Exploring the Limits of State Law in Resolving Federal Tax Disputes: Tax Court Denies the IRS’s “Back Door” Approach in Alimony Case

By Hale E. Sheppard

Hale Sheppard explores the limits of state law in resolving federal tax disputes.

Introduction

People are fond of saying that there are only two certainties in life: death and taxes. This statement, while true, is incomplete. Recent studies indicate that more than 50 percent of first-time marriages end in divorce, and the divorce rate is even higher the second time around.\(^1\) Based on these statistics, it might be more accurate to say that there are at least three inevitabilities, namely death, taxes and divorce. This article focuses on the latter two, which are tightly linked.

Many divorces are acrimonious. Hurt feelings frequently cause spouses to take advantage of, or inflict maximum pain on, each other, both before and after the divorce proceeding. One common way of achieving this goal is to creatively “re-interpret” the tax implications of the divorce or settlement instrument after the fact. Another familiar ploy is for one spouse to change tax reporting positions because of a subsequent event, such as remarriage. Regardless of which technique is used, the result is usually the same: an IRS audit of both spouses. This triggers a significant cost to the spouses in terms of time, money and effort. The key, therefore, is to understand divorce tax law and, perhaps more importantly, the limits of the IRS in applying such law. A recent Tax Court case, M.A. Crompton, provides new guidance in this regard.\(^2\) In particular, it describes circumstances in which the IRS cannot inject state law into federal tax issues through the “back door.”

Overview of the Law

To appreciate the importance of Crompton, it is first necessary to review the evolution of the relevant law. In its current form, Section 71(a) provides that the recipient of any “alimony” or “separate maintenance” payments during a particular year must include such payments as part of gross income on the federal income tax return. On the other side of the equation, Section 215(a) generally allows the party making the “alimony” or “separate maintenance” payments to deduct these amounts. Let’s see how we arrived at this point.

A. The Law As of 1954

Section 71 was introduced in 1954.\(^3\) It provided the following general rule:
If a wife is divorced or legally separated from her husband under a decree of divorce or of separate maintenance, the wife’s gross income includes periodic payments (whether or not made at regular intervals) received after such decree in discharge of a legal obligation which, because of the marital or family relationship, is imposed on or incurred by the husband under the decree or under a written instrument incident to such divorce or separation.

This and similar rules under Section 71 generated a significant amount of tax-related litigation in the following decades, much of which focused on whether the husband had a “legal obligation” to make payments to his former spouse. If he did, he could deduct the payments; if he did not, he was out of luck. In determining whether the husband was obligated to pay (particularly in situations where the ex-wife got remarried and failed to inform her ex-husband of the event), the courts and the IRS seemed to take different, often inconsistent stances on how to resolve the issue. Sometimes they looked to the laws of the state in which the parties divorced; on other occasions they limited themselves to scrutinizing the express verbiage of the state court decree.

B. The Law As of 1984

Congress attempted to clarify this and other issues upon modifying Section 71 as part of the Deficit Reduction Act of 1984. It sought to halt taxpayers from falsely characterizing property settlements as alimony and then taking large deductions for one-time, lump-sum payments that were not truly linked to the support needs of the spouse. Moreover, Congress desired uniformity and certainty; it wanted to create a definition of alimony that would be easier for the IRS and divorcing taxpayers to apply. Official statements and legislative history illustrate the importance of the second goal. For example, the Treasury Department advocated drafting the law in such a way that it would not harm unsuspecting taxpayers, stating that:

[T]he definition of alimony should provide clear, objective standards by which the parties can understand the tax consequences of their divorce settlement and make their plans accordingly. This factor is especially important since divorce is such a common occurrence and frequently involves parties who have little knowledge of the tax concept of alimony and who cannot afford sophisticated tax counsel.

Speaking before Congress, the Treasury representative went on to explain that the new law should eliminate the rule that, in order to be treated as a alimony for federal tax purposes, a payment must be in discharge of a “legal obligation” derived from a marital or family relationship. The representative stated the following in support of his position:

Present law gives undue weight to the first consideration by limiting alimony to payments made in discharge of a legal obligation arising out of the marital or family relationship. This standard, which necessarily depends on all of the facts and circumstances relating to the divorce settlement, has resulted in a great deal of litigation and, in many cases, denies certainty to the parties in planning their divorce settlement. We support the elimination of this test from the definition of alimony and its replacement with tests which are more objective.

The House Ways and Means Committee echoed the ideas of the Treasury Department, urging rules that would not require an examination of the underlying state law. Its report contained the following reasons for change:

The committee believes that the present law definition of alimony is not sufficiently objective. Differences in State laws create differences in Federal tax consequences and administrative difficulties for the IRS. The committee believes that a uniform Federal standard should be set forth to determine what constitutes alimony for Federal tax purposes. This will make it easier for the Internal Revenue Service, the parties to a divorce, and the courts to apply the rules to the facts in any particular case and should lead to less litigation.

The law was revamped in 1984 based on the preceding rationales. After modification, Section 71(b)(1) provided that a payment will be considered “alimony” or “separate maintenance” if all of the following six elements are met: (i) the payment is made in cash; (ii) the payment is received by a spouse, or on behalf of a spouse, under a divorce
or written separation instrument; (iii) the divorce or separation instrument does not specifically designate the payment as one that is not includible in the recipient's gross income under Section 71 and not allowable as a deduction to the paying spouse under Section 215; (iv) in cases where spouses are legally separated from one another, the spouses are not sharing the same household at the time the payment is made; (v) the spouses, if still married, do not file a joint federal income tax return; and (vi) the obligation to make payments terminates upon the death of the recipient spouse.

The last factor, commonly known as the “death contingency,” was actually more restrictive. Under the 1984 law, the divorce or separation instrument was required to specifically address the death contingency. The relevant provision stated that “a payment is deemed to be alimony if, among other things, there is no liability to make any such payment for any period after the death of the payee spouse ... (and the divorce or separation instrument states that there is no such liability).”

C. The Law As of 1986

Congress soon realized that the 1984 law, especially the express death contingency requirement, was causing many payments intended as alimony to be excluded from this category because of a failure to meet the six elements of Section 71(b)(1). Therefore, Congress decided to jettison this element when it enacted the Tax Reform Act of 1986. Under the new Section 71(b), the spouse paying the alimony is not deprived of the deduction simply because the divorce or separation instrument does not expressly state that the payment obligation will cease upon the death of the recipient spouse. Various IRS pronouncements clearly delineate between the 1984 and the 1986 alimony requirements, emphasizing the possibility of looking to state law in this context:

Under pre-Tax Reform Act law, payments could qualify as alimony or separate maintenance payments only if the payor spouse's liability to continue to make such payments terminated upon the death of the payee spouse. Moreover, it was required that the divorce or separate maintenance instrument expressly state that the liability to make payments would so terminate, even if, independent of the terms of the agreement, the liability to continue to make the payments would terminate upon the death of the payee spouse as a result of State law ... Under the Tax Reform Act, as under pre-Tax Reform Act law, payments may qualify as alimony or separate maintenance payments only if the payor spouse's liability terminates upon the death of the payee spouse. The termination of liability need not, however, be expressly stated in the instrument it, for example, the termination would occur by operation of State law.

Now, in determining whether a death contingency exists, the courts may consider the divorce or separation instrument, the applicable state statute, or state common law. Allowing courts to review state law in deciding federal tax issues is contrary to the congressional goals of objectivity and uniformity, but it is entirely consistent with the notion of helping hapless taxpayers. This is true because the majority of states call for automatic termination of alimony obligations when the recipient spouse dies. Therefore, in most states, the sixth element of Section 71(b) is satisfied (and the payments are considered deductible alimony), even though a taxpayer or his representative neglected to include an express death contingency in the divorce or separation instrument. Congress, in essence, somewhat sacrificed its goals of objectivity and uniformity in an effort to avoid denying the intentions of divorcing parties because of a technicality.

Over the last two decades, the congressional compromise in 1986 has led many federal courts to review state law in cases concerning the death contingency element in Section 71(b)(1)(D). However, until recently, the courts had not focused extensively on whether it is appropriate to examine state law in deciding if other elements in Section 71(b)(1) have been satisfied. Hence the importance of Crompton.

Analysis of the Case

The significant facts in Crompton are as follows: In November 1996, the couple got divorced in Delaware family court. In connection with the divorce, the court issued a “Stipulation and Order Resolving Ancillary Matters Pursuant to a Decree of Divorce” (“Order”) in January 1997. Among other things, the Order required the ex-husband to pay his ex-wife alimony in the amount of $500 per month for a period of 10 years. No initial doubt existed between
the parties as to the proper tax treatment because the
Order stated that the “payments will be treated as
alimony for income tax purposes, fully reportable as
taxable income by [ex-wife] and fully deductible by
[ex-husband].”16 However, the Order did not contain a
provision explaining what impact, if any, remarriage
by the ex-wife would have on the ex-husband’s alimony
obligation.

The ex-husband paid his ex-wife $500 per month in
accordance with the Order for approximately seven
years. During this period, the ex-husband deducted
these payments from his Form 1040 as alimony, while
the ex-wife included them as income. The ex-wife
then remarried. She did not tell the ex-husband about
the nuptials, and he was not otherwise informed of
this dramatic change in her civil status. The ex-wife’s
failure to inform her ex-husband of the new marriage
violated Delaware law.17 To compound her deceit,
the ex-wife also did not include the payments as part
of gross income on her Form 1040. In other words,
she failed to properly report her remarriage to the
ex-husband and she likewise failed to report her
income to the IRS.

The ex-husband, completely oblivious to the remar-
riage, continued to make monthly payments to his
ex-wife and claim the related alimony deductions.
According to court documents, the ex-husband con-
tinued to make payments after ex-wife’s remarriage
“under the impression that she had not remarried
and that payments were still required pursuant to the
Delaware Family Court decree.” Thus, the ex-husband
deducted on his Form 1040 for 2004 the $6,000 that
he paid during the year, i.e., $500 multiplied by 12
monthly payments. The IRS audited the ex-husband,
disallowed the deduction in full, and ultimately is-
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The IRS argued that the ex-husband was not
entitled to an “alimony” deduction based on the fol-
lowing analysis. Section 215(a) generally allows a
deduction for any alimony or separate maintenance
payments made during a year. Section 215(b)(1)
clarifies that, for these purposes, the term “alimony
or separate maintenance payment” includes only
those payments that must be reported as gross in-
come by the recipient under Section 71. To meet
the definition of “alimony or separate maintenance
payment” under Section 71(b), a payment must
satisfy several criteria, including Section 71(b)(1)(A).
This provision states that a payment is deduct-
able if it is received “under a divorce or separation
instrument.” Delaware law provides that “[u]nless
otherwise agreed by the parties in writing and ex-
pressly provided in the decree, the obligation to pay
future alimony is terminated upon ... the remar-
riage of the party receiving the alimony.”18 The IRS
concluded that the payments by the ex-husband
did not qualify as deductible alimony because, ac-
cording to applicable state law, his obligation to pay
terminated when his ex-wife remarried, irrespective
of the fact that the ex-husband was clueless about
the remarriage. Therefore, the ex-husband did not
make the payments “under a divorce or separation
instrument.”

For his part, the ex-husband invoked equity and
common sense, explaining to the Tax Court that he
continued to pay what he believed was his obligation
under the Order because of his ignorance of his ex-
wife’s remarriage.

In ruling in favor of the ex-husband, the Tax
Court noted that Congress amended Section 71
in 1984, and later in 1986, to develop a uni-
form standard in determining what constitutes
alimony for federal tax purposes. The Tax Court
gone on to say that the definition of alimony is
based on an “objective standard,” and the courts
generally should not make subjective inquiries
under the varying state laws. Citing a relevant
congressional report, the Tax Court stated that
“[i]t is Congress’s intent that courts, in determining
whether payments constitute alimony under Sec-
tion 71, will look to State law only to determine
whether the requirements of Section 71(b)(1)(D) is
satisfied, i.e., whether State law provides that the
payments terminate upon the payee’s death.” In
other words, the Tax Court indicated that judicial
analysis of state law in deciding a federal tax is-
issue is appropriate only in cases involving Section
71(b)(1)(D) (where courts must determine if one
ex-spouse has an obligation to continue making
payments after the other ex-spouse dies), not in
cases concerning Section 71(b)(1)(A) (where courts
need to decide if a particular payment is made
“under” a state-governed divorce or separation
instrument). The Tax Court reasoned that if it were
to accept the IRS’s theory, it would first need to
review Delaware law to ascertain whether the
Order was enforceable and, therefore, whether
the payments were made “under” a divorce or
separation instrument. The Tax Court rejected the
need for an initial analysis of state law, conclud-
The positions are taken “inconsistent positions” against them in or-
If the “alimony” amount does not appear on the
Security number of the recipient of the payment.20
is largely attributable to the fact that the IRS easily
overall fees and a prolongation of the dispute. This
analysis is frequently omitted for financial reasons;
demonstrates, failure to adequately address the
amount of tax at issue.19
First, the case illustrates how tax and family law
are intertwined. All too often tax considerations
are not raised in the divorce context. The tax
analysis is frequently omitted for financial reasons;
 divorcing parties hope to minimize costs to the
extent possible. Timing is an issue, too. Divorcing
couples generally oppose extending the process
any more than necessary. Ironically, as Crompton
demonstrates, failure to adequately address the
tax issues at the front end often results in larger
overall fees and a prolongation of the dispute. This
is largely attributable to the fact that the IRS easily
identifies alimony-related discrepancies through a
computer matching program. The tax code requires
the person claiming an alimony deduction to place
on his or her federal income tax return the Social
Security number of the recipient of the payment.20
If the “alimony” amount does not appear on the
recipient’s federal income tax return, then the IRS
typically opens on audit of both ex-spouses and
takes “inconsistent positions” against them in or-
der to protect the public fisc.21 The positions are
inconsistent in that the IRS generally denies the
alimony deduction to the ex-spouse making the
payment, while simultaneously proposing to in-
crease the recipient’s income by the amount of the
payment. In other words, the IRS often maintains
that the payment was not alimony when it comes
to claiming a deduction for it, but was alimony in
the context of determining the annual income of
the recipient.
Second, Crompton shows that fairness is not the
foundation on which many tax cases are built. The
court documents demonstrate that the IRS was fully
aware of several important facts before the Tax
Court case: (i) the spouses divorced in 1996; (ii) the
divorce Order expressly stated that the payments
at issue would be treated as alimony for federal
tax purposes, fully taxable to the ex-wife and fully
deductible by the ex-husband; (iii) the ex-wife remarried in 2003; (iv) until her remarriage, the
ex-wife reported the payments as alimony income;
(v) the ex-wife failed to inform the ex-husband of
her remarriage; (vi) the ex-wife’s silence violated
Delaware law; (vii) the ex-wife continued to ac-
cept the payments after her remarriage yet failed
to pay taxes on them; and (viii) the ex-husband
honestly believed that he was required to make
the payments in question to his ex-wife. Never-
theless, the IRS pursued the ex-husband for a tax
deficiency. The Tax Court victory likely vindicated
the ex-husband to a certain degree, but he no
doubt endured considerable angst during the audit,
administrative appeal and/or litigation process. The
ex-husband could potentially seek reimbursement
from the IRS for administrative and litigation costs
in an effort to assuage his pain.22 He is unlikely
to pursue this option, though, because of the
limitations. Among other things, he would have to
prove that he exhausted all of his administrative
remedies, he or his representative participated
sufficiently with the IRS during the process, the
IRS’s position was not substantially justified, he
falls within certain net worth parameters, and the
costs he incurred were reasonable.23 He would also
have to spend more time embroiled in a dispute
with the IRS before the Tax Court, which is rarely
enticing to taxpayers.
Third, the case of Crompton is significant for
what it does not address, namely the actions by
the IRS toward the ex-wife. The IRS has relied on a
variety of legal theories in situations, like the one
in Crompton, where the ex-wife remarries and con-
tinues to receive payments from her ex-husband.
In H.I. Joss, a couple married and divorced shortly
thereafter. The separation agreement stated that the
ex-husband would pay the ex-wife $23,000 per year
until her death or remarriage. The ex-wife remarried
the following year, failed to inform her ex-husband
of the remarriage (though she knew that state law
mandated such notice), and continued taking the
annual payments. She failed to report the payments
Small Tax Deficiency,
Big Ruling
The significance of a given case often eludes people.
This is particularly true with tax disputes, which tend
to be dense, technical and complex. Therefore, this
article identifies several reasons why Crompton is
noteworthy, notwithstanding the relatively small
amount of tax at issue.19

The Tax Court ruled that the ex-wife received the
payments “under a divorce or separation instru-
ment” for federal tax purposes, regardless of the
remarriage and the effect thereof under state law.
Accordingly, the ex-husband was entitled to the
alimony deduction.
as income on her federal tax returns based on the theory that the money did not constitute taxable alimony because, under the terms of the separation agreement, the ex-husband had no legal duty to make the payments. The IRS eventually issued a Notice of Deficiency to the ex-wife, claiming that she failed to report income, not under Section 71, but rather under Code Sec. 61. The latter provision states that a taxpayer’s gross income generally means “all income from whatever source derived.” The Tax Court sided with the IRS, ruling that payments in such circumstances constitute income under Section 61, unless they are gifts, loan repayments or are specifically excluded from gross income under some other provision of the tax code. There was no evidence of gifts, loans or exclusions in Joss; indeed, the Tax Court recognized that the ex-wife obtained the money unlawfully and was akin to an embezzler. The IRS has raised similar Section 61 arguments in other cases and administrative pronouncements, too. Crompton provides a glimpse into only one side of the equation, yet it triggers valuable speculation about how the IRS pursued the ex-wife, if at all.

Fourth, Crompton arguably shows an attempt to shift IRS policy in divorce-related cases. In several important cases concerning alimony issues under the 1954 law, the IRS urged the court not to examine state law in determining whether an ex-spouse had a “legal obligation” to make a particular payment. For example, in M.K. Brown, the IRS argued that Congressional revisions to Section 71 were designed to end distinctions based on variations between state laws. Therefore, maintained the IRS, the provisions of the divorce decree should control for federal tax purposes, despite any provisions in the applicable state law. Similarly, in A. Hoffman, the IRS contended that the “legal obligation” in Section 71 was not a duty dependent on the enforceability under state law, but rather a federal standard using that term in the sense of a general support obligation arising from a marital or family relationship. The IRS further suggested that looking to state law for purposes of resolving issues under Section 71 would place “an insurmountable legal and factual burden” on the IRS because “there are 50 local law jurisdictions” and staying abreast of all such laws would be a “difficult task.” The IRS raised similar arguments on appeal, pointing out that legislative history to Section 71 indicates that Congress “intended to eliminate problematical uncertainties and inequities resulting from variances in the laws of different states.” Brown and Hoffman clearly show the IRS’s aversion at that time to resorting to state law in resolving federal income tax disputes. If any doubt remained regarding the IRS’s position, it was eliminated by an administrative pronouncement regarding a proposed revenue ruling. The relevant IRS memorandum, which expressly references Brown and Hoffman, states the following: “We understand the purpose of the proposed ruling to be the publishing of our position that the Service will not go behind a state court decree providing for support payments to ascertain its enforceability under that state’s law. We feel that this position has been sufficiently publicized by prior actions of the Service.”

Several years later, when Congress was amending Section 71 in 1984, the Treasury (and thus the IRS) adopted a similar stance. They advocated a definition of alimony that was clear, objective, and free from state law considerations. After many decades of resisting consultation of state law in resolving federal tax disputes, it is interesting that the IRS adopted the opposite approach in Crompton, asking the Tax Court to review Delaware law to determine whether the ex-husband made payments “under a divorce or written separation agreement.”

Finally, the Tax Court clarified in Crompton that the IRS may not circumvent congressional intent and introduce state law in certain situations. In particular, the court explained that judicial review of state law in deciding a federal tax issue is not appropriate in cases involving Section 71(b)(1)(A), where the issue is whether a payment was made “under” a state-governed divorce or separation instrument. Such state law analysis, ruled the Tax Court, is proper only in cases concerning Section 71(b)(1)(D), where the issue centers on the death contingency. This taxpayer-favorable ruling becomes even more interesting upon further reflection. As explained earlier, one of the six elements to be considered “alimony” under the 1984 law was an express death contingency; that is, the divorce or separation instrument had to specifically state that no further payments were due once the recipient spouse dies. Congress, realizing that...
this requirement could cause taxpayers to have their “alimony” payments inadvertently transformed into nonalimony, changed the law in 1986 to remove the express death contingency. Thus, because most state laws dispense with the payment obligation upon death of the recipient, a taxpayer’s failure to include it in their death benefit agreement would not be fatal. In effect, Congress deviated from its goals of objectivity and complicated tax administration by forcing the IRS to look at up to 50 different state laws) in order to assist hapless taxpayers. In Crompton, the Tax Court also assisted taxpayers who would otherwise suffer adverse tax effects due to their ignorance, not of the law, but rather of the remarriage of their former spouse. Unlike Congress, though, the Tax Court achieved this by prohibiting the IRS from looking to state law.

Conclusion

Statistics reveal that the majority of people will face divorce at least once in their lives. If not them personally, divorce will no doubt affect someone they know. Accordingly, understanding the tax aspects of divorce is pivotal. It is also paramount to grasp the restrictions on the IRS in applying divorce tax law, particularly in the area of alimony. As this article demonstrates, Crompton, while a relatively small case in economic terms, contains new insight into the Section 71 analysis. Divorcing taxpayers and their representatives should appreciate the impact of Crompton in defending a case before the IRS. Indeed, not doing so could result in the IRS improperly inserting state law into a federal tax dispute through the “back door.”

**ENDNOTES**

3 This provision was first enacted as Section 22(k) of the Internal Revenue Code of 1939. It was substantially reenacted as Section 71 in the Internal Revenue Code of 1954.
4 Section 71(a)(1), as in effect under the Internal Revenue Code of 1954 (emphasis added).
10 Id.
13 Notice 87-9, 1987-1 CB 421 (emphasis added).
14 LTR 9326010 (Mar. 26, 1993).
15 These facts are compiled from the published decision (i.e., M.A. Crompton, TC Summ., Op 2008-102 (Aug. 13, 2008)). The petition filed by Mr. Crompton with the U.S. Tax Court on January 22, 2007, the Joint Stipulation of Facts dated March 17, 2008, and the Pre-Trial Memorandum filed by the IRS on March 17, 2008. The preceding documents are in the author’s possession.
16 Pre-Trial Memorandum for the IRS filed with the U.S. Tax Court on March 17, 2008.
17 Delaware law provides that “[a] party receiving alimony shall promptly notify the other party of his or her remarriage or cohabitation.” 13 DEL. CODE ANN. §1512(g).
18 13 DEL. CODE ANN. §1519(b).
19 The case involved one deduction of $6,000, which resulted in a proposed deficiency of $1,500. Generally, Tax Court decisions in cases involving proposed tax deficiencies do not serve as “shall not be reviewed in any other court and shall not be treated as a precedent for any other case.” Code Sec. 7666(a)(2).
20 Section 215(c); Reg. §1.215-1 T Q-1.
21 IRM §4.19.1.6.21.3 (Jan. 1, 2006).
22 Code Sec. 7430.
23 Code Sec. 7430; Reg. §301.7430-1 et seq.
24 Section 61(a); Reg. §1.61-1(a).
29 Hoffman, supra note 28, 54 TC, at 1611.
30 Hoffman, supra note 28, 455 F2d, at 162.
31 GCM 34415 (Feb. 1, 1971).