

Divorce and Taxes In Texas

By:

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Resume

EDUCATION, CERTIFICATIONS & LICENSES:

BBA, The University of Texas at Austin, January 1968.
CPA, Texas State Board of Public Accountancy, August 1972.
ABV, AICPA Certification for Accreditation in Business Valuation, November 1998.

PROFESSIONAL EXPERIENCE:

From 1972 to present: public accounting and business valuations as a CPA. Currently providing the following services: business valuations, due diligence analysis, financial statement analysis, tax preparation, research, general accounting services, business consulting services, litigation support services, and financial planning for businesses and individuals.

SPEAKING AND WRITING CREDITS:

- ❑ Speaker: MCLE Course- *Digging and Prospecting in tax returns and public documents for assets, liabilities and cash flow.*
- ❑ Speaker: *Digging and Prospecting in tax returns and public documents for assets, liabilities and cash flow*, Brazos Valley Estate and Financial Planners, March 1999.
- ❑ Co-Chair; *How to Present, Admit, and Attack the Financial Expert's Report*; South Texas College of Law & TSCPA; November 1998
- ❑ Mock trial participant ABA Family Law course at University of Houston School of Law, May 1996.
- ❑ Speaker: *Goodwill*, Houston Chapter of CPAs-Litigation Symposium, October 1995.
- ❑ Speaker: *Comparison of CPA and ASA Valuation Services*, Houston Chapter of CPAs-Litigation Symposium, October 1994.
- ❑ Speaker: *What is Business Valuation?* Texas Society of CPAs-Litigation Services Conference, May 1993.
- ❑ Speaker: *Professional Standards in Litigation Support Engagements*, Houston Chapter of CPAs, November 1990.

MEMBERSHIPS:

- ❑ American Institute of Certified Public Accountants.
- ❑ Texas Society of Certified Public Accountants.
- ❑ Houston Chapter of Certified Public Accountants.
- ❑ Texas Society of CPAs Litigation Support Services Member Section.

TRAINING:

- ❑ Basis Mediation Training (40hours), April 23, 1995.
- ❑ Mediation for Family Disputes (24hours), February 19, 1995.
- ❑

Court Appointments:

- ❑ **Federal Bankruptcy Court:** As an examiner, chapter 11 trustee, receiver, and liquidating agent under a plan of arrangement.
- ❑ **State Civil District Court:** As receiver and auditor.
- ❑ **State Family District Court:** As receiver and valuation expert.

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I. Assumptions and Limitations:

This article concerns Texas residents filing divorce considering the Texas Family Code and the Internal Revenue Code for the following:

- Reporting income, deductions, credits and payments during a divorce and the divorce decree year and
- Property Settlement Tax Issues
- Filing Status Issues
- Dependant / Exemption Issues

This paper is written from the perspective of the CPA dealing with problems and issues of complying with the Internal Revenue Code.

This paper is not written to offer *legal advice* but to offer *tax advice* on how to handle tax compliance issues for divorcing and recently divorced taxpayers.

II. Abbreviations & Article Organization:

The following are abbreviations used throughout this article:

- Code = The Internal Revenue Code.
- RIA = Research Institute of America.
- IDC&P = Income, deductions, credits and payments.
- H&W = Husband and/or Wife.
- Form 8857 = Request for Innocent Spouse Relief.
- yyyy = year.
- TxCIRM = Texas Community Income Reporting Method.

Comments, opinions and recommendations of the author, Charlie Gerhardt, are written in Italics.

III. Acknowledgements:

I would like to acknowledge and thank the Research Institute of America ¹ for their permission to use and quote their "RIA's Tax Desk."

IV. Background:

CPAs face numerous compliance issues and/or problems after a divorce has been completed. These issues/problems include complying with Texas community property laws, the Tax Code and a complaining client.

Often the divorce decree makes little reference to tax issues and how they are to be handled other than-"Parties will comply with the IRS in filing returns and Parties should exchange information before March 1."

For 95% of divorce cases the above works just fine. This article is about the other 5%. The pitfalls, traps and those items that could cause an attorney or accountant "wasted days and sleepless nights."

V. Acrimony Issues:

In this article, I have tried to address acrimony issues, with which I frequently deal.

When appropriate, I have cross-referenced bulleted acrimony issues.

- Exchange of Information between estranged spouses.
See paragraph VII.B, which imposes a duty to notify other spouse.
- No Tax Returns Filed in Prior Years.
See paragraphs VII.B and VII.C, which imposes a duty to notify other spouse and report income.
- Current IRS Collection Issues On Unpaid Taxes.
See paragraphs VII.B and VII.C, which imposes a duty to notify other spouse and report income.
- Spouse Files Return Reporting Selected Income (disregarding the Code).
- Income of Children and Related Returns (Kiddie tax issues).
See paragraphs XI.D.5.
- IRS has audited prior returns and assesses a deficiency against spouses and former spouses.
See paragraphs VII.B and VII.C, which imposes a duty to notify other spouse and report income.
See paragraphs XIII, which concerns filing Form 8857.
- Fear that the other spouse (former spouse) may be a "tax cheat."
- Amending Returns.
Not addressed in this article.
- Which party gets the exemption?
See paragraph X.
- Should the Taxpayer file as married, single, or head of household?
See paragraph IX.
- No extension filed for spouse.
See paragraph XII.A.
- Non community property state income issues.
Not addressed in this article.

VI. Predominate Method of Reporting of Income Through Date of Divorce in Texas:

The following discusses the Code's definition of community income for tax reporting purposes and joint and several liability, which is how income is reported in Texas.

That is to say: Community income, deductions, credits and payments (IDC&P) are allocated to each spouse equally (50/50) through the date of divorce.

In Texas, this is the predominate method used to report IDC&P. Normally on a joint return. I hereinafter refer to, and call this method, the Texas Community Income Reporting Method (TxCIRM) What follows is the applicable Code and its Regulations.

A. Definition of (TxCIRM) Community Income for Tax Purposes:

Reg. § 1.879-1 definition: "Community income includes all gross income, whether derived from sources within or without the U.S., which is treated as community income of the spouses under the community property laws of the State, foreign country, or possession of the U.S. in which the recipient of the income is domiciled. Income from real property also may be community income if so treated under the laws of the jurisdiction in which the real property is located."²

The following may change the community or separate character of the income for tax purposes and is not further discussed in this article:

- Moving in or out of Texas during the divorce proceeding, or
- Income from another State which may affect the character of IDC&P, or
- Income from a Foreign country, or
- Non-resident alien spouse.

B. Definition of Joint and Several Liability:

Definition: "Generally, **joint and several liability** applies to all joint returns. This means that both H&W (or former spouses) are liable for any underpayment of tax (tax shown on a return but not paid) plus any deficiency (understatement of tax as determined by the IRS) that may become due later. This is true even if a divorce decree states that the Taxpayer's former spouse will be responsible for any amounts on previously filed joint returns."³

VII. Alternatives to the Predominate Method (TxCIRM) found in Code § 66:

Section 66 of the Code provides one *exception* to reporting community income by the predominate method and *two alternative reasons* the Secretary of the Treasury will disregard (not impose) the predominate method.

A. Only Exception to the TxCIRM:

This exception can be found in the Sec 66 (a) of the Code. This exception defines the conditions for the exception and how the community income is to be reported for tax purposes:

1. Conditions for the Exception:

If you are married at any time during the calendar year, you and your spouse may report the community income as discussed below, if you and your spouse meet all of the following conditions:

- Two individuals are married to each other at any time during a calendar year⁴, and
- Had earned income from the calendar year that is community.⁵
- One or both of the spouses have earned income from the calendar year that is community income,⁶ and did not transfer, directly or indirectly, any of the earned income (item between the parties before the end of the year.) Transfers of small amounts do not count, nor do payments or transfers to dependent children.⁷
- Lived apart all year,⁸ and did not file a joint return for a tax year beginning or ending in the calendar year. This applies to non-calendar taxpayers.⁹

2. Tax Treatment of Community Income for the Exception:

If all the above conditions are met, community income prior to the date of divorce can be treated in accordance with the rules provided by section 879(a) and more fully defined in Revenue Ruling 1.879-1, as follows:

- Earned Income is reported by person who performed the services¹⁰ including: wages, salaries, commissions, professional services, and personal services.
- Trade or Business Income (not partnership) is reported by person carrying on the trade or business.¹¹
- Partnership Income or Loss is reported by person who is the partner.¹²
- Social Security Benefits & Tier 1 Railroad Retirement Benefits are reported by person receiving the benefits.
- Other Income, including Dividends, Rents, Interest, Royalties, and Gains, are reported in accordance with Texas community property laws.¹³

This exception is useful when H&W have been living apart for a substantial time and each has their own source of earned income.

The divorce decree could reflect the above language and/or the "Parties will report income in accordance with Revenue Ruling \$1.879-1 for the calendar year(s) "yyyy."

The Parties should put a statement in their respective tax returns stating how community income was treated and that the Taxpayer has met the conditions.

B. First Reason to Disregard TxCIRM by the Secretary of Treasury:

This alternative can also be found in Sec 66 (b) of the Code. This section allows the Secretary of the Treasury to disregard the application of community property laws under certain conditions.

Code § 66(b) is as follows:

- Secretary may disregard community property laws where spouse not notified of community income.
- The Secretary may disallow the benefits of any community property law to any taxpayer with respect to any income if such taxpayer acted as if solely entitled to such income and failed to notify the taxpayer's spouse before the due date (including extensions) for filing the return for the taxable year in which the income was derived of the nature and amount of such income.

This section allows a former spouse relief from having to pay taxes or deficiency on items that were unknown. It is used in filing form 8857, which is discussed at paragraph XIII.

This section is the one that I use (thinly stretched) as a basis for allocating IDC&P in the year of the divorce, which is discussed at paragraph VIII.C.

C. Second Reason to Disregard TxCIRM by the Secretary of the Treasury:

This alternative can also be found in Sec 66(c) the Code. This section allows the Secretary of the Treasury to relieve spouse of liability in certain other cases.

Code § 66 (c) is as follows:

Spouse relieved of liability in certain other cases. Under regulations prescribed by the Secretary, if:

- An individual does not file a joint return for any taxable year, and
- such individual does not include in gross income for such taxable year an item of community income properly includable therein which, in accordance with the rules contained in section 879(a), would be treated as the income of the other spouse, and
- the individual establishes that he or she did not know of, and had no reason to know of, such item of community income, and
- taking into account all facts and circumstances, it is inequitable to include such item of community income in such individual's gross income,
- Then, for purposes of this title, such item of community income shall be included in the gross income of the other spouse (and not in the gross income of the individual).
- Under procedures prescribed by the Secretary, if, taking into account all the facts and circumstances, it is inequitable to hold the individual liable for any unpaid tax or any deficiency (or any portion of either) attributable to any item for which relief is not available under the preceding sentence, the Secretary may relieve such individual of such liability.

The use of this Code section usually arises after a joint return has been audited by the IRS and a deficiency notice is issued to both Taxpayers, who are now former spouses. If the deficiency is because of an item of which one of the former spouses had no knowledge, i.e. unreported income, then there is a reason to request "Equitable Relief" for a Taxpayer and the foundation for filing Form 8857, which is discussed later in this article (paragraph VIII.C).

VIII. Income Reporting in Year of Divorce:

The following three scenarios apply to preparation of a tax return for the year of a divorce

A. TxCIRM Through Date of Divorce, or

This was discussed previously (paragraph VI.A.).

The divorce decree is along the lines of "The Parties will prepare their respective tax returns in accordance with the Internal Revenue Code and the Parties will exchange all necessary documentation on or before March 1."

B. Exception to TxCIRM Through Date of Divorce:

This was discussed previously (paragraph VII.A.).

The divorce decree should note that the Parties meet the conditions of Sec § 66(a) and will file items in accordance with Revenue Ruling 1.879-1 and will exchange all necessary information that is allocated 50/50 including but not limited to the following: dividend statements from XYZ Corp, interest from ABC Bank, etc.

C. Alternative to Community Property Laws Disregarded a/k/a Agreed Allocation:

"Community property laws do not apply to an item of community income and the Taxpayer is responsible for reporting all of the community income if:

- H or W treats the item as if only solely entitled to the income, and
- H or W do not notify former spouse of the nature and amount of the income by the due date for filing the return (including extensions)."¹⁴

RIA's analysis of the Code and case law is: "In other words, IRS may charge the spouse with the tax on his or her entire income."¹⁵

In brief, from beginning of the year to date of divorce, the parties agree to an allocation of IDC&P, and agree to treat the IDC&P as if solely entitled to the item and agree to prepare the returns in a prescribed manner as the Judge so orders. The IRS will accept this method.

However, this method is in effect retroactively partitioning IDC&P, which is not provided for by the TEXAS FAMILY CODE.¹⁶ Therefore, the IRS could take this position, audit and refigure the return (of either former spouse) or returns (of both former spouses) filed using the TxCIRM.

Attorneys should include language in the divorce decree which provides, in the event the IRS changes the Taxpayers' original return allocations, that the parties agree to indemnify and reimburse between themselves.

IX. Filing Status Issues:

The filing status of a Taxpayer is important because it determines the Taxpayer's tax rate (tax bracket).

The following discussion does not deal with a Widow(er) Taxpayer.

A. Marriage Penalties:

Many spouses with separate incomes pay more tax married than they would pay if they were able to file as two single Taxpayers. This tends to be more of an issue in non-community property states where the income differentials can be tax advantageous.

B. Married on December 31, yyyy:

The following are the three filing statuses, which may be used:

1. Married Filing Joint:

2. Married Filing Separate:

3. Head of Household:

To file as Head of Household (HOH) all of the following must be met:

- Taxpayer has paid over ½ of home maintenance cost for the entire year which includes property taxes, mortgage interest, property & flood insurance, food (consumed on the premises), and other household expenses.
- Spouse did not live in the home for the last six months of the tax year. (Tax Court denied Head of Household status to a Taxpayer whose spouse slept a single night in her home during the last six months of the years.¹⁷)
- Principal residence for more than six months for the Taxpayer's child, even if the child is the dependent of the other spouse (non-custodial parent) under a divorce decree.

Choosing HOH in Texas could offer some tax savings if, as discussed above (paragraph VII), there was some taxable income difference between the spouses.

C. Single on December 31, yyyy:

The following are the two filing statuses, which may be used:

1. Single, or

2. Head of Household:

To file as Head of Household, all of the following must be met:

- Taxpayer has paid over ½ of home maintenance cost for the entire year which includes property taxes, mortgage interest, property & flood insurance, food (consumed on the premises), and other household expenses.
- Principal residence for more than six months for the Taxpayer's child, even if the child is the dependent of the other spouse (non-custodial parent) under a divorce decree.

Here is a tax planning opportunity. Both single ex-spouses could be entitled to HOH status if there is more than one child or children from another marriage. Attorneys could establish the principle residence of each child by custody language.

X. Exemption / Dependents Issues:

The Taxpayer can take an exemption for each person who qualifies as a dependent, subject to phase out ranges.¹⁸

Who gets the dependency exemption(s) is determined either by the divorce decree, written declaration between the spouses or ex-spouses, or the Code.

Form 8332 is Release of Claim to Exemption for Child of Divorced or Separated Parents.

The following outlines the rules:

A. Divorce Decree:

Specifies who gets the exemption.

A form 8332 still has to be completed and attached to the return of the non-custodial parent to claim the exemption.

I have seen the acrimonious custodial parent not sign and deliver the form 8332 with regard to "Release of Claims to Exemption for Current Year" until threatening letters arrived, even though the Decree designated the ex-spouse as having the exemption. Therefore, the Decree should require the other the party to sign and deliver the Form 8332 with regard to "Release of Claim to Exemption for Future Years."

B. Written Declaration:

If not specified in the Decree, then the custodial parent will have to give the non-custodial parent Form 8332, which is attached to the non-custodial parents return.

C. IRS Code:

If neither A nor B above is in place, then in general¹⁹ the Code (Sec 152(e)) says the parent who has actual physical custody of the child for the greater portion of the year gets the exemption.²⁰

Tax issue: The Taxpayer who claims the dependency exemption is allowed the child tax credits of up to \$500 for that child.

This question frequently arises after the child becomes a student at college. The student spends most of the vacation and summers at mom's house (eating her out of house and home and running the air conditioner all day) but all college tuition, room and board are paid for by dad. The decree covers the period only until the student is 18. Both parents want the exemption.

Point to consider: Maybe the Decree should have language that states as long as X child qualifies as a dependant in accordance with the IRS Code, then Y parent shall be entitled to the exemption.

XI. Tax Issues in Property Settlements:

The following are various tax-impacted issues found associated with property settlements and/or divorce decrees:

A. Gain or Loss on Transfer:

No gain or loss is recognized on a transfer of property from one party to (or in trust for the benefit of):

- The spouse,²¹ or
- The former spouse,²² but only if the transfer is incident to your divorce.²³
- Exception:
 - This rule does not apply if the spouse or former spouse is a nonresident alien.²⁴
 - Nor does it apply to certain "Transfers in Trust" where the liabilities exceed the basis.²⁵

1. Incident to divorce:

A property transfer is incident to a divorce if the transfer:

- Occurs within one year after the date the marriage ends, or
- Is related to the ending of the marriage, if both the following conditions apply:
 - The transfer is made under the original or modified divorce or separation instrument.
 - The transfer occurs within 6 years after the date the marriage ends.

RIA's analysis states the following: Unless these conditions are met, the transfer is presumed not to be related to the ending of the marriage. However, this presumption will not apply if it can be shown that the transfer was made to carry out the division of property owned by one of the party and the spouse at the time the marriage ended. For example, the presumption will not apply if it can be shown that the transfer was made more than 6 years after the end of the marriage because of business or legal factors, which prevented earlier transfer of the property.

This Code section can be used to modify divorce decree and/or property settlements when the Parties for some reason would like to change the terms, i.e. former spouse makes a big score in the market and would like to pay off (eliminate) any required future payments.

2. Transfers to third parties:

Property transferred to a third party by the Taxpayer for the benefit of Taxpayer's spouse (or former spouse, if incident to divorce) is treated as two transfers (transactions). Each transfer (transaction) may have different tax treatments, and the third party must meet certain conditions.

The two step transfer (transaction) and the tax treatment are more fully discussed as follows:

a) First Transfers (Transaction):

The first transfer of the property is considered to be between spouses or former spouses, where no gain or loss is recognized to either party.

b) Second Transfer (Transaction):

The second transfer of property is considered an immediate transfer of the property from a spouse or former spouse to the third party. For this to also be a tax-free transfer, one of the following conditions must apply: Transfer is:

- Required by the divorce or separation instrument, or
- Requested in writing by Taxpayer's spouse or former spouse, or
- Consented to in writing by Taxpayer's spouse or former spouse. The consent must state that both Taxpayer and Taxpayer's spouse or former spouse intend the transfer to be treated as a transfer from a spouse to the former spouse subject to the rules of section 1041 of the Internal Revenue Code. Taxpayer must receive the consent before filing his/her tax return for the year Taxpayer transfers the property.

3. Transfers in Trust:

If a Taxpayer makes a transfer in trust for the benefit of his (her) spouse (or former spouse, if incident to divorce), the Taxpayer must recognize gain or loss in certain situations which follow:

- A gain must be recognized in the amount by which the liabilities assumed by the trust, plus the liabilities to which the property is subject, exceeds the total of the adjusted basis in the property transferred.
 - Example: Taxpayer transfers property to a trust with Fair Market Value of \$100,000 and debts of \$60,000. However, if the basis of the property is \$25,000, the Taxpayer has a gain of \$35,000 (60,000-25,000).
- A gain or loss must be recognized if an installment obligation is transferred to a trust. There are some exceptions to this rule, of course, which are not covered in this article.

B. Basis Issues:

Basis is an item which concerns CPAs. Admittedly, basis is not always 'cut and dry'—even for CPAs. But basis is important because: this is the amount by which the Code determines items such as (1) gains and losses from sale of assets and (2) asset depreciation and amortization calculations.

Code § 1012 states, "The basis of property shall be the cost of such property, except as otherwise provided in this subchapter and subchapters C (relating to corporate distributions and adjustments), K (relating to partners and partnerships), and P (relating to capital gains and losses). The cost of real property shall not include any amount in respect of real property taxes which are treated under section 164(d) as imposed on the taxpayer."

The Taxpayer has to turn to the gift tax provisions of the Code for determining basis. Code § 1041 titled: "Transfers of property between spouses or incident to divorce" reads as follows with respect to basis:

Transfers between spouses during marriage, or

Transfers of property between spouses or former spouses (incident to a divorce) shall be treated as acquired by the transferee by gift²⁶ and the basis of the transferee in the property shall be the adjusted basis of the transferor.²⁷

There is an imposed duty to supply basis information as set fourth in the Regulations as follows:

"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."²⁸

It has been my experience that this information is difficult to obtain post divorce.

The following are selected topics with unique tax basis issues for divorcing and divorced parties:

C. Other Unique (Often Overlooked) Issues:

1. Suspended Losses on Passive Activities:

In the case of a disposition of any interest in a passive activity by gift, the basis of the interest is increased immediately before the gift by the amount of any passive activity losses allocable to the activity for which no deduction has been allowed on account of the passive loss rule. Thereafter, the losses used to increase the basis of the property are not deductible in any tax year. If the taxpayer gives away less than his entire interest in the property, the allocable portion of his unused losses are added to the donee's basis.²⁹

Passive Activities are determined by either "at risk" rules or "participation." The list of income items which can be included is extensive, including: rentals, farm and ranch operations, trade or business, partnerships, and rentals of personal property not for profit.

The taxpayer does not get to deduct the past passive losses against future passive income and must adjust the basis. The Taxpayer only gets the loss deduction when disposing of the asset.

This information is found in IRS form 8582 and accompanying six worksheets, which are not usually attached to the tax return filed with the IRS. When requesting copies of tax returns, the attorney should always request any "Passive Activities Calculations," including but not limited to Form 8582 and associated worksheets.

This is a problem when separate property of one spouse is transferred to other spouse in the property settlement. It may well pose a problem if the language in either the Decree or the transfer documents is inappropriate and the amount of suspended losses is material.

2. Net Operating Losses (NOLs):

A net operating loss (NOL) deduction may be taken only by the taxpayer that originally sustained the net operating losses and only to reduce income generated

by that taxpayer.³⁰ This rule was determined from the application of two Revenue Rulings concerning corporations and decedent's estate.

If taxpayers have not been married to each other in all net operating loss (NOL) years, the NOL deduction may only be taken by the spouse who incurred the loss and only to offset income generated by that spouse in the carry-back or carry-forward years.³¹

This rule has been applied in the following cases:

- NOL sustained by one spouse before marriage could not, when carried to a year in which she was married, be used to offset the income of her husband.³²
- NOL sustained after divorce or after death of a spouse and carried back to a year of marriage could be deducted only against the income of the spouse who sustained the loss. This is the case even though taxpayer (the "loss" spouse) was also married (to someone else) in the loss year and whether or not the couple resided in a community property state in the deduction year (though community property rules apply to determine the income of community property taxpayers).³³
- Taxpayer filed joint return with his first wife in 1978 and 1979, was divorced in 1980, sustained a NOL in 1981 for which he filed as an unmarried individual, remarried in 1982 and filed a joint return with his second wife. The 1981 NOL is carried back and carried over only to the income that would have been reported by the taxpayer had a separate return been filed. However, the joint rates are applied to the reduced joint taxable income.³⁴
- The above cases require the following two-step computation:
 - Step one. The figures used in this step are unreduced by any carryover. Here, taxpayer's separate tax liability, computed as if the taxpayer had filed separately, is divided by the total of both spouses' separate liabilities (as separately computed) and multiplied by the actual total taxes they paid jointly as estimated taxes or with the joint return. The product of that computation is then added to any amounts withheld from taxpayer's salary or wages or other income. The result, in the absence of clear and convincing evidence to the contrary, is considered to be taxpayer's contribution to the payment of the joint taxes.³⁵
 - Step two. The figures used in this step are reduced by the carryover. Here, taxpayer's separate tax liability is divided by the total of both spouses' separate tax liabilities and multiplied by the amount of the re-computed joint tax liability.³⁶

This information can be found on the tax returns as "Other Income (page 1 of 1040) and/or in the supporting schedules attached to the return. If there is a current deduction for NOL then on page 1 of the 1040. If the NOL is being carried forward, the information will be found in the supporting schedules.

The above is confusing for divorcing or divorced parties. It does not cover the following:

The fact situation between divorced parties can be at issue.

Losses can only be deducted to the extent of any investment in both partnerships and sub-s corporations. What if the H&W worked for the partnership or corporation? What if the investment was from community funds?

The IRS has difficulty in applying these rulings in a community property state. A divorced Taxpayer who thinks he/she has the NOL carry-forward may be surprised when confronted by a former spouse presenting arguments to the IRS for all or 1/2 the NOL carry-forward.

Discussion Point: If the NOL carry-forward has value to the Taxpayer that can utilize it, is it intangible property? The Bankruptcy Code thinks so and recognizes NOLs as one of various "Tax Attributes of the Debtor." These are legal questions and issues, which are fun to ponder.

To the practical side of the issue: If there is a substantial NOL carry-forward, the property settlement or divorced decree should state which party is entitled to it.

3. Investment Tax Credits:

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.³⁷

This information could be found on the tax credits line page 2 of the 1040 and/or on any supporting documents or schedules attached to the return.

I would opine that any general business tax credit should follow the property, business interest, or investment that created the tax credit.

4. Capital Loss Carry-forwards:

There is very little definitive information or guidance regarding Capital Loss Carry-forwards for divorcing parties.

There is a regulation on spouse of a deceased taxpayer not being entitled to a capital loss carry-forward from the decedent's separate property.³⁸

The Code Regulations at §1.1212-2 discuss capital loss from Married Filing Joint return transfers over to Married Filing Separate returns based on the allocation of gains in the original returns.

To determine the amount of capital loss carry-forward look on Schedule D, page 2 of the 1040.

In the past I have successfully argued with the IRS that without specific reference in the divorce decree it was originally on a joint return, therefore presumed community, therefore spouse was entitled to 1/2 of the capital loss carry-forward. The attorney was then in a position to modify the divorce decree and transfer the 1/2 the capital-loss carry-forward to former spouse for substantial consideration.

This information can be found on Schedule D of the 1040 and in supporting documents attached to the return.

D. Other Tax Issues:

1. Alimony:

This article does not discuss the requirements, front loading, or other aspects of alimony.

However, for settlement purposes, the parties can choose to make the alimony tax-free.

Parties can treat payments in the nature of alimony as taxable to the payee spouse and deductible to the payor spouse, or tax free to the payee spouse and nondeductible to the payor spouse as they please, by designating whether the payments are or are not to be treated as alimony. However, they cannot stipulate that payments that don't qualify as alimony are to be treated as alimony.³⁹

Tax impacted alimony is a great settlement tool. It is a tax savings potential with income shifting from a person with a higher tax bracket to someone with a lower bracket. Non-dischargeable in bankruptcy.

Did you know that alimony for the recipient would qualify as compensation received in determining amount of IRA contributions?

2. Interest Paid on Property Settlement Deductible:

A wife transferred stock, real estate and her principle residence to her former husband in accordance with a property settlement. In exchange, he agrees to pay her \$300,000 and loan her another \$625,000 at 10% per year for 10 years. The H sought to deduct his interest payments. The IRS denied the deduction as personal interest; however, the Tax Court upheld the deduction. According to the Tax Court, interest on indebtedness incurred incident to a divorce is not required under Code § 1041 to be characterized as nondeductible personal interest. Therefore, interest paid can be deducted if it is investment interest, passive activity interest or qualified residence interest (Seymour v. Commissioner, 109TC no 14, 1977).⁴⁰

3. Estimated Tax Payments:

Estimated payments on any unfilled returns not specifically assigned on the divorce decree are fair game.

4. Potential Refunds:

Any potential refunds will be split 50/50 unless specified otherwise in the divorce decree.

5. Children's Tax Returns (Kiddie Tax Issues):

Children under the age of 14 are taxed on their earned income and on their investment income (unearned income) of more than \$1,400 in '99, under the "kiddie tax" rule,). The children are taxed at their parents' marginal tax rate, even if that's higher than what the child would pay. A parent may elect to report the child's income on the parent's return, instead of filing a separate return for the child.⁴¹

The general rule is that where custodial parents file a joint return, the parental taxable income that must be taken into account in determining the child's share of allocable parental tax is the total taxable income shown on the joint return of the custodial parents⁴². This is true even where the custodial parent who files a joint return is not the parent of the child⁴³.

In the case of married individuals filing separately, the income of the parent with the greater taxable income is taken into account⁴⁴.

If the child's parents are not married (within the meaning of Code Sec. 7703), the parent whose income is taken into account for purposes of computing the tax on the child's income is the parent who has custody of the child⁴⁵.

Which parent has custody of the child for this purpose is determined under the same rules that determine which parent has custody for the purpose of claiming the dependency exemption for the child⁴⁶? For discussion, see paragraph X.C.

The following are almost always contentious issues between parents whose children have either assets or trust funds:

- Who files the tax returns (makes decisions)?
- Who pays for the tax return preparation?
- Who keeps records?
- Who holds the assets?
- Who is going to pay the tax?

Imagine the situation where the high-income earner wants the dependant deduction.

6. Medical savings accounts:

If you transfer your interest in a medical savings account to your spouse or former spouse under a divorce or separation instrument, it is not considered a taxable transfer. After the transfer, the interest is treated as your spouse's medical savings account.

XII. Miscellaneous Divorce Tax Issues:

A. Extensions:

An extension filed by one spouse does not include the other spouse, unless named.

For all clients in the process of a divorce, my recommendation is that around March 15, the client should be notified of the upcoming tax return due deadline. And if your client one who does not normally take care of the extension and return preparation for the Community, I would notify opposing Counsel something on the order of:

"Your client has in the past normally prepared and filed all extensions for the Community. If your client needs information from my client, please let me know. If your client is not going to file a joint extension and/or have the joint return prepared, then please forward the necessary information which is in your clients custody so that my client can timely file their return and/or extension. This matter is of concern as penalties may accrue to my client and/or the Community estate."

My recommendation, when in doubt, is to always have your client file an extension. This is not a cure-all because a reasonable estimate of the tax liability must be made on the April 15 extension. The IRS can invalidate the extension if the estimated tax is understated.⁴⁷

B. Amended Returns:

Married Taxpayers cannot change their filing status from joint to separate after due date of original return (April 15th).

XIII. Relief from Tax Liability:

Form 8857 allows the Taxpayer to request that *joint and several tax liability* not apply to part or all of any unpaid tax and deficiency plus penalties and interest. The Taxpayer may be allowed all or either of the following types of relief:

It is recommended that upon the initial interview with your client, you determine his/her extent of tax knowledge and involvement. Lack of knowledge is the key ingredient for relief of tax liability as discussed in A and B as follows:

A. Separation of Liability: Elect to allocate a deficiency:

This applies to taxpayers, which have not lived together all year. Taxpayers can file an election to designate the tax liability.

B. Innocent spouse relief.

The TxCIRM and Texas community property laws are not taken into account in determining whether an item belongs to the Taxpayer or Taxpayer's spouse (former spouse) for purposes of requesting any relief from liability or deficiency that the Taxpayer believes should be paid only by Taxpayer's spouse (or former spouse), you must file Form 8857. Request publication 971 for instructions.

C. Equitable relief (applies in Texas):

"The IRS will consider your request for equitable relief in situations where it would be unfair to hold you liable for tax that should be paid only by your spouse (or former spouse)"⁴⁸

This relief is used mainly for ex-spouses burdened with a tax liability from a disallowed deduction or unknown (as to Taxpayer) income included in the return.

XIV. IRS Resources:

With your personal computer and modem, you can access the IRS on the Internet at www.irs.ustreas.gov. While visiting their web site, you can select:

- [Frequently Asked Questions](#) to find answers to questions you may have.
- [Fill-in forms](#) to complete tax forms on-line.
- [Forms and Publications](#) to download forms and publications or search publications by topic or keyword.
- [Comments & Help](#) to e-mail IRS with comments about web site or with tax questions.
- [Digital Dispatch and IRS Local News Net](#) to receive their electronic newsletters on hot tax issues and news.

A. Forms and Publications:

The following are forms and publications that may be of interest or assistance:

- Publication 501, EXEMPTIONS, STANDARD DEDUCTION, AND FILING INFORMATION.
- Publication 504, DIVORCED OR SEPARATED INDIVIDUALS.
- Publication 544, SALES AND OTHER DISPOSITIONS OF ASSETS.
- Publication 555, COMMUNITY PROPERTY.
- Publication 590, INDIVIDUAL RETIREMENT ARRANGEMENTS (IRAs).
- Form 8857, REQUEST FOR INNOCENT SPOUSE RELIEF
- Form 8332, Release of Claim to Exemption for Child of Divorced or Separated Parents.
- Pub 501, EXEMPTIONS, STANDARD DEDUCTION, AND FILING INFORMATION

End:

XV. Divorce Decree Checklist for Income Tax Issues:

Questions?	None or N/A	Yes	Decree Reference
Income, deductions, credits and payments in year of divorce issues resolved: <ul style="list-style-type: none"> • Community Property Rules through date of divorce, or? • Allocated with indemnity agreement, or? • Living apart previous calendar year, etc.? 			
Dependents have been assigned? <ul style="list-style-type: none"> • All returns not filed through date of divorce? • Year of divorce? • After divorce? • Multiple Exemption Form 8332 completed? 			
Information & exchange issues resolved on the following: <ul style="list-style-type: none"> • Year of divorce return preparation, including the following: <ul style="list-style-type: none"> ◆ Who will prepare allocations or return? ◆ Date certain for document exchange? • Passive activities and/or suspended losses? • Residence basis? • Net Operating Losses? • Capital Losses Carry-forwards and Carry-backwards? • Basis support documents for all assets of property received in settlement by spouse who does not have access to records? 			
Are the children's tax returns issues resolved as follows: <ul style="list-style-type: none"> • Who is responsible for filing returns? • Who keeps the information? • Who holds the assets? • Who is liable for paying the taxes? 			
Tax liability issues resolved on returns filed while married including the following: <ul style="list-style-type: none"> • Payment of taxes or deficiency? • Audit of returns? • Ownership or allocation of refunds? 			
QDRO; assignment of retirement plan tax issues resolved?			
IRA's assignment of IRAs resolved?			
Alimony checked for tax issues: <ul style="list-style-type: none"> • Front loading issues checked? • Termination upon death? • Taxable or non-taxable is clear in the decree? • It does not look, smell or feel like child support? • Not even thinly tied to child support? 			

Bibliography and List of Publications:

- Pub 504 = IRS publication 504; Divorced or Separated Individuals.
- Pub 555 = IRS Publication 555; Community Property.
- Form 8857 = Tax Form 8857 & instructions; REQUEST FOR INNOCENT SPOUSE RELIEF (And Separation of Liability and Equitable Relief).
- RIA - Research Institute of America, "Tax Desk".
- TMI - TMI Tax Services, Inc.

¹ Warren Gorham & Lamont of the Practitioners Publishing Company.

² Reg § 1.879-1(a)(1).

³ Per Form 8857.

⁴ Code Sec. 66(a)(1).

⁵ Code Sec. 66(a)(3).

⁶ Code Sec. 66(a)(3).

⁷ Code Sec. 66(a)(4).

⁸ Code Sec. 66(a)(2)(A).

⁹ Code Sec. 66(a)(2)(B).

¹⁰ Code Sec. 879(a)(1).

¹¹ Code Sec. 879 (a)(2) and Rutledge, Rome, (1992) TC Memo ¶92052,63CCHTCM1926, TCMemo 1992-52, affd on other issue (1993,CA%)4 F3d 990.

¹² Code Sec. 879(a)(2).

¹³ Code Sec. 66(a); Code Sec. 879 (a)(4).

¹⁴ Code Sec. 66(b); Rutledge, Rome, (1992) TC memo ¶63 CCH TCM1926, TC Memo 1992-52. And Pub555; "Community Property Laws Disregarded."

¹⁵ RIA ¶ 57,362; and Hardy, Cathy Miller v. Comm., (1999, CA9) 84AFTR2d 99-5015,99-2 USTC ¶50643.

¹⁶ Sampson & Tindall's -TEXAS FAMILY CODE - ANNOTATED; August 1999 Edition; Sec 4.101 to 4.206; pages 48 to55.

¹⁷ Hpokins TC Memo. 1992-326.

¹⁸ Phase out ranges are as follows:

Filing Status:	Starting at:	Completely Phased out at:
MFJ	\$ 189,950	\$ 312,450
MFJ	94,975	156,225
SINGLE	126,600	249,100
HOH	158,300	280,800

¹⁹ Code assumes custodial parent provides over ½ of support. Exception may come in to place when non-custodial parent challenges the support test.

²⁰ Reg 1.152-4(b).

²¹ Code Sec. 10419(A)(1).

²² Code Sec 1041(a)(2).

²³ Code Sec 1041 (a)(2).

²⁴ Code Sec 1041 (d).

²⁵ Code Sec 1041 (e).

²⁶ Code Sec. 1041(b)(1).

²⁷ Code Sec. 1041(b)(2).

²⁸ Reg § 1.1041-1T (e).

²⁹ RIA §

³⁰ RIA § 35,404.

³¹ RIA § 35,405 and Rev Rul 60-216, 1960-1 CB 126; Calvin, Asa E. v. U.S., (1965, CA10) 16 AFTR 2d 6025, 354 F2d 202, 66-1 USTC ¶9108.

³² Calvin, Asa E. v. U.S., (1965, CA10) 16 AFTR 2d 6025, 354 F2d 202, 66-1 USTC ¶9108.

³³ Rev Rul 71-382, 1971-2 CB 156; Rev Rul 65-140, 1965-1 CB 127; York, Virginia v. U.S., (1964, DC TX) 18 AFTR 2d 5543, 66-2 USTC ¶9628; Zeeman, Audrey v. U.S., (1967, DC NY) 21 AFTR 2d 679, 275 F Supp 235, affd & remd(1968, CA2) 21 AFTR 2d 1380, 395 F2d 861, 68-1 USTC ¶9406.

³⁴ Rev Rul 80-6, 1980-1 CB 296; Rev Rul 75-368, 1975-2 CB 480.

³⁵ Rev Rul 80-6,1980-1 CB 296.

³⁶ Rev Rul 80-6-1980-1 CB 296.

³⁷ Reg § 1.1041-1T (d)(Q-13/A-13).

³⁸ Reg § 1.1212.

³⁹ RIA § 34,152

⁴⁰ Journal of Accountancy, February 1998, page 34.

⁴¹ RIA § 56,830.

⁴² Reg § 1.1(i)-1T, Q&A 10 & RIA § 56,841.

⁴³ Reg § 1.1(i)-1T, Q&A 13.

⁴⁴ Code Sec. 1(g)(5)(B); Reg § 1.1(i)-1T, Q&A 11.

⁴⁵ Code Sec. 1(g)(5)(A).

⁴⁶ Code Sec. 1(g)(5)(A).

⁴⁷ IRS Notice 93-22.

⁴⁸ Form 8857.