A GUIDE TO
TAX ISSUES IN DIVORCE

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I. Introduction

A divorce case can present tax issues in a number of areas including, but not limited to awards of alimony, equitable distributions or property divisions, the allocation of dependency exemptions, the deductibility of attorney's fees and innocent spouse issues. This paper is intended to cover these issues by providing the relevant authority for each area with citations to the Internal Revenue Code of 1986, as amended; Revenue Rulings; case law and other authorities. It will also include some practice pointers to consider when these issues present themselves to you in one of your cases. As a divorce practitioner, remember, no two cases are alike. Therefore, use care not to use form language in your divorce agreements. But, a basic understanding of the issues and the law will help you navigate the tax land mines that exist in divorce litigation.

First, we examine alimony. Specifically, what is considered alimony? Does it include only payments made directly from one former spouse to another? Will the payments of debt for a former spouse be considered alimony? Is alimony taxable income to the recipient and a tax deduction to the payor spouse? Finally, we examine whether it is possible to avoid tax on alimony payments.

In many cases, avoiding alimony can be easily accomplished with a larger equitable distribution award to the other spouse, or can it? We examine whether the transfer of property in

a divorce case is a taxable event. And, perhaps most importantly, we examine how best to make an award of equitable distribution fair for both spouses by examining various types of assets.

In addition to alimony and equitable distribution issues, one of the hot button issues is the allocation of the dependency exemption between the custodial parent and noncustodial parent. How can you protect your client, the noncustodial parent, in the allocation of the exemption when negotiating the divorce settlement?

Often times, in the initial consultation with a new client, or at some point during the case, you will be asked, "Are my attorney's fees deductible?" The answer may surprise both you and your client.

Finally, we review the rules for innocent spouse relief. Your client, who didn't know anything about her Husband's business, may be surprised by what she hears.

II. Alimony

Before the tax consequence of an alimony award can be examined, there must be an understanding of what is alimony. The Internal Revenue Code[1] has numerous provisions that address the inclusion of alimony in gross income to the recipient spouse as well as the deductibility of alimony to the Payer spouse.

A. Is Alimony Taxable Income to the Recipient Spouse and Deductible by the Payor Spouse?

The analysis starts at section 61(a)(8) which specifically includes alimony and separate maintenance payments as income. However, the definition of alimony and separate maintenance payments is contained in section 71.

[1] All citations to the "Code" are made to the Internal Revenue Code of 1986, as amended.

Section 71, provides, in pertinent part, as follows:

(a) General Rule – Gross income includes amounts received as alimony or separate payments.
(b) Alimony or separate maintenance payments defined.- For purposes of this section-
  (1) In general. – The term "alimony or separate maintenance payment" means any payment in cash if-
    (A) Such payment is received by (or on behalf of) a spouse under a divorce or separation instrument,
    (B) The divorce or separation instrument does not designate such payment as a payment which is not includible in gross income under this section and not allowable as a deduction under section 215,
    (C) In the case of an individual legally separated from his spouse under a decree of divorce or of separate maintenance, the payee spouse and the payor spouse are not members of the same household at the time the payment is made, and
    (D) There is no liability to make any such payment for any period after the death of the payee spouse and there is no liability to make any payment (in cash or property) as a substitute for such payment after the death of the payee spouse.
(2) Divorce or separation instrument. – the term "divorce or separation instrument" means-
    (A) A decree of divorce or separate maintenance or a written instrument incident to such decree,
    (B) A written separation agreement, or
    (C) A decree (not described in subparagraph A) requiring a spouse to make payments for the support or maintenance of the other spouse.

While section 61 (a)(8) includes alimony in gross income and section 71 defines alimony, section 215 provides a payor spouse with a deduction for alimony payments. Specifically, section 215 provides, in pertinent part as follows:

(a) General Rule. - In the case of an individual, there shall be allowed as a deduction an amount equal to the alimony or separate maintenance payments paid during such individual's taxable year.
(b) Alimony or separate payments defined. – For purposes of this section, the term "alimony or separate maintenance payment" means any alimony or separate maintenance payment (as defined in section 71(b)) which is includible in the gross income of the recipient under section 71.

B. Review of Case Law

While the Code is clear in defining the terms “Alimony and Separate Maintenance payments” and when those payments are deductible by the payor spouse, care must be taken in drafting divorce settlement agreements to ensure that the intent of the parties is clear in the document. If not, alimony payments may be considered part of a property settlement, or vice versa, and have unintended tax consequences.

In Gammill v. Commissioner, former Husband and Wife both appealed a Tax Court determination that payments made by Husband to Wife were part of a property settlement agreement and not alimony.[2] In Gammill, the parties reached an agreement that Husband would pay Wife $417,000, or approximately 50% of the marital estate. This agreement was then incorporated into the parties divorce decree. The decree also contained language that “provided for the payment by [Husband] of $250,000 to Wife. [Wife] was granted judgment in the amount of $250,000 to be payable at [Husband’s] option without interest in equal monthly installments of $1,041.47 for a period of 240 months with the right of prepayment.”[3] Another provision in the decree indicated that should Husband die the entire amount would be due and owing. The entire amount would also become due if Husband was more than 30 days past due on any payment.[4] On his tax returns, Husband took the position that the payments were alimony and took a deduction for the amounts paid.[5] The Service took the position these payments were in the nature of a property settlement and disallowed the deductions.[6] The Tax Court disallowed the

[2] Gammill v. Commissioner, 710 F.2d 607 (10th Cir. 1982).
[3] Id. at 608.
[4] Id. at 609.
[5] Id. at 608.
[6] Id.

deductions and Husband appealed.[7] In examining the issue, the Tenth Circuit set forth a five part test, aside from the parties' intent, to determine the nature of the payments:

(1) Is there a fixed sum,
(2) The payments are not related to the obligor's income,
(3) The payments are to continue regardless of the obligee's death or remarriage,
(4) The obligee gave consideration for the payments, and
(5) The obligor has put up security to insure payment.

If these five factors are present, the payment is to be regarded as part of a property settlement agreement.[8] Using these five factors, the Court determined that the payments in Gammill were not alimony but rather part of a property settlement agreement and disallowed the deductions.

For divorce practitioners, the Gammill test supplements the requirements of section 71 and sets forth a road map that should be followed to avoid unintended alimony tax consequence. As a result of Gammill, it is not sufficient for an agreement to simply state that the payments are intended to be alimony by the parties. The requirements of section 71, and the five part test in Gammill, must be examined and satisfied.

In White v. Commissioner, the Seventh Circuit was asked to address a similar issue.[9] In White, Husband and Wife entered into an agreement that was subsequently incorporated into the parties' divorce decree. The agreement provided, at paragraph 5, that Husband would pay Wife "alimony in gross" as follows: (a) $180,000 in 72 monthly installments of $2,500 each, not defeasible by the death or remarriage of either party; and (b) $2,250 per month until [Wife's] death, [Wife's] remarriage, or the making of 240 of such payments. The agreement further provided, at paragraph 6 that "all payments made to Wife under paragraph 5 would be includible

[7] Wife also appealed the Tax Court on another issue arising from the Agreement.
[8] Id. at 610.
[9] White v. Commissioner, 770 F.2nd 685 (7th Circuit, 1985).

in [Wife's] gross income and deducted from [Husband's] gross income to the full extent permissible under such law or laws."[10]

For the tax years in question, Husband deducted the entire amount set forth in paragraph 5 of $4,750 per month. However, Wife included in her gross income only those payments set forth in paragraph 5(b). The Commissioner issued notices of deficiency to both parties.[11] The Tax Court ruled in favor of Husband against Wife, determining that the payments set forth in paragraph 5 should be viewed as a "single stream" of support.[12]

The Seventh Circuit reversed. The Court examined section 71, and in particular, section 71 (c)(1), which at that time, provided, "…installment payments discharging part of an obligation the principal sum of which is, either in terms of money or property, specified in the decree, instrument, or agreement shall not be treated as periodic payments."[13] The Seventh Circuit also specifically rejected the Tax Court's "single stream" of payment theory and held,

> We therefore reject the analysis of the Tax Court and hold that each of the two distinct types of payments in paragraph 5 of the memorandum agreement must be treated separately when considering its proper characterization under section 71. When viewed in this light, it is clear that the payments under subparagraph 5(a) an unconditional installment payments, not includable in Wife's taxable income and not deductible by Husband.[14]

In Preston v. Commission, [15] the taxpayer argued that payments made under a court order were alimony payments rather than child support payments and that he was therefore entitled to a

[10] Id. at 687.
[11] Id.
[12] Id.
[13] Section 71 (c)(1) has since been amended to delete this language.
[14] Id. at 689.
[15] Preston v. Commissioner, 209 F.3rd 1281 (11th Circuit, 2000).

deduction for said payments.[16] The trial court in Georgia entered a final Order which required Husband to pay, among other things, his son's private school tuition for one year and his daughter's car insurance premiums until her eighteenth birthday as well as $600 per month in child support.[17] On appeal, the Eleventh Circuit held that Husband's payments fell under section 71 (c) related to the payment of child support. As a result, Husband was not entitled to a deduction for the expenses paid.[18]

Alimony payments are not limited to direct payments from one spouse to another. As set forth in section 71(b)(1)(A), payments made on behalf of one spouse by the other can be classified as alimony and included as income under section 71 to the recipient spouse and deductible under section 215 to the payor spouse. In Maher v. Commissioner,[19] the Tax Court permitted a husband to claim as an alimony deduction for those amounts paid for wife's homeowners insurance; mortgage payments and real estate taxes; health insurance premiums and automobile insurance premiums.[20]

As the cases demonstrate, divorce agreements must be artfully drafted to meet the client's true intent and avoid unnecessary tax implications. Therefore, if you are asked to draft an agreement which contains a term of alimony, you must carefully review section 71 and case law to insure that you meet the criteria for alimony. Be sure to specify that alimony is paid as a result of a separation and impending divorce. Be sure to specify that the amount to be paid is "alimony" to the recipient and therefore included in the recipient spouse's income and that the payments will be tax deductible to the payor spouse. Make it clear to your client that only

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[16] Id. at 1282.

[17] Id. at 1284.

[18] Id. at 1284-1285. The Eleventh Circuit did remand the case to the Tax Court to reconsider those expenses that the government conceded was deductible but which were disallowed by the Tax Court.

[19] Maher v. Commissioner, 85 T.C.M. (CCH) 1053, T.C.M. (RIA) 2003-085 (2003).

[20] Id.

payments made after the parties physically separate will be considered alimony. The agreement must be also clear that alimony will terminate upon the death of the recipient spouse[21].

The advice you give your client will obviously depend on whether you represent the payor spouse or the recipient spouse and the home state of the parties. For example, if you represent the payor spouse, in addition to the benefits of tax deductible payments, some states, including Pennsylvania[22], may count the alimony payment as income to the recipient spouse for purposes of calculating child support. Therefore, the payor spouse will not only benefit from the tax deductibility but also from a decreased child support payment.

For example, assume that your client and his spouse presently reside in Pennsylvania. The parties' have two minor children who will reside with their Mother. Your client's income is $250,000 per year. His spouse's income is $50,000. The projected alimony award is $2,477 per month for 60 months and the projected child support award is $2,207 per month for a total of $4,684 per month. Your client is reluctant to agree to the alimony amount. However, you explain that the $29,688 yearly alimony amount will be deducted from his gross income and will be added to his spouse's gross income.[23] Therefore, the adjusted child support amount will now be $1,955. Accordingly, your client will not only benefit from a tax deduction of $29,688 for alimony paid but will also reduce his child support obligation by $252.00 per month.

Conversely, if you represent the recipient spouse in the above example, it is incumbent upon you to explain that an alimony award is not always the best result. As demonstrated above, not only is the alimony award taxable income but it could also reduce her child support award. There are two possible solutions to avoid this problem, or at least minimize it. First, if there are

[21] I.R.C. §71.
[22] Pa.R.C.P. 1910.01, *et seq*.
[23] Pa.R.C.P. 1910.16-2(a)(7).

sufficient assets, the recipient spouse could request a larger percentage of the marital assets (ie. 60% rather than 50%) in exchange for an alimony award. Not only will this transfer of assets be tax free at the exchange[24] but it will eliminate the possibility of a lower child support award. Second, if there are insufficient assets to avoid an alimony award, the agreement could be drafted so as to exclude the alimony deduction to the payor spouse for the purposes of a child support calculation thereby eliminating the problem of a reduced child support order. If the payor spouse will not agree to that proposal, an alternative could be to provide the payor spouse with the deduction for the alimony paid but specifically exclude the award from the recipient's income for purposes of calculating child support. In this scenario, the child support will still be decreased to $2,037 per month rather than the $1,955 if it were included in the recipient's income. This is a savings of $85 per month.

As a drafter of the divorce settlement agreement, use care not to link a reduction of the alimony amount to be paid to the children's birthdays or high school graduations. This type of language could be confused with a child support award and the deduction could be disallowed.[25]

Finally, in drafting agreements, be careful not to front load alimony payments or you may have to deal with section 71(f). This will cause unintended and unexpected tax consequences. Section 71 (f) provides for the recomputation where alimony is front loaded and states:

> (1) In general. – If there are excess alimony payments—
>
> (A) The payor spouse shall include the amount of such excess payments in gross income for the payor spouse's taxable year beginning in the 3rd post-separation year, and

[24] I.R.C. §1041.

[25] I.R.C. §71(c)(1) provides, as follows: "Subsection (a) shall not apply to that part of any payment which the terms of the divorce or separation instrument fix (in terms of an amount of money or part of the payment) as sum which is payable for the support of the children of the payor spouse."

(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.

Section 71 (f) also sets forth specific formulas to assist in calculating the excess amount to be recaptured.[26] For an example of how section 71(f) is applied, assume the following facts:

Year #1 Alimony Paid	$80,000
Year #2 Alimony Paid	$40,000
Year #3 Alimony Paid	$10,000

Year 2 Excess Calculation: $40,000 – ($10,000 + $15,000) = $15,000

Year 1 Excess Calculation: $80,000 –[($25,000 + $10,000) /2 + $15,000 = $47,500

Total Alimony Recapture = $62,500

Therefore, in drafting your agreements avoid large variations in the amount of alimony in the first three years of the alimony schedule or section 71(f) will apply and cause the payor spouse to incur unexpected tax liabilities.

III. Property Division in Divorce Cases

At some point in representing a divorce client, you will be asked if there are tax consequences in the division of marital property. Your initial response may be "No." And, at least initially, this is the correct answer. But the explanation cannot end there, as there is more to the story.

Section 1041 addresses "Transfers of property between spouses or incident to divorce." It provides, in pertinent part, as follows:

[26] The second year excess calculation: 2nd year payments – (3rd year payments + $15,000) = excess for second year. The first year excess calculation: 1st year payments – [(2nd year payments – 2nd year excess+ 3rd year payments)/2 + $15,000] = excess for first year.

(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 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 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.

While it may be true that the transfer of property incident to divorce is a tax free transaction, your client must be prepared for the tax implications that will occur once the property is ultimately disposed of. We now examine some types of assets normally distributed in a divorce case.

A. Types of Assets

A divorce practitioner must be aware of the basis, and holding period, of the assets that will be distributed as they may and will have separate tax consequences and should not be distributed in the same manner. In many cases, you will be dealing with real property; investment accounts; savings bonds and pension accounts. In higher asset cases, you may also have to deal with business entities. These can and should be handled very carefully to effectuate an equitable division of assets.

Let's assume that a client walks in to your office and discloses the following assets:

Type of Asset	**Fair Market Value**	**Adjusted Basis**
Primary Residence	$500,000	$200,000
Investment Account	$1,500,000	$500,000
Savings Bonds	$50,000	$5,000

Bank Accounts	$50,000	$50,000

The client advises that he and Wife have agreed on an equal division of marital assets with each party receiving $1,050,000 worth of assets. The client and his Wife have decided that Wife will receive the Marital Residence valued at $500,000 and the savings bonds of $50,000. Your client will retain the bank accounts valued at $50,000 as well as the investment accounts but will transfer $500,000 to equalize the division of assets. He would like you to prepare the agreement. On preliminary review of the plan, you agree that it appears as though this is, in fact, an equal distribution. However, there are tax issues that must be factored into the distribution which the client clearly has not considered and which will make this a disproportionate distribution.

1. <u>Savings Bonds</u>

Rev. Rul. 1987-112 examines the distribution of savings bonds incident to divorce. Specifically, it addresses the relationship between section 61 (a) related to gross income; section 454 related to obligations issued at a discount; and Section 1041. Rev. Rul. 1987-112 states, "[A]lthough section 1041(a) of the Code shields from recognition gain that would ordinarily be recognized on a sale or exchange of property, it does not shield from recognition income that is ordinarily recognized upon the assignment of that income to another taxpayer. Because the income at issue here is accrued but unrecognized interest, rather than gain, section 1041(a) does not shield that income from recognition."[27] Therefore, in our example, if the client has not included as income the deferred interest earned on the savings bonds for each year that he held the bonds, this unrecognized gain will be considered income for which the client will have to pay

[27] Rev.Rul. 1987-112, 1987—2 C.B. 207.

tax, at the time of transfer, notwithstanding section 1041. Therefore, when distributing savings bonds incident to a divorce, you must be cognizant of unrecognized interest.

2. Investment Account

The transfer of $500,000 from the investment account from the client to Wife would be shielded from immediate gain recognition pursuant to section 1041. However, assume that you represent Wife in this example. It is imperative that you inquire of your client what she intends to do with the $500,000 investment account transfer. If, for example, her goal is to use the money to purchase a vacation home, she must be aware that upon liquidation of the investment funds she will have either long term or short term capital gains tax depending on the character of the investment account.[28] This could be a rather significant tax liability. In this case, as Wife received 1/3 of the account in the divorce and therefore she would have a basis in the investment account of $166,667 or one-third of the original basis. This would result in a net gain of $333,333 or a tax liability of $116,666.65, using a 35% tax rate.

3. Marital Residence

The transfer of the marital residence from the client and Wife to Wife will not subject the Wife to any gain recognition pursuant to section 1041. However, as with the investment account, there may be tax implications that will arise when the marital residence is disposed of.[29] Section 121 excludes from gross income gain on the sale or exchange of property if the homeowner used and occupied the property for two of the five years prior to the sale or exchange. However, the limitation, for a single tax payer is $250,000. Therefore, depending on how Wife uses the property, there may be tax consequences, intended or not.

[28] I.R.C. §§1001 (a); 1221; and, 1223.
[29] I.R.C. §121 related to the exclusion of gain from the sale of a principal residence.

4. Pension Plans

The division of pension plans in a divorce case can be especially difficult. Failure to properly divide the pension plan can result in serious unintended tax consequences. There are essentially two types of pension plans: defined contribution plans[30] and defined benefit plans[31]. In order to divide either type of plan and avoid adverse tax consequences, the use of a "Qualified Domestic Relations Order" or a "Domestic Relations Order" is required.[32]

Qualified Domestic Relations Orders and Domestic Relations Order must include specific facts including: the name, address of both the participant and the alternate payee; the amount or percentage of the participant's benefits that have been assigned to alternate payee; the manner in which the payments are to be made; and to which plan the order applies. The Order must also be clear that it will not alter the type of benefit available or increase the benefits available.[33]

As a divorce practitioner, serious thought should be made into whether you should consult with an expert in the area of pensions given the specific requirements of Qualified Domestic Relations Orders and Domestic Relations Order. Failure to properly prepare the Order will result in either or both parties owing tax immediately rather than the deferral of the tax liability until disbursement of the pension plan at retirement.

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[30] I.R.C. §414 (i) defines a defined contribution plan as follows: "…a plan which provides for an individual account for each participant and for benefits based solely on the amount contributed to the participant's account, and any income, expenses, gains and losses, and any forfeitures of accounts of other participants which may be allocated to such participant's account.

[31] I.R.C. §414(j) defines a defined benefit plan as follows: "….means any plan which is not a defined contribution plan."

[32] I.R.C. 414 (p)(1)(A) defines a 'qualified domestic relations order" as "…a domestic relations order (i) which creates or recognizes the existence of an alternate payee's right to, or assigns to an alternate payee the right , receive all or a portion of the benefits assigned to the participant under a plan…." The term "domestic relations order" means, "any judgment, decree, or order (including approval of a property settlement agreement) which (i) relates to the provisions of child support, alimony payments, or marital property rights to a spouse, former spouse, child or other dependent of a participant, and (ii) is made pursuant to a State domestic relations law (including a community property law."

[33] I.R.C. 414(p)(2)-(3).

B. Tax Planning in the Division of Assets.

As demonstrated in the above examples, careful thought should be placed into how and which assets should be divided. Using the assets set forth above, a more equitable division of assets could have been accomplished and still meet the client's goals of an equal division of assets. For example, prior to the division of assets, a calculation of the tax consequences on the investment account and the savings bonds should be made. This will provide more accurate values when dividing the assets and therefore result in a more equitable distribution. Of course, as a divorce practitioner you must balance the costs involved in calculating the tax implications of the various proposed transfers as well as the time necessary to do complete the calculations with the goals of the client to effectuate a quick resolution of the matter. It is incumbent on you, the divorce practitioner, to allow the client to make an informed decision with all the information available.

IV. Dependency Deduction.

A common question that is presented in a divorce case, when children are involved, is how dependency exemptions handled is. Section 151 provides for an allowance of deductions for personal exemptions including dependents.[34] Section 152(e) provides special rules for divorced parents, in pertinent part, as follows:

> (1) In general – Notwithstanding subsection (c)(1)(b), (c)(4), or (d)(1)(C), if –
> (A) A child receives over one-half the child's support during the calendar year from the child's parents –
> (i) Who are divorced or legally separated under a decree of divorce or separate maintenance,

[34] I.R.C. 151 (c) provides, "An exemption of the exemption amount for each individual who is a dependent (as defined in section 152) of the taxpayer for the taxable year."

(ii) Who are separated under a written separation agreement, or
(iii) Who live apart at all times during the last 6 months of the calendar year and

(B) Such child is in the custody or 1 or both of the child's parents for more than one-half the calendar year, such child shall be treated as being the qualifying child or qualifying relative of the noncustodial parent for a calendar year, if the requirements of paragraph (2) or (3) are met.

Subparagraph (2) relates to a custodial parent signing a written declaration stating that the custodial parent will not claim the child for the taxable year. Subparagraph (3) contains an exception for pre-1985 instruments.

In order to eliminate any confusion over the exercise of the dependency exemption, care should be taken to address the issue directly in the divorce settlement agreement. The divorce practitioner should insert language into the divorce agreement that requires the custodial parent to execute the requisite forms established by the Secretary. In fact, it may be wise to include the language in the form established by the Secretary directly in the divorce agreement if there is a belief that the custodial parent might refuse to execute the requisite form in the future. In that case, the taxpayer can attach the relevant pages of the divorce agreement in the hope that it will be accepted.[35]

The election of the dependency exemption was addressed by the Tax Court in McCullar v. Commissioner.[36] In McCullar, Mother had primary custody of the minor child pursuant to the custody order. However, both parents claimed that dependency deduction for the child in 1998. Father based his argument, for claiming the deduction, on a log he maintained showing that the minor child was in his custody more than 50% of the time. The Service determined he was not

[35] Reg. §1.152-4(e)(1)(ii) and (e)(5).
[36] McCullar v. Commissioner, 86 T.C. M. (CCH) 384, 2003 T.C.M. (RIA) 2003-272.

entitled to the deduction.[37] In examining the issue, the Tax Court cited Section 1.152-4(b), which provided, at that time, "[i]n the event of so called 'split' custody, or if neither the decree or agreement establishes who has custody…'custody' will be deemed to be with the parent who, as between both parents, has the physical custody of the child for the greater portion of the calendar year."[38]

In Konrad v. Commissioner,[39] taxpayer and his former Wife had four minor children. The Court awarded Mother custody of the four children with visitation rights to taxpayer. However, the parties' agreement provided that in the event Wife secured full-time employment, taxpayer and his Wife would split the deductions with each party taking two exemptions.[40] In accordance with the parties' agreement and after Wife admitted to working two to three days per week, taxpayer took two dependency exemptions.[41] In filing his tax return, taxpayer failed to attach Form 8332[42] or any other document to his return that complied with the requirement of Form 8332. During the litigation, taxpayer did produce the transcript from the court proceeding which sets forth the parties' agreement. The Service took the position that taxpayer was not entitled to the dependency exemption that was not specifically designated in the parties agreement.[43] The Tax Court first examined section 152 and noted that taxpayer had not substantiated that the minor child at issue was his dependent or qualifying relative. The Tax Court then went on to examine section 152(e) (1) and the essential elements set forth therein. In disallowing the dependency exemption, the Tax Court held, "[o]ne of the essential elements for conforming to

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[37] Id.
[38] Id. However, both §152 and Reg. 1.152-4 were changed in 2008 to the current version set forth above.
[39] Konrad v. Commissioner, 100 T.C.M. (CCH) 131, 2010 T.C.M. (RIA) 2010-179.
[40] Id.
[41] Although the parties' agreement provided for the taxpayer to take two dependency exemptions, the taxpayer claimed one of the children which was specifically designated as his dependent and another who was specifically designated as Wife's dependent. The remaining two children were not claimed by either party.
[42] Form 8332 is entitled, "Release of Claim to Exemption for Child of Divorced or Separated Parents."
[43] Konrad, 100 T.C.M. (CCH) at 132, 2010 T.C.M. (RIA) 2010-179 at 180.

the form and substance of Form 8332 is the custodial parent's signature on the release of the dependency exemption to the noncustodial parent….The stipulation and the judgment [taxpayer] submitted do not conform to the form and substance of Form 8332. Taxpayer failed to procure [Wife's] signature on either the stipulation or the judgment."[44]

As a divorce practitioner, it is imperative that you ensure that the agreements you prepare clearly set forth not only which children your client is entitled to claim the dependency deduction for, but also which year or years your client is entitled to do so. As noted above, the language in your agreement should mirror Form 8332. Ensure that the agreement your client may reach with their former spouse is in writing and signed by both parties. Finally, advise your client to only claim deductions for the children they are entitled to claim the deduction for under the terms of the agreement. If you follow these simple steps, your client will avoid the issues faced by the taxpayer in Konrad.

V. Deductibility of Counsel Fees

Costs and fees paid in connection with a divorce, separation or child support are generally not deducible by either spouse.[45] This general principal is based on sections 262[46] and 267[47] unless expressly permitted in another section.

Section 212 provides a possible exception to the general rule set forth in sections 262 and 267. Specifically, section 212, provides as follows:

> In the case of an individual, there shall be allowed as a deduction all the ordinary and necessary expenses incurred during the taxable year-

[44] Id. at 134, 2010 T.C.M. (RIA) 2010-179 at 182.

[45] Reg. §1.262-1 (b)(7). *See also*, Martin J. McMahon, Jr., Tax Aspects of Divorce and Separation, 32 Family Law Quarterly 221, 256 (Spring, 1998).

[46] I.R.C. 262 disallows the deduction for personal, living and family expenses.

[47] I.R.C. 267 which disallows losses between related taxpayers.

(1) For the production or collection of income;
(2) For the management, conservation, or maintenance of property held for the production of income; or
(3) In connection with the determination, collection, or refund of any tax.

The question then becomes, does section 212 allow a divorce litigant to deduct attorney's fees paid in connection with the divorce, alimony and child support settlements?

In United States v. Gilmore, the Supreme Court addressed the issue of deductibility of expenses incurred in a divorce matter.[48] In Gilmore, Husband took the position that attorney's fees incurred in defeating Wife's claims of community property to his various businesses were deductible for federal income tax purposes.[49] The Court ultimately set forth the following test:

> …We resolve the conflict among the lower courts on the question before us in favor of the view that the origin and character of the claim with respect to which an expense was incurred, rather than its potential consequences upon the fortunes of the taxpayer, is the controlling basic test of whether the expenses was 'business' or 'personal' and hence whether its deductible or not…[50]

The Supreme Court ultimately determined that the expenses were not deductible to Husband.[51] This general rule on nondeductibility extends to all legal expenses incurred by either spouse in connection with a divorce matter with several exceptions.[52]

Reg. 1.262-1(b) (7) specifically addresses an exception to the Gilmore rule regarding the deductibility of attorney's fees in divorce matters, as follows:

> Generally, attorney's fees and other costs paid in connection with a divorce, separation, or decree of support are not deductible by either husband or wife. However, the part of an attorney's fee and

[48] United States v. Gilmore, 372 U.S. 39 (1963). The Supreme Court granted certiorari as a result of a conflict of views among "the Court of Claims, the Courts of Appeals and the Tax Court…." Id. at 40-41.
[49] Id. at 41.
[50] Id. at 49.
[51] Id. at 52.
[52] McMahon, *supra*, at 257.

> the part of the other costs paid in connection with a divorce, legal separation, written separation agreement, or decree for support which are attributable to the production or collection of amounts includible in gross income under section 71 are deductible by the wife under section 212.

The deductibility of attorney's fees related to an award of alimony was addressed by the Tax Court in Wild v. Commissioner.[53] In Wild, Wife deducted $6,000 in attorney's fees she incurred in connection with an award of alimony. She attached to her return an invoice she received from her attorney which itemized the fees incurred between divorce, custody and property settlement from those incurred in the pursuit of alimony.[54] The Service disallowed the deduction on the basis that Wife failed to establish that "expenses were ordinary and necessary and closely related to the production of income…." The Service relied on the Supreme Court's holding in Gilmore in disallowing the deduction.[55] The Tax Court rejected the Service's argument as the parties stipulated to the facts of the case which established that the fees deducted were related to the award of alimony.[56] The Tax Court went on the distinguish Wild from Gilmore as follows:

> In the Gilmore case the applicable statute was section 23(a)(2) of the Internal Revenue Code 1939 which was substantially similar to the same effect as section 212(2). In those cases it was held that the expenses of husbands in connection with resisting money demands of their wives in divorce actions could not be deducted under section 212(2) as expenses paid for the management, conservation or maintenance of property held for the production of income. In the instant case the deduction is claimed under section 212(1), which expressly provides for the deduction of expenses 'paid or incurred***for the production or collection of income.' Here the expenses were paid 'for the production or collection' of alimony which was reported, when paid to the petitioner, as her

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[53] Wild v. Commissioner, 72 T.C. 706 (1964).
[54] Id. at 707.
[55] Id. at 707.
[56] Id. at 709.

> taxable income in conformity with the provisions of the Internal Revenue Code.[57]

A second possible exception to the general rule of nondeductibility was seen in Glassman v. Commissioner.[58] In a memorandum decision, the Tax Court addressed the issue of the deductibility of attorney's fees incurred in the pursuit of income pursuant to a Qualified Domestic Relations Order which awarded Wife a portion of Husband's pension incident to divorce. The Tax Court used the same principles that permit a taxpayer to deduct attorney's fees incurred in pursuing a claim of alimony to allow Mrs. Glassman to deduct fees incurred in pursuing income from the Qualified Domestic Relations Order.[59]

Once a determination is made that attorney's fees are deductible the inquiry does not end. The next step is determining whether a taxpayer will actually receive any benefit from the deduction.

Deductions under section 212 are miscellaneous itemized deductions. Therefore, if a taxpayer does not itemize deductions under section 63(e), no benefit will be received. "Furthermore, even if the taxpayer does itemize deductions, pursuant to section 67, the otherwise deductible legal fees actually are deductible only to the extent that when aggregated with other miscellaneous itemized deductions they exceed two percent of the taxpayer's adjusted gross income."[60]

VI. Innocent Spouse Relief

[57] Id. at 710.
[58] Glassman v. Commissioner, 74 T.C.M.(CCH) 1106, 1997 T.C.M. (RIA) 97,497.
[59] Id.
[60] McMahon, *supra*, at 258.

Married couples typically file joint tax returns because they can typically reduce their tax liability as opposed to filing separate returns.[61] Generally, if a Husband and Wife file a joint return for a taxable year, they are jointly and severally liable for all tax, penalties and interest due.[62] However, section 6015 provides relief from the general rule.[63] "In practice, the overwhelming number of innocent spouse cases involve situations in which after a divorce the IRS seeks to collect taxes on a former husband's income from his former wife."[64]

A basic premise for innocent spouse relief is that a joint return must have been filed. In order to have jointly filed return, both spouses must have an intent to file a joint return.[65] If a spouse can establish that they signed the return under duress, then the intent requirement has not been satisfied and no joint return has been filed.[66] Therefore, in this example, no innocent spouse relief is available as a joint return has not been filed.

Section 6015 sets forth a series of tests which must be satisfied in order for innocent spouse relief to be afforded. There are three types of innocent spouse relief which are available. Section 6015(b) provides relief to taxpayers who are still married and who have an understatement of income tax. [67] Section 6015(c) provides relief to taxpayers who are no longer married or those that are separated and who have an understatement of tax. [68] Section §6015(f) provides equitable relief for taxpayers who do not meet the requirements of (b) or (c) and who

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[61] I.R.C. §1.
[62] I.R.C. §6013(d)(3).
[63] Typically referred to as "Innocent Spouse Relief."
[64] McMahon, *supra*, p. 261.
[65] I.R.C. §6013(a).
[66] Brown v. Commissioner, 51 T.C. 116 (1968).
[67] I.R.C. §6015(b)(1)(B).
[68] I.R.C. §6015(c)(3)(A)(i)(I).

can meet the criteria established by the Secretary. Subsection (f) is available for both understatements and underpayments.[69]

In order to qualify for relief under section 6015, a taxpayer must meet four universal requirements. First, a joint return must have been filed[70]. Second, the amount due must concern income tax.[71] Third, there must have been a timely election for innocent spouse relief.[72] Finally, the claim must not be barred under the doctrine of res judicata or final administrative determination.[73]

A. §6015(b) Relief

After the universal requirements have been satisfied, each type of relief has additional factors that must be satisfied to obtain relief. In order to obtain relief under subsection (b), a taxpayer must meet the following additional requirements. One, there must be an understatement of tax attributable to an erroneous item of the non-requesting spouse. [74] Second, the requesting spouse did not know of the erroneous item and had no reason to know, of the erroneous items existence.[75] Third, taking into account all of the facts and circumstances, it is inequitable to hold the requesting spouse liable.[76] An understatement of tax is defined as the "excess of the amount of the tax required to be shown on the return for the taxable year over, the amount of tax imposed

[69] I.R.C. §6015(f).
[70] I.R.C. §6015(a)(1).
[71] Id.
[72]§6015 (b)(1)(E); §6015 (c)(3)(B) and Reg. §1.6015-5(b)(3). *See also*, Lantz v. Commission, 607 F.3d 479 (7th Cir. 2010)(7th circuit reversed the Tax Court which held that since section 6015(f) had no specific deadline to file for relief there was no deadline for a request for relief under section 6015 (f)). *But see*, Simcox v. Commissioner, T.C. Summ. Op. 2010-101, 2010 WL 2942055, which declined to follow the Lantz decision.
[73] Reg. §1.6015-1(e).
[74] I.R.C. §6015(b)(1)(B).
[75] I.R.C. §6015(b)(1)(C).
[76] I.R.C. §6015(b)(1)(D).

which is shown on the return, reduced by any rebate…"[77] If a taxpayer can meet the criteria for relief under §6015(b), then the innocent spouse "shall be relieved of the liability for tax (including interest, penalties, and other amounts) for such taxable year to the extent such liability is attributable to such understatements."[78]

Regarding the requirement of knowledge, courts have required that the requesting spouse prove they had no knowledge of the erroneous item and that they had reason to know. In reviewing a requesting spouse's argument of lack of knowledge, courts have applied a reasonably prudent person standard.[79] Some of the factors that the courts will use to examine a requesting taxpayer's lack of knowledge argument are: lifestyle; unusual or lavish expenditures; participation in the business activity causing the erroneous item; the level of inquiry by the requesting spouse into the nonrequesting spouse's activities; and, the requesting spouse's level of education.[80]

B. §6015(c) Relief

The additional requirements for relief under subsection (c) are as follows. One, the spouse requesting relief is no longer married or is legally separated from, or no longer lives with, the individual with whom the joint return was filed.[81] Two, the requesting spouse did not have

[77] I.R.C. §6662(d)(2).
[78] I.R.C. §6015(b)(1).
[79] Guth v. Commissioner, 897 F.2d 441 (9th Cir. 1990)
[80] *See*, Vesco v. Commissioner, 39 T.C.M. (CCH) 144, T.C.M. (P-H) 79,379 (1979)(wife of extravagant spender benefited from his practice of using company plane for personal travel and charging personal expenses to company account); Turner v. Commissioner, 55 T.C.M. (CCH) 1425, T.C.M. (P-H) 88,379 (1988)(innocent spouse relief denied to husband with respect to wife's embezzlement income where family purchases beyond normal support exceeded legitimate income); Krause v. Commissioner, 100 T.C.M. (CCH) 524 (2010), T.C.M. 2010-270 (wife's claim of lack of knowledge not reasonable in light of family's financial circumstances); and, Barnes v. Commissioner, 2004 T.C.M. (RIA) 266 (2004)(Both spouse involved in the partnership giving rise to the erroneous deduction.)
[81] I.R.C. §6015(c)(3)(A)(i)(I) and (II).

actual knowledge of the erroneous item.[82] The burden of proof to establish actual knowledge is on the Service rather than on the taxpayer as set forth under subsection (b). The Service must prove that at the time the return was signed, the requesting spouse had actual knowledge of an erroneous item giving rise to the deficiency.[83] Third, there must not have been a fraudulent transfer of assets to avoid tax.[84] The relief provided to the innocent spouse is:

> The portion of any deficiency on a joint return allocated to an individual shall be the amount which bears the same ratio to such a deficiency as the net items taken into account in computing the deficiency and allocable to the individual under paragraph (3) bears to the net amount of all items taken into account in computing the deficiency.[85]

If relief is not available under either subsections (b) or (c), a taxpayer may attempt to obtain relief under subsection (f). Subsection (f) is an equitable provision that will apply if fairness dictates that the request spouse should obtain relief.

C. §6015(f) Relief

The Conference Committee Report with regard to section 6015(f) states:

> The conferees intend that the Secretary will consider using the grant of authority to provide equitable relief in appropriate situations to avoid the inequitable treatment of spouses in such situations. For example, the conferees intend that equitable relief be available to a spouse that does not know, and had no reason to know, that funds intended for the payment of tax were instead taken by the other spouse for such other spouse's benefit.
>
> The conferees do not intend to limit the use of the Secretary's authority to provide equitable relief to situations where tax is shown on a return but not paid. The conferees intend that such

[82] I.R.C. §6015(c)(3)(C).
[83] I.R.C. §6015(c)(3)(C).
[84] I.R.C. §6015(c)(3)(A)(ii).
[85] I.R.C. §6015(d)(1).

> authority be used where, taking into account all facts and circumstances, it is inequitable to hold an individual liable for all or part of any unpaid tax or deficiency arising from a joint return. The conferees intend that relief be available where there are both and understatement and an underpayment of tax.[86]

There is a comprehensive list of factors to examine under Rev. Proc. 2003-61. In addition to the factors already discussed above, some additional factors are as follows:

1. Economic hardship to the requesting spouse.
2. Nonrequesting spouse's legal obligation under the terms of a Divorce Settlement Agreement.
3. The requesting spouse's compliance with tax law including in prior years tax liability.
4. Physical abuse inflicted upon the requesting spouse by the nonrequesting spouse
5. The mental and physical age of the requesting spouse.[87]

As a divorce practitioner, a careful review of prior year tax returns is essential in confronting innocent spouse issues. By reviewing tax returns and incomes at the inception of the case, a determination can be made as to whether a client should file a joint return with their spouse or whether a separate return should be filed to avoid potential tax issues. In reviewing the tax returns, in the context of child support or alimony issues, if a potential tax issue comes to light, a client may still be able to file an amended return to correct any potential problems.

Equally important, in preparing for a potential innocent spouse filing, is a careful examination of the lifestyle of the parties; the benefits received by the requesting spouse from the erroneous items; the educational background of the requesting party and the participation in the activity which gave rise to the erroneous item. This examination is critical in determining

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[86] H.R. Conf. Rep. No. 599, 105th Cong., 2d Sess. 254-255 (1998), 1998 C.B. 1008-09.
[87] Rev. Proc. 2003-61, 2003-2 C.B. 296.

whether the requesting spouse knew or should have known of the erroneous item. Simply put, be prepared to make the best argument possible for innocent spouse relief, if necessary.

VII. Conclusion

As we have seen, simply because you may be a divorce practitioner does not mean that you can ignore tax issues. As a divorce attorney, you must be keenly aware of the pitfalls of the tax world and how it will affect your client moving forward both in the short term and the long term. A failure to recognize the tax implications of a given course of conduct or a failure to properly draft a divorce settlement agreement can have profound effects on both the client and you as the practitioner. Be mindful of the areas of concern and carefully research both the tax code and other authority to ensure that your client has received the best advice possible and can make an education decision on how to proceed with the issues that arise.