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TAX CONSEQUENCES OF DIVORCE AND LEGAL SEPARATION

Duncan A. Peete*
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I. INTRODUCTION

Legal separation and divorce frequently involve the payment of alimony, child support, and division of property. Such payments and property transfers raise significant tax considerations for the general practitioners who assist in separation or divorce. The Internal Revenue Code (the Code) contains specific provisions that govern the former spouses' tax consequences during separation and divorce. A familiarity with these provisions is necessary to minimize the tax detriment and to maximize the tax benefit to both spouses.

This Article specifically addresses the tax consequences of alimony payments, child support payments, and property transfers incident to separation or divorce. Moreover, this Article analyzes the effect that separation or divorce has on former spouses' filing status and dependency exemptions. Finally, this Article explains the rules that govern the deductibility of legal expenses that arise during separation or divorce.

II. ALIMONY PAYMENTS

A divorce decree or separation agreement may require a taxpayer to provide for the financial support of the former spouse. This support usually takes the form of alimony or separate maintenance payments. The recipient of alimony or separate maintenance payments is entitled to a tax deduction for the amount paid. The payer of alimony or separate maintenance payments is entitled to a tax deduction for the amount paid, subject to certain limitations.


** Associate, Crowley, Haughey, Hanson, Toole & Dietrich, Billings, Montana. B.S., Montana State University, 1986; J.D., University of Montana, 1992.

1. The Code uses the terms "divorce," "alimony," and "separation." Applying the no-fault concept, Montana law refers to "divorce" as a "dissolution of marriage," MONT. CODE ANN. § 40-4-104 (1993), and "alimony" as "maintenance," MONT. CODE ANN. § 40-4-203 (1993). For consistency, the authors have chosen to use the terms "divorce" and "alimony." Additionally, the authors use the terms "separation" and "legal separation" interchangeably.

2. The Code defines "divorce or separation instrument" as: "(A) a decree of divorce or separate maintenance or a written instrument incident to such a decree, (B) a written separation agreement, or (C) a decree . . . requiring a spouse to make payments for the support or maintenance of the other spouse." I.R.C. § 71(b)(2) (1988).
(payee spouse) must include such payments in gross income. The individual making the payments, the payor spouse, can deduct the payments made during the taxable year when calculating taxable income. This assignment of income from the payor spouse to the payee spouse may produce tax savings if the payor spouse is in a higher income tax bracket than the payee spouse. Congress, however, has prescribed a number of requirements that former spouses must satisfy in order for these payments to qualify as alimony for federal income tax purposes.

A. Payments Must Be in the Form of Cash

To qualify as alimony, the Code requires that the payments be in the form of cash. Cash payments include checks and money orders payable on demand. Cash payments, however, do not include:

1. a transfer of services,
2. a transfer of property,
3. the execution of a debt instrument by the payor spouse,
4. the use of property belonging to the payor spouse.

B. Payments Must Be Made to or on Behalf of Payee Spouse

The payor spouse usually makes alimony payments directly to the payee spouse. Sometimes, however, the payor spouse provides payments to a third party on behalf of the payee spouse. A cash

5. For example, if the payor spouse is in the 28% tax bracket and the payee spouse is in the 15% tax bracket, alimony payments of $10,000 during the year will result in an overall tax savings of $1,300 at the 1993 income rates. The payor spouse receives $2,800 in tax savings by claiming a $10,000 deduction, and the payee spouse experiences an increased tax liability of $1,500 by including $10,000 in gross income.
10. See I.R.C. § 71(b)(1)(A) (1988). For example, pursuant to a divorce decree or sep-
payment to a third party qualifies as alimony as long as the payor spouse makes the payment pursuant to a divorce or separation instrument.\textsuperscript{11} Thus, payment of the payee spouse's expenses, whether living or other expenses, qualifies as alimony if made pursuant to the terms of a divorce or separation instrument. Additionally, a payor spouse’s payment of premiums on a life insurance policy that covers the payor spouse’s life also qualifies as alimony “to the extent that the payee spouse is the owner of the policy.”\textsuperscript{12} However, cash payments, including mortgage payments, real estate taxes, and insurance premiums, which maintain property that the payor spouse owns and the payee spouse uses, do not constitute alimony even if made pursuant to a divorce or separation instrument.\textsuperscript{13}

Even if the divorce or separation instrument does not provide for cash payments to a third party, such payments may qualify as alimony if the payor spouse makes these payments pursuant to the written request, consent, or ratification of the payee spouse.\textsuperscript{14} The payee spouse’s written request, consent, or ratification must state that the former spouses intend these third-party payments to be treated as alimony for tax purposes.\textsuperscript{15} Furthermore, the payor spouse must receive the written request, consent, or ratification before filing a tax return for the year of payment.\textsuperscript{16}

\textbf{C. Payments Cannot Be Designated as Excludible and Nondeductible}

If the divorce or separation instrument designates the payments as excludible from the payor spouse's gross income and nondeductible by the payor spouse, the payments do not qualify as alimony.\textsuperscript{17} Consequently, the former spouses may elect to treat qualifying alimony payments as non-alimony for tax purposes by including such a provision in a divorce or separation instrument.\textsuperscript{18}

\begin{itemize}
  \item[12.] Temp. Treas. Reg. § 1.71-1T(b), Q & A-6.
  \item[13.] Temp. Treas. Reg. § 1.71-1T(b), Q & A-6.
  \item[15.] Temp. Treas. Reg. § 1.71-1T(b), Q & A-7.
  \item[16.] Temp. Treas. Reg. § 1.71-1T(b), Q & A-7. Payments that a payor spouse makes pursuant to a payee spouse's written request, consent, or ratification must replace amounts directly payable to the payee spouse under a divorce or separation instrument. Otherwise, the payments will constitute voluntary payments that the payor spouse cannot deduct. I.R.C. § 71(b)(1)(A) (1988).
  \item[18.] The former spouses cannot, however, treat non-qualifying payments as alimony.
\end{itemize}
If the former spouses have already executed a written separation agreement, they may subsequently designate qualifying alimony payments as non-alimony if this designation is made in a separate writing that refers to the original separation agreement.\(^{19}\) Additionally, if one of the spouses is providing support under a temporary support order and both spouses wish to treat the support payments as excludible from the payee spouse's gross income and nondeductible by the payor spouse, they must make such a designation in the original or subsequent temporary support order.\(^{20}\) If the spouses choose to make the non-alimony election, the payee spouse must attach a copy of the divorce or separation instrument containing such designation to the payee spouse's income tax return for each year in which the former spouses make the election.\(^{21}\)

The spouses have until the filing deadline, April 15 of the following calendar year, to decide whether to make the non-alimony election.\(^{22}\) The spouses can change this election from year to year.\(^{23}\) Any change, however, requires the spouses to amend the divorce or separation instrument, unless the instrument specifically contains a clause that provides for such changes from year to year.\(^{24}\)

**D. Spouses Cannot Be Members of the Same Household**

For payments to qualify as alimony for purposes of deducting them from the payor spouse's gross income, former spouses who are legally separated under a decree of divorce or separate maintenance are prohibited from living in the same household when the alimony or separate maintenance payments are made.\(^{26}\) Even if both "spouses physically separate themselves within the dwelling unit," the Internal Revenue Service (the Service) considers a dwelling unit shared by both spouses to constitute one household.\(^{26}\) The Service, however, does not treat spouses as members of the

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25. I.R.C. § 71(b)(1)(C) (1988). The Seventh Circuit has strictly construed the "separate residences" requirement. In Coltman v. Commissioner, 980 F.2d 1134, 1136 (7th Cir. 1992), the Seventh Circuit held that because the taxpayer was residing in his estranged wife's residence three days a week while actively pursuing a divorce, he could not deduct any of the payments that he made to her during this period.
same household if one spouse is preparing to depart and does depart no later than one month after the payment is made. 27 Nonetheless, if the spouses are not legally separated under a decree of divorce or separate maintenance, payments that the payee spouse receives pursuant to a written separation agreement or temporary support order qualify as alimony or separate maintenance and must be included in the payee spouse’s gross income regardless of whether the spouses are living together at the time the payments are made. 28

E. Support Obligations Must Terminate on the Death of Payee Spouse

For support payments to qualify as alimony for tax purposes, the divorce or separation instrument must not state that such payments continue after the payee spouse’s death. 29 If a payor spouse is obligated to make support payments after the payee spouse’s death, none of the payments, whether made before or after the payee spouse’s death, qualifies as alimony or separate maintenance for tax purposes. 30 If the divorce or separation instrument requires the payor spouse to make one or more payments in cash or property after the payee spouse’s death as a substitute for the continuation of pre-death alimony payments, none of the payments that the payor spouse makes before or after the payee spouse’s death will qualify as alimony for tax purposes. 31 “Substitute payments” are any payments that “begin to be made, increase in amount, or become accelerated in time as a result of the death of the payee spouse.” 32

The divorce decree or separation agreement, however, does not need to state specifically that support payments will terminate upon the payee spouse’s death. 33 The existence of a state law that terminates support payments on the death of the payee spouse alone satisfies this requirement. 34

33. I.R.C. § 71(b)(1)(D). The previous version of I.R.C. § 71(b)(1)(D) required that the divorce or separation instrument state that there is no liability for payments after the payee spouse’s death. This version was repealed by Public Law No. 99-514, 100 Stat. 2085 (1986).
Conversely, the Code does not require that support payments cease upon the payee spouse's remarriage or the payor spouse's death. Support payments may continue after the occurrence of either of these events and still receive alimony treatment. However, whether support payments continue after the payee spouse remarries or after the payor spouse dies is a question that the divorce decree or separation agreement should address. If the instrument fails to address these issues, state law governs.

Montana law terminates the payor spouse's support obligation upon the remarriage of the payee spouse or the death of the payor spouse unless the spouses agree or the court provides otherwise in the divorce decree or separation agreement or in another writing. If, however, determination of alimony for state law purposes may differ substantially from a determination of alimony for tax purposes. The divorce decree or separation agreement should, therefore, specifically address these questions rather than allow state law to govern by default.

III. CHILD SUPPORT PAYMENTS

In addition to the requirements discussed above, a payment must avoid classification as child support if it is to qualify as alimony or separate maintenance. If the divorce decree or separation agreement fixes an amount for the support of the payor spouse's children, that amount will not constitute alimony or separate maintenance payments for tax purposes. As a result, child support payments are not includable in the payee spouse's income and are not deductible by the payor spouse.

The divorce decree or separation agreement does not need to refer to a specific dollar amount for a payment to be fixed as child support. Courts have construed the word "fix" in I.R.C. 71(c)(1) to mean that the total actual payments made by the payor spouse under the divorce or separation instrument can be precisely allocated between child support and alimony. Thus, child support payments may fluctuate from year to year and yet still be fixed under the Code. However, if the Service cannot determine from

35. MONT. CODE ANN. § 40-4-208(4).
36. I.R.C. § 71(c)(1) (1988). If the divorce decree or separation agreement requires the payor spouse to pay a certain amount of child support and a certain amount of alimony, and the payor spouse's actual support payment is less than the two amounts combined, the Code requires the former spouses to apply the payment first to child support and the remainder to alimony. I.R.C. § 71(c)(3) (1988).
the language of the written instrument how much of each payment constitutes child support, the Service treats the entire payment as alimony.\(^{40}\)

If the separation agreement or divorce decree provides for a reduction in support payments upon the happening of a contingency related to the child, the Code classifies the amount of the reduction as child support.\(^ {41}\) For a reduction in payments to qualify as child support, the separation agreement or divorce decree must specify the particular contingency that relates to the child. Examples of such contingencies include the child’s attaining a specified age or income level, the child’s marrying, dying, leaving school, leaving the payee spouse’s household, and obtaining employment.\(^ {42}\)

If the separation agreement or divorce decree does not specify the contingency relating to the child, the Service may, nonetheless, treat a reduction in payments as child support if it finds that the payments are reduced “at a time which can clearly be associated with a contingency” relating to the child.\(^ {43}\) The Treasury Regulations specifically indicate two situations in which the Service presumes that a reduction in payments is associated with a contingency relating to the child. The first situation involves the reduction of payments “not more than 6 months before or after the date the child is to attain the age of 18, 21, or local age of majority.”\(^ {44}\) The second situation deals with the reduction of payments “on two or more occasions which occur not more than one year before or after a different child of the payor spouse attains a certain age between the ages of 18 and 24, inclusive.”\(^ {45}\) The certain age referred to above “must be the same for each such child, but need not be a whole number of years.”\(^ {46}\)

\(^ {45}\) Temp. Treas. Reg. § 1.71-1T(c), Q & A-18.
\(^ {46}\) Temp. Treas. Reg. § 1.71-1T(c), Q & A-18. The example in Temporary Treasury Regulation, § 1.71-1T(c), Q & A-18 provides a good illustration of the second situation in which the Service presumes that a reduction in support payments is clearly associated with the happening of a contingency relating to a child of the payor spouse. In that example, A and B divorce when their children, C and D, are 14 and 12, respectively. Pursuant to the divorce decree, A is required to make alimony payments to B of $2,000 per month. Such payments decrease to $1,500 per month approximately five and one-half years after the divorce and to $1,000 per month approximately nine and one-half years after the divorce. At the time, the alimony payments decrease to $1,500 per month, C will be 20 years, 5 months, and 17 days old. At the time, the alimony payments decrease to $1,000 per month, D will be 22 years, 3 months, and 9 days old. Consequently, each of the reductions in payments occurs...
Although these two situations create a presumption that a reduction in support payments is associated with a contingency relating to the child, the presumption can be rebutted by a showing that the date for reduction was independent of any contingencies relating to the child. Thus, in the first circumstance, the former spouses or the Service can conclusively rebut the presumption by showing that the reduction in support payments will result in the complete elimination of alimony "during the sixth post-separation year... or upon the expiration of a 72-month period." Moreover, the former spouses or the Service can rebut the presumptions if the local custom is to cease alimony payments after a certain period such as a period equal to one-half the duration of the marriage.

Although the former spouses can elect to treat qualifying alimony or separate maintenance payments as non-alimony for federal income tax purposes, they cannot make a similar election that will classify child support payments as alimony. The former spouses, however, can assure that payments will qualify for alimony treatment by satisfying the requirements of alimony as prescribed by the Code and by ensuring that the payments are not fixed as child support in the divorce decree or separation agreement. Furthermore, the former spouses can prevent the treatment of payments as child support by providing in the divorce decree or separation agreement that payments will not be reduced upon the happening of a contingency related to the child or at a time that can be associated with a contingency related to the child. Thus, careful drafting on the part of the former spouses should prevent the Service from treating certain payments by the payor spouse as child support rather than alimony.

IV. Excess Front-Loading of Alimony

Since the Code allows the payor spouse to deduct alimony not more than one year before or after a different child reaches the age of 21 years and 4 months old. Thus, the reduction in payments of $1,000 per month will be treated as fixed for the support of the children of A and will not qualify for alimony.

50. Neither the Code nor the Treasury Regulations provide for an election to treat child support payments as alimony.
51. See Temp. Treas. Reg. § 1.71-1T(c), Q & A-16.
payments from gross income, the payor spouse may attempt to disguise all or part of the property settlement payments as alimony. This can be accomplished by adding the amount allocated to property settlement to the amount allocated to alimony and designating the entire amount as alimony in the separation agreement or divorce decree. The spouse receiving the excess alimony payments generally accepts the unfavorable tax consequences. For example, the payee spouse may not be fully advised of the tax law, may be in a low enough tax bracket that the additional income would not have a large impact, or may be pressured to do so by the payor spouse. To prevent such abuses, Congress enacted I.R.C. § 71(f), a particularly complex area of the Code. Section 71(f) tries to properly classify alimony payments and property settlements by using restrictions on what the Code refers to as “excess front-loading of alimony payments.” Congress enacted the current law in 1984 and simplified it in 1988 yet it remains one of the most confusing provisions in the Code.

A. Calculation of Excess Front-Loading

Excess front-loading of alimony occurs when the payor spouse makes greater “alimony” payments in post-separation years one and two, than in year three. The Service chose the three-year period to separate the types of payments because property settlements are traditionally paid within a short time after the divorce decree or decree of legal separation and are substantially higher than the remaining alimony payments. The rule also established a $15,000 threshold amount to eliminate recapture on payment fluctuations less than that amount.

The impact of I.R.C. § 71(f) on the taxpayer can be substantial. This section requires the payor spouse to include in gross income the excess portion of alimony that I.R.C. § 71(f) determines

53. The recipient must include in gross income all alimony payments received. I.R.C. § 71(a) (1988).
57. “[T]he term ‘1st post-separation years’ means the 1st calendar year in which the payor spouse paid to the payee spouse alimony or separate maintenance payments. The 2nd and 3rd post-separation years [are] the 1st and 2nd succeeding calendar years respectively.” I.R.C. § 71(f)(6) (1988).
actually to be part of the property settlement. This amount is deemed to be recaptured because the taxpayer deducted it with the true alimony payments in post-separation years one and two. Likewise, the Code allows the payee spouse to deduct from gross income the amount determined to be excess front-loading of alimony. The payee spouse is allowed a deduction in post-separation year three, because the payee spouse included in gross income in post-separation years one and two amounts attributable to the property settlement, which are not includible in gross income.

For example, assume the payor spouse agrees to pay the payee spouse alimony over a period of ten years. The taxpayers agree that the property settlement shall be $50,000 and alimony shall be $30,000 a year for ten years for a total of $350,000. The divorce decree or separation agreement calls for the payor spouse to pay $60,000 the first year, $50,000 the second year, and $30,000 for the remaining eight years. The amount of excess front-loading of alimony would be calculated as follows:

Determination of the amount of 2nd-year recapture

| 2nd-year payment | 50,000 | (A) |
| 3rd-year payment | -30,000 | (B) |
| Excess | 20,000 |
| Threshold amount | -15,000 |
| Amount recaptured | 5,000 | (C) |

Determination of the amount of a 3rd-year recapture

| 1st-year payment | 60,000 |
| Average of 2nd- & | -37,500 |
| 3rd-year payments | [(A + B - C)/2] |
| Excess | 22,500 |
| Threshold amount | -15,000 |
| Amount recaptured | 7,500 |


65. To determine the average, one must add both the second and third post-separation year payments, less any amount recaptured from the second year. This requires the calculation of the second-year recapture before making the third-year determination.

The excess front-loading provision of I.R.C. § 71(f) occasionally comes into effect even where no property settlement amounts are involved. For example, often the payee spouse receives additional alimony in the years immediately following the divorce. The payor spouse generally pays this additional amount to allow the payee spouse to obtain a certain position or salary level in a particular job, to earn a bachelor or masters degree, or to start a new business. These additional payments, generally termed "rehabilitative alimony," usually last for a few years immediately following separation. Even though these payments are not related to a property settlement, because they produce larger alimony payments in the first two years after separation, I.R.C. § 71(f) may classify such payment as excess front-loading of alimony.67

B. Planning Strategies to Avoid the Pitfalls of Excess Front-Loading

Planning strategies to avoid the effects of I.R.C. § 71(f)68 are particularly important for two reasons. First, the payor spouse may experience a significant tax burden by adding two years of deductions to the third post-separation year's taxable income.69 Second, the payor spouse can avoid taxes imposed under I.R.C. § 71(f) altogether, merely by planning ahead. As we will see with the planning pointers, the cooperation of both spouses is essential in avoiding the application of I.R.C. § 71(f). Therefore, the agreement should be prepared with both taxpayers' interests in mind.

The most obvious planning pointer is to specify in the separation agreement or divorce decree that the alimony payments remain constant for the first three years after divorce. Since I.R.C. § 71(f) only concerns discrepancies between the first two years and the third post-separation year, any excess amount should be spread over three years.70 The payor spouse thus can avoid the impact of I.R.C. § 71(f) altogether and still make the additional payments over a relatively short period of time.71 Also, if the former spouses desire a lump-sum payment, the divorce decree or separation agreement should provide for the payment to be made no ear-

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67. I.R.C. § 71(f). As we have seen, § 71(f) includes all "alimony" payments in the excess front-loading calculation.
68. I.R.C. § 71(f).
69. The additional income has the potential to push the payor spouse into a higher tax bracket.
70. As discussed, several reasons exist why former spouses wish to front-load payments, including property settlement, rehabilitative alimony, and payments made for other matters.
71. Three tax years following divorce.
lier than third year after divorce, so that the payment will not produce a significant fluctuation in alimony payments in the first two years.

Section 71(f) of the Code allows a limited amount of front-loading without recapture. The provision allows for variation in amounts of alimony paid up to a threshold amount of $15,000 per year. Tax experts have devised a "maximum acceleration" formula to enable the taxpayer to take full advantage of the threshold amount.

Applying the maximum acceleration formula to our earlier example produces the following calculations. Subtract $37,500 from the total property settlement of $50,000 to arrive at $12,500. Divide the $12,500 by three to reach the base amount of $4,167. Adding this base amount to the variation adjustments and the alimony payment, the formula yields a payment of $56,666 in the first year, $49,167 in the second year, and $34,167 in the third post-separation year. Applying these figures to our excess front-loading recapture formula, we have the following:

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73. Hesch, supra note 24, at A-8. The formula requires:
   Starting with the [total] property settlement amount, subtract $37,500 and divide the remaining portion by three. This gives a base amount to be paid each year. Add $22,500 [first-year variation adjustment] to the base amount for the first year's payment and $15,000 [second-year variation adjustment] for the second year's payment. These amounts are added to any amount of actual alimony that will remain the same over at least the three post-separation years.
74. Due to rounding, the amount attributable to the first year is $4,166, and the amount attributable to the second and third years is $4,167 each.
75. Combine $22,500 with $4,166 for the property settlement portion and $30,000 for alimony.
76. Combine $15,000 with $4,167 for the property settlement portion and $30,000 for alimony.
77. The base year amount of $4,167 for the property settlement portion and alimony of $30,000.
Determination of the amount of 2nd-year recapture

- 2nd-year payment $49,167 (A)
- 3rd-year payment - $34,167 (B)
- Excess $15,000
- Threshold amount - $15,000
- Amount recaptured $-0- (C)

Determination of the amount of 3rd-year recapture

- 1st-year payment $56,666
- Average of 2nd- & 3rd-year payment $41,667
- $[(A + B - C)/2]
- Excess $14,999
- Threshold amount - $15,000
- Amount Recaptured $-0-

Using the maximum acceleration formula has obvious advantages. By applying the formula, the payor spouse can avoid recapture in the third post-separation year. Moreover, this formula allocates most of the property settlement amounts between the first two post-separation years by taking full advantage of the threshold amounts.

Even if recapture of excess front-loading of alimony cannot be avoided, one or both of the taxpayers may still benefit by including property settlement amounts in their alimony payments. A payor spouse can defer recognition of income by taking deductions in post-separation years one and two and postponing recapture until post-separation year three. Several advantages may flow from this strategy. First, the payor spouse may attempt in year one to reduce gross income to allow a higher deduction for itemized deductions, including legal expenses incidental to divorce. Second, the payor spouse may anticipate little or no income in year three, for example, due to retirement or sale of assets in prior years. Under such a scenario, the recapture would not seriously impact the amount of the payor spouse's tax liability. Finally, even though significant recapture is required, the payor spouse may benefit from the deferral of taxes in years one and two, when taking into consideration cash flow and the time value of money.

Front-loading also can benefit the payee spouse. The payee spouse may be in a situation where taxable income is low in the

78. For further discussion of itemized deductions, see infra part IV.C.
first two years following divorce, for example, due to school or a new job. Also, the payee spouse may be starting a new profession or new business and would be in a lower tax bracket initially, with gross income increasing over time. Thus, the payee spouse could benefit from the third-year deduction for excess front-loading.\(^8^0\)

**C. Exceptions to the Excess Front-Loading Rule**

The Code provides several exceptions to avoid the effects of the excess front-loading rule.\(^8^1\) First, if payments cease because the payee spouse either dies or remarries before the end of the third year following divorce, the excess front-loading rule does not apply.\(^8^2\) The second exception occurs when a temporary support order requires the payor spouse to make certain payments to the payee spouse for support or maintenance.\(^8^3\) This exception prevents the taxpayer from being penalized for court-ordered payments that trigger recapture. The third exception to the excess front-loading rule relates to fluctuation payments over which the payor spouse lacks control.\(^8^4\) These payments must relate to "portions of the income from a business or property or from compensation for employment or self-employment."\(^8^5\) In other words, taxpayers are exempt from I.R.C. § 71(f) when a payee spouse receives a percentage of the payor spouse's profit and, theoretically, neither spouse has control over that amount.

The importance of planning is apparent, given the potential harm of recapture and the ease with which it can be avoided. Consequently, practitioners should attempt to create an agreement acceptable to both parties while avoiding I.R.C. § 71(f).

**V. Alimony Trusts**

Rather than paying alimony periodically, former spouses may agree that the payor spouse will establish and fund an alimony trust, naming the payee spouse as beneficiary. Under this arrangement the payee spouse will receive the income generated from the trust's assets (the trust principal). The Service taxes the payee

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80. Under this theory, the payee spouse could be in the 15% tax bracket in the first and second post-separation years, and then in the third post-separation year earn enough to be subject to the 36% tax bracket before receiving the excess front-loading deduction.


spouse on the income generated by the trust instead of taxing the payor spouse who established the trust. The Code, however, does not allow the payor spouse to claim a deduction for trust payments made to the payee spouse.

A divorced couple may prefer an alimony trust to other methods that are used to provide support to the payee spouse. Establishing an alimony trust guarantees the payee spouse a series of future alimony payments. Such a trust eliminates any risk involving the payor spouse’s ability to make alimony or separate maintenance payments in the future. Furthermore, appointment of a competent trustee can ensure that the trust principal is properly managed and invested to maximize return.

Setting up and fully funding an alimony trust should relieve the payor spouse of the obligation to provide further support to the payee spouse. To ensure that the principal of the trust is available solely for the payee spouse’s support, the trust should be irrevocable. Nevertheless, the trust instrument should provide that the trust shall terminate and principal shall revert to the payor spouse when support payments are no longer necessary. Because the grantor trust rules do not apply to alimony trusts, the payor spouse does not have to include trust income in gross income even though the payor spouse receives the trust principal at some future date.

The payor spouse may use the alimony trust as a vehicle to avoid the pitfalls of recapturing alimony payments under the excess front-loading rule. Generally, the income generated by a trust is fixed or varies only slightly from year to year. As long as this variation is not greater than $15,000 a year within the three years following divorce or legal separation, the Code does not require recapture of alimony payments. Additionally, when the trust’s principal produces fluctuating amounts of income each year and these fluctuations are beyond the payor spouse’s control, the income generated by the trust may qualify under an exception to the excess front-loading rule.

86. I.R.C. § 682(a) (1988) (providing the payor spouse must, however, pay tax on trust income to the extent that the divorce decree, separation agreement, or trust instrument specifies that a certain amount is for the support of the payor spouse’s children).
88. The payor spouse, a bank, and a trust company are examples of trustees for an alimony trust.
89. See I.R.C. § 682(a); Treas. Reg. 1.682(a)-1(a)(3) (1957).
91. I.R.C. § 71(f)(5)(C) (1988) (applying exception to payments that vary in amount because they are based on a fixed portion of income from a business, property, or compensation from employment or self-employment).
The Code taxes alimony trusts and their beneficiaries in the same manner as the Code taxes most trusts and beneficiaries. The trust must include the income generated by the trust principal within its own gross income for the taxable year. The trust, however, may deduct any income distributions made to the beneficiary to the extent the distributions do not exceed the trust's distributable net income. The beneficiary of the alimony trust must include the income distributions from the trust within gross income. If the income distributions exceed the trust's distributable net income, the excess amount passes tax-free to the beneficiary. Finally, the income earned by the trust retains its same character as it passes through to the beneficiary.

In setting up an alimony trust, the practitioner should keep in mind the objectives that the client wishes to achieve. The payor spouse wants to establish a trust that generates sufficient income to satisfy the support obligation. The payee spouse wants a trust established to provide for financial needs. To ensure that these goals are met, the practitioner should select a competent and financially astute trustee. A bank or trust company may satisfy such criteria. Moreover, the practitioner should ensure that the payor spouse transfers sufficient assets to the trust to provide a consistent and adequate income stream to the payee spouse.

Finally, the payor spouse wants the income distributions from the trust to qualify as alimony or separate maintenance payments. To prevent the trust income from being characterized as child support, the payor spouse should avoid reductions in the amount of the income distributions based on the age of the children. Furthermore, to avoid the appearance of a property settlement transfer, the practitioner should draft a clause in the trust instrument that causes the trust principal to revert to the payor spouse on the payee spouse's death or remarriage. If both the payor and payee spouse take such matters into consideration, they will avoid the prospect of future litigation.

94. I.R.C. §§ 651, 661 (1988). Section 651 of the Code applies to a trust that is required to distribute all of its income currently. Section 661 of the Code applies to a trust that is allowed to accumulate income and/or distribute corpus.
97. I.R.C. § 652(b) (1988). For example, if the income generated by the trust principal constitutes tax-exempt interest, the income will be characterized as tax-exempt interest in the hands of the beneficiary.
VI. PROPERTY SETTLEMENTS

When a cash payment or property transfer between former spouses does not satisfy the requirements of alimony or child support, the Service treats the payment or transfer as a property settlement.98 The Code views such a transfer of property as a gift for income tax purposes.99 Thus, the payor spouse may not deduct the fair market value of the property transferred in determining taxable income,100 and the payee spouse does not include the fair market value of such property in gross income.101

Because the Code characterizes a property settlement transfer as a gift, the payee spouse takes a basis in the property equal to the payor spouse's basis immediately before the transfer.102 Additionally, the payee spouse determines the holding period in the property by including the payor spouse's holding period in the property prior to the transfer.103 These rules are best illustrated by an example. Payor spouse (A) owns a capital asset with a basis of $100,000. A holds the asset for seven months before A transfers it to payee spouse (B). The fair market value of the asset at the time of transfer is $110,000. B holds the asset for six months and then sells it to a third party for $125,000. B recognizes $25,000 of long-term capital gain. Upon receipt of the asset, B takes A's basis of $100,000, not a basis equal to the asset's fair market value at the time of the transfer.104 Furthermore, B's gain on the sale is long-term capital gain because A and B's combined holding period in the property exceeded one year.105

The Code prevents the recognition of gain or loss on a transfer of property between current spouses and former spouses.106 The
nonrecognition treatment on property transfers between former spouses, however, only occurs on transfers incident to a divorce. The Code mandates that the transfer of property between former spouses must satisfy one of two criteria for nonrecognition treatment.

The Service applies the above rules liberally with regard to transfers between spouses and former spouses. The Temporary Treasury Regulations in this area provide for nonrecognition treatment even when the transfer involves a sale at arm's length and for full consideration. However, spouses or former spouses will not receive nonrecognition treatment under Section 1041 of the Code if at the time of the transfer the transferee or payee spouse is a nonresident alien.

Section 1041 of the Code also applies to property transfers between spouses or former spouses and trusts established for their benefit. However, if the transferor/payor spouse transfers assets into a trust, and the liabilities assumed by the trust exceed the assets' total adjusted basis, section 1041 does not apply. Thus, in this instance, the transferor or payor spouse must recognize gain to the extent that the liabilities exceed the adjusted basis. The amount of gain recognized will be added to the trust's basis in the assets.

The nonrecognition of loss under section 1041 of the Code differs from the nonrecognition of loss in a typical gift scenario under section 1015 of the Code. Under section 1041, the transferee or

110. I.R.C. § 1041(c)(2) (1988). A transfer of property between former spouses is related to the cessation of the marriage if "the transfer is pursuant to a divorce or separation instrument... and the transfer occurs not more than 6 years after the date on which the marriage ceases." Temp. Treas. Reg. § 1.1041-1T(b), Q & A-7 (1984); see, e.g., Priv. Ltr. Rul. 93-06-015 (Feb. 22, 1993) (eight years after the divorce is presumably unrelated to the divorce).
113. Transfers to third parties on behalf of their spouse or former spouse may qualify for nonrecognition treatment, provided that other requirements of § 1041 of the Code are met. Temp. Treas. Reg. § 1041-1T(c) (1984); see, e.g., Arnes v. United States, 981 F.2d 456 (9th Cir. 1992).
payee spouse's basis in the property equals the transferor or payor spouse's basis in the property immediately before the transfer.\(^{118}\) The transferee or payee spouse will use that transferred basis to determine a loss on a subsequent sale of the property.\(^{119}\) Therefore, when the transferee spouse sells the property, the transferee spouse recognizes the same loss as the transferor spouse would have recognized if the transferor spouse had sold the property for the same price. For example, A owns property with a basis of $100,000 and transfers this property to B as provided in the divorce decree. At the time of transfer, the fair market value of the property is $75,000. Shortly after receipt, B sells the property for $85,000 and recognizes a $15,000 loss. B's basis in the property prior to the sale was $100,000—the same basis as A.

Because the Code views property transfers between spouses and former spouses as gifts, recognition of ordinary income on the transfer of property subject to depreciation recapture is not required.\(^{120}\) The Code, however, requires the recapture of depreciation on disposition of the property.\(^{121}\) Thus, because the transferee spouse has the same adjusted basis in the property as the transferor spouse,\(^{122}\) the transferee spouse recognizes ordinary income on a subsequent disposition of the property.\(^{123}\) With such potential ordinary income built into the depreciable property transferred between the former spouses, what may first appear to be a fair property settlement agreement may, in fact, result in unfavorable tax consequences to the payee spouse.

For example, a couple owns a tract of land worth $150,000 with an adjusted basis of $135,000 and business equipment worth $150,000 with an original purchase price (cost basis) of $100,000 and an adjusted basis of $50,000. Both assets have been held for more than one year. A receives the land and B receives the equipment pursuant to the property settlement agreement or divorce decree. If A sells the land for its fair market value shortly after the transfer, A must report a long-term capital gain of $15,000.\(^{124}\) If B sells the business equipment for its fair market value, B recognizes

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119. I.R.C. § 1001(a), (c) (1988).
122. I.R.C. § 1041(b)(2).
123. I.R.C. §§ 1245(a)(1), 1250(a)(1).
124. If the land was held for investment, A will report $15,000 of long-term capital gain pursuant to §§ 1221 and 1222(3) of the Code. If the land was used in a trade or business, A will report $15,000 of long-term capital gain. I.R.C. § 1231(a)(1) (1988).
$50,000 of ordinary income and $50,000 of section 1231 gain. The above example illustrates the adverse tax consequences created by section 1041 and the significance of basis in drafting a fair property settlement agreement. The practitioner should consider the client’s potential tax liability when giving advice with respect to a property settlement. Additionally, the practitioner should determine the length of time the client intends to hold the property received in a dissolution of marriage. If the client desires to sell the property immediately after receipt, the practitioner should attempt to allocate long-term capital gain property to the client. Such an allocation under the property settlement agreement allows the client to receive favorable tax treatment on a later sale of the property.

A practitioner representing a spouse during a dissolution of marriage should draft a property settlement agreement in a manner that ensures full compliance with I.R.C. § 1041. Compliance allows former spouses to defer the recognition of gain and to shift the tax attributes of property to the spouse who can derive the greatest tax benefit.

VII. DEPENDENCY EXEMPTION

A dissolution of marriage can have collateral tax effects on former spouses with children. The Code permits a taxpayer to claim a dependency deduction for each child who qualifies as a dependent. Following a divorce, only one of the former spouses, however, can claim the child as a dependent on an income tax return. The Code specifically addresses this situation by providing rules for determining which spouse is entitled to the dependency deduction.

125. The $50,000 of ordinary income represents the difference between the equipment’s recomputed basis of $100,000 and its adjusted basis of $50,000. I.R.C. § 1245(a)(1)(A) (1988).

126. The section 1231 gain of $50,000 will be characterized as long-term capital gain if B’s § 1231 gains exceed § 1231 losses for the taxable year. I.R.C. § 1231(a)(1).

127. I.R.C. § 151(c) (1988). The taxpayer may take a dependency deduction if the taxpayer provides over half of the child’s support and the child is either under 19 years of age or is a student under 24 years of age. I.R.C. §§ 151(c)(1)(B), 152(a)(1) (1988). The taxpayer may also take a dependency deduction if the taxpayer provides over half of the child’s support and the child’s gross income for the calendar year is less than the amount of the dependency exemption. I.R.C. §§ 151(c)(1)(A), 152(a)(1) (1988).

128. A state district court may assign the dependency exemption to either parent in the decree of dissolution if the court finds that such assignment is in the best interests of the children and the parents. In re Marriage of Milesnick, 35 Mont. 88, 94, 765 P.2d 751, 754-55 (1988).


https://scholarship.law.umt.edu/mlr/vol55/iss2/3
In the case of divorced parents, the Code grants the dependency exemption to the parent who has custody of the child for the greater portion of the calendar year. For the custodial parent rule to apply, three conditions must be satisfied. First, the divorced parents, in the aggregate, must provide more than one-half of the child's support during the calendar year. Second, the parents must be: (1) “divorced or legally separated under a decree of divorce or separate maintenance,” (2) “separated under a written separation agreement,” or (3) “liv[ing] apart at all times during the last 6 months of the calendar year.” Third, one or both parents must have custody of the child for more than one-half of the calendar year.

The noncustodial parent, however, may claim the dependency exemption under certain circumstances. The noncustodial parent is entitled to the dependency exemption if the custodial parent signs a written declaration relinquishing the right to the exemption and the noncustodial parent attaches this written statement to the income tax return for the taxable year in which the noncustodial parent claims the dependency deduction. This transfer of the dependency deduction may result in significant tax savings to the noncustodial parent if that parent is in a higher income tax bracket.

A noncustodial parent may also claim a dependency deduction when a multiple support agreement is in effect. A multiple support agreement is in effect when four requirements are met. First, the child must not have received more than one-half of the support from any one person. Second, the child must have received over one-half of the support from two or more persons, each of whom

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133. I.R.C. § 152(e)(1)(B) (1988). Even if the non-custodial parent provides more than one half of the child's support for the calendar year, the custodial parent will still receive the tax benefit of the dependency deduction. See I.R.C. § 152(e)(1).
134. The custodial parent may release to the noncustodial parent a claim to the dependency exemption for a single year, for a specified number of years, or for all future years. Temp. Treas. Reg. § 1.152-4T(a), Q & A-4 (1984). The custodial parent releases the right to the dependency exemption by completing and signing IRS Form 8332.
135. I.R.C. § 152(e)(2). The Tax Court disallowed a noncustodial parent's dependency exemption after finding that the noncustodial parent failed to the income tax return the custodial parent’s release to attach. Nieto v. Commissioner, 92 T.C.M. (RIA) 296 (1992). If the noncustodial parent intends to claim the dependency exemption for subsequent taxable years, the taxpayer must attach a copy of the custodial parent's written release to the return for future taxable years. Temp. Treas. Reg. § 1.152-4T(a), Q & A-4.
would have been able to claim the child as a dependent on an income tax return if that person would have provided that child with more than one-half of the support.\textsuperscript{138} Third, the person claiming the dependency deduction must have provided more than ten percent of the child’s support.\textsuperscript{139} Fourth, all other persons who are eligible to claim the dependency deduction must file written statements waiving their right to the dependency exemption.\textsuperscript{140} If the noncustodial parent claims the dependency deduction when a multiple support agreement is in effect, the noncustodial parent must attach these written statements to the income tax return.\textsuperscript{141}

Finally, the noncustodial parent may be entitled to the dependency exemption if the noncustodial parent has entered into a qualified pre-1985 instrument with the former spouse.\textsuperscript{142} The Code defines a “qualified pre-1985 instrument” as any divorce decree or separation agreement which became effective prior to January 1, 1985, and which states that the noncustodial parent can claim the child as a dependent on the income tax return.\textsuperscript{143} However, before taking a dependency deduction pursuant to a qualified pre-1985 instrument, the noncustodial parent must have provided the child with $600 of support for the calendar year at issue.\textsuperscript{144}

Using a dependency exemption may result in significant tax savings. As a result, the general practitioner should advise the client of the potential tax consequences of claiming a dependency exemption or transferring the exemption to the former spouse. If the practitioner advises the client to release the client’s right to the dependency exemption, the practitioner should be certain that the client receives from the former spouse some form of compensation that is at least equal to the tax cost of surrendering the exemption. Such an arrangement ensures that both parties receive equitable income tax treatment after the dissolution of marriage.

\textsuperscript{138} I.R.C. § 152(c)(2) (1988). Section 152(a) of the Code lists the individuals who qualify as dependents of the taxpayer if the taxpayer provided over one-half of the individual’s support. I.R.C. § 152(a) (1988).

\textsuperscript{139} I.R.C. § 152(c)(3) (1988).

\textsuperscript{140} I.R.C. § 152(c)(4) (1988). Those persons who decide not to claim the person as a dependent must sign I.R.S. Form 2120. Treas. Reg. § 1.152-3(c) (as amended in 1963).

\textsuperscript{141} Treas. Reg. § 1.152-3(c).

\textsuperscript{142} See I.R.C. § 152(e)(4) (1988).

\textsuperscript{143} I.R.C. § 152(e)(4)(B)(i)-(ii) (1988). A “qualified pre-1985 instrument” does not, however, include any divorce decree or separation instrument that has been expressly amended to disregard the statutory rules that existed prior to 1985. I.R.C. § 152(e)(4)(B)(iii) (1988).

VIII. FILING STATUS

Divorce raises significant procedural questions with respect to taxpayers’ filing status. For example, taxpayers who are living apart pending a divorce may still file a joint return as long as they are married on the last day of the tax year. Additionally, the Code allows a divorced taxpayer to file a joint return if the taxpayer remarries before the last day of the tax year. Thus, a taxpayer’s marriage status at the end of the tax year greatly affects the amount of federal income tax the taxpayer has to pay. For example, in 1993, a taxpayer with taxable income of $25,000 and married filing jointly, rather than single, would save $377 in tax liability while a taxpayer with $50,000 taxable income would save $1,924.

Furthermore, the Code grants special relief to unmarried divorced taxpayers. A divorced taxpayer may choose between single or head of household filing status. Section 1(c) automatically grants single status to all unmarried individuals. However, a taxpayer must meet specific requirements to qualify for head of household status. A taxpayer must:

1. not be married at the close of the tax year;
2. not be a surviving spouse;
3. maintain a household that constitutes the “principal place of abode” for a child for more than one-half the tax year; and
4. furnish over one-half the cost of maintaining the household during the tax year.

145. See I.R.C. §§ 2(b)(2)(B), 7703(a) (1988), provided there is no decree that legally separates the couple, such as a divorce decree or decree of separate maintenance. See also Boyer v. Commissioner, 79 T.C. 143, 146-47 (1982) (ordering support and separation of the parties; married filing joint return not allowed); Boettiger v. Commissioner, 31 T.C. 477 (1958), acq., 1959-1 C.B. 3 (court-ordered support only; couple can still file joint return); Johnson v. Commissioner, 39 T.C.M. (CCH) 868 (1980) (voluntary separation; the couple can still file as married).
146. I.R.C. § 7703(a)(1) (1988); Treas. Reg. § 1.2-2(b)(5) (as amended in 1971). For most taxpayers, December 31 is the last day of the tax year.
148. In 1993, a taxpayer with $25,000 taxable income filing as head of household, rather than single, would save $377 in taxes; a taxpayer with $50,000 of taxable income qualifying as head of household would save $975. Head of household status taxes $7,500 more at the 15% rate, as opposed to 28% for single status. See I.R.C. § 1 (1988).
149. I.R.C. § 1(c) (1988).
While the first two requirements are self-explanatory, the third and fourth requirements are more complex. The third factor requires that the taxpayer and the child occupy the household in order for the home to qualify as the principal place of abode. The Service treats the taxpayer’s child as occupying the household even if the child is temporarily absent. Examples of temporary absences are “illness, education, business, vacation, military service, or a custody agreement under which a child or stepchild is absent for less than six months in the taxable year.”

Under the fourth requirement, the taxpayer maintains a household only if the taxpayer furnishes over half of the cost of maintaining the household during the taxable year. The Service considers the cost of maintaining a household to be any expense incurred in the operation of the principal place of abode for the mutual benefit of the occupants. The Code includes the following as examples of expenses of maintaining a household: “property taxes, mortgage interest, rent, utility charges, upkeep and repairs, property insurance, and food consumed on the premises.”

Although only one of the divorced spouses may qualify for head of household status, both parties may still secure tax benefits from raising a child. A taxpayer does not need to claim the child as a dependent in order to qualify as head of household. Therefore, a spouse who qualifies for head of household status may transfer to the former spouse the right to a dependency exemption. This election allows the divorced couple to split the tax benefits of having a dependent child—one spouse receives the exemption and the other spouse qualifies for head of household filing.

155. Marriage is determined at one point in time, the last day of the tax year—generally December 31. Surviving spouse designation is granted special filing status in the year of the spouse’s death and the following two years, provided, however, that the surviving spouse maintains a household for a dependent and is not married at the end of the year in which the surviving spouse status is claimed. I.R.C. § 2(a)(2)(A) (1988).
156. Treas. Reg. § 1.2-2(c) (as amended in 1971).
157. Treas. Reg. § 1.2-2(c).
158. See Blair v. Commissioner, 63 T.C. 214 (1974), aff’d on other grounds, 538 F.2d 155 (7th Cir. 1976) (although child was away at school more than six months of the tax year, the parent’s home still qualified for the child’s principal place of abode).
159. Treas. Reg. §§ 1.2-2(c).
162. Treas. Reg. § 1.2-2(d).
163. Splitting custody of two or more children will allow both taxpayers to qualify as head of household. However, “[u]nder no circumstances shall the same child be used to qualify more than one taxpayer as the head of a household for the same taxable year.” Treas. Reg. § 1.2-2(b)(2) (as amended in 1971).
status.

Head of household filing status provides significant tax savings. This special status allows more income to be taxed at lower rates.\textsuperscript{166} Additionally, the taxpayer receives a larger standard deduction when the taxpayer files as a head of household instead of single.\textsuperscript{167} The standard deduction is the amount the Service allows a taxpayer to deduct from adjusted gross income if the taxpayer chooses not to itemize deductions.\textsuperscript{168} This Article discusses standard and itemized deductions in a subsequent section.\textsuperscript{169}

Usually, taxpayers make custody and child care arrangements with little, if any, concern for the tax consequences. As a result, the practitioner can provide little tax planning advice for a taxpayer wishing to qualify as a head of household. Nevertheless, the practitioner should advise clients of the head-of-household status and its requirements. The practitioner should also keep in mind that a couple appearing to be divorced will be able to file a joint return unless a divorce decree or final decree of separate maintenance has been issued.\textsuperscript{170}

The practitioner can use tax planning to avoid one common pitfall. A problem occurs when a taxpayer attempting to claim head of household filing status receives both alimony and child support payments. The taxpayer must provide over one-half the expense of maintaining the child’s home.\textsuperscript{171} If the payee spouse uses child support payments for maintaining the household, the taxpayer may not qualify for head of household filing status. Therefore, he or she should pay expenses that do not qualify for maintaining a household\textsuperscript{172} out of child support payments.

\section*{IX. DEDUCTIBILITY OF LEGAL EXPENSES}

The Service does not allow taxpayers to deduct expenses related to divorce, because a divorce is personal in nature.\textsuperscript{173} This rule is consistent with the Code’s general theme of not allowing

\begin{footnotesize}
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\item \textsuperscript{166} See supra note 148.
\item \textsuperscript{167} I.R.C. § 63(c)(2) (1988). In 1994, the standard deduction for single status is $3,800, for head of household the standard deduction is $5,600, and married filing joint is $6,350. See I.R.C. § 63(c)(2)(B), (C) (1988).
\item \textsuperscript{168} I.R.C. § 63(b) (1988).
\item \textsuperscript{169} See infra part IX.
\item \textsuperscript{170} See supra notes 145-46.
\item \textsuperscript{171} I.R.C. § 2(b)(1).
\item \textsuperscript{172} See Treas. Reg. § 1.2-2(d) (among items not included in maintaining the household are clothing, education, medical, meals away from home).
\end{itemize}
\end{footnotesize}
deductions for personal expenditures. However, the Code allows limited deductions under special circumstances.

Generally, legal expenses incidental to a divorce or separation are not deductible. However, in certain limited contexts, a taxpayer may deduct a portion of the legal fees associated with the divorce or separation. If part of the legal fees are attributable to the collection of alimony or income-producing property, that part qualifies as a miscellaneous deduction. Additionally, if part of a taxpayer's legal fees are attributable to advice on tax matters incidental to a divorce or separation, that part also qualifies as a miscellaneous itemized deduction. When the taxpayer receives legal advice on tax matters as well as other matters, the taxpayer must properly allocate and substantiate the expenses associated with the tax advice.

Practitioners should note that taxpayers making alimony payments (payor spouses) have an even greater limitation on the deduction of legal fees. Legal fees incurred in defending non-payment of alimony or in attempting to reduce alimony payments are not deductible. Additionally, the payor spouse cannot deduct payment of the payee spouse's legal fees.

A taxpayer must itemize deductible legal expenses. These expenses are considered miscellaneous itemized deductions and are subject to a two percent floor. Taxpayers calculate the two percent floor by multiplying their adjusted gross income (AGI) for the tax year by .02. Any amount of deductible legal fees greater than the two percent floor is deductible as an itemized expense.

As a practical matter, taxpayers seldom benefit from deducting legal expenses. Most taxpayers rarely incur miscellaneous deductions, including legal fees, that exceed the two percent bar-

rier. Moreover, even if the total miscellaneous itemized deductions exceed the two percent floor, the taxpayer loses the amount up to the two percent floor. For example, assume a taxpayer has adjusted gross income of $32,000, $750 in deductible legal expense, and $90 in other miscellaneous expenses. The two percent floor is computed by multiplying .02 by $32,000 which equals $640. The total miscellaneous deductions are $840 ($750 + $90). Therefore, the deductible amount is $200 ($840 - $640), which is the amount of miscellaneous deductions in excess of the two percent floor. Finally, total itemized deductions must exceed the standard deduction that applies to the taxpayer's filing status. In 1994, the standard deduction for married filing joint taxpayers is $6,350, for head of household is $5,560, and for single taxpayers is $3,800. Therefore, if a taxpayer's total itemized deductions do not exceed the standard deduction, the taxpayer would not receive any benefit by itemizing.

As illustrated above, the Service has made full deductibility impossible and partial deductibility very difficult. In summary, the taxpayer must overcome two major hurdles before receiving any tax benefit for these expenses. First, the taxpayer must incur miscellaneous deductions in one tax year that exceed two percent of the taxpayer's AGI. Second, the taxpayer must incur total itemized deductions greater than the standard deduction allowed in that tax year.

Proper planning can reduce the effects of these provisions, but cannot eliminate the partial loss of the deduction caused by the two percent floor. The taxpayer should group and pay legal and

188. See I.R.C. § 67(a).
189. See supra notes 176-79 and accompanying text.
190. See Temp. Treas. Reg. § 1.67-1T.
193. Continuing the previous example, further assume that the single taxpayer has $2,000 in mortgage interest, has $500 in property taxes and made $300 in deductible contributions. Since the combined total of itemized deductions is only $3,000, it is more advantageous for the taxpayer to use the $3,800 standard deduction available to single taxpayers. Hence, under this scenario, the taxpayer receives no real deduction or benefit from paying legal fees.
194. See I.R.C. § 67 (1988). The amount up to the two percent floor is lost.
196. I.R.C. § 67(b); Temp. Treas. Reg. § 1.67-1T(a).
197. Reported on I.R.S. Form 1040, Schedule A.
198. I.R.C. § 63(c).
other itemized deductible expenses in the same tax year.\textsuperscript{199} This planning will help ensure that the deductions exceed both the two percent floor and the standard deduction. Furthermore, if possible, the taxpayer should postpone income to another year in order to reduce AGI in the year that the taxpayer takes the deductions. The reduction in AGI reduces the two percent floor, which allows the taxpayer to use a larger amount of miscellaneous deductions. Finally, the practitioner should allocate the billed fee between tax and production of income advice and other legal advice concerning the divorce.\textsuperscript{200} This allocation ensures proper substantiation of the deduction.

X. Conclusion

The attorney who represents a party during divorce proceedings should consider the tax implications of alimony and child support payments and divisions of property and payment of attorneys' fees. A lack of tax planning may cause the client to experience unfavorable tax consequences. Such consequences add to the frustrations the client has already endured while undergoing a divorce. Consequently, a basic understanding of the relevant tax laws is imperative when counseling a client during a dissolution of marriage.

Although this Article has not covered every conceivable tax consideration, it has, nevertheless, attempted to familiarize the general practitioner with the most important tax laws that apply to a dissolution of marriage. A thorough review of these laws and their application to the client's situation should eliminate most adverse tax consequences to the client.

\textsuperscript{199} For example, if all the legal work will be completed in January of the following year, the taxpayer may wish to accelerate payment of the legal fees in the current year.