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Stewart B. Barmen

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In a rare demonstration of concern as to the financial impact of divorce, on July 18, 1984 new tax legislation was enacted which extensively reforms the existing tax rules.

The Domestic Relations Tax Reform Act of 1984 (DRTRA) revolutionizes and simplifies the tax treatment of alimony, and of property transfers between spouses. It also modifies the areas of dependency exemptions and innocent spouse rules. On August 30, 1984, to further clarify and supplement the DRTRA, the Treasury issued Temporary Regulations which are also the proposed final Regulations.

With certain exceptions, the DRTRA and its Regulations apply to transactions that occur after December 31, 1984. The DRTRA, however, contains certain provisions permitting parties to utilize the new rules for transactions occurring before the effective date. This article is intended to provide a brief description of this new tax legislation and its Regulations.

I. Property Transfers

Prior law provided that property transfers which effectively divided the asset equally between spouses were considered transfers not subject to recognition of gain or loss. All other transfers between spouses were subject to such recognition. If the transfer occurred while the parties were married, the transferor in certain circumstances was required to report any gain as ordinary income. If the transfer occurred following a divorce, the gain qualified for capital gains treatment.

In 1962, the United States Supreme Court in *United States v. Davis*[1] ruled that a transfer of appreciated property to a spouse (or former spouse) in exchange for the release of marital claims results in the recognition of gain to the transferor. The spouse receiving

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* The author is a partner in the Pittsburgh, Pennsylvania law firm of Rothman, Gordon, Foreman and Groudine, P.C.

1. 370 U.S. 65 (1962).

the property reports a basis in the asset transferred equal to its fair market value. The effect of the *Davis* ruling has created nightmares for parties and their counsel who have attempted to transfer property from one spouse to another in order to effectuate a divorce settlement. Thus, a number of states have attempted to amend divorce legislation to avoid a *Davis*-type transaction.

Section 421 of the DRTRA, which adds section 1041 to the Internal Revenue Code, provides that no gain or loss shall be recognized on a transfer of property from an individual to a spouse or to a former spouse. The Act provides that transfers to former spouses must only be incident to a divorce. For further clarification, Temporary Regulation 1.1041-1T provides that a transfer is incident to a divorce if the transfer occurs within one year after the date on which the marriage ceases or if the transfer is related to the cessation of the marriage and occurs within six years of such cessation. It further provides that an annulment or the cessation of a marriage that is void due to violations of state law constitutes a divorce for the purpose of this section of the Act. Therefore, in the divorce context, a transfer of property between former spouses would not be subject to taxation.

The spouse receiving the property would no longer receive, as in a *Davis*-type transaction, a stepped-up basis for the property. Under the DRTRA, the recipient would receive a carryover basis, that being the transferor's adjusted basis in the property as in a gift transfer. Even if the transfer is a bona fide sale, the transferee does not acquire a basis equal to the transferee's cost (fair market value) but rather acquires the transferor's adjusted basis. In addition, the Regulation provides that this carryover basis rule applies for the purposes of determining loss as well as gain upon the subsequent disposition by the transferee. This rule differs from the rule applied in section 1015 of the Internal Revenue Code for determining the basis of property acquired by gift, in that section 1015 provides a different basis for gain and for loss.

There would not be a recapture of investment tax credits on the transfer as long as the transferee continues to use the property in the same trade or business. However, the Regulation provides that a later disposition of the property by the transferee would result in a recapture to the same extent as if the disposition had been made by the transferor. Thus, the transferor, at the time of the transfer, is required to supply the transferee with records sufficient to determine the amount and period of potential liability for any investment tax credit recapture.

The effective date provisions of the DRTRA allow retroactive elections so that spouses, by a joint election, can elect non-recognition treatment for any transfer made after December 31, 1983, and before the date of enactment. Both spouses can also elect non-recognition treatment for transfers made after the enactment pursuant to decrees entered on or before the effective date of the Act. An election made under the retroactive election applies to all transfers governed by that election and is irrevocable.

In order to effectuate a retroactive election, the Regulation requires that an election statement, signed by both former spouses, and including each spouse's social security number, must be attached to the transferor's filed income tax return for the taxable year in which the first transfer occurs. In addition, a copy of the election statement must be attached to the transferor's return for each subsequent year involving a transfer subject to the election.

Generally, these provisions do not apply to transfers between a spouse and a third party, even if the transfer is part of a divorce property settlement. This means that redemption of stock by a corporation would be taxed under regular redemption rules, and transfers with a partnership would be taxed under rules for partnerships. However, the Regulation provides for three situations in which a transfer of property to a third party on behalf of the spouse or former spouse will qualify as a transfer under the Act. The three situations are (1) where the transfer is required by a divorce property agreement; (2) where the transfer is pursuant to a written request of the non-transferring spouse; and (3) where the transferor receives from the other spouse a written consent or ratification of the transfer. In these three situations the transfer will be treated as made directly to the non-transferring spouse and the non-tranferring spouse will be treated as immediately transferring property to the third party. There is no gain or loss recognized by the transferor but the subsequent deemed transfer by the non-transferring spouse to a third party will not qualify for non-recognition of gain.

The DRTRA and its Regulations truly simplify tax problems pertaining to transfers of property in the divorce context by legislatively eliminating, with certain limited exceptions, taxation on the transfer.

II. Alimony

The most radical change in the new legislation pertains to the amendments to section 71 of the Internal Revenue Code. Section

71 required the inclusion of alimony payments as income to the recipient and section 215 permitted the deduction by the payor. The definition for alimony was included under section 71 and provided that: (1) payments arising from the family or marital relationship, (2) which are periodic in nature, (3) between spouses who are divorced or separated, and (4) which are imposed under a decree of divorce or separate maintenance or other written instrument incident to the divorce or separation, or (5) by a decree of support or maintenance, would be treated as alimony. Section 71 further provided that a specified number of payments to be made in installments of more than ten years would be considered periodic. Over the years the Internal Revenue Service has adopted many regulations, revenue rulings and procedures to interpret and apply the alimony deduction. At least half of the tax court decisions in the area of divorce taxation pertain to treatment of alimony and the attempt to distinguish the alimony payment from a property settlement payment.

The United States Supreme Court in *Commissioner v. Lester*[2] determined that any unallocated payment for support and maintenance of a spouse and children would be considered alimony under section 71. Section 423 of the DRTRA effectively repeals *Lester*. The portion of an unallocated payment that may be attributed to child support will not qualify as alimony. To the extent the payment specified in the instrument will be reduced upon the happening of events such as the child (1) attaining a specified age; (2) marrying; (3) dying; (4) leaving school; or (5) other similar contingencies, that amount will be considered child support and not alimony. Temporary Regulation 1.71-1T provides that the portion of a payment which can be clearly associated with an event relating to the child, such as (1) payments to be reduced not more than six months before or after the child achieves the age of 18 or 21; or (2) payments to be reduced on two or more occasions which occur within one year of different children of the payor spouse attaining a certain age between the ages of 18 and 24, will be considered child support rather than alimony. The tax benefit of unallocated payments is severely limited.

The DRTRA no longer requires that the payor be under a legal obligation to make the payments and eliminates the requirement that the payments be periodic in nature. The ten year principal sum rule (section 71(c) of the Code) is eliminated and a six year

2. 366 U.S. 299 (1961).

period rule is substituted. Any payment of $10,000 or less in a calendar year will qualify as alimony providing the payments terminate upon the death of the payee. Any payment in excess of $10,000 will not qualify unless it is conditioned upon the death of either spouse or the remarriage of the payee, or the payments continue for at least six post-separation years. The Regulation then defines six post-separation years as the six consecutive years beginning with the first calendar year in which the payor pays alimony to the payee. The six year period need not commence with the year in which the spouses separate or divorce.

In addition, the DRTRA requires the following: (1) the payments are to made in cash; (2) received by a spouse under a divorce or separation instrument; and (3) the payor and payee are not to be members of the same household at the time the payments are made. Additionally, there will be no requirement to make the payments following the death of the payee spouse. The aforementioned Regulation clarifies and expands on the Act's requirements. It provides that cash payments made to a third party on behalf of the payee spouse under the terms of the divorce or separation instrument qualify as alimony, and payments made by the payor on the payor's life insurance policy under the instrument will qualify as alimony to the extent the payee spouse is the owner of the policy. However, payments to maintain the marital residence being used by the payee spouse will not qualify as alimony.

In a further attempt to protect against cloaking a property settlement payment as alimony, a recapture rule is introduced by the DRTRA. This recapture rule applies to limit payments during the first six years after the alimony payments begin. Although this rule as written appears to be quite complex, in application it is rather simple. There will be a recapture to the extent the amount paid in any of the first six years exceeds by more than $10,000 the lowest amount of alimony paid during any subsequent year in the six year period. The recapture occurs in any of the five consecutive post-separation years; the payor reports the recaptured amount as ordinary income and the recipient deducts the same amount. The Regulation requires the recipient to deduct the recaptured amount by reference to the date when payments were made and not to the date when payments were received.

There are certain exceptions to the recapture rule so as to require no recapture in any post-separation year subject to an exception. More specifically, there is no recapture (1) for any payments made under a support order or decree; (2) for any payments made under an obligation to pay a fixed portion of income from a business or property or from compensation for employment or self-employment, providing the liability to pay extends for at least six years; and (3) in any post-separation year following the death of either spouse or remarriage of the payee spouse.

The DRTRA now provides that the parties can jointly elect that all or a portion of payments that would qualify for alimony treatment will not be taxable as gross income to the payee and nondeductible by the payor. The Regulation provides that this election must be contained in the written divorce or separation instrument and that the payee must attach a copy of said instrument to his or her tax return for each applicable year.

The new alimony rules are effective for agreements and decrees executed after December 31, 1984. The Regulation, in this instance, provides that if a divorce decree entered after January 1, 1985 adopts an agreement executed before January 1, 1985 the decree will be subject to the old section 71 of the Code. However, if the same divorce decree adopts but modifies the pre-1985 agreement, the decree is subject to section 71 as amended by the DRTRA.

The DRTRA, along with Temporary Regulation 1.215-1T, requires that any individual receiving alimony payments must furnish his or her identification number to the party making the payment and the payor must include the recipient's identification number on the payor's tax return for the taxable year in which the payments are made. Failure to comply with this reporting requirement will cause a penalty of fifty dollars for each failure unless the failure is due to reasonable cause and not willful neglect.

III. Dependency Exemptions

Under the prior law, a $1,000 deduction for dependency exemption was generally allowed for each dependent child of the taxpayer, providing a child received over half of his or her support for the year from the taxpayer. The child could not have gross income in excess of $1,000 in the taxable year unless the child was under the age of nineteen or was a student. In the case of children of divorced or separated parents, special rules applied in determining which parent provided over half of the support. These special rules are set forth in section 152(e) of the Internal Revenue Code.

Section 424 of the DRTRA, which amends section 152(e) of the Code, simplifies the dependency exemption rules by allowing the deduction only to the custodial parent. The non-custodial parent may be permitted the dependency exemption if the custodial parent signs a written declaration in a form to be prescribed by the Internal Revenue Service that such custodial parent will not claim the child as a dependent in any particular tax year and the written declaration is attached to the non-custodial parent's tax return. The parties may make a permanent declaration, a copy of which the non-custodial parent is required to attach to each year's tax return. The DRTRA will continue to apply the former law for certain decrees or agreements executed prior to January 1, 1985, and under which the custodial parent had agreed to release his or her claim to the dependency exemption to the non-custodial parent. Thus, for existing agreements, the non-custodial parent may continue to claim the dependency exemption if he or she provides at least $600 for the support of the child during the year. The Act also provides that the support by the spouse of a remarried parent will be treated as support provided by that parent in applying these rules.

For purposes of the medical expense deduction, each parent may now deduct medical expenses paid by that parent for the child even though a dependency exemption for the child may be allowed only to one parent.

IV. Conclusion

The impact of this new tax legislation is extensive and will be seen immediately in the financial areas of divorce. It is essential that the practitioner be aware of the changes of the tax rules and fashion agreements to maximize tax benefits for clients.