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Together We Can Make a Difference

My first order of business is to thank and congratulate Scott Friedman for a fantastic year as chair. He did a marvelous job in planning two great meetings, one is Deer Valley, Utah, and the other in Bermuda. Scott promised that we would have fun during his year, and we did. I’m hoping to do the same.

Scott instituted leadership training at his meetings. Leadership training is something I believe should be repeated for all those in state and local bar leadership, and I hope to be able to provide a similar experience for attendees at the spring meeting in Carlsbad, California.

We now look forward to the upcoming meeting in Stowe, Vermont. We have an amazing host committee headed by Allan Palmer and have a great meeting planned. The CLE is cutting edge and intended to help you as you advance in your family-law-practice skills. We are also holding special CLE on assisted reproductive technology, which has its own set of problems nationally and internationally as this area of family law practice grows. It is at the section’s meetings that you learn things you didn’t even know you needed to know but which make you a better, more knowledgeable lawyer. Plus, it’s in Vermont with all that state has to offer.

The Family Law Section is an amazing collection of the best minds practicing family law today. Participation in the section allows you to touch shoulders with these people. These are among the people that I learn from every day. We have numerous member benefits, including a listserve that provides answers to daily questions, from the straight-forward questions asked by new practitioners to the incredibly complex questions on topics such as retirement division and jurisdiction.

The section also provides top-notch publications. This publication, Family Advocate, gives topic-specific hands-on, practical answers to a range of family-law-practice questions. This issue on taxes answers many complex questions a practitioner faces every day as well and providing additional resources to look to when faced with a tax problem in a case. Some issues of the Advocate have become required reading in some law schools due to the advanced presentation of family law issues.

The Family Law Quarterly is a leading source of scholarly, thoughtful articles on family law as it is practiced today both in the United States and around the world and where the practice is likely to go tomorrow. Each issue tackles a complex family law topic and provides a variety of perspectives on the intellectual examination of those topics. The Quarterly has been cited in numerous court opinions as a leading authority on family law.

Past chairs gather in Boston.

As family law attorneys, we work every day with individuals facing some of life’s most complex problems. You hear daily news reports about families in crisis and the efforts made to resolve those difficult issues. As I write this column, the news is rampant with the discussion of the problems faced by a surrogate mother and the twin that was left behind. It is the members of this section who are working nationally and internationally to resolve the extremely complex and difficult issues surrounding reproductive technology, which include those faced by the surrogates and the childless families hoping for a way to

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Thank you, Mel!

This issue is dedicated to the memory of Melvyn Frumkes, who was the guru of divorce tax issues for many of us. Mel was a long-time member of the Family Advocate Board of Editors. He was a regular attendee at our meetings and often put many of us younger folks to shame with his zest for exploring and willingness to try unusual activities, not to mention his seemingly endless travel and adventure “bucket list.”

Mel was the issue editor of this edition until his death in April 2014. He had a dedication to the practice of law and to his role on the Board of Editors of this publication that would be hard to match. Mel was still editing articles and providing insightful feedback and suggestions from his hospital bed during what turned out to be his final days.

As many of you know, Mel was the author of a treatise, Frumkes on Divorce Taxation, now in its ninth edition. That volume has become an indispensable reference work for many family law practitioners. It is a testament to Mel’s generosity of spirit, time, and knowledge that he allowed the publisher to include his personal e-mail and his cell-phone number on the “About the Author” page in that publication. It would be typical of Mel to conclude that such instant access might be of more practical value to readers than the very abbreviated list of his credentials and accomplishments included on the same page. I have already had occasions in my own practice when I found myself reaching for Mel’s number with a “quick question” only to recall that I could no longer expect his distinctive voice at the other end of the line.

Long-time readers of the Family Advocate may recall that we did a taxation issue several years ago, Vol. 27, No. 3 (Winter 2005). Those of you who still have that issue (or access to it in electronic format) should hang on to it. As Mel told the rest of the Board of Editors—the basics have not really changed much since he spearheaded the creation of that prior issue. However, since we were creating a magazine and not a book—there was a lot of territory not covered in that issue. Mel’s vision for the present issue was not to “rehash” the prior topics, but to focus on some of the more advanced concepts that frequently arise in family law cases and which had not been previously addressed in the Advocate.

continued on page 7
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Spotting the Hired Gun

One of the most consequential decisions an attorney, parent, court mediator/conciliator, or judge can face is how to select and/or evaluate a forensic expert. Here are some guidelines for spotting the "hired gun" or unprofessional professional:

- **Experience and training:** The expert’s experience and training do not fit the parameters or foci of the case at hand, but he or she is willing to issue assessments and opinions anyhow. The mismatch doesn’t seem to bother.

- **Will issue contradictory opinions depending on who the hiring party is:** One expert I saw in court explained why joint custody is damaging and the very next day espoused the opinion that it is the best arrangement for children.

- **No history of successful interventions:** The hired gun is willing to do reconciliation therapy, for example, but have virtually never succeeded or even performed it previously.

- **Reputation and ethical standards:** By doing a background investigation, it is usually possible to explore an expert’s ethical and professional qualities. Are honesty, fairness, an impressive scope of knowledge, and thoroughness on display? Or are you confronted with bias and other qualities that are problematic? All professional organizations have ethical standards for their members. These can be used as barometers for professional behaviors; hired guns violate their organizational guidelines with impunity.

- **Time frames:** Hustlers or hired guns will take cases at the last minute and come up with opinions based on limited contact time and/or research. I saw one case in which an “expert” was hired on Friday and had a (cookie-cutter) report 40-pages long by Monday. I remembered seeing the custody report before, but with different names on the cases. Another “expert” gave an opinion on sexual abuse by a teen after one 45-minute interview. Good cross-examination made it clear that he was not meeting a reasonable time standard of assessment.

- **Has not followed common procedures in assessments and/or reporting:** Reports are often scattered, inarticulate, and contain “filler.” Opinions are frequently intermixed with data. Alienation is asserted but not well researched. Home visits are missing.

- **Conclusions have inadequate forensic bases to them:** This is a classic problem for hired guns because their conclusions were likely drawn before they did the research.

- **Being around a long time is no guarantee of quality:** Some hired guns have ingratiated themselves with guardians, judges, attorneys, and others. Examine their patterns of opinions, writings, ethics, bias, conclusions, research, and time frames carefully.

- **Organizational affiliations do not equal professionalism:** Some experts with famous academic associations are for hire (often at $10,000 or more a day). In one case, a bevy of academic/clinical experts came to testify on the abusive nature of a father without ever seeing the father. The judge asked one of them, “Did you call the court-appoint child supervisor?” After hemming and hawing, the expert said, “no.” The judge directed one of the experts to visit the child and parent during supervised visitation, and the good “expert” was shocked to see the loving interaction of father and child. So much for the ungrounded opinion. The judge instructed the lawyer he would dismiss the opinions of the other hired guns if they presented similarly unsubstantiated opinions.

- **Tend to log a lot of cases with certain firms:** These experts are often on call for the same attorneys and are rarely court appointed, attorney agreed upon, or GAL recommended. 

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Stanley S. Clawar, Ph.D., C.C.S., is chair of Clinical Sociology, Forensic Sociology/Criminology, & Deaf Studies Programs at Rosemont College. He is director of Walden Counseling & Therapy Center, Bryn Mawr, Pennsylvania, and author (with Brynne V. Rivlin) of the ABA FLS publication, Children Held Hostage (2d ed. 2013).

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FAMILY ADVOCATE www.ambar.org/familyadvocate
Yet again, Mel has left us with a list of vital and interesting topics that go far beyond the space constraints of this magazine. Nevertheless, board member and issue co-editor Livia Barndollar has done a stellar job of picking up where Mel left off and bringing this issue to completion. Livia, the rest of the board, and the authors of this issue have done our best to cover as much of Mel’s vision as we can in the space of a single issue.

The subject of taxation in divorce cases is one in which a little knowledge is truly a dangerous thing. As well, client misconceptions abound and can have unfortunate, and sometimes damaging, results if it turns out that those assumptions as to taxability, deductibility, or liability are incorrect. The authors of this issue have done their best to alert readers not just to tax pitfalls associated with divorce situations, but also with the opportunities for legally minimizing tax obligations and sharing tax benefits. We can’t remove the inevitability of taxes, but we hope we have removed some of the mystery.

It is up to us as section members to assist our clients and the courts in resolving these complex matters without increasing the trauma experienced by the individuals during the process. Past chair Mitch Karpf began the Families Matter project, which was designed to “develop practice methods and approaches to minimize the destructive consequences of divorce on families.” This has resulted in a best-practices theme, which is applied to all of our CLE and overlays what the section teaches. It is just such instruction and learning that the section offers, which is not available anywhere else. What we learn in this section gives us the tools to do our best work and make things better for our clients.

I look forward to the coming year and working with tremendous individuals during my time as chair. I have the wisdom of past chairs to follow and a great team of officers and committee leaders to work with as we move the section forward. It is impossible to quantify the hours or name all the individuals who donate time and energy to make the section what it is, so this inadequate thank you will have to suffice as we begin another exciting year in the section. 

More Taxing Questions?
Although this issue of Family Advocate covers many complicated tax issues, we couldn’t cover them all. For additional answers, take a look at our prior taxation issue, Vol. 27, No. 3 (Winter 2005).

More Taxing Questions?
Although this issue of Family Advocate covers many complicated tax issues, we couldn’t cover them all. For additional answers, take a look at our prior taxation issue, Vol. 27, No. 3 (Winter 2005).
The case of \textit{United States v. Windsor}, 570 U.S. \textbf{133} S. Ct. 2675 (2013), held that section 3 of the 1996 Defense of Marriage Act (DOMA) was unconstitutional as a deprivation of liberty protected by due process and equal protection. Section 3 of DOMA stated that for purposes of federal law, the word “marriage” meant only a legal union between one man and one woman as husband and wife, and the word “spouse” referred only to a person of the opposite sex who is a husband or a wife. As a result of \textit{Windsor}, section 3 of DOMA is void \textit{ab initio} and federal benefits, rights, and privileges are extended to the partners/spouses of valid same-sex marriages.

The General Accounting Office identified 1,138 federal statutory provisions involving marital status as of December 31, 2003, in 13 subject categories whose applicability depends on whether a couple is married, including income tax, gift tax, estate tax, Social Security, health insurance benefits for an employee’s spouse, spousal IRA rollovers, employee benefit plans, defined contribution plans, cafeteria plans, flexible spending accounts, and health savings accounts. In addition, the General Accounting Office issued a report in 2004 that identified 198 separate Internal Revenue Code (Code) provisions tied to marital status.

As of August 1, 2014, 19 states and the District of Columbia recognize same-sex marriages as valid. Those states are California, Connecticut, Delaware, Hawaii, Illinois, Iowa, Maine, Maryland, Massachusetts, Minnesota, New Hampshire, New Jersey, New Mexico, New York, Oregon, Pennsylvania, Rhode Island, Vermont, and Washington. In addition, several United States District Courts have issued decisions that certain state laws prohibiting or not recognizing same-sex marriages are unconstitutional. These decisions are on appeal. These cases involve nonrecognition statutes in Ohio, Texas, Utah, Oklahoma, Kentucky, Tennessee, Virginia, Michigan, and Illinois. These decisions are on appeal at the present time, the Tenth Circuit and Fourth Circuit Courts of Appeal have issued decisions upholding the lower court cases.

The \textit{Windsor} opinion requires a valid, recognized marriage. For purposes of federal law, marriage is determined by state law. Thus, the...
issue is which state’s law controls—the state of marriage (State of Ceremony) or the state of residency (State of Residence). On June 20, 2014, Attorney General Eric Holder issued a Memorandum to the President regarding “Implementation of United States v. Windsor.” The memorandum reviews the status of federal agencies adopting State of Ceremony or State of Residence. Only two federal agencies, the Social Security Administration and the Veterans Administration, are using State of Residence because of federal statutory restrictions.

Federal income tax laws
The Windsor opinion has significant federal income, gift, and estate tax consequences for those same-sex married couples that live in states that do recognize same-sex marriages (Recognition States) and for those same-sex married couples that live in states that do not recognize same-sex marriages (Nonrecognition States).

On August 29, 2013, the Internal Revenue Service issued Revenue Ruling 2013-17 (the Ruling), recognizing for federal tax purposes the validity of, and extending all federal income, gift, and estate tax laws to the spouses to, a valid same-sex marriage, regardless of the state in which the parties reside.

The Ruling, however, concludes that for federal tax purposes a “marriage” does not include, and federal tax law will not be extended to, parties who have entered into a registered domestic partnership, civil union, or other similar form of relationship recognized under state law that is not denominated as a marriage under the laws of that state, regardless of whether the parties to the marriage are same sex or opposite sex.

The Ruling is to be applied prospectively as of September 16, 2013. On and after that effective date, all federal tax laws will apply to the parties to a valid same-sex marriage as long as the marriage was performed in a place, whether in the United States or in a foreign jurisdiction, that recognized the marriage as valid.

On the same date as the issuance of the Ruling, the IRS also issued Answers to Frequently Asked Questions for Registered Domestic Partners and Individuals in Civil Unions and Answers to Frequently Asked Questions for Individuals of the Same Sex Who Are Married Under State Law. These FAQs attempt to clarify the Ruling and address additional issues arising out of it.

Taxpayers may rely on the Ruling for purposes of filing original returns, amended returns, adjusted returns, or claims for credit or refund resulting from the Ruling’s holdings as long as the applicable statute of limitations under Code section 6511 for filing the claim has not expired. In such cases, all items required to be reported on the return or claim that are affected by marital status must be reported consistent with the married filing status.

FAQ-2 dealing with same-sex spouses states that a same-sex married couple must file as married for tax year 2013 as well as for tax year 2012 if spouses file an original tax return on or after the Ruling’s effective date. For spouses who filed their tax returns for 2012 or earlier years or before the Ruling’s effective date, FAQ-2 also provides that same-sex spouses may, but are not required to, amend their earlier tax returns to use married status as long as the applicable statute of limitations has not expired.

The Ruling provides that taxpayers may rely (subject to the conditions of statute of limitations and consistency) on the Ruling retroactively regarding employee benefit plans or arrangements or any benefit provided thereunder only for purposes of filing original, amended, or adjusted returns or claims for a refund of an overpayment of tax concerning employment tax and income tax with respect to employer-provided health coverage benefits or fringe benefits that were provided by the employer and are excludable from income under Code sections 106, 117(d), 119, 129, or 132, based on marital status.
If an employee made a pretax salary-reduction election for employer-provided health coverage under a cafeteria plan and also elected to provide health coverage for a same-sex spouse on an after-tax basis under a group health plan sponsored by the same employer, the affected taxpayer may treat amounts that were paid by the employee for coverage of the same-sex spouse on an after-tax basis as pretax salary reduction amounts.

The IRS issued Notice 2013-61, providing special administrative procedures for employers and employees to make claims for refund or adjustments of overpayments of FICA taxes and income tax withholdings with respect to certain benefits provided to same-sex spouses and remuneration paid to same-sex spouses in 2013 and prior years. In addition, the IRS recently issued Notice 2014-1, providing guidance on flexible spending arrangements under Code section 125, and health savings accounts under Code section 223.

In addition, on April 4, 2014, the IRS issued Notice 2014-19 regarding the retroactive effect of Revenue Ruling 2013-17 to qualified retirement plans. This notice, which also includes issuance of Answers to Frequently Asked Questions, states that these plans must recognize, for tax qualification purposes, same-sex marriages at least as of June 26, 2013, if the applicable state of residence recognized the marriage as of that date. Otherwise, the plan must recognize the marriage as of September 16, 2013. Sponsors of plans must amend them before the last to occur of (i) the tax return filing date for the plans and (ii) December 31, 2014. Governmental plans have special rules for amending them.

Recognition States
As a result of Windsor and the Ruling, all federal income tax laws will apply to same-sex married couples beginning in the calendar year 2013. Presumably, all transactions occurring during the calendar year 2013 will be covered, even though the Ruling’s effective date is September 16, 2013, since the Ruling states that it applies to original returns filed on or after that date.

Same-sex couples who reside in Recognition States will now be required to file their federal tax returns as either married filing joint returns or married filing separate returns. Clearly, this filing status will apply for the tax return for the taxable year 2013 and subsequent years.

Although a taxpayer generally does not have an obligation to file an amended return for a prior year, an issue arises as to whether an amended federal tax return (Form 1040X; claims for refund are made on an amended return) should be filed for a prior year with the status of married if there is a benefit in doing so. Obviously, such a question would arise only if filing as a married couple for federal income-tax purposes would result in an overall income tax savings as compared to the amount previously paid by each spouse.

The 2013 Instructions to IRS Form 1040X state that a taxpayer is not required to change filing status on a pre-September 16, 2013 filed return, even if filing an amended return for another reason.

Furthermore, the issue arises as to how many prior years an amended return can be filed. The normal federal income tax statute of limitations on refund claims is three years from the date the return was filed or two years from the date the tax was paid, whichever is later.

Under the Ruling, claims for refund for a prior year can be filed only if the statute of limitations is still open at the time the claim is filed. Prudence would dictate that claims for refund be filed as soon as possible for all years that would still be open under the applicable statute of limitations, provided there would be a net tax savings (refund) resulting from filing married as opposed to single. Under the Ruling, all items and transactions for the prior year for which an amended return is filed must be treated consistent with the married filing status.

However, all transactions occurring during a prior year for which a claim for refund is being considered should be analyzed to determine if the federal tax treatment originally reported would change if the same-sex couple was now considered married in the year for which the amended return is filed.

Another issue relates to same-sex married couples that are divorced. Clearly, same-sex couples divorced in a Recognition State will be afforded the tax benefits of Code section 1041 (tax-free property settlement), alimony under Code section 71 (income to payee) and under Code section 215 (deductible to payor), and child support under Code section 71 (exclusion from income). However, a couple that was granted a divorce prior to June 26, 2013, or September 16, 2013, should determine whether the property settlement and payments are entitled to a more favorable federal tax treatment than originally reported or if the divorce should be reopened and restructured to take into account tax benefits under the Code.

It is not clear whether, in an IRS audit of one spouse to a same-sex marriage for a pre-Windsor year, the Service unilaterally can treat the taxpayer/spouse as married for federal tax purposes for the audit year, even though the spouse filed as a single person. The better position would be that the Service not be able to change the marital status for the prior year.

Nonrecognition States
Under the Ruling, same-sex married couples that live in a Nonrecognition State will be subject to the same income tax rules and uncertainties as described above for Recognition States and will be required to file as married persons for federal income tax purposes. However, since many
Nonrecognition States also have a personal income tax (presently, 41 states have a broad-based personal income tax), the same-sex married couple will not be able to file state returns as married in most of these states. They will need to file state returns as single, which will require more work on allocation-of-tax items, such as income and deductions, between them.

Missouri, a Nonrecognition State, recently announced that solely for state income tax filings, a same-sex married couple can file a joint tax return. Utah announced in Tax Notice issued January 15, 2014, that solely for state income tax filings for 2013, a same-sex couple married on or before December 31, 2013, can elect to file a state income tax return as married. Utah’s status as a Nonrecognition State is discussed above.

The Colorado state income tax return, Form 104, states that individuals must use the same filing status on federal and Colorado income tax returns. Colorado currently is a Nonrecognition State.

The allocation of income and deductions becomes more complex in community property states that are Nonrecognition States. For example, it would appear that the community property laws of Texas would not apply to a same-sex married couple since section 3.002 of the Texas Family Code defines community property as property acquired by either spouse during marriage and, as discussed above, section 6.204 of the Texas Family Code provides that no right or claim to a legal benefit exists for a same-sex married couple in Texas. Thus, it would appear that income of one same-sex spouse would not be community income, but would be the income of the spouse who earned the income or owns the asset producing the income, the same as if the two individuals were not married. As stated in FAQ-14 dealing with Registered Domestic Partners, “Generally, state law determines whether an item of income constitutes community income.”

Nonrecognition States that do not permit joint returns have their own requirements for determining income for each separate state return. Some states allocate federal income on a joint federal return using a state-provided schedule for determining state income; some states require preparation of a pro-forma federal single return; some states apportion federal income using a ratio of federal adjusted gross income; and some states do not use the federal return at all but use their own method. There is no one method; it all depends on which Nonrecognition State is the state of residence.

In addition, the same considerations as above should be given to whether an amended return/claim for refund should be filed for all open years if a refund in tax would result from filing as married. However, before a same-sex married couple living in a Nonrecognition State makes a final determination to file such a claim for refund (if such action is otherwise warranted), the couple should consider the potential disadvantages of filing as married from an income-tax point of view.

A same-sex married couple that live in a Nonrecognition State and are seeking a divorce have a fundamental problem since they may not be able to obtain a divorce either in the Nonrecognition State (since the marriage is not recognized in that state) or in any other state that requires residency as a condition of granting a divorce. However, under Code section 1041, a property settlement between the spouses upon a split-up should be a nontaxable event since the couple would still be married for federal purposes. In addition, if properly structured and desired, cash payments should qualify for alimony or child support under the Code section 71.

Another difference in Recognition States arises with respect to the proper parties to a subchapter S election. In a community property Recognition State, both spouses to a same-sex marriage would sign the S election if the stock is community property. In a community property Nonrecognition State, the community property laws of that state seemingly would not apply; therefore, only the same-sex spouse in whose name the stock is registered would sign the election, absent a joint ownership arrangement between the spouses.

Conclusion

Although the Supreme Court in Windsor extended federal law to same-sex married couples in Recognition States, the Windsor Court did not address how those same couples are to be treated in Nonrecognition States. As a result, federal agencies, including the Internal Revenue Service, are issuing guidance in this area. In addition, conflicts exist between federal law and Nonrecognition State law as applied to same-sex married couples.

With time and the continuing developments in this area of law, we most likely will see more same-sex marriages and more Nonrecognition States recognizing same-sex marriages, whether voluntarily or involuntarily. This area of law is developing quickly and, until fully developed, the quagmire continues for same-sex married couples. FA

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Divorce usually involves a long list of matters to be resolved between spouses, not the least of which is filing income tax returns. How to file can be a highly contentious issue and a pressure-driven one that often arises just days before the tax filing deadline. Failure to meet the filing and payment deadlines can result in Internal Revenue Service (IRS) penalties and interest.

Many divorcing spouses share the common goal of electing to file their federal income tax return jointly, which frequently minimizes their overall tax liability. This is not always the case, however. How to file tax returns can become an issue in dispute when spouses distrust each other or one spouse questions the other’s honesty and accuracy in filling out the return. This is, of course, a topic for which a concerned spouse should seek professional tax advice to understand the consequences of an election to file jointly or separately with a spouse who is not trusted on tax matters.

Filing returns jointly or separately also may impact the two spouses differently. For example, depending on the tax consequences of the assets owned by one spouse, or the income earned by that spouse, filing in a particular manner may result in a greater benefit, or lesser detriment, to one spouse than the other. Likewise, when filing jointly or separately affects the two spouses in disparate ways, one spouse’s acquiescence can be a source of leverage in negotiations of other issues in the divorce case.

This situation arises, for example, when:
- one spouse has higher earned income than the other;
- an asset titled in only one spouse’s name generated a significant amount of income;
- a spouse has failed to make estimated tax payments;
- one spouse has paid spousal maintenance to the other; or
- one spouse would qualify for head-of-household filing status.

The acquiescing spouse may agree, as part of settlement negotiations, to file in the requested manner (i.e., jointly or separately) in exchange for a majority or all of a refund payment or some other financial asset or concession. Thus, the tax-filing deadline can become a valuable settlement tool.

**Can you file a different way later?**

There are five tax rate schedules for individuals and couples under the Internal Revenue Code (I.R.C.). Considering both tax rates and other potential tax benefits (e.g., credits) available when filing with a certain tax filing status, from the least to most favorable, the tax rate schedules are: (1) married filing separately; (2) single; (3) head of household; (4) married filing jointly; and (5) qualified widower with dependent child. Each of these has specific requirements...
An individual is not considered married for tax status purposes if he or she is separated by a decree of legal separation.

Particularly when parents of dependent children divorce, one or both spouses will be eligible to file their federal income tax return following the divorce as head of household, which is a more preferred tax rate than the single rate. It is also possible, though, for an individual who is not divorced or legally separated to be considered unmarried and qualify for head-of-household status if they meet the necessary requirements.

The Dependency Exemption

By Cheryl L. Young, Gerald L. Shoemaker, Jr., & Leslie Dawson

General requirements for claiming a dependent:

A. The taxpayer cannot be claimed as a dependent of another.
B. The dependent must be a U.S. citizen, U.S. resident alien, U.S. national, or a resident of Canada/Mexico for some part of the year.
C. The dependent cannot claim himself/herself as an exemption on his or her own return.
D. The dependent must be either a Qualifying Child or a Qualifying Relative.

1. Qualifying Child
   a. Child must be the taxpayer’s son, daughter, stepchild, foster child, brother, sister, half brother or sister, stepbrother, stepsister or descendant of any.
   b. Child must be:
      i. Under age 19 at the end of the year and younger than the taxpayer and spouse,
      ii. Under age 24 at the end of the year, a full-time student, and younger than the taxpayer and spouse,
      iii. Any age if permanently disabled.
   c. The child must have lived with the taxpayer for more than half of the year.
   d. The child must not have provided more than half of his or her own support.
   e. The child is not filing a joint return for the year.
   f. Only one person can treat a child as a qualifying child. A parent will trump any other relationship. The parent who has primary physical custody will trump the other parent. In the case of two parents with equal physical custody, the parent with the higher gross income will trump the other.

2. Qualifying Relative
   a. Relative cannot be Qualifying Child of anyone else.
   b. Person must be a relative or must live all year as a member of the household.
   c. Relative’s gross income must be less than $3,900.
   d. Taxpayer must provide more than half of the person’s total support for the year.

If multiple parties provide support for the dependent, each party must apply the above tests and follow the priority set forth if the dependent is in college, the taxpayer to whom the child returns when not in school receives credit for the child’s time in college in terms of determining where the dependent “lives.”

For 2013, the exemption amount is $3,900, and for 2014, the full exemption amount is $3,950. The exemption is subject to “phase outs.”

Divorce situations

There is a special rule for children of divorced or separated parents under I.R.C. § 152(e). The custodial parent will be entitled to claim the child as a dependent if all of the following apply:

1. The parents are divorced, separated, or otherwise living apart for the last six months of the year.
2. The parents together provide more than half of the child’s support.
3. The child is in the custody of one or both parents for more than half the year.

Custody is determined either:

1. Legally—according to the written separation agreement or court order;
2. Physically—based on which parent has the child for the greater number of nights during the year. If there is a tie, the parent with the greater adjusted gross income will be deemed the custodial parent.

The custodial parent may release the exemption to the noncustodial parent by completing and signing a Form 8332 “Release Revocation of Release of Claim to Exemption for Child by Custodial Parent.” The noncustodial parent must attach this form to his or her return in order to claim the child as a dependent.

The IRS is very particular about using this form. A settlement agreement or court order will only replace this form if there is an unconditional assignment of the dependency exemption to the noncustodial parent and the agreement’s only purpose is for this assignment. In other words, a provision in the overall divorce settlement will not work. Furthermore, any provision conditioning the assignment of the dependency exemption on the current payment of child support will also not be accepted.

An emancipated child is not considered in the custody of either parent and, thus, these special rules do not apply. They must qualify under the general dependency rules.

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taxpayer has lived apart from his or her spouse for the last six months of the taxable year and provides more than half the cost of maintaining a household that is the principal place of abode of the taxpayer’s dependent child for more than half of the year.

Because married filing joint is one of the most beneficial tax rates, filing a joint income tax return frequently minimizes the overall income tax liability for spouses as a unit. Even when spouses are divorcing, they often share the goal of applying the beneficial married filing joint tax rate to minimize their overall tax liability, or maximize their overall tax refund, at the time they are filing their returns. There are circumstances, however, under which there could be tax savings to one or both spouses if each files as married filing separate, or when only one spouse benefits from a married filing joint status. It is important for individuals in the divorce process to consult with a tax advisor to understand their tax filing options based on their specific facts and circumstances.

When one spouse strongly desires to file a joint income tax return and the other is unwilling to do so, one settlement tool which many courts have upheld is the use of indemnification and hold-harmless instruments to protect the unwilling or uninterested spouse from any liability in filing a joint return. Because this approach is not a clear, well-established protection in all jurisdictions, to protect a spouse who agrees to file jointly, a clause should be included which reserves the trial court’s jurisdiction to adjust the support, monetary or property settlement, between the spouses in the event the spouse reluctant to file jointly incurs liability resulting from the joint tax returns.

Family law attorneys should assist their clients in examining federal tax filing status options during a divorce. Careful consideration and sound advice can result in substantial financial tax benefits to clients and can be used as a settlement tool or as leverage to help the client achieve other objectives in the divorce process.

**Amending to file a joint return**

Even if a spouse files a married filing separate return, the spouse has the option to amend the return to file a joint return with his/her spouse within three years of the original tax return due date. An amendment to a joint filing status often is possible provided the two individuals were legally married on December 31 of the applicable tax year for which they wish to amend the return, even if the individuals are divorced or legally separated at the time they are filing the amended return.

An election to amend a return for a given taxable year from a separate return to a joint return cannot be made, however, in certain limited circumstances, such as: (1) when one individual has filed a petition with the tax court concerning a notice of deficiency from the IRS with respect to such taxable year; (2) after either individual has commenced a suit in any court for the recovery of any part of the tax for that taxable year; (3) after either individual has entered into a closing agreement with the IRS with respect to such taxable year; or (4) after any civil or criminal case arising against either individual has been compromised between the individual and the IRS or the attorney general. When spouses elect to file a joint return, they may not later amend their returns to file separately.

When spouses do not have sufficient time, or are unable to resolve the issue of electing a tax filing status, they may wish to file separate returns in a timely manner and subsequently decide whether they agree to amend

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**When spouses are unable, to resolve the issue of electing a tax filing status, they may wish to file separate returns in a timely manner and subsequently decide whether they agree to amend their returns to file jointly**

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**HEAD-OF-HOUSEHOLD FILING STATUS**

Head-of-household filing status provides greater tax benefits in the form of lower tax rates and more beneficial thresholds.

Requirements for filing as head of household:

1. The taxpayer is unmarried or considered unmarried on the last day of the year.
2. The taxpayer paid more than half the cost of keeping a home for the year.
3. A qualifying person lives with the taxpayer for more than half the year. A qualifying person is one of the following:
   a. Qualifying child—whether or not the child is claimed as a dependent by the taxpayer,
   b. Other relative that lives with and can be claimed as a dependent of the taxpayer, and
   c. Parent that the taxpayer can claim as a dependent.

Head-of-household status is based on actual custody and cannot be negotiated between the parties as the dependency exemption may. Thus, while a custodial parent can release the dependency exemption to the noncustodial parent, he or she alone retains the ability to file as head of household.

—Cheryl Young et al.
their returns to file jointly. A spouse’s choice to file jointly cannot later be amended. Divorcing spouses should seek appropriate tax and legal advice in making what could be a consequential tax-filing-status decision.

**Failure to file and failure to pay**

Because of the potential complexity and difficulty in resolving disputes surrounding the filing of income tax returns, parties to a divorce proceeding may need to file an extension and may incur penalties and interest relative to the timing of their tax return filing and payments.

Failing to file a tax return by the tax deadline may result in an IRS “failure-to-file” penalty. Failing to pay a required tax payment by the due date (April 15 for most individuals in most years) or the extended due date (October 15 for most individuals in most years) may result in a “failure-to-pay” penalty. In limited circumstances, the IRS may not assess a “failure-to-file” or “failure-to-pay” penalty if the taxpayer can show that the failure was due to reasonable cause, and not willful neglect. (The distinction between reasonable cause and willful neglect in this context is beyond the scope of this article.)

The penalty for filing a return late is usually 5% of the unpaid taxes for each month or part of a month that the return is late, with a maximum of 25% of the unpaid taxes. If a return is filed more than 60 days after the due date or extended due date, the minimum penalty is the smaller of $135 or 100% of unpaid tax.

If an individual does not make the required tax payment by the due date, a “failure-to-pay” penalty is typically assessed at .5% to 1% of the unpaid taxes for each month or part of a month after the due date. The “failure-to-pay” penalty can be as much as 25% of the total unpaid taxes due. Note that the tax payment is required to be made by the due date, which is usually April 15, and requesting an extended due date for purposes of filing a federal tax return does not grant any extension for payment of the tax due. If an individual requests an extension of time to file by the tax deadline and paid at least 90% of the actual tax liability by the original due date, however, the IRS will not assess a “failure-to-pay” penalty if the remaining balance is paid by the extended due date.

If both the “failure-to-file” and “failure-to-pay” penalties apply in any month, the 5% “failure-to-file” penalty is reduced by the “failure-to-pay” penalty. However, if the return is filed more than 60 days after the due date or extended due date, the minimum penalty is still the smaller of $135 or 100% of unpaid tax.

If a joint return is filed, both spouses or former spouses have joint and several liability, and both parties are responsible for the tax and any interest or penalties due on the return, as well as any understatement of tax that may become due later. If one spouse does not pay the tax, the other may have to do so.

The “failure-to-file” penalty is generally greater than the “failure-to-pay” penalty. Therefore, even if an individual or couple cannot pay all taxes owed, the parties should still file the return on time and pay as much of the payment due as possible, subsequently exploring other payment options with the IRS.

The potential penalties and interest on the penalties that may be assessed against divorcing spouses in the event they fail to timely file income tax returns or pay tax liabilities, should be considered carefully. The issue of electing tax filing status and cooperating to file income tax returns must be part of the divorcing spouse’s decision-making and case strategy for resolving issues in the divorce.

**Conclusion**

ELECTING AN INCOME TAX FILING STATUS, OR MAINTAINING THE POSSIBILITY OF AMENDING A RETURN IN THE FUTURE, CAN BE AN IMPORTANT CHOICE FOR A DIVORCING SPOUSE AND MAY BE A VALUABLE SETTLEMENT TOOL. PARTIES TO A DIVORCE SHOULD ALSO BE AWARE OF AND CONSIDER THE POTENTIAL PENALTIES AND INTEREST THAT CAN RESULT FROM A FAILURE TO TIMELY FILE TAX RETURNS OR PAY REQUIRED TAX PAYMENTS. SUCH PENALTIES AND INTEREST MAY MAKE THE FILING OF INCOME TAX RETURNS PARTICULARLY TIME-SENSITIVE IN A DIVORCE. LIKEWISE, TAX REFUNDS, LIABILITIES, PENALTIES, AND INTEREST RESULTING FROM THE PARTIES’ FILING STATUS ELECTIONS AND PAYMENTS MAY BE CONSIDERED AS PART OF THE OVERALL PROPERTY DIVISION IN THE DIVORCE.

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MOST MARRIED COUPLES WILL FILE THEIR income taxes jointly without considering the consequences or considering only the dollar tax savings (marriage bonus) from rate splitting for single-earner couples. Couples with two wage earners more likely face a marriage penalty, not a bonus, compared to two single filers. Sometimes a spouse will ask, “Should I elect to file separately?” The question is posed especially when divorce proceedings are ongoing or concluded after December 31 of a tax year.

The question shows a lack of understanding about tax-filing status. Married couples must affirmatively elect to file a joint return. Absent the election of filing jointly, each spouse’s tax liability is determined separately and each spouse’s liability for the tax owed is individual, not “joint and several,” as is the case when a joint return is filed (unless one spouse qualifies for relief under the so-called “innocent spouse” rules of section 6015). The difference is not mere semantics.

For example, if no joint return is filed at all, the IRS cannot prepare a substitute joint return under section 6020 (all references, unless otherwise noted are to the Internal Revenue Code of 1986, as amended) but must prepare two separate returns, one for each spouse, assuming both would be required to file a return. Separate-return status means that each spouse is liable only for the tax determined on his or her separate income and allocated joint items of income and expense.

In community property states, each spouse, if filing separately, reports one half of the other’s community income, but the tax liability on each return is still determined...
separately. While the community property spouse who files separately pays tax on one half of his or her spouse’s community income and, likewise, the other spouse does the same, each spouse may have noncommunity income and deductions as well. The separately filing spouse will only pay tax to the IRS on one half of community income less allocated deductions plus his or her separate income less separate deductions. Moreover, if separate returns are filed, each spouse’s separate noncommunity assets (for example, in some community property jurisdictions, assets acquired before the marriage or after the dissolution) are not subject to levy for the tax imposed on the other spouse’s share of community income. Thus, the liability for the tax on separate returns is personal and not joint and several as on a joint return where each spouse is fully liable for the entire joint tax liability. Only separate assets or separate interests (also tenants by entireties interests) in joint assets may be levied upon, seized, or foreclosed upon to pay the individual tax debt.

In some states, a married couple may enter into an agreement that affects the status of property or income as community or separate property or income. Also, certain community income is treated as separate income where one community spouse is a nonresident alien and the spouses live apart, file separate returns, and meet some other conditions. Also, I.R.C. section 66(c) provides innocent spouse relief for a community spouse who did not file a joint return and did not report community income because he or she did know of the income, where it would be inequitable to hold that spouse liable for the tax liability resulting from application of the community income tax rules.

Reasons not to file jointly
Some state court final judgments of divorce have included a mandate that divorcing spouses file a joint return for one or more years of the marriage. A spouse may rightly not wish to file jointly for many reasons apart from tax savings that include:

- A joint return carries with it joint and several liability to the U.S. Treasury for the tax shown to be due on the return or later assessed with regard to the return year.
- Nonmarital assets of each spouse may be levied upon to pay the tax debts attributable to income of the other spouse.
- While section 6015 offers limited relief to a so-called “innocent spouse,” the facts justifying relief from joint and several liability can be difficult to establish.
- The right of indemnification from the other spouse, almost always included in marital settlement agreements, is an imperfect protection. The IRS is not bound to first pursue the indemnifying spouse, and collection efforts against the indemnified spouse may cause hardship to the spouse who files jointly with little income to report.

- A joint return is signed under express penalties of perjury carrying felony consequences for falsity, although criminal liability is individually determined.
- In a divorce, one spouse often has already been deceived in the relationship and does not believe in the honesty of the other spouse. This level of distrust often is compounded if one spouse is self-employed or operates a business in which he or she has some ability to control the income reported and expense deductions claimed.
- Preparing the joint return will involve communicating information to the tax preparer. If the preparer’s loyalty is perceived to be primarily to only one of the spouses, positions taken in the return may not be in the best interest of the other spouse.

The seriousness of one’s decision to file a joint return was highlighted in In re Theresa M. Karam v. Commissioner, 2011 TC Memo 230. The tax court, holding that petitioner was entitled to relief from joint and several liability on a joint return, noted as one of its findings of fact that the petitioner had recovered a judgment of $250,000 against the CPA–return preparer for his negligence in not advising petitioner about the pitfalls in filing a joint return.

Despite the understandable reluctance of most spouses to file jointly with their soon-to-be former spouse, some courts, looking solely at the immediate financial gain to the marital res, have ordered the unwilling spouse to accept the risks and file a joint return. In reviewing case law on this issue, it is important to distinguish between cases in which the court enforced a pre-existing agreement between the parties to file a joint return, and cases in which the court ordered the filing of a joint return in the absence of such as agreement.

For example, in one of the latter types of cases, a New Jersey Appellate Court, in upholding the trial court’s order for a spouse to execute a joint return stated that, “trial courts should have discretion to compel the filing of a joint tax return,” since the legislature has directed courts to consider the tax consequences of their rulings on alimony and equitable distribution. Burstyn v. Burstyn, 879 A. 2d 129 (N.J. App. Div. Crv. 2005). Pursuant to the court order, the wife’s alimony payments were to be held until she executed the joint tax return. The expert in Burstyn had testified that by filing a joint return, as opposed to “married, filing separately,” the parties would substantially decrease the amount of tax owed. That the wife gave no reason whatsoever for her refusal to file jointly certainly influenced the court, however.
The Bursten court, and others that have issued such orders, relied on the court’s equitable distribution powers under various state laws. Equitable distribution, however, requires only that the court allocate or distribute marital assets and liabilities between the spouses; it does not empower the court to create a new debt to a third party, in this case the U.S. Treasury. The unwilling spouse might not be required to file a return, if not ordered to execute the joint return (although he or she may want to file a married-filing-separately return to prevent the other spouse from filing a putative joint return).

To illustrate, with another type of debt, the court can require one spouse or the other to pay off a mortgage on the family home; but, the court lacks the power, under equitable distribution, to order that one spouse apply for an entirely new mortgage that did not exist during the marriage. With income taxes, the spouses may be jointly responsible inter se for income taxes incurred on marital income, but they are not per se jointly liable to the IRS unless they elect to file jointly.

**Bock v. Dalbey**

In Bock v. Dalbey, Nebraska couple Mathew Bock and Jennifer Dalbey divorced in August 2010, and the trial court ordered them to file joint federal income tax returns for the years 2008 and 2009. They were married in 2006 and had filed jointly for the year 2007. Dalbey did not want to file a joint return with her former spouse, although the election to file jointly was available to them because they were married on December 31, 2008, and December 31, 2009, the dates that determine marital status for those years.

The lower court had ordered Bock to pay the tax on the joint return, and filing jointly would have produced a lower tax liability for him than would have resulted on a married-filing-separately return. But Dalbey had little income and signing the joint return would have subjected her to joint and several liability for her former husband’s tax liability if he did not pay the tax due on the return or was assessed additional taxes on audit. Dalbey appealed, but the Nebraska Court of Appeals decision, Bock v. Dalbey, 19 Neb. App. 210, 809 N.W.2d 785 (2011), upheld the trial court’s order requiring that she join in filing joint federal income tax returns for the years 2008 and 2009.

Dalbey again appealed. The Nebraska Supreme Court decision, in reversing, refers to Leftwich v. Leftwich, 442 A.2d 139 (D.C. 1982), as the most cited case holding that a trial court in a dissolution proceeding may not compel spouses to file a joint return, stating in part:

To sanction the trial court’s effectively ordering a spouse to cooperate in filing a joint return would nullify the right of election conferred upon married taxpayers by the Internal Revenue Code. Such a right is not inconsequential; its exercise affects potential criminal and/or civil liabilities of taxpayers…. Married individuals filing a joint return expose themselves to joint and several liability for any fraudulent or erroneous aspect of the return.

The Nebraska Supreme Court noted that Leftwich held critical the fact of the wife’s exposure to liability and the availability of less intrusive measures for dealing with marital tax liabilities, i.e., altering other aspects of the distribution of marital property to adjust for any perceived disadvantage to the husband from filing separately.

The Nebraska Court of Appeals had found that this abridgment of the right to elect under federal law (I.R.C. § 6013) did not conflict with federal law or violate the Supremacy Clause of the U.S. Constitution because marital rights are strictly a matter of state law concern and outside the scope of federal jurisdiction. The Nebraska Supreme Court noted, however, “altering the equitable distribution of marital property was a less intrusive option to remedy a tax disadvantage” to one spouse from filing separately and required the lower court to consider the lesser remedy before resorting to compulsion regarding filing a joint return.

Without commenting on the applicability of the Supremacy Clause, the Nebraska Supreme Court, decided under state law that adjusting equitable distribution is the preferred method for dealing with a tax disadvantage to one spouse from filing separately, and that a trial court lacks discretion to order the filing of a joint return, stating as its reasons for so holding:

- The U.S. Tax Court is not bound to respect the state court order and might well find under IRS regulations and its own case law that such a return was not a valid joint return because the unwilling spouse did not intend to file jointly but was compelled to do so. The Supreme Court stated, “This means that a trial court cannot know with certainty whether its equitable division of the marital estate based on consideration of a joint tax return will be given effect by federal authorities or courts.”

- The lower court’s order is a mandatory injunction, an extremely harsh remedy that should not be exercised...
unless damage would be irreparable and no adequate remedy at law is available. In the case at hand, Nebraska’s equitable distribution law, section 42-365, is broad in its scope and could be employed to adjust for any tax inequity.

The trial court may consider a party’s unreasonable refusal to file a joint return in making equitable adjustment where the other spouse is disadvantaged by filing separately. The Supreme Court stated: “because we conclude that § 42-365 permits a court to adjust its division of the marital estate to fit the equities of the case, we agree with the Leftwich court that equity principles weigh against permitting a trial court to resort to the coercive remedy of compelling a party to file a joint tax return.”

An unfavorable trade-off

Joint return and innocent spouse issues emanate from the present tax-rate structure and other tax law provisions, making it almost always highly disadvantageous to file under the status of married filing separately. Thus, spouses and frequently divorcing spouses will file jointly, only later to realize that tax savings is not a favorable trade-off for assuming joint and several liability for a spouse’s tax debt. Even nonmarital assets may be subject to forced collection action by the IRS.

The election to file jointly pushes spouses into joint filing for short-sighted financial benefit, but operates adversely with regard to the interests of the lower-earning or nonearning spouse who at the time of electing often cannot foresee or understand these substantial detriments.

“A resisting spouse’s exposure to liability under the federal tax code is too difficult to predict if compelled to file a joint return…. Obtaining relief under the innocent spouse statute, however, is far from certain…. Summed up, for a divorcing spouse with little or no taxable income for the tax year, signing a joint tax return may pose considerable liability risk with no appreciable benefit.”

“Because the risks frequently outweigh the benefits, in private negotiations a spouse will often not agree to a joint return without the other spouse’s agreement to share in the tax savings and to promise indemnity. We believe that these decisions are best left to the parties to negotiate after considering the risks and benefits of a joint return. If a spouse unreasonably refuses to file a joint return, the other spouse can take the matter up with the court.”

“(The) filing deadlines under the federal tax code create practical hurdles to allowing a trial court to compel the parties to file joint returns. Under § 6013(b) of the tax code, a husband and wife can only elect to file a joint return for up to 3 years after they filed separate returns. But the opposite is not true. If the husband and wife filed a joint return, they cannot revoke that decision after the filing time limits for the taxable year have expired. So, if a trial court orders a party to file a joint return, he or she will usually have to comply quickly or risk being held in contempt. Yet even if the party appeals the order, the party cannot revoke the joint return. The party’s only avenue for relief from federal tax liability is the tax code’s innocent spouse statute. As discussed, that option is a precarious road at best. Thus, the tax code’s time limitations also weigh against permitting trial courts to order the parties to file a joint return.”

Thus, the Nebraska Court of Appeals was reversed. The Nebraska Supreme Court did not find it necessary to rule on the Supremacy Clause issue because state law provided a less harsh remedy at law making equitable compulsion unnecessary and, therefore, improper. This is a very well-reasoned opinion that should be read by every family lawyer and every tax preparer before advising clients to file a joint return.

Robert S. Steinberg is an attorney-CPA in Miami, Florida, whose practice is limited to taxation. He has authored many tax articles and speaks often to groups on tax subjects. This article is based, in part, on “Can and Should a State Court Order an Unwilling Spouse to File a Joint Federal Income Tax Return?” by Melvyn B. Frumkes and Robert S. Steinberg.
As divorce practitioners, we are constantly running through an endless list of major and minor issues in a case: Do we need to hire an expert? How should the antiques be divided? Who gets to spend time with the child on his or her birthday?

When the case settles or the trial is over, we may breathe a sigh of relief and prepare to send out a closing letter. There is, however, one important aspect of the divorce that should not be overlooked in each attorney’s checklist. In many cases, some portion of a party’s attorney’s fees are tax deductible, and it is our responsibility to inform our clients of this possibility.

Divorce can be a costly ordeal, both financially and emotionally, so it may come as good news to a client that some of that cost is tax deductible. In general, attorneys’ fees incurred in connection with a divorce are considered personal expenses, even though the divorce may have significant business implications. However, there are exceptions, and attorneys’ fees incurred in connection with a divorce are deductible in a few circumstances. When deductible, attorneys’ fees are treated as “miscellaneous itemized deductions.” They are deductible only to the extent they exceed 2% of the taxpayer’s adjusted gross income and are subject to a phase out when the adjusted gross income exceeds a certain amount. Further, they cannot be taken into consideration when computing the alternate minimum
tax. In order to take maximum advantage of the 2% rule, the client should pay all deductible legal fees in one year.

Attorney’s fees and other litigation costs are deductible to the extent they are incurred to produce taxable income. Because spousal support or alimony can be includable in income, the fees incurred in obtaining the spousal support or in collecting delinquent spousal support are deductible to the extent it is taxable. For example, if one party pays the other’s support during a separation that is not subject to an order or written agreement, the support is nontaxable, nondeductible, and any fees related to produce that support are, therefore, nondeductible. By way of contrast, fees and costs to produce child support are not deductible, since child support is not taxable to the payee.

The principle of deducting fees and costs for production of taxable income extends to other circumstances. A payee can deduct fees and costs in connection with an application for a modification of taxable spousal support or alimony. In addition, fees incurred to obtain an interest in the employee spouse’s retirement plan are also tax deductible, since distributions will be taxable when received. Attorney’s fees incurred in obtaining royalties, residuals, and other income taxable to the client may also be tax deductible.

The deductibility is not limited to just your fees as the movant’s attorney. An accountant’s fees also may be tax deductible to the extent the accountant’s work involved obtaining spousal support, such as work involved in determining the parties’ actual cash flow. Even the fees incurred to hire an expert, such as a vocational counselor, may also be deductible to the extent they were expended to obtain an order for spousal support.

Fees are also deductible to the extent they are paid for tax planning advice. Much of the advice we give our clients may fall under the umbrella of “tax planning” so it is important to take note of the following, which may be allocated to tax planning or production of taxable income. Costs of:

- determining the adjusted basis of assets in a property settlement;
- advising a client on whether or not they qualify for any exemption of taxable gain when selling a principal residence;
- planning an alimony trust or annuity agreement to avoid some of the restrictions on deductible spousal support;
- estate planning that assures proper estate and gift tax consequences for the payment or receipt of support or property divisions;
- preparing a settlement agreement to assure deductible support payments when parties are separated;
- maximizing the deductible portion of spousal support or of minimizing the taxable portion of spousal support;
- allocating dependency exemptions;
- obtaining advice regarding the tax consequences of divorce or separation instrument or of gathering information for actual preparation of tax returns; and
- drafting a QDRO and submitting it to the plan administrator for approval.

Fees paid in connection with a divorce are not deductible business expenses. However, fees incurred in establishing or defending title to property may be capitalized and added to the basis of the property reducing tax on gain when it is sold. Once we are aware of all the possible ways a client’s fees can be deductible, how do we share that knowledge with the client? The best way to handle the deductibility of attorney’s fees is by separately itemizing the services that involved tax advice or the “production or collection of income.” This may mean setting up a special toggle in your billing software to indicate whether a service is deductible or not, or the timely task of going through a client’s fee history and marking the charges that may be eligible. Creating detailed and explanatory billing entries will be extraordinarily helpful with this.

With the advice of an accountant, you should send the client a letter at the conclusion of his or her case that expressly identifies the deductible versus nondeductible services rendered. In the event the client’s deductions are disputed, the IRS may need this letter.

With careful tax planning, parties can use the tax deductibility of attorneys’ fees to the advantage of both parties in a case. For example, we can allocate fees between the spouses: if Husband pays $10,000 as temporary spousal support, and Wife pays her attorney’s fees from this money and she is able to deduct a significant portion of her fees, the transaction benefits both parties. It gives incentive for Husband to pay Wife’s attorney’s fees by making them tax deductible as spousal support and gives Wife the partial tax deduction for her attorney’s fees when incurred for production of income or for tax advice.

Family law attorneys already wear many hats when handling a case. The more knowledge we have as practitioners about tax issues, the better we can serve our clients, negotiate deals, and settle cases.
The Internal Revenue Code (I.R.C.) imposes joint and several liability on spouses who are married and file a joint tax return through the provisions of I.R.C. § 6013(d)(3). This provision gives the IRS the latitude to collect any outstanding tax, in its entirety, from both spouses, or from just one spouse if the IRS so chooses. And such joint and several liability cannot be waived or attributed to one spouse through a divorce settlement or legal separation, as the IRS is not bound by such agreements.

For clear reasons, such an imposition of liability on both spouses can, and does, at times rise to the level of inequity. Understandably, there are occasions in a marriage when one spouse is unaware of certain income earned by the other spouse, or situations in which moneys provided by one spouse to pay taxes are misappropriated by the other spouse. It is for these legitimate situations that the “innocent spouse” regulations of the I.R.C. were implemented. Their original form was codified in I.R.C. § 6013(e), but has since been superseded and reemerged in I.R.C. § 6015. I.R.C. § 6015 sets forth three forms of relief to one spouse from joint and several liability: (a) innocent spouse relief (I.R.C. § 6015(b)); (b) separation of liability (I.R.C. § 6015(c)); and (c) equitable relief (I.R.C. § 6015(f)).

The union of marriage has long been seen as the merging of two into one; shared checking accounts, title to the marital home, and the filing of a joint tax return are a few of the more common mergers. The dissolution of that union, and the subsequent division of one back into two, is frequently not so fluid a process. While closing a joint checking account and executing a quit-claim deed to a home require little more than filing paperwork, absolving oneself from the lasting ramifications of incorrectly filed joint tax returns and the penalties which attach thereto is not so easy.

**Background**

The Internal Revenue Code (I.R.C.) imposes joint and several liability on spouses who are married and file a joint tax return through the provisions of I.R.C. § 6013(d)(3). This provision gives the IRS the latitude to collect any outstanding tax, in its entirety, from both spouses, or from just one spouse if the IRS so chooses. And such joint and several liability cannot be waived or attributed to one spouse through a divorce settlement or legal separation, as the IRS is not bound by such agreements.

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All three forms of relief have different requirements and different tests to be met, but four universal rules apply to all:

1. A joint tax return must have been filed. Without a joint tax return, no joint and several liability can exist.
2. Form 8857, requesting the relief, must have been filed properly within the time limitations.
3. The request for relief must be from liability attributed to that spouse for income taxes.
4. If a final judgment has been rendered by a court on the question of the income tax liability and no request for relief was made during that proceeding, then the spouse is precluded from requesting relief thereafter.

Provided these four requirements have been met, a spouse is eligible for relief pursuant to I.R.C. § 6015.

**Innocent spouse relief**

Perhaps the most commonly known, and cited to, form of relief from joint tax liability is innocent spouse relief. Innocent spouse relief shifts the responsibility for unpaid taxes, together with accrued interest and penalties, to the spouse who improperly reported or omitted items on the subject joint tax return. The burden of proof in effectuating that shift is not so simple, and requires the spouse seeking relief to meet four enumerated conditions: (1) presence of erroneous items attributable to the nonseeking spouse; (2) no knowledge, whether actual or constructive, of the spouse seeking relief; and (3) a facts-and-circumstances test, which determines whether holding the innocent spouse liable would be unfair.

It is important to note that innocent spouse relief is available only for understatements of tax, which is when the amount owed, as stated on the return, is lower than the actual amount due. This is distinguished from an underpayment of tax, which may trigger a different form of relief. An underpayment of tax is when the amount due is correctly stated on the return, but has not yet been paid.

Erroneous items occur in one of two forms: (1) as unreported income; or (2) as an incorrect deduction, credit, or basis. Unreported income includes any gross income item received, but not reported on the subject joint income tax return. Conversely, an improper deduction, credit, or property basis is one that is claimed, in order to reduce taxable income and therefore the total tax burden to the couple, but which is never actually taken as a deduction or does not qualify as a deductible expense.

The knowledge component is satisfied if the spouse seeking relief had no actual knowledge of the wrongdoing or can prove that a reasonable person in similar circumstances would not have known of the wrongdoing (constructive knowledge). Constructive knowledge considers a set of criteria in determining whether a reasonable person would have known of the wrongdoing, including: the amount and characterization of the improper deduction or omission in relation to other deductions, the financial situation of each spouse and the educational acumen of each, the extent of participation engaged in by each spouse with respect to the activity that led to the erroneous item, and whether such a deduction or omission was one taken in prior years or represented a departure from prior year’s filings.

Historically, partial relief has been granted where the spouse seeking relief can prove no actual or constructive knowledge of at least some portion of the erroneous item. However, both spouses remain jointly and severally liable for the tax liability attributable to the remaining portion of the erroneous item.

The facts-and-circumstances component of qualifying for innocent spouse relief is the most subjective, and essentially poses the question of whether holding both spouses responsible, in light of all facts and circumstances, is “fair and equitable.” In determining whether holding both spouses liable is “fair and equitable,” the IRS considers the current relationship of the spouses, if they are divorced or separated, whether the erroneous item actually resulted in a benefit, and whether the innocent spouse received a significant benefit as a result. The IRS defines a “significant benefit” as any benefit in excess of normal support, with “normal support” having no definition but, rather, dependent on “particular circumstances.” Historically, a significant benefit has included lavish vacations or purchases, or the existence of a “fraudulent scheme,” such as a transfer of property between spouses. The existence of a fraudulent scheme, which also includes schemes to defraud the IRS, creditors, or business partners, can be evidence of a significant benefit, even if it occurred some years after the filing of the return giving rise to the erroneous item.

It is important to note that innocent spouse relief is available only for understatements of tax, which is when the amount owed, as stated on the return, is lower than the actual amount due.
The second type of relief comes in the form of separation of liability. Separation of liability literally divides the understatement of tax, together with accrued interest and penalties, between the spouses, allocating an amount to each for which they are responsible. Separation of liability is unique among the three forms of relief in that it is available only for unpaid liabilities resulting from understatements of tax. It does not have the converse effect, which would allocate a refund between the two spouses and, like innocent spouse relief, it does not provide relief for underpayments of tax.

Qualification for separation of liability requires the spouses in question to be divorced or legally separated, or for spouses to not be members of the same household for the twelve months preceding the date on which relief was requested. The IRS defines “members of the same household” narrowly, and includes spouses who reside in the same dwelling or spouses who do not reside in the same dwelling, but one spouse is only temporarily absent. A temporary absence is when one spouse is serving a sentence in prison, is serving a tour with the military or armed forces, or is temporarily living elsewhere while pursuing educational endeavors.

As with innocent spouse relief, a separation-of-liability claim requires actual knowledge. However, the actual knowledge standard under a separation-of-liability claim differs from that of an innocent spouse claim. Under a separation-of-liability claim, actual knowledge is defined as literally having knowledge of the erroneous item itself. Knowledge of the source of the erroneous item or reason to know of the existence of the erroneous item is not sufficient to establish an inference of actual knowledge. However, having actual knowledge of the tax treatment of such erroneous item or how it was reported on the tax return does not need to be proven in order for actual knowledge to exist. If a spouse had knowledge of an erroneous item, even if that spouse did not know such item was taxable, then actual knowledge is deemed to exist.

The IRS is permitted great latitude in determining whether actual knowledge of an erroneous item existed. For example, the IRS may take into account whether the spouse seeking relief made a deliberate effort to avoid having knowledge of such item, in order to be shielded from liability. The IRS also takes into consideration ownership of the property resulting in the erroneous item, and whether it was owned jointly or individually. However, if the innocent spouse can prove all or a portion of the tax deficiency is not attributable to him or her, such proof is sufficient to shift that portion of the liability to the other spouse.

As with innocent spouse relief, evidence of fraudulent schemes or property transfers entered into for the purpose of tax avoidance is sufficient to preclude relief in a separation-of-liability claim. A transfer of property between spouses within one year of the IRS issuing a notice of deficiency is a rebuttable presumption that such transfer was for the purpose of avoiding taxes. Naturally, such a presumption does not apply if the transfer was made pursuant to a divorce decree, separate maintenance agreement, or other similar written instrument.

The third and final form of relief is a “catch-all” only available to spouses who do not qualify for either innocent spouse relief or separation of liability. Unlike innocent spouse relief and separation of liability, equitable relief is a remedy that is available for both understatements of tax and underpayments of tax. If relief was denied under either of its counterparts due to fraudulent schemes or tax avoidance, then a remedy under equitable relief is precluded as well. Equitable relief also requires that the tax liability, for which relief is being sought, be attributable to the nonseeking spouse. A tax liability that is attributable to the spouse seeking relief is grounds for denial under equitable relief, unless that spouse can prove domestic abuse or duress was the cause of such liability being attributable to him or her.

Historically, that was where equitable relief ended, with some additional facts-and-circumstance tests and consideration of actual and constructive knowledge in determining whether to grant relief. However, time and again, determinations were being made based upon a set of criteria, with the result being unfair and inequitable—contrary to the purpose of I.R.C. § 6015. Or, conversely, relief was being granted, but too late to prevent the innocent spouse from enduring economic hardship.

A series of IRS notices and regulations issued thereafter and, in 2013, Rev. Proc. 2013-34 laid out guidelines for “streamlined” procedures and allowed claims for equitable relief to be divided into two categories: those on the fast-
track (streamlined) and standard claims (nonstreamlined).

If a claim is placed in the streamlined category, relief is almost always granted, and the claimant has successfully shown that: (1) the spouses are divorced, legally separated, or have not been members of the same household for the preceding twelve months; (b) economic hardship will result to the innocent spouse if relief is not granted; and (c) the innocent spouse did not know of the deficiency or did not have reason to know the spouse would not, or could not, pay the deficiency.

While Rev. Proc. 2013-34 devised a welcome solution to the hardships being faced by spouses now eligible for the streamlined proceedings, the substantive alterations to I.R.C. § 6015(f) really occurred with respect to “non-streamlined” cases. The new provisions have created more of a balancing test, rather than a set of rigid criteria, to determine whether holding both spouses liable is fair and equitable. The IRS considers the following factors in its analysis:

1. Whether the spouses are divorced or legally separated and, if separated, whether the separation is temporary and it is reasonable to assume that the absent spouse will return;
2. Whether the spouse seeking relief will suffer a significant economic hardship if relief is not granted;
3. Whether any legal obligations exist, pursuant to a divorce decree or separation agreement, requiring one spouse to pay the tax (However, this factor may not be considered if it can be shown that the spouse seeking relief knew, or had reason to know, that his or her former spouse would not pay the tax liability);
4. Whether a significant benefit, beyond normal support, as a result of the unpaid tax or item causing the tax understatement, was received;
5. Whether a good faith effort to comply with federal income tax laws was made, not only in the year for which an error or omission occurred, but in subsequent years as well;
6. Whether the spouse seeking relief knew or had reason to know that the items causing the understatement or tax would not be paid.

The increased awareness of spouses suffering in abusive or domineering relationships, and the subsequent hardships they faced in attempts to meet the standards for relief, are set forth not only in the newly implemented streamlined procedures, but also in the “weight” accorded to each of the factors considered in the nonstreamlined test.

### Domestic abuse

Rev. Proc. 2013-34 unequivocally directs the IRS to place greater weight on spouses who have suffered from domestic abuse, to the point of negating other factors that previously would have been sufficient for denial of relief. This factor also influences consideration of other criteria, such as the ever-important “actual knowledge.” Where a spouse had actual knowledge but did not challenge it due to fear of retribution by the other spouse, such actual knowledge does not create an automatic preclusion of equitable relief.

Additionally, Rev. Proc. 2013-34 sets forth minimum standards of income, expenses, and assets to take into consideration when considering whether economic hardship would result in the event of a denial. New, too, is that if this question is answered in the negative, the nonexistence of economic hardship is now merely a neutral factor; whereas, prior to Rev. Proc. 2013-34, such nonexistence would weigh against other positive factors. Likewise, where there is no evidence of domestic abuse, yet there is a finding of actual knowledge on the part of the spouse seeking relief, such knowledge is no longer weighted more heavily than other factors, as it was previously.
Statute of limitations

Formerly, claims for equitable relief had to be filed within two years of receipt of a notice of deficiency (a time limitation which still exists for innocent spouse relief and separation of liability claims). In 2011, the IRS issued Notice 2011-70, which extended the time limitations to equal that of the IRS’s collection deadline: ten years after assessment of the liability. This was an important change and a much-litigated issue prior to its implementation. Failure to meet the statute of limitations is grounds for automatic preclusion from relief.

In addition, for those spouses who were previously denied equitable relief due to failure to meet the two-year statute of limitations, Notice 2011-70 provides transitional rules intended to cure these denials. The new transitional rules provide that spouses who were previously denied due solely to failure to file within two years now have the opportunity to refile those claims. For spouses whose claims were litigated and a final judgment was rendered, where the judgment was solely due to expiration of the statute of limitations, the IRS will no longer seek to collect on that judgment. Finally, future requests for equitable relief are also permitted, regardless of the date on which the IRS first attempted to collect a deficiency.

Aside from the statute of limitations accorded to spouses seeking relief, it also is important to consider the statute of limitations that limits the IRS’s ability to take action against a taxpayer. There are two basic statutes of limitation: a three-year limit (from the date of filing the tax return) imposed on the IRS to assess an additional tax (I.R.C. § 6501(a)) and a ten-year statutory collection period (I.R.C. § 6502(a)).

The three-year statute of limitations has two significant exceptions: first, that it may be extended to six years if the taxpayer has omitted more than 25% of his or her gross income and, secondly, that there is no statute of limitations where a tax return has not been filed. The ten-year collection period does not begin to run until the last tax assessment for that particular return is made. Innocent spouse claims have a secondary effect on the statute of limitations imposed on the IRS: filing an innocent spouse claim actually suspends (and ultimately extends) the statute of limitation until the IRS notifies the taxpayer that the claim has been denied and for sixty days thereafter.

The statutes of limitations imposed on the IRS with respect to action against a taxpayer are important to consider in conjunction with innocent-spouse-relief claims. The length of time the IRS has remaining to assess and collect tax deficiencies may have an impact on its decision to approve or deny an innocent-spouse-relief claim.

Refunds

Like the statute-of-limitation issue, equitable relief was also revised to include provision for refunds. Spouses who are granted relief are eligible for refunds for any separate payments made after July 22, 1998, if the spouse can prove that he or she provided the funds used to make the tax payment for which a refund is sought. However, any tax payments made with the joint return, as a joint payment, or as a payment by the wrongdoing spouse, are not eligible for refunds.

Refunds are subject to some rather narrow time limitation rules, however. The amount of refund available is determined based upon the length of time that has passed since the filing of the return. If relief is requested within three years of filing, the refund may not exceed the portion of the tax paid within the three years before filing a request for relief. If the request for relief is made subsequent to the three-year period, but within two years from the time the tax was paid, then the refund may not be more than the tax paid within the two years immediately prior to the year in which a request for relief was filed.

Conclusion

The modifications to equitable relief set forth in the last few years are a clear indicator that the IRS, and the nation as a whole, has realized that the stringency of former regulations too often resulted in unfair and inequitable outcomes. With a nation now topping a 50% divorce rate, it became clear that spouses were frequently uninformed as to their true financial pictures until commencing divorce proceedings, by which time the statute of limitations had often run out. The new guidelines and regulations are a step in the right direction.

While innocent spouse relief and separation of liability have not undergone drastic changes, they are still available and, in the event such claims are denied, the newly revised equitable relief remedy is now truly a “catch-all,” intended to capture those claims that should fairly and equitably be granted. Implementation of these guidelines is still in its infancy, but with the transitional rules in place, it is to be hoped that those real claims truly are considered in a fair and equitable fashion. FA
“Family Support,” the new genre for unallocated child support and spousal support (alimony/maintenance) is a permissible tax-savings vehicle under the Internal Revenue Code (I.R.C.). It can, under certain circumstances, provide a considerable income tax benefit for both parties and their children: less paid to Uncle Sam and more available for the family as a whole. Family law attorneys and judges alike should be aware of its advantages, the required conditions for it, and its potential pitfalls and traps. Family law practitioners and courts must also be cognizant of the specific law in their own states as some seemingly mandate child support in an allocated amount in accordance with their child support guidelines. However, state courts have traditionally ordered unallocated support, and most state guidelines allow deviation for income tax considerations or to achieve an equitable result. Saving income taxes for the benefit of the parties and their children would certainly appear to be an “equitable result” and arguably satisfy either factor.

**Basic concept**
Essentially, family support is the unallocated or undifferentiated combination of a child support and spousal support award. Under the I.R.C., and presuming the requisite requirements are met, the entirety of the family support amount can be deductible by the payor and includible as taxable income to the payee. Usually, the payor is in a higher (sometimes vastly higher) tax bracket than the payee. In such case, a tax savings results when the payor receives the full deduction for family support at his or her higher income tax rate and the payee includes such support as income at a lower income tax rate. In practice, payor former spouses love this concept, albeit payee former spouses must be convinced of its advantages. This generally is accomplished by simply “doing the math” evincing the tax savings.

**Historical perspective**
In understanding the policy and intent of Congress and the I.R.C. regarding treatment of unallocated support, a brief synopsis of the historical background is helpful. Sections 22(k) and 23(u) of the I.R.C. of 1939 (as amended by the Revenue Act of 1942) defined taxable alimony as “…periodic payments… received… in discharge of… a legal obligation which, because of the marital or family relationship, is imposed upon or incurred by [the payor spouse] under… a written instrument incident to” a divorce.

The I.R.C. of 1954 contained similar language. The general rule of the Revenue Act requiring inclusion in the recipient’s income excluded “that part of any such periodic payment which the terms of the decree or writing instrument fix, in terms of an amount of money or a portion of the payment, as a sum which is payable for the support of minor children.” See section 22(k), I.R.C. of 1939; section 71(b), I.R.C. of 1954.

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ALIMONY RECAPTURE

By KATHLEEN A. HOGAN

The fact that alimony is typically deductible to the payor and taxable to the recipient sometimes offers an opportunity to reduce the combined tax burden of the parties because the effect is to have dollars taxed at the alimony recipient’s lower rate, rather than at the payor’s higher rate. That, of course, leads the IRS to suspect that attempts may be made to make a property settlement payment deductible by loading cash payments into the first year or two after the divorce, but calling those payments alimony.

Under Internal Revenue Code (I.R.C.) § 71, recapture requirements apply if what the IRS defines as “excess” alimony payments, also commonly known as “maintenance” or “spousal support,” are front-loaded into the first three post-separation years.” Recapture in this context means the IRS recaptures the previous tax benefit in this way: The payor is taxed on the “recapture” amount as ordinary income, although he or she clearly does not receive any sum of money as a result of the recapture. In short, the payor is taxed on income he or she did not receive. By contrast, the payee receives a deduction for the “recapture” amount in that same third post-separation year. Although three calendar years of payments are compared for purposes of the computation, the recapture tax adjustment occurs only in the third year, according to IRS regulations. This affects the return that is subject to adjustment, but does not mean that the limitation period for adjustments is any different than for other tax adjustments.

Obviously, the goal for the family law practitioner is not to prepare the client for the recapture, but to craft an alimony award that does not create a recapture issue. The easiest way to avoid the recapture problem is to understand the types of payment patterns that will trigger the problem and thereby understand what payment amounts or terms must be avoided in any given case.

The recapture computation contains many traps for the unwary—even beyond its mere existence. Keep in mind that the recapture computation refers to three calendar years. The first post-separation year for recapture purposes will typically be the calendar year in which the divorce judgment is entered, no matter what month of the year that might be. As a result, if a divorce judgment calling for the payment of alimony was entered June 30, 2014, the “first post-separation year” for IRS purposes includes only the remaining six months of 2014. By contrast, lawyers and courts negotiate or order alimony and finalize judgments that may take effect at any time during a given calendar year. Such agreements and judgments typically peg a payment duration as running from the date of the judgment and not on a calendar-year basis. As a result, if that same judgment calls for alimony of $3,000 per month for one year, for purposes of the recapture calculation, the payment in the first post-separation year will be only the amount paid in calendar year 2014, and not the entire amount of the “one year” alimony obligation.

As well, keep in mind that the eventual recapture calculation will apply to the payments actually made and not to the payment stream that was negotiated or ordered. Calculations in advance can and should be done to determine whether a problem is being built into the agreement. However, in carrying out that agreement or order, the client can lose the benefit of that careful planning by making advance payments or failing to make the required payments. As well, if the payor seeks and obtains a termination or downward modification of the payment obligation prior to the conclusion of the three-year period, that modification could trigger a recapture issue, even if there would have been no such issue under the original order. The fact that the payor suffered a severe illness or injury or has other legitimate basis for modification will not affect the calculation.

In many cases, where alimony is paid, there may have been interim or temporary alimony payments made during the pendency of the action or during some other time period prior to the final divorce judgment. No recapture analysis applies to such payments, regardless of amount or duration. Payments during that time period also do not “count” in calculating either the amount or the duration of the post-divorce payment stream for recapture purposes.

Fortunately, only the first three post-divorce calendar years are relevant under the recapture provisions of the tax code. No further recapture analysis takes place, even if there is a sharp drop or total elimination of alimony payments after the third post-divorce year.

Even though the purpose of the recapture provision was to avoid property division payments disguised as alimony, the recapture analysis is in the nature of an absolute rule. It is not merely a presumption that can be overcome by demonstrating that the payment terms were based on other legitimate spousal-support-related considerations. The only two exceptions to this absolute rule are (1) when payments cease as a result of a death or remarriage, or (2) when payment fluctuations are not within the control of the payor. An example would be an obligation that requires payment of a fixed percentage of the payor’s income, rather than a fixed-dollar amount.

RECAPTURE COMPUTATIONS

The statutory language describing the computations necessary to determine if there is a recapture issue is lengthy and, to many readers, will sound confusing. The IRS also provides a worksheet for performing the calculations in IRS Publication 504:

1. Alimony paid in 2nd year
2. Alimony paid in 3rd year
3. $15,000
4. ______
5. ______
6. ______
7. ______
8. ______
9. ______
10. ______
11. ______
12. ______
13. ______
14. ______

*If alimony was deducted, this amount must be reported as gross income. If alimony was received, this amount is deducted.

An even easier solution is to create a template in Excel or another spreadsheet program to perform the calculations. For those who may be computer “challenged,” a number of such templates are also available online and from commercial sources.
Continued from page 27

In 1961, the U.S. Supreme Court rendered Commissioner v. Lester, 366 U.S. 299 (1961). In Lester, the divorce agreement provided for the periodic payments to be reduced by one-sixth after each of the parties’ minor children married, became emancipated, or died. The Commissioner interpreted the I.R.C., and held that “[t]he agreement must expressly specify or ‘fix’ a sum certain or percentage of the payment for child support before any of the payment is excluded from the wife’s income.” (Italic’s added) In so holding, the Court noted that the stated intent of Congress was that if the periodic payment “amount paid to the wife includes the support of children, but no amount is specified for the amount of the children, the entire amount goes into the income of the wife.”

Accordingly, the U.S. Supreme Court provided family law attorneys and judges flexibility in crafting child support and alimony awards to effectively “disguise” child support as alimony for income tax purposes. While such flexibility still persists, Congress tweaked the rules in the Deficit Reduction Act of 1984 and the Tax Reform Act of 1986.

Present position of I.R.C.

Currently, and not unlike before, section 71(a) of the I.R.C. states the general rule that “[g]ross income includes amounts received as alimony or separate maintenance payments.” Correspondingly, section 215(a) of the I.R.C. allows “as a deduction an amount equal to the alimony or separate maintenance payments paid during [an] individual’s taxable year.”

Also, like before, section 71(c)(1) of the I.R.C. provides that the general rule of inclusion by the recipient as income: [S]hall not apply to that part of any payment which the terms of the divorce or separation instrument (in terms of an amount of money or a part of the payment) as a sum which is payable for the support of children of the payor spouse.

However, unlike before, the I.R.C. now articulates in section 71(c)(2) that for purposes of section 71(c)(1) and whether a payment is for the support of children, if any amount specified in the instrument will be reduced (1) on the happening of a contingency specified in the instrument relating to a child (such as attaining a specified age, marrying, dying, leaving school, or a similar contingency) or (2) at a time which can clearly be associated with such a contingency, then the amount equal to the sum of such reduction will be treated as an amount fixed as payable for the support of children of the payor spouse. In other words, in such event, the amount so fixed shall not be includable in the recipient’s income or deductible by the payor, notwithstanding the delineation of the full payment as family support or unallocated support.

Moreover, while the I.R.C. does not define the phrase “clearly associated with,” Temporary Regulations provide two rebuttable presumed situations. One is when the payments are to be reduced within six months of the date a child attains age 18, 21, or the local age of majority. The second is when payments are to be reduced on two or more occasions that occur not more than one year before or after a different child of the payor spouse attains a certain age.

When is alimony taxable/deductible?

The term “alimony” as commonly used in state statutes (also called spousal support or maintenance) is not the same as “alimony” expressed in the Internal Revenue Code. (I.R.C. § 71). As described in section 71, alimony is taxable to the recipient spouse or former spouse and deductible to the payor spouse or former spouse.

To qualify as alimony under the Code, a stream of payments—and a separate stream of payments can have different tax effects—need not be for spousal support. Payments can be for a property buyout as long as they meet the requirements of the Code. Those requirements are:

1. Payments must be cash to or on behalf of the recipient spouse or former spouse. (The terms “spouse” and “former spouse” are hereafter interchangeable.)
2. Pursuant to a divorce or separation agreement.
3. Payments must not be designated as not taxable to the payee and not deductible to the payor. (Thus, the stream of payments can be designated as nontaxable/nondeductible.)
4. If the status of the marriage has changed (i.e., the parties are divorced or legally separated), the parties must not be members of the same household.
5. Liability for payments must cease upon the death of the payee.
6. Payments must not be fixed as child support.
7. The parties cannot file a joint tax return. Should the parties do so, the alimony deduction cannot be taken.

Although not a requirement, an important caveat to consider are the excess front-loading rules, which will cause unexpected recapture of income. (See page 28.) Payments to a spouse or former spouse must be in cash, which includes checks and money orders. Payments also may be made directly to a third party as long as they are for the benefit of the spouse—but not the payor. For example, payments may go directly to the spouse’s health-care provider or educational institution.

For a more in-depth look at the tax deductibility of alimony, see “Make the Tax Code Your Friend—and Alimony More Palatable” by Christopher C. Melcher, Family Advocate 34:03, p. 16 (Winter 2012).

— Melvyn Frumkes
between the ages of 18 and 21, inclusive (with the “certain age” being the same for each child), but need not be a whole number of years.

The second presumption is clearly confusing. In October 2013, the I.R.S. issued Publication 504 to now provide the second presumption applies when the “payments are to be reduced on two or more occasions that occur not more than 1 year before or after a different one of [the] children reaches a certain age from 18 to 24,” which “certain age must be the same for each child, but need not be a whole number of years.”

The presumptions are overcome if the facts indicate that the time of the reduction in payments was determined independently of any contingencies relating to the children of the payor, such as the time selected is merely a “coincidence” that also falls near a child’s birthday. See section 1.71-1T(c), Q&A–18, Temporary Income Tax Regs. 49 Fed. Reg. 34451, 34457 (Aug. 31, 1984). Publication 504 provides guidance by stating that if a taxpayer can show the period of alimony payments is customary in the applicable state, such as a period equal to half the length of the marriage, the presumption may be overcome.

I.R.S. not concerned with guideline amount

Presuming all conditions of section 71 of the I.R.C. for taxable alimony are met, including particularly those requisites contained in subsections (b) and (c) and the requirement for such payments to cease on the payee’s death (whether by express provision in the underlying judgment, decree, order, agreement, or pursuant to state law), and further assuming the laws of the applicable state permit for an award of family support, the Internal Revenue Service will permit the full deduction by the payor and require the full amount in the payee’s income. Such is true, notwithstanding the particular state’s child support guidelines and the guideline child support amount that may otherwise be required thereunder.

For example, in Lawton v. Commissioner, T.C. Memo 1999-243, a Pennsylvania temporary order provided “for support of spouse and one child” (i.e., family support). When tax time came, the wife claimed a portion of the support paid to her was not taxable to her or deductible by the husband, arguing all support awards must conform to the federally mandated child support guidelines. The tax court rejected her argument because I.R.C. section 71(c)(1) expressly requires that the amount of child support be specifically fixed by the “terms of the divorce or separation agreement,” and not outside of the instrument.

Similarly, in Simpson v. Commissioner, T.C. Memo 1999-251, the subject order directed the husband to pay $718 per month toward the support of his spouse and two children. No allocation was made between spousal support and child support. The wife excluded the support payments on her 1994 and 1995 income tax returns. She argued that despite the unallocated award, “the entire $718 per month should be attributable to child support because under Pennsylvania Support Guidelines…Mr. Simpson was required to pay $789 each month for the support of his two children” and therefore the entire $718 payment should be considered child support under section 71(c) for Federal income tax purposes.” The tax court disagreed, observing:

To determine whether any portion of the payment is child support, we look solely to the language contained in the court order itself. It is inappropriate, in light of [the] clear statutory language [of section 71(c)(1)], to look beyond the written instrument to examine what effects, if any, are made by operation of State law. If Congress had intended for us to look beyond the written instrument, it would have amended section 71(c)(1) to so reflect.

The foregoing rational and reasoning arguably would apply even if a family support obligation is subsequently modified. For instance, assume a family support order for a former wife and minor child is entered in 2005, and in 2007 the primary residence of the minor child is changed from the former wife to the former husband. Assume further the former husband successfully seeks to modify the child support component of the family support by showing what the child support guidelines amount would have been initially (and thus perforce the difference is “alimony”), such a modification should not “in the eyes” of the I.R.S. affect the taxability of the family support payments made prior to the modification because the I.R.S. should not look beyond the written instrument that was in effect when the payments were made.

Conclusion

If the state allows for such, and the court or the parties are contemplating an award of family support (a/k/a unallocated or undifferentiated support), it can and should be used to save the family income taxes, which can be considerable depending upon the parties financial circumstances. The taxes saved can be allocated between the parties or otherwise utilized for the benefit of the child(ren). Most, if not all, states have child support guidelines that provide and permit deviation in a variety of situations after consideration of a number of factors, including tax and equitable reasons. So long as the requisite set forth in sections 71(b) and (c) are met, the IRS will allow for the full payments to be deducted by the payor and includible as income by the payee, regardless of state child support guidelines. FA
The gross income of the payee typically includes alimony. I.R.C. § 71. Alimony is also an adjustment that reduces the gross income of the payor. I.R.C. § 215. Child support, however, is neither includable nor taxable. I.R.C. § 71(C).

Unallocated alimony and child support, sometimes called unallocated family support, allows all alimony and child support to be tax deductible to the payor, who is typically in a higher marginal tax bracket, and taxable to the payee spouse, who is typically in a lower tax bracket. The effect is to create more after-tax dollars for the family. Unallocated payments, however, do not make tax sense where the payee, as a result of the payments, will be in the same or in a higher marginal tax bracket than the payor.

For unallocated payments to be deductible, they must satisfy the requirements for deductible alimony:

1. The payment must be in cash or equivalent.
2. The payment must be made pursuant to a dissolution or a separation instrument.
3. The dissolution or separation instrument must not designate the payment as not includable in gross income or not allowable as a deduction from gross income.
4. If divorced or legally separated, the payor and payee must not be members of the same household at the time the payment was made.
5. The death of the payee must terminate the obligation to make the payment.

These requirements are somewhat technical and addressed elsewhere in this issue.

For unallocated payments to be fully tax-deductible care must be taken to avoid any portion of the payments being deemed child support. A portion of the payments will be deemed to be child support, and not deductible or includable from the outset, in three situations: (1) where the decree or agreement fixes a portion of the payments as child support; (2) where the payments are to reduce upon the happening of a contingency relating to a child; or (3) where the payments are to reduce at a time clearly associated with a contingency relating to a child.

If the intent is to make the entire stream of unallocated payments tax deductible and includable, the divorce instrument should not say how much of the unallocated payments is for child support. I.R.C. § 71 (C)(2).

The second situation is also easy to avoid. If the decree or agreement provides that payments are to reduce upon the occurrence of a contingency relating to a child, the amount of the reduction will be treated as fixed as child support, ab initio. The following contingencies relate to a child and would result in the reduction being deemed as fixing child support:

1. The child’s attaining a specified age or income level;
2. The child’s dying;
3. The child’s marrying;
4. The child’s leaving school;
5. The child’s leaving the payee’s household; or
6. The child’s gaining employment.

Temp. Reg. § 1.71-1T(C), Q-17.

To avoid some of the unallocated payments being deemed nondeductible and nontaxable child support, neither the
agreement nor the judgment should provide for a specific reduction in the unallocated payments upon the occurrence of any of those six events.

The third situation is somewhat arcane and more difficult to avoid. If a decree or agreement provides that payments will reduce “at a time which can clearly be associated with a contingency relating to a child,” the amount equal to the reduction will be considered child support and, as a result, not deductible by the payor and not taxable to the payee. I.R.C. § 71(C)(2).

Payments will be presumed to be “clearly associated” in either of two situations:

1. Where payments are to reduce not more than six months before or after a child attains the age of 18, 21, or the local age of majority. Temp. Reg. § 1.71-1T(C), Q-18.

2. Where payments are to be reduced on two or more occasions that occur not more than one year before or after the children reach an age between 18 and 24 inclusive. Temp. Reg. § 1.71-1 T(C), Q-18.

Avoiding the loss of deductibility and taxability because of the six-month rule is easy. If the age of majority is 18, do not provide for a reduction between the time a child attains 17 years and 6 months of age and 18 years and 6 months of age.

In the second situation, the child’s “age” need not be a whole number of years. For example, it could be 19 years and 7 months or 20 years and two months. Operation of the rule, as a result, is, at best, complicated. Helpful to avoiding it is an understanding of the rule’s rationale. The “evil” that the regulation seeks to avoid is a situation where the parties pick an “age” and agree to reduce payments at a time associated with that age.

The regulation illustrates the rule with the following example: The parties’ two children are Carl, born July 15, 1970, and David, born September 23, 1972. The dissolution-of-marriage decree obligates the payor to pay alimony of $2,000 per month until January 1, 1991, $1,500 per month thereafter until January 1, 1995; and $1,000 per month thereafter. On the date of the first reduction, Carl will be 20 years and 5 months old. On the date of the second reduction, David will be 22 years and 3 months old. Thus, each reduction occurs within one year of David’s and Carl’s attaining the age of 21 years and 4 months. As a result, the reductions will be presumed to be clearly associated with a contingency relating to the children. Unless the presumption is rebutted, only $1,000 per month will qualify as alimony. Plotting the children’s ages, the question of the age at the time of each reduction, and their ages plus and minus 12 months at the time of each reduction may aid in understanding the rule. (see chart)

Unallocated alimony and support, if carefully employed, can minimize the family’s total income taxes. That result can usually be achieved only through settlement because courts are, in many jurisdictions, required to make child support payments terminate upon a child’s attainment of the age of majority. As a result, a potential unintended consequence of the child support rules may very well be to promote settlement. However, the complexity of escaping the child support rules undoubtedly discourages many from even attempting to achieve unallocated alimony treatment for alimony and support payments.

The presumption that arises when payments reduce within six months of a child’s attaining the age of majority or when payments reduce within one year of two children attaining an age between 18 and 24 may be rebutted by “showing that the time at which the payments are to be reduced was determined independently of any contingencies relating to the children.” Temp. Reg. § 1.71-1T(C). If there is a rationale for reducing the payments unrelated to a child, the divorce instrument should so state. In addition, “[t]he presumption in the first situation will be rebutted conclusively if the reduction is a complete cessation of alimony or separate maintenance payments during the sixth post-separation year… or upon the expiration of a 72–month period.” Treas. Reg. § 1.71-1 T(C) Q-18. A post-separation year begins with the first calendar year in which a payor pays alimony, excluding temporary payments, Id. Q-22. The presumption also may be rebutted in other circumstances; for example, by showing that alimony payments are to be made for a period customarily provided in the local jurisdiction, such as a period equal to one-half the duration of the marriage if that is the local practice. Temp. Reg. § 1.71-1T(C).

In some cases, it may be impractical to time reductions so as to avoid them being deemed “clearly associated” with a contingency associated with a child. If there are many children in the family and they are close in age, the only way to avoid the presumption could well be to have reductions when the oldest child is significantly less than 18 or the youngest is significantly older than 24 or both.

There are some less than perfect “solutions” to situations where the clearly associated rules cannot be satisfied. One solution is to provide for level payments of unallocated alimony and child support with the stream modifiable upon a substantial change in circumstances. In other words, the agreement would not specify the amount of any reductions. The agreement would, in that situation, define

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### PLOTTING AGES & REDUCTIONS

<table>
<thead>
<tr>
<th>Date of Birth</th>
<th>Carl</th>
<th>David</th>
</tr>
</thead>
<tbody>
<tr>
<td>1st reduction: 1/1/91</td>
<td>7/15/70</td>
<td>9/23/72</td>
</tr>
<tr>
<td>Age at 1st reduction</td>
<td>20 yrs. 5 mos.</td>
<td>18 yrs. 3 mos.</td>
</tr>
<tr>
<td>+ 12 months</td>
<td>21 yrs. 5 mos.</td>
<td>19 yrs. 3 mos.</td>
</tr>
<tr>
<td>- 12 months</td>
<td>19 yrs. 5 mos.</td>
<td>17 yrs. 3 mos.</td>
</tr>
<tr>
<td>2nd reduction: 1/1/95</td>
<td>24 yrs. 5 mos.</td>
<td>22 yrs. 3 mos.</td>
</tr>
<tr>
<td>Age at 2d reduction</td>
<td>25 yrs. 5 mos.</td>
<td>23 yrs. 3 mos.</td>
</tr>
<tr>
<td>+ 12 months</td>
<td>23 yrs. 5 mos.</td>
<td>21 yrs. 3 mos.</td>
</tr>
</tbody>
</table>
Unallocated alimony and support, if carefully employed, can minimize the family’s total income taxes

A child’s attainment of age 18 or any or all contingencies relating to a child-related event as a substantial or material change in circumstances sufficient to trigger modification. Because both the amount of the reduction of alimony and support and the timing of the reduction would be uncertain, one would expect that the reduction would not be deemed to have been fixed as child support.

A few caveats are in order. First, care should be taken in detailing the circumstances that would trigger modification and the factors the court should consider in hearing the modification. Second, this approach leaves the parties with uncertainty and with an increased likelihood of further litigation.

Another solution is to make the stream of unallocated alimony and child support subject to renegotiation by the parties upon a child’s attainment of age 18 or any of the child-related contingencies. Similar care should be taken to detail the circumstances that would trigger renegotiation and the factors to be considered by the parties in renegotiating the level of payments, or the court, if renegotiation is unsuccessful. The same caveats apply to this solution.

Yet another approach is to avoid defining amounts of unallocated alimony and child support as a dollar amount. Instead, alimony and support would be a percentage of gross earned income, which would increase and decrease as income fluctuates. The percentage would, by terms of the agreement, reduce when a child attains majority or a child-related contingency. Because the dollar amount of child support or of the reduction is not specified, payments should be fully deductible. There are problems with this solution, as well. Neither the payor nor the payee will be able to rely upon the amount of alimony and support being stable. Documentation should be required and, depending upon the complexity of the payor’s employment, can be frequent and sometimes onerous. Finally, while the Code expressly exempts from its recomputation rules payments that fluctuate outside the payor’s control because they are a percentage of the payor’s income or compensation, I.R.C. § 71(f)(5)(C), there is no similar provision about the clearly associated rules.

Of course, sometimes unallocated payments don’t make enough tax sense to justify the effort involved in negotiating and drafting them. Counsel should consider that, where small payments are involved, shifting the dependency exemption for a child can achieve the same tax result as characterizing a similar amount of child support as “alimony.” Thus, it may be wise, where the amounts are small, to avoid complication and uncertainty and simply shift one or more exemptions, which is $3,950 per child per year in 2014, and will likely increase each year.

In short, ensuring that unallocated payments are fully tax-deductible and includable requires effort in many cases. In some cases, achieving that end may not be worth the effort. In some cases, counsel should consider alternative solutions to the traditional reductions at or near each child’s attainment of the age of majority. FA

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In divorce cases, the court is required to determine the amount of child support that parents must pay, and the amount of spousal support/alimony/maintenance that spouses or former spouses must pay. These determinations require a calculation of the amount of income that is available to a party for support. When a support litigant has an ownership interest in a business, the judicial officer must determine the litigant’s “business income available for support” (BIAS).

“Phantom income” is created when an owner of a business is required to report and pay tax on his or her proportionate share of income generated by the business, but the owner does not actually receive all of that income.

Either litigant—payor or recipient—may have BIAS. For ease of reference, let’s consider the calculation of “Patrick Payor’s” BIAS. A judicial officer calculating “Rene Recipient’s” BIAS would perform the same factual analyses and apply the same legal principles.

Patrick Payor, whether a partner, an LLC member, or a subchapter S corporation shareholder, is required to report his proportionate share of the entity’s taxable income on an individual Form 1040, and is required to pay income tax on this “pass-through income.” This is true whether all (or any) of the pass-through income actually has been distributed to Payor. That portion of the pass-through income that has not been distributed to Payor is called “phantom income.”

**Taxable income versus cash flow**

Understanding the distinction between Payor’s cash flow (money that is available for support) and income (an accounting determination, which does not necessarily reflect money available for support) is important when analyzing phantom income. Family law attorneys and forensics have been accused of blurring the distinction between income and cash flow. In *In re Marriage of Riddle* (2005) 125 Cal. App. 4th 1075, 1080, the California Court of Appeal, dealing with the determination of a litigant’s ability to pay child and spousal support, stated:

While we recognize that family lawyers and forensic accountants sometimes use the phrase “cash flow” as a sloppy synonym for the word “income” as it appears in the support statutes, it isn’t.

Pass-through income can cause Payor’s cash flow and taxable income to differ drastically. Payor’s pass-through income (i.e., pro rata share of pass-through entity profit) comes within the definition of “gross income” under Internal Revenue Code (I.R.C.) section 61.
The I.R.C.’s definition of gross income does not address the issue of whether sums Payor is required to recognize as income for tax purposes represent funds that are actually available to Payor for the payment of child or spousal support. The fact that monies are available for support doesn’t necessarily mean they are taxable as income, and the fact that monies are taxable as income doesn’t necessarily mean they are available for support. Differences between tax law and support law may be illustrated by two examples: municipal bond interest and phantom income.

Municipal bond interest is not taxable to Payor, but is available to satisfy Payor’s support obligation. The $10,000 in municipal bond interest that Payor receives during a given tax year will be available for support payment purposes despite the fact that it is not subject to income taxation.

Family law attorneys and forensics have been accused of blurring the distinction between income and cash flow

Phantom income is taxable to Payor but unavailable to pay Payor’s support obligation. If during a given tax year, Payor is required to report $10,000 in pass-through income, but receives no distributions from the business, his tax return will show $10,000 in income, but none of it will be available to pay support.

When income generated by a business is not fully distributed to the owner, a careful analysis must be done to determine why. If the Payor has manipulated distributions by the pass-through entity to artificially reduce his BIAS, it may be appropriate for the court to consider the phantom income that monies are taxable as income doesn’t necessarily mean the fact that monies are available for support doesn’t available to Payor for the payment of child or spousal support. The fact that monies are taxable as income doesn’t necessarily mean they are available for support. Differences between tax law and support law may be illustrated by two examples: municipal bond interest and phantom income.

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Beware the Tax Traps of U.S. Savings Bonds

Many people have acquired U.S. Savings Bonds during their marriages. The bonds represented a secure way to save for the future, with some added advantages. Interest on the bonds is exempt from state income tax. Typically, interest on Series E and Series EE United States Savings Bonds is not subject to current taxation because, although interest accrues, it is not paid until the bond is redeemed, and the tax on the interest can be deferred until the bonds are redeemed. However, the division of Series E or Series EE U.S. Savings Bonds represents a tax trap for the unwary in connection with a divorce. Under section 454(c) and regulation 1.454-1(a), the increase in redemption value of the bond must be included in gross income for the taxable year in which the bond matures, is redeemed, or is disposed of, unless the taxpayer reports the interest income each year. Counsel should inquire whether the parties reported the interest on the bonds as income as it accrued, but that seldom occurs.

Lawyers and clients who overcome the hurdle of assigning a value to the bonds—keeping in mind that neither the face value nor the original purchase price is likely to be the actual current value—may mistakenly assume they have no other difficulties to address. The remaining tax trap arises out of the nature of the bond’s appreciation in value: it is accrued interest income not capital gain. The concept is that income is taxed to the person who earns it, and that one who has accrued the right to receive income cannot avoid the taxes by an assignment of the right to receive that income to another.

This principle comes from the United States Supreme Court case of Lucas v. Earl, 281 U.S. 111 (1930), and has been repeated in subsequent decisions and in IRS regulations, § 1.454-1(a). The trap for the unwary is that the assignment-of-income principles apply not just to employment earnings, but also to other types of income, such as interest or dividends that may be accrued but not yet received or taxed.

Under the assignment of income doctrine, the transferee remains obligated to pay taxes on the accrued income he or she has assigned. This trap with respect to U.S. Savings Bonds differs from the situation that arises when a savings account with accrued interest is divided in this key respect: the interest accrued in the typical savings account was taxed annually; by contrast, the interest accruing on the savings bonds has typically not been reported and taxed.

In Rev. Rul. 87-112, the IRS addressed the transfer of Series E and EE bonds to a former spouse incident to a divorce. The conclusion of that Revenue Ruling is that § 1041, which operates to insulate from tax most property transfers incident to divorce, does not apply to the transfer of these savings bonds. The IRS noted that the income at issue was accrued but unrecognized interest rather than gain; therefore, section 1041 does not shield the income from recognition. In short, the transaction constitutes, in part, an assignment of accrued income rather than a transfer of appreciated property.

The Revenue Ruling used the example of a Wife who held Series E and EE bonds in her name and purchased entirely with her funds, with a maturity date after the date of divorce. She had not previously reported and paid the tax on any interest that accrued on the bonds. In connection with the divorce, she transferred the bonds to her former Husband who redeemed the bonds the following year. The Revenue Ruling concludes that the Wife must include in her income in the year of transfer the deferred accrued interest, from the date of the original issue of the bonds to the date of transfer. Husband’s newly acquired basis in the bonds was equal to the Wife’s basis in the bonds immediately prior to the transfer plus any income recognized by the Wife as a result of the transfer of the bonds. By contrast, the IRS indicated that the Husband would be required to include in his income only the deferred, accrued interest in the bonds from the date of the transfer from Wife to the date of his redemption of the bonds.

The problem is not entirely averted if the bonds were held by the spouses jointly and are transferred to one of them incident to the divorce. In that case, the spouse transferring interest in the bonds would be required to report his or her share of the accrued income up to the date of the transfer.

—Kathleen A. Hogan
income as available when determining Payor’s ability to pay support. As explained above, BIAS law must distinguish fraudulent nondistribution of profit from bona fide nondistribution of profit.

Some states begin with a presumption that support income is different from taxable income. Other states begin with a presumption that support income is the same as taxable income. As a prerequisite to understanding phantom income, the family law attorney should appreciate the differences between taxable income and cash flow.

**Others determine profit distribution**

What happens to phantom income as BIAS to Payor when the decision not to distribute profit was made by someone other than Payor? Consider the Maryland case of *Walker v. Grow*, 907 A.2d 255 (2006), in which the husband was the chief operating officer of a subchapter S corporation in which he held a 30% ownership interest. The issue on appeal was whether corporate phantom income should be included when calculating the husband’s appropriate level of child support. The court noted that the husband did not receive the phantom income because, as first and foremost, he was a minority shareholder and had no right to force the corporation to make distributions. However, *Walker v. Grow* places on Payor the burden of proving that he hasn’t manipulated business distributions in order to avoid his support obligation. If Payor carries that burden, his phantom income will not be included as BIAS.

It is common for a pass-through corporation to not be included as BIAS.

**On first glance, there seems to be no big difference between an IRA and a 401(k) in terms of dividing assets in a divorce case. Each is a relatively liquid individual account with an easily identified value. However, there are important distinctions between the two, and failing to understand and provide for those differences can lead to unexpected difficulties after the divorce is final.**

For the most part, employers sponsor 401(k) plans, and individuals (by definition) establish and fund IRAs (Individual Retirement Accounts). There is actually something known as a "Solo 401(k)," but this arrangement is very rare. There are also employer-sponsored IRAs, such as SEPs (Simplified Employee Plans). Suffice it to say that Solo 401(k)s are subject to the 401(k) rules, and employer-sponsored IRAs are subject to the IRA rules when it comes to division of these assets.

Fortunately, the QDRO provisions permit the tax-free transfer of 401(k) funds in divorce cases

Employers establish 401(k) plans in which their employees can participate, and into which the employer must contribute a defined amount for participating employees. Employees can add additional funds to match their employer’s contributions.

Employer-sponsored 401(k) plans are governed by ERISA and (not surprisingly) section 401(k) of the Internal Revenue Code (I.R.C.). As all family law attorneys know, it is ERISA that creates the need for QDROs. Under ERISA, retirement benefits are not assignable or transferable—the accumulated funds can only be paid to the employee (the Participant) and are protected against claims by creditors. There is an exception in ERISA and section 414(p) of the Internal Revenue Code, which permits the transfer of retirement funds through a Qualified Domestic Relations Order (QDRO) under certain circumstances in domestic relations matters.

**When QDROs can be used**

Most family law attorneys are under the impression that QDROs can only be used in divorce cases and only after a final decree has been entered. Actually, QDROs can be used in any domestic relations action, so long as the order is issued under state domestic relations law and the recipient of the awarded funds is a “spouse, former spouse, child or other dependent” of the employee. 29 U.S.C. § 1056(d)(3). QDROs can be entered before a divorce is final and for support and other nondivorce domestic relations actions.

The QDRO provisions of ERISA and the tax code create exceptions to both the rule against transferring retirement benefits and the tax penalties for the early withdrawal of retirement funds before reaching retirement age. If these exceptions did not exist, then 401(k) funds could not be transferred in divorce actions. To pay retirement funds awarded to their former spouses, Participants would have to withdraw funds from their 401(k)s and pay the former spouse directly in cash. If the Participant was under age 59½, then the withdrawal would be subject to a 10% early withdrawal penalty, along with mandatory withholding of 20% (and would ultimately be taxed at the Participant’s regular income tax rate for the year in which it was received). Without the QDRO provisions, withdrawals from 401(k)s in divorce actions would involve at least a 30% reduction off the top, which could end...
up even further reduced, depending on the income tax rate of the Participant.

Fortunately, the QDRO provisions permit the tax-free transfer of 401(k) funds in divorce cases. There is no tax or penalty to the Participant. The withdrawal to transfer funds to the former spouse (Alternate Payee) is not considered an early withdrawal and thus is not subject to the 10% penalty or to income tax. The funds transferred are taxable to the recipient, depending on when and in what form the Alternate Payee elects to receive them.

Once the funds are transferred from the Participant’s account, the Alternate Payee normally has the option to receive the funds in cash (which is subject to automatic 20% withholding for federal income taxes, and ultimately taxed at the Alternate Payee’s regular income tax rate for the year in which it was received). Alternatively, all (or any portion) of the funds can be rolled into an IRA or other retirement account. If the funds are rolled into an eligible retirement account and not paid in cash, the Alternate Payee will not be taxed on those funds until they are removed from the account once he or she reaches retirement age. Even if the funds are paid in cash, the Alternate Payee still has 60 days to transfer the funds into an eligible retirement account to avoid being subject to income tax—but this needs to be handled carefully. 26 U.S.C. § 402(a)(5)(A)-(C).

In contrast, IRAs are not subject to ERISA. The provision for the nontaxable transfer of IRA funds in connection with a divorce is found in the tax code at 26 U.S.C. § 408(d)(6). A transfer may be made to a spouse or former spouse under this section if pursuant to a decree of divorce or a written instrument incident to a divorce. The “written instrument” can be a separation agreement in connection with a divorce or a decree requiring payment of support to a spouse or former spouse.

A QDRO should not be necessary to transfer funds from an IRA in a divorce. A letter of instruction and copy of the final judgment and/or settlement agreement should suffice to transfer funds from an IRA in a divorce case. Many financial institutions that sponsor IRAs have simple forms to fill out to effectuate the tax-free transfer of funds in connection with a divorce. This is known as a “trustee-to-trustee transfer,” and it should not result in tax consequences to either party if it is clear that the transfer is incident to a divorce.

Although 401(k)s and IRAs have many of the same characteristics and may be treated interchangeably in many respects, their differences become significant in the divorce context.

To illustrate the differences

The case of Jim and Pam illustrates how the differences can create problems if not addressed properly.

Jim and Pam were divorced several years ago. Jim fell behind on his support payments, and Pam filed a contempt action against Jim to collect $100,000 in arrears. At the courthouse on the day of the hearing, the parties and their lawyers worked out a settlement in which Jim

would transfer the $100,000 to Pam from his 401(k) through a QDRO. They read their agreement into the record. The judge questioned both lawyers about the terms, and everyone stated several times that the transfer from the 401(k) would be handled by a QDRO. After the hearing, an order effectuating the oral agreement was submitted by counsel and entered by the court.

When Jim’s counsel attempted to prepare the QDRO, he realized that Jim’s 401(k) was really an IRA. This should not matter, right? Pam can still get her $100,000, so what difference does it make? At least the parties can save some money, since they won’t have the expense and delay of preparing a QDRO.

Well, from Pam’s perspective, it makes a $10,000 difference. These funds were for unpaid support. Pam made the deal under the impression that she would be receiving cash, which she needs immediately to pay off debts she incurred to support herself and the children while Jim failed to make support payments. With an IRA transfer, the funds will go directly into an IRA in her name. She will not have the opportunity to receive the funds in cash without being hit with a 10% penalty for early withdrawal, since she is only 43 years old. She understood when she entered into the agreement that she would have to pay taxes on the cash she received from the QDRO (initially 20% mandatory withholding, and ultimately adjusted to her income tax rate for the year). So, she expected to receive $80,000 once the QDRO was finished. However, since the funds are coming from an IRA, she will only receive $70,000 because of the additional 10% penalty.

A letter of instruction and copy of the final judgment and/or settlement agreement should suffice to transfer funds from an IRA in a divorce case.

Jim and his counsel took the position that he is still paying $100,000 to Pam, as agreed.

There are numerous other ways that parties can inadvertently run into problems when IRAs and 401(k)s are mistakenly treated interchangeably in divorce cases. Lawyers who remain aware of the differences between IRAs and 401(k)s, verify the type of account they are attempting to divide, and draft their agreements accordingly will avoid unpleasant surprises.

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entity to make a distribution to Payor only sufficient to pay the income tax liability on Payor’s pass-through income. A serious complication is created when there is pass-through income to be reported, but there are no distributions to the owner, or distributions are less than the tax on the pass-through income. Not only is the pass-through income not available for the payment of support, but also the taxes that have to be paid actually reduce cash that would have been available from other income sources.

Pass-through income

Consider the situation in which Payor is a medical doctor who is also a member of a partnership that owns the building where his practice is located. Assume that he has net after-tax earnings from his medical practice of $240,000 per year. Ignoring Payor’s ownership of the partnership interest, he would have net-after-tax income for support of $20,000 per month. However, as a partner, he must report and pay taxes on $100,000 in annual pass-through income from the partnership and, through no fault of his own, he received no distributions from the partnership.

Assuming a 36% tax rate, Payor will have to use $36,000 of his net after-tax medical practice income to pay the tax on the partnership pass-through income. As a result, Payor will not have $20,000 per month available to pay support; he will only have $17,000 per month as after-tax income available for support.

The issue before the Florida Supreme Court in Zold v. Zold, 911 So. 2d 1222 (2005), was whether phantom income should be considered income for purposes of calculating a husband’s child support, spousal support, and attorney’s fees. The husband was the 57% owner, and chief executive officer, of a subchapter S corporation. The trial court included husband’s entire pro rata share of the corporation’s net income, both distributed and undistributed, as BIAS. The Florida District Court reversed, noting that a subchapter S shareholder does not necessarily receive distributions equal to his proportionate share of the corporation’s net income because a portion of the corporate income may be unavailable for distribution. The Florida Supreme Court listed factors that a trial court should consider when measuring BIAS:

1. the extent to which the shareholder-spouse has access to or control over “pass-thru” income retained by the corporation…and (3) the purpose(s) for which the “pass-thru” income has been retained by the corporation. Although a shareholder-spouse’s ownership interest should be considered, it is not dispositive even where the spouse is a sole or majority shareholder in the corporation and has the ability to control the retention and distribution of the corporation’s income. Ownership of capital stock does not entitle shareholders to income that has been retained by an S Corporation because shareholders do not have a right to an interest in the corporation’s income…Thus, more important than the shareholder spouse’s ownership interest is the purpose for which the undistributed “pass-thru” income has been retained by the corporation. (Id., at p. 1233.)

Zold v. Zold echoes Walker v. Grow’s holding that Payor bears the burden of proving that the nondistribution of phantom income was bona fide. Zold v. Zold further holds that, even if Payor holds a majority interest in a business (and, thus, may decide how much pass-through income will be distributed), valid business obligations to creditors and employees may prevent distribution.

Necessary business capitalization

California’s In re Marriage of Blazer, 176 Cal. App. 4th 1438 (2009), concerned the spousal support obligation of a husband who owned a profitable agriculture brokerage company. Husband presented expert trial testimony that the agriculture brokerage industry was endangered because produce buyers and sellers were increasingly “cutting out the middle man” by contracting directly with each other. Husband’s expert testified that in order to remain viable, husband’s business needed to retain earnings and use them to invest in berry-growing operations (thereby expanding “down” into the production side of agriculture commerce) and buy warehouses (thereby expanding “up” into the distribution side of agriculture commerce). Wife argued that it was husband’s choice to spend the
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business profit in this fashion and that the business’s entire profit (unreduced by sums the business used to diversify) should be considered husband’s BIAS.

The trial court accepted the testimony of husband’s expert and found that earnings retained, then used to capitalize “vertical integration,” were reasonable expenses that should not be included in husband’s BIAS. The California Court of Appeal affirmed, noting the trial court’s findings that: (a) the company would not continue to exist if it did not diversify through vertical integration, and (b) funds spent for that purpose were “reasonable expenses” properly chargeable to the business, not to the husband.

Financial statements
Attorneys dealing with the issue of BIAS will analyze the business’s financial statements. A complete financial statement has three components:

1. **Balance Sheet.** The balance sheet provides a snapshot of business assets, liabilities, and owner’s equity at a given point in time.

2. **Income Statement.** The income statement reports revenues and business expenses for a given time period. The income statement provides a determination of net profit, usually before income taxes.

3. **Cash-Flow Statement.** The statement of cash flow converts the accrual basis of accounting used to prepare the income statement and balance sheet back to a cash basis. The cash-flow statement is important to be able to analyze the actual level of cash flowing into and out of the business.

Without seeing all three components, the practitioner will not have an accurate picture of what should be considered as BIAS. Occasionally, the family law attorney will encounter a balance sheet and income statement without an accompanying cash-flow statement. The attorney should insist on production, or generation, of the cash-flow statement. The cash-flow statement in many ways holds the factual “key” to BIAS analysis.

Expert testimony
The central issue in BIAS litigation is how much pass-through income should the business have distributed? Zold v. Zold teaches that the needs of business creditors and employees must be considered. In re Marriage of Blazer teaches that business capital-improvement and capital-investment requirements also must be considered.

A trial court will need expert testimony to properly evaluate these issues. The expert should be knowledgeable about operating expenses and capitalization needs within the particular industry. The litigation team presenting the more compelling expert witness testimony is likely to win the BIAS competition.

Conclusion
Although each jurisdiction’s precedent may contain different rules, certain phantom income principles are emerging:

1. Unless profit distribution has been manipulated to permit Payor to avoid paying support, phantom income isn’t BIAS because it isn’t “available” for payment of support.

2. The trial court must scrutinize business finances and practices to ensure that no manipulation has occurred.

3. To facilitate appellate court review, the trial court should make an express finding on the issue of whether manipulation has occurred.

4. Payor bears the burden of proving that the phantom income should not have been distributed.

5. Valid reasons for nondistribution of profit include obligations to creditors, duties to employees, and business capitalization requirements.

As family law attorneys, we should study the person and business tax returns as well as phantom income precedents and practices. We must understand the differences between taxable income and cash flow, as this is the only way to properly present what Business Income is Available for Support (BIAS)—and woe unto the hapless advocate who uses cash flow as a “sloppy synonym” for income.

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To understand income tax related to capital gains and losses, one must start with the definition of a “capital asset.” It is interesting to note that the Internal Revenue Code (I.R.C.) does not define what a capital asset is, but instead what a capital asset is not. Thus, an asset will be treated as a capital asset unless it falls into one of the following classifications:

1. Stock in trade or inventory held primarily for sale to customers in the ordinary course of the taxpayer’s trade or business, e.g., the goods and products for sale in a department store.

2. Property subject to depreciation, such as machinery and equipment and rental real estate. However, as with most sections of the I.R.C., there is an exception for rental real estate or real estate used in a trade or business that can result in the asset receiving “capital asset” treatment.

3. A copyright; a literary, music, or artistic composition; a letter or memorandum or similar property held by a taxpayer whose personal efforts created such property or for whom the letter or memorandum was prepared. For example, a novel’s transcript sold by the author, is not a capital asset. However, a letter written by the President of the United States to the Secretary of State, which is owned by an individual as an investment, would be a capital asset in the owner’s hand, but not in the president’s hand.

4. Accounts or notes receivable arising in the ordinary course of business from either the rendering of services or from the sale of inventory described in item one above. Thus, for family law practitioners, your accounts receivable from clients are not capital assets.


6. Any commodities-derivative financial instrument acquired by a dealer in the ordinary course of business.

7. Any hedging transactions; and

8. Supplies of a type generally used or consumed by a taxpayer in the ordinary course of business, e.g., pens and pencils within your office.
It is important to differentiate between capital assets and noncapital assets because under the I.R.C. they have different income tax treatment.

The most common capital assets encountered in family law cases are the divorcing couple’s portfolio of stocks and bonds and other similar financial types of investments, their principal residence, and perhaps a vacation residence or rental real estate. (Author’s note: capital gain aspects of vacation residences and rental real estate are beyond the scope of this article.)

An examination of the couple’s U.S. Individual Income Tax return—Form 1040, will reveal the existence of any short-term or long-term capital loss carry forwards and perhaps the sale of a prior principal residence if it occurred within the time frame of the tax return years being reviewed. These tax attributes need to be addressed in negotiating any settlement or presented to the court for proper adjudication and distribution.

Capital assets that are bought and sold by a taxpayer result in either a capital gain or a capital loss. Depending on how long the taxpayer holds (i.e., owns) the asset, the capital gain or loss can be classified either as “short term” or “long term.” Capital assets that are sold after being held by the taxpayer for less than one year result in “short-term” capital gains or losses. Capital assets held by the taxpayer for more than one year result in “long-term” capital gains or losses. More than one year means exactly what it says—holding an asset for one year and one day (366 days) is more than one year and results in “long-term” treatment when sold; whereas, holding an asset for exactly one year (365 days) results in “short-term” treatment.

**Why the distinction?**
Capital assets held by a taxpayer for more than one year and whose sale results in a gain receive favorable income tax treatment because, depending on the income levels of the taxpayer/seller, the gain can be taxed at rates ranging from 0% to 31.8%. Generally, long-term capital gains, depending on one’s tax bracket, are taxed at rates from 0% to 20%. However, a portion of long-term gains resulting from the sale of depreciated assets is taxed at 25%, and long-term gains resulting from the sale of collectibles and precious metals are taxed at 28%.

When one factors in the “net investment income tax” of 3.8%, applicable to those taxpayers with overall income, including investment income above $200,000 for single taxpayers and $250,000 for married taxpayers, you arrive at a potential maximum long-term capital gains tax rate of 31.8%. However, most taxpayers’ long-term capital gains are taxed at 15%. (The 3.8% net investment income tax referenced above was enacted as part of the Affordable Care Act (Obamacare), effective for taxpayers starting with the 2013 tax year.)

The gain on capital assets sold after being held for less than one year (depending on the income levels of the taxpayer/seller) can be taxed at rates ranging from 0% to 43.4%. These are the federal rates applicable to capital gains and do not take into consideration any state or local taxes that may be imposed on such gains.

All of a taxpayer’s sales of capital assets in a given tax year are recorded on his or her tax return. Short-term gains and losses are netted against one another and result

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**Sale of the Marital Residence**

In general, section 121 of the Internal Revenue Code (I.R.C.) provides for the exclusion of up to $250,000 of gain—$500,000 for married taxpayers satisfying the requirements summarized below—on the sale of a home owned and used as a principal residence by the taxpayer for two of the five years preceding the date of sale.

**Married taxpayers filing jointly qualify for the $500,000 exclusion under the following conditions:**

- The parties file a joint return for the year of sale.
- At least one spouse satisfies the two-out-of-five-years ownership requirement.
- Both spouses satisfy the two-out-of-five-years use requirement.
- Neither spouse is ineligible for the exclusion due to having used it during the two years preceding the date of sale.

A taxpayer is entitled to a prorated exclusion of a sale resulting from a divorce or legal separation or resulting from a change in employment or health problems.

If a taxpayer remarries and intends to sell a house with a gain exceeding $250,000, the following conditions must be satisfied for the parties to qualify for a $500,000 exclusion:

- The taxpayer’s new spouse must use the house as his or her principal residence for at least two years prior to the sale.
- The taxpayer and new spouse must file a joint tax return for the year of sale.
- The taxpayer and new spouse must file a joint tax return for the year of sale.
- The taxpayer’s new spouse must not have used the house as his or her principal residence for at least two years prior to the sale.

If a spouse is excluded from the principal residence by virtue of a “divorce or separation instrument,” the Code will 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 Code provides that an individual is treated as using the property as that individual’s principal residence during any period that the spouse remaining in the house is granted use of the principal residence under a divorce or separation instrument provided that the spouse or former spouse used the property as his or her principal residence.

—Melvyn Frumkes
in either a net short-term capital gain or a net short-term capital loss. Similarly, long-term gains and losses are netted against one another and result in either a net long-term capital gain or a net long-term capital loss. The net short-term gains or losses are then netted against the net long-term gains or losses, and the result is either an overall short-term or long-term gain or loss.

Any overall gain is taxed at either the rates applicable to short-term gains or long-term gains as explained in the previous paragraph. For example, suppose a taxpayer sold shares of Google that were owned for six months and resulted in a $10,000 short-term capital gain. Within the same year, the taxpayer sold shares of Microsoft that were owned for five years, which resulted in a long-term loss of $4,000. The taxpayer has a reportable net short-term capital gain of $6,000 ($10,000 short-term gain minus $4,000 long-term loss = $6,000 net short-term gain). Assuming the maximum tax rate, this net short-term gain results in $2,604 of income taxes ($6,000 x 43.4% = $2,604).

Now assume that the Google stock was held for two years, thus qualifying it for long-term treatment. The net gain of $6,000 would be classified as a net long-term gain. Assuming a very common 15% tax rate, $900 in income tax would be due, as opposed to the $2,604 above. The tax savings of $1,704 highlights the importance of the holding period.

**Deducting a capital loss**

What happens if a taxpayer’s overall capital transactions result in a net capital loss for the tax year? Although the IRS will tax one on an overall capital gain for the year, it does not allow a taxpayer to fully deduct all overall capital losses in one year. Capital losses are only deductible against other income, such as wages, interest, and dividends, at the rate of $3,000 per year. The balance of the capital losses are “carried forward” to be applied 100% against future capital gains, or they can be deducted against other income, but only at the rate of $3,000 per year. The unused capital loss carry forward is always applied to current year capital gains, before it is applied to other income.

Suppose, for example, that a couple has an overall capital loss for stock transactions of $30,000 within a tax year. For simplicity, let’s assume that all stocks qualify as long term. This couple is allowed to deduct $3,000 of this loss against other income. Assume that the couple’s wages and other income total $100,000. Only $3,000 of their capital loss is deductible against the $100,000 of other income, resulting in adjusted gross income of $97,000. The balance of the unused capital loss is deemed to be a “carry forward” to future tax years. The carry-forward amount is $27,000 ($30,000 of losses, minus the $3,000 used = $27,000 carry forward). Assuming no other capital transactions in future years, it will take this couple nine years to receive the full tax benefit of this capital loss carry forward ($27,000/$3,000 = 9).

As an additional example, assume in the same year as incurring a capital loss of $30,000, the couple realizes a $20,000 capital gain; the $20,000 gain can be offset against the $30,000 loss, resulting in a net capital loss of $10,000, which would then be subject to the same limitations to offset other noncapital gain income as in the previous example; $3,000 of the loss could offset other income, and the balance of $7,000 would be available to be carried forward to the next tax year.

One more variation—assume that the couple realizes a $40,000 capital gain in the same year as the $30,000 capital loss, the gain and loss would be netted, resulting in a net capital gain of $10,000; there would be no unused loss to be carried forward to the next tax year.

After the 2008 financial crisis, many taxpayers incurred capital losses involving hundreds of thousands of dollars. If a taxpayer has a $150,000 capital loss carry forward, at the rate of $3,000 per year, it will take 50 years to use this loss, assuming no subsequent capital gains.

Capital loss carry forwards are available to offset future capital gains before those gains are taxed. Assume, as another example, that a couple with the $150,000 capital loss carry forward realizes a $200,000 capital gain in a subsequent year. The capital loss carry forward of $150,000 will be fully applied to the $200,000 capital gain resulting in a net $50,000 capital gain. Whether that gain is short term or long term depends on how long the couple held the asset that resulted in the $200,000 gain. If they held the asset for one year or less, the gain will receive short-term capital gain tax treatment (maximum tax 43.4%). If they held the asset for more than one year, the gain will receive long-term capital gain tax treatment (maximum tax 31.8%).

So what should the family law practitioner consider when a divorcing couple’s investment portfolio includes an unused capital loss carry forward? Initially, when analyzing the division of an investment portfolio between husband and wife, determine if there are any unrealized gains or losses and what potential taxes may result from the ultimate sale of the assets within the portfolio. (Author’s note: the applicability or nonapplicability of tax effecting assets that are not presently being sold and are subject to division between spouses is beyond the scope of this article.)

For example, if each holding will be divided equally between spouses, i.e., a portfolio of 1,000 shares of Apple stock will result in each party getting 500 shares, then the capital gains tax burden, if any, will be borne equally. Or will it?

Let’s look closer at this sample portfolio of 1,000 shares of Apple stock. Five hundred shares were purchased at $50 per share, and an additional 500 shares were purchased at $100 per share. If the shares are later worth $300 per share, there is a capital gain of $250 per share on the shares that were purchased at $50 each, and a capital gain of $200 per share on those purchased at $100 per share. The shares with the lower tax basis ($50 per share) have a higher capital gain and higher capital gains tax upon their
sale than those with the $100 per share cost basis.

In dividing this asset, each party should receive 250 shares with the tax-cost basis of $50 per share and 250 shares with the tax-cost basis of $100 per share. Thus, each party receives an equal division of the different tax bases of the shares, and each party receives 50% of the gain associated with each tax bases of the shares. If one party were to receive the entire 500 shares with the cost basis of $50 per share, that party would be burdened with 100% of the capital gains tax, as opposed to 50% of the capital gains tax when the shares are divided correctly.

However, if one party is to receive 100% of an investment portfolio, then at a minimum have the portfolio analyzed by the appropriate professional to determine any unrealized gain or loss and the potential tax consequences resulting from the ultimate liquidation of the portfolio. By way of example, one party receiving $100,000 of a brokerage account with an unrealized tax liability of $20,000 is not equal to the other spouse receiving $100,000 in an after-tax savings account, although it appears at first glance that they are each receiving $100,000 of assets.

Now, as a further example, let’s turn our attention to the divorcing couple’s tax return. Your review (or your forensic accountant’s review) of the tax return indicates a $50,000 long-term capital loss carry forward (Note: such a carry forward generally can be found on page two of Schedule D—Capital Gains and Losses or indicated on a separate summary page attached to the return).

The capital loss carry forward was generated from the sale of securities in a jointly titled brokerage account. The unused capital loss carry forward should and can be divided equally between the spouses. Each party would report 50%, or $25,000, on his or her separate post-divorce tax return, and the capital loss carry forward receives the same treatment as has been discussed above.

Alternatively, let’s assume that the loss resulted from the sale of marital securities, but the brokerage account was titled solely in the wife’s name. Even though the assets that generated the loss were marital, the loss is not divisible between the spouses, since capital loss carry forwards generated from the sale of assets solely in one spouse’s name are not assignable under the I.R.C. Instead, the wife would be entitled to claim 100%, or $50,000, on her postdivorce tax return. Assuming the wife is in the 20% tax bracket, this capital loss carry forward will generate $10,000 in future tax savings ($50,000 x 20% = $10,000). How does the husband receive his portion of this tax benefit since the loss was generated from the sale of marital assets? The simplest way to handle this is a credit to the husband or the unequal division of another asset to compensate the husband.

Principal residence

Let’s turn now to the sale of a principal residence, which in most cases is the couple’s marital residence. Although the tax treatment of this particular asset can be the subject of a separate article, I offer the following points:

A couple’s principal residence is a capital asset. Generally, if the residence is owned and used by the taxpayers as their principal residence for two out of five years before its sale, then a gain of up to $250,000 on a separate return, or $500,000 on a joint return, can be excluded from taxation. It does not matter if the residence is not replaced with another residence after its sale. There are, however, exceptions, including divorce, if the time tests are not met, which result in the above exclusions being pro-rated.

If after the exclusion is applied there is still a gain, then any unused capital loss carry forward can be applied to the remaining gain. Any remaining gain then will be taxed at capital gains rates.

Consider yet another example: Assume that a couple sells their principal (marital) residence and realizes a $600,000 gain (difficult in today’s market, but this is only an example). After applying the $500,000 exclusion, there remains a $100,000 gain. Assuming a $50,000 capital loss carry forward, the taxable portion of the gain is only $50,000. Since the ownership and use tests are met, the gain would be a long-term capital gain, taxable at the favorable rates discussed previously.

The sale of a principal residence, which results in a loss, is not deductible and does not create a capital loss carry forward. Anyone who sells a home at a loss—something virtually unheard of before 2008—receives no tax benefit from the loss. As a general rule, the sale of any personal asset that is a capital asset, such as a room full of furniture, which results in a gain, is taxable. However, the sale of that same asset at a loss is not deductible.

Capital loss carry forwards are valuable. They have been judicially recognized in Florida, where I practice, as a marital asset subject to valuation and distribution. Capital loss carry forwards can result in future tax savings and, as such, should not be overlooked.

In conclusion, family law attorneys must be aware of the tax ramifications of capital gains and losses, including the resulting potential tax consequences or benefits. Be particularly aware of any unused capital loss carry forwards that have an economic benefit because of the potential tax savings they represent. FA
WHILE MOST FAMILY LAW ATTORNEYS understand the basics of individual income taxation related to marital dissolution, few understand the tax issues related to high wage earners and/or business owners. And frankly, they shouldn’t. Whereas, financial people are not expected to take more than one business law class while earning their financial degree, family law attorneys are not expected to be experts in financial matters including taxation. Thus, a good family law attorney will bring in a financial person for a variety of aspects in a dissolution proceeding.

In handling a divorce case, whether it is being heavily litigated or very collaborative, one of the greatest challenges is identifying all of the assets of the estate. Once all assets are identified and agreed upon, they need to be valued. Then how best to distribute those assets to the parties must be decided or agreed upon.

Oftentimes, financial experts are asked to value a business, analyze and determine a party’s true economic income, conduct a forensic analysis to find hidden assets, or simply assist the attorney and client regarding the overall financial settlement of a case. One of the first things I tell family law attorneys is not to ignore the financial assets that are in plain sight.

In every divorce case involving a closely held business, it is important for the attorney and financial expert to thoroughly examine the business and personal tax returns. The family law attorney needs to understand all of the financial issues related to a particular case. There can be numerous financial issues in each case, some of which are very basic, such as the current tax basis of an asset or an overpayment of income taxes. However, many others are more complicated.

Some of the commonly overlooked assets in a divorce relate to net operating losses (NOLs) and income tax carry-
Carry-forward capital losses

Many lawyers are familiar with carry forwards associated with capital losses. A capital loss results when a capital asset is sold (e.g., stock or bond) for less than its purchase price. Each tax year, capital losses must first be deducted from capital gains, if any. If net capital losses exceed net capital gains, up to $3,000 of the excess loss may be deducted from other income reported on Form 1040. If net capital losses exceed net capital gains by more than $3,000, any excess over the $3,000 must be carried over to the following tax year and included in the calculation of net capital gains and losses for that year. A substantial carry-forward capital loss can be a valuable asset to the parties in a divorce case.

For example, let’s consider a scenario in which a party incurred long-term capital losses of $120,000 in 2012. Only $3,000 can be deducted for 2012, and the remaining $117,000 of losses is carried forward to 2013. With $14,000 of capital gains in 2013 and $117,000 of capital losses, a net loss of $103,000 occurs. Thus, the party would get a tax benefit of $3,000 and carry forward the excess $100,000 of capital losses to 2015.

The remaining $100,000 of carry-forward capital losses can be valuable and may be an asset for consideration on the marital balance sheet. For example, capital gains tax rates vary depending on an individual’s income tax bracket, but let’s assume a 15% capital gains rate for illustrative purposes. Obviously, if an individual had $100,000 of capital gains next year, he or she would be able to offset the entire gain with the carry-forward capital losses and thus, save approximately $15,000 in taxes. However, the likelihood of a $100,000 gain may be rather optimistic, so you might look at the present value of the expected $3,000 capital loss per year over the period needed to recoup the entire $100,000 of capital losses. Therefore, the value of that $15,000 would be less, but still could be a valuable asset of the estate.

Another important item to remember is that capital losses cannot be carried back to offset past capital gains. Therefore, these types of carry-forward losses are different than net operating losses.

Net operating loss

In general, if your deductions for the year are more than your income, you may have a net operating loss (NOL). A year in which a NOL occurs is referred to as a NOL year. To have a NOL, the loss must generally be caused by deductions from your trade or business, work as an employee, casualty and theft loss, moving expenses, or rental property. A NOL may be deducted from income in another year or years to reduce income tax liability.

There are rules that limit what can be deducted when figuring a NOL. In general, according to IRS Publication 536, the following items are not allowed when figuring a NOL.

- Any deduction for personal exemptions,
- Capital losses in excess of capital gains,
- The section 1202 exclusion of the gain from the sale or exchange of qualified small business stock,
- Nonbusiness deductions in excess of nonbusiness income,
- The net operating loss deduction, and
- The domestic production activities deduction.

NOLs can be applied to the previous two years by amending tax returns for the previous years. These are commonly described as NOL carrybacks. Generally, the entire amount of the NOL must be carried back to the two tax years before the NOL year (the carryback period), and then any remaining NOL must be carried forward for up to 20 years after the NOL year (the carry-forward period). These are commonly described as NOL carry forwards.
NOLs (C corporations)
C corporations are recognized as separate tax-paying entities for federal income tax purposes. While this structure is no longer the incorporation status of choice, there are still a number of private, closely held businesses operating under this structure. A loss from operating a business is the most common reason for a NOL. A corporation generally figures and deducts a NOL the same way an individual, estate, or trust does.

Thus, the same two-year carryback and up to 20-year carry-forward periods apply. The same sequence applies when the corporation carries two or more NOLs to the same year. A corporation’s NOL differs from individual, estate, and trust NOLs in the following ways: (i) a corporation can take different deductions when figuring a NOL, (ii) a corporation must make different modifications to its taxable income in the carryback or carry-forward year when figuring how much of the NOL is used and how much is carried over to the next year, and (iii) a corporation uses different forms compared to an individual when claiming a NOL deduction.

NOLs (S corporations, partnerships and sole proprietorships)
For federal income tax purposes, S corporations, partnerships, and sole proprietorships pass corporate income, losses, deductions, and credits through to their shareholders. These entities generally cannot use a NOL at the corporate level. However, S corporation shareholders, partners, and sole proprietors can use their reported income and business deductions to figure their individual NOLs.

Many closely held businesses are structured as S corporations. Shareholders of S corporations report the pass-through of income and losses on their personal tax returns and assessed taxes at their individual income tax rates. Thus, no previous year’s taxable net income exists to offset at the corporate level.

A shareholder’s percentage of the S corporation’s net ordinary business income or loss for the year is reported to the shareholder on Line 1 of the Schedule K-1. In the example of an S corporation incurring a loss, the loss reported on the Schedule K-1 will be passed through to the shareholder on Schedule E of the individual’s Form 1040.

For example, if the shareholder of an S corporation reported a $100,000 ordinary business loss on his or her Schedule K-1, the first step would be to add back any nonbusiness net capital gains and nonbusiness net income. If there was $25,000 of nonbusiness net capital gains and nonbusiness net income, the NOL carryback or carry-forward would be $75,000.

For federal income tax purposes, S corporations, partnerships, and sole proprietorships pass corporate income, losses, deductions, and credits through to their shareholders

If you are handling a divorce involving carrybacks, carry forwards, and NOLs, here are some of the important items to consider:

- If the marital status changes because of death or divorce and in a later year a NOL occurs, that individual can carry back that loss only to the part of the income report on the joint return (filed with the former spouse) that was related to his/her taxable income. After he/she deducts the NOL in the carryback year, the joint rates apply to the resulting taxable income.
- If spouses file a joint tax return for each year involved in figuring NOL carrybacks/carry forwards, it is treated as a joint NOL. The IRS allocates carry-forward credit based on the parties’ proportional income in the current year.
- If spouses file separate returns for each year involved in figuring NOL carrybacks/carry forwards, the spouse who sustained the loss may take the NOL deduction on a separate return.
- If spouses file separate returns for a carryback/carry-forward year, but filed a joint return for any or all of the tax years involved in figuring NOL carryover, figure each spouse’s carryover separately.
- NOLs carried forward from a joint return for spouses who subsequently divorce should be divided between spouses as though the amounts are being carried forward from separately filed prior returns.
- Passive activity losses carry forward with the entity that caused the loss. Where property is jointly owned and transferred to one spouse incident to divorce, that spouse must add unused passive losses to basis and lose out on carryovers tied to the other spouse’s pretransfer share of property.
- Where the property is jointly owned prior to the transfer, the capital loss carry forward is divided equally between the spouses.

See IRS Publication 536 and Patricia Barrett, CFP, CDFA, Divorce and Taxes.

Hobby loss rule
Now that we have covered many issues related to losses, it might be important to investigate why the losses occurred in the first place. There could be a number of reasons an individual or business incurred losses: divorce planning, economic and/or industry impacts, or simply avoidance of the taxman.

The IRS presumes that an activity is carried on for profit if it makes a profit during at least three of the last five tax years, including the current year. According to IRS section 183, the various factors considered include the following:
- Does the time and effort put into the activity indicate
an intention to make a profit?

● Does the taxpayer depend on income from the activity?

● If there are losses, are they due to circumstances beyond the taxpayer’s control or did they occur in the start-up phase of the business?

● Has the taxpayer changed methods of operation to improve profitability?

● Does the taxpayer or his/her advisors have the knowledge needed to carry on the activity as a successful business?

● Has the taxpayer made a profit in similar activities in the past?

● Does the activity make a profit in some year?

● Can the taxpayer expect to make a profit in the future from the appreciation of assets used in the activity?

If the activity is not for profit, losses from that activity may not be used to offset other income. The limit on not-for-profit losses applies to individuals, partnerships, estates, trusts, and S corporations. This limit on not-for-profit losses does not apply to C corporations.

If the activity is not carried on for profit, allowable deductions cannot exceed the gross receipts for the activity. To determine if the company is for-profit or not-for-profit (i.e., a hobby), the parties may have a forensic expert review the nature and necessity of the historical expenses reported by the business.

It is not the intention of the attorney or the financial expert to kill the “golden goose” in a divorce matter. However, a proper amount of due diligence should be conducted so that one fully understands the financial aspects of the case. If it turns out that the business owner is simply cheating the taxman, the parties may no longer have an asset on their marital balance sheet from the reported losses, but rather a hefty unrecorded liability payable to the IRS.

In working with a financial expert, the family law attorney should be aware of all these situations. While NOLs and carry forwards can be complicated from a valuation perspective, it is imperative not to overlook these nontraditional assets in a case. FA

JAMES M. GODBOUT is a partner with Sikich, LLP, specializing in business valuation, forensic accounting, dispute advisory and financial consulting for marital dissolution matters. Additionally, James has been trained in mediation and collaborative law. He has lectured, published articles, and presented to organizations including the American Bar Association, the American Association of Matrimonial Lawyers, and numerous state and local bar associations. Jessica L. Tillinghast, CVA, provided research for this article.
Many family law issues require evidence of the tax impact of a particular result. For example, distribution of property involves actual and potential tax implications. Illinois statute requires a court to consider the tax implications of a particular property award (750 ILCS 5/503). Family lawyers frequently must determine a party’s “net” or post-tax income for purposes of child support or to determine that party’s cash flow. In arguing about the allocation of a child as a dependency exemption, lawyers must present evidence of the relative benefits to the parties. Sufficient evidence must be presented to the court to resolve these types of issues.

In presenting this evidence, one has a number of options. Most simply, one can rely on an expert witness who can provide opinions concerning tax issues. But sometimes an expert is unavailable or unaffordable. Without the help of an expert, the lawyer must get the necessary information to the judge in other ways. Here are a few suggestions for presenting tax information without the benefit of an expert witness.

**STRATEGIES FOR ADMISSION OF TAX EVIDENCE WITHOUT EXPERT TESTIMONY**

**TRY STIPULATIONS FIRST**

Don’t overlook this approach. While you may assume that some opponents are unwilling to stipulate to taxes, don’t rule it out. Remember, if taxes are an issue for you, they are probably an issue for your opponent as well. He or she also may need to figure out how best to present the evidence and arguments. Prior to trial or hearing, suggest a joint or cooperative approach to presenting tax evidence. Perhaps the tax analysis can be prepared by a jointly retained accountant and presented to the court as a stipulated exhibit. Or stipulations can be presented regarding the authenticity of a FinPlan report or other tax analysis.
CONCLUSION

As with any evidentiary issue, determine your goal and the best way to achieve it. Taxes often make a judge’s eyes glaze over, but taking a commonsense approach and breaking the underlying facts and tax law into bite-sized pieces for the court, can overcome the absence of a tax professional as a witness. 

JUDICIAL NOTICE

Lawyers often use computer software such as FinPlan, a software package from Thomson-West, or other similar programs for calculating income taxes in various income/support scenarios related to child support and alimony. See M.O. v. J.C.C., 2010 Del. Fam. Ct. LEXIS 59 (2010) (court took judicial notice of tax implications based on FinPlan computation.)

To present these calculations to the court, ask the judge to take judicial notice of the reliability of the tax program (assuming it is used regularly by the local legal community). If the court refuses to take judicial notice of the reliability of the program or the accuracy of the calculations, you will need to establish the reliability of the program. Contact the publisher and ask for information that can be presented informally in support of a request for judicial notice.

Otherwise, the only practical way to admit the printout is to bring in a representative from Thompson-West or another software company to lay the foundation for its reliability. As a practical matter, without a company representative, stipulation, or judicial notice, it is unlikely you will be able to authenticate the report from such a program and thus you will need to consider other options.

PRESENT GOVERNMENT PUBLICATIONS

Federal Rule of Evidence 803(8) allows, as an exception to the hearsay rule, the admission of records of a public agency prepared during the ordinary course of business. Also, governmental reports are considered self-authenticated under Federal Rule of Evidence 902.

The Internal Revenue Service publishes information regarding common tax issues affecting divorced families. Publication 504 (http://www.irs.gov/publications/p504/ar02.html#en_US_2013_publink1000175898) addresses the tax rules pertaining to these topics: filing status, exemptions, alimony, and property settlements. Although technically one does not need to admit the “law” as evidence, these types of publications may be helpful and persuasive, particularly if the reports clearly support the position you are advocating to the court. Even if not admitted as an exhibit, the court may consider the publications during the argument phase of the case.

REFRAME THE ISSUE AS LEGAL ARGUMENT

The court must take judicial notice of the applicable law. This includes federal tax law. A tax analysis is ultimately a legal analysis. In other words, if you argue the tax implication of a particular result, aren’t you really arguing tax law? While aggressive, consider offering a FinPlan (or other) printout as a demonstrative illustration of your tax analysis (tax law as applied to the facts of your case). You must get in the underlying data to make the argument. Determine all of the underlying facts a court needs to rely on in calculating taxes.

For example, in calculating a potential capital gain liability for an investment, present evidence of the basis (typically the purchase price) and period of ownership. If the underlying data is presented to the court as evidence, then it is only a matter of applying that data to the applicable tax law, of which the court must take judicial notice. At that point, it is only math, which can be presented as part of your argument.

CONCLUSION

As with any evidentiary issue, determine your goal and the best way to achieve it. Taxes often make a judge’s eyes glaze over, but taking a commonsense approach and breaking the underlying facts and tax law into bite-sized pieces for the court, can overcome the absence of a tax professional as a witness.

STEVEN N. PESKIND is a principal with the Peskind Law Firm in St. Charles, Illinois. In practice for more than 28 years, he has been recognized as one of the Best Lawyers in America, and is the author of The Family Law Evidence Handbook, published in 2013 by the ABA Section of Family Law.
A Practitioner’s Guide to Innocent Spouse Relief  
(2d ed.) Robert B. Nadler

The words “concise” and “clear” do not apply as often as readers might like in connection with books or articles on tax-related issues. Fortunately, both of those terms come to mind in reviewing Mr. Nadler’s recently published second edition of his Guide to Innocent Spouse Relief. Mr. Nadler certainly has reason to know his subject, having completed 30 years of tax controversy practice with the IRS Office of Chief Counsel, followed by many years of practice representing low-income taxpayers in controversies with the IRS, in addition to many years of teaching tax practice and procedure as an adjunct professor at Vanderbilt University Law School. Thus, he brings a broad spectrum of experience to the subject.

The author has thoroughly explained the ins and outs of the process of examining and possibly pursuing an innocent spouse claim from the initial interview through the administrative process and up to the post-trial brief for the U.S. Tax Court. In so doing, Mr. Nadler has discussed not only where the law stands now, but has included enough of the historical progression in legislation and IRS positions to put things in context. This serves not just to inform the legal history buffs. For the lawyers representing taxpayers, it is hard to imagine a better way to “know your opponent” than to have a brief history of the prior arguments made and positions taken by the IRS.

Even family law practitioners who have no intention of ever finding themselves in tax court would be well served by having this publication on the shelf. All too often family law attorneys encounter issues of unreported income, inaccurate tax returns, and/or spouses who have signed joint returns containing figures about which they have little actual information. Without some basic background knowledge, the divorce lawyer hearing that tale of woe may make unfounded assumptions about innocent spouse relief or unwittingly take steps in the divorce case that impact the viability of such a claim. The chapter on the first client meeting contains an outline of the questions to be asked, which would serve many of us well in divorce cases any time tax difficulties come up in the initial interview. Refreshingly, Mr. Nadler goes beyond the questions to ask and also provides an outline of potential actions to be taken and follow-up steps to consider—even when the issue of potential tax problems was not apparent until divorcing parties and counsel had progressed through the discovery and financial disclosure process incident to the divorce.

Family law practitioners will also be well advised to review the discussion about what constitutes a joint tax return. Far more can be involved than simply checking a box on the 1040 form. That section contains a useful list of questions and factors for consideration in determining whether the necessary knowledge and intent existed. Fortunately, there is also an analysis of the impact the position on this issue might have on other potential claims.

As some of you may know, a claim for innocent spouse relief may fall under three different statutory subsections, depending on the particulars of the case. Mr. Nadler includes a detailed discussion of the necessary elements and strategies for each type of claim. He also provides an analysis of the pros and cons of various grounds for relief. Importantly, he also explains when and how the potential claims should be bolstered with accompanying documentation.

Two things are immediately apparent from this discussion: first, the IRS forms do not tell the taxpayer or the lawyer for the taxpayer all they need to know to prepare a successful claim; and second, Mr. Nadler has the ability not only to prepare such claims successfully but also to share that knowledge in a useful and coherent fashion.

Unlike some tax-related treatises, Mr. Nadler’s book contains many examples of successful (and unsuccessful) approaches to the various elements of an innocent spouse claim. Fortunately, he has devised these examples, not just as a collection of war stories but as a set of illustrations of the right and wrong ways to present a claim. This approach makes the concepts far more understandable than would a bare recitation of the terms of the tax code and/or the Revenue Rulings.

Innocent spouse relief

As well, it is apparent from the examples that innocent spouse relief is not just for the wealthy. Rather, the discussions of duress, physical and emotional abuse, and financial hardship drive home the point that potential claimants for innocent spouse relief may often be among the financially disadvantaged, including the clients served by domestic violence shelters, pro bono agencies, and other legal aid organizations. Readers who do not deal with high-income individuals or large-asset cases are as likely to find their clients’ situations described in this book as are the practitioners whose clients include the rich and famous. FA
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What are mediation and arbitration?

Who decides how much child support I pay?

What happens to my insurance?

How long will the divorce take?
NEW FLS Leaders Elected in Boston
Section members attending the 2014 Section Annual Meeting in Boston, Massachusetts, elected the following officers and council members:
• Chair-elect: Greg J. Ortiz, Highlands Ranch, CO
• Vice Chair: Mary T. Vidas, Philadelphia, PA
• Secretary: Roberta S. Batley, Albuquerque, NM
• At-large Council Members—three-year terms: Jonathan Wolfe, Livingston, NJ; Anne Marie Jackson, Washington, DC; Kendra Randall-Jolivet, Baltimore, MD
• Region V Representative—three-year term (composed of Montana, Idaho, Wyoming, Utah, Colorado, Arizona, New Mexico, Texas): Virginia R. Dugan, Albuquerque, NM
• The new Parliamentarian is Edward H. Newman, Providence, RI, and the new Law Student Liaison is David Kershaw of Columbia, SC

Congratulations to these new officers and council members and thanks to the following members who completed their terms of office in August:
• Immediate Past Chair: Maryann E. Foley, Anchorage, AK
• At-Large Council Member: Roberta S. Batley, Albuquerque, NM
• CLE Co-chair: Melissa J. Avery, Indianapolis, IN
• Parliamentarian: Herbert J. Belgrad, Baltimore, MD
• Law Student Liaison: Tanisha Bostick

To learn more about new section leaders, please visit www.americanbar.org/family and click on “About Us” on the left-hand side of the page.

Nominations Open for 2015–2016 Leadership
The Nominating Committee, chaired by Chair-elect Greg J. Ortiz, is accepting nominations for the 2015 elections. Nominating Committee members include: Don Schiller, Kathy Root, Peter Walzer, and Diane Holmes. The committee seeks nominations for the following positions:
• Chair-elect (one-year term)
• Vice Chair (one-year term)
• Secretary (one-year term)
• Section Delegate (one position, three-year term)
• At-large Council Representatives (three positions; three-year terms expiring 2018)
• Region II Representative (three-year term expiring 2018) composed of Maryland, District of Columbia, Virginia, West Virginia, North Carolina,

Section Members Are Recognized for Service
At the Annual Awards luncheon on August 9, 2014, Michael Mosberg received the Chair’s Cup for his many contributions to the Section. Most recently he served as Sponsorship Committee co-chairman, and he is now co-chairing the Continuing Legal Education Committee.

Henry DeWoskin was feted for his role as co-chairman of the Sponsorship Committee. Henry has also served the Family Law Section as the Young Lawyers’ Division Representative on council, and as a council member from Region IV.

Jonathan Wolfe and Kendra Randall-Jolivet were given special awards for their hard work as co-chairs of the Member Benefit Development Committee. Their efforts to launch the successful Leadership Day during the Spring Conference were commendable. Jonathan has just completed one term on council in an at-large position. Both he and Kendra were elected to at-large council positions in the 2014 elections.
Feeling overwhelmed, angry, confused, and out of control is normal for divorce clients. This handbook provides thoughtful, reassuring answers to a range of questions about the legal process and the client’s role in it.

To order, See back cover for ordering information and quantity discounts or go to www.ambar.org/clientmanual.

Hand a copy of Surviving Your Divorce & Beyond: A Client Manual to every new client (along with your card) as a tangible reminder that you care.
Stewart Gagnon Receives 2014 Pro Bono Award

By STELLA PITTS

Congratulations to the 2014 American Bar Association Family Law Section Pro Bono Award winner, Stewart Gagnon, of Houston, Texas. Stewart was nominated for his leadership and dedication to volunteerism in the city of Houston and across his home state.

Stewart’s personal connection with his community at large is clear from his more than 1,000 hours of pro bono service over his 40-year law practice. Stewart’s work with low-income litigants is a particularly important part of his contributions to access to justice. In 2013 alone, he directly represented 32 low-income clients in matters involving divorce, child custody, property, and spousal maintenance issues. This included a landmark spousal maintenance case for a pro bono client.

In addition to his work with low-income litigants, Stewart also worked with Texas Supreme Court Justice Eva Guzman to create and staff an assisted pro se advice booth and clinic in Houston’s Family Law Center. This booth was staffed daily by volunteers he recruited until the Houston Volunteer Lawyers were able to provide a staff attorney. During this time, Stewart also acted as a family law mentor for many of these clinics. Since 2011, he has chaired the Texas Supreme Court Uniform Forms Task Force, which has worked to develop forms and self-help kits for divorces, protective orders, and other family law matters. His instrumental involvement once again, demonstrates his commitment to access to justice.

Stewart’s direct efforts in the successful recruitment of other volunteer attorneys for pro bono representation are widely recognized. In addition to being a partner at Norton Rose Fulbright, Stewart leads the firm’s pro bono program nationwide. Stewart reinforced this culture of volunteerism when he developed a Family Law Intern Program (FLIP) in which family law attorneys mentor law students who provide supervised representation of pro bono clients.

Both the Houston Bar Association and the Houston Bar Foundation have recognized Stewart’s pro bono efforts. The Harris County Judiciary and Harris County Bar have acknowledged his service with a joint award, and the State Bar of Texas has recognized his outstanding service on behalf of under-represented people. Stewart is regularly named a Texas Super Lawyer and is listed among the Best Lawyers in America. In his decades of family law practice, he has improved the lives of thousands and given many the chance to grow in a safe environment. Congratulations, Stewart.

Winners of the Pro Bono Award receive $1,500 to be donated to the pro bono or public service organization of their choice. Stewart has chosen the Houston Volunteer Lawyers, a service of the Houston Bar Association.

For more information about the Pro Bono Award, visit www.ambar.org/flprobono.

STELLA PITTS practices family law in Seattle, Washington, and is chair of the section’s Pro Bono Committee.

Section Names 2014 Schwab Winners

We are pleased to announce the following winners of the 2014 Howard C. Schwab Memorial Essay Contest:

First Place: Moriah Silver, Northeastern Law School; “The Second Rape: Legal Options for Rape Survivors to Terminate Parental Rights.”

Second Place: Aaron Young, Georgetown University Law Center, “All in the Constitutional Family: Revisiting Definitions of Family Relationships in Immigration Law.”

Third Place: Lindsee A. Acton, Washburn University School of Law, “Overturning In re Gardiner: Ending Transgender Discrimination in Kansas.”

Joining the Family Law Section at the section’s Annual Awards Luncheon in Boston was our first-place winner, Moriah Silver, shown here receiving her award from Section Chair Scott N. Friedman.

The section would like to thank Jim Preston (Chief Judge) and judges Kelly Lise Murray, Bruce Kogan, Jeff Atkinson, Linda Radvlin, and Kendra Fershee for their time and dedication in selecting this year’s 2014 Howard C. Schwab Memorial Essay Contest winners. FA
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—Sandra Morgan Little, Albuquerque, NM

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is a 40-page client handbook from the editors of Family Advocate magazine. It offers simplified explanations to some complicated concepts:

- Filling out financial disclosure forms
- About your finances: Do's and Don'ts
- Getting your digital house in order
- What should happen to the house?
- Is bankruptcy an option?
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