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FAMILY LAW FINANCES: DIVORCE AND THE TAXPAYER RELIEF ACT OF 1997

By Todd L. Torvinen

SALE OF A PRINCIPAL RESIDENCE

In general

Non-recognition of gain on rollover of a principal residence repealed: The repealed law was formerly IRC Section 1034.

The Taxpayer Relief Act of 1997 amended IRC Section 121. IRC Section 121 formerly provided for exclusion of gain from sale of personal residence by individuals who had attained the age of 55. The over age 55 exclusion is now gone.

In general, IRC section 121 now provides that individuals may exclude up to $250,000 of gain on a sale of a principal residence every two years.

The term "principal residence" is not defined under the 97 Act. Presumably, the definition of a principal residence under Treasury Regulation Section 1.1034-1(c)(3) still applies. This is a facts and circumstances test. Under this Treasury Regulation, property used by a taxpayer as a principal residence may include a houseboat, a house trailer, or stock held by a tenant/stockholder in a co-operative house corporation.

Married persons filing a joint return (subject to special rules) may exclude up to $500,000 of gain on the sale of principal residence. The new law applies to all sales of residences that occur after May 6, 1997.

Some taxpayers use their residences for both business and personal use. Often, a taxpayer will depreciate part of the residence solely devoted to the business use under a IRC Section 1250. To the extent depreciation is taken on a residence after May 6, 1997, it may not be excluded from income under IRC Section 121 when the house is later sold.

Qualifying for exclusion

In order for a person to qualify for the exclusion, the residence must have been *owned and used* by the person as his principal residence for periods of time aggregating two years or more during the five-year period ending on the date of sale or exchange of the residence. See IRC Section 121(a). Presumably, the use as a principal residence for two of the five years does not need to be continuous. This interpretation is consistent with the pre-1997 Act Section 121.

Rules which apply to joint returns - Married taxpayers filing a joint return qualify for the $500,000 exclusion if: (1) *Either* the Husband or the Wife has *owned* the residence for two aggregate years out of the five-year period preceding the sale, (2) *Both* Husband and Wife have *used* the residence for an aggregate period of two years out of the five-year time period preceding the sale, and (3) Neither spouse has sold a residence within two years prior to the date of the sale of the principal residence. See IRC Section 121(b).

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Special rules which apply if only one spouse qualifies - If only one spouse satisfies the use requirement (using residence for two of the previous five years as a principal residence), the amount of gain that may be excluded is limited to $250,000 on a joint return. Further, if either spouse meets the ownership and use requirement, then $250,000 may be excluded on a joint return. See IRC Section 121(d).

Limitation of one sale every two years

In order to qualify for full exclusion (whether $250,000 single or married separate, or $500,000 joint return) there can be only one sale of a principal residence during the two years immediately preceding the sale in question. See IRC Section 121(b)(3). Note that sales of homes prior to May 7, 1997 are not counted. However, the Code does not leave these persons completely in the cold.

Persons who have not owned and used a residence for a period of two years prior to sale, or who have more than one sale within a two-year period may qualify for partial exclusion. Where such a sale is caused by change of employment or change in health, then the shortest length of time which actually qualifies (which would be less than two years) over two (2) (a fraction) multiplied by the exclusion amount is what may be excluded by the taxpayer. For example, if a taxpayer sold a residence and excluded the gain, and then purchased a new residence which he used for one-half year and later sold (because he had to move for health reasons) at a gain of $50,000, he would be able to exclude the whole gain (6 months/24 months multiplied by $250,000 = $62,500).

Application to divorced or divorcing persons

The residence is transferred to one of the spouses - if a divorcing (or divorced) spouse receives a residence under a non-taxable transfer pursuant to a divorce (IRC Section 1041(a)), then the spouse who receives the house may tack the transferring spouse's ownership period onto his or her ownership period for purposes of qualifying for the full exclusion ($250,000). See IRC Section 121(d)(3)(A).

Example: Suppose Sallie Sue and Jimmy Joe get married. At the time of marriage, Jimmy Joe owns a residence. Jimmy Joe and Sallie Sue stay married for 10 years and live in the residence. During this time, title to the residence is never changed. As a result of the MSA and divorce (a transfer under a divorce or separation instrument), Sallie Sue receives the residence under IRC Section 1041(a) with a basis of $100,000 and a value of $300,000. Without special treatment, if Sallie Sue desires to sell the residence immediately after divorce, she will recognize $200,000 gain under IRC Section 121(b) because, although she has used the house for more than two years of the previous five, she has not owned the house for two of the previous five (her ex-husband owned the house). However, she receives special relief under IRC Section 121(d)(3)(A). Therefore, she may tack his ownership period of at least ten years onto her own. As a result, after the operation of this Code Section, she will be deemed to have *owned and used* the house for at least two of the five previous years. Therefore, she may exclude the entire $200,000 gain

The house will be sold by both spouses at a later date, but one spouse has moved out - if the house is sold after divorce (or separation) after one of the spouses moves out, the "out spouse" may step into the use period of the spouse who remains in residence. Therefore, in such a case after divorce, both the spouse who stays in-house and the spouse who moves out may qualify for exclusion. The exclusion would be limited to $250,000 on a married filing separate return or on a single filing return.

However, a word of *caution* here. Only post separation use provided for under a divorce or separation instrument may be used by the "out spouse." Accordingly, if the "out spouse" vacates the residence without the benefit of a temporary order, a stipulation for the same purpose, or a divorce instrument granting the "in spouse" possession, he or she may not use the "in spouse's" use time for purposes of qualifying under IRC Section 121 when the house is later sold.

Example: Jimmy Joe and Sallie Sue get married on January 1, 1998. At the date of marriage, Jimmy Joe and Sally Sue purchase a residence for $100,000. The residence is community property and is titled as such. Jimmy Joe and Sallie Sue have mari-

tal bliss for one year. On January 1, 1999 the parties separate. Jimmy Joe moves out of the residence without a separation agreement. Six months later, on July 1, 1999 Sallie Sue files for divorce, and receives an order for pendente lite exclusive possession of the house. The parties are divorced on January 1, 2000. Under the terms of the MSA, the house is sold for $200,000 on January 2, 2000. The proceeds are divided equally under the MSA.

Result: Sallie Sue has owned and used the residence for two of the previous five years. Jimmy Joe has owned the residence for two of the previous five years but not used the residence for two of the previous five years. He has only use the residence for 1 1/2 years. The six months of voluntary removal from the house from January 1, 1999 through June 30, 1999 is not counted toward his two years of use. However, if Jimmy Joe had separated on January 1, 1999 under a separation agreement, or if Sallie Sue had been awarded exclusive possession of the residence under a pendente lite order, then the six-month period would count, and Jimmy Joe would qualify for two years of use.

TPOs: What happens if one spouse obtains a TPO and boots the other spouse out of the residence. Will the "out spouse" still qualify for use under IRC Section 121? It appears so.

A Divorce or Separation Instrument is defined at IRC Section 71(b)(2). A divorce or separation instrument is generally defined as a decree of divorce, decree of separate maintenance, a written agreement related to either of those, or a decree (which is not a divorce decree or separate maintenance decree) requiring one spouse to make payments for the support and maintenance of the other spouse. Typically, when the TPO Court awards one spouse exclusive possession, the applicant, may seek through extended order, to make the "out spouse" make payments on the mortgage or payments for support of the applicant or the minor child. See NRS 33.030.2.(b)(2). Such payments would seem to qualify as payments for the support and maintenance of the other spouse under IRC Section 71. Therefore, in such a case, the "out spouse's" TPO induced absence should qualify for use under IRC Section 121.

Recognizing Gain

IRC Section 121(f) allows a taxpayer to elect to recognize the gain on the sale of a residence. Perhaps the only reason to elect out would be if the taxpayer had capital loss to offset against the gain. If the taxpayer also had another residence which would qualify under IRC Section 121, and the sale would take place within two years of the sale of the first residence, then it might make sense to elect out of the sale of the first residence, so the taxpayer could exclude all of the gain from the sale of the second residence.

REFUNDABLE DEPENDENT CREDIT

In General

In general, parents are allowed a credit against income tax for each "qualifying child." The amount of the credit is $400 *per child* for 1998, and $500 *per child* for years after that.

Qualifying Child

A child qualifies to be taken for credit if: (1) the child is allowed as a dependency exemption under IRC Section 151, (2) the child is age 16 or less at all times during the taxpayer's taxable year (usually a calendar year) (note: this ignores that age 18 is majority in the states), and (3) the child is a son, daughter (or other lineal descendant), step son or daughter, or foster child of the parent who lives with the parent for the entire year. See IRC Section 24(c).

Application to divorce

IRC Section 24 does not provide rules for allocation of the Dependent Tax Credit. However, this Code Section defines a "qualifying child" as a child for whom the dependency exemption under IRC Section 151 may also be claimed. IRC Section 152(e) provides a special rule for allocation of the dependency exemption between divorced parents. In general, under IRC Section 152(e), the parent having custody of the minor child or children for the greater part of the taxable year is entitled to the exemption. Therefore, by analogy, the same rule ought to apply with regard to allocation of the Dependent Credit.

Because of this statutory arrangement, it would appear that a noncustodial parent may claim the credit under agreement, or in years when the custodial parent releases the dependency exemption pursuant to IRC Section 152(e)(2).

Nevada Law - Under the case of *Sertic v. Sertic*, 901 P.2d 148, 111 Nev. 1119 (Nev. 1995), a court has the power to require one party to execute a waiver to the other party transferring the Dependency Exemption. As a result, again by analogy, it would seem that the *Sertic* case would also apply to the Dependent Credit. Therefore, a court would have the power to allocate the Dependent Credit between divorced parents.

Claiming the Credit

A parent may not claim the dependent credit unless he or she provides the name and the taxpayer identification number (So-

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cial Security Number - need to file a form SS-4 to obtain) of the child to the IRS. This information must be provided on the tax return for the taxable year in which the credit is claimed. No credit is allowed for a partial taxable year. See IRC Section 24(e).

Phase-out of Credit

The child tax credit is phased out for parents at certain adjusted gross income levels. For married persons filing a joint tax return, phase out starts at $110,000. For parents filing as single or head of household, phase out starts at $75,000. For married taxpayers filing separate returns, phase out starts at $55,000. The credit is phased out and disappears by $50 for each $1000 that exceeds the applicable threshold amount. See IRC Section 24(b). Obviously, in a divorce context, one would want to allocate the credit to the parent who can use it. If one parent's income would require phase-out, then the other parent should be allocated the Dependent Credit.

Congressional Complexity

Congress also provided a complex formula for refunding the credit where the parent or parents have three or more children. The credit also interacts with the earned income credit. In addition, the new law also provides that Social Security Taxes may be refunded. A detailed description is beyond the scope of this discussion.

THE HOPE AND LIFETIME LEARNING CREDITS

In General

Added Code Section 25A which allows individuals an income tax credit for higher education and tuition related expenses. See IRC Section 25A(a).

The Hope Scholarship Income Tax Credit

The Hope Scholarship Credit has a maximum benefit of $1500 per student. The credit is only available for two taxable years for each eligible student. As result, the Hope Scholarship credit is allowed for only the first two years of post-secondary education for an eligible student. See IRC Section 25A(b)(C). Further, the eligible student must be at least a halftime student for a portion of the taxable year. See IRC Section 25A(b)(B).

The credit is equal to 100 percent of the qualified postsecondary tuition and related expenses for the first (freshman) year of the student. However, the credit for the freshman year is limited to $1000. In the second (sophomore) year the credit is equal to 50 percent of qualified postsecondary tuition and related expenses. However, in the sophomore year the credit is limited to $500. As a result, $1000 may be claimed as a credit in the freshman year, and $500 may be claimed is a credit in the sophomore year. This totals $1500, of course.

The Lifetime Learning Credit

The Lifetime Learning Credit is equal to 20 percent of the qualified tuition and related expenses paid by the taxpayer during the taxable year. In years prior to January 1, 2003, such education expenses are limited to $5000. In years after 2003 the qualifying education expenses rise to $10,000. See IRC Section 25A(c). The Lifetime Learning Credit is available for expenses paid after June 30, 1998. It applies to expenses other than expenses to which the Hope Scholarship Credit is taken. The Lifetime Learning Credit may be claimed for an unlimited number of years.

Rules Applicable to Both Credits

Under IRC 25A(f)(A), "qualified tuition and related expenses" include such education expenses which are paid for any dependent which the taxpayer has claimed a dependency exemption under IRC Section 151 for that particular year. Qualified Tuition and Related Expenses also include expenses paid for the taxpayer and the taxpayer's spouse. Note: the credit is reduced by non-taxable scholarships under IRC Section 117 or other educational assistance. Qualifying expenses do not include expenditures for books, meals, lodging, student activity fees, athletic fees or similar personal or extracurricular activity expenses.

The Hope Scholarship Credit applies to educational expenses paid after December 31, 1997. Both credits are phased out for joint return adjusted gross income in excess of $80,000 or single or head of household return adjusted gross income in excess of $40,000. IRC Section 25A(d). The credits are not available if a married couple files separate income tax returns.

If a child who is claimed as a dependent by a parent incurs qualified tuition and related expenses, the parent, and not the child, is deemed to have paid such expenses. Therefore in such a case, the parent would take the credit.

Application of Credits to Divorce

Both the Hope Scholarship Credit and the Lifetime Learning Credit require that the payments of educational expenses of a person qualify for credit only if the person can be claimed as a dependency exemption on the parent's tax return. Where the parents are divorced, and one parent pays the tuition while the other parent claims the dependency exemption, the credit would be lost. Therefore, Marital Settlement Agreements should be drafted to ensure that the parent paying the tuition also claims the dependency exemption.

After parties are divorced, the credits would not be available to a former spouse who pays the educational expenses (rehabilitative alimony expenses) of the other former spouse. Therefore, it is probably a good idea to pay such amounts as direct alimony under IRC Sections 71 & 215. Then, the payor would receive a deduction, and the payee would receive income, and qualify for the credit. This is something to be bargained for in the MSA.

EDUCATION IRA

Beginning in 1998, taxpayers may set up and contribute up to $500 a year to a special IRA for education purposes on behalf of anyone under age 18. Only one Education IRA can be established for any individual. Contributions to an Education IRA are not deductible, but withdrawals from the IRA, including investment earnings and gains, are tax free. Unlike the two learning credits, qualifying expenses paid from an Education IRA include books, supplies, equipment, and certain room and board expenses, in addition to tuition. The Education IRA may be rolled over to another IRA for another child. There is a 10% tax if an

amount withdrawn from an Education IRA exceeds qualified education expenses or isn't distributed by age 30 but an Education IRA can be rolled over to a regular IRA.

The eligibility to contribute to an Education IRA is phased-out for adjusted gross income levels between $95,000 to $110,000 for single filers and $150,000 to $160,000 for joint filers.

Obviously, in a divorce context, if one spouse is obligated to fund the college education of the child or children through the Education IRA, then the obligation should be structured so that phase-out is avoided. For example, if the high income spouse would be phased-out, it makes more sense to create either an alimony or a child support obligation from the high income spouse to the low income spouse, and then obligate the low income spouse to fund the Education IRA.

ROTH IRA

There are three main features of the Roth IRA: (1) the contributions are in after-tax dollars, (2) the distributions in most cases are tax-free, and (3) the distributions do not have to begin at age 70 and 1/2 (as with conventional IRA) and, are not required to begin until after the owner's death.

The Roth IRA begins in 1998. Annual contributions are limited to the lesser of $2,000 or the owner's earned income for the year. See IRC Section 408A(c)(2)(A). In addition, as with a regular IRA, a spouse filing a joint tax return may also contribute up to an additional $2,000 so that the couple's combined Roth IRA contributions may be $4000. However, the Roth IRA is linked to the regular IRA contributions. There is a dollar for dollar reduction. Therefore, if a taxpayer qualified and took a $2,000 regular IRA contributions/deduction he would receive no Roth IRA contribution. See IRC Section 408A(c)(2)(B).

There is no age limit for contributions to Roth IRA. See IRC Section 408A(c)(4). Remember that contributions to a regular IRA are not possible after the individual attains the age of 70 1/2.

Adjusted Gross Income Phase-out — in the case of a single individual, no Roth IRA contribution is allowed if the adjusted gross income exceeds $110,000. The phase out is from $95,000 to $110,000. In the case of married individuals, no contribution is allowed to a Roth IRA if the adjusted gross income exceeds $160,000. The phase-out is between $150,000 & 160,000. In general, individuals filing married separate returns do not qualify for the Roth IRA. See IRC Section 408A(c)(3)(C)(ii).

Converting a regular IRA to Roth IRA — much has been written about this technique. Taxpayers cannot qualify for this rollover if their adjusted gross incomes exceed $100,000. See IRC Section 408A(c)(3)(B). If a taxpayer rolls over her his regular IRA, all of the pretax amounts in the regular IRA are includable in his income and taxed. However, the amount rolled into the Roth IRA is not subject to the 10 percent penalty even if the individual has not attained the age of 59 1/2. See IRC Section 408A(d)(3)(A)(ii). If the rollover occurs in 1998, the amount of the taxable distribution is spread evenly over four years. This rule does not apply after 1998. The general rule of thumb, is that a taxpayer should not rollover his regular IRA unless he is at least 7-10 years away from retirement.

Distributions from a Roth IRA — "qualified distributions" from a Roth IRA are not taxable. In general, a qualified distribution is one which occurs after the Roth IRA owner attains age 59 1/2, is to the beneficiary after the owner's death, is attributable to the owner's disability, or up to $10,000 may be used to purchase a first-time principal residence for the Roth IRA owner or his spouse, child, grandchild or ancestor. In addition, in order to be a qualified distribution, the distribution cannot be made sooner than five years from: the (1) the year the Roth IRA owner made his first annual contribution, or (2) the year the Roth IRA owner rolled over or converted his regular IRA.

Divorce - It appears that the Roth IRA can be divided without tax consequence by a domestic relations order. This is the same treatment received by a regular IRA.

CAPITAL GAINS TAX CUTS

There are now three different types of capital gain rates for non-corporate taxpayers: (1) short-term gains on assets held for one-year or less are treated and taxed at ordinary income rates (15 percent to 39.6 percent); (2) mid-term capital gains from the sale of assets held more than one-year but not more than 18 months, and are taxed at a maximum rate of 28 percent; and (3) long-term capital gains from the sale of assets held more than 18 months which are taxed at a maximum of 20 percent (or 10 percent if the taxpayer is in the 15 percent bracket).

Todd L. Torvinen is a Reno attorney and CPA and serves as Financial Officer of the Family Law Section. He presented a seminar on this topic to the Washoe County Bar Association in April of 1998.

Wall Street Journal Reports Praise for IRS in "Equitable Relief"

The following appeared in the Wall Street Journal on Tuesday, October 6, 1998.

The IRS wins praise for speedy action to help divorced and separated taxpayers.

IRS officials are moving quickly to implement part of a law enacted July 22. The law is designed to help separated and divorced taxpayers avoid getting saddled with hefty tax bills that should belong to the other spouse or ex-spouse. Event though the new law gives the IRS until early next year to issue guidance, Commissioner Charles Rossotti has already taken a few steps that have drawn applause.

Mr. Rossotti says that if someone files for relief under the new law, the IRS will suspend collection efforts for the years covered by the claim. The IRS also promises to automatically consider if that person qualifies for the "equitable relief" under the new law if he or she doesn't qualify for other relief. The agency issued Notice 1213 as an interim step to help spouses using the current Form 8857 to request relief. A new form will be issued later.

"I am really impressed" with Mr. Rossotti and his staff, says Elizabeth Cockrell, who heads Women for IRS Financial Equity and who has met with the commissioner."

CASE SUMMARIES

Prepared by Marshal S. Willick

Denial of Alimony Reversed Where Temporary Support Used for Maintenance of Community Expenses, the Husband Awarded Community Property Producing Large Annual Income, and Wife Awarded Community Property that would be Dissipated in the Immediate Future to Provide for Living Expenses; No "Trust" for Minor Child of Property Left in Possession of Husband

Shydler v. Shydler, 114 Nev. ___, ___ P.2d ___ (Adv. Opn. No. 23, Feb. 26, 1998) Husband and wife married in 1976. Husband went into construction, and began a company (Aztec) which by the late 1980s began to earn substantial profits, allowing husband salaries of $60,000.00 to $200,000.00 per year. In 1982, wife began an insurance brokerage (Alamo), making a maximum of $57,000.00 in 1983, while the company itself lost money. Company profits were less than $21,000.00 per year after 1986, and it had to borrow over $60,000.00 from Aztec to say open.

The husband lost his driver's license due to 3 DUIs. The wife drove him to work for ten months.

The district court (Fine) found that a valuable piece of property had been traded between the parties to the husband, in exchange for the wife keeping her gambling winnings, that a collection of toy soldier's, etc., were "held in trust" by the husband for one of the children, and that the remaining property was to be divided equally, giving the husband all the cash, and the wife the real property, chattels, and an equalizing payment to be received over time and without interest. The wife received no alimony.

The Supreme Court stated that it would only reverse "decisions concerning divorce proceedings for an abuse of discretion," and would affirm those based on substantial evidence, but added that alimony decisions required an award that was "just and equitable, having regard to the conditions in which the parties will be left by the divorce." It then reiterated the seven factors set out in *Sprenger v. Sprenger*, 110 Nev. 855, 878 P.2d 284 (1994).

Here, during a 17 year marriage, the husband obtained a contractor's license and built up a successful company, and so "developed the business acumen which has provided him with a thriving business and substantial assets." While the wife "had the opportunity to develop marketable skills," the husband's drinking "may have interfered" with her work. The husband testified that she could earn $25,000.00, and his expert testified that she could earn up to $59,000.00, which the Court termed "not at parity with [the husband's] documented earnings of more than $100,000.00." The Court noted that, at best, the wife's brokerage could not even reach break-even for six months.

The lower court had denied alimony based on pre-divorce temporary support payments, and the equalizing payments to be received by her after divorce. The appellate court noted that the temporary support received by the wife during the divorce proceedings were "mainly disbursed for then-current community expenses. Thus, this award was not alimony rendered solely for the benefit of [the wife]." The Court held that such payments should "not preclude" post-divorce alimony, "particularly where part of all of those interim payments are used to make payments on community property." Turning to the post-divorce payments, the Court labeled the lower court decision "unfair" where "the district court awarded [the husband] the portion of the community property which was producing an annual income in excess of $100,000, while [the wife's] share of the community property was to be dissipated in the immediate future to provide for [her] living expenses so that [the husband] would not have to pay spousal support."

Going back to NRS 123.220-.225, NRS 125.150(1)(b), and *McNabney v. McNabney*, 105 Nev. 652, 782 P.2d 1291 (1989), the Court reiterated that a community property award "serves to divide community property acquired during marriage to which the recipient spouse is entitled as a matter of law." The Court distinguished such property from alimony, which it defined as "an equitable award serving to meet the post-divorce needs and rights of the former spouse," citing *Gardner v. Gardner*, 110 Nev.1053, 881 P.2d 645 (1994) and NRS 125.150.

From this, the Court held that "two of the primary purposes of alimony, at least in marriages of significant length, are to narrow any large gaps between the post-divorce earning capacities of the parties . . . and to allow the recipient spouse to live 'as nearly as fairly possible to the station in life [] enjoyed before the divorce." The amount and length of alimony are to be determined by "the individual circumstances of each case."

Citing *Wolff v. Wolff*, 112 Nev. 1355, 929 P.2d 916 (1996), the Court held that "property and alimony awards differ in effect," so that the property equalization payments "do not serve" as a substitute for alimony. The Court acknowledged that the amount of community property divided "may be considered" in setting alimony, but noted that here, the wife had to use her community property for support, while the husband's share of the community property "was actually providing a substantial income for his support." The Court held that here, there should be an award of spousal support, "at least for a period of rehabilitation." The Court directed that "While our case law does not require the district court to award alimony so as to effectively equalize salaries, an alimony award must nonetheless be awarded when just and equitable, and be set at a fair rate based on the individual circumstances of the parties." The alimony question was remanded.

In an echo of the unanswered questions as to fault raised in *Heim v. Heim*, 104 Nev. 605, 763 P.2d 678 (1988), the Court added a footnote finding it "troubling" that the lower court emphasized the wife's "apparent misuse of community funds during the separation, but failed to adequately consider [the husband's] apparent misuse of community funds to support another woman."

Turning to the toy soldier and "militaria" collection, the Court reversed, stating that "the collections were not set aside for child support and, indeed, would not have been appropriate for that purpose." While Nevada law does allow for a child support trust to be established under NRS 125.510, it was found inapplicable here because community property cannot be put into trust for a child "unless the trust is established for

the support of the child." The Court remanded for valuation and division of the value.

Tersely, the Court found that "there was evidence in the record to support the district court's valuation of Aztec and Alamo," but the Court did direct a $60,000.00 "inconsistency" to be addressed on remand. It found substantial evidence to support the lower court's finding that the valuable property lot had been transmuted into the husband's separate property.

Justice Springer, dissenting, argued that the lower court's alimony decision should not be second-guessed on appeal, and that the toy soldiers could have been awarded in trust.

Cohabitation Does Not, in and of itself, Merit Termination of Spousal Support; Economic Impact Must be Proven

Gilman v. Gilman & *Callahan v. Callahan*, 114 Nev. ___, ___ P.2d ___ (Adv. Opn. No. 52, Apr. 9, 1998) In *Callahan*, Ken and Valerie married in 1984, and Valerie stopped working to stay home, a status made permanent when their child was born around 1988. They divorced in 1994, and Valerie was awarded temporary monthly spousal support starting at $2,000.00 for 2 years, followed by $1,500.00 for three years. Support was terminable upon Ken's death or Valerie's remarriage; there was no mention of cohabitation. Valerie and the child moved to Reno with her boyfriend Chuck, and in 1996 Ken moved to terminate alimony, alleging that Valerie and Chuck were cohabiting and "acting in every way as if they were married except the legal solemnization of the marriage." He argued that there had been a change of circumstances under NRS 125.150. Valerie admitted a romantic involvement, but denied that Chuck supported her (or the child) financially, said that she and Chuck shared living expenses, and that he had loaned her money. Ken made about $6,500.00 per month. The district court (Sanchez) denied modification.

In *Gilman*, Richard and Marjorie were married in 1963; he worked outside the home, she did not. The parties divorced in 1990 on stipulated terms, which included termination of the $1,500.00 per month alimony upon death or Marjorie's remarriage, and that "the court will consider the issue of spousal support in the event of cohabitation by [Marjorie] with and adult male who significantly contributes to her support." Between 1991 and 1993, Marjorie sometimes lived with her "friend-boyfriend" Tom at his house. She lived there full time for some seven months, paying rent, for her own phone, and for some of the food. She and Tom then moved to Massachusetts, where she bought a house in her name alone; Tom moved in with her. She could not find a job through 1994, but did receive $4,000.00 to $8,000.00 per year from a family trust. Tom did not pay rent, or for food or any part of living expenses, but he contributed carpentry work to Marjorie's house. Richard filed a motion to terminate spousal support based on changed circumstances. He made $9,325.00 per month. The district court (Marren) denied modification.

The Supreme Court affirmed both decisions. In the first footnote, the Court rejected as "without merit" any contention that long-term relationships or cohabitation could constitute a "de facto marriage" for the purpose of terminating alimony, noting that Nevada does not recognize common law marriage, and that "remarriage" requires a solemnization ceremony, citing *Watson v. Watson*, 95 Nev. 495, 596 P.2d 507 (1979). The Court refused to find a rebuttable presumption of changed circumstances, deferring to the legislature.

Rulings on modifications to alimony under NRS 125.150(7) are reviewed on the abuse of discretion standard. Citing law review articles and cases from elsewhere, the Court sided with the "majority rule" that spousal support may be modified or terminated "only if the recipient spouse's need for the support decreases as a result of the cohabitation." The Court noted that "similarly," authority elsewhere provided that if alimony is used to benefit a cohabitant, it may be eliminated or reduced to meet the recipient spouse's actual needs.

Under the "economic needs" test, shared living arrangements, without evidence of decrease in actual financial needs, are insufficient to modify alimony. This test was held to "not unduly impinge upon an individual's freedom to choose to cohabit," and the Court found that it "recognizes the fact that a recipient spouse may be left largely unprotected, from an economic standpoint, if he or she breaks off a relationship with a cohabitant." This was found to be important because part of the reason for spousal support is to keep spouses off the welfare rolls, and "generally, cohabitants owe no legal or financial support to one another." The Court concluded that the financial rights or the payor spouse were taken into consideration, noting the possibility that "cohabitants may sometimes act improperly to maximize their joint wealth (and retain any s payments) by appearing to maintain "separate financial identities." The test "promotes fiscal fairness" by allowing modification if payments are "essentially subsidizing third party cohabitants, or supporting ex-spouses who have significantly improved their financial situation."

The Court found this result consistent with *Jackson v. Jackson*, 111 Nev. 1551, 907 P.2d 990 (1995), which case, the Court said, held that the financial support provided by cohabitants should be considered when modifying court-imposed or court-ratified support obligations."

The final holding was that "a showing that the recipient spouse has an actual decreased financial need for spousal support due to the fiscal impact of a cohabitant may constitute changed circumstances sufficient to require a modification of unaccrued payments under that support obligation." The Court noted that it agreed "in general terms" with the decision of the New Jersey Supreme Court in *Gayet v. Gayet*, 456 A.2d 102 (N.J. 1983), but it could not "adopt wholesale the implication that modification of a spousal support award is absolutely warranted where the third party contributes anything to the recipient spouse's support," because the contribution might be minimal and have little or no impact on "actual needs." The Court stressed that decisions must be made case-by-case.

In the cases before the Court, it was held that where Valerie had to borrow money from her boyfriend Chuck, in part because Ken did not timely pay child support and spousal support, there was no abuse of discretion in the lower court's determination that Chuck's contributions were not significant enough to warrant termination, or even modification, of spousal support; Ken produced "virtually no evidence" of a decrease in Valerie's actual financial needs. As for Richard, the divorce decree was a contract, and the parties "were free to place that cohabitation provision in their divorce decree" and "the provision is valid and

enforceable," affirming *Spector v. Spector*, 112 Nev. 1395, 929 P.2d 964 (1996). Since the divorce decree only provided for modification if a third party "significantly contributed" to her, it was irrelevant if she supported another with those funds, as they intended that their "contractual cohabitation provision, and not the general 'changed circumstances' statute," apply in the event of Marjorie's cohabitation [under a species of *inclusio unis est exclusio alterias*].

Apparently addressing the dissent, the Court made a point of finding how the cases considered were "in no way . . . similar to the circumstances of *Western States Construction v. Michoff*, 108 Nev. 931, 840 P.2d 1220 (1992), noting the joint business, holding out as husband and wife, filing of joint income taxes, and designation of holdings as community property, and stating that there the Court had simply "enforce[d] the agreement of the parties coequal ownership." The Court stated that in *Michoff*, "the cohabitation element of the relationship was virtually incidental." In these two cases, the Court saw no evidence of contract, no evidence of a pooling of assets or of holding out as husband and wife, or treating assets as community property, or building a business together. The Court now states that "neither cohabitation nor a romantic relationship is the real basis for the Michoff holding."

Justice Springer, dissenting at length, would have affirmed in *Gilman* (because the boyfriend did not "significantly contribute") but would have reversed in *Callahan* because to his view Valerie and Chuck had formed what he called a "*Michoff* marriage, enabling her to make a claim against Chuck for support, or at least a portion of jointly-accrued property, if they had broken up, and it would be unfair to allow her to have such rights while continuing to receive spousal support, which would effectively amount to double-dipping. After extensive criticism of *Michoff*, the dissent called on the majority "to clean up this mess" created by the earlier decision.