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Nobody Gets Married For The First Time Anymore —A Primer on the Tax Implications of Support Payments in Divorce

C. Garrison Lepow*

Abie, walking west on 56th Street into the setting sun, a cloud of butterflies about him like falling cherry blossoms, a demented—or is it lovesick—smile on his face, remembered his parting words: "It's all yours, Becky, I'm off to find the last orange grove in California, where I will spend the rest of my life in the study of astrophysics, or the Karmasutra, or the simple sea turtle; I haven't decided which." At Second Avenue, Abie bumped into his lawyer. The lawyer eyed the butterflies and said, "It's time you got a divorce." This is the end of Abie's second marriage. He anticipates a need for tax advice. However, for Abie the tax law will differ substantially from his previous divorce.

Abie and Becky are a mythical husband and wife. However, they become enmeshed in the tax issues that force real couples to mold their divorce settlements in accordance with tax objectives rather than a convenient or an efficient way to pay support. Unfortunately, the taxation of support payments is not simply a transaction involving a tax cost but one primarily involving a serious social problem needlessly exacerbated by the tax law. Under the Deficit Reduction Act of 1984¹ and the Tax Reform Act of 1986², tax consequences depend entirely upon the form of payment. For example, a direct payment of support to a former spouse and children generally will not be deductible unless the payments are structured to fit the requirements of the Internal Revenue Code

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(Code). This article explains the impact of tax laws on divorce-related support payments after the complex revisions of the Code in 1984 and again in 1986 and the domestic relations law of many states, the safe harbors and the other more adventurous ports of call available and the various tax costs for Abie, Becky and the rest of us.

I. ALIMONY

Alimony is still income to the recipient⁹ and deductible by the payor⁴ under section 71 as under prior law. Once that is noted, one enters new territory. The alimony rules have been substantially rewritten.⁸ The major change in the tax treatment of alimony payments is the adoption of a unified federal definition of alimony which enlarges the tax concept of alimony⁷ beyond support payments⁷ to include the buyout of property rights.⁸ But needless to say, it wasn't always this way.

Prior to 1942, support payments to a former wife were not income to her nor deductible by the payor.⁹ Tax rates reaching up to 75% during World War II¹⁰ created pressure on Congress to provide alimony relief to the mythic taxpayer whose entire income went towards paying alimony and taxes.¹¹ The solution was to shift the tax burden for alimony payments to the recipient.¹² Since 1942, alimony became gross income to the recipient and deductible by the payor.¹³ These provisions were largely unchanged¹⁴ and un-

4. I.R.C. § 215(a); see also I.R.C. § 62(13); (alimony is deductible for determining adjusted gross income); H.R. REP. No. 755, 94th Cong. 2d Sess. (1976). This article is limited to the tax consequences of support payments. The tax aspects of property settlements are noted only incidentally where relevant to the alimony provisions.
criticized until 1984. Of course deductible alimony had the particular character of support payments.\textsuperscript{18} Between 1942 and 1984, alimony treatment hinged on whether the payment related to the recipient's right to lifelong support, or to a portion of the wealth accumulated during the marriage.\textsuperscript{16} Only support payments were deductible.\textsuperscript{17} Property settlements were not.\textsuperscript{18} The distinction between property or support rights was often impossible to apply because "in reality the payment (possessed) a hybrid nature sharing characteristics of both."\textsuperscript{19}

In 1942, only the eight community property states provided that the non-earner spouse had a vested right in the wealth amassed during marriage.\textsuperscript{20} In 1970, no-fault divorce statutes replaced the


16. Beard v. Commissioner, 77 T.C. 1275, 1277, 1287-88 (1981); see also Oman v. Commissioner, 767 F.2d 290 (6th Cir. 1985) (state court designation of temporary alimony paid in lump sum and permanent payments over nine years not alimony); Green v. Commissioner, 51 T.C.M. (CCH) 1326 (1986) (award equal to three times value of marital property was alimony to the extent sum exceeded one half marital property); Yoakum v. Commissioner, 82 T.C. 128 (1984) (no alimony deduction where payments attributed to property rights).

17. Treas. Reg. § 1.71-1(b)(4) (1960); White v. Commissioner, 770 F.2d 685 (7th Cir. 1985) (no deduction for unconditional monthly payments); Fowler v. Commissioner, 1985 Tax Ct. Mem. Dec. (P-H) ¶ 85,457 (payment of community debt not alimony where total settlement to wife equaled half community property); Slawski v. United States, 54 A.F.T.R.2d (P-H) ¶ 84-5427 (Cl. Ct. 1984) (cash payment attributable to share of marital property pursuant to New Jersey statute not alimony under pre-1984 law). The form of payment, cash or property was not relevant under pre-1984 law. See Olster v. Commissioner, 751 F.2d 1168 (11th Cir. 1985) (under pre-1984 law husband's transfer of mortgage and notes in satisfaction of back and future alimony payments, held alimony where value of transfer was less than back alimony).

18. Campbell v. Lake, 220 F.2d 341 (5th Cir. 1955); Beard v. Commissioner, supra note 16, (lump sum and installment payments not alimony); Ficchi v. Commissioner, 51 T.C.M. (CCH) 988 (1986) (prior to 1984 employee taxed on pension income paid directly to former spouse; monthly payment of former spouse's military pension not alimony); Ltr. Rul. 8535012 (pre-1984 military pension paid to former spouse not alimony; husband recognized gain under Davis); but see Wright v. Commissioner, 543 F.2d 593 (7th Cir. 1976). Compare Gable v. Commissioner, 50 T.C.M. (CCH) 764 (1985) (unequal property division not indicated support where parties had unequal bargaining power) with Green v. Commissioner, supra (50% of value of marital property excluded from alimony).


20. ARIZ. REV. STAT. ANN. § 25-211 (1976); CAL. CIV. CODE § 5110 (West 1986); IDAHO
lifelong right to spousal status. Alimony for life was traded for a piece of the marital property upon divorce. By 1984, the property settlement had replaced alimony as the primary method of resolving marital rights upon divorce. Spousal claims to some portion of marital property existed virtually in every state. The amendments to section 71, defining alimony, undermine these changes in state law to property rights by permitting property settlements under state law to be deducted as alimony by the payor. The process of separating support rights from property interests survives as a limited mechanical determination of whether there is "the liability to make any payment for any period following death" of the recipient. Congress treated such liability as both an essential characteristic of a payment of the property settlement and a characteristic wholly incompatible with the payment of support rights. Under this definition, a one-time lump sum payment contingent on the life of the recipient is at least partially deductible as alimony. Hence, a property settlement under state law may be treated as alimony for federal tax purposes.

Under prior law, the federal definition of alimony was dependent upon state law. Often the state-created rights did not fit the fed-


22. Id. at 3.
23. Id. at 2.
24. Id.
25. The exception is Mississippi. Spousal status per se does not confer proper rights, Bond v. Bond, 355 So.2d 672, 673 (Miss. 1978). But see Pickens v. Pickens, 490 So.2d 872 (Miss. 1986) (separation of parties living together for twenty years where each worked for wages required for the division of assets).
26. See infra note 45. In general, transfers of property between spouses or incident to divorce are treated as a nonrecognition transaction. I.R.C. § 1041(a). The recipient of the property takes its pre-transfer basis in the hands of the transferor. I.R.C. § 1041(b). The tax significance of noncash property divisions are not within the scope of this article.
29. See I.R.C. § 71(f) (lump sum payment of $15,000 or less is alimony). A payment of more than $15,000 is initially deductible but the excess is subject to recapture (see infra notes 120-134 and accompanying text); cf. Temp. Treas. Reg. § 1.71-1T(d), A-20 (1984). The allowable amount of alimony not subject to recapture under the 1984 Act was $10,000.
30. Green v. Commissioner, supra note 16 (settlement equal to 300 percent of marital property is alimony); see Schottenstein v. Commissioner, 75 T.C. 451, 460-61 (1981), acq.,
eral categories of support or property rights. Such malocclusion often caught the tax collector between the conflicting tax positions of former spouses: the payor claiming the payments were deductible alimony payments; the recipient claiming the payments were a property settlement excluded from income. The conflict in reporting positions of the former was discouraged by section 215(c) requiring the payor of alimony to report the recipient’s social security number. However, failure to report the number does not affect the alimony deduction.

The alimony rules are divided into three parts: (1) the basic rules, applicable to all direct alimony payments, (2) the complicated rules applicable only to direct payments over $15,000 per year under the 1986 Act and (3) the alimony trust rules. Except for non-alimony option, all rules operate automatically. The three sets of rules give the taxpayer choices. Although the requirements for alimony treatment were relaxed under the 1986 Act, alimony treatment is often hard to achieve without the collaboration of the recipient.

After the 1984 and 1986 Acts, few of the requirements of the former statute remain. The requirement that the payment be made pursuant to a legal obligation has been dropped. For example, under Virginia law the obligation to pay alimony to a former spouse ends upon the recipient’s remarriage. Nevertheless, under

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32. Wright v. Commissioner, 543 F.2d 593 (7th Cir. 1976); see Beard v. Commissioner, supra note 18; Schottenstein v. Commissioner, supra note 31; see also H.R. Rep. No. 432, 98th Cong., 1st Sess. 191 (1983) (tax collector whipsawed by inconsistent reporting positions).
33. I.R.C. § 215(c) (1984); see also I.R.C. § 6676(c)(2) ($50 penalty for failure to supply recipient’s social security number).
34. I.R.C. §§ 71(a)-(e).
35. I.R.C. § 71(c).
36. I.R.C. § 682.
section 71, a payment after the recipient's remarriage is deductible as alimony even if the agreement is not enforceable under state law.\(^{42}\) Other former requirements that the payment be periodic\(^{43}\) and for support\(^{44}\) of the recipient are also omitted from section 71. Hence, with proper drafting, a single lump sum payment or cash buyout of marital property rights will qualify as alimony.\(^{45}\)

In order for alimony to be deductible the payments must:

1. Be paid in cash only;\(^{46}\)
2. End on the death of the recipient;\(^{47}\)
3. Be pursuant to a divorce or separation instrument;\(^{48}\)
4. Not designated non-includible in recipient's income (the non-alimony option);\(^{49}\)
5. Comply with special rules if over $15,000 per year;\(^{50}\) and
6. Be unrelated to child support.\(^{51}\)

Two additional requirements relate to spousal conduct rather than the form of the payment.
7. Generally, spouses do not share the same household; and\(^{52}\)
8. Separated spouses do not file a joint return.\(^{53}\)

A. The Cash Requirement


43. See id.
44. Id.
45. Id. at 996; but see H.R. REP. No. 432, 98th Cong., 1st Sess. 195 (1983) (recapture intended to prevent taxing one-time property settlement as alimony). Converting a property settlement under state law into alimony for federal tax purposes goes against the current trend in state matrimonial and divorce law, and the expectations of most married people that property acquired during the marriage is "ours." UNIF. MAR. PROP. ACT, Prefatory Note at 9 supra note 21. This expectation may no longer be an "evanescent hope" but a "reality as a result of provisions of the Uniform Marital Property Act giving spouses a present vested ownership right which each has in all property acquired by the personal efforts of either during the marriage." Id.
47. Id.
50. I.R.C. § 71(f).
51. I.R.C. § 71(c).
52. I.R.C. § 71(b)(1)(C).
54. I.R.C. § 71(b)(1).
Transfers in kind do not qualify. Hence, an annuity is not alimony nor is a debt instrument of a third party, a new BMW every year for life, nor the right to use property rent free. Nevertheless, certain payments to third parties on behalf of the recipient spouse are deductible as alimony.

Are Abie's expenses for maintaining the farm while Becky resides there deductible alimony? The Code expressly authorizes the deduction of payments to third parties on behalf of Becky provided that such payment benefits her. According to the Service, the benefit to the recipient includes not only the payment of the recipient's obligations but also such non-economic benefits as a gift to charity made on behalf of the former spouse. Where Abie has title to the property, whether Abie's payments of real estate taxes, mortgage, and insurance premiums qualify as alimony does not merely turn on whether the payments benefit Becky. The best way to find whether a third party payment will pass muster as alimony is not to look at the benefit to the recipient. Instead look

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56. Id.
58. Id. See also Stiles v. Commissioner, 43 T.C. M. (CCH) 107 (1981); Taylor v. Commissioner, 45 T.C. 120 (1975).
59. Id. The temporary regulations continue the principle of prior law that the use of property was not alimony. See Mandel v. Commissioner, 229 F.2d 382 (7th Cir. 1956); Seligmann v. Commissioner, 207 F.2d 489 (7th Cir. 1953); Bradley v. Commissioner, 30 T.C. 701 (1958); Rev. Rul. 70-218, 1970-1 C.B. 19.
60. See also infra note 141 and accompanying text.
65. See Grutman v. Commissioner, 80 T.C. 464 (1983); but see I.R.C. §§ 162 (state taxes) and 163 (interest itemized deductions). The 1986 Act limits the deduction of personal interest. The deduction for non-business interest is limited to an offset of income from certain passive investments. I.R.C. § 163(d)(1) as amended by 1986 Act, tit. V(B), Sec. 511 (1986); I.R.C. § 469(a) as amended by 1986 Act, tit. V(A), Sec. 501 (1986).
for a lack of benefit to the payor. Where the third party payment either increases Abie's basis in his property,\textsuperscript{66} or satisfies Abie's own obligation, the payment will not be treated as alimony.\textsuperscript{67} Here since Abie owns the property, although Becky literally requested Abie to pay, in substance Abie is merely paying his own obligation not alimony. On the other hand, payment of utility bills while Becky occupies the farm does not increase Abie's basis in the property and therefore is deductible as alimony.\textsuperscript{68}

Compare the tax result above with what happens when Abie transfers his farm to Abie, Inc., a wholly owned corporation. The corporation gives Becky a lease and Abie pays the bill. Oddly now Abie's rental payment to the corporation on behalf of Becky is deductible under section 71.\textsuperscript{69}

The benefit to the payor test is useful to separate the payment of deductible from the non-deductible premiums on Abie's life insurance. Premiums paid to an insurance company on a policy insuring Abie's life increase the owner's basis in the policy. Hence, the premiums are not alimony if Abie is the owner and Becky is the beneficiary.\textsuperscript{70} Where Abie is the owner, the payments may benefit Becky indirectly as a beneficiary of the policy,\textsuperscript{71} but an increase in Abie's basis in the policy is incompatible with the alimony deduction. If Becky is the owner of the policy, premiums

\textsuperscript{66} Bradley v. Commissioner, 30 T.C. 701 (1958); Ltr. Rul. 8414003 (fair rental value of wife's life estate in residence not alimony).

\textsuperscript{67} Id.


\textsuperscript{69} Rothschild v. Commissioner, 78 T.C. 149 (1982), acq. 1984-1 C.B. (where wife had right to occupy co-op apartment, husband's payments none of which was attributable to amortization of mortgage, taxes or interest deductible as alimony); Marinello v. Commissioner, 54 T.C. 577 (1954). The costs of owning the property and depreciation will be deductible expenses for Abie, Inc. which will offset the rental income; see I.R.C. §§ 162, 168 (profit motive required for deduction); but cf. I.R.C. § 469(a) as amended by 1986 Act, tit. V(A), Sec. 501 (limitation on passive losses).


paid directly to the insurance company are alimony.\textsuperscript{72}

Provided the requirements of section 71 are satisfied, Abie's payment of Becky's attorney's fee is alimony. This changes prior law.\textsuperscript{73} Apart from alimony treatment, attorney's fees paid in connection with divorce or separation are not generally deductible.\textsuperscript{74} Fees relating to tax advice,\textsuperscript{75} are limited under the 1986 Act.\textsuperscript{76} Fees paid to secure taxable alimony are deductible by the recipient as an ordinary and necessary expense incurred for the "production or collection of income."\textsuperscript{77} But fees paid to avoid paying alimony are not deductible.\textsuperscript{78} Refer to Table 1 on the following page.

\textsuperscript{72} See Temp. Treas. Reg. § 1.71-1T(b), A-6 (1984). This is in accord with prior law. See Stevens v. Commissioner, 439 F.2d 69 (2d Cir. 1971). After the 1984 premiums paid on term as well as whole life insurance owned by Becky are alimony; \textit{id.}; \textit{but see} Wright v. Commissioner, supra note 18 (premium paid on term policy not alimony prior to 1984).

\textsuperscript{73} Turner v. United States, 58 A.F.T.R.2d (P-H) ¶ 86-5324 (1986) (husband's payment of wife's attorney's fees, not periodic, not deductible under pre-1984 law); I.R.C. § 71(a) repealed by 1984 Act (one time payment not periodic).

\textsuperscript{74} Treas. Reg. § 1.262-1(b)(7) (1972).

\textsuperscript{75} I.R.C. §§ 67 (two percent floor on itemized deductions), 212(3) (itemized deduction). \textit{Cf.} Carpenter v. United States, 338 F.2d 366 (Ct. Cl.1964) (any reasonable basis for allocation between tax and non-tax advice, difficulty, customary fees, amount involved); Rev. Rul. 72-545, 1972-2 C.B. 179 (70% of fee allocated for tax advice).


\textsuperscript{77} I.R.C. § 212(1).

Table 1. *The Deduction of Payments To Third Parties As Alimony*

<table>
<thead>
<tr>
<th>OWNER</th>
<th>ABIE</th>
<th>BECKY</th>
<th>JOINT</th>
</tr>
</thead>
<tbody>
<tr>
<td>Periodic</td>
<td>X</td>
<td>X</td>
<td>X</td>
</tr>
<tr>
<td>Repair</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Utility</td>
<td>X</td>
<td>X</td>
<td>X</td>
</tr>
<tr>
<td>Non Periodic</td>
<td>X</td>
<td></td>
<td>X</td>
</tr>
<tr>
<td>Repair or Capital Expense</td>
<td>X</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Co-op Maintenance</td>
<td>X</td>
<td>X</td>
<td>X</td>
</tr>
<tr>
<td>Property</td>
<td>X</td>
<td>X</td>
<td>X</td>
</tr>
<tr>
<td>Taxes</td>
<td>X</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Interest</td>
<td>X</td>
<td></td>
<td>X</td>
</tr>
<tr>
<td>Life Insurance</td>
<td>X</td>
<td></td>
<td>X</td>
</tr>
<tr>
<td>Premium on Abie’s Life</td>
<td>X</td>
<td></td>
<td>X</td>
</tr>
</tbody>
</table>

X means the payment is deductible. All payments are made by Abie pursuant to an appropriate divorce instrument. I.R.C. §71(b)(2).

a. One half is deductible provided there is no right of survivorship in the contenancy.


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B. *Alimony Payments Must End on the Death of the Recipient*

The requirement that the payments end at the death of the recipient\(^79\) illustrates that the rules are intended to operate mechanically. Under the 1986 Act, temporary support orders by state courts are exempt from this requirement.\(^80\) Under a separation instrument, Abie agrees to pay Becky $14,000 per year for ten years or until she remarries. None of the payments are deductible. Under the 1986 Act, state law can rescue improperly drafted alimony deductions.\(^81\) If there is no legal obligation to make payments after the death of the recipient and no such payments are

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\(^79\) I.R.C. § 71 (b)(1)(D).

\(^80\) I.R.C. § 71(f)(5)(B) as amended by 1986 Act, tit. XVIII, Sec. 1843, § 422. See note 81, infra.

made, the result changes. A corollary of the rule that payments must end on the recipient's death is that there be no payment to substitute for the alimony payments. A payment which begins, or increases in amount or is accelerated in time as a result of the recipient Becky's death will taint all payments. Such posthumous payments do not meet the rigorous form requirements of the 1984 amendments. None of the payments before or after Becky's death will qualify for alimony treatment. This is true although the payments during the recipient's life are in substance alimony. For example, Abie is required to pay Becky $20,000 per year for a period ending on the first to occur of the expiration of three years, or the death of Becky. Upon Becky's death during the three year period, Abie will pay Becky's estate the amount Abie would have paid Becky if she had lived for the three years. Hence, if Becky dies at the end of two years Abie must pay Becky's estate $20,000 ($20,000 x one year). Here Abie's liability to Becky's estate substitutes for the amount of the future annual $20,000 payments to Becky. In such a case, none of the payments to Becky will be treated as alimony. Similarly, the requirements of Section 71 will not be satisfied if an amount were paid to Becky's children after her death.

The cash payment of a property settlement is distinguished from a cash payment of alimony under the new statute by the characteristic that alimony payments end on the recipient's death. Whether the cash payment is for the support of the recipient is no longer at

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82. But see Temp. Treas. Reg. § 1.71-1T(b), A-11 (1984). Under the 1984 Act the alimony document was required to state that payments ended on death of the recipient. Failure to so state resulted in denial of alimony treatment for all payments. See Ltr. Rul. 8624125 (separation agreement modified after 1984 did not support alimony deduction). The cure was formal. Add "Abie shall pay Becky $14,000 per year until the earlier of ten years or Becky's death," and there is no obligation to make any payment, in cash or property, as a substitute for such payment after Becky's death. The final clause is unnecessary under the 1986 Act. 1986 Act, tit. XVIII, Sec. 1843, § 422(b) (repealed last clause in I.R.C. § 71(b)(1)(D)).
83. I.R.C. § 71(b)(1)(D).
85. Id.
86. Id.
90. Id. at ex. 1; H.R. Rep. No. 432, 98th Cong., 1st Sess. 195 (1983); but see I.R.C. § 71(f)(5)(A)(i).
issue.\textsuperscript{92}

Lest one suggest that the survival requirement discourages disguising the payment of a property settlement as alimony, the statute was constructed with a clear fault. Abie may pay the premiums on an insurance policy on Becky's life payable to Becky's estate or another beneficiary of Becky's choice. The House Report suggests that life insurance purchased by Abie insuring Becky's life will not be considered a post-death alimony substitute.\textsuperscript{93} Hence, life insurance can protect Becky's heirs, yet not compromise Abie's deduction of the payment.

\textbf{C. Documentary Requirements, Written Instrument}

Each week Abie sends Becky a check for $250. On the back of the check he writes "alimony." Each week Abie tells Becky "Don't worry about money. I will take care of you." Each week Becky cashes the check and smiles mysteriously. She knows Abie cannot deduct the payment. Only payments pursuant to a decree, a written separation agreement or a written instrument incident to a divorce or separation decree will qualify as alimony. Under prior law an oral unilateral offer, a notation on a check followed by the payee cashing the check, does not constitute the "written separation agreement" required by section 71.\textsuperscript{94} Section 71 still requires that an alimony payment be pursuant to a document including a decree of divorce, separation or support, a written separation agreement or a written instrument incident to a decree of divorce or separation.\textsuperscript{95} The term "instrument" is not substantially different from the term "agreement."\textsuperscript{96} Section 71 requires a mutual un-

\textsuperscript{92} Id.
\textsuperscript{93} Id.
\textsuperscript{95} I.R.C. §§ 71(b)(2)(A) (decree of divorce or separate maintenance), 71(b)(2)(B) (separation agreement), 71(b)(2)(C) (decree of support).
\textsuperscript{96} I.R.C. § 71(b)(2)(A). The additional term "instrument," added in 1984, in contrast to "separation agreement" appears to permit the divorced couple to determine tax consequences of a marital dissolution before or after the divorce decree is final. Cf. I.R.C. § 2516 (post-divorce tax agreement is expressly authorized); Temp. Treas. Reg. § 1.71-1T(b), A-7 (1984) (alimony payment based on recipient's written request, consent or ratification). The request, in writing and stating the parties intend the payment to be treated as an alimony payment under I.R.C. § 71, must be received before the date for filing taxpayer's first tax
understanding though not necessarily a contract enforceable under state law. On the contrary, whether the agreement is enforceable is irrelevant to the tax consequences of the agreement. Here a contract enforceable under state law, such as an oral agreement, followed by conduct indicating the existence of a contract, does not satisfy the documentation requirements necessary for alimony treatment. Thus, in this case, Becky will keep smiling. She has no alimony income. On the other hand, Abie may be bound to make the payments if the couple’s conduct forms a contract enforceable under state law.

An issue still unresolved in the 1984 and 1986 legislation is whether an ex-parte divorce decree obtained by the payor and later declared invalid in an action by the recipient will support an alimony deduction. Under prior law, the Tax Court held that an invalid decree did not support any alimony deductions, while the Second Circuit permitted alimony deductions claimed prior to the date of the invalidity. The deletion in 1984 of the requirement


97. An oral separation agreement will not support alimony deduction; Jachym v. Commissioner, 47 T.C.M. (CCH) 1486 (1984) (alimony paid under oral judgment not deductible until written order); Lebeaure v. Commissioner, 1984 Tax Ct. Mem. Dec. (P-H) ¶ 84,181 (oral agreement to pay alimony read into court record satisfied writing requirement); see Saniewski v. Commissioner, 38 T.C.M. (CCH) 1295 (1979) (letter promising to send $800 per month not separation agreement). Garner v. Commissioner, 32 T.C.M. (CCH) 352 (1973); Smith v. Commissioner, 26 T.C.M. 443 (1967). The term “written agreement” includes an independent written agreement as well as a formal separation agreement whether or not merged into the divorce decree. There is some authority that a letter or memorandum of a prior oral agreement and not rejected by taxpayer is sufficient to satisfy requirements of a written instrument; See Osterbauer v. Commissioner, 43 T.C.M. (CCH) 1364 (1982) (post-divorce modification); but see Dean v. Commissioner, 42 T.C.M. (CCH) 1237 (1981) (payments made subsequent to divorce under agreement held nondeductible as alimony).


100. Conversely a writing unenforceable as a contract under state law may sustain alimony treatment. For example although the undertaking is not for present consideration or is not enforceable because it violates state policy concerning maintenance of a former spouse, the undertaking is a sufficient writing under section 71. See Taylor v. Campbell, 335 F.2d 841, 845-46 (5th Cir. 1964); Bardwell v. Commissioner, 318 F.2d 786, 789 (10th Cir. 1963); I.R.C. § 71(a)(1)(1982) repealed by 1984 Act (legal obligation).


102. Wondel v. Commissioner, 350 F.2d 339 (2d Cir. 1965); cert. denied 383 U.S. 935,
that alimony payments be made pursuant to a legal obligation was consistent with the Second Circuit holding.\textsuperscript{103} As under prior law, where a decree was invalid, a separation agreement will support the alimony deduction.\textsuperscript{104}

A decree of annulment is not specified by section 71. However by implication, annulment or divorce are synonymous for tax purposes.\textsuperscript{105} Although there are no reported cases on the issue of palimony, it appears that a void or voidable marital relationship, as opposed to an illicit partnership, need exist before the payor of alimony gets a tax deduction.\textsuperscript{106}

\textbf{D. The Nonalimony Election}

A payment that otherwise would qualify as alimony can be changed to non-alimony by expressly stating that the payment is "not income to the recipient nor deductible by the payor."\textsuperscript{107} Thus, the alimony paying taxpayer can spin gold into straw. However, the labeling device does not work in reverse. Payments must meet the statutory rigors to be deductible.\textsuperscript{108}

\textbf{E. Special Anti Front Loading Rules for Alimony Over $15,000}

Special rules apply to alimony payments over $15,000 per year. The anti-front loading rules of section 71(f) are intended merely to exact an excise on the conversion of a property settlement into alimony. A property division under state law may be structured as alimony for tax purposes. For such amounts to be fully deductible, the payments must comply with the minimum term rule and the recomputation rules.\textsuperscript{109} The 1986 Act amended section 71(f) making a fully deductible buy-out of property rights significantly easier.\textsuperscript{110}

\textsuperscript{104} I.R.C. § 71(b)(2)(B).
\textsuperscript{107} I.R.C. § 71(b)(1)(B).
\textsuperscript{109} I.R.C. § 71(f)(1).
\textsuperscript{110} I.R.C. § 71(f)(2); compare Section 71(f)(1) (a one-time lump sum payment up to $15,000, deductible) and I.R.C. § 71(f)(2) (principle sum payments spread evenly over three
Under the 1986 Act the minimum pay-out period required for alimony treatment has been reduced from the six year period required by the 1984 Act to three years. Hence, to be fully deductible, alimony payments in excess of $15,000 must continue for three consecutive years.\(^{111}\) This three year period, called the "post-separation year[s],"\(^{112}\) runs from the initial calendar year in which the payment qualifying as alimony exceeds $15,000 per year. The three years do not run from the date of the agreement or decree.\(^{113}\) For example, suppose Abie and Becky obtain a final divorce decree in 1987 which requires Abie to pay Becky $2,000 per month starting in January 1988. However, Abie and Becky share the same household until 1989. The first post-separation year for purposes of the three year rule is 1989. The 1988 payments do not qualify as alimony because Abie and Becky shared the same household that year.\(^{114}\) For Abie to deduct more than $15,000 of the alimony payment in 1989 free of recapture, he must continue the alimony payments for three years, until 1991.

Suppose that Abie is required to pay Becky $75,000 for two years—1987 until 1989. Under the 1986 Act a portion of the payment will be subject to recapture because this violates the minimum term rule. Nevertheless, part of the payment is deductible. On the other hand, fluctuating payments, based upon a portion of income from a business, property, or earnings from the personal services of the payor must continue for at least three consecutive years. In this case, payments running for less than the minimum term are not characterized as alimony and hence are not deductible.\(^{115}\) Thus, under the 1986 Act the minimum term rule still applies strictly to fluctuating payments. However, in the case of the payment of a sum certain, the application of the minimum term rule is merely related to the recapture formula. In contrast to the general minimum term requirement explained above, payments made under a support decree do not count for purposes of the three year rule.\(^{116}\) For example, if Abie paid Becky one third of his

\(^{111}\) I.R.C. § 71(f)(1).
\(^{112}\) I.R.C. § 71(f)(6).
\(^{113}\) The date of the divorce decree or the separation agreement or other governing instrument is irrelevant, except that the writing must precede the payment. Cf. id.; see also Temp. Treas. Reg. § 1.71-1T(d), A-22 (1984).
\(^{114}\) See I.R.C. § 71(b)(1)(C).
\(^{115}\) I.R.C. § 71(f)(2)(C).
salary for one year under a temporary support order followed by a similar payment for two more years pursuant to a divorce decree, the payments during the first year are ignored for purposes of the minimum term rule. Abie thus is credited with alimony payments for the second two years but not for the first year. The tax consequences of the identical payments are determined under different provisions. For Abie, the tax results are not consistent. The entire payment pursuant the support decree is deductible as alimony because payments under the support decree are exempt from the minimum term rule. The payments pursuant to the divorce decree start an independent post-separation period for purposes of the three year rule. Hence, a portion of the payment is subject to recapture. In the case of the payment of a sum certain, the minimum term rule has little effect under the 1986 Act. The tax to be saved by Abie and paid by Becky will depend on the recomputation rules explained below.

The recomputation rules, designed to limit the deduction of a property settlement over a short period of time, have been substantially changed in 1986. Under the revision, alimony is fully deductible when paid. Recapture by the payor is determined at the end of the three year minimum term, described above. Under the 1986 procedure, the average of the alimony payments in the second and third years is compared to the payment made in the first year to determine whether any of the alimony payments deducted in the first and/or second year will be recaptured by the payor. Where the annual amount of alimony paid in any year during the three year period is more than the amount paid in subsequent years by a defined portion, part of the earlier payment is treated as an “excess amount” of alimony. This excess amount will return in the third year as income to the payor and a deduction for the recipient. This ghost is created by means of the complex recomputation rules of section 71(f). Under the 1986 Act, the excess amounts are calculated by a different formula for the first and second year. The excess amounts from the first and second years are recaptured

123. I.R.C. § 71(f)(4) as amended by the 1986 Act, tit. XVIII, Sec. 1843, § 422(c).
by the payor as ordinary income in the third year. The recipient must recognize all alimony payments, including the excess payments, as income in the year received and deduct the recaptured amount in the third year.

Under the 1986 Act, if the payment in the first year is more than $15,000 greater than the average amount paid in the second and third years, the difference is recaptured as ordinary income by the payor in the third year. Similarly, if the payment in the second year is more than $15,000 greater than the amount paid in the first year, the excess is also recaptured in the third year. The recapture provisions of the 1986 Act are designed to prevent persons divorced at the end of the year from making a fully deductible property settlement at the beginning of the next year. For example, Abie pays Becky alimony for three years in the following amounts: $50,000 first year, $20,000 second year and zero third year; the recapture will consist of $5,000 from the second year and $27,500 from the first year. The formula for calculating recapture can be expressed as follows.

125. I.R.C. § 71(a).
128. Id. The calculation differed under the 1984 Act. Under prior law, the “excess amount”, was the difference between the higher amount paid in one year and the lower amount paid in a following year during the six year period, minus $10,000. I.R.C. § 71(f)(3) repealed by 1984 Act. Hence, a shortfall of up to $10,000 from one year to the next during the critical six year period did not trigger recapture. However, the excess amount paid in the earlier years was taken into gross income of the payor and deducted by the recipient in the year in which the shortfall exceeded the $10,000 permitted amount. The prior year's income and deduction is not recalculated. For example, Abie paid alimony to Becky in the following amounts: 1985—$25,000, 1986—$12,000. The payment in 1986 was more than $10,000 less than the payment in the prior year. This triggered recapture. Temp. Treas. Reg. § 71-1T(d), A-24 (1984). The difference between the payments in 1985 and 1986 was $13,000 from which the $10,000 permissible shortfall was deducted. The excess amount of alimony deducted in 1985 which was recaptured in 1986 was $3,000. In 1986 Abie had $3,000 of recapture income and Becky had a matching recapture deduction. Hence, Becky's alimony income in 1986 was $9,000 ($12,000 actually received, less $3,000 recapture deduction from 1985). Abie's deduction was the same. For subsequent computations, 1985 alimony was reduced by the $3,000, the recaptured amount, to $22,000. This adjustment to the amount of alimony paid in a prior year prevented recapture of the $3,000 amount more than one time.

If Becky had no other income in 1987, the deduction was of no value to her. Her income tax burden from prior years was not reduced. On the other hand Abie had $11,000 income in 1987 based on recapture of $12,000 alimony deducted in prior years and $1,000 (minus $12,000 plus $1,000) paid in 1987. Abie is taxed on a phantom receipt.

Recapture under the 1984 Act is illustrated in Table A on the following page.
If Abie pays $50,000 in alimony to Becky in the first year and nothing in either the second or third years, Abie will deduct the $50,000 payment in the first year and recapture $35,000 in the third year. Becky will have $50,000 in income in the first year and a $35,000 deduction in the third year. There is no recapture in the second year. Under the 1986 Act there is no limit on the amount of alimony initially deductible. Hence, although in the end Abie will have deducted only $15,000 in alimony, he will have the benefit of the full $50,000 deduction for two years. 129

Table A

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This table illustrates the reduction of the actual amount of alimony paid for purposes of the recapture rules. A reduction in the amount of alimony paid by $10,000 or less does not cause recapture of prior alimony payments.

Under the 1984 Act, Abie was able to deduct a greater amount of alimony by continuing token payments to meet the minimum term requirements rather than ending payments after three years. The 1986 amendments obviated the benefit of token payments. 129

If Becky's only source of income were alimony, Becky's tax liability for the first year will not be offset by a deduction in the third year. Cf. I.R.C. §§ 1301-1305 repealed by 1986 Act, tit. I(E) Sec. 141 (1986) (income averaging). Under the 1984 Act only $10,000 would have been treated as alimony in the first year and nothing would have been recaptured.

Under the 1986 Act, recapture is a five step process which starts with the calculation of
The 1986 Act automatically foreshortens the recapture period from six years to three years for all alimony payments made pursuant to section 71(f) of the 1984 Act. The remaining provisions of the 1986 Act apply to decrees of divorce and separation instruments executed after December 31, 1986 and modifications of post-1984 instruments expressly incorporating the 1986 changes by reference.

As under the 1984 provisions, recapture will be triggered if alimony payments decline below the permissible amount during the three year period for any reason other than the statutory exceptions mentioned below. Thus, recapture applies if the payments stop when Abie becomes permanently disabled and has no income, if the divorce decree is modified, or if Becky waives her right to alimony because she wins the lotteries in New York, California and Illinois in the same week.

There are three exceptions common to both the minimum term and recapture rules. Neither rule applies to payments pursuant to a support order that is not part of a decree of divorce or separation, nor to payments equal to $15,000 or less per year. In addition, recapture and the minimum term rule do not apply if payments end upon the death of either party, or the remarriage of the recipient. Furthermore, an agreement accelerating payment upon remarriage will not trigger recapture. Although subject to the three year rule, recapture does not apply to fluctuating payments under an agreement to pay a fixed percentage of income from a

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130. 1986 Act, tit XVIII, Sec. 1843, § 422(c)(3) (transitional rules).
131. Id. at § 422(c)(2)(A).
132. Id. at § 422(c)(2)(B).
134. Id.
135. Id. (1984). Abie agrees to pay Becky $15,000 per year for the shorter of ten years, life or remarriage. However, upon remarriage Abie agrees to pay Becky the remainder of the payments during the year of remarriage. Neither recapture nor the minimum term rule apply. Id.
business, property or personal services rendered by the payor.\textsuperscript{136}

F. Spouses May Not Be Members Of The Same Household

The key to the alimony deduction is not whether the parties are members of the same household, but whether the alimony payments are made pursuant to an agreement or a court decree. Abie and Becky may share the same house without compromising Abie's alimony deduction so long as a decree has not been entered.\textsuperscript{137} However, if Becky and Abie are legally separated under a decree of divorce or separate maintenance, and are still in the same household, the payment will not qualify as alimony. Physical separation within the former residence, Abie in the West Wing, Becky in the East, is not sufficient for the deduction. A limited exception may save Abie's deduction. If one of the parties is preparing to move and does so within a month of the payment, alimony treatment is permissible. If Abie and Becky cannot agree on which one should move, they win each other's close attention, but Abie loses his deduction for Becky's support payments.

II. Child Support

For divorced parents, there are ongoing tax problems. The tax consequences of child support payments are easily stated. Child support is not gross income to the recipient and is not deductible by the payor.\textsuperscript{138} Consider an agreement whereby Abie agrees to pay Becky $800 per month for the support of herself and their three children. However, as each child becomes emancipated the payment is reduced by $200. Although simple arithmetic indicates that $600 of each payment is child support, the Supreme Court in

\textsuperscript{136} I.R.C. § 71(f)(5)(C). For example, Becky supported Abie while he earned his medical degree. The state divorce court awarded Becky 10% of Abie's future income from the practice of medicine, not as alimony but as her share of marital property. \textit{See generally} O'Brien v. O'Brien, 66 N.Y.2d 576, 489 N.E.2d 712, 498 N.Y.S.2d 743 (1985) (medical practice deemed marital asset subject to equitable apportionment). If the payment extends for three years or more and meets other section 71 requirements it will be taxed as alimony and not subject to the recapture rule. I.R.C. § 71(b)(2)(C); \textit{see also} Sullivan v. Sullivan, 37 Cal.3d 762, 691 P.2d 1020, 209 Cal. Rptr. 254 (1984) (wife entitled to compensation for supporting husband while he was in medical school).

\textsuperscript{137} I.R.C. § 71(h)(1)(C).

Commissioner v. Lester,\textsuperscript{139} held that such wording is insufficient to fix "any specific amount or portion" of the payments as child support.\textsuperscript{140} Hence, under the Lester principle child support payments "buried"\textsuperscript{141} in an alimony clause were classified as alimony.\textsuperscript{142}

In 1984, section 71 was amended to overturn Lester.\textsuperscript{143} On the other hand, Congress did not amend section 682, governing alimony trusts, to conform to section 71. Indirect child support payments from an alimony trust are still construed according to the Lester principle.\textsuperscript{144} Thus, after 1984, two inconsistent sets of rules govern the tax consequences of child support payments. Moreover, the two different rules produce grossly different money outcomes for Abie and Becky. In the example of the $800 payment above, under section 71 the payment is allocated between $600 of child support and only $200 of alimony. Thus, if the combined payment is made directly by Abie, Becky has $200 of gross income and Abie's deduction is limited to a like amount.\textsuperscript{145} On the other hand, an identical payment pursuant to an identical agreement but made through an alimony trust results in $800 of gross income for Becky.\textsuperscript{146}

\textsuperscript{139} 366 U.S. 299 (1961).
\textsuperscript{140} Id. at 300.
\textsuperscript{142} In Lester, the Supreme Court required an intent to shift the ordinary tax consequences of alimony from Becky to Abie. 366 U.S. at 303. The rule favored alimony treatment for combined alimony-child support payments, accord Gable v. Commissioner, 1985 Tax Ct. Mem. Dec. (P-H) ¶ 85, 423 (combined support payments alimony); Love v. Commissioner, 1984 Tax Ct. Mem. Dec. (P-H) ¶ 84,641; LeBow v. Commissioner, 1983 Tax Ct. Mem. Dec. ¶ 83,417; but see Harbin v. United States 307 F. Supp. 490 (E.D. Tenn. 1969) (Lester distinguished after divorce judge testified that amount was unreasonable to support both spouse and child). Under prior law, money paid directly to a third party, such as a university, for the benefit of the payor's children was not treated as alimony, Barrer v. Commissioner, 41 T.C.M. (CCH) 1582 (1981) (amount not for spousal support). Under current law, the amount paid directly for children's tuition is an amount fixed as child support and not deductible as alimony. See I.R.C. § 71(c)(2); cf. Morrill v. United States, 228 F. Supp. 734 (D. Me. 1964) (grantor of trust charged with income for children). Alternatively, the payout to Becky who then pays the university, creates two obstacles to the alimony deduction. First, Becky is merely acting as a conduit for the children. Second, even if Becky were contractually liable for the tuition expense, the duration of the obligation relates to a contingency specified by statute as child support. I.R.C. § 71(c)(2)(A) ("leaving school").
\textsuperscript{144} The wording of I.R.C. § 682(a) is identical to I.R.C. § 71(b)(1982) repealed by 1984 Act.
\textsuperscript{145} I.R.C. § 71(c)(1).
\textsuperscript{146} None of the income will be taxable to Abie. I.R.C. § 682(a).
A. The Mechanics of Section 71(c)

Section 71(c) overrules Lester by defining child support as an alimony payment which decreases upon the happening of two kinds of events: (1) the decrease occurs upon the happening of a contingency expressed in the divorce instrument, such as when a child becomes a specified age or employed, marries, dies, leaves school, attains a certain level of income, or leaves recipient spouse’s household;147 or (2) the decrease factually coincides with a time clearly associated with such a milestone in the child’s life, such as alimony ending during the year the child reaches eighteen.148

The recharacterization of the alimony payment, as nondeductible child support occurs as one would expect where the divorce instrument combines support of the recipient spouse with the support of the payor’s children. However, the recharacterization occurs unexpectedly where the payment is solely for the support of the recipient spouse and/or where a different payment is also labeled child support.149 The temporary regulations offer two examples of payments qualifying as alimony in all other respects but which are presumed to be disguised child support and hence not deductible.150

First, suppose the payments decline within six months before or after the date that Abie’s child becomes eighteen, twenty-one or the local age of majority. For example, where Abie pays Becky $800 per month for seven years and coincidentally Abie’s child is eleven years old at the start of the payments.151 The payments are presumed to be child support and hence not deductible.152

Second, suppose the payments decline at two points in time which correspond to the time (give or take a year) when two or more of Abie’s children reach a “certain age”. That dangerous “certain age” is between eighteen and twenty-four.153 For example, Abie pays Becky $800 per month for seven years, then $400 per month for three years. If the couple’s children become nineteen in seven and ten years respectively, the presumption of child support

151. Id.
152. Id.
153. Id.
The I.R.C. & Support Payments

The result is the same if one of the children becomes eighteen and the other nineteen in the seven and ten year time period. If one child is seventeen and the other twenty when the alimony payment is reduced, the presumption does not apply.

However, the presumptions are rebuttable. Alimony payments terminating during their third year conform to the minimum term rule and negate the first presumption. Otherwise, the presumption can be rebutted by showing that the reduction in payments had a cause unconnected with the children. Showing that alimony payments were paid for the typical time period in the local jurisdiction, such as a period equal to one-half of the duration of the marriage or other circumstances will rebut the presumption.

Here are Abie and Becky acting out this calendrical and financial plot in the circumstances similar to those set forth in the temporary regulations. Abie and Becky divorce on June 11, 1986, when their children Chad born July 13, 1972, Laura born August 21, 1974, and Monica born August 25, 1976 are fourteen, twelve and ten years old respectively. Pursuant to a separation agreement Abie will pay Becky $800 per month until July 15, 1993, then $600 per month until January 4, 1997, then $400 per month until January 15, 1999. The remaining payments of $200 per month will end in the year 2009. On July 15, 1993, the date of the first decrease, Chad will be twenty-one years and two days old. (Actually the decrease will occur not more than one year give or take a year after Chad, Laura and Monica are 21 years and 2 days through 22 years 5 months and 20 days). Unless rebutted, these decreases will be presumed to be clearly associated with the happenings of a contingency relating to the children. The amount of decreases will be recharacterized for tax purposes as child support and hence will

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154. Id.
155. Id.
156. See id.
157. See id. The temporary regulations, issued before 1986, required six years or 72 months which was required before the 1986 Act.
158. Id. Where support payment which is part child support and part alimony is not paid in full, the payment is first fully allocated to child support and the remainder is then allocated to alimony. I.R.C. § 71(c)(3). For example, Abie agreed to pay Becky $2,000 alimony and $2,000 child support. If Abie paid only $1,500 the entire amount would be treated as child support. Hence, nothing would be included in Becky’s income. Abie would have no deduction. If instead Abie paid $3,000 of the $4,000 obligation, $2,000 is allocable to child support and $1,000 to alimony. Becky would then have income of $1,000 and Abie would have a deduction of $1,000. This is the same as prior law.
not be deductible.\textsuperscript{160} The remaining $200 will be deductible as alimony.\textsuperscript{161}

Apart from the situations outlined above, no other circumstances will trigger recharacterization of alimony as child support.\textsuperscript{162}

### III. Alimony Trusts

Often the awkward structure needed to meet the alimony requirements of section 71 can be avoided by making payments through a trust. The transfer of an income interest in trust to a former spouse is treated as a property settlement rather than alimony as under pre-1984 law. In general, the transferor spouse recognizes no gain or loss,\textsuperscript{163} and the recipient spouse is treated as the beneficiary of an ordinary trust.\textsuperscript{164} Under section 682 one former spouse may shift income from property to the other free of the constraints that fetter direct transfers of income between former spouses.\textsuperscript{165} The alimony trust was not previously a simple alternative to a direct payment\textsuperscript{166}. The current simplicity in the use of a trust in divorce settlements results from the deletion of section 71(d) which taxed trust distributions as alimony under prior law.\textsuperscript{167}

Hence, trust payments are now generally taxed as if the property were transferred directly to the recipient.\textsuperscript{168}

\textsuperscript{160} Id.

\textsuperscript{161} I.R.C. § 215; see also Rev. Rul. 84-171, 1984-2 C.B. 310. Child support payments or alimony payments including child support over $150 which are delinquent at least three months may be collected by the recipient spouse through the Service from tax refunds otherwise due the payor. The procedure which is limited to enforcement of state court or administrative decrees, is made through an authorized state agency. See I.R.C. § 402(a); Treas. Reg. § 301.6402-5(a)(2) (1984). A joint return refund may be withheld to pay back the child support obligation of one spouse. Jahn v. Regan, 584 F. supp. 399 (E.D. Mich. 1985) (no separate claim for refund by nonobligated spouse); cf. Sorenson v. Sec. of Treas. 752 F.2d 1433 (9th Cir. 1985), cert. granted, 106 S. Ct. 1600 (1986).


\textsuperscript{163} I.R.C. § 1041(a) (gain or loss not recognized when property transferred to a spouse, for the benefit of a spouse or incident to divorce); but see I.R.C. § 1041(e) (nonrecognition not applicable when property whose liability exceeds basis or an installment obligation is transferred in trust for the benefit of a spouse or former spouse); cf. Amabile v. Commissioner, 1986 Tax Ct. Mem. Dec. (P-H) ¶ 86,180 (trust established for benefit of taxpayer's spouse disregarded for tax purposes). Where the trust creates an income interest in a former spouse and a remainder interest in a third party, section 1041 applies only to the transfer of the income interest to the spouse.

\textsuperscript{164} I.R.C. § 682.

\textsuperscript{165} Compare I.R.C. § 682 with I.R.C. § 71.

\textsuperscript{166} I.R.C. §§ 71(d), 682(a), repealed by 1984 Act.


\textsuperscript{168} Compare I.R.C. § 102(b) (a gift of income from property not excluded) with
In developing the particulars of this provision one sees that the tax status of the trust's income is also transferred to the recipient spouse. For example, if the trust is funded with tax exempt securities, the distribution of income from the trust is also tax exempt income to the payee. Similarly, if the corpus is distributed it too will not be taxable to the recipient. Here is a change contrary to prior law again. Generally, prior law held payments by a trust established in connection with divorce taxed to the payee as alimony, whether or not the source of the payment constituted gross income under trust accounting principles. The grantor spouse received no income and no deduction from the trust payments. Hence, a trust distributing nontaxable income to a former spouse was the tax equivalent of a spite fence, not to mention a kind of gift to the Commissioner.

Superficially section 682 appears to be the equivalent of alimony under section 71. However, the 1984 amendments which separate section 682 from section 71 create two alternative systems for the taxation of alimony. Neither the recapture rules, nor the child support rules of section 71 apply to trusts. As under the repealed provisions of section 71 and Commissioner v. Lester, combined alimony and child support payments are construed as alimony under section 682. In contrast, under section 71 the combined child support-alimony payment is not deductible.

Under prior law, the transfer of property to a trust for ten years

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172. I.R.C. § 682.
173. I.R.C. § 71(c). Compare the alimony trust, where all income is taxed to Becky at her marginal rates with a trust for the benefit of the children. Here, under the 1986 Act, trust income is taxed to the children at Abie's presumably higher rate. I.R.C. § 1(h) as added by 1986 Act, tit. XIV(B), Sec. 1411 (generally, unearned income of children under 14 is taxed at donor parent's rate subject to adjustments). The income is reduced by the greater of $500 or deductible expenses related to the production of the child's income.
175. Id. at 303.
176. I.R.C. § 71(c) (1982); cf. I.R.C. 71(c), repealed by 1984 Act; see supra text and accompanying notes 146-161. The 1986 Act perpetuates the disparate definitions of child support. Technical corrections to section 682 cross reference alimony and section 71, H.R. Rep. No. 841 99th Cong., 2d Sess. 7569 (1986). However, section 682 does not contain the term alimony and the technical correction does not produce a substantive change in the tax treatment of the recipient spouse.
after which it reverted to the grantor, permitted the grantor to deflect the tax on income from the corpus of the trust without ultimately losing control of the corpus. The 1986 Act repealed these provisions for ordinary grantor trusts. A transition rule excepts transfers in trust made pursuant to a binding property settlement agreement entered into on or before March 1, 1986. This reference may portend a technical amendment to the alimony trust provision. However, section 682 was not amended by the 1986 Act. To read the grantor trust provision consistently with the alimony trust provision, the transition rule must be limited to a transfer for the benefit of one other than the former spouse, such as the grantor’s children.\textsuperscript{177}.

IV. FILING THE RETURN

A. Separation, The Joint Return and the Innocent Spouse Rules

No one will be surprised that even the act of filing a tax return will be filled with financial opportunities and hazards for Abie and Becky. This section will address the problems of taxpayers who are separated—but not divorced—and taxpayers with dependent children.

Abie and Becky have been informally separated for six months.\textsuperscript{178} During this period Abie earned approximately $50,000

\textsuperscript{177} See I.R.C. § 71(c). See also I.R.C. § 673(a) as amended by 1986 Act, tit. XIV(A) Sec. 1402(a) (Clifford trust taxed to grantor); but see I.R.C. § 682 (alimony trust exempted from grantor trust rules); Temp. Treas. Reg. § 1.71-1T(b), A-9 (1984). Prior to the 1984 Act payments to a former spouse were treated as alimony income to the recipient if paid directly or by a trust created upon the divorce, see I.R.C. § 71(d), repealed by 1984 Act. However, the trust income was taxed to the recipient spouse. In contrast, under the 1986 amendments, a trust created during marriage will be treated as a grantor trust. See I.R.C. § 672(e) (grantor taxed as owner of spouse’s interest where grantor and spouse living together at the creation of the trust). See generally 1986 Act, tit. XIV(A), secs. 1401 (adds I.R.C. § 672(e)), 1402 (amends I.R.C. § 673), 1403 (adds I.R.C. § 645). Payments from a trust created prior to divorce were not treated as alimony, see I.R.C. § 682(b) repealed by 1984 Act.

\textsuperscript{178} Spouses separated informally also have the option to file a joint return. I.R.C. § 7703(a). But cf. I.R.C. § 71(b)(1)(A) (no deduction for support payments, without a written separation agreement. I.R.C. § 71(b)(1)(C) adds the requirement that husband and wife "not [be] members of the same household" at the time the alimony payment is made. Parties sharing the same residence are not treated as sharing a household if one party is preparing to move out. H.R. REP. No. 432, 98th Cong., 1st Sess. 195 (1983). This codifies the holding in Sydnes v. Commissioner, 577 F.2d 60, 63 (8th Cir. 1978) and also overturns the Tax Court holding in other circuits. See, e.g., Hertsch v. Commissioner, 43 T.C.M. (CCH) 703 (1982); Washington v. Commissioner, 77 T.C. 601 (1981); see also Lyddan v. United States, 721 F.2d 873 (2d Cir. 1983); Treas. Reg. § 1.71-1(b)(3)(1960) (requires parties to be "separated and living apart").
in his dental practice. Becky was unemployed. However, Abie paid her $6,000 for support during this period. Nevertheless, Abie is not entitled to an alimony deduction for the payments to Becky. The $6,000 will not be taxed to Becky as alimony without a written instrument. 179 Abie can split his income tax liability with Becky by filing a joint return with Becky for the year in which they were separated. 179 The fact that he has not split his income with her is irrelevant. In their case, since Abie is the sole earner his income alone or his and Becky's joint income is the same—$50,000. Assuming there are no children and no itemized deductions, under the rate system in effect before the 1986 Act, as well as the new rate systems, filing a joint return dramatically reduces the tax liability of the earner spouse. 181 In contrast, if Becky and Abie file separate federal returns as residents of a noncommunity property state, Becky will have no income and Abie will pay taxes on the entire amount of his earnings. 182


180. See Temp. Treas. Reg. § 1.71-1T(b), A-9 (1984). In general, taxpayers without dependents who are married on the last day of the year are married for purposes of filing a tax return. I.R.C. § 7703(a). However, taxpayers divorced on the last day of their tax year file as single individuals, I.R.C. § 7703(b); but cf. Klementowski v. Commissioner, 1986 Tax Ct. Mem. Dec. (P-H) ¶ 86,145 (interlocutory order in divorce proceeding giving wife exclusive possession of residence not equivalent to decree of divorce or separation; taxpayer not single under I.R.C. § 7703(a)(2)); Boyter v. Commissioner, 74 T.C. 989 (1980) (taxpayers divorced in Caribbean each December remarried following year treated as married for tax purposes) rev'd. 668 F.2d 1382 (4th Cir. 1982) (remanded to determine whether divorce was sham transaction).

181. Tax computed using the 1985 tax table rate for joint returns. Their joint tax liability is $11,048.

182. Tax computed using the 1985 Tax Table rate for married filing separately. The tax for a single taxpayer with the same income is $13,589. Becky's tax is zero, Abie's tax is $15,932, an increase of $4,884. After 1986, the structure of the tax rates has changed. Under the new system, individuals will be entitled to a standard deduction in various amounts determined by their filing status, and a personal exemption for themselves and their dependents. Taxpayers who are blind or elderly are allowed an additional deduction of $600 for married individuals ($1,200 for one who is both elderly and blind). Income will be taxed at rates of 15% and 28% with a surtax on higher incomes equivalent to a tax rate of 33%. The starting point for the 28% bracket is at approximately $29,750 for taxpayers filing joint returns, $23,900 for heads of household, $17,850 for single taxpayers and $14,875 for married individuals filing separately. The rate schedules enacted in 1986 are effective for 1988. Transitional rules apply to 1987. In this example, using 1987 rates, Becky's tax is still zero. However, Abie's tax as a married individual filing separately is subject to transitional rules applicable in 1987. Abie will be entitled to a standard deduction of $1,900 and a personal exemption of $1,900 and will be taxed at the rate of 35%. In 1988 Becky again has zero liability and Abie's personal exemption is $1,900, his standard deduction is 2,500. His remaining income is subject to the 28% tax. In contrast, filing a joint return in 1988 raises the personal exemption to $2,900 each for Abie and Becky and the standard deduction to $5,000. The personal exemption is $2,000 in 1989. In 1990, both the standard deduction and
The income-splitting of a joint return will obviate Abie's inability to deduct the support payment caused by the lack of the necessary written instrument. But even if the couple has a written instrument, the joint return may still be advantageous. It allows Abie to split his income with Becky whether or not Becky receives support equal to one half of Abie's income. Clearly, in such cases, Abie will lower his tax bill by filing a joint return with Becky.\(^{183}\)

What about Becky? Assuming that Abie will send the check to the Service, has Becky anything to lose in filing jointly? Yes. The filing of a joint return makes the nonearner spouse liable for the entire amount of the tax due on the return.\(^{184}\) In the case of a refund due both spouses, the overpayment may be applied to separate prior tax liability of one party.\(^{185}\) Spouses filing a joint return are jointly and severally liable for tax due.\(^{186}\) This means that if Abie intentionally or negligently underpays his tax, Becky is left with the tax liability and penalties and interest.

The 1984 amendments offer some relief for Becky if Abie places her in such a situation. For example, if all income is earned by Abie and Abie substantially misstates his income, Becky may be relieved of liability under the innocent spouse rules. The rules require "substantial understatement" of tax.\(^{187}\) The law was expanded in 1984 to cover not only a misstatement of income but also the inflation of deductions or credits as well.\(^{188}\) There are cer-


\(^{184}\) With the alimony deduction, Abie's income tax, based on the 1985 Tax Tables for married persons filing separately, is $13,270. Becky's tax based on the same table is $541. Here Abie's tax liability is still $2,222 more than if he and Becky had filed a joint return for 1985. See also I.R.C. § 6013 (joint return may be elected after separate return filed); but see Currie v. Commissioner 51 T.C.M. (CCH) 486 (1986) (deficiency notice on separate return bars joint return). Kitcher v. Commissioner, 1986 Tax Ct. Mem. Dec. (P-H) ¶ 86,041 (I.R.C. § 6013(b)(2) prohibits joint return after petition filed in Tax Court by either spouse).

\(^{185}\) See Rev. Rul. 80-7, 1980-1 C.B. 296 (method for computing amount of overpayment credited to separate liability for prior year). Ltr. Rul. 8609038 (formula by which overpayment on joint return credited to liability on prior separate return); but see Shea v. Commissioner, 780 F.2d 1157 (11th Cir. 1986) (wife not liable where her name was signed to return without her knowledge). Douglas v. Commissioner, 1984 Tax Ct. Mem. Dec. (P-H) ¶ 84,369 (joint return not signed by both spouses valid where separation agreement required joint return, and nonsigning spouse did not report income on separate return).

\(^{186}\) Id. Gordon v. United States, 757 F.2d 1157 (11th Cir. 1985)(joint return filed after divorce for one year when couple married, caused joint and several liability).

\(^{187}\) I.R.C. § 6013(e).

\(^{188}\) I.R.C. § 6013(e)(1)(B); H.R. Rep. No. 861, 98th Cong., 2d Sess. 1000 (1984). If the income provisions were construed to fix child support in accordance with Lester, Abie will
tain threshold requirements to cross before Becky can claim the
innocent spouse relief. First, the understatement of tax must be
substantial. A substantial understatement of tax is more than
$500. Second, where the understatement is attributable to a de-
duction, basis or credit, as opposed to an omission of gross income,
the liability must exceed a percentage of the spouse’s gross income
for the taxable year prior to the deficiency. Ten percent qualifies
for taxpayers with adjusted gross income of up to $20,000. Twenty-
five percent qualifies for taxpayers whose adjusted gross income is
more than $20,000. Third, the expanded innocent spouse protec-
tion is applicable to any open tax returns under the 1939 and 1954
codes. Furthermore, Becky must show that under all facts and cir-
cumstances it would be inequitable to hold her liable. Suppose
Abie and Becky filed a joint return last year. Abie understated his
income by $600. Becky neither knew nor had reason to know that
the statement was incorrect. Under the innocent spouse rules
Becky is entitled to relief from liability for the tax.

The tax law does not blend naturally with community property
law. Again assume that Abie, who earned $50,000, paid $6,000 to
Becky. Because Abie and Becky live in a community property or a
marital property state, however, the filing of separate returns may
have the same tax benefits for Abie as filing a joint return. In a
community property state, each spouse is treated as earning one
half of the community income. In the case of separated spouses, in
Washington and California the community is split on separa-
tion and no portion of the spousal earnings during the period of
separation is imputed to the other. In the remaining community
property states, and in Wisconsin, a marital property state, the
community earnings continue to be treated as belonging equally to
each spouse. Therefore, on the filing of a separate return the

be taxed on trust income under the grantor trust provisions. I.R.C. §§ 671-679. The 1986 Act
perpetuates the disparate definitions of child support.

189. Shea v. Commissioner, supra.
190. Farmer v. United States, 794 F.2d 1163 (6th Cir. 1986) (percentage of income
includes spouse’s liability for tax plus penalties; excludes interest accruing after notice).
191. Shea v. Commissioner, supra note 185 (innocent spouse relief denied where tax-
payer had access to financial records, knew that husband was an alcoholic and that he
signed unauthorized checks); Purcell v. Commissioner, 1986 Tax Ct. Rep. Dec. (P-H) ¶ 86.16
(concession regarding deduction did not show it was grossly erroneous, no relief). Hodges v.
business, not innocent).
193. CAL. CIV. CODE § 5118 (West 1986).
194. See, e.g., Brent v. Commissioner, 630 F.2d 356 (5th Cir. 1980); LA. CIV. CODE ANN.
nonearner spouse is taxed on one half of the earnings of the other spouse. Here Becky will be taxed on $25,000 of earnings. The catch for Becky, a Catch-22, is that there is no requirement that Becky actually get the $25,000. Becky is merely taxed as if she had an income of $25,000.196

Section 66(a) was passed in 1980 to relieve the abandoned nonearner spouse from tax liability for unshared community income. The provisions of section 66(a) assign income from personal services, trade or business, partnership income, or income from separately owned property to the spouse who earned the income or owned the property. For section 66(a) to provide relief, (1) spouses live apart for the entire year (2) not file a joint return, (3) have earned income for the calendar year and (4) not transfer earned income between spouses during the entire calendar year. Section 66(a) does not remedy Becky's tax problem. She and Abie were separated for only six months, not the entire year. Further one remembers that Becky received $6,000 of income from Abie.

Two new provisions of section 66 may rescue Becky from responsibility for Abie's taxes. Section 66(c) will save Becky from taxation on Abie's earnings if (1) a joint return is not filed, and (2) if Becky did not know or have reason to know of the items of Abie's income and (3) it is inequitable to include an item of community income in Becky's income.

There are additional factors such as whether Becky benefited from the untaxed income196 and whether the defense was raised in time to prevent the period of limitations from running against the

195. I.R.C. § 66(c)(1), see also I.R.C. § 66(c)(2) (not include personal service, trade or business or partnership income, income from separate property attributable to spouse).

government's claim against Abie.\textsuperscript{197} Becky also may have a problem proving that she did not know of Abie's earnings, even though she did not share them equally with him.\textsuperscript{198}

Congress may have saved some more Beckies from the tax collector with section 66(b). The section permits the Service to disregard community property laws where Abie acted as if he was solely entitled to the income and also failed to notify Becky of the nature and amount of such income prior to the due date for filing the return.\textsuperscript{199} However, if on April 14th our Becky receive a letter such as Dear Becky, I earned $60,000 during our six month separation. Cheers, Abie, Becky will lose the protection of section 66(b). Further, if earnings from community owned investments, as opposed to personal service income, are collected and kept by Abie, Becky finds no help in the innocent spouse rules of section 6013(e) which apply only to the filing or joint returns and are therefore of no use to Becky.\textsuperscript{200} Congress has authorized the Service to issue regulations concerning the innocent spouse in a community property state.\textsuperscript{201} Becky must await the future in the matter of tax liability for unshared community income.

B. The Dependency Exemption

Again assume that Becky has custody of the children and Abie pays child support to her. Abie's payment of child support to Becky will not in itself entitle Abie to a dependency exemption. Without an agreement to the contrary, if the children receive over half of their support from Abie and Becky, the dependency exemption automatically goes to Becky.\textsuperscript{202} This is a change. Prior law allowed the non-custodial parent, who contributed a minimum

\textsuperscript{197} I.R.C. § 66(c)(4).
\textsuperscript{198} Kern v. Commissioner, 1985 Tax Ct. Mem. Dec. (P-H) § 85,400 (spouse liable for tax in recapture income and late penalty). The fact that deductions lowered the amount of tax on prior years return was deemed a benefit making innocent spouse protection inapplicable. Id.
\textsuperscript{201} I.R.C. § 66(c)(2); 879(a) (excludes earned income, partnership income, income from separate property).
\textsuperscript{202} I.R.C. § 152(e)(1)(A). The dependency exemption for children of divorced parents also applies to parents who have never been married, and have lived apart at all times during the last six months of a year. I.R.C. § 152(e)(1)(A)(iii). As in the case of divorced parents, generally the custodial parent is eligible to claim the dependency exemption, I.R.C. § 152(e)(1), unless waived, I.R.C § 152(e)(2); see also I.R.C. §§ 152(e)(3) (multiple support) 152(e)(4) (pre-1985 instruments).
amount of child support,\textsuperscript{203} to claim the exemption upon showing that he or she paid more than one half of the support for the child. Under that rule, it was difficult for the custodial parent claiming the deduction to trace the amounts of money spent on the child. Now the custodial parent automatically qualifies for the exemption and some of the taxpayer's bookkeeping burden is diminished.\textsuperscript{204}

Once Becky waives her right to claim the children as her dependents, Abie is entitled to claim the children regardless of the support contributions of Becky, his former wife, or her new husband.\textsuperscript{205}

The Code denies recognition of joint physical custody between divorced parents. The exemption is tied to the parent with physical custody for the greater number of days during the calendar year.\textsuperscript{206} If each claims exactly 182 and one half days, neither meets the statutory requirement.\textsuperscript{207}

\textsuperscript{203} I.R.C. § 152(e)(2)(1982) \textit{repealed by} 1984 Act (decree granting exemption, $600; no decree, $1200 per child).

\textsuperscript{204} I.R.C. § 152(e)(5). If more than half of the child's support is paid by the child's parents or their new spouses, the custodial parent is entitled to the exemption. There are four exceptions to the custodial parent exemption: (1) The exemption may be waived by the custodial parent annually or permanently. There are no minimum payments required for the release; (2) a multiple support agreement giving the exemption to another who contributes to the support of the child; (3) prior law continues for decrees or agreements executed before January 1, 1985. If the custodial parent released the exemption, the non-custodial parent can claim the exemption if he or she paid $600 or more toward the support of the child for the year. (4) The parents collectively do not pay over half of the child's support. \textit{See also} I.R.S. Announcement 85-45 — I.R.B. — 3/5/85 (waiver by custodial parent, Form 8332, must be filed with return).

\textsuperscript{205} I.R.C. § 152(e)(5); H.R. REP. No. 439, 98th Cong., 1st Sess. 198 (1983). \textit{See} Schneier v. Commissioner, 735 F.2d 375 (9th Cir. 1984), \textit{cert. denied}, 105 S. Ct. 962 (1985) (stepfather who provided more than half of child support not entitled to exemption which was awarded to wife's former husband); \textit{but cf.} Penny v. Commissioner, 51 T.C.M. (CCH) 42 (1985) (grandparents who supported and had custody of child entitled to exemption despite separation agreement granting exemption to father). \textit{See also} Sorenson v. Sec. of Treas., \textit{supra} (earned income credit intercepted to pay back child support) I.R.C. § 6402. Income from sheltered workshops operated by government or charity is excluded for purposes of the dependency exemption. I.R.C. § 152(e)(5). The custodial parent is deemed to have contributed the rental value of the residence occupied by the parent. Goodsmann v. Commissioner, 1985 Tax Ct. Mem. Dec. (P-H) ¶ 85,596 (house co-owned by non-custodial parent); Barnes v. Commissioner, 1985 Tax Ct. Mem. Dec. (P-H) ¶ 85,379 (out-of-pocket expense, such as mortgage payment, is not proper measure of support).

\textsuperscript{206} I.R.C. § 152(e)(1)(B). Legal, as opposed to physical custody, is irrelevant to the dependency exemption. The exemption can be split where there is an even number of children with each parent claiming a different child. In the case of one child, the parents may agree on which of them takes the exemption or they may alternate the exemption annually.

\textsuperscript{207} \textit{Id. Cf.} Barnes \textit{supra} note 205 (I.R.S. argued unsuccessfully neither parent paid more than half the support—court awarded exemption to custodial parent). \textit{See generally} Kourouklis v. Commissioner, 1986 Tax Ct. Mem. Dec. (P-H) ¶ 86,068 (commuting expense
C. Medical Deductions

New rules apply for the medical deduction. For the first time, either or both parents can claim medical expenses paid on behalf of the child. The deduction of medical expenses is independent of the dependency exemption.

Suppose in 1985 Abie paid $750 in dental expenses for the care of Chad, Laura and Monica. Grandma paid $2,000 in medical expenses, and Becky paid $700 in medical expenses. Becky claimed the children as dependents for the year. Both Abie and Becky can claim the children's medical expenses as a tax deduction even though Abie does not claim the children as dependents. Grandma has no deduction.

D. Filing Status

Becky has been separated from Abie and living with the children since June. Under section 7703, Becky is considered a single, rather than married, individual for income tax filing purposes. As a single person, Becky has the benefit of lower rates than those for married individuals filing separate returns. Further, Becky may also qualify for head of household status which has tax rates between single and joint taxpayers. Head of household status for purposes of the earned income credit and child care credit are available to the parent who waives the dependency exemption. If
Becky is employed full-time, she can file as a single head of household and may be eligible for the earned income and child care credit.\textsuperscript{216}

\section*{V. GIFT AND ESTATE TAX}

No one expects to be caught with estate and gift tax liability. Both judicial and statutory exceptions appeared to have nearly repealed the tax. But the tax will still bite the poorly advised taxpayer because transfers made as part of a divorce settlement are potentially subject to estate and gift tax. Abie's problem starts with the basic application of the transfer tax.\textsuperscript{217} By statute, lifetime transfers made without full and adequate consideration in money or money's worth are subject to gift tax.\textsuperscript{218} Similarly, under the estate tax provisions\textsuperscript{219} a claim based upon a "promise or an

\begin{itemize}
\item \textsuperscript{215} Under the 1986 Act, the maximum earned income credit is $800 in 1988, subject to phase out at $17,000 adjusted gross income or earned income. In 1989 the phase out will be indexed for inflation; transition limitations apply to 1987. H.R. REP. No. 841, 99th Cong., 2d Sess. II 12-13 (1986) (Statement of Managers) see I.R.C. \textsection 32(a)(1984) as amended by 1986 Act tit. I, \textsection 111.
\item \textsuperscript{216} I.R.C. \textsection 21 (maximum credit $5,000, $2,500 married, filing separate). If Abie and Becky filed a joint return based on an income earned entirely by Abie of $46,040 with no itemized deductions, their combined tax liability is $3,492, including a child care credit of $4,800. Assuming that Becky has waived the dependency exemption, and has no itemized deductions, using 1985 tax rates her tax is zero. Abie's tax filing as married filing separately with three personal exemptions (himself and the two children) is $4,769. On the other hand, if Becky did not waive the dependency exemption her tax liability (now with three exemptions), is again zero. Abie's tax liability with only one exemption is $4,835. Thus, Abie pays more tax than if he paid tax on his and Becky's combined liability. The overall tax savings available if Becky waives her right to the dependency exemption will not benefit Becky unless Abie agrees to increase Becky's child support payments. Under the lower rates which become fully effective in 1989, tax on a joint return is $9,251. Tax on separate returns for Becky is again zero. Tax for Abie with one exemption is $11,631; with three exemptions $10,511.
\item \textsuperscript{218} See I.R.C. \textsection 2512(b).
\item \textsuperscript{219} I.R.C. \textsection 2053(c)(1).
\end{itemize}
agreement," including a separation agreement, is not deductible as a claim against the estate unless supported by monetary consideration or its equivalent.\textsuperscript{220} To illustrate the problem take a simple example: Becky offers to release her right to a portion of the marital property in exchange for the value of these rights in cash. Application of the transfer tax is determined by whether Becky's release is full consideration. Becky's release of her marital property claim is clearly a detriment to Becky and consideration under state contract law.\textsuperscript{221} But detriment does not count as consideration for gift and estate tax.\textsuperscript{222} Detriment suffered by Becky, the recipient, along with moral, social or sentimental gratification to Abie, the payor, will not replenish Abie's estate with property having value equivalent to the transfer at issue.\textsuperscript{223} Property subject to the right of dower, or a similar marital right to a share of the estate, is includible in the gross estate.\textsuperscript{224} The payment or settlement of such a
claim in a separation agreement is consequently inadequate consideration. Furthermore, under section 2043(b)(1) marital rights are valued at zero.225

Consequently, Abie, or his estate, will be liable for the transfer tax in this example unless an exception to the tax applies.226 The four exceptions are: (1) transfers complying with section 2516; (2) transfers ordered by court decree; (3) transfers in satisfaction of his support obligation; (4) transfers before the divorce decree becomes final. Despite the apparently long list of exceptions, interspousal transfers are not exempt per se from the gift and estate tax. A divorced transferor of property, such as Abie, cannot easily comply with the technical requirements of these exceptions. Thus, Abie may be caught in a residue of tax liability.

The only exception to estate and gift tax which is based on federal law is the agreement provision of section 2516. The other exceptions are of limited application because federal tax consequences depend upon the resolutions of issues of local law. The juxtaposition of state and federal law in the resolution of a tax dispute cannot help but produce uncertain results. The application of state law by federal courts caused chaos under pre-1984 income tax provisions. These local concepts are no more static in the case of gift and estate. Hence, the taxpayer who transferred property, including cash, to a former spouse incident to divorce had a good chance of being caught with gift or estate tax on the transfer unless the provisions of section 2516 were met.

A written property settlement agreement will replace monetary consideration provided that the agreement is made within a three year period starting two years before the divorce and ending one year after the divorce.227 In contrast, the time of the transfer itself is not limited.228 The agreement need not be approved by the di-

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225. See supra note 222.
227. Section 2516 applies to divorce, not merely to a legal separation. Estate of Hundley v. Commissioner, 52 T.C. 495 (1969), aff’d, 435 F.2d 1311 (4th Cir. 1971); see Treas. Reg. § 25.6019-3(b). Section 2516 applies to transfers by estates of decedents dying after July 18, 1984 and to a divorce-related transfer after that date.
228. I.R.C. § 2516(1); see Rev. Rul. 68-379, 1968-2 C.B. 414. The amount of property transferred to a former spouse is unlimited. See Rev. Rul. 79-118, 1979-1 C.B. 315. Section 2516 applies to transfers for the support of minor children of the marriage. I.R.C. § 2516(2). A transfer for child support is limited to a “reasonable allowance” for support. Id. The transfer must occur before the child reaches the age of majority. Treas. Reg. § 25.2516-2
The coordination of the timing between the property settlement agreement and the date of the divorce is crucial to the application of section 2516. If the agreement is stale, section 2516 does not apply. For example, an agreement made more than one year after the divorce or more than two years before the divorce does not comply with section 2516. Hence, without the section 2516 exception Abie's transfer to Becky is not made for adequate and full consideration and is a gift. There are other potentially applicable exceptions.

A lack of consideration does not trigger the tax if the transfer is pursuant to a divorce decree. Under *Harris v. Commissioner*, the Supreme Court held that the transfer is not pursuant to an agreement and therefore consideration is not required for the estate to deduct the claim. The decree exception is applied although a separation agreement survived the divorce decree. *Harris* applies only where the court granting the decree has the power to alter Becky and Abie's property settlement agreement without the consent of either party. However, a divorce court's power to reject an agreement between Abie and Becky merely because it is unconscionable or fraudulent is not sufficient to invoke the decree exception. If the court lacks the power to divide property on its own, the transfer is treated as made pursuant to the property settlement agreement (age of majority 21 for federal transfer tax). The term children includes adopted but not stepchildren. *Compare* Treas. Reg. § 25.2516-2 (1958); with I.R.C. § 151(e)(3) (definition of child includes stepchildren). There are no cases challenging the regulation on the basis of an obligation to support stepchildren imposed by state law.


231. Rosenthal v. Commissioner, 205 F.2d 505 (2d Cir. 1953); Commissioner v. Barnard's Estate, 176 F.2d 233 (2d Cir. 1949).

232. Fenton's Estate v. Commissioner, 70 T.C. 263 (1978) (Mexican court did not have jurisdiction to alter separation agreement); see Commissioner v. Watson's Estate, 216 F.2d 941 (2d Cir. 1954); McMurtry v. Commissioner, 203 F.2d 659 (1st Cir. 1953); Barrett's Estate v. Commissioner, 56 T.C. 1312 (1971); Rev. Rul. 76-113, 1976-1 C.B. 276.

233. See Gray v. United States, 541 F.2d 228 (9th Cir. 1976).
The distinction is without substance and has been criticized because "divorce courts are not going to freely and wantonly change" property settlement agreements "just to prove their undoubted authority." The requirement that the court be able to construct its "own settlement" despite the wishes of the divorced couple is inconsistent with the divorce statutes in many states. Harris does not apply to transfers to adult children, or transfers prior to the decree.

In the context of a modern divorce, the support exemption is misleading. Literally the release of the obligation of support is full consideration for the transfer of property. There is no gift, and consequently, no gift tax. However, the obligation to support one's former spouse for life has been abolished by most states. The compensation for property rights has replaced alimony as the primary means of settling marital dissolution.

236. Gray v. United States, 541 F.2d 228 (9th Cir. 1976).
240. See, e.g., Cal. Civ. Code §§ 4801(c) (rehabilitation) & (d) (term of years) (West 1986).
241. This change limits tax planning opportunities. See, e.g., White v. Commissioner, 770 F.2d 685, 689 (7th Cir. 1985) ("we cannot change the tax laws to allocate the tax burden as the parties contemplated"); White v. United States, 740 F.2d 826 (11th Cir. 1985) (installment payments of lump sum held property settlement not alimony income). Hybrid rights such as the right to an equitable portion of marital property are difficult to classify for federal tax purposes. For example, a property transfer may be based on such diverse factors as the recipient's contribution to the accumulation of family wealth or his or her need for support and the portion of property awarded on these grounds may vary from zero to 100%. See, e.g., N.Y. Dom. Rel. L. § 236B (McKinney 1986). The divorce court is not normally obligated to explain a property award in terms of its federal tax consequences, and even if the state court specified that the transfer was (or was not) for support, the federal court is not bound by its finding. Commissioner v. Estate of Bosch, 387 U.S. 456, 457 (1967). Under pre-1984 law the following factors indicated that a transfer satisfied the transferor's obligation to support his or her spouse; payor's annual income; extent of payor's assets, comparative life expectancies, probability of recipient's remarriage. See United States v. Past, 347 F.2d 7 (9th Cir. 1965); Estate of Glen v. Commissioner, 45 T.C. 323 (1966) (a lack of property rights under state law indicated transfer for support); but see Estate of Johnson v. Commissioner, 77 T.C. 120 (1981) (value of homestead exemption deductible). A transfer to children is not a gift if made to settle a litigated claim, Friedman's Estate v. Commissioner, 40 T.C. 714 (1963) (will contest); Beveridger v. Commissioner, 10 T.C. 915 (1948) (lawsuit brought by estranged child). A transfer in trust, income to support child during
where there is still an obligation to support one's former spouse, the right is limited to the extent of their joint lives. Thus, if the transfer exceeds the value of the support rights, the difference constitutes a gift.

An outright transfer of property occurring before the divorce is final will qualify for the marital deduction and therefore will cancel all the gift tax liability. Under section 2553 outright transfers between husband and wife made after 1981, are generally eligible for the 100% marital deduction. Section 2056 similarly permits the marital deduction for estate tax. The marital deduction will

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minority, remainder to child upon reaching 21 is a transfer for partial consideration, see I.R.C. 2516(b). The remainder is a taxable gift. The income from the trust will be taxed to the transferor. I.R.C. § 677.


243. See Ellis v. Commissioner, 437 F.2d 442 (6th Cir. 1971); United States v. Past, 347 F.2d 7 (9th Cir. 1965). Sherwood v. United States, 1979 Tax Ct. Mem. Dec. (P-H) ¶ 79,149 (state support rights are not the equivalent of alimony under federal law). Abie or his estate must prove Becky took a lesser amount per installment in exchange for a longer pay out period. Rev. Rul. 71-67, 1971-1 C.B. 271. The value of Becky's support rights is calculated from the date of Abie's death. Id. The Service has in the past accepted a "reasonable allocation" between support and property rights made by the parties. Rev. Rul. 68-379, 1968-2 C.B. 414 (husband had duty to support wife for joint lives or remarriage). Amounts exceeding the dower or statutory intestate share were considered as payment of support. Since 1984, the concept of support has no analog under the income tax provisions. See I.R.C. § 71(b) (alimony income is no longer defined as a support payment); cf. Spruance v. Commissioner, 60 T.C. 140 (1973) aff'd by unpublished opinion, 3d Cir. 1974. However, although a gift is made in such circumstances, the gift will be attributed to Becky where Abie can show that his spouse relinquished either property or support rights in exchange for a transfer to the children. For example, Becky relinquished her right to support, worth $500,000 in exchange for $400,000 and $100,000 to be paid to her son Bobby age 30. The $100,000 will be deemed a gift from Becky to Bobby. Abie is not liable for gift tax because he has received full consideration for his transfer in the release of Becky's support rights. See Leopold v. United States, 510 F.2d 617, 622-24 (9th Cir. 1975); Rev. Rul. 79-363, 1979-2 C.B. 346; Rev. Rul. 77-314, 1977-2 C.B. 349; see also DuPont v. Commissioner, 37 T.C.M. (CCH) 115 (1978); Bowes v. United States, 77-2 U.S. Tax Cas. (CCH) ¶ 13,212, 41 A.F.T.R. 2d (P-H) ¶ 148,201 (1977). In addition, a transfer for child support is limited to a reasonable allowance for the support and must occur before the child reaches the age of majority. See also 1986 Act, tit. XIV(A) Sec. 1402 (Clifford Trust provisions I.R.C. § 673(a) repealed by 1986 Act, tit. XIV(B) Sec. 1411) (unearned income of children under 14 generally taxed at parent's rates if property was gift from parent), tit. I Sec. 103 (children lose exemption if claimed as dependent).

244. Marital status is determined under I.R.C. § 7703.

apply to transfers made before the divorce was final or to transfers made after divorce, where the obligation to make the transfer was enforceable before the divorce was final. The transfer need not be incident to the divorce.

However, not every interest in property transferred to a spouse is eligible for the marital deduction. Certain terminable interests in property such as an interest for a term of years will not qualify for the marital deduction. For example, Abie transfers property in trust, the income payable to Becky for life, remainder to Aunt Martha or her estate. This transfer is a terminable interest and will not qualify for the marital deduction. In simplified terms, the terminable interest rule states that if another person's interest in property (Aunt Martha's interest) follows the expiration of the recipient spouse's interest (Becky's interest) and both the spouse and the third party received their property interest from the transferor spouse (Abie), the transfer violates the terminable interest rule. The dual purpose of the terminable interest rule is first to allow property to pass tax-free between spouses by eliminating gift or estate tax to the transferor spouse; and second to defer the tax to the time when the property will be transferred by the recipient spouse or will be included in the recipient spouse's estate.

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246. See I.R.C. § 1041(c); but see Rosenthal v. Commissioner, supra, (the tax attaches on execution of the separation agreement). Whether the agreement is enforceable is a matter of state law. Hence, the date of delivery of the deed (before or after the divorce) is not significant. See Deyoe v. Commissioner, 66 T.C. 904 (1976) (title passed when burdens and benefits of ownership transferred); Commissioner v. Copley's Estate, 194 F.2d 364 (7th Cir. 1952), aff'g 15 T.C. 17, 1950, acq. 1965-2 C.B. 4; Rev. Rul. 69-347, 1969-1 C.B. 227. (ante-nuptial agreement). Housman v. Commissioner, 105 F.2d 973 (2d Cir. 1939) cert. denied 309 U.S. 656 (1940); Rev. Rul. 79-384, 1979-2 C.B. 344; Rev. Rul. 69-347, 1969-1 C.B. 227 (ante-nuptial agreement).


248. See Burnett v. United States, 41 A.F.T.R.2d (P-H) ¶ 148,206 (1977); Paulkerson's Estate v. United States, 301 F.2d 231 (7th Cir. 1962); Rev. Rul. 77-170, 1977-1 C.B. 290. Contrast Abie's transfer to Becky with one that does not constitute a terminable interest. Abie makes a similar transfer, but the interests are reversed (this is income to Aunt Martha for life, remainder to Becky or her estate). The marital deduction is allowed. In theory, the marital deduction is permitted as a deferral of the transfer tax on the estate of the first spouse to die.

249. There are many exceptions to the terminable interest rule the most important of which is I.R.C. §§ 2056(b)(7) (estate tax) and 2523(f) (gift tax). The marital deduction may be elected if (1) the recipient spouse has a right to income from the property or trust for life, and (2) can appoint the property to him or herself or his or her estate, and (3) no one has the power to appoint the property to one other than the spouse during the spouse's life, and (4) income is paid to the spouse annually or more frequently. I.R.C. § 2056(b)(7)(B)(ii); see I.R.C. § 2044 (QTIP election). See generally, R. STEVENS, G. MAXFIELD & S. LIND, FED-
The terminable interest rule makes the typical alimony trust in which Becky’s interest ends on her remarriage ineligible for the marital deduction exception to the gift and estate tax. The qualified terminable property trust, commonly called a QTIP trust, is an awkward way in which Abie can take advantage of the marital deduction yet not give up all control of the property. The QTIP trust requires that Becky must have a life interest in the property and all the income from the trust must be distributed to Becky at least once a year. This provision ties up Abie’s property for a period that is longer than the typical trust term which is contingent on Becky’s remarriage as well as her death. During Becky’s life the corpus of the trust cannot be transferred to anyone but Becky. However, a third party can appoint the trust property at or after Becky’s death. The property transferred in this form will either be subject to gift tax if Becky disposes of her interest during her life or estate tax on her death. The exception must be elected.

The transfer of a present interest in property to Becky is also eligible for the $10,000 annual per donee exclusion.

eral Estate And Gift Taxation, ¶ 5.06(8)(b)(3) (5th ed. 1983). The fact that the recipient spouse’s estate is subject to tax does not guarantee that the transfer qualifies for the marital deduction. A power to appoint property to the recipient’s creditors, a general power of appointment, will result in the inclusion of the property subject to the power in the recipient’s estate. This is required by I.R.C. §§ 2041(a)(1) and 2056(b)(7). The recipient spouse has the power to appoint the property to him or herself. Here the recipient’s estate will be taxed but the marital deduction is not applicable. The transfer violates the terminable interest rule and does not qualify for the marital deduction election under I.R.C. § 2056(b)(7). See also Baratta-Lorton v. Commissioner, 86 T.N.T. 62-19 (9th Cir. 1986) (marital deduction denied because not raised prior to appeal).

250. I.R.C. §§ 2056(b)(7)(B)(ii)(I). I.R.C.§2523(f)(3) (incorporates I.R.C. § 2056(b)(7)(B) by reference). The problem is whether a previous transfer by the decedent to an alimony trust is includible in the estate. The governing issue is whether the transfer was made for monetary consideration or its equivalent. Support is full consideration.

251. I.R.C. § 2056(b)(7)(B) (exempts power to transfer property at or after recipient’s death).

252. I.R.C. § 2519 (transfer of life estate deemed transfer of complete property interest.

253. I.R.C. § 2044 (property received under QTIP trust treated as passing from recipient spouse).


255. I.R.C. § 2503(a).
### Table 2. The Residue of Tax Liability

<table>
<thead>
<tr>
<th>Exception</th>
<th>Donee</th>
<th>Time Limit</th>
<th>$ Limit</th>
<th>State Law</th>
<th>Form of Donee's Interest</th>
</tr>
</thead>
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<tr>
<td>2516 Agreement</td>
<td>x spouse, minor child</td>
<td>x</td>
<td>—</td>
<td>—</td>
<td>—</td>
</tr>
<tr>
<td>Support</td>
<td>spouse, x spouse, minor child</td>
<td>x, x</td>
<td>x</td>
<td>—</td>
<td>—</td>
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<tr>
<td>Marital Deduction</td>
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<td>—</td>
<td>—</td>
<td>x</td>
<td>x</td>
</tr>
<tr>
<td>Decree</td>
<td>x spouse</td>
<td>—</td>
<td>—</td>
<td>x</td>
<td>—</td>
</tr>
<tr>
<td>Annual Exclusion</td>
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<td>x</td>
<td>—</td>
<td>x</td>
</tr>
</tbody>
</table>

The few instances when the gift and estate tax will be applicable to the transfer of property in divorce are purely accidental gaps between federal and state law. There is no policy justification for the limitations applicable to section 2516. Although the section does not depend on state law it can cause hardship. For example, the possibility exists that the agreement may have become stale and that the recipient spouse is unwilling to sign a new agreement within a year after the divorce. A rational policy would repeal section 2516 entirely and exempt the transfer of property to a spouse or former spouse incident to divorce from the gift and estate tax. The repeal of section 2516 will also cause transfers by a former spouse to his or her children to be treated as transfers to children by married parents.256

## VI. CONCLUSION

The federal tax law adds a random element to a marital division structured by state law. The scattered provisions of the Code compartmentalize the elements of alimony, child support and property settlement into nominally different categories of transactions with variant tax consequences dependent on whether the transfer is made directly or indirectly, in cash, or in kind. The Code's method of solving the problems raised in taxing the division of a marriage is based on the notion that the spouses have separate rights and obligations that merely have to be properly labeled and allocated. Congress has provided a unified nationwide result based upon fed-

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256. See 1986 Act, tit. XIV(B) Sec. 1411 (1986).
eral definitions applicable to theoretically distinctive pieces of the marriage. However, all assets and obligations of the spouses have been scrambled. Property rights and support rights are different forms of the former spouse's right to a share of the marital wealth and should be taxed according to the same standard.257 The tax consequences under the Code, however, have no significance under the divorce laws of most states.

The artificial divisions found under the Code reflect a lack of consensus regarding a tax policy applicable to divorce. For example, the conflicting definitions of child support for the purposes of direct alimony and alimony trusts as well as the recharacterization of a property settlement under state law as alimony for federal tax purposes, make the scope of the tax provisions uncertain. Uncertainty hinders a final and complete apportionment of the cost of the divorce. Inevitably, the tax results which must be based on federal rather than state definitions of overlapping marital rights and obligations clash with the state created structure of the agreement.258 Where ninety percent of divorces are settled by agreement, the bottom line is essential.259 The only rational policy to follow in the case of a divorce settled by agreement between the parties is to follow the assumed tax consequences in the agreement. Judicial precedent may provide a solution.

Where the question is not whether tax is due but merely which of two parties to an agreement will bear the tax burden, the Court of Appeals for the Third Circuit in Danielson v. Commissioner,260 reversed the Tax Court and upheld the presumed tax consequences of a covenant not to compete which was part of the sale of a business, absent grounds, such as fraud or duress which would allow

257. Congressional tax policy was formulated without consideration of economic and social effects of the tax costs of support. For a discussion of the economic aspects of divorce see Weitzman, The Economics of Divorce: Social and Economic Consequences of Property, Alimony and Child Support Awards, 28 UCLA L. REV. 1181 (1981). After divorce, mothers with young children experience extreme economic decline. Id. at 1244. At high income levels, husbands' predivorce income rose 200%; wives' incomes fell 52%. At low levels husband had twice the post divorce income of their former wives. Ninety percent of the children of divorce live with their mothers. Frank, Divorce's Fallout, 71 A.B.A.J. 28 (1985) (children of wealthy divorced fathers have lower economic status because of inadequate support); see also H.R. REP. No. 432, 98th Cong., 1st Sess, 194 (1983) (Congress characterized the alimony deduction as a combined tax benefit). The deduction, however, benefits the payor alone because the former spouses no longer an economic unit.


259. Mnookin & Kornhauser, Bargaining in the Shadow of the Law: The Case of Divorce, 88 YALE L.J. 950, 951 n.3 (1979) (less than 10% of divorces are contested).

the taxpayer to rescind the contract under state law. The supposed tax consequences of buyer and seller were used to determine the sales price. To change these consequences would have resulted in a windfall to the buyer. Similarly, the net amount of alimony has been a consideration in divorce cases. Danielson was applied to a divorce by the Sixth Circuit in Commissioner v. Schatten. Although the case was decided before the 1984 amendments to the Code, the problem raised in the case persists. The federal courts considering the tax issues arising from divorce are faced with whether to abandon the notion of substance over form where the tax result is inconsistent with the divorce agreement, or to permit the federal court to be the instrument of revenge in a marital dispute. The former result may undermine the consistent interpretation of the Code. Yet, the latter result is unacceptable.

261. Id. at 773.
262. Id. at 775.
263. In re Marriage of Williams, 714 P.2d 548 (Mont. 1986) (Montana divorce court considered tax factors in property divisions).
264. 746 F.2d 319 (6th Cir. 1984).