CHAPTER 11

TAX CONSEQUENCES OF SEPARATION AND DIVORCE

CONTENTS

A. Chapter Competencies

After studying chapter 11 the student should be able to:

1. state the tax consequences of alimony payments, child support payments, and property division.
2. state the seven tests for deductible alimony.
3. determine when, if ever, voluntary alimony payments are deductible.
4. determine when cash payments made to a third person can be deductible alimony.
5. state why the Internal Revenue Service (IRS) suspects payments made after the death of the recipient.
6. state when the IRS says a reduction in "alimony" payments is nondeductible child support.
7. state the presumption that is used when a reduction is connected to the child's age of majority.
8. state the suspicion of the IRS when it determines that there has been a front loading of alimony payments.
9. state the recapture rule when there has been a front loading of payments.
10. state when income, gain, or loss is realized.
11. define fair market value.
12. determine the adjusted basis of property.
13. determine how taxable gain is determined in the sale of property.
14. state the tax consequences of a property division in cash.
15. state the tax consequences of a property division of appreciated property.
16. determine when a property transfer is incident to a divorce.
17. determine when legal and related fees in obtaining a divorce are deductible.
18. state when an innocent spouse is given relief on taxes and penalties owed.

B. Assignment 11.1 (tax calculations)

a. No, unless the divorce decree or separation agreement required John to make extra alimony payments to cover such emergencies. If not, the extra $400 is a nondeductible voluntary payment. Not deductible to John, nor reportable by Carol. Only the $500 is deductible/includible if all the other tests for alimony are met.

b. A payment made to a third party (here, the state tax department) is deductible as alimony if the following conditions are met:

- the payment to the third party is required by the divorce decree or by the separation agreement,
- the payment to the third party is in lieu of payments of alimony directly to the spouse,
- there must be a written request, signed by both spouses, that both intend the payment to the third party to be treated as alimony,
- the written request must be received before the return seeking the deduction is filed

The facts say that John was giving Carol a "gift" of $1,200. If it was a gift, John was not obligated to make the payment under the divorce decree or separation agreement. Hence the first condition is not met. Also, there is no indication in the facts that Carol sent John a written request for the $1,200 in which there was a statement that both she and John considered the $1,200 to be alimony. Hence the second condition is not met. Therefore the $1,200 is neither deductible to John nor includible in the income of Carol.

c. September 1, 1991: If parties have been separated under a decree of divorce, they cannot be members of the same household when the alimony payment is made. The question is whether they were in separate households in view of the separate entrances.

October 1, 1991: Here again, parties separated under a decree of divorce cannot be members of the same household when the alimony payment is made. We have the same issue here regarding the separate entrances. There is, however, a one-month grace period. If one spouse is planning to move out and does move out within one month of the payment, it is deductible even if the spouses were living together when the payment was made. John moved out on October 25—within the one month grace period. The only question is whether he intended to move out when he made the payment on October 1.

d. None of the $300,000 and none of the $150,000 is deductible alimony. Alimony payments must end on the death of the recipient. The parties cannot get around this condition by building in a lump-sum payment to the estate of the recipient, which, in effect, is a substitute for continuing the pre-death payments that otherwise would qualify as deductible alimony.
e. The $900 payment is subject to a contingency that relates to their child—the child's marriage. This contingency will reduce the payment by $500. The $500, therefore, is child support and cannot be deducted as alimony. The remaining $400 is deductible alimony if it otherwise qualifies.

It makes no difference that the agreement also provides $200 a month that the parties specifically label as child support. This looks like a feeble effort to throw the IRS off track. Can't you hear John arguing that none of the $900 is child support because child support is specifically provided for elsewhere in the separation agreement? Nice try.

It also makes no difference that the contingency may never occur. Even if Nancy never marries, the offending contingency is present and thus defeats the attempt to disguise child support as alimony.

f. Same analysis as in problem (e) above. The reduction is again related the child—the child being away at boarding school. It makes no difference that the child may be away only temporarily. The $500, therefore, is child support and cannot be deducted as alimony.

C. Assignment 11.2 (tax calculations)

a. The IRS will *presume* that a reduction is child support if the reduction is to occur not more than six months before or after the child reaches the age of majority in the state. We are not told the age of majority in the state.

If it is eighteen, the IRS will presume that the amount of the reduction ($1,800) is child support, regardless of the statement in the separation agreement that nothing will be used for child support. Greg will be eighteen on July 31, 1998. The reduction occurs on April 15, 1998, which is about four months before he turns eighteen. The reduction occurs less than "six months before . . . the child reaches the age of majority" assuming that the age of majority in the state is eighteen.

If, however, the age of majority in the state is twenty-one, the presumption of child support will not apply since the reduction was not within six months before or after Greg's age of majority.

b. Millie must show $6,000 as recaptured income on her 1989 return. Paul can deduct $6,000 on his 1989 return.

WORKSHEET:

1. Alimony paid in second year	$ 4,000
2. Alimony paid in third year	$ 4,000
3. Floor	$15,000
4. Add lines 2 and 3	$19,000
5. Subtract line 4 from line 1	$ 0
6. Alimony paid in first year	$25,000
7. Adjusted alimony paid in second year (line 1 less line 5)	$ 4,000
8. Alimony paid in third year	$ 4,000
9. Add lines 7 and 8	$ 8,000

10. Divide line 9 by 2	$ 4,000
11. Floor	$15,000
12. Add lines 10 and 11	$19,000
13. Subtract line 12 from line 6	$ 6,000
14. Recaptured Alimony (add lines 5 and 13)	$ 6,000

c. The transfer to Ken was *incident to a divorce* since the transfer occurred within one year after the marriage ended. Based on our facts, the transfer occurred on the same day that the marriage ended.

When Helen originally bought the building in 1986, her basis was $1,000,000. When she transferred it to Ken in 1989, her adjusted basis was $1,200,000 due to the $200,000 in capital improvements. Although the building appreciated in value to $1,500,000, she does not realize a taxable gain when she transfers the building to Ken. The transfer is a nontaxable event. When Ken received the building from Helen, he assumed her adjusted basis of $1,200,000. When he sold it for $800,000, he realized a loss of $500,000 ($1,200,000 − $800,000).

d. Dan cannot deduct the $12,000 in legal fees that he pays for his ex-spouse, Karen. But can't he deduct them as *alimony*? In addition to the $1,000 a month, suppose that he agrees to pay her additional "alimony" of $500 a month for twenty-four months ($500 × 24 = $12,000). He may want to send this amount directly to Karen's attorney. Cash payments made to a third party (here, Karen's attorney) that are required by a divorce decree or by a separation agreement can be deducted as alimony by the payor if the other requirements for deductible alimony are met, e.g., the payments must end on the death of the recipient. There must also be a mutually signed written request received before an alimony deduction is taken. To make it clear that the extra alimony ends when Karen dies, the agreement could read "$500 a month for twenty-four months or until Karen dies, whichever occurs earlier."

Of course, Karen's attorney must be willing to wait twenty-four months to be paid. Perhaps a higher amount over a shorter period might have to be made. And there is a risk that the arrangement will fall apart if Karen dies before the twenty-four months are over. If Karen dies before the entire $12,000 is paid, Dan's obligation to continue payments ends. Also, whatever Dan can successfully claim as deductible alimony must be reported as income by Karen.

D. Ethics in Practice

The paralegal has unethically disclosed confidential information about a client. He gave his wife the following information to which she was not entitled:

- Harrison is a client of the paralegal's firm.
- Harrison has claimed a $2,000,000 alimony deduction.
- The IRS has challenged this deduction.
- He may lose the challenge.

There is no indication in the facts that the wife learned any of this in the media. Therefore, it was unethical for a law firm employee to give her this information.