

Effect of TRA 1997 and RARA 1998 on Divorce Taxation

by
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On July 18, 1984, by virtue of the domestic relations provisions of the Tax Reform Act of 1984¹ (DRTRA 1984), a new system of divorce taxation came into being which was the most monumental change in the tax law for the past 30 years. Since 1984, the rate of change in divorce taxation has accelerated in many meaningful respects.

In 1997 and 1998 Congress passed and the President signed into law two tax acts which impact on divorcing parties: the Taxpayer Relief Act of 1997² (TRA 1997) and the Internal Revenue Service Restructuring and Reform Act of 1998³ (RARA 1998).

The most important changes of TRA 1997 affecting parties to a divorce are: the modification of the rates and holding periods for capital gain treatment on the sale of qualified assets;⁴ taxation of gains on the sale of a principal residence;⁵ and the introduction of the Child Tax Credit.⁶ There are also some minor changes that can make an impact in divorce, including modification of the periods for carry-backs and carry-forwards of net operating losses,⁷ and the avoidance of the 10% penalty for early withdrawal from IRAs for higher education expense⁸ and for first time home buyers.⁹

The RARA 1998's major impact on the tax laws that affect spouses and former spouses is the liberalization of the innocent spouse rules, creating additional relief by virtue of the right to elect separate liability for joint filers and allowing of equitable

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² Pub. L. No. 98-369 (1984).

³ Tax Payer Relief Act. Pub. L. No. 105-34, 111 Stat. 788 (1997).

⁴ RARA Pub. L. No. 105-206, 112 Stat. 685 (1998).

⁵ § 311 of the Act. Pub. L. No. 105-34, § 311, 111 Stat. 788 (1997).

⁶ § 312 of the Act. *Id.* at § 312.

⁷ § 101 of the Act. *Id.* at § 101.

⁸ § 1082 of the Act.

⁹ § 203 of the Act.

relief to a spouse where warranted for liability on a joint return.¹⁰ RARA 1998 also modified the holding period for assets to qualify for capital gain treatment.¹¹

I. Transfers of Property

A. No Recognizable Gain on Transfer to Spouse or Former Spouse

DRTRA brought to the field of divorce tax law Internal Revenue Code § 1041 which provides, in substantial part, that there shall be no recognition of a gain or loss on a transfer of property,¹² to a spouse¹³ or a former spouse if the transfer is incident to the divorce.¹⁴ “Property” includes real or personal, tangible or intangible.¹⁵

A transfer is incident to divorce if such transfer occurs within one year after the date on which the marriage ceases¹⁶ or is related to the cessation of the marriage.¹⁷ A transfer of property is treated as related to the cessation of the marriage if the transfer is pursuant to a divorce or separation instrument,¹⁸ and the transfer occurs not more than six years after the date on which the marriage ceases. A rebuttal presumption exists that any transfer not pursuant to a divorce or separation instrument and any transfer occurring more than six years after the cessation of the marriage is not related to the cessation of the marriage.¹⁹

A significant aspect of a § 1041 transfer of property between spouses or former spouses is that the basis²⁰ of the transferred property is the adjusted basis²¹ in the hands of the transferor im-

¹⁰ § 303 of the Act.

¹¹ RARA *supra* n. 3 at § 3201(a) § 3201(a) of the Act.

¹² § 5001 of the Act. *Id.* at 5001.

¹³ I.R.C. § 1041(a) (1984).

¹⁴ I.R.C. § 1041(a)(1).

¹⁵ I.R.C. § 1041(a)(2).

¹⁶ Temp. Treas. Reg. § 1.1041-1T, A-4 (1984).

¹⁷ I.R.C. § 1041(c)(1).

¹⁸ I.R.C. § 1041(c)(2).

¹⁹ A divorce or separation instrument includes (A) a decree of divorce or separate maintenance or a written instrument incident to such a decree, (B) a written separation agreement or (C) an interim order for spousal support. I.R.C. § 71(b)(2) (1984).

²⁰ Temp. Treas. Reg. § 1.141-1T, A-4.

²¹ I.R.C. § 1012.

mediately before the transfer. This carry over basis rule applies whether the adjusted basis of the transferred property is less than, equal to, or greater than its fair market value at the time of the transfer and applies for purposes of determining loss as well as gain upon the subsequent disposition of the property of the transferee.²² The holding period of the transferee includes that of the transferor.²³

If a gain²⁴ occurs on the sale of a capital asset²⁵ which will trigger a tax,²⁶ that in turn will have an impact on the net proceeds from such sale (e.g., the sales price less any tax resulting from the gain from such sale). If this tax will be considered in any way in the distribution of assets, whether the distribution is equal or equitable,²⁷ the amount of that tax is material. Thus, knowledge of the rate of the capital gain tax is critical.

B. Capital Gain Tax

There has been no recent change in the tax on short-term capital gains;²⁸ it remains taxed at the same rate as ordinary income. However by TRA 1997 Congress reduced the maximum rate of 28% on long term capital gains and modified the holding period to qualify for long term gain, introducing a new concept of "mid-term gain," for sales and exchanges after May 6, 1997.²⁹ The mid-term concept of a holding period of more than one year but not more than 18 months for applying a long term capital

²² I.R.C. § 1016.

²³ Temp. Treas. Reg. § 1.141-1T, A-11.

²⁴ I.R.C. § 1223(2).

²⁵ The difference between the property's fair market value and its adjusted basis.

²⁶ A capital asset generally means any property except (1) inventory, stock in trade, or property held primarily for sale to customers in the ordinary course of the taxpayer's trade or business, (2) depreciable or real property used in the taxpayer's trade or business, (3) specified literary or artistic property, (4) business accounts or notes receivable, or (5) certain U.S. publications. H.R. Rep. No. 105-148, at 340 (June 24, 1997). See also I.R.C. § 1221.

²⁷ I.R.C. § 1(h).

²⁸ "[T]he word 'equitable' itself implies the weighing of many considerations and circumstances that are presented in each case." *Stout v. Stout*, 382 A.2d 659, 663 (N.J. Super. Ct. App. Div. 1977).

²⁹ "Short term capital gain" is defined as "gain from the sale or exchange of a capital asset held for not more than 1 year. . . ." I.R.C. § 1222(1).

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gain rate at the previous maximum of 28% was eliminated retroactively for sales after 1997 by RARA 1998.³⁰

The rationale for reducing the capital gain rate was articulated by the House Committee on the Budget. There the Committee stated

To serve the American people, balancing the Federal budget is only half the job. Congress and the administration must, at the same time, let Americans keep more of their own money - to save, to invest, and to make their own choices about how best to use the resources they have earned.³¹

Accordingly, under TRA 1997 the maximum long-term capital gain rate, as modified by RARA 1998, for capital assets held for more than one year drops from 28% to 20% (10% for individuals in the 15% tax bracket).³² A lower rate of 18% (8% for individuals in the 15% bracket) applies to transactions after December 31, 2000, when the asset is held more than five years.³³

A special election is provided for capital assets acquired before January 1, 2001. For property acquired before the year 2001, an 18% rate can be utilized by paying the capital gains tax on the appreciation as of the date. The 18% then will apply to any future appreciation of property held for more than five years.³⁴

A 28% maximum rate continues on the sale of collectibles³⁵ held for more than one year.³⁶ To the extent of depreciation claimed on real estate held for one year or more,³⁷ a maximum rate of 25% will apply.³⁸

To summarize, generally for sales of capital assets after January 1, 1998, the rates on gains will be as follows:

³⁰ § 311 of the Act. See n. 4.

³¹ RARA § 5001 of the Act.

³² H.R. Rep. No. 105-148, at 283 (June 24, 1997).

³³ I.R.C. § 1(h)(1)(B) and (C).

³⁴ I.R.C. § 1(h)(2)(A) and (B).

³⁵ §311(e)(1)(B) of the Act. See n. 4.

³⁶ Such as artworks, rugs, metals, jewels, gems, antiques, stamp and coin collections and alcoholic beverages. I.R.C. § 408(m)(2). *See also* proposed Treas. Reg. §1.408-10(b) (1981).

³⁷ I.R.C. § 1(h)(5)(A)(i).

³⁸ Unrecaptured I.R.C. § 1250 gain.

Property	Rates
Holding period: one year or less ("short-term capital gain")	Ordinary
Holding period: more than one year ("long-term capital gain")	20% (10% for those in 15% bracket)
Otherwise eligible gains for depreciation claimed on real estate (unrecaptured I.R.C. § 1250 gain) held for one year or more	25%
After year 2000, property acquired then or later and held for five years	18% (8% for those in 15% bracket) ³⁹
For property acquired before year 2001, if election made and tax paid on gain, provided held for five years	18%
Collectibles held for more than one year	28%

The capital gain tax reduces the net proceeds of a sale of the capital asset; however, while in some divorces a sale is required or anticipated, in many more no sale is contemplated - only a distribution of the assets with one party or the other retaining some assets and distributing other assets to the spouse or former spouse. If no actual sale occurs, because there may be a difference between the adjusted basis of the property and its then fair market value, there is a potential tax liability. This liability is also referred to as the "contingent" or "hypothetical" tax liability. It may eventually affect the value or net proceeds to be realized from that asset, especially if one spouse retains or receives low basis property and the other retains or receives high basis property.

C. Consideration of Contingent Tax Liability

The majority of courts hold that they need not speculate on potential tax consequences that may or may not arise after the division of property⁴⁰ unless there is "proof of an immediate and specific tax liability."⁴¹ One opinion held that the court must

³⁹ I.R.C. § 1(h)(1)(D).

⁴⁰ The asset does not have to be acquired after December 31, 2000, for the five year period to begin.

⁴¹ In re Marriage of Fonstein, 552 P.2d 1169, 1175 (Cal. 1976) ("Once having made [the division of property] the court is not required to speculate about what either or both of the spouses may possibly do with his or her . . . share."); England v. England, 626 So. 2d 330, 332 (Fla. Dist. Ct. App. 1993)

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consider tax consequences of a sale only when it orders the sale.⁴² A Florida court held that “it is not error for a trial court to refuse to take into account the potential of future tax liability in making awards [of equitable distribution].”⁴³

The majority rule has many exceptions as well as many varied factual patterns where courts have held it is appropriate for the contingent tax liability to be considered either in the valuation of the assets or in the quantity of assets to be distributed.⁴⁴

One court rejected the reduction in value by a contingent tax liability where such a consequence was demonstrated as to only one of many assets to be distributed. If a tax effect is to be considered by the court, it should be demonstrated as to all the assets subject to distribution between the spouses.⁴⁵

(Where there was no evidence of “an imminent or even contemplated” sale or “tax benefits such as depreciation, investment tax credits, or the like . . . to have been taken by either party . . . during the marriage years, it was error to reduce the value of the corporation by potential capital gains tax.”)

⁴² *In re Marriage of Sharp*, 143 Cal. App. 3d 714, 715 (Cal. Ct. App. 1983).

⁴³ *Crooker v. Crooker*, 432 A.2d 1293 (Me. 1981).

⁴⁴ *Levan v. Levan*, 545 So. 2d 892, 893 (Fla. Dist. Ct. App. 1989). *See also* *Hovis v. Hovis*, 541 A.2d 1378, 1380-81 (Pa. 1988).

⁴⁵ *Nicewonder v. Nicewonder*, 602 So. 2d 1354, 1358 (Fla. Dist. Ct. App. 1992) (J. Zehmer concurring) (emphasis added) [“In determining the value of the properties being equitably distributed, the trial court’s use of a perceived fair market value without considering potential income tax consequences and including the effect of such contingent income tax liabilities *generated during the marriage* simply ignores the value of both assets and liabilities created during the marriage. . . .”].

Miller v. Miller, 625 So. 2d 1320, 1321 (Fla. Dist. Ct. App. 1993) (emphasis added) (“*If both of the assets are sold relatively soon after dissolution, a likely prospect in view of the ages of the parties, the tax consequences would create an inequitable disparity favoring the spouse receiving the marital residence.*”)

Orgler v. Orgler, 568 A.2d 67, 74 (N.J. Super. Ct. 1989) (“Although hypothetical tax consequences should not reduce the present *value* of marital assets, such a consideration . . . has an important place in the equitable distribution process. . . . [T]he hypothetical tax consequence . . . is a factor to be considered with all other factors, such as the respective earning capacity of the parties, their health, education and contribution to the marriage, in determining the distributive share of each party.”)

II. Sales of Principal Residence

TRA 1997 creates very substantial changes in the tax treatment of the sale or exchange of a principal residence. I.R.C. § 1034 (the non-recognition rollover rule) was repealed⁴⁶ and I.R.C. § 121 (the \$125,000 one time exclusion for those 55 years of age and older) is completely amended⁴⁷ by the TRA 1997.⁴⁸

A. Pre-1997 Rules

Former I.R.C. § 1034 provided that if a principal residence of a taxpayer was sold and within 24 months (before or after) the taxpayer purchased or constructed another principal residence, a gain was recognized on the sale only to the extent the “adjusted sale price” exceeds the cost of the new residence. Any gain that was not taxed in the year of sale of the old home was subtracted from the cost (the basis) of the new home. This gave a lower basis in the new home.⁴⁹

⁴⁶ In *Vaccaro v. Vaccaro*, 677 So. 2d 918, 922 (Fla. Dist. Ct. App. 1996), where the husband’s complaint on appeal that the trial judge failed to take into consideration the tax consequences of the distribution of stock of a close corporation was rejected, the court explained:

A party who demands consideration of the tax consequences of receiving a tax burdened asset should demonstrate good faith by assisting the trial court in consideration of the tax consequences of all the tax burdened marital assets, whether or not the demanding party is to receive those particular assets. It is only through the presentation of the consequences as to all assets that the trial court may order a distribution that is equitable. Selection of only one asset to demonstrate a worst case tax consequence when others are also burdened may require that the trial court ignore the tax consequences as to all distributable assets.

⁴⁷ § 312(b) of the Act. See n. 4.

⁴⁸ § 312(a) of the Act. See n. 4.

⁴⁹ The reasons for the change in the law, that is the repeal of the rollover provision of I.R.C. § 1034 and the complete revamping of the \$125,000 one-time exclusion of I.R.C. § 121, as expressed in both the U.S. House and Senate Committee reports to the 1997 Act are (1) alleviating the arduous and long-time recordkeeping requirements except for the “few taxpayers” where gain would exceed \$250,000, (2) to relieve taxpayers from the necessity of purchasing larger and more expensive homes to defer gains under the old rollover rule, (3) to encourage mobility of the elderly who are discouraged from selling their homes where they would have realized a gain in excess of \$125,000 or for those who have already used their exclusion and (4) to avoid “certain tax traps for the

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The postponement of the gain on the replacement of the old home was mandatory. If the new home was sold at a later time and again replaced, any gain was again postponed. The home that was sold and the one bought to replace it must both have qualified as the principal home. The sold home must have been used as the taxpayer's principal residence at the time of sale.⁵⁰

Generally, for property to have been "used by the taxpayer as his or her principal residence" within the meaning of § 1034(a), that taxpayer must have physically occupied and lived in the house. The issue of whether property constitutes a principal residence depended upon the facts and circumstances of each case.⁵¹ By and large, cases in which taxpayers have been allowed the benefits of I.R.C. § 1034(a) even though they were not in possession of the old residence at the time of sale involved either the temporary rental of the property or, in situations involving longer rentals, exceptional or unusual facts and circumstances over which the taxpayer had no control.⁵²

unweary" such as "the unintended effect of penalizing individuals who marry someone who has already taken the exclusion" and "divorcing couples [who] may incur substantial capital gains taxes if they do not carefully plan their house ownership and sale decisions." H.R. Rep. No. 105-148, at 347 and 348. S. Rep. No. 105-33, at 36 and 37.

⁵⁰ I.R.C. § 1034(e).

⁵¹ I.R.C. § 1034(a); Treas. Reg. § 1.1034-1(b)(1).

⁵² There was no definition of principal residence in I.R.C. § 1034. However, Treas. Reg. § 1.1034-1(c)(3) provides, in part, as follows:

(3) *Property used by the taxpayer as his principal residence.* (i) Whether or not property is used by the taxpayer as his residence, and whether or not property is used by the taxpayer as his principal residence (in the case of a taxpayer using more than one property as a residence), depends upon all the facts and circumstances in each case, including the good faith of the taxpayer. The mere fact that property is, or has been, rented is not determinative that such property is not used by the taxpayer as his principal residence. For example, if the taxpayer purchases his new residence before he sells his old residence, the fact that he temporarily rents out the new residence during the period before he vacates the old residence may not, in the light of all the facts and circumstances in the case, prevent the new residence from being considered as property used by the taxpayer as his principal residence. Property used by the taxpayer as his principal residence may include a houseboat, a house trailer, or stock held by a tenant-stockholder in a cooperative housing corporation.

Under former I.R.C. § 121, taxpayers could elect to exclude from gross income up to \$125,000 of gain (\$62,500 if married, filing separately) on the sale or exchange of principal residence if:

- (i) the taxpayer was 55 years of age or older on the date of the sale or exchange,⁵³ and
- (ii) the principal home was owned and lived in for at least three years out of the five year period ending on the date of sale or exchange,⁵⁴ and
- (iii) neither the taxpayer nor the taxpayer's spouse ever excluded gain on the sale or exchange of a home after July 26, 1978.⁵⁵

The required three years of ownership and use during the five year period ending on the date of sale or exchange did not have to be continuous. The test could be met if it was shown that the principal home was owned and lived in for either 36 full months or 1,095 days (365 x 3) during the five year period. Short temporary absences for vacations or other seasonal absences, even if the property was rented out during the absence, were counted as periods of use.⁵⁶

If the choice to exclude the gain was taken once, it could never be used again, by either spouse, at any time thereafter with the same spouse, alone or with another spouse. The taxpayer and a subsequent spouse were "tainted" if a prior election were taken by either if married at the time of the sale or exchange of the property. A taxpayer who has not used the election will be prohibited from making the election if that taxpayer married someone who had made the election prior to the marriage or whose then-spouse made the election.⁵⁷

⁵³ As to the issue of a taxpayer having no control, the circuit court explained in *Perry v. Commissioner*, 91 F.3d 82, 86 (9th Cir. 1996), that

"it is true that not every aspect of a divorce is, strictly speaking, within the taxpayer's control; nevertheless . . . a divorce, while often unpleasant and unwanted, is uniquely personal and is not the type of external objective circumstance that allows a taxpayer not in possession of a home to be deemed a residence therein for purposes of section 1034(a)."

⁵⁴ Pre-TRA 1997 § 121(a)(a)(1).

⁵⁵ Pre-TRA 1997 § 121(a)(2).

⁵⁶ Pre-TRA 1997 § 121(b)(2).

⁵⁷ Treas. Reg. § 1.121-1(c).

B. TRA 1997 Rules

Now, under TRA of 1997, each taxpayer, regardless of age, can exclude up to \$250,000 in gain on the sale or exchange of his or her interest in the principal residence where the ownership and use test is met,⁵⁸ unless an election otherwise is made.⁵⁹

The provisions of this new I.R.C. § 121 adopted by TRA 1997, now entitled “Exclusion of Gain from Sale of Principal Residence,” is retroactive to May 7, 1997.⁶⁰

The principal residence that is sold or exchanged must have been owned and used by the taxpayer for two or more years during the five year period ending on the date of sale or exchange.⁶¹ The period of time counts back from the date of sale or exchange.⁶²

The ownership and use test is expressed in terms of “owned and used by the taxpayer as the taxpayer’s principal residence for periods aggregating two years or more.”⁶³ Thus, continuous and uninterrupted use and ownership is not necessary, only for a cumulative two year period.

The pre-TRA 1997 § 121 required ownership and use for a period “aggregating three or more years.” The Internal Revenue Service’s regulations were interpreted to mean that the three year requirement can be satisfied “by establishing ownership and use for 36 full months or for 1,095 days.”⁶⁴ Accordingly, one should be able to presume, at least until the new regulations are promulgated, that the two year use and ownership requirement under the Act can be at any time during the five year period so long as the cumulative time aggregates to two years (an aggregate of 730 days). The regulation goes on to provide that “short temporary absences such as for a vacation or other seasonal absences, even if the property was rented out during the absence, were counted as periods of use.”⁶⁵ Again, it is probable that the

⁵⁸ Pre-TRA 1997 § 121(b)(2); Treas. Reg. § 1.121-2(b).

⁵⁹ I.R.C. § 121(a) and (b)(1).

⁶⁰ I.R.C. § 121(f).

⁶¹ Act § 312(d)(1).

⁶² I.R.C. § 121(a).

⁶³ I.R.C. § 121(b)(3)(A).

⁶⁴ I.R.C. § 121(a).

⁶⁵ Treas. Reg. § 1.121-1(c).

same language will be applicable to the use and ownership requirements as provided under TRA 1997.

For the purpose of the current two year use and ownership rule a taxpayer who deferred tax on a gain under the provisions of the then existing rollover provision of I.R.C. § 1034 can tack the old home's ownership and use period on to that of the new home.⁶⁶

A taxpayer who fails to meet the two of the past five years ownership and use test by reason of a change of place of employment, health or other unforeseen circumstances⁶⁷ is able to exclude a fraction of the \$250,000 (\$500,000 if married filing a joint return) equal to the fraction of two years that these requirements are met.⁶⁸

The Internal Revenue Service regulations describe a principal residence as including "a houseboat, a house trailer or stock held by a tenant-stockholder in a cooperative housing corporation."⁶⁹

If a joint return is filed, the exclusion is up to \$500,000 if (1) either spouse satisfies the ownership test, (2) both spouses satisfy the use test and (3) neither spouse is ineligible for the exclusion because of a sale or exchange within the two year period.⁷⁰ If one spouse is ineligible to use the exclusion because it was used within the two year period when single, it will not preclude the other spouse from claiming the exclusion; however, the spouse entitled will be limited to a \$250,000 exclusion.

So long as the two year use test is met by both parties, if they are eligible to file a joint return for the year in which the sale took place they need not have been married for the entire two year period to qualify for the \$500,000 exclusion.

In the case of joint filers not sharing a principal residence, an exclusion of \$250,000 is available on a qualifying sale or exchange of the principal residence of one of the spouses. Once

⁶⁶ Treas. Reg. § 1.121-1(c).

⁶⁷ I.R.C. § 121(g).

⁶⁸ It is doubted that a divorce will be considered as an "unforeseen circumstances." See *supra* note 52 for quote from *Perry v. Commissioner*.

⁶⁹ I.R.C. § 121(c)(2)(B).

⁷⁰ Treas. Reg. § 1.1034-1(c)(3). Although this regulation applied to I.R.C. § 1034, now repealed, it is presumed the IRS will adopt the same definition to apply under the amended I.R.C. § 121.

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both spouses satisfy the eligibility rules and two years have passed since the last exclusion was allowed to either of them, the taxpayers may exclude \$500,000 of gain on their joint return.

The exclusion can be claimed every two years for the sale of a principal residence but only once during each two year period.⁷¹ A pre-May 1997 sale is not taken into account under the once every two year rule.⁷²

The previous taking of the \$125,000 exclusion pursuant to the pre-TRA 1997 I.R.C. § 121 will not preclude the utilization of the now available \$250,000 exclusion (\$500,000 for married, filing jointly), if all other requirements are met.⁷³

A spouse or former spouse who has a principal residence distributed to him or her (an I.R.C. § 1041 transaction) can tack the transferor's ownership on to his or her own ownership.⁷⁴ To illustrate, where a departing spouse holds 100% title to the principal residence and has occupied it with the other spouse for two or more years, when the departing spouse transfers title to the other or former spouse, if incident to a divorce,⁷⁵ the departing spouse's ownership will be tacked onto that of the other spouse or former spouse enabling that other spouse or former spouse to be availed of the \$250,000 exclusion for a sale within two years of the transfer. Accordingly, although the new title holder did not own the house for the entire two of the past five years, the ownership by the departing spouse will suffice.

Of considerable importance in divorce cases, TRA 1997 will now give relief to the "out" spouse or former spouse notwithstanding that the principal residence is not sold until three years after the "out" spouse's departure. The Act provides that an individual is treated as using the property as that individual's principal residence during any period that the remaining spouse is granted use of the principal residence under a divorce or separation instrument.⁷⁶

⁷¹ I.R.C. § 121(b)(2).

⁷² I.R.C. § 121(b)(3)(A).

⁷³ I.R.C. § 121(b)(3)(B).

⁷⁴ I.R.C. § 121(b)(3)(B).

⁷⁵ I.R.C. § 121(d)(3)(A).

⁷⁶ "If incident to a divorce" means within one year after the marriage ceases or within six years after the marriage ceases if pursuant to a divorce or separation instrument, thus an I.R.C. § 1041 transaction.

For example, Robert Young⁷⁷ was not permitted to avail himself of I.R.C. § 1034 (rollover of gain from the sale of a principal residence) where his wife and daughter were given exclusive rights to reside in the residence by the divorce decree until the daughter finished her education three years hence. The Tax Court's ruling was notwithstanding the fact that Mr. Young, by the divorce decree, was required to continue to pay the mortgage, real estate, water, taxes and homeowner's insurance on the residence. Now, under TRA 1997, Mr. Young would have the right to have up to a \$250,000 exclusion for any gain resulting from a sale of his interest in the residence any time within three years of when his wife and daughter vacate the residence because the ex-wife's use of the residence would be treated as his use of it.

Similarly, Curtis Perry⁷⁸ moved from his residence and commenced living at his lady friend's house. He was divorced a year and a half later. The settlement agreement provided for exclusive possession of the jointly titled house by the wife, with the house to be sold as soon as possible after their daughter reached her majority. The sale occurred four years after Mr. Perry moved out and within one year of the daughter reaching her majority. Mr. Perry accordingly could not take advantage of the non-recognition of gain rule of I.R.C. § 1034. Now, under the Act, he would have up to a \$250,000 exclusion on any gain because the wife's occupancy was pursuant to "a divorce or separation instrument" and, notwithstanding that he moved, the house would still be construed as his principal residence.

Commenting on the new I.R.C. § 121, Joseph N. DuCanto⁷⁹ has said:

This new provision is a proverbial barn-burner for many couples going through a divorce where a highly appreciated home is among the array of assets. Not only does the Act eliminate many of the convoluted rules formerly found which limited use of the former exclusion of \$125,000 in gain from taxation, but in one sweep also eliminates the mandatory rollover of gain from one home to another.

Quite obviously, in the overwhelming percentage of cases, there need not be serious quibbling over who pays the resultant capital gains tax, since few homes in middle-income America will demonstrate as much

⁷⁷ I.R.C. § 121(d)(3)(B).

⁷⁸ Young v. Commissioner, 49 T.C.M. (CCH) 1002 (1985).

⁷⁹ Perry v. Commissioner, 91 F.3d 82 (9th Cir. 1996).

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as \$250,000 increase over its adjusted basis. Freedom from payment of a future tax, usually in the wife's hands, will make this property even more valuable as an item of concession in negotiations, calling for some appropriate offset to the husband, and there will be less incentive on the part of husbands to retain a financial or ownership interest in the former marital home.

III. Child Tax Credit

In addition to the dependency exemption,⁸⁰ TRA 1997 added another benefit for taxpayers with children who can claim the dependency exemption.⁸¹ It is the child tax credit,⁸² which is an offset against tax liability.⁸³ Any excess over actual tax liability is lost.

The child tax credit cannot be split from the parent who can take the dependency exemption.⁸⁴ Thus, neither the parties by agreement nor the court by order can provide that one parent will utilize the dependency exemption and the other parent will take advantage of the child tax credit.

⁸⁰ Seminar materials were prepared and presented by Joseph N. DuCanto for the 1997 annual meeting of the Family Law Section of the Oklahoma Bar Association, held in Tulsa in November 1997, copy on file with author. Mr. DuCanto of the law firm of Schiller, DuCanto & Fleck, Chicago, Illinois is a nationally recognized expert and leader in the field of divorce taxation.

⁸¹ I.R.C. § 151(c).

⁸² I.R.C. § 152(e).

⁸³ I.R.C. § 24.

⁸⁴ Senate Report No. 105-33 explains the reasons for adding this Child Tax Credit as follows:

The Committee believes that the individual income tax structure does not reduce tax liability by enough to reflect a family's reduced ability to pay taxes on family size increases. In part, this is because over the last 50 years the value of the dependent personal exemption has declined in real terms by over one-third. The Committee believes that a tax credit for families with dependent children will reduce the individual income tax burden of those families, will better recognize the financial responsibilities of raising dependent children, and will promote family values. In addition, the Committee believes that the credit is an appropriate vehicle to encourage taxpayers to save for their children's education.

S. Rep. No. 105-33, at 3 (June 20, 1997).

The child tax credit will be for each qualifying child⁸⁵ who is under the age of 17 at the end of the tax year. The amount of credit for each child is \$400 for 1998 and \$500 for each year thereafter. The term “qualifying child” does not include a child “who is not a citizen or national of the United States unless such [child] is a resident of the United States.”⁸⁶ If a taxpayer has three or more qualifying children, certain other benefits concerning the credit may be taken.⁸⁷

The tax saving of the child tax credit begins to phase-out⁸⁸ at different levels than the commencement of phase-out for the dependency exemption.⁸⁹ The phase-out for the child tax credit begins at a modified adjusted gross⁹⁰ income for joint filers of \$110,000, single filers and head of household of \$75,000 and \$55,000 for married filing separately.

The phase-out for the total child tax credit (i.e., the credit amount times the number of qualifying children) is \$50 for each \$1,000 (or part thereof) of modified adjusted gross income above the thresholds.⁹¹ Because the phase-out reduces the total credit, the more children qualifying, the more income a taxpayer can have before the credit is completely phased out.

Neither the amount of credit nor the phase-out thresholds will be indexed for inflation for the child tax credit.⁹² The phase-out for the dependency exemption is indexed for inflation.⁹³

A comparison of the phase out thresholds for the child tax credit and the dependency exemption is as follows:

⁸⁵ I.R.C. § 24(c)(1)(A).

⁸⁶ A “qualifying child” is defined as “an individual for whom the taxpayer can claim a dependency exemption and who is a son or daughter of the taxpayer (or a descendent of either), a stepson or stepdaughter of the taxpayer or an eligible foster child of the taxpayer.” I.R.C. § 32(c)(B).

⁸⁷ I.R.C. §§ 24(c)(2), 152(b)(3).

⁸⁸ I.R.C. § 24(d).

⁸⁹ I.R.C. § 24(b).

⁹⁰ I.R.C. § 151(d)(3).

⁹¹ Modified adjusted gross income (AGI) is the AGI increased by foreign (I.R.C. § 911) possessions (I.R.C. § 931) and Puerto Rico (I.R.C. § 933) income exclusions.

⁹² I.R.C. 24(b)(1).

⁹³ I.R.C. § 24(b)(2).

	Modified AGI Threshold Amounts for Child Tax Credits	AGI Threshold Amounts for Dependency Exemptions 2000
Married Filing Jointly	\$110,000	\$193,400
Head of Household	\$ 75,000	\$161,500
Single	\$ 75,000	\$128,950
Married Filing Separately	\$ 55,000	\$ 96,700

Because of this additional benefit to the party who has the dependency exemption, the right to have the dependency exemption will likely be contested more often and more vigorously.

IV. No 10% Penalty for Early Withdrawals from IRAs for Higher Education Expense and First-Time Home Purchase

Prior to TRA 1997, all distributions from an IRA to the taxpayer are taxed at ordinary rates and in addition are subject to the 10% penalty⁹⁴ unless made:

- a. after age 59 1/2;⁹⁵
- b. to a beneficiary (or to the estate of the employee)⁹⁶ after death;
- c. attributable to the taxpayer being disabled⁹⁷; or,
- d. in the form of a single life or joint and survivor annuity payable in substantially equal periodic payments (not less frequently than annually) over the life or life expectancy of the taxpayer or the joint lives (or joint expectancies) of the taxpayer and the taxpayer's designated beneficiary.⁹⁸

Commencing in 1998,⁹⁹ there will be no 10% penalty for withdrawal from IRAs prior to age 59 1/2 for qualified higher education expenses¹⁰⁰ (including those related to graduate-level courses at a post-secondary eligible educational institution¹⁰¹) for the taxpayer, the taxpayer's spouse, child or grandchild of the

⁹⁴ I.R.C. § 151(d)(4).

⁹⁵ I.R.C. § 72(t)(1). Section 72(t) is made applicable not only to qualified retirement plans but also to IRAs. I.R.C. § 4974(c)(4).

⁹⁶ I.R.C. § 72(t)(2)(A)(i).

⁹⁷ I.R.C. § 72(t)(2)(A)(ii).

⁹⁸ I.R.C. § 72(t)(2)(A)(iii).

⁹⁹ I.R.C. § 72(t)(2)(A)(iv).

¹⁰⁰ TRA 1997 Act §§ 203(c) and 303(c).

¹⁰¹ § 203 of the Act, I.R.C. § 72(t)(2)(E).

taxpayer or the taxpayer's spouse.¹⁰² Of course, such withdrawals will be subject to regular federal income tax. Qualified expenses include tuition fees, books, supplies, room and board and equipment required for enrollment or attendance at an eligible education institution.¹⁰³ It should be noted that no penalty-free provision exists for the pre-age 59 1/2 withdrawal from a qualified plan. Thus it may benefit the taxpayer to roll over part of that which is in a plan, if possible, into an IRA.

Further, after 1997, a first-time homebuyer¹⁰⁴ can make a 10% penalty-free withdrawal from an IRA for a principal residence for the taxpayer, the taxpayer's spouse or a child, grandchild or ancestor of either.¹⁰⁵ A lifetime \$10,000 limitation¹⁰⁶ is imposed "for qualified acquisition costs."¹⁰⁷ The distribution from the IRA must be used for this purpose within 120 days of withdrawal.¹⁰⁸

V. Net Operating Losses

Net operating losses¹⁰⁹ (NOLs) can be deducted from gross income, thus can be of value to one or the other spouse. This in turn can save considerably either in future taxes, when carried forward, or create a refund if carried back. NOLs can prove to be a valuable "asset" for one or the other spouse who is divorcing. The number of years to enable a carryback or carryforward is pertinent.

¹⁰² I.R.C. § 529(e)(5) states that "The term 'eligible education institutions' means an institution which is described in section 481 of the Higher Education Act of 1965 (20 U.S.C. 1088). . . ."

¹⁰³ I.R.C. § 72(t)(7).

¹⁰⁴ I.R.C. § 529(e)(3).

¹⁰⁵ TRA 1997 defines "first-time homebuyer" as an individual (and if married, such individual's spouse) who "has no present ownership interest in a principal residence during the 2 year period ending on the date of acquisition of the principal residence to which [the second of the Act] applies." Act § 303(b). I.R.C. § 72(t)(8)(D)(i).

¹⁰⁶ I.R.C. § 72(b)(8)(A).

¹⁰⁷ I.R.C. § 72(t)(8)(A)(i).

¹⁰⁸ The TRA 1997 defines "qualified acquisitions costs" as "the cost of acquiring, constructing or reconstructing a residence. Such term includes any unusual or reasonable settlement, financing, or other closing costs." Act § 303(b). I.R.C. § 72(t)(8)(C).

¹⁰⁹ I.R.C. § 72(t)(8)(A).

The carryback period for net operating losses (NOL) has been reduced from three to two years. However, the carryforward period increases from 15 to 20 years,¹¹⁰ effective for NOLs arising in tax years commencing after the Act was adopted.¹¹¹

VI. Tax on Excess Distribution from Retirement Funds

Knowledge regarding access to retirement funds can be quite important in the divorce context because these funds may provide a source of alimony, child support or a funding for property distribution.

Under prior law, a 15% excise tax was imposed on excess distribution from qualified retirement plans, tax sheltered annuities and IRAs.¹¹² The tax did not apply for the years 1997 through 1999. An additional 15% estate tax was imposed on an individual's excess retirement accumulations. TRA 1997 repealed both the 15% excise tax on excess distributions from qualified plans, tax sheltered annuities and IRAs and the 15% excise on excess retirement accumulations.¹¹³

VII. 1998 Innocent Spouse Relief (and Separation of Liability and Equitable Relief)

Many married taxpayers choose to file a joint tax return because of the lower rates this filing status allows.¹¹⁴ Both taxpayers are jointly and individually responsible for the tax and any interest or penalty due on the joint return even if they later divorce.¹¹⁵ This is true even if a divorce decree states that a former spouse will be responsible for any amounts due on previously filed joint returns.¹¹⁶ One spouse may be held responsible for all

¹¹⁰ Generally the excess of business deduction over gross income.

¹¹¹ § 1082(a) of the Act. I.R.C. § 172(B)(1).

¹¹² § 1082(c) of the Act.

¹¹³ I.R.C. § 4980A, now repealed.

¹¹⁴ § 1073(a) of the Act.

¹¹⁵ I.R.C. § 1 establishes the tax rates which are adjusted annually for inflation. I.R.C. § 1(f).

¹¹⁶ I.R.C. § 6013(d)(3).

the tax due even if all the income was earned by the other spouse.¹¹⁷

Under former law,¹¹⁸ relief from liability for tax, interest and penalties was available for “innocent spouses” in certain circumstances. To qualify for such relief, the innocent spouse had to establish: (1) that a joint return was made;¹¹⁹ (2) that an understatement of tax, which exceeds the greater of \$500 or a specified percentage of the innocent spouse’s adjusted gross income for the preadjustment (most recent) year¹²⁰ was attributable to a grossly erroneous item¹²¹ of the other spouse; (3) that in signing the return, the innocent spouse did not know, and had no reason to know, that there was an understatement of tax;¹²² and (4) that taking into account all the facts and circumstances, it was inequitable to hold the innocent spouse liable for the deficiency in tax.¹²³ The specified percent of adjusted gross income is 10% if adjusted gross income is \$20,000 or less. Otherwise, the specified percent is 25%.¹²⁴

Commenting on the shortcomings of the old “innocent spouse” rules, Ian McLachlan wrote:

The rule is unsatisfactory. Because relief is limited only to cases where the item in question results in substantial understatement of tax, a spouse without knowledge of unreported income and who received no benefit from it, would nonetheless have liability unless the understatement of tax is substantial. The innocent spouse rule is vague and unpredictable because of the subjective nature of the innocence and equity requirements. Because of these subjective requirements, a review of the cases makes it clear that the determinative issue was

¹¹⁷ Brown v. US, 272 F.2d 215 (5th Cir. 1959).

¹¹⁸ Pesch v. Commissioner, 78 T.C. 100, 129 (1982).

¹¹⁹ I.R.C. § 6013(e).

¹²⁰ Former I.R.C. § 6013(e)(1)(A).

¹²¹ Former I.R.C. § 6013(e)(4).

¹²² Former I.R.C. § 6013(e)(2) provided:

(2) Grossly erroneous items. For purposes of this subsection, the term “grossly erroneous items” means, with respect to any spouse—

(A) any item of gross income attributable to such spouse which is omitted from gross income, and

(B) any claim of a deduction, credit, or basis by such spouse in an amount for which there is no basis in fact or law.

¹²³ Former I.R.C. 6013(e)(1)(C).

¹²⁴ Former I.R.C. § 6013(e)(1)(D).

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whether the spouse seeking relief under these provisions can move the judge to sympathy.¹²⁵

RARA 1998 repealed the previous innocent spouse provision of the Code.¹²⁶ It adopted instead I.R.C. § 6015 entitled "Relief from Joint and Several Liability on Joint Return." I.R.C. § 6015¹²⁷ generally makes innocent spouse status easier to obtain. It eliminates all of the understatement thresholds and requires only that the understatement of tax be attributable to an erroneous (and not just a grossly erroneous) item of the other spouse.¹²⁸

RARA 1998 also added two other provisions for relief. If the taxpayer is divorced, separated or no longer living with the spouse, relief can be requested by separating the liability for an understatement of tax between the parties.¹²⁹

If the taxpayer does not qualify for either innocent spouse relief or relief by separation of liability, the IRS may grant equitable relief. Equitable relief may be granted if it would be unfair to hold the taxpayer liable for the tax that should be paid only by the spouse.¹³⁰ To take advantage of the provision of the Code for innocent spouse or relief by separation of liability an election must be made by the spouse seeking relief.¹³¹ The new rules apply to any liability for tax arising after the date of the enactment of RARA 1998 (July 22, 1998) and any liability for tax arising on or before this date but remaining unpaid as of this date.¹³²

I.R.C. § 6015 provides for relief only from joint and several liability arising from a joint return. If an individual signed a joint return involuntarily while under duress, the signature is not valid and a joint return was not made. The individual is not jointly and severally liable for liabilities arising from such a return and, therefore, I.R.C. § 6015 does not apply.

¹²⁵ Former I.R.C. § 6013(e)(4)(A) and (B).

¹²⁶ C. Ian McLachlan, *Spousal Mobility and Federal Income Taxes*, 10 J. Am. Acad. Matrim. Law 65, 72 (1993).

¹²⁷ Former I.R.C. § 6013(e) entitled "Spouse relieved of liability in certain cases."

¹²⁸ § 3201 of the Act.

¹²⁹ I.R.C. § 6015(b)(1)(B).

¹³⁰ I.R.C. § 6015(a).

¹³¹ I.R.C. 6015(f).

¹³² I.R.C. § 6015(a)(1) and (2).

The following chart¹³³ compares the rules for the three types of relief. Each type of relief has different requirements.

Factors	Rules for Innocent Spouse Relief	Rules for Separation of Liability	Rules for Equitable Relief
Type of Liability	You must have filed a joint return that has an understatement of tax due to an erroneous item of your spouse.	You must have filed a joint return that has an understatement of tax due, in part, to an item of your spouse.	You must have filed a return that has either an understatement or an underpayment of tax.
Marital Status		You must be no longer married, legally separated, or have not lived with your spouse in the same house for an entire year before you file for relief.	
Knowledge	You must establish that at the time you signed the joint return you did not know, and had no reason to know, that there was an understatement of tax.	If IRS establishes that you actually knew of the item giving rise to the understatement, then you are not entitled to make the election to the extent of the actual knowledge.	
Other Qualifications			You do not qualify for innocent spouse relief or separation of liability.
Unfairness	It must be unfair to hold you liable for the understatement of tax taking into account all the facts and circumstances		It must be unfair to hold you liable for the under-payment or under-statement of tax taking into account all the facts and circumstances
Refunds	Yes, your request can generate a refund.	No, your request cannot generate a refund.	Yes, for amounts paid between July 22, 1998, and April 15, 1999, and for amounts paid pursuant to an installment agreement after the date the request for relief is made.

¹³³ I.R.C. § 6015(g)(1).

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In December 1998 the IRS revised its Form 8857 to include all three requests for relief under the RARA Act. Only one Form 8857 needs to be filed even if relief is requested for more than one year.

The IRS will review the form, figure the understatement or underpayment of tax and related interest and penalties, and let the applicant know if he or she qualifies. The IRS is required to inform the applicant's spouse or former spouse if innocent spouse relief or separation of liability is requested, and to allow the spouse (or former spouse) to participate in the determination of the amount of relief of liability.¹³⁴

Relief can be sought in the U.S. Tax Court in the following two situations:¹³⁵

1. If there is a disagreement with the determination by the IRS to deny the request.
2. If no determination is received from the IRS within six months from the date of filing Form 8857.

The petition to the U.S. Tax Court must be filed no later than 90 days from the date the IRS mails its determination notice.¹³⁶

The election may be made by filing Form 8857 at any time not later than two years after collection activities begin with respect to the electing spouse after July 22, 1998.¹³⁷ It is intended that the two year period will not begin until collection activities have been undertaken against the electing spouse that have the effect of giving the spouse actual notice of the IRS's intention to collect the joint liability from such spouse. For example, garnishing wages or mailing a notice of intent to levy against the property of the electing spouse would constitute collection activity against the electing spouse. Mailing a notice of deficiency and demand for payment to the last known address of the electing spouse, addressed to both spouses, would not.

An individual may be relieved of liability for tax (including interest, penalties and other amounts)¹³⁸ if:

¹³⁴ IRS Publication 971, *Innocent Spouse Relief* 3 (Rev. December 1998).

¹³⁵ § 3201(d) of the Act.

¹³⁶ I.R.C. § 6015(e).

¹³⁷ I.R.C. § 6015(e)(1)(A).

¹³⁸ I.R.C. § 6015(b)(1)(E) and (c)(3)(B).

- (A) a joint return has been made for a taxable year;¹³⁹
- (B) there is an understatement of tax attributable to erroneous items of the other spouse filing the return;¹⁴⁰
- (C) the spouse seeking the innocent spouse relief establishes that he or she did not know, and had no reason to know, that an understatement existed;¹⁴¹
- (D) taking into account all the facts and circumstances it would be inequitable to hold the spouse liable for the deficiency attributable to such understatement¹⁴²; and
- (E) the spouse seeking relief elects innocent spouse status not later than two years after tax collection activities have begun with respect to that spouse.¹⁴³

If the spouse seeking relief cannot establish that he or she did not know nor have reason to know of the understatement, that spouse may still obtain relief if he or she did not know or have reason to know the extent of such understatement. The relief will then be to the extent such liability is attributable to the portion of such understatement of which he or she did not know or have reason to know.¹⁴⁴

In addition to the innocent spouse election,¹⁴⁵ a spouse may elect to limit liability for any deficiency with respect to a joint return¹⁴⁶ if at the time of election that spouse is either:

- (A) no longer married; or
- (B) legally separated,¹⁴⁷ or
- (C) not a member of the same household at any time during
- (D) 12 months ending the date of the election.¹⁴⁸

¹³⁹ I.R.C. § 6015(b)(1).

¹⁴⁰ I.R.C. § 6015(b)(1)(A).

¹⁴¹ I.R.C. § 6015(b)(1)(B).

¹⁴² I.R.C. § 6015(b)(1)(C). In *Stevens v. Commissioner*, 872 F.2d 1499, 1505 (11th Cir. 1989), the court summarized the factors relevant to determination of “reason to know” as follows: level of education, involvement in the family’s business and financial affairs, the presence of expenditures that appear lavish or unusual when compared to the family’s past levels of income, standard of living, and spending patterns, and the culpable spouse’s evasiveness and deceit concerning the couple’s finances.

¹⁴³ I.R.C. § 6015(b)(1)(D).

¹⁴⁴ I.R.C. § 6015(b)(1)(E).

¹⁴⁵ I.R.C. § 6015(b)(2).

¹⁴⁶ I.R.C. § 6015(b).

¹⁴⁷ I.R.C. § 6015(c).

¹⁴⁸ I.R.C. § 6015(c)(3)(A)(i)(I).

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The limitation of liability is to the extent that items giving rise to the deficiency are allocable to that spouse.¹⁴⁹

The separate liability election also applies in situations where the tax shown on a joint return is not paid with the return. In that case, the amount determined under the separate liability election equals the amount that would have been reported by the electing spouse on a separate return. However, if any item of credit or deduction would be disallowed solely because a separate return is filed, the item of credit or deduction will be computed without regard to such prohibition. The separate liability election may not be used to create a refund or to direct a refund to a particular spouse.¹⁵⁰

Items are generally allocated between spouses in the same manner as they would have been allocated had the spouses filed separate returns. The Secretary may prescribe other methods of allocation by regulation. The allocation of items is to be accomplished without regard to community property laws.¹⁵¹

The following are special rules to prevent the inappropriate use of the election:

First, if the IRS demonstrates that assets were transferred between the spouses in a fraudulent scheme joined in by both spouses, neither spouse is eligible to make the election under the provision (and consequently joint and several liability applies to both spouses).¹⁵²

Second, if the IRS proves that the electing spouses had actual knowledge that an item on a return is incorrect, the election will not apply to the extent any deficiency is attributable to such item. Such actual knowledge must be established by the evidence and shall not be inferred based on indications that the electing spouses had a reason to know. The rule that the election will not apply to the extent any deficiency is attributable to an item for which the electing spouse had actual knowledge is expected to be applied by treating the item as fully allocable to both spouses.¹⁵³

Third, the portion of the deficiency for which the electing spouse is liable is increased by the value of any disqualified assets

¹⁴⁹ I.R.C. § 6015(c)(3)(A)(i)(II).

¹⁵⁰ I.R.C. § 6015(c)(1).

¹⁵¹ H.R. Conf. Rep. No. 105-599, pt. 1 at 68 (1998).

¹⁵² *Id.*

¹⁵³ *Id.* at 71.

received from the other spouse. Disqualified assets include any property or right to property that was transferred to an electing spouse if the principal purpose of the transfer is the avoidance of tax (including the avoidance of payment of tax). A rebuttable presumption exists that a transfer is made for tax avoidance purposes if the transfer was made less than one year before the earlier of the payment due date or the date of the notice of proposed deficiency. The rebuttable presumption does not apply to transfers pursuant to a decree of divorce or separate maintenance. The presumption may be rebutted by a showing that the principal purpose of the transfer was not the avoidance of tax or the payment of tax.¹⁵⁴

RARA 1998 provides that if relief is not available under the new “innocent spouse” rules or if the relief provided under the separate liability election is not available, relief from liability may be provided under procedures prescribed by the IRS if, “taking into account all facts and circumstances, it is inequitable to hold the individual liable for any unpaid tax or any deficiency (or any portion of either).”¹⁵⁵ Equitable relief is similarly afforded to spouses who file a separate return in community property states.¹⁵⁶

The intention of Congress is stated in the Conference Committee Report:

The conferees intend that the Secretary will consider using the grant of authority to provide equitable relief in appropriate situations to avoid the inequitable treatment of spouses in such situations. For example, the conferees intend that equitable relief be available to a spouse that does not know, and had no reason to know, that funds intended for the payment of tax were instead taken by the other spouse for such other spouse’s benefit.¹⁵⁷

On January 19, 2000, the Internal Revenue Service issued Revenue Procedure 2000-15 on “Equitable Spousal Relief From Tax Liability.” The revenue procedure provides guidance for a spouse who requests either equitable relief from joint and several liability under I.R.C. § 6015(f), or relief from separate liability under I.R.C. § 66(c) that arises due to the operation of commu-

¹⁵⁴ *Id.* at 71.

¹⁵⁵ *Id.* at 72.

¹⁵⁶ I.R.C. § 6015(f).

¹⁵⁷ Section 3201(b) of the Act, amending I.R.C. § 66(c).

nity property law, with respect to any liability for tax arising after July 22, 1998, or any liability for tax arising on or before July 22, 1998, that was unpaid on that date. The procedure describes eligibility to be considered for equitable relief, the circumstances under which equitable relief will ordinarily be granted and the factors for determining whether to grant equitable relief. The procedure articulates a partial list of the positive and negative factors that will be taken into account in determining whether to grant full or partial equitable relief under the aforesaid sections of the Code. The procedure makes it clear that no single factor will be determinative of whether equitable relief will or will not be granted in any particular case. Rather, it provides that all factors will be considered and weighed appropriately and that the list is not intended to be exhaustive.

The factors are:

1. *Factors weighing in favor of relief include, but not limited to:*

a. *Marital status.* The requesting spouse is separated (whether legally separated or living apart) or divorced from the nonrequesting spouse.

b. *Economic hardship.* The requesting spouse would suffer economic hardship (within the meaning of section 4.02(1)(c) of this revenue procedure) if relief from the liability is not granted.

c. *Abuse.* The requesting spouse was abused by the nonrequesting spouse, but such abuse did not amount to duress.

d. *No knowledge or reason to know.* In the case of a liability that was properly reported but not paid, the requesting spouse did not know and had no reason to know that the liability would not be paid. In the case of a liability that arose from a deficiency, the requesting spouse did not know and had no reason to know of the items giving rise to the deficiency.

e. *Nonrequesting spouse's legal obligation.* The nonrequesting spouse has a legal obligation pursuant to a divorce decree or agreement to pay the outstanding liability. This will not be a factor weighing in favor of relief if the requesting spouse knew or had reason to know, at the

time of the divorce decree or agreement was entered into, that the nonrequesting spouse would not pay the liability.

f. *Attributable to nonrequesting spouse.* The liability for which relief is sought is solely attributable to the nonrequesting spouse.

2. *Factors weighing against relief which include, but are not limited to:*

a. *Attributable to the requesting spouse.* The unpaid liability or item giving rise to the deficiency is attributable to the requesting spouse.

b. *Knowledge, or reason to know.* A requesting spouse knew or had reason to know of the item giving rise to a deficiency or that the reported liability would be unpaid at the time the return was signed. This is an extremely strong factor weighing against relief. Nonetheless, when the factors in favor of equitable relief are unusually strong, it may be appropriate to grant relief under § 6015(f) in limited situations where a requesting spouse knew or had reason to know that the liability would not be paid, and in very limited situations where the requesting spouse knew or had reason to know of an item giving rise to a deficiency.

c. *Significant benefit.* The requesting spouse has significantly benefitted (beyond normal support) from the unpaid liability or items giving rise to the deficiency. See Tres. Reg. § 1.6013-5(b).

d. *Lack of economic hardship.* The requesting spouse will not experience economic hardship (within the meaning of section 4.02(1)(c) of the revenue procedure) if relief from the liability is not granted.

e. *Noncompliance with federal income tax laws.* The requesting spouse has not made a good faith effort to comply with federal income tax laws in the tax years following the tax year or years to which the request for relief relates.

f. *Requesting spouse's legal obligation.* The requesting spouse has a legal obligation pursuant to a divorce decree or agreement to pay the liability.

As a result of the easing of the “innocent spouse” rules and the ability to exercise the separate liability election, parties

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should be less reluctant to sign a joint return during divorce proceedings.

Notwithstanding that the relief for an “innocent spouse” has been liberalized, as an inducement to signing a joint return an indemnification and hold harmless agreement should be requested. Furthermore, counsel should advise that the obligation of such an agreement can be discharged in bankruptcy.¹⁵⁸

Furthermore, even though the 1998 Act provides substantial relief, courts should adhere to the majority position that a party should not be required to sign a joint return.¹⁵⁹

VIII. Conclusion

Congress is constantly fine tuning the tax code. Oftentimes the changes, including many of the most recent changes, significantly impact on spousal and child support, property distribution and deductions as well as upon retirement funds, their distribution and taxability. Practitioners must keep up with all changes in this aspect of the law which affects divorcing parties, their children and their property interests. Even if there are no substantive changes in the tax law, rate changes abound. For example: applicable tax rate on income is adjusted annually;¹⁶⁰ the maximum earnings on which FICA is to apply changes annually; and the phase out threshold for the dependency exemption is adjusted each year for inflation.¹⁶¹ Unless kept fully current, the unwary matrimonial practitioner could be disadvantaging his client at best; committing malpractice at worst.

¹⁵⁸ *Supra* note 149, at 72, 73.

¹⁵⁹ *Parker v. Carnahan*, 772 S.W.2d 151 (Tex. Ct. App. 1989).

¹⁶⁰ *Leftwich v. Leftwich*, 442 A.2d 139 (D.C. Ct. App. 1980). *Sweeney v. Sweeney*, 583 So. 2d 398 (Fla. Dist. Ct. App. 1991).

¹⁶¹ I.R.C. § 1(f).