CHAPTER 21 TAXATION AND DIVORCE*

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§ 21.01 Introduction

The chapter is organized based on the formula for computing taxable income. A taxpayer's filing status is discussed and then items of gross income, deductions, the calculation of tax, and credits are reviewed in the context of divorce. Property transfers to a spouse or incident to a divorce, alimony, child support, and alimony recapture are discussed in detail. A tax planning section is presented at the end of the chapter.

The Tax Cuts and Jobs Act (P.L. 115-97) made major changes to the tax treatment of alimony payments. Alimony payments related to divorce or separation instruments executed after December 31, 2018 are not deductible by the payor or taxable to the recipient. The parties to divorce or separation instruments executed before 2019 and modified after December 31, 2018 can control the tax law applied to the modified agreement.

Under the Tax Cuts and Jobs Act (P.L. 115-97), the value of the dependency exemption was reduced to zero and replaced with a larger standard deduction. While the Act eliminated the tax savings related to the dependency exemption deduction, the rules related to the parent eligible to claim the deduction remain in place. The eligibility to claim a dependency exemption is important in determining who may claim benefits such as the child tax credit.

The chapter should be used only as a guide to identifying many of the common and complicated tax issues related to divorce. The chapter is not intended to be exhaustive and does not identify every tax issue that should be considered when tax planning for divorce. Each taxpayer's particular situation should be analyzed and the advice of an experienced tax professional should be obtained.

§ 21.02 Filing Status

[1] In General

A taxpayer's filing status is determined on the last day of the tax year.[1] A joint tax return is allowed if a spouse dies during the tax year unless the surviving spouse remarries during the same tax year.[2]

[2] Single

A single person is defined as an unmarried person or a person who is legally separated or divorced at the end of a tax year. A single person may qualify for head of household status. The single filing status is not available if a taxpayer is married at the end of the tax year.

[3] Married Filing Jointly

A married individual is defined as a person who is legally married at the end of the tax year. Separation agreements without a court order do not terminate a marriage for federal income tax purposes.[3] An individual who is not legally separated or divorced at the end of the tax year cannot file a tax return with a filing status of single but can file a tax return with a filing status of married filing separately.

An individual legally married at the end of the tax year may be considered single at the end of the tax year under the abandoned spouse rules for the purpose of using the head of household filing status.[4]

The joint filing status is generally more favorable than the filing status of married filing separately. Numerous deductions and credits are available only if spouses file a joint tax return. Examples include the earned income credit, the dependent care credit, and the income exclusion related to interest earned on U.S. Savings Bonds used to pay for college tuition.

Individuals filing a joint tax return are jointly and severally liable for the entire tax reflected on the return.[5] This is true even if one spouse has no income. A joint return cannot later be amended to change the filing status to married filing separately.[6] A spouse may qualify for relief from the other spouse's share of the joint income tax liability under the innocent spouse rules. An executor of a deceased spouse may disaffirm a joint return filed by the surviving spouse.

Tax motivated divorces are considered a sham and are ignored for federal income tax purposes.[7] Taxpayers cannot become divorced before the end of a tax year and file single tax returns (assumingly to save taxes) and then remarry the same person in the following tax year.

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[1] I.R.C. § 7703(a)(1)
[2] I.R.C. § 2(b)(2)
[3] I.R.C. § 7703(a)(2)
[4] Reg. § 1.2-2(e)
[5] I.R.C. § 6013(d)(3)
[6] I.R.C. § 6013(b)
[7] Rev. Rul. 76-255

[4] Married Filing Separately

A person must be married at the end of the tax year to use the married filing separately filing status. The married filing separately tax schedule and standard deduction amounts are one-half of the married filing joint amounts. Married taxpayers that file separate tax returns must both either itemize deductions or use the standard deduction amount. This rule is to prevent taxpayers from receiving larger deductions than would be available if a joint return was filed.

The married filing separately filing status eliminates joint and several tax liability where both spouses are equally liable for the entire tax reflected on a joint tax return. Married taxpayers can amend separately filed tax returns to change to the joint filing status.

[5] Head of Household

The head of household standard deduction amount and the level of income taxed at lower rates is more favorable than the single filing status but less favorable than the filing status of married filing jointly. To qualify for head of household filing status a taxpayer must be unmarried as of the end of the tax year and furnish more than one-half of the cost of a household for a dependent child whose principle place of residence was the taxpayer's residence for more than one-half of the tax year. The taxpayer must occupy the residence for the entire tax year to use the head of household filing status.[8] Temporary absences related to illness, education, business, vacation, or military service would not disqualify a taxpayer from using the head of household filing status.

A custodial parent who releases the dependency exemption to the non-custodial parent will still qualify for head of household filing status if the remaining head of household tests are met. Dependents other than the taxpayer’s child may also allow for the use of head of household filing status.

[6] Abandoned Spouses

Generally, an individual must be single at the end of a tax year to use the head of household filing status. An individual who is legally married at the end of a tax year but who has not lived with his or her spouse at any time during the last six months of the tax year may qualify for head of household filing status.[9] The so-called abandoned spouse rules allow a married taxpayer who is the custodial parent of a dependent child to use the head of household filing status as long as the other tests related to the head of household filing status are met.

The spouse who is not claiming head of household filing status under the abandoned spouse rules is required to use the filing status of married filing separately. It

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[8] I.R.C. § 2(b)
[9] I.R.C. § 7703(b)

is possible that both married spouses will qualify for head of household filing status when multiple children are involved.

§ 21.03 Gross Income Inclusions

[1]Alimony

Alimony payments related to divorce or separation agreements executed before 2019 are taxable to the recipient.[10] See § 21.12 for additional rules related to the tax treatment of alimony and child support payments.

[2] Capital Gains and Losses

Capital gains and losses are included in the calculation of gross income.[11] There are limitations placed on the deductibility of capital losses. Individual taxpayers can deduct capital losses only to the extent of capital gains plus an additional $3,000.[12] This rule results in a maximum capital loss deduction of $3,000 in a tax year. Capital gains and losses are not recognized on the transfer of property to a spouse or property transferred incident to a divorce.

§ 21.04 Gross Income Exclusions

[1] Child Support

Child support is not taxable to the recipient.[13] See § 21.12 for additional rules related to the tax treatment of alimony and child support payments.

[2] Benefits Received on Behalf of Children

Employer provided medical reimbursements, health insurance on the account of children, and distributions from health savings accounts (HSA) are excluded from the income of both parents as long as the following conditions are met:

1. The parents are legally divorced or separated or both parents lived apart during the entire last six months of the tax year,
2. One or both parents combined provided more than one-half of the child's support during the tax year, and
3. One or both parents have custody of the child for more than one-half of the tax year.[14]

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[10] I.R.C. § 71(a)
[11] I.R.C. § 61
[12] I.R.C. § 1211
[13] I.R.C. § 71(c)
[14] I.R.C. § 105(b)

It is immaterial which parent is entitled to the dependency exemption for the child.

[3] Interest Income from U.S. Savings Bonds Used for Higher Education Expenses

Interest earned on Series EE or Series I U.S. Savings Bonds can be excluded from income if the proceeds are used to pay for college tuition and related expenses.[15] The exclusion is not available for room and board. The bonds must be issued to an individual at least 24 years of age. That is, the bond must be issued to the parent(s) and not to the child who is or will be attending college. The bonds can be jointly owned by the parents but not jointly owned by a parent and someone else such as a parent's child.

Interest is excluded from income when bond proceeds are used for college tuition and related expenses. Proceeds from bond redemptions that exceed the cost of tuition and related expenses are allocated proportionately between taxable interest and nontaxable interest.

The interest exclusion is reduced or eliminated for higher income taxpayers.[16] For married taxpayers filing a joint tax return a portion of the exclusion is lost when adjusted gross income (AGI) in 2018 exceeds $119,300. The exclusion is not available to married taxpayers with AGI in excess of $149,300. The phase-out range for single individuals and married individuals eligible to use the head of household filing status is $79,550 to $94,550 in 2018. The threshold amounts are adjusted annually to reflect inflation.

The exclusion is not available to married taxpayers who file separate tax returns.[17] The definition of married excludes a taxpayer considered an abandoned spouse and is eligible to use the head of household filing status. The exclusion is only available to the parent who deducts the dependency exemption for the child. The exclusion is not available to the custodial parent if the exemption is released to the noncustodial parent.

[4] Sale of the Marital Residence

A taxpayer may exclude from income, once every two years, up to $250,000 ($500,000 for married individuals filing a joint return), of the gain from the sale of a principal residence.[18] To qualify for this exclusion a taxpayer must have owned the property and used the property as a principal residence for at least two out of five tax years preceding the date of sale.[19]

A spouse who owned the marital residence and then transferred ownership to the other spouse pursuant to a divorce decree or separation agreement also transfers the

[15] I.R.C. § 135(a)
[16] I.R.C. § 135(b)(2)
[17] I.R.C. § 135 (a)(3)
[18] I.R.C. § 121
[19] I.R.C. § 121(b)

"owned" attribute to the transferee spouse.[20] The time the marital residence was owned by the transferor spouse is added to the time the transferee spouse is deemed to own the residence for purposes of qualifying for the exclusion. Example: S1 owns 100 percent of the marital residence and lived with S2 for 18 months prior to a divorce. S2 (the transferee spouse) lives in and owns the residence for seven months and then sells the residence. The length of time S2 is deemed to have owned the house prior to the sale is two years and one month. The transaction qualifies for the sale of principal residence exclusion.

A taxpayer may never deduct a loss from the sale of a residence.[21] A residence is considered a personal asset that is not held for investment. It is immaterial if the sale is related to a decree of divorce or separate maintenance.

[5] Life Insurance

Life insurance proceeds received due to death are excluded from the gross income of the beneficiary (including a beneficiary who is a former spouse).[22] If a beneficiary of a life insurance policy elects to receive the face value of the policy in installment payments, the interest portion of the installment payments is taxable.

§ 21.05 Deductions Allowed in Arriving at Adjusted Gross Income

[1]In General

Deductions allowed in arriving at adjusted gross income (AGI) are commonly referred to as "above-the-line" deductions. Unlike itemized deductions that are only available to taxpayers that elect to itemize, deductions allowable in arriving at AGI income are available to all taxpayers. It is important to distinguish between deductions allowable in arriving at AGI and itemized deductions because various nonbusiness deductions and income exclusions are limited based on a taxpayer's AGI.

[2] Alimony and Child Support

Alimony is deductible by the payor for divorce and separation instruments executed before 2019.[23] See § 21.12 for additional rules related to the tax treatment of alimony and child support payments.

§ 21.06 Itemized Deductions and Standard Deductions

[1] In General

[20] I.R.C. § 121(d)(3)
[21] Reg. § 1.165-9
[22] I.R.C. § 101
[23] I.R.C. § 215(a)

Itemized deductions are allowed if total itemized deductions exceed a taxpayer's standard deduction amount. The standard deduction amount is based on filing status.[24] The greater of itemized deductions or the standard deduction amount is subtracted from adjusted gross income in arriving at taxable income. The standard deduction amounts are adjusted annually for inflation. For 2018 the standard deduction amounts are:[25] [26]

Married filing jointly - $24,000

Married filing separately - $12,000

Head of household - $18,000

Single - $12,000

An additional standard deduction is allowed for taxpayers over the age of 65, blind, or both 65 and blind.[27] The additional standard deduction in 2018 is $1,600 for single taxpayers and $1,300 for married taxpayers.

When married taxpayers file separate tax returns, both spouses must either itemize deductions or use the standard deduction amount. This rule is to prevent taxpayers from receiving larger deductions than would be available if a joint return was filed.

[2] Medical Expenses

Medical expenses paid for the care of a taxpayer, a spouse, or a dependent are deductible to the extent that they exceed 10 percent of adjusted gross income (AGI). The AGI limitation is 7.5 percent in 2018.[28] Medical expenses are defined as amounts paid for the diagnosis, cure, prevention, and treatment of disease. Health insurance premiums paid with after-tax dollars are deductible as a medical expense.

Both parents are entitled to a medical expense deduction for medical expenses paid for a child if the following conditions are met:

1. The parents are legally separated, divorced, or lived apart during the entire last six months of the tax year,
2. One or both parents combined provided more than one-half of the child’s support during the tax year, and
3. One or both parents had custody for more than one-half of the tax year.[29]

[24] I.R.C. § 63(c)(2)
[25] I.R.C. § 63(c)(2)
[26] Rev. Proc. 2013-35
[27] I.R.C. § 63(c)(3)
[28] I.R.C. § 213(a)
[29] I.R.C. § 213(a)

Married taxpayers filing separate returns are entitled to deduct medical expenses actually paid by them. Medical expenses paid with a joint checking account are generally allocated one-half to each taxpayer.

[3] Home Mortgage Interest

Home mortgage interest on the first $750,000 of acquisition indebtedness can be deducted. Interest on a home equity loan can no longer be deducted beginning in 2018.[30] To qualify for the deduction the loan must be secured by the taxpayer's residence. A taxpayer can also deduct mortgage interest on a second residence. Married taxpayers filing separate returns are each entitled to one-half of the mortgage interest deduction if the residence is jointly owned and used as a residence by both taxpayers. Mortgage interest paid on a home not owned by a taxpayer is not deductible as mortgage interest expense, but may be considered alimony deductible by the payor.

[4] Real Estate Taxes

[a] In General

Real estate taxes levied on the marital residence are deductible when paid.[31] Married taxpayer's filing separate tax returns are each entitled to deduct one-half of real estate taxes paid on the marital home if the property is jointly owned. Real estate taxes paid on a marital residence not owned by the taxpayer are generally treated as alimony. The tax consequences of alimony payments are discussed in § 21.12.

[b] Overall Limitation on Deduction of Taxes

Beginning in 2018, the itemized deduction for taxes is limited to $10,000 ($5,000 on married filing separately returns).[32] This limitation is applied to the combined total of real estate taxes, personal property taxes, state and local income taxes, and state and local sales taxes.

[5] Two-percent Miscellaneous Itemized Deductions

Beginning in 2018, expenditures classified as miscellaneous itemized deductions are no longer deductible.[33] Prior to 2018, legal fees incurred to obtain alimony payments where deductible to the extent that they exceeded two percent of a taxpayer's adjusted gross income.

§ 21.07 Personal and Dependency Exemptions

[1] In General

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[30] I.R.C § 163(h)(3)(F)
[31] I.R.C. § 164(a)
[32] I.R.C. § 164(b)(6)
[33] I.R.C. § 67(a)

The value of the deduction for personal and dependency exemptions is zero for the tax years 2018-2025.[34] The reduction of the exemption amount to zero does not alter the operation of other provisions of the Internal Revenue Code that refer to an allowed deduction under I.R.C. § 151. Example: A taxpayer is allowed a tax credit under I.R.C. § 24(a) for each qualifying child (defined in I.R.C. § 152(c)) even though the value of the allowed deduction under I.R.C. § 151 has been reduced to zero.[35]

[2] Dependency Exemptions and Qualifying Child Rules

Taxpayers are allowed a deduction (valued at zero for the tax years 2018 through 2025) for each child where the qualifying child rules are met. Five requirements must be met before a taxpayer is entitled to claim a child, stepchild, adopted child, or foster child as a dependent. They are as follows:

1. A dependent must be a citizen of the United States; a resident of the United States, Canada, or Mexico; or a child adopted by a United States citizen and living with the citizen in a foreign country,
2. A child must have as a principal residence the taxpayer's residence for more than one-half of the tax year,
3. A dependent must not provide over one-half of his or her support during the tax year,
4. A dependent must be under the age of 19, under the age of 24 if the child is a full-time student, or any child who is permanently and totally disabled, and
5. A dependent may not file a joint return with a spouse unless the only purpose for filing the return is to obtain a refund.[36]

A special rule applies to the dependency exemption for children of divorced or separated parents. The general rule is that the parent that has custody of a child for more than one-half of the tax year is entitled to a dependency exemption deduction (valued at zero for tax years 2018 through 2025). The custodial parent may grant (or may be required to transfer as part of a divorce settlement) the dependency exemption to the non-custodial parent if a release is signed on IRS Form 8332 by the custodial parent and the following information conditions are met:

1. The parents were legally separated, divorced, or lived apart during the entire last six months of the tax year,
2. One or both parents combined provided more than one-half of the child’s support during the tax year, and
3. One or both parents had custody for more than one-half of the tax year.

§ 21.08 Calculation of Tax

[34] I.R.C. § 151(d)(5)
[35] H.R. Rep No. 115-466, at 203 (2017)
[36] I.R.C. § 152

[1] Tax rates

A taxpayer’s income tax liability is computed by applying tax rates ranging from 10 percent to 37 percent of taxable income.

[2] Long-term Capital Gains Tax Rates

A maximum tax rate is applied to net long-term capital gains in excess of net short-term capital losses.[37] Generally, the maximum capital gains rate is 15 percent. The tax rate is zero for taxpayers with an ordinary income tax rate of 15 percent or less. The maximum net long-term capital gains tax rate is 20 percent for married taxpayers filing a joint return with taxable income of $479,000 or more, for taxpayers qualifying for head of household filing status when taxable income is $452,400 or more, and for married taxpayer's filing separate returns with taxable income of $239,500 or more.

[3] Tax on Unearned Income of a Child (Kiddie Tax)

The unearned income of a child exceeding $2,100 is taxed at the ordinary and capital gains tax rates of estates and trusts.[38] The 2017 Tax Cuts and Jobs Act simplified the "kiddie tax" and the tax rate applied to a child's unearned income is no longer determined by the parents' marginal tax rates. The "kiddie tax" applies to a child under the age of 18 or of a child who is a full-time student.[39] This rule prevents parents from transferring income-generating investments to their children to obtain a lower tax rate.

[4] Medicare Tax on Net Investment Income

A 3.8 percent Medicare tax is imposed on net investment income for married taxpayers filing a joint tax return if modified adjusted gross income (AGI) exceeds $250,000. The modified AGI threshold is $200,000 for single taxpayers and $125,000 for married taxpayers filing separate returns.[40] Investment income includes dividends, certain annuities, rents, royalties, and capital gains and losses.

[5] Loss Carryforwards

A net operating loss generated in a year when a joint income tax return was filed must be allocated to each spouse based on the recomputed separate net operating loss of each spouse.[41] The separately computed net operating loss of each spouse can be deducted on each spouses' future income tax returns.

[37] I.R.C. § 1(h)(1)
[38] I.R.C. § 1(j)(4)
[39] I.R.C. § 1(g)(2)
[40] I.R.C. § 1411
[41] Reg. 1.172-7(d)

[6] Amended Tax Returns

An amended joint tax return related to a joint tax return filed prior to a divorce will be accepted by the IRS even if the amended return is signed only by one spouse. The refund will be issued to the former spouse who signed the amended return. The refund is based on the reduction in the joint income tax liability. The refund allocated to the spouse who filed the amended return is based on a percentage of each spouse's separate tax liability to the total separate tax liabilities of both spouses.

§ 21.09 Tax Credits

[1] In General

A tax credit results in a dollar for dollar reduction in a taxpayer's tax liability. The two types of tax credits are refundable and nonrefundable tax credits. A nonrefundable tax credit can be used to reduce a taxpayer's tax liability to zero. Refundable tax credits reduce a taxpayer's tax liability to zero and the excess credit amount is refunded to the taxpayer. Some tax credits have both refundable and nonrefundable attributes.

[2] Dependent Care Credit

The child and dependent care credit is a nonrefundable credit. The credit is calculated by applying a credit rate of 20 to 35 percent to dependent care expenses paid for a qualifying individual(s). A qualifying individual is a child under the age of 13 or any person who is a dependent of the taxpayer and is physically or mentally incapable of self-care. A person must live with the taxpayer for more than one-half of the year before the taxpayer is eligible to claim the dependent care credit.[42]

The amount of dependent care expenses eligible for the credit is $3,000 for one qualifying individual and $6,000 for two or more qualifying individuals. Expenses allowed in calculating the credit cannot exceed the earned income of the spouse with the lowest earned income. Earned income is wages and/or self-employment income.

Married taxpayers must file a joint return to claim credit. The credit is available only to the custodial parent if the parents are legally divorced or separated. This rule applies even if the custodial parent releases the dependency exemption to the noncustodial parent.

[3] Child Tax Credit

[42] I.R.C. § 21

Taxpayers who may claim a dependency exemption (valued at zero beginning in 2018) for a child under the age of 17 are entitled to a child tax credit.[43] The amount of the credit is $2,000 per child. The child credit is reduced when a taxpayer's modified adjusted gross income (MAGI) exceeds the threshold amounts of $400,000 for joint filers and $200,000 for any other filing status. The credit is reduced by $50 for every $1,000 increment that modified MAGI exceeds the threshold amount.[44]

The unused portion of the child tax credit (the amount left over after the tax is reduced to zero) is re-characterized as a refundable tax credit to the extent of 15 percent of earned income in excess of $2,500. The maximum refundable credit is $1,400 per qualifying child.

A taxpayer can claim the child tax credit only if the taxpayer is entitled to a dependency exemption for the child qualifying the taxpayer for the credit.[45] If the custodial parent releases the dependency exemption to the noncustodial parent, the noncustodial parent is entitled to the credit.

[4] Earned Income Credit

The earned income tax credit is a refundable credit available to low-income taxpayers and is based on earned income (wages and/or self-employment income). To qualify for the earned income tax credit a taxpayer must (1) have one or more qualifying children or (2) maintain a residence in the United States for more than one-half of the tax year, (3) be at least 25 (but not older than 65) before the end of the tax year, and (4) not be claimed as a dependent by another taxpayer. A qualifying child is a child that is a dependent under the dependency exemption rules.[46]

The maximum credit amount for taxpayers with at least one qualifying child ranges from $3,461 to $6,413 in 2018. The credit is reduced for taxpayers with adjusted gross income between $18,660 and $54,884 in 2018 and is adjusted annually for inflation.

The credit is only available to married individuals who file a joint tax return. Individuals who are married but considered single and eligible for head of household filing status under the abandoned spouse rules are eligible for the credit. The credit is available to the custodial parent even if the dependency exemption is released to the noncustodial parent.[47]

[5] Education Tax Credits

[a] In General

[43] I.R.C. § 24(a)
[44] I.R.C. § 24(b)
[45] I.R.C. § 24(a)
[46] I.R.C. § 32
[47] I.R.C. § 32(c)(3)

In the same tax year, a taxpayer may elect, with respect to an eligible student, the American Opportunity Credit or the Lifetime Learning Credit. A different credit may be elected with respect to each eligible student in a tax year. Eligible students are the taxpayer, the taxpayer's spouse, and the taxpayer's dependent(s).

Education credits may only be claimed by married individuals if a joint return is filed.[48] Married individuals considered single and eligible for the head of household filing status under the abandoned spouse rules are eligible to claim education credits. The credit is available to the parent who claims the dependency exemption. A custodial parent who releases the dependency exemption to the noncustodial parent is not allowed to claim the credit.

[b] American Opportunity Credit

The American Opportunity Credit is calculated as 100 percent of the first $2,000 of tuition and fees, plus 25 percent of the next $2,000 of tuition and fees paid during the tax year. The maximum credit is $2,500 per tax year per student. The American Opportunity Credit is available for the first four years of post-secondary education for students enrolled in school on at least a half-time basis. Forty percent of the credit is refundable and 60 percent of the credit is nonrefundable. The credit is phased out for single taxpayers with an adjusted gross income (AGI) between $80,000 and $90,000 and for married taxpayers with an AGI between $160,000 and $180,000.[49]

[c] Lifetime Learning Credit

The Lifetime Learning Credit is a nonrefundable credit equal to 20 percent of the first $10,000 of post-secondary education tuition and fees paid in a tax year. The maximum credit per student in a tax year is $2,000. A student is eligible for the credit beyond the first four years of post-secondary education and at least half-time enrollment is not required.[50] The credit is phased out for single individuals with an adjusted gross income (AGI) between $57,000 and $67,000 and for married individuals filing a joint tax return with an AGI between $114,000 and $134,000.[51] The phase-out amounts are adjusted annually for inflation.

[6] Allocation of Estimated Tax Payments

Taxpayers who are not considered married cannot make joint estimated tax payments. Taxpayers who are married can make joint or separate estimated tax payments and later file a joint tax return or separate tax returns.[52] The filing of joint or separate

[48] I.R.C. § 25A(g)(6)
[49] I.R.C. § 25A(i)
[50] I.R.C. § 25A(c)
[51] I.R.C. § 25A(d)
[52] IRS Pub. 505

estimated tax payments does not constitute an election to either file a joint tax return or separate tax returns.

Estimated tax payments are allocated to each spouse based on the payments made by each spouse when married taxpayers make separate estimated tax payments and file separate tax returns. Married taxpayers that make joint estimated tax payments and file separate tax returns can allocate the estimated tax payments in any agreed upon manner. Absent an agreement among spouses, the IRS will allocate joint estimated tax payments based on a percentage of each spouse's separate tax liability to the total separate tax liabilities of both spouses.[53]

§ 21.10 Relief from Joint and Several Liability on Joint Return

[1] In General

Each spouse is jointly and severally liable for the tax liability reflected on a tax return.[54] If an inaccurate return is filed and one spouse did not have knowledge of the inaccurate return, that spouse is relieved from the tax deficiency related to the inaccurate return item(s) for which the spouse did not have knowledge.

Relief is available for income taxes and self-employment taxes including the interest and penalties associated with tax deficiencies. Relief is not available for transferee liability associated with property transfers. If the Internal Revenue Service grants relief, the tax liability (including interest and penalties) of the spouse requesting the relief is recomputed excluding return items that are the basis for granting the relief request.

There are three types of relief from joint and several liability associated with the filing of a joint tax return. They are:

1. Innocent spouse relief under I.R.C. § 6015(b),

2. Separation of liability under I.R.C. § 6015(c), and

3. Equitable relief under I.R.C. § 6015(f).

Relief is also available if a joint return was signed under duress.[55]

A request to be relieved from a tax liability associated with a joint return is made by filing Form 8857 with the IRS. The non-requesting spouse has the right to receive, and will be provided with, notice by the IRS that a claim for relief has been filed.[56]

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[53] Rev. Rul. 76-140
[54] I.R.C. § 6013(d)(3)
[55] Reg. § 1.6013-4(d)
[56] Reg. § 1.6015-6(a)

[2] Innocent Spouse Relief

Under I.R.C. § 6015(b)(1) innocent spouse relief can be granted when:

1. A joint return is filed,
2. The understatement of a tax liability is related only to the actions of one of the spouses,
3. The injured spouse (claimant) did not have knowledge of the inaccurate return when the return was filed,
4. When taking into account all the facts and circumstances, it is inequitable to hold the claimant responsible for the tax liability associated with the inaccurate portion(s) of the return, and
5. The person claiming innocent spouse status elects to invoke the benefits of the status within 2 years after the Internal Revenue Service began collection activity.

Knowledge of an inaccurate return is determined by using a facts and circumstances test. The Internal Revenue Service has the burden of proof to establish that the spouse requesting relief had actual knowledge of an erroneous item on a tax return.[57] Knowledge with respect to a particular return item may be partial knowledge. If the claimant has partial knowledge of an inaccurate return item, relief is only available for the tax deficiency not related to the partial knowledge.[58]

[3] Separation of liability

Under I.R.C. § 6015(c) joint and several liability can be limited for taxpayers who are no longer married, who are legally separated, or who where not members of the same household for 12 months prior to filing a separation of liability election. If an election is made under I.R.C. § 6015(c) the responsibility for a tax deficiency related to inaccurate return items is allocated to each spouse in the same manner that the return items would be allocated if separate returns were filed.[59] Both spouses may request relief under the separation of liability rules.

To be eligible for separation of liability relief the all of the following must apply:

1. A joint return was filed and the election for separate liabilities was made,[60]

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[57] Reg. § 1.6015-2(c)
[58] Reg. § 1.6015-3(c)(2)
[59] I.R.C. § 6015(d)(3)
[60] I.R.C. § 6015(c)(3)

2. At the time of the separate liability election the claimant was divorced, legally separated, or was not a member of the same household as the other party to a joint return for at least 12 months prior to filing the election,[61]

3. The claimant has the burden of proof to show that the inaccurate return item is related to the other spouse filing the joint return,[62]

4. The claimant can not have knowledge of an inaccurate return when the joint return was signed,[63] and

5. No fraudulent asset transfers (transfers with the principal purpose of tax avoidance) were made by the non-claimant spouse.[64] [65]

[4] Equitable Relief

If a taxpayer does not qualify for relief from joint and several tax liability under the innocent spouse or separation of liability provisions, relief may be granted under the inequitable relief provisions of I.R.C. § 6015(f). If, given all the facts and circumstances, it is inequitable to hold a party to a joint return responsible for a joint tax deficiency the Secretary may relieve the individual from the tax liability.[66] To qualify for equitable relief the following must apply:

1. A joint tax return was filed for the year of the relief request,

2. Relief is not available under I.R.C. § 6015(b) or (c),

3. The request must be filed by the collection statute expiration date which is generally 10 years from the date of a tax assessment,

4. There were no asset transfers between spouses that were part of a fraudulent scheme,

5. There were no transfers of property or property rights by the non-requesting spouse solely for purposes of tax avoidance,

6. The spouse requesting relief did not knowingly participate in the filing of a fraudulent return, and

7. The tax deficiency used as the basis for the claim for relief must be related to return items of the non-requesting spouse.[67] [68]

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[61] I.R.C. § 6015(c)(3)(A)(i)
[62] I.R.C. § 6015(c)(2)
[63] I.R.C. § 6015(c)(3)(C)
[64] Reg. 1.6015-3(c)(3)(iii)
[65] I.R.C. § 6015(c)(4)
[66] I.R.C. § 6015(f)(2)
[67] Rev. Proc. 2003-61

§ 21.11 Property Transfers between Spouses or Incident to a Divorce

[1] In General

No gain or loss is recognized when property is transferred between spouses under I.R.C. §1041. Divorce need not be contemplated or even occur. I.R.C. §1041 is not elective and a taxpayer cannot elect out of the non-recognition rules. This is true even if a bonafide sale occurs between spouses.

No gain or loss is recognized when property is transferred between former spouses incident to a divorce. A transfer is considered incident to a divorce if the transfer occurs within one year after a marriage ends or if the transfer is related to a decree of divorce or separate maintenance and the transfer occurs within six years.[69]

Transfers of property in trust are generally not taxable, however the non-recognition rules do not apply to transfers in trust where the liabilities transferred exceed adjusted basis of property transferred.[70] The transfer of a health savings account due to a decree of divorce or separate maintenance is not taxable.[71] The transfer of a retirement plan is not subject to the unrecognized income rules. See § 21.11(c) for the tax treatment of retirement plans that are assigned to a former spouse.

The nonrecognition rules do not apply to assets with built-in unrecognized income. The assignment of income doctrine (which prevents a taxpayer from assigning income to another taxpayer) overrides the nonrecognition rules. An example is the transfer of savings bonds that have accrued interest that has not been recognized. A taxpayer is required to include in income the unrecognized interest on the date of the transfer. The nonrecognition rules do not apply to the transfer of an installment note receivable.[72] Income is recognized by the transferor on the date of the installment note receivable transfer. The interest portion of the installment obligation is recognized by the transferee.

[2] Basis and Character of Property Transferred Between Spouses or Transferred Incident to Divorce

A carryover basis rule applies to property transfers between spouses while they are married and to transfers occurring incident to a divorce.[73] The basis of property received is the same as the basis in the hands of the transferor. This is commonly called a carryover basis and this rule applies regardless of the fair market value of an asset on the

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[68] Rev. Proc. 2013-34
[69] I.R.C. § 1041c)
[70] I.R.C. § 1041(e)
[71] I.R.C. 223(f)(7)
[72] I.R.C. 453B(g)(1)
[73] I.R.C. § 1041(b)

date of a transfer. The carryover rule applies if the basis is less than, equal to, or more than the fair market value. The basis carryover rule also applies to property sold to a spouse or former spouse at fair market value in a bonafide sale when the non-recognition rules of I.R.C. § 1041 apply.

Tax attributes are also carried over with the basis of the property. The holding period, the character of the asset (ordinary income property or capital gains property), and built-in ordinary income recapture are attached to the property and conveyed to the transferee.

[3] Transfer of Retirement Plans

[a] Qualified Pension Plans and Qualified Domestic Relation Orders

Generally, a qualified pension plan may not allow for the assignment of rights to benefits under the plan.[74] For divorced individuals the creation of a Qualified Domestic Relation Order (QDRO) allows for the creation of an alternate payee and an assignment of some or all of the rights to benefits under the plan.[75] The creation of a QDRO is not a taxable event. The effect of QDRO on a qualified plan participant is that distributions are not taxed to a qualified plan participant but are taxed to the former spouse that receives plan distributions. The allocation of tax-free investments (basis or after tax contributions) in a qualified pension plan is allocated to the participant and the alternate payee of the plan on a prorated basis.

A QDRO must clearly state the percentage of the participant's interest in a qualified retirement plan to be transferred to an alternate payee and the number of payments or period for the payments to be made. A QDRO must not alter the form of the benefit to be received under the plan and must be presented to the plan administration prior to any distribution.[76] If distributions are made before a valid QDRO is presented to a plan administrator, the distribution will be taxable. There is no cure for pension plan distributions occurring before a valid QDRO is in place.

[b] Individual Retirement Accounts

No tax is associated with the transfer of all or a portion of an individual retirement account to a former spouse pursuant to a decree of divorce or separate maintenance.[77] This can be accomplished by a direct trustee-to-trustee transfer or by simply changing the name on the account.[78]

[c] Non-qualified Deferred Compensation Plans

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[74] I.R.C. § 401(a)(13)(A)
[75] I.R.C. § 401(a)(13)(B)
[76] I.R.C. § 414(p)
[77] I.R.C. § 408(d)(6)
[78] IRS Pub. 590 (2017), p. 28

The transfer of an interest in a vested non-qualified deferred compensation plan is not a taxable event. The tax associated with non-qualified deferred compensation plan disbursements is the responsibility of the transferee spouse receiving the deferred compensation. This rule does not apply to unvested compensation rights at the time of the transfer. Unvested compensation rights later transferred to a former spouse represent taxable income to the former spouse.[79]

§ 21.12 Alimony, Child Support, and Alimony Recapture

[1] Alimony

[a] Post 2018 Divorce or Separation Instruments

Alimony payments resulting from divorce or separation instruments executed after December 31, 2018 are not deductible by the payor and are not taxable to the recipient.[80]

[b] Divorce or Separation Instruments executed before January 1, 2019

Alimony is taxable to the recipient and deductible by the payor.[81] [82] Payments to a former spouse are considered alimony if the following conditions are met:

1. The payments must be made in cash,
2. The payments must be required under a written support, separation, or divorce decree,
3. The payments cannot be considered something other than alimony in a court document (payments designated as nontaxable to the recipient and nondeductible by the payee are not considered alimony),
4. The former spouse does not live in the same household when the payments are made,
5. The payments must end upon the death of a former spouse,
6. The payment must not be designated or treated as child support,
7. The payments that are front-loaded must be recaptured, and
8. A joint tax return cannot be filed.[83]

Cash equivalents such as checks or money orders are considered cash payments.

Any type of written court order requiring payments in support of a spouse can be considered alimony. It is not necessary that spouses be legally divorced or separated for

[79] IRS Letter Ruling 9340032
[80] P.L. 115-97, § 11051(c)(1)-(2)
[81] I.R.C. § 71(a)
[82] I.R.C. § 215(a)
[83] I.R.C. § 71(b)

support payments to be considered alimony. Payments made under a court order *pendente lite* in support of a spouse are classified as alimony.

Payments must be made after the execution of the written instrument requiring the payments. Payments made prior to the execution of a written agreement are not considered alimony. Payments made after the execution of a written instrument and which are related to a period before the written instrument was executed are considered alimony.

If payment otherwise meets the definition of alimony the parties can designate the payments as non-deductible by the payor and nontaxable by the recipient. This can be accomplished with or without a court order. This may be beneficial if the payor spouse will receive little or no benefit from the alimony paid deduction.

Alimony payments must end upon the death of a spouse.[84] Payments owed to a spouse on the date of death do not fall into this category. Substitute payments that begin on the date of death will not qualify the payment as alimony.

Payments made to maintain the marital residence are not considered alimony if the residence is owned by the payor.[85] Mortgage payments, real estate taxes, insurance, and other expenses of a residence cannot be considered alimony if the property is owned by the payor-spouse. Payments not considered alimony may still be deductible under other provisions of the Internal Revenue Code. A taxpayer owning the marital residence can deduct mortgage interest and real estate taxes as an itemized deduction if a former spouse retains the right to live in the residence. The right of a former spouse to live in the marital residence must be based on a written separation or divorce decree.

If property is jointly owned by both spouses, then one-half of payments related to the marital residence are considered alimony.[86] If a spouse has the right to use the payor's home, then utilities paid by the payor spouse are considered alimony.

Payments made on a life insurance policy of a spouse are considered alimony if the payee spouse is the owner of the policy.[87] Payments made on the life insurance policy of a payor spouse are considered alimony if the payee spouse is the irrevocable beneficiary of the policy.

[c] Divorce or Separation Instruments Executed Before 2019 and Modified After December 31, 2018

The parties to divorce or separation instruments executed before 2019 and modified after December 31, 2018 can control the tax laws applied to amended agreements. Alimony payments related to instruments executed before 2019 are

[84] I.R.C. § 71(b)(1)(D)
[85] Reg. § 1.71-1T(b), Q & A 6
[86] IRS Pub. 504 (2017), p. 15
[87] Reg. § 1.71-1T(b)

deductible by the payor and taxable to the recipient. Alimony payments related to instruments executed after December 31, 2018 are not deductible by the payor and are not taxable to the recipient.

Generally, the pre-2019 tax law applies to agreements executed before 2019 and modified after December 31, 2018. The parties to an amended agreement can apply the post December 31, 2018 rules where alimony payments are nondeductible and nontaxable if the amended agreement expressly provides for the application of the post December 31, 2018 rules contained in the Tax Cut and Jobs Act.[88]

[2] Child support

Child support is not deductible by the payor and is nontaxable to the recipient. Generally, payments are considered child support if the payments are designated as child support in divorce decree or written separation agreement.

Payments are deemed alimony disguised as child support if the payments cease within six months before or after a child reaches the age of 18. The legal terminology used in a divorce decree has no bearing on the automatic re-characterization as child support payments that end within six months of a child reaching the age of majority.

Payments that terminate upon an event are considered child support. They include:

1. If a child leaves school,
2. If a child is no longer a member of the payee spouse's household,
3. If a child finds employment, or
4. If a child gets married or dies.

[3] Alimony Recapture

[a] In General

The alimony recapture rules do not apply to divorce or separation instruments executed after 2018. Under the Tax Cuts and Jobs Act (P.L. 115-97) alimony payments related to divorce or separation instruments executed after December 31, 2018 are not deductible.

[b] Calculation of Alimony Recapture

Nontaxable property transfers to a spouse that are disguised as alimony are subject to the alimony recapture rules. The alimony recapture rules usually apply to payments made soon after a divorce that are disproportionate to payments made in future tax years.[89]

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[88] P.L. 115-97, § 11051(c)(1)-(2)
[89] I.R.C. § 71(f)

Alimony payments that are deemed disguised property transfers are subject to the alimony recapture rules.

Generally, alimony is deductible by the payor and taxable to the recipient. The alimony recapture rules reverse the treatment of alimony on the originally filed returns of both the payor and recipient. Alimony recapture is the sum of the excess alimony payments in year one plus the excess alimony payments in year two. Alimony recapture results in the inclusion of the recapture amount in the taxable income of the payor and a deduction of the recapture amount by the recipient. The tax returns of both parties are adjusted in the third post-separation tax year.

Alimony payments will be recaptured if one or both of the following apply:

1. Alimony payments made in the second post-separation year are $15,000 or more than the alimony payments made in the third post separation year, and/or
2. Alimony payments made in the first post-separation year are $15,000 or more than the average of the sum of alimony payments made in the second post-separation year (reduce by the second year excess alimony payments) and alimony payments made in the third post-separation year.[90]

Example: John and Mary Smith were divorced on April 1, 2012. The following alimony amounts were paid by John:

2012 (first post-separation year)	$80,000
2013 (second post-separation year)	$45,000
2014 (third post-separation year)	$25,000

<u>Year 2 alimony recapture</u>

Payments made in second post-separation year (2013)	$45,000
Less: payments made in third post-separation year (2014)	<u>25,000</u>
Year two payment in excess of year three payments	$20,000
Less: $15,000 floor	<u>15,000</u>
	<u>$5,000</u>

<u>Year 1 alimony recapture</u>

Payments made in first post-separation year (2013)	$80,000
Less: the average of 1) year 2 payments (minus year 2 recapture) and 2) year 3 payments [($45,000 -$5,000) +	<u>32,500</u>

[90] I.R.C. § 71(f)

$25,000)] ÷ 2

	$47,500
Less: $15,000 floor	15,000
	$32,500

John will deduct alimony paid of $80,000 in 2012 and $45,000 in 2013. The alimony recapture amount of $37,500 ($5,000 + $32,500) will be included on John's 2014 taxable income. John will also receive a deduction of $25,000 for alimony paid in 2014.

Mary will include in income alimony received of $80,000 in 2012 and $45,000 in 2013. The alimony recapture amount of $37,500 ($5,000 + $32,500) will be deducted by Mary when computing 2014 taxable income. Mary will also include $25,000 of alimony received in 2014 taxable income.

There are four exceptions to the application of the recapture provisions:

1. Payments that end because of the death or remarriage of the payee,
2. Payments made because of temporary support orders,
3. Payments that decrease by less than $15,000 over a three year period, or
4. Payments based on a fixed percentage of wages, business income, or income from property.

§ 21.13 Defense of Marriage Act (DOMA)

The Defense of Marriage Act (DOMA) was declared unconstitutional in June 2013 by the U.S. Supreme Court.[91] For tax returns filed after September 2013 and for tax years beginning in 2013, same-sex couples legally married under state statutes are considered married for federal income tax purposes.

A person is considered married for the tax year if they are married on the last day of the tax year. Relationships such as registered domestic partnerships, civil unions, and any other relationship not considered a marriage under state law is not considered marriage for federal income tax purposes.

§ 21.14 Gift and Estate Taxes

The gift tax rules are not applicable to transfers between spouses or transfers made "incident to divorce" and are excluded from income under I.R.C. 1041.

§ 21.15 Tax Planning Opportunities

[91] 570 U.S. 744 (2013)

[1] Filing Status

A taxpayer's filing status may affect the ability to utilize exclusions, deductions, and tax credits. A taxpayer contemplating divorce may not desire to file a joint tax return with his or her spouse. It is also possible that neither spouse is allowed to use the head of household filing status under the abandoned spouse rules. Consideration should be given to the tax consequences of married individuals who file separate tax returns. The following are not available to married individuals who file separate tax returns:

1. U.S. Savings Bond interest earned exclusion (§ 21.04[3])

2. Dependent care credit (§ 21.09[2])

3. Earned income credit (§ 21.09[4])

4. Education tax credits (§ 21.09[5])

[2] Dependency Exemption

The value of the dependency exemption is zero for tax years 2018-2025; however, the eligibility to claim the exemption may result in additional tax benefits. Generally, the noncustodial parent is eligible to claim a dependency exemption. The release of the dependency deduction by the custodial parent may result in the transfer of tax benefits to the noncustodial parent. The parent eligible to claim a dependency exemption is eligible for the following tax benefits:

1. U.S. Savings Bond interest earned exclusion (§ 21.04[3]),

2. Child tax credit (§ 21.09[3]), and

3. Education tax credits (§ 21.09[5])

[3] Planning for Property Transfers

Property transfers to a spouse or incident to a divorce are nontaxable under I.R.C. § 1041. An analysis of basis of property transferred in relation to the fair market value of the property is prudent. This will allow for a review of the tax consequences associated with a future sale of the property.

It may be beneficial to transfer assets with a lower basis in relation to the fair market value to the spouse who will be subject to a lower tax rate when the property is sold. Consideration should also be given to the special tax rates associated with capital gains. Taxpayers with an ordinary income tax rate of 15 percent or less have a capital gains tax rate of zero. Higher income taxpayers have a capital gains tax rate of 15 or 20 percent (see § 21.08[2]). Gains from the sale of property may also be subject to the additional Medicare tax on net investment income (see § 21.08[4]).