TAX WORKSHOP: THE FUNDAMENTALS

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- *Tax Traps and Tricks for the Complex Property Case,* [panelist]
  State Bar Of Texas New Frontiers in Marital Property Law, October, 2000.

- *Marital Property Agreements - the Family Law Perspective*,
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- *Strategic Use of Law Beyond the Family Code*, [panelist]
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- *Premarital Agreements - Representing the Non-monied Party,*
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Tax Workshop: The Fundamentals©

by

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I. Introduction. This Article has been jointly written by CPA William C. Bradley, and attorneys Richard R. Orsinger and Brenda Keen Schwartz. Topics included are: calculating net taxable income, tax exemptions for dependents, tax considerations in property division on divorce, year-of-divorce taxes, tax sheltered plans and accounts, alimony taxation, and what to do if a spouse has violated tax law. The following other cle articles covering tax law and divorce are available on the State Bar of Texas' new On-Line Library, which can be accessed at <http://www.texasbarcle.com/>:

> *Top 10 Taxation Issues in Divorces*, by Bryan C. Rice from Marriage Dissolution Institute 2001 (May 04, 2001)
>
> *Drafting Tax Motivated Provisions -- Stock Options, Alimony, and Business Buyouts* by Randall B. Wilhite from Family Law Drafting 1999 (December 09, 1999)
>
> *Tax Impact of Property Division: Seeing the Landmines Before You Step On Them* by Edwin W. Davis from Family Law Course 1998 (August 19, 1998)
>
> *Drafting Ira Beneficiary Designations - Is it More than Filling in Blanks?* by DIANE V. PERRIN from the 9th Annual Advanced Drafting: Estate Planning and Probate Course 1998

II. Calculating Net Taxable Income. [Author: Bradley] This Section is intended to aid the family law practitioner in calculating taxable income, identifying which tax bracket is applicable and determining the difference in net taxable income and net resources for child support calculations. By providing charts, tables, definitions, and guidelines, the practitioner will have some of the necessary tools with which to make these computations.

A. Where to Find Tax Tables. The Internal Revenue Service has created tax tables to aid in the calculation of income tax liabilities for individuals. These tables can be found in the Package X, which is published annually by the Internal Revenue Service or in another publication, the U.S. Master Tax Guide, which is published annually by Commerce Clearing House. The tables can also be found on the Internet at the Internal Revenue Service site http://www.irs.gov/prod/ind_info/tax_tables/index.html. The tax tables are to be used if the individual's taxable income is less than $100,000.

B. Tax Brackets. Where the tax tables aid in determining income tax liability, the tax brackets identify the tax percentage attributable to each incremental increase in the level of the taxpayer's taxable income. The chart, in the form of the Tax Rate Schedules, can also be located in the Package X, or the U.S. Master Tax Guide, published annually. The Tax Rate Schedules can also be found on the internet at the Internal Revenue Service website at http://www.irs.gov/ind_info/tax_tables/tax_sched.html. The tax rate schedules are used in calculating income tax liabilities of individuals when their taxable income is $100,000 or more.

On May 25, 2001, House and Senate negotiators agreed on the $1.35 trillion tax cut bill (H.R. 1836). The central provision of the Conference Agreement (the Act) is a reduction in marginal individual income tax rates. The Act provides a new 10% regular income tax bracket for a portion of taxable income that is currently taxed at 15%, effective for taxable years beginning after 2000. The 15% regular income tax bracket is modified to begin at the end of the new 10% income tax bracket and ends at the same level as under present law. The present law regular income tax rates of 28%, 31%, 36%, and 39.6% are reduced after June 30, 2001, to 25%, 28%, 33%, and 35%, respectively, in stages through 2006. The 2001 Act provides that all provisions of, and amendments made by the 2001 Act will not apply to tax years beginning after December 31, 2010.

C. Net Taxable Income. According to Paragraph 61 - Computation of Taxable Income: Individuals, as found in the 2001 U.S. Master Tax

Guide, the computation of an individual's taxable income involves several steps. Items that constitute income for tax purposes must be sifted from items that do not constitute income. Similarly, expenses that are deductible must be sifted from expenses that are not deductible. In addition, deductible expenses must be divided into expenses that are deductible from gross income and those that are deductible as itemized deductions.
Gross income includes:

A wages, salaries, and other compensation;
A annuities, pensions, and certain distributions
A dividends received
A state and local income tax refunds
A alimony received
A interest received and original issue discount
A gross business profits
A gains on sales or exchanges
A commissions, bonuses, tips, fees, and certain fringe benefits
A rents and royalties
A prizes and awards
A farm income
A social security
A unemployment compensation
A certain scholarships and fellowships
A illegal gains
A trust and estate distributions
A S corporations and partnership income.

Deductions from gross income include:

A trade or business expenses
A performing artists' expenses
A employee's reimbursed expenses
A losses from sales or exchanges
A expenses of producing rental or royalty income
A self-employed retirement plan contributions
A alimony paid
A contributions to IRAs
A interest forfeited upon premature withdrawal from time savings accounts
A repayment of supplemental unemployment compensation benefits
A jury duty pay given to employer
A moving expenses
A medical savings accounts
A student loan interest

D. Net Resources for Child Support. Net resources for the purpose of determining child support, as defined by The Texas Family Code Section 154.062 - Net Resources, are calculated by taking all resources less deductions for social security taxes, federal income tax based on the tax rate for a single person claiming one personal exemption and the standard deduction, state income tax, union dues, and expenses for health insurance coverage for the obligor's child.
Resources include:

A 100 percent of all wages and salary income and other compensation for personal services, including tips, commissions, overtime pay, and bonuses
A interest, dividends, and royalty income
A self-employment income
A net rental income, defined as rent after deducting operating expenses and mortgage payments, but not including noncash items such as depreciation
A all other income actually being received, including severance pay, retirement benefits, pensions, trust income, annuities, capital gains, social security benefits, unemployment benefits, disability and workers' compensation benefits, interest income from notes regardless of the source, gifts and prizes, spousal maintenance, and alimony

Resources do not include return of principal or capital, accounts receivable, or benefits paid in accordance with aid for families with dependent children.

E. Difference Between Net Taxable Income and "Net Resources" For Child Support. There are considerable differences between net taxable income and net resources for the purpose of determining child support. The Texas Family Code deducts from resources items such as social security taxes and federal income taxes for one personal exemption, whereas these are not deducted for net taxable income as defined by the Internal Revenue Service. Other items deducted from gross income for the purpose of calculating net resources, are union dues and health insurance expenses for the obligor's child. These items are

normally included on the taxpayer's Schedule A - Itemized Deductions, and are subject to income limitations. Also for rental income, the IRS considers the rent payments received, an income item and the expenses, related to generating the income, a deduction to that income. For net resource calculations, net rental income is defined as the rental payments received less operating expenses and mortgage payments, but no deductions for noncash items such as depreciation on the rental property are allowed. Although the depreciation expense is not deducted, the entire amount of the mortgage payments including the principal portion is deducted for the net resources computation, in contrast to IRS guidelines, where only the interest portion of the mortgage payments is deductible. The Texas Family Code also does not take into consideration some of the normal and customary deductions on an income tax return such as alimony paid, individual retirement account contributions, and student loan interest.

F. AG's Table for Purposes of Setting Child Support. Once the net monthly resources of the individual have been calculated, the monthly obligation for child support can be determined. The Child Support Guidelines, found in The Texas Family Code, Section 154.125 - Application of Guidelines to Net Resources of $6,000 or less, is a chart used in calculating the monthly child support obligation. When the obligor's monthly net resources are $6,000 or less, the court shall presumptively apply the schedule in rendering the child support order. The calculation is based on the net monthly resources of the obligor times the percentage from the table that corresponds with the number of children before the court. The schedule is as follows: 1 child - 20% of Obligor's Net Resources, 2 children - 25%, 3 children - 30%, 4 children - 35%, 5 children - 40%, and 6 or more children - not less than the amount for 5 children.

When computing support for children in more than one household, an alternative method may be determined by the court. The Multiple Family Adjusted Guidelines, also found in The Texas Family Code, Section 154.128 - Computing Support for Children in More Than One Household, may be used. This chart calculates child support based on the monthly net resources of the obligor times the corresponding percentage in the chart for the number of children before the court and the number of other children for whom the obligor has a duty of support. The chart extend the guidelines to cover from 1 to 7 children before the court and 0 to 7 other children for whom the obligor has a duty of support.

Both of these charts are guidelines for application in situations in which the obligor's monthly net resources are $6,000 or less. According to Section 154.126 - Application of Guidelines to Net Resources of More Than $6,000 Monthly, from the Texas Family Code, if the obligor's net resources exceed $6,000 per month, the court shall presumptively apply the percentage guidelines to the first $6,000 of the obligor's net resources. Without further reference to the percentage recommended by these guidelines, the court may order additional amounts of child support as appropriate, depending on the income of the parties and the proven needs of the child.

III. Tax Exemptions for Dependents. [Author: Bradley] Section 151(b) of the Internal Revenue Code generally allows a taxpayer to claim an exemption for himself or herself. Code Section 151(c) generally allows a taxpayer additional exemptions for dependents as defined in Code Section 152.

A. What Are They Worth? Personal exemptions, including dependency exemptions, are deducted in computing taxable income under Section 63(a) of the Internal Revenue Code. For tax years beginning in 2000, the exemption amount is $2,800 per dependent and for tax years beginning in 2001, the personal exemption amount is $2,900 per dependent. The amount is adjusted annually to reflect the inflation rate per the Internal Revenue Code Section 151(d).

B. When Do They Phase Out? Internal Revenue Code Section 151(d) (3) provides for the phaseout of the tax benefit of the personal exemptions allowed by Section 151. The reduction in the amount of personal exemptions caused by the phaseout is calculated by reducing the total amount of personal exemptions by 2 percent for each $2,500 increment, or 2 percent for each $1,250 increment for married taxpayers filing separate returns, or portion thereof, of adjusted gross income in excess of a threshold phaseout amount.

For example: For 2001, Mary and John Smith have a combined adjusted gross income of $250,000, can claim three personal exemptions, and file a joint tax return. Before the phaseout, their personal exemption amount would be $8,700 (3 X $2,900). Since their adjusted gross income exceeds the threshold amount for the phaseout, they must reduce their exemption amount. The excess amount of adjusted gross income of $50,550 ($250,000 - $199,450) is divided by $2,500. The result is 20.22, and is rounded up to the next whole number, 21. Their personal exemptions of $8,700 must be reduced by $3,654 (21 X 2% X $8,700) to $5,046 under the phaseout ($8,700 - $3,654).

For tax years beginning in 2000, the threshold phaseout amounts and completed phaseout amounts are as follows: $193,400 and $315,900 for married filing joint taxpayers, $161,150 and $283,650 for head of household taxpayers, $128,950 and $251,450 for single taxpayers, and $96,700 and $157,950 for married filing separate taxpayers.

For tax years beginning in 2001 the threshold phaseout amounts and the completed phaseout amounts are as follows: $199,450 and $321,950 for married filing joint taxpayers, $166,200 and $288,700 for head of household taxpayers, $132,950 and $255,450 for single taxpayers, and $99,725 and $160,975 for married filing separate taxpayers.

The Economic Growth and Tax Relief Act provides for the repeal of the personal exemption phaseout beginning in the year 2006. The repeal will be phased in over a five-year period.

For example: Assume the same facts in the previous example. For the years 2006 and 2007, the amount of the phaseout amount would be $2,436 ($3,654 X 2/3) and for the years 2008 and 2009 the phaseout amount would be $1,218 ($3,654 X 1/3). In the year 2010 the personal exemption amount would be the full $8,700.

Individuals that may divorce in coming years should be warned not to waive the exemption for children permanently. This waiver may have made sense when the high-income parent could not benefit from the exemption. However, the repeal of the phaseout on personal exemptions changes this thinking.

It should be noted that the 2001 Act provides that all provisions of, and amendments made by the 2001 Act will not apply to tax years beginning after December 31, 2010.

C. How Do You Allocate Them? In the typical, two-parent family situation, the parents ordinarily file a joint return and general dependency exemption rules under Internal Revenue Code Section 151(c) and 152(a) apply to determine whether they are entitled to claim a child as a dependent in any tax year. However, special rules set out in Code Section 152(e) determine which parent is entitled to claim the deduction when the parents are divorced or are separated and filing separate returns.

Provided the other dependency exemption requirements are satisfied, Internal Revenue Code Section 152(e)(1) permits the custodial parent to claim his or her child as a dependent if the child: receives over one-half of his or her support from both parents; is in the custody of one or both of the parents for more than half of the calendar year; the parents are divorced or legally separated under a divorce decree or decree of separate maintenance or separated under a written separation agreement; or the parents are living apart at all times during the last six months of the calendar year.

If Internal Revenue Code Section 152(e)(1) applies, a child will be treated as having received over half of his or her support from the parent having custody of the child for a greater portion of the calendar year and that parent, the "custodial parent", will be entitled to claim the child as a dependent for that year unless he or she "gives" the exemption to the noncustodial parent as provided in Code Section 152(e)(2).

Code Section 152(e)(1) allocates the dependency exemption to the "custodial parent," which is defined as being the parent having custody of the child for the greater part of a calendar year. "Custody" in Code Section 152(e) implicitly means physical custody. Internal Revenue Income Tax Regulations Section 1.152-4(b) specifies that "custody", for purposes of Internal Revenue Code Section 152(e), will be determined by the terms of

the decree of divorce or separate maintenance, or later custody decree, or, if no decree, a written separation agreement.

On a further note, Code Section 152(e) does not supercede the general dependency exemption requirements. These are threshold requirements. If the divorced or separated parents would not have been able to claim their child as a dependent under Code Section 151(c) and 152(a) on a joint return, Code Section 152(e) will not apply and the general dependency exemption rule or multiple support rule will operate to determine who, if anyone, will be entitled to claim the child as a dependent.

IV. Tax Considerations in Property Division on Divorce. [Author: Orsinger]

A. No Capital Gain Upon Divorce. In the case of *United States v. Davis*, 370 U.S. 65 (1962), the United States Supreme Court held that the transfer of appreciated property between spouses incident to a divorce was a taxable event to the transferring spouse. The taxable gain to the transferring spouse was the difference between the spouse's adjusted basis in the property and the fair market value of the property at the date of the transfer. The receiving spouse received a new tax basis in the property equal to its fair market value. This rule did not apply to the equal division of community property or jointly-owned property. In 1984, the U.S. Congress adopted Internal Revenue Code § 1041 to eliminate the rule in *Davis*. Under Section 1041, a transfer between spouses incident to divorce is not recognized for tax purposes. *See In re Marriage of Marron*, 170 Cal.App.3d 151, 158, 215 Cal.Rptr. 894, 900 (1985) ("[T]he Domestic Relations Tax Reform Act of 1984 . . . provides no recognition of gain or loss, for tax purposes, on transfers of property between spouses incident to dissolution [of a marriage].").

Section 1041 reads:

26 U.S.C. § 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.

(Added Pub.L. 98-369, div. A, title IV, Sec. 421(a), July 18, 1984, 98 Stat. 793; amended Pub.L. 99-514, title XVIII, Sec. 1842(b), Oct. 22, 1986, 100 Stat. 2853; Pub.L. 100-647, title I, Sec. 1018(l)(3), Nov. 10, 1988, 102 Stat. 3584.)

Shortly after the enactment of 1041, the Treasury department published a temporary regulation, which is still in effect. The temporary regulation pertaining to IRC § 1041 is as follows:

26 C.F.R. § 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 recordkeeping 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.

In the case of an election regarding preexisting decrees:

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.

B. When Redemption of Corporate Stock is Involved. In the case of *Arnes v. U.S.*, 981 F.2d 456 (9th Cir. 1992), husband and wife agreed that wife's interest in the corporation would be redeemed by the corporation. The wife argued that no capital gain tax was due on the redemption, because it was pursuant to divorce,

which IRC § 1041 exempted from capital gains tax. The 9th Circuit Court relied upon Question and Answer 9 of the Temporary Regulation, which explains that in certain cases a transfer of property to a third party "on behalf of" a spouse or former spouse should be treated as a transfer to the spouse or former spouse. The court held that the transfer qualified for nonrecognition of gain pursuant to the I.R.C. § 1041, the exemption for transfers made to spouses or former spouses incident to a divorce settlement.

Arnes was criticized by the Tax Court in *Blatt v. Commissioner*, 102 T.C. 77, 82-83 (1994), on the basis that the Ninth Circuit Court of Appeals never identified where the obligation of the husband to buy the stock came from. The Tax Court revisited the Arnes dispute in *Arnes v. Commissioner*, 102 T.C. 522, 528-29 (1994) ("Arnes II "). In *Arnes* II the Tax Court held that it was the corporation which was under the obligation to buy the wife's stock, and not the husband. Thus, the redemption was "on behalf" of the corporation, and not the husband, and Section 1041 was not implicated as a result.

Then in *Read v. Commissioner*, Tax. Ct. Rep. (CCH) No. 53,736, at 3911 (Feb. 4, 2000), the Tax Court appeared to back-peddle. In *Read*, pursuant to the divorce decree, H elected to buy out W's shares in a corporation by having the corporation purchase W's stock in exchange for a promissory note to W bearing 9% interest for the balance of the purchase price, which note H unconditionally guaranteed in his individual capacity. *See Id.* at 3916. The Tax Court held that Section 1041 applied. A similar result was reached in *Craven v. U.S.*, 215 F.3d 1201 (11th Cir. 2000).

In *Young v. Commissioner of Internal Revenue*, 240 F.3d 369 (4th Cir. 2001), Section 1041 was applied to a situation where at the time of divorce H gave W a promissory note for $ 1.5 million secured by 71 acres of land. H defaulted, wife foreclosed, then later sold the property. W was given H's original basis in the property, and taxed accordingly.

C. Ignore or Consider Future Tax Considerations? Section 1041 excludes capital gain recognition of a transfer upon divorce, and gives the receiving spouse a carry-over basis in the asset. If that asset is later sold for a gain, that gain will be taxed. Because of this, many lawyers consider the net after-tax value of assets being divided in a divorce. However, there is Texas case law prohibiting trial courts from considering tax attributes of assets in making the property division.

In *Harris v. Holland*, 867 S.W.2d 86 (Tex. App.–Texarkana 1993, no writ), the court held that it was error for a divorce court to subtract potential capital gains tax liability while valuing a capital asset for purposes of divorce. The court relied upon two earlier cases, *Freeman v. Freeman*, 497 S.W.2d 97, 99 (Tex. Civ. App.--Houston [14th Dist.] 1973, no writ), and *Simpson v. Simpson*, 679 S.W.2d 39, 41 (Tex. App.-- Dallas 1984, no writ). In *Freeman* it was held to be improper for the divorce court to deduct the hypothetical tax liability that the husband would incur if a retirement plan were to be immediately liquidated. In *Simpson* it was error for the divorce court, in valuing retirement plans, to assume immediate liquidation of the two plans thus generating a projected tax liability calculated using the husband's income tax rate at the time of divorce. It can be argued that assuming immediate tax consequences in a tax-sheltered retirement account is not analogous to built-in capital gains tax associated with corporate stock, and that the same rule should not apply. It can also be argued that deferred tax liability, even on retirement accounts, should be considered, albeit discounted to present value from the projected date of retirement.

A number of courts of other states have also concluded that the tax implications of a future sale of property to a third party are too speculative to permit the divorce court to subtract this future tax liability from the present value of the asset–unless it could be ascertained that under the court's decree, such sale would actually occur. *See, e.g., In re Marriage of Goldstein*, 120 Ariz. 23, 583 P.2d 1343 (1978); *Levan v. Levan*, 545 So.2d 892 (Fla.App. 1989); Burkhart v. Burkhart, 169 Ind. App. 588, 349 N.E.2d 707 (1976); *Nemitz v. Nemitz*, 376 N.W.2d 243 (Minn.App. 1985); *In re Marriage of Beck*, 631 P.2d 282 (Mont. 1981); *Orgler v. Orgler*, 237 N.J. Super. 342, 568 A.2d 67 (1989); *Hovis v. Hovis*, 518 Pa. 137, 541 A.2d 1378 (1988); *Bettinger v. Bettinger*, 183 W. Va. 528, 396 S.E.2d 709 (1990). However, the

Supreme Court of Massachussetts ruled that a trial court properly"imputed an estimated capital gains tax in order to assign a more accurate value to those assets." *Williams v. Massa*, 430 Mass. 619 (Mass. 2000).

The Second Circuit Court of Appeals, in *Eisenberg v. Commissioner*, 155 F.3d 50 (2nd Cir. 1998), has acknowledged the validity of adjusting for built-in capital gains tax when valuing C corporation stock. The Court distinguished earlier case law to the contrary, saying that at the time of those cases the General Utilities Doctrine permitted corporations to sell or distribute assets, or liquidate without incurring the built-in capital gains tax. The General Utilities Doctrine was abrogated in the Tax Reform Act of 1986. *See* Karen J. Damiano (CPA), *Eisenberg v. Commissioner: Court Allows Adjustment for Potential Built-In Capital Gains Tax*, WILLAMETTE MANAGEMENT ASSOCIATES INSIGHTS pp. 1-2 (Winter 1999). The Second Circuit commented:

> We believe it is common business practice and not mere speculation to conclude a hypothetical willing buyer, having reasonable knowledge of the relevant facts, would take some account of the tax consequences of contingent built-in capital gains on the sole asset of the Corporation at issue in making a sound valuation of the property.
>
> * * *
>
> We believe that an adjustment for potential capital gains tax liabilities should be taken into account in valuing the stock at issue in the closely held C corporation even though no liquidation or sale of the Corporation or its assets was planned at the time of the gift of the stock.

The Court relied upon *Estate of Davis v. Commissioner*, Daily Tax Report (BNA) No. 126, at K-12, K-19 (T.C. June 30, 1998), in which the Tax Court found that an adjustment or discount attributable to potential built-in capital gains tax was appropriate.

The following article discusses the subject: Martin C. Van Acker, *Should Built-In Gains Tax Be Considered in Valuing Corporations?*, http://www.aaml.org/buil tingains.htm [7-8-2001].

In Obermer v. U.S., 238 F. Supp. 29, 34 (D.C. Haw. 1964), the court recognized unpaid capital gains on undistributed dividends as a proper factor to consider in valuing stock. *See* Hood, Mylan & O'Sullivan, *"Valuation of Closely Held Business Interests*, 65 UNIV. MO. AT KANSAS CITY L. REV. 399, 440 (1997).

D. Assignment of Income Problem. In the case of *Lucas v. Earl*, 281 U.S. 111 (1930), the U.S. Supreme Court ruled that a person who had earned but not yet receive income could not transfer that income and the tax on that income to another person. In *Helvering v. Horst*, 311 U.S. 112, 114 (1940), the Supreme Court held that a father could not escape taxation on future bond interest income by assigning the interest to his son.

The IRS has sometimes taken the position that the assignment of income doctrine applies to income assigned from one spouse to the other in connection with divorce. *See* Rev. Rul. 87-112, 1987-2 C.B. 61 (accrued interest on savings bond not shielded by 1041 because such income is not gain within the meaning of that section). *See* Nunnallee, *The Assignment of Income Doctrine as Applied to Section 1041 Divorce Transfers: How the Service Got it Wrong*, 68 ORE. L. REV. 615 (1989).

In IRS Field Service Advice, FSA 200005006 (November 1, 1999), the IRS considered whether husband is taxed under I.R.C. Section 83 when stock options are transferred to his ex-wife pursuant to a divorce decree or when they are exercised by his ex-wife. The IRS concluded that Husband is taxed under Section 83 at the time of the transfer of options to ex-wife. Ex-wife receives a carryover basis in the options under Section 1041(b). Ex-wife's tax consequences upon the ultimate disposition of the stock would be governed by Section 1001. Thus, neither husband nor ex-wife is taxed under Section 83 when the options are exercised by ex-wife.

In *Kenfield v. United States*, 783 F.2d 966, 968 (10th Cir. 1986), the IRS contended that H could be taxed on the income from a partnership even

though the trial court in the divorce had awarded to W one-half of all future income from the partnership, based on the assignment-of-income doctrine. The appellate court rejected this position, noting that the assignment was an involuntary transfer imposed by the divorce court, and further because "a division of property between co-owners [is] not an assignment."

V. Tax Reporting Considerations on Divorce [Author: Schwartz]

A. "Tax Years" and Divorce Decrees. On divorce, there are actually three periods the family law practitioner should consider: prior years tax liability or refund for years for which a return has been filed, prior year's tax liability or refund for years for which a return has not yet been filed as well as tax liability for the portion of the year of divorce that precedes the divorce.

In each of these instances, it is possible to simply ignore the issue in the decree - but the practitioner is warned that ignoring the issue should be a conscious decision and not part of an overall "ostrich" approach to the subject matter. Moreover, it is critical to understand and remember that nothing in the decree or agreement can operate to affect the rights of the IRS. The decree or agreement will operate to give one party a claim against the other party - no more, no less. An indemnification is valuable only to the extent the indemnified party can collect in damages from the indemnifying party.

B. Prior Years' Tax Returns and Reporting. Allocation of responsibility for tax liabilities and rights to refunds for years prior to the year of divorce, both as to filed joint returns and years for which a return has not yet been filed, may be handled using the same approaches and considerations that are available for the reporting of pre-divorce income for the year of divorce. For "open" years, however, taxpayers married on the last day of the tax year may elect to file a joint return (IRC Sec. 6013), or each may file a separate return and pay tax in accordance with the rate schedule for "married filing separately" taxpayers.

1. Married Filing Separate: Avoidance of joint and several liability may be the primary factor in advising a taxpayer to file a separate return. If the spouses decide to file separately, one-half of all community income must generally be reported in the separate return of each spouse, unless the reporting spouse meets the requirements of IRC Sec. 66(a) relating to separated spouses. Also, the separate return should include one-half of all community deductions and credits. Thus, a separate return may help to limit liability to 50% of the total reported tax, but may not limit liability for unreported community income, unless the spouse can prove "innocence".

2. Abandoned Spouse An individual who is still legally married can file as an unmarried taxpayer if they maintain a home for more than half a year for a qualifying dependent, bear more than one-half of the cost of the home, and the other spouse is not a member of the household for the last six months of the taxpayer year. IRC Sec. 7703(b). Under this set of circumstances, the taxpayer will likely qualify for the lower "head of household" tax rates.

3. Section 66(a) Treatment of Community Income Where Spouses Live Apart. Section 66(a) is a relief measure designed to protect separated (or abandoned) spouses from federal tax inequities that could result from application of community property rules. Sec. 66(a) can apply to a separated spouse for years prior to the year of divorce.

4. Agreed Allocations The balance of this section of the paper is devoted to a discussion of the effect of the different methods of allocating responsibility for tax liability on pre-divorce income. The same principles apply to allocations for prior years' income and returns.

C. Year of Divorce- the Basic Rules

1. Allocation of Income Each spouses' tax return for the year of divorce will generally include half of all community, pre-divorce income and deductions, all post-divorce income and deductions of the spouse filing the return, all pre-divorce separate income of the filing spouse; and half of pre-divorce federal tax withholding and estimated tax payments.

Under IRC Sec 66(a) -Treatment of Community Income Where Spouses Live Apart - the allocation of community income may be modified where the

spouses live apart for the pre-divorce portion of the year of divorce. Section 66(a) is a relief measure designed to protect separated (or abandoned) spouses from federal tax inequities that could result from application of community property rules. This rule may also be used in preparing the tax returns for the year of divorce. The aim of the statute is to tax only the spouse who produced and benefitted from the income. Sec. 66(a) can apply to a separated spouse if all the following conditions exist:

- The spouses live apart at all times during the calendar year;
- For the year in question, the spouses do not file a joint return;
- Either or both of the spouses have earned income which is community income; and
- No portion of such income has been transferred between the spouses during the calendar year.

While the Code and Regulations do not elaborate on this point, it is generally accepted that the payment of child support is not treated as a transfer of earned income, but transactions such as making a mortgage payment for the other spouse or paying bills owing by another spouse may be deemed a transfer of income.

2. Allocation of Items of Credit Income tax withholding, payments of estimated tax, prior year overpayments, and unused tax credits are generally divided equally between the spouses - a schedule should be attached to the tax return showing the allocation of all of these items to each of the spouses. However, even though these items may be community in nature, the parties are free to negotiate an allocation other than a 50-50 split so long as both spouses report the allocation (with schedules) on a consistent basis. See Rev. Rul. 76-140, 1976-1 CB 276 and Floyd v. U.S., 39 AFTR 2d 77-1109.

Typically, married couples make their quarterly estimated tax payments on a joint basis. In the event of a later separation, there is usually some desire to file separate tax returns. Recently, the Internal Revenue Service issued a legal memorandum (No. 200011047) to spell out the procedure for allocating the *joint* payment to *separate* returns. Generally, the Internal Revenue Service will accept the allocation agreed to by the spouses (only if the sum of the allocation adds up to the actual payment!).

If the spouses cannot agree, the Internal Revenue Service will rely on the formula in Reg. Sec. 1.6015(b)-1(b) and allocate the payment in proportion to each spouse's separate tax liability. This allocation will override the application of the community property rules.

It is important to note that any estimated payments made with a separate declaration form cannot be allocated to the other spouse even if the payments were made with community funds.

Unused net operating loss carryovers existing at the time of the divorce are generally allocated to the parties equally due to the community nature of the pre-divorce income and deductions. Unused tax credit carryovers (limited by the Tax Reform Act of 1986) must follow the property creating the credit (due to the potential for recapture). These carryforwards may be extremely valuable to a newly separated spouse that is about to renter the work-force and who has little or no deductions to offset the current income.

D. Allocation of the Tax Liability - Texas Family Law Practice Manual Clauses

1. Tax Rate Proportion Allocation

*IT IS ORDERED AND DECREED that, for calendar year [**year of divorce**], [**name of party A**] shall timely pay and hold [**name of party B**] and [his/her] property harmless from any liability of either party for federal income taxes for all income attributable to the parties, or either of them, during calendar year [**year of divorce**], except for the following amount of tax, which [**name of party B**] is ordered to pay: that amount of tax arrived at by independent calculation by multiplying [**name of party B**]'s taxable income (including only [**name of party B**]'s separate income before divorce, all income after divorce, deductions, exemptions, or adjustments attributable to [his/her] income after date of divorce) by the effective federal income tax rate as determined by dividing taxable income as reported on [his/her] [**year of divorce**] U.S. Individual Income Tax Return into the tax as computed in the return. In making this*

*computation, [**name of party B**] shall be entitled to only those deductions, exemptions, or adjustments attributable to [him/her] after the date of divorce. The independent calculation shall credit against [**name of party B**]'s liability all income tax withheld from [his/her] earnings after the divorce is granted and all estimated tax payments made by [him/her] after that date, and any resulting overpayment shall belong to [**name of party B**]. All other income tax withheld from earnings of [**name of party B**] in the year of divorce and all other estimated tax payments made by the parties, or either of them, with respect to the year of divorce shall be credited to [**name of party A**] for the purposes of this calculation.*

Paul Mueller, in *Tax Traps/Tax Tricks and the Complex Property Case*, from NEW FRONTIERS IN MARITAL PROPERTY 2000 (October 5, 2000) explains and comments on this clause:

> The indemnified spouse is only responsible for taxes relative to her separate income and any post-divorce income. Tax on this income is based on the effective tax rate for the year. This differs from the marginal tax rate, which refers to a specific tax bracket. The effective tax rate is a blended rate determined by dividing the reported tax liability by the taxable income shown on the Form 1040. Since this calculation includes one-half of all pre-divorce community income of both spouses, this will typically drive up the tax rate. Generally, this method (out of the three common methods) will result in a higher tax allocation to the indemnified spouse.

2. Nontax-Rate Proportion Allocation

IT IS ORDERED AND DECREED that, for calendar year [year of divorce], [name of party A] shall timely pay and hold [name of party B] and [his/her] property harmless from any federal income tax liability attributable to the income of the parties or either of them from January 1 of that year through the date of divorce unless such additional tax, penalty, and/or interest resulted from [name of party B]'s omission of income [he/she] earned or recognized in [year of divorce] or from erroneous deductions proffered by [name of party B], in which case [name of party B] shall pay such resulting tax, penalties, and/or interest thereon, and [he/she] shall indemnify and hold [name of party A] harmless therefrom. IT IS ORDERED AND DECREED that [name of party A] shall be entitled to use as a credit against [her/his] tax liability for calendar year [year of divorce] all prepayments and withholdings made by either party before the date of divorce and all deductions, exemptions, and adjustments attributable to either party's income and expenses before the date of divorce.

IT IS ORDERED AND DECREED that [name of party A] shall timely pay and hold [name of party B] and [his/her] property harmless from any tax liability attributable to [name of party A]'s income from the date of divorce until December 31 of that year. IT IS ORDERED AND DECREED that [name of party B] shall timely pay and hold [name of party A] and [her/his] property harmless from any tax liability attributable to [name of party B]'s income from the date of divorce until December 31 of that year. IT IS ORDERED AND DECREED that each party shall be solely entitled to use as a credit against his or her own tax liability for calendar year [year of divorce] all prepayments and withholdings made by him or her after the date of divorce and all deductions, exemptions, and adjustments attributable to his or her income and expenses after the date of divorce. In this regard, IT IS ORDERED AND DECREED that [name of party B]'s tax liability shall be that amountarrived at by independent calculation that [name of party B] would owe if [he/she] were filing a separate return for the entire year and reporting only the income earned or received by [him/her] from the date of divorce to December 31 of that year, and with only those deductions attributable to expenditures made by [him/her] from the date of divorce to December 31 of that year, with 100 percent of any statutory deduction available to [him/her] in lieu of itemizing [his/her] deductions and 100 percent of one full dependency exemption.

IT IS ORDERED AND DECREED that any portion of the income tax on [name of party B]'s return paid by [name of party A] during this year

shall be deemed part of [name of party B]'s share of the marital estate of the parties.

Mueller, *id.,* explains and comments on this clause:

> Using this method, the indemnified spouse is only responsible for taxes arising on post-divorce income. This method is typically used when one spouse has agreed to be responsible for all tax liabilities up through the date of divorce. The allocated tax for the indemnified spouse is calculated as if the spouse filed a separate return reporting only those income and deduction items occurring after the date of divorce. Where such income is minimal, this may result in a zero liability or one that is based on the lowest, 15% income tax bracket. When compared to the earlier tax allocation method, this method typically results in a lower allocation to the indemnified spouse.

3. Each Party Pays for Own Earnings and Income

*IT IS ORDERED AND DECREED that, for the calendar year [**year of divorce**], each party shall timely pay and indemnify and hold the other party and his or her property harmless from any federal income tax liability attributable to the personal earnings of the reporting party and any net income resulting from property subject to the sole management and control of the reporting party from January 1 of that year through the date of divorce and for all such post-divorce earnings and income.*

IT IS ORDERED AND DECREED that each party shall be entitled to use as a credit against his or her tax liability all estimated tax payments, credit for tax payments made in prior years, and withholdings made solely in the name of the reporting party and 50 percent of such estimated tax payments, credit for tax payments, and withholdings made in the names of both parties before the date of divorce together with any net loss resulting from property subject to the sole management and control of the reporting party and 50 percent of any net loss attributable to property subject to the joint management of the parties.

Again, the following explanation and commentary from Paul Mueller *[id]*

> The underlying rationale for this allocation method is to make each spouse responsible for the taxes on their own income. This can be when on of the spouses is self-employed, or where there is a significant difference in the income earned by each spouse. It is also ideal when there is a concern that one of the spouses has under-withheld taxes on their income or has not made adequate quarterly estimated tax payments. Each spouse is required to prepare a pro-forma income tax return to exclude the pre-divorce earnings and tax payments attributable to the other spouse. To the extent this decreases the net refund or increases the balance due (as compared to the return actually being filed with the IRS), the reporting spouse is entitled to reimbursement from the other spouse.

E. What Happens in Real Life

1. "Allocation" Does NOT Equal "Reporting" Mr. Mueller's comments highlight the importance of keeping in mind, at all times, the difference between allocation clauses and reporting rules. None of the three "allocation" clauses affect the manner in which community tax items are reported for the year of divorce.

2. "Allocation" Does Not Specify How and When. None of the allocation clauses specify a means or method by which the former spouses are to effectuate this part of their agreement. Consideration should be given in the decree to who will prepare the returns and make the independent calculations called for, and when the payments between spouses will be due. The following is a sample of a clause specifying these items:

Husband shall pay to Wife an amount calculated as follows:

- *The total tax reflected by her return, prepared in accordance with [reference to decree or Internal Revenue Code]*
- *LESS the tax she would have paid had her return included only income earned and received by her in [YOD] after the date of divorce, and items of deduction and credit arising in [YOD]after the date of divorce; and*
- *LESS an amount equal to items of pre-divorce credit reported on Wife's return.*

Husband shall pay said sum to Wife within ten days of his receipt of notice from her of the amount due, which notice shall include her tax preparer's calculations.

3. The KISS Clause

In this author's experience, the vast majority of folks are dismayed at the prospect of having to deal with the "ex" in the future on much of anything, including the exchange of information the following year that is necessary to preparation of a year of divorce return that divides pre-divorce income and other tax items between the separate returns. The author has been advised, on numerous occasions, "off the record" by various un-named, reliable but confidential "CPA" sources, that as a practical matter, as long as all items of pre-divorce year of divorce income shows up on one return or the other, the IRS is not likely to complain. The following clause is one that's been frequently used by this author - with a caveat to the client that the client should seek the advice of his or her tax preparer regarding the year of divorce return BEFORE including this clause in the divorce agreements or decree:

Each files for year of divorce as if not married on January 1

*Each party shall file a separate income tax return for the year of divorce and shall report all items of income, credit and deduction as if the parties' divorce had occurred on January 1 of the year of divorce. Each party shall indemnify and hold the other party harmless on all taxes, interest and penalties related to income earned by the indemnifying party for personal services [as reflected by W-2 series forms in said party's name and Social Security number] and income earned by the indemnifying party on assets maintained in the indemnifying party's name [as reflected by all 1099 series forms and K-1's in the indemnifying party's name and Social Security number] or otherwise subject to the indemnifying party's control for calendar year **** to the date of divorce. In the event the parties are required to prepare and file their respective tax returns in a manner other than as contemplated by this Agreement, the parties shall make such payments to each other as may be necessary to effectuate the indemnity specified by this paragraph.*

VI Tax Sheltered Plans and Accounts [Author: Schwartz].

A. Kinds of Plans and Accounts Plans approved by the IRS for favorable tax treatment are often generally referred to as "qualified" retirement plans. The favorable tax treatment comes in the form of tax deductions for contributions and tax-deferred earnings. The list of plans includes 401(k)s, SEPs, IRAs, Keoghs, SIMPLEs, and defined benefit pension plans. Each plan has different contribution limits and other rules. (www.quicken.com/glossary [July 22, 2001])

It is important, however, to distinguish among these plans on the basis of whether or not it is an "ERISA qualified plan." If an employee benefit arrangement is not an "employee benefit plan" it is not subject to ERISA. An employee benefit arrangement (other than an apprenticeship or training program) is not an "employee benefit plan" if it does not provide benefits to one or more common law employees. Thus, a plan providing benefits solely to partners or sole proprietors (such as Keogh or H.R. 10 plans) is not an employee benefit plan covered by Title I of ERISA. PWBA Reg. § 2510.3-3.

If the plan is governed by ERISA, the benefit can be divided using a QDRO. If the plan or account is NOT an ERISA governed account, a different form of transfer is available on divorce. The rules affecting taxation of distributions also differ between the two categories.

B. Taxation of Distributions Pursuant to QDROs When an ERISA governed benefit is divided by a domestic relations order meeting the requirements specified under IRC 414 (p) and that order is accepted as a QDRO, the alternate payee basically steps into the shoes of the

participant. The alternate payee receives no greater rights or benefits from the plan than the participant had, although ERISA does allow for a provision that the payments to the alternate payee may be made on the earliest date on which the participant reaches "earliest retirement age" under the plan.

If the alternate payee is the spouse, or former spouse of the participant, any distribution from a qualified plan to this alternate payee pursuant to a QDRO will be included in the alternate payee's gross income for the year of distribution. This would be true even if you had a lump sum distribution, unless that alternate payee elected a rollover. This rollover is available only when the alternate payee is a spouse, or former spouse of the participant (IRC Section 402c, 402 (e) (1) (B), and Private Letter Ruling 9109052). If the alternate payee is the participant's *child*, any distribution from the qualified plan to such alternate payee, would be included in the *participant's* gross income for the year of distribution.

When it comes to taxation of distributions, however, the alternate payee may find him or herself in a better position than the participant. Typically, under IRS Section 72 (t), if a taxpayer receives an amount from a qualified plan prior to attaining the age of 59 1/2, there is an additional tax of 10% on the early distribution. However, IRS Section 72 (t) (2) (c) provides an exception for payments to alternate payees pursuant to QDROs. Thus, if the qualified plan makes an early payment or distribution to an alternate payee pursuant to a qualified domestic relation order and the alternate payee does not roll over their amount received, the alternate payee will not be subject to the 10% penalty. Receipt of the payment, however, will still be subject to regular income taxes.

To avoid the income tax hit, the funds can be rolled over into another qualified plan (if the alternate payee works, is covered by a plan at work and the plan accepts rollovers) or to an IRA. Once the rollover occurs, though, the alternate payee loses the exemption from penalty. Thus, a later pre-59 1/2 distribution following the rollover will be subject to penalty. Rollovers, however, do not have to be "all or nothing". The alternate payee may want to consider holding back some of the QDRO distribution for current and short-term needs (subject to income tax) and rollover the remainder to an IRA.

C. Transfers to Effect Division of IRA's Under IRC Section 408 (d) (6), the transfer of an IRA is permitted from one spouse to a former spouse as part of the divorce settlement without having to report any income. Because this transfer is outside the QDRO rules, it is not exempt from the 10% penalty. In order to qualify under Sec. 408(d)(6), the funds must be transferred to the former spouse pursuant to a divorce instrument. The best way, therefore, to handle the IRA transfer is to have it specifically stated in the divorce decree that it is, in fact, pursuant to the divorce and then have the IRA funds transferred from *trustee to trustee*.

The failure to follow this procedure led to disastrous tax consequences in a Tax Court case. *Bunney*, 114 TC No. 17. Under California community property law, each spouse owned 50% of IRA. The divorce court, therefore, ordered Husband to give Wife half of his IRA. Thinking he was following orders, but without seeking proper guidance, Husband withdrew half of the account which he deposited into his money market account. Later, he transferred a portion of the funds to Wife in a transaction whereby he acquired her interest in the family residence. The Tax Court ruled that Husband was solely responsible for the tax since he was the initial recipient of the withdrawal. On top of that, he was also subject to the 10% penalty since he was not yet age 59 ½. Husband could have avoided this result had he instructed his IRA trustee to convey the funds to Wife or to her IRA in a trustee – to – trustee rollover.

It should be noted that the transfers of IRAs from one spouse to the other appear only to be addressed in the context of a divorce. Accordingly, the timing and nature of the transaction is critical. If the transfer of an IRA from one spouse to another is made prior to a divorce settlement or some time after and not as a part of the divorce settlement, it would probably be deemed taxable to the account owner as an early distribution.

D. Taxation of Withdrawals from IRA's As noted above, the transfer of an IRA as part of a

divorce settlement is not subject to the same rules that apply for QDRO's. If funds are withdrawn from an IRA before age 59 and ½ , the 10% penalty. Un-penalized access to IRA funds, however, before age 59 and ½ , is possible under various exceptions. If withdrawals are made as part of a series of substantially equal payments over the IRA owner's life expectancy, the 10% penalty will not apply to the withdrawals made before age 59 and ½.. An IRS-approved distribution method must be used to determine the amount of the annual distribution, and at least one distribution annually must be taken. The "life expectancy method" is set out in IRS Publication 590 "Individual Retirement Arrangements (IRAs) and information as to the amortization method and the annuity method may be found in IRS Notice 89-25 in Internal Revenue Cumulative Bulletin 1989-1.

VII. Alimony Taxation. [Author: Orsinger] Alimony is deductible to the payor and taxable as income to the payee.

A. Conditions for Deductibility. For a payment to be deductible and reportable as alimony:

A it must be in cash;

A it must be received by (or on behalf of) a spouse under a divorce or separation instrument,

A the divorce or separation instrument must not designate such payment as a payment which is not includible in gross income under Section 71 and not allowable as a deduction under Section 215,

A 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 must not be members of the same household at the time such payment is made, and

A there must be no liability to make any such payment for any period after the death of the payee spouse and there must be no liability to make any payment (in cash or property) as a substitute for such payments after the death of the payee spouse.

See IRC §§ 71, 215.

B. Recapture for Front-End Loading. The Internal Revenue Code is set up to avoid front-end loading of alimony in the first two years. Under IRC § 71(f), excess alimony deducted or reported in the first post-separation year and second post-separation year must be treated by the payor as income in the third post-separation year and must be deducted by the payee in the third post-separation year.

The calculation will be explained for year two, then year one.

Excess alimony in the second post-separation year is calculated by subtracting from the amount of alimony paid during the second post-separation year the amount of alimony paid during the third post-separation year plus $15,000. In other words, excess alimony in year two is the amount by which the alimony paid in year two exceeds the sum of alimony paid in year three plus $15,000.

Excess alimony in the first post-separation year is calculated by subtracting from the amount of alimony paid during the first post-separation year the sum of $15,000 plus the average of (1) the amount of alimony paid during the second post-separation year exclusive of any excess payments, and (2) alimony paid in year three. In other words, to figure the excess alimony paid in the first post-separation year, calculate non-excess alimony paid in year two, and average that with alimony paid in year three, then add $15,000, then subtract all that from the alimony paid in year one.

Alimony recapture rules do not apply if either spouse dies prior to the end of the third post-divorce year of alimony and further payments are suspended on death. The recapture rules do not apply to payments of at least three years duration that constitute a percentage of the payor spouse's income (i.e."fluctuating payments not within control of payor spouse").

In case you want to see for yourself how to calculate alimony recapture, here is the Code language:

(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 eginning 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.

C. Converting Child Support to Alimony. Parties are not allowed to disguise child support as alimony. Accordingly, the IRS will deduct from the alimony and will treat as non-deductible and non-taxable child support any reduction in alimony that occurs:

(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).

IRC § 71(c). 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. IRC § 71(c).

VIII. What If One or Both Spouses Have Violated Tax Laws? [Author: Bradley] The Internal Revenue Code ("Code") contains several provisions that provide for penalties, both civil and criminal, for failure to comply with the tax provisions of the Code.

The proposed regulations referenced in this outline can be accessed at the Internal Revenue Service www.irs.ustreas.gov/tax_regs/index.html.

A. Failure to File Tax Returns. Pursuant to §7203 of the Code it is a misdemeanor to willfully fail to pay any tax, make a return, keep records or supply information required to be supplied under the Code.

The elements of an offense under §7203 are (1) willfulness and (2) the omission of at least one of the four required acts listed above. Willfulness has been defined as the: Voluntary, intentional violation of a known legal duty. U.S. v. Pomponio, 429 U.S. 10, 13 (1976), reh'g denied, 479 U.S. 987 (1976); U.S. v. Kim, 884 F.2d 189, 192 (5th Cir. 1989). A good faith misunderstanding of the law may negate the willfulness. The Code specifically requires that the defendant deliberately and intentionally failed to file a return with knowledge that he was required by law to do so. If convicted, the defendant can be fined not more than $25,000, or imprisoned not more than 1 year, or both together with the costs of prosecution.

B. Failure to Report Income or Excessive Deductions. The failure to report income or to claim excessive deductions generally is not, by itself, adequate evidence of fraudulent intent. However, the consistent failure to report substantial amounts of income or claim excessive deductions over a number of years would indicate fraud. Also the taxpayer's knowledge of the tax law is important in determining if fraud has been committed.

The Internal Revenue Service uses several methods to determine that income has been understated:

- Net worth method
- Expenditure method
- Bank deposit method
- Percentage method

These methods can be used for both criminal and civil fraud penalties.

Under the net worth method, the taxpayer's assets and liabilities are determined for the beginning and end of the year. Added to the increase in net worth are his nondeductible expenses and nontaxable receipts are subtracted for the year in question. The difference is taxable income. The Internal Revenue Service also must prove a likely source of income or negate all possible nontaxable income.

The expenditure method focuses on the taxpayer's expenditures. Using this method the Internal Revenue Service tries to determine that expenditures exceed the income reported

Bank deposits and cash expenditures are added together under the bank deposit method. From this known non-income items are eliminated to determine gross income. Then deductions are subtracted to determine net income.

The last method compares the taxpayer's tax return to others in the same business. It uses variations in percentages that may indicate unreported income.

If convicted of fraud, the taxpayer shall be fined no more than $100,000, or imprisoned no more than 5 years, or both together with costs.

C. Innocent Spouse Protections. Generally, when a joint return has been filed, both spouses are jointly and severally liable for the tax due on the return and any subsequent additions to the tax, including interest or penalties. The innocent spouse rules were enacted to provide relief in this area. Section 3501 of the 1998 Reform Act, P.L. 105-206 required the Internal Revenue Service to

notify married taxpayers of their tax liability. Also, deficiency notices pertaining to a joint return must be send to both spouses separately, if possible.

If a spouse can prove that he or she is an innocent spouse, relief is available under §6015 of the Code. There are three types of relief available:

- All taxpayers meeting the requirements
- Divorced, legally separated or estranged spouses
- Equitable relief

The electing spouse files Form 8857 (Appendix A) to request relief. The form cannot be filed before the receipt of a deficiency notice, notice of an audit, or collection proceedings. The electing spouse may file the election any time after receiving notice but it must be within two years from the date collection activity begins.

In *King v. Commissioner*, 115 T.C. No. 8 (2000), acq. 2000-41 I.R.B. np, the court held:

> In any case where an individual petitioner seeks relief from joint liability pursuant to sec. 6015, I.R.C., the other individual who filed the joint return is entitled to notice and, if not already a party in the case, an opportunity to intervene for purposes of challenging the propriety of relieving the petitioner of liability.

Proposed Regulation 1.6015-6 requires the Internal Revenue Service to notify the non-requesting spouse of claim for relief. The non-requesting spouse must be giving the opportunity to submit any information and the Service can share certain information. The Service is not required to provide such things as new name, address, employer, etc.

1. Relief Available to All Joint Filers § 6015(b).

If all of the following conditions are met, the innocent spouse will receive relief of the liability attributable to the understatement (partial relief is also available):

- The spouses filed a joint return
- There is an understatement of tax attributable to erroneous items of one spouse
- It is determined that in signing the return he or she did not know and had no reason to know that there was an understatement
- It would be inequitable to hold him or her liable for the deficiency considering all the facts and circumstances
- The spouse elects to apply the provisions of §6015 of the Code.

a. Understatement and Erroneous Items. An understatement of tax is the difference between tax assessed upon audit and the amount of tax reported on the tax return. An erroneous item is any item attributable to the understatement to the extent it was improperly reported or omitted from the return.

If the taxpayer's activity gave rise to the item, it is considered the taxpayer's item. Community property laws are disregarded. Proposed Regulation 1.6015-1 (f) (2) provides the following example:

> (i) H and W are married and have lived in State A (a community property state) since 1987. On April 15, 2003, H and W file a joint Federal income tax return for the 2002 taxable year. In August 2005, the Internal Revenue Service proposes a $17,000 deficiency with respect to the 2002 joint return. A portion of the deficiency is attributable to $20,000 of H's unreported interest income from his individual bank account, the remainder of the deficiency is attributable to $30,000 of W's disallowed business expense deductions. Under the laws of State A, H and W each own ½ of all income earned and property acquired during marriage.
>
> (ii) In November 2005, H and W divorce and W timely elects to allocated the deficiency. Even though the laws of State A provide

> that ½ of the interest income is W's, for purposes of relief under this section, the $20,000 unreported interest income is allocable to H, and the $30,000 disallowed deduction is allocable to W. The community property laws of State A are not considered in allocating items for this paragraph.

b. Knowledge or Reason to Know. Both the regulations under §6015 and case law provided guidance pertain to what is knowledge or reason to know. Proposed Regulation 1.6015-2 (c) states that:

> A requesting spouse has knowledge or reason to know of an erroneous item if he or she either actually knew of the item giving rise to the understatement, or if a reasonable person in similar circumstances would have known of the item giving rise to the understatement.

The proposed regulation also provides a list of some of the facts and circumstances that will be considered, some of which are as follows:

- Nature of the item and amount
- The couple's financial situation
- Educational background and business experience of the requesting spouse
- Extent of the requesting spouse's participation in the activity that gave rise to the erroneous item
- Whether the requesting spouse failed to inquire, at or before signing the return, about items on the return or omitted from the return that a reasonable person would question
- Whether the erroneous item was a departure from prior years.

The rules pertaining to actual knowledge are contained in Proposed Regulation 1.6015-3 (c) (2). If the Secretary demonstrates that the requesting spouse had actual knowledge at the time the return was signed of an erroneous item that is allocable to the nonrequesting spouse, the election to allocate the deficiency attributable to that item is invalid, and the requesting spouse remains liable for the portion of the deficiency attributable to that item.

Proposed Regulation 1.6015-3 (c) (4) provides examples for the following:

- Actual knowledge of an erroneous item
- Actual knowledge not inferred from a requesting spouse's reason to know
- Actual knowledge of return reporting position
- Actual knowledge of an erroneous item of income
- Actual knowledge of a deduction that is an erroneous item
- Disqualified asset presumption
- Disqualified asset presumption inapplicable

The disqualified asset presumption applies to a transfer of property to the innocent spouse by the other joint filer to avoid taxation or payment of tax. Then the portion of the deficiency for which the innocent spouse is liable is increased by the value of such property. The disqualified assets assumption is inapplicable to transfers pursuant to a divorce decree.

In addition to the regulations, case law provides guidance in this area. In Butler v. Commissioner, 114 T.C. No. 19 (2000), the Tax Court made note of the fact that a taxpayer has reason to know of an understatement if a reasonably prudent taxpayer could be expected to know of the understatement or that further investigation was warranted. The Court used some of the criteria listed in the regulations to arrive at its decision. Other factors considered by the courts in this area include participation in the business, lavish and unusual expenditures, and reluctance of the husband to disclose information about the couple's income.

To have actual knowledge, the taxpayer must have actual knowledge of both the amount and the item in dispute. See Martin v. Commissioner, T.C. Memo. 2000-346 and Charlton v. Commissioner, 114 T.C. 333 (2000). The courts have also held that a taxpayer could have actual knowledge even if they are not aware of the tax treatment. The nature of the transaction must be known. See Braden v. Commissioner, T.C. Memo. 2001-69 and Cheshire v. Commissioner, 115 T.C. 183 (2000).

If a spouse had knowledge of a portion of the understatement, she may receive relief for the portion she knew nothing about.

c. Inequitable to Hold Spouse Liable. In determining if would be inequitable to hold the spouse liable, a facts and circumstance test is applied. One significant factor is whether or not the spouse received any benefit, either direct or indirect.

2. Relief Available to Divorced, Legally Separated, or Estranged Spouses §6015(c). Section 6015(c) provides relief for spouses that are divorced, legally separated or have been living apart for a minimum of 12 months. The election may be made at any time after the Internal Revenue Service indicates that there may be a deficiency, but within two years of the collection activity.

If one spouse makes the separate liability election under §6015(c), the other spouse should also elect. Unless the other spouse qualifies for relief under §6015(b) or (f), they would be liable for the entire deficiency, including any amount allocated to the electing spouse.

The deficiency is allocated to the innocent spouse based on a ratio of the net items giving rise to the deficiency allocable to the innocent spouse had a separate return been filed bears to the total deficiency.

For example, Jane and Robert, who are divorce, filed a joint return in a prior year. Upon audit, a deficiency of $10,000 resulted from disallowed deductions. Jane is unaware of the nature of these deductions. If Jane and Robert had filed separate returns, 15% of the disallowed deductions would been allocated to Jane. Jane would be allocated $1,500 of the deficiency if she makes an election under §6015(c).

The proportionate allocation rule will not apply in the following situations:

- The requesting spouse had actual knowledge
- The deficiency is attributable to a separate treatment item of the individual i.e. self-employment tax
- A deficiency relating to a child's liability
- A deficiency attributable to alternative minimum tax
- A deficiency relating to fraud or accuracy related penalties

Proposed Regulation 1.6015-3 (d) (5) contains examples of the allocation method for the following:

- Allocation of erroneous items
- Proportionate allocation
- Proportionate allocation with joint erroneous items
- Separate treatment items
- Allocation of the alternative minimum tax
- Innocent spouse receives benefit of the join return from the nonrequesting spouse's erroneous item
- Calculation of innocent spouse's benefit on the joint return when the nonrequesting spouse's erroneous item is partially disallowed.

3. Equitable Relief §6015(f). If the innocent spouse does not qualify for relief under either §6015(b) or §6015(c) discussed above, the Internal Revenue Service has discretion to grant equitable relief.

To qualify for relief under §6015(f) the following conditions must be meet:

- A joint return was filed
- They fail to qualify under §6015(b) or §6015(c)
- There is an unpaid liability at the time of request
- Assets were not transferred between the spouses in a fraudulent scheme
- The innocent spouse did not file the joint return with fraudulent intent
- There was not a transfer of disqualified assets.
- The request is made within two years from the start of the collection procedure

When considering the request under this provision all the facts and circumstances are considered. Revenue Procedure 2000-15, 2000-5 I.R.B. 447

provides guidance for requesting relief under equitable relief.
Some of the factors weighing in favor for determining whether to grant equitable relief are:

A Marital status
A Economic hardship
A Abuse
A No knowledge or reason to know
A Nonrequesting spouse's legal obligation
A The item is solely attributable to the nonrequesting spouse

Some of the factors weighing against relief are:

A The unpaid liability is attributable to the requesting spouse
A The requestor had knowledge or reason to know
A The requester received significant benefit
A Lack of economic hardship
A Noncompliance with federal income tax laws
A The legal obligation of the requestor

Examples of significant benefit include transfers of property, even years after the year the omitted income should have been included in income. Another is where a spouse receives more than he or she otherwise would as part of a divorce. Also considered, as a benefit would be an erroneous deduction reducing the innocent spouse's taxable income more than the other joint filer.

4. Conclusion. The Internal Revenue Code provides three methods for receiving relief under the innocent spouse rules. One method is available to married couples, one for taxpayers that are divorced or separated, and finally, if either of the first two methods are not granted, equitable relief. If an individual fails to qualify under the first two methods, the Internal Revenue Service will consider equitable relief and a separate request is not required.

If innocent spouse relief is not granted, there may be an alternative. If it can be proved that the return was signed under duress, the return is not considered to be a joint return. A spouse that signs under duress is relieved of the joint and several liability. After filing the Form 8857, expect the taxpayer to be contacted by an IRS agent asking the taxpayer to respond to the questions in Appendix B.

IX. Appendices.

Form **8857** **OMB No. 1545-1596**
(Rev. October 1999)
Department of the Treasury
Internal Revenue Service

APPENDIX A

Request for Innocent Spouse Relief
(And Separation of Liability and Equitable Relief)

>Do not file with your tax return. > See instructions.

Your name **Your Social Security Number**

Your current address Apt. No.

City, town or post office, state, and ZIP code. If a foreign address, see instructions Daytime phone no. (optional)

Do not file this form if all or part of your overpayment was (or is expected to be) applied against your spouse's past-due debt (such as child support). Instead, file **Form 8379,** Injured Spouse Claim and Allocation, to have your share of the overpayment refunded to you.

TIP

>> The IRS can help you with your request. If you are working with an IRS employee, you can ask that employee, or you can call 1-800-829-1040.

Part I

1 Enter the year(s) for which you are requesting relief from liability of tax……

2 Information about the person to whom you were married as of the end of the year(s) on line 1.

Name Social Security Number

Current home address (number and street). If a P.O. box, see instructions. Apt. no.

City, town or post office, state, and ZIP code. If a foreign address, see instructions. Daytime phone no. (if known)

See **Spousal Notification** On page 3.

3 Do you have an **Understatement of Tax** (that is, the IRS has determined there is a difference between the tax shown on your return and the tax that should have been shown)?
[ ] **Yes.** Go to Part II. [ ] **No.** Go to Part IV.

Part II

4 Are you divorced from the person listed on line 2 (or has that person died)?
[ ] **Yes.** Go to line 7. [ ] **No.** Go to line 5.

5 Are you legally separated from the person listed on line 2?
[ ] **Yes.** Go to line 7. [ ] **No.** Go to line 6

6 Have you lived apart from the person listed on line 2 at all times during the 12-month period prior to filing this form?
[ ] **Yes.** Go to line 7. [ ] **No.** Go to Part III.

7 If line **4, 5** or **6** is **Yes**, you may request **Separation of Liability by attaching a statement** (see page 3).
Check here [ ] and go to Part III below.

Part III

8 Is the understatement of tax due to the **Erroneous Items** of your spouse (see page 4)?
[ ] **Yes.** You may request **Innocent Spouse Relief** by **attaching a statement (see page** 4). Go to Part IV below.
[ ] No. You may request **Equitable Relief** for the understatement of tax. Check **Yes** in Part IV below.

Part IV

9 Do you have an Underpayment of Tax (that is, tax that is properly shown on your return but not paid) or another tax liability that qualifies for Equitable Relief (see page 4)?
[ ] **Yes.** You may request Equitable Relief by attaching a statement (see page 4).
[ ] No. You cannot file this form unless line 3 is Yes.

Under penalties of perjury, I declare that I have examined this form and any accompanying schedules and statements, and to the best of my knowledge and belief, they are true, correct, and complete. Declaration of preparer (other than taxpayer) is based on all information of which preparer has any knowledge.

Internal Revenue Service website – www.irs.gov/forms_pubs/index.html

For Privacy Act and Paperwork Reduction Act Notice, see page 4. Form 8857 (Rev. 10-99)

General Instructions

Purpose of Form

Use Form 8857 to request relief from liability for tax, plus related penalties and interest, for which you believe only your spouse (or former spouse) should be held liable. Generally, you must have filed a joint return for the year(s) for which you are requesting relief (but see **Community Property Laws** on page 3). The IRS will evaluate your request and tell you if you qualify.

You may be allowed one or more of these three types of relief (see pages 3 and 4):

- Separation of liability,
- Innocent spouse relief, or
- Equitable relief.

Statement To Attach

You must attach a statement to Form 8857 explaining why you qualify for relief. Complete the statement using the best information you have available. Include your name and social security number (SSN) on the statement.

If you are requesting relief for more than 1 tax year, you only need to file one Form 8857. However, you must include a separate statement for each year. Clearly indicate in the statements) the type(s) of relief you are requesting for each year.

See the specific instructions for each part for details on the information to be included with the statement(s). The IRS will ask you for additional information if needed, or you may provide additional information at any time.

Additional Information

See **Pub.** 971, Innocent Spouse Relief, for more details. You can get Pub. 971 by calling 1-800-TAX-FORM (1-800-829-3676).

When To File

Generally, you should file Form 8857 as soon as you become aware of a tax liability for which you believe only your spouse (or former spouse) should be held liable. The following are some of the ways you may become aware of such a liability.

- The IRS has examined your tax return.
- The IRS sends you a notice.

You generally must file Form 8857 no later than 2 years after the first IRS attempt to collect the tax from you. However, you may file it any time up to 2 years after the first IRS attempt to collect the tax from you that occurs after July 22, 1998. An example of an attempt to collect the tax from you is garnishment of your wages.

Note: *The time that the IRS will be allowed to collect taxes, interest, and penalties will be extended while your request for relief is being considered.*

STF FED904911

Where To File

Do not file Form 8857 with your tax return or fax it to the IRS. Instead, see below.

IF. . .	THEN file Form 8857 with . . .
You are meeting with an IRS employee for an examination, examination appeal, or collection	That IRS employee.
You received an IRS notice of deficiency, and the 90-day period has not expired*	The IRS employee named in the notice. Attach a copy of the notice. **Do not** file Form 8857 with the Tax Court.
Neither specified situation above applies to you	**Internal Revenue Service Center Cincinnati, OH 45999-0857**

'Before the end of the 90-day period, you should file a petition with the Tax Court, as explained in the notice. By doing so, you *preserve* your rights if the IRS is unable to properly consider your request before the end of the 90-day period. Include the information that supports your position, including when and why you filed Form 8857 with the IRS, in your petition to the Tax Court. The time for filing with the Tax Court is **not** extended while the IRS is considering your request

Definitions

Understatement of Tax

An understatement of tax, or deficiency, is generally the difference between the total amount of tax that the IRS determines should have been shown on the return, and the amount that actually was shown on the return.

Example. You and your spouse filed a joint return showing $5,000 of tax, which was fully paid. The IRS later examines the return and finds $10,000 of income that your spouse earned but did not report. With the additional income, the total tax becomes $6,500. The understatement of tax is $1.500, for which you and your spouse are both liable.

Underpayment of Tax

An underpayment is tax that is properly shown on your return but has not been paid.

Example. You and your former spouse filed a joint return that properly reflects your income and deductions but showed an unpaid balance due of $5,000. The underpayment of tax is $5,000. You gave your former spouse $2,500 and he or she promised to pay the full $5,000, but did not. There is still an underpayment of tax of $5,000, for which you and your spouse are both liable.

Note: *If you have both an underpayment and understatement of tax, you may have to request different types of relief. You may only request equitable relief for the underpayment of tax. Complete Parts II and III on page 1 to see which type of relief you can request for the understatement of tax.*

Joint and Several Liability

Generally, joint and several liability applies to all joint returns. This means that both you and your spouse (or former spouse) are liable for any underpayment of tax plus any understatement of tax that may become due later. This is true even if a divorce decree states that your former spouse will be responsible for any amounts due on previously filed joint returns.

Community Property Laws Generally, you must follow community property laws when filing a tax return if you are married and live in a community property state. Community property states are: Arizona, California, Idaho, Louisiana, Nevada, New Mexico, Texas, Washington, and Wisconsin. Generally, community property laws provide that you and your spouse are both entitled to one-half of your total community income and expenses. If you and your spouse filed separate returns, each of you must report one-half of your total community income and expenses on your separate returns. See Pub. 555, Community Property, for details.

If you and your spouse filed a joint return in a community property state, you are both jointly and severally liable for the total liability on the return. If you request relief from joint and several liability, state community property laws are not taken into account in determining whether an item belongs to you or your spouse (or former spouse). **Note:** *if you* were *married and filed a separate return in a community property state and are now liable for an underpayment or understatement of tax, you may request equitable relief if you believe it is unfair for you to be held liable for the unpaid tax.*

Tax Court Review of Request

You may petition (ask) the Tax Court to review your request for innocent spouse relief or separation of liability (but not equitable relief) if:

- The IRS sends you a determination notice denying, in whole or in part, your request for relief, or
- You do not receive a determination notice from the IRS within 6 months from the date you filed Form 8857.

You may petition the Tax Court to review your case no later than the end of the 90-day period that begins on the date the IRS mails you a determination notice. See Pub. 971 for details on petitioning the Tax Court to review your request.

Specific Instructions

Foreign address. Enter the information in the following order city. province or state, and country. Follow the country's practice for entering the postal code. **Do not** abbreviate the country name.

Part I

Line 2

Enter the current name and SSN of the person to whom you were married at the end of the year(s) listed on line 1. If the name of the person shown on that year's tax return(s) is different from the current name, enter it in parentheses after the current name. For example, enter "Jane Maple (formerly Jane Oak).* Also enter the current address and phone number *if you* know it.

P.O. box. Enter the box number instead of the street address **only** if you do not know the street address.

Spousal Notification

The IRS will inform the person listed on line 2 of your request for relief, and allow the person listed on line 2 to participate in the determination of the amount of relief from liability. The IRS will not inform the person listed on line 2 of your current address. If your name has changed, the IRS will not inform the person listed on line 2 of your new name.

Part II — Separation of Liability You may request separation of liability for any underpayment of tax shown on the joint retum(s) you filed with the person listed on line 2 if you and that person:

- Are no longer married, or
- Are legally separated, or
- Have lived apart at all times during the 12-month period prior to the date you file Form 8857.

See **Pub. 504,** Divorced or Separated Individuals, for details on divorce and separation.

Separation of liability applies only to amounts owed that are not paid. It cannot give you a refund of amounts already paid.

Requesting Separation of Liability You must attach a statement to Form 8857. Show the total amount of the understatement of tax. For each item that resulted in an understatement of tax, explain whether the item is attributable to you, the person listed on line 2, or both of you. For example, unreported income earned by the person listed on line 2, plus any related self-employment tax, would be allocated to that person. See Pub. 971 for more details. Exception. If, at the time you signed the joint return, you knew about any item that resulted in part or all of the understatement, then your request will not apply to that part of the understatement.

Part III — Innocent Spouse Relief

You may be allowed innocent spouse relief only If **all** of the following apply.

• You filed ajoint return for the year(s) entered on line 1.
• There is an understatement of tax on the return(s) that is due to erroneous items (defined below) of the person listed on line 2.
• You can show that when you signed the retum(s) you did not know and had no reason to know that the understatement of tax existed (or the extent to which the understatement existed).
• Taking into account all the facts and circumstances, 'it would be unfair to hold you liable for the understatement of tax.

Erroneous Items

Any income, deduction, credit, or basis is an erroneous item if it is omitted from or incorrectly reported on the joint return.

Partial Innocent Spouse Relief

if you knew about any of the erroneous items, but not the full extent of the item(s), you may be allowed relief for the part of the understatement you did not know about. Explain in the statement you attach to Form 8857 how much you knew and why you did not know, and had no reason to know, the full extent of the item(s).

Requesting Innocent Spouse Relief

You must attach a statement to Form 8857 explaining why you believe you qualify. The statement will vary depending on your circumstances, but should include **all** of the following.

• The amount of the understatement of tax for which you are liable and are seeking relief.
• The amount and a detailed description of each erroneous item, including why you had no reason to know about the item or the extent to which you knew about the item.
• Why you believe it would be unfair to hold you liable for the understatement of tax.

For relief of liability of amounts paid as of July 22, 1998, check the "Yes" box on line 8 and attach the statement as described above. See Pub. 971 for details.

Part IV — Equitable Relief

You may be allowed equitable relief if, taking into account all the facts and circumstances, the IRS determines you should not be held liable for any understatement or underpayment of tax. Equitable relief generally applies only to:

You should request separation of liability or innocent spouse relief for any understatement of tax if you are eligible. The IRS will consider equitable relief for any understatement of tax if it determines that innocent spouse relief and separation of liability do not apply.

Equitable relief is generally available only for liabilities that are unpaid. However, you may be able to receive a refund of:

• Amounts paid after July 22, 1998, and before April 16, 1999, and
• Certain installment payments made after you file Form 8857.

For additional information on equitable relief, see Pub. 971 and Notice 98-61, 1998-51 I.R.B. 13.

Requesting Equitable Relief

You must attach an explanation of why you believe it would be unfair to hold **you** liable for the tax instead of the person listed on line 2. if you are attaching a statement for separation of liability or innocent spouse relief, only include any additional information you believe supports your request for equitable relief.

Privacy Act and Paperwork Reduction Act Notice, We ask for the information on this form to carry out the Internal Revenue laws of the United States. We need it to determine the amount of liability, if any, of which you may be relieved, internal Revenue Code section 6015 allows relief from liability. If you request relief of liability, you must give us the information requested on this form. Code section 6109 requires you to provide your social security number. Routine uses of this information include giving 'it to the Department of Justice for civil and criminal litigation, and to cities, states, and the District of Columbia for use in administering their tax laws. If you do not provide all the information in a timely manner, we may not be able to process your request.

You are not required to provide the information requested on a form that is subject to the Paperwork Reduction Act unless the form displays a valid 0MB control number. Books or records relating to a form or its instructions must be retained as long as their contents may become material in the administration of any internal Revenue law. Generally, tax returns and return information are confidential, as required by Code section 6103.

The time needed to complete and file this form will vary depending on individual circumstances. The estimated average time is: **Learning about the law or the form,** 17 min., **Preparing the form,** 22 min.; and **Copying, assembling, and sending the form to the IRS,** 20 min.

APPENDIX B

Innocent Spouse Questionnaire for Electing Spouse

1. Provide copies of the tax returns and Forms W-2 or 1099 for all applicable years. In addition, please provide copies of any audit reports or reports of adjustments made to the original returns, if applicable. If there were adjustments made to the tax on the original returns, what were the reasons? Did you and your spouse agree to the adjustments? Did you sign the agreement form?

2. What was your involvement in the preparation of the income tax returns? What was your spouse's involvement? Did you assist, compile, sort or provide any information to the return preparer? Who prepared the returns?

3. If you are requesting relief from tax reported on an original return, were you aware of the liability reported on the return and did you think the tax was or would be paid at the time of filing. Provide, in a sworn statement under penalties of perjury, a detailed explanation of why you thought the tax was or would be paid.

4. If the tax was not paid at the time of filing, please describe the plan you and your spouse had for paying this tax?

5. Did you review/discuss the completed returns with your spouse and/or the return preparer? If so, did you question any items or amounts on the returns? What answers did you receive? Did you agree with those answers?

6. During the years involved, did you and your spouse have joint bank accounts, separate accounts, and/or both? Please list all accounts at all financial institutions, indicate if business or personal, who had signature authority, and type of account (checking, savings, etc.).

7. In which account did each of you deposit your income, including wages, business receipts, and other income? Who made deposits? Do you still have the bank account statements or copies, including deposit slips and cancelled checks?

8. Who took care of the household finances? What arrangement did you and your spouse have regarding money and payment of household bills?

9. Did you and your spouse rent or own your home during the tax years in question? What were the monthly payments? Please list any other significant loan payments or purchases, and the amounts, in the tax years in question.

10. Please provide details of you and your spouse's living and working arrangements during the years in question. Where and when did each of you live and work, including all periods of separation and unemployment (include dates).

11. What was your spouse's line of business during the years involved? What was his/her source of income? Self-employed or a wage earner? If you assisted your spouse in this business, how were you involved?

12. What is your education level? What business-related courses have you studied? What was your profession during the years in question and what is it currently?

13. Are you currently divorced, legally separated, widowed, or not living together with your spouse? Please provide a copy of your divorce decree, if applicable. If you are not divorced, provide records that verify the date of your separation (i.e., copies of your legal separation, new lease agreement, etc.). If you are not legally separated, provide the date that you and your spouse ceased living together, along with support documentation. If you spouse is deceased, provide a copy of the death certificate and a copy of the Last Will and Testament.

14. Have any enforceable agreements been entered into providing that one spouse will pay the liability. Provide copies.

15. With the exception of having your refunds held and applied to the liability, have you made any other payments to the liability? If so, provide copies of the cancelled checks or proof of the payments. What collection actions have been taken against you?

16. Please provide information regarding what hardship (financial or personal loss) you would incur if required to pay the liability. Provide detailed responses.

17. Please provide a current address and telephone number of your spouse, if different from yours.

18. Provide a telephone number where you can be reached during the day.

19. Provide any other information that you feel should be considered. Include detailed explanations and any supporting documentary evidence available.