

Tax Issues in Divorce Matters

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Property Transfers

- No gain or loss is recognized on a transfer of property to a former spouse that is incident to a divorce. IRC 1041
 - Transfer is incident to a divorce if the transfer occurs within 6 years of the divorce. Treas. Reg. 1041-1T
 - If more than six years, then there is a presumption that the transfer is not incident to a divorce. However, this transfer can be rebutted. Treas. Reg. 1041-1T
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Corporation Redeems Spouse's Stock

- IRC 1041 does not apply.
 - The redemption could be treated as a taxable distribution to the spouse. Treas. Reg. 1.1041-2
 - The parties can decide which spouse will be responsible for any tax. Treas. Reg. 1.1041-2
 - The parties need to state the following in the separation agreement: Treas. Reg. 1.1041-2
 - The parties intend for the redemption to be treated as a redemption to the nonredeeming spouse.
 - This agreement supersedes any other instrument or agreement concerning the purchase, sale, redemption or other disposition of the stock that is subject to the redemption.
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Transfer of United States Savings Bonds

- The transferor of Series E or EE United States Savings Bonds must include accrued interest on the bonds in his/her gross income in the year of the transfer. Rev. Rul. 87-112.
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Transfer of Stock Options

- Prior to 2002, the transferor would be responsible for any tax once the stock options were exercised. Now, pursuant to Rev. Rul. 2002-22, the transferee will be responsible for any tax on transferred stock options.
 - However, the IRS specifically stated that Rev. Rul. 2002-22 does not apply to unvested stock options or unfunded deferred compensation plans.
 - Separation agreements should specifically state that Transferee Spouse shall pay to the Transferor Spouse an amount equal to the Transferor Spouse's tax detriment as a result of the stock options transferred to Transferee Spouse.
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Tax on Sale of Real Property

- Exclusion of up to \$500,000 (\$250,000 for single filer) on gain on the sale of a principal residence. IRC 121.
 - Must be owned and used for 2 of the past 5 years. IRC 121.
 - Will apply even if, pursuant to a decree of divorce, one spouse is given exclusive use and possession of the principal residence.
 - The titleholder for the property will be responsible for any capital gains tax. Treas. Reg. 121-1.
 - Consider transferring to joint ownership.
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Interest on Property Settlement Payments

- Interest on property distributions will be included in payee's gross income. IRC 61.
 - Interest on a property settlement will most likely not be deductible to the payor. IRC 163(h).
 - Exception: The portion of interest attributable to the distribution of property that is characterized as investment interest, passive activity interest, or qualified residence interest.
 - Solutions for the Tax Treatment of Interest
 - Treat the interest as alimony
 - Gross up the property settlement payments
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Mortgage Interest Deduction

- The mortgage interest deduction can only be claimed by the party that actually paid the mortgage. Notice 88-74
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Issues Regarding Spousal Support

- Spousal support will be taxable/deductible unless specifically stated in the separation agreement.
 - Spousal support must be paid in cash or cash equivalents.
 - Spousal support must terminate upon the death of the payee.
 - Payments to third parties on behalf of the spouse could be deemed to be spousal support.
 - Mortgage Payments on Marital Residence:
 - Depends on who holds the title to the marital residence. *Picou v. Commissioner.*
 - Payments to spouses attorney
 - Could be deductible if provided that payment is not required if spouse dies before payment is made. *Stedman v. Commissioner.*
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Spousal Support Recapture Rule

- The payor will be required to recapture in the third post-separation year any excess spousal support over the first and second post-separation years two and three. IRC 71
 - Rule: A first calculation compares the second year payments to the the third year payments. If the amount paid in the third year plus \$15,000 is less than the amount paid in the second year, the excess amount will be recaptured. The second calculation compares the first year to the adjusted average of the second and third years. Payments in the second and third years will be reduced by an recapture from the first calculation. The second and third year payments will be averaged. If this average plus \$15,000 is less than the payments in the first year, the excess amount will be recaptured. IRC 71
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Spousal Support Recapture Rule

- Example : If the payor makes alimony payments of \$50,000 in the first year and no payments in the second or third year, \$35,000 will be recaptured.
 - Result: The payor must include \$35,000 in his gross income and payee receives a deduction of \$35,000.
 - Exceptions: The spousal support terminates, the spousal support is pursuant to a temporary order or the support fluctuates due to support being tied to a percentage of payor's income.
 - When to be concerned: If your client may need to significantly reduce support within three years of the decree.
 - Solution: Make the support nontaxable and nondeductible.
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Temporary Spousal Support

- Payments on behalf of spouse will be taxable unless specifically stated in the Temporary Orders.
 - Consider adding: All payment on the behalf of spouse are designated as payments which are no includable in gross income under Section 71 and not allowable as a deduction under Section 215 of the Revised Code.
 - Consider making temporary support nondeductible and nontaxable.
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Estimated Tax Payments on Alimony

- The payee must make estimated tax payments on the 15th of April, June, September and January.
 - Generally, 90% of the annual tax liability is to be paid by estimated tax payments.
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Dependency Exemptions

- The custodial parent is entitled to the dependency exemption. IRC 152.
 - Notwithstanding the determination made by the court, the custodial parent is defined as the parent with whom the child resides for the greater number of nights. Treas. Reg. 1.152-4
 - As of July 3, 2008, noncustodial parent may only claim the child if the custodial parent waives his/her right to claim the child by executing Form 8332. Form 8332 must be attached to the noncustodial parent's tax return.
 - Consider having the custodial parent execute several Form 8332's at the time of finalizing the divorce.
 - Dependency exemption cannot be purchased.
 - A phase-out of the exemption begins once adjusted gross income exceeds \$250,000 for a single taxpayer, \$275,000 for a head of household, \$300,000 for married filing jointly and \$150,000 for married filing separately.
 - For each \$2,500 of adjusted gross income over the threshold, the exemption is reduced by 2%.
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Deductibility of Attorney Fees

- Deductible if services relate to tax advice. Treas. Reg. 1.212-1.
 - Fees attributable to attempting to secure taxable spousal support are deductible. IRC 212.
 - Deductible only to payee.
 - Fees for collecting taxable support in arrears are deductible. Elliot v. Commissioner
 - Fees in connection with securing a increase in taxable support are deductible. Gale v. Commissioner.
 - Deductible even if not successful.
 - Payor cannot deduct for defending or seeking a modification. Sunderland v. Commissioner.
 - Fees associated with protecting profit seeking activities are deductible.
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Amending a Tax Return

- Parties can amend a separate return in order to file a joint return as long as the amendment is done within three years of the original due date. Treas. Reg. 1.6013-2.
 - Parties cannot amend a joint return in order to file a separate return.
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No Signature on a Joint Return

- The fact that a spouse did not sign a filed joint return does not preclude joint return status. *Crew v. Commissioner*
 - The Tax Court will look to the intent of the non-signing spouse. The Tax Court will consider the following factors:
 - Whether the non-signing spouse intended to sign a joint return
 - Whether the returns were prepared pursuant to an established practice of preparing and filing returns
 - Whether an affirmative act was taken indicating an intention to file other than jointly
 - Whether one spouse entirely relied on the other spouse to file returns
 - Whether the spouse examined the returns presented for signature
 - Whether separate returns are filed
 - Whether the returns include the income and deductions of the non-signing spouse
 - Whether the non-signing spouse was aware of the contents of purported returns
 - Whether the parties have a history of filing joint returns
 - Factors showing lack of intent:
 - The non-signing spouse refusal to sign due fear of becoming liable for taxes
 - The non-signing spouse files a separate return or notifies the IRS
 - The non-signing spouse was unaware that a joint return had been prepared and filed.
 - Forging the signature of the spouse
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Innocent Spouse Relief Election

- Innocent spouse will need to file Form 8857 no later than two years after collection activities have commenced. IRC 6015.
 - You cannot file for innocent spouse relief until IRS notifies the spouse that an outstanding tax liability exists for the tax year. Treas. Reg. 1.6015.
 - Innocent spouse has the burden of proof. *Shafman v. United States Department of Treasury*.
 - The innocent spouse must not have known or reason to know of an erroneous item giving rise to an understatement of income. Treas. Reg. 1.6015-2.
 - Factors considered
 - The nature of the erroneous item and the amount of the erroneous item relative to other items
 - The couple's financial situation
 - The innocent spouse's education, background and experience
 - The extent of the innocent spouse's involvement in the activity that caused the understatement
 - The presence of expenditures that appear lavish when compared to the family's past levels of income, standard of living and spending patterns.
 - Whether there is evidence of deceit.
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Separate Liability Election

- A divorce or legally separate spouse can file Form 8857 for the Separate Liability Election. IRC 6015.
 - Under this election, the spouse can limit the liability to any deficiency allocable to that spouse – essentially as if the spouse filed a separate return.
 - Must also not have actual knowledge of the item giving rise to the deficiency.
 - The Service has the burden of proof regarding actual knowledge. *Culver v. Commissioner*.
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Equitable Relief Election

- Make an election on Form 8857.
 - Taxpayer must show that he/she will suffer economic hardship if not relieved of the liability for income taxes
 - Economic hardship is defined as unable to pay reasonable living expenses
 - Can be used even if the parties signed a joint return and the spouse had actual knowledge of a deficiency.
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