

Family Law Tax Update
Tax Issues In Divorce Mini-Conference
January 23, 2008

Alimony

Private Letter Ruling 200720007 – 5/18/07:

“Contractual alimony” is not the same thing as court ordered alimony and thus, the state’s (not California) automatic provision that alimony terminates upon the recipient spouse’s death does not apply.

Cosby v. Commissioner (TC Summary Opinion 2007-8):

Follows *Berry v. Commissioner (TC Memo 2005-91)* to indicate that a family support order will automatically terminate at the death of the recipient spouse. This should make it easier for most family support orders to qualify as deductible alimony. Arrangements where custody of the children will NOT automatically revert to the paying spouse upon the death of the recipient spouse will still be problematic as they probably will not fall under this rule.

Webb v. Commissioner (TC Summary Opinion 2007-91):

1. Facts of the case are unique, not reviewable by any court and cannot be used as precedent.
2. Court order provided that Husband could make support payments but he wasn’t required to.
 - a. If he did make support payments, they were to be includable in Wife’s income and deductible by Husband.
3. In 2002 Husband made support payments out of concern for his children’s welfare. He deducted the payments and it appears that Wife included them in her income.
4. IRS argued that since they were not *required* by the court order, they were not made pursuant to a divorce or separation instrument as required in §71(b)(1)(A).
5. The tax court pointed out that there is no longer a requirement that the payments be made under a legally enforceable duty (the requirement was removed in 1984), just that they be made pursuant to a written instrument.

Proctor v. Commissioner (129 T.C. No 12 – 10/10/07):

1. Husband was ordered to pay a portion of his monthly retirement pay under the Uniformed Services Former Spouses’ Protection Act (USFSPA).
2. Husband made the payments and then deducted them as alimony.
3. The payments met all the requirements of alimony except that the marital settlement agreement did not specifically terminate them upon Wife’s death.
4. However, USFSPA automatically terminates the payments upon Wife’s death.

5. Thus, the payments qualified as alimony.

Dependency Exemption

Proposed Amendment 1.152-4:

1. Amends the regulation to reflect code and case law changes.
2. Includes examples including when a child is a “qualifying child”.
3. Also includes examples of what agreements can be used in lieu of the form 8332 to allow the non-custodial parent to claim the exemption.
 - a. An agreement that *unconditionally* provides that the non-custodial parent will receive the exemption may be used in lieu of form 8332.
 - b. Unconditionally means that it does not depend on whether support payments are current or any other condition.

Chamberlain v. Commissioner (TC Memo 2007-178):

1. Wife signed Form 8332 releasing the exemption “for all future years” to Husband in 1995.
2. The form was lost in a fire in 1996.
3. Husband then started attaching “post-it-notes” to his subsequent returns referencing the 1995 Form 8332 signed by Wife.
4. IRS did not question the dependency exemption until 2003 when it was denied for not having a proper Form 8332 attached.
5. Husband argued that the IRS was precluded from denying the exemption since it had honored it without the Form 8332 for the years 1996-2002.
6. The court ruled that the code is very clear in that a Form 8332 must be attached to the non-custodial spouse’s return to claim the dependency deduction.
7. Furthermore, case law has established that the IRS’ allowance of a deduction in one year does not preclude denial in a subsequent year.

Harris v. Commissioner (TC Memo 2007-239):

1. Husband argued that IRC §152(e) which grants the dependency exemption to the custodial spouse regardless of the percentage of support paid by each parent was unconstitutional.
2. The court pointed out that §152(e) was added in 1984 to prevent the IRS from having to mediate the disputes between parents.
3. Since the rule advances enforcement of the statute in a rational manner, it is not unconstitutional.

Community Property Income

Cooper v. US (99 AFTR 2d 2007-3425 – 6/21/07):

1. Husband and Wife filed separate returns after separation.
2. Husband argued that Wife was required to report 50% of his wages, but it appears he claimed all of the withholding from those wages.
3. The IRS argued that it may disregard community property rules where the spouse did not share in the income and was not informed of the income (IRC §66(b)).
4. The IRS also argued that even if the wages were to be reported 50% by Wife, the resulting tax is a community debt which can be satisfied with the amounts withheld from that community income (i.e. the taxes withheld from the wages).
5. Husband lost.

Commissioner v. Dunkin (100 AFTR 2d 2007-5870 – 8/31/07):

1. This was an appeal by the IRS to Dunkin v. Commissioner (124 T.C. 180 – 2005).
2. Husband was eligible for retirement benefits from the City of Los Angeles in 1989 but chose to continue working.
3. Husband and Wife entered into an MSA in 1997 which stated that Wife was entitled to \$2,072 per month as her share of Husband's defined benefit plan whether he actually retired or not (*Gilmore* election).
 - a. A QDRO was also ordered to be entered into to pay Wife \$2,072 per month once Husband actually retired.
4. Husband made the payments to Wife under the *Gilmore* election from his current earnings and deducted the payments as alimony.
5. The IRS posed three arguments to tax Husband:
 - a. Husband was not actually paying Wife her share of the community pension benefits because he wasn't receiving any...he was paying an amount from his separate property wages in lieu of the benefits.
 - b. Assignment of income doctrine.
 - c. IRC §402 states that the benefits are taxable to the person receiving them, Husband should have obtained a QDRO for an early distribution to Wife.
6. The Tax Court, relying on Eatinger v. Commissioner (TC Memo 1990-310) and Powell v. Commissioner (101 TC 489), ruled in favor of Husband with the following responses:
 - a. California community property rights do not depend on the form or source of the payment.
 - b. Poe v. Seaborn dictates that the assignment of income doctrine does not apply to community property income.
 - c. IRC §402 does not apply because Husband did not receive pension benefits and no QDRO was required.
7. The Court of Appeals reversed since the source of the payments was not community, the source was Husband's separate income for which he was fully taxable.

Green v. Commissioner (TC Memo 2007-39):

Jury award for employer retaliation was deemed community property and thus, Husband and Wife each report 50% on their separate returns.

Stock Options & Property Issues

Private Letter Ruling (PLR) 200737009 – 9/14/07:

This is another private letter ruling allocating to a non-employee spouse the income and tax consequences of his/her community property share of incentive stock options that remain in the name of the employee spouse.

Private Letter Ruling 200709014 – 3/2/07:

Property Transfer Under §1041

1. Husband and Wife enter into Agreement #1 at the time of the divorce that requires Husband to include a provision in his will giving Wife a certain number of shares of stock.
2. Some time later (not indicated) Husband and Wife enter into Agreement #2 in which Wife agrees to trade 50% of her interest in the stock in the future (i.e. Husband's death) for 25% of that interest now.
3. Agreement #2 will actually amend Agreement #1.
4. The IRS determined that Agreement #2 is a modification of Agreement #1 and thus, the transfer will fall under §1041 and neither party will recognize any tax consequences.
5. Furthermore, the transaction will not constitute a gift as it is considered made for "full and adequate consideration".

Gottesman v. U.S (99 AFTR 2d 2007-1212 – 1/12/07):

Enforceable Claims on Estate

1. Husband was Jim Henson of "muppet" fame.
2. Husband owned 61% of Henson Associates and Wife owned 39%.
3. The marital separation agreement provided that Wife transfer her shares to Husband in exchange for:
 - a. Initial payment of \$1M and 20 installment payments of \$2M each.
 - b. Husband's conditional requirement to pay Wife a portion of any proceeds received from a merger or sale of the stock during Wife's lifetime taking into account the amounts paid above.
4. Shares of stock were deposited into an escrow account to protect Wife's interest upon a sale or merger.
5. Husband was entitled to give a certain number of both parties' shares to their children and reduce the escrow account accordingly.
6. Husband died at a time when 25.5% of the outstanding shares remained in escrow.
7. Husband's estate transferred the company to the children pursuant to Husband's will.

8. The children wished to sell the company but were prevented from doing so because of the escrow.
9. The children and Wife entered into an agreement that Wife would release the shares from escrow and release her claim under the separation agreement in exchange for \$10M.
10. The Estate claimed a deduction for the \$10M as an enforceable claim.
11. The court ruled that once the Estate transferred the company to the children, the conditional requirement in the separation agreement could no longer be enforced – only Husband and the Estate were obligated, not the children.
 - a. Had the Estate sold the shares, Wife would have had an enforceable claim for the conditional payment.
12. No deduction for the Estate.

Estate of Jelke v. Commissioner (100 AFTR 2d 2007-6694 – 11/15/07):

For estate tax purposes, a C Corporation can receive a dollar for dollar discount for built in capital gains taxes assuming the company is liquidated on the date of death. While this is an estate tax case, it may provide basis for similar reductions in family law matters.

Registered Domestic Partnerships

Franchise Tax Board Publication 737 – Tax Information For Registered Domestic Partners:

1. For California purposes, Registered Domestic Partners (RDPs) file as married.
2. For federal purposes, RDPs files as single.
3. Three possible methods to calculate California taxes based on the separate federal returns:
 - a. If there are no “adjustments”, combine the AGIs from the separate federal returns onto the joint California return.
 - b. Complete a California RDP Adjustments Worksheet (included in the publication).
 - c. Prepare a pro forma joint federal return treating the RDPs as “married” and transfer that information to the California return.

Strong v. State Board of Equalization.(Court of Appeal – 3rd District; C052818, Super. Ct. No. 05AS01701 – 10/2/07):

1. In 2003, the State Board of Equalization (SBE) issued regulations that excluded RDPs from property tax reassessment under Proposition 13 when inheriting property upon the death of the other partner.
2. In 2005, the California legislature expanded this regulation to include lifetime transfers.
3. These rules gave RDPs rights similar to as spouses pertaining to property taxes.
4. The Court of Appeal upheld that these rules did not violate the California State Constitution.

5. The SBE summarized these rules in SBE Letter To Assessors 2007/043 which further provides retroactive relief for transfers between RDPs which occurred between January 1, 2000 and January 1, 2006.
 - a. A claim for retroactive relief must be filed by June 30, 2009.

Innocent Spouse Relief

New Form 8857 - Request for Innocent Spouse Relief:

Contains more questions on the initial application to address the factors in favor of or against relief.

Farmer v. Commissioner (TC Memo 2007-74):

Wife granted equitable innocent spouse relief despite knowing that the taxes wouldn't be paid at the time she signed the return.

Kovitch v. Commissioner (128 TC No 9):

The automatic stay from Husband's bankruptcy didn't bar the IRS from considering Wife's innocent spouse claim. Husband's joint liability remains the same whether Wife is granted innocent spouse relief or not.

Chief Counsel Notice 2007-13:

New procedures for tax court cases involving the IRS' relief of equitable innocent spouse relief (6015(f)).

Fain v. Commissioner (129 T.C. No 11 – 10/2/07):

A non-electing spouse's right to intervene in the electing spouse's innocent spouse claim survives the death of the electing spouse.