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Course Information

Course Title: *Divorce Tax Planning* *#491024*

Recommended CPE credit hours for this course

In accordance with the standards of the CFP Board, the National Registry of CPE Sponsors, the IDFA, and the IRS, CPE credits have been granted based on a 50-minute hour.

CFP®: 10 (All States)

CFP Board sponsor number: 1008. CFP Board Course ID# 195326

CPA: 15.5 (All States)

National Registry of CPE Sponsors ID Number: 107615.
Sponsor numbers for states requiring sponsor registration:
Florida Division of Certified Public Accountancy: 0004761 (Ethics #0011467)
Hawaii Board of Public Accountancy: 14003
New York State Board of Accountancy (for ethics): 002146
Ohio State Board of Accountancy: CPE .51 PSR
Pennsylvania Board of Accountancy: PX 178025
Texas State Board of Accountancy: 009349

EA/OTRP: 15 (All States) IRS: Qualified Sponsor number: *FWKKO.*

CDFA®: 16 (Certified Divorce Financial Analyst) IDFA sponsor #105392.

Course Description

This course will teach participants how to apply, implement, and evaluate the strategic tax aspects of marital dissolutions and living together arrangements. Current perspectives on property transfers, asset divisions, alimony, filing status, exemptions, and child support are examined with an emphasis on planning considerations. Property settlements, basis allocation, third party transfers, and purchases between spouses are explored and analyzed. Special attention is given to the division of business interests, retirement plans (including QDROs), insurance policies, and family residences.

Course Content

Publication/Revision Date: 7/25/2024.
Author: Danny Santucci, J.D.
Final exam (online): One-hundred twenty questions (multiple-choice).

Program Delivery Method: Self-Study (NASBA QAS Self-Study / Interactive)

Subject Codes/Field of Study:
NASBA (CPA), CFP Board of Standards, Inc., NAPFA, IDFA (CDFA®): Taxes.
IRS (EA, OTRP): Federal Tax Law.

Course Level, Prerequisites, and Advance Preparation Requirements:

Program Level: CFP Board, NAPFA, IDFA (CDFA®): Intermediate; NASBA/CPA, IRS: Overview. This program is appropriate for professionals at all organizational levels.
Prerequisites: Basic familiarity with federal taxation
Advance Preparation: None

Instructions for Taking This Course

- **Log in to your secure account at www.bhfe.com. Go to "My Account."**
- **You must complete this course within one year** of purchase (If the course is "Expired," contact us and we will add the latest edition of the course to your account (no charge).
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- **Complete the course by** following the learning objectives listed for the course, studying the text, and, if included, studying the review questions at the end of each major section (or at the end of the course).
- **Once you have completed studying the course** and you are confident that the learning objectives have been met, answer the final exam questions (online).

Instructions for Taking the Online Exam

- **Log in to your secure account at www.bhfe.com. Go to "My Account."**
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- You will have three attempts to pass the exam (call or email us after three unsuccessful attempts for instructions).
- The exam is not timed, and it does not need to be completed in one session.
- For a printed copy of the exam questions, open the exam and press "Print Exam."
- Once you pass the exam, the results (correct/incorrect answers) and certificate of completion appear in "My Account." A confirmation email is also sent.
- CFP Board and IRS credit hours, if applicable, are reported on Tuesdays and at the end of the month.

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Learning Assignments & Objectives

As a result of studying each assignment, you should be able to meet the objectives listed below each assignment.

ASSIGNMENT **SUBJECT**

Chapter 1 Basic Marital Tax Matters

At the start of Chapter 1, participants should identify the following topics for study:

* Marital status
* Joint return
* Separate returns
* Head of household
* Exemptions
* Divorce costs
* Withholding & estimated tax
* Community property states
* Ending the community
* Living together

Learning Objectives

After reading Chapter 1, participants will be able to:

1. Specify the factors used to determine federal filing status and the effects of filing as married or unmarried.

2. Identify the requirements for filing a joint return and how to avoid being penalized.

3. Determine the key elements of filing separate returns including what items to report and identify whether or not married taxpayers should file separate returns.

4. Cite the requirements for filing as head of household and the tax advantages and disadvantages of this filing status.

5. Recognize the repeal of personal & dependency exemptions, their former phaseout, availability, and reporting requirements.

6. Differentiate custodian and noncustodian parent, identify the dependency determination impact, determine the current "qualified child" standard using residency, and identify requirements that must be met for parents to treat a child as a qualifying child of a non-custodial parent.

7. Identify deductible and nondeductible divorce expenditures specifying which spouse is subject to tax imposed upon withheld wages, and recognize the effects of making separate estimated tax payments or joint declarations of estimated tax.

8. Determine community property and the community property states, identify the effects of conversion and commingling of property, and how to avoid such marital property issues.

9. Identify community income earned by married couples for reporting purposes by:

a. Specifying reporting guidelines, recognizing the allocation of income and what income and property belongs to which spouse when they have different residency statuses;

b. Recalling the requirements for the special community income allocation rules of §66(a), determining what constitutes community property termination and specifying the treatment of alimony payments versus community share; and

c. Recognizing the use of statements and records to provide estimates of a former spouse's income and identifying conditions for greater tax relief.

10. Identify the effect of living together on filing statuses and dependency, determine differences between the married tax rate and other tax rates, recognize the tax consequences of having a living together contract to avoid tax traps, and specify the results of *Marvin v. Marvin*.

After studying the materials in Chapter 1, answer exam questions 1 to 30.

ASSIGNMENT SUBJECT

Chapter 2 Transfers Incident to Divorce

At the start of Chapter 2, participants should identify the following topics for study:

* Property rights
* Premarital agreements
* Application of §1031
* Incident to divorce
* Property basis
* Purchases of residence between spouses
* Purchases of business interests between spouses
* Selected asset divisions of residence & business interests
* Real & personal property
* Pension benefits

Learning Objectives

After reading Chapter 2, participants will be able to:

1. Identify types of marital property and their likely division in marital property settlements and specify the legal principles used in dividing assets and providing support on divorce or separation.

2. Determine the benefits of premarital agreements and the requirements and permissible provisions for a valid and comprehensive agreement under the Uniform Premarital Act.

3. Specify the position of *U.S. v. Davis* on interspousal transfers and the changes made by §1041, and identify the requirements of §1041 and the scope of its application.

4. Select factors that determine whether a property transfer is incident to divorce and identify how to meet these factors or avoid §1041 altogether when desired.

5. Determine the application of §1041 to transfers in trust under §1041(e) and to third-party transfers on behalf of a spouse or former spouse.

6. Recognize deferred tax liability by identifying property basis for the transferor spouse and transferee spouse under §1041 after a property settlement.

7. Specify the application of §1041 to property transfers where the transferee assumes liabilities encumbering the property, and the obligation to supply basis information.

8. Recognize the dangers of purchasing a former spouse's interest in property, particularly a marital residence and its tendency to create deferred tax liability.

9. Determine tax effects of purchasing an interest in personal or real property used in a business or held for investment, recognize potential recapture and identify the use of a §1031 exchange to dispose of low-basis property received in a §1041 transfer.

10. Specify common disposition alternatives available on divorce and identify the home sale exclusion requirements and the tax treatment and use of installment obligations under §453 in divorce.

11. Recognize sale, redemption, recapitalization, liquidation, and third-party transfers as methods of dividing a business in a marital settlement citing unique provisions under §302, §736, and §754.

12. Identify whether gain or loss on a sale of real or personal property is capital or ordinary and, recognize the tax treatment of such gain or loss and the role and tax treatment of life insurance in property settlements.

13. Specify popular methods of dividing private and military retirement benefits in a divorce or separation action identifying the requirements and tax consequences of a "qualified domestic relations order (QDRO).

After studying the materials in Chapter 2, answer exam questions 31 to 69.

ASSIGNMENT SUBJECT

Chapter 3 Spousal & Child Support

At the start of Chapter 3, participants should identify the following topics for study:

* Divorce or separation instrument
* Alimony requirements of instruments executed after 1984
* Alimony requirements of instruments executed before 1984
* Deducting alimony paid & reporting alimony received
* Recapture of alimony for type A & B agreements
* Alimony substitution trusts & annuities
* Alimony paid by estate
* Child support
* COBRA coverage
* Qualified medical child support orders

Learning Objectives

After reading Chapter 3, participants will be able to:

1. Recognize how the tax treatment of spousal support payments has dramatically changed under the TCJA, identify the §71 requirements for pre-2019 decree alimony, and differentiate the tax treatment with current law.

2. Identify the tax treatment of child support and circumstances where a payment will be fixed as child support, and specify events that determine whether a contingency is clearly child-related and how to rebut this presumption of child support.

3. Recognize the COBRA and qualified medical child support order rules by:

   a. Identifying whether COBRA rules apply to different plans including notice & deadline requirements and specifying situations that may result in a termination of continuing coverage; and

   b. Determining what constitutes "qualified medical child support orders" recognizing differences with other similar orders and identifying the procedures, requirements, and jurisdiction of QMCSOs.

After studying the materials in Chapter 3, answer exam questions 70 to 99.

ASSIGNMENT **SUBJECT**

Chapter 4 Selected Marital Tax Issues Outside of Divorce

At the start of Chapter 4, participants should identify the following topics for study:

* Marriage penalty
* Spousal travel
* Dower & curtsey
* Joint interests and powers of appointment
* Life insurance
* Marital deduction
* Tax basis for estate assets
* Business interests upon the death of a spouse
* Gift taxes
* Social Security survivors' benefits

Learning Objectives

After reading Chapter 4, participants will be able to:

1. Identify the marriage penalty and marriage bonus associated with filing a joint return by recognizing how standard deductions and tax brackets have differed over time.

2. Determine the tax treatment of spousal travel including additional cost limitations and identify the benefits of husband and wife partnerships, particularly with regards to Social Security qualification.

3. Recognize the application of federal estate tax on couples and where estate planning may be necessary as a result of marital status.

4. Specify the treatment of co-tenancies with or without a right of survivorship identifying qualified joint interests, recognize the impact on the value of a general power of appointment, determine what insurance proceeds are included in the gross estate because of incidents of ownership, and cite the community property issue involved with ownership of life insurance.

5. Determine the impact of the marital deduction on the gross estate recognizing outright transfer methods and specify the use of a "marital deduction (QTIP) trust" and a "qualified terminable interest trust."

6. Identify marital deduction variables including deduction limitations and specify the federal income tax treatment and gift tax treatment of non-citizen spouses.

7. Recognize the effect common transactions and community property have on §1014 property basis and the benefits of a bypass trust specifying its effect on the marital deduction.

8. Determine the purposes of the federal gift tax identifying its computational methods and applicable exclusions, specify the advantages of splitting gifts and the gift tax marital deduction recognizing dangers as to "excess" gifts and terminable trusts, and identify Social Security eligibility for family members of a system participant.

After studying the materials in Chapter 4, answer the exam questions 100 to 120.

Notice

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Divorce Tax Planning

By
Danny C. Santucci

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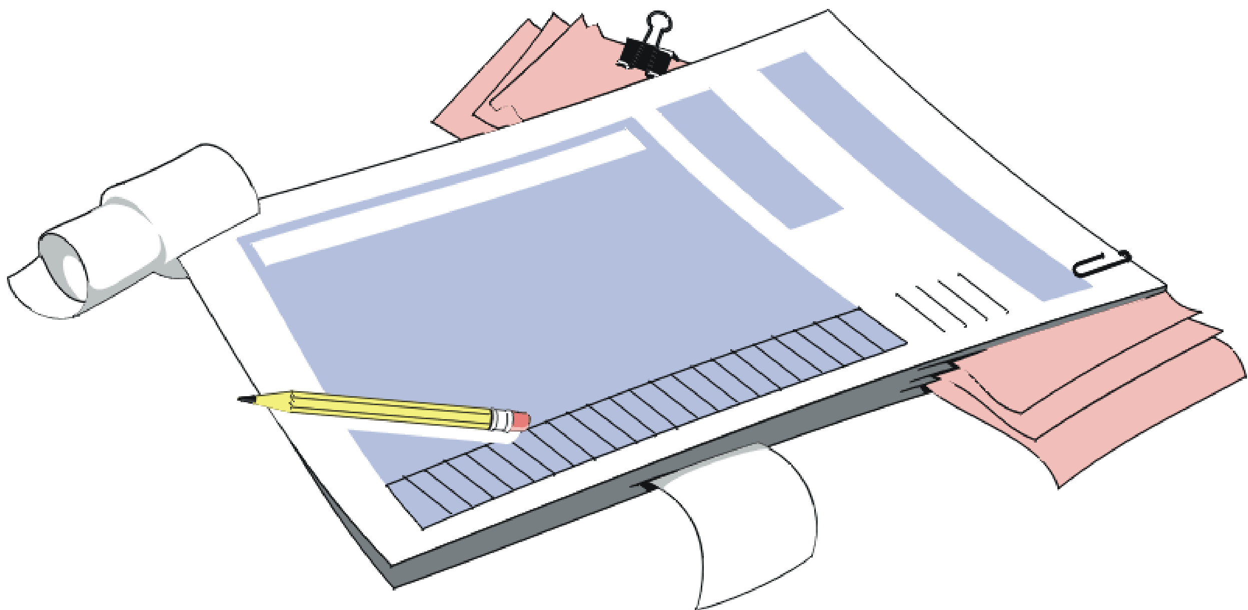
CHAPTER 1

Basic Marital Tax Matters



When someone is going through the trauma of a divorce they often do not realize that there are severe tax implications when making decisions such as:

(1) When to separate,

(2) When to file for the divorce,

(3) How to handle child support and alimony,

(4) Who is entitled to the deductions, credits, and exemptions,

(5) How to divide property, *and*

(6) How to file the final return.

Interestingly enough, the one decision the divorcing taxpayers have almost always made on their own, and not always correctly, is whether to file joint or separate returns for the year or years preceding the finalization of the divorce.

It is imperative to have good advice when determining the division of property, alimony, and child support. Although many couples want to save money and do everything themselves, this is not usually a good idea.

Filing Status

Filing status affects a person's filing requirement, standard deduction, and correct tax. It may also determine whether certain deductions and credits may be claimed.

Marital Status

Marital status is determined on the *last* day of the tax year. If a taxpayer is unmarried, their filing status is:

(1) Single, *or*

(2) If they meet certain requirements, head of household.

If a taxpayer is married, their filing status is either:

(1) Married filing a joint return, *or*

(2) Married filing a separate return.

> Note: Married couples may find it beneficial to figure their tax on both joint and separate returns to see which gives the lower tax.

Unmarried

A taxpayer is considered unmarried for the whole year if:

(a) They have obtained a final decree of divorce or separate maintenance by the *last* day of their tax year[1]; *or*

> Note: If a couple obtains a divorce in one year for the sole purpose of filing tax returns as unmarried individuals, and at the time of divorce they intend to remarry each other and do so in the next tax year, they must file as married individuals (R.R. 76-255).

(b) They have obtained a decree of annulment, which holds that no valid marriage *ever* existed.

> Note: Taxpayers also must file *amended returns* claiming unmarried status for all tax years affected by the annulment that are not closed by the statute of limitations. The statute of limitations generally does not end until 3 years after the filing of the original return.

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[1] State law determines if a taxpayer is divorced or legally separated. For example, in California an interlocutory decree is not a separate maintenance decree or legal separation and the spouses are still considered married.

Abandoned Spouse Rule - §7703

A married person living apart from their spouse is *treated* as an *unmarried* taxpayer if they do *all* of the following:

(1) Files a separate return;

(2) Maintains as a household, which, for more than half the taxable year, is the principal place of abode of a son, daughter, stepson, or stepdaughter for whom the taxpayer is entitled to a dependency deduction, or would have been so entitled except that:

(i) By the taxpayer's written declaration the taxpayer allows the noncustodial parent to claim the dependent, or

(ii) The noncustodial parent provided at least $600 for the support of the dependent and claims the dependent under a pre-1985 agreement;

(3) Furnishes more than one-half the cost of maintaining the household; *and*

(4) Do not have the other spouse living in the household during the *last* six months of the taxable year (§2(c); §7703(b)).

Married

A taxpayer is considered married for the whole year if they are separated, but have not obtained a final decree of divorce or separate maintenance by the last day of their tax year. An *interlocutory decree* is not a final decree.

Note: Although a taxpayer is considered married if they are not divorced or legally separated, if a taxpayer lives apart from their spouse, under certain circumstances, they may be considered unmarried and can file as head of household.

Same-Sex Marriage

The U.S. Supreme Court has held unconstitutional Section 3 of the Defense of Marriage Act (DOMA) in *E.S. Windsor*, SCt., 2013-2 USTC ¶50,400. Additionally, the IRS has ruled it will treat all *legally* (based on place of celebration) married same-sex couples as married for all federal tax purposes, including income and gift and estate taxes, regardless whether the couples' state of residency recognizes same-sex marriage (R.R. 2013-17).

Note: The IRS also provided that individuals in a same-sex marriage may file original or amended returns for still open tax years and choose to be treated as married. However, the IRS stated that it does not treat registered domestic partners, individuals in a civil union, or similar relationships as married for federal tax purposes.

Moreover, in *Obergefell v. Hodges*, 576 U.S. 644 (2015), the Supreme Court held that states must issue licenses for same-sex marriages and must recognize same-sex marriages lawfully performed in another state. Thus, same-sex marriages will be recognized, for tax purposes, regardless of where the couple resides. The ruling avoids a mismatch between filing status for federal and state purposes and now treats such couples as married for both purposes.

Joint Return

Married taxpayers may file a joint return. If spouses file jointly, both must include all their income, exemptions, deductions, and credits on that return. Spouses can file a joint return even if one had no income or deductions. Both spouses must sign the return, or it will not be considered a joint return.

Note: Getting both spouses to sign the joint return may be a problem if they have already separated.

Citizenship

To file a joint return, at least *one* spouse must be a U.S. citizen or resident at the end of the tax year. However, when either spouse is a nonresident alien at any time during the tax year, a joint return can be filed if the taxpayers agree to treat the nonresident spouse as a resident of the United States. Thus, both spouses' combined worldwide incomes would be subject to U.S. income tax (§6013(g)).

Liability

Both spouses are responsible, *jointly* and *individually*, for the tax and any interest or penalty due on their joint return. This means that one spouse may be held liable for all the tax due even if the other spouse earned all the income.

Divorced taxpayers are *still* jointly and individually responsible for any tax, interest, and penalties due on a joint return filed *before* their divorce. This responsibility applies *even if* the divorce decree states that a former spouse will not be responsible for any amounts due on previously filed joint returns.

Innocent Spouse Exception

Over the years, tax legislation has made innocent spouse relief *easier* to obtain. All of the understatement thresholds have been eliminated and it is only required that the understatement of tax be attributable to an erroneous (and not just a grossly erroneous) item of the other spouse.

A *separate liability election* is also provided for a taxpayer who, at the time of the election:

(1) Is *no longer married to*,

(2) Is *legally separated* from, *or*

(3) Has been *living apart for at least 12 months*,

from the person with whom the taxpayer originally filed a joint return.

Such taxpayers may elect to have the liability for any deficiency limited to the portion of the deficiency that is attributable to items allocable to the taxpayer. The election is not available if the IRS demonstrates that assets were transferred between individuals filing a joint return as part of a fraudulent scheme of the individuals or if both individuals had *actual* knowledge of the understatement of tax.

Expanded innocent spouse relief and the separate liability election must be elected *no later than two years* after the date on which the IRS has begun collection activities with respect to the individual seeking the relief. The Tax Court has jurisdiction with respect to disputes about innocent spouse relief.

The IRS is further authorized to relieve an individual of liability if relief is not available under the expanded innocent spouse rule or the separate liability election, but it would be *inequitable* to hold the individual liable for any unpaid tax or any deficiency (§6015, §66(c)).

Refund Offset Program - §6402

If a taxpayer is due a refund but has not paid certain debts, all or part of their refund may be used to pay the past-due amount. The debts that may be paid from a refund are:

(a) Child support payments[2] (as defined in §464(c) of the Social Security Act),

(b) Spousal support payments, *and*

(c) Federal debts such as student loans.

Note: In *Sorensen v. Secretary of Treasury*, 475 U.S. 851 (1986), the U.S. Supreme Court held that the tax-intercept law applies to refundable income tax credits as well as to tax overpayments.

Injured Spouse - Form 8379

A taxpayer can prevent their share of a tax refund on a joint return from being applied to a debt owed *by their spouse* by attaching a completed Form 8379, *Injured Spouse Claim and Allocation*, to their return. Write "Injured Spouse" in the upper left corner of Form 1040.

Note: If filing an injured spouse claim to receive part of a joint overpayment for a return already filed, use Form 8379 to obtain the refund. Do not attach it to Form 1040.

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[2] The IRS is required to reduce a taxpayer's refund of taxes by the amount of any past-due child support payments assigned to a state and remit the overpayment to the state (§6402(C)).

To be an injured spouse a taxpayer must meet the following requirements:

(i) They are not obligated to pay the non-tax debt (e.g., child support or a student loan - not past income taxes);

(ii) They had income (wages, interest, etc.) that was reported on the joint return;

(iii) They had tax withheld, estimated tax payments, or a refundable credit that was reported on the joint return; *and*

(iv) They had an overpayment that will be (or was) applied to their spouse's debt.

Review Questions

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Short explanations for both correct and incorrect answers are given after the list of questions. We recommend that you answer each of the following questions and then compare your answers. For more detailed explanations and references, you may do an electronic search using Ctrl+F (if you are viewing this course on computer), consult the text Index, or review the general Glossary.

1. The course materials list six critical tax consequences of a divorce. However, which of the following can individuals disregard when going through a divorce?

a. alimony and child support.

b. property division.

c. final income tax return.

d. one's own former personal exemption.

2. A taxpayer's filing requirement, standard deduction, and tax rate are determined by his or her filing status. What is the filing status of an unmarried taxpayer?

a. separate or individual.

b. single or head of household.

c. single or domestic partner.

d. living together or head of household.

3. Innocent spouse relief has become easier to obtain. In several circumstances, spouses can elect to limit their liability to allocable items. However, under which circumstance is this election unavailable?

a. A taxpayer is not married to his or her former spouse anymore.

b. A taxpayer and his or her spouse are legally separated.

c. A taxpayer lives separately from his or her spouse for no less than 12 months.

d. A taxpayer no longer resides in the United States.

4. When a refund is due to a taxpayer, it may be used to offset certain debts. Which of the following debts may be paid from a refund?

a. marital settlement payments.

b. property taxes.

c. FHA mortgage payments.

d. child-support payments.

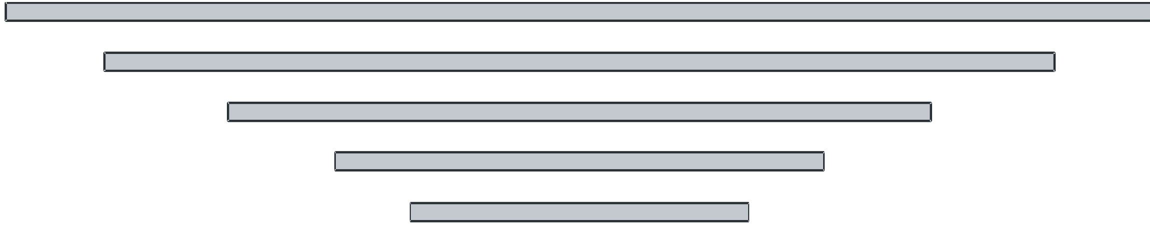
5. When four requirements are met, injured spouses may receive a portion of an overpayment for an already filed joint return. Under these requirements, which of the following is disregarded in determining injured spouse status?

a. The taxpayer has been married for less than three years.

b. The taxpayer's income was accounted for on the joint return.

c. Tax, attributable to the taxpayer, was withheld on the joint return.

d. An overpayment was put toward the spouse's debt.



Separate Returns

If spouses file separate returns, each should report only their own income, exemptions, deductions, and credits on their individual returns. A spouse can also file a separate return if only one spouse had income. If spouses file separately, each is responsible *only for* the tax due on their *own* return.

Itemized Deductions

Remember, if spouses file separate returns and one spouse *itemizes* deductions, the other spouse will *not* qualify for the standard deduction and should also itemize deductions.

Medical Expenses

If a taxpayer resided in a non-community property state, paid the medical expenses of a qualifying person with funds deposited in a joint checking account in which the taxpayer and their spouse have an equal interest, and file separate returns, the taxpayer, and their spouse are presumed to have paid the medical expenses equally for purposes of computing the medical expenses deduction. This presumption may be rebutted if the taxpayer can show that they alone paid the expenses.

Property Tax & Interest

If both spouses paid property tax and interest on mortgaged property held as *tenants by the entirety*, on their separate return a taxpayer can deduct the amount of property tax and interest that only the taxpayer *actually* paid.

State Income Taxes

If a taxpayer pays state income taxes and files *separate state* and *separate federal* returns, they can deduct on their federal return the amount of

state income tax imposed (up to $10,000 for 2018 and later) on and paid by the taxpayer during the year.

If a taxpayer pays state income taxes and files a *joint state* return and a *separate federal* return, they can deduct on their federal return that portion of the total state income taxes imposed and paid during the year which their gross income bears to their combined gross income, but not more than the amount the taxpayer *actually paid* during the year. However, if the taxpayer and their spouse are jointly and individually liable for the full amount of the state income tax, then the taxpayer can deduct on a separate federal return the amount of such tax the taxpayer *actually paid* during the year.

Casualty Loss

If a taxpayer sustained a pre-2018 casualty loss on a residence owned as *tenants by the entirety*, they may report one-half of the casualty loss on their separate return. Neither spouse could report the total casualty loss.

Separate vs. Joint Dilemma

Some married couples file separate returns because each wants to be responsible only for his or her tax. However, in almost all instances, the filing of separate returns results in *more* combined federal tax than with a joint return. This is because the tax rate is higher for married persons filing separately.

Disadvantages of a Separate Return

Married taxpayers who file separate returns may not:

(a) Take the earned income credit;

(b) Take the child and dependent care credit;

(c) Exclude interest from Series EE savings bonds used for qualified education expenses; *or*

(d) Use a standard deduction on one return and itemized deductions on the other return.

Married taxpayers who live together but file separate returns:

(a) May not claim the $25,000 passive activity loss allowance for rental property;

(b) May not claim the credit for the elderly or disabled;

(c) Could lose all or part of an IRA deduction because the phase-out amount is $10,000 for a married filing separate return and a taxpayer is considered covered by a retirement plan if the spouse was covered;

(d) Must calculate taxable social security - up to 85% of social security could be included in adjusted gross income- even if the taxpayer has little income; *and*

(e) May lose head of household status.

Advantages of a Separate Return

Consider filing separate returns when:

(a) The taxpayers lived together and want to force the suspension of passive activity losses;

Example

Dan and Diane lived together. They had a $10,000 loss from rental real estate. They were not real estate professionals. They had $10,000 in wages. They had mortgage interest of $10,000 and $5,000 in personal exemptions. Their taxable income is 0 and they have no net operating loss because business loss does not exceed business income. Without the $10,000 passive activity loss, their taxable income would be 0. They file separate returns so that they are forced to suspend the passive activity loss.

(b) The taxpayers have disproportionate medical and/or miscellaneous itemized deductions;

(c) The taxpayer is concerned about accepting full liability for any taxes owed now, or later as a result of a tax audit;

Note: Don't be left holding the bag for a spouse who underreports income or overreports deductions.

(d) The spouses live apart and one may qualify as head of household under abandoned spouse rules; *and*

(e) When one spouse owes back taxes from before the marriage, back child support payments, or unpaid federal student loans.

Note: Filing a separate return may keep the nondebtor's tax refunds from being taken by the IRS (or another agency) for the other's old debts.

Joint Return After Separate Returns

If the spouses file separate returns, they *can* change to a joint return any time within 3 years from the due date (not including extensions) of the separate returns. This applies even if the separate returns were filed as single or head of household. Use Form 1040X, *Amended U.S. Individual Income Tax Return*.

If the tax on the joint return is more than the total paid on the separate returns, the additional tax must be paid when Form 1040X is filed.

Note: After the due date of the return, spouses *cannot* file separate returns if they previously filed a joint return.

In the past, taxpayers wanting to go from separate return filings to a joint return were required to pay the joint tax return liability at the time of the filing. Beginning with tax years after July 30, 1996, taxpayers may go from separate to joint without paying the tax in full (§6013(b)(2)). The change allows taxpayers to utilize an installment agreement to pay their joint tax liability.

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6. Taxpayers may be allowed to deduct their full state income taxes up to $10,000. Under which circumstance may this deduction be allowed on their federal return?

    a. A taxpayer and spouse file a joint state return and a separate federal return using the standard deduction.

    b. A taxpayer and spouse are jointly and individually liable for the entire state income tax amount.

    c. State income taxes are paid, and a joint state return and a separate federal return are filed.

    d. State income taxes are paid, and separate state and separate federal returns are filed.

7. A reason that certain married taxpayers file separate returns is to pay their taxes on their own. Which of the following is the most likely result of filing separate returns?

a. lower tax rates than filing joint returns.

b. increased tax liability and responsibility.

c. higher combined federal tax than if filing joint returns.

d. the better ability to take the earned income credit.

8. The author presents numerous consequences of filing separate returns for married couples. What is one of these consequences?

a. A reduced credit for the elderly or disabled.

b. For rental property, a $25,000 passive activity loss allowance.

c. Series EE savings bonds interest applied to qualified education expenses is income included.

d. A standard deduction may not be used on both returns.

9. While separate returns are not always disadvantageous, the materials identify five advantages a married couple might experience when filing separate returns. Under which of the following circumstances should a couple consider filing separate returns?

a. Neither spouse is delinquent on federal student loans.

b. They have roughly equal medical deductions.

c. They lived together and one may qualify as head of household under abandoned spouse rules.

d. They lived together and want to use passive activity losses.

Head of Household

A taxpayer may be eligible to file as head of household if they meet the requirements discussed later. Filing as head of household has advantages:

(1) The standard deduction can be claimed *even if* the other spouse itemizes deductions on a separate return;

(2) The standard deduction is *higher* than that allowed for a single or married filing a separate return;

(3) The tax may be *lower* than that on a single or married filing a separate return; *and*

(4) The taxpayer *may* be able to claim certain credits they cannot claim on a married filing separate return.

Requirements

A taxpayer is able to file as head of household if he or she:

(1) is unmarried or "considered unmarried" on the last day of the year,

(2) paid more than half the cost of keeping up a home for the year, *and*

(3) had a "qualifying person" live with them in their home for more than half the year (except for temporary absences, such as school).

Note: If the "qualifying person" is your dependent parent, he or she does not have to live with you.

Considered Unmarried

A taxpayer is considered unmarried on the last day of the tax year if they meet all of the following tests:

(1) The taxpayer files a separate return;

(2) The taxpayer paid more than half the cost of keeping up their home for the tax year;

(3) The taxpayer's spouse did not live in the taxpayer's home during the last 6 months of the tax year; *and*

(4) The taxpayer's home was, for more than half the year, the main home of their child, stepchild, adopted child, or foster child whom the taxpayer could claim as a dependent.

> Note: A taxpayer can still meet this last test if they *cannot* claim their child as a dependent because they state in writing to the noncustodial parent that he or she may claim an exemption for the child (§7703(b)).

If the taxpayer's spouse was a *nonresident alien* at any time during the tax year, and the taxpayer has *not* chosen to treat their spouse as a resident alien, the taxpayer is considered *unmarried* for head of household purposes. However, their spouse does *not* qualify as a relative. The taxpayer must have *another* qualifying relative and meet the other requirements to file as head of household.

Keeping Up a Home

A taxpayer is keeping up a home only if they pay more than half of the cost of its upkeep (Reg. §1.2-2(d)). Costs include rent, mortgage interest, taxes, insurance on the home, repairs, utilities, and food eaten in the home. Do not include the cost of clothing, education, medical treatment, vacations, life insurance, transportation, or the rental value of a home. Also, do not include the value of the taxpayer's services or those of a member of the taxpayer's household.

Qualifying Person

Each of the following individuals is considered a qualifying person:

(1) a "qualifying child" under the definition of §152,

> Note: If the taxpayer is a noncustodial parent, the term "qualifying child" for head of household filing status does not include a child who is their qualifying child for exemption purposes only because the custodial parent signs a written declaration that he or she will not claim the child as a dependent for the year. If you are the custodial parent and those rules apply, the child is generally your qualifying child for head of household filing status even though the child is not a qualifying child for whom you can claim an exemption.

(2) a "qualifying relative" other than the taxpayer's mother or father who lives with the taxpayer more than half the year, an exemption is taken and is related in one of the following ways:

Son	Half brother
Daughter	Brother-in-law
Grandparent	Sister-in-law
Brother	Son-in-law
Sister	Daughter-in-law
Stepbrother	Stepsister
Stepmother	If related by blood:
Stepfather	Uncle
Mother-in-law	Aunt
Father-in-law	Nephew
Half-sister	Niece, and

Note: Any of these relationships that were established by marriage are not ended by death or divorce.

(3) a "qualifying relative" who is the taxpayer's father or mother for whom an exemption may be claimed.

Note: A taxpayer can be eligible to file as head of household even if their dependent parent does *not* live with them. The taxpayer must pay more than half the cost of keeping up a home that was the main home for the entire year for their father or mother. A taxpayer is keeping up a main home for their dependent father or mother if they pay more than half the cost of keeping their parent in a rest home or home for the elderly (§2(b)(1)(B); R.R. 70-279).

Nonresident Alien Spouse

If the taxpayer's spouse was a *nonresident alien* at any time during the tax year, and the taxpayer has *not* chosen to treat their spouse as a resident alien, the taxpayer is considered *unmarried* for head of household purposes. However, their spouse does *not* qualify as a relative. The taxpayer must have *another* qualifying relative and meet the other requirements to file as head of household.

Exemptions

Under §151, there are two types of exemptions:

(1) personal exemptions, *and*

(2) dependency exemptions (§151(b), (c)).

Formerly, exemptions generally were allowed for the taxpayer, his or her spouse, and any dependents. However, an individual who qualified as someone else's dependent could not claim a personal exemption.

Note: Exemptions could be claimed *whether or not* the taxpayer itemized deductions.

However, the TCJA has now suspended (eliminated) exemptions (and the exemption phase-out). Thus, exemption deductions for yourself, your spouse, or your dependents, have been eliminated. As a result, the personal and dependency exemptions under §151(d) are $0 and the phase-out of exemption deductions for higher-income taxpayers has become moot.

Note: Formerly, personal and dependency exemptions were phased out for higher-income taxpayers. While TCJA eliminated personal and dependency exemptions, it also eliminated this exemption phase-out for tax years 2018-2025.

Personal Exemptions

Taxpayers were allowed one exemption for themselves (unless they could be claimed as a dependent by another taxpayer) and, if married, one exemption for their spouse (§151(d)(2)). These were called personal exemptions.

If another was entitled to claim the taxpayer as a dependent, the taxpayer could not take an exemption for himself or herself. This was true even if the other taxpayer did not actually claim the exemption (§151(d)(2)).

Spouses

A spouse is *never* considered a dependent. However, a taxpayer could take an exemption for a spouse simply because they were married.

If a married couple filed a joint return, an exemption for each spouse could be claimed. If separate returns were filed, a taxpayer could take an exemption for their spouse *only if* their spouse:

(1) Was not filing a return,

(2) Had no gross income, *and*

Note: If alimony or spousal support was paid to a spouse and the taxpayer deducted it on their separate return, an exemption could not be taken for the spouse. This was because alimony was gross income to the spouse who received it.

(3) Was not the dependent of someone else[3] (Reg. §1.151-1(b)).

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[3] This was true even if the taxpayer's spouse was a nonresident alien.

Former Spouse

If at the end of the tax year a taxpayer was divorced or legally separated under a final decree, they could not take an exemption for their former spouse. This rule applied even if the taxpayer paid all the former spouse's support.

Deemed Personal Exemption for Related Incorporating Provisions

In Notice 2018-70, the IRS announced that the suspension of personal exemptions for taxable years 2018-2025 will *not* be taken into account for purposes of:

(1) determining whether a person is a qualifying relative under §152(d)(1)(B),

(2) the $500 credit for other dependents under §24(h)(4), *and*

(3) head-of-household filing status under §2(b)

Thus, while the §151 dependency exemption deduction is zero from 2018 through 2025, this elimination is not taken into account for qualifying relatives, family credit, and eligibility for head-of-household status purposes. In 2024 for these purposes, the amount is $5,050 (up from $4,700 in 2023).

Dependency Exemptions & Credits

Taxpayers were allowed one exemption for each person they could claim as a *dependent*. A dependent was defined as any person who met all the dependency tests. The term "dependent" still means someone who meets the dependency tests for either:

(1) a qualifying child (§152(c)), *or*

(2) a qualifying relative (§152(d)).

Unified Definition of a Qualified Child

Section 152(c) provides a unified definition of a "qualified child" and despite the elimination of dependency exemptions is still applicable for purposes of the:

(i) child tax credit,

(ii) earned income credit,

(iii) dependent care credit, *and*

(iv) head of household status.

In general, tests involving residency and relationship will be the same across the board. However, some provisions (e.g., child tax credit) will continue to use different ages

Comment: If a potential dependent is not a "qualified child" they may be a "qualified relative." For "qualifying relatives" the old gross income, support,

joint return, and citizenship/residency tests still exist. There are eight categories of such "relatives." Non-relatives who live with the taxpayer during the entire year also qualify.

Conclusion: While the determination of qualified child status is still important for the child tax credit, earned income credit, dependent care credit, and head of household, it is no longer relevant for the now suspended (until 2026) dependency exemption.

Four Tests

The "qualified child" definition of §152(c) emphasizes residency (i.e., time) as opposed to the previous emphasis on support (i.e., money) and is based on a total of four tests:

(1) residency (152(c)(1)(B)) and citizenship (152(b)(3)) ,

(2) relationship (§152(c)(2)),

(3) age (§152(c)(3)), *and*

(4) joint return prohibition (152(b)(2)).

There is no support (unless the child provides more than half of their *own* support) or gross income test. Instead, the child must have the same principal place of abode as the claimant for more than half the year.

Note: To be a qualifying child, the child must not have provided more than half of his or her own support for the year.

Test #1 - Residency (or Time) & Citizenship

The child must live with the claimant for more than half of the year. However, temporary absences due to education, business, vacation, military service, or illness are not counted as absences. Thus, a student at college is not necessarily absent.

In addition, a taxpayer cannot claim a person as a dependent unless that person is a U.S. citizen, U.S. resident alien, U.S. national, or a resident of Canada or Mexico, for some part of the year.

Children of Divorced or Separated Parents

A child of divorced parents can be a qualifying child based on the uniform definition. Because of the requirement that a qualifying child have the same principal abode of the taxpayer for more than one-half the calendar year, the custodial parent is the one with whom a child shared the same principal place of abode for the greater part of the year *regardless* of support (§152(c)(1) & (4)).

Note: If the support of the child is determined under a multiple support agreement, this special rule for divorced or separated parents does not apply.

Custodial vs. Noncustodial Parent

The term "custodial parent" means the parent having custody of the child for the greater portion of the calendar year. Under the regulations, the unit of time used to measure who has this greater portion is the number of nights spent during the calendar year (Proposed Reg. §1.152-4(c)). The term "noncustodial parent" means the parent who is not the custodial parent (§153(e)(4).

If the parents divorced or separated during the year and the child lived with both parents before the separation, the custodial parent is the one with whom the child lived for the greater part of the rest of the year.

Example

Under the terms of your divorce, your child lived with you for 10 months of the year. The child lived with your former spouse for the other 2 months. You are considered the custodial parent.

Custody

Custody is usually determined by the most recent decree of divorce, separate maintenance, or a later custody decree. If there is no decree, the written separation agreement is used. If neither a decree nor agreement establishes custody, then the parent who has *physical* custody of the child for the *greater* part of the year is considered the custodial parent. This also applies if the validity of a decree or agreement awarding custody is uncertain because of legal proceedings pending on the last day of the calendar year.

Joint custody creates special problems since it presupposes that the parents equally "share" the child. Proposed Reg. §1.152-4(c) provides that if a child resides with each parent for an equal number of nights, the parent with the higher adjusted gross income is the custodial parent.

Formerly, §152(e)(2)(A) provided that the parents could resolve this issue in a divorce decree, separate maintenance, or written separation agreement that:

(a) gave the exemption to one (e.g., the noncustodial) parent, *or*

Note: If the divorce decree or separation agreement unconditionally stated that the taxpayer could claim the child as their dependent, the taxpayer could attach to their return copies of the decree or agreement *instead* of Form 8332

(b) required the presumed custodial parent to sign a Form 8332 waiver.

However, §152(e) now solely refers to the waiver procedure using Form 8332 (or a similar statement containing the same information). As a result, while the parties might still wish to enter into an agreement to avoid confusion, the parent having actual custody for a *greater* portion of the year gets the dependency exemption unless there is Form 8332 compliance (§152(e)).

Form 8332 Waiver

Dependency waiver requirements and the use of Form 8332 remain. Thus, parents can continue to treat a child as the qualifying child of the non-custodial parent using Form 8332 if:

(1) a child receives over one-half of the child's support during the calendar year from the child's parents;

(2) the parents are divorced or legally separated under a decree of divorce or separate maintenance, separated under a written separation agreement, or live apart at all times during the last six months of the calendar year; *and*

Note: The decree or separation agreement must provide that the non-custodial parent is entitled to any personal exemption deduction for the child, or the custodial parent must sign a written declaration that they will not claim the child as a dependent for the tax year (§152(e)(2)).

(3) the child is in the custody of one or both of the parents for more than one-half of the calendar year (§152(e)).

Note: Custodial waivers in effect on October 4, 2004, continue to be effective if they continue to satisfy the waiver rules.

Form 8332, *Release of Claim to Exemption for Child of Divorced or Separated Parents*, can release the exemption (qualified child status? - since the exemption is suspended) for:

(1) a single year,

(2) a number of specified years (for example, alternate years), *or*

(3) all future years.

The noncustodial parent must attach the release to their return. If the release is for more than one year, the noncustodial parent must attach the *original* release to their return the first year and a copy each following year.

Test #2 - Relationship Test

The potential dependent must be related to the claimant as a:

(1) child or descendant of a child,

(2) brother, sister, stepbrother, stepsister, or a descendant of any such relative,

(3) brother or sister by half blood,

(4) foster child, *or*

(5) adopted child.

Note: Not all of the above are necessarily biologically or legally children.

Test #3 - Age Test

The potential dependent meets the age test if they are:

(1) under age 19 at the close of the calendar year,

(2) a full-time student (at least parts of five months during the year) under age 24 at the close of the calendar year, *or*

(3) permanently and totally disabled.

Test #4 - Joint Return Restriction

While a taxpayer is not barred from taking a deduction for a married dependent, the dependent *cannot* have filed a joint return for the current tax year (§151(c)(2)).

However, if neither the dependent nor the dependent's spouse is required to file, but they file a joint return to get a refund of all tax withheld, a taxpayer can claim the dependent if the other four tests were met.

Medical Expenses

A child of divorced or separated parents is treated as a dependent of *both* parents for the medical expense deduction. Thus, a parent can deduct medical expenses they paid for the child even if an exemption for the child was claimed by the other parent.

Child-Care Credit

Under §21, the *custodial* parent will qualify for the child-care tax credit. When the custodial parent cannot claim a dependency deduction for a child who is under age 13 or disabled (i.e., because of a waiver), the child is still a dependent of that spouse under the child-care credit.

Definition of a Qualified Relative

Section 152(d)(1) outlines the criteria for an individual to qualify as a "qualifying relative" for tax purposes. To meet this definition, an individual must satisfy the following conditions:

1. *Relationship:* The individual must have a specific relationship with the taxpayer.

2. *Income Test:* Their gross income for the calendar year must be less than the exemption amount defined in §151(d).

3. *Support Test:* Over half of their financial support during the calendar year must come from the taxpayer.

4. *Not Be a Qualified Child*: Section 152(d)(1)(D) specifies that the individual cannot be a qualifying child of the taxpayer or of any other taxpayer for the same taxable year.

Section 152(d)(2)(H) allows a qualifying relative to include an individual who shares the same primary residence as the taxpayer and is a member of the taxpayer's household

$500 Credit for Certain Dependents - §24(h)(4)(A)

For 2018 through 2025, the TJCA creates a $500 nonrefundable credit for certain dependents of a taxpayer other than a qualifying child described in §24(c), for whom the child tax credit is allowed. The $500 credit applies to two categories of dependents:

(1) qualifying children for whom a child tax credit is not allowed, *and*

(2) qualifying relatives as defined in §152(d).

Final Regulations of Qualifying Relatives - TD 9913

The IRS has issued TD 9913 containing final regulations that clarify the definition of a "qualifying relative" for purposes of various provisions of the Internal Revenue Code for taxable years 2018 through 2025. These regulations generally affect taxpayers who claim Federal income tax benefits that require a taxpayer to have a qualifying relative.

Review Questions

Under NASBA-AICPA self study standards, self study sponsors are required to present review questions intermittently throughout each self-study course. The following questions are designed to meet those requirements and increase the benefit of the materials. However, they do not have to be completed to receive any credit you may be seeking with regard to the text. Nevertheless, they may help you to prepare for any final exam.

Short explanations for both correct and incorrect answers are given after the list of questions. We recommend that you answer each of the following questions and then compare your answers. For more detailed explanations and references, you may do an electronic search using Ctrl+F (if you are viewing this course on computer), consult the text Index, or review the general Glossary.

10. Many taxpayers miss the opportunity to file as head of household. What is a consequence of this filing status?

   a. The tax paid may be higher than that on a single status return.

   b. The taxpayer may claim the standard deduction regardless of whether deductions are itemized by the spouse on a separate return.

   c. The taxpayer takes a lower standard deduction than that allowed on a single or married filing separate return.

   d. This filing can force the suspension of passive activity losses.

11. An individual can be considered a head of household taxpayer if they pay the majority of the costs of maintaining a home. Which of the following costs are included in determining whether a taxpayer has met this requirement?

   a. utilities.

   b. education.

   c. life insurance.

   d. the home's rental value.

12. A client is single and has three children, and no other taxpayer may claim the client as a dependent. How many personal exemptions may your client claim?

   a. 1.

   b. 0.

   c. 3.

   d. 4.

13. Formerly, exemptions could be taken for dependents. When was a spouse deemed to be a dependent?

   a. if the spouse does not file a return.

   b. if the spouse is disabled.

   c. if the taxpayer takes an exemption for the spouse.

   d. never.

14. The "qualified child" standard, applicable to dependency exemptions, was established by the Working Family Relief Act. The text outlines four tests used by this standard. However, which former test is now disregarded?

   a. residency.

   b. age.

c. support.

d. joint return prohibition.

15. If three conditions are met, parents can regard a child as a "qualifying child" of the non-custodial parent. What is one of the conditions?

a. During the calendar year, the child receives less than 50% of the support from his or her parents.

b. A relative has custody of the child for over 50% of the calendar year.

c. One or both of the parents have custody of the child for 50% of the calendar year.

d. From July to December the parents continuously live apart.

16. For medical expense deduction purposes, how is a child of divorced or separated parents treated?

a. as a dependent of both parents.

b. as a dependent of the custodial parent.

c. as a dependent of the non-custodial parent.

d. as a separate taxpayer.

Divorce Costs

Legal fees and court costs for getting a divorce, separation, or a support decree are *not* deductible (Reg §1.262-1(b)(7)). The costs of personal advice, counseling, or legal action in a divorce are not deductible even if they are paid, in part, to arrive at a financial settlement or to protect income-producing property.

Formerly, attorney's fees paid in a divorce *were* deductible under §212 (subject to the 2% of AGI limit) when in connection with the determination, collection, or refund of any tax. This also included fees paid to appraisers, actuaries, and accountants for services determining tax. Fees paid often included deductible and nondeductible charges and a breakdown showing the amount charged for each service performed was advised.

Note: Deductible fees could only be claimed if the taxpayer itemized deductions on Schedule A (Form 1040) claiming them as miscellaneous deductions subject to the 2% of adjusted gross income limit (§67).

This treatment has changed with:

(1) the suspension, until 2026, of all itemized deductions subject to the 2% AGI limit of §67, *and*

(2) the permanent exclusion, for 2019 and later, of alimony payments as income to the recipient.

Tax Advice - §212(3)

Fees for advice on federal, state, and local taxes of all types, including income, estate, gift, inheritance, and property taxes were deductible. Expenses properly allocable to advice on the tax consequences of a divorce or separation were also deductible subject to the 2% AGI limit (*U.S. v. W.K. Carpenter*, 338 F 2d 366 (Ct Cl., 1964)). However, all itemized deductions subject to the 2% AGI limit of §67 are now suspended until 2026.

Note: Fees paid to a spouse's attorney for tax advice given to the spouse have never been deductible (*U.S. v. Davis*, 370 US 65 (1962)).

Fees to Obtain Alimony or Protect Income - §212(1) & (2)

Legal fees paid to get or collect alimony *have been* deductible under §212 subject to the 2% AGI limit since alimony received had to be included in gross income, (*Wild v. Commissioner*, 42 TC 706 (1964)). This rule included the collection of increased or back alimony payments.

Note: Section 212 has also been applied to the conservation of income-producing property, such as deferred compensation (*Dolese v. U.S.*, 605 F 2d 1146 (10th Cir, 1979)) or income from a family business (*Hahn v. Commissioner*, 35 TCM 509 (1976)).

However, all itemized deductions subject to the 2% AGI limit of §67 are now suspended until 2026. In addition, for 2019 and later, the inclusion of alimony payments in the income of a recipient is repealed and fees to obtain alimony will no longer be deductible under §212. Attorney's fees to avoid or reduce alimony (*Sunderland v. Commissioner*, 36 TCM 512 (1977)) or to resist monetary claims or demands from a spouse (*Tressler v. Commissioner*, 228 F 2d 356 (1955)) have never been deductible.

Fees to Obtain Property - §1012 & 1016

Certain legal fees paid specifically for a property settlement can be added to the basis of the property received. Under §1012, the basis of property is its cost. Cost includes the expenses of acquisition. For example, the cost of preparing and filing a deed to put title to a house in the taxpayer's name alone can be added to

the basis of the house. The costs of a property settlement in which *new* property interests are acquired may be added to the basis of the property.

Nondeductible Expenses

The costs of personal advice, counseling, or legal action in a divorce are *not* deductible (*U.S. v. Gilmore*, 372 US 39 (1963)). These costs are not deductible, even if they are paid, in part, to arrive at a financial settlement or to protect income-producing property.

A deduction is *not* allowed for the collection of child support. Child support is not taxable to the recipient. Under §265, costs allocable to the production or collection of tax-exempt income are not deductible.

> Note: Some fees may be deductible if time was spent on tax planning for the dependency exemption, head of household status, child-care credit, and/or medical deduction.

When a taxpayer has no legal responsibility arising from the divorce settlement or decree to pay their spouse's legal fees, the payments are gifts and may be subject to the gift tax. However, if the divorce or separation instrument requires it, if the other spouse requests it in writing, consents to it, or ratifies it in writing, the payment may qualify as alimony.

Withholding & Estimated Tax

A credit against tax is allowed for tax *withheld by an employer* on a taxpayer's wages, even if the employer does not pay the withheld tax to the government §31(a)).

For the purpose of the credit, the recipient of the income is the person subject to the tax imposed upon the wages from which the tax was withheld. In the case of community income, since each spouse is taxable on half of the wage income, *each* spouse is also entitled to half of the credit for income tax withholding on that income (Reg. §1.31-1(a)).

Divorced or separated taxpayers will usually have to file a new Form W-4, *Employee's Withholding Allowance Certificate*, with their employer to claim their proper withholding allowances. If insufficient tax is paid, either through withholding or by making estimated tax payments, there will be an underpayment of estimated tax and a related penalty. In addition, if alimony is received, estimated tax payments may be required.

> Note: If a taxpayer does not pay enough tax by the due date of each payment, they may have to pay a penalty even if they are due a refund when they file their tax return.

Joint Estimated Tax Payments

The estimated tax provisions differ depending on whether the payments are:

(1) Separate, *or*

(2) Joint.

If one spouse makes a *separate* estimated tax payment, that payment is credited solely to the spouse making the payment, even if community property was the source of the funds (*Morris v. Commissioner*, 25 TC Memo 1248 (1966); *Janus v. U.S.*, 557 F.2d 1268 (9th Cir. 1977)).

A husband and wife may make a *joint* declaration of estimated tax even though they are not living together. However, a joint declaration may *not* be made if they are separated under a decree of divorce or of separate maintenance.

> Note: A joint declaration may not be made if the taxpayer's spouse is a nonresident alien (including a nonresident alien who is a bona fide resident of Puerto Rico during the entire taxable year) or if the spouse has a different taxable year.

If a *joint* declaration is made, the estimated income tax must be computed on the aggregate estimated taxable income of the spouses (§6013(d)(3)), while the estimated self-employment tax must be computed on the separate estimated self-employment income of each spouse (§1401; §1402; and Reg. §1.6017-1(b)(1)). Liability for the estimated tax, in the case of a joint declaration, is joint and several.

A joint declaration of estimated tax does not preclude a husband and wife from filing separate returns. Where a joint declaration is made but a *joint return* is *not* filed in the same taxable year, the estimated tax payments may be:

(1) Treated as payments on account of the tax liability of *either* the husband or wife for the taxable year, *or*

(2) Divided between them in such a manner as they may agree.

If husband and wife *fail* to agree to a division, such payments are allocated between them in accordance with the following rule:

> *The portion of such payments to be allocated to a spouse shall be that portion of the aggregate of all such payments as the amount of tax on the separate return of the taxpayer bears to the sum of the taxes shown on the separate returns of the taxpayer and their spouse (Reg. §1.6015(b)-(1)).*

In short, if the spouses cannot agree on the division of the joint estimated tax payment credit, the respective individual credits are based on the amount of tax (including self-employment tax and alternative minimum tax) each shows on their separate returns. If a taxpayer is divorced during the tax year, the same rule *should* apply.

$$\text{Individual's Estimated Tax Payment Credit} = \frac{\text{Individual's Separate Tax Liability}}{\text{Combined Tax Liabilities}} \times \text{Estimated Tax Payment}$$

When a taxpayer claims any of the payments on their tax return, enter the former spouse's social security number in the block provided on the front of Form 1040. If a taxpayer is divorced and remarries in the same tax year, enter the present spouse's social security number in that block and write the former spouse's social security number, followed by "DIV," to the left of line 56 (Form 1040).

Refunds & Deficiencies

Normally, married couples file joint income tax returns. When they do, §6013(d) imposes joint and several liability for the tax. Likewise, spouses are individually entitled to refunds from prior joint returns (R.R. 74-611).

Nonresident Alien Spouse Withholding

If a U.S. citizen or resident pays alimony to a nonresident alien spouse or former spouse, the citizen or resident taxpayer must withhold income tax at a rate of 30% (or lower treaty rate) on each payment.

Marital Property

Marital property is property acquired during a marriage by either party other than by gift or inheritance. Essentially, it is all property that is not the separate property of either spouse. Marital property is subject to "equitable distribution" or other property division.

> Note: In addition, some states treat appreciation on separate property as marital property based on active or passive events.

Marital property jurisdictions can be divided into two basic types:

(a) common-law states, *and*

(b) community property states.

Common Law Property

Traditional common law principles developed in England and came to the United States with the colonists. Under common law, marital property is divided at divorce according to who has legal title to the property. The court can divide only property jointly owned by a couple. Earnings belong to the spouse who earned the income.

Note: At the time of this writing, only one state - Mississippi - is a strict common law jurisdiction.

Equitable Distribution

In common law states with equitable distribution, assets and earnings accumulated during *long-term* marriages are divided equitably (i.e., fairly) at divorce. As a result of this concept, marital property is all property, regardless of how it is titled, that isn't the separate property of either spouse.

Note: Most common-law states, have adopted a concept of equitable distribution for long-term marriages.

While equitable should mean equal, in practice, equitable often means that as much as 2/3 of the property goes to the higher wage earner and as little as 1/3 goes to the lower (or non) wage earner. However, some equitable distribution states require the "guilty" spouse to receive less than a full share of the marital property upon divorce.

Note: Forty states follow equitable distribution principles.

Community Property

In community property states, each spouse has a present vested equal (50%) interest in the marital property. Separate property can become community through:

(a) commingling,

(b) moving to a community property state, *or*

(c) transmutation.

When a taxpayer's domicile (permanent legal home) is in a community property state during any part of a tax year, special rules determine income. One-half of any income described by state law as community income is included in each spouse's gross income (*Poe v. Seaborn*, 282 US 101 (1930, S. Ct.)).

Community property rules present problems in determining wages, salary, and other income when the spouses are living apart or going through a divorce. While state laws vary, community property generally includes all property acquired by either spouse during their marriage other than by gift, devise, or bequest. Thus, income earned by a spouse is community property.

Income from community property is also community property. However, states vary in their treatment of income earned from separate property. Some deem it community - others hold it to be separate.

Community Property States

The following are community property states:

(1) Arizona,

(2) California,
(3) Idaho,
(4) Louisiana,
(5) Nevada,
(6) New Mexico,
(7) Texas,
(8) Washington, *and*
(9) Wisconsin.

A good understanding of community property laws is imperative when determining taxable income belonging on separate returns. The attorney will also use it when determining which property will go to which spouse. Normally it is up to the attorney and the court to determine which income is community and separate, but it is helpful to have a good understanding of what to expect in the settlement.

Federal law looks to state law to determine what is community property. Thus, community property rules may vary based on the location of the taxpayer's domicile (§66(d)(2)).

Community property is property that is acquired during a marriage. It is owned one-half by each spouse. However, couples can have premarital separate property agreements. If a couple has a separate property agreement and keeps the property separate, it should not become community property. Couples can also have postmarital separate property agreements. When a married couple enters into a separate property agreement, the community ceases and future property will not be treated as community property provided it is kept separate.

> Note: Although there could be some good tax planning reasons to create separate property, there are numerous other legal ramifications to changing assets to or from community property.

Generally, property brought into the marriage is not considered community property although it can become community property if it is not kept separate.

Example

When Dan and Mary Lee were married. Dan owned an apartment building with equity of $75,000 and had $25,000 in the bank. Mary Lee owned a home with $50,000 equity and had $50,000 in the bank. Initially, they kept their bank accounts separate, and Dan deposited his rent checks and paid all expenses using his separate account. However, later, they decided it would be best to have both names on all their as-

sets. Dan quitclaimed one-half of the property to Mary Lee, thus gifting her one-half. Mary Lee quitclaimed one-half of her property to Dan. They made all the bank accounts joint accounts and use these accounts to deposit their paychecks and to pay joint expenses. Dan and Mary Lee now have no separate property. All of their property is community property.

Transmutation

Sometimes couples that own property will convert the title from one spouse's sole name or from joint tenancy to "Husband and Wife as Community Property." This is often done for estate planning and probate avoidance purposes. By changing the title to "Husband and Wife as Community Property" you have effectively given the other spouse one-half interest in the property. In the previous example of Dan and Mary Lee, if they were to divorce after they had changed title to the properties, in a divorce settlement all their assets would probably be considered community property. Always seek legal advice when changing title to property.

Commingling

If a taxpayer has a separate account and puts community funds or separate funds of the other spouse into the account, it can become community

property. In the previous example, Dan and Mary Lee created community property out of their separate bank accounts because they commingled the funds.

If the taxpayers create a living trust and put separate property into the family trust, separate property becomes community property unless a clause is included in the living trust that designates that deeding the separate property does not change its character.

If community funds are used to maintain separate property, that property can become partially community property. In a divorce settlement, the non-owner spouse will often receive a reimbursement. This is a reimbursement for the increase in the value of the property due to the non-owner spouse's share of payment of the principal.

If a spouse owns a business as sole and separate property and does not take a "competitive salary" from the business, a portion of the increase in

fair market value of the business can become community. Normally, if a competitive salary is taken out of the business, the business will remain separate property provided it is neither commingled nor transmuted.

Typically, the community ends when the husband and wife separate with no intention of reuniting. It is not necessary to be legally separated or to have filed for separation or divorce. In some states, the community does not end until a taxpayer is legally separated or divorced.

Example

Dan and Jane have been married for 10 years. On January 1, after a particularly dreary New Year's Eve, they decide to separate. Dan moves out on February 1. Both Dan and Jane are employed. Their income from wages is no longer community property beginning January 1 - the point at which they decided to separate.

Spouses may also enter into a postmarital separate property agreement, thus making their Income separate property from that point on. A postmarital agreement may also state that previous assets are community or not community. However, once separate funds are established, they can become community by commingling or transmutation.

Review Questions

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17. Formerly, taxpayers could deduct selected divorce expenses. However, currently, fees paid to a lawyer for associated tax advice:

a. are deductible under §265.

b. are not deductible.

c. must be amortized.

d. are deductible as a cost of settlement.

18. In some divorces, taxpayers must, unfortunately, use their own funds to collect court-ordered child support. How are such costs and fees for collection treated?

a. as deductible subject to an AGI limitation.

b. as nondeductible personal expenses.

c. as a deductible expense for the production of income.

d. as support under the definition of "qualified child."

19. Spouses may file separate returns and make a joint declaration of estimated tax. However, if the spouses are unable to agree to a division of the estimated tax payments, what happens?

a. The payments are treated as if they were a result of the tax liability of the higher-paid spouse.

b. The individual credits are determined according to the tax amount found on their returns.

c. The joint declaration is dismissed.

d. The payment is credited only to one spouse.

20. Which of the following statements about marital property is NOT correct?

a. Marital property can include assets acquired by either spouse during the marriage.

b. Property received as a gift during the marriage is always considered marital property.

c. Marital property can be subject to equitable distribution in the event of a divorce.

d. Inherited assets are generally not considered marital property.

21. Married couples may want to change the title of certain property to "Husband and Wife as Community Property." What does this title change do?

a. commingles their property.

b. establishes a community property agreement.

c. generates a taxable gift.

d. transmutes the property.

22. If a spouse owns a business as their separate property, they may or may not take a competitive salary. When a spouse does take a competitive salary what should be the result in a community property jurisdiction?

a. Part of any increase in a business's fair market value can become community property.

b. The business becomes community property, however, compensation remains separate.

c. The business becomes community property.

d. The business remains separate property unless it was commingled or transmuted.

Income Reporting

Taxpayers who file joint returns must include all income from both spouses on the return. If taxpayers elect to file separate federal returns, the community property income should be equally divided. Separate income should be allocated to the spouse to whom it belongs. Deductions should be split in the same manner. Withholding should also be allocated in the same manner as wages.

If a couple has net operating losses or carryover credits at the divorce, they should be divided between the spouses based on the character of the original transaction. For example, if all the couple's income and expenses were community, the credits, and net operating losses should be divided that way.

In this age of computers, the IRS will be looking for income under the social security number to which it has been reported. Thus, it is best to determine where the computer will look for the income, report it there, and adjust the difference. Here are some suggestions:

1. Include wages, interest, dividends, pensions, and any other source of income reported under that social security number on the appropriate line of the tax return.

2. Schedule C income and partnership income that is subject to self-employment tax should be reported entirely on the tax return of the

earning spouse. The earning spouse will pay 100% of the self-employment tax on that income. Although there are no regulations or rulings on the issue of who takes the deduction for self-employment tax, it would seem that the deduction should be split in the same manner as the income. Although, it could be argued that the deduction should be split or not split depending on when the social security tax was paid, and if it was paid from community funds or was paid from separate funds.

3. Attach a "splitting statement" to the return and make an adjustment on the Other Income line of the return. If there is to be a division of home mortgage interest on Schedule A, the spouse whose social security number does not appear on Form 1098 should include the amount on the line for mortgage paid to individuals with an explanation.

> Note: Withholding should be split in the same manner as wages. Identify the withholding on the splitting statement. Identify on the return the amount that you have allocated to each spouse with large * or NOTE.

Spouses with Different Residency Statuses

It is becoming more and more common for married couples to live in different states because of their employment. These situations provide a whole new complexity when filing tax returns.

When spouses are residents of different states, the state law of each spouse's state determines the taxation of the income. The income of the spouse who is a resident of a community property state is community property. The income of the spouse who is domiciled in and a resident of another state is also community income if that state is a community property state. However, it is separate property if the other state is a separate property state.

Special Income Rules For Spouses Living Apart - §66(a) & §879

Relief is provided to spouses living apart who would be taxed on a portion of the community income earned by the other spouse. Under these rules, spouses who live apart all year may treat community or joint income as separate income.

Section 66(a) provides special community income allocation rules that apply when the taxpayer and/or their spouse:

(1) Are married at *anytime* during the calendar year;

(2) Live apart *all* year;

(3) Do *not* file a joint return for a tax year beginning or ending in the calendar year;

(4) Have earned income for the calendar year that is community income; *and*

(5) Have *not* transferred, directly or indirectly, any of the earned income in item (4) between themselves before the end of the year[4].

When a taxpayer and their spouse are separated but do not meet the five conditions discussed above, they must treat their income according to the laws of their state. State law determines whether their income is separate or community income.

Mandatory Application

If *all* of these conditions exist, the taxpayer and their spouse *must* report their community income as explained in the following sections.

Note: The requirements of §66(a) are so restrictive that they are rarely used during a divorce. Maintenance, spousal support, and other payments often require that transfers of community property take place. However, de minimis transfers are not taken into account in determining whether any portion of the earned income is transferred between spouses. Likewise, a transfer for the benefit of a dependent child is not treated as an indirect transfer (S Rept No. 96-1036 (PL 96-605) p. 8).

Earned Income

Treat earned income that is *not* trade, business, or partnership income as the income of the spouse who performed the services to earn the income (§66(a); §879(a)). Earned income is wages, salaries, professional fees, and other compensation for personal services.

Earned income does not include amounts paid by a corporation that are a distribution of earnings and profits rather than a reasonable allowance for personal services rendered.

Trade or Business Income

Treat income and related deductions from a trade or business that is *not* a partnership as those of the spouse carrying on the trade or business (§879(a)(2)).

If capital investment and personal services are combined to produce business income, treat all of the income as trade or business income.

[4] Do not take into account transfers satisfying child support obligations or transfers of very small amounts or value.

Partnership Income or Loss

Treat income or loss from a trade or business carried on by a partnership as the income or loss of the spouse who is the partner (§879(a)(2)).

Separate Property Income

Treat investment income from the separate property of one spouse as the income of that spouse (§879(a)(3)).

Social Security Benefits

Treat social security and equivalent railroad retirement benefits as the income of the spouse who receives the benefits.

Other Income

Treat all other community income, such as dividends, interest, rents, royalties, or gains, as provided under state community property law (§879(a)(4)).

Example

Dan and Althea were married throughout the year but did not live together at any time during the year. Both were domiciled in a community property state. They did not file a joint return or transfer any of their earned income between themselves. During the year their incomes were as follows:

	Dan	*Althea*
Wages	*$20,000*	*$22,000*
Consulting business	*5,000*	
Partnership		*10,000*
Dividends from separate property	*1,000*	*2,000*
Interest from community property	*500*	*500*
Totals	$26,500	$34,500

Under the community property law of their state, all the income is considered community income. (Some states treat income from separate property as separate income—check your state law.) Althea did not take part in Dan's consulting business.

Ordinarily, they would each report $30,500, half the total community income, on their separate returns. But because they meet the four conditions discussed earlier, they must disregard community property law in reporting all their income except the interest income from community property. They each report on their returns only their own earnings and other

income, and their share of the interest income from community property. Dan reports $26,500 and Althea reports $34,500.

Denial of Community Property Reporting - §66(b)

The IRS may disallow the benefits of any community property law to a taxpayer with respect to any income if such taxpayer acted as if they were solely entitled to the community income and failed to notify their spouse before the return due date (including extensions) of the nature and amount of such income (§66(b)).

Note: Congress has not provided standards for the IRS to use in determining whether the benefits of community property law may be denied.

The earner spouse must notify the non-earner spouse of the income that should have been reported on that taxpayer's return prior to the due date of the return, including extensions (§66(b)). Unfortunately, it is almost never easy to get a couple that is divorcing and filing separate returns to agree to disclose the information needed. If an estimate is made, attach a statement to the return explaining how and why you used the numbers that you used.

In many cases, the taxpayers who are separated do not know how much income the other spouse earned. In these instances, a little detective work and puzzle solving may be in order.

If the spouse works for wages, the taxpayer may use the prior year's return to estimate the amount of income that the taxpayer had.

If the taxpayer was self-employed, income may be estimated by:

(a) Amount of deposits put into the joint checking account during the period the spouses lived together;

Example

Dan moved out in a huff on December 26, 2018, leaving all his checking account statements. When preparing the tax return, Mary Lee (Dan's spouse) calculated the self-employment income using the bank statements.

(b) Amount of income reported by spouse on the divorce papers; *or*

Example

During the family court discovery process, Dan states that his income is $3,000 per month. It would be reasonable for Mary

Lee to include one-half of that as her income for the period they lived together.

(c) Amount of income needed to pay expenses of the household that were not paid by the spouse whose return you are preparing.

Example

Jane refuses to tell her husband Dan how much income she earned from her gardening business. The previous year Jane and Dan's tax return showed a $50,000 net profit from Jane's plant business. Dan and Jane separated on July 1. Up until that time, Jane paid all the household expenses. Dan had a part-time job and most of his income went to pay for expenses for their children and vacations for the family. Their mortgage payment was $3,000 per month; utilities $300; food $600; and misc. $200. It would be reasonable to assume that Jane's net income from self-employment was $4,100 per month. One-half of that would be taxable to Dan for each month that they lived together.

Community Reporting Relief Provisions - §66(c)

Section 66(c) is designed to provide spouses greater relief than that provided by §66(a) and §879 from community property reporting when one spouse does not receive the benefit of community earnings. Under §66(c), a married taxpayer who:

(1) Does not file a joint return (§66(c)(1)),

(2) Omits from their gross income an item of community income (§66(c)(2)),

(3) Establishes that they did not know of, and had no reason to know of, such item of community income (§66(c)(3)), *and*

Note: Meeting this standard is difficult. The taxpayer must prove they (i) did not know and (ii) had no reason to know of the omitted community income. A claim that the specific amount of the unreported community income was not known by the taxpayer is irrelevant (*Roberts*, 860 F 2d 1235 (5th Cir., 1988)).

(4) Taking into account all facts and circumstances, it is inequitable[5] to include such an item of community income in such taxpayer's gross income (§66(c)(4))

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[5] In determining whether it would be inequitable to include the item in the gross income of the spouse lacking knowledge, the determination may include whether that spouse benefited from the untaxed income, and whether the defense was promptly raised to prevent the statute of limi-

is relieved from income tax liability on such omitted income. Thus, when all four conditions are met, such an item of community income shall be included in the gross income of the *other* spouse (and not in the gross income of the taxpayer).

Ending the Community

In some states, income earned after separation but before a final decree of divorce continues to be community income. In other states, it is separate income. In some states, the spouses may agree that any income earned by either of them for personal services is his or her separate income rather than community income.

> Note: While a pre- or postmarital agreement can classify income as community or separate, such agreements are prospective only in effect (*Schmitz*, 46 TCM 1091 (1983)). Thus, income received prior to such an agreement cannot be later recharacterized.

When the marital community is ended, the community assets (money and property) are divided between the spouses. Income received before the community ends is treated according to the rules explained earlier. Income received after the community ends is separate income, taxable only to the spouse to whom it belongs.

> Note: Under California law, the earnings and accumulations of a spouse while living separately and apart are the separate property of that spouse (Civil Code §5118).

Annulment

An absolute decree of divorce or annulment ends the community in all community property states. A decree of annulment, even though it holds that no valid marriage ever existed, usually does not nullify community property rights arising during the "marriage." However, state law should be checked for exceptions.

Separation

A decree of legal separation or separate maintenance may or may not end the community[6]. The court issuing the decree may terminate the community and divide the property between the spouses.

A separation agreement may divide the community property between the spouses. It may provide that this property, along with future earnings and

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tations from running on the other spouse (H.R. Rept. No. 98-432 (PL 98-369) pp. 1502 through 1503).

[6] A final judgment of separation from bed and board or separation of property also ends the community in Louisiana.

property acquired will be separate property. Such an agreement may end the community. In some states, the community ends when the spouses permanently separate, even if there is no formal agreement.

Example

Dan and Jane were domiciled in a community property state for the whole year. Under state law, all earned income of the spouses is community income until they get a final decree of divorce.

Dan and Jane separated on March 15 and got a final decree of divorce on September 15. Dan was employed all year, but Jane began working only after the separation. Their gross wages were:

Payday	Dan	Jane
1/10	$2,000	
2/10	2,000	
3/10	2,000	
4/10	2,000	$626
5/10	2,000	1,250
6/10	2,000	1,250
7/10	2,000	1,250
8/10	2,250	1,250
9/10	2,250	1,250
10/10	2,250	1,250
11/10	2,250	1,250
12/10	2,250	1,250
Totals	$25,250	$10,626

These totals are shown on Dan's and Jane's Forms W-2 for the year. However, these are not the amounts they enter on their tax returns as wages. The correct amounts are as follows:

Dan's wages before 9/15	$18,500
Jane's wages before 9/15	6,876
Total community earnings	$25,376
Half community earnings	$12,688
Dan's wages after 9/14	6,750
Amount Dan reports	$19,438
Half community earnings	$12,688
Jane's wages after 9/14	3,750

Amount Jane reports	$16,438

Dan and Jane each take credit for one-half of the income tax withheld from their wages before September 15.

Both Dan and Jane should attach to their return a statement showing how they figured the amount they entered on the return and why it is different from the amount on their Forms W-2.

If state law provided that earned income was community income until the date of separation, Dan would enter on his return $22,250 gross wages, and Jane would report $13,626 gross wages.

Pre-2019 Alimony vs. Community Income

Payments that may otherwise qualify as pre-2019 alimony are not deductible by the payer if they are the recipient spouse's part of community income. They are deductible as pre-2019 alimony only to the extent they are *more than* that spouse's part of community income.

Pre-2019 Example

Dan lives in a community property state. He is separated and his spouse has no income. Under a written agreement, Dan pays his spouse $12,000 of his $20,000 total yearly community income. Under state law, earnings of a spouse living separate and apart from the other spouse continue as community property. On his or her separate returns, each spouse must report $10,000 gross income (half of the total community income). In addition, Dan's spouse must report $2,000 as alimony received on line 11 of Form 1040. Dan can deduct $2,000 as alimony paid on line 31a Form 1040, Schedule 1.

Living Together

In order to file as "married filing jointly," a couple must be legally married. Marital status for federal income tax purposes is determined by reference to *state* law (R.R. 58-66). If the marriage is valid under state law, it is recognized for federal income tax purposes.

Note: A few states have provisions for common law marriages but such cases are rare.

A couple is not deemed husband and wife for joint return purposes if their marriage was void under applicable state law (*John Untermann*, (1962) 38 TC 93). However, the IRS will not deny married status because of state *antimiscegenation*

statutes forbidding marriage between persons of different races, since such statutes have been held unconstitutional by the Supreme Court (R.R. 68-277).

Married v. Unmarried Tax Rate Comparison

Working couples with *similar* incomes will often find a tax advantage in *not* marrying. Obviously, this will vary greatly with the individual or couple and will depend on many other tax variables, but there is a "marriage penalty" under federal income tax for many couples. On the other hand, couples with only *one* income, or with widely *differing* incomes, will often find it tax advantageous to *be* married.

Sham Divorce

While it is legal to divorce and continue to live together to qualify for lower tax rates (PLR 7835076), the IRS has ruled that a married couple can't save income taxes by getting a year-end divorce in order to file as single individuals and then *remarry* each other early in the next year (R.R. 76-255). Such a year-end divorce (even if jurisdictionally valid) will be disregarded as a sham.

Dependency Exemptions

Section 152 basically defines dependents as:

(i) Close relatives or *unrelated* persons,

(ii) Who live in the taxpayer's household as their principal abode, *and*

(iii) Are supported by the taxpayer.

As a result, it may have been possible to claim a person living with the taxpayer as a dependent and get an exemption. However, from 2018 through 2025, the TCJA now suspends (eliminates) personal and dependency exemptions.

Attributable Income

If I agree to scratch your back in return for you scratching mine, theoretically, both of us have income. Likewise, when one person contracts with another (either orally or in writing) for services (e.g., housekeeping services), the result is income. Thus, in a living together situation, it is technically possible for the supporting partner to have income for the receipt of services.

Courts may determine whether there was a contract and the nature of the contract by examining the conduct of the parties within the relationship (*Marvin v. Marvin*, 18 Cal. 3d 660 (1976)). However, the contract *cannot* be for *meretricious sexual services*.

Moreover, the transfer will not be a gift. A payment is not an income-tax-free gift unless it is made without consideration. If the payment is given in exchange

for services or any other valuable consideration, it is not a gift (*Commissioner v. Duberstein*, 363 US 278 (1960, S. Ct.)).

Alimony & Property Divisions

Alimony is a creature of divorce laws and is only available to married couples. Likewise, marital property laws do not apply to unmarried couples. However, unmarried couples can contract (oral or in writing) for support payments and property rights.

A leading California case in this area is *Marvin v. Marvin*, 18 Cal. 3d 660 (1976). The *Marvin* case held that:

(1) Unmarried couples may make oral or written contracts;

(2) The fact that couples live together without marriage, and engage in a sexual relationship, does not invalidate such contracts;

(3) Contracts between non-marital partners fail only to the extent that they rest upon a consideration of meretricious sexual services; *and*

(4) Where no written or oral contract exists, the court may examine the couple's life and decide whether an implied contract exists.

Review Questions

Under NASBA-AICPA self study standards, self study sponsors are required to present review questions intermittently throughout each self-study course. The following questions are designed to meet those requirements and increase the benefit of the materials. However, they do not have to be completed to receive any credit you may be seeking with regard to the text. Nevertheless, they may help you to prepare for any final exam.

Short explanations for both correct and incorrect answers are given after the list of questions. We recommend that you answer each of the following questions and then compare your answers. For more detailed explanations and references, you may do an electronic search using Ctrl+F (if you are viewing this course on computer), consult the text Index, or review the general Glossary.

23. When spouses in a community property jurisdiction decide to file separate returns, the author gives selected rules for correct reporting. What is one of those rules?

a. all deductions should be allocated equally.

b. separate income should be allocated pro-rata.

c. withholding should be divided based on each spouse's actual wage.

d. community income should be equally divided.

24. If spouses live in different states due to work commitments and one is a resident of California (a community property state), while the other is a resident of New York (a separate property state). How would their income be classified for tax purposes?

a. All of the couple's income would be considered community property.

b One's income would be community property, while the other's income would be separate property.

c Both spouses' income would be considered separate property.

d. All of the couple's income would be considered separate property

25. Five requirements exist for the application of §66(a)'s special community income allocation rules. What is one of these requirements?

a. Spouses are married for the whole calendar year.

b. Spouses file jointly for a tax year beginning or ending in the calendar year.

c. Spouses have community income from income that was earned by at least one of the spouses.

d. Spouses live apart the majority of the calendar year.

26. Under what circumstances can the IRS disallow the benefits of community property law to a taxpayer regarding their income?

a. When the taxpayer files their tax return late without requesting an extension.

b. When the taxpayer lives in a separate property state but claims community property benefits.

c. When the taxpayer's spouse refuses to sign a joint tax return.

d. When the taxpayer acts as if they were solely entitled to the community income and fails to notify their spouse before the return due date (including.

27. The rules regarding the termination of a community that are applied in each community property state vary. However, in all community states, what terminates a community?

a. a separation agreement.

b. a decree of separate maintenance.

c. when the spouses decide to end the community.

d. an annulment.

28. Which of the following statements about separation agreements and community property is NOT correct?

a. A separation agreement can divide existing community property between spouses.

b. A separation agreement can stipulate that future earnings and property acquired will be considered separate property.

c. In all states, the community automatically ends when spouses permanently separate, regardless of whether there's a formal agreement.

d. A separation agreement has the potential to end the community property arrangement between spouses.

29. A marriage must be legal in order for couples to file jointly. For federal income tax purposes, how is marital status first tentatively determined?

a. according to federal law.

b. according to local law.

c. according to state law.

d. according to Supreme Court decisions.

30. *Marvin v. Marvin* was a case in California that dealt with property and other rights between couples that live together. What was one of the conclusions of this case?

a. A contract is valid even if "payment" is made by any meretricious service.

b. If unmarried couples fail to create a contract for support or property divisions, all property is deemed separate.

c. Oral or written contracts between unmarried partners may be made.

d. The acts of living together and participating in a sexual relationship themselves invalidate any service contract.

Learning Objectives

After reading Chapter 2, participants will be able to:

1. Identify types of marital property and their likely division in marital property settlements and specify the legal principles used in dividing assets and providing support on divorce or separation.

2. Determine the benefits of premarital agreements and the requirements and permissible provisions for a valid and comprehensive agreement under the Uniform Premarital Act.

3. Specify the position of *U.S. v. Davis* on interspousal transfers and the changes made by §1041, and identify the requirements of §1041 and the scope of its application.

4. Select factors that determine whether a property transfer is incident to divorce and identify how to meet these factors or avoid §1041 altogether when desired.

5. Determine the application of §1041 to transfers in trust under §1041(e) and to third-party transfers on behalf of a spouse or former spouse.

6. Recognize deferred tax liability by identifying property basis for the transferor spouse and transferee spouse under §1041 after a property settlement.

7. Specify the application of §1041 to property transfers where the transferee assumes liabilities encumbering the property, and the obligation to supply basis information.

8. Recognize the dangers of purchasing a former spouse's interest in property, particularly a marital residence and its tendency to create deferred tax liability.

9. Determine tax effects of purchasing an interest in personal or real property used in a business or held for investment, recognize potential recapture and identify the use of a §1031 exchange to dispose of low-basis property received in a §1041 transfer.

10. Specify common disposition alternatives available on divorce and identify the home sale exclusion requirements and the tax treatment and use of installment obligations under §453 in divorce.

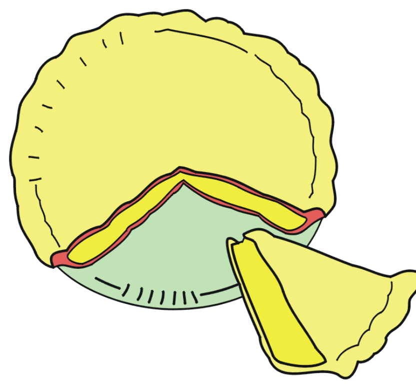
11. Recognize sale, redemption, recapitalization, liquidation, and third-party transfers as methods of dividing a business in a marital settlement citing unique provisions under §302, §736, and §754.

12. Identify whether gain or loss on a sale of real or personal property is capital or ordinary and, recognize the tax treatment of such gain or loss and the role and tax treatment of life insurance in property settlements.

13. Specify popular methods of dividing private and military retirement benefits in a divorce or separation action identifying the requirements and tax consequences of a "qualified domestic relations order (QDRO).

CHAPTER 2

Transfers Incident to Divorce



Property Rights

Before beginning a property settlement, the parties must know what property is owned separately and what property is marital. State laws obviously differ as to the legal relationship between and liabilities of spouses. While the specific property laws of each state vary, the following rules can be used as general legal principles.

Marital Property

Married couples accumulate property, called marital property. However, marital property will take various forms depending on state law.

Common Law Property

Traditional common law principles developed in England and came to the United States with the colonists. Under common law, marital property is divided at divorce according to who has legal title to the property. The court can divide only property jointly owned by a couple. Earnings belong to the spouse who earned the income.

Note: At the time of this writing, only one state - Mississippi - is a strict common law jurisdiction.

Community Property

In a community property state, all earnings during marriage and all property acquired with those earnings are community property. In divorce, community property is divided equally between the spouses. However, in some community property states, a spouse deemed at fault in ending the marriage may be awarded less than 50% of the community property.

Note: There are currently nine community property states - Arizona, California, Idaho, Louisiana, Nevada, New Mexico, Texas, Washington, and Wisconsin.

Equitable Distribution

In equitable distribution states, assets and earnings accumulated during marriage are divided equitably (i.e., fairly) at divorce. While equitable should mean equal, in practice, equitable often means that as much as 2/3 of the property goes to the higher wage earner and as little as 1/3 goes to the lower (or non) wage earner. However, some equitable distribution states require the "guilty" spouse to receive less than a full share of the marital property upon divorce.

Note: Forty states follow equitable distribution principles.

Separate Property

All states permit a married person to treat certain earnings and assets as separate property. On divorce, this separate property is not divided but is kept by the spouse who owns it. In the equitable distribution states, separate property includes:

(1) Property acquired by a spouse before marriage;

(2) Property received in exchange for separate property;

(3) Compensation for personal injury;

(4) Gifts made to only one spouse; *and*

(5) Inheritances obtained by only one spouse.

Community property states typically treat as separate property:

(1) Property acquired before marriage;

(2) Property received in exchange for separate property;

(3) Compensation for personal injury;

(4) Property acquired during marriage with *premarital* earnings or with the proceeds of the sale of *premarital* property;

(5) Gifts made to only one spouse;

(6) Inheritances obtained by only one spouse; *and*

(7) Property acquired after separation.

Note: In both community property and equitable distribution states, the separate property of a spouse remains separate property unless mixed with marital property or the other spouse's separate property. However, appreciation of separate property may be considered marital property, especially if the spouse's efforts contributed to the appreciation.

Under strict common law, all property is the separate property of the acquiring spouse unless a title document shows otherwise. Earnings are a spouse's separate property, and assets acquired with those earnings are not divided on divorce unless they've been commingled with jointly owned property or the property of the other spouse.

Asset Division Principles

Several general principles seem to guide courts in the division of assets and provision of support on divorce or separation:

(1) Need,

Note: A spouse should be supported sufficiently to remain off public welfare that is a saving to all taxpayers. However, support should end when the need ends.

(2) Training and rehabilitation,

Note: If a spouse lacks the necessary skills to be self-sufficient, assets and funds should be provided for training and rehabilitation. Such payments should be of short duration with a fixed termination date to encourage the recipient to enter the job market.

(3) Contribution,

Note: Ideally, a marriage is an economic partnership to which each spouse contributes, although one may contribute services rather than income. Section 307 of the Uniform Marriage and Divorce Act provides that in allocating property and awarding alimony, "the contribution of the spouse as a homemaker of the family unit" should be considered. On divorce, such services may need to be valued.

(4) Fault, *and*

Note: Fault allocates assets to punish the spouse that caused the divorce. While no-fault divorce statutes predominate, even in California, where no-fault divorce started, fault is admissible in child custody cases.

(5) Status.

Note: This principle applies a standard of living test. It presumes that a spouse should be able to maintain a similar standard of living when the marriage terminates. However, the standard is the one that prevailed during the marriage and should not encompass the post-divorce success of the other former spouse.

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31. Certain issues must be determined before dividing up property between spouses in a divorce. Which of the following is most important for the parties to know about property?

    a. which property is encumbered and which is free and clear.

    b. which property is separate property and which is marital property.

    c. which property is real estate property and which is personal property.

    d. which property is tangible property and which is intangible property.

32. Marital property rights depend on the state in which the taxpayer resides. For example, in Nevada, what would initially be considered separate property?

    a. property received by both spouses as an inheritance.

    b. property received as a gift to both spouses.

    c. property obtained in exchange for community property.

    d. property obtained by a spouse prior to marriage.

33. In some instances, property is deemed separate in both equitable distribution states and community property states. Which of the following is most likely separate property in both types of states?

    a. payment for personal injury.

    b. property obtained after separation.

c. property obtained during the marriage using premarital earnings.

d. property obtained during the marriage using sales proceeds premarital property.

34. In the author's opinion, U.S. courts use five main principles in dividing assets between spouses. Which of these principles is sometimes used in child custody cases but disregarded in such asset divisions?

a. need.

b. contribution.

c. fault.

d. status.

Premarital Agreements

A premarital agreement is a contract between prospective spouses that changes or limits what would otherwise have been the law governing the ownership of property in the marital relationship, especially upon death or divorce. Anticipating the economic and emotional problems of a potential divorce, premarital agreements are increasingly popular.

Historically, such agreements were void, as against public policy, because they supposedly promoted divorce. Now, most states view such agreements differently. States such as California, Colorado, Illinois, Indiana, Iowa, Kentucky, Minnesota, Ohio, Oklahoma, Oregon, and Washington approve of premarital agreements *when* restricted to property rights only.

Uses & Benefits

Premarital agreements can be used:

(1) To protect the wealth of one spouse against access by the other spouse upon death or divorce;

(2) To protect the inheritance rights of children of prior marriages;

(3) To protect a spouse who is surrendering financial security by marrying (e.g., giving up alimony or trust income);

(4) To ensure that laws, as they exist in the marital state, will govern in event of divorce (rather than revised laws, or laws of another state or country);

(5) To protect the control, management, and ownership of a family business from the prospective spouse and his or her legatees; *and*

(6) To clarify the separate or marital property nature of certain assets, such as professional degrees and licenses, professional goodwill and reputation, creative works in progress, etc.

Premarital agreements can have additional benefits:

(1) The parties have the opportunity to express their expectations regarding the marriage, both explicit and hidden;

Note: These may include religious values, male and female roles, and attitudes toward work and recreation.

(2) The premarital agreement can be used to smooth the way for future discussions in the course of the marriage; *and*

Note: Expressing concerns now gives the parties the opportunity to enhance their relationship.

(3) In the course of developing the agreement, many issues are resolved, avoiding intense arguments later.

Control & Scope

Typically, a premarital agreement can (and should) have provisions dealing with the following property, income, and rights:

(1) Property owned at the date of prospective marriage,

Note: Section 2523(a) provides an unlimited marital deduction for gifts during marriage. No transfer should be made or required to be made under the premarital agreement before marriage, or the gift will be taxable.

(2) Property acquired during marriage,

(3) Income from services and property owned at the date of marriage and acquired later,

(4) Gifts and will provisions between the spouses and others,

Note: Transfers on death required by a premarital agreement will qualify for the unlimited marital deduction under §2056.

(5) Support of spouse during and after marriage,

(6) The spouse's right to elect to take against the will, *and*

Note: A non-qualified terminable interest required by a premarital agreement may be deducted as a claim against the estate under §2053 to the extent it is in satisfaction of the spouse's support rights.

(7) Appreciation of property during the marriage.

Limitations

A premarital agreement cannot:

(a) Limit a child's right to support,

Note: In most states, the agreement must not limit the rights of either spouse to adequate support. But provisions limiting support will generally not be deemed invalid if they take into account the adequacy of the spouse's means of support, or if the support obligation is subject to increase or decrease as conditions change.

(b) Violate public policy, *or*

Note: The agreement must not encourage divorce. It has generally been found that terms providing for earnings to remain separate, waivers of inheritance rights, and guaranteed minimum periods of support do not promote dissolution.

(c) Waive rights under the Retirement Equity Act of 1984.

Retirement Equity Act of 1984

The Retirement Equity Act of 1984 provides that certain rights in retirement benefits cannot be waived in a premarital agreement. Under the REA '84, the surviving spouse has an independent right to a survivor benefit in a qualified retirement plan separate and apart from their marital property rights in the plan.

The REA '84 establishes the following rules:

(i) A waiver of a joint and survivor annuity must be made within 90 days of the participant's spouse's annuity starting date;

(ii) A preretirement survivor annuity must be waived on or after the first day of the retirement plan year in which the participant spouse attains age 35; *and*

(iii) 90 days prior, a non-participant spouse must consent to any loans from the retirement plan;

A clause in the premarital agreement stating that the pension is entirely the property of the participant spouse will not extinguish the non-participant spouse's right to a spousal annuity. To be effective, a waiver must be:

(i) Made by written consent of the spouse,

(ii) With specific language acknowledging the impact of the consent,

(iii) Notarized and witnessed, *and*

(iv) Executed within the statutory election period.

The premarital agreement may provide that the non-participant spouse will waive spousal benefits and execute the necessary waiver at the required time, upon the request of the participant spouse.

Note: For added protection, include a clause stating that if the participant spouse fails to request the waiver, or if the waiver is ineffective for any other reason and the non-participant spouse receives benefits, the non-participant spouse agrees to pay those benefits over to the beneficiary designated by the participant spouse.

Enforceability Requirements

In general, premarital agreements must:

(1) Disclose each party's financial condition;

Note: Financial statements should be attached to the agreement as an exhibit. Each spouse should also make a positive affirmation as to knowledge of the other spouse's financial condition.

(2) Be signed voluntarily with informed consent;

Note: Attorneys for each spouse should review the agreement. Dual representation by one attorney can give rise to a presumption of undue influence. Provide adequate time for consideration and review of the agreement. Avoid "Wagner Agreements" that are executed while the wedding music is playing.

(3) Not be unconscionable (one which no person in his or her senses would make, and which no fair and honest person would accept); *and*

Note: Disclosure, waiver of disclosure, or independent knowledge of the financial condition of the other party is sufficient to permit enforcement of an egregiously one-sided agreement under the Uniform Premarital Agreement Act. The burden of proof is on the contesting party.

(4) Must be in writing.

Note: The agreement may require acknowledgment and attorney certification.

Rescission may be oral in accordance with general contract principles and may be confirmed by actions not in accordance with the agreement (e.g., taking property in both names or commingling marital and separate property if contravention to terms of the agreement).

Checklist

The following is a checklist of suggestions and observations to be reviewed before entering into a premarital agreement:

(1) The provisions should apply to both parties;

Example: If his property is to remain separate, hers should not become community. If one spouse's earnings are to remain separate, the other spouse's earnings should also remain separate.

(2) There should be full disclosure of all assets and liabilities;

Note: Attach documentation, with current values. Contingent rights to trust funds and other assets should be disclosed.

(3) The agreement should not encourage divorce (e.g., she will have no rights in any property except upon divorce);

Note: Consider a formula that increases benefits according to the length of the marriage (but beware of cliff vesting).

(4) There should be adequate time for each party to review the document and consult with attorneys;

Note: The attorney for the monied spouse-to-be should not represent both parties and should not recommend an attorney for the other prospective spouse.

(5) There should be no provision limiting support for children (and in some states the spouse);

Note: This may invalidate the entire agreement as being against public policy. At the very least, specifically state that should the clause limiting support be invalidated, the rest of the agreement will remain enforceable.

(6) The agreement should evidence a fair exchange (e.g., the groom will keep his property separate, but will name the bride as beneficiary of a life insurance policy on his life);

Note: If a future spouse accepts the benefits of the bargain, they will have difficulty later arguing that the terms of the agreement were unjust.

(7) The signatures should be acknowledged;

Note: Signature should be notarized and witnesses should be present to verify that the parties are not under any obvious undue influence.

(8) Make sure the parties understand the agreement and have systems in place to conduct their financial affairs by the terms of the agreement, to avoid claims of waiver;

Note: Courts will be reluctant to interfere with premarital agreements, where it is clear that the parties have been living by them.

(9) Include "Anti-Palimony" or "Marvin" language;

Example: "Each of the parties releases any claim to the property of the other which may have existed prior to the parties' marriage. This agreement supersedes all other agreements between the parties, whether oral or written, express or implied."

(10) Make sure the agreement is reviewed and revised as needed;

Note: This is especially true upon the birth of children, an increase or decrease in wealth, or the disability of either spouse;

(11) Any loans from separate property to the marital unit should be documented, and signed by the other spouse; *and*

Note: Such loans will probably not be collectible since in most states such transfers would be considered to be in the nature of a gift. However, it may serve as a bargaining chip. Consider borrowing from a third party rather than from a spouse.

(12) If any loans from separate property to the marital unit are repaid, the repaid funds should not be commingled with other funds.

Note: If the loan is presumed to be a gift from the outset, then the marital property used to repay the loan will likely remain marital property, so commingling with separate property should be avoided.

Uniform Premarital Act - The California Example

California has adopted the Uniform Premarital Agreement Act (Family Code §1600, et seq.). Under the act premarital agreements:

(1) Must be in writing;

(2) Signed by both parties;

(3) Can only be amended or revoked after marriage by a written agreement;

(4) Become effective upon marriage; *and*

(5) Cannot adversely affect the rights of a child to support

Permitted Items of Agreement

Despite the above limitations, the parties are free to make an agreement as to any of the following items:

(i) The rights and obligations of each of the parties in any property (whenever and wherever acquired or located);

Note: This includes rights to buy, sell, use, transfer, exchange, abandon, lease, consume, expend, assign, create a security interest in, mortgage, encumber, dispose of, or otherwise manage and control property.

(ii) The disposition of property upon separation, marital dissolution, death, or any other event;

(iii) The making of a will, trust, or other arrangement to carry out the agreement;

(iv) The ownership of a life insurance policy and disposition of its death benefit;

(v) The state law governing the construction of the agreement; *and*

(vi) Any other matter, including their personal rights and obligations, not in violation of public policy or statute.

Unenforceable Items

Nevertheless, a premarital agreement is unenforceable if it is:

(i) Not executed voluntarily; *or*

(ii) Unconscionable *and* before signing there is:

(1) No fair and reasonable disclosure of the property or financial obligations of the other party;

(2) No written waiver to such disclosure; *and*

(3) No adequate knowledge of the property or financial obligations of the other party.

California courts historically have failed to enforce waivers of *spousal support* in premarital agreements (*Marriage of Dawley* (1976) 17 Cal. 3d 342, 131 Cal.

Rptr. 3). However, the language allowing an agreement over any matter not in violation of public policy might cover certain spousal support limitations.

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35. Despite their critics, premarital agreements have numerous benefits and uses. However, which of the following items is a limitation on premarital agreements?
    a. They cannot protect inheritance rights.
    b. They cannot clarify separate versus marital property.
    c. They cannot protect a family business.
    d. They cannot relinquish certain rights in retirement benefits.
36. A valid premarital agreement must meet at least four requirements. What is one such requirement?
    a. It must at least be implied by the conduct of the parties.
    b. There must be mutual consent to the agreement.
    c. It must highlight in bold type any one-sided provisions.
    d. It must make known the financial condition of each party.

37. A premarital agreement should be as inclusive as possible and be reviewed and detailed before being signed. In that regard, the parties should seriously consider the inclusion of:

a. a provision that limits child support.

b. treatment of any loans from separate property to the marital unit.

c. a provision indicating that any loans from separate property to the marital unit that are repaid will be commingled.

d. no provision dealing with any "Marvin" case issues.

Property Settlements

A transfer of property that is not a gift is normally a taxable event. The transferor recognizes gain or loss on the difference between:

(1) The fair market value, *and*

(2) The adjusted basis of the property.

The tax rules for property settlements were previously uncertain. The main question was whether the *U.S. v. Davis*, 370 U.S. 65 (1962) ruling applied. In this case, the Supreme Court held that a transferor of property in satisfaction of "marital rights" under a property settlement recognized gain or loss on the transfer. The Delaware law at issue was an equitable distribution statute. The Court held that the property interest conveyed by equitable distribution was not equivalent to co-ownership and, thus, not a division of property between co-owners. Under Davis, the spouse receiving the property got a basis equal to the transferred property's then fair market value, also known as a "stepped-up basis". Any gain recognized by the transferor spouse equaled the difference between the fair market value of the transferred assets and their adjusted tax bases. Thus, the transfer of appreciated property held by one spouse in exchange for the release of marital claims by the other spouse resulted in the recognition of gain to the transferor. In short, the property was deemed sold by the transferor spouse.

Such deemed sales between spouses could have had a variety of "bad" tax consequences:

1. Gain would have been treated as ordinary income if the property was subject to depreciation in the hands of the transferee (§1239); *and*

2. Gain from an installment sale of depreciable property could not have been reported on the installment sale basis (§453).

Section 1041

The passage of §1041 reversed *U.S. v. Davis*. Under §1041, *no gain or loss* is recognized on a transfer of property from an individual to (or in trust for the benefit of) a spouse, or a *former* spouse if *incident to a divorce* (§1041(a)). Nonrecognition of gain or loss treatment applies even if the transfer is in exchange for cash, the release of marital rights, the assumption of liabilities, or other consideration. In short, §1041 provides that no gain or loss is recognized on a transfer of property from an individual to:

(i) a spouse, or

(ii) a former spouse, but only if the transfer is incident to a divorce.

> Comment: The effect of §1041 is to defer the tax consequences (recognition of gain or loss) until the transferee disposes of the property. The transfer is treated as a gift and the basis of the transferee in the property is the adjusted basis of the transferor.

Code §1041

Sec. 1041. TRANSFERS OF PROPERTY BETWEEN SPOUSES OR INCIDENT TO DIVORCE.

(a) General rule. No gain or loss shall be recognized on a transfer of property from an individual to (or in trust for the benefit of) —

(1) a spouse, or

(2) a former spouse, but only if the transfer is incident to the divorce.

(b) Transfer treated as gift; transferee has transferor's basis. In the case of any transfer of property described in subsection (a) —

(1) for purposes of this subtitle, the property shall be treated as acquired by the transferee by gift, and

(2) the basis of the transferee in the property shall be the adjusted basis of the transferor.

(c) Incident to divorce. For purposes of subsection (a)(2), a transfer of property is incident to the divorce if such transfer —

(1) occurs within 1 year after the date on which the marriage ceases, or

(2) is related to the cessation of the marriage.

(d) Special rule where spouse is nonresident alien. Subsection (a) shall not apply if the spouse (or former spouse) of the individual making the transfer is a nonresident alien.

(e) Transfers in trust where liability exceeds basis. Subsection (a) shall not apply to the transfer of property in trust to the extent that —

(1) the sum of the amount of the liabilities assumed, plus the amount of the liabilities to which the property is subject, exceeds

(2) the total of the adjusted basis of the property transferred.

Proper adjustment shall be made under subsection (b) in the basis of the transferee in such property to take into account gain recognized by reason of the preceding sentence.

However, this nonrecognition rule does *not* apply:

(1) If the recipient-spouse or former spouse is a *nonresident alien* (§1041(e));

Note: Since nonresident aliens are generally not subject to U.S. tax on the sale of property, this exception is to prevent avoidance of U.S. taxes on a later sale by the nonresident alien spouse.

(2) To a transfer in *trust* to the extent the adjusted basis of the property is *less* than the amount of the liabilities assumed and liabilities on the property (§1041(e)); *or*

(3) To transfers of installment obligations in trust for the benefit of spouses or former spouses incident to divorce (§453(g)).

Note: Section 1041 is not restricted to property transfers incident to divorce, but applies to all property transfers between spouses (except certain non-U.S. citizen spouses), whether the transfer is a gift, sale, or exchange between spouses.

Application of §1041

Section 1041 is not limited to transfers of property incident to divorce. Section 1041 applies to any transfer of property between spouses regardless of whether the transfer is a gift or is a sale or exchange between spouses acting at arm's

length (including a transfer in exchange for the relinquishment of property or marital rights or an exchange). A divorce or legal separation need not be contemplated between the spouses at the time of the transfer nor must a divorce or legal separation ever occur.

Example from §1.1041-1T

A and B are married and file a joint return. A is the sole owner of a condominium unit. A sale or gift of the condominium from A to B is a transfer that is subject to the rules of section 1041.

U.S. vs. Foreign Spouse

A taxable sale of property between married spouses is only possible under §1041 when the transferee spouse is a *nonresident* alien. Gain or loss (if any) is recognized (assuming no other nonrecognition provision applies) at the time of a transfer of property if the property is transferred to a spouse who is a nonresident alien (Reg. §1.1041-1T(a), Q&A-3). The spouse making the transferor will be taxed on the gain (the difference between the fair market value of the property transferred and his or her adjusted tax basis in the property).

Note: A taxable sale would give the purchasing spouse a stepped-up basis that could increase their depreciable base and/or be beneficial in a later sale to a third party.

When both spouses are United States residents, a taxable sale requires a sale to a third party by one or both of the spouses, with a later repurchase by one of the spouses.

For example, if the asset were publicly traded stock, the spouses acting together might sell the stock on an established market. One or both spouses would then repurchase the stock on the open market.

Such a sale and repurchase, even if documented and carried out between real parties, would be vulnerable to the *step transaction doctrine*. Under this doctrine, all steps in a single transaction can be integrated. The result would be the application of §1041.

Example Based on Reg. §1.1041-1T

A and B are married and file separate returns. X Company is a corporation wholly owned by A. In the ordinary course of business, X Company makes a sale of property to B. This sale is not a sale between spouses subject to the rules of §1041. However, in appropriate circumstances, general tax

principles, including the step-transaction doctrine, may be applicable in recharacterizing the transaction.

Mandatory Scope

Section 1041 mandates that any transfer of property from one spouse to another (or former spouse if incident to divorce) is income tax-free. No deductible loss or taxable gain can be declared. This section applies to transfers during marriage as well as in the divorce process.

Example

Dan and Althea are married and file a joint return. Dan is the sole owner of a condominium unit. A sale or gift of the condominium from Dan to Althea is a transfer that is subject to the rules of §1041 (Reg. §1.1041-1T Q&A 2, Example (1)).

Example

Dan and Althea are married but file separate returns. Dan is the owner of an independent sole proprietorship, XYZ Company. In the ordinary course of business, XYZ Company sells property to Althea. The sale is subject to §1041(Reg. §1.1041-1T Q&A 2, Example (2)).

Dan recognizes no gain or loss on the sale. His basis for the property carries over to Althea, and she has no income from receipt of the property. The IRS would presumably disallow any deduction claimed by Dan for the cost of the property sold or recapture any deduction for such cost previously taken under the tax benefit rule because the cost was a personal (nonbusiness) expenditure.

Section 1041 would also apply to any such transfer if Dan and Althea were divorced and the sale occurred within one year following the divorce.

Example

Assume the same facts as in the previous example, except that XYZ Company is a corporation wholly owned by Dan. This sale is not a sale between spouses subject to the rules of section 1041. However, in appropriate circumstances, general tax principles, including the step-transaction doctrine, may be applicable in recharacterizing the transaction (Reg. §1.1041-1T Q&A 2, Example (3)).

Property vs. Income

Section 1041 applies to transfers of "property." This includes real property, tangible or intangible personal property, cash, and cash equivalents. In fact, either spouse need not have owned the property during the marriage. Thus, a property transfer between former spouses incident to divorce is subject to §1041 even if the property is acquired after the divorce.

Although §1041(a) shields from recognition gain that would ordinarily be recognized on a sale or exchange of property, it does *not* apply to transfers between spouses that are assignments of income (Reg. §1.1041-1T Q&A 4)). Under the "assignment of income" doctrine, income must be taxed to the person who actually earned it. In a divorce, this issue can arise in determining if:

(1) Funds transferred have already been earned as income by the transferring spouse prior to the transfer, *or*

(2) The transfer in effect gives the assignee spouse a right to receive income in the future.

As a general rule, if a taxpayer transfers income-producing property, such as an interest in a business, rental property, stocks, or bonds, any profit or loss, rental income or loss, dividends, or interest, that is generated or derived from the property during the year up to the date of transfer is reportable by the taxpayer. Any income or loss that is generated or derived from the property after the date of transfer is reportable by the spouse, or former spouse, who receives the property.

Unpaid Income

Although transfers between spouses in a divorce are typically not taxed, the IRC does not provide guidance on how to handle unpaid income in such transfers. As a result, the IRS may apply the assignment of income doctrine, which was developed by the courts, to tax the person who made the transfer.

> Note: For qualified plan transfers, a court-issued qualified domestic relations order (QDRO) can override the assignment of income doctrine. However, transferring qualified plan benefits before the court issues a QDRO may not only disqualify the plan but can also cause negative tax consequences.

The anticipatory assignment of income doctrine states that if a taxpayer earns or creates a right to receive income, they will be taxed on any gain realized from it. This is true even if the taxpayer transfers the right to receive the income before actually receiving it, as long as the taxpayer has the right to receive the income or if, based on the realities and substance of the events, the receipt of the income is practically certain to occur.

Savings Bonds

While §1041 shields gain that is ordinarily recognized on a sale or exchange of property, it does not shield income that is ordinarily recognized on the assignment of that income to another taxpayer. R.R. 87-112 holds that the accrued interest on Series E and Series EE United States Savings Bonds is includable in the income of a transferor when the bonds are assigned to the transferor's former spouse as part of a divorce settlement. Thus, when a U.S. savings bond is transferred, the transferor must include in income all interest on the bond that has been earned up to the date of transfer but not previously reported. Interest earned after the transfer is included in the income of the bond's recipient (R.R. 54-143).

> Note: R.R.87-112 also held that the excess of the redemption value of the bonds over their original issue price was not "gain" that would be nontaxable under §1041. Instead, it was held to be accrued interest required to be included in the transferor's income under §454 (see *Cofield v. Koehler*, 207 F. Supp 73 (1962) for an earlier decision that conflicted with this position).

The transferee's basis in the bonds after the transfer is the transferor's basis in the bonds increased by the interest income includable by the transferor as a result of the bonds.

Receivables

When marital assets include receivables for personal services rendered and the receivables are transferred to one of the spouses (usually the spouse who rendered the services), the income remains taxable to the assignor when received. Thus, if the receivables are awarded to the non-earning spouse, the earning spouse may nevertheless be taxed on the income when it is collected by the assignee under the assignment-of-income doctrine (for a conflicting court opinion see, *Kenfield v. U.S.*, 783 F.2d 966 (1986)).

To protect the assignor spouse, the settlement agreement might:

(i) Award the receivables to the earning spouse[1], *or*

(ii) If the receivables are awarded to the non-earning spouse, provide that the assignee will pay all income tax liabilities attributable to the income assigned, including any taxes assessed against the assignor.

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[1] In a community state, both spouses may be considered the earning spouse (*Johnson v. United States*, 135 F2d 125 (9th Cir., 1943)). Thus, an equal division of the receivables may avoid this issue.

Note: Transfer of receivables also involves the issue of self-employment tax. Apparently, receivables collected by the transferee (i.e., nonworking) spouse would be free from any self-employment tax. Thus, any income taxes paid by the nonworking spouse would not reduce the self-employment tax of the working spouse.

Interest

Section 1041(b)(1) requires that the receipt of all property (including cash) in a §1041 transaction be treated as a gift. Thus, when a note relating to a transfer of property between spouses or incident to a divorce pays interest, it could be inferred from §1041(b)(1) that the interest is a gift.

However, in Private Letter Ruling 8640046, the IRS has ruled that the payment of interest on a note arising out of a transaction subject to §1041 is interest and not a gift.

Imputed Interest

Sections 483, 1272, 1274, and 7872 do not discuss the application of imputed interest or original issue discount (OID) rules on deferred payments used to effect a §1041 transaction. However, Prop. Regs. §1.483-1(c)(2)(iii) and §1.1274-1(b)(10) provide that §483 and §1271-1275 do *not* apply to any transfers of property subject to §1041.

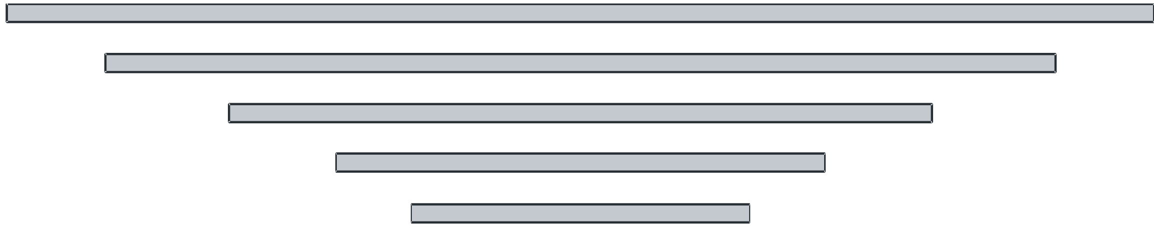
In Private Letter Ruling 8645082, the IRS ruled that:

(i) §483 and §1274 do not apply to recharacterize principal payments as interest on a below-market interest rate note between separated spouses since a §1041 transaction is not treated as a sale or exchange;

(ii) No amounts due on the note would be considered OID under the rules of §§1271-1275 because there is no OID under §1273(b)(4); *and*

(iii) §7872 would not apply to payments under the note since the loan was not a "gift loan" within the meaning of §7872(f)(7).

Note: A private letter ruling is valid only for the person who requested it and is unusable as a precedent.



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38. Under §1041, a nonrecognition rule applies to property transfers between current and former spouses. However, what fails to qualify as property under §1041?

   a. tangible or intangible personal property.

   b. real property.

   c. cash and cash equivalents.

   d. assignments of income.

39. Section 1041 protects gain that might be ordinarily recognized on a property sale or transfer. However, what should a taxpayer do when he or she transfers a U.S. savings bond?

a. strip the income coupons before the transfer.

b. pay tax on the interpolated terminal reserve value of the bonds.

c. include in income all bond interest earned up to the transfer date but not previously reported.

d. pay tax on the accrued income when the bonds mature.

40. In a marital settlement, receivables for personal services may be transferred or awarded to the non-earning spouse. In such an instance, what is a tax consequence?

a. The income is taxable to the recipient spouse.

b. The income is taxable to the assignor when received.

c. The income is taxable to the assignor when transferred.

d. The income is taxable to the recipient spouse when transferred.

41. Under Private Letter Ruling 8640046, when interest is paid on a note relating to the transfer of property subject to §1041, it is treated as interest. What do Prop. Regs. §1.483-1(c)(2)(iii) and §1.1274-1(b)(10) further determine regarding such obligations?

a. They are not subject to the imputed interest rules.

b. They are subject to the passive loss rules.

c. They are subject to the alternative minimum tax.

d. They are taxable if in exchange for marital rights.

Transfers to a Former Spouse Incident to Divorce

A property transfer is "incident to divorce[2]" if:

(1) Made within *one year* after the marriage terminates[3], *or*

[2] A divorce, for this purpose, includes the ending of the marriage by annulment or due to violation of state law (Temp. Reg. §1.1041-1T, Q&A-8).

Example

Dan and Jane's marriage is legally dissolved on August 23rd. Any transfer made on or before August 23rd of the next year is regarded as being incident to divorce. It is immaterial whether a divorce or separation instrument requires the transfer.

(2) *Related to* marital termination (§1041(c)).

Note: When a property transfer is within one year after the end of the marriage, it is not necessary to determine if it was related to marital termination.

Related To Termination

A property transfer is related to marital termination when:

(a) Required by a *divorce or separation instrument* (either original or modified), *and*

(b) The transfer is *not* more than six years[4] after the marital termination (Temp. Reg. §1.1041-1T(b), Q&A-14).

Example

Under Dan's decree title to the residence was awarded to his ex-spouse, Jane. However, Dan was granted a right of first refusal to purchase the residence, which he exercised three years later. The transfer to Dan is related to the cessation of the marriage, thus §1041 applies. As a result, Jane has no tax consequences and Dan takes title to the residence at its original basis (see PLR 8833018).

Note: A method of avoiding §1041 is to intentionally structure the transaction so that it is not incident to divorce. A possibility might be to divide the assets at divorce and wait for six years before transferring the property again between the spouses.

Rebuttable Presumption

A transfer not meeting the above requirements is *presumed* unrelated to the marital termination. This presumption can only be *rebutted* by proof

[3] A way to avoid §1041 treatment would be to make a transfer after one year that is not required by the divorce or separation instrument.

[4] Section 1041 could also be avoided by making a transfer after six years, even if provided for in the divorce or separation instrument.

the transfer was made to effect the division of property owned by the former spouses at the marital termination.

Regulation §1.1041-1T, at Q&A-7, states that the presumption may be overcome by showing that:

(i) A transfer of property owned at the cessation of marriage was *not* made within either the one-year or six-year periods mentioned because of factors hampering an earlier transfer (such as legal or business impediments or disputes regarding value); *and*

(ii) The transfer was made promptly after the impediment to the transfer was removed.

Example

Under a 2017 divorce decree, Dan and Jane's publishing business was to go to Jane. However, Dan is legally unable to transfer the franchise to Jane until 2024. To overcome the presumption that the business transfer is unrelated to the divorce, it must be shown that Dan and Jane could not legally transfer the franchised business until 2024.

Divorce or Separation Instrument

The term "divorce or separation instrument" means:

(1) a decree of divorce or separate maintenance or a written instrument incident to that decree (§71(b)(2)(A));

(2) a written separation agreement (§71(b)(2)(B)); *or*

(3) a decree or any type of court order requiring a spouse to make payments for the support or maintenance of the other spouse (§71(b)(2)(C)).

Note: This includes a temporary decree, an interlocutory (not final) decree, and a decree of alimony pendente lite (while awaiting action on the final decree or agreement).

Transfers in Trust

Under §1041(e), the nonrecognition provisions of §1041(a) do not apply to the transfer of property in trust when the transferred property is encumbered by an obligation that is in excess of the property's adjusted basis and such obligations are assumed or taken subject to by the transferee. Thus, when a taxpayer makes a transfer in trust, they must recognize gain to the extent that the liabilities assumed by the trust, plus the liabilities to which the property is subject, exceed the total of the adjusted basis in the property transferred. In addition, gain or loss is generally recognized on a transfer in trust of an installment obligation.

Note: The trust may adjust its basis in the property by the amount of gain recognized by the transferor.

Example

Dan owns property with a fair market value of $10,000 and an adjusted basis of $1,000. The property is subject to a $5,000 liability. His recognized gain on the transfer of the property in trust to his spouse is $4,000 ($5,000 minus $1,000).

Third-Party Transfers

If a taxpayer transfers property to a third party on behalf of their spouse or former spouse, the property may be treated as if:

(1) Transferred to their spouse or former spouse, *and*

(2) Their spouse or former spouse immediately transferred it to the third party.

However, this will only be true if the transfer otherwise qualifies, and the taxpayer fits at least *one* of the following three situations:

(1) A divorce or separation instrument required the transfer;

(2) The transfer follows a written request of the recipient spouse or former spouse; *or*

(3) The recipient spouse or former spouse gives the transferor written consent[5] to transfer the property (Temp. Reg. §1.1041-1T, Q&A-9).

Example

As part of his mid-life crisis, Dan runs up credit card debt on his soon-to-be ex-wife's credit cards. In dividing up the marital assets, Dan requests that funds due him be paid directly to the credit card company.

Only the first (deemed) transfer to the transferee spouse is under §1041. The second (deemed) transfer (that from the taxpayer's spouse or former spouse to the third party) is *not* treated as a gift and can result in gain or loss to a spouse or former spouse.

[5] This consent must state that the parties intend the transfer to be treated as a transfer to the recipient spouse or former spouse under these rules. The transferor must receive this before filing the tax return for the year the transfer was made. The accountant will often need to alert the taxpayer to get this paperwork done.

Note: The transfer from the nontransferring spouse to the third party is not under §1041, and may be taxed as a sale, exchange, gift, or other disposition, depending on the reason for the transfer.

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42. Under §1041, there are several circumstances where a property transfer is "incident to divorce." What is one of these circumstances?
    a. The transfer is made within 10 years after the marital termination.
    b. The transfer is made within one year after the marital termination.
    c. The transfer is associated with the termination of the relationship.
    d. The premarital agreement declares the transfer to be such.

43. In certain instances, it may be desirable to avoid §1041. How might a couple arrange a property transfer so that it fails to qualify as incident to divorce under §1041?

a. separate the property at divorce and make the property transfer six years afterward.

b. exercise the right of first refusal to purchase the property three years after the separation.

c. transfer the property at the time of the divorce instrument.

d. transfer the property within a year following the marriage termination.

44. Section 1041 requires a valid divorce or separation instrument. However, which of the following items would most likely fail as such a divorce or separation instrument?

a. a judicial order.

b. a decree of legal separation.

c. an oral agreement to vacate.

d. a judgment of separate maintenance.

45. A taxpayer may make a valid property transfer under §1041 to a third party on behalf of his or her spouse. In such a circumstance, how is the subject property procedurally treated?

a. as if not transferred.

b. as if only transferred to the spouse.

c. as if transferred immediately to the third party.

d. as if transferred to the spouse and then directly to the third party.

46. If two transfers are considered to have taken place in a single transfer, each is treated differently. How is the first deemed transfer to a transferee spouse treated?

a. It can result in gain to a former spouse.

b. It can result in loss to a spouse.

c. It is not treated as a gift.

d. It is subject to §1041.

Property Basis

Under §1041(b), the *transferor* spouse's adjusted basis[6] in property transferred becomes the *transferee's* basis. Accordingly, the basis of property received is the same as it was for the transferor (i.e., "carryover basis"). Moreover, the transferee will not acquire additional basis in the property *even if* required to pay the transferor for the property.

Example

After fourteen years of marriage, Dan and Mary Lee divorce. Two apartment buildings, worth $100,000 each, are the only major items of property in the settlement. One apartment has a basis of $20,000, and the other a basis of $100,000.

Although Dan and Mary Lee may each receive one of the apartments in their divorce settlement, the one who receives the lower tax basis parcel will be disadvantaged from an after-tax viewpoint.

Example

Dan owns a beach house worth $400,000 with a tax basis of $50,000. Dan borrows $200,000 from the bank, using the house as collateral. In his divorce, Dan transfers the house, subject to the $200,000 mortgage, to Jane. While Dan recognizes no gain or loss on the transfer, Jane's basis in the house remains at $50,000 despite her effectively assuming Dan's $200,000 mortgage.

Because of this nonrecognition rule under §1041, divorcing parties who receive properties of equal value may not be in the same position when tax consequences are considered. Thus, a correct (i.e., equal and/or fair?) division of assets requires consideration of deferred gains and losses.

Gift Variation

Section 1041 treatment is similar to that which applies in the case of a gift. However, there is a difference. In calculating a loss on a later sale or exchange, a donee's basis for property received by gift is the *lesser of:*

(1) The transferor's basis, *or*

(2) The fair market value of the property at the time of the gift (§1015).

Under §1041 the transferee's basis is the same as that of the transferor in calculating *either gain or loss*. In addition, basis is adjusted for any gain recog-

[6] The adjusted basis of property is its original cost adjusted as provided in §1016.

nized by the transferor on a transfer of property in trust in which the sum of the liabilities assumed, plus the liabilities to which the property is subject, is more than the adjusted basis of the property transferred.

Passive Activity Loss Property

When a taxpayer gives passive activity property to their spouse or former spouse, the basis in the gift is increased immediately before the transfer by the amount of any passive activity losses allocable to the property. These losses cannot be deducted for any year.

> Note: In a community property state, half the property would get a basis adjustment under this rule. The balance of passive activity losses would carry forward.

This rule is based on the interplay of §469(j)(6) and §1041(b). Section 469(j)(6) provides that in the disposition of any interest in a passive activity by gift, the basis of the interest immediately before the transfer is increased by the amount of any suspended passive activity losses allocable to the interest and such losses will not be allowable as a deduction for any taxable year. Section 1041(b) provides that for income tax purposes, property acquired in an interspousal transfer is deemed acquired by gift.

> Note: These passive activity rules differ from the net operating and long-term capital loss carryforward provisions.

Property Transferred In Trust

When the transferor recognizes gain on property transferred in trust, the *trust's* basis in the property is increased by the recognized gain.

Example

Dan's spouse transfers property to him in trust, recognizing a $4,000 gain. His spouse's adjusted basis in the property was $1,000. The trust's basis in the property is $5,000 ($1,000 + $4,000).

Basis in U.S. Savings Bonds

The *recipient's* basis in U.S. savings bonds transferred is increased by the interest included in the *transferor's* income.

Negotiated Property Divisions

The tax basis of assets in a property settlement agreement is an important consideration and should be *strongly* negotiated, particularly, since courts won't pay much attention to taxes.

Comment: In an ideal world, net-of-estimated-tax figures should be used to arrive at an equitable property settlement and the value of any appreciated investments held in taxable accounts be reduced by applicable built-in tax liabilities.

A solution might be for each spouse to take a fair share of low-basis and high-basis assets. However, sufficient assets to accomplish this rarely exist.

Another solution could be that the spouse who gets the greater share of low-basis assets is compensated by the other spouse for half of the built-in tax, perhaps with a discount based on the date of the anticipated sale.

A final solution could be to have one spouse agree to pay part of the tax if and when the property is later sold.

Adjudicated Property Divisions

In an adjudicated property division, courts frequently view the impact of taxes as *speculative* and will *not* require an equal division of low-basis and high-basis assets (see Calif. C.C. §4800(b)). Typically, courts do not consider potential tax costs that may arise at some unspecified time in the future.

Caselaw

In *Marriage of Fonstein*, 131 Cal. Rptr. 873 (1976), the California Supreme Court held that potential tax liabilities from the later sale of a partnership interest need not be considered. The husband had argued that the value of his law partnership, which was awarded to him in the property division, be reduced by the taxes he might later incur on sale and withdrawal, even though he had no present intention of doing so.

Later, the California Supreme Court distinguished *Fonstein* stressing that the holding only applies in the *absence* of proof that a taxable event has occurred during the marriage or will occur in connection with the division of the community property (*Marriage of Epstein*, 24 Cal. 3d 76 (1979)).

In *Epstein*, most of the personal property had been awarded to the husband. The family residence was ordered sold and the proceeds divided to equalize the property division. Since the sale of the residence (and resulting tax) arose from the court order and was certain, the court held the possibility of capital gains tax had to be considered (see also, *Marriage of Clark*, 80 Cal. App. 3d 417 (1978), involving the consideration of income tax consequences to a selling spouse from an interspousal stock sale required by a court-ordered division of property[7]; *Marriage of Sharp*, 192

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[7] *Clark* indicated two ways to consider the tax burden: (i) make an immediate adjustment to the property division to compensate for the tax or, (ii) in an installment sales situation, order the transferee spouse to pay the transferor spouse half of the tax each year.

Cal. Rptr. 97 (1983); and *Marriage of Davies*, 143 Cal. App. 3d 851 (1983)).

General Rule - Immediate & Specific

These California cases illustrate the general rule[8] that the courts will not consider the tax impact of property divisions unless the taxable event is likely to occur in the near future. If the tax impact is uncertain, the later taxes may be ignored.

Example

Under Dan's divorce decree, marital assets are to be divided by his ex-wife receiving a cash payout over a ten-year period. The marital assets are substantially made up of real property and to make such payments Dan will have to sell property to make each payment resulting in severe tax consequences to him. Under the general rule, the court can consider such tax consequences.

If the parties and/or their counsel fail or refuse to deal with potential tax consequences, they might still file a post-judgment motion to amend the decree to alleviate adverse tax consequences. Alternatively, the tax burden could be characterized as an "after-discovered" liability requiring post-judgment equitable action by the court (see Calif. Civil Code §4253).

Liabilities

A transfer of property is subject to §1041 even if the transferee assumes or takes subject to liabilities encumbering the property from the transferor. Regulation §1.1041-1T Q&A-12 provides the following example.

Example

A owns property having a fair market value of $10,000 and an adjusted basis of $1,000. In contemplation of making a transfer of this property incident to a divorce from B, A borrows $5,000 from a bank, using the property as security for the borrowing. A then transfers the property to B and B assumes or takes the property subject to, the liability to pay the $5,000 debt. Under section 1041, A recognizes no gain or loss upon the transfer of the property, and the adjusted basis of the property in the hands of B is $1,000.

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[8] See *Levan v. Levan*, 545 So.2d 892 (Fla. 3d DCA 1989); *Crooker v. Crooker*, 432 A. 3d 1293 (Maine 1981); and *Hovis v. Hovis*, 541 A. 2d 1378 (Pa. 1988).

Relief from a liability is normally the equivalent of the receipt of cash. However, under §1041, it apparently would be excludable from income as a gift.

Note: Can relief from a liability be treated as a cash payment of alimony? This is uncertain, to say the least.

Holding Period

While §1041 does not address the holding period for an asset transferred between spouses or former spouses incident to divorce, §1041(b)(1) provides that a transfer under §1041 will be treated as acquired by gift. Under §1015, the donee of a gift has a holding period that includes the donor's holding period. Thus, the holding period is the *same* as the holding period immediately before the transfer. For example, when a transferor holds property for twelve months and one day and then transfers it, the transferee is deemed to have held the property for twelve months and one day upon receipt.

Notice & Recordkeeping

Under Reg. §1.1041-1T, Q&A-14, the transferor of property under §1041 *must*, at the time of the transfer, supply the transferee with records sufficient to determine the adjusted basis and holding period of the property. In the case of property with potential credit recapture, the transferor must also supply the transferee with records sufficient to determine the amount of such potential liability. *No* sanctions are specified for failure of the transferor to comply with these rules. As a result, consideration should be given to incorporating these rules into the divorce decree or separation instrument where property is to be transferred.

Note: The regulations do not address potential depreciation recapture, although this potential liability also carries over to the transferee spouse.

Review Questions

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Short explanations for both correct and incorrect answers are given after the list of questions. We recommend that you answer each of the following questions and then compare your answers. For more detailed explanations and references, you may do an electronic search using Ctrl+F (if you are viewing this course on computer), consult the text Index, or review the general Glossary.

47. Section 1041(b) deals with the basis of property received in an interspousal transfer. What is the general rule of this provision?

a. the transferee spouse's basis is increased by any additional funds paid.

b. the transferee spouse takes on the transferor's basis.

c. the fair market value of the property at the date of transfer is the transferee's basis.

d. the appraised value of the property at the date of transfer is the transferee's basis.

48. Amazingly, §1041 treatment is similar to that which applies in the case of a gift for purposes of the passive loss rules. When a taxpayer receives passive activity property from a former spouse, what happens to the basis in this deemed "gift"?

a. Directly before the transfer it increases by the total passive activity losses allocable to the property.

b. Directly before the transfer it is reduced by the amount of suspended passive activity losses.

c. It is unchanged, but the suspended losses are disallowed.

d. It is subject to gift taxation.

49. When a taxpayer receives U.S. savings bonds from a spouse or former spouse, the recipient's basis in the bonds is:

a. the same as if the bond transfer was a true gift.

b. increased by the interest that was a part of the transferee's income.

c. increased by the interest that was a part of the transferor's income.

d. the same as if the bond transfer were a taxable transfer to a trust.

50. For the most part, courts disregard the tax consequences of property divisions. However, when might they most likely consider such consequences?

a. if the parties fail to deal with potential tax consequences.

b. if the parties' counsel refuses to deal with potential tax consequences.

c. if the tax impact needs to be clarified.

d. if it is expected that the taxable event will transpire in the near future.

51. Section 1041 fails to address the holding period for asset transfers between spouses and former spouses. However, as a result of the provision's analogy to gifts, what is held to be the transferee's holding period?

a. It is identical to the transferor's holding period.

b. It will start again in the hands of the transferee.

c. It commences on the filing date of the petition for divorce.

d. It is the same as the transferor's holding period if gift taxes are paid.

52. Under §1041, a transferee must receive certain records regarding the property that is transferred. What additional records should be provided if the property has possible credit recapture?

a. ample records allowing the transferee to figure the adjusted basis.

b. ample records allowing the transferee to clarify the property's holding period.

c. ample records allowing the transferee to calculate the total potential liability.

d. ample records allowing the transferee to see whether the value is what it was claimed to be

Purchases Between Spouses

Before §1041, the transferor spouse recognized gain on the transfer of appreciated property to the transferee spouse or former spouse in satisfaction of marital rights or in exchange for cash or other separate property[9].

Under §1041, the transferor spouse is not taxed on the transfer, but the transferee spouse cannot increase the basis of the property, even by amounts they may have paid to the other spouse for the property (Reg. §1.1041-1T, Q&A-11). In all cases, the basis of the transferred property in the hands of the transferee spouse is the adjusted basis of such property in the hands of the transferor spouse immediately before the transfer - even if the transfer was a bona fide sale.

[9] See *U.S. v. Davis*, 370 U.S. 65 (1962).

Thus, a spouse who buys property from another spouse is disadvantaged as compared to a third party purchaser.

This rule applies even if the transferred property is subject to liabilities that exceed the adjusted basis of the property (Reg. §1.1041-1T, Q&A-12).

Example from Reg. §1.1041-1T, Q&A-12

Assume A owns property having a fair market value of $10,000 and an adjusted basis of $1,000. In contemplation of making a transfer of this property incident to a divorce from B, A borrows $5,000 from a bank, using the property as security for the borrowing. A then transfers the property to B and B assumes, or takes the property subject to, the liability to pay the $5,000 debt. Under section 1041, A recognizes no gain or loss upon the transfer of the property, and the adjusted basis of the property in the hands of B is $1,000.

Residence

Before one negotiates for the family residence, several preliminary questions should be answered:

(1) Do you really want the home?

(2) Can you afford the present payments?

(3) Can you afford to buy out the other spouse with cash or asset trade?

(4) How long do you intend to keep the house?

(5) Do you qualify for a reverse mortgage?

(6) What are the deferred tax liabilities and could §1041, the §121 $500,000 exclusion, or §453 apply?

When a spouse sells their interest in the marital residence to the other spouse and receives the purchasing spouse's note as part of the purchase price, the selling spouse does not report any gain (or loss) on the sale under §1041. However, the deferred gain is transferred to the purchasing spouse, since the basis is carried over to the buyer (§1041(b)(2)).

Section 1041 is particularly dangerous in community property states. Typically, if community property cannot be divided equally, one spouse "purchases" the other's interest in one or more assets to equalize the value. Such "purchases" are often structured when the value of the residence exceeds more than 50% (or any other percentage) of the couple's net worth and they do not wish to (or can't) sell it and divide the sale proceeds.

Example

Dan and Jane reside in California, a community property state. They own a home worth $500,000 that is subject to a $100,000 mortgage (i.e., $400,000 net equity) and has a $70,000 tax basis. Using the home as collateral, Dan obtains a loan and buys Jane's interest in the home for $200,000. Dan's tax basis in the home remains at $70,000.

Home Mortgage Interest

Interest on a mortgage incurred to acquire all or a portion of a residence incident to divorce or legal separation is qualified housing interest under §163(h) and §56(e) (Notice 88-74). While a note issued incident to a divorce or separation for the acquisition of a spouse's interest in the personal residence can qualify as a debt incurred in acquiring a residence, the residence must still secure the note. If the note is not secured by the residence, the interest will be personal and, therefore, not deductible.

Note: If the interest payments are nondeductible, there is no reason to pay interest since the recipient has to report the interest as income. It would be better for the note to pay no interest because the imputed interest rules do not apply to §1041 transactions.

Deferral & Exclusion of Gain

Receiving low-basis property, without a basis increase when the residence (or a portion thereof) is purchased from a spouse, creates *deferred tax liability*.

In cases where the property is a primary personal residence, §121 (i.e., the $500,000 exclusion) may offer some relief.

Business & Investment Property

Under §1041, when the transferee spouse or former spouse purchases an interest in tangible personal property or real property used in a trade or business or held for investment:

(1) The purchasing spouse will not acquire additional basis for any amounts paid for the property;

(2) The transferred property may be subject to depreciation or investment credit recapture on later disposition; *and*

(3) If the property is subject to a mortgage, it can be subject to the mortgage in excess of basis rules on a later disposition.

Recapture

While the Code contains a variety of recapture provisions, the major provisions are for depreciation and investment tax credit. Normally, these provi-

sions do not apply to §1041 transfers as long as the transferred property continues in its identical use after the transfer. However, a later sale or exchange (or merely a different use) of the property can trigger recapture.

Under §1245 and §1250, depreciation recapture occurs on the sale or exchange of depreciated property. Depreciation recapture causes a portion of the gain from the sale of property to be ordinary income rather than capital gain. While depreciation recapture does not apply to §1041 transfers because such a transfer is considered to be a gift if the transferee spouse later sells or exchanges the property, any gain is subject to recapture.

Section 1031 Exchange

When a taxpayer receives low-basis business or investment property in a §1041 transfer, they should consider the use of a nontaxable exchange in any later disposition of that property. The exchange of property for like-kind property under §1031 is the most common type of nontaxable exchange. To be nontaxable, a like-kind exchange should meet the following conditions:

1. Both the property traded and the property received must be held by the taxpayer for business or investment purposes.

   Note: Buildings, land, and rented houses are examples of properties that might qualify.

2. The property traded and the property received must not be property held primarily for sale.

   Note: Inventories, raw materials, accounts receivable, other current assets, and real estate that dealers hold for sale to customers are examples of properties that would not qualify.

3. There must be an exchange of like property[10]. The exchange of real estate for real estate is an exchange of like property. However, if the like-kind exchange includes the receipt of money or unlike property, the taxpayer may have a taxable gain.

   Note: The trade of an apartment house for a store building is a like-kind exchange. An exchange of personal property for real property does not qualify as a like-kind exchange. An exchange of city property for farm property or improved property for unimproved property is a like-kind exchange.

4. The property must be tangible property. Section 1031 does not apply to exchanges of stocks[11], bonds, notes, choses in action, certificates of trust

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[10] A transaction may be a nontaxable exchange when a taxpayer sells property used in your trade or business, immediately buys similar property to replace it, and the sale and purchase are mutually related transactions.

[11] However, there may be a nontaxable exchange of corporate stock under *other* code sections.

or beneficial interest, other securities or evidences of debt or interest, or the exchange of partnership interests.

5. The property must meet the *identification* requirement. The property to be received must be identified on or before the date that is 45 days after the date the taxpayer transfers the property given in the exchange.

6. The exchange must meet the completed transaction requirement. The property must be received *on or before* the earlier of:

(i) The 180th day after the date on which the taxpayer transfers the property given up in the exchange, or

(ii) The due date, including extensions, for the tax return for the tax year in which the transfer of the property given up occurs.

Asset Separation

An exchange of the assets of a business for the assets of a similar business cannot be treated as an exchange of a single property for a single property. Whether a taxpayer has engaged in a like-kind exchange depends on an analysis of each asset involved in the exchange. However, like-kind exchanges are only allowed for like-kind exchanges of real property.

Related Parties

Rules limit whether certain exchanges made between related parties are nontaxable. These rules affect both direct and indirect exchanges.

Two-Year Restriction

If related parties exchange like-kind property, no gain or loss is recognized. However, if either party disposes of the property within 2 years after the exchange, then the exchange is disqualified from nonrecognition treatment.

The 2-year holding period begins on the date of the last transfer of property that was part of the like-kind exchange. The gain or loss must then be recognized as of the date of disposition of the property.

Foreign Property

Real property located in the United States, and real property located outside of the United States are not considered like-kind property. Therefore, if a taxpayer exchanges foreign real property for property located in the U.S., the exchange cannot be treated as a nontaxable like-kind exchange.

Exception: This rule does not apply to the replacement of condemned real property. Foreign and U.S. real property can still be considered like-kind under the rules for replacing condemned property to postpone gain on the condemnation.

Form 8824

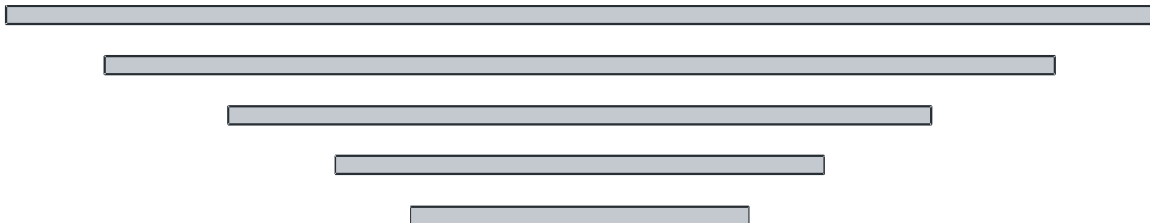
When a taxpayer exchanges property in a like-kind transaction, they must file Form 8824, Like-Kind Exchanges, in addition to Schedule D (Form 1040) or Form 4797.

Spousal Transfers

No gain or loss is recognized (included in income) on a transfer of property from an individual to (or in trust for the benefit of) a spouse, or to a former spouse if incident to divorce. This rule does not apply if the recipient spouse is a nonresident alien. It also does not apply to a transfer in trust if the adjusted basis of the property is less than the amount of the liabilities assumed and liabilities on the property.

Installment Sale of Assets

Low-basis property received in a §1041 transfer might also be disposed of in an installment sale. While taxable, it would at least spread the gain over a term of years.



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53. One spouse may purchase an interest in a marital residence from the other spouse for a note. What results when the selling spouse receives this note?

a. The buying spouse gets stuck with any deferred gain.

b. Interest on the note is deemed personal and nondeductible.

c. Gain or loss on the sale is reported by the selling spouse.

d. The purchasing spouse's basis in the residence increases.

54. The author reviews several techniques to be considered when low-basis property is received in a marital settlement. What tax issue are these techniques primarily directed to alleviate?

a. tax on the original transfer in settlement.

b. third party transfer involvement.

c. deferred tax liability.

d. recapture of depreciation or tax credits.

55. When depreciated property is sold or exchanged, §§1245 and 1250 provide that depreciation recapture can occur. What does such recapture do to part of any gain from such a disposition?

a. taxes it under special rules provided by §1041.

b. suspends it until a later disposition.

c. makes it capital gain.

d. makes it ordinary income.

56. There are several types of nontaxable exchanges under the Code. In the author's opinion, what is the most common type of these exchanges?

a. like-kind property exchanges of real property.

b. the exchange of property that is held primarily for sale.

c. the exchange of real estate for personal property.

d. the exchange of notes or beneficial interests.

57. Like-kind exchanges can be used to effectively deal with low basis property but must meet certain conditions. Which of the following might qualify as a like-kind exchange transaction?

a. inventories for raw material.

b. land for a rental house.

c. the exchange of partnership interests.

d. the exchange of personal property for real property.

Selected Asset Divisions

Particular tax consequences sometimes follow from the division of certain types of property between spouses or former spouses incident to divorce.

Residence

Since the family residence is the most valuable asset owned by most couples, its use and ultimate disposition must be given attention as soon as the spouses decide to terminate the marriage. There are three common *disposition* alternatives available on divorce:

(1) A sale to a third party followed by a division of the sale proceeds;

> Note: If there is taxable gain under this alternative, consideration should be given to using the installment method under §453 and/or the $500,000 exclusion under §121.

(2) A transfer by one spouse to the other of their interest in the home so that one spouse ends up owning the entire home; *and*

> Note: Under this scenario, consideration must be given to what the surrendering spouse will receive in return for giving up their interest in the home. If there are other assets, the transfer of the home can be part of the overall division of assets. When the home is the sole or major asset, the acquiring spouse will have to arrange for payment to the surrendering spouse

(3) A continuation of joint ownership with one spouse occupying the home.

Note: Typically, in such a situation, the home will later be sold and the proceeds divided at that time. The spouse would then have to consider again the use of the installment method under §453 and/or the $500,000 exclusion under §121.

Section 121 Home Sales

When a spouse transfers their home (or share of a jointly owned home) to a spouse or ex-spouse as part of a divorce settlement, they are considered to have no gain or loss (§1041). There is nothing to report from the transfer unless the spouse or ex-spouse was a nonresident alien, then there will likely be gain or loss from the transfer.

However, when the home received or kept in the divorce settlement is later sold, gain will likely be recognized unless there is an exclusion of gain under §121. Under §121, when a taxpayer has a capital gain from the sale of their main home, they may qualify to exclude up to $250,000 of that gain from their income, or up to $500,000 of that gain if they file a joint return with their spouse. This exclusion can be used once every two years.

Note: This exclusion does not apply to any gain attributable to depreciation deductions taken in connection with the rental or business use of the property for periods after May 6, 1997.

Two-Year Ownership & Use Requirements

The §121 exclusion requires a taxpayer to have owned *and* used the property as his or her principal residence for at least *two years* during the *five-year period* ending on the date of the sale or exchange. The exclusion is allowed each time a taxpayer who sells or exchanges a principal residence meets the eligibility requirements, but no more often than once every two years.

Married couples filing a joint return are entitled to a $500,000 exclusion where:

(1) *Either* spouse meets the ownership requirement,

(2) *Both* spouses meet the use requirement, *and*

(3) *Neither* spouse has had a sale in the preceding two years subject to the exclusion.

Married couples not sharing a principal residence, but filing a joint return, are each entitled to a $250,000 exclusion. In addition, single taxpayers who marry a taxpayer who has used the exclusion within two years are allowed a $250,000 exclusion.

Note: Once both spouses satisfy the eligibility requirements and two years have passed since the last exclusion was allowed to either spouse, a full $500,000 exclusion is available for the next sale or exchange of their principal residence.

Special Divorce Rules

A taxpayer is considered to have *used* property as their main home during any period when:

(1) They owned it, *and*

(2) Their spouse or former spouse is allowed to live in it under a divorce or separation instrument.

If a taxpayer's home was transferred to them by their spouse (or former spouse if the transfer was incident to divorce), the taxpayer is considered to have *owned* it during any period of time when their spouse owned it.

Tacking of Prior Holding Period

If a taxpayer acquired their residence in a transaction covered by the prior rollover rules, the periods of ownership and use of the prior residence count in determining ownership and use of the current home.

Prorata Exception

A taxpayer may be entitled to a prorated exclusion if they fail to meet either two-year requirement because of a change in:

(a) Place of employment,

(b) Health, *or*

(c) Other unforeseen circumstances.

Under this prorata exception, the exclusion is a ratio of:

(a) The aggregate amount of time the taxpayer owned and used the property as his or her principal residence during the five-year period, or, if shorter, the amount of time since the most recent prior sale to which the exclusion applied, to

(b) Two years.

Example

Dan and his spouse purchased and occupied a home in Los Angeles. One year later, his employer transfers Dan to Orlando and the family moves. Dan sells the family home for a $300,000 gain. Since the time Dan and his spouse spent in the home is only one-half the required two years, the gain eligible for exclusion is one-half the amount otherwise allowed, or $250,000.

Limitations on Exclusion

Additional limitations apply to the exclusion, including:

(1) Taxpayers can elect not to have the exclusion apply;

(2) Certain periods an individual resides in a nursing home count under the two-year use requirement;

(3) Periods a deceased spouse owned and used the property before death count under the two-year requirements;

(4) An individual is held to use property as his or her principal residence during any period of ownership while the individual's spouse or former spouse is granted use of the property under a divorce or separation instrument; *and*

> Note: This provision does much to relieve the problems of the out-spouse in the subsequent sale of the marital residence.

(5) For stock co-ops, the ownership requirement applies to the holding of such stock and the use requirement is applied to the house or apartment the taxpayer is entitled to occupy as a stockholder.

Installment Obligations

While §453B provides for the recognition of gain on the disposition of an installment obligation, a transfer between spouses or former spouses incident to divorce does not result in the recognition of gain or loss under §453B(a) (except for transfers in trust). The transferee is entitled to the same tax treatment on the installment obligation as the transferor (§453B(g)(2)). Effectively, the transferee stands in the transferor's shoes.

If the transferee spouse or former spouse disposes of the installment obligation to a third party, gain or loss is recognized. The difference between the carryover basis of the obligation (disregarding any amounts paid to the other spouse) and the amount realized is the amount of gain or loss (§453B(a)(1)).

When an installment obligation is disposed of *other* than in a sale or exchange[12], the amount of gain or loss is the difference between the obligation's basis and its fair market value (§453B(a)(2)).

> Note: Fair market value is the obligation's face amount when the obligor and obligee are related parties (§453B(f)).

Since installment obligations can carry severe built-in tax liabilities, the parties might consider dividing the obligation between them and thus the tax consequences. Another solution would be to reduce the value of the installment obligation in recognition of its deferred tax liabilities.

[12] For example, when an installment obligation becomes unenforceable or is canceled, it is disposed of *other* than by a sale or exchange.

Business Interests

While a business can be divided between the spouses, typically, it is awarded entirely to one spouse. As a result, a spouse may have to purchase the other spouse's interest in the business. The purchase of the business by a spouse or former spouse incident to divorce is tax-free under §1041, without any increase in basis for the amount paid.

Corporate Stock

In a divorce, the tax consequences of a transfer or sale of corporate stock between spouses are relatively precise. Under §1041, neither gain nor loss is recognized on the transfer of property between spouses (whether by gift, sale, or otherwise). Any gain or loss is deferred and the transferred property's basis and holding period carry over to the recipient spouse (§1041(b)(2) & §1223(2)). Section 1041 also applies to property transfers to (or in trust for the benefit of) *former* spouses when made within six years after the marriage terminates (§1041(c) & Reg. §1.1041-1T, Q&A 6).

Under Reg. §1.1041-1T, Q&A 9, a transfer to a *third party* on behalf of a former spouse can qualify for §1041 nonrecognition treatment in three instances:

(1) A divorce or separation instrument required the transfer;

(2) The transfer is made pursuant to a written request of the non-transferring spouse (or former spouse); *or*

> Note: When a transfer is made under a written consent of the non-transferring spouse, the transferring spouse must receive a copy of the consent before filing an income tax return for the year of the transfer. In addition, the consent must state the parties' intent to treat the transfer as made to the non-transferring spouse under §1041.

(3) The transfer is pursuant to written consent by the non-transferring spouse (or former spouse).

In a third party transfer qualifying under §1041, the non-transferring spouse is treated as:

(1) Receiving the transferred property from the transferring spouse, *and*

(2) Immediately transferring it to the third party.

The transferring spouse recognizes no gain (and cannot recognize any loss) on the transfer because the original transfer is under §1041. However, the deemed transfer from the non-transferring spouse to the third party is not under §1041. Thus, the non-transferring spouse may recognize gain on the transfer to the third party.

Cases & Rulings

Numerous court cases have tried to determine when a transfer to a third party on behalf of a former spouse is under §1041. Many of these cases involve a husband and wife each owning stock in a small closely held corporation and the corporation redeeming all of the wife's stock. The issue is whether:

(a) The wife is required to recognize gain on the stock redemption, *or*

(b) The husband received a dividend distribution.

Representative cases and rulings discussing this dilemma are *Arnes v. U.S.*, 981 F. 2d 456 (9th Cir. 1992); *Pozzi v. U.S.*, (D.C. Or. 1993); *Hayes vs. Comm.*, 101 T.C. No. 40 (1993); *Blatt v. Comm.*, 102 T.C. No. 5 (1994); and PLR 9046004 (July 20, 1990).

Section 302 Stock Redemption

Where corporate stock is divided in a divorce, a later redemption of one spouse's interest under §302 could unify ownership in the managing spouse. Using §302, a corporation can redeem its stock for cash or a note. The result would be capital gain or loss to the selling spouse, equal to the difference between the redemption price and their stock basis.

Section 302 provides that if a corporation redeems its stock pursuant to one of the four tests of §302(b), the redemption will be treated as a distribution in partial or full payment of a shareholder's stock and *not* a dividend. The four types of qualified redemptions are those that are:

(i) Not essentially equivalent to a dividend (§302(b)(1));

(ii) Substantially disproportionate (§302(b)(2));

(iii) Complete terminations of a shareholder's interest (§302(b)(3); *and*

(iv) Partial liquidations (§302(b)(4)).

Recapitalization

A stock recapitalization, which creates a class of nonvoting stock to be awarded to one spouse, could be another solution. In a tax-free corporate recapitalization under §368(a)(1)(E), one spouse would exchange their common stock for nonvoting preferred stock in the corporation and the other spouse would retain the voting common.

Partnerships

Where a partnership interest is divided in a divorce, one spouse's interest might be liquidated by the partnership under §736. Section 736 provides for flexible treatment when the interest of one partner is bought by the partnership. Money payments are allocated between amounts paid for the partner's

interest in partnership property under §736(b) and other payments under §736(a). (Reg. §1.736-1(a)(2))

Section 736(a) Payments

Cash payments made to a withdrawing partner shall, except as provided below, be considered as a distributive share or as a guaranteed payment:

As a *distributive share* (i.e., income distribution), if they are determined by reference to the partnership income, thus reducing the amount of partnership income available to the continuing partners.

As *guaranteed payments*, if they are not determined by reference to the partnership income, thus producing a deduction from gross income to arrive at the partnership's taxable income.

Effect on Recipient

The amount received is *ordinary income* to the recipient whether it is a distributive share *or* a guaranteed payment. If it is a distributive share, it also increases the recipient's outside basis by the amount of the distributive share; outside basis is then reduced by the amount of cash actually distributed. If it is treated as a guaranteed payment, it does not affect outside basis at all (§736(a)). A payment described in §736(a) is treated as "income in respect of a decedent" and thus is fully taxable to a deceased partner's estate or other successor (§753; R.R. 66-325). The receiving partner includes the payments in gross income for the related partnership year that ends with or within the partner's year.

Section 736(b) Payments

When the cash payment is made in exchange for the interest of the retiring or deceased partner in partnership property, it is treated as a current *distribution* (nonliquidating) by the partnership and *not* as a distributive share or a guaranteed payment.

Effect

Like other distributions, the recipient does not realize ordinary income. Liquidating cash payments under §736(b) are considered a return of capital to the extent of the partner's basis in the partnership, and *capital gain* is recognized to the extent of any excess. However, if substantially appreciated inventory and/or other unrealized receivables are present, *ordinary income* is created in the year received (Reg. §1.736-1(a)(5)).

Thus, when cash distributed exceeds the recipient's outside basis, it creates capital gain and if it is less than the basis, it generates a capital loss. There is no deduction to the other partners (§736(b)).

Exclusions From §736(b) Treatment

Section 736(b) payments do *not* include the following:

1. Payments for *unrealized receivables*. Payments in exchange for the partner's interest in unrealized receivables are subject to §736(a) rather than §736(b). (§736(b)(2)(A))

2. Payments for *goodwill* in excess of the partner's share of the goodwill basis to the partnership that have not been specifically provided for in the partnership agreement. Thus, amounts received in exchange for the partner's interest in the goodwill of the partnership are taxed under §736(a) as *ordinary income*, rather than under §736(b) as made in exchange for the interest, *unless* the partnership agreement specifically provides for a payment as to goodwill (§ 736(b)(2)(B)). If the partnership agreement provides for goodwill payments to a partner in excess of the partner's share of the partnership basis, such payments are *capital gain*. This reference must be specific (*Smith v. Commissioner*, 313 F. 2d 16 (10th Cir., 1962)).

> Note: Even if the partnership agreement failed to provide for a payment for goodwill, it can be modified and the modification will be given effect for tax purposes. The partnership agreement can be effectively modified at any time before the date on which the partnership return for the taxable year is due. Thus, even after the payment is made, the agreement can be retroactively amended up to the due date of the return (§761(c)). A modification to provide for a goodwill payment has been upheld (*Commissioner v. Jackson Investment Co.*, 346 F. 2d 187 (9th Cir. 1965)).

3. While a payment in exchange for the partner's interest in substantially appreciated inventory is dealt with under §736(b), it would produce ordinary income rather than capital gain (§751(b)).

Liabilities

In making computations under §736, partnership liabilities forgiven or assumed by another party (or by the partnership) are treated as cash withdrawals. Normally, the amount included in the partner's basis for liabilities is the same as the amount considered withdrawn, and the two amounts "wash." When a partner's share of partnership liabilities exceeds the basis of the partner's interest, gain recognized can exceed the cash actually received. This occurs when the partners have withdrawn loan proceeds or when cumulative partnership losses have exceeded the partner's capital investment (exclusive of debts).

Series of Payments

When liquidating cash distributions are spread over several years, it is necessary to allocate the total amounts paid between §736(a) and §736(b) payments. If the partners have dealt at arm's length and specifically agreed to the allocation and timing of each class of payment, such an agreement normally controls the tax consequences.

In a series of §736 liquidating payments that eliminate a partner's entire interest, the question of imputed interest may arise. If unpaid amounts due to a partner are related to an arms' length loan to the partnership, the rules for below-market-rate loans *could* apply. However, if none of the payments are related to such a loan, apparently the unpaid amounts simply will constitute a §736(b) distribution or a §736(a) guaranteed payment (Prop. Reg. §1.7872-2(a)(1), (b)(3), -4(c)(1), and (c)(2) and Reg.. §1.731-1(a)(1) and (c)(2)).

Section 754 Election

When a third party purchases a partnership interest, an election under §754 can be made by the partnership to allow the purchaser to receive increased depreciation deductions and basis adjustments for partnership property. However, since a transferee spouse is considered to have received the partnership interest by gift, the provisions of §754 presumably do not apply. This is true even if the spouse does, in fact, purchase the interest from the other spouse.

Review Questions

Under NASBA-AICPA self study standards, self study sponsors are required to present review questions intermittently throughout each self-study course. The following questions are designed to meet those requirements and increase the benefit of the materials. <u>However, they do not have to be completed to receive any credit you may be seeking with regard to the text</u>. Nevertheless, they may help you to prepare for any final exam.

Short explanations for both correct and incorrect answers are given after the list of questions. We recommend that you answer each of the following questions and then compare your answers. For more detailed explanations and references, you may do an electronic search using Ctrl+F (if you are viewing this course on computer), consult the text Index, or review the general Glossary.

58. When a couple decides to terminate their marriage, what is NOT mentioned as a common disposition alternative for the family residence?

a. Selling the home to a third party and dividing the proceeds between the spouses.

b. Renting out the family home and splitting the rental income between the spouses.

c. One spouse transferring their interest in the home to the other spouse, resulting in sole ownership.

d. Continuing joint ownership with one spouse occupying the home.

59. Current §121 replaced the rules for gains on the sale of a personal residence under §§1034 and old 121. Under current §121, who can be entitled to a combined $500,000 exclusion on the sale of their principal residence?

a. a single taxpayer who marries a taxpayer who has used the exclusion within two years.

b. married couples filing a joint return and using the property as their principal residence for at least one year during a five-year period.

c. married couples sharing a principal residence and filing a joint return.

d. married couples who have sold a primary residence in the preceding two years.

60. Special ownership and use rules apply when a transferor spouse transfers a home to a transferee spouse. Under §121, when is the transferee deemed to have owned said property?

a. during any period of time when both spouses used the property.

b. when two years have passed since the last exclusion was allowed to either spouse.

c. during any time period when the transferor owned it.

d. during any period of time when they jointly owned it and the transferor is allowed to live in it under a separation instrument.

61. Under Reg. §1.1041-1T, Q&A 9, which of the following is NOT one of the instances where a transfer to a third party on behalf of a former spouse can qualify for §1041 nonrecognition treatment?

a. The transfer is required by a divorce or separation instrument.

b. The transfer is made pursuant to a written request of the non-transferring spouse (or former spouse).

c. The transfer is made pursuant to written consent by the non-transferring spouse (or former spouse).

d. The transfer is made pursuant to a verbal request of the non-transferring spouse (or former spouse).

62. There are four types of qualified redemptions under §302 allowing capital rather than ordinary or dividend treatment. What is one of these qualified redemptions?

a. a full liquidation.

b. an absolute termination of a shareholder's interest.

c. one that is fundamentally the same as a dividend.

d. one that is substantially proportionate.

63. The treatment of cash payments made to a withdrawing partner depends on whether or not such payments are determined by reference to the partnership income. How are such payments treated when they produce a deduction from gross income?

a. as a current distribution.

b. as a distributive share.

c. as guaranteed payments.

d. as income distribution.

Insurance Policies

Life insurance is often used in divorce to secure alimony, child support, or property settlement payments. In addition, life policies (with cash values) are common marital assets.

Benefits paid under a life insurance contract, by reason of the death of the insured, are excluded from gross income (§101(a)). However, the exclusion for life insurance does *not* apply to a taxpayer who has *purchased* an existing policy (§101(a)(2)). In this case, only the consideration plus premiums and other charges subsequently paid by the transferee are excludable.

Example

The owner of an existing policy sells it to Jane for consideration. Jane pays additional premiums. The insured dies. The proceeds are taxed to Jane less the purchase price plus later premiums.

However, the "purchaser" rule does not apply if the person acquiring the policy has a carryover basis from the transferor. This is exactly what happens under §1041. The entire proceeds are excludable, not just the transferee's basis. Thus, spouses and former spouses may transfer insurance policies among themselves (with or without consideration) without resulting in a later inclusion in income.

Real & Personal Property

While property transfers between spouses or former spouses incident to divorce are not taxable under §1041, a later sale of such property is taxable under general income tax rules. The character of the gain (or loss) as ordinary or capital will depend upon the asset classification in the hands of the spouse receiving it.

Classification of Assets

To determine whether the gain or loss on the sale of an asset is *capital* gain or loss or *ordinary* gain or loss, the assets sold must be classified as:

(1) Capital assets held one year or less,

(2) Capital assets held for more than one year,

(3) Real property and depreciable property used in business and held one year or less,

(4) Real property and depreciable property used in business and held for more than one year, *and*

(5) Property held primarily for sale (for example, stock-in-trade or inventory).

Character of Gain or Loss

It is important to properly distinguish or classify gains and losses as either ordinary or capital gains or losses and as either short-term or long-term gains or losses. These distinctions are essential to correctly arrive at net capital gain or loss.

The correct classification of gains and losses is also important for determining the limit on capital losses.

Note: Capital losses are allowed in full against capital gains plus up to $3,000 of ordinary income.

Capital Assets - §1221

Under §1221, everything is a capital asset *except*:

1. Property held mainly for sale to customers or property that will physically become a part of the merchandise that is for sale to customers,

2. Accounts or notes receivable acquired in the ordinary course of a trade or business, or for services rendered as an employee, or from the sale of any properties described in (1),

3. Depreciable property used in a trade or business (even though fully depreciated),

4. Real property used in a trade or business,

5. A copyright, a literary, musical, or artistic composition, a letter or memorandum, or similar property:

a) Created by the taxpayer's personal efforts, *or*

b) A letter, memorandum, or similar property, prepared or produced for the taxpayer, *or*

c) Acquired from a person who created the property, or for whom the property was prepared, under circumstances entitling the taxpayer to his or her basis (for example, by gift), *and*

6. U.S. Government publications obtained from the government free or for less than the normal sales price or acquired under circumstances entitling the taxpayer to the basis of someone who got the publications free or for less than the normal sales price, if the taxpayer sells, exchanges, or contributes the publication.

Long-Term or Short-Term

The treatment of capital gains and losses depends on how long the asset was held before sale or exchange. If a capital asset is held for one year or less, the gain or loss from its disposition is short-term. If a capital asset is held for longer than one year, the gain or loss from its disposition is long-term.

To determine the holding period of an asset, start counting on the day following the day the taxpayer acquired the property. The same date of each following month is the beginning of a new month regardless of the number of days in the preceding month. The day the asset is disposed of is part of the holding period.

Example

If Dan bought an asset on June 19, 2024, he should start counting on June 20, 2024. If Dan sells the asset on June 19, 2025, his holding period is not more than one year, but if he sold it on June 20, 2025, the holding period would be more than one year.

Installment Sale

The gain from an installment sale of a capital asset qualifying for long-term capital gain treatment in the year of sale will continue to be long-term in later tax years. If it is short-term in the year of the sale, it will continue to be short-term when payments are received in later tax years.

Net Gain or Loss

Whether short-term or long-term, the amount of capital gain or loss from a sale is the difference between the amount realized and the adjusted basis of the property plus selling expenses. Capital gains and losses are figured on Schedule D.

The rate at which capital gains may be taxed applies only to a taxpayer's net capital gain. Section 1221(11) defines a *net capital gain* as the excess (if any) of a taxpayer's net long-term capital gain for a taxable year over the taxpayer's net short-term capital loss for the year.

A *net long-term capital gain* is the excess (if any) of a taxpayer's long-term capital gains for a taxable year over the taxpayer's long-term capital losses for the year. A *net short-term capital loss* is the excess (if any) of the taxpayer's short-term capital losses for the taxable year over the short-term capital gains for the year (§1221(6)).

These terms can be expressed by the following formulas:

  long-term capital gains
- long-term capital losses
  net long-term capital gain

  short-term capital losses
- short-term capital gains
  net short-term capital loss

  net long-term capital gain
- net short-term capital loss
  net capital gain

Treatment of Net Capital Gains

Beginning in 1987, net capital gains were taxed at the same rate as ordinary income. However, starting in 1991, there was an *alternative tax computation* when taxable income included net capital gain (§1(j)). The alter-

native tax computation taxed the net capital gain component of taxable income at a maximum tax rate of 28%.

Note: When taxable income including the net capital gain did not put the taxpayer into the 33% or 35% rate brackets, the alternative tax computation did not yield a tax benefit.

The net capital gain alternative tax was the sum of the following:

(1) The tax computed using the regular rates on the greater of:

(a) Taxable income less the net capital gain, *or*

(b) The amount of taxable income taxed at a rate below 28%, *plus*

(2) 28% of taxable income in excess of taxable income used in (1) above.

Currently, the highest tax rate on a net capital gain is generally 15% (or 20% for high-income taxpayers and 5% or even 0% for low-income taxpayers). However, there are 3 exceptions to the 15% rate:

(1) The taxable part of a gain from qualified small business stock is taxed at the old maximum 28% rate;

(2) Net capital gain from selling collectibles such as coins or art is taxed at a maximum 28% rate; *and*

(3) The part of any net capital gain from selling §1250 real property that is due to the recapture of straight-line depreciation is taxed at a maximum 25% rate.

Section 1231 Assets

Property used in a trade or business or held for the production of rents or royalties and held for more than one year is known as §1231 property and is subject to § 1231 treatment. In a disposition of *depreciable* property, figure the *ordinary* income part of the gain. Any remaining gain is then included in the §1231 computation.

Property used in a trade or business includes real property[13] and depreciable personal property[14], but not property held for sale to customers.

Gains & Losses

Combine all gains and losses from the sales or dispositions of §1231 property for the tax year. If the §1231 gains exceed the §1231 losses, there is a net §1231 gain. If the §1231 gains are more than the §1231 losses, then these gains and losses must be treated as long-term capital

[13] This includes all interests, such as easements, leaseholds, water rights, etc., that are recognized as real property under applicable state law.

[14] Most assets used to carry on a trade or business, for which the taxpayer expects to get back most or all of their investment through depreciation deductions are depreciable assets.

gains or long-term capital losses. An excess of §1231 losses over §1231 gains results in a net §1231 loss. If the §1231 losses equal or exceed the §1231 gains, then treat each item as an ordinary gain or loss.

Recapture Of Net Ordinary Losses

A net §1231 gain is treated as ordinary income to the extent the gain does not exceed nonrecaptured net §1231 losses taken in prior years. Nonrecaptured losses are net § 1231 losses deducted for the five most recent tax years that have not yet been applied (recaptured) against any net §1231 gains in a tax year beginning after 1984. Losses are considered recaptured beginning with the earliest year subject to recapture.

Ordinary Assets

Property is ordinary income property if its sale at fair market value on the date it was contributed would have resulted in ordinary income or in short-term capital gain.

Note: Examples of ordinary income property are inventory, works of art created by the donor, manuscripts prepared by the donor, and capital assets held for one year or less.

Gains on ordinary assets constitute ordinary income. It generally is recognized that where gains are involved, capital gains are better than ordinary income. However, where losses are involved, it's just the opposite. Ordinary losses are more valuable than capital losses. This is because capital gains can be used to absorb capital losses dollar-for-dollar up to the full amount of gain. On the other hand, where capital losses exceed capital gains, they can offset ordinary income only to the extent of $3,000 in any one year.

Depreciable Property

If a taxpayer disposes of depreciable property at a gain, he or she may have to treat all or part of the gain as ordinary income. The taxpayer must keep permanent records of the facts necessary to figure the amount of depreciation that was allowed or allowable on depreciable property to figure any gain that must be reported as ordinary income. This includes the date of acquisition, cost or other basis, depreciation, and all other adjustments that affect basis.

Recapture on Personal Property

A gain on the disposition of §1245 property is treated as ordinary income to the extent of depreciation allowed or allowable on the property.

Section 1245 Property

Section 1245 property includes any property that is or has been subject to an allowance for depreciation and that is:

(1) Personal property (both tangible and intangible),

(2) An elevator or an escalator (placed in service before 1987),

(3) Real property (not included in (4) below), to the extent its adjusted basis has been reduced by amortization deductions for certified pollution control facilities, expenditures to remove architectural and transportation barriers to the handicapped and elderly, reforestation expenditures, on-the-job training, and child-care facilities, or for which a §179 deduction was taken, *or*

(4) A special purpose structure or storage facility.

Treatment of Gain

The amount of gain treated as ordinary income on the sale, exchange, or involuntary conversion of §1245 property, including a sale and leaseback transaction, is limited to the *lower* of the amounts listed below:

(1) The recomputed basis of the property minus the adjusted basis of the property, *or*

Note: Recomputed basis is the total of the adjusted basis plus depreciation and amortization (allowed or allowable) included in the adjusted basis.

(2) The amount realized from the sale minus the adjusted basis of the property.

For any other disposition of §1245 property, ordinary income is measured by the amount the fair market value exceeds the adjusted basis of the property.

Recapture on Real Property

A gain on the disposition of §1250 property is treated as ordinary income to the extent of additional depreciation allowed or allowable on the property. Additional depreciation is any depreciation in excess of the straight-line rate. Since only straight-line depreciation can now be deducted under MACRS, §1250 is of diminishing importance.

Section 1250 Property

Section 1250 property includes all real property that is subject to an allowance for depreciation and that is not and has never been §1245 property or §1245 recovery property. It also includes leased property (such as a building) to which the lessee has made improvements that

are subject to an allowance for depreciation and the cost of acquiring a lease.

Note: If, because of a change in its use, §1250 property becomes §1245 property in the hands of a taxpayer, it may never again be treated as §1250 property by that taxpayer.

Pension Benefits

Several approaches can be used when dividing retirement plan benefits in a divorce or separation action. Popular methods include:

(1) To the extent the participant spouse's benefits are vested, liquid, and available for withdrawal, transferring all or a portion of the benefits to the nonparticipant spouse (present distribution method);

(2) Placing a present value on the benefits, permitting the participant spouse to retain those benefits and transferring other marital property to the nonparticipant spouse (present transfer of equivalent assets method);

(3) Having the divorce court retain jurisdiction until the benefits come into pay status and then dividing the benefits (deferred determination method); *and*

(4) Giving the nonparticipant spouse the right to receive all or part of the benefits as an *alternate payee* under a "qualified domestic relations order" (deferred division method).

Note: Retirement plans subject to ERISA must establish written procedures for the payment of benefits under a QDRO (ERISA §206(d)(3)(A)).

Qualified Domestic Relations Order

A "qualified domestic relations order" (QDRO) is a judgment, decree, or court order, including an approved property settlement agreement, that is issued under the domestic relations law of a state (ERISA §206(d)(3)(B)(ii); IRC §414(o)(1)(B)). A QDRO gives a spouse, former spouse, child, or dependent of a participant in a retirement plan the right to receive all or part of the benefits as an *alternate payee* that would be payable to the participant under the plan.

Note: A QDRO can be used not only for the division of retirement benefits as marital property but can also be used to enforce an obligation to pay spousal and child support.

The order must contain the following specific information:

(1) The name and last known mailing address of the participant spouse and each alternate payee;

Example

The participant spouse's name is Danny Santucci. His mailing address is c/o YMCA, 1234 Main Street, Anytown, USA 01234. The alternate payee's (i.e., spouse or former spouse's) name is Marla Maples. Her mailing address is One Trump Plaza, New York, NY 01010.

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(2) The amount or percentage of the participant spouse's benefits to be paid to each alternate payee or the manner in which the amount or percentage is to be determined;

Example

The benefits of the participant spouse under the subject defined benefit retirement plan are determined to be marital property to the extent that they were acquired during marriage. The marital portion shall be the participant spouse's accrued normal retirement benefit as of the date when payment of benefits begins multiplied by the fraction set forth below. The numerator of the fraction shall be the number of days of employment from the date of the parties' marriage to (and including) the date of their separation. The denominator of the fraction shall be the number of days of employment of the participant spouse from employment entry to (and including) the date when payment of benefits begins. The alternate payee shall be entitled to fifty percent (50%) of the marital portion.

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(3) The number of payments or the period to which the order applies; *and*

Note: The alternate payee may elect to receive said share in any form in which such benefit may be payable to the participant spouse under the provisions of the subject retirement plan.

(4) Each plan to which the order applies (ERISA §206(d)(3)(C); IRC §414(p)(2)).

Example

The participant spouse is employed by the Republican National Committee (RNC), Democratic Misinformation Section, 1600 Pennsylvania Ave., Washington, D.C. 01010 and since January 1, 1980, has been a participant in the RNC Pension Plan (referred to as the "subject retirement plan").

However, a QDRO must *not* require a plan to provide:

(1) Benefits not otherwise provided by the plan;

Note: There is an exception to this rule. A QDRO can provide that payments to the alternate payee may begin on or after the date on which the participant spouse attains the earliest retirement age under the retirement plan, even though the participant spouse does not actually retire on attaining that age (ERISA §206(d)(3)(E); IRC §414(p)(4)). Thus, a participant spouse cannot postpone an alternate payee's benefits by failing to take advantage of the plan's early retirement option.

(2) Increased benefits (determined on the basis of actuarial value); *or*

(3) Payment of benefits to an alternate payee that is required to be paid to another alternate payee under a previous QDRO (ERISA §206(d)(3)(D); IRC §414(p)(3)).

Note: Notice 97-11 provides sample language to be used in QDROs.

The plan administrator must promptly notify the participant spouse and alternate payee of the procedures to determine if a QDRO meets the plan provisions. Within a reasonable time, the plan administrator is required to inform the parties of the outcome. In the meantime, the plan administrator must segregate the alternate payee's share.

Note: A domestic relations order becomes a QDRO when it has been reviewed by the plan administrator and determined to meet all requirements. Technically, the divorce court does not enter a QDRO but a domestic relations order that turns into a QDRO upon the plan administrator's approval.

If the order is a QDRO, the retirement plan must pay benefits to the alternate payee under the terms of the order or risk losing its qualified status.

Taxation of Distributions

If the payee of the QDRO is a spouse or former spouse, the payee is taxed on the distribution (unless it is rolled over into an IRA) as the participant would have been taxed. Under §414(p)(8), retirement benefits paid to an alternate payee who is the spouse or former spouse of the participant are taxed to that person when the benefits are received.

However, if the payee is a child or dependent, the distribution is taxable to the participant. This can create a trap. For example, a retirement benefit could be awarded to a nonparticipant spouse as an annuity under a QDRO. If the nonparticipant spouse then dies, the continuing or remaining benefits might be paid to a third party such as a new spouse or children. In such a case, §402(a)(9) may result in benefits being taxed to the participant spouse.

Likewise, there may be a trap when the husband fails to pay non-taxable child support and the wife gets a court order to have it paid from the husband's retirement plan. Such funds may now be taxable to the wife whereas the payment of the original support moneys would not have been.

Deferred v. Present Division of Benefits

Generally, a QDRO will allow a taxpayer named as an alternate payee to remain in the retirement plan (deferred division) *or* opt for a present division, which he or she can roll over into an IRA or not at his or her option[15]. There are arguments for each form of division.

Deferred Division Arguments

a. In a defined benefit plan, valuation requires making certain assumptions, which will be somewhat, or even grossly, wrong.

b. Uncertainty as to the future vesting of unvested benefits may dictate deferred division.

c. If there are not enough assets to offset an award of the retirement plan to the employee spouse, then deferred division may be the only way to balance the property allocation, particularly, if the plan assets cannot be divided and currently distributed under the terms of the plan.

d. The alternate payee may not want to invest and manage the funds if rolled over into an IRA.

e. If the benefits will mature in a relatively short period of time, deferred division may be less cumbersome and therefore preferable.

f. If the plan is growing at an exceptional rate, the alternate payee spouse may not wish to remove the funds until retirement.

g. If the plan has certain growth or cost-of-living increases that cannot be duplicated in an IRA (e.g., benefits based on high-five employment years), the alternate payee spouse may wish to continue to participate in the retirement plan provided by the employee spouse's employer.

h. The case law of some states mandates or encourages deferred division.

Present Division or Alternate Property Arguments

a. The economic ties between the spouses are severed regarding the retirement plans.

b. The alternate payee spouse can control his or her own retirement assets, using his or her own knowledge and advisers.

c. The alternate payee spouse can pay tax on a portion of the retirement benefits withdrawn and keep them available for emergencies, living expenses, and asset acquisitions.

d. A deferred division may present problems down the road in identifying the alternate payee's interest in the benefits eventually paid by the plan, especially if the benefit received is not a normal retirement benefit com-

[15] Another option may be to just take like value in other property.

mencing at normal retirement age (although the use of a QDRO to identify the respective interests should help clarify matters in most cases).

e. It may be argued that deferred division of defined benefit plans which identify the divisible portion of future payments as the fractionate interest computed by the division of the years of service during marriage by the total years of service will result in an unfairly high allocation to the alternate payee that is based on service of the employee after the divorce.

f. Present division may thin out retirement plans that may otherwise result in a 15% penalty tax for excess distributions to the employee spouse.

g. By taking a present division, the alternate payee avoids future risks that the plan might incur large investment losses, or that the company might suffer business declines or bankruptcy (in the case of an ESOP plan that holds securities issued by the employer).

h. An employee who expects to live a long time may wish to effect a present division in the form of alternate property because the employee will likely outlive the mortality tables and will thus receive larger payments over a longer period of time.

i. Payments to alternate payees are not subject to the 10% penalty tax (unless it is from an IRA), and thus some couples who find this result desirable will be able to take money from the plan before age 59½ without paying a penalty if it is incident to a divorce proceeding.

Note: Generally, it would not be cost-effective to divorce just to extract premature distributions penalty-free.

Individual Retirement Arrangements

The transfer of a taxpayer's interest in an IRA to their spouse or former spouse, under a decree of divorce or separate maintenance or a written instrument incident to divorce, is not considered a taxable transfer. Starting from the date of the transfer, the IRA is treated as the spouse's or former spouse's IRA.

Note: Distributions from an IRA to a spouse or former spouse must be rolled into another IRA to avoid the 10% penalty.

IRA Deduction Limit

For IRA purposes, compensation includes any *taxable* alimony and separate maintenance payments received under a decree of divorce or separate maintenance but only with respect to divorce or separation instruments executed on or before 2019, that have not been modified to exclude such amounts.

If a taxpayer is not covered (or not considered covered) by an employer retirement plan, they can deduct contributions to their IRA equal to the *least* of the following amounts:

(i) $7,000 (in 2024),

(ii) 100% of compensation, *or*

(iii) Actual contributions to the IRA for the year.

If a taxpayer is covered by an employer retirement plan, their deduction for contributions to their IRA may be reduced or eliminated.

> Note: If a taxpayer gets a final decree of divorce or separate maintenance by the end of the tax year, they cannot deduct contributions they make to their *former* spouse's individual retirement arrangement (IRA). They can deduct only contributions to their own IRA.

Rollovers

A rollover is a tax-free distribution of cash or other assets from one retirement program to another. Rollovers are not deductible.

Divorce Distributions

A taxpayer can make a tax-free rollover into an IRA of all or part of a distribution received from their spouse's or former spouse's qualified employee benefit plan because of a divorce or similar proceeding if the distribution is:

(i) The balance to the taxpayer's credit (not the employee's credit) in the plan,

(ii) Made under a qualified domestic relations order, *and*

(iii) Rolled over within 60 days after the taxpayer receives it.

For distribution of property other than money, the taxpayer must roll over the same property received from the plan.

> Note: Only an IRA can receive the rollover. A pension or annuity plan does not qualify.

Amounts Not Rolled Over

When a taxpayer rolls over only part of the distribution, the amount kept must be included in income in the year it was received. However, this amount can be reduced by a prorated share of the participant's cost (investment in the contract). Special rules for lump-sum distributions (special averaging method or capital gain treatment) may apply. However, the 10% additional tax on premature distributions does *not* apply.

If a lump-sum distribution is received from a qualified retirement plan, part of the distribution from active participation in a plan before 1974

may qualify for long-term capital gain treatment. The part from participation after 1973 (and any part from participation before 1974 that is not reported as capital gain) is taxed as ordinary income. This ordinary income part may be taxed under the special 5- or 10-year averaging method (§402(a)(2); §402(e)(1)).

Retirement Planning After Divorce

Divorce is particularly devastating to retirement planning for older individuals who are nearing retirement age, and who have only a fraction of the retirement assets after divorce that they had before. Aggressive asset accumulation after divorce is needed to catch up. Here are a few strategies:

(1) Roll QDRO distributions into IRAs to prevent current taxation and build retirement assets;

(2) Invest retirement assets for growth;

(3) If funds are also invested outside a retirement plan, put income-producing assets into the plan and keep growth assets outside the plan to reduce current taxation;

(4) Make contributions to §401(k) and §403(b) plans, and live off savings, if necessary, to do it;

(5) Use annuities to sock away lump sums for retirement; *and*

(6) Use the new §121 exclusion to scale down housing costs and capture the $250,000 to $500,000 tax-free.

Social Security Benefits

The Social Security system has benefits for a former spouse that a divorce court may not modify or eliminate. The former spouse must meet certain eligibility requirements and make application through a Social Security office.

Divorced Spouse Benefits

These benefits are separate from the other spouse's benefits under Social Security. The other spouse will receive no less due to the former spouse's entitlement.

The following requirements must be met to receive the former spouse benefit:

(1) They must be at least 62 years old,

(2) They must not be remarried when they apply,

Note: A divorced spouse will lose their spousal benefit if they remarry at any time. However, when the participant spouse dies, the former spouse may be able to receive survivor benefits if they meet those separate requirements.

(3) They must have been married to the participant spouse for at least ten years (which need not be consecutive), *and*

(4) The participant spouse must either:

(a) Have begun collecting Social Security benefits, *or*

(b) Be at least 62 and be eligible to collect Social Security benefits.

A qualifying former spouse will receive a monthly benefit equal to a maximum of 50% of their participant spouse's basic age-65 benefit. However, the ex-spouse cannot double-dip on Social Security retirement benefits. Instead, they receive the greater of Social Security:

(1) retirement benefits based on their own work record, *or*

(2) spousal benefits based on the ex-spouse's work record.

Example

Mary's spousal benefit is $2,000 monthly but her own Social Security retirement benefit is $1,600, she'll receive her $1,600 retirement benefit plus $400 as a spousal benefit.

Divorced Widow(er) Benefits

If a participant is divorced (even if they have remarried), their ex-spouse will be eligible for benefits on the participant's record when the participant dies. To qualify the participant's ex-spouse must:

(a) Be at least 60 years old (or 50 if disabled) and have been married to the participant for at least 10 years;

(b) Be any age if caring for a child who is eligible for benefits on the participant's record;

(c) Not be eligible for an equal or higher benefit on his or her own record; *and*

(d) Not be currently married, unless the remarriage occurred after age 60 or 50 for disabled widows.

Note: Remarriage at age 60 or older does not affect survivor benefits. In cases of remarriage after the age of 60, the ex-spouse will be eligible for a widow's benefit on the participant's record or a dependent's benefit on the record of his or her new spouse, whichever is higher.

If a participant's ex-spouse receives benefits on the participant's account, it does not affect the amount of any benefits payable to other survivors.

Military Pensions

Military and federal civil service retirement systems are not subject to ERISA (IRC §401(a) and §411(e)). However, legislation has established separate

procedures by which a nonparticipant spouse or former spouse may reach the participant spouse's benefits in a divorce or separation action. Payments to a nonparticipant spouse under such procedures need not be made pursuant to a QDRO to be taxable to the nonparticipant rather than the participant.

Divorced Spouse Benefits

The retirement system covers members of all the uniformed services. Active duty members of the military are also covered by Social Security. The Uniformed Services Former Spouses Protection Act (10 U.S.C. §1408(c)(1)) permits a state court to award a divorced spouse a share of the military spouse's retirement benefits, known as "retired pay." However, there are several additional aspects that are not present elsewhere:

(1) A jurisdiction requirement,

(2) A "disposable pay" limitation, *and*

(3) Special prerequisites for direct payment.

Jurisdiction Requirement

The Uniformed Services Former Spouses Protection Act (USFSPA) permits states to treat a military pension like any other pension provided the state has jurisdiction over the service member because of:

(1) The service member's consent,

(2) Domicile, *or*

(3) Residence for reasons other than military service.

Note: California has held that military pensions are community property subject to division on divorce (*Marriage of Milhan*, 27 Cal.3d 765 (1980)).

If the spouses live in different states, which may be the case in long-term separations, the jurisdiction rule can present great hardship for the nonmilitary spouse, if they are the spouse filing for divorce. The nonmilitary spouse would have to file in the military spouse's state of residence or domicile in order to claim a share of the retired pay as marital property.

Disposable Pay

The USFSPA provides that a court may only treat the military spouse's "disposable" retired pay as marital property and award no more than 50% of that amount to a former spouse. Disposable pay is the retired pay remaining after certain deductions. Besides deductions to pay for spousal survivor benefits, health insurance, and other standard items, the deductions include:

(1) Military disability retired pay,

(2) Disability retired pay from the Department of Veterans Affairs, *and*

Note: A disabled military retiree may have part or all of their regular retired pay replaced by military disability retired pay or VA disability retired pay. Neither the disability pay nor the retired pay it replaces can be treated as marital property.

(3) Government salary or pension.

Note: A military retiree who takes a post-retirement job as a civilian for the federal government is often required to give up part of their retirement pay while working. This would reduce or eliminate disposable retired pay available to a former spouse. When the spouse retires from their civilian job, they may choose to waive military retired pay and instead have their military service counted in determining civilian retirement benefits. A former spouse cannot receive a share of military retired pay that has been converted to a government salary or civilian retirement benefits. The Court order should address this conversion contingency since if the original order only deals with retirement from the military, the former spouse will have an order that is unenforceable.

If, after all this, there is any disposable pay to divide, payment to the former spouse can begin as soon as the military spouse starts collecting their retired pay and continues as long as the retiree continues to receive benefits.

Direct Payment

The former spouse's share in a military pension can be paid directly by the military. Upon presentation of a valid court order, spousal or child support can be paid directly once a month.

Note: Most former spouses favor direct payment from the military to avoid the risk of nonpayment and contact with the other spouse.

While there is no length of marriage requirement to share in a military pension, direct payment of retired pay as a division of marital property (as opposed to alimony) is available only if the former spouse was married to the military spouse for at least 10 years of the spouse's active duty service.

Direct payment to former spouses cannot exceed 50% of the service member's disposable pay. If more than one former spouse is entitled to make a claim, court orders are honored on a "first come, first served" basis.

Divorced Widow(er) Benefits

The Survivor Benefit Plan Annuity (SBP) is the military retirement system's pension for the surviving spouse. It may be awarded to a former

spouse by court order or provided voluntarily by the retiree making an election at the time of retirement. There is no length of marriage requirement for eligibility and the former spouse may start receiving the monthly SBP annuity immediately after the retiree's death. However, the retiree's benefit will be reduced by 6.5% to pay for the cost of the SBP annuity and the SBP annuity cannot be split between two beneficiaries. Thus, if the former spouse is awarded the SBP annuity and then the military ex-spouse remarries, the second spouse cannot receive any pension on the military spouse's death.

There is no disposable pay limit. Pension benefits are based on the military spouse's full retired pay. If the former spouse is under age 62 when the military spouse dies, the maximum SBP benefit is 55% of the military spouse's unreduced retired pay. After age 62, the SBP is reduced to 35% of the full benefit under the Social Security offset rule.

Social Security Offset

At age 62, the former spouse's SBP benefit is reduced to 35% of the decedent's benefit. This reduction reflects the fact that the former spouse is entitled to collect the Social Security widow(er) benefit at that age.

Note: If the former spouse is age 62 or older when the military spouse dies, the former spouse will never collect more than a 35% SBP benefit.

If the former spouse remarries before age 55, the SBP annuity stops. However, benefits can be restored if the later marriage ends in divorce or the death of the other spouse.

Civil Service Pensions

The Civil Service Retirement System (CSRS) covers most federal government civilian employees hired before 1984. Employees under the CSRS are not covered by Social Security. When an employee can start receiving a pension (known as an "annuity,") depends on:

(a) The number of years worked, *and*

(b) The age at which the worker leaves government service.

Most are eligible to receive an annuity if they have:

(a) 30 years of service and work to age 55, *or*

(b) 20 years of service and work to age 60.

Employees with at least five years of service, who leave before becoming eligible for payments, must wait until age 62 to collect any benefits.

Note: If a participant spouse leaves government service before reaching retirement age, they can still collect benefits starting at age 62, at which time the former spouse can also start collecting their share. But, if the retiree dies

after leaving the government and before starting to collect, no retirement or survivor benefits are payable to the former spouse or any other person.

Federal law permits a state divorce court to divide a civil service annuity. Length-of-marriage requirements are minimal. However, a court may grant an ex-spouse a smaller share in a short-term marriage.

Divorced Spouse Benefit

Typically, an award is likely to be no more than 50% of the retiree's pension benefits; however, a former spouse may be awarded up to 100%. This benefit is not separate. Whatever the former spouse receives is subtracted from the amount received by the retired participant spouse.

The former spouse can have their share paid directly by the Office of Personnel Management (OPM) if the court issues an order that meets certain requirements. The court order can provide that a divorced spouse start receiving payments as soon as, but no earlier than, the date at which the retiree spouse starts drawing payment. Thus, if the retiree spouse postpones collecting benefits, the former spouse's benefits are also postponed.

If a participant spouse leaves government service before retirement age, they can receive a refund of their contributions, without interest. As a result, rather than sharing in an annuity, a former spouse may want to claim a share of the retiree's returned CSRS contributions. Any court order should anticipate this contingency and either:

(1) Prevent the retiree from withdrawing contributions, *or*

(2) Provide that the former spouse receives a share of the refund.

Note: When a retiree is permitted to obtain a refund of their contributions, the former spouse will lose the future right to share in an annuity or survivor annuity.

Divorced Widow(er) Benefit

A former spouse can receive a widow(er)'s pension (known as a "former spouse survivor annuity") either by:

(1) A voluntary election made by the retiree spouse on the former spouse's behalf, *or*

Note: Such an election can be made on retirement or divorce if the divorce occurs after retirement. The election is irrevocable until the former spouse either remarries before age 55 or dies.

(2) A qualifying court order.

Note: The federal law states that a survivor annuity may not be paid to a former spouse if it is awarded in a "modified" court order issued after the employee's retirement. Thus, an order, issued after retirement, will

not be enforceable if it "amends, explains, clarifies, or interprets" the original divorce decree. Thus, the order must be done right the first time.

The survivor annuity may be as much as 55% of the retiree's unreduced annuity. Payment to the former spouse starts immediately after the retiree's death, regardless of the former spouse's age, and continues for the rest of their life. However, the survivor annuity will stop permanently if the divorced widow(er) remarries before age 55. Once canceled due to remarriage, it cannot be restored, even if the new marriage ends.

Note: This penalty applies only to the former spouse's survivor annuity. Remarriage has no effect on a divorced spouse's right to a share of the retiree's pension during the retiree's lifetime.

Divorced widow(er)s may wish to be awarded pre-retirement survivor protection in the event the retiree spouse dies while working for the federal government and before retirement. However, providing a survivor annuity for death after retirement means that the retiree spouse must take a reduction (usually less than 10%) in his or her own benefit, which would result in a smaller share for the divorced spouse. On the retiree's death, the reduction is discontinued and the survivor annuity is computed on the full benefit amount.

Railroad Pensions

Most railroad employees are covered by the railroad retirement system. The pension actually consists of several benefits:

(1) The basic benefit is known as the "Tier 1" benefit, *and*

Note: The Tier 1 benefit resembles Social Security, except it provides somewhat larger benefits. However, on divorce, the Tier 1 benefit is calculated as Social Security, leaving a smaller benefit for the divorced spouse or widow(er).

(2) Other benefits comparable to private pensions called "Tier 2" benefits.

Tier 1 benefits are automatically available to divorced spouses. A divorce court may not deny the Tier 1 benefit or "award" a different amount. However, Tier 2 benefits are paid on a permissive basis.

Note: The Tier 1 benefit may be partially or wholly "offset" if the divorced spouse or widow(er) is also entitled to their own Social Security worker benefit or a federal, state, or local government employee pension. In addition, the divorced spouse or widow(er)'s Tier 1 benefit can be reduced if they take a job after starting to collect benefits and have earnings over the retirement system's yearly allowable limits (the "earnings test").

Divorced Spouse Benefit

A Tier 1 benefit payable during the retiree's lifetime is automatically available to a divorced spouse who applies to the Railroad Retirement Board and meets the following eligibility requirements:

(1) The former spouse must have been married to the participant spouse for at least ten consecutive years,

(2) The divorced spouse *and* the participant spouse must be at least 62 years old,

(3) The divorced spouse must not be remarried when they apply, *and*

> Note: A Tier 1 divorced spouse benefit stops on remarriage at any age but can be restored if the subsequent marriage ends due to divorce or the new spouse's death.

(4) The participant spouse must have actually begun collecting their railroad retirement benefits.

> Note: Under Social Security, on the other hand, the divorced spouse can begin collecting benefits when the other spouse reaches retirement age, regardless of whether they have actually started collecting benefits.

The divorced spouse benefit is equal to 50% of the Tier 1 pension the participant spouse would receive at age 65. The former spouse may start collecting their benefit as early as age 62, but like Social Security, it will be reduced for each month before age 65.

> Note: The former spouse's and participant spouse's Tier 1 benefits are separate and one does not reduce the other's benefit.

Tier 2 benefits may, but are not required to, be divided as marital property. They can only be awarded by court order A divorced spouse may be awarded up to 100% of Tier 2 benefits. However, since the former spouse's Tier 2 share is taken out of the participant spouse's benefit, awards are typically 50% or less. The divorced spouse need not be a specific age to receive payments but payments cannot start until the participant's payments begin.

The court order can require that the divorced spouse's share is paid by the participant spouse or directly by the Railroad Retirement Board.

> Note: Thus, during the retiree's lifetime, the former spouse can receive both a 50% Tier 1 benefit and a variable share of the retiree's Tier 2 benefit.

Divorced Widow(er) Benefit

A Tier 1 widow(er)'s benefit is automatically available to a former spouse who is at least 60 years old and meets certain eligibility requirements. This is a separate benefit and does not reduce the participant's benefit.

A Tier 1 widow(er)'s pension ends if the former spouse remarries before age 60, but can be reinstated if the new marriage ends through divorce or the spouse's death.

The divorced widow(er)'s benefit is 100% of the participant's benefit if the divorced widow(er) starts collecting it at age 65, but it will be reduced to as little as 71.5% if they start collecting at age 60.

No Tier 2 benefits are payable to a divorced widow(er) and any Tier 2 benefits that were being paid to the former spouse stop when the participant spouse dies.

Bankruptcy

Debts arising from property settlements are *dischargeable* in bankruptcy. However, bankruptcy law does not allow for the discharge of:

(1) Alimony,

(2) Maintenance, *or*

(3) Child support.

The bankruptcy court is empowered to find the true nature of the marital settlement to determine if the payments are actually for nondischargeable support or dischargeable property interests. Thus, the distinction between property settlements and support for bankruptcy purposes is not always the same as for tax purposes. For example, inserting a clause that a payment will terminate at death may serve to convert an otherwise nondeductible property settlement into deductible alimony for income tax purposes, but may not change the character of the property settlement in bankruptcy.

Debts to third parties that are nondischargeable under the support exception include:

(1) Medical and dental payments for children, *and*

(2) Mortgage payments on a home.

Since debts arising from property settlements are *dischargeable* in bankruptcy and support obligations are *not* dischargeable, the following strategies should be considered:

(1) The obligation to pay pension plan benefits should be done through a QDRO so that the payments are made directly from the pension plan;

(2) Legal and accounting fees to be paid by one spouse for services to the other spouse should be couched as support payment; *and*

(3) The obligation to pay housing or other costs should be characterized as support to circumvent the possibility of discharge in bankruptcy.

Review Questions

Under NASBA-AICPA self study standards, self study sponsors are required to present review questions intermittently throughout each self-study course. The following questions are designed to meet those requirements and increase the benefit of the materials. However, they do not have to be completed to receive any credit you may be seeking with regard to the text. Nevertheless, they may help you to prepare for any final exam.

Short explanations for both correct and incorrect answers are given after the list of questions. We recommend that you answer each of the following questions and then compare your answers. For more detailed explanations and references, you may do an electronic search using Ctrl+F (if you are viewing this course on computer), consult the text Index, or review the general Glossary.

64. Under §101, life insurance proceeds paid upon the death of the insured person are excluded from income tax. However, when are such proceeds income taxable?

    a. when paid under a health insurance policy.

    b. when paid due to an accident.

    c. if paid pursuant to an endowment contract.

    d. if the policy was transferred to the recipient for a price.

65. Currently, excluding the three exceptions, what is the highest tax rate on a net capital gain?

    a. 15% (20% for higher-income taxpayers).

    b. 25%.

    c. 28%.

    d. 37%.

66. The author provides four methods of separating retirement plan benefits in a divorce or separation. Which method involves requesting that the court maintain control until the benefits are to be paid, at which time the benefits will be divided?

    a. deferred determination method.

    b. deferred division method.

    c. present distribution method.

    d. present transfer of equivalent assets method.

67. A participant's spouse, former spouse, child, or dependent may be able to take pension plan benefits in whole or in part as an alternate payee. What is able to confer such a right on a nonparticipant?

    a. a defined benefit plan.

b. a qualified domestic relations order (QDRO).

c. a rollover.

d. an individual retirement arrangement (IRA).

68. One method for dividing up pension plan benefits in a divorce is the present division method. What is an argument for this method?

a. It may be the only way to make an asset distribution equal.

b. Funds may stay in the plan if it is ticking upward quickly.

c. Case law may require or recommend this method.

d. The economic connection to the participant is dissolved.

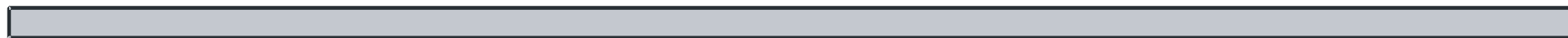
69. When a taxpayer who has gone through a property settlement files for bankruptcy, he or she will find that certain costs are nondischargeable. However, what may be discharged?

a. debts derived from transferring property to a spouse or former spouse.

b. alimony and child support.

c. medical and dental payments for children.

d. mortgage payments on a home.



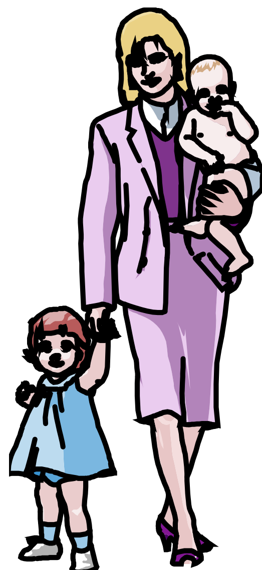
Learning Objectives

After reading Chapter 3, participants will be able to:

1. Recognize how the tax treatment of spousal support payments has dramatically changed under the TCJA, identify the §71 requirements for pre-2019 decree alimony, and differentiate the tax treatment with current law.
2. Identify the tax treatment of child support and circumstances where a payment will be fixed as child support, and specify events that determine whether a contingency is clearly child-related and how to rebut this presumption of child support.
3. Recognize the COBRA and qualified medical child support order rules by:
    a. Identifying whether COBRA rules apply to different plans including notice & deadline requirements and specifying situations that may result in a termination of continuing coverage; and
    b. Determining what constitutes "qualified medical child support orders" recognizing differences with other similar orders and identifying the procedures, requirements, and jurisdiction of QMCSOs.

CHAPTER 3

Alimony & Child Support



Alimony

The tax treatment of alimony is dependent upon the date of the divorce decree or separation instrument being either pre-2019 or 2019 and later.

For pre-2019 divorces, alimony (sometimes called "spousal support") payments by a separated or divorced spouse to the other spouse are fully deductible. Divorced taxpayers can deduct the cost of §71 qualified alimony payments above the line (§62(13)) while alimony recipients report such payments as taxable income (§71(a) & §215). Thus, alimony or separate maintenance payments are deductible by the payer spouse and includible in the recipient spouse's income if paid under a divorce or separation agreement executed before 2019.

For 2019 and later divorce or separation instruments executed or modified after 2018 (if the modification expressly provides TCJA amendments apply), the deduction for alimony (and separate maintenance) payments and the inclusion of such payments in gross income are repealed. Thus, taxpayers cannot deduct ali-

mony or separate maintenance payments made under a divorce or separation agreement (i) executed after 2018, or (ii) executed before 2019 but later modified if the modification expressly states the repeal of the deduction for alimony payments applies to the modification. Alimony and separate maintenance payments received under such an agreement are not included in the recipient's gross income.

Pre 2019 Decrees

Section 71 formerly provided rules regarding the tax treatment of alimony and separate maintenance payments but was repealed by the TCJA effective for any divorce or separation instrument executed after 2018. Thus, prior to 2019, to qualify as alimony under §71, payments to a spouse or former spouse had to meet the following numbered requirements and restrictions.

#1 - Divorce or Separation Instrument - (§71(b)(1)(A))

The spouse or former spouse had to receive alimony payments under a divorce or separation instrument. Section 71(b)(2) still defines the term "divorce or separation instrument" to mean:

(1) a decree of divorce or separate maintenance or a written instrument incident to that decree (§71(b)(2)(A));

(2) a written separation agreement (§71(b)(2)(B)); *or*

(3) a decree or any type of court order requiring a spouse to make payments for the support or maintenance of the other spouse (§71(b)(2)(C)).

Note: This includes a temporary decree, an interlocutory (not final) decree, and a decree of alimony pendente lite (while awaiting action on the final decree or agreement). An instrument also included a written agreement incident to a divorce or written separation agreement (§71(b)(2)).

With the exception of item (3) above, there was *no* requirement that the payments be for the support of the payee spouse or that they be described in the instrument as alimony or separate maintenance payments.

Invalid Decree

Payments under a divorce decree could be alimony even if the decree's validity was questioned. A divorce decree is valid for tax purposes until a court having proper jurisdiction holds it invalid.

Amended Instrument

An amendment to a divorce decree could change the nature of the payments. Amendments were *not* ordinarily *retroactive* for federal tax purposes. However, a retroactive amendment to a divorce decree correcting

a *clerical* error to reflect the *original intent* of the court was generally given effect for federal tax purposes.

Example

A court order retroactively corrected a mathematical error under Dan's pre-2019 divorce decree to express the original intent to spread the payments over more than 10 years. This change is given effect for federal tax purposes.

Example

Dan's original pre-2019 divorce decree did not fix any part of the payment as child support. To reflect the true intention of the court, a court order retroactively corrected the error by designating a part of the payment as child support. The amended order is given effect for federal tax purposes.

Premarital Agreements

When a *premarital agreement* provides for support payments, such payments may *not* be alimony if the *divorce decree* is silent as to the terms of the premarital agreement. However, such payments are alimony if the premarital agreement is *incorporated* into the decree or separation instrument.

Note: Support payments may also be alimony if the premarital agreement expressly provided that the payments were in contemplation of divorce.

Example

When Dan married Jane, they entered into a premarital agreement that provided that Dan would pay Jane $2,000 a month for life. After several years, the couple divorced in 2018. The premarital agreement was incorporated into the divorce decree. As a result, the support payments are alimony.

Voluntary Payments

Alimony only included payments *required* by a pre-2019 divorce or separation instrument. Thus, *voluntary* payments were *not* alimony under §71(b) and may have been gifts. This same rule applied to voluntary increases in qualified alimony payments.

Note: Taxpayers wishing to increase alimony payments should seek an amendment to the written instrument to avoid the voluntary payment issue.

Example

Believing (erroneously?) that chivalry is not dead, Dan without legal coercion pays his ex-spouse, Jane, $1,000 in memory of the "good times." The payment is not alimony.

Example

Under his pre-2019 divorce decree, Dan pays Jane $2,000 per month in alimony. In June, Rocko, their teenage son, came down with athlete's foot, and Jane asked Dan to foot the extra $1,000 to pay doctor bills. Dan paid it and even added another $200 for future "emergencies." Since the $1,200 was not required by the decree, Dan's alimony is limited to $24,000 ($2,000 x 12 months).

Payments to Remarried Spouse

If the legal obligation to make payments ends upon remarriage, payments to a remarried former spouse are *not* alimony. Whether there is a legal obligation to make payments after remarriage will depend upon the state law and the terms of the marital settlement agreement.

#2 Different Households - (§71(b)(1)(C))

Payments to a spouse while the taxpayer and the spouse are members of the *same* household are *not* alimony if the taxpayer and spouse are separated under a pre-2019 *decree of divorce* or *separate maintenance* (§71(b)(1)(C)).

Note: A home the parties formerly shared is considered one household, even if the parties physically separate themselves in the home.

However, spouses are not treated as members of the same household if:

(i) One spouse is preparing to leave the household, *and*

(ii) Does leave not more than one month after the date of the payment (Reg. §1.71-1T, Q&A-9).

Exception

When the parties are *not legally separated* under a decree of divorce or separate maintenance, a payment under a written separation agreement, support decree, or other court order *may* qualify as alimony or

separate maintenance *even if* the parties are members of the same household when the payment is made.

#3 Termination at Death - §71(b)(1)(D))

If a taxpayer had to continue to make payments for any period after their spouse's death, *none* of the payments made *before or after* the death were alimony.

This requirement could be met by having the divorce or separation instrument state there is no liability for payments after the payee spouse's death. However, the divorce or separation instrument did not have to make such a statement if the liability for continued payments would end at death under state law.

Historical Note: The Tax Reform Act of 1984 required that the instrument state that the liability to pay terminates at the death of the recipient spouse. Temporary Regulation §1.71-1T Q&A-12 states that it is not enough that local law requires termination of the payments at the death of the payee (as in the case of California). However, the Tax Reform Act of 1986 retroactively repealed this requirement for agreements executed after 1984. Since local law may be unclear, a statement in the divorce or separation instrument is best.

Example

Dan must pay his former spouse $10,000 in cash each year for 10 years. Dan's pre-2019 divorce decree states that the payments will end upon his former spouse's death. Dan must also pay his former spouse or his former spouse's estate $20,000 in cash each year for 10 years.

The $10,000 annual payments are alimony. But because the $20,000 annual payments will not end upon Dan's former spouse's death, they are not alimony.

Substitute Payments

While alimony payments had to cease upon death, there could not be any liability to make payments after the recipient's death as a substitute for payments stopped at death Thus, if a taxpayer had to make any payments in cash or property after their spouse's death as a substitute for continuing otherwise qualifying payments, the otherwise qualifying payments were *not* alimony. Payments could be considered substitute payments, depending on the facts and circumstances, to the extent that any payments were to begin, increase in amount, or become accelerated in time as a result of the spouse's death.

Note: Amounts payable under an insurance policy on the receiving spouse's life are not substitute payments.

Example

Under Dan's pre-2019 divorce decree, he must pay his former spouse $30,000 annually. The payments will stop at the end of 6 years or upon his former spouse's death, if earlier.

Dan's former spouse has custody of their minor children. The decree provides that if any of those children are still minors at Dan's spouse's death, he must pay $10,000 annually to a trust until the youngest child reaches the age of majority. The trust income and corpus (principal) are to be used for the children's benefit.

These facts indicate that the payments to be made after the former spouse's death are a substitute for $10,000 of the $30,000 annual payments. Therefore, $10,000 of each of the $30,000 annual payments is not alimony.

Example

Under Dan's pre-2019 divorce decree, he must pay his former spouse $30,000 annually. The payments will stop at the end of 15 years or upon his former spouse's death, if earlier. The decree provides that if the former spouse dies before the end of the 15-year period, Dan must pay the estate the difference between $450,000 ($30,000 x 15) and the total amount paid up to that time. For example, if his spouse dies at the end of the tenth year, Dan must pay the estate $150,000 ($450,000 - $300,000).

These facts indicate that the lump-sum payment to be made after the former spouse's death is a substitute for the full amount of the $30,000 annual payments. Therefore, none of the annual payments are alimony. The result would be the same if the payment required at death were to be discounted by an appropriate interest factor to account for the prepayment.

#4 Payments Must Be In Cash - (§71(b)(1))

Only cash payments, *including* checks and money orders, qualified as alimony (§71(b)(1)). Transfers of services or property (including a debt instrument of a third party or an annuity contract), execution of a debt instrument, or the use of property did *not* qualify as alimony (Reg. §1.71-1T, Q&A-5).

Payments to a Third Party

Cash payments to a third party *under the terms* of a taxpayer's pre-2019 divorce or separation instrument could qualify as a cash payment to their spouse.

Common instances where such third party payments could occur were:

(1) Dental expenses,

(2) Medical costs,

(3) Rent,

(4) Living expenses,

(5) Mortgage payments,

(6) Utility bills

(7) Education, *and*

(8) Income tax.

> Note: If an agreement was made to pay the income tax on alimony paid to a former spouse, a pyramid of tax on tax resulted. In such an event, it might have been better to just gross up the alimony to include the tax. For example, if the recipient spouse were in a combined state and federal tax bracket of 50%, the alimony would be doubled.

Instead of paying the spouse directly, the taxpayer could make payments for or on behalf of their spouse. However, such payments to a third party had to be made *on behalf of the spouse*.

Temporary Regulation §1.71-1T, Q&A-6 (T.D. 7973), provided:

> *"Assuming all other requirements are satisfied, a payment of cash by the payor spouse to a third party under the terms of the divorce or separation instrument will qualify as a payment of cash which is received "on behalf of a spouse." For example, cash payments of rent, mortgage, tax, or tuition liabilities of the payee spouse made under the terms of the divorce or separation instrument will qualify as alimony or separate maintenance payments."*

Such third-party payments were treated as received by the spouse and then paid to the third party.

Example

Under Dan's divorce decree, he must pay his former spouse's medical and dental expenses. If the payments otherwise qualify, Dan can deduct them as alimony on his return. His former spouse must report them as alimony received and can include them in figuring deductible medical expenses.

Example

Under Dan's separation agreement, he must pay the real estate taxes, mortgage payments, and insurance premiums on a home owned by his spouse. If they otherwise qualify, Dan can deduct the payments as alimony on his return and his spouse must report them as alimony received. If itemizing deductions, his spouse can deduct the real estate taxes and also include the interest on the mortgage in figuring deductible interest.

Written Requests, Consents, or Ratifications

Cash payments made to a third party at the written request[1], consent, or ratification of the taxpayer's spouse could qualify as alimony.

If the taxpayer's spouse requested *in writing* that the taxpayer make a cash payment directly to a third party, instead of to the spouse as required by the pre-2019 divorce or separation instrument, such a payment could qualify as an alimony or separate maintenance payment. A payment made by the taxpayer to a third party *without* the written request of the spouse (or pursuant to a verbal request) also qualified if the spouse consented to or ratified the payment in *writing*.

However, the written request, consent, or ratification had to:

(a) State that both spouses *intended* the payments to be treated as alimony or separate maintenance payment to the taxpayer's spouse subject to the rules of §71; *and*

(b) Be received by the taxpayer before filing their tax return for the year the payments were made (Temp. Reg. §1.71-1T, Q&A-7).

A variety of obligations could be paid in this way, including rent, mortgage debt, taxes, or tuition for the spouse.

[1] This could be a letter from payee to payor.

Review Questions

Under NASBA-AICPA self study standards, self study sponsors are required to present review questions intermittently throughout each self-study course. The following questions are designed to meet those requirements and increase the benefit of the materials. However, they do not have to be completed to receive any credit you may be seeking with regard to the text. Nevertheless, they may help you to prepare for any final exam.

Short explanations for both correct and incorrect answers are given after the list of questions. We recommend that you answer each of the following questions and then compare your answers. For more detailed explanations and references, you may do an electronic search using Ctrl+F (if you are viewing this course on computer), consult the text Index, or review the general Glossary.

70. The continuing importance of alimony under §71 and the current tax treatment of support payments to a former spouse are dependent on:

   a. the date of the divorce decree being either pre-2019 or 2019 and later.

   b. the consent of the parties to the divorce.

   c. a significant contingency

   d. local and state regulation.

71. "Alimony" is defined under §71 and is an important concept for payments to a former spouse originating under a pre-2019 decree. What other term is often used for such payments?

   a. family support.

   b. spousal support.

   c. marital obligation payments.

   d. periodic payments.

72. For divorces finalized before 2019, how are alimony payments treated for tax purposes?

   a. Alimony payments are not deductible for the payor and not taxable for the recipient.

   b. Alimony payments are partially deductible for the payor and partially taxable for the recipient.

   c. Alimony payments are fully deductible for the payor and fully taxable for the recipient.

   d. Alimony payments are fully deductible for the payor but not taxable for the recipient.

73. Under §71(b)(1)(A), a cash payment can be deemed "alimony" or a "separate maintenance payment" if four conditions are met. What is such a condition?

a. A spouse receives the payment under the divorce or separation instrument.

b. Under the divorce or separation instrument, the cash payment is excludable from gross income.

c. When the cash payment is made, both spouses live in the same household but in separate quarters.

d. The payor spouse is required to make payments after the payee spouse's death.

74. Alimony payments must be received under an existing and valid divorce or separation instrument. However, there is an exception where payments can still be alimony:

a. even retroactively if based on a later amendment to the instrument.

b. while the instrument is legally contested.

c. even if the court making the decree lacked jurisdiction.

d. if they meet the requirements of §215 but not §71.

75. A premarital agreement might provide for support payments on divorce. When do such payments constitute alimony?

a. if the premarital agreement is later made a part of the decree.

b. if the divorce decree is silent as to the premarital agreement.

c. if the agreement and the divorce decree were rendered in the same jurisdiction.

d. if the premarital agreement stated that the payments were not in contemplation of divorce.

76. Assuming all other §71 requirements are met, payments pursuant to a pre-2019 divorce decree are alimony. How are voluntary payments treated?

a. as failing to qualify as alimony.

b. as alimony if paid in cash.

c. as taxable income to the recipient.

d. as tax-deductible gifts.

77. The commencement and termination of payments to a former spouse is an important consideration. What is the treatment of payments when the payor spouse is required to make payments under a pre-2019 decree after the payee spouse's death?

a. only payments made subsequent to the death are not alimony.

b. both payments made before and after the death are not alimony.

c. payments made after death are gifts.

d. payments are presumed to be a property settlement.

78. To satisfy an obligation under a pre-2019 decree to make continuing payments after a spouse's death, a taxpayer might make a lump sum or property payment. What are these cash or property payments deemed?

a. alimony.

b. gifts.

c. a death settlement.

d. substitute payments.

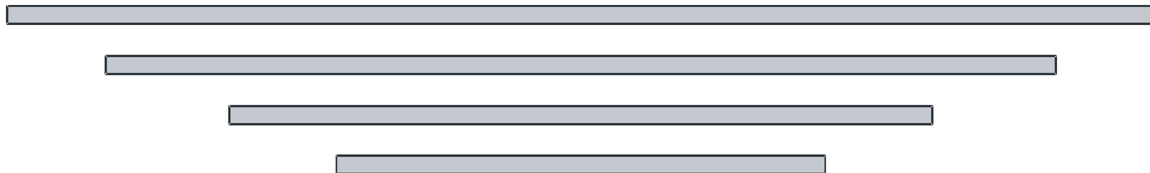
79. Cash payments to a third party can sometimes qualify as alimony. However, how must qualifying payments be made?

a. solely pursuant to a divorce decree.

b. on the spouse's behalf.

c. on behalf of any children.

d. through the former spouse.



Payments for Family Residence

The tax treatment of housing costs (such as mortgage interest and principal, real estate taxes, and insurance) on the family residence depended upon how the home was owned.

> Note: The key to proper characterization of the housing cost payments was whether the payments "primarily benefitted" the occupying or nonoccupying spouse.

Taxpayer-Owned Home

If the pre-2019 divorce or separation instrument allowed one's ex-spouse to occupy a family residence *owned by the taxpayer*, the rental value of the house was *not* alimony. Neither the rental value nor housing costs paid by the taxpayer were alimony.

Temporary Regulation §1.71-1T, Q&A-6 (T.D. 7973) provides that:

> *"Any payments to maintain property owned by the payor spouse and used by the payee spouse (including mortgage payments, real estate taxes and insurance premiums) are not payments on behalf of a spouse even if those payments are made pursuant to the terms of the divorce or separation instrument."*

Example

Under Dan's pre-2019 written separation agreement, his spouse lives rent-free in a home Dan owns and Dan must pay the mortgage, real estate taxes, insurance, repairs, and utilities for the home. Because Dan owns the home and the debts are Dan's, his payments for the mortgage, real estate taxes, insurance, and repairs are not alimony. Neither is the value of his spouse's use of the home.

Thus, if the nonoccupying spouse owned the entire home, all housing payments (mortgage interest and principal, real estate taxes, and insurance) required to be made by the nonoccupying spouse under the terms of a divorce or separation instrument were made primarily for the nonoccupying spouse's benefit and were *not* alimony.

However, interest and real property taxes paid by the nonoccupying spouse could be claimed as itemized deductions subject to the home mortgage interest rules for second homes.

Spouse-Owned Home

If the *occupying spouse owned the entire home*, all housing payments (mortgage interest and principal, real estate taxes, and insurance) required to be made by the *nonoccupying* spouse under the terms of a divorce or separation instrument were made primarily for the occupying spouse's benefit and *were* alimony.

> Note: Since 2019, the occupying spouse does not include the payment in income and can claim the interest and real property taxes as itemized deductions.

The reasoning was that the occupying spouse primarily benefited from the nonoccupying spouse's payment of the mortgage, taxes, and insur-

ance on a home owned by the occupying spouse. In *Grutman v. Commissioner*, 80 T.C. 464 (1983) the tax court held that:

> *"in the area of housing, payments which directly and more than incidentally benefit the wife and which do not directly and primarily benefit the husband constitute alimony income to the wife."*

Jointly-Owned Home

If a pre-2019 divorce or separation instrument stated that a taxpayer had to pay expenses for a home owned by the taxpayer *and* their spouse, some of the payments could be alimony.

Mortgage Payments on Jointly-Owned Home

When a pre-2019 decree or separation instrument required a taxpayer to make *all* the mortgage payments (principal and interest) on a *jointly-owned* home, *and* they otherwise qualified, the taxpayer treated one-half of the total payments as alimony *if* both spouses were liable on the mortgage. If a taxpayer itemized deductions, they could include the other half of the interest in figuring their deductible interest.

The taxpayer's spouse treated one-half of the payments as alimony received and, if itemizing deductions, could include one-half the interest on the mortgage in figuring deductible interest.

Note: If the taxpayer's spouse was not liable on the mortgage, none of the mortgage payments paid were alimony. However, the taxpayer could claim the interest and taxes as itemized deductions.

Taxes & Insurance on Jointly-Owned Home

If a taxpayer had to pay *all* the real estate taxes or insurance on a home held as *tenants in common*, they treated one-half of these payments as alimony. Likewise, the taxpayer's spouse treated one-half of these payments as alimony received. If the taxpayer and their spouse itemized deductions, they could each deduct one-half of the real estate taxes.

If the home was held as *tenants by the entirety* or *joint tenants* (with the right of survivorship), *none* of the taxpayer's payments for taxes or insurance were alimony. However, if the taxpayer itemized deductions, they could deduct all the real estate taxes.

Utilities

Where a nonoccupying spouse was required by the pre-2019 divorce or separation instrument to pay the utilities on a residence occupied by

the other spouse, the utility payments primarily benefit the occupying spouse and *were* alimony.

> Note: The payment of utilities (for which the other spouse is liable) was alimony regardless of title.

Rent On Property Owned by a Third Party

If the nonoccupying spouse was required under the pre-2019 divorce or separation instrument to pay the rent on a home owned by a third party but occupied by the other spouse, the rent payments were primarily for the benefit of the occupying spouse and were alimony.

Payments for Life Insurance

Premiums paid pursuant to a pre-2019 divorce or separation instrument for insurance on the taxpayer's life qualified as alimony to the extent the taxpayer's spouse owned the policy. If the taxpayer was the owner of the policy, such premiums could not qualify as alimony or separate maintenance (Temp. Reg. §1.71-1T, Q&A-6).

The spouse had to be:

(a) The absolute owner of the policy, *and*

(b) Irrevocably named as beneficiary of the proceeds[2].

> Note: A *lump sum* payment to purchase a policy was not alimony. The cash surrender value of an existing policy assigned to the taxpayer's spouse was also not alimony. Such transfers would probably be considered part of the property settlement.

Example

Under a pre-2019 divorce decree, Dan buys an insurance policy on his life, naming his ex-spouse, Mary Lee, beneficiary. The policy is irrevocably assigned to Mary Lee and Dan gives up all ownership and control of the policy or the right to take it back. The premiums Dan pays are alimony.

Contingent Interest

A contingent interest in the policy could have denied a taxpayer a pre-2019 deduction for alimony. A deduction was *denied* when any of the following contingencies existed:

(1) The policy reverted to the taxpayer upon their spouse's death,

(2) The taxpayer retained the right to the cash surrender value or to borrow against the policy, *or*

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[2] The spouse's rights to the policy must vest as part of the divorce decree.

(3) The policy reverted to the taxpayer upon their spouse's remarriage.

#5 No Designation as Not Alimony - §71(b)(1)(B)

Spouses could characterize otherwise alimony payments as nonalimony by including a provision in their pre-2019 divorce or separation instrument. For this purpose, any writing signed by both parties that made this designation and that referred to a previous written separation agreement was treated as a written separation agreement. If there was an active temporary support order, the designation had to be made in the original or a subsequent temporary support order.

> Comment: To exclude the payments from income, the *payee spouse* had to attach a copy of the instrument designating them as not alimony to their return for each year the designation applied. In addition, it was good practice and avoided confusion, to have the divorce or separation instrument state whether or not payments are to be deductible by the payor and taxable to the payee.

Some may wonder why taxpayers would ever make such a designation. In general, when a deduction was not needed by the alimony paying spouse, a reduction in payments could be negotiated based on such a potential designation since it would greatly reduce the payee spouse's after-tax income by excluding the payments from income.

#6 Payment Cannot Be Child Support - §71(c)(1)

Child support is not alimony. Child support payments are not taxable to the receiving spouse nor deductible by the paying spouse. However, pre-2019 ordered support payments were treated as alimony *unless* they were specifically designated as child support. The pre-2019 decree or separation instrument had to clearly state a fixed amount for child support, or the entire payment was deemed alimony.

Example

Under Dan's pre-2019 divorce decree, he must pay Mary Lee $1,000 a month for her support and the support of their child. The entire $1,000 is alimony since the decree does not expressly allocate any part of the payment to child support.

Past Due Child & Spousal Support Payments

Where confusion existed over whether past due child support or alimony had been paid, §71(c) presumed that *child support* had been paid. Thus, when both child and spousal support was required, and

payment of less than the total amount was made or if payment was made in arrears, payment was first allocated to child support.

Example

Dan's pre-2019 divorce decree calls for him to pay his former spouse $200 a month as child support and $150 a month as alimony. If Dan pays the full amount of $4,200 during the year, $1,800 is alimony. If Dan pays only $3,600 during the year, $2,400 is child support. Dan can treat only $1,200 as alimony.

#7 Joint Return Prohibited

Payments were not alimony if the spouses filed a joint tax return (§71(e)). Thus, couples who were married (but not legally separated) on the last day of the tax year *had to* file as "married-filing-separate" or "head of household" for any payment to be considered alimony or maintenance payments.

Note: Legally separated married couples cannot file a joint return (§6013(d)).

2019 & Later Decrees – No More Alimony

The TCJA makes the §71 list moot for federal purposes if the divorce or separation instrument was executed in 2019 or later. Alimony includes all payments made to a spouse or former spouse under a divorce decree, maintenance decree, or separation agreement whose purpose is to prevent a drastic decline in quality of living for a lower-earning spouse. Child support and property settlement payments continue not to be considered alimony. However, all are currently nondeductible to the payor and tax free to the recipient.

Thus, the distinction between child support and alimony has lost much of its tax impact since 2019. Payments for either one are no longer deductible by the paying taxpayer or includable in the income of the recipient. In addition, since 2005, support is not a deciding factor in determining who is the custodial parent.

Tax Treatment of Alimony

The tax treatment of alimony changed as a result of the Tax Cuts & Jobs Act of 2017 (TCJA). There are now dramatic tax differences based on whether the divorce or separation instrument was executed before or after 2019.

Instruments Executed Before 2019

The tax treatment of alimony for instruments executed before 2019 remains essentially unchanged by the TCJA unless the instrument is modified.

Alimony Paid - Deductible

For any divorce or separation instrument executed *before* 2019, taxpayers can still deduct alimony paid (§215), whether or not they itemize deductions on their return *provided* the instrument has not been modified to adopt the TCJA "no deduction no income" provision. Enter the alimony on line 31a of Form 1040, Schedule 1. Form 1040A and Form 1040EZ are no longer available.

The taxpayer is required to enter the spouse's or former spouse's social security number. If a taxpayer does not make this entry, they may have to pay a $50 penalty and their deduction may be disallowed. The payee must furnish their social security number (§215(c) and Temp. Reg. §1.215-1T).

When a taxpayer pays alimony to more than one person, enter the social security number of one of the recipients. Show the social security number and amount paid for each recipient on an attached statement. A $50 civil penalty is imposed for each failure to include the social security number on the payor spouse's return (§6676(c)).

Reporting Alimony Received - Income

Qualifying alimony payments are included in the spouse's or former spouse's income (§71(a) & §61(a)(8)). Alimony received is reported on line 11 Form 1040, Schedule 1. Form 1040A and Form 1040EZ cannot be used and are no longer available.

A person who receives alimony must give the person who paid the alimony their Social Security number (§215(c) and Temp. Reg. §1.215-1T). If they do not, there is a $50 penalty (§6676(c)).

Alimony as Compensation

Alimony and separate maintenance payments made under pre-2019 decrees are considered taxable income under §71 and §61(a)(8) and constitute compensation for purposes of determining the IRA deduction limits for individuals (§219(f)(1)). Thus, a person whose only income is such alimony or separate maintenance can set up an IRA.

> Note: As a result of the Tax Cuts and Jobs Act of 2017, if a divorce agreement is signed after December 31, 2018, the alimony is neither tax deductible for the payer nor taxable for the recipient. IRA contributions can only be made from taxable income. Thus, such payments can not be used to fund IRA contributions.

Recapture of Alimony

"Recapture" requires that an item previously deducted be taken into income at a later time. In the case of alimony, the recapture rule changes the tax treatment of past payments by requiring previously deducted alimony to be included in income. It also allows the taxpayer's spouse, who previously included the alimony in income, to deduct the recaptured amount.

Note: The alimony recapture rules differ depending upon the year in which the divorce or separation instrument was executed.

The recapture rule may apply if alimony payments are reduced or terminated during the first 3 calendar years. These 3 years start with the first calendar year a payment is made which qualifies as alimony under a decree of divorce or separate maintenance, or a written separation agreement. The second and third years are the next 2 calendar years, whether or not payments are made during those years.

The reasons for a reduction or termination of alimony payments can include:

(1) A failure to make timely payments,

(2) A change in the divorce or separation instrument,

(3) A reduction in the spouse's support needs,

(4) A reduction in the taxpayer's ability to provide support, *or*

(5) A short-term marriage.

Pre-2019 Example

A pre-2019 divorce decree requires Dan to make payments to Ann of $24,000 in 2018 and $1 per year in 2019 and 2020. Payments in year one exceed average payments in the second and third years by $23,999. The excess over $15,000 (i.e., $8,999) is recaptured as income in the third year (i.e., 2020). Thus, Dan has $8,999 of income in 2020, and Ann has an $8,999 deduction.

Exceptions to Recapture

The recapture rule does not apply unless annual alimony payments decrease by more than certain dollar amounts:

(a) For instruments executed after 1986, the amount is $15,000; *and*

(b) For instruments executed in 1985 or 1986, the amount is $10,000.

Taxpayers do *not* have to recapture any of the following payments, regardless of their amount:

(a) Payments under a temporary support order before divorce or separation (§71(f)(5)(B)),

(b) Payments required over a period of at least 3 calendar years of a fixed part of the taxpayer's income from a business or property, or from compensation for employment or self-employment (§71(f)(5)(C)), *or*

(c) Payments that end because the taxpayer or their spouse dies or their spouse remarries within the first 3 calendar years of payments (§71(f)(5)(A)).

Query: What if the payments terminate because the spouse is living with someone?

Including the Recapture in Income

When a taxpayer must include a recapture amount in income, show it on line 11 Form 1040, Schedule 1 ("Alimony received"). Cross out "received" and write "recapture" on the dotted line next to the amount, and enter the spouse's last name and social security number.

Deducting the Recapture

If a taxpayer can deduct a recapture amount, show it on line 31a Form 1040, Schedule 1 ("Alimony paid"). Cross out "paid" and write "recapture" in the space provided, and enter the spouse's social security number. The payee must furnish their social security number (§215(c) and Temp. Reg. §1.215-1T).

Exceptions

The recapture rule does not apply to:

(1) Any year in which payments ended due to the death of either spouse or the remarriage of the receiving spouse;

(2) Temporary support payments received under an instrument described in §71(b)(2)(C); *or*

Note: This is a decree requiring a spouse to make payments for the support or maintenance of the other spouse.

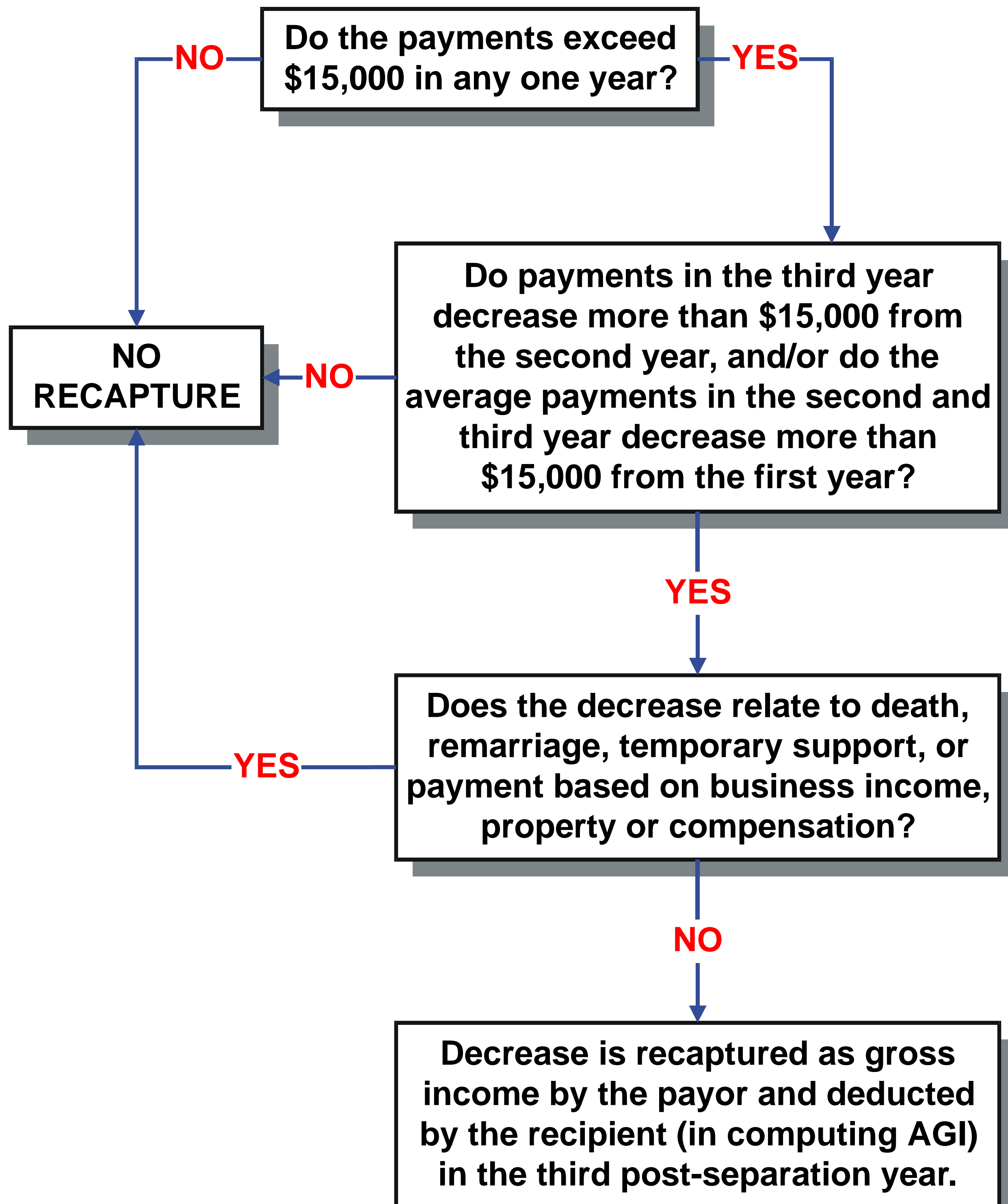
(3) A written agreement that requires payments over a 3-year period, based upon a fixed percentage of the income from:

(a) A business,

(b) Property, *or*

(c) Compensation for employment or self-employment.

Alimony Recapture



Temporary Regulation §1.71-1T Q&A-25 indicates that the foregoing exceptions are the only ones available. If alimony or separate maintenance payments decline or cease in a post-separation year for any other reason (including a failure by the payor to make timely payments, a modification of the divorce or separation instrument, a reduction in the support needs of the payee, or a reduction in the ability of the payor to provide support), excess amounts are subject to recapture.

Computation

Figuring "excess alimony" requires three steps:

1. Determine excess alimony for the second year.

   Under §71(f)(4), excess alimony for the second year is the amount of alimony payments paid during the second year, in excess of:

   (a) The alimony payments paid during the third year, *plus*

   (b) $15,000.

2. Determine excess alimony for the first year.

   Under §71(f)(3), excess alimony for the first year is alimony payments paid during the first year in excess of the sum of:

   (a) $15,000, *plus*

   (b) The *average* of:

   (i) The alimony payments paid during the second year reduced by the excess payments for the second year (determined in (1) above), *and*

   (ii) The alimony payments paid during the third year.

3. Determine recapturable excess alimony.

   Under §71(f)(2), recapturable excess alimony is the sum of:

   (a) The excess alimony for the first year (see 2 above); *and*

   (b) The excess alimony for the second year (see 1 above).

   Note: The TRA '86 recapture rule may be avoided if the difference in alimony payments between the second and third years is not more than $15,000, and the average of the second-year payments (less the recaptured amount) and the third-year payments do not exceed the first-year payments by more than $15,000 (§71(f)(5)(B)).

Pre-2019 Example

Myrna pays Phil the following amounts of alimony under their 2016 divorce decree.

Year	*Amount*
2016	*$60,000*
2017	*40,000*

2018 20,000

The recaptured alimony is $22,500, as shown in a filled-in Worksheet for Recapture of Alimony. Myrna shows $22,500 as alimony received on her 2018 Form 1040, Schedule 1. Phil deducts $22,500 on his 2018 Form 1040, Schedule 1.

Worksheet for Recapture of Alimony
(For instruments executed after 1986)

Note: Do not enter less than zero on any line.

Line				
1.	Alimony paid in **2nd year**		$40,000	
2.	Alimony paid in **3rd year**	$20,000		
3.	Floor	$15,000		
4.	Add lines 2 and 3		$35,000	
5.	Subtract line 4 from line 1			$5,000
6.	Alimony paid in **1st year**		60,000	
7.	Adjusted alimony paid in **2nd year** (line 1 less line 5)	35,000		
8.	Alimony paid in **3rd year**	20,000		
9.	Add lines 7 and 8	55,000		
10.	Divide line 9 by 2	27,500		
11.	Floor	$15,000		
12.	Add lines 10 and 11		42,500	
13.	Subtract line 12 from line 6			17,500
14.	**Recaptured alimony.** Add lines 5 and 13			$22,500

Alimony Substitution Trusts & Annuities

If a taxpayer transfers property to a trust or buys or transfers an annuity or endowment contract to pay pre-2019 alimony, the trust income or other proceeds that would ordinarily have been includible in the taxpayer's income are included in the former spouse's income to the extent received. The taxpayer does *not* include the payments in their income, *nor* can they deduct them as alimony paid under pre- or post-2019 rules.

Note: This rule does not apply to any trust income that is fixed for child support.

Example

Dan's lawyer drafts a trust incorporating the terms of Dan's pre-2019 divorce decree. Dan then transfers separate property stock to the trust. The trustee pays Dan's ex-wife, Mary Lee, $1,000 per month from the stock dividends. These payments are income to Mary Lee. If the stock had not been placed in trust, the dividends would have been income to Dan. With the trust, Dan does not report the income, but neither does he claim a deduction.

Such trust payments were not alimony. Instead, the receiving spouse is treated as a trust beneficiary and reports income earned by the trust as a trust beneficiary. However, payments from trust *principal* are not taxable to the receiving spouse.

Note: The reasons for such trusts were primarily non-tax. Using a trust or annuity could eliminate potential collection problems and reduce unwanted contact between spouses after the dissolution.

Annuities

Taxpayers could also purchase an annuity contract or insurance policy to pay the alimony required by their pre-2019 decree or agreement. Proceeds from annuity and endowment contracts bought for or transferred to a spouse were not alimony. Instead, the receiving spouse succeeded to the payor spouse's investment in the annuity contract and recovered this investment under the annuity rules of §72. Thus, annuity payments were not fully taxable to the receiving spouse.

Alimony Paid by an Estate

Payments of alimony by an estate to a former spouse of a decedent were deductible under §661 as distributions to a beneficiary of the estate, rather than as alimony under §215. In addition, the computed value of the payments was deductible for estate tax purposes under §2053(a)(3) as a claim against the estate (R.R. 67-304).

Instruments Executed After 2018

Taxpayers cannot deduct alimony or separate maintenance payments made under a divorce or separation agreement:

(1) executed after 2018, *or*

(2) for any divorce or separation instrument executed before 2019 *and* modified after that date if the modification expressly provides that the changes made by the TCJA apply to such modification.

Alimony and separate maintenance payments received under such an agreement are not included in gross income.

Related impacts because of the new alimony rules include:

(1) the new rule will take away the opportunity for an unemployed spouse to make contributions toward an IRA;

(2) legal fees paid to attorneys to help secure alimony will no longer be deductible;

(3) the new rules may nullify many provisions in pre- and post-nuptial agreements;

(4) high-income divorcing spouses will aggressively fight to pay less in alimony; *and*

(5) the total money available to spouses for alimony will shrink.

Review Questions

Under NASBA-AICPA self study standards, self study sponsors are required to present review questions intermittently throughout each self-study course. The following questions are designed to meet those requirements and increase the benefit of the materials. However, they do not have to be completed to receive any credit you may be seeking with regard to the text. Nevertheless, they may help you to prepare for any final exam.

Short explanations for both correct and incorrect answers are given after the list of questions. We recommend that you answer each of the following questions and then compare your answers. For more detailed explanations and references, you may do an electronic search using Ctrl+F (if you are viewing this course on computer), consult the text Index, or review the general Glossary.

80. When a written request is made to have the payor spouse directly pay cash to a third party, what is required of such a written request under §71?

   a. It must include the date that such payments will begin.

   b. It must be received within 30 days of the payment.

   c. It must subsequently receive approval and be ratified by a court.

   d. It must assert that it is the intent of both spouses for such payments to be characterized as alimony.

81. Payments for housing costs on a residence can sometimes be deemed alimony. How such treatment is primarily determined?

   a. by looking at the way the residence is owned.

   b. by determining who is the custodial parent.

   c. by ascertaining who is the nonworking parent.

   d. by examining the housing allowance allowed by the divorce court.

82. If a spouse who lives in the home is also the sole owner, how are housing payments made by a nonoccupying spouse to the occupying spouse treated?

a. Some of the payments may be alimony.

b. Interest and real property taxes may be claimed by the nonoccupying spouse as itemized deductions subject to the home mortgage interest rules for second homes.

c. The payee spouse includes the payment in income (if under a pre-2019 decree) as alimony.

d. The payments are treated as rent payments for tax purposes.

83. When a spouse pays life insurance premiums under a pre-2019 decree that otherwise qualify as alimony, certain contingent policy interests can nevertheless disallow a deduction as alimony. However, which of the following contingencies would still allow such a deduction?

a. The policy returns to the payor spouse on their spouse's death.

b. The payee spouse includes the full premiums in income.

c. The payor spouse keeps the right to the cash surrender value.

d. The payor spouse has the right to take a loan against the policy.

84. Sometimes it may be unclear as to whether a payment under a pre-2019 decree has been made for overdue child support or alimony. How does §71(c) treat such an issue?

a. The payment is treated pro-rata as both child support and alimony.

b. It presumes that the payment is alimony.

c. It presumes that the payor made the child support payment.

d. The payment is treated as an unallocated payment.

85. Filing status can determine the tax treatment of payments between spouses. For example, alimony treatment is precluded under a pre-2019 decree when:

a. the spouses file as married-filing-separate.

b. the spouses file a joint tax return.

c. the spouses file a joint return while separated.

d. one spouse files as head of household.

86. Qualified alimony paid under a pre-2019 decree can be deducted. Such payments are properly deductible:

a. on Form 1040A.

b. only as an itemized deduction.

c. whether or not itemized as a deduction.

d. on Form 1040EZ.

87. Under §219, alimony under a pre-2019 decree is treated as compensation. What is a tax consequence of this treatment where alimony is the only income received?

a. The recipient may establish an IRA.

b. The recipient qualifies for the earned income credit.

c. The recipient need not file a tax return.

d. The recipient can deduct household expenses.

88. In some circumstances, a taxpayer who had earlier deducted an item must include it in income sometime in the future. What is this tax concept?

a. the tax benefit rule.

b. income recharacterization.

c. tax recovery.

d. recapture.

89. Certain conditions must be met in order for pre-2019 alimony recapture rules to apply. What is one of these conditions?

a. The payor made payments under a temporary support order prior to divorce.

b. Within the first three calendar years, payments are lessened.

c. Within the first three calendar years, the payor spouse terminated payments when the payee spouse remarried.

d. The payor had to make payments over a period of no less than three calendar years of a set part of the taxpayer's business income.

90. A payor spouse could have funded their spousal support obligation under a pre-2019 decree by transferring property to a trust that pays the support. How is such trust income treated?

a. The payor spouse may deduct it.

b. It accumulates tax-free.

c. It is taxable to the trust.

d. The payor spouse includes the amount paid in his or her income.

91. A spouse receiving income from an alimony trust reports income paid to them from trust income as:

a. the grantor of the trust.

b. alimony.

c. a trust beneficiary.

d. a principal distribution.

92. Alimony trusts were popular devices. What was one of their advantages?

a. Trust payment can be used to fund an IRA.

b. They could eliminate potential collection problems.

c. The beneficiary spouse can be taxed on the part of income allocated for child support.

d. The recipient spouse will be taxed only on portions paid from trust corpus.

93. Which of the following statements is TRUE regarding the tax treatment of spousal support or separate maintenance payments (formerly known as alimony) under current law?

a. Payments made under decrees executed after 2018 are deductible for the payor and taxable for the recipient.

b. Payments made under pre-2019 agreements that were modified after 2018 to incorporate TCJA changes are not deductible for the payor but are taxable for the recipient.

c. Payments made under any decree, regardless of execution date, are always deductible for the payor and taxable for the recipient.

d. Payments made under decrees executed after 2018 are not deductible for the payor and are not included in the recipient's gross income.

Child Support

A payment that is fixed (by dollar amount or by a percentage) or treated as fixed[3] as child support under a divorce or separation instrument is generally not deductible by the payor spouse and not taxable to the payee spouse (§71(c) & §215).

A payment is fixed as child support if the instrument specifically designates an amount or part of the payment as support for a child. The designated amount or part may vary from time to time.

A payment will be treated as fixed as child support if the payment is reduced either:

(1) On the happening of a *contingency relating to the child*, or

(2) At a time that can be *clearly associated* with the contingency.

A payment may be treated as fixed as child support even if other separate payments are specifically designated as child support.

Contingency Relating To the Child

A contingency relates to a child if it depends on any event relating to that child. It does not matter whether the event is certain or likely to occur. Events relating to a child include the child's:

(1) Reaching a specified age or income level,

(2) Dying,

(3) Marrying,

(4) Leaving school,

(5) Leaving the household, *or*

(6) Becoming employed (§71(c)(2)(A); Temp. Reg. §1.71-1T(c), Q&A-16 & Q&A-17).

If the contingency relates to a person other than the child (e.g., the payee spouse's remarriage), no sum is treated as child support.

Clearly Associated With a Contingency

Payments are presumed to be reduced at a time clearly associated with the happening of a contingency relating to a child only in the following situations:

(i) The payments are to be reduced not more than 6 months before or after the date the child will reach the local age of majority; *or*

[3] Amounts denominated in a settlement agreement as "alimony" may nevertheless constitute child support for tax purposes.

(ii) The payments are to be reduced on two or more occasions that occur not more than one year before or after a different child reaches a certain age from 18 to 24, which must be the same for each child, but need not be a whole number of years (Temp. Reg. §1.71-1T(c), Q&A-18).

In all other situations, reductions in payments are not treated as clearly associated with the happening of a contingency relating to the child.

Heller Case

In *Heller v. Commissioner*, T.C. Memo 1994-423, Lawrence and Madeline Heller were married in 1971, separated in 1985 and were later divorced. After the divorce, the couple's two minor children resided with Madeline. In 1989, Madeline received $32,400 from Lawrence, of which the divorce instrument designated $20,400 as spousal support and $12,000 as child support.

The divorce instrument provided that future spousal support would be reduced by any court-ordered increase in child support. Madeline did not report any alimony on her 1989 tax return, and the IRS determined a deficiency. The Tax Court sustained the Service's determination, holding that the entire amount paid was taxable and deductible as alimony since the spousal support met all of the definitional requirements of §71(b). Madeline's contention that the payments were excepted under section 71(c)(2) from the definition of alimony because the divorce instrument contains a contingency "relating to" a child was rejected. The Court noted that although the divorce instrument allowed for the modification of child support, that provision did not rise to the level of a contingency related to a child.

The Court concluded that a modification that increases the amount of child support with a corresponding decrease in spousal support does not qualify as a contingency relating to a child attaining a specified income level. Accordingly, the entire amount paid and received was taxable and deductible as alimony.

Rebuttable Presumptions

Either the taxpayer or the IRS may defeat the presumption in the two situations above. This is done by showing that the time at which the payments are to be reduced was determined *independently* of any contingencies relating to the children.

For example, a taxpayer can defeat the presumption by showing that alimony payments are to be made for a period customarily provided in the local jurisdiction, such as a period equal to one-half the duration of the marriage.

Note: The presumption in the first situation (a reduction within six months of the child's age of majority) is rebutted when the reduction is a complete

cessation of alimony during the sixth year or on expiration of a 72-month period[4] (Temp. Reg. §1.71-1T(c), Q&A-18).

Example

Dan and Jane divorced on July 1, 2008, when their children, Rocko (born July 15, 1993) and Blaze (born September 23, 1995), were 14 and 12, respectively. Under the divorce decree, Dan is to make alimony payments to Jane of $2,000 per month. Such payments are to be reduced to $1,500 per month on January 1, 2014, and to $1,000 per month on January 1, 2018. On January 1, 2014, the date of the first reduction in payments, Rocko will be 20 years 5 months and 17 days old. On January 1, 2018, the date of the second reduction in payments, Blaze will be 22 years 3 months and 9 days old. Each of the reductions in payments is to occur not more than one year before or after a different child of Dan attains the age of 21 years and 4 months. (Actually, the reductions are to occur not more than one year before or after Rocko and Blaze attain any of the ages 21 years 3 months, and 9 days through 21 years 5 months and 17 days.) Accordingly, the reductions will be presumed to clearly be associated with the happening of a contingency relating to Rocko and Blaze. Unless this presumption is rebutted, payments under the divorce decree equal to the sum of the reduction ($1,000 per month) will be treated as fixed for the support of the children of Dan and therefore will not qualify as alimony or separate maintenance payments.

COBRA Coverage

Employers of 20 or more employees who maintain health care coverage plans must offer identical coverage to ex-spouses and other qualified beneficiaries in case of divorce or separation. The continuing coverage must be the same as that provided to employees under the plan and cannot be conditioned on evidence of insurability.

Note: The cost of maintaining coverage under their employer's policy, via COBRA can be up to 102% of the cost of coverage.

COBRA rules apply to plans maintained by private employers and by any state that receives funds under the Public Health Service Act, and any political subdivision, agency, or instrumentality of such a state. The rules do not apply to plans maintained by the District of Columbia, or territories, possessions, agencies, or

[4] When the temporary regulations become final, a 3 year/36 month period will probably be adopted.

instrumentalities of the United States. Church plans under §414(e) and the plans of the federal government are excluded.

> Note: On-site facilities providing medical care do not constitute a group health plan if the care is primarily first aid for employees provided for free during working hours. However, medical care offered under a flexible benefit plan constitutes a group health plan for those individuals actually covered under the medical care option on the day before the divorce or legal separation.

The ex-spouse and other qualified beneficiaries must be allowed to continue coverage for at least 36 months, beginning with the date of divorce or legal separation. However, an ex-spouse or dependent will only be eligible for coverage if group health plan coverage was in effect for that individual at the time of divorce or legal separation.

Coverage Termination

Continuing coverage may terminate if one of the following occurs:

(1) Employer ceases to maintain health coverage for *any* employee;

(2) The covered individual fails to make premium payment within 30 days when due;

(3) The covered individual becomes covered under another group health plan which does not include a pre-existing conditions clause; *or*

(4) The covered individual becomes entitled to Medicare benefits.

Notice

COBRA has several detailed notice requirements. In general, notice must be provided to each covered employee and spouse covered under the group health plan within the first 90 days of coverage giving a description of the continuation coverage, what beneficiaries must do upon qualifying events, and plan contact information.

> Divorce: The employee or ex-spouse has at least 60 days from the date of divorce or legal separation to notify the plan administrator. The administrator has 14 days from the time it is notified of the divorce or separation to notify the ex-spouse and other beneficiaries of their COBRA rights.

> Subsidy Notice: ARPA provided a 100% subsidy for COBRA premiums to assistance-eligible individuals for COBRA continuation. Group health plans have provided notices of assistance availability, extended election periods, and subsidy expiration.

Election

An ex-spouse and other qualified beneficiaries have 60 days from the later of the date of divorce or legal separation or the date on which notification was sent to elect continuing coverage.

Coverage may be waived and the waiver may be revoked at any time during the election period. Premium payments for periods preceding the election may not be required until 45 days after the election. An election by an ex-spouse is effective for all dependents. Children can make their own elections if the parent declines coverage.

Choice of Coverage

If there is a choice of coverage under the plan, such as an HMO or a PPO, the ex-spouse, and other qualified beneficiaries are entitled to make a separate selection among such types of coverage. Even if the employee elects certain coverage, the ex-spouse or dependents may elect different coverage at the next open enrollment period.

If the plan allows active employees to add a spouse or dependent to coverage, then the COBRA continuee may also add a spouse or dependent. If the employer plan provides for a conversion privilege that conversion privilege must be extended to qualified beneficiaries.

If coverage is modified for active employees, the coverage must also be modified for those covered under the COBRA continuation of coverage provisions. Ex-spouses with HMO coverage who move out of the area may choose alternative coverage if an active employee moving to the same area would be offered such coverage.

Cost

The ex-spouse and other qualified beneficiaries who elect to continue coverage must pay for the coverage, at a rate not to exceed 102% of the plan's cost for other similarly situated employees.

> Note: Similarly situated employees are active employees covered under the same plan having the right to elect the same options.

For a self-insured plan, the applicable premium is a reasonable estimate of the cost of providing coverage for similarly situated employees.

> Note: ARPA provided a 100% subsidy for COBRA premiums to assistance-eligible individuals for COBRA continuation coverage from April 1, 2021, through September 31, 2021. Subsidy amounts were not included in the gross income. As a result, individuals involuntarily terminated from employment could maintain existing health insurance, via COBRA, from April through September 2021 at no cost. Employers were allowed a quarterly tax credit against the Medicare payroll tax equal to the premiums not paid by assistance-eligible individuals.

American Recovery & Reinvestment Act: The Act provides that, for a period not exceeding 9 months, an assistance eligible individual is treated as having paid any premium required for COBRA continuation coverage under a group health plan if the individual pays 35 percent of the premium. Thus, if

the assistance eligible individual pays 35 percent of the premium, the group health plan must treat the individual as having paid the full premium required for COBRA continuation coverage, and the individual is entitled to a subsidy for 65 percent of the premium.

> Comment: In short, laid-off workers would pay 35% of the COBRA premium and the former employer would pay the remaining 65% for nine months.

Deductibles

Generally, payments made toward deductible and coinsurance limits will carry over into the continuation period. In the case of family deductibles, any remaining deductible at the beginning of continuation coverage will be the deductible for each family unit. If there are two family units, each unit will have to satisfy the remaining deductible.

Qualified Medical Child Support Orders

OBRA 1993 amended ERISA to create a new type of court order issued in domestic relations proceedings referred to as a Qualified Medical Child Support Order (QMCSO). QMCSOs provide rights to a dependent child of a participant in a group health plan to continue receiving benefits under the plan. The most common use of a QMCSO is when a dependent child would lose coverage under a group health plan as a result of a divorce.

> Note: The law governing QMCSOs is similar to the ERISA rules governing qualified domestic relations orders.

Definition

QMCSOs are medical child support orders that meet certain requirements. A medical child support order is an order, judgment, or decree providing:

(1) Child support for a child of a participant under a group health plan, *or*

(2) Health benefits coverage to a child, under the domestic relations law of a state.

A *qualified* medical child support order must contain certain information and comply with a variety of restrictions on the benefits it provides. The QMCSO must:

(1) Specify the name and address of the participant, each alternate recipient, and the plans and periods to which the order applies;

> Note: The term "alternate recipient" includes any child of a participant that a medical child support order recognizes as entitled to enroll under a participant's group health plan. If a group health plan provides coverage for dependent children of participants, the plan must provide benefits to adopted

dependent children under the same terms and conditions as applied to natural dependent children.

(2) Specify either:

(a) A reasonable description of the type of coverage that the alternate recipient is to receive under the plan, *or*

(b) The manner for determining the coverage;

(3) Not require that a plan provide any type of benefit or option not otherwise provided under the plan, except to the extent necessary to meet the requirements of a law relating to medical child support described in §1908 of the Social Security Act.

Note: Group health plans often have preexisting condition restrictions. Since a QMCSO cannot require a plan to provide any type of benefit or option that it does not otherwise provide, a QMCSO should not be able to mandate that a plan provide coverage for a pre-existing condition.

Procedures & Duties

All group health plans must establish procedures for QMCSOs that must:

(1) Be in writing,

(2) Provide for notification of each alternate recipient of the written procedures, *and*

(3) Permit an alternate recipient to designate a representative to receive copies of notices from the plan administrator.

The duties of a plan administrator who receives a QMCSO are similar to the duties of plan administrators who receive domestic relations orders. The administrator must promptly notify the participant and each alternate recipient of receiving the order and the plan's QMCSO procedures. The administrator also must, within a reasonable time, determine whether the order is a QMCSO and notify the participant and alternative recipient of the determination.

Jurisdiction

A court may enter a medical child support order requiring coverage for a child when the child would not otherwise be eligible for coverage under the plan. All group health plans to which the QMCSO applies must provide benefits in accordance with the order.

Review Questions

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94. When a divorce decree provides that a spouse must pay a fixed amount as child support, that payment is not deductible by the payor spouse and not taxable to the payee spouse. When are such payments treated as being fixed as child support?

  a. The payment is increased as a result of a contingency.

  b. The payment is clearly designated as such by the parents.

  c. The payment is possibly connected to a contingency.

  d. The payment is lessened on the occurrence of a contingency involving the child.

95. If a contingency is based on any incident concerning a child, said contingency is deemed child-related. However, what event concerning the child is excluded from being characterized as a child-related contingency?

  a. age majority.

  b. dying.

  c. marrying.

  d. leaving school.

96. According to regulations, under which of the following circumstances would payments NOT be presumed to be reduced at a time clearly associated with a contingency relating to a child?

  a. Payments are reduced 5 months before the child reaches the local age of majority.

  b. Payments are reduced on two occasions, each occurring 11 months before two different children reach age 21.

  c. Payments are reduced 7 months after the child reaches the local age of majority.

d. Payments are reduced on three occasions, each occurring 6 months after three different children reach age 18.

97. COBRA coverage must be available to former spouses and certain other qualified beneficiaries. Which of the following plans are subject to COBRA rules?

a. plans maintained by any political subdivision of a state that receives funds under the Public Health Service Act.

b. plans maintained by churches.

c. plans maintained by the District of Columbia or territories, possessions, agencies, or instrumentalities of the United States.

d. plans maintained by the federal government.

98. Which of the following is NOT mentioned as a reason for early termination of COBRA continuation coverage?

a. The employer stops offering health coverage to all employees.

b. The covered ex-spouse remarries.

c. The covered individual fails to pay the required premium within the grace period.

d. The covered individual becomes covered under another group health plan without pre-existing condition limitations.

99. A Qualified Medical Child Support Order (QMCSO) is a medical child support order that must contain certain information. Which of the following is unnecessary in a QMCSO?

a. The participant's name and address.

b. Which plans and periods are subject to the order.

c. Each alternate recipient's name and address.

d. The Social Security numbers of all children covered.

Learning Objectives

After reading Chapter 4, participants will be able to:

1. Identify the marriage penalty and marriage bonus associated with filing a joint return by recognizing how standard deductions and tax brackets have differed over time.
2. Determine the tax treatment of spousal travel including additional cost limitations and identify the benefits of husband and wife partnerships, particularly with regards to Social Security qualification.
3. Recognize the application of federal estate tax on couples and where estate planning may be necessary as a result of marital status.

4. Specify the treatment of co-tenancies with or without a right of survivorship identifying qualified joint interests, recognize the impact on the value of a general power of appointment, determine what insurance proceeds are included in the gross estate because of incidents of ownership, and cite the community property issue involved with ownership of life insurance.

5. Determine the impact of the marital deduction on the gross estate recognizing outright transfer methods and specify the use of a "marital deduction (QTIP) trust" and a "qualified terminable interest trust."

6. Identify marital deduction variables including deduction limitations and specify the federal income tax treatment and gift tax treatment of non-citizen spouses.

7. Recognize the effect common transactions and community property have on §1014 property basis and the benefits of a bypass trust specifying its effect on the marital deduction.

8. Determine the purposes of the federal gift tax identifying its computational methods and applicable exclusions, specify the advantages of splitting gifts and the gift tax marital deduction recognizing dangers as to "excess" gifts and terminable trusts, and identify Social Security eligibility for family members of a system participant.

CHAPTER 4

SELECTED MARITAL TAX ISSUES OUTSIDE OF DIVORCE

Federal Income Tax

Marriage Penalty

A married couple generally is treated as one tax unit that must pay tax on the unit's total taxable income. Although married couples may elect to file separate returns, the rate schedules and provisions are structured so that filing separate returns usually results in a higher tax than filing joint returns. Other rate schedules apply to single persons and single heads of household.

A "marriage penalty" exists when the sum of the tax liabilities of two unmarried individuals filing their own tax returns (either single or head of household returns) is less than their tax liability under a joint return (if the two individuals were to marry). A "marriage bonus" exists when the sum of the tax liabilities of the individuals is greater than their combined tax liability under a joint return.

The size of any marriage penalty or bonus depends upon the individuals' incomes and itemized deductions. As a general rule married couples whose earnings were split more evenly than 70-30 suffered a marriage penalty. Married couples whose earnings are largely attributable to one spouse generally receive a marriage bonus.

Standard Deduction

To eliminate the "marriage penalty" in the standard deduction for a married couple, the 2001 EGTRRA increased the basic standard deduction for a married couple filing a joint return to twice the basic standard deduction for an unmarried individual filing a single return. The increase in the standard deduction for married taxpayers filing a joint return was to be phased in and fully effective in 2009.

Taxable Year Standard Deduction for Married Couples Filing Joint Returns as Percentage of Standard Deduction for Unmarried Individual Returns	
2003 & 2004	200%
2005	174%
2006	184%
2007	187%
2008	190%
2009	200%

Note: Taxpayers who do not itemize deductions can choose the basic standard deduction. The size of the basic standard deduction varies according to filing status and is adjusted annually for inflation.

However, subsequent legislation accelerated the full application of this doubling of the standard deduction to 2003 and later tax years. This marriage penalty relief in the standard deduction amounts has been permanent since 2013. As a result, the standard deductions for 2023and 2024 are:

Filing Status	2023	2024
Married Filing Separately	$13,850	$14,600
Single	$13,850	$14,600
Head of Household	$20,800	$21,900
Married Filing Jointly	$27,700	$29,200
Surviving Spouse	$27,700	$29,200

Tax Brackets

The 2001 EGTRRA increased the size of the 15% regular income tax rate bracket for a married couple filing a joint return to twice the size of the corresponding rate bracket for a single individual filing a single return. The increase was to be phased in and fully effective in 2008.

Taxable year End Point of 15-Percent Rate Bracket for Married Couples Filing Joint Returns as Percentage of End Point of 15-Percent Rate Bracket for Unmarried Individuals	
2003 & 2004	200%
2005	180%
2006	187%
2007	193%
2008	200%

However, later legislation accelerated the full application of this doubling of the 15% bracket to 2003 and later tax years. This marriage penalty relief has been permanent since 2013. Thus, the size of the regular income tax rate brackets for *lower income* married couples filing a joint return was increased to twice the regular income tax rate brackets for an unmarried individual filing a single return.

However, for 2018 and later, the Tax Cuts and Jobs Act of 2017 (TCJA) equalized married filing jointly tax rates with those of two single individuals combined (each with half the amount of taxable income of the joint filers), up to the bottom threshold of the *highest tax bracket*. In short, the size of the various tax brackets for joint filers and qualified surviving spouses remains at 200% of the various tax brackets for individual filers (§1(i)(1)).

For 2024, the size of the various tax brackets for joint filers and qualified surviving spouses remains at 200% of the various tax brackets for individual filers (§1(i)(1)). In fact, for 2024, the married filing jointly income thresholds are exactly double the single thresholds for all but the two highest tax brackets. In other words, the marriage penalty has been effectively eliminated for everyone except married couples earning more than $487,450.

> Note: The marriage penalty continues in the upper brackets as the joint bracket does not equal twice the single amounts for the 35% and 37% brackets.

> Comment: The TCJA, however, left (or increased) other factors contributing to a marriage tax penalty such as (1) the tax advantage of head of household filing status, and (2) the impact of a married couple's combined income on SALT and mortgage interest limitations, and taxability of Social Security benefits.

Spousal & Companion Travel Expenses - §274(m)(3)

Travel expenses paid or incurred for a spouse, dependent, or *other* individual who accompanies a taxpayer on business travel are generally *not* deductible. Providing incidental services[1] or help is also not sufficient to generate a deduction (Reg. §1.162-2(c)).

Formerly, such travel expenses were deductible if the individual's presence on the trip had a bona fide business purpose. In addition, the mere fact that a spouse spent a substantial amount of time on personal matters, such as attending to laundry and greeting guests, did *not* rule out a finding of a bona fide business purpose.

Regulation §1.162-2(c) still provides:

> *"Where a taxpayer's wife accompanies him on a business trip, expenses attributable to her travel are not deductible unless it can be adequately shown that the wife's presence on the trip has a bona fide business purpose. The wife's performance of some incidental service does not cause her expenses to qualify as deductible business expenses. The same rules apply to any other members of the taxpayer's family who accompany him on such a trip."*

However, currently, travel expenses paid or incurred for an individual who accompanies the taxpayer on business travel are *not* deductible unless the individual:

(1) Is the taxpayer's employee,

> Note: If a business associate travels with a taxpayer and meets the conditions in (2) and (3) above, the taxpayer can claim the deductible travel expenses the taxpayer pays for that person. A business associate is someone with whom the taxpayer can reasonably expect to actively conduct business. It does not matter if the taxpayer has already conducted business with the person as long as the taxpayer reasonably expects to do so. A business associate can be a customer, client, supplier, employee, agent, partner, or professional advisor.

(2) Has a bona fide business purpose for the travel, *and*

> Note: For a bona fide business purpose to exist, the taxpayer must prove a real business purpose for the individual's presence. Incidental services, such as typing notes or assisting in entertaining customers, are not enough to warrant a deduction.

(3) Would otherwise be allowed to deduct the travel expenses (§274(m)(3)).

> Note: All the other regular IRS rules for deductible travel expenses must still apply. This means the costs must be reasonable and not lavish or extravagant.

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[1] Secretarial services have been found sufficient (*Duncan v. Bookwalter*, 216 F. Supp. 301 (W.D. Mo. 1963)). However, no deduction was allowed where a wife simply typed notes for the taxpayer and attended business lunches and dinners with him (R.R. 56-168).

No Additional Cost Rule

If the spouse's presence does *not* meet the requirements of §274(m)(3), the expenses deductible by the taxpayer are those the taxpayer would have incurred had he or she been alone, *not* merely half of the total cost. Thus, the presence of the spouse or family member may *not* affect the amount of the deduction at all.

Example from Publication 463 (Rev '23)

You drive to Chicago on business and take your spouse with you. Your spouse isn't your employee. Your spouse occasionally types notes, performs similar services, and accompanies you to luncheons and dinners. The performance of these services doesn't establish that your spouse's presence on the trip is necessary to the conduct of your business. Your spouse's expenses aren't deductible. You pay $199 a day for a double room. A single room costs $149 a day. You can deduct the total cost of driving your car to and from Chicago, but only $149 a day for your hotel room. If both you and your spouse use public transportation, you can only deduct your fare. [R.R. 56-168]

When a corporation pays for a spouse to accompany an executive on a business trip and the requirements of §274(m)(3) are *not* met, the corporation's payment of the spouse's expenses can be includable in the taxpayer's gross *income* as compensation, or perhaps as a *dividend* (R.R. 64-9).

Note: The above rules could apply to the travel expenses of any member of the taxpayer's family.

Employee Exclusion of Spousal Travel Reimbursements - §132

Regulation §1.132-5 permits the *exclusion* of an employer's payment of travel expenses with respect to a spouse, dependent, or other individual accompanying an employee on business as a *working condition fringe benefit*, provided that the payments for such expenses would be *deductible by the employee* under §162 or §167.

Reg. §1.132-5(t)(1) provides:

If an employer's deduction under section 162(a) for amounts paid or incurred for the travel expenses of a spouse, dependent, or other individual accompanying an employee is disallowed by section 274(m)(3), the amount, if any, of the employee's working condition fringe benefit relating to the employer-provided travel is determined without regard to the application of section 274(m)(3). To be excludable as a working condition fringe benefit, however, the amount must otherwise qualify for deduction by the employee under section 162(a). The amount will qualify for deduction and for exclusion as a working condition fringe benefit if it can be adequately shown that the spouse's, dependent's, or

> *other accompanying individual's presence on the employee's business trip has a bona fide business purpose and if the employee substantiates the travel within the meaning of paragraph (c) of this section. If the travel does not qualify as a working condition fringe benefit, the employee must include in gross income as a fringe benefit the value of the employer's payment of travel expenses with respect to a spouse, dependent, or other individual accompanying the employee on business travel. See sections 1.61-21(a)(4) and 1.162-2(c). If an employer treats as compensation under section 274(e)(2) the amount paid or incurred for the travel expenses of a spouse, dependent, or other individual accompanying an employee, then the expense is deductible by the employer as compensation and no amount may be excluded from the employee's gross income as a working condition fringe benefit. See section 1.274-2(f)(2)(iii)(A).*

Thus, the denial of a deduction to the *employer* for the employer's payment of travel expenses of a spouse, dependent, or other individual accompanying an employee on business travel, does *not* preclude those expenses from qualifying as working condition fringe benefits (Reg. §1.132-5(t)(1)). The amounts may qualify to the extent that:

(1) The employer has *not* treated the amounts as compensation under §274(e)(2),

> Note: An employer may choose to exercise the option of avoiding any §274 disallowance at the employer level by characterizing the payments of travel expenses with respect to a spouse, dependent, or other individual accompanying an employee as compensation (§274(e)(2)).

(2) The amounts would be *deductible* under §162 (without regard to §274(a) and §274(m)(3)), *and*

> Note: The amount will qualify for deduction and for exclusion as a working condition fringe benefit if it can be adequately shown that the spouse's, dependent's, or other accompanying individual's presence on the employee's business trip has a bona fide business purpose.

Example

In United States v. Disney, 413 F.2d 783 (9th Cir.1969), the Ninth Circuit concluded that the employer's reimbursement of the wife's travel expenses was excludable from gross income. The court found a long-standing company policy to insist that spouses accompany executives on business trips to help establish the family image of the company. The court, however, limited the holding to the facts of the particular case, pointing out that the simple fact that an employer pays the cost of a spouse's travel is not determinative of the question of legitimate business purpose.

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(3) The employee *substantiate*s the expenses within the meaning of §274.

An employer may choose to exercise the option of avoiding any §274 disallowance at the employer level by characterizing the payments of travel expenses with respect to a spouse, dependent, or other individual accompanying an employee as compensation (§274(e)(2)).

Husband-Wife Partnerships

When spouses carry on a business together and expect to share in the profits and losses, they may be partners whether or not they have a partnership agreement. If so, spouses should report income or loss on Form 1065, (and not on Schedule C, Form 1040, in the name of one spouse as proprietor) and carry their respective shares of the partnership net income or loss to their joint or separate Form(s) 1040. They should include their respective shares of the partnership net income or loss on separate Schedules SE (Form 1040). Doing this will usually not increase their total tax, but it will give each spouse credit for social security earnings on which retirement benefits are based.

Qualified Joint Venture Election

Electing to be treated as a qualified joint venture allows husband-and-wife businesses to be treated as sole proprietorships rather than partnerships for tax purposes. The option also helps ensure each spouse gets proper Social Security credit.

The Small Business and Work Opportunity Tax Act of 2007 changed the treatment of qualified joint ventures of married couples *not* treated as partnerships. The Act permits a qualified joint venture whose only members are a husband and wife filing a joint return *not* to be treated as a partnership for Federal tax purposes.

A qualified joint venture is a joint venture involving the conduct of a trade or business, if:

(1) the only members of the joint venture are a husband and wife,

(2) both spouses materially participate in the trade or business, *and*

(3) both spouses elect to have the provision apply.

Under the provision, a qualified joint venture conducted by a husband and wife who file a joint return is not treated as a partnership for Federal tax purposes. All items of income, gain, loss, deduction, and credit are divided between the spouses in accordance with their respective interests in the venture. Each spouse takes into account his or her respective share of these items as a sole proprietor. Each spouse accounts for his or her respective share on the appropriate form, such as Schedule C. For purposes of determining net earnings from self-employment, each spouse's share of income or loss from a qualified joint venture is taken into account just as it is for Federal income tax purposes under the provision (i.e., in accordance with their respective interests in the venture).

This generally does not increase the total tax on the return, but it does give each spouse credit for social security earnings on which retirement benefits are based. However, this may not be true if either spouse exceeds the social security tax limitation.

One Spouse Employed by the Other

If your spouse is your employee, not your partner, you must pay Social Security and Medicare taxes for him or her. The wages for the services of an individual who works for his or her spouse in a trade or business are subject to income tax withholding and Social Security and Medicare taxes, but not to FUTA tax.

Review Questions

Under NASBA-AICPA self study standards, self study sponsors are required to present review questions intermittently throughout each self-study course. The following questions are designed to meet those requirements and increase the benefit of the materials. However, they do not have to be completed to receive any credit you may be seeking with regard to the text. Nevertheless, they may help you to prepare for any final exam.

Short explanations for both correct and incorrect answers are given after the list of questions. We recommend that you answer each of the following questions and then compare your answers. For more detailed explanations and references, you may do an electronic search using Ctrl+F (if you are viewing this course on computer), consult the text Index, or review the general Glossary.

100. A married couple may experience either a marriage penalty or a marriage bonus. However, the size of any marriage penalty or bonus depends upon the individuals'

   a. alternative minimum tax rate.

   b. incomes and itemized deductions.

   c. tax shelter income.

   d. stock investments.

101. The author argues that the under present tax law the marriage penalty has lessened because:

a. married couples became subject to the alternative minimum tax.

b. the repeal of the child tax credit.

c. the standard deduction and the tax brackets have equalized.

d. single taxpayers were given a lower capital gain rate.

102. Congress has attempted to reduce the marriage penalty through legislation that has doubled the standard deduction for certain couples. What has been another legislative solution?

a. to increase the size of the alternative minimum tax exemption for married couples.

b. to increase the size of the earned income tax credit.

c. to increase the size of the tax brackets for married couples.

d. to increase the size of the child tax credit.

103. Travel expenses paid for an individual who accompanies a taxpayer on business travel are deductible when three requirements are met. Which of the following is such a requirement?

a. The companion is an independent contractor of the taxpayer.

b. The companion has a bona fide business purpose for the travel.

c. The companion is the taxpayer's domestic partner or spouse.

d. The companion would otherwise not be permitted to take such deduction.

104. Under the no additional cost rule, the presence of a spouse may not affect the business travel deduction. Under what circumstance would the deduction be unaffected by the spousal travel?

a. if the expenses are under $2,000.

b. if the expenses are not lavish or extravagant.

c. if the expenses are solely for meals and lodging.

d. if the taxpayer would have incurred such expenses anyhow.

105. Spouses may jointly perform business activities and anticipate sharing the business's profits and losses. If this is the case, what may be the consequence?

a. They may increase their total tax.

b. They may lose credit for Social Security.

c. They may be deemed partners.

d. They must use a combined Schedule SE.

Federal Estate Tax

Federal estate tax is a death tax imposed on the fair market value of taxable assets, *less* liabilities, owned at death. Federal estate tax is applied to the "taxable estate" (§2001). Taxable assets include the home, all life insurance (even though paid to someone else), and property owned jointly with someone else. Federal estate tax is not a property tax. Under §2051, the "taxable estate" is defined as the "gross estate" less any allowable deductions.

Dower & Curtsey - §2034

Dower and curtsey are *not* vested interests, but mere expectancies in the property and are not included in the taxable estate. A dower (to the wife) or curtsey (to the husband) is a statutory provision in a common-law state that directs a certain portion of the estate to the surviving spouse. Section 2034 includes in the decedent's gross estate "the value of all property to the extent of any interest therein of the surviving spouse, existing at the time of the decedent's death as dower or curtsey, or by virtue of the statute creating an estate in lieu of dower or curtsey." Thus, property owned at death is included at its *full* value without reduction for the surviving spouse's marital interests therein (Reg. §20.2034-1).

For example, a husband without a will dies, with an estate of $1,200,000. Under state law, the wife is entitled to one-third of the husband's estate. As a result, the $400,000 that the wife receives is included in the *husband's* estate under §2034.

Community Property Comparison

In community property states each spouse *owns* a present, undivided one-half interest in the community assets. On the death of either spouse, only their one-half is includible in their estate.

Joint Interests - §2040

Under §2040, co-tenancies with a "right of survivorship" (e.g., joint tenancies, tenancies by the entirety, joint bank accounts, etc.) *are* included in the gross estate of the *first* joint tenant to die. Co-ownership *without* survivorship rights (e.g., tenancies in common, community property, etc.) is *not* taxable under §2040. However, the interest of the decedent in such property *is* taxable under §2033.

The inclusion is *not* limited to the value of the decedent's undivided interest. It applies to the *full* value of the joint tenancy property *except* any part shown to have originally belonged to the survivor and never to have been received or acquired by the survivor from the decedent for less than full consideration (§2040(a)). Thus, to the extent the property originally belonged to the survivor or the survivor furnished consideration for its acquisition, the property is not includible in the decedent's estate.

> Note: The amount excluded from the decedent's estate is not the amount that the survivor contributed. It is an amount proportionate to the survivor's contribution.

Formerly, a gift made to a noncitizen spouse toward the creation of a joint tenancy is the surviving noncitizen spouse's consideration in determining the value of the tenancy includible in the gross estate of the first spouse to die. Currently, the transfer creating a joint tenancy is consideration belonging to the surviving spouse. This rule, however, only applies if the transfer would have constituted a gift had the donor been a U.S. citizen. The transfer, therefore, proportionately reduces the amount of the joint tenancy property includible in the gross estate of the first spouse to die.

Qualified Joint Interest

Section 2040(b) provides a *special* rule for husband-and-wife joint tenancies. In the case of such "qualified joint interests," only *one-half* of the value of the property will be included in the estate of the first to die, without regard to which co-tenant furnished the consideration at the time of the joint tenancy's creation.

> Note: The qualified joint interest rule does not apply where the surviving spouse is not a U.S. citizen, unless (1) the surviving spouse becomes a U.S. citizen before the estate tax return is filed, and (2) the spouse was a U.S. resident at all times after the decedent's death and before becoming a U.S. citizen (§2056(d)).

A "qualified joint interest" is any interest held by a decedent and the decedent's spouse that is either:

(i) A tenancy by the entirety, *or*

(ii) A joint tenancy with right of survivorship, but only if the decedent and his or her spouse are the *only* joint tenants.

Note: In community property states, each spouse has a present, vested one-half interest in all community assets. Thus, on the death of either spouse, only the deceased spouse's one-half of the community property is taxable under §2033.

Powers of Appointment - §2041

A "power of appointment" is a power granted by one person to another to dispose of property even though it is "owned" by another. Section 2041 *includes* in the gross estate of the holder of such a power the value of the property subject to a *general* power of appointment.

Note: Under §2041(a), a general power of appointment is "a power which is exercisable in favor of the decedent, his estate, his creditors, or the creditors of his estate . . ." (§2041(b)(1)).

Ascertainable Standard

Section 2041 provides an exception for a power to consume, invade, or appropriate property for the benefit of the decedent which is limited by an *ascertainable standard* relating to health, education, support, or maintenance of the decedent (§2041(b)(1)(A)). Even though such a limited power enables the decedent to appoint the property to himself or herself or his or her creditors, it is not a general power. Where an ascertainable standard is used, *anyone,* including the trust beneficiary, may be the trustee.

Example

Dan dies having set up a trust for his wife, Daphne, in which she is the sole trustee, receives all income, and can use the trust principal for her "health, support, maintenance, and education." On Daphne's death, she is not considered the owner of the trust assets, and they are not taxed in her estate.

The terms "health, support, maintenance, and education" are important:

1. "Health" would include medical treatment such as hospital, doctor, convalescent hospital, prescription drugs, nursing care, etc.
2. "Education" refers to payments to an educational institution such as a private secondary school, college or university, graduate school, and even trade school, together with related expenses such as room and board, transportation, books, etc.
3. "Support" and "maintenance" mean the normal standard of living that the individual enjoys at the time the trust is created or the trustor dies. It includes the cost of housing, utilities, transportation, clothing, and other reasonable, related expenses.

If a "nonascertainable standard," such as "joy or comfort" is used, there may be problems. If the surviving spouse is the beneficiary and trustee and can take out the principal of the trust for their "joy," then the entire trust could be revoked. Under §2041, this would be a general power. However, it is possible to use a broad, *nonascertainable* standard when there is an *independent* trustee.

5/5 Power

An individual can also be given the right to withdraw a portion of the trust each year. Under §2041(b)(2), one can withdraw up to 5% of the value of the trust *or* $5,000, whichever is greater, *each* calendar year. This right cannot be accumulated and must be used each year or lost.

Example

Dan creates a trust for his wife, Daphne, and gives her the right to withdraw the greater of 5% of the value of the trust or $5,000. If the trust has a $600,000 value, she can withdraw up to $30,000 (5% of $600,000, which is greater than $5,000).

There is a disadvantage to this right. In the year the beneficiary dies, the beneficiary's estate will be taxed on this right if it is not used. If no withdrawal in the year of death occurred, then 5% of the value of the trust will be added to the beneficiary's estate (R.R.79-373).

Example

For example, assume that A transferred $200,000 worth of securities in trust providing for payment of income to B for life with the remainder to B's issue. Assume further that B was given a noncumulative right to withdraw $10,000 a year from the principal of the trust fund (which neither increased nor decreased in value prior to B's death). In such a case, the failure of B to exercise his right of withdrawal will not result in estate tax with respect to the power to withdraw $10,000 which lapses each year before the year of B's death. At B's death, there will be included in his gross estate the $10,000 which he was entitled to withdraw for the year in which his death occurs less any amount which he may have taken during that year (Reg. §20.2041-3(d)(3)).

Life Insurance - §2042

Under §2042, the proceeds from life insurance on the decedent's life are includible in the gross estate if the proceeds are:

(i) Payable to (or for the benefit of) the decedent's estate; *or*

(ii) Payable to any *other* beneficiary, but *only if* the decedent possessed "incidents of ownership" in the policy at the time of death.

Incidents of Ownership

The Code does not define "incidents of ownership." However, regulations (e.g., Reg. §20.2042-1(c)(2)) apply the phrase to any right or interest in the policy where the insured has the power, directly or indirectly, to:

(a) Control of the existence of the policy,

(b) Rearrange the economic interests therein, *or*

(c) Affect the benefits payable thereunder.

If the insured makes a complete and effective gift of all ownership and beneficial interests in the policy, the proceeds are normally not taxable in the estate. However, if the insured transfers incidents of ownership within three years of death, the proceeds will be taxed in his or her estate by reason of the interaction between §2035 and §2042.

Before the unlimited marital deduction, a common estate planning technique was to make the spouse with the longest life expectancy (typically, the wife) the owner of any policies on the life of the spouse with the shortest life expectancy (typically, the husband). If done properly, the policy would not be taxable on the first spouse's death since they were not the owners of the policy. Now, with the unlimited marital deduction, it does not matter if the other spouse is the owner or not when the survivor is the policy beneficiary.

Community Property Issue

Where insurance is purchased with *community* property funds, it is treated as a community asset. Each spouse is deemed to have an *existing,* one-half interest in the policy. Thus, if the *insured* spouse dies first one-half of the proceeds are taxable in the insured's estate under §2042. If the *uninsured* spouse dies first, the deceased spouse's one-half interest in insurance on the other spouse's life is "property owned by the decedent" and taxable under §2033. The value of this property would be one-half of the present value of the insurance (measured by its replacement cost). When the insured subsequently dies, all of the proceeds attributable to premiums paid by the insured are taxable.

Example

If 60% of premiums are paid with community funds while husband and wife are alive (30% attributable to each spouse), and 40% of the premiums are paid by the insured husband after the uninsured wife's death, then 70% of the proceeds are taxed in the insured's estate when he later dies (Scott v. Commissioner, 374 F.2d 154 (9th Cir. 1967)).

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106. The federal government imposes several taxes on decedents at death. Which taxes are imposed on the transfer of assets at death?

a. federal estate taxes.

b. federal inheritance taxes.

c. federal gift taxes.

d. federal income taxes.

107. Section 2034 provides that a certain share of the estate is to be directed to the surviving husband in a common-law state. What is this statutory provision called?

a. a contingent remainder.

b. a curtsey.

c. a dower.

d. a vested remainder.

108. Under §2041, the value of property subject to a general power of appointment can be included in the holder's estate. However, there is an exception for powers of appointment subject to a determinable standard relating to the decedent's:

a. comfort and well-being.

b. health, education, or maintenance.

c. accustomed manner of living.

d. ability to appoint property to himself or herself.

109. Under §2041, which of the following would most likely be considered as constituting "support"?

a. books.

b. convalescent hospital care.

c. room and board while at college.

d. utilities.

110. Section 2042 provides that when a decedent possessed incidents of ownership in a life insurance policy, the proceeds are includible in the decedent's estate. Based on Reg. §20.2042-1(c)(2), which power would fail to be an incident of ownership?

a. The power to terminate the policy.

b. The power to select the insurance company.

c. The power to have an effect on the policy benefits to be paid.

d. The power to reorganize the financial rights in the policy.

Marital Deduction - §2056

Four basic deductions are allowed under federal estate tax law:

(1) Expenses of and claims against the estate (§2053);

(2) Casualty & theft losses during estate administration (§2054);

(3) Charitable transfers (§2055); *and*

(4) The marital deduction (§2056).

Under §2056, a deduction is permitted for all assets passing to a surviving spouse at death. Formerly, the maximum allowable deduction was 50% of the adjusted gross estate; however, with the passage of the 1981 Revenue Act, a deduction is allowed for all property passing to the spouse - i.e., a 100% deduction. Thus, if either husband or wife dies and leaves all assets to the survivor, no federal estate tax is due, regardless of the amount.

The deduction is allowed for property passing *unconditionally* to the surviving spouse of the decedent's death. Section 2056(a) provides that this deduction shall be an "amount equal to the value of any interest in property which passes or has passed from the decedent to his surviving spouse . . ." This marital deduction can be obtained in a number of different ways.

Outright to Spouse

Assets left outright to your spouse qualify under the marital deduction and pass tax-free. The amount transferred to the surviving spouse can come from the deceased spouse's separate or community property. "Outright" transfers can be made by:

(1) Joint tenancy,

(2) Will,

(3) Intestate succession,

(4) Beneficiary designation,

(5) Living trust, *or*

(6) Any other method provided there is no restriction on the surviving spouse.

Marital Deduction (QTIP) Trust

A marital deduction trust qualifies for the marital deduction. Under this trust, the first spouse to die leaves their assets in trust for the survivor's benefit. The survivor is required to receive all the trust's income and have a general power of appointment over the assets at death. Such a trust eliminates tax on the first death but causes the assets to be taxed on the second spouse's death.

Qualified Terminable Interest Trust

This is also a trust for the spouse's benefit. Here, the spouse can get all the trust income for life, but at death, the surviving spouse cannot direct who will get the trust assets. With the terminable interest trust, you can delay tax until the second spouse's death and still control the final disposition of the assets.

"Qualified terminable interest property" is defined as property that passes from the decedent, in which the surviving spouse has a qualifying income interest for life, and for which the decedent's executor makes an election to have the property qualify (2056(b)(7)(B)(i)).

The surviving spouse has a "qualifying income interest for life" if he or she is entitled to all of the income from the property, payable at least annually, and no person has a power to appoint any part of the property to anyone other than the surviving spouse, except that the surviving spouse (or some other person) may be granted a power of appointment if this power is exercisable only at or after the surviving spouse's death (2056(b)(7)(B)(ii)).

Requirements

The marital deduction has *six* basic requirements:

(1) The decedent must have been a citizen or resident of the United States (§2056(a));

(2) Property passing to the surviving spouse must have been included in the decedent's estate (§2056(a));

(3) The decedent must have been married at the time of death;

> Note: Marital status is determined by state law (R.R. 67-442).

(4) The spouse survived the decedent;

> Note: Survival is determined using the presumptions under the Uniform Simultaneous Death Act (Reg. §20.2056(e)-2(e)).

(5) Property must have "passed" from the decedent to the surviving spouse - by will, by operation of law, or otherwise; *and*

(6) The property must be a "deductible interest." Nondeductible interests include interests:

(a) Not included in gross estate,

(b) Deductible under §2053 or §2054, *and*

(c) *Some* (but not all) "terminable interests."

> Note: Section 2056(b)(1) defines a terminable interest as one where "on the lapse of time, on the occurrence of an event or contingency, or on the failure of an event or contingency to occur, an interest passing to the surviving spouse will terminate or fail . . ."

Net Value Rule

The marital deduction is restricted to the *net* value of property passing to the surviving spouse. When property going to the surviving spouse is subject to a mortgage (which has not been paid off by the estate), the value of the property under the marital deduction is reduced by that debt (§2056(b)(4)(B)).

The value of the property must also be reduced by any death taxes payable by the spouse or payable out of property passing to the spouse (§2056(b)(4)(A)).

Non-Citizen Spouse

When a foreign-born spouse is a United States *resident* but *not* a citizen, they are still taxed in the same manner as a United States citizen for federal *income tax* purposes. Likewise, if such a spouse makes a gift of property abroad (outside the United States), they would be subject to *gift tax* like any United States citizen. Should the foreign-born spouse be the first to die, their estate would be entitled to the marital deduction for bequests and transfers to the surviving citizen spouse. However, if the foreign-born spouse is the survivor, there are important *estate tax* implications.

Example

Dan's spouse was born in France, and even though she has established permanent residence in California, she has never given up her French citizenship to become a United States citizen. She is considered a non-citizen or alien.

Under §2056(d)(1), no marital deduction is allowed if the surviving spouse is not a citizen of the United States, even though the decedent is a citizen. Thus, if a citizen spouse dies, assets passing to a surviving non-citizen spouse will not qualify for the unlimited estate tax marital deduction that is available to United States citizens.

> Note: The marital deduction is allowed if the surviving spouse becomes a citizen before the estate tax return is filed, and was a resident of the U.S. at all times after the decedent's death and before becoming a citizen.

This denial of the marital deduction for non-citizen spouses has an important exception. If assets, otherwise qualifying for the marital deduction, are transferred into a qualified domestic trust (QDT), the marital deduction will be available without limit (§2056(d)(2)).

Under §2056A(a), a QDT means a trust:

(a) That requires that at least one trustee be an individual U.S. citizen or a domestic corporation,

> Note: Under Prop. Reg. §20.2056A-2(c), a domestic corporation would be defined as a corporation that is created or organized under the laws of the U.S. or the laws of any state or the District of Columbia.

(b) That provides that no distribution (other than a distribution of income) may be made from the trust unless a trustee who is an individual U.S. citizen or domestic corporation has the right to withhold the tax imposed by §2056A,

> Note: The tax imposed by §2056A is the amount by which the citizen-decedent's estate tax would have been increased if the amount taxable (the amount of the distribution or amount remaining in trust at the survivor's death) had been included in the citizen-decedent's taxable estate. For this purpose, any previous taxable distribution must be taken into account. All distributions from a qualified domestic trust except distributions of income or distributions to the surviving spouse on account of hardship are subject to the tax imposed by §2056A. The tax imposed because of a distribution during the surviving spouse's life is due on the 15th day of the fourth month following the calendar year in which the distribution occurs.
>
> The tax is also imposed on the value of any property remaining in the trust on the date of the surviving spouse's death (§2056A(b)(1)(B)).
>
> The trustee is personally liable for the amount of tax imposed. In addition, there is a lien against the property giving rise to the tax for 10 years after the taxable event.
>
> Some relief for this tax cost is also offered through a credit provision. If property is bequeathed to a non-citizen spouse and that property transfer is subjected to estate tax but would not have been taxed if the surviving spouse had been a citizen, a credit will be available to the surviving spouse's estate on their death. This percentage credit will be for the tax paid by the first spouse's estate on the earlier transfer to the non-citizen spouse who did not qualify for the marital deduction.

(c) Which meets such requirements as the Treasury Secretary may by regulations prescribe to ensure the collection of the tax, *and*

> Note: The IRS has exercised the authority given by this section to issue proposed regulations. A sample of these regulations follows.
>
> Under Prop Reg. §20.2056A-2(d)(1), if the fair market value of the assets passing to the QDT, determined as of the date of the decedent's

death, exceeds $2,000,000, the trust instrument would have to require that either:

(1) At least one U.S. trustee be a bank, as defined in §581, or

(2) The U.S. trustee furnish a bond or security in an amount equal to 65% of the fair market value of the trust corpus determined as of the date of the decedent's death.

If the fair market value of the assets passing to the QDT is $2,000,000 or less, the trust instrument would either have to meet requirement (1) or (2), above, or require that no more than 35% of the fair market value of the trust assets, determined annually on the last day of the tax year of the trust, may consist of real property located outside of the U.S. that is owned by the trust.

When the U.S. trustee of a QDT is an individual U.S. citizen, the individual would have to have a tax home in the U.S. (Prop. Reg. §20.2056A-2(d)(2)).

A QDT would have to provide that all trust assets must be physically located in the U.S. (Prop. Reg. §20.2056A-2(d)(3)). However, this rule would not apply when the requirements for QDTs with assets in excess of $2,000,000 apply.

The U.S. trustee of a QDT would have to file a statement annually with the IRS. The statement would have to be attached to the fiduciary income tax return (Form 1041) filed by the QDT (Prop Reg. §20.2056A-2(d)(4)(i)).

(d) With respect to which the citizen-decedent's executor elects to have the trust qualified as a qualified domestic trust.

Note: The executor must make an irrevocable election on the estate tax return with respect to the trust. However, the executor is not required to make such an election. The executor's right to make this election should appear in the will or the QDT trust.

An executor may make a protective election if there is a bona fide legal controversy that would render the making of the election at the time of the estate tax return not feasible (Prop. Reg. §20.2056A-3(c))). Partial QDT elections are not permitted.

If property passes to a trust that otherwise would qualify for the marital deduction except that the surviving spouse is not a U.S. citizen, the property can be treated as passing to a qualified domestic trust if the trust is reformed to meet the QDT requirements. The revision may occur pursuant to the decedent's will, trust, or a judicial proceeding (Prop. Reg. §20.2056A-4(a)).

Gifts to Non-Citizen Spouses

The gift tax provisions specify that the unlimited marital deduction is not available for gifts to non-citizen spouses. However, a gift of up to $100,000 (indexed to inflation) per year can be made to a non-citizen spouse without

incurring a gift tax (§2523(i)). To qualify, the gift must be one of a present interest. Under this provision, substantial assets can be transferred to a non-citizen spouse during lifetime to effect estate planning objectives.

Example

Dan, a U.S. citizen, is married to Maria, a resident alien. Dan transfers to Maria 100 shares of X Corporation stock valued for federal gift tax purposes at $130,000. The transfer is a gift of a present interest and is a deductible interest for gift tax purposes. Accordingly, $100,000 of the $130,000 gift is not included in the total amount of gifts made by Dan during the calendar year for federal gift tax purposes. Dan must include $30,000 on his annual gift tax return, Form 709, as a taxable gift.

Tax Basis for Estate Assets - §1014

Under §1014, heirs receive a *stepped-up* basis in estate assets and take as their income tax basis the fair market value of the property included in the estate.

Property Basis

Property Basis in Common Transactions		
Type of Transaction	Basis	Holding Period Starts
Purchase	Cost of property plus improvements	Date of purchase
Gift Later Sold At Gain	Donor's basis	Date donor's holding period started
Gift Later Sold At Loss	Lesser of: Donor's basis, or FMV on the date of the gift	Date donor's holding period started on the date of the gift
Seller Repossession	Adjusted basis of the debt due, plus gain from the repossession, plus any repossession expenses	The holding period includes the period before and after the seller's repossession
Tax-deferred Exchange	Original basis of property given up, plus "boot" given, plus any net increase in debt	The holding period includes the period before and after the exchange

Inheritance	FMV on date of death or 6 months thereafter	Date of decedent's death

Community Property Cost Basis

Holding title as community property can have significant cost basis advantages. When property is held as "community property," the decedent's *and* the surviving spouse's respective community shares of an asset receive a complete "stepped-up" basis at the decedent's death. This is true even though *only* the decedent's share is included in the estate.

This could result in a substantial income tax advantage over couples holding property in other forms of joint ownership. Here only the portion of an asset included in the decedent's estate will be eligible for a "step-up" in basis.

Business Interests - Death of a Spouse

A frequent assumption is that the spouse who is active in the business will die before the non-active spouse. This may not be the case and the possibility of a non-active spouse dying first should be considered, particularly, where the business is marital property.

Typically, a non-active spouse's interest in a business is valued at death the same as if the active spouse died first. However, this similarity can be changed when:

(1) The active spouse's services were a significant component of the business goodwill, *or*

(2) There is a buy-sell agreement.

A properly drafted buy-sell agreement will set the value of the business interest for death tax purposes. However, often the buy-sell agreement is only triggered on the active spouse's death and is not binding for death tax valuation purposes on the inactive spouse's death since there is no obligation to sell.

Bypass Trust

When a spouse leaves their entire estate to the surviving spouse using the unlimited marital deduction, there will be no estate tax on death. However, use of the marital deduction may increase the surviving spouse's estate. A bypass trust reduces this result. Thus, any buy-sell agreement should not prevent the inactive spouse from leaving their interest in the business to a bypass trust.

The buy-sell agreement should permit a disposition of the business interest, on the inactive spouse's prior death, to a trust for the benefit of the surviving active spouse and/or other beneficiaries. The active spouse can be named as the trustee of the bypass trust if their powers are limited to an ascertainable standard. However, as trustee, the active spouse's control of the business interest will be as a fiduciary and other beneficiaries may complain if the business interest is unproductive.

Review Questions

Under NASBA-AICPA self study standards, self study sponsors are required to present review questions intermittently throughout each self-study course. The following questions are designed to meet those requirements and increase the benefit of the materials. However, they do not have to be completed to receive any credit you may be seeking with regard to the text. Nevertheless, they may help you to prepare for any final exam.

Short explanations for both correct and incorrect answers are given after the list of questions. We recommend that you answer each of the following questions and then compare your answers. For more detailed explanations and references, you may do an electronic search using Ctrl+F (if you are viewing this course on computer), consult the text Index, or review the general Glossary.

111. Section 2056 provides a marital deduction for federal estate taxes. Under this provision, when a spouse dies and passes all assets to the surviving spouse, what is the outcome?

a. No federal estate tax is due, regardless of the amount.

b. No federal estate tax is due on 50% of the decedent's estate.

c. Federal estate tax is due but only on amounts in excess of the applicable exclusion amount.

d. Federal estate tax is due on the full amount transferred.

112. Several transfer methods qualify as being left outright to a spouse. However, which of the following most likely fails as being left outright?

a. joint tenancy.

b. a reversionary interest.

c. intestate succession.

d. a living trust.

113. To qualify for the §2056 marital deduction, there are six requirements. What is a requirement at the time the transfer is made?

a. The couple must have at least planned to be married.

b. The surviving spouse must receive property through a trust.

c. The property that is passed is a terminable interest.

d. The decedent spouse must have been either a U.S. citizen or a U.S. resident.

114. A qualified domestic trust (QDT) is one way that a surviving non-citizen spouse can obtain an unlimited marital deduction. However, a number of requirements apply to a QDT. What is one such requirement?

a. Trustee must make a revocable election on the income tax return to have the trust qualify as a QDT.

b. Surviving spouse must become a citizen before the estate tax return is filed.

c. Trustee must waive any right to withhold the tax on any distribution.

d. Trustee is either an individual citizen of the United States or a domestic corporation.

115. Under §1014, heirs receive a stepped-up basis in estate assets and take as their income tax basis the fair market value of the property included in the estate. For married couples, what is the effect of holding assets as community property?

a. It can provide considerable advantages to the cost basis.

b. It can deny heirs a full step up in basis.

c. It can mean a loss of the marital deduction.

d. It can be a disadvantage to the surviving spouse.

116. Using the unlimited marital deduction to pass a whole estate, including business interests, can enlarge the estate of a surviving spouse. What can be used to limit this increase?

a. a buy-sell agreement.

b. an electing small business trust.

c. a bypass trust.

d. a simple trust.

Gift Taxes - §2501 to §2524

The gift tax applies to any transfer of property by gift whether made directly or indirectly and whether made in trust or otherwise. A transfer is a transaction where property is passed to or conferred upon another regardless of the means or device employed.

Because estate and inheritance taxes are based on graduated rates, as the estate grows, these tax costs consume an increasing portion of the estate. Gifting is a method of reducing or eliminating this growth in estate value and consequent tax liability. Each completed gift made over a donor's lifetime removes not only the current value of the property gifted from the estate but any appreciation in the property as well.

However, there is a price to pay for making gifts. This price is the federal gift tax. This tax has two purposes:

(1) To discourage the avoidance of federal income taxes by giving away income-producing assets to those in lower income tax brackets, *and*

(2) To limit avoidance of federal estate taxes by lifetime gifts that remove property from the donor's estate.

The present gift tax had its roots in the Revenue Act of 1932 and persists today in §2501 through §2524.

Gift Tax Computation

Lifetime gifts and transfers at death are taxed on a *partially* unified tax schedule that has cumulatively progressive rates. Each taxable transfer, including the final transfer at death, begins in the tax bracket attained by the prior gift.

The gift tax applicable exemption (as a result of being reunified with the estate tax) is the same as the exemption amount for estate tax purposes. Thus, gifts also have an applicable exemption amount of $13.61 million in 2024 and a top gift tax rate of 40%.

Calculation Steps

The following schedule is an outline of the basic gift tax calculation steps:

Federal Gift Tax

1. Gross value of current gift		$__________
2. Less: 50% of line 1 if spouse splits gift	$__________	
3. Less: Annual exclusion ($18,000 in 2024 per donee)	$__________	
4. Less: Marital deduction if the gift is to spouse	$__________	
5. Less: Charitable deduction if the gift is to charity	$__________	

6. Equals: Current taxable gift (line 1 less lines 2-5)		$________
7. Sum of all prior taxable gifts		$________
8. Add lines 6 and 7		$________
9. Tax on line 8		$________
10. Less: Tax on line 7	$________	
11. Equals: Tentative tax on current taxable gift		$________
12. Less: Exclusion credit equivalent for the year of gift	$________	
13. Plus: Any exclusion credit equivalent previously used		$________
14. Gift tax due and payable		$________

Applicable Exclusion - §2505

Under the Tax Reform Act of 1976, a single or *unified* set of graduated gift and estate tax rates applied to both lifetime and death transfers. However, the Tax Relief Act of 2001 changed this unified structure. For gifts made in 2010, the applicable exclusion amount for gift tax purposes was $1 million and the gift tax rate was 35%.

For gifts made after December 31, 2010, the gift and estate tax were again reunified with the *same* applicable exclusion amount and a top estate and gift tax rate of 35%. Since 2013, the American Tax Relief Act ("ATRA") permanently increased the top estate, gift, and GST rate from 35% to 40% for transfers over the applicable exclusion amount ($13,610,000 in 2024).

Application - §2501

Under §2501, the gift tax is imposed on the transfer of property by gift by any individual[2]. The tax applies whether the transfer is in trust or otherwise, whether the gift is direct or indirect, and whether the property is real or personal, tangible or intangible (§2511(a)).

> Note: Nonresident aliens pay gift tax on transfers of property located in the United States (§2511(a)). However, gifts of intangible property by nonresident aliens are exempt from gift tax (§2501(a)(2)).

Entity Rule

When a gift is made to an entity, the gift is deemed made to the individuals who own beneficial interests in the entity. Thus, a gift to a trust is *not* treated as a *single* gift to the trustee, but a gift to each of the trust beneficiaries. The same rule applies to corporations and partnerships.

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[2] This language implies that gift tax cannot apply to entities. However, the regulations state that a gift by an entity is taxable to the persons owning a beneficial interest in the entity (Reg.. §25.2511-1(h)).

Split Gifts - §2513

If a married individual makes a gift of his or her own separate property to someone other than the spouse, and the donor's spouse consents[3] to a "split-gift," it may be regarded as made *one-half* by *each* spouse (§2513). The net effect of this gift-splitting provision is to make the gift tax exclusions and credit of the spouse available to the donor. Thus, the first $36,000 (in 2024) of gifts of present interests is excluded when the non-donor spouse consents to split the gift.

This privilege of "splitting" gifts is extended only to separate property given away by a husband or wife.

> Note: The spouses must be married when the gift is made and the consent must be applied to all gifts made by each spouse during the year (Reg. §25.2513-1).

Community Property States

For gifts of community property, there is *no* need to "split" the gift since each spouse actually owns his or her one-half interest in the property. Thus, persons with community property have the advantage of not having to file a gift tax return on a gift of $36,000 (in 2024) worth of community property to a given donee.

Annual Exclusion

Section 2503 provides an annual exclusion of $18,000 (in 2024) for gifts (*other than*" future interests") made to any donee. Tax law provides for annual indexing for inflation of the $18,000 (in 2024) annual exclusion for gifts.

Indexing the annual exclusion permits donors to give more property without transfer tax costs and without using part of their applicable exclusion amount. Lifetime transfers deliver deeper tax savings because the post-transfer appreciation in the value of the gifts shifts to the recipient of the gift, instead of the donor's estate.

The annual gift tax exclusion applies only to "present interests." No exclusion is allowed for a "future interest in property" (§2503(b)).

> Note: Under Reg. §25.2503-3, a *future interest* is any interest or estate, whether vested or contingent that is:
>
> (1) Limited to commence in use, possession, or enjoyment at a future date, or
>
> (2) Subject to the will of some other person.

[3] The consent is made on the gift tax return.

Per Donee/Per Year

The annual exclusion is available with respect to gifts made to each donee, irrespective of the number of donees. For instance, if $18,000 (in 2024) is given to each of 10 individuals (a total of $180,000), the annual exclusion applies to each, and there is no gift tax liability. Moreover, the annual exclusion is available year after year, and gifts made within three years of the donor's death are *not* brought back into the donor's estate, as are pre-1982 gifts in excess of the annual exclusion.

> Note: For a gift in trust, each beneficiary of the trust is treated as a separate person for purposes of the annual exclusion.

A gift to a corporation is a gift of a future interest to its stockholders and does not qualify for the annual exclusion. If the donor's spouse is a shareholder, such a gift qualifies for the marital deduction in proportion to the interest of the donor's spouse in the corporation.

Gifts in Excess of the Annual Exclusion

Gifts in excess of the *annual* exclusion can be made *without* having to pay gift taxes, *provided* the remaining *applicable* exclusion amount is sufficient to offset the "tentative gift tax." The applicable exclusion amount *offsets* the gift tax liability otherwise due with respect to the gift. The maximum gift applicable exclusion amount may be used to offset gift taxes on lifetime transfers and, to the extent not so used, to offset estate taxes upon death.

Despite this reduction of the applicable exclusion amount available for estate tax purposes, it may still be advantageous to make certain gifts during one's lifetime. For instance, if a gift of *appreciating* property is made prior to death, neither the donor nor the estate incurs any transfer tax liability on the *appreciation* amount (i.e., the appreciation is removed from the donor's estate without tax liability to the donor).

Gift Tax Marital Deduction

The value of gifts made to a spouse may be deducted from the total amount of gifts made during the calendar year. The amount of this marital deduction is *unlimited*. However, to qualify for the marital deduction, the following conditions must be met at the time the gift is made:

(1) The spouses must be married; *and*

> Note: A gift to a person who becomes the donor's spouse after the gift has been made does not qualify for the marital deduction.

(2) The spouse receiving the gift must be a U.S. citizen.

> Note: The spouse making the gift does not have to be a U.S. citizen or resident.

Nondeductible Terminable Interests

Not all interests qualify for the gift tax marital deduction. Nondeductible interests include property interests transferred to a spouse that are *terminable interests*. A terminable interest in property is an interest that will end or fail after a period of time or when some contingency occurs or fails to occur. Examples of terminable interests are life estates, annuities, estates for a term of years, and patents.

For purposes of the marital deduction, there is a distinction between "property" and an "interest in property." "Property" refers to the underlying property in which various interests exist. However, interests in property are not considered "property."

For purposes of the marital deduction, terminable interests fall into three categories:

(a) Terminable interests that qualify for the marital deduction without the need for an election;

> Note: If the donor transfers a property interest to their U.S. citizen spouse and the two spouses are the only joint tenants, the donor is not considered to have retained an interest in the property and the marital deduction is allowed even if the donor may receive the property because their spouse dies or the tenancy is severed. Likewise, if the donor makes a transfer of a life estate with power of appointment that meets certain conditions, the donor is considered to have made a transfer to their spouse that qualifies for the marital deduction.

(b) Terminable interests that do not qualify for the marital deduction unless the donor makes an election to treat the interest as qualified terminable interest property; *or*

> Note: If the donor gives their spouse a life interest in property, the gift generally is a terminable interest and does not qualify for the marital deduction. However, the donor may elect to treat the life interest as a qualified terminable interest for which the marital deduction is allowed. The election is made on the gift tax return for the calendar year in which the interest was transferred. You must make the election on or before the due date, including extensions, for filing the return (§2523(f)(4)(A)). This election is irrevocable and may be made for any property in which the spouse has a qualifying income interest for life.

(c) Terminable interests that cannot qualify for the marital deduction.

Social Security Survivors Benefits

When a participant dies, certain members of their family may be eligible for benefits on the participant's Social Security record. Family members who can collect benefits include:

(1) A widow or widower who is 60 or older;

(2) A widow or widower who is 50 or older and disabled;

(3) Widow or widower at any age if she or he is caring for a child under 16 or a disabled child who is receiving Social Security benefits;

(4) Children if they are unmarried, *and*:

(a) Under 18; *or*

(b) Under 19 but in an elementary or secondary school as a full-time student; *or*

(c) 18 or older and severely disabled (the disability must have started before age 22); *and*

(5) Parents, if they were dependent on the participant for at least half of their support.

Note: A special one-time payment of $255 also will be made after the participant's death. This benefit is paid only to the participant's widow(er) or minor children.

Review Questions

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Short explanations for both correct and incorrect answers are given after the list of questions. We recommend that you answer each of the following questions and then compare your answers. For more detailed explanations and references, you may do an electronic search using Ctrl+F (if you are viewing this course on computer), consult the text Index, or review the general Glossary.

117. Which of the following statements about the gift tax is NOT correct according to the text?

a. The gift tax applies to both direct and indirect transfers of property.

b. The gift tax only applies to monetary gifts, not property transfers.

c. Transfers made through trusts are subject to gift tax

d. A transfer is defined as any transaction where property is passed to or conferred upon another person.

118. When a gift is made to an entity, how is it treated for gift tax purposes?

a. The gift is treated as separate gifts to each individual with a beneficial interest in the entity.

b. The gift is considered a single gift to the entity itself.

c. The gift is only taxable if made to a trust, but not to corporations or partnerships.

d. The gift is considered a single gift to the manager or trustee of the entity.

119. A taxpayer may deduct the amount of gifts made to a spouse from the full amount of gifts made during a calendar year. What is the amount of this gift marital deduction?

a. the annual exclusion.

b. twice the annual exclusion.

c. gift exemption amount.

d. unlimited.

120. On the death of a Social Security recipient, some family members may qualify to receive benefits on the decedent's record. Of the following, who would be able to collect said benefits?

a. a 55-year old widow or widower.

b. a married 18-year old child.

c. a parent who depended on the decedent for no less than 50% of his or her support.

d. a disabled 24-year old child who became disabled in his or her 23rd year.

Answers & Explanations

1. The course materials list six critical tax consequences of a divorce. However, which of the following can individuals disregard when going through a divorce?

   a. Incorrect. Alimony and child support issues are frequently hotly debated in a divorce. The tax treatment between the two types of payments varies dramatically.

   b. Incorrect. The division of marital assets is typically a civil law issue. However, the deferred tax liability that may be locked into the assets received is a major tax issue in a divorce.

   c. Incorrect. Whether to file jointly or married filing separately in the last year of marriage is nearly always a major tax consideration.

   d. Correct. A taxpayer does not lose or risk his or her former personal exemption when going through a divorce. [Chp. 1]

2. A taxpayer's filing requirement, standard deduction, and tax rate are determined by his or her filing status. What is the filing status of an unmarried taxpayer?

   a. Incorrect. Under the Code, there is no such tax filing status as individual. However, married individuals may file as married filing separately.

   b. Correct. When a taxpayer is unmarried, their filing status is single or head of household. Practitioners should exercise care in using the single tax filing status. In many cases, the taxpayer could also qualify for head of household which is disproportionately favored under the Code.

   c. Incorrect. While some states have recognized a tax status as domestic partner (e.g., California), the federal government has not.

   d. Incorrect. Living together is not a tax filing status under the Code. [Chp. 1]

3. Innocent spouse relief has become easier to obtain. In several circumstances, spouses can elect to limit their liability to allocable items. However, under which circumstance is this election unavailable?

   a. Incorrect. The separate liability election is available to a taxpayer who, at the time of the election, is no longer married to the person with whom the taxpayer originally filed a joint return.

   b. Incorrect. The election is available to a taxpayer who is legally separated from the person with whom the taxpayer originally filed a joint return.

   c. Incorrect. The election is available to a taxpayer who for at least 12 months has been living apart from the person with whom the taxpayer originally filed a joint return.

d. Correct. The availability of the separate liability election does not depend upon whether the taxpayer resides in the United States. [Chp. 1]

4. When a refund is due to a taxpayer, it may be used to offset certain debts. Which of the following debts may be paid from a refund?

a. Incorrect. Marital settlement payments are not included in debt that may be paid from a federal tax refund. Such obligations are enforced through state court action.

b. Incorrect. Under §6402, property taxes are not included in the debts that may be paid from a federal income tax refund. Such obligations are enforced by local and state authorities through tax liens on the property.

c. Incorrect. Mortgage payments are not debts that can be paid from a federal income tax refund even if made or backed by the Federal Housing Authority.

d. Correct. Debts that may be paid from a refund are child support payments, spousal support payments, and federal debts such as student loans. [Chp. 1]

5. When four requirements are met, injured spouses may receive a portion of an overpayment for an already filed joint return. Under these requirements, which of the following is disregarded in determining injured spouse status?

a. Correct. The availability of Form 8379 is not based on the taxpayer having been married for less than three years.

b. Incorrect. In order to use Form 8379, the taxpayer must have had income (wages, interest, etc.) that was reported on the joint return.

c. Incorrect. The taxpayer is required to have had tax withheld, estimated tax payments, or a refundable credit that was reported on the joint return in order to be deemed an injured spouse.

d. Incorrect. To be deemed an injured spouse, the taxpayer is required to have had an overpayment that will be (or was) applied to their spouse's debt. [Chp. 1]

6. Taxpayers may be allowed to deduct their full state income taxes up to $10,000. Under which circumstance may this deduction be allowed on their federal return?

a. Incorrect. The federal deduction for state income taxes is an itemized deduction. Taxpayers using the standard deduction would not be entitled to it.

b. Incorrect. If the taxpayer and their spouse are jointly and individually liable for the full amount of the state income tax, then the taxpayer can deduct on a separate federal return the amount of such tax the taxpayer *actually paid* during the year.

c. Incorrect. If a taxpayer pays state income taxes and files a *joint state* return and a *separate federal* return, they can deduct on their federal return that por-

tion of the total state income taxes imposed and paid during the year which their gross income bears to their combined gross income, but not more than the amount the taxpayer *actually paid* during the year.

d. Correct. If a taxpayer pays state income taxes and files *separate state* and *separate federal* returns, they can deduct on their federal return the amount of state income tax imposed (up to $10,000 for 2018 and later) on and paid by the taxpayer during the year. [Chp. 1]

7. A reason that certain married taxpayers file separate returns is to pay their taxes on their own. Which of the following is the most likely result of filing separate returns?

a. Incorrect. The tax rate is higher for married persons filing separately.

b. Incorrect. Some married couples file separate returns because each wants to be responsible only for his or her tax. Filing a separate return limits a taxpayer's liability to that return. Joint returns have joint and several liability.

c. Correct. In almost all instances, the filing of separate returns results in more combined federal tax than with a joint return.

d. Incorrect. This rarely occurs. Typically, joint returns produced dramatically different tax results than married filing separate returns. If married filing separate status reduces or eliminates many beneficial tax provisions. For example, married taxpayers who file separate returns may not take the earned income credit. [Chp. 1]

8. The author presents numerous consequences of filing separate returns for married couples. What is one of these consequences?

a. Incorrect. Married taxpayers who live together but file separate returns may not claim the credit for the elderly or disabled.

b. Incorrect. Married taxpayers who live together but file separate returns may not claim the $25,000 passive activity loss allowance for rental property.

c. Correct. Married taxpayers who file separate returns may not exclude interest from Series EE savings bonds used for qualified education expenses.

d. Incorrect. Married taxpayers who file separate returns may use standard deductions on both returns. [Chp. 1]

9. While separate returns are not always disadvantageous, the materials identify five advantages a married couple might experience when filing separate returns. Under which of the following circumstances should a couple consider filing separate returns?

a. Incorrect. A couple should consider filing separate returns when one spouse owes unpaid federal student loans. Filing a separate return may keep the nondebtor's tax refunds from being taken by the IRS (or another agency) for the other's old debts.

b. Incorrect. A couple should consider filing separate returns when the taxpayers have disproportionate medical and/or miscellaneous itemized deductions.

c. Incorrect. A couple should consider filing separate returns when the spouses live apart and one may qualify as head of household under abandoned spouse rules.

d. Correct. A couple should consider filing separate returns when the taxpayers live together and want to force the suspension of passive activity losses. [Chp. 1]

10. Many taxpayers miss the opportunity to file as head of household. What is an advantage of this filing status?

a. Incorrect. Head of household status is disproportionately favored under the Code. In most cases, the tax Paid will be lower than that on a single status return.

b. Correct. An advantage of filing as head of household is that the standard deduction can be claimed *even if* the other spouse itemizes deductions on a separate return.

c. Incorrect. An advantage of filing as head of household is that the standard deduction is *higher* than that allowed on a single or married filing separate return.

d. Incorrect. This filing status cannot force the suspension of passive activity losses. If this is the taxpayer's goal, he or she should consider using a different filing status. [Chp. 1]

11. An individual can be considered a head of household taxpayer if they pay the majority of the costs of maintaining a home. Which of the following costs are included in determining whether a taxpayer has met this requirement?

a. Correct. Utilities are included in determining whether a taxpayer has paid the majority of the costs of keeping up a home. Other costs that are included are mortgage interest, taxes, and repairs.

b. Incorrect. Education is not included in the costs of upkeep. Other costs that are excluded from consideration in making this determination are the costs of clothing, medical treatment, vacations, and transportation.

c. Incorrect. While insurance on the home is included in the costs of upkeep, life insurance is not included.

d. Incorrect. In making such a determination, the home's rental value is excluded from the upkeep costs. However, costs of upkeep do include rent. [Chp. 1]

12. A client is single and has three children, and no other taxpayer may claim the client as a dependent. How many personal exemptions may your client claim?

a. Incorrect. Formerly, if the client could be claimed as a dependent of another taxpayer, your client could not claim any personal exemptions.

b. Correct. From 2018 until 2026, the TCJA has now suspended (eliminated) personal exemptions.

c. Incorrect. Prior to 2018, the client could take three *dependency* exemptions so long as the dependents met the dependency tests.

d. Incorrect. Formerly, the total number of personal and dependency exemptions that the client could take was four, unless there were other qualifying children or relatives who met the dependency exemption rule. [Chp. 1]

13. Formerly, exemptions could be taken for dependents. When was a spouse deemed to be a dependent?

a. Incorrect. If separate returns were filed, a taxpayer could take a personal exemption for their spouse *only if* their spouse, among other things, was not filing a return.

b. Incorrect. Having a disabled spouse did not entitle a taxpayer to claim a dependency exemption. However, a personal exemption could be claimed for the spouse.

c. Incorrect. A taxpayer could take an exemption for a spouse only because they were married. The reason for this exemption was what was in question.

d. Correct. Personal exemptions were different than dependency exemptions. A spouse was *never* considered a dependent. [Chp. 1]

14. The "qualified child" standard, applicable to dependency exemptions, was established by the Working Family Relief Act. The text outlines four tests used by this standard. However, which former test is now disregarded?

a. Incorrect. The child must live with the claimant for more than half of the year. However, temporary absences due to education, business, vacation, military service, or illness are not counted as absences. Thus, a student at college is not necessarily absent.

b. Incorrect. The potential dependent meets the age test if they are under age 19 at the close of the calendar year, a full-time student (at least parts of five months during the year) under age 24 at the close of the calendar year, *or* permanently and totally disabled.

c. Correct. There is no longer a support (unless the child provides more than half of their own support) or gross income test. Instead, the child must have the same principal place of abode as the claimant for more than half the year.

d. Incorrect. An individual cannot be claimed as a qualified child if they are able to file a joint return with another. [Chp. 1]

15. If three conditions are met, parents can regard a child as a "qualifying child" of the non-custodial parent. What is one of the conditions?

a. Incorrect. Parents can continue to agree that a child is treated as the "qualifying child" of the non-custodial parent if, among other things, a child receives over one-half of the child's support during the calendar year from the child's parents.

b. Incorrect. Parents can continue to agree that a child is treated as the qualifying child of the non-custodial parent if, among other things, the child is in the custody of one or both of the parents.

c. Incorrect. Parents can continue to agree that a child is treated as the qualifying child of the non-custodial parent if, among other things, the child is in the custody of one or both of the parents for more than one-half of the calendar year.

d. Correct. Parents can continue to agree that a child is treated as the qualifying child of the non-custodial parent if, among other things, the parents are divorced or legally separated under a decree of divorce or separate maintenance, separated under a written separation agreement, or live apart at all times during the last six months of the calendar year. [Chp. 1]

16. For medical expense deduction purposes, how is a child of divorced or separated parents treated?

a. Correct. A child of divorced or separated parents whose support test is based on the special rules is treated as a dependent of both parents for the medical expense deduction. Thus, a parent can deduct medical expenses they paid for the child even if an exemption for the child is claimed by the other parent.

b. Incorrect. Under the special rules, the parent who had custody of the child for the greater part of the year is generally treated as the parent allowed to claim the exemption for the child if the other dependency tests are met. However, the rules vary for medical expenses.

c. Incorrect. The special rules require that the parent who did not have custody, or who had it for a shorter time, is not allowed to take a dependency exemption for the child. However, the treatment of medical expenses varies.

d. Incorrect. A child of divorced or separated parents is a dependent of one of the parents. They are not typically considered an independent or separate taxpayer. [Chp. 1]

17. Formerly, taxpayers could deduct selected divorce expenses. However, currently, fees paid to a lawyer for associated tax advice:

a. Incorrect. Under §265, costs allocable to the production or collection of tax-exempt income are not deductible.

b. Correct. Legal fees paid for tax advice in connection with divorce and legal fees to get alimony *are not* deductible.

c. Incorrect. Fees paid to a lawyer for associated tax advice are now personal expenses and can not be amortized or deducted.

d. Incorrect. There is no deduction for the cost of settlement in a divorce. [Chp. 1]

18. In some divorces, taxpayers must, unfortunately, use their own funds to collect court-ordered child support. How are such costs and fees for collection treated?

a. Incorrect. Such costs and fees are not deductible subject to an AGI limitation.

b. Correct. A deduction is *not* allowed for the collection of child support. However, child support is not taxable to the recipient.

c. Incorrect. Costs and fees for the collection of child support are not treated as an expense for the production of income.

d. Incorrect. Costs and fees for collecting child support are not considered in determining who provides support. [Chp. 1]

19. Spouses may file separate returns and make a joint declaration of estimated tax. However, if the spouses are unable to agree to a division of the estimated tax payments, what happens?

a. Incorrect. In this instance, the estimated tax payments may be treated as payments on account of the tax liability of either the husband or wife for the taxable year. Tax law does not provide that the payments will be treated as payments on account of the tax liability of the higher-paid spouse.

b. Correct. If a division cannot be agreed upon, the credits are determined according to the tax amount found on their returns. Reg. §1.601(b)-(1) provides that the allocated payments be apportioned in the same ratio of the combined payments as the separate tax amounts.

c. Incorrect. Certain rules apply in this instance. However, none of the rules indicate that a joint declaration will be dismissed or disallowed.

d. Incorrect. In this instance, the payment is still divided. When a spouse makes a separate estimated tax payment, the payment is credited only to the spouse who made the payment. [Chp. 1]

20. Which of the following statements about marital property is NOT correct?

a. Incorrect. Marital property can include assets acquired during the marriage. For example, property acquired with joint funds is generally marital property.

b. Correct. Property received as a gift during the marriage is not considered marital property, but rather separate property.

c. Incorrect. In non-community property states marital assets are generally divided pursuant to equitable distribution.

d. Incorrect. Property received as an inheritance during the marriage is not considered marital property, but rather separate property. [Chp. 1]

21. Married couples may want to change the title of certain property to "Husband and Wife as Community Property." What does this title change do?

a. Incorrect. If a taxpayer puts separate funds into a joint account with their spouse, the taxpayer has commingled the funds. Such commingling could make all funds in the account community. A title change is not an example of commingling.

b. Incorrect. While changing the title to property may make that property community, it does not establish a general or inclusive community property agreement.

c. Incorrect. Under §1041, transfers to a spouse are not taxable.

d. Correct. In changing the title to "Husband and Wife as Community Property," a spouse has effectively transmuted their property, giving the other spouse one-half interest in the property. [Chp. 1]

22. If a spouse owns a business as their separate property, they may or may not take a competitive salary. When a spouse does take a competitive salary what should be the result in a community property jurisdiction?

a. Incorrect. If a spouse owns a business as sole and separate property and does not take a "competitive salary" from the business, a portion of the increase in the fair market value of the business can become community. Commingling can also be through effort that is not properly compensated.

b. Incorrect. Whether competitive or not, wages and salaries paid during a marriage are community property in such jurisdiction.

c. Incorrect. If community funds or efforts are used to maintain separate property, it can gradually become community property. However, where the spouse is adequately compensated the business should remain separate.

d. Correct. If a spouse owns a business as sole and separate property and a competitive salary is taken out of the business, the business will remain separate property provided it is neither commingled nor transmuted. [Chp. 1]

23. When spouses in a community property jurisdiction decide to file separate returns, the author gives selected rules for correct reporting. What is one of those rules?

a. Incorrect. Separate deductions should be allocated to the spouse to whom they belong.

b. Incorrect. Separate income should be allocated to the spouse to whom it belongs.

c. Incorrect. Like wages, total aggregate withholding should be divided 50% to each spouse.

d. Correct. In a community property state, income during a marriage belongs 50% to each spouse on an aggregate basis. As a result, community income should be equally divided between the spouses' separate returns. [Chp. 1]

24. If spouses live in different states due to work commitments and one is a resident of California (a community property state), while the other is a resident of New York (a separate property state). How would their income be classified for tax purposes?

a. Incorrect. There is separate property for one spouse if the other state is a separate property state.

b. Correct. The Californian's income is community property because they reside in a community property state. The New York spouse's income is separate property because they reside in a separate property state.

c. Incorrect. The income of the spouses would be divided between community and separate based on their states of residency.

d. Incorrect. There is community property for one spouse if the other state is a community property state. [Chp. 1]

25. Five requirements exist for the application of §66(a)'s special community income allocation rules. What is one of these requirements?

a. Incorrect. One of the requirements that must be met in order for special community income allocation rules to apply is that the taxpayer and/or their spouse are married at *anytime* during the calendar year.

b. Incorrect. One of the requirements that must be met in order for special community income allocation rules to apply is that the taxpayer and/or their spouse do *not* file a joint return for a tax year beginning or ending in the calendar year.

c. Correct. One of the requirements that must be met in order for special community income allocation rules to apply is that the taxpayer and/or their spouse have earned income for the calendar year that is community income.

d. Incorrect. One of the requirements that must be met in order for special community income allocation rules to apply is that the taxpayer and/or their spouse live apart *all* year. [Chp. 1]

26. Under what circumstances can the IRS disallow the benefits of community property law to a taxpayer regarding their income?

a. Incorrect. The ability of the IRS to use §66(b) is not triggered by the filing of a tax return late without requesting an extension.

b. Incorrect. Section 66(b) applies to a spouse who lives in a community property state and exercises control of the entire community income but only wants to be taxed on half of the community property income.

c. Incorrect. The ability of the IRS to use §66(b) is not triggered by the taxpayer's spouse refusing to sign a joint tax return.

d. Correct. Under §66(b), the IRS may disallow community property law benefits if the taxpayer acted as if they were solely entitled to the community income and failed to notify their spouse of the nature and amount of such income before the tax return due date, including extensions. [Chp. 1]

27. The rules regarding the termination of a community that are applied in each community property state vary. However, in all community states, what terminates a community?

a. Incorrect. Depending on the state, community property may be divided under a separation agreement. Such an agreement could separate property and future earnings and property. Further, a separation agreement may terminate a community. Even yet, the community may terminate when the spouses permanently separate, regardless of whether there is a formal agreement.

b. Incorrect. A decree of separate maintenance may terminate a community in some community states, while in other states such a decree does not end it.

c. Incorrect. A community often terminates at the time when the spouses separate and do not intend to get back together. Thus, many times it is unnecessary to have a legal separation or a decree of separation or divorce. However, in some states, the community terminates only when a taxpayer is legally separated or divorced.

d. Correct. In all community property states, an annulment terminates the community. Even though the presumption of an annulment is that there was never a valid marriage, usually community property rights arising during the "marriage" are upheld. Individual state laws should be verified for exceptions. [Chp. 1]

28. Which of the following statements about separation agreements and community property is NOT correct?

a. Incorrect. A separation agreement can divide the community property between the spouses.

b. Incorrect. A separation agreement can provide that future earnings and property acquired will be separate property.

c. Correct. In some not all states, the community ends when the spouses permanently separate, even if there is no formal agreement.

d. Incorrect. A separation agreement can end the community. [Chp. 1]

29. A marriage must be legal in order for couples to file jointly. For federal income tax purposes, how is marital status first tentatively determined?

a. Incorrect. For federal income tax purposes, marriage is not determined by federal law. Marital status is controlled by state law.

b. Incorrect. Local law does not hold precedence with regard to marital status determination.

c. Correct. In order to file as "married filing jointly," a couple must be legally married. Marital status for federal income tax purposes is determined by reference to *state* law. A couple is not deemed husband and wife for joint return purposes if their marriage was void under applicable state law.

d. Incorrect. The IRS will not deny married status because of state *antimiscegenation* statutes forbidding marriage between persons of different races, since such statutes have been held unconstitutional by the Supreme Court. Supreme Court decisions affect how certain locations treat marriage, but they do not govern marital status. [Chp. 1]

30. *Marvin v. Marvin* was a case in California that dealt with property and other rights between couples that live together. What was one of the conclusions of this case?

a. Incorrect. If a contract between unmarried partners involves any "payment" in the form of meretricious sexual service, the contract is invalidated.

b. Incorrect. If unmarried couples fail to create a contract regarding support or property divisions, the court may decide whether an implied contract is in existence depending on an examination of the partners' lives. While it is possible that all property may be deemed separate, it is also a possibility that the property may be deemed joint.

c. Correct. As a result of this case, the court determined that oral or written contracts may be made between unmarried partners. This is the essence of palimony.

d. Incorrect. Living together without being married and participating in a sexual relationship does not invalidate contracts made between unmarried partners. [Chp. 1]

31. Certain issues must be determined before dividing up property between spouses in a divorce. Which of the following is most important for the parties to know about property?

a. Incorrect. While an encumbrance may affect the equity of a property, it is not a necessary ingredient to begin negotiating a property settlement.

b. Correct. The parties must know what property is owned separately and what property is marital before beginning a property settlement. In most instances, separate property is not subject to division while marital property is subject to division.

c. Incorrect. Distinguishing between real and personal property for property settlement purposes is not crucial to its division in a property settlement.

d. Incorrect. Differentiating between tangible and intangible property for property settlement purposes is not critical. However, care should be exercised in discovering intangible property since it has a greater potential for being missed in a property settlement. [Chp. 2]

32. Marital property rights depend on the state in which the taxpayer resides. For example, in Nevada, what would initially be considered separate property?

a. Incorrect. Nevada, a community property state, deems property received as inheritance by one spouse as separate property. Thus, if both spouses received the inheritance of a parent, it would be deemed community property.

b. Incorrect. Nevada is a community property state in which property received as a gift to one spouse is deemed separate property. Therefore, if both spouses receive a gift, said gift is community property.

c. Incorrect. Property obtained in exchange for separate property is included as separate property in community states such as Nevada. Thus, when property is received in exchange for community property, the property received would be included in community property.

d. Correct. Nevada would include property obtained by a spouse prior to marriage as separate property. In actuality, equitable distribution states might also come to this conclusion. [Chp. 2]

33. In some instances, property is deemed separate in both equitable distribution states and community property states. Which of the following is most likely separate property in both types of states?

a. Correct. In both equitable distribution states and community property states, separate property includes compensation for personal injury.

b. Incorrect. Property acquired after separation is treated as separate property in community property states, but not in equitable distribution states.

c. Incorrect. Property acquired during marriage with premarital earnings is treated as separate property in community property states, but not in most equitable distribution states.

d. Incorrect. Property acquired during marriage with the proceeds of the sale of premarital property is treated as separate property in community property states, but not in equitable distribution states. [Chp. 2]

34. In the author's opinion, U.S. courts use five main principles in dividing assets between spouses. Which of these principles is sometimes used in child custody cases but disregarded in such asset divisions?

a. Incorrect. Need is considered in divorce or separation cases in order to make certain a spouse does not have to receive public welfare, which would ultimately cost all taxpayers. Courts would typically not disregard this principle and would also consider it in child custody cases.

b. Incorrect. Contribution is another main principle that is considered in divorce or separation cases since both partners contribute to the marriage, whether it is in services or income. Contribution would likely be considered in child custody cases also.

c. Correct. Courts sometimes consider fault in divorce or separation cases and use it to punish the spouse who caused the divorce. However, in some states, no-fault divorce statutes predominate, and courts may not punish said spouse. Even so, in these states, courts often use this principle in child custody cases.

d. Incorrect. Courts in divorce or separation cases consider the status of spouses by applying a standard of living test. This is likely to be considered in child custody cases also. [Chp. 2]

35. Despite their critics, premarital agreements have numerous benefits and uses. However, which of the following items is a limitation on premarital agreements?

a. Incorrect. Premarital agreements can be used to protect the inheritance rights of children of prior marriages.

b. Incorrect. A frequent purpose of premarital agreements is to clarify the separate or marital property nature of certain assets, such as professional degrees and licenses, professional goodwill and reputation, creative works in progress, etc.

c. Incorrect. Premarital agreements can be used to protect the control, management, and ownership of a family business from the prospective spouse and his or her legatees.

d. Correct. The Retirement Equity Act of 1984 provides that certain rights in retirement benefits cannot be waived in a premarital agreement. Under the REA '84, the surviving spouse has an independent right to a survivor benefit in a qualified retirement plan separate and apart from their marital property rights in the plan. [Chp. 2]

36. A valid premarital agreement must meet at least four requirements. What is one such requirement?

a. Incorrect. Premarital agreements must be in writing. In addition, the agreement may require acknowledgment and attorney certification.

b. Incorrect. Premarital agreements must be signed voluntarily with informed consent. In addition, attorneys for each spouse should review the agreement. Dual representation by one attorney could give rise to a presumption of undue influence and lack of informed consent.

c. Incorrect. Premarital agreements must not be unconscionable (one which no person in his or her senses would make, and which no fair and honest person would accept). This is particularly true if the other side waves or is not represented by counsel.

d. Correct. Premarital agreements must disclose each party's financial condition. Without such complete disclosure, there may be no informed consent. [Chp. 2]

37. A premarital agreement should be as inclusive as possible and be reviewed and detailed before being signed. In that regard, the parties should seriously consider the inclusion of:

a. Incorrect. Before entering into a premarital agreement, it should be reviewed to make certain that there is no provision that limits support for children. This may invalidate the entire agreement as being against public policy. At the very least, specifically state that should the clause limiting support be invalidated, the rest of the agreement will remain enforceable.

b. Correct. Before entering into a premarital agreement, it should be reviewed to make certain that any loans from separate property to the marital unit should be documented, and signed by the other spouse.

c. Incorrect. Before entering into a premarital agreement, it should be reviewed to make certain that, if any loans from separate property to the marital unit are repaid, the repaid funds should be not commingled with other funds.

d. Incorrect. Before entering into a premarital agreement, it should be reviewed to make certain that "Marvin" language is included. [Chp. 2]

38. Under §1041, a nonrecognition rule applies to property transfers between current and former spouses. However, what fails to qualify as property under §1041?

a. Incorrect. Under §1041, tangible or intangible personal property would be deemed property. Thus, nonrecognition of gain or loss treatment could apply to these assets.

b. Incorrect. Section 1041 provides that real property is considered property. Thus, this provision could apply to the transfer of real property.

c. Incorrect. Cash or cash equivalents are considered property under §1041. As a result, nonrecognition of gain or loss treatment could apply to the transfer of cash or cash equivalents.

d. Correct. Under §1041, assignments of income are not classified as property. Thus, transfers between spouses that are assignments of income are not subject to the nonrecognition rule of §1041. [Chp. 2]

39. Section 1041 protects gain that might be ordinarily recognized on a property sale or transfer. However, what should a taxpayer do when he or she transfers a U.S. savings bond?

a. Incorrect. There are no income coupon bonds attached to the U.S. savings bonds.

b. Incorrect. The concept of interpolated terminal reserve value is used for the valuation of insurance policies, not U.S. savings bonds.

c. Correct. R.R. 87-112 holds that the accrued interest on Series E and Series EE U.S. Savings Bonds is includable in the income of a transferor when the

bonds are assigned to the transferor's former spouse as part of a divorce settlement.

d. Incorrect. The income on transferred bonds is not attributable to the transferor on the date of maturity but on the date of transfer. [Chp. 2]

40. In a marital settlement, receivables for personal services may be transferred or awarded to the non-earning spouse. In such an instance, what is a tax consequence?

a. Incorrect. If marital assets include receivables for personal services rendered and the receivables are transferred to the non-earning spouse, the recipient spouse doesn't report the amount as income.

b. Correct. When the receivables are awarded to the non-earning spouse, the earning spouse may nevertheless be taxed on the income when it is collected by the assignee under the assignment-of-income doctrine.

c. Incorrect. The income is not taxable at the time of the transfer.

d. Incorrect. The income is nontaxable to the recipient spouse when transferred. [Chp. 2]

41. Under Private Letter Ruling 8640046, when interest is paid on a note relating to the transfer of property subject to §1041, it is treated as interest. What do Prop. Regs. §1.483-1(c)(2)(iii) and §1.1274-1(b)(10) further determine regarding such obligations?

a. Correct. Sections 483, 1272, 1274, and 7872 do not discuss the application of imputed interest or original issue discount (OID) rules on deferred payments used to effect a §1041 transaction. However, Prop. Regs. §1.483-1(c)(2)(iii) and §1.1274-1(b)(10) provide that §483 and §1271-1275 do not apply to any transfers of property subject to §1041.

b. Incorrect. The passive loss rules affect certain §1041 transfers of property. However, IRS Pub. 504 covers their interaction and it does not apply to notes issued in a property settlement.

c. Incorrect. Transfers of property subject to §1041 are not subject to the alternative minimum tax. Section 1041 is a nonrecognition provision for both regular and AMT tax.

d. Incorrect. This was the basis for the taxation of divorce settlements under the *Davis* case. The *Davis* case was effectively overruled in 1984 with the passage §1041. Thus, this issue was resolved in 1984 by the issuance of §1041. [Chp. 2]

42. Under §1041, there are several circumstances where a property transfer is "incident to divorce." What is one of these circumstances?

a. Incorrect. The transfer must be made not more than six years after the marital termination.

b. Correct. A property transfer is "incident to divorce" when made within one year after the marriage terminates as defined in §1041(c).

c. Incorrect. A property transfer related to a marital termination can be incident to the divorce.

d. Incorrect. A premarital agreement does not take precedence over the Code. [Chp. 2]

43. In certain instances, it may be desirable to avoid §1041. How might a couple arrange a property transfer so that it fails to qualify as incident to divorce under §1041?

a. Correct. One method of avoiding §1041 is to intentionally structure the transaction so that it is not incident to divorce. A possibility might be to divide the assets at divorce and wait for six years before transferring the property again between the spouses.

b. Incorrect. If one spouse exercises a right of first refusal to purchase property three years after they divorce, the transfer is probably related to the cessation of the marriage, thus §1041 applies. As a result, the transferor has no tax consequences and the transferee takes title to the property at its original basis.

c. Incorrect. A property transfer is related to the marital termination when required by a divorce or separation instrument (either original or modified) and the transfer is not more than six years after the marital termination. Thus, §1041 applies.

d. Incorrect. When a property transfer is within one year after the end of the marriage, it is not necessary to determine if it was related to marital termination. [Chp. 2]

44. Section 1041 requires a valid divorce or separation instrument. However, which of the following items would most likely fail as such a divorce or separation instrument?

a. Incorrect. A judicial decree, judgment, or order of divorce is a divorce or separation instrument.

b. Incorrect. A decree of legal separation is a judicial decree, judgment, or order of separate maintenance, which qualifies as a divorce or separation instrument.

c. Correct. An oral agreement of a spouse to vacate the marital premises is not a divorce or separation instrument. The agreement must be in writing.

d. Incorrect. A judicial decree, judgment, or order of separate maintenance is a divorce or separation instrument. [Chp. 2]

45. A taxpayer may make a valid property transfer under §1041 to a third party on behalf of his or her spouse. In such a circumstance, how is the subject property procedurally treated?

a. Incorrect. A taxpayer's transfer of property to a third party on behalf of their spouse is treated as a transfer as long as the transfer otherwise qualifies.

b. Incorrect. The transfer that follows the transfer to the spouse must be taken into account.

c. Incorrect. A transfer of property to another party on behalf of a taxpayer's spouse is treated as eventually being transferred to the third party.

d. Correct. If a taxpayer transfers property to a third party on behalf of their spouse or former spouse, the property may be treated as if their spouse or former spouse immediately transferred it to the third party. [Chp. 2]

46. If two transfers are considered to have taken place in a single transfer, each is treated differently. How is the first deemed transfer to a transferee spouse treated?

a. Incorrect. The second (deemed) transfer can result in gain to the former spouse.

b. Incorrect. The second (deemed) transfer can result in loss to the spouse.

c. Incorrect. The second (deemed) transfer is *not* treated as a gift.

d. Correct. Only the first (deemed) transfer to the transferee spouse is under §1041. [Chp. 2]

47. Section 1041(b) deals with the basis of property received in an interspousal transfer. What is the general rule of this provision?

a. Incorrect. The transferee does not acquire additional basis in the property even if required to pay the transferor for the property.

b. Correct. The basis of property received is the same as it was for the transferor (i.e., "carryover basis").

c. Incorrect. The property received by the transferor spouse does not get a stepped-up basis equal to the fair market value of the property at the date of the transfer.

d. Incorrect. While the appraised value of property may be useful in making a property division, this value does not become the basis of the property in the hands of the transferor spouse. [Chp. 2]

48. Amazingly, §1041 treatment is similar to that which applies in the case of a gift for purposes of the passive loss rules. When a taxpayer receives passive activity property from a former spouse, what happens to the basis in this deemed "gift"?

a. Correct. If a taxpayer transfers passive activity property to their spouse or former spouse, the basis in the "gift" is increased immediately before the transfer by the amount of any passive activity losses allocable to the property. This rule is based on the interplay of §469(j)(6) and §1041(b).

b. Incorrect. The transfer of property to a former spouse does not reduce the basis of the property by the suspended passive losses. Section 469(j)(6) pro-

vides that in the disposition of any interest in a passive activity by gift, the basis of the interest immediately before the transfer is increased by the amount of any suspended passive activity losses allocable to the interest.

c. Incorrect. While these losses cannot be deducted for any year, they are not completely lost. Since they add to the basis of the property, they can be used when the property is ultimately disposed of.

d. Incorrect. While the gift analogy is used for purposes of transferring property with suspended losses to a former spouse, the analogy does not go as far as requiring gift tax on the transfer. [Chp. 2]

49. When a taxpayer receives U.S. savings bonds from a spouse or former spouse, the recipient's basis in the bonds is:

a. Incorrect. In calculating a loss on a later sale or exchange, a donee's basis for property received by gift is the lesser of the transferor's basis or the fair market value of the property at the time of the gift (§1015). Under §1041 the transferee's basis is the same as that of the transferor in calculating either gain or loss.

b. Incorrect. The basis transferred does not increase by the interest that was part of the transferee's income; the basis would not double.

c. Correct. The recipient's basis in U.S. savings bonds transferred is increased by the interest included in the transferor's income.

d. Incorrect. When the transferor recognizes gain on property transferred in trust, the trust's basis in the property is increased by the recognized gain. [Chp. 2]

50. For the most part, courts disregard the tax consequences of property divisions. However, when might they most likely consider such consequences?

a. Incorrect. If the parties fail to deal with potential tax consequences, they might still file a post-judgment motion to amend the decree to alleviate adverse tax consequences.

b. Incorrect. If the parties' counsel refuses to deal with potential tax consequences, they might still file a post-judgment motion to amend the decree to alleviate adverse tax consequences.

c. Incorrect. If the tax impact is uncertain, the later taxes may be ignored. Divorce court judges are rarely qualified to clarify federal income tax consequences.

d. Correct. The general rule is that the courts will not consider the tax impact of property divisions unless the taxable event is likely to occur in the near future or as a result of the court's order. [Chp. 2]

51. Section 1041 fails to address the holding period for asset transfers between spouses and former spouses. However, as a result of the provision's analogy to gifts, what is held to be the transferee's holding period?

a. Correct. The holding period for the transferee is the *same* as the holding period for the transferor immediately before the transfer.

b. Incorrect. The holding period does not start again for the transferee. Because of the gift analogy, the transferee takes a carryover basis from the transferor.

c. Incorrect. The filing date for the divorce petition is essentially a civil matter and does not commence any holding period for tax purposes.

d. Incorrect. No gift taxes are due under §1041. The holding period for the transferee is the same as the holding period for the transferor regardless of gift taxes. [Chp. 2]

52. Under §1041, a transferee must receive certain records regarding the property that is transferred. What additional records should be provided if the property has possible credit recapture?

a. Incorrect. Ample records allowing the transferee to figure the adjusted basis should be provided regardless of whether or not the property has possible credit recapture.

b. Incorrect. Ample records allowing the transferee to clarify the property's holding period should always be provided.

c. Correct. When the property has possible credit recapture, the transferor should provide ample records allowing the transferee to calculate the total potential liability. However, no sanctions are specified for the transferor's failure to comply.

d. Incorrect. Prior to the transfer, the transferee would likely determine whether the property's value is what the transferor claimed it to be. The transferee would likely have the property assessed prior to the transfer and would not wait until after the transfer is completed to find out this crucial information. [Chp. 2]

53. One spouse may purchase an interest in a marital residence from the other spouse for a note. What results when the selling spouse receives this note?

a. Correct. When a spouse sells their interest in the marital residence to the other spouse and receives the purchasing spouse's note as part of the purchase price, any deferred gain is transferred to the purchasing spouse.

b. Incorrect. The treatment of the interest will depend upon a number of factors. If the note is secured by the residence, the interest could be qualified home mortgage interest. If the note is not secured by the residence, the interest will be personal and, therefore, not deductible.

c. Incorrect. When a spouse sells their interest in the marital residence to the other spouse and receives the purchasing spouse's note as part of the purchase price, the selling spouse does not report any gain (or loss) on the sale under §1041.

d. Incorrect. When a spouse sells their interest in the marital residence to the other spouse and receives the purchasing spouse's note as part of the purchase price, the basis is carried over to the buyer. [Chp. 2]

54. The author reviews several techniques to be considered when low-basis property is received in a marital settlement. What tax issue are these techniques primarily directed to alleviate?

a. Incorrect. Now, under §1041, the transferor spouse is not taxed on the transfer, but the transferee spouse cannot increase the basis of the property, even by amounts they may have paid to the other spouse for the property.

b. Incorrect. A third party is involved since the question assumes the spouse directly receives the property.

c. Correct. Receiving low basis property, without a basis increase even if purchased from a spouse, creates deferred tax liability.

d. Incorrect. While the Code contains a variety of recapture provisions, the major provisions are for depreciation and investment tax credit. Normally, these provisions do not apply to §1041 transfers as long as the transferred property continues in its identical use after the transfer. [Chp. 2]

55. When depreciated property is sold or exchanged, §§1245 and 1250 provide that depreciation recapture can occur. What does such recapture do to part of any gain from such a disposition?

a. Incorrect. Depreciation recapture does not apply to §1041 transfers because such a transfer is considered to be a gift.

b. Incorrect. Under §1245 and §1250, depreciation recapture occurs on the sale or exchange of depreciated property.

c. Incorrect. Depreciation recapture does not cause a portion of the gain from the sale of property to be capital gain.

d. Correct. Depreciation recapture causes a portion of the gain from the sale of property to be ordinary income. [Chp. 2]

56. There are several types of nontaxable exchanges under the Code. In the author's opinion, what is the most common type of these exchanges?

a. Correct. The exchange of property for like-kind property under §1031 is the most common type of nontaxable exchange.

b. Incorrect. There is no nontaxable exchange provision under the Code for property held primarily for sale. In order to be a like-kind exchange, the property traded and the property received must not be property held primarily for sale.

c. Incorrect. The exchange of real estate for personal property is not recognized as a nontaxable exchange under the Code. In order to be a like-kind exchange, there must be an exchange of like property. The exchange of real

estate for real estate and the exchange of personal property for similar personal property are exchanges of like property.

d. Incorrect. There is no nontaxable exchange provision under the Code for notes or beneficial interests. Such items are not permitted to be exchanged under §1031. [Chp. 2]

57. Like-kind exchanges can be used to effectively deal with low basis property but must meet certain conditions. Which of the following might qualify as a like-kind exchange transaction?

a. Incorrect. Inventories, raw materials, accounts receivable, other current assets, and real estate that dealers hold for sale to customers are examples of property that would *not* qualify as a like-kind exchange.

b. Correct. Land and rented houses are examples of property that might qualify as a like-kind exchange.

c. Incorrect. Section 1031 does not apply to exchanges of stocks, bonds, notes, choses in action, certificates of trust or beneficial interest, other securities or evidences of debt or interest, or the exchange of partnership interests.

d. Incorrect. An exchange of personal property for real property does not qualify as a like-kind exchange. [Chp. 2]

58. When a couple decides to terminate their marriage, what is NOT mentioned as a common disposition alternative for the family residence?

a. Incorrect. Selling the residence and dividing the proceeds between the spouses is a common alternative for the disposition of the family residence.

b. Correct. Renting out the home and splitting rental income is not mentioned by the author as a common alternative. Besides, this would not be a disposition of the residence.

c. Incorrect. Selling the residence to the other spouse is a common alternative for the disposition of the family residence.

d. Incorrect. While not exactly a disposition, joint ownership of the residence with one spouse occupying is common. Frequently, this is done when market conditions are not favorable for immediately selling the property. [Chp. 2]

59. Current §121 replaced the rules for gains on the sale of a personal residence under §§1034 and old 121. Under current §121, who can be entitled to a combined $500,000 exclusion on the sale of their principal residence?

a. Incorrect. A single taxpayer who marries a taxpayer who has used the exclusion within two years is allowed a $250,000 exclusion.

b. Incorrect. Married couples who do not use the property as their principal residence for at least two years during the five-year period ending on the date of the sale or exchange do not meet the use requirement and therefore do not qualify for the full $500,000 exclusion.

c. Correct. Married couples filing a joint return are entitled to a $500,000 exclusion where both spouses meet the use requirement.

d. Incorrect. Married couples filing a joint return are entitled to a $500,000 exclusion where neither spouse has had a sale in the preceding two years subject to the exclusion. [Chp. 2]

60. Special ownership and use rules apply when a transferor spouse transfers a home to a transferee spouse. Under §121, when is the transferee deemed to have owned said property?

a. Incorrect. Married couples filing a joint return are entitled to a $500,000 exclusion where either spouse meets the ownership requirement; *both* spouses meet the use requirement, and neither spouse has had a sale in the preceding two years subject to the exclusion. Use does not create ownership.

b. Incorrect. Once both spouses satisfy the eligibility requirements and two years have passed since the last exclusion was allowed to either spouse, a full $500,000 exclusion is available for the next sale or exchange of their principal residence. However, this waiting period in order to reuse the provision does not affect ownership.

c. Correct. If a taxpayer's home was transferred to them by their spouse (or former spouse if the transfer was incident to divorce), the taxpayer is considered to have owned it during any period of time when their spouse owned it.

d. Incorrect. A taxpayer is considered to have used property as their main home during any period when they owned it, and their spouse is allowed to live in it under a divorce or separation instrument. [Chp. 2]

61. Under Reg. §1.1041-1T, Q&A 9, which of the following is NOT one of the instances where a transfer to a third party on behalf of a former spouse can qualify for §1041 nonrecognition treatment?

a. Incorrect. A transfer required by a divorce or separation instrument is one of the three instances specified by the regulation where a transfer to a third party on behalf of a former spouse can qualify for §1041 nonrecognition treatment.

b. Incorrect. A transfer made pursuant to a written request of the non-transferring spouse is one of the three instances specified by the regulation where a transfer to a third party on behalf of a former spouse can qualify for §1041 nonrecognition treatment.

c. Incorrect. A transfer made pursuant to written consent by the non-transferring spouse is one of the three instances specified by the regulation where a transfer to a third party on behalf of a former spouse can qualify for §1041 nonrecognition treatment.

d. Correct. The regulation specifies three instances where a transfer to a third party on behalf of a former spouse can qualify for §1041 nonrecognition treatment, and a verbal request is not one of them. [Chp. 2]

62. There are four types of qualified redemptions under §302 allowing capital rather than ordinary or dividend treatment. What is one of these qualified redemptions?

a. Incorrect. Those redemptions that are partial, not full, liquidations are qualified redemptions.

b. Correct. Those redemptions that are complete terminations of a shareholder's interest are qualified redemptions.

c. Incorrect. Those redemptions that are not essentially equivalent to a dividend are qualified redemptions.

d. Incorrect. Those redemptions that are substantially disproportionate are qualified redemptions. [Chp. 2]

63. The treatment of cash payments made to a withdrawing partner depends on whether or not such payments are determined by reference to the partnership income. How are such payments treated when they produce a deduction from gross income?

a. Incorrect. When the cash payment is made in exchange for the interest of the retiring or deceased partner in partnership property, it is treated as a current distribution (nonliquidating) by the partnership.

b. Incorrect. If cash payments made to a withdrawing partner are determined by reference to the partnership income, they are considered a distributive share.

c. Correct. Cash payments made to a withdrawing partner shall be considered as guaranteed payments, if they are not determined by reference to the partnership income, thus producing a deduction from gross income to arrive at the partnership's taxable income.

d. Incorrect. When cash payments made to a withdrawing partner are determined by reference to the partnership income, they are considered an income distribution [Chp. 2]

64. Under §101, life insurance proceeds paid upon the death of the insured person are excluded from income tax. However, when are such proceeds income taxable?

a. Incorrect. Life insurance proceeds paid because of the death of the insured person are not taxable even if they were paid under a health insurance policy.

b. Incorrect. Life insurance proceeds paid because of the death of the insured person are not taxable even if they were paid under an accident.

c. Incorrect. Life insurance proceeds paid because of the death of the insured person are not taxable even if they were paid under an endowment contract.

d. Correct. Life insurance proceeds paid because of the death of the insured person are not taxable unless the policy was turned over to the recipient for a price. [Chp. 2]

65. Currently, excluding the three exceptions, what is the highest tax rate on a net capital gain?

a. Correct. The highest tax rate on a net capital gain is 15% (20% for higher-income taxpayers), or 5% if it would otherwise be taxed at 15% or less.

b. Incorrect. One of the three exceptions referenced in the question is that the part of any net capital gain from selling §1250 real property that is due to recapture of straight-line depreciation is taxed at a maximum 25% rate.

c. Incorrect. Between 1991 and 2001, the alternative tax computation taxed the net capital gain component of taxable income at a maximum tax rate of 28%.

d. Incorrect. The 37% bracket is not a capital gain bracket but, a rate applied to capital assets held for less than one year. [Chp. 2]

66. The author provides four methods of separating retirement plan benefits in a divorce or separation. Which method involves requesting that the court maintain control until the benefits are to be paid, at which time the benefits will be divided?

a. Correct. Using the deferred determination method, the court maintains control of the plan benefits until they are to be paid, at which time the benefits will be divided.

b. Incorrect. Using the deferred division method, the nonparticipant spouse is given the right to receive the benefits in whole or in part as an alternate payee.

c. Incorrect. Using the present distribution method, the benefits in whole or in part are transferred to the nonparticipant spouse to the extent that the benefits are vested, liquid, and available for withdrawal.

d. Incorrect. Using the present transfer of equivalent assets method, a present value is placed on the benefits. This allows the participant to keep those benefits and transfer other marital property to the nonparticipant instead. [Chp. 2]

67. A participant's spouse, former spouse, child, or dependent may be able to take pension plan benefits in whole or in part as an alternate payee. What is able to confer such a right on a nonparticipant?

a. Incorrect. A defined benefit plan is a company retirement plan in which you expect to receive a fixed amount on a regular basis from your employer. It does not confer rights in an alternate payee.

b. Correct. A QDRO gives a spouse, former spouse, child, or dependent of a participant in a retirement plan the right to receive all or part of the benefits as an alternate payee that would be payable to the participant under the plan.

c. Incorrect. A rollover is a tax-free distribution of cash or other assets from one retirement program to another. It does not confer rights in an alternate payee.

d. Incorrect. An IRA is a type of savings account for retirement. It does not confer rights in an alternate payee. [Chp. 2]

68. One method for dividing up pension plan benefits in a divorce is the present division method. What is an argument for this method?

a. Incorrect. A deferred division method may be the only way to balance property allocation if there are few assets owned that can offset an award of the retirement plan to the employee's spouse. This may be especially true if plan assets cannot be separated and currently distributed under the plan's terms. In this case, a present division would not be feasible.

b. Incorrect. In a deferred division, if the plan is ticking upward rapidly, the alternate payee spouse may want to keep the funds in the plan until retirement. In the present division method, the alternate payee may not keep the funds in the plan but must take receipt of the funds immediately.

c. Incorrect. Often, case law requires or recommends the deferred division method of asset distribution.

d. Correct. One of the arguments for the present division method is that the economic connection to the participant is immediately dissolved, whereas, in the deferred division method, those bonds remain until the plan makes payments. [Chp. 2]

69. When a taxpayer who has gone through a property settlement files for bankruptcy, he or she will find that certain costs are nondischargeable. However, what may be discharged?

a. Correct. Debts derived from transferring property to a spouse or former spouse are dischargeable. Thus, as a planning strategy, consider couching legal and accounting fees to be paid by one spouse for services to the other spouse as support payment.

b. Incorrect. Alimony is nondischargeable by bankruptcy law. Thus, payments must continue even through bankruptcy.

c. Incorrect. Medical and dental payments for children are considered child support, which is nondischargeable by bankruptcy law. Thus, when a spouse goes through bankruptcy, this should be considered.

d. Incorrect. Mortgage payments on a home, a secured debt to a third party, are nondischargeable. Thus, these payments must be made. To prevent the possibility of housing payments being discharged, such obligation should be characterized as support in the decree. [Chp. 2]

70. The continuing importance of alimony under §71 and the current tax treatment of support payments to a former spouse are dependent on:

a. Correct. The tax treatment of alimony is dependent upon the date of the divorce decree or separation instrument being either pre-2019 or 2019 and later.

b. Incorrect. The consent of the parties to a divorce did not determine the tax treatment of spousal support payments.

c. Incorrect. The significance of a contingency relates to the termination of a fixed payment and would therefore constitute child support.

d. Incorrect. The federal tax treatment of support payments constitutes a federal issue and is not dependent on local and state regulation. [Chp. 3]

71. "Alimony" is defined under §71 and is an important concept for payments to a former spouse originating under a pre-2019 decree. What other term is often used for such payments?

a. Incorrect. Family support is a dangerous term that many tax courts have held constitutes an unallocated award. Such a determination makes it difficult to determine which portion of the award is alimony.

b. Correct. Spousal support is a term often used in lieu of alimony or separate maintenance payments.

c. Incorrect. "Marital obligation payments" is arcane language that refers back to the *Davis* case. Since the passage of §1041, payments to a former spouse are no longer in consideration of the cancellation of a marital obligation.

d. Incorrect. Prior to 1985, periodic payments were required in order to constitute alimony. Since that date, periodic payments are no longer a requirement. [Chp. 3]

72. For divorces finalized before 2019, how are alimony payments treated for tax purposes?

a. Incorrect. Alimony or separate maintenance payments are deductible by the payer spouse and taxable to the recipient spouse if under a pre-2019 divorce.

b. Incorrect. Alimony or separate maintenance payments are fully deductible by the payer spouse and fully includible in the recipient spouse's income if paid under a divorce or separation agreement executed before 2019.

c. Correct. Alimony or separate maintenance payments are deductible by the payer spouse and includible in the recipient spouse's income if paid under a divorce or separation agreement executed before 2019.

d. Incorrect. Alimony or separate maintenance payments are fully includible in the recipient spouse's income if paid under a divorce or separation agreement executed before 2019. [Chp. 3]

73. Under §71(b)(1)(A), a cash payment can be deemed "alimony" or a "separate maintenance payment" if four conditions are met. What is such a condition?

a. Correct. The term "alimony or separate maintenance payment" can be a payment in cash if such payment is received by a spouse under a divorce or separation instrument.

b. Incorrect. The term "alimony or separate maintenance payment" can be a payment in cash if the divorce or separation instrument does not designate such payment as a payment that is not includible in gross income under §71 and not allowable as a deduction under §215.

c. Incorrect. The term "alimony or separate maintenance payment" means any payment in cash if, in the case of an individual legally separated from his or her spouse under a decree of divorce or of separate maintenance, the payee spouse and the payor spouse are not members of the same household at the time such payment is made.

d. Incorrect. The term "alimony or separate maintenance payment" means any payment in cash if there is no liability to make any such payment for any period after the death of the payee spouse. [Chp. 3]

74. Alimony payments must be received under an existing and valid divorce or separation instrument. However, there is an exception where payments can still be alimony:

a. Incorrect. Amendments are not ordinarily retroactive for federal tax purposes.

b. Correct. Payments under a divorce decree can be alimony even if the decree's validity is questioned. A divorce decree is valid for tax purposes until a court having proper jurisdiction holds it invalid.

c. Incorrect. To be a valid decree the court must have legal jurisdiction over the matter.

d. Incorrect. Section 71 lays out the requirements necessary to constitute alimony for federal income tax purposes. [Chp. 3]

75. A premarital agreement might provide for support payments on divorce. When do such payments constitute alimony?

a. Correct. Such payments are alimony if the premarital agreement is incorporated into the decree or separation instrument.

b. Incorrect. When a *premarital agreement* provides for support payments, such payments may *not* be alimony if the *divorce decree* is silent as to the terms of the premarital agreement.

c. Incorrect. Jurisdiction goes to the validity of a divorce decree not to the ability of a premarital agreement to establish valid alimony payments under §71.

d. Incorrect. Support payments may also be alimony if the premarital agreement expressly provided that the payments *were* in contemplation of divorce [Chp. 3]

76. Assuming all other §71 requirements are met, payments pursuant to a pre-2019 divorce decree are alimony. How are voluntary payments treated?

a. Correct. Voluntary payments are *not* alimony under §71(b) and may be gifts. This same rule would apply to voluntary increases in qualified alimony payments. Taxpayers wishing to increase their deductible alimony payments should seek an amendment to the written instrument to avoid the voluntary payment issue.

b. Incorrect. Voluntary payments do not constitute deductible alimony under §71 even if they are paid in cash.

c. Incorrect. Since voluntary payments do not constitute alimony and are most likely gifts, they are not taxable income to the recipient.

d. Incorrect. While voluntary payments may constitute gifts, they would not be tax deductible. [Chp. 3]

77. The commencement and termination of payments to a former spouse is an important consideration. What is the treatment of payments when the payor spouse is required to make payments under a pre-2019 decree after the payee spouse's death?

a. Incorrect. While the payments made subsequent to death are not alimony, the payments before death are also not alimony.

b. Correct. If a taxpayer must continue to make payments for any period after their spouse's death, *none* of the payments made *before or after* the death are alimony.

c. Incorrect. The treatment of payments made after the death of the former spouse are not gifts since they were not voluntarily made but required by the divorce or separation instrument.

d. Incorrect. There is no presumption that payments made after the death of a former spouse become part of the property settlement. [Chp. 3]

78. To satisfy an obligation under a pre-2019 decree to make continuing payments after a spouse's death, a taxpayer might make a lump sum or property payment. What are these cash or property payments deemed?

a. Incorrect. Such payments are considered substitutes for payments after death. As a result, they do not qualify as alimony

b. Incorrect. Since the payments were based upon the taxpayer's obligation to a former spouse, they do not constitute gifts.

c. Incorrect. In this case, the term "death settlement" is not an appropriate concept for tax law purposes. Such payments would be deemed to be substituted payments.

d. Correct. Substitute payments are payments in cash or property that are made after their spouse's death as a substitute for continuing otherwise qualifying payments. As a result, otherwise qualifying payments are deemed not alimony. [Chp. 3]

79. Cash payments to a third party can sometimes qualify as alimony. However, how must qualifying payments be made?

a. Incorrect. While cash payments to a third party under the terms of a decree can qualify as alimony, payments made to a third party at the written request of a taxpayer's spouse can also qualify as alimony.

b. Correct. Instead of paying the spouse directly, a taxpayer can make payments to a third party and have them qualify as alimony if they are for or on behalf of their spouse.

c. Incorrect. Payments made to third parties on behalf of any children would be more properly characterized as child support, not alimony.

d. Incorrect. Qualifying payments can be made directly to a third party. Under this exception, qualified payments do not have to be made through the spouse. [Chp. 3]

80. When a written request is made to have the payor spouse directly pay cash to a third party, what is required of such a written request under §71?

a. Incorrect. There is no requirement that the written request, consent, or ratification include the date that such payments will begin. While this information would seem to be beneficial, it is not required under the regulations (Temp. Reg. §1.71-1-T, Q&A-7).

b. Incorrect. The written request, consent, or ratification must be received by the taxpayer before filing their tax return for the year the payments were made.

c. Incorrect. Such payments pursuant to written request do not have to be subsequently approved and ratified by a court.

d. Correct. The written request, consent, or ratification must state that both spouses *intend* the payments to be treated as alimony or separate maintenance payments under §71. [Chp. 3]

81. Payments for housing costs on a residence can sometimes be deemed alimony. How such treatment is primarily determined?

a. Correct. The tax treatment of housing costs (such as mortgage interest and principal, real estate taxes, and insurance) on the family residence depends upon how the home is owned.

b. Incorrect. Who is the custodial parent or whether or not there are children is not a factor in determining whether the payment of housing costs constitutes alimony.

c. Incorrect. Whether or not a spouse is a working parent is immaterial in determining the tax treatment of housing costs as alimony.

d. Incorrect. While a court may approve an allowance for housing to a former spouse, it does not necessarily determine the tax treatment of housing costs paid. [Chp. 3]

82. If a spouse who lives in the home is also the sole owner, how are housing payments made by a nonoccupying spouse to the occupying spouse treated?

a. Incorrect. If a divorce or separation instrument states that a taxpayer must pay expenses for a home owned by the taxpayer and their spouse, some of the payments may be alimony, but not if the occupying spouse is the sole owner.

b. Incorrect. This would hold true if the nonoccupying spouse owned the entire home. In this case, all housing payments required to be made by the nonoccupying spouse under the terms of a divorce or separation instrument are made primarily for the nonoccupying spouse's benefit. Interest and real property taxes paid by the nonoccupying spouse may be claimed as itemized deductions subject to the home mortgage interest rules for second homes.

c. Correct. If the occupying spouse owns the entire home, all housing payments required to be made by the nonoccupying spouse's divorce or separation instrument are made primarily for the occupying spouse's benefit and are alimony. The occupying spouse includes the payment in income (if under a pre-2019 decree) but can claim the interest and real property taxes as itemized deductions.

d. Incorrect. This would hold true if the divorce or separation instrument allows one's ex-spouse to occupy a family residence owned by the taxpayer. However, the rental value of the house or the housing costs paid to the ex-spouse would not qualify as alimony. [Chp. 3]

83. When a spouse pays life insurance premiums under a pre-2019 decree that otherwise qualify as alimony, certain contingent policy interests can nevertheless disallow a deduction as alimony. However, which of the following contingencies would still allow such a deduction?

a. Incorrect. A deduction is *denied* when the policy reverts to the taxpayer upon their spouse's death.

b. Correct. The taxpayer's spouse must include the full amount of the premiums paid under a pre-2019 decree in income, not just the amount by which the premium increases the cash surrender value.

c. Incorrect. If the taxpayer retains the right to the cash surrender value, the deduction for alimony is denied.

d. Incorrect. When the taxpayer retains the right to borrow against the life insurance policy, the payment of life insurance premiums will not constitute deductible alimony. [Chp. 3]

84. Sometimes it may be unclear as to whether a payment under a pre-2019 decree has been made for overdue child support or alimony. How does §71(c) treat such an issue?

a. Incorrect. Section 71(c) does not divide the treatment of uncertain past due payments on a pro-rata basis. The payments are first treated as child support then any remainder as alimony.

b. Incorrect. The presumption of §71 is child support, not alimony.

c. Correct. Where confusion exists over whether past due child support or alimony has been paid, §71(c) presumes that *child support* has been paid. Thus, when both child and spousal support is required, and payment of less than the total amount is made or if payment is made in arrears, payment is first allocated to child support.

d. Incorrect. The payment is not treated as unallocated under §71(c) but, is presumed to be child-support first and alimony second. [Chp. 3]

85. Filing status can determine the tax treatment of payments between spouses. For example, alimony treatment is precluded under a pre-2019 decree when:

a. Incorrect. Filing as married-filing-separate will still allow the payments to be treated as alimony. However, the payments must meet all other requirements.

b. Correct. Payments are not alimony if the spouses file a joint tax return (§71(e)).

c. Incorrect. This would be impossible since legally separated married couples cannot file a joint return (§6013(d)).

d. Incorrect. Filing as head of household would still allow the payments to qualify as alimony. All other requirements must be met. [Chp. 3]

86. Qualified alimony paid under a pre-2019 decree can be deducted. Such payments are properly deductible:

a. Incorrect. Taxpayers cannot use Form 1040A to deduct alimony paid. Form 1040A is no longer available. Alimony is deducted on Form 1040.

b. Incorrect. Alimony paid under a pre-2019 decree is an above-the-line deduction and does not require itemization.

c. Correct. Taxpayers can deduct alimony paid under a pre-2019 decree, whether or not they itemize deductions on their return.

d. Incorrect. Taxpayers cannot use old Form 1040EZ to deduct alimony paid. Alimony paid under a pre-2019 decree is deducted on Form 1040. [Chp. 3]

87. Under §219, alimony under a pre-2019 decree is treated as compensation. What is a tax consequence of this treatment where alimony is the only income received?

a. Correct. Section 219(f)(1) includes pre-2019 alimony and separate maintenance payments in the definition of compensation for purposes of determining the IRA deduction limits for individuals. Thus, a person whose only income is alimony can set up an IRA.

b. Incorrect. Under §32, there is no automatic qualification for the earned income credit based upon a taxpayer's sole income being alimony.

c. Incorrect. Alimony is taxable income and a tax return would be required if the recipient spouse otherwise meets the filing thresholds.

d. Incorrect. Household expenses are personal and not deductible regardless of the source of one's income. [Chp. 3]

88. In some circumstances, a taxpayer who had earlier deducted an item must include it in income sometime in the future. What is this tax concept?

a. Incorrect. The tax benefit rule is a doctrine limiting the recognition of income from the recovery of a previously deducted expense or loss year to the amount of such deduction reduced taxable income.

b. Incorrect. Income recharacterization occurs when a particular type of income is reclassified as a correction or because of subsequent events.

c. Incorrect. A tax recovery occurs when a deduction or creditable expense paid in an earlier year is later refunded to the taxpayer.

d. Correct. "Recapture" requires that an item previously deducted be taken into income at a later time. In the case of alimony, the recapture rule changes the tax treatment of past payments by requiring previously deducted alimony to be included in income. [Chp. 3]

89. Certain conditions must be met in order for pre-2019 alimony recapture rules to apply. What is one of these conditions?

a. Incorrect. Taxpayers do *not* have to recapture payments made under a temporary support order before divorce, regardless of their amount.

b. Correct. The recapture rule may apply if alimony payments are reduced or terminated during the first three calendar years. These three years start with the first calendar year a payment is made which qualifies as alimony under a decree of divorce or separate maintenance, or a written separation agreement.

c. Incorrect. Taxpayers do *not* have to recapture payments that end because the taxpayer or their spouse dies or their spouse remarries within the first three calendar years of payments, regardless of their amount.

d. Incorrect. Taxpayers do *not* have to recapture payments required over a period of at least three calendar years of a fixed part of the taxpayer's income from a business or property, or from compensation for employment or self-employment, regardless of their amount. [Chp. 3]

90. A payor spouse could have funded their spousal support obligation under a pre-2019 decree by transferring property to a trust that pays the support. How is such trust income treated?

a. Incorrect. The trust income is not deductible by the spouse who sets up the alimony trust even though the income is paid to a former spouse.

b. Incorrect. An alimony trust is not a tax exempt organization like a retirement plan trust. Income in the trust does not accumulate tax-free.

c. Incorrect. Trust income paid to the support beneficiary would be a deduction to the trust not income under the conduit principles. The net effect is that the trust is not taxed on income distributed.

d. Correct. When a taxpayer transfers property to a trust or buys or transfers an annuity or endowment contract to pay alimony, the trust income or other proceeds that would ordinarily be includible in the taxpayer's income are included in the former spouse's income to the extent received. [Chp. 3]

91. A spouse receiving income from an alimony trust reports income paid to them from trust income as::

a. Incorrect. The recipient spouse is not the grantor of the trust. The grantor of a trust is the person who created the trust.

b. Incorrect. Trust payments made to a spouse under an instrument executed after 1984 are not treated as alimony.

c. Correct. The receiving spouse is treated as a trust beneficiary and reports income earned by the trust as a trust beneficiary.

d. Incorrect. The income of the trust is not treated as a distribution of principal. However, payments from trust principal may not be taxable to the receiving spouse. [Chp. 3]

92. Alimony trusts were popular devices. What was one of their advantages?

a. Incorrect. Alimony trust payments are not alimony, so the beneficiary spouse cannot make IRA contributions based on this income. This is one of the disadvantages of an alimony trust.

b. Correct. Alimony trusts may be used to avoid the requirement that alimony payments end at the recipient's death. This way, if any payments are made by the trust after the death of the spouse or former spouse, the payments will still be treated as alimony.

c. Incorrect. Unless the agreement clearly states intention, portions meant for non-taxable child support may be taxed to the beneficiary spouse. This is a disadvantage of the alimony trust.

d. Incorrect. The recipient spouse is not taxable on amounts paid from the trust corpus, which is a benefit of using an alimony trust for the recipient spouse. A disadvantage for the grantor spouse is that no alimony deduction is allowed on the amounts paid from the trust principal. [Chp. 3]

93. Which of the following statements is TRUE regarding the tax treatment of spousal support or separate maintenance payments (formerly known as alimony) under current law?

a. Incorrect. Support payments (formerly known as alimony) are no longer deductible for the payor and are not included in the recipient's gross income after 2019.

b. Incorrect. Payments made under pre-2019 agreements that were modified after 2018 to incorporate TCJA changes are not taxable for the recipient.

c. Incorrect. Taxpayers cannot deduct spousal support (alimony) payments made under a divorce or separation agreement executed after 2018. The tax treatment of such payments is dependent upon the date of the divorce decree or separation instrument being either pre-2019 or 2019 and later

d. Correct. Support payments (formerly known as alimony) are no longer deductible for the payor and are not included in the recipient's gross income after 2019. [Chp. 3]

94. When a divorce decree provides that a spouse must pay a fixed amount as child support, that payment is not alimony. When are payments treated as being fixed as child support?

a. Incorrect. A payment will be treated as fixed as child support if the payment is *reduced* either on the happening of the contingency related to a child or at a time that can be clearly associated with the contingency.

b. Incorrect. A payment is fixed as child support if the *divorce or separation instrument* specifically designates an amount or part of the payment as support for a child.

c. Incorrect. For a payment to be treated as fixed as child support, the reduced payment must be *clearly* associated with the contingency.

d. Correct. A payment will be treated as fixed as child support if the payment is reduced on the happening of a contingency relating to the child. [Chp. 3]

95. If a contingency is based on any incident concerning a child, said contingency is deemed child-related. However, what event concerning the child is excluded from being characterized as a child-related contingency?

a. Correct. Once a child becomes an adult, payments cannot be fixed or treated as child support.

b. Incorrect. Events relating to a child include the child's death.

c. Incorrect. For purposes of determining a contingency relating to the child, the child's marriage is an event relating to the child.

d. Incorrect. Leaving school is an event relating to a child for purposes of the contingency rules. [Chp. 3]

96. According to regulations, under which of the following circumstances would payments NOT be presumed to be reduced at a time clearly associated with a contingency relating to a child?

a. Incorrect. Reducing the payments 5 months before the child reaches majority would be presumed clearly associated with a contingency relating to the child.

b. Incorrect. Payments are presumed to be reduced at a time clearly associated with a child-related contingency if payments are reduced on two or more occasions within one year before or after different children reach a certain age between 18 and 24.

c. Correct. Payments are presumed to be reduced at a time clearly associated with a child-related contingency if the reduction occurs not more than 6 months before or after the child reaches the local age of majority.

d. Incorrect. Payments are presumed to be reduced at a time clearly associated with a child-related contingency if payments are reduced on two or more occasions within one year before or after different children reach a certain age between 18 and 24. [Chp. 3]

97. COBRA coverage must be available to former spouses and certain other qualified beneficiaries. Which of the following plans are subject to COBRA rules?

a. Correct. COBRA rules apply to plans maintained by private employers and by any state that receives funds under the Public Health Service Act, and any political subdivision, agency, or instrumentality of such a state.

b. Incorrect. Church plans under §414(e) are excluded from COBRA rules.

c. Incorrect. COBRA rules do not apply to plans maintained by the District of Columbia, or territories, possessions, agencies, or instrumentalities of the United States.

d. Incorrect. The plans of the federal government are excluded from COBRA rules. [Chp. 3]

98. Which of the following is NOT mentioned as a reason for early termination of COBRA continuation coverage?

a. Incorrect. If the employer stops offering health coverage to all employees, it is a correct reason for early termination of COBRA coverage.

b. Correct. Remarriage of the ex-spouse is not a correct reason for early termination of COBRA coverage.

c. Incorrect. Continuing coverage may terminate if the covered individual fails to make premium payment within 30 days when due.

d. Incorrect. If the covered individual becomes entitled to Medicare benefits continuing coverage may terminate. [Chp. 3]

99. A Qualified Medical Child Support Order (QMCSO) is a medical child support order that must contain certain information. Which of the following is unnecessary in a QMCSO?

a. Incorrect. A qualified medical child support order must contain the name and address of the participant.

b. Incorrect. The plans and periods to which the order applies are required information for a qualified medical support order.

c. Incorrect. A qualified medical child support order must contain the names and addresses of each alternative recipient.

d. Correct. This is not a requirement of a QMCSO. A qualified medical child support order does not have to contain the Social Security numbers of all children covered. [Chp. 3]

100. A married couple may experience either a marriage penalty or a marriage bonus. However, since the TCJA when would a couple most likely be affected by a penalty?

a. Incorrect. The marriage penalty has essentially been eliminated for taxpayers in the 22% bracket.

b. Correct. The TCJA equalized married filing jointly tax rates with those of two single individuals combined (each with half the amount of taxable income of the joint filers), up to the bottom threshold of the highest tax bracket.

c. Incorrect. When one spouse has substantial income and the other has little or none, a marriage bonus is most likely to occur.

d. Incorrect. While sole proprietorship income is included through Schedule C on a couple's joint return, it is not determinative of whether or not there is a marriage penalty. [Chp. 4]

101. The author argues that the under present tax law the marriage penalty has lessened because:

a. Incorrect. Married couples were subject to the alternative minimum tax prior to recent legislation.

b. Incorrect. The child tax credit has not been repealed.

c. Correct. The TCJA, except for the highest brackets, has equalized the standard deduction and tax brackets.

d. Incorrect. Recent legislation did not grant single taxpayers a lower capital gain rate. [Chp. 4]

102. Congress has attempted to reduce the marriage penalty through legislation that has doubled the standard deduction for certain couples. What has been another legislative solution?

a. Incorrect. The alternative minimum tax exemption for married couples has not been dramatically increased in response to the marriage penalty.

b. Incorrect. The earned income tax credit is available to single and married taxpayers.

c. Correct. The legislative solution to the "marriage penalty" has been to double the standard deduction and increase the size of most regular income tax rate brackets for married couples filing a joint return to twice the size of the corresponding rate bracket for a single individual filing a single return.

d. Incorrect. While the child tax credit has been increased, it is not been done in response to the marriage penalty. [Chp. 4]

103. Travel expenses paid for an individual who accompanies a taxpayer on business travel are deductible when three requirements are met. Which of the following is such a requirement?

a. Incorrect. Under §162, the deductibility exception requires the accompanying individual be an employee, not an independent contractor.

b. Correct. There must be a bona fide business purpose for the travel of the companion in order to meet the exception under §162.

c. Incorrect. Expenses paid for a travel companion who is the taxpayer's spouse or domestic partner would not be deductible under these requirements. However, under Regulation §1.132-5, such expenses might qualify as a working condition fringe benefit.

d. Incorrect. The individual accompanying the taxpayer must have been able to independently deduct the travel expenses. [Chp. 4]

104. Under the no additional cost rule, the presence of a spouse may not affect the business travel deduction. Under what circumstance would the deduction be unaffected by the spousal travel?

a. Incorrect. There is no $2,000 threshold for spousal travel expenses. What $2,000 limitation there is applies to cruise conventions.

b. Incorrect. Under §162, all business expenses must not be lavish or extravagant if they are to be deductible. Not being lavish or extravagant is not a special exception for the permissibility of spousal travel expenses.

c. Incorrect. No exception is provided for meals and lodging of an accompanying spouse.

d. Correct. If the spouse's presence does not have an established business purpose, the expenses deductible by the taxpayer are those the taxpayer would have incurred had he or she been alone, not merely half of the total cost. Thus, the presence of the spouse or family member may not affect the amount of the deduction at all. [Chp. 4]

105. Spouses may jointly perform business activities and anticipate sharing the business's profits and losses. If this is the case, what may be the consequence?

a. Incorrect. Doing this will usually not increase their total tax.

b. Incorrect. Being labeled a partnership will give each spouse credit for Social Security earnings on which retirement benefits are based.

c. Correct. When spouses carry on a business together and expect to share in the profits and losses, they may be partners whether or not they have a partnership agreement.

d. Incorrect. They should include their respective shares of the partnership net income or loss on separate Schedules SE (Form 1040). [Chp. 4]

106. The federal government imposes several taxes on decedents at death. Which taxes are imposed on the transfer of assets at death?

a. Correct. The federal government imposes federal estate taxes on the transfer of assets on death.

b. Incorrect. Inheritance tax generally refers to those state taxes imposed on the receipt of property by heirs. There are no federal inheritance taxes.

c. Incorrect. If a decedent made taxable gifts during his or her lifetime but failed to pay gift taxes, federal gift taxes plus interest and penalty must be paid by the executor.

d. Incorrect. No one ever dies on December 31 while mailing their income tax return early, so a federal income tax return is due for the period January 1 to the date of death. [Chp. 4]

107. Section 2034 provides that a certain share of the estate is to be directed to the surviving husband in a common-law state. What is this statutory provision called?

a. Incorrect. A *contingent remainder* is an interest that does not come into enjoyment or possession unless a future condition occurs, *or* can end on the occurrence (or nonoccurrence) of a future event.

b. Correct. A curtsey (to the husband) is a statutory provision in a common-law state that directs a certain portion of the estate to the surviving spouse.

c. Incorrect. A dower (to the wife) is a statutory provision in a common-law state that directs a certain portion of the estate to the surviving spouse.

d. Incorrect. A *vested remainder* is included in the estate of a remainder person who dies before obtaining such property interest. [Chp. 4]

108. Under §2041, the value of property subject to a general power of appointment can be included in the holder's estate. However, there is an exception for powers of appointment subject to a determinable standard relating to the decedent's:

a. Incorrect. Comfort and well-being of the decedent are not an ascertainable standard. This standard is too vague.

b. Correct. Section 2041 provides an exception for a power to consume, invade, or appropriate property for the benefit of the decedent which is limited

by an *ascertainable standard* relating to health, education, or maintenance of the decedent (§2041(b)(1)(A)).

c. Incorrect. Custom manner of living is not an ascertainable standard. This standard is too vague.

d. Incorrect. The ability to appoint property to himself or herself would be a general power of appointment in the hands of the decedent and includable in the decedent's estate. [Chp. 4]

109. Under §2041, which of the following would most likely be considered as constituting "support"?

a. Incorrect. "Education" under §2041 refers to related expenses such as room and board, transportation, books, etc.

b. Incorrect. Under §2042, "health" would include medical treatment such as hospital, doctor, convalescent hospital, prescription drugs, nursing care, etc.

c. Incorrect. "Education" refers to payments to an educational institution such as a private secondary school, college or university, graduate school, or even trade school.

d. Correct. "Support" means the normal standard of living that the individual enjoys at the time the trust is created or the trustor dies. It includes the cost of housing, utilities, transportation, clothing, and other reasonable, related expenses. [Chp. 4]

110. Section 2042 provides that when a decedent possessed incidents of ownership in a life insurance policy, the proceeds are includible in the decedent's estate. Based on Reg. §20.2042-1(c)(2), which power would fail to be an incident of ownership?

a. Incorrect. The Code does not define "incidents of ownership." However, regulations (e.g., Reg. §20.2042-1(c)(2)) apply the phrase to any right or interest in the policy where the insured has the power, directly or indirectly, to control the existence of the policy.

b. Correct. Selection of the insurance company to be used is not an incident of ownership.

c. Incorrect. The regulations under §2042 defined the power to affect the benefits payable under the policy to be an incident of ownership.

d. Incorrect. The regulations under §2042 defined the ability to rearrange the economic interest in the policy to be an incident of ownership. [Chp. 4]

111. Section 2056 provides a marital deduction for federal estate taxes. Under this provision, when a spouse dies and passes all assets to the surviving spouse, what is the outcome?

a. Correct. Under §2056, an unlimited deduction is permitted for all assets passing to a surviving spouse at death. Thus, if either husband or wife dies

and leaves all assets to the survivor, no federal estate tax is due, regardless of the amount.

b. Incorrect. Prior to the 1981 Revenue Act, the maximum allowable deduction was 50% of the adjusted gross estate.

c. Incorrect. A marital deduction is allowed on all assets passing on death between spouses. The applicable exclusion amount is available to all decedents regardless of their marital status.

d. Incorrect. A married decedent would be entitled on death to use the unlimited marital deduction for their spouse or the applicable exclusion amount for other heirs. As a result, the federal estate tax would not be due on the full amount transferred to a spouse. [Chp. 4]

112. Several transfer methods qualify as being left outright to a spouse. However, which of the following most likely fails as being left outright?

a. Incorrect. Creating a joint tenancy with a surviving spouse is an outright transfer under the unlimited marital deduction provisions.

b. Correct. A reversionary interest is a transfer of property subject to certain restrictions that can result in the property reverting back to the original transferor. An outright transfer contains no such restriction on the surviving spouse.

c. Incorrect. Intestate succession qualifies as an outright transfer to a spouse under the marital deduction provisions.

d. Incorrect. A transfer using a living trust qualifies as an outright transfer to a spouse under the marital deduction provisions provided there are no restrictions on the surviving spouse's ability to access the trust funds. [Chp. 4]

113. To qualify for the §2056 marital deduction, there are six requirements. What is a requirement at the time the transfer is made?

a. Incorrect. The spouses must be married. A transfer to a person who becomes the transferor’s spouse after the transfer has been made does not qualify for the marital deduction.

b. Incorrect. The surviving spouse may receive property through a will, by operation of law, or otherwise. Also, assets received by the surviving spouse must have been a part of the decedent’s estate.

c. Incorrect. One of the requirements is that the property must be a deductible interest. Nondeductible interests include interests that are excluded from the gross estate, deductible interests under §2053 or §2054, and some terminable interests. Thus, some terminable interests may be deemed a deductible interest and thus qualify for the marital deduction, and others may fail to qualify for the deduction.

d. Correct. One of the requirements under §2056 is that the decedent must have been either a U.S. citizen or a U.S. resident. There is no such requirement for the surviving spouse. [Chp. 4]

114. A qualified domestic trust (QDT) is one way that a surviving non-citizen spouse can obtain an unlimited marital deduction. However, a number of requirements apply to a QDT. What is one such requirement?

a. Incorrect. An election must be made to have the trust qualify as a QDT. However, the executor would make the election, which must be irrevocable, and would be made on the estate tax return.

b. Incorrect. It is *not* a requirement of a QDT that the surviving non-citizen spouse becomes a citizen before the estate tax return is filed. However, this is another way for a non-citizen spouse to obtain the marital deduction.

c. Incorrect. Under §2056A(a), a QDT means a trust that provides that no distribution (other than a distribution of income) may be made from the trust unless a trustee has the right to withhold the tax imposed by §2056A.

d. Correct. A QDT means a trust that requires that at least one trustee be an individual U.S. citizen or a domestic corporation. A domestic corporation is defined as a corporation that is created or organized under the laws of the U.S. or under the laws of any state or the District of Columbia. [Chp. 4]

115. Under §1014, heirs receive a stepped-up basis in estate assets and take as their income tax basis the fair market value of the property included in the estate. For married couples, what is the effect of holding assets as community property?

a. Correct. When property is held as "community property," the decedent's *and* the surviving spouse's respective community shares of an asset receive a complete "stepped-up" basis at the decedent's death.

b. Incorrect. Community property title actually maximizes a full step up in basis for assets by increasing the basis of both the decedent's and survivor's community interest.

c. Incorrect. Property qualifying for the marital deduction can come from either community or separate assets.

d. Incorrect. The fact that property was held together with the decedent spouse as community property is an advantage to the surviving spouse since both halves of the community property are stepped up in basis. [Chp. 4]

116. Using the unlimited marital deduction to pass a whole estate, including business interests, can enlarge the estate of a surviving spouse. What can be used to limit this increase?

a. Incorrect. A buy-sell agreement can be used to set the value of the business interest for death tax purposes.

b. Incorrect. An electing small business trust (ESBT) is an estate and tax-planning tool that can be used by taxpayers holding interests in S corporations. Such a trust is allowed to hold S corporation stock and allows the owner of the stock to plan for its transfer during life or at death.

c. Correct. A bypass trust can be used to limit the increase in the surviving spouse's estate when a marital deduction is taken and the decedent leaves the entire estate to the surviving spouse.

d. Incorrect. A simple trust is a trust that must distribute during the tax year all of the income it received to the beneficiaries only. This type of trust would not limit the surviving spouse's estate. Even if distributions are not made, trust income is taxable to the recipient. [Chp. 4]

117. Which of the following statements about the gift tax is NOT correct according to the text?

a. Incorrect. The gift tax applies regardless of the means or device employed, including both direct and indirect transfers.

b. Correct. The gift tax applies to any transfer of property by gift.

c. Incorrect. The gift tax applies to transfers made in trust or otherwise.

d. Incorrect. The gift tax applies regardless of the means or device employed, including both direct and indirect transfers. [Chp. 4]

118. When a gift is made to an entity, how is it treated for gift tax purposes?

a. Correct. Under §2501, when a gift is made to an entity, the gift is deemed made to the individuals who own beneficial interests in the entity.

b. Incorrect. Under §2501, the gift is not considered a single gift to the entity itself but, is deemed a gift made to the individuals who own interests in the entity.

c. Incorrect. Under §2501, this same rule applies to trusts, corporations, and partnerships.

d. Incorrect. Under §2501, the gift is not treated as a single gift to the entity or its manager/trustee, but as separate gifts to each beneficiary or individual with a beneficial interest in the entity. [Chp. 4]

119. A taxpayer may deduct the amount of gifts made to a husband or wife from the full amount of gifts made during a calendar year. What is the amount of this gift marital deduction?

a. Incorrect. Section 2503 provides an annual exclusion for gifts (*other than*" future interests") made to any donee.

b. Incorrect. The net effect of the gift-splitting provision is to make the gift tax exclusions and credit of the spouse available to the donor. Thus, an amount equal to twice the annual exclusion is excluded when the non-donor spouse consents to split the gift.

c. Incorrect. The Tax Relief Act of 2001 increased the applicable exemption amount for total gifts and transfers made to any donee. The applicable exclusion amount can be used during lifetime *or* at death, not both.

d. Correct. The value of gifts made to a spouse may be deducted from the total amount of gifts made during the calendar year. The amount of this marital deduction is *unlimited*. [Chp. 4]

120. On the death of a Social Security recipient, some family members may qualify to receive benefits on the decedent's record. Of the following, who would be able to collect said benefits?

a. Incorrect. A 55-year old widow or widower would not qualify for Social Security benefits of a decedent participant unless he or she was disabled or caring for a child under 16 or a disabled child receiving benefits. Widows and widowers must be 60 years or older to collect benefits if they are not disabled or caring for a child under 16 or a disabled child receiving benefits.

b. Incorrect. A married 18-year old child may never collect benefits. If the 18-year old is unmarried, he or she may collect benefits.

c. Correct. A parent who depended on the decedent for no less than 50% of his or her support qualifies to collect the decedent participant's benefits. Such individuals are one of five family members who qualify.

d. Incorrect. An unmarried, disabled 24-year old child who became disabled prior to age 22 qualifies to receive benefits. Thus, no child who becomes disabled subsequent to age 22 may receive the participant's benefits. [Chp. 4]

Appendix A

Section 71 & Regs.

Code §71

Sec. 71. Alimony and separate maintenance payments.

(a) General rule. Gross income includes amounts received as alimony or separate maintenance payments.

(b) Alimony or separate maintenance payments defined. For purposes of this section —

(1) In general.

The term "alimony or separate maintenance payment" means any payment in cash if —

(A) such payment is received by (or on behalf of) a spouse under a divorce or separation instrument,

(B) the divorce or separation instrument does not designate such payment as a payment which is not includible in gross income under this section and not allowable as a deduction under section 215,

(C) in the case of an individual legally separated from his spouse under a decree of divorce or of separate maintenance, the payee spouse and the payor spouse are not members of the same household at the time such payment is made, and

(D) there is no liability to make any such payment for any period after the death of the payee spouse and there is no liability to make any

payment (in cash or property) as a substitute for such payments after the death of the payee spouse.

(2) Divorce or separation instrument.

The term "divorce or separation instrument" means —

(A) a decree of divorce or separate maintenance or a written instrument incident to such a decree,

(B) a written separation agreement, or

(C) a decree (not described in subparagraph (A)) requiring a spouse to make payments for the support or maintenance of the other spouse.

(c) Payments to support children.

(1) In general.

Subsection (a) shall not apply to that part of any payment which the terms of the divorce or separation instrument fix (in terms of an amount of money or a part of the payment) as a sum which is payable for the support of children of the payor spouse.

(2) Treatment of certain reductions related to contingencies involving child.

For purposes of paragraph (1), if any amount specified in the instrument will be reduced —

(A) on the happening of a contingency specified in the instrument relating to a child (such as attaining a specified age, marrying, dying, leaving school, or a similar contingency), or

(B) at a time which can clearly be associated with a contingency of a kind specified in subparagraph (A),

an amount equal to the amount of such reduction will be treated as an amount fixed as payable for the support of children of the payor spouse.

(3) Special rule where payment is less than amount specified in instrument.

For purposes of this subsection, if any payment is less than the amount specified in the instrument, then so much of such payment as does not exceed the sum payable for support shall be considered a payment for such support.

(d) Spouse. For purposes of this section, the term "spouse" includes a former spouse.

(e) Exception for joint returns. This section and section 215 shall not apply if the spouses make a joint return with each other.

(f) Recomputation where excess front-loading of alimony payments

(1) In general.

If there are excess alimony payments —

(A) the payor spouse shall include the amount of such excess payments in gross income for the payor spouse's taxable year beginning in the 3rd post-separation year, and

(B) the payee spouse shall be allowed a deduction in computing adjusted gross income for the amount of such excess payments for the payee's taxable year beginning in the 3rd post-separation year.

(2) Excess alimony payments.

For purposes of this subsection, the term "excess alimony payments" mean the sum of —

(A) the excess payments for the 1st post-separation year, and

(B) the excess payments for the 2nd post-separation year.

(3) Excess payments for 1st post-separation year.

For purposes of this subsection, the amount of the excess payments for the 1st post-separation year is the excess (if any) of —

(A) the amount of the alimony or separate maintenance payments paid by the payor spouse during the 1st post-separation year, over

(B) the sum of —

(i) the average of —

(I) the alimony or separate maintenance payments paid by the payor spouse during the 2nd post-separation year, reduced by the excess payments for the 2nd post-separation year, and

(II) the alimony or separate maintenance payments paid by the payor spouse during the 3rd post-separation year, plus

(ii) $15,000.

(4) Excess payments for 2nd post-separation year.

For purposes of this subsection, the amount of the excess payments for the 2nd post-separation year is the excess (if any) of —

(A) the amount of the alimony or separate maintenance payments paid by the payor spouse during the 2nd post-separation year, over

(B) the sum of —

(i) the amount of the alimony or separate maintenance payments paid by the payor spouse during the 3rd post-separation year, plus

(ii) $15,000.

(5) Exceptions.

(A) Where payment ceases by reason of death or remarriage. Paragraph (1) shall not apply if —

(i) either spouse dies before the close of the 3rd post-separation year, or the payee spouse remarries before the close of the 3rd post-separation year, and

(ii) the alimony or separate maintenance payments cease by reason of such death or remarriage.

(B) Support payments. For purposes of this subsection, the term "alimony or separate maintenance payment" shall not include any payment received under a decree described in subsection (b)(2)(C).

(C) Fluctuating payments not within control of payor spouse. For purposes of this subsection, the term "alimony or separate maintenance payment" shall not include any payment to the extent it is made pursuant to a continuing liability (over a period of not less than 3 years) to pay a fixed portion or portions of the income from a business or property or from compensation for employment or self-employment.

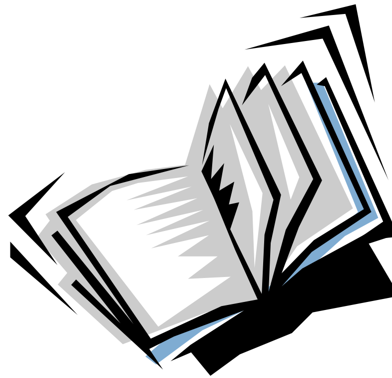
(6) Post-separation years.

For purposes of this subsection, the term "1st post-separation years" means the 1st calendar year in which the payor spouse paid to the payee spouse alimony or separate maintenance payments to which this section applies. The 2nd and 3rd post-separation years shall be the 1st and 2nd succeeding calendar years, respectively.

(g) Cross References.

(1) For deduction of alimony or separate maintenance payments, see section 215.

(2) For taxable status of income of an estate or trust in the case of divorce, etc., see section 682.



Regulations

§1.71-1 Alimony and separate maintenance payments; income to wife or former wife.

(a) In general. Section 71 provides rules for treatment in certain cases of payments in the nature of or in lieu of alimony or an allowance for support as between spouses who are divorced or separated. For convenience, the payee spouse will hereafter in this section be referred to as the "wife" and the spouse

from whom she is divorced or separated as the "husband." See section 7701(a)(17). For rules relative to the deduction by the husband of periodic payments not attributable to transferred property, see section 215 and the regulations thereunder. For rules relative to the taxable status of income of an estate or trust in case of divorce, etc., see section 682 and the regulations thereunder.

(b) Alimony or separate maintenance payments received from the husband. *(1) Decree of divorce or separate maintenance.* (i) In the case of divorce or legal separation, paragraph (1) of section 71(a) requires the inclusion in the gross income of the wife of periodic payments (whether or not made at regular intervals) received by her after a decree of divorce or of separate maintenance. Such periodic payments must be made in discharge of a legal obligation imposed upon or incurred by the husband because of the marital or family relationship under a court order or decree divorcing or legally separating the husband and wife or a written instrument incident to the divorce status or legal separation status.

(ii) For treatment of payments attributable to property transferred (in trust or otherwise), see paragraph (c) of this section.

(2) Written separation agreement. (i) Where the husband and wife are separated and living apart and do not file a joint income tax return for the taxable year, paragraph (2) of section 71(a) requires the inclusion in the gross income of the wife of periodic payments (whether or not made at regular intervals) received by her pursuant to a written separation agreement executed after August 16, 1954. The periodic payments must be made under the terms of the written separation agreement after its execution and because of the marital or family relationship. Such payments are includible in the wife's gross income whether or not the agreement is a legally enforceable instrument. Moreover, if the wife is divorced or legally separated subsequent to the written separation agreement, payments made under such agreement continue to fall within the provisions of section 71(a)(2).

(ii) For purposes of section 71(a)(2), any written separation agreement executed on or before August 16, 1954, which is altered or modified in writing by the parties in any material respect after that date will be treated as an agreement executed after August 16, 1954, with respect to payments made after the date of alteration or modification.

(iii) For treatment of payments attributable to property transferred (in trust or otherwise), see paragraph (c) of this section.

(3) Decree for support. (i) Where the husband and wife are separated and living apart and do not file a joint income tax return for the taxable year, paragraph (3) of section 71(a) requires the inclusion in the gross income of the wife of periodic payments (whether or not made at regular intervals) received by her after August 16, 1954, from her husband under any type of court order or decree (including an interlocutory decree of divorce or a decree of alimony pendente lite) en-

tered after March 1, 1954, requiring the husband to make the payments for her support or maintenance. It is not necessary for the wife to be legally separated or divorced from her husband under a court order or decree; nor is it necessary for the order or decree for support to be for the purpose of enforcing a written separation agreement.

(ii) For purposes of section 71(a)(3), any decree which is altered or modified by a court order entered after March 1, 1954, will be treated as a decree entered after such date.

(4) Scope of section 71(a). Section 71(a) applies only to payments made because of the family or marital relationship in recognition of the general obligation to support which is made specific by the decree, instrument, or agreement. Thus, section 71(a) does not apply to that part of any periodic payment which is attributable to the repayment by the husband of, for example, a bona fide loan previously made to him by the wife, the satisfaction of which is specified in the decree, instrument, or agreement as a part of the general settlement between the husband and wife.

(5) Year of inclusion. Periodic payments are includible in the wife's income under section 71(a) only for the taxable year in which received by her. As to such amounts, the wife is to be treated as if she makes her income tax returns on the cash receipts and disbursements method, regardless of whether she normally makes such returns on the accrual method. However, if the periodic payments described in section 71(a) are to be made by an estate or trust, such periodic payments are to be included in the wife's taxable year in which they are includible according to the rules as to income of estates and trusts provided in sections 652, 662, and 682, whether or not such payments are made out of the income of such estates or trusts.

(6) Examples. The foregoing rules are illustrated by the following examples in which it is assumed that the husband and wife file separate income tax returns on the calendar year basis:

Example (1). W files suit for divorce from H in 1953. In consideration of W's promise to relinquish all marital rights and not to make public H's financial affairs, H agrees in writing to pay $200 a month to W during her lifetime if a final decree of divorce is granted without any provision for alimony. Accordingly, W does not request alimony and no provision for alimony is made under a final decree of divorce entered December 31, 1953. During 1954, H pays W $200 a month, pursuant to the promise. The $2,400 thus received by W is includible in her gross income under the provisions of section 71(a) (1). Under section 215, H is entitled to a deduction of $2,400 from his gross income.

Example (2). During 1945, H and W enter into an antenuptial agreement, under which, in consideration of W's relinquishment of all marital rights (including dower) in H's property, and, in order to provide for W's support and household

expenses, H promises to pay W $200 a month during her lifetime. Ten years after their marriage, W sues H for divorce but does not ask for or obtain alimony because of the provision already made for her support in the antenuptial agreement. Likewise, the divorce decree is silent as to such agreement and H's obligation to support W. Section 71(a) does not apply to such a case. If, however, the decree were modified so as to refer to the antenuptial agreement, or if reference had been made to the antenuptial agreement in the court's decree or in a written instrument incident to the divorce status, section 71(a)(1) would require the inclusion in W's gross income of the payments received by her after the decree. Similarly, if a written separation agreement were executed after August 16, 1954, and incorporated the payment provisions of the antenuptial agreement, section 71(a)(2) would require the inclusion in W's income of payments received by W after W begins living apart from H, whether or not the divorce decree was subsequently entered and whether or not W was living apart from H when the separation agreement was executed, provided that such payments were made after such agreement was executed and pursuant to its terms. As to including such payments in W's income, if made by a trust created under the antenuptial agreement, regardless of whether referred to in the decree or a later instrument, or created pursuant to the written separation agreement, see section 682 and the regulations thereunder.

Example (3). H and W are separated and living apart during 1954. W sues H for support and on February 1, 1954, the court enters a decree requiring H to pay $200 a month to W for her support and maintenance. No part of the $200 a month support payments is includible in W's income under section 71(a)(3) or deductible by H under section 215. If, however, the decree had been entered after March 1, 1954, or had been altered or modified by a court order entered after March 1, 1954, the payments received by W after August 16, 1954, under the decree as altered or modified would be includible in her income under section 71(a)(3) and deductible by H under section 215.

Example (4). W sues H for divorce in 1954. On January 15, 1954, the court awards W temporary alimony of $25 a week pending the final decree. On September 1, 1954, the court grants W a divorce and awards her $200 a month permanent alimony. No part of the $25 a week temporary alimony received prior to the decree is includible in W's income under section 71(a), but the $200 a month received during the remainder of 1954 by W is includible in her income for 1954. Under section 215, H is entitled to deduct such $200 payments from his income. If, however, the decree awarding W temporary alimony had been entered after March 1, 1954, or had been altered or modified by a court order entered after March 1, 1954, temporary alimony received by her after August 16, 1954, would be includible in her income under section 71(a)(3) and deductible by H under section 215.

(c) Alimony and separate maintenance payments attributable to property. *(1)*(i) In the case of divorce or legal separation, paragraph (1) of section 71(a) requires the inclusion in the gross income of the wife of periodic payments (whether or not made at regular intervals) attributable to property transferred, in trust or otherwise, and received by her after a decree of divorce or of separate maintenance. Such property must have been transferred in discharge of a legal obligation imposed upon or incurred by the husband because of the marital or family relationship under a decree of divorce or separate maintenance or under a written instrument incident to such divorce status or legal separation status.

(ii) Where the husband and wife are separated and living apart and do not file a joint income tax return for the taxable year, paragraph (2) of section 71(a) requires the inclusion in the gross income of the wife of periodic payments (whether or not made at regular intervals) received by her which are attributable to property transferred, in trust or otherwise, under a written separation agreement executed after August 16, 1954. The property must be transferred because of the marital or family relationship. The periodic payments attributable to the property must be received by the wife after the written separation agreement is executed.

(iii) The periodic payments received by the wife attributable to property transferred under subdivisions (i) and (ii) of this subparagraph and includible in her gross income are not to be included in the gross income of the husband.

(2) The full amount of periodic payments received under the circumstances described in section 71(a)(1), (2), and (3) is required to be included in the gross income of the wife regardless of the source of such payments. Thus, it matters not that such payments are attributable to property in trust, to life insurance, endowment, or annuity contracts, or to any other interest in property, or are paid directly or indirectly by the husband from his income or capital. For example, if in order to meet an alimony or separate maintenance obligation of $500 a month the husband purchases or assigns for the benefit of his wife a commercial annuity contract paying such amount, the full $500 a month received by the wife is includible in her income, and no part of such amount is includible in the husband's income or deductible by him. See section 72(k) and the regulations thereunder. Likewise, if property is transferred by the husband, subject to an annual charge of $5,000, payable to his wife in discharge of his alimony or separate maintenance obligation under the divorce or separation decree or written instrument incident to the divorce status or legal separation status or if such property is transferred pursuant to a written separation agreement and subject to a similar annual charge, the $5,000 received annually is, under section 71(a)(1) or (2), includible in the wife's income, regardless of whether such amount is paid out of income or principal of the property.

(3) The same rule applies to periodic payments attributable to property in trust. The full amount of periodic payments to which section 71(a)(1) and (2) applies is includible in the wife's income regardless of whether such payments are made out of trust income. Such periodic payments are to be included in the wife's income under section 71(a)(1) or (2) and are to be excluded from the husband's income even though the income of the trust would otherwise be includible in his income under subpart E, part I, subchapter J, chapter 1 of the Code, relating to trust income attributable to grantors and others as substantial owners. As to periodic payments received by a wife attributable to property in trust in cases to which section 71(a)(1) or (2) does not apply because the husband's obligation is not specified in the decree or an instrument incident to the divorce status or legal separation status or the property was not transferred under a written separation agreement, see section 682 and the regulations thereunder.

(4) Section 71(a)(1) or (2) does not apply to that part of any periodic payment attributable to that portion of any interest in property transferred in discharge of the husband's obligation under the decree or instrument incident to the divorce status or legal separation status, or transferred pursuant to the written separation agreement, which interest originally belonged to the wife. It will apply, however, if she received such interest from her husband in contemplation of or as an incident to the divorce or separation without adequate and full consideration in money or money's worth, other than the release of the husband or his property from marital obligations. An example of the first rule is a case where the husband and wife transfer securities, which were owned by them jointly, in trust to pay an annuity to the wife. In this case, the full amount of that part of the annuity received by the wife attributable to the husband's interest in the securities transferred in discharge of his obligations under the decree, or instrument incident to the divorce status or legal separation status, or transferred under the written separation agreement, is taxable to her under section 71(a)(1) or (2), while that portion of the annuity attributable to the wife's interest in the securities so transferred is taxable to her only to the extent it is out of trust income as provided in part I (sections 641 and following), subchapter J, chapter 1 of the Code. If, however, the husband's transfer to his wife is made before such property is transferred in discharge of his obligation under the decree or written instrument, or pursuant to the separation agreement in an attempt to avoid the application of section 71(a)(1) or (2) to part of such payments received by his wife, such transfers will be considered as a part of the same transfer by the husband of his property in discharge of his obligation or pursuant to such agreement. In such a case, section 71(a)(1) or (2) will be applied to the full amount received by the wife. As to periodic payments received under a joint purchase of a commercial annuity contract, see section 72 and the regulations thereunder.

(d) Periodic and installment payments. *(1)* In general, installment payments discharging a part of an obligation the principal sum of which is, in terms of money

or property, specified in the decree, instrument, or agreement are not considered "periodic payments" and therefore are not to be included under section 71(a) in the wife's income.

(2) An exception to the general rule stated in subparagraph (1) of this paragraph is provided, however, in cases where such principal sum, by the terms of the decree, instrument, or agreement, may be or is to be paid over a period ending more than 10 years from the date of such decree, instrument, or agreement. In such cases, the installment payment is considered a periodic payment for the purposes of section 71(a) but only to the extent that the installment payment, or sum of the installment payments, received during the wife's taxable year does not exceed 10 percent of the principal sum. This 10-percent limitation applies to installment payments made in advance but does not apply to delinquent installment payments for a prior taxable year of the wife made during her taxable year.

(3) (i) Where payments under a decree, instrument, or agreement are to be paid over a period ending 10 years or less from the date of such decree, instrument, or agreement, such payments are not installment payments discharging a part of an obligation the principal sum of which is, in terms of money or property, specified in the decree, instrument, or agreement (and are considered periodic payments for the purposes of section 71(a)) only if such payments meet the following two conditions:

(a) Such payments are subject to any one or more of the contingencies of death of either spouse, remarriage of the wife, or change in the economic status of either spouse, and

(b) Such payments are in the nature of alimony or an allowance for support.

(ii) Payments meeting the requirements of subdivision (i) are considered periodic payments for the purposes of section 71(a) regardless of whether—

(a) The contingencies described in subdivision (i) (a) of this subparagraph are set forth in the terms of the decree, instrument, or agreement, or are imposed by local law, or

(b) The aggregate amount of the payments to be made in the absence of the occurrence of the contingencies described in subdivision (i) (a) of this subparagraph is explicitly stated in the decree, instrument, or agreement or may be calculated from the face of the decree, instrument, or agreement, or

(c) The total amount which will be paid may be calculated actuarially.

(4) Where payments under a decree, instrument, or agreement are to be paid over a period ending more than ten years from the date of such decree, instrument, or agreement, but where such payments meet the conditions set forth in subparagraph (3)(i) of this paragraph, such payments are considered to be periodic payments for the purpose of section 71 without regard to the rule set forth in subparagraph (2) of this paragraph. Accordingly, the rules set forth in subparagraph (2) of this paragraph are not applicable to such payments.

(5) The rules as to periodic and installment payments are illustrated by the following examples:

Example (1). Under the terms of a written instrument, H is required to make payments to W which are in the nature of alimony, in the amount of $100 a month for nine years. The instrument provides that if H or W dies the payments are to cease. The payments are periodic.

Example (2). The facts are the same as in example (1) except that the written instrument explicitly provides that H is to pay W the sum of $10,800 in monthly payments of $100 over a period of nine years. The payments are periodic.

Example (3). Under the terms of a written instrument, H is to pay W $100 a month over a period of nine years. The monthly payments are not subject to any of the contingencies of death of H or W, remarriage of W, or change in the economic status of H or W under the terms of the written instrument or by reason of local law. The payments are not periodic.

Example (4). A divorce decree in 1954 provides that H is to pay W $20,000 each year for the next five years, beginning with the date of the decree, and then $5,000 each year for the next ten years. Assuming the wife makes her returns on the calendar year basis, each payment received in the years 1954 to 1958, inclusive, is treated as a periodic payment under section 71(a)(1), but only to the extent of 10 percent of the principal sum of $150,000. Thus, for such taxable years, only $15,000 of the $20,000 received is includible under section 71(a)(1) in the wife's income and is deductible by the husband under section 215. For the years 1959 to 1968, inclusive, the full $5,000 received each year by the wife is includible in her income and is deductible from the husband's income.

(e) Payments for support of minor children. Section 71(a) does not apply to that part of any periodic payment which, by the terms of the decree, instrument, or agreement under section 71(a), is specifically designated as a sum payable for the support of minor children of the husband. The statute prescribes the treatment in cases where an amount or portion is so fixed but the amount of any periodic payment is less than the amount of the periodic payment specified to be made. In such cases, to the extent of the amount which would be payable for the support of such children out of the originally specified periodic payment, such periodic payment is considered a payment for such support. For example, if the husband is by terms of the decree, instrument, or agreement required to pay $200 a month to his divorced wife, $100 of which is designated by the decree, instrument, or agreement to be for the support of their minor children, and the husband pays only $150 to his wife, $100 is nevertheless considered to be a payment by the husband for the support of the children. If, however, the periodic payments are received by the wife for the support and maintenance of herself and of minor children of the husband without such specific designation of the portion for the support of such children, then the whole of such amounts is in-

cludible in the income of the wife as provided in section 71(a). Except in cases of a designated amount or portion for the support of the husband's minor children, periodic payments described in section 71(a) received by the wife for herself and any other person or persons are includible in whole in the wife's income, whether or not the amount or portion for such other person or persons is designated.

T.D. 6270, 11/16/57.

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§1.71-1T Alimony and separate maintenance payments (temporary).

(a) In general.

Q-1 What is the income tax treatment of alimony or separate maintenance payments?

A-1 Alimony or separate maintenance payments are, under section 71, included in the gross income of the payee spouse and, under section 215, allowed as a deduction from the gross income of the payor spouse.

Q-2 What is an alimony or separate maintenance payment?

A-2 An alimony or separate maintenance payment is any payment received by or on behalf of a spouse (which for this purpose includes a former spouse) of the payor under a divorce or separation instrument that meets all of the following requirements:

(a) The payment is in cash (see A-5).

(b) The payment is not designated as a payment which is excludible from the gross income of the payee and nondeductible by the payor (see A-8).

(c) In the case of spouses legally separated under a decree of divorce or separate maintenance, the spouses are not members of the same household at the time the payment is made (see A-9).

(d) The payor has no liability to continue to make any payment after the death of the payee (or to make any payment as a substitute for such payment) and the divorce or separation instrument states that there is no such liability (see A-10).

(e) The payment is not treated as child support (see A-15).

(f) To the extent that one or more annual payments exceed $10,000 during any of the 6-post-separation years, the payor is obligated to make annual payments in each of the 6 post-separation years (see A-19).

Q-3 In order to be treated as alimony or separate maintenance payments, must the payments be "periodic" as that term was defined prior to enactment of the Tax Reform Act of 1984 or be made in discharge of a legal obligation of the payor to support the payee arising out of a marital or family relationship?

A-3 No. The Tax Reform Act of 1984 replaces the old requirements with the requirements described in A-2 above. Thus, the requirements that alimony or sep-

arate maintenance payments be "periodic" and be made in discharge of a legal obligation to support arising out of a marital or family relationship have been eliminated.

Q-4 Are the instruments described in section 71(a) of prior law the same as divorce or separation instruments described in section 71, as amended by the Tax Reform Act of 1984?

A-4 Yes.

(b) Specific requirements.

Q-5 May alimony or separate maintenance payments be made in a form other than cash?

A-5 No. Only cash payments (including checks and money orders payable on demand) qualify as alimony or separate maintenance payments. Transfers of services or property (including a debt instrument of a third party or an annuity contract), execution of a debt instrument by the payor, or the use of property of the payor do not qualify as alimony or separate maintenance payments.

Q-6 May payments of cash to a third party on behalf of a spouse qualify as alimony or separate maintenance payments if the payments are pursuant to the terms of a divorce or separation instrument?

A-6 Yes. Assuming all other requirements are satisfied, a payment of cash by the payor spouse to a third party under the terms of the divorce or separation instrument will qualify as a payment of cash which is received "on behalf of a spouse." For example, cash payments of rent, mortgage, tax, or tuition liabilities of the payee spouse made under the terms of the divorce or separation instrument will qualify as alimony or separate maintenance payments. Any payments to maintain property owned by the payor spouse and used by the payee spouse (including mortgage payments, real estate taxes and insurance premiums) are not payments on behalf of a spouse even if those payments are made pursuant to the terms of the divorce or separation instrument. Premiums paid by the payor spouse for term or whole life insurance on the payor's life made under the terms of the divorce or separation instrument will qualify as payments on behalf of the payee spouse to the extent that the payee spouse is the owner of the policy.

Q-7 May payments of cash to a third party on behalf of a spouse qualify as alimony or separate maintenance payments if the payments are made to the third party at the written request of the payee spouse?

A-7 Yes. For example, instead of making an alimony or separate maintenance payment directly to the payee, the payor spouse may make a cash payment to a charitable organization if such payment is pursuant to the written request, consent or ratification of the payee spouse. Such request, consent or ratification must state that the parties intend the payment to be treated as an alimony or separate maintenance payment to the payee spouse subject to the rules of section 71, and must be received by the payor spouse prior to the date of filing of

the payor's first return of tax for the taxable year in which the payment was made.

Q-8 How may spouses designate that payments otherwise qualifying as alimony or separate maintenance payments shall be excludible from the gross income of the payee and nondeductible by the payor?

A-8 The spouses may designate that payments otherwise qualifying as alimony or separate maintenance payments shall be nondeductible by the payor and excludible from gross income by the payee by so providing in a divorce or separation instrument (as defined in section 71(b)(2)). If the spouses have executed a written separation agreement (as described in section 71(b)(2)(B)), any writing signed by both spouses which designates otherwise qualifying alimony or separate maintenance payments as nondeductible and excludible and which refers to the written separation agreement will be treated as a written separation agreement (and thus a divorce or separation instrument) for purposes of the preceding sentence. If the spouses are subject to temporary support orders (as described in section 71(b)(2)(C)), the designation of otherwise qualifying alimony or separate payments as nondeductible and excludible must be made in the original or a subsequent temporary support order. A copy of the instrument containing the designation of payments as not alimony or separate maintenance payments must be attached to the payee's first filed return of tax (Form 1040) for each year in which the designation applies.

Q-9 What are the consequences if, at the time a payment is made, the payor and payee spouses are members of the same household?

A-9 Generally, a payment made at the time when the payor and payee spouses are members of the same household cannot qualify as an alimony or separate maintenance payment if the spouses are legally separated under a decree of divorce or of separate maintenance. For purposes of the preceding sentence, a dwelling unit formerly shared by both spouses shall not be considered two separate households even if the spouses physically separate themselves within the dwelling unit. The spouses will not be treated as members of the same household if one spouse is preparing to depart from the household of the other spouse, and does depart not more than one month after the date the payment is made. If the spouses are not legally separated under a decree of divorce or separate maintenance, a payment under a written separation agreement or a decree described in section 71(b)(2)(C) may qualify as an alimony or separate maintenance payment notwithstanding that the payor and payee are members of the same household at the time the payment is made.

Q-10 Assuming all other requirements relating to the qualification of certain payments as alimony or separate maintenance payments are met, what are the consequences if the payor spouse is required to continue to make the payments after the death of the payee spouse?

A-10 None of the payments before (or after) the death of the payee spouse qualify as alimony or separate maintenance payments.

Q-11 What are the consequences if the divorce or separation instrument fails to state that there is no liability for any period after the death of the payee spouse to continue to make any payments which would otherwise qualify as alimony or separate maintenance payments?

A-11 If the instrument fails to include such a statement, none of the payments, whether made before or after the death of the payee spouse, will qualify as alimony or separate maintenance payments.

Example (1). A is to pay B $10,000 in cash each year for a period of 10 years under a divorce or separation instrument which does not state that the payments will terminate upon the death of B. None of the payments will qualify as alimony or separate maintenance payments.

Example (2). A is to pay B $10,000 in cash each year for a period of 10 years under a divorce or separation instrument which states that the payments will terminate upon the death of B. In addition, under the instrument, A is to pay B or B's estate $20,000 in cash each year for a period of 10 years. Because the $20,000 annual payments will not terminate upon the death of B, these payments will not qualify as alimony or separate maintenance payments. However, the separate $10,000 annual payments will qualify as alimony or separate maintenance payments.

Q-12 Will a divorce or separation instrument be treated as stating that there is no liability to make payments after the death of the payee spouse if the liability to make such payments terminates pursuant to applicable local law or oral agreement?

A-12 No. Termination of the liability to make payments must be stated in the terms of the divorce or separation instrument.

Q-13 What are the consequences if the payor spouse is required to make one or more payments (in cash or property) after the death of the payee spouse as a substitute for the continuation of pre-death payments which would otherwise qualify as alimony or separate maintenance payments?

A-13 If the payor spouse is required to make any such substitute payments, none of the otherwise qualifying payments will qualify as alimony or separate maintenance payments. The divorce or separation instrument need not state, however, that there is no liability to make any such substitute payment.

Q-14 Under what circumstances will one or more payments (in cash or property) which are to occur after the death of the payee spouse be treated as a substitute for the continuation of payments which would otherwise qualify as alimony or separate maintenance payments?

A-14 To the extent that one or more payments are to begin to be made, increase in amount, or become accelerated in time as a result of the death of the payee

spouse, such payments may be treated as a substitute for the continuation of payments terminating on the death of the payee spouse which would otherwise qualify as alimony or separate maintenance payments. The determination of whether or not such payments are a substitute for the continuation of payments which would otherwise qualify as alimony or separate maintenance payments, and of the amount of the otherwise qualifying alimony or separate maintenance payments for which any such payments are a substitute, will depend on all of the facts and circumstances.

Example (1). Under the terms of a divorce decree, A is obligated to make annual alimony payments to B of $30,000, terminating on the earlier of the expiration of 6 years or the death of B. B maintains custody of the minor children of A and B. The decree provides that at the death of B, if there are minor children of A and B remaining, A will be obligated to make annual payments of $10,000 to a trust, the income and corpus of which are to be used for the benefit of the children until the youngest child attains the age of majority. These facts indicate that A's liability to make annual $10,000 payments in trust for the benefit of his minor children upon the death of B is a substitute for $10,000 of the $30,000 annual payments to B. Accordingly, $10,000 of each of the $30,000 annual payments to B will not qualify as alimony or separate maintenance payments.

Example (2). Under the terms of a divorce decree, A is obligated to make annual alimony payments to B of $30,000, terminating on the earlier of the expiration of 15 years or the death of B. The divorce decree provides that if B dies before the expiration of the 15 year period, A will pay to B's estate the difference between the total amount that A would have paid had B survived, minus the amount actually paid. For example, if B dies at the end of the 10th year in which payments are made, A will pay to B's estate $150,000 ($450,000-$300,000). These facts indicate that A's liability to make a lump sum payment to B's estate upon the death of B is a substitute for the full amount of each of the annual $30,000 payments to B. Accordingly, none of the annual $30,000 payments to B will qualify as alimony or separate maintenance payments. The result would be the same if the lump sum payable at B's death were discounted by an appropriate interest factor to account for the prepayment.

(c) Child support payments.

Q-15 What are the consequences of a payment which the terms of the divorce or separation instrument fix as payable for the support of a child of the payor spouse?

A-15 A payment which under the terms of the divorce or separation instrument is fixed (or treated as fixed) as payable for the support of a child of the payor spouse does not qualify as an alimony or separate maintenance payment. Thus, such a payment is not deductible by the payor spouse or includible in the income of the payee spouse.

Q-16 When is a payment fixed (or treated as fixed) as payable for the support of a child of the payor spouse?

A-16 A payment is fixed as payable for the support of a child of the payor spouse if the divorce or separation instrument specifically designates some sum or portion (which sum or portion may fluctuate) as payable for the support of a child of the payor spouse. A payment will be treated as fixed as payable for the support of a child of the payor spouse if the payment is reduced (a) on the happening of a contingency relating to a child of the payor, or (b) at a time which can clearly be associated with such a contingency. A payment may be treated as fixed as payable for the support of a child of the payor spouse even if other separate payments specifically are designated as payable for the support of a child of the payor spouse.

Q-17 When does a contingency relate to a child of the payor?

A-17 For this purpose, a contingency relates to a child of the payor if it depends on any event relating to that child, regardless of whether such event is certain or likely to occur. Events that relate to a child of the payor include the following: the child's attaining a specified age or income level, dying, marrying, leaving school, leaving the spouse's household, or gaining employment.

Q-18 When will a payment be treated as to be reduced at a time which can clearly be associated with the happening of a contingency relating to a child of the payor?

A-18 There are two situations, described below, in which payments which would otherwise qualify as alimony or separate maintenance payments will be presumed to be reduced at a time clearly associated with the happening of a contingency relating to a child of the payor. In all other situations, reductions in payments will not be treated as clearly associated with the happening of a contingency relating to a child of the payor.

The first situation referred to above is where the payments are to be reduced not more than 6 months before or after the date the child is to attain the age of 18, 21, or local age of majority. The second situation is where the payments are to be reduced on two or more occasions which occur not more than one year before or after a different child of the payor spouse attains a certain age between the ages of 18 and 24, inclusive. The certain age referred to in the preceding sentence must be the same for each such child, but need not be a whole number of years.

The presumption in the two situations described above that payments are to be reduced at a time clearly associated with the happening of a contingency relating to a child of the payor may be rebutted (either by the Service or by taxpayers) by showing that the time at which the payments are to be reduced was determined independently of any contingencies relating to the children of the payor. The presumption in the first situation will be rebutted conclusively if the reduction is a complete cessation of alimony or separate maintenance payments during the

sixth post-separation year (described in A-21) or upon the expiration of a 72-month period. The presumption may also be rebutted in other circumstances, for example, by showing that alimony payments are to be made for a period customarily provided in the local jurisdiction, such as a period equal to one-half the duration of the marriage.

Example: A and B are divorced on July 1, 1985, when their children, C (born July 15, 1970) and D (born September 23, 1972), are 14 and 12, respectively. Under the divorce decree, A is to make alimony payments to B of $2,000 per month. Such payments are to be reduced to $1,500 per month on January 1, 1991 and to $1,000 per month on January 1, 1995. On January 1, 1991, the date of the first reduction in payments, C will be 20 years 5 months and 17 days old. On January 1, 1995, the date of the second reduction in payments, D will be 22 years 3 months and 9 days old. Each of the reductions in payments is to occur not more than one year before or after a different child of A attains the age of 21 years and 4 months. (Actually, the reductions are to occur not more than one year before or after C and D attain any of the ages 21 years 3 months and 9 days through 21 years 5 months and 17 days.) Accordingly, the reductions will be presumed to clearly be associated with the happening of a contingency relating to C and D. Unless this presumption is rebutted, payments under the divorce decree equal to the sum of the reduction ($1,000 per month) will be treated as fixed for the support of the children of A and therefore will not qualify as alimony or separate maintenance payments.

(d) Excess front-loading rules.

Q-19 What are the excess front-loading rules?

A-19 The excess front-loading rules are two special rules which may apply to the extent that payments in any calendar year exceed $10,000. The first rule is a minimum term rule, which must be met in order for any annual payment, to the extent in excess of $10,000, to qualify as an alimony or separate maintenance payment (see A-2(f)). This rule requires that alimony or separate maintenance payments be called for, at a minimum, during the 6 "post-separation years". The second rule is a recapture rule which characterizes payments retrospectively by requiring a recalculation and inclusion in income by the payor and deduction by the payee of previously paid alimony or separate maintenance payment to the extent that the amount of such payments during any of the 6 "post-separation years" falls short of the amount of payments during a prior year by more than $10,000.

Q-20 Do the excess front-loading rules apply to payments to the extent that annual payments never exceed $10,000?

A-20 No. For example, A is to make a single $10,000 payment to B. Provided that the other requirements of section 71 are met, the payment will qualify as an alimony or separate maintenance payment. If A were to make a single $15,000

payment to B, $10,000 of the payment would qualify as an alimony or separate maintenance payment and $5,000 of the payment would be disqualified under the minimum term rule because payments were not to be made for the minimum period.

Q-21 Do the excess front-loading rules apply to payments received under a decree described in section 71(b)(2)(C)?

A-21 No. Payments under decrees described in section 71(b)(2)(C) are to be disregarded entirely for purposes of applying the excess front-loading rules.

Q-22 Both the minimum term rule and the recapture rule refer to 6 "post-separation years". What are the 6 "post separation years"?

A-22 The 6 "post-separation years" are the 6 consecutive calendar years beginning with the first calendar year in which the payor pays to the payee an alimony or separate maintenance payment (except a payment made under a decree described in section 71(b)(2)(C)). Each year within this period is referred to as a "post-separation year". The 6-year period need not commence with the year in which the spouses separate or divorce, or with the year in which payments under the divorce or separation instrument are made, if no payments during such year qualify as alimony or separate maintenance payments. For example, a decree for the divorce of A and B is entered in October, 1985. The decree requires A to make monthly payments to B commencing November 1, 1985, but A and B are members of the same household until February 15, 1986 (and as a result, the payments prior to January 16, 1986, do not qualify as alimony payments). For purposes of applying the excess front-loading rules to payments from A to B, the 6 calendar years 1986 through 1991 are post-separation years. If a spouse has been making payments pursuant to a divorce or separation instrument described in section 71(b)(2)(A) or (B), a modification of the instrument or the substitution of a new instrument (for example, the substitution of a divorce decree for a written separation agreement) will not result in the creation of additional post-separation years. However, if a spouse has been making payments pursuant to a divorce or separation instrument described in section 71(b)(2)(C), the 6-year period does not begin until the first calendar year in which alimony or separate maintenance payments are made under a divorce or separation instrument described in section 71(b)(2)(A) or (B).

Q-23 How does the minimum term rule operate?

A-23 The minimum term rule operates in the following manner. To the extent payments are made in excess of $10,000, a payment will qualify as an alimony or separate maintenance payment only if alimony or separate maintenance payments are to be made in each of the 6 post-separation years. For example, pursuant to a divorce decree, A is to make alimony payments to B of $20,000 in each of the 5 calendar years 1985 through 1989. A is to make no payment in 1990. Under the minimum term rule, only $10,000 will qualify as an alimony payment

in each of the calendar years 1985 through 1989. If the divorce decree also required A to make a $1 payment in 1990, the minimum term rule would be satisfied and $20,000 would be treated as an alimony payment in each of the calendar years 1985 through 1989. The recapture rule would, however, apply for 1990. For purposes of determining whether alimony or separate maintenance payments are to be made in any year, the possible termination of such payments upon the happening of a contingency (other than the passage of time) which has not yet occurred is ignored (unless such contingency may cause all or a portion of the payment to be treated as a child support payment).

Q-24 How does the recapture rule operate?

A-24 The recapture rule operates in the following manner. If the amount of alimony or separate maintenance payments paid in any post-separation year (referred to as the "computation year") falls short of the amount of alimony or separate maintenance payments paid in any prior post-separation year by more than $10,000, the payor must compute an "excess amount" for the computation year. The excess amount for any computation year is the sum of excess amounts determined with respect to each prior post-separation year. The excess amount determined with respect to a prior post-separation year is the excess of (1) the amount of alimony or separate maintenance payments paid by the payor spouse during such prior post-separation year, over (2) the amount of the alimony or separate maintenance payments paid by the payor spouse during the computation year plus $10,000. For purposes of this calculation, the amount of alimony or separate maintenance payments made by the payor spouse during any post-separation year preceding the computation year is reduced by any excess amount previously determined with respect to such year. The rules set forth above may be illustrated by the following example. A makes alimony payments to B of $25,000 in 1985 and $12,000 in 1986. The excess amount with respect to 1985 that is recaptured in 1986 is $3,000 ($25,000-($12,000 + $10,000)). For purposes of subsequent computation years, the amount deemed paid in 1985 is $22,000. If A makes alimony payments to B of $1,000 in 1987, the excess amount that is recaptured in 1987 will be $12,000. This is the sum of an $11,000 excess amount with respect to 1985 ($22,000-$1,000 + $10,000)) and a $1,000 excess amount with respect to 1986 ($12,000-($1,000 + $10,000)). If, prior to the end of 1990, payments decline further, additional recapture will occur. The payor spouse must include the excess amount in gross income for his/her taxable year beginning with or in the computation year. The payee spouse is allowed a deduction for the excess amount in computing adjusted gross income for his/her taxable year beginning with or in the computation year. However, the payee spouse must compute the excess amount by reference to the date when payments were made and not when payments were received.

Q-25 What are the exceptions to the recapture rule?

A-25 Apart from the $10,000 threshold for application of the recapture rule, there are three exceptions to the recapture rule. The first exception is for payments received under temporary support orders described in section 71(b)(2)(C) (see A-21). The second exception is for any payment made pursuant to a continuing liability over the period of the post-separation years to pay a fixed portion of the payor's income from a business or property or from compensation for employment or self-employment. The third exception is where the alimony or separate maintenance payments in any post-separation year cease by reason of the death of the payor or payee or the remarriage (as defined under applicable local law) of the payee before the close of the computation year. For example, pursuant to a divorce decree, A is to make cash payments to B of $30,000 in each of the calendar years 1985 through 1990. A makes cash payments of $30,000 in 1985 and $15,000 in 1986, in which year B remarries and A's alimony payments cease. The recapture rule does not apply for 1986 or any subsequent year. If alimony or separate maintenance payments made by A decline or cease during a post-separation year for any other reason (including a failure by the payor to make timely payments, a modification of the divorce or separation instrument, a reduction in the support needs of the payee, or a reduction in the ability of the payor to provide support) excess amounts with respect to prior post-separation years will be subject to recapture.

(e) Effective dates

Q-26 When does section 71, as amended by the Tax Reform Act of 1984, become effective?

A-26 Generally, section 71, as amended, is effective with respect to divorce or separation instruments (as defined in section 71(b)(2)) executed after December 31, 1984. If a decree of divorce or separate maintenance executed after December 31, 1984, incorporates or adopts without change the terms of the alimony or separate maintenance payments under a divorce or separation instrument executed before January 1, 1985, such decree will be treated as executed before January 1, 1985. A change in the amount of alimony or separate maintenance payments or the time period over which such payments are to continue, or the addition or deletion of any contingencies or conditions relating to such payments is a change in the terms of the alimony or separate maintenance payments. For example, in November 1984, A and B executed a written separation agreement. In February 1985, a decree of divorce is entered in substitution for the written separation agreement. The decree of divorce does not change the terms of the alimony A pays to B. The decree of divorce will be treated as executed before January 1, 1985 and hence alimony payments under the decree will be subject to the rules of section 71 prior to amendment by the Tax Reform Act of 1984. If the amount or time period of the alimony or separate maintenance payments are not specified in the pre-1985 separation agreement or if the decree of divorce changes the amount or term of such payments, the decree of divorce will not be

treated as executed before January 1, 1985, and alimony payments under the decree will be subject to the rules of section 71, as amended by the Tax Reform Act of 1984.

Section 71, as amended, also applies to any divorce or separation instrument executed (or treated as executed) before January 1, 1985 that has been modified on or after January 1, 1985, if such modification expressly provides that section 71, as amended by the Tax Reform Act of 1984, shall apply to the instrument as modified. In this case, section 71, as amended, is effective with respect to payments made after the date the instrument is modified.

T.D. 7973, 8/30/84.

Appendix B

Section 1041 & Regs.

Code §1041

Sec. 1041. Transfers of property between spouses or incident to divorce.

(a) General rule. No gain or loss shall be recognized on a transfer of property from an individual to (or in trust for the benefit of) —

(1) a spouse, or

(2) a former spouse, but only if the transfer is incident to the divorce.

(b) Transfer treated as gift; transferee has transferor's basis. In the case of any transfer of property described in subsection (a) —

(1) for purposes of this subtitle, the property shall be treated as acquired by the transferee by gift, and

(2) the basis of the transferee in the property shall be the adjusted basis of the transferor.

(c) Incident to divorce. For purposes of subsection (a)(2), a transfer of property is incident to the divorce if such transfer —

(1) occurs within 1 year after the date on which the marriage ceases, or

(2) is related to the cessation of the marriage.

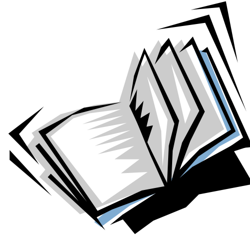
(d) Special rule where spouse is nonresident alien. Subsection (a) shall not apply if the spouse (or former spouse) of the individual making the transfer is a nonresident alien.

(e) Transfers in trust where liability exceeds basis. Subsection (a) shall not apply to the transfer of property in trust to the extent that —

(1) the sum of the amount of the liabilities assumed, plus the amount of the liabilities to which the property is subject, exceeds

(2) the total of the adjusted basis of the property transferred.

Proper adjustment shall be made under subsection (b) in the basis of the transferee in such property to take into account gain recognized by reason of the preceding sentence.



Regulations

§1.1041-1T Treatment of transfer of property between spouses or incident to divorce (temporary).

Q-1 How is the transfer of property between spouses treated under section 1041?

A-1 Generally, no gain or loss is recognized on a transfer of property from an individual to (or in trust for the benefit of) a spouse or, if the transfer is incident to a divorce, a former spouse. The following questions and answers describe more fully the scope, tax consequences and other rules which apply to transfers of property under section 1041.

(a) Scope of section 1041 in general.

Q-2 Does section 1041 apply only to transfers of property incident to divorce?

A-2 No. Section 1041 is not limited to transfers of property incident to divorce. Section 1041 applies to any transfer of property between spouses regardless of whether the transfer is a gift or is a sale or exchange between spouses acting at arm's length (including a transfer in exchange for the relinquishment of property or marital rights or an exchange otherwise governed by another nonrecognition provision of the Code). A divorce or legal separation need not be contemplated between the spouses at the time of the transfer nor must a divorce or legal separation ever occur.

Example (1). A and B are married and file a joint return. A is the sole owner of a condominium unit. A sale or gift of the condominium from A to B is a transfer which is subject to the rules of section 1041.

Example (2). A and B are married and file separate returns. A is the owner of an independent sole proprietorship, X Company. In the ordinary course of business,

X Company makes a sale of property to B. This sale is a transfer of property between spouses and is subject to the rules of section 1041.

Example (3). Assume the same facts as in example (2), except that X Company is a corporation wholly owned by A. This sale is not a sale between spouses subject to the rules of section 1041. However, in appropriate circumstances, general tax principles, including the step-transaction doctrine, may be applicable in recharacterizing the transaction.

Q-3 Do the rules of section 1041 apply to a transfer between spouses if the transferee spouse is a nonresident alien?

A-3 No. Gain or loss (if any) is recognized (assuming no other nonrecognition provision applies) at the time of a transfer of property if the property is transferred to a spouse who is a nonresident alien.

Q-4 What kinds of transfers are governed by section 1041?

A-4 Only transfers of property (whether real or personal, tangible or intangible) are governed by section 1041. Transfers of services are not subject to the rules of section 1041.

Q-5 Must the property transferred to a former spouse have been owned by the transferor spouse during the marriage?

A-5 No. A transfer of property acquired after the marriage ceases may be governed by section 1041.

(b) Transfer incident to the divorce.

Q-6 When is a transfer of property "incident to the divorce"?

A-6 A transfer of property is "incident to the divorce" in either of the following 2 circumstances—

(1) The transfer occurs not more than one year after the date on which the marriage ceases, or

(2) The transfer is related to the cessation of the marriage. Thus, a transfer of property occurring not more than one year after the date on which the marriage ceases need not be related to the cessation of the marriage to qualify for section 1041 treatment. (See A-7 for transfers occurring more than one year after the cessation of the marriage.)

Q-7 When is a transfer of property "related to the cessation of the marriage"?

A-7 A transfer of property is treated as related to the cessation of the marriage if the transfer is pursuant to a divorce or separation instrument, as defined in section 71(b)(2), and the transfer occurs not more than 6 years after the date on which the marriage ceases. A divorce or separation instrument includes a modification or amendment to such decree or instrument. Any transfer not pursuant to a divorce or separation instrument and any transfer occurring more than 6 years after the cessation of the marriage is presumed to be not related to the cessation of the marriage. This presumption may be rebutted only by showing that

the transfer was made to effect the division of property owned by the former spouses at the time of the cessation of the marriage. For example, the presumption may be rebutted by showing that (a) the transfer was not made within the one- and six-year periods described above because of factors which hampered an earlier transfer of the property, such as legal or business impediments to transfer or disputes concerning the value of the property owned at the time of the cessation of the marriage, and (b) the transfer is effected promptly after the impediment to transfer is removed.

Q-8 Do annulments and the cessations of marriages that are void ab initio due to violations of state law constitute divorces for purposes of section 1041?

A-8 Yes.

(c) Transfers on behalf of a spouse.

Q-9 May transfers of property to third parties on behalf of a spouse (or former spouse) qualify under section 1041?

A-9 Yes. There are three situations in which a transfer of property to a third party on behalf of a spouse (or former spouse) will qualify under section 1041, provided all other requirements of the section are satisfied. The first situation is where the transfer to the third party is required by a divorce or separation instrument. The second situation is where the transfer to the third party is pursuant to the written request of the other spouse (or former spouse). The third situation is where the transferor receives from the other spouse (or former spouse) a written consent or ratification of the transfer to the third party. Such consent or ratification must state that the parties intend the transfer to be treated as a transfer to the nontransferring spouse (or former spouse) subject to the rules of section 1041 and must be received by the transferor prior to the date of filing of the transferor's first return of tax for the taxable year in which the transfer was made. In the three situations described above, the transfer of property will be treated as made directly to the nontransferring spouse (or former spouse) and the nontransferring spouse will be treated as immediately transferring the property to the third party. The deemed transfer from the nontransferring spouse (or former spouse) to the third party is not a transaction that qualifies for nonrecognition of gain under section 1041.

(d) Tax consequences of transfers subject to section 1041.

Q-10 How is the transferor of property under section 1041 treated for income tax purposes?

A-10 The transferor of property under section 1041 recognizes no gain or loss on the transfer even if the transfer was in exchange for the release of marital rights or other consideration. This rule applies regardless of whether the transfer is of property separately owned by the transferor or is a division (equal or unequal) of community property. Thus, the result under section 1041 differs from the result in United States v. Davis, 370 U.S. 65 (1962).

Q-11 How is the transferee of property under section 1041 treated for income tax purposes?

A-11 The transferee of property under section 1041 recognizes no gain or loss upon receipt of the transferred property. In all cases, the basis of the transferred property in the hands of the transferee is the adjusted basis of such property in the hands of the transferor immediately before the transfer. Even if the transfer is a bona fide sale, the transferee does not acquire a basis in the transferred property equal to the transferee's cost (the fair market value). This carryover basis rule applies whether the adjusted basis of the transferred property is less than, equal to, or greater than its fair market value at the time of transfer (or the value of any consideration provided by the transferee) and applies for purposes of determining loss as well as gain upon the subsequent disposition of the property by the transferee. Thus, this rule is different from the rule applied in section 1015(a) for determining the basis of property acquired by gift.

Q-12 Do the rules described in A-10 and A-11 apply even if the transferred property is subject to liabilities which exceed the adjusted basis of the property?

A-12 Yes. For example, assume A owns property having a fair market value of $10,000 and an adjusted basis of $1,000. In contemplation of making a transfer of this property incident to a divorce from B, A borrows $5,000 from a bank, using the property as security for the borrowing. A then transfers the property to B and B assumes, or takes the property subject to, the liability to pay the $5,000 debt. Under section 1041, A recognizes no gain or loss upon the transfer of the property, and the adjusted basis of the property in the hands of B is $1,000.

Q-13 Will a transfer under section 1041 result in a recapture of investment tax credits with respect to the property transferred?

A-13 In general, no. Property transferred under section 1041 will not be treated as being disposed of by, or ceasing to be section 38 property with respect to, the transferor. However, the transferee will be subject to investment tax credit recapture if, upon or after the transfer, the property is disposed of by, or ceases to be section 38 property with respect to, the transferee. For example, as part of a divorce property settlement, B receives a car from A that has been used in A's business for two years and for which an investment tax credit was taken by A. No part of A's business is transferred to B and B's use of the car is solely personal. B is subject to recapture of the investment tax credit previously taken by A.

(e) Notice and record keeping requirement with respect to transactions under section 1041.

Q-14 Does the transferor of property in a transaction described in section 1041 have to supply, at the time of the transfer, the transferee with records sufficient to determine the adjusted basis and holding period of the property at the time of the transfer and (if applicable) with notice that the property transferred under section 1041 is potentially subject to recapture of the investment tax credit?

A-14 Yes. A transferor of property under section 1041 must, at the time of the transfer, supply the transferee with records sufficient to determine the adjusted basis and holding period of the property as of the date of the transfer. In addition, in the case of a transfer of property which carries with it a potential liability for investment tax credit recapture, the transferor must, at the time of the transfer, supply the transferee with records sufficient to determine the amount and period of such potential liability. Such records must be preserved and kept accessible by the transferee.

(f) Property settlements—effective dates, transitional periods and elections.

Q-15 When does section 1041 become effective?

A-15 Generally, section 1041 applies to all transfers after July 18, 1984. However, it does not apply to transfers after July 18, 1984 pursuant to instruments in effect on or before July 18, 1984. (See A-16 with respect to exceptions to the general rule.)

Q-16 Are there any exceptions to the general rule stated in A-15 above?

A-16 Yes. Two transitional rules provide exceptions to the general rule stated in A-15. First, section 1041 will apply to transfers after July 18, 1984 under instruments that were in effect on or before July 18, 1984 if both spouses (or former spouses) elect to have section 1041 apply to such transfers. Second, section 1041 will apply to all transfers after December 31, 1983 (including transfers under instruments in effect on or before July 18, 1984) if both spouses (or former spouses) elect to have section 1041 apply. (See A-18 relating to the time and manner of making the elections under the first or second transitional rule.)

Q-17 Can an election be made to have section 1041 apply to some, but not all, transfers made after December 31, 1983, or some but not all, transfers made after July 18, 1984 under instruments in effect on or before July 18, 1984?

A-17 No. Partial elections are not allowed. An election under either of the two elective transitional rules applies to all transfers governed by that election whether before or after the election is made, and is irrevocable.

(g) Property settlements—time and manner of making the elections under section 1041.

Q-18 How do spouses (or former spouses) elect to have section 1041 apply to transfers after December 31, 1983, or to transfers after July 18, 1984 under instruments in effect on or before July 18, 1984?

A-18 In order to make an election under section 1041 for property transfers after December 31, 1983, or property transfers under instruments that were in effect on or before July 18, 1984, both spouses (or former spouses) must elect the application of the rules of section 1041 by attaching to the transferor's first filed income tax return for the taxable year in which the first transfer occurs, a statement signed by both spouses (or former spouses) which includes each spouse's

social security number and is in substantially the form set forth at the end of this answer.

In addition, the transferor must attach a copy of such statement to his or her return for each subsequent taxable year in which a transfer is made that is governed by the transitional election. A copy of the signed statement must be kept by both parties.

The election statements shall be in substantially the following form:

In the case of an election regarding transfers after 1983:

Section 1041 Election

The undersigned hereby elect to have the provisions of section 1041 of the Internal Revenue Code apply to all qualifying transfers of property after December 31, 1983. The undersigned understand that section 1041 applies to all property transferred between spouses, or former spouses incident to divorce. The parties further understand that the effects for Federal income tax purposes of having section 1041 apply are that (1) no gain or loss is recognized by the transferor spouse or former spouse as a result of this transfer; and (2) the basis of the transferred property in the hands of the transferee is the adjusted basis of the property in the hands of the transferor immediately before the transfer, whether or not the adjusted basis of the transferred property is less than, equal to, or greater than its fair market value at the time of the transfer. The undersigned understand that if the transferee spouse or former spouse disposes of the property in a transaction in which gain is recognized, the amount of gain which is taxable may be larger than it would have been if this election had not been made.

Section 1041 Election

The undersigned hereby elect to have the provisions of section 1041 of the Internal Revenue Code apply to all qualifying transfers of property after July 18, 1984 under any instrument in effect on or before July 18, 1984. The undersigned understand that section 1041 applies to all property transferred between spouses, or former spouses incident to the divorce. The parties further understand that the effects for Federal income tax purposes of having section 1041 apply are that (1) no gain or loss is recognized by the transferor spouse or former spouse as a result of this transfer; and (2) the basis of the transferred property in the hands of the transferee is the adjusted basis of the property in the hands of the transferor immediately before the transfer, whether or not the adjusted basis of the transferred property is less than, equal to, or greater than its fair market value at the time of the transfer. The undersigned understand that if the transferee spouse or former spouse disposes of the property in a transaction in which gain is recognized, the amount of gain which is taxable may be larger than it would have been if this election had not been made.

T.D. 7973, 8/30/84.

Appendix C

California Uniform Premarital Agreement Act

California Family Code Sections 1600-1617

§1600. This chapter may be cited as the Uniform Premarital Agreement Act.

§1601. This chapter is effective on and after January 1, 1986, and applies to any premarital agreement executed on or after that date.

§1610. As used in this chapter:

(a) "Premarital agreement" means an agreement between prospective spouses made in contemplation of marriage and to be effective upon marriage.

(b) "Property" means an interest, present or future, legal or equitable, vested or contingent, in real or personal property, including income and earnings.

§1611. A premarital agreement shall be in writing and signed by both parties. It is enforceable without consideration.

§1612. (a) Parties to a premarital agreement may contract with respect to all of the following:

(1) The rights and obligations of each of the parties in any of the property of either or both of them whenever and wherever acquired or located.

(2) The right to buy, sell, use, transfer, exchange, abandon, lease, consume, expend, assign, create a security interest in, mortgage, encumber, dispose of, or otherwise manage and control property.

(3) The disposition of property upon separation, marital dissolution, death, or the occurrence or nonoccurrence of any other event.

(4) The making of a will, trust, or other arrangement to carry out the provisions of the agreement.

(5) The ownership rights in and disposition of the death benefit from a life insurance policy.

(6) The choice of law governing the construction of the agreement .

(7) Any other matter, including their personal rights and obligations, not in violation of public policy or a statute imposing a criminal penalty.

(b) The right of a child to support may not be adversely affected by a premarital agreement .

§1613. A premarital agreement becomes effective upon marriage.

§1614. After marriage, a premarital agreement may be amended or revoked only by a written agreement signed by the parties. The amended agreement or the revocation is enforceable without consideration.

§1615. (a) A premarital agreement is not enforceable if the party against whom enforcement is sought proves either of the following:

(1) That party did not execute the agreement voluntarily.

(2) The agreement was unconscionable when it was executed and, before execution of the agreement, all of the following applied to that party:

(A) That party was not provided a fair and reasonable disclosure of the property or financial obligations of the other party.

(B) That party did not voluntarily and expressly waive, in writing, any right to disclosure of the property or financial obligations of the other party beyond the disclosure provided.

(C) That party did not have, or reasonably could not have had, an adequate knowledge of the property or financial obligations of the other party.

(b) An issue of unconscionability of a premarital agreement shall be decided by the court as a matter of law.

§1616. If a marriage is determined to be void, an agreement that would otherwise have been a premarital agreement is enforceable only to the extent necessary to avoid an inequitable result.

§1617. Any statute of limitations applicable to an action asserting a claim for relief under a premarital agreement is tolled during the marriage of the parties to the agreement . However, equitable defenses limiting the time for enforcement, including laches and estoppel, are available to either party.

Glossary

Alimony: Funds paid to a former spouse in connection with a divorce or separation under §71.

Annuity: An annual payment of money by a company or individual to a person called an annuitant.

Annulment: Invalidation of a marriage because of its illegality.

Child support: Payments for support of a child pursuant to the court order, court decree, or other legal obligation.

Community property: Property or income of a married couple, living in a community property state, which is considered to belong equally to each spouse.

Divorce or separation instrument: A written agreement or court decree requiring a spouse to make payments for the support or maintenance.

Equitable distribution: An attempt to divide assets and earnings accumulated during marriage fairly upon divorce.

Incident to divorce: A transfer occurring within a year of divorce or related to the cessation of the marriage.

Marital deduction: A provision that allows for unlimited transfers from one spouse to another without having to pay any gift or estate taxes.

Marital property: Property spouses acquire during their marriage.

Premarital agreement: A contract between prospective spouses that changes or limits what would otherwise have been the law governing the ownership of property in the marital relationship, especially upon death or divorce.

Principal residence: A taxpayer's main or primary home. The principal residence may be a house, condominium, mobile home, or houseboat, as long as it is the place where the taxpayer lives most of the time.

Property settlement: A division of property owned or acquired by marriage partners achieved through a dissolution of marriage or legal separation.

QDRO: Qualified Domestic Relations Order is a court order that recognizes or creates a spouse's or a former spouse's right to a portion of a member's retirement benefits.

Recapture: Inclusion of depreciation deducted in previous years in this year's taxable income.

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