Tax Aspects of Divorce and Separation: Alimony, Child Support and Property Transfers

Robert E. Lee
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By

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I. Alimony and Child Support

A. Law prior to 1985

1. Alimony was includable as ordinary income (§ 71) and deductible from gross income; i.e., alimony was deductible even if the taxpayer did not itemize deductions (§ 215).

2. To be alimony, a payment must have been:
   a. In discharge of an obligation of the marital relationship;
   b. imposed under a decree of divorce or separate maintenance or a written instrument incident to the divorce or separation;
   c. "periodic"; and
   d. not designated as child support.

3. The "periodic" requirement caused most of the problems under the "old" law.
   a. Payments were periodic if they were contingent as to amount or as to the period of time over which they were to be made.
   b. Payments were not periodic if they were in discharge of an obligation to pay a principal amount unless the payments were to continue for a period of more than 10 years.

4. In order for a payment to constitute child support, it was required that the payment be specifically designated as such. If a single monthly payment was designated as being for both
child support and alimony, and it was not specifically allocated between the two, the whole payment would be treated as alimony for tax purposes even though the child support portion could be computed with reasonable certainty under the instrument. This was known as the Lester rule. Comm. v. Lester, 366 U.S. 299 (1961).

B. Chances made by the Deficit Reduction Act of 1984 ("DEFRA") and the Tax Reform Act of 1986 ("TRA 86")

1. DEFRA and TRA 86 made substantial changes in the rules governing the tax effects of alimony.

2. Alimony is still ordinary income to the recipient and is still deductible from gross income by the payor. §§ 71 and 215. Child support is still not alimony. § 71(c).

3. The "periodic" requirement was eliminated by DEFRA.

4. To be alimony, payments now must meet the following requirements:

   a. Payments must be in cash. § 71(b)(1).
      i. For these purposes, cash includes checks and money orders payable on demand. It does not include a debt instrument of the payor or of a third party. Reg. § 1.71-1T, A-5.
      ii. If all other requirements are met, cash payments to third parties for the benefit of a spouse or former spouse do qualify.

         a. For example, cash payments of rent, mortgage, tax, or tuition liabilities of the payee spouse made under the terms of the divorce or separation instrument will qualify. Reg. § 1.71-1T, A-6.

         b. Payments of premiums on insurance policies (term or whole life) on the payor's life will qualify as
Payments on behalf of the payee spouse to the extent that the payee spouse is the owner of the policy. Reg. § 1.71-1T, A-6.

c. Any payments to maintain property owned by the payor spouse and used by the payee spouse (including mortgage payments, real estate taxes and insurance premiums) are not payments on behalf of a spouse even if they are required by the divorce or separation instrument. Reg. § 1.71-1T, A-6.

d. Any cash payments to third parties must be made pursuant to the written request, consent or ratification of the payee spouse. The request, consent or ratification must state that the parties intended the payment to be treated as alimony and must be received by the payor spouse prior to the date of filing of the payor's first tax return for the taxable year in which the payment is made. Reg. § 1.71-1T, A-7.

b. Payments must be made under a "divorce or separation instrument" as those terms are defined in § 71(b)(2). § 71(b)(1)(A).

c. Payments must cease upon the death of the payee and there must be no liability for any kind of substitute payment. § 71(b)(1)(D).

i. Insurance on the life of the payee will not be treated as a substitute payment.

ii. DEFRA originally required that the divorce or separation instrument specifically state that there is no liability to continue the payments after the death of the payee. In other words, it was not enough that state law provided for this; the instrument had to
state it specifically. This requirement was repealed by TRA 86.

d. Payments must be made between spouses (or former spouses) who do not file a joint return and, in some cases, between spouses who are not members of the same household. The "separateness" rule applies if the spouses are separated under a decree of divorce or of separate maintenance. § 71(b)(1)(C).

e. Payments must not be designated by the divorce or separation instrument as a payment which is not includable in gross income and not allowable as a deduction. § 71(b)(1)(B).

5. Alimony is "compensation" for the purposes of making contributions to Individual Retirement Accounts. § 219(e)(1).

6. DEFRA overruled Lester. Now, any decrease in alimony payments that is triggered by a contingency specified in the instrument relating to a child (such as attaining a specified age or income level, dying, marrying, leaving school, leaving the spouse's household or gaining employment), or any reduction which can clearly be associated with a contingency of this type, will be treated as non-deductible child support to the extent of the reduction. § 71(c)(2).

a. Temporary regulations provide guidance as to when one or more reductions in alimony will be considered to "clearly be associated with ...a contingency" related to a child of the payor. Reg. § 1.71-1T, A-18.

i. Single reductions in alimony are presumed to be clearly associated with a contingency related to a child if the payments are reduced within six months before or after any child of the payor attains the age of 18, 21 or the local age of majority. Reg. § 1.71-1T, A-18.

ii. Multiple reductions in alimony are presumed to be clearly associated with a
contingency related to a child if the payments are reduced "not more than one year before or after a different child of the payor attains a certain age between the ages of 18 and 24, inclusive." Reg. § 1.71-1T, A-18.

Example: 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, 3 months and 17 days old. On January 1, 1995 the date of the second reduction payments, 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 1 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 reduction will be presumed to be clearly associated with the happening of a contingency relating to C and D. Unless the presumption is rebutted, the payments under the divorce decree equal to the sum of the reduction ($1,000 per month) will be treated as fixed for the support of the children of A and will therefore not qualify as alimony or separate maintenance payments.
iii. To avoid having the portions of alimony payments subject to multiple reductions presumed to be child support, the reductions should be:

a. scheduled to occur before any child of the payor attains age 17, or after all children of the payor attain age 25; or

b. separated by a time period greater than two years plus the difference in ages between the oldest and youngest children.

iv. The presumptions created in the temporary regulations may be rebutted (either by the Internal Revenue Service or the taxpayers) by showing that the timing of the reductions was determined "independently of any contingencies relating to the children of the payor." Reg. § 1.71-T, A-18.

v. In the case of a single reduction, the presumption is rebutted conclusively if the reduction is a complete cessation of payments during the sixth post-separation year or upon the expiration of a 72-month period. The presumption may also be rebutted by showing that the payments were scheduled for a period customarily provided in the local jurisdiction. Reg. § 1.71-1T, A-18.

vi. The conclusive presumption that a complete cessation of payments during the sixth post-separation year or upon the expiration of a 72-month period is not related to a contingency related to a child of the payor is obviously geared to the recapture rules that existed under DEFRA. See IB9a. below. Since TRA 86 revised the recapture rules to provide for a three post-separation year recapture period, a complete cessation of payments in the third post-separation year or upon the expiration of a 36-
month period should now qualify for the conclusive presumption.

7. If both alimony and child support are fixed and payable, any partial payment will be first considered as a payment for child support. § 71(c)(3).

8. It may also be possible to achieve a "Lester-like" effect (i.e., getting income tax deductions for payments which are in essence child support and having those payments reduced upon the happening of a contingency involving the child) by using an "alimony" trust under § 682. That section provides that if a wife who is divorced or legally separated is entitled to receive income of a trust which would otherwise be includable in the income of a husband, such income shall be included in the gross income of the wife. The section goes on to provide that "... such amount shall not, despite any other provision of this subtitle, be includable in the gross income of such husband." (Emphasis added.) On the other hand, it is clear that § 682 does not apply to any part of the income that is fixed as support of minor children by the decree, written separation agreement, or trust instrument.

9. DEFRA and TRA 86 provided certain "recapture" rules.

a. DEFRA provided that, if payments were in excess of $10,000 per year, they had to be made in 6 post-separation years in order to qualify as alimony. If the payments decreased by more than $10,000 in any year, recapture rules applied to prior years' payments. In the year of the excess decrease, the payor spouse is required to include an amount in income and the payee spouse is allowed a deduction from gross income.

b. TRA 86 revised the recapture provisions to provide that the recapture period will be the first three post-separation years and that the base amount is $15,000. § 71(f).
c. Unlike the recapture rules under DEFRA, TRA 86 rules provide that all recapture, if any, will occur in the third post-separation year. § 71(f)(1)(A).

d. If the payments in the second post-separation year exceed the payments made in the third post-separation year by more than $15,000, there are excess payments in the second year. Then, if the payments in the first post-separation year exceed the average of the payments in the second post-separation year (reduced by any excess payments for that year) and the third post-separation year plus $15,000, there are excess payments in the first post-separation year. The excess payments for both the first and second post-separation years are includable in the income of the payor spouse and are deductible by the payee spouse in the third post-separation year. § 71(f)(1), (2), (3) and (4).

Example: A makes alimony payments to B of $36,000 in 1987, $18,000 in 1988, and $2,000 in 1989. On their 1989 income tax returns, A must include $12,500 in income and B gets a $12,500 deduction from gross income. The result is arrived at as follows:

The 1988 excess is $1,000 ($18,000 - ($2,000 + $15,000)).

The 1987 excess is $11,500 ($36,000 - ($2,000 + $17,000 + 2 + $15,000)).

e. A "post-separation" year is a calendar year in which the payor makes an alimony or separate maintenance payment (other than one under a temporary support or pendente lite order). It is not necessarily a full calendar year and the first post-separation year is not necessarily the year in which the spouses divorce or separate. For example, A and B are divorced in October 1985. The decree requires A to make monthly payments to
B commencing November 1, 1985, but A and B are members of the same household until February 15, 1986. Since the payments made in 1985 do not qualify as alimony, 1986 is the first post-separation year. Reg. § 1.71-1T, A-22.

10. Exceptions to recapture rules.

   a. The recapture rules will not apply if the payments cease because of the death of either spouse or the remarriage of the payee spouse. § 71(f)(5)(A).

   b. The recapture rules will not apply if the payments fluctuate because they are made pursuant to a continuing liability (over a period not less than three years) to pay a fixed portion of the income from a business or property, or from compensation for employment or self-employment. (Under DEFRA this fluctuating payment exception required payments for more than six years.) § 71(f)(5)(C).

   c. The recapture rules will not apply if the payments are made under a temporary support or pendentive lìte order. § 71(f)(5)(B).

11. The payor spouse must include on his or her tax return the taxpayer identification number of the payee spouse. § 215(c). There is a $50 penalty for failing to do so unless such failure is due to reasonable cause. § 6676(c).

12. The amendments made by DEFRA apply to divorce or separation instruments executed after December 31, 1984. They also apply to pre-1985 instruments modified after December 31, 1984 if the modification expressly provides that the DEFRA amendments shall apply. DEFRA § 422(a).

13. The amendments made by TRA 86 apply to divorce or separation instruments executed after December 31, 1986. They also apply to pre-1987 instruments modified after December 31, 1986 if the modification expressly provides that the TRA 86 amendments shall apply. TRA 86 § 1843(c)(2).
II. Property Transfers


1. The transfer of property between spouses incident to divorce was treated as a taxable transaction if the consideration for the transfer was the release of marital rights.

2. Thus, if appreciated property was transferred, the transferor recognized a gain equal to the difference between the transferor's basis and its fair market value at the time of the transfer.

3. The nature of the gain, if any, recognized by the transferor depended upon the type of property and the timing of the transfer. For example, the special rule of § 1239 converting a capital gain into ordinary income on the transfer of depreciable assets between related parties might have applied, as might the recapture provisions of §§ 1245 and 1250.

4. If the parties were still married at the time of the transfer, no loss was recognized and installment sale treatment was not available. §§ 267 and 453.

5. The transferee received a basis in the property equal to its fair market value. The transferee recognized no gain on the surrender of the marital rights.

6. The Davis rule did not apply to nearly equal divisions of jointly held or community property.

B. DEFRA repealed Davis

1. Now, § 1041 provides that there is no gain or loss recognized on a transfer of property from an individual to (or in trust for the benefit of), a
spouse, or a former spouse, but only if the latter
transfer is "incident to the divorce." § 1041(a).

2. Generally, the transfer is treated as a gift and
the adjusted basis of the transferor carries over
and becomes the basis of the transferee. Unlike
the gift rules, this is true even if the fair
market value of the property at the time of the
transfer is less than the adjusted basis of the
transferor. § 1041(b).

3. The transfer of property is treated as incident to
the divorce if the transfer either occurs within
one year after the date on which the marriage
ceases, or is "related to the cessation of the
marriage." § 1041(c).

a. DEFRA did not define the term "related to the
cessation of the marriage."

b. However, temporary regulations provide that
a transfer of property is treated as related
to the cessation of the marriage if the
transfer is pursuant to a divorce or
separation instrument and the transfer occurs
not more than six years after the date on
which the marriage ceases. A divorce or
separation decree or instrument includes a
modification or amendment to such decree or

c. Any transfer not pursuant to a divorce or
separation instrument and any transfer
occurring more than six years after the
cessation of the marriage is presumed to be
not related to the cessation of the
marriage. This presumption may be rebutted
only by showing that the transfer was made to
effect a division of property owned by the
former spouses at the time of the cessation
of the marriage. For example, the
presumption may be rebutted by showing that
the transfer was not completed within the
appropriate time periods because of legal or
business impediments or disputes concerning
the value of the property and by showing that
the transfer was effected promptly after the
impediments were removed. Reg. § 1.1041-1T, A-7.

4. The provisions of § 1041 do not apply if the transferee is a nonresident alien. § 1041(d).

5. Section 1041 is not elective. It applies to all transfers between spouses whether incident to divorce or not, even if the transfers are intended as bona fide sales. Reg. § 1.1041-1T, A-2.

6. Nonrecognition treatment also applies to indirect transfers; i.e., transfers in trust and transfers of property to third parties on behalf of the spouse or former spouse. § 1041(a) and Reg. § 1.1041-1T, A-9.

7. A transfer of property to a third party on behalf of a spouse or former spouse must be: (a) required by the divorce or separation instrument, (b) requested in writing by the other spouse, or (c) specifically consented to in writing or ratified by the transferee spouse. Such consent or ratification must state that the transfer was intended to be subject to § 1041 and the consent or ratification must be received by the transferor prior to the filing date of the transferor's first tax return for the taxable year in which the transfer was made. Reg. § 1.1041-1T, A-9.

8. Annulments and cessations of marriages that are void ab initio due to violations of state law constitute divorces for the purposes of § 1041. Reg. § 1.1041-1T, A-8.

9. Unless the property is transferred in trust, nonrecognition rules and carry-over basis rules of § 1041 apply even if the property is subject to liabilities in excess of its basis. Reg. § 1.1041-1T, A-12.

10. To be subject to § 1041, it is not necessary that the property transferred to a former spouse have been owned by the transferor spouse during the marriage. Property acquired after the marriage ceases may be governed by § 1041. Reg. § 1.1041-1T, A-5.
11. Exceptions to § 1041:

a. If property is transferred in trust, gain will be recognized to the extent that the sum of the liabilities assumed, plus the amount of the liabilities to which the property is subject, exceeds the adjusted basis of the property transferred. In such case, the transferee's basis is increased by the amount of gain recognized by the transferor. § 1041(e);

b. Section 1041 does not apply to transfers to which the assignment of income doctrine would apply. In Rev. Rul. 87-112, 1987 C.B. 207, the Internal Revenue Service ruled that the deferred, accrued interest on U.S. savings bonds is includable in the transferor's gross income in the taxable year in which the bonds are transferred to a spouse or former spouse. The transferee's basis in the bonds immediately after the transfer is equal to the transferor's basis increased by the interest income includable by the transferor as a result of the transfer; and

c. transfers of services are not subject to the rules of § 1041. Reg. § 1.1041-1T, A-4.

C. Specific types of transfers

1. Installment obligations

a. If the transfer is not in trust and is otherwise subject to § 1041, the transfer of installment obligations to a spouse or former spouse will not cause the acceleration of the deferred gain and the transferee would receive the same tax treatment as would have applied to the transferor. § 453B(g).

2. Transfer of a passive activity

a. Section 469(j)(6) provides that if a passive activity is disposed of by gift, the basis of such interest immediately before the transfer shall be increased by the amount of the suspended passive activity losses allocable
to such interest and that such losses shall not be allowed as a deduction in any taxable year. Since § 1041(b) treats transfers of property between spouses or former spouses as gifts, § 469(j)(6) would apply to transfers of passive activity property between spouses or former spouses.

3. Investment tax credit property
   a. In general, property transferred under § 1041 will not result in the recapture of the investment tax credit. However, the transferee will be subject to recapture if, upon or after the transfer, the property is disposed of or ceases to be § 38 property. Reg. § 1.1041-1T, A-13.

4. Transfers of "phantom income" property
   a. If a § 1041 transfer involves property which, if sold by the transferor, would result in recognition of "phantom income" (such as an interest in a tax shelter or property subject to liabilities which exceed its basis), the transferee will recognize such phantom income when the property is sold or foreclosed upon.

5. Transfer of retirement benefits
   a. A Qualified Domestic Relations Order ("QUADRO") may require that retirement plan benefits be paid to a payee other than the participant ("alternate payee") as child support, alimony, or a division of property. §§ 401(a)(13) and 414(p).
   b. A distribution to a spouse or former spouse pursuant to a QUADRO is includable in the gross income of the spouse or former spouse and thus is not taxable to the participant. § 402(a)(9).
   c. A distribution to a nonspouse alternate payee (such as a child) is includable in the participant's gross income.
d. The 10% additional tax on early distributions from retirement plans does not apply to distributions pursuant to a QUADRO. § 72(t)(2)(d).

e. The 15% excise tax on excess distributions does not apply to a distribution to a spouse or former spouse pursuant to a QUADRO. § 4980A(c)(2)(B). However, the fact that retirement benefits are subject to a QUADRO will not serve to avoid the increased estate tax on excess retirement plan accumulations. See § 4980A(d).

f. An alternate payee who is a spouse or former spouse is eligible for any special tax treatment that may apply to lump sum distributions such as special five-year or ten-year income averaging, capital gain treatment, and nonrecognition of net unrealized appreciation. § 402(e)(4)(O).

i. Amounts payable to an alternate payee pursuant to a QUADRO are not taken into account in determining whether a participant's distribution is eligible for these treatments. § 402(e)(4)(M).

g. An alternate payee may avoid current taxation of a lump sum distribution pursuant to a QUADRO by rolling the amount over to an individual retirement account within sixty days of receipt. § 402(a)(6)(F).

h. An annuity payable to an alternate payee pursuant to a QUADRO is taxable under the ordinary rules for annuities and the alternate payee is allocated a pro rata share of the participant's investment in the contract, if any, based on the ratio of the present value of the alternate payee's benefits to the present value of all other benefits. § 72(m)(10).

D. Effective dates.

1. If there is no divorce or separation instrument executed before July 19, 1984, (or if there is no
instrument at all), § 1041 is effective for all transfers after July 18, 1984. DEFRA § 421(a).

2. If there is a divorce or separation instrument executed before July 19, 1984, the "old law" applies to transfers pursuant to such instrument unless both spouses (or former spouses) elect to have § 1041 apply. DEFRA § 421(d)(3).

a. The spouses (or former spouses) must elect to have § 1041 apply to all transfers under the instrument; i.e., a partial election is not permitted. Reg. § 1.1041-1T, A-17.


c. The transferor must attach the election to his or her tax return for each subsequent year in which transfer is made. Reg. § 1.1041-1T, A-18.

3. In any event, both spouses (or former spouses) may elect to have the provisions of § 1041 apply to all transfers made after 1983. DEFRA § 421(d)(2).


b. The form is also contained in Reg. § 1.1041-1T, A-18.

c. The transferor must attach the election to his or her tax return for each subsequent taxable year in which a transfer is made. Reg. § 1.1041-1T, A-18.