Divorce and Taxes: Fifty Years of Changes

by
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I. The Advent of Income Tax

Until the Sixteenth Amendment was ratified, the U.S. Constitution provided that direct taxes could only be apportioned among the states in proportion to the census. This mandate proved to be difficult if not impossible to implement in practice. Attempts to avoid the apportionment conundrum by imposing taxes labeled "indirect" failed to pass constitutional muster on a number of occasions, the Court holding that such levyies were thinly disguised direct taxes. At the same time, the government found itself in serious need of funds. Congress ultimately determined that a Constitutional amendment was the only remedy.

The Sixteenth Amendment to the U.S. Constitution granted Congress the right to tax income and was ratified in 1913. The Amendment was a response to an earlier decision of the U.S. Supreme Court declaring the federal income tax law of 1894 unconstitutional.[1] The new law provided for a graduated income tax without apportionment among the states. It survived various constitutional challenges and taxes on income soon became the government's major source of income.

Tax law has been a major source of controversy throughout the years and efforts to reform the law and resolve problems that have developed along the way have resulted in a complex statutory scheme generating much commentary, legislative activity, and litigation, keeping lawyers busy. Federal tax law as it affects transactions incident to divorce and separation has entailed ma-

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[1] Pollock v. Farmers' Loan & Trust Co., 157 U.S. 429 (1895).

jor changes over the years, and has evolved into an important aspect of matrimonial practice.[2]

II. Filing Status

Joint tax returns, enabling married couples to pool their income and deductions, were first included in the tax laws in 1918. Most married persons file joint tax returns because it saves them money to do so. The *quid pro quo* for the lower taxes resulting from a joint filing is joint and several liability on the return. The government benefits because the joint filing renders the parties jointly and severally liable for the taxes, and jointly owned property subject to lien for collection of delinquent taxes. Joint tax returns are therefore favored, and parties are permitted to amend separately filed tax returns to joint returns within three years of the due date of the original returns.[3] Conversely, filing an amended separate return after a previously filed joint return is not permissible after the time for filing the original return has expired.[4] The rationale for joint and several liability on a joint return assumes that both spouses benefit from lower taxes and that it is therefore fair for the burden to be shared regardless of the source of the income or the fact that one spouse may be less informed about the contents of the return.[5]

The marital status of the parties at the end of the tax year determines their federal tax filing status options. Parties who are divorced at any time during the calendar year, including December 31, are "single" for purposes of filing their taxes even though they may have been married for essentially the entire year.[6] The timing of the actual divorce is therefore an important consideration in terms of potential tax savings. Parties who are married may file jointly no matter how long they have been separated.

Although same-sex couples are legally entitled to marry in a growing number of states, these marriages are not recognized under federal law pursuant to the Defense of Marriage Act that

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2 See Joseph N. DuCanto, *"Conversion of Property to "Alimony": Working with the Original Issue Discount Rules and DuCanto Alimony Discount Charts*, 10 J. Am. Acad. Matrim. Law. 15 (1993).

3 26 U.S.C. § 6013; Treas. Reg. 1.6013-2.

4 26 U.S.C. § 6013; Treas. Reg. 1.6013-1.

5 Sonnenborn v. Comm'r, 57 T.C. 373 (1971).

6 26 U.S.C. § 7703(a).

defines marriage as a union between one man and one woman.[7] Federal benefits, including application of the tax laws, are available only to spouses in marriages consistent with the traditional model.[8] The Act further provides that states are not required to recognize same-sex marriages contracted elsewhere.[9] Consequently, legally married same-sex couples are not entitled to file joint tax returns.[10] Other federal tax benefits, including alimony treatment of post-dissolution payments from one spouse to the other are also unavailable to same-sex couples.

A person who is "legally separated" pursuant to a decree of divorce or separate maintenance qualifies for the "single" filing status.[11] The key factor in determining a party's eligibility to file as a single tax payer is the legal change of status. Written separation agreements and support orders therefore do not qualify as a legal separation and the parties' options are limited to filing jointly or as married filing separately.[12]

The higher tax liability of a separated individual who must file as "married filing separately" as opposed to the lower tax imposed on a similarly situated single person is referred to as the "marriage penalty."[13] The marriage penalty was gradually phased out beginning in 2005.

Each taxpayer has the right to choose his or her own filing status, but the party who withholds consent to file joint tax returns to extract some unrelated concession may be held to a joint filing by the taxing authorities even where the party has not signed the return.[14] Whether a tax return is accepted as a joint or separate filing by the Internal Revenue Service is determined by the intent of the parties in the context of the circumstances of the specific case. For example, where the parties have historically filed joint tax returns and the party withholding signature failed to file a separate return, the return filed by the spouse may be

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7 Pub. L. No. 104-199, 110 Stat. 2419 (1996), amending Titles 1 and 28 of the United States Code.

8 1 U.S.C. § 7.

9 28 U.S.C. § 1738C.

10 Melvyn B. Frumkes, *Taxation of Same-Sex Marriage and Live-Ins*, 22 J. Am. Acad. Matrim. Law. 117 (2009).

11 26 U.S.C. § 7703.

12 26 U.S.C. § 7703; Donigan v. Comm'r, 68 T.C. 632 (1977).

13 See Melvyn B. Frumkes, Frumkes on Divorce Taxation §9.4.

14 Riportolla v. Comm'r, T.C.M. (CCH) 1981-463

determined to be a joint filing. For example, in *Federbush v. Commissioner*,[15] the court found that the return was a joint filing although wife had refused to sign it. Her refusal had nothing to do with the contents of the return but was related to the parties' marital problems. The court noted that the parties had historically filed joint returns although Ms. Federbush claimed that she signed the returns under duress because of her husband's threats. The court concluded that, at the time the returns were filed, Ms. Federbush intended to file jointly with her husband and that her disavowal of the returns was an afterthought occasioned by the large deficiency assessed against the parties.

Joint returns must be intended by both parties and the fact that the parties previously filed joint returns does not, standing alone, establish intent to file jointly. In *Springmann v. Commissioner,*[16] the court held that the wife's intent to file a separate return rather than a joint return was unambiguously established by the actual filing of her married, filing separately return.

In *Anderson v. Commissioner*,[17] the court held that the wife did not intend to file a joint return but signed it only when ordered to do so by the divorce court. Ms. Anderson had no income and was not required to file a tax return. She resisted signing a joint return because she had concerns about the propriety of deductions for losses. Her concerns proved to be justified because of a subsequently imposed deficiency resulting from disallowance of the losses. The determination that Ms. Anderson did not intend to file a joint return relieved her of any liability for the deficiency.

When intent is driven by threats of abuse or duress, the factual circumstances may require a conclusion that the signing, or the refusal to sign, was not intentional within the meaning of applicable tax law. Consequently, abuse or threats amounting to duress can operate as a defense to joint liability, provided that the conduct is directly related to the signing or refusal to sign.[18]

The lowest rate of tax is imposed on parties filing their returns as "head of household." This favorable filing status is avail-

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15 34 T.C. 740 (1960), aff'd, 325 F. 2d 1 (2nd Cir. 1963)

16 T.C.M. (CCH) 1987-474.

17 T.C.M. (CCH) 1984-82.

18 Melvyn B. Frumkes, *Duress Diverts Dual Tax Liability for Joint Returns*, 19 J. Am. Acad. Matrim. Law. 1 (2004).

able to both married and singles persons who meet the specific statutory requirements of providing a home for a qualifying dependent for more than half of the taxable year. The taxpayer must have been separated for the entire year or divorced before the end of the tax year. Qualifying dependents are minor children as well as dependent adults.[19]

The joint and several liability imposed on spouses in connection with joint returns is limited to those returns and does not extend to the separate liability of one the spouses on a separate return. The fact that the parties are married does not confer joint and several liability in the absence of an actual joint filing.[20]

III. Liability

The exception to the rule of joint and several liability for joint tax returns is known as the *innocent spouse doctrine*,[21] first introduced in 1971. To qualify as an "innocent spouse" and escape liability on the tax return, spouses were required to prove not only that they did not know that items on the return were incorrectly reported but also that they did not benefit from the underpayment of tax. For example, the court relieved a wife of liability pursuant to the *innocent spouse doctrine* where there was no improvement in the parties' standard of living during the period in question. The court reasoned that in the absence of some evidence that the family income had increased the wife had no way of knowing that her husband was underpaying his taxes. Moreover, she did not benefit from the money that the husband used surreptitiously for his own purposes.[22]

In the usual case, the income in question was the family's income. Consequently, the benefit hurdle proved impossible to surmount in most instances. The conclusion of most commentators was that the protection afforded by the *innocent spouse doctrine* was illusory.[23]

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19 I.R.C. § 2 (b).

20 Maragon v. United States, 153 F. Supp. 365 (Ct. Cl. 1957).

21 26 U.S.C. § 6015.

22 Hinds v. Comm'r, T.C.M. (CCH) 1988-426, 1988 WL 92148 (1988).

23 See Richard C.E. Beck, *Looking for the Perfect Woman: The Innocent Spouse in the Tax Court*, 15 REV. TAX'N INDIVIDUALS 3 (1990); C. Ian McLachlan, *Spousal Liability and Federal Income Taxes*, 10 J. AM. ACAD. MATRIM. LAW. 65 (1993).

In 1998, Congress responded to criticism of the stringent tests imposed on petitioners by amending the statute to afford broader protection to spouses from the consequences of joint returns that understated the parties' tax liability.[24] Under the new statutory scheme, spouses could elect both separate tax liability and innocent spouse relief.[25] Parties could seek relief from joint liability by establishing both lack of knowledge of the understatement of tax on the return and that it would be inequitable under the circumstances to hold that party liable for the deficiency.[26] A party who would ordinarily be denied innocent spouse relief because she knew or should have known and had a duty to inquire may nevertheless be relieved of liability if the spouse's failure to challenge items on the return was attributable to fear of retaliation in the form of domestic violence.[27] The domestic violence exception to the knowledge requirement does not apply to a spouse who is not threatened with physical or mental abuse but simply defers to the other spouse.[28]

Property owned in tenancy by the entireties is generally protected from attachment for the debts of only one of the spouses.[29] However, federal tax liens can attach to entireties property to secure the tax liability of only one of the spouses, thereby eroding the traditional protection afforded to married couples under state law.[30]

IV. Tax Refunds

Tax refunds resulting from overpayment of income tax, either by withholding or payment of estimated taxes can involve

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24 The Internal Revenue Service Restructuring and Reform Act of 1998, Pub. L. No. 105-206, § 3201(a), 112 Stat. 734, effective July 22, 1998 (codified at I.R.C. § 6015(f) (2006)).

25 See 26 U.S.C. § 6015; Rev. Proc. 2003-61. See also IRS Form 8888, Direct Deposit of Refund to More Than One Account.

26 26 U.S.C. § 6015(b). See Robert S. Steinberg, *Three at Bats Against Joint and Several Liability: (1) Innocent Spouse (2) The Election to Limit Liability and (3) Equitable Relief; The Treasury and Courts Begin to Interpret IRC 6015After Enactment of the IRS Restructuring and Reform Act of 1998*, 17 J. Am. Acad. Matrim. Law. 403 (2001).

27 Treas. Reg. §1.6015-3(c)(2)(i).

28 Frumkes, *supra* note 18.

29 See, e.g., Matter of Hunter, 122 B.R. 349, 353 (N.D. Ind. 1990).

30 United States v. Craft, 535 U.S. 274 (2002).

substantial sums. Federal tax law often dictates a different result than the treatment afforded by state law regarding equitable distribution or dissolution of the community. Although parties to a joint federal income tax return are jointly and severally liable for taxes due, and although the refund check is drawn to the order of the parties jointly, they do not necessarily have joint ownership rights to the tax refund. It is the source of the overpayment that determines ownership of the refund.[31] An overpayment by a married couple filing a joint return is owned by each spouse separately to the extent that each contributed to the overpayment.[32] Each spouse has a separate interest in the family income as reported on a joint return and, consequently, a separate interest in any overpayment.[33] The IRS has developed a formula for determining each spouse's share of a joint tax refund, adopting the method in the Estate and Gift Tax Regulations.[34]

The formula does not apply in community property situations if the source of the overpayment was separate property rather than community income. In states in which community property is subject to the separate debts of either spouse, the government may exercise a right of offset against an amount that would otherwise be refunded to the other spouse for payment of the spouse's separate tax liability.

Overpayments can be refunded or credited to tax liability for a subsequent year, at the option of the taxpayer. One of the potential hazards of filing jointly is the possibility that one of the joint filers could appropriate a refund to which the other is actually entitled. In *United States v. MacPhail*,[35] the parties' 1997 separation agreement contained a provision requiring them to file joint tax returns for the previous year but was silent as to payment of any taxes due or entitlement to any refund. The taxes due on the joint return were almost entirely attributable to the wife's income from her family business. She accompanied the parties' request for an extension to file the return with a substantial payment from her own funds. When the return was eventu-

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31 United States v. Anthony, No. CIV 97–1772–PHX–SMM, 1999 WL 424884 (D. Ariz. Apr. 27, 1999).

32 Rev. Rul. 74-611, 1974-2, C.B. 399.

33 Id.

34 Rev. Rul. 80-7, 1980-1, C.B. 296.

35 313 F. Supp. 2d 729 (S.D. Ohio 2003).

ally prepared, it showed an overpayment of approximately $300,000. The overpayment was designated on the return as a credit against the parties' tax liability for the following year. Now divorced, the parties would be filing separate returns. The husband filed first, showing a tax liability of approximately $1,000, and claiming the credit. The IRS applied the overpayment to husband's tax liability and issued a refund to him of $299,000. When the wife later filed her tax return, claiming the $300,000 credit she thought she had coming, the IRS refused her claim, stating that the husband had already received the refund. Only after protracted negotiation did the taxing authorities acknowledge that the funds had been paid to the husband in error and granted the wife a credit on her separate return. The IRS then demanded repayment from the husband but he had already spent the money and was essentially judgment proof. The IRS then sued both parties. Ultimately, the court determined that the credit was appropriately given to the wife because she was the source of the overpayment and that the government was required to look to the husband for repayment although acknowledging that this was a futile act.

In *United States v. Anthony*,[36] the wife sought a refund of $125,000, one-half of the $250,000 in estimated tax payments made by the husband on a joint return for a prior year. Because the $250,000 in estimated tax payments was made from the husband's separate property rather than from community property, it retained its character as the husband's separate property. The tax court found that the wife never had an ownership interest in the $250,000 and she was therefore not entitled to any portion of the refund, rejecting her argument that the filing of a joint tax return converted the overpayment to community property.

Contributing income that is reported on the tax return does not alter the ownership of the refund which belongs to the person who made the overpayment and not necessarily the person who earned the income.[37]

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36 1999 WL 424884.

37 26 U.S.C. § 402. See also Gens v. United States, 615 F.2d 1335 (3d Cir. 1980), on remand, 673 F.2d 366 (Ct. Cl. 1982).

V. Alimony and Child Support

Alimony began receiving special treatment in the Revenue Act of 1942.[38] Previously, alimony was neither deductible to the payor nor taxable income to the payee.[39] The amendment of the tax law was intended to alleviate the hardships that often resulted from requiring payment of alimony in after-tax dollars. The constitutionality of the new tax provisions was upheld.[40]

Alimony, alimony *pendente lite*, lump-sum alimony, rehabilitative alimony, spousal support, and maintenance are terms of state law, designating particular types of payments. Whether the payments qualify for alimony treatment under federal tax law is determined by the characteristics of the payments and not the manner in which they are labeled under state law.[41]

The 1954 Internal Revenue Code included two key provisions: section 71, providing that alimony payments are includable in the taxable income of the recipient, and section 215, providing that alimony payments are deductible to the payor. These provisions remain part of current tax law, although they have been subject to significant revisions over the years.

Initially, to qualify as taxable/deductible alimony, payments had to be periodic. Installment payments of a principal sum did not qualify for periodic payment treatment unless the installments were payable for a period of more than ten years.[42] The ten-year requirement was rigidly enforced.[43] Payments over a shorter period of time than ten years could qualify for periodic payment treatment, provided that the total sum of the payments

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38 Section 210, Revenue Act of 1942, 56 Stat. 816, adding § 22(k) to 26 U.S.C.

39 Gould v. Gould, 245 U.S. 151 (1917).

40 Mahana v. United States, 88 F. Supp. 285 (Ct. Cl. 1950), cert. denied, 339 U.S. 978 (1950).

41 26 U.S.C. § 71; Hess v. Comm'r, 60 T.C. 685, 1973 WL 2534 (1973), aff'd without published opinion, 511 F.2d 1393 (3d Cir. 1975); Beard v. Comm'r, 77 T.C. 1275, 1981 WL 11310 (1981); Schottenstein v. Comm'r, 75 T.C. 451, 1980 WL 4585 (1980).

42 26 U.S.C. § 71(c).

43 See Blake v. Consolidated Freightways, 823 F.2d 553 (11th Cir. 1987), affirming the Tax Court, T.C.M. 1986-103, which held that payments payable over a period that was only one day short of ten years were not entitled to alimony treatment under section 71(c)(2) of the Code.

was rendered uncertain by a contingency such as the death of either party or the remarriage of the payee.[44]

The payments must have been made in discharge of a family or support obligation as opposed to a payment for transfer of property or a property settlement.[45] It was necessary that the payments confer an economic benefit on the payee although they need not necessarily have been made in cash, or directly to the beneficiary.[46]

Prior to 1984, payments could be qualified as alimony only by meeting specific tests. The parties were required to file separate returns and must have been actually separated, although a divorce was not required.[47] It was necessary for the payments to be "periodic," and the total of these payments had to be an uncertain sum as opposed to a specific lump sum payment or an ascertainable total.[48] The payments must have been made pursuant to a decree, court order or written agreement.[49] In the case of an agreement, the requirement was that it be signed by both parties. Informal agreements for payment of support or temporary alimony that were confirmed by an exchange of letters between lawyers did not qualify, nor did oral agreements between the parties.[50] The requirement of a writing has remained unchanged despite subsequent amendments to the Code.[51]

The Domestic Relations Tax Reform Act of 1984 (DRTRA)[52] and the Tax Reform Act of 1986 (TRA)[53] amended the

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44 Treas. Reg. § 1.71-1(d)(3)(i); Dorn v. Comm'r, 46 T.C.M. 1545, T.C.M. 1983-605 (1983).

45 Treas. Reg. § 1.71-1(b)(4); 1.71-1(c)(4); Gable v. Comm'r, U.S.T.C. 31622-81 (Aug. 14, 1985); Gammill v. Comm'r, 710 F.2d 607 (10th Cir. 1982); Lewis v. Comm'r, T.C.M. 1983-770; Goninen v. Comm'r, 47 T.C.M. 737, T.C.M. 1983-679 (1983).

46 Grutman v. Comm'r, 80 T.C. 464 (1983); Stiles v. Comm'r, 43 T.C.M. 107, T.C.M. 1981-771 (1981).

47 26 U.S.C. § 71(a); Lyddan v. United States, 721 F.2d 873 (2d Cir. 1983). Contra Sydnes v. Comm'r, 577 F.2d 60 (8th Cir. 1978).

48 26 U.S.C. § 71(c); Treas.Reg. §1.71-1(d)(3)(i).

49 26 U.S.C. § 71(a)(1), (3); Watt v. Comm'r, 41 T.C.M. 251 (1980); Barrer v. Comm'r, 41 T.C.M. 1582, T.C.M. 1981-256 (1981).

50 Bishop v. Comm'r, 56 T.C.M. 15, T.C.M. 1983-240 (1983) (oral modifications to a written agreement).

51 Kennedy v. Comm'r, 60 T.C.M. 456 (1990).

52 Tax Reform Act of 1984, Pub. L. 98-369, 98 Stat. 583 (codified as amended in scattered sections of 26 U.S.C.).

Internal Revenue Code[54] and dramatically changed the tax law with respect to alimony and child support.[55] Most of the changes are beneficial to divorcing parties and provide matrimonial lawyers with previously nonexistent planning possibilities. Practitioners found that a working knowledge of the ever-changing and crucial tax provisions was a necessary part of the practice.[56] Since 1984, parties have been able to designate payments as nontaxable to the payee and non-deductible to the payor.[57] The designation by the parties is honored by the taxing authorities.

The concept of recapture, to prevent "front-loading" or the disguising of property settlements as alimony to obtain tax advantages, was introduced in 1984 in lieu of the multi-faceted and cumbersome tests utilized under prior law. Structuring payments as alimony was and is a frequently utilized device to maximize the benefits of a property settlement to both parties by providing the advantage of a deduction to the payor or transferor who would therefore be in a position to minimize the generally lesser tax burden of the recipient. To limit the use of alimony for payment of property settlements, the statute placed limits on the accelerated payment of alimony by recapturing excess payments in the earlier years and adding that excess amount back to the payor's taxable income.[58] The recapture provisions are inapplicable where the payments in year two are greater than or equal to year one minus $7500 and the payments in year three are greater than year two minus $15,000. Where the payments in only the first post separation year, the excess over $15,000 is subject to recapture. This provision affords a safe harbor for modest

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53 Tax Reform Act of 1986, Pub. L. 99-514, 100 Stat. 2085 (codified as amended in scattered sections of 26 U.S.C.).

54 The Internal Revenue Code is codified in Title 26 of the United States Code.

55 The amendments apply to instruments executed after December 31, 1984, and also to instruments executed before January 1, 1985, if these instruments are subsequently modified and the modified instruments provide that the provisions of the Act are to apply. Prior federal tax law continued to apply to pre-DRTRA transactions.

56 See Melvin B. Frumkes, *Effect of TRA 1997 and RARA 1998 on Divorce Taxation*, 16 J. AM. ACAD. MATRIM. LAW. 121 (1999).

57 26 U.S.C. § 71(b)(1)(B).

58 26 U.S.C. § 71(f).

property distributions and rehabilitative alimony.[59] The recapture rules also do not apply to temporary support or alimony payments, or to fluctuating payments that are not within the control of the payor, such as an obligation to pay a fixed percentage or percentages of income.[60] The rule is applicable only to qualifying payments made in the first three post-separation years.

Although child support payments are neither deductible to the payor nor taxable to the payee, payments that are unallocated between spousal support and child support are entitled to alimony treatment under the Internal Revenue Code.[61] Unallocated payments in the wake of the Supreme Court decision in *Commissioner v. Lester* became a popular device that often resulted in making additional funds available to the family. The payor who was able to deduct the payments invariably paid taxes at a significantly higher rate than the payee who was required to declare them. Thus, the payor would be able to afford to pay a larger amount, a portion of which would be retained by the payee rather than paid out in taxes. The *Lester* principle proved to be so popular that many states have incorporated the unallocated payment structure in their support statutes.[62]

The Tax Reform Act of 1986 (TRA) was enacted on October 22, 1986[63] and fine-tuned a number of the provisions contained in the Domestic Relations Tax Reform Act of 1984 (DRTRA),[64] particularly with respect to the stringent recapture rules.[65] TRA eliminated the prior requirement that the instrument specifically provide that the payments terminate on the death of the payee as long as the stream of payments ceased by local law, and eased the recapture provisions by reducing the term subject to recapture from six years to three years and changed the formula.

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59 Id.

60 26 U.S.C. § 71(f)(5)(C).

61 Comm'r v. Lester, 366 U.S. 299 (1961).

62 See, e.g., Pa. R. Civ. P. 1910.16-4(f)(1) (guidelines assume unallocated orders; the tax consequences have been "built into the formula").

63 Pub. L. No. 99-514.

64 Pub. L. No. 98-336.

65 See I.R.C. § 1041 (2007).

VI. Property Distribution

The 1962 decision in *United States v. Davis*,[66] created endless difficulties for matrimonial litigants and lawyers. Although there was no sale and no money changed hands, a transfer of appreciated property in exchange for marital rights was considered to be a "sale" and the transferor was therefore liable for payment of capital gains taxes. The gain was determined by the fair market value of the asset on the date of the transfer and the transferor was deemed to have received value equal to that portion of the fair market value transferred to the other spouse. The transferee was charged with neither gain nor loss because the marital rights relinquished were not appreciated property even though these rights were considered to be equal in value to the fair market value of the property received.[67] The transferee of appreciated property received a stepped-up basis in the asset equal to the fair market value of the portion transferred. Imposing a tax on the transferor of property incident to divorce was often viewed as a perverse tax consequence. The transferor who was parting with an asset like the marital residence, often reluctantly, frequently viewed the imposition of a tax in addition to the taking of an asset to be punitive. Pursuant to the Economic Recovery Tax Act of 1980, gifts between husband and wife were free of gift tax. Spouses could therefore make unlimited gifts to each other without imposition of tax. However, transfers of appreciated property between spouses incident to divorce remained taxable events in that such transactions were viewed as sales rather than gifts. Lawyers found that the tax consequences impeded settlement and generally rendered equitable settlements more difficult.

The Domestic Relations Tax Reform Act of 1984 changed the *Davis* rule so that divorce-related transfers after July 18, 1984, are treated as gifts that result in neither gain nor loss and result in no tax consequences. The transferee receives the asset at the original basis rather than a stepped-up basis and is taxed on the gain when the property is ultimately sold. The transfer is not a taxable event in that no tax is immediately imposed on the transferred property.

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66 370 U.S. 65 (1962).

67 Rev. Rul. 67-221.

Prior to 1984, transfers of appreciated property such as real estate or stock between spouses incident to a divorce were considered taxable events.[68] The transferor was subject to capital gains taxes on the gain from the original basis of the property to the fair market value as of the date of the transfer. This tax liability was imposed even though no money changed hands between the parties. The theory justifying the tax was that even if the transferor received no money, the consideration for the transfer was "money's worth" in exchange for the transfer. The transferee took the property at the new stepped-up basis, the fair market value of the property as of the date of the transfer. DRTRA dramatically changed the law with respect to transfers of appreciated property between spouses incident to a divorce by providing that the property could pass to the transferee at the original basis with no tax imposed upon the transfer.[69] Of course, the transferee was required to eventually pay the capital gains taxes or qualify for an exemption when the property was ultimately sold. The shift of the tax burden from the transferor to the transferee was temporarily rendered more onerous with the passage of the Tax Reform Act of 1986,[70] that eliminated preferential capital gains tax treatment and imposed tax on capital gains at ordinary income rates.[71] The Taxpayer Relief Act of 1997[72] eliminated taxes on capital gains of up to $250,000 realized from the sale or exchange of the taxpayer's principal residence.[73]

Deferred compensation payments from non-qualified plans and stock options transferred incident to divorce do not trigger an immediate tax consequence to the transferor. The tax liability is imposed on the transferee upon exercise of the options or receipt of the deferred compensation.[74] However, cashing out a retirement account and transferring the proceeds results in imposition of tax to the transferor. To avoid an immediate tax consequence, the transfer must be of the transferor's *interest* in the

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68 United States v. Davis, 370 U.S. 65 (1962).

69 This is known as an IRC § 1041 transaction.

70 Pub. L. No. 99-514.

71 26 U.S.C. § 1202 was repealed by section 301(a) of the Tax Reform Act of 1986.

72 Aug. 5, 1997, Pub. L. No. 105-34.

73 Taxpayer Relief Act of 1997, Pub. L. No. 105-34, § 312(b), repealing 26 U.S.C. § 1034 and amending 26 U.S.C. § 121.

74 Rev. Rul. 2002-22.

account, either by way of a rollover directly into the transferee's account or by changing the name on the account.[75]

VII. Dependency Exemptions and Credits

Prior to 1984, a parent could claim a dependency exemption for his or her child if the parent paid more than half of the child's support for the year in question. Application of this test generated disputes between parents and significant administrative problems for the IRS because parties were in frequent disagreement as to the basic costs of child support and which items should be included in the total amount. In cases where both parties claimed a dependency exemption, they were required at audit, usually years later, to produce proof of their expenditures for food, clothing, medical care, shelter and so on. These provisions were changed in 1984 to entitle the primary custodial parent to claim the exemption absent a written waiver to the other parent. The bright line presumption that the primary custodial parent is entitled to the dependency exemption is not a rebuttable presumption but the entitlement to the exemption can be waived. This was an important feature because personal exemptions were phased out for high income taxpayers, so it cost little or nothing for a payor in a high income bracket to grant the exemption to the other party to whom the exemption actually confers a benefit. The phase-out was phased out beginning in 2009.

Congress created an additional benefit to parents in 1997 in the form of the Child Tax Credit that acts to offset actual tax liability.[76] The Child Tax Credit is in addition to the dependency exemption and is available only to a parent who is entitled to claim the exemption.[77]

An additional credit, the Child and Dependent Care Credit, is available to a custodial parent who may claim the credit even if the parent waives the dependency exemption in favor of the other parent.[78]

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75 Jones v. Comm'r, T.C.M. 2000-219 (2000).

76 26 U.S.C. § 24.

77 Id.

78 26 U.S.C. § 21(b)(1)(A). See Pearline Anklesaria, *Child Related Tax Breaks for Divorced Parents*, 22 J. Am. Acad. Matrim. Law. 425 (2009).

VIII. Conclusion

From a simple concept one hundred years ago, to provide a source of revenue for the federal government by taxing income, federal tax law has steadily evolved and expanded and, despite periodic expressions of intentions to simplify the tax laws, has grown ever more complex. Changes in the tax laws over the past fifty years have generally been modifications that are responsive to the needs of divorcing couples and their children. When viewed analytically, the changes in the tax laws relating to divorce have, almost without exception, been improvements. Matrimonial lawyers have used their experiences in considering and applying the tax consequences of transactions incident to divorce into catalysts for change. The current state of the tax law as it applies in the divorce and separation context remains a work in progress, but with each change, it is better than it was.