Trouble Never Comes Alone – Some Issues of Divorce and Taxation

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To have divorce and taxation problems at the same time is like having Murphy's Law supplemented by Catch-22 regulations. So, paraphrasing Joseph Heller, to try to resolve the tax problems and to resolve the problems caused by divorce, the taxpayer needs "to live forever, or die in the attempt". This work tries to examine some of the solutions to the problems created by the intersection of family and tax laws without having to "to live forever".

I. INTRODUCTION "If something can go wrong, it will"

Divorce is stressful enough to forget anything else while struggling through the emotions of the ruined life and lifestyle, accusations, and insults arguably results in one of the most intense stresses of modern life. This stress brings decreased income, reduction in property, and a lack of attention to matters other than the divorce itself, such as taxes. As a result, a lot of changes that divorce brings into the tax situation and tax treatment of the items go unattended. While Taxpayers struggle through the divorce, tax returns filed by both would-be-divorcees are often drastically incorrect. Mistakes on the tax return bring examinations by federal and then by state taxing authorities. The finances are low as a result of the dramatic financial drain caused by the divorce lawyers, court-appointed professionals, mental health "experts", and other wonderful predators in the divorce court.

There are usually very limited funds left to spare for the successful defense in the tax matters, not to mention that assets could be frozen by

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the court *pendente lite*. To add insult to injury, divorce courts "may take into account either party's *earning capacity* as well as actual income of a divorcing spouse in fixing temporary spousal support"[1], thus making support orders based on ***imputed*** rather than actual income. Therefore, by the time of filing the tax return, taxpayer might have all or a significant part of his or her income taken by the dream team of ex (to be ex)-spouse/attorney/ex's attorney/court fees/child support/spousal support/"professionals". Thus there is no money at all for the taxes to be paid, not to mention that taxes are usually *WAY* more than the taxpayer has estimated before the divorce started.

One advice to the taxpayer who avoided being hit by a car, but could not avoid the divorce is to *MAKE SUBSTANTIAL ESTIMATED PAYMENT* at the time the taxpayer serves or been served with standard divorce papers (form FL-100/103 in California. California law will be used as the example in this article unless otherwise stated). Notwithstanding big estimated tax payments, to mitigate the tax consequences of divorce, tax professional/taxpayer has to at least know how to navigate the labyrinth created at the intersection of Family and Tax laws (both such wonderful misnomers).

Intersection of the tax law and family law creates the astounding number of combinations that could not all be reviewed in this article. The goal of this article is to review some controversial and unexpected combinations and provide some tools for tax planning.

While presuming some understanding of tax law, this article stresses the tax law applications in different situations that family court judges (actually, divorce law judges) create, usually without having considered tax ramifications. An additional layer of confusion and complications is added by the addition of Same-Sex Married Couples to the players in the field of Family law by United States Supreme Court decision in *US v. Windsor*[2] invalidating §7 of DOMA Act (1 USC §7) and allowing legally married same-sex persons (SSMPs) to be treated as married for federal income tax purposes. Following the Supreme Court decision, IRS promulgated Revenue Rulings 2013-2 and 2013-17 allowing legally married same sex couple to be considered married for the income tax purposes regardless of the state in which they live[3]. There is a multitude of issues in the tax and family laws alike that are to be addressed in a separate research. For the purposes of this article, we are treating the SSMP the same as any other married couple.

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[1] Marriage of Wittgrove, supra, 120 CA4th at 1329, 16 CR3d at 497
[2] United States v. Windsor (2013) 570 U.S. (Docket No 12-307)
[3] Rev. Rul. 2013–17, 2013–2 CB2 201, eff. 9/16/13

II. *GENERAL TAX CHANGES DUE TO DIVORCE "Left to themselves, things tend to go from bad to worse"*

a. **Changes Due to Divorce 101** "*If there is a possibility of several things going wrong, the one that will cause the most damage will be the FIRST to go wrong*"

The first thing to remember is that the tax return becomes very different after the separation. The filing status, deductions (above and below the line), phase-out amounts, exemptions, and credits, as well as property rights and itemized deductions, are all affected by divorce[4, 5] (i.e. alimony paid is generally deductible to the payer and taxable to the recipient). One of the immediate consequences is that the taxpayer loses one or more dependency exemptions[6]. The standard deduction becomes smaller as well due to the change of the filing status[7]. With property division, the only good news is that the transfer of property incident to divorce is generally treated as tax-free transfers[8].

To add to the complications of the tax situation due to the divorce, the new Patient Protection and Affordable Care Act (PPACA)[9] added a provision that requires the custodial parent to be responsible for the health coverage of the child, thus creating a controversy with the majority of state orders when courts assign one of the spouses to maintain medical insurance for children, but Federal law stripped the family court of jurisdiction. As result, family courts kept issuing orders for the medical insurance coverage, but absent the release of exemption by custodial parent to the non-custodial, the orders are technically void.

The separated spouses each will be taxed on their respective earnings separately. But they will have to allocate income, treating income earned before the separation date as community property (taxable half to each) and income earned on and after the separation date as the earning spouse's separate property[10]. If all income is community income, then the

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[4] 26 USC §62(a)(1),(2),(6),(7),(10)
[5] 26 USC §68(b)
[6] 26 USC §151,152
[7] 26 USC §63(c)
[8] 26 USC §1041
[9] Pub. L. 111–148, 124 Stat. 119 (42 USC §1 through §§18445)
[10] Thatcher v. Commr.(1988), TC Memo. 1988–537 (after separation, husband is taxed on value of his services, but husband and wife are each taxed on one-half balance of profits; Adams v. Commr. (1984) 82 TC 563, 569–570 (allocation of partnership income); Carrino v. Commr., TC Memo. 2014–34 (wife required to report on her

income and deductions are evenly divided between the spouses. The total tax on separate and joint returns will be the same (ignoring some of the credits and deductions not available to the married filing separate). However, certain items are treated as separate property for tax purposes, even if they are community property under the state law[11]. In addition, on separate returns, both spouses are supposed to take the standard deduction unless both spouses elect to itemize[12]. The coordination of such election becomes problematic, especially in cases with high acrimony and lost contact between estranged spouses. The coordination of the filing might be done by the tax professionals involved (sometimes it makes sense to have the same person prepare the tax returns of both spouses and waive conflict of interest). The filing could also be coordinated through the Family law professionals, since filing itemized deductions might release a certain amount of money to be available to the child and spousal support desired by the receiving party. An additional point is that no child care credit can be claimed on a spouse's separate return unless the other spouse was absent from the household during the last six months of the year[13].

b. MFJ - Possible Solution for the Changes During the Separation Time "*The buddy system is essential to your survival; it gives the enemy somebody else to shoot at.*"

The period of uncertainty due to the divorce procedure could last for years while the case is adjudicated in the family court. There are multiple reasons for it, including the backlog of the courts and prolongation of the divorce process by the parties and family law professionals. A surprising solution for the losses and controversies could be filing joint returns during the years between the separation and final divorce decree. A joint tax return can be filed by spouses who are separated at the close of the calendar year, as long as both separated spouses intend that the return be filed as a joint return[14]. Family courts in California have an inherent authority to make or enforce orders as it seems necessary[14a]. Family courts do not hesitate to use this power, especially while the case is pending. One application is the court ordering spouses to sign a joint return to achieve an optimal tax result to have money available for the court designated needs (like attorney fees, fees of court appointed

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separate federal return half of community property income from partnership started post separation by husband with Community property funds)

[11] 26 USC §408(g); Morris v. Commr., TC Memo. 2002–17 (IRA distribution taxed to employee-owner husband even though IRA is community property under state law)

[12] 26 USC §63(e)(1)

[13] 26 USC §21(e)(3) and (4)

[14] Etesam v. Commr.(1998), TC Memo. 1998–73 (wife did not intend for husband to file joint return where she had already filed separate return)

[14a] Cal. Fam. Code §290

professionals, and court's fees). Courts of appeal usually side with judges citing broad discretion given to the judicial officers in domestic relations cases. The signature of both spouses is not dispositive, though, since the intent is to be inferred from the spouses' conduct; so even one signature on the joint return might be sufficient, so long as the intent to file a joint return is to be evident[15]. Thus, there is some controversy between case law and the plain language of the statute, which states: "any return, statement, or other document required to be made under any provision of the internal revenue laws or regulations shall be signed in accordance with forms or regulations prescribed by the Secretary."[16] To resolve the controversy, courts have provided for the implied authority of one spouse to sign for another. If the spouses have always filed jointly, even after separation (but before marriage dissolution), than one spouse may have the implied authority to sign for the other[17]. On the other hand, it is clear that both spouses must agree to file a joint return[18]. Surprisingly, the Tax Court has stated that a spouse who unwillingly signed a joint return after being ordered to do so is liable for tax deficiencies shown on return, though eligible for innocent spouse relief[19]. So, while there should be intent to file a joint return, a signature under duress of family court might result in a tax liability. Here we have another disconnect between family courts and tax courts since California Court of Appeal (contradicting itself) stated that courts may not order unwilling spouses to file a joint return (though the application of the case appears to be mostly in computation of the support rather than actual filing)[20].

The resolution of the aforementioned situation might be in refusal to sign the return under the order of the court with immediate filing of notice of the request for a writ of mandate (*mandamus*) to the higher court, including a request for stay of execution of contempt, if charged. Alternatively, if the court threatens to bring serious sanctions and the taxpayer is not strong enough to withstand court and attorneys' pressure, to sign the tax return and immediately file an innocent spouse petition, to be protected from the tax liability of the other spouse. Another alternative is to disavow the joint return after filing. A spouse can avoid a joint return liability by establishing he or she signed the return under duress. The defense is tricky though, since it requires showing that the spouse was

[15] Magee v. Commr.(2005), TC Memo. 2005–263 (Where a taxpayer has consented to the filing of a joint return, such joint return may be considered valid even if only one taxpayer signs return)
[16] 26 USC §6061
[17] Riportella v. Commr. (1981), TC Memo. 1981–463
[18] Moore v. United States (Ct. Cl. 1941) 37 F. Supp. 136, 139–140
[19] Bruen v. Commr. (2009), TC Memo. 2009–249
[20] Marriage of Carlton & D'Allessandro (2001) 91 CA4th 1213, 1218–1219, 111 CR2d 329, 332 (court stated that it is an error to assign husband "married filing jointly" tax filing status in computing guideline child support where wife refused to file joint return.)

unable to resist the demands to sign the return and that he or she would not have signed the return but for such demands[21]. As usual, there is an exception to the exception, so a court order requiring spouses to execute and file a joint return does not constitute duress[22]. Note also, that under California law, it is a misdemeanor for a person to sign his or her spouse's name on an income tax return (or any schedules or attachments thereto) without the spouse' consent[23]. Yet another possibility is to sign for the spouse under the power of attorney to sign such a return (use Form 2848)[24]. Under the last situation, the Power of Attorney properly executed gives the presumption of agreement to file jointly, so the signature of one spouse for both would be sufficient to have a joint tax return recognized, or in case of non- recognition, it might be sufficient to petition the family court to award sanctions against non-signing spouse in the amount of lost tax benefits. On the other hand, refusal to sign a Power of Attorney and preserved correspondence regarding the refusal, might be sufficient to claim innocent spouse relief from joint tax liability.

c. **Overview of Relief from Joint Liability** "*If everything seems to be going well, you have obviously overlooked something*"

Generally spouses have joint and several liability for the income tax deficiencies, interest, and penalties, attributable to the other spouse, if they filed a joint tax return[25]. The relief from joint liability could be in the form of innocent spouse relief[26], separate liability relief[27], and equitable relief from liability[28]. California tax law has similar provisions[29]. Also, one of the possible methods of relief from joint liability is an indemnification agreement between spouses. An indemnification agreement operates, however, only between the spouses; it is not binding on the IRS and thus does not preclude the IRS from proceeding against either or both spouses who file a joint return. An additional trap might be in determination of whether the indemnification payment could be income itself. Even though a 1939 case ruled that such a payment is not gross income[30], IRS has asserted that it will treat such payments as taxable[31]. Therefore, indemnification payments might create a tax liability by

[21] Treas. Reg. §1.6013–4(d); Pirnia v. Commr.(1990), TC Memo. 1990–444
[22] Price v. Commr.(2003), TC Memo. 2003–226
[23] Ca. Rev. & Tax Code §19701.5
[24] Treas. Reg. §1.6013–1(a)(2)
[25] 26 USC §6013(d)(3)
[26] 26 USC §6015(b)
[27] 26 USC §6015(c)
[28] 26 USC §6015(f)
[29] Ca. Rev. & Tax Code §18533(a)-(h)
[30] Clark v. Commr. (1939) 40 BTA 333 (amount received by taxpayer from accountant who had negligently filed a tax return that increased his taxes is not gross income)
[31] RS Priv. Ltr. Rul. 9833007, May 13,1998

themselves without a corresponding deduction. Taxpayers are usually using the 1939 Clark case to point that such indemnifications are not income. IRS disagrees and is eager to litigate the matter of taxability of the indemnification payments especially since the issue has not been addressed since 1939 (except for some IRS letter rulings stating that indemnification income is taxable within the meaning of IRC §61). It is probably advisable to include a provision in the divorce decree increasing the spousal support for the "innocent" party to compensate for any increase in tax liability as a result of such indemnity payments as well. An additional possibility to eliminate the taxation of the indemnity proceeds would be treating indemnification as part of the property settlement that is not taxable as long as it is a settlement incident to divorce[31a].

The remaining option is to ask for affirmative relief from the joint liability from tax authorities. Specifically, "innocent spouse" relief under Title 26 authorizes relief from liability for understatements of tax, interest, penalties and other amounts if*:*

- A joint return has been made for a taxable year;
- The return contains an understatement of tax attributable to an erroneous item of one of the joint filers;
- The spouse claiming relief establishes that in signing the return he or she did not know, and had no reason to know, there was an understatement;
- Taking into account all the facts and circumstances, it is inequitable to hold the innocent spouse liable for the tax deficiency attributable to the understatement; ***AND***
- The spouse seeking relief elects the benefits of innocent spouse relief no later than two years after the date the IRS has begun collection activities with respect to that spouse[32].

Specific provisions exist in post-separation/divorce to mitigate the liability of joint-return filers[33]. These provisions permit the liability to be allocated in proportion to each spouse's contribution to the deficiency ("separation of liability election"). In order to be eligible for the separation of liability election taxpayer has to be either:

- *No longer married* to the spouse with whom the joint return was filed;
- *Legally separated* from the spouse with whom the joint return was filed; ***OR***

[31a] 26 USC §1041
[32] 26 USC §6015(b)(1)(A)-(E)
[33] 26 USC §6015(c)

- *Not a member of the same household* as the spouse with whom the joint return was filed at any time during the preceding 12–month period ending on the date the election is filed[34].

It should be kept in mind also, that the Code treats certain married individuals not living together as not married for tax purposes. This rule applies to a married individual who files a separate return, maintains a household which constitutes a principal residence for a dependent child for more than half of the year, and furnishes at least half the cost of this home's maintenance, if his or her spouse has not lived in this home for the last six months of the year. In the case described the relief from joint liability is in filing as a Head of Household (as described below)[35].

On the other hand, Regulations presume spouses to be treated as members of the same household even if one of them is temporarily absent due to incarceration, military service, and other reasons, if such spouse can reasonably be expected to return. Spouses living in the same dwelling are considered members of the same household even if they lead separate lives within the structure[36]. A taxpayer may elect either or both types of relief (innocent spouse and separate relief)[37].

d. Dilemma of Requesting Relief from Joint Liability "*That's some catch, that Catch-22, - It's the best there is*"

The real catch is between seeking relief from joint liability for income tax in Tax Court and demanding a share of community property in family court. The short version is that by demanding a share in the community business, taxpayer admits knowledge of and participation in the business. To get the relief from joint liability taxpayer has to claim exactly the opposite. The resolution is in careful planning, and the defense is in patient waiting for all of the filings from the claiming spouse and properly using it in RFOs (Requests for Orders that substituted Motions in California family courts).

Specifically, a §6015(c) separate liability election will ***not*** relieve the requesting spouse from deficiencies allocated to the other spouse if the requesting spouse had *actual knowledge* when signing the return of the *item giving rise to the deficiency*[38]. The word "item" for this purpose means knowledge of the *particular item of income, deduction, or credit*—*not* knowledge of its tax consequences[39]. The IRS ordinarily bears both the

[34] 26 USC §6015(c)(3)(A)
[35] 26 USC §7703(b)
[36] Treas. Reg. §1.6015–3(b)(3)
[37] Treas. Reg. §1.6015–1(a)(2)
[38] 26 USC §6015(c)(3)(C); Treas. Reg. §1.6015–3(c)(2); Gonce v. Commr., TC Memo. 2007–328
[39] Treas. Reg. §1.6015–3(c)(4), ex. 1 (Wife failed to pay self-employment tax on her earnings as a musician; Husband had actual knowledge because he knew Wife received the income, even though he did not know it was

burden of producing evidence and the burden of proof by a preponderance of the evidence to prove the actual knowledge of specific item of income (whereas the taxpayer has the burden to show eligibility for innocent spouse relief)[40]. "Actual knowledge" of omitted income can be established if the requesting spouse knew that a particular item of income has been received[41]. The Tax Court looks for "an actual and clear awareness (as opposed to reason to know) of the existence of an item which gives rise to the deficiency"[42]. Additionally, The Regulations identify the following factors which, when considered together with all other facts and circumstances, may demonstrate a requesting spouse' "actual knowledge":

1. The requesting spouse's deliberate effort to avoid learning about an item in order to be shielded from liability.
2. The spouses' joint ownership of the property that resulted in the erroneous item. For this purpose, however, a requesting spouse' joint ownership cannot be based solely on community property law; there must also be a showing that either the requesting spouse' name appeared on the ownership documents or he or she exercised control over the community property item[43].

By filing the request for the relief of joint liability, a spouse admits that he or she does not jointly own property (separate property), does not have reason to know about the income coming from the property (living standard), does not know about the omitted income (living standard), and does not receive any benefits derived from the property (living standard). The filing itself could be used in the family court to prove the fact that income and property is separate and to prove the marital lifestyle. California Family Code provides definitions and rules for separate property and the income derived from it as: "(a) Separate property of a married person includes all of the following: (1) All property owned by the person before marriage. (2) All property acquired by the person after marriage by gift, bequest, devise, or descent. (3) The rents, issues, and profits of the property described in this section. (b) A married person may, without the consent of the person's spouse, convey the person's separate property."[44]

By filing the request for relief from joint liability, a spouse actually states that the property that gave rise to the income tax liability was *NOT*

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subject to self-employment tax); also Cheshire v. Commr. (5th Cir. 2002) 282 F3d 326, 335–338; Mitchell v. Commr. (DC Cir. 2002) 292 F3d 800, 805–806; Sykes v. Commr., TC Memo. 2009–197

[40] Treas. Reg. §1.6015–3(c)(2), see Culver v. Commr. (2001) 116 TC 189, 193–198—spouse disqualified only by actual knowledge of item giving rise to deficiency, not by reason to know

[41] Treas. Reg. §1.6015–3(c)(2)(i)(A)

[42] Stergios v. Commr., TC Memo. 2009–15—Wife knew about Husband's unreported stock trading but did not have actual knowledge of specific trades.

[43] Treas. Reg. §1.6015–3(c)(2)(iv)

[44] Cal. Fam. Code §770

held as community property. All property not held by husband and wife as community property is separate property[45]. Generally, the spouse claiming separate status of property has the burden of proof to show that the property is in fact separate especially if the property is acquired during the marriage. A spouse' claim that property acquired during the marriage is separate property must be proven by a preponderance of the evidence[46]. The fact that one spouse asks for the relief creates sufficient evidence that such spouse did not have anything to do with the asset in question and, therefore, the asset is at least presumed to be separate. In one case the court used the fact that Wife did not participate in partnership operations and did not even know of its existence, as dispositive to treat the partnership, where both spouses were official partners, as Husband's separate property and even to relieve Husband from sanctions for the violation of fiduciary duties for not disclosing the partnership to Wife[47]. (Actually, the court found that no partnership was ever formed – it was a tax avoidance scheme of Husband's). Overall, claiming the relief from joint liability might cause permanent loss of the property in the divorce proceedings. As a result, it is advisable to balance interest of relief and interest in property.

On the other hand, the item giving rise to the deficiency must be attributable to the non-electing spouse. However, for this purpose, the Tax Court looks not only to how ownership is nominally held between the spouses, but to each spouse' level of participation in the activity[48]. Also, as stated above, the spouse seeking relief must establish that he or she *did not know, and had no reason to know,* there was an understatement[49]. A spouse has "reason to know" of an understatement, if a reasonably prudent taxpayer in his or her position at the time the return was filed could be expected to know that it contained an understatement[50]. The case law specifies a lot of factors that court is to consider deciding the issue of knowledge. The filing with family court that specifies the property and/or activity could be treated as affirmative proof that the "innocent" spouse is not so innocent with regards to the knowledge of the activity.

Additionally, based on the facts in the family court declaration re: property/business activities and (for California) Forms FL 150, 141, 160,

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[45] Siberell v. Siberell (1932) 214 Cal. 767
[46] In re Marriage of Valli (2014) 171 Cal.Rptr.3d 454
[47] In re Marriage of Geraci (2006), 144 Cal.App.4th 1278
[48] Wiener v. Commr., TC Memo. 2008–230—tax shelters purchased with joint funds were not attributable to electing spouse because she was not involved with, and did not know about, the investment; Capehart v. Commr., TC Memo. 2004–268, affirmed (9th Cir. 2006) 204 Fed. Appx. 618—partnership interest attributable to both spouses where both signed agreement and electing spouse was substantially involved with the investment]
[49] 26 USC §6015(b)(1)(C); Treas. Reg. §1.6015–2(c)
[50] Price v. Commr. (9th Cir. 1989) 887 F2d 959, 965; Barranco v. Commr., TC Memo. 2003–18

the court might decide that the understatement is attributable to the claiming spouse and thus would be reason for denial of relief from joint liability. It should be noted that Tax Court applies the "knowledge-of-the-transaction test" to both omitted income cases *and* erroneous deduction cases. Under this test, the mere knowledge of the *underlying transaction* (e.g., that the investment was made) is sufficient to give a spouse "reason to know" the resulting deductions are erroneous[51]. However, if a case is appealable to a circuit that has adopted a different knowledge test for erroneous deductions, the Tax Court applies that circuit's test rather than its knowledge-of-the-transaction test[52].

As with the other areas in tax law, there are a lot of clarifications, exceptions and specific rules with respect to the innocent spouse provisions. For instance, knowledge of the *source* of an erroneous item is *not sufficient* to determine actual knowledge of an item of income (e.g., Wife's knowledge that Husband owns stock in Widget Co. does not mean she knows that Widget Co. paid a dividend)[53]. Another exception is the domestic abuse exception. A requesting spouse is *not* considered to have had actual knowledge of items on the return if he or she establishes that he or she was the victim of *domestic abuse* before the joint return was signed and, as a result of the prior abuse, did not question the treatment of any items on the return out of fear of the other spouse' retaliation[54]. There are also the fraud exception and "the tax avoidance as primary purpose" exceptions, whose descriptions should be self-explanatory. An additional problem to be aware of is that in California, a community property state, since community property is liable for the debts of either party incurred before or during marriage and before separation[55], an innocent spouse who remains married to (and not separated from) the guilty spouse is not permitted to claim a refund of taxes that were paid with community funds. In other words, the innocent spouse provisions do not preempt community property law with respect to refund claims[56]. An "innocent spouse" determination operates only to relieve that spouse from liability *to the IRS*. It does not control the allocation of tax liabilities as between the spouses under state law[57].

[51] Bokum v. Commr. (1990) 94 TC 126, 151–152, affirmed on other grounds (11th Cir. 1993) 992 F2d 1132, 1134; Juell v. Commr., TC Memo. 2007–219
[52] Cheshire v. Commr., 282 F3d at 333, fn. 17
[53] Treas. Reg. §1.6015–3(c)(2)(iii)
[54] Treas. Reg. §1.6015–3(c)(2)(v)
[55] Cal. Fam. Code §910(a) & (b)
[56] Ordlock v. Commr. (9th Cir. 2008) 533 F3d 1136, 1140–1145; Karp v. Commr., TC Memo. 2009–40 (declining to review denial of innocent spouse relief to W because, per Ordlock, Wife would not be entitled to refund even if granted §6015(b) and/or (f) relief)
[57] Marriage of Hargrave (1995) 36 CA4th 1313, 1320–1321—where state court dissolution judgment evenly divided tax liability between Husband and Wife, Wife required to pay half despite IRS ruling that she was "innocent spouse"

Another line of defense that might help mitigate the effect of the contradictory results between family court and the IRS is partial ignorance theory. The theory states that a spouse may be eligible for innocent spouse relief even though he or she knew or had reason to know of *some* of the erroneous items. Section 6015(b) allows for *partial* relief—i.e., a spouse who knew or had reason to know of only part of the understatement can obtain "innocent spouse" relief for that *portion* of the understatement of which he or she did not know and had no reason to know[58].

The procedures for requesting and granting relief are described in details by Rev. Proc. 2013-34. Decision to request the relief should be made after consideration and comparison of family law and tax consequences.

III. FILING STATUS – HEAD OF HOUSEHOLD, PREFERABLY

"Am I married, divorced, or what?"

a. **Filing Status after Separation** "*If anything simply cannot go wrong, it will anyway*"

Four filing categories are available to individuals: married filing joint returns (and surviving spouses); heads of household; unmarried individuals (other than surviving spouses and heads of households); and married individuals filing separate returns[59]. Except for surviving spouses, the date as to when people are eligible to file joint returns is determined by their status on the last day of the taxable year[60]. This rule applies whether or not the taxpayer is married at the beginning of the year or whether the marital status changes after the last day of the year but before the tax return is filed.

Generally, separate filing brings certain disadvantages to one or both "High Divorcing Parties" (even though the amounts and time spent during divorce are comparable with those spent during the negotiation of the highest international treaties, for simplicity we will call them husband and wife or under new terminology Spouse 1 and Spouse 2). Separated spouses must file returns as married persons filing separately if they are still married at the end of the taxable year, unless they agree to file a joint return or a court has entered a decree of separate maintenance (judgment of legal separation)[61]. A later judgment of marriage dissolution does not relate back to an earlier year in which the parties were still married[62].

[58] 26 USC §6015(b)(2), Treas. Reg. §1.6015–2(e) (adopting 9th Cir. view under Wiksell v. Commr. (9th Cir. 1996) 90 F3d 1459, 1463–1464)
[59] 26 USC §1(a) to (d)
[60] 26 USC §6013(a)
[61] 26 USC §§1(d), 7703(a)
[62] Freyre v. United States (6th Cir. 2005) 135 Fed. Appx. 863, 865–866

Note, however, that a married individual may file as unmarried if he or she qualifies under the "abandoned spouse" rule (26 USC §66 rule allowing the "abandoned" spouse who meets all of the requirements of said §66 to allocate to him/herself only income that was actually earned by said spouse disregarding among other things community property rules)[63]. Marital status for California is determined under rules similar to federal rules[64] Generally, married taxpayers use the same filing status for federal and state purposes; however, exceptions may apply where either spouse (1) is a nonresident for any portion of the taxable year; (2) was an active member of the armed forces or any auxiliary branch; or (3) was a nonresident for the entire taxable year and had no income from a California source[65].

b. Head of Household Requirements "*Now you are HEAD of the House, finally*"**.**

California Revenue and Taxation Code provides that for California taxation purposes "§2(b) and (c) of the Internal Revenue Code, relating to the definitions of head of household and certain married individuals living apart, respectively, shall apply, *except as otherwise provided*. [Emphasis added]"[66]. Internal Revenue Code §2(b) defines Head of Household as an individual who is not married at the close of his taxable year and has a qualified child (child, not married, lives more than half-year with the taxpayer, is provided more than half of support by the taxpayer, and is less than 19 years old or, if a student, less than 24 years old)[67]. For the purposes of this article we omit the reference to relatives other than a child[67a]. Additionally, a foster child would qualify as a child if placed with taxpayer by the government agency or court decree[67b].

The Internal Revenue Code also defines the status of unmarried for the purposes of the Head of Household determination as "legally separated

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[63] 26 USC §152(e)
[64] 26 USC §7703, CA Rev & Tax. Code §17021.5
[65] CA Rev & Tax. Code, §18521(c)
[66] Ca. Revenue and Taxation Code §17042
[67] 26 USC §2(b)
[67a] For the purposes of qualifying for the Head of Household status a taxpayer can have not only a qualified child but a qualifying relative as well. "Qualifying relative" is defined by 26 USC §152(d) as an individual who is related to the taxpayer, whose gross income for the related calendar year is less than the exemption amount (defined in section 151(d)), with respect to whom the taxpayer provides over one-half of the individual's support for the applicable calendar year, and who is not a qualifying child of such taxpayer or of any other taxpayer for any taxable year beginning in the applicable calendar year. Relationship test of the "qualifying relative" lists child or a descendant of a child; a brother, sister, stepbrother, or stepsister; the father or mother, or an ancestor of either; a stepfather or stepmother; a son or daughter of a brother or sister of the taxpayer; a brother or sister of the father or mother of the taxpayer; a son-in-law, daughter-in-law, father-in-law, mother-in-law, brother-in-law, or sister-in-law; and an individual (other than an individual who at any time during the taxable year was the spouse, determined without regard to §7703, of the taxpayer) who, for the taxable year of the taxpayer, lived in taxpayer's residence and was a member of the taxpayer's household.
[67b] 26 USC §152(f)(1)(C)

from his spouse under a decree of divorce or of separate maintenance [shall not be considered as married]"[68]. Additionally, a married individual living apart might be considered not married as of the end of the year[69] if "the taxpayer files a separate return, maintains as his home a household which constitutes for more than one-half of the taxable year the principal place of abode of a child (within the meaning of §152(f)(1)) with respect to whom such individual is entitled to a deduction for the taxable year under §151 (or would be so entitled but for §152(e)), … furnishes over one-half of the cost of maintaining such a household during the taxable year, … *and during the last six months of the taxable year, such individual's spouse is not a member of such household* [Emphasis added]"[70].

California adds to the federal law used by California the provision that in order to be Head of Household the taxpayer has to either be entitled to the Dependent Exemption Credit or be unmarried and his/her qualified child also has to be unmarried (See FTB Publication 1540).

Additionally, California provides for the so-called "Joint Custody Head of Household" that will be defined below[71].

A. *Head of Household Status before the Divorce Papers Were Filed*

"*The anticipation of Death is worse than Death itself*"**.**

Head of Household status questions might arise where the Taxpayer lives separately from his/her spouse prior to the filing of the divorce papers.

The general rule is that a taxpayer cannot claim Head of Household status before he/she is separated from the spouse. Even though California courts acknowledge that "HOH filing status to be inequitable because it does not make an exception for married persons who live temporarily with their spouses after physically separating, but prior to filing for divorce", Californian courts still apply a strict interpretation of the law to the determination of Head of Household status. Courts consider that even temporary babysitting by an estranged spouse is enough to deny Head of Household status[72].

Nevertheless, there might be some instances where a married taxpayer might be able to claim Head of Household status in the State of California. The first instance is where there is a permanent restraining order issued against or for the taxpayer and the taxpayer has a qualified

[68] 26 USC §2(b)(2)(A)
[69] 26 USC 2(c)
[70] 26 USC §7703(b)
[71] Ca. Revenue and Taxation Code §17054.5(c)
[72] In the Matter of the Appeal of: PATRICIA C. FLEMING, 2008 Cal. Tax LEXIS 367, 7

child (or qualified relative). The courts are very picky in determining whether a restraining order qualifies a separated taxpayer for Head of Household status. For example, in one case where a restraining order was issued, the Court denied Head of Household status based on the fact that the restraining order did not have the box requiring the residence to be vacated checked (even though the "100 yards away from home" box was checked)[73]. In that particular case, the Court adhered to the form over substance line of thinking. In multiple other cases the courts have applied different types of analysis of the restraining order to deny the Head of Household status due to the temporary nature of the order[74], timing of the order (before marriage (!))[75], questions as to the finality of the separation by the particular restraining order within the meaning of legal separation[76], and some other technical arguments. It should be noted that courts do not doubt the restraining order per se to be insufficient for the determination of spouses' separation. Additionally, recently revised California Family Code provides that "[i]n the discretion of the court, the personal conduct, stay-away, and residence exclusion orders contained in a court order issued after notice and a hearing under this article may have a duration of not more than five years, … These orders may be renewed, upon the request of a party, either for five years or ***permanently*** [Emphasis added], without a showing of any further abuse since the issuance of the original order"[77]. Under such law, the restraining order provides for physical *AND* legal separation, since the rest of the orders are somehow subordinate to the restraining order.

Conclusively, a permanent restraining order issued against or for the taxpayer has to have duration, exclusion from the residence, and custody provisions spelled out. In that instance, the taxpayer might meet the requirement to be unmarried for the Head of Household status purposes and providing that other requirements are met, the taxpayer might successfully defend this status against a Franchise Tax Board challenge.

Another situation where the taxpayer might receive a tax benefit comparable to Head of Household status is when the taxpayer can claim Joint Custody Head of Household Credit, kind of unique California tax benefit. The California Revenue and Taxation Code provides that this credit is equal to lesser of 30% of Net Income[78] and $200[79] (to be

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[73] In the Matter of the Appeal of: Lyrae Zorich (97A-1469), 1999 Cal. Tax LEXIS 178, 4
[74] In the Matter of the Appeal of: Ali Vazirabadi (98A-0699), 1998 Cal. Tax LEXIS 577, 5
[75] In the Matter of the Appeal of: Raymond Sherley (96A-0327), 1996 Cal. Tax LEXIS 495, 3-4
[76] In the Matter of the Appeal of: Ali Vazirabadi (98A-0699), 1998 Cal. Tax LEXIS 577, 4
[77] CA Fam. Code §6345(a)
[78] Ca. Revenue and Taxation Code §17054.5(a)(1)
[79] Ca. Revenue and Taxation Code §17054.5(a)(4)

recomputed annually)[80]. To qualify for this credit, a married taxpayer must (1) have his parents available as qualified relatives, (2) file a separate return, (3) not have had his spouse as a member of his household for the last six months of the year, (4) maintain a household (whether or not the taxpayer's primary home, which constitutes the principal place of abode of a dependent mother or father of the taxpayer for the taxable year), (5) furnish over one-half of the cost of maintaining the household during the taxable year, and (6) not be able to file as Head of Household[81].The joint custody part of this credit is discussed below.

While not as beneficial as Head of Household status, this credit partially remedies the disproportionate taxation in case of taxpayers living apart before filing for divorce.

Lastly, some courts in California follow exactly the rule of the Internal Revenue Code, which is that married individual is not married for tax purposes if a) files a separate return, b) maintains as his/her home a household, which c) constitutes the principal place of abode of a child for more than one-half of the taxable year, d) furnishes over one-half of the cost of maintaining such household during the taxable year, and e) during the last six months of the taxable year, such individual's spouse is not a member of such household[82]. Providing all other requirements are met, Head of Household status would be available to such taxpayers.

Overall, it is difficult, yet possible to protect either Head of Household status or at least the Head of Household Credit. It is important for the taxpayer (especially the potential payer of all kind of imaginable and unimaginable types of support) to establish the date of separation, careful consideration of California status can save substantial amounts of money (future support) in addition to the tax benefits while keeping the still-married taxpayer in compliance with the law.

B. *Head of Household Status after the Petition for Divorce Was Filed but before Final Adjudication of Divorce* "*Nothing is more permanent than the temporary*"

California divorce courts (ironically named "family" courts) have a notorious habit to drag out divorces actions for years (literally). Where taxpayers are between married and divorced status multiple technical tax problems are created for taxpayers, not the least of which is determining filing status (there are multiple problems with determination of property, income streams, tax and basis attributes, and many others that are beyond the scope of this article). The safe harbor default marriage status during

[80] Ca. Revenue and Taxation Code §17054.5(b)
[81] Ca. Revenue and Taxation Code §17054.5(e)
[82] In the Matter of the Appeal of: Cherri Fune (96A-1351) 1998 Cal. Tax LEXIS 32, 5 citing 26 USC 7703(b)

the divorce procedures would be Married Filing Separately. It is the least advantageous, but safest status. Usually, taxpayer encounters problems in case of declaring Head of Household status while the divorce is still pending.

The foremost advice in this case would be to *BIFURCATE* the status and get the divorce declared as soon as possible, leaving custody, property, and support adjudication for later[83]. The self-guided form to file to request bifurcation is FL-347. The problem is that the bifurcation of status is usually left to the discretion of the judge (evident by the word "may"[84]) who might, well, not be willing to let that part of the case go. In these circumstances the careful tax/divorce planning is required.

One of the tests of Head of Household status is the existence of decree of legal separation for still married taxpayers. The stream of cases demonstrates that physical separation after filing for divorce is not itself sufficient to satisfy the separation requirement of the Head of Household status[85, 86]. Under such circumstances, it would be wise for both parties to obtain support order while case is *pendente lite* and to have temporary custody arrangements written in the same order (see the DVRO provisions analysis above). Such order will provide the evidence of legal separation, legal requirement to pay support, and the possibility to compute the number of days each parent has custody of the child. Furthermore, after obtaining the final decree of divorce, taxpayer has to make sure that the date of separation is referred back to at least the date of filing of divorce process, not the date of divorce. Since an FTB examination usually comes after a certain period of time, there is a strong possibility that the divorce's final judgment with date of separation will serve as a retroactive ratification of the legal separation and thus Head of Household status taken by one or both parents (or more than two parents, starting on January 1, 2014 per SB274).

Also, it should be noted that "50/50 shared custody" provision, "joint physical custody" without defining the custodial time of each parent, or "share custody of the child equally" provisions would immediately disqualify *BOTH* parents from Head of Household status[87]. As a result, it would be advisable to specifically outline the exact number of days each parent has custody of the child. In case of more than 1 child, it appears that it would be advisable to have at least one child to live with

[83] CA Fam. Code §2337

[84] CA Fam. Code §2337(a) that states "In a proceeding for dissolution of marriage, the court, upon noticed motion, **may** sever and grant an early and separate trial on the issue of the dissolution of the status of the marriage apart from other issues." [emphasis added]

[85] In the Matter of the Appeal of: Craig Dawkins (97A-0836), 1998 Cal. Tax LEXIS 197,5

[86] In the Matter of the Appeal of: Imran R. Farooqi (97A-0221), 1998 Cal. Tax LEXIS 101,6

[87] In the Matter of the Appeal of: Thomas LaBeau (96A-0866), 1997 Cal. Tax LEXIS 146, 4

each parent 183 days or more per the custody order, so each parent might qualify for Head of Household.

An additional possibility provided by law for the parents who do not qualify for` Head of Household status is the joint custody Head of Household credit. The credit amount is described above. For married taxpayers the requirements are: filing a separate return, living separately from the spouse for the entire year, having a qualified child in the household for no less than 146 days of the taxable year but no more than 219 days of the taxable year, under a decree of dissolution or separate maintenance, or under a written agreement between the parents prior to the issuance of a decree of dissolution or separate maintenance where the proceedings have been initiated[88]. A "qualifying child" means a son, stepson, daughter, or stepdaughter of the taxpayer or a descendant of a son or daughter of the taxpayer"[89]. The courts look favorably on the joint custody Head of Household credit and even sometimes compute the days for the taxpayer to avail him/her of the credit, in case of disallowance of the Head of Household status[90].

Overall, while the divorce proceedings are in progress, it is important to make sure that court orders clearly spell out separation, dates, and custody arrangements, in order to protect taxpayers' tax benefits, including those related to the filing status.

C. *Head of Household Status after the Final Decree of Divorce*

"Everything takes longer than you think."

After the final decree of divorce, the marriage status, separate maintenance, relation, and half of the cost of household tests for Head of Household are straightforward (or close to it). Child support is usually counted towards the support provided by the custodial parent. Issues usually arise over the test of whether the child lives with the taxpayer for more than a half of the tax year.

The divorce judgment is the primary consideration for the Tax Court's determination of the status of the taxpayer. The custody arrangements in the judgment are considered the primary evidence of the number of days the child lives with the respective parent. As noted above, "every other week", "every other month", "50/50", and other pronouncements of the kind would disqualify both parents from being Head of Household for the tax purposes due to having custody of the child for less than 183 days. Usually Form FL-341 attached to the judgment provides sufficient information to determine whether the child is a

[88] Ca. Revenue and Taxation Code §17054.5(c)
[89] Ca. Revenue and Taxation Code §17054.5(d)
[90] In the Matter of the Appeal of: Darren M. DeBerry (98A-0514), 1999 Cal. Tax LEXIS 110, 7-10

qualified child of the taxpayer. Provisions of joint custody Head of Household are similarly applicable after the divorce.

A confusing situation might arise in the case where there is a non-custodial parent who, through a series of visitations orders and smart exercising of a right of first refusal, obtains the "non-custodial visitation time" that will sum up to more than 183 days in a taxable year. Generally, the court requires a showing of a material change of circumstances to change the custody of a child[91]. It is a sufficiently high standard, and thus the taxpayer filing as Head of Household probably would not miss the change. However, the right of first refusal, which, if recorded in judgment, states that one parent is required to offer another parent to watch over the child before hiring a babysitter. Additionally, change of parental time does not require a change of custody and showing a change of circumstances[92]. Even restructuring of the joint custody agreement that leads to complete reversal of custody does not require a material change of circumstances[93]. As a result, through a chain of additions and through supplemental care time by right of first refusal, a non-custodial parent might obtain the number of days sufficient for claiming Head of Household status and hence, defeat the head of household filing status of the custodial parent.

c. **Head of Household, Conclusion** "*When working toward the solution to a problem, it always helps if you know the answer. Provided, of course, that you know there is a problem.*"

Overall, there are ample possibilities to obtain (or lose) Head of Household status before, during, and after the divorce. In case of comparable custodial time, the arrangements should be reviewed especially carefully. But in the end, kids will reach the age of majority and Head of Household issue will not be that important anymore.

IV. A FEW WORDS ABOUT SUPPORT "Just because you're paranoid doesn't mean they aren't after you" Catch-22

Generally, "family support" as applied by the heavy hand of family courts is a considerable burden on the payer (and considerable help for the payee). In addition to support, there are tax consequences of support that are not always favorable to the payer. Unless otherwise designated, spousal support (referred to by the Code as "alimony") is taxable to the

[91] In re Marriage of Carney (1979), 24 Cal.3d, 725.
[92] In re Marriage of Lucio (2008), 161 Cal.App.4th 1068
[93] In re Marriage of Birnbaum (1989), 211 Cal.App.3rd 1508

recipient[94] and deductible by the payer[95]. Child support, on the other hand, is not taxable to anyone (recipient or child) and is not deductible. Spousal support is deductible as an adjustment to gross income. It is not an itemized deduction. As the result of deductibility/inclusion of spousal support, a strategy emerges for *FRIENDLY* divorcing couples. The strategy could be described as shifting of taxable income (or "money to the children, not to the government"). The strategy entails increasing the ratio of spousal support over the child support (usually by stipulation of parties). The court may consider the stipulation and apply one or more of the spousal support factors stating on the record that the court considers the orders that "the court determines are just and equitable"[96]. As to the child support reduction by stipulation of parties, the court has statutory discretionary authority to depart from the uniform guidelines[97]. At least one Circuit supports this scheme, characterizing unallocated payment by a spouse as alimony, and disregarding the instructions of the family court as to the administration of those payments for tax purposes. According to the Third Circuit, "an unallocated payment order not only frees the parents from restrictive court instructions that dictate who pays for what, but may allow the parties to enjoy a tax benefit at a time when they face increased expenses as they establish independent homes. This advantage would be lost by taxing all unallocated payments to the payer spouse"[98]. Since tax consequences of the characterization of payments as spousal support could be significant to both the paying and receiving spouses, tax law has created a substantial number of qualifications for the payment to be so considered.

a. Spousal Support Requirements "*Nothing is as easy as it looks.*"

Taxable/deductible spousal support must be in the form of ***cash*** (or cash equivalent) payments[99]. The tax problems of the payer start when in order to preserve cash-flow, a payer-spouse tries to pay spousal support through services, rights to use property, or by third party obligation.

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[94] 26 USC §71
[95] 26 USC §215
[96] Cal. Fam. Code §4320(n)
[97] Cal. Fam. Code §4052
[98] Kean v. Commr. (3rd Cir. 2005) 407 F3d 186, 193
[99] 26 USC §71(b)(1), Treas. Reg. §1.71–1T, A–5

Sometimes even the family courts make orders of non-cash support. In such cases, the payer/obligor loses the deduction of the support payments. That is because no spousal support deduction is allowed for the transfer of a third-party debt instrument or a debt instrument of the payer. Similarly, no spousal support deduction will be allowed for the value of property the payer allows the recipient to use (such as rent-free occupancy of a dwelling)[100]. On the other hand, a third party's cash payment to the supported spouse or made on the supporting spouse' behalf may be characterized as a payment to the supporting spouse by the payer and considered spousal support (providing all other requirements are met). For example, payments to a former spouse made by the obligor spouse's controlled corporation, which were required by a divorce or separation instrument, were taxed as constructive dividends to the obligor, and then treated as if they had been paid in cash by the obligor spouse to the payee spouse. As result, the payee has taxable income and the obligor has a spousal support deduction[101]. One of the requirements to be adhered to is that the payment has to be received "***by or on behalf of***" a receiving spouse and ***under divorce or separation instrument***[102] (not discussed here in detail). The one provision that should be remembered, however, is that voluntary payments of spousal support before the separation or divorce instrument are *not* deductible/includible under IRC §71. Therefore, it is not possible to retroactively change the nature of the payments already made. For example, spousal support paid ***voluntarily*** during the separation period ***cannot be*** made deductible even if a later written separation agreement or court order attempts to re- characterize the payments retroactively[103]. Here the tax professional sometimes can correct the mistake of family law professional by applying the common law exception to the retroactivity provisions. A "*nunc pro tunc*" court order[103a] can have retroactive effect if it corrects an error in a previous order (but not if it substantively changes the prior order)[104]. So, as a practical manner, tax

[100] Treas. Reg. §1.71–1T, A–5; Lofstrom v. Commr. (2005) 125 TC 271, 276–277
[101] Medlin v. Commr., TC Memo. 1998–378—corporate payments of Wife's car and medical insurance expenses, which Husband had included in income as constructive dividends, are deductible spousal support by Husband and taxable spousal support to Wife.
[102] 26 USC §71(b)(1)(A)
[103] Ali v. Commr., TC Memo. 2004–284—retroactive stipulation and order that separation payments were intended as family support not effective for tax purposes; Ewell v. Commr., TC Memo. 1996–253—payments pursuant to informal agreement prior to formal stipulation not deductible; Keegan v. Commr., TC Memo. 1997–359—payments predating temporary support order not deductible (letter from payer's attorney to payee's attorney offering to settle OSC for spousal support not a written separation agreement for §71 purposes because not signed and returned by payee)
[103a] It means now for then. In general, a court ruling "nunc pro tunc" applies retroactively to correct an earlier ruling. A court nunc pro tunc order reverses or modifying an earlier ruling retroactively.
[104] Ali v. Commr., TC Memo. 2004–284, fn. 2 (dictum); Johnson v. Commr., TC Memo. 1989–415—original order providing payments were for child support corrected by subsequent order stating they were spousal support (original order did not give effect to judge's intent and was therefore erroneous)

practitioners, providing they are involved at the early stages of the proceedings, can either examine the existing court orders to determine if a slight modification would come under "correcting errors" exception to the retroactive orders of the family court and thus make spousal support deductible, or if no orders yet exist, whether deductible/includible treatment is desired for payments preceding the court order (during the separation period). It is imperative that the spouses reduce their agreement on support to *writing* and *hold off* making any support payments until after the agreement is executed. The agreement need not be legally enforceable[105].

Spousal support payments are not deductible if the payer spouse is obligated to make the payments *AFTER* the payee spouse' death (***termination at death requirement***). The requirement for termination of alimony payments on the death of the payee spouse is designed to prevent the spouses from obtaining alimony treatment for the simple division of property which occurs at the death of the payee spouse[106].

Spousal support payments are also not deductible if the payer spouse is liable to make any payment as a "substitute for such payments after the death of the payee spouse"[107]. Thus, if the instrument requires continued payments after the payee's death, NONE of the payments are deductible—before or after the payee's death[107, 108]. Even if the family court intends the support payments to be deductible, the fact remains that payments to the spouse and her attorney are not deductible spousal support because the obligation would continue in the form of substitute payments to the parties' children or to the attorney after the recipient spouse' death[108]. The deductibility of payments is to be decided by the written instrument, whether judgment or prenuptial agreement. Payments that are to be continued to be made to the heirs of the recipient spouse are not qualified as alimony[109]. Even lump sum alimony might be not deductible if the obligation to pay does not terminate at death[110]. In California, as well as in some other states, there is no need to explicitly state that the payments are terminable upon the supported spouse' death, if they would be terminable upon the payee's death by operation of law[111]. California law specifically states that "except as otherwise agreed by the parties in writing, the obligation of a party under an order for the support of the other party terminates upon the death of either party or the remarriage of

[105] Bogard v. Commr. (1972) 59 TC 97, 100–101 & fn. 3.
[106] Moore v. C.I.R., T.C. Memo. 1989-49
[107] 26 USC §71(b)(1)(D); Treas. Reg. §1.71–1T, A–10
[108] Okerson v. Commr. (2004) 123 TC 258, 264–266
[109] LaPoint v. Commr., TC Memo. 2012–107
[110] Nye v. Commr., TC Memo. 2013–166
[111] 26 USC §71(b)(1)

the other party"[112]. Thus, for deductibility purposes, it is sufficient that California law makes spousal support payments terminable upon the supported spouse' death[113]. According to a Tax Court opinion, family support payments are deductible as alimony because the obligation to pay family support terminates upon the death of the supported spouse under California law. The Tax Court rejected the idea that the payments are not deductible because a third party might take custody of the children after the supported spouse' death and the payer might be required to continue making child support payments[114].

b. Special Situations of Spousal Support Deductibility "*It is impossible to make anything foolproof because fools are so ingenious.*"

As expected, the question of spousal support deductibility creates a variety of situations where deductibility of spousal support is not assured. For example, if the spouse fails to pay the full amount of spousal and child support owed under a divorce or separation instrument, under the Code, a payment is applied first to child support. Any amount exceeding the current unpaid child support amounts and those in arrears are treated as alimony for tax purposes, regardless of how the parties choose to label the payments[115]. On the other hand, spousal support paid in a month after it is due is deductible if it would have been deductible had it been paid on time[116]. Prepayments are treated differently from delinquent payments. A prepayment of spousal support that is due in a future year is not taxable or deductible in the future year to which it is applicable[117]. The prepayment is not deductible/taxable even in the year paid because it would not have been paid "under a divorce or separation instrument" The logic is that prepayments are voluntary payments and thus not deductible[118]. So, ironically, tax advice to the divorcing payer would be: Do not prepay; the tax planning could be achieved only in delaying the spousal support payments. Treatises suggest also using alimony trusts and annuity support

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[112] Cal. Fam. Code §4337

[113] Johanson v. Commr. (9th Cir. 2008) 541 F3d 973, 976–977 (Tax court applied California case law interpreting §4337 to find payments not terminable at death)

[114] Berry v. Commr., TC Memo. 2005–91

[115] 26 USC §71(c)(3); Proctor v. Commr. (2007) 129 TC 92, 94; Haubrich v. Commr., TC Memo. 2008–299 (no deduction since unpaid child support obligations exceeded total support payments for the year

[116] Rev. Rul. 55–457, 1955–2 CB 527; Barrett v. United States (5th Cir. 1996) 74 F3d 661, 666 (payment to Wife in discharge of delinquent and future spousal support taxable to Wife, deductible to Husband, to extent of past arrearages but not with respect to future support; Olster v. Commr. (11th Cir. 1985) 751 F2d 1168, 1171–1172

[117] Melvin v. Commr., TC Memo. 2008–115, affirmed (11th Cir. 2008) 303 Fed. Appx. 791 (no deduction in 2003 with respect to amounts paid in prior years but applicable to 2003)

[118] Joslyn v. Commr. (1954) 23 TC 126, 134

as a solution to predictability and deductibility of the support[119]. A discussion of alimony trusts and annuity support are beyond the scope of this article.

Very often, trying to preserve assets "for the children", parties agree to (or are ordered to) pay spousal support in the form of direct payments of obligations to third parties. Such payments frequently create tax consequences unintended by the parties/lawyers/judges. One of the most common "spousal support" non-direct-cash payment orders is an order to pay the mortgage on the former family residence. The catch is that only the primary obligor on a loan can deduct the interest payments[120]. Consequently, if one spouse owns the home subject to a mortgage, the other spouse cannot deduct interest on that mortgage. The same rule applies to property taxes. So, if court awards the property to one spouse and makes the other pay the mortgage, none of the spouses could claim tax deduction for the mortgage interest, at least before final divorce decree which should supposedly decide the ownership of the family home and final support order is made. Note that if the property tax paying party does not have the ownership of the home after the final divorce decree, property tax payments are still not deductible. So, parties can agree that paying party will own the house but the recipient party will live in the house (i.e. until the majority of children, or specific number of years). Under certain circumstances, the "out spouse" may be able to deduct the mortgage interest paid on a house occupied rent-free by a former spouse[121]. That way, the paying party can deduct the mortgage interest and retain the hard earned and paid property, while non-paying party would enjoy rent-free dwelling for significant amount of time without recognizing income. That strategy would meet both tax planning goals and declared goals of "family" courts to have equitable fair division of property while assisting the non-working spouse to get back to the workforce easier with less stress.

Note that the owner spouse cannot deduct *as spousal support* payments of property taxes, mortgage interest, repairs, insurance, etc. on a house occupied by the other spouse unless specifically ordered by the family court as spousal support or equivalent[122]. Of course, the taxpayer can still deduct the mortgage interest for his or her residence under provisions of the Internal Revenue Code dealing with second residences[122a]. The rental value is also not deductible spousal support to

[119] Rutter Guide Cal. Prac. Guide Family L. Ch. 6-B (Hogoboom et al) [10:146-165]
[120] Diez-Arguelles v. Commr., TC Memo. 1984–356
[121] 26 USC §163 (h).
[122] Zinsmeister v. Commr., TC Memo. 2000–364, affirmed (8th Cir. 2001) 21 Fed. Appx. 529
[122a] 26 USC 164(h)(4)(A)(i)(II)

the owner/out spouse when the other has rent-free possession of the home[123]. However, the owner/out spouse can take a spousal support deduction for payment of the in spouse's utility bills (provided those payments are required by the divorce or separation instrument and meet all other §71 requirements for a spousal support deduction). Similarly, the out spouse's (spouse not living in the family residence) rent payments on behalf of the in spouse (spouse living in the residence) *should* qualify as deductible spousal support to the out spouse/payer (provided the payments are required by the divorce or separation instrument and otherwise satisfy the usual requirements for includible/deductible spousal support)[124]. Also, in a situation where one spouse owns stock of a cooperative apartment (or probably a timeshare), and is thus entitled to its occupancy, but allows the other spouse to live there rent-free, the owner spouse's payments to the corporation are treated as taxable/deductible spousal support (again, assuming the IRC spousal support rules are otherwise satisfied)[125].

Family courts often fail to consider tax implications of "family support" orders. One spouse is often ordered to make rent payments for the benefit of the custodial parent's household. Those payments cannot be treated as deductible spousal support to the extent they decline upon a contingency related to a child (e.g., when the child moves out of house, turns 18, etc.)[126].

This problem can readily be solved. The payer spouse can simply increase the amount of deductible support; the recipient can then use the additional amounts to pay interest and taxes or rent. Of course, such additional payments must meet all the prerequisites for deductible spousal support.

In addition, the Regulations permit the payer spouse to take a spousal support deduction for interest and taxes applicable to property owned by the payee spouse[127]. Assuming the payments meet the Code requirements (termination at supported spouse' death, etc.), they are deductible by the payer, and taxable to the supported spouse, even though paid *directly* to the mortgagee or the tax collector. The supported spouse, in turn, can deduct the interest and property tax payments made on his or

[123] Bradley v. Commr. (1958) 30 TC 701, 706–707; Treas. Reg. §1.71–1T, A–5, A–6; Ltr. Rul. 8710089

[124] Treas. Reg. §1.71–1T, A–6; Marinello v. Commr. (1970) 54 TC 577, 579 (predating TRA 1984) (Husband's rent payments deductible spousal support where Husband had transferred property to his corporation and leased it back, giving Wife occupancy); but nevertheless Serednesky v. Commr., TC Memo. 1993–566 (out spouse' rent and utility payments on behalf of in spouse not deductible spousal support where divorce instrument stated payments were required "in lieu of additional child support and alimony")

[125] Rothschild v. Commr. (1982) 78 TC 149, 153–154

[126] Israel v. Commr., TC Memo. 1995–500 (only 1/3 of Husband's rent payments on Wife's apartment were includible/deductible spousal support because agreement required 2/3 reduction of rent obligation if child resided with Husband for more than half of year)

[127] Treas. Reg. §1.71–1T, A–6

her behalf. However, to warrant a deduction, the interest or property tax payments must be required by the divorce or separation instrument, or be made at the written request or ratification of the recipient spouse[128].

A little bit more complicated situation for the tax practitioner occurs when, as a result of property division and support negotiation/order, the spouses were awarded joint ownership of the property. Most of the time, a tax professional is not initially involved. So, in case of joint ownership, tax results depend on the form of joint ownership. If the former spouses hold the residence in ***joint tenancy***, the spouse paying the taxes gets the property tax deduction; and the tax payments are not taxable to the other spouse[129]. Obviously, under certain circumstances, the payer spouse may deduct the interest payments[130].

If the former spouses hold the residence as ***tenants in common*** and one spouse makes all the payments, one half of the payments is deductible spousal support to the paying spouse (assuming, of course, they meet all the requirements for deductible spousal support) and is taxable income to the nonpaying spouse[131]. In addition, each spouse is entitled to a deduction for half of the property taxes[132]. But mortgage interest is deductible only under statutorily-specified circumstances[133].

One of the less common situations is when one spouse owns a residence and rents it to the other. The owner out spouse should treat the rental transaction as a trade or business and report the profit or loss on Schedule E of Form 1040. The same analysis applies to a house the parties own jointly or as tenants in common: the out spouse could rent his or her interest in the house to the in spouse, providing the court does not order one of the spouses to vacate the property (or cede the exclusive use to the other). A rental transaction may have desirable tax results, because the owner out spouse could treat the house as a tax shelter, deducting from other income the depreciation on the house as well as other expenses (insurance, repairs, condo charges, etc.).

Speaking of "tax shelters", to deduct annual losses on the house, the out spouse "lessor" must establish he or she is holding it for the production of income. This means the out spouse must charge a fair market rental and act like an "outside landlord"[134]. And as a rule, to use

[128] Treas. Reg. §1.71–1T, A–7
[129] Rev. Rul. 62–38, 1962–1 CB 15
[130] 26 USC §163(h).
[131] Rev. Rul. 62–39, 1962–1 CB 17
[132] Rev. Rul. 62–39
[133] 26 USC §163(h); Also, in Ewell v. Commr., TC Memo. 1996-253 tax court allows Husband to deduct entire amount of interest and taxes on community property paid with his separate property, which might also considered another way of transmutation.
[134] Ware v. Commr., TC Memo. 1986–406 (Husband could not deduct loss where he leased to Wife for less than market rental and paid for repairs which Wife, as tenant, was supposed to pay for)

the rented house (or part of it) as a tax shelter, the out spouse "lessor" must consider the "passive loss" rules of IRC §469. Under these rules, losses on rentals are "passive losses" which can be deducted only from "passive income" (rental income in this case), not from other income (such as salary or self-employment income, or investment income such as interest or dividends). For rental activities there is also an exception to the passive loss rules that permits up to $25,000 a year in passive losses on rental real estate to be deducted from other (non-passive) income, if the taxpayer's (here, the out spouse's) adjusted gross income is under $100,000 per year with a phase out of the $25,000 exception at $150,000 AGI. However, there is an important condition: The out spouse claiming this deduction must "actively participate" with respect to the rental activity[135]. The Internal Revenue Code also provides an exception to the passive loss rules for real estate professionals to deduct losses on rental real estate. A real estate professional for this purpose is a taxpayer who spends more than 750 hours per year on real estate businesses in which he or she materially participates[136].

c. Some Other Available Deductions in the Context of Divorce-Related Payments "*When you really need something, it's either not available, or can't be found. When you don't need it, it's either available, or lays around in plain sight.*"

Some of the deductions that arise out of the divorce process could be either allowable, or not, depending on the facts, circumstances, and specific law requirements.

A supported payee *cannot* take a "bad debt deduction" under §166 for spousal or child support that was never paid. The reason is that the payee has no tax basis for these claims since the non-received payments were never reported as income[137].

A supported spouse who is required to repay spousal support received and included in income in prior years is entitled to *deduct* the amounts repaid. The Code allows such deductions to be taken in the tax brackets either of the year in which the amounts are repaid *or* the year in which the amounts were originally received[138].

d. Child support "*No good deed goes unpunished.*"

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[135] 26 USC §469(i)
[136] 26 USC §469(c)(7)
[137] Spousal support: Perry v. Commr. (1989) 92 TC 470, 478–479; Child support: Swenson v. Commr. (1965) 43 TC 897, 899 (child support); see Rev. Rul. 93–27, 1993–1 CB 32
[138] 26 USC §§111, 1341; Feldman v. Commr., TC Memo. 1991–153

Whenever a "family" court gets a divorce case for a couple with children, child support is one of the most serious and potentially damaging to the parties issues in the proceedings. For starters, child support is statutory. Child "support" refers to a support obligation owing on behalf of a child or an amount owing to a county for reimbursement of public assistance paid on behalf of a child pursuant to California Family Code §17402. It also refers to past due support and arrearages; and, for children owed a duty of support, includes "maintenance and education"[139]. Similar provisions exist in all states' law. Child support payments are not included under the definition of gross income under Internal Revenue Code[140]. Thus, child support payments are neither deductible by the payer spouse nor included in income by the child or other parent for income tax purposes[141].

Very often "family" courts issue orders where they specifically award "family support" without specification whether it is child or spousal support. Family support (unallocated combined spousal and child support) is fully includible/deductible provided it meets all the IRC requirements for spousal support deductibility. The obligation to pay family support must terminate on the supported spouse' death and no part of the payment can be fixed as child support or be reduced upon the occurrence of a contingency relating to the children[142]. So it is important that a tax professional is involved at the preparation of the proposed judgment. If the intended treatment is child support (not taxable), parties have to specifically designate the support as support for children rather than "family support". If the terms of a divorce or separation instrument fix an amount of money or a part of a payment as a sum which is payable for the support of children of the payer spouse, that part of the payment is not treated as "alimony and separate maintenance payments," which in effect removes that portion from being treated as gross income to the recipient[143]. Payments "fixed" as child support are not taxable/deductible spousal support. "Subsection (a) shall not apply to that part of any payment which the terms of the divorce or separation instrument fix (in terms of an amount of money or a part of the payment) as a sum which is

[139] CA Family Code § 150; Monterey County v. Banuelos (2000) 82 CA4th 1299, 1305
[140] 26 USC §61
[141] 26 USC §§71(c), 215(b); Treas. Reg. §1.71-IT(c) A 15
[142] DeLong v. Commr., TC Memo. 2013–70; Schilling v. Commr., TC Memo. 2012–256 (if recipient has complete discretion when spending unallocated family support payment, entire payment treated as spousal support rather than child support); Theurer v. Commr., TC Memo. 2008–61 (Husband's $20,000 per month payments to Wife under court order that deferred characterization of payments as spousal or child support, or combination thereof, were taxable spousal support to Wife because court order clearly stated payments would cease on W's death)
[143] 26 USC §§71&215; Tres. Reg. §1.71-IT(c) A 15

payable for the support of children of the payer spouse"[144]. It is important to remember that even if state law could be used to "reconstruct" child support payments, the amount of support is taxable/deductible if the amount is not fixed as child support[145].

Generally, a nunc pro tunc order (an order which makes the change effective from the beginning of the original decree) is not recognized for tax purposes by the Service or the Tax Court unless the amended order retroactively corrects a mistake, inadvertence, or clerical error to enforce the original intent of the Court[146].

The Code also treats as nontaxable/nondeductible child support any amount specified in the instrument that will be reduced (1) "on the happening of a contingency . . . relating to a child (such as attaining a specified age, marrying, dying, leaving school, or a similar contingency)," or (2) "at a time which can clearly be associated with" such a contingency[147]. If the reduction in payments were not so closely tied to the children reaching majority, but yet could be "clearly associated" with this event, the payments would be treated as child support for tax purposes as well[148].

Overall, if deductibility is desired, the taxpayer has to make sure that the support ordered by the court does not have a clear association with the child and is presumably not terminable at child's majority or other such contingency. Alternatively, it is possible to arrange for spousal support that terminates at dates different than a clearly identifiable contingency related to children, without tainting the payment as "child support".

V. *SOME CONSIDERATION REGARDING ATTORNEY FEES AND COSTS IN DIVORCE* "*They have the right to do anything we can't stop them from doing.*" Catch-22

a. General Deductibility of Costs and Fees Related to Divorce "*Behind every little problem there's a larger problem, waiting for the little problem to get out of the way.*"

The Internal Revenue Code allows a taxpayer to deduct all of the ordinary and necessary expenses paid or incurred during the taxable year

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144 26 USC §71(c)(1)

145 Lawton v. Commr., TC Memo. 1999–243—amount must be "fixed" in divorce or separation instrument, not through extraneous source such as statutory guidelines.

146 CIR v. Bosch's Estate, 387 U.S. 456 (1967); Graham v. Commissioner of Internal Revenue, 79 T.C. 415, 1982 WL 11143 (1982); Freyre v. United States (6th Cir. 2005) 135 Fed. Appx. 863, 866–68

147 26 USC §71(c)(2)(A) & (B); Fosberg v. Commr., TC Memo. 1992–713 ("alimony" that stops when wife remarries or dies or youngest child reaches 18 is nondeductible child support)

148 26 USC §71(c)(2)(B), Ltr. Rul. 8820052; Ltr. Rul. 8725003

for the production or collection of income[149]. Taxpayers have often attempted to claim a deduction under §212(2) for the management, conservation or maintenance of property held for the production of income. In general, the United States Supreme Court has held that the determination of deductibility or lack of deductibility of legal fees, including legal fees in connection with a divorce, is based upon the "origin of the claim" doctrine[150]. Claims to property and alimony settlements are of a personal character and origin, even though the claim may have business consequences. Therefore, such payments are not deductible. Similarly, deductions for attorneys' fees were not allowed in connection with property settlements[151], recommendations regarding acquiescence, or in connection with the invalidation of an ante nuptial agreement[152].

b. The Main Rule for Attorney Fees and Costs in the Divorce: They Are Not Deductible "*The light at the end of the tunnel is a train.*"

The general rule for the divorce-related expenses is that the fees charged by attorneys, accountants, appraisers and other experts in connection with marriage dissolution, child custody, and similar family law disputes are, as a general rule, not deductible by either party because they are considered personal expenses[153]. Specifically, attorney fees incurred to obtain child support are not deductible, since child support is not included in income[154]. Similarly, the costs of collecting delinquent child support, or of seeking an increase or resisting a decrease in child support, are not deductible. Rationale: these items are deemed costs of obtaining nontaxable income[155]. Deductions are not allowed for amounts spent on attempts to reduce alimony or separate maintenance payments, on the basis that not only are the origins of the claim personal, but also the reduction of the payer spouse's obligation to make such payments does not produce any amounts which are includable in the payee spouse's gross income[156]. In some instances, the related legal costs are not currently deductible because they either create or protect title to a specific property right[156a]. In those cases, these costs would be capitalized and included in the basis of the assets protected[156b].

[149] 26 USC §212(1)
[150] U.S. v. Gilmore, 372 U.S. 39 (1963), and U.S. v. Patrick, 372 U.S. 53 (1963)
[151] Albergottie v. CIR., T.C. Memo. 1973-9, T.C.M. (P-H) (1973)
[152] Fleischman v. CIR., 45 T.C. 439 (1966)
[153] Treas. Reg. §1.262–1(b)(7); United States v. Gilmore (1963) 372 US 39, 48–49
[154] Swenson v. Commr. (1965) 43 TC 897, 900
[155] 26 USC §265(1)
[156] Hunter v. U.S., 123 F. Supp. 763, judgment affirmed, 219 F.2d 69 (2d Cir. 1955)
[156a] 26 USC §263(a)(1)
[156b] 26 USC §§1016, 1012; See also Bowers v. Lumpkin, C.C.A.4 (S.C.) 1944, 140 F.2d 927, certiorari denied 322 U.S. 755, (Legal expenses involved in defending or protecting title to property are not "ordinary and necessary expenses" deductible as nontrade or nonbusiness expenses from gross income in order to compute the

Costs incurred in resisting the imposition of an obligation to pay spousal support (or child support) are not deductible, even though the spousal support itself is deductible[157]. Also nondeductible are the costs of resisting an action to collect delinquent support, or the costs of seeking a decrease in support, or of resisting an increase in support.

Likewise, the costs incurred in negotiating or litigating whether property is subject to equitable distribution, or whether it is community or separate property, are not deductible[158]. Similarly, legal and accounting fees incurred in litigating the valuation of divisible marital property interests are a nondeductible personal expense[159]. Litigation may even have important business implications: although one spouse might incur significant counsel fees in connection with marriage dissolution to make certain that a family business is protected, his or her litigation expenses are "personal" and nondeductible[160].

The only tax-related advantage that could be derived from otherwise non-deductible fees incurred in establishing or defending title to property would be to capitalize and add them to basis. Nevertheless, a carefully crafted, separated, and itemized legal bill for the expenses could create at least partially deductible legal expenses. Recall from our discussion above that not *all* legal costs incurred in the proceedings need to be lumped together for tax purposes. Carefully analyzing individual items of legal expense and their nature and purpose may separate those that are capitalizable or currently deductible from those that are non-deductible.

c. Deductible Legal Expenses Incurred in the Process of Divorce or Legal Separation "*Chaos always wins, because it's better organized.*"

Despite the blanket denial of the deductibility of legal fees in divorce proceedings, certain types of advice might give rise to deductible legal expenses. With careful consideration, a taxpayer might be able to request the lawyer/CPA to properly itemize the bill and be able to deduct at least part of the legal expenses that became a real menace in the divorce

taxable net income, but constitute a capital charge which should be added to cost of property and taken into account in computing the capital gain or loss in case of subsequent sale.)

157 Sunderland v. Commr., TC Memo. 1977–116; Melcher v. Commr., TC Memo. 2009–210

158 United States v. Gilmore (1963) 372 US 39, 51–52

159 Melat v. Commr., TC Memo. 1993–247 (valuation of H's share of unpaid fees and goodwill of his law partnership)

160 Melat v. Commr., TC Memo. 1993–247 (Husband cannot deduct cost of fighting value of his share of unpaid law firm contingency fees), see also United States v. Gilmore, 372 U.S. 39 (1963) (Court held that the origin and character of claim with respect to which expense was incurred, rather than its potential consequences upon fortunes of taxpayer, is controlling basic test of whether expense was 'business' or 'personal' and, hence, whether it is deductible as expense incurred for conservation of property held for production of income)

proceedings. The deduction could partially mitigate the damage of the attorney fees to the Taxpayer.

One example of deductible legal expenses is legal expenses incurred in litigating a business dispute between spouses. Such expenses are deductible, if the origin of the claim arose from the taxpayer's "profit-seeking" rather than personal activities [161]. The deduction might be allowable even though marriage dissolution was also involved[162]. The important strategy is in allocating legal expenses (since divorce-related property division legal expenses are not allowable) between the portion of the fees attributable to the business litigation per se and the portion attributable to dividing up ownership of the business as part of the marriage dissolution proceeding[163].

Another example is litigation of property rights in the context of marital dissolution litigation. Even though defense of property would not qualify a taxpayer for the deduction, litigation regarding some of the rights that give rise to itemized deductions and AGI might provide a basis for the deduction of legal costs associated with it. However, these costs are treated as "miscellaneous itemized deductions", deductible in Schedule A of the Taxpayer's return along with other miscellaneous itemized deductions (e.g., unreimbursed employee business expenses). They are deductible only to the extent they exceed 2% of adjusted gross income[164]. Also, such deductions are subject to a cap when AGI exceeds certain levels[165]; and they cannot be taken into account when computing the Alternative Minimum Tax[166].

Contingent fees create additional problems as to deductibility. Assume that a spouse recovers an amount that is taxable (such as disputed spousal support) and incurs deductible attorney fees under a contingency fee contract. The spouse cannot exclude the amount of the fees from income. Instead, the full amount recovered must be included in income[167].

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[161] 26 USC §212(2) (deduction for "ordinary and necessary expenses" paid or incurred "for the management, conservation, or maintenance of property held for the production of income"); United States v. Gilmore, 372 US at 48–49

[162] Liberty Vending, Inc. v. Commr., TC Memo. 1998–177 (Husband can deduct attorney fees incurred in resisting Wife's attempt to seize Husband's business assets (legal expenses arose from his profit-seeking activities because incurred to establish his right to possession of, or participation in, business income))

[163] Dolese v. United States, 605 F2d at 1151–1152 (corporation's legal expenses arising out of divorce between shareholder-owner and spouse deductible to extent incurred to resist actions interfering with its business activities)

[164] 26 USC §67; Glassman v. Commr., TC Memo. 1997–497 (costs of litigating amount due under QDRO are miscellaneous itemized deductions subject to §67)

[165] 26 USC §68

[166] 26 USC §56(b)(1)(A)(i)

[167] Commissioner v. Banks (2005) 543 US 426, 430 (when litigant's recovery constitutes taxable income, the taxable income includes portion of recovery paid to his or her attorney as contingent fee] The attorney's fee is deductible, but the deduction may be limited or lost entirely because it is a miscellaneous itemized deduction subject to the 2% rule and it is not allowable at all in computing the AMT)

On the other hand, legal fees and other litigation costs incurred to obtain income that is includible in the recipients' gross income are deductible[168]. For example, the cost of obtaining an interest in the other spouse' pension or profit-sharing plan would be deductible, since distributions from the plan will be taxable when received[169]. The same tax treatment is afforded to the cost of obtaining other assets that will be taxable when received – these costs are immediately deductible.

Another example is spousal support. It is includible in gross income; therefore, legal fees incurred in securing a right to spousal support or in collecting delinquent spousal support are deductible[170] as ordinary and necessary expenses incurred during the taxable year for the production of income. Note that the legal costs of the payer spouse generally are not deductible (other than payments for tax advice), although in some instances legal costs may be capitalized. Similarly, legal fees for the collection of alimony payments are deductible, even when such fees are contingent and calculated as a percentage of the total amount of alimony settlement received[171].

Likewise, costs incurred in a modification proceeding (or negotiation) to increase, or resist a decrease in, spousal support are deductible[172]. Thus, where the payee spouse pays attorneys' fees for the collection, modification, or production of alimony which is includible in gross income, those fees are deductible[173].

As to the choice of the spouses who would be entitled to the deduction, to the extent the fees are attributable to the production or collection of income or for tax planning, they are deductible only by the spouse who incurred them. Hence, the paying spouse gets no deduction if the fees were incurred by the other spouse[174]. However, careful tax planning can prevent the loss of deductions caused by application of the above rule: if properly structured, fees paid by one party on behalf of the other can be deducted as spousal support. Cash payments to a third party on behalf of a spouse can qualify as spousal support payments, if they are made pursuant to the terms of a divorce or separation instrument. Similarly, spousal support paid to a third party at the request of the

[168] Young v. Commr. (4th Cir. 2001) 240 F3d 369, 378 (legal fees in collecting note arising out of marriage dissolution deductible to extent allocable to recovery of taxable items)
[169] Glassman v. Commr., TC Memo. 1997–497 (cost of litigating amount of pension due from employer under QDRO is deductible under §212(1) but is miscellaneous itemized deduction subject to §67)
[170] 26 USC §212(1); Treas. Regs. §1.262–1(b)(7); Hesse v. Commr. (1973) 60 TC 685, 693–694, affirmed (3rd Cir. 1975) 511 F2d 1393
[171] 26 USC §212(1); Treas. Regs. §1.262–1(b)(7); Hesse v. Commr. (1973) 60 TC 685, affirmed (3rd Cir. 1975) 511 F2d 1393
[172] Id.
[173] Wild v. CIR., 42 T.C. 706, 1964 WL 1227 (T.C. 1964), Treas. Reg. §1.262-1(b)(7), (d)
[174] United States v. Davis (1962) 370 US 65, 74–75

supported spouse or pursuant to that spouse' consent or ratification qualify as deductible support[175].

When one spouse pays the attorney fees of the other and deducts the payment as spousal support, the recipient spouse must include these amounts in income. However, subject to the limitations of §67, the recipient spouse may then be entitled to a partial deduction for those portions of the attorney's bill allocable to tax advice or to producing or collecting income subject to applicable limitations.

Therefore, during the negotiation of the fee award prior to dissolution judgment, the provision of the attorney fees to be part of spousal support (although subject to the front-loading limitation[175a]) should be one of the topics for the payer. The rules for spousal support treatment apply to the determination above. Thus, these payments must be contingent upon the recipient spouse' survival[176].

d. Fees for Tax Advice Are Deductible Legal Fees Incurred in Process of Divorce or Legal Separation "*The only difference between tax man and taxidermist is that taxidermist leaves skin.*" – Mark Twain

The Internal Revenue Code allows deducting all of the ordinary and necessary expenses paid or incurred in connection with the determination, election, or refund of any tax[177]. Thus, expenditures for tax advice to determine the tax consequences of a taxpayer's divorce are deductible under this provision as an itemized deduction, although the 2% aggregate floor for miscellaneous deductions also applies to limit the deductions[178].

Consequently, legal fees incurred with respect to tax advice related to a divorce are deductible under §212(3), where the taxpayer at the time of the divorce engaged a law firm to advise him of a Federal income tax consequences of a proposed property settlement agreement, or the taxpayer, at the time of the divorce, engaged tax counsel to advise him of the Federal income, gift and estate consequences of establishing an alimony trust which would fund the taxpayer's obligations to support his spouse. By the same token, if the taxpayer engaged an attorney to represent him in connection with his divorce, and the tax and nontax

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[175] Treas. Regs. §1.71–1T, A–6, A–7

[175a] Under 26 USC §71, recapture requirements apply if excess alimony payments are front-loaded into the first three post-separation years. Their purpose is to discourage divorcing spouses from improperly characterizing property settlement payments as alimony. "Recapture" in this context means to give back or to adjust for a tax benefit that was improperly taken at an earlier point in time.

[176] 26 USC §71(b)(1)(D); Preston v. Commr. (11th Cir. 2000) 209 F3d 1281, 1285

[177] 26 USC §212(3)

[178] 26 USC §67(a), (b)

advice was split out reasonably, the tax portion would be deductible[179]. California Family Practice Guide (Rutter Guide, 2014) suggests the following examples of tax advice in the context of the divorce:

- Costs of properly structuring, a property division to produce desired tax effects.
- Costs of determining the adjusted basis of assets which are distributed from one spouse to the other as a part of property settlement.
- Costs of planning an alimony trust or annuity agreement, utilized to avoid some of the restrictions on deductible spousal support.
- Costs of estate planning which relate to assuring proper estate and gift tax consequences for the payment or receipt of support or property divisions.
- Costs of preparing a written separation agreement to assure deductible support payments during the separation period.
- Costs of maximizing the deductible portion of spousal support or of minimizing the taxable portion of spousal support.
- Costs of allocating dependency exemptions.
- Costs of obtaining advice about the tax consequences of a divorce or separation instrument; or of gathering information for and actual preparation of tax returns.
- Costs of drafting a QDRO (Qualified Domestic Relation Order) and submitting it to the plan administrator for approval.

Once more, it is important to remember that the burden of proof for the items of deductions is on the taxpayer[180]. On the question of deductibility, attorney fees incurred in marriage dissolution proceedings typically have to be allocated between work performed for deductible items and work performed for nondeductible items[181].

VI. ***SOME CONCLUSIONS*** "*This is too difficult for mathematician. It takes a philosopher.*" Albert Einstein on filing a tax return

This article covers just a few of the divorce-related issues that taxpayers face before, during, and after the divorce. There are also business related issues of divorce taxation, property division, and many

[179] Revenue Ruling, 1972-2 C.B. 179, Rev. Rul. 72-545 (1972); Carpenter v. United States (Ct. Cl. 1964) 338 F2d 366

[180] 26 USC §6001

[181] Young v. Commr. (1999) 113 TC 152, 157, affirmed (4th Cir. 2001) 240 F3d 369 (Wife incurred legal fees in collecting note arising out of marriage dissolution: 30% of amount Wife received was allocable to taxable items, 70% to nontaxable property division, and Wife thus could deduct only 30% of her attorney fees and collection expenses)

The article also uses quotes from Catch-22 by Joseph Heller and Murhy Laws quotes.

others. The main conclusion of this article is that before going into the divorce, it would be very advisable to pre-plan for the tax consequences. Considering the general disregard of tax issues by “family” court judges and lawyers, taxpayers ought to seek advice from tax professionals before signing the pleadings that will materially change their tax situations. Another conclusion is that through careful tax planning, the divorcing taxpayer can partially mitigate the losses and damage imposed on him (and occasionally her) by the “family” court judges, lawyers, and other fee-sucking professionals. And last, but not least, the conclusion is that if it is possible to avoid a divorce, it should be avoided. In all practical matters it is probably easier to avoid (and understand) divorce than taxation.