inequitable To Tax Spouse 145

E. Non-Innocent Spouse Must Report 100 Percent Of The Income 147

F. IRS May Override Community Property Law If Innocent Spouse Has No Notice Of The Income 148

III. Interplay Of Section 66(a) And Section 66(c) 150

IV. Effective Dates 151

INNOCENT SPOUSE TREATMENT OF JOINT RETURNS 152

I. Law Before The DRTRA 152

A. 25 Percent Omission 152

B. No Knowledge 152

C. Inequitable Test 153

II. New Innocent Spouse Law 153

A. General Rules 154

B. Deduction, Credit Or Basis Error 156

C. Special Rule For Pre-1985 Returns 165

III. Effective Date 166

ALIMONY PAYMENTS: OVERVIEW OF NEW RULES

I. Law Before the DRTRA.

A. GENERAL RULES.

The principal alimony rules in the Internal Revenue Code are contained in Section 71. Under Section 71, alimony payments are taxable to the payee who receives them. The alimony payor receives a tax deduction for the payments under Section 215.

For instruments executed before January 1, 1985, alimony payments must meet four general requirements:

1. The payments must be made because of the general obligation to support due to a marital or family relationship.
2. The payments must be made pursuant to a decree of divorce or separation or, if the parties are separated, a written separation agreement or a support order.
3. The payments must be periodic.
4. The payments may not be fixed as child support.

B. SUPPORT OBLIGATION.

The support obligation requirement is founded on a person's general obligation under state law to support the person's

spouse. The principal effect of the support obligation is to exclude from alimony those payments made for property rights or other nonsupport rights, such as for loans between spouses. The support obligation requirement has caused numerous difficulties. The courts have developed extensive tests to determine whether payments are for support or are in exchange for property rights. These tests examine various factors about the form of the payments, the payee's rights under state law, and the drafting of the documents. These tests are subjective and are applied on a case by case basis. The law before the DRTRA is also complex about the alimony status of payments made in exchange for such other material rights as dower or equitable distribution property rights.

C. WRITTEN INSTRUMENT.

Alimony payments must be made pursuant to a written instrument that must be a decree, a separation agreement or a support order. The requirement of a written instrument ensures that the alimony payments are determinable and the amount can be confirmed by the IRS. This

requirement has created no substantial problems.

D. <u>PERIODIC PAYMENTS</u>.

The periodic payments requirements are the most complicated provisions of Section 71. Alimony payments must be periodic to qualify under Section 71. Three types of payments are classified as periodic:

1. <u>Installment payments</u>. Installment payments of a fixed amount payable for a fixed time that is more than ten years are periodic under Section 71(c). No more than ten percent of the total sum may be deducted in any year. Section 71(c) does not apply if the payments are terminable, such as at death or remarriage.

<u>Example</u>: Bob will pay $1,000 per month to his former spouse, Becky, for 121 months for a total payment of $121,000. Because 121 months is more than ten years (120 months), the payments are all periodic alimony payments.

<u>Example</u>: Tim will pay $1,000 per month to his former spouse, Susan, for 60 months (five years) for a total payment of $60,000. The payments are not periodic

because the time period is less than ten years.

2. Fixed payments subject to a contingency. Payments of a fixed amount are periodic, when payable over less than ten years, if the obligation to pay is subject to a contingency in the time or amount of the payments. The most common contingencies are payments that change at the death of either spouse, the payee's remarriage or due to a change in economic status.

Example: Frank will pay $1,000 per month to his former spouse Rachel for five years. The payments will terminate if either party dies or Rachel remarries during the five-year period. The payments are periodic.

Example: Pete will pay $1,000 per month to his former spouse Patty for five years. To the extent that Patty's adjusted gross income is more than $20,000 per year, the payments will be decreased dollar for dollar. These payments are periodic because the total amount to be paid is contingent.

The contingency rules have caused problems in several areas. First, the contingencies may be imposed by state law rather than in the instrument. These contingencies may not be intended by the parties and may result in the parties taking different positions about the tax status of the payments. Contingencies that alter only the timing, but not the amount, of the payments may not make the payments periodic.

3. Payments of a variable amount. Payments that may vary in amount are always periodic, regardless of the length of time they will be paid. Common variable payments are those set as a percentage of the payor's income.

E. PAYMENTS FIXED AS CHILD SUPPORT ARE NOT ALIMONY.

Payments that are designated solely as child support are not alimony payments under Section 71(b). In Commissioner v. Lester, 366 U.S. 299, 7 AFTR 2d 1445 (1961), the Supreme Court held that an indirect designation of child support is not a "fixed" amount. Combined spousal and child support that is reduced for events related to a child, such as emancipation,

are treated completely as alimony.

Example: Sam will pay $1,000 per month for the support of his former spouse, Mary, and their three children. At the earlier of each of the children dying, marrying or reaching age 18, the payments are reduced $200. The entire $1,000 is treated as alimony, even though $600 is related to the three children.

II. Reasons For Change: Cash For Property Or For Support, Dependency Controversies.

In rewriting Section 71 in the DRTRA of 1984 Congress viewed the alimony provisions of the Code as too subjective which caused several problems. State law variations led to federal tax differences for spouses, depending on their residence. The reliance on many state law principles made administration difficult for the IRS, the courts and taxpayers.

Congress intended to create a uniform federal alimony standard that could be more easily applied to the facts of a particular case, eliminating property or support controversies. Congress intended to reduce the amount of tax litigation about domestic

relations issues. The revisions to Section 71 have two principal conceptual changes from prior law. The first change is the elimination of the support requirement for alimony payments. The second change is the elimination of the periodic payment requirements.

An initial intent of Congress was also to simplify tax rules for alimony to make them easier for taxpayers to understand. The version of the DRTRA passed by the House of Representatives would have been a major simplification. At the joint House-Senate conference on the Tax Reform Act of 1984, the Senate Finance Committee insisted on amendments to the DRTRA. These amendments added several complicated, difficult to apply provisions to the DRTRA. The basic system created by the House is retained with the other provisions added.

The Tax Reform Act of 1986 ("TRA 86") corrected many of the problems with the DRTRA. Most importantly, TRA 86 eliminated the complicated alimony recomputation rule.

III. Basic Alimony Rules Under The DRTRA As Amended By TRA 86.

Alimony payments are still taxable income to the payee, but Section 71 of the Code is entirely rewritten. A new term is added to describe taxable alimony payments: "alimony or separate maintenance payments". To be alimony or separate maintenance payments, the payments must meet these requirements.

A. PAYMENTS IN CASH.

The payments must be in cash, checks, or money orders payable on demand.

B. DIVORCE OR SEPARATION INSTRUMENT.

The payments must be made to or for the benefit of a spouse or former spouse under a divorce or separation instrument. These instruments are composed of the same three types of documents as under prior law.

1. A decree of divorce or separate maintenance or a written instrument incident to such a decree,
2. A written separation agreement, or
3. Any other decree requiring a spouse to make payments for the support or maintenance of the other spouse. These decrees include all temporary support orders and *pendente lite* orders.

C. SEPARATE HOUSEHOLDS.

If the spouses are divorced or legally separated under a separation decree, the spouses cannot be members of the same household when the payment is made. The spouses may live in the same household for one month while one is preparing to depart.

D. PAYMENTS END AT PAYEE'S DEATH.

The payor has no liability to make payments past the payee's death. There may be no substitute payments, such as a lump sum cash payment. The parties may provide life insurance on the payee's life payable to the payee's estate or other beneficiary.

E. PAYMENTS ARE NOT FOR CHILD SUPPORT.

As under prior law, payments that are fixed as child support are not alimony or separate maintenance payments. The DRTRA makes a significant change from the way prior law was interpreted. The DRTRA overrules the effect of the Lester case. Under the DRTRA, to the extent any payments are reduced due to a contingency relating to a child, such as attaining a certain age, marrying, dying or leaving school, the payments would be treated as fixed as child support and would not be alimony. Any contingency clearly associated with certain events relating to a child would have the

same effect, such as payments that terminate in the same month as a child's 18th birthday.

F. <u>PARTIES ELECT EXCLUDIBLE/ NONDEDUCTIBLE TREATMENT</u>.

If all of the previous requirements are met, the parties can designate that the payments are not taxable to the payee and are not deductible by the payor. A court also may make this designation in a decree or order. This is a major change to allow private ordering of the tax consequences of marital dissolutions.

G. <u>NEW TRA 86 ALIMONY RECOMPUTATION RULES</u>.

TRA 86 eliminates both of the six-year rules in TRA 84: the six-year minimum term rule and the six-year recapture rule. (See paragraph H, below). In their place, TRA 86 has a three-year recomputation rule. This new three-year rule does not have any minimum term requirement. The three-year recomputation rule also uses a different method of calculating the recomputation, which reduces the potential adverse tax consequences.

Recomputation can occur only at the end of the third post-separation year. Regardless of the relative amounts of payments in the first two years, there

cannot be any recomputation in the second post-separation year or in any year after the third post-separation year.

The recomputation requires two separate calculations. The first recomputation calculation subtracts the total of the year three alimony plus $15,000 from the year two alimony. The difference is a recomputation amount. The second recomputation calculation has five steps to compare the adjusted average of year two and year three payments to the year one payments. First, the year two and year three payments are added together. Second, the first recomputation amount is subtracted from the sum of year two and year three payments. Third, the difference is divided by two. Fourth, $15,000 is added to the difference. Fifth, this product is subtracted from the year one payments, and the difference is the second recomputation amount. The sum of the two recomputation amounts is income to the alimony payor and a deduction to the alimony payee in year three. If either calculation produces a number below zero, then zero is used.

There are three circumstances in which the recomputation rules do not take effect:

1. If either spouse dies or the payee spouse remarries and the alimony or separate maintenance payments cease for that reason before the end of the third post-separation year, there is no recomputation.
2. Payments made under a temporary support order or similar temporary court decree are not covered by the recomputation rules. The rules apply only to payments made under a decree of divorce or separation or under a written separation agreement.
3. Payments are not counted to the extent the payor's liability is to pay a fixed portion or portions of the income from a business or property or from compensation. The liability to pay must continue for at least three full years.

H. TRANSITION RULES FOR 1985 AND 1986.

There is an additional test for alimony or separate maintenance payments under 1985 and 1986 instruments. It is a six-year minimum term rule. There is also a different recomputation calculation

FORM NO. 1

RECOMPUTATION CALCULATION

PAYOR: Alex

PAYEE: Betty

a.	1st Post-Separation Year 1990	$40,000
b.	2nd Post-Separation Year 1991	$40,000
c.	3rd Post-Separation Year 1992	$10,000
	Recomputation Test One	
d.	Enter amount from b.	$40,000
e.	Enter c. + $15,000.	$25,000
f.	Subtract e. from d. (not less than $0)	$15,000
	Recomputation Test Two	
g.	Enter b.	$40,000
h.	Enter c.	$10,000
i.	Add g. and h.	$50,000
j.	Enter f.	$15,000
k.	Subtract f. from i. (not less than $0)	$35,000
l.	Divide k. by 2	$17,500
m.	Enter a.	$40,000
n.	Enter l. + $15,000	$32,500
o.	Subtract n. from m. (not less than $0)	$ 7,500
	Total Recomputation	
p.	Add f. and o.	$22,500

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in 1. The Conference Report gives as an example a reduction made in the month when a child happens to reach age 18.

The scope of contingencies related to a child would include most or all provisions formerly used in Lester arrangements. Other contingencies that could be held to fix child support amounts include: the child moving from the custodial parent's home, the child entering the military, the child securing employment, the child's income reaching a set level, or the custody of the child changing to the payor.

C. CLEARLY ASSOCIATED CONTINGENCIES.

The regulations provide that in only two situations are payments presumed to be reduced at times that are clearly associated with a child-related contingency. In all other situations, reductions will not be treated as clearly associated. The regulations have substantially compensated for the statute's vagueness, although they present their own uncertainties. (Reg. Sec. 1.71-1T, Q-18).

The first situation is a reduction not more than six months before or after

the date the child is to attain the age of 18, 21 or the local age of majority. The regulations do not address the effect of a change in residence under which the local age of majority is changed. For example, a reduction six months after age 19 is allowable if the local age of majority is 19, but not if the age is 18. The better rule would test the reduction under the local law of the child's residence when the instrument is executed without regard to future changes in residence.

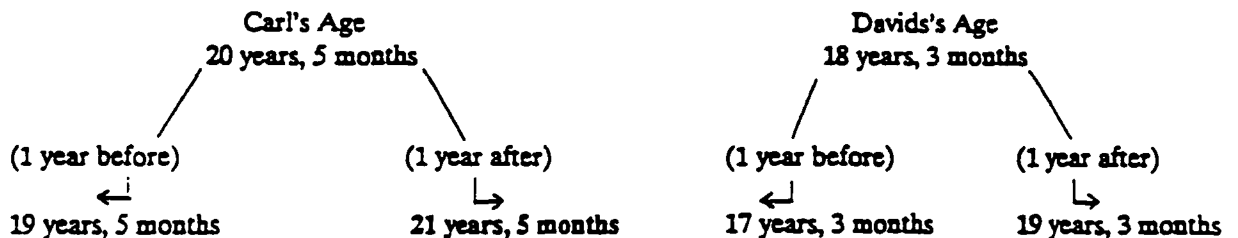
The second situation applies when the parties have two or more children and the payments are reduced two or more times. The ages that the various children will be when the reductions are made are matched to the reductions. The ages of the children between ages 18 and 24 are counted. If the relative ages of the children at the reductions are less than two years apart, the reductions are deemed to be clearly associated.

Example: Albert and Betty were divorced on July 1, 1985. Their two children, Carl (born on July 15, 1970) and

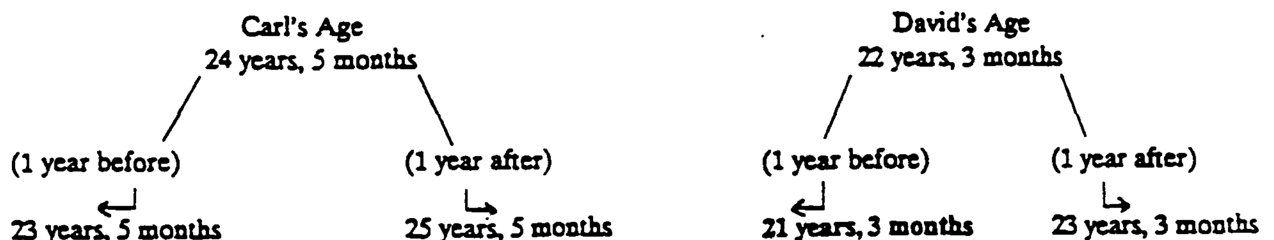
David (born on September 23, 1972), are 14 and 12, respectively. Albert must pay Betty $2,000 in alimony payments per month. The divorce decree states that the payments are to be reduced by $500 on each of two dates, January 1, 1991 and January 1, 1995.

On the first reduction date, January 1, 1991, Carl is age 20 years, 5 months and David is age 18 years, 3 months. On the second reduction date, January 1, 1995, Carl is age 24 years, 5 months and David is age 22 years, 3 months. The regulations prohibit reductions on occasions that occur not more than one year <u>before</u> or <u>after</u> Carl and David attain a certain age between 18 and 24, inclusive. Therefore, the test works like this:

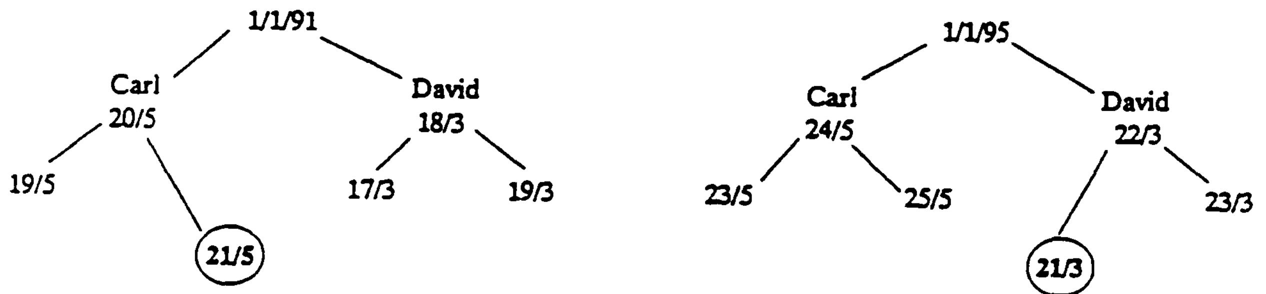
<u>First Reduction Date</u>
January 1, 1991



<u>Second Reduction Date</u>
January 1, 1995



Each occasion of a reduction occurs less than one year before or after a different child attains the age of 21 years, 4 months. (The first reduction date occurs less than one year before Carl turns age 21 years, 5 months, and the second reduction date occurs less than one year after David turns age 21 years, 3 months. Thus, each reduction date occurs within one year from the date Carl and David reach age 21 years, 4 months.) By arranging the reduction dates charts side by side, the "clearly associated" date becomes more apparent:



less than one year apart

midpoint = 21 years/4 months

Age 21 years, 4 months is within one year of the age of a different child at both reduction dates. Therefore, both of the reductions would be presumed clearly associated with the children. Payments under the divorce decree totaling the amount of the reductions ($1000) would not qualify as alimony payments, and would be treated as nondeductible child support payments by Albert.

The presumption that reductions are clearly associated with the children may be rebutted by the taxpayer or by the IRS. To rebut the presumption, it must be shown that the time of the reduction was determined independently of any contingencies related to the children. The presumption from the six-month period may be rebutted conclusively if the reduction is a complete cessation during the sixth post-separation year or at the end of a 72-month period. The presumption also may be rebutted by showing other facts and circumstances. The regulations' example is alimony set for a customary period of time

in the locality, such as equal to half of the marriage.

D. HOW TO DRAFT UNALLOCATED SUPPORT AGREEMENTS

The tax advantages for both parties of the unallocated support arrangements such as in Lester are such that many divorcing spouses will want to continue the same type of payments. Under the new Section 71(c), the drafting of such arrangements is not as direct as before. The parties have to accept some imprecision or uncertainty as a price for the tax advantages. Here are some drafting ideas for agreements without the Lester rule. Each of these ideas must be tested against Q-18 in the alimony regulations to ensure that the dates set in the instrument and the birth dates of the children do not violate the "clearly associated" test. (See Reg. Sec. 1.71-1T, Q-18).

1. Reductions At Set Dates Not Directly Keyed To Children. This drafting technique relies on the IRS interpretation of the "clearly associated with" test. The reductions should be on set dates that do not directly correspond to the children under the two tests in the regulations.

VII. Recomputation Of Prior Years' Deductions Under TRA 86.

The DRTRA, as enacted in 1984, created a new concept to tax planning for alimony by providing for recomputation of prior years' alimony deductions. The DRTRA formula for recomputation involved six post-separation years in which the difference between a prior year's alimony and each succeeding year's alimony plus $10,000 was subject to being recaptured in the payor's income. The six-year recomputation was complicated and created problems for taxpayers who, for bona fide reasons, wanted a shorter period of alimony or who were unable to meet the requirements because of events beyond their control.

An earlier version of the DRTRA that was passed by the House of Representatives had a three-year recomputation period that was aimed at one-time property settlements disguised as alimony. Under Senate pressure, the House-passed version was changed in the Conference Committee on the 1984 tax bill. Congress later reconsidered its action and concluded that three-year recomputation is less complicated and more

equitable. In the Tax Reform Act of 1986, Congress instituted a three-year recomputation rule for instruments executed after December 31, 1986.

A. <u>OVERVIEW OF TRA 86 RECOMPUTATION</u>.

For post-1986 instruments, the TRA 86 recomputation can occur only once, after the third post-separation year. Two calculations are made to obtain an amount that is the total recomputation. The total recomputation amount is income to the alimony payor and a deduction to the alimony payee.

There are two important terms in Section 71(f). The "first post-separation year" is the first calendar year in which the payor makes alimony or separate maintenance payments that are subject to the recomputation rules. (IRC, Sec. 71(f)(6)). Payments under a support order are not subject to recomputation as explained below. The second and third post-separation years are the two succeeding calendar years.

The "excess alimony payments" are the excess payments for the first post-separation year plus the excess payments

for the second post-separation year. The recomputation requires two separate calculations. The first recomputation calculation subtracts the total year three alimony plus $15,000 from the year two alimony. The difference is the first recomputation amount. The second recomputation calculation has five steps to compare the adjusted average of year two and year three payments to the year one payments. First, the year two and year three payments are added together. Second, the first recomputation amount is subtracted from the sum of the year two and year three payments. Third, the difference is divided by two to determine the average. Fourth, $15,000 is added to the average. Fifth, this sum is subtracted from the year one payments, and the difference is the second recomputation amount. The sum of the two recomputation amounts is the total recomputation amount. If either calculation produces a number below zero, then zero is used.

Example 1: Alex and Betty are divorced in 1990. Alex pays alimony as

follows: 1990: $40,000, 1991: $40,000, and 1992: $10,000. In 1992, Alex will have recomputation income calculated as follows. The 1991 payment, $40,000, is larger than the sum of the 1992 payment, $10,000, plus $15,000. The excess is $15,000 and would be the first recomputation amount. $40,000 - ($10,000 + $15,000) = $15,000 recomputation. The second calculation adds the 1991 and 1992 payments. $40,000 + $10,000 = $50,000. The first recomputation amount, $15,000, is then subtracted from the total. $50,000 - $15,000 = $35,000. This sum is divided by two to determine the average. $35,000/2 = $17,500. The $15,000 safe harbor is added to the adjusted average. $17,500 + $15,000 = $32,500. The 1990 payment, $40,000, is larger than $32,500, and the excess $7,500 is the second recomputation amount. $40,000 - $32,500 = $7,500. The total recomputation amount would be $22,500. $15,000 + $7,500 = $22,500. In 1992, Alex would have an alimony deduction of $10,000 and recomputation income of $22,500, for net income of $12,500. Betty would have

alimony income of $10,000 and a recomputation deduction of $22,500, for a net deduction of $12,500.

Example 2: Alex makes alimony payments as follows: 1990: $40,000, 1991: $40,000, 1992: $20,000. Under recomputation test one, the 1991 payment, $40,000, is larger than the 1992 payment, $20,000, plus $15,000. The excess $5,000 would be the first recomputation amount. $40,000 - ($20,000 + $15,000) = $5,000 recomputation. Under recomputation test two, the 1991 and 1992 payments are added, the first recomputation is subtracted, and that number is divided by 2. ($40,000 + $20,000) - $5,000 = $55,000; $55,000/2 = $27,500. $15,000 is then added, and the result is compared to the 1990 payment. $27,500 + $15,000 = $42,500. Because of $42,500 is larger than the 1990 payment of $40,000, there is no recomputation amount under recomputation test two. The total recomputation amount would be $5,000.

As shown in Example 2, there is a strong incentive to maintain relatively similar payments over the first three years

and not decrease alimony payments during that period. Alex increased his alimony payment to $20,000 in 1992 (compared with a 1992 payment of $10,000 in Example 1) and saved $17,500 in recomputation income ($22,500 - $5,000 = $17,500). By increasing his third year payment by $10,000, Alex saved $17,500 in recomputation income. This example shows that the three-year recomputation system is an effective incentive to avoid one-time, lump-sum property settlements disguised as alimony.

Here is an example of how the three-year recomputation affects payments reduced differently.

Example 3. The alimony payments are as follows: 1990: $30,000, 1991: $10,000, 1992: $10,000. Under recomputation test one, the 1991 and 1992 payments are the same, therefore, there is no recomputation amount. Under recomputation test two, the 1991 and 1992 payments are added, divided by two and $15,000 is added to the result. $10,000 + $10,000 = $20,000; $20,000/2 = $10,000;