1996

Tax Issues in Divorce

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Repository Citation
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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

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

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

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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.

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
D. PERIODIC PAYMENTS.

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. **Installment payments.** 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.

   **Example:** 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.

   **Example:** 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.

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.

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.

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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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.

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 before or after Carl and David attain a certain age between 18 and 24, inclusive. Therefore, the test works like this:

**First Reduction Date**
January 1, 1991

<table>
<thead>
<tr>
<th>Carl’s Age</th>
<th>David’s Age</th>
</tr>
</thead>
<tbody>
<tr>
<td>20 years, 5 months</td>
<td>18 years, 3 months</td>
</tr>
<tr>
<td>(1 year before)</td>
<td>(1 year before)</td>
</tr>
<tr>
<td>19 years, 5 months</td>
<td>17 years, 3 months</td>
</tr>
<tr>
<td>←</td>
<td>←</td>
</tr>
</tbody>
</table>

**Second Reduction Date**
January 1, 1995

<table>
<thead>
<tr>
<th>Carl’s Age</th>
<th>David’s Age</th>
</tr>
</thead>
<tbody>
<tr>
<td>24 years, 5 months</td>
<td>22 years, 3 months</td>
</tr>
<tr>
<td>(1 year before)</td>
<td>(1 year before)</td>
</tr>
<tr>
<td>23 years, 5 months</td>
<td>21 years, 3 months</td>
</tr>
<tr>
<td>←</td>
<td>←</td>
</tr>
</tbody>
</table>
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:

```
Carl   David
20/5   18/3
19/5   17/3
21/5   19/3
```

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.

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
A. OVERVIEW OF TRA 86 RECOMPUTATION.


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;