Divorce - more of a tax issue today than ever before?

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ABSTRACT

As unsettling as a divorce might be for two individuals desiring to end a marriage, it can be even worse than necessary if tax implications are not considered. The divorce negotiations should, therefore, necessarily include consideration of the federal (and state) tax implications of the soon to be former spouses. This should include among other concerns the proper structuring of any alimony or child support payments. Related issues include when alimony payments will cease, when child support payments will cease, will there be payments of personal expenses for one former spouse by the other, and front-loading of alimony payments. Proper consideration of as many of these factors as possible, should lead to a divorce agreement that the parties should be able to agree upon.

Keywords: alimony, child support, indirect alimony, front-loading

Introduction

In these unsure economic times, incomes are tenuous for many; including those newly unemployed and those who are perhaps under employed. Where there is the added stress of a broken marriage heading for divorce, one does not have to think long without realizing that in such a situation added tax troubles would not be desirable. However, due to the application of our federal income tax law as defined under the Internal Revenue Code of 1986[1], tax troubles may arise.

Most of the divorces which make the news may involve a focus on personal issues and personalities. Lurking behind the scenes, even in these often publicly aired divorces, are potentially devastating tax consequences. Take for example, a much publicized breakup of the marriage of Michael and Dina Lohan.

From the press accounts, Michael believed that his estranged wife should be able to pay him millions in alimony because of the earnings of their daughter, a teenage movie starlet. Michael and Dina Lohan's daughter is superstar Lindsay Lohan. Lindsay has reportedly made millions for her roles in such movies as The Parent Trap, Freaky Friday, Mean Girls, and Herbie: Fully Loaded. According to the father, it made no difference that the mother and daughter had a restraining order against him, he felt he was entitled to the alimony due to his economic status.

In the Lohan case, as with many others, it's easy to see that claims for alimony do not follow any given pattern and can often cause many interesting personal issues. The personal issues invariably translate to tax concerns because when alimony is paid, it is normally deductible by the paying spouse (payor) and includible in the income of the receiving spouse (payee). Therefore, to understand the tax issues of alimony payments, careful navigation of the tax rules must be completed.

Alimony And The Federal Tax Law

In 1984, and again in 1986, the Code was amended to make the alimony rules more flexible, simpler, and less dependent upon state law. An understanding of the current rules for alimony is essential for purposes of advising clients or contending with the tax consequences of a divorce or separation. This article will examine these rules and emphasize specific areas that have imposed a threat or a trap for the unwary taxpayer.

Historically, the word "alimony" referred to monies paid from one spouse to another while they were separated. When they divorced, the monies payable became referred to as "maintenance." Therefore, in a divorce or separation, the payment served to fulfill the financial obligation of one spouse to another that comes with marriage. In some states, the payment amount is established according to a statutory formula. In other states, the amount of the alimony payment is usually set by a judge and granted in proportion to the needs of the person requiring it, and the circumstances of the person paying it. Typically, the parties' relative ability to earn money, their age, health and length of marriage are contributing factors. However, as a rule, a judge will only award alimony where one spouse has been economically dependent upon another spouse for most of a lengthy marriage.

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[1] Hereafter, all references are to the Internal Revenue Code of 1986 or the Code.

Alimony For Tax Purposes

Alimony, as defined in the Code, was originally enacted to provide a uniform definition so that alimony payments could be distinguished from property settlements which receive a much different tax treatment. Under this provision, a payment is only considered "alimony" when: (A) it is paid in cash; (B) the payment is received by (or on behalf of) a spouse under a divorce or separation instrument; (C) the parties are not members of the same household at the time of payment; (D) the payer spouse is not liable to continue making the payments after the death of the payee spouse; and (E) the payment(s) otherwise qualifying as alimony should not be designated as non-alimony.[2]

In addition to these requirements, the payment cannot be fixed as child support either directly or indirectly and excess front-loading of alimony payments is prohibited. Both of these concepts will be discussed later in more detail. A payment that meets all of the above requirements automatically qualifies as an alimony payment. There is no requirement, as under pre-1985 law, that the payment be periodic or that it be made in discharge of a legal obligation to support arising out of a marital or family relationship.

Only payments made under a divorce or separation instrument are deductible as alimony; voluntary payments are never considered as such. A divorce or separation instrument includes a written separation agreement, any type of written court order or decree, or any other order requires one spouse to make payments for the other spouse's support or maintenance. [3]

Voluntary payments include payments made before or after there is a legally enforceable payment obligation, payments made under oral agreements or orders, and payments that exceed amounts required by the divorce or separation instrument. A voluntary payment cannot be cured by making a separation retroactive to the date that earlier payments were made.[4]

Payments will not qualify as alimony if the payer is required to continue payments after the death of the payee spouse. Such a payment would more closely resemble a legal obligation related to a property settlement than alimony, since it would be payable to the estate or an heir of the decedent spouse. Although best to do so, the support or divorce instrument does not have to state that payments will terminate on the death of the payee spouse if state law or circumstances would terminate such payments on the payee spouse's death. Payments that continue after the payee-spouse's death disqualifies all pre-death payments. However, a substitute payment may disqualify only a portion of the pre-death payments [5].

Illustration

As a portion of his support, Gertrude is to pay William $5,000 in cash each year for a period of 15 years under their divorce which does not state that the payments will terminate upon the death of William. Accordingly, none of the payments (not just the payments preceding death) will qualify as alimony. If for some reason State law required the payments to terminate upon William's death, the payments would qualify as alimony.

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[2] Code Section 71(b)(1).
[3] Code Section 71(b)(2).
[4] *Beaugard v. Commissioner*, T.C. Memo. 1980-311.
[5] Reg. Section 1.71-1T(b) Q&A 13 and 14.

Illustration
Assume the same facts as above but the divorce instrument states that upon the death of William, payments to William's estate will continue at the rate of $1,000 each year. In this case, $4,000 of the cash payments will qualify as alimony.

If a husband and wife are divorced or legally separated, a payment does not qualify as alimony if the spouses are members of the same household at the time the payment is made. A household shared by both spouses is not considered two separate households even if the spouses physically separate themselves under the same roof. However, the parties will not be treated as members of the same household if one of the parties is preparing to depart from the household shortly and does in fact depart not more than one month after the date the payment is made [6].

Illustration
Mary and Sam are legally separated but still living in the same household as of June, 1, 2010. If Mary had received a payment from Sam on May 18 of $3,000, it will not be considered alimony under the general rule. However, if Mary plans to permanently move from the household she is sharing with Sam and does leave before June 18, the payment will be considered alimony (assuming it will otherwise qualify as alimony).

If the spouses are not legally separated under a decree of divorce or separate maintenance, payments made under a written separation agreement qualify as alimony notwithstanding the fact that the spouses are members of the same household at the time the payment is made. Under this rule, payments under a written agreement qualify as alimony even if the spouses continue to live in the same household until they receive a decree of divorce or legal separation.[7]

The forgoing examination of the general requirements of section 71(b) seems to indicate that the tax treatment of alimony is easily understood and applied. Anyone who deals with the Code and related regulations and court cases, knows that there are many special rules and interpretations which may affect the application of these rules in varying fact patterns. The remainder of this article will be concerned with covering some of these unusual situations.

Child Support Payments and Related Issues

Payments for child support pursuant to a divorce or legal separation are neither income to the payee nor deductible by the payor.[8] Normally, one party will be given primary custody of minor children. As will become evident, it is possible that the tax rules might potentially be manipulated by the parties to minimize tax consequences in this situation. Congress was concerned that payments which were actually child support might be disguised in order to have them classified as alimony. As a result, the tax law has been written to eliminate this possibility; albeit by adding a degree of complexity to the law itself as the following will illustrate.

[6] Reg. Section 1.71-1T(b), Q&A 9.
[7] Id.
[8] Section 71(c).

The test for alimony fixed as child support can actually be thought of as three separate tests which must be satisfied. (1) It can't be called child support; (2) A change can't be based on the happening of a contingency related to the child; and (3) It can't be changed based upon something that's associated with the happening of a contingency related to a child.

The first test is fairly straightforward and is based on the terminology that is found in the statute. Payments can be characterized as child support even though they are for the support of an adult child. The second two tests can be more complicated and require further discussion.

Child Related Contingencies

Making a payment subject to being reduced as a result of an occurrence of a specified contingency relating to the child, will convert what would be referred to as alimony into child support. The types of contingencies which are normally encountered can include a child's marrying, dying, leaving home, leaving school, becoming employed full-time and/or reaching a certain income level.

> **Illustration**
> Tyler will receive alimony of $800 each month from his former wife, Mildred. However, the payment will stop when their child leaves home. The presence of this contingency will convert the alimony into child support.

Child Related Contingencies – An Associated Event

Dates of significance related to this issue are discussed in Section 71(c)(2)(B). In effect, any reduction in alimony which would occur in close proximity to a date of significance of an event related to a child could be enough to change the tax treatment from alimony to child support. The regulations yield some guidance in this area by providing two tests to provide clarity.[9] The first test is easily understood and applied. The second test is not as simple and can be difficult to apply.

Test #1 – Alimony cannot be reduced within six months of the 18th or 21st birthday of a child, or the local age of majority.

Test #2 – The second test takes place only if there are at least two children and at least two reduction dates. The regulations state that payments will not be considered alimony where the amounts are to be reduced on two or more occasions which occur not more than one year before or after a different child of the payor spouse attains a certain age between the ages of 18 and 24, inclusive. The certain age referred to in the preceding sentence must be the same for each such child, but need not be a whole number of years.

When a reduction satisfies one or both of the tests above, there is a rebuttable presumption that the payment will be considered child support to the extent the reduction coincides with the contingency related to the child. Rebutting the presumption requires a showing (either by the taxpayer or by the IRS) that the date of the reduction is set

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[9] Reg. Section 1.71-1T(a), Q&A 18.

independently of a contingency related to a child. The regulations provide further guidance on these tests.

Payments To Third Parties (Indirect Alimony)

Indirect alimony may be deductible by the payor and includible in the income of the indirect beneficiary. Indirect alimony may include cash payments to a third party to provide a residence for a former spouse (e.g., rent, mortgage, utilities, etc.), insurance on the life of the payor, paying medical costs, or other such expenses incurred by the payee. Even though the payments are made directly to the third party, they are treated as if they were received by the payee former spouse and then paid to the third party.

Over the years, primarily court decision driven rules have been developed to determine whether indirect payments are alimony for tax purposes. The distillation of these rules has focused on whether the payee former spouse receives an economic benefit by reason of the payor former spouse's paying of such expenses. If the payee former spouse benefits economically by reason of the payment, the decision has been that such indirect payments were indeed alimony. In general, if the payee does not benefit economically, a payment to a third party will not be considered alimony.

Living Expenses - Personal Residence

It is not unusual for one spouse to be required to make the mortgage payments on a residence that the former spouse is entitled to occupy. In addition, other home related expenses may also be required to be paid (e.g. real estate taxes, home insurance, and any other maintenance costs). Assuming that these indirect payments meet the previously discussed requirements of section 71, the payments are for the benefit of the payee spouse and will be considered as alimony payments.

Illustration
Harold, under a separation agreement, is required to pay the real estate taxes, mortgage payments, and insurance premiums on a home now owned by his former spouse Jill. Assuming all of the other alimony requirements are met, Harold can deduct the payments as alimony on his tax return, and Jill must report them as alimony received. When itemizing her deductions, Jill can deduct the real estate taxes and also the interest on the mortgage (provided the home is a qualified home).

The payments made by Harold above were treated as alimony because the mortgage, taxes and insurance were "for the benefit of the spouse in possession."[10] Jill was the one that owned the house. If the payor spouse holds title to the property, the payment of the mortgage, taxes, and insurance is not considered to be for the benefit of the spouse in possession and generally is not treated as alimony. In *Stiles v. Commissioner*,[11] the separation agreement gave title of the residence to the husband, who was solely responsible for the mortgage payments. The wife, however, was entitled to reside in the house until her death or remarriage. The Tax Court denied an alimony deduction and held that the payment of the mortgage was not alimony

[10] *Mace v. Commissioner*, 64-2 U.S.T.C. para. 9732 (S.D. Cal. 1964).
[11] T.C. Memo. 1981-711.

because it served only to increase the husband's equity in the residence and did not benefit the former spouse in any way.

Non Arm's Length Property Rentals

Terms of a divorce or separation agreement may allow a former spouse to occupy a residence owned by the other spouse rent-free. In this situation, the courts have disallowed attempts by the owner-spouse to deduct the use of the residence as alimony (fair market value or otherwise) because no cash had been paid.[12] Alternatively, the payment of rent to a third party for a residence occupied by a former spouse will be deductible as alimony assuming that the taxpayer (and not a surrogate such as the taxpayer's LLC) makes the payment.

Payment of Legal Expenses

It is not uncommon as a result of a divorce for one spouse to be responsible for paying the legal expenses of the other, either by agreement or by decree. Normally, the payment of another spouse's attorney fee(s) is not generally deductible. However, where the requirements of Code Section 71 are satisfied, such payments can be treated as alimony.

As will be discussed more fully below, large attorney fees paid on behalf of a former spouse may result in unintentional front-loading. Such front-loading may result in recapture which occurs when there is a reduction of more than $15,000 in annual payments during the first three post-separation years. In general, the payor spouse may have to include a recapture amount in income. Where a spouse has agreed to pay in excess of $15,000 for the other spouse's attorney fees, proper planning would suggest extending any such additional amounts over multiple years in order to avoid recapture.

Front-Loading of Alimony

Special front-loading rules have been enacted to prevent payments from being deducted as alimony that are really disguised property settlements. Where front-loading is present, the law requires recapture of excess amounts that had been treated as alimony. In order for the front-loading recapture rules to apply, alimony payments must be reduced or terminated during the first three years. Where a recapture situation exists, excess alimony payments are recaptured in the payor's tax year beginning in the third post-separation year by including the excess in income that year. Since the payee would have previously included the alimony in income, the payor's recapture amount can be deducted from the payee's gross income in the tax year beginning in the third post-separation year.

The first step in applying the front-loading rules is to identify the relevant years as the first, second and third post-separation years. The first post-separation year is the year in which the payor first makes payments qualifying as alimony or separate maintenance payments. The next two succeeding calendar years are known as the second and third post-separation years. The general rule is that, if during the first three years, the amount of the alimony paid decreases by more than $15,000 between years, the excess over $15,000 is alimony recapture.

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[12] *Pappenheimer v. Allen,* 164 F.2d 428 (5th Cir. 1947), and *Bradley v. Commissioner,* 30 T.C. 701 (1958).

There is a two step process required in determining the amount of recapture. First, the statute requires a determination of the decrease between the second and third years to determine alimony recapture for year two. The next step is to determine the alimony recapture for year one. This step requires that the average of payments for years two and three be compared to the year one payment in order to determine if there is a prohibited decrease. In making this calculation, the year two payment is revised to the extent any year two payment will be recaptured alimony. Year two would now be defined as revised alimony and this amount is to be used in this part of the calculation. Year two revised alimony would be the actual alimony paid in year two less any year two alimony recapture computed in the first step.

Now that the excess payments for both the first and second post-separation years have been determined, the results are combined to determine the amount subject to recapture in the third post-separation year.

Illustration

Austin and Katie divorce in 2007. Pursuant to the divorce instrument, Katie will pay Austin $50,000 in 2007 and $20,000 in 2008, and nothing in later years. Katie will deduct alimony in 2007 and 2008 of $50,000 and $20,000 respectively. Austin will include those same amounts as income on his return in the same respective tax years. At the end of 2009, the front-loading calculation would result in alimony recapture of $32,500 calculated as follows:

Year 2 recapture =

Year 2 alimony – (year 3 alimony + $15,000 decrease allowed)

= $20,000 – ($0 + $15,000) = $5,000

Year 1 recapture =

$$\text{Year 1 payment} - \left\{ \frac{\text{year 2 revised alimony} + \text{year 3 alimony}}{2} + \$15{,}000 \text{ allowed} \right\}$$

$$= \$50{,}000 - \left\{ \frac{(\$20{,}000 - \$5{,}000) + \$\text{-}0\text{-})}{2} + \$15{,}000 \right\} = \$27{,}500$$

Year 3 recapture =

Year 1 recapture + Year 2 recapture

= $27,500 + $5,000 = $32,500

Since the front-loading rules are applicable only in the first three years of the divorce, the forgoing recapture computations are performed at the end of year three. Where there is recapture, the payor includes the amount in gross income in year three and the payee deducts the same amount from gross income in year three.

Front-Loading – Exceptions

Where any of four exceptions are present, the general rules related to front-loading and recapture will not apply. These exceptions are:[13]

1. Payments that cease by reason of death or remarriage;
2. Temporary support payments;
3. Payments that decline by $15,000 or less over the three-year;

[13] Section 71(f)(5)(C).

4. Fluctuating payments not within the control of the payor spouse

Illustration
As part of the divorce decree, Buster was to pay Stephanie alimony each year of no less than $30,000 and up to as much as 25 percent of his earnings. In each of the two first years, Buster earned $240,000 and paid Stephanie $60,000. The following year, Buster only earned $100,000, and he paid Stephanie $30,000, the minimum payment. In year three, alimony paid in comparison to the previous year did decline more than the $15,000 recapture trigger. However, there is no recapture in Year 3 because the payments are within the fluctuating payment exception (see 4. above).

Payment of Arrearages

It is not uncommon for alimony payment dates to be missed. In such a case, a late payment may be made to "catch up" for a missed payment or payments. For tax purposes, the regulations place the payor and payee on a cash basis for alimony purposes. [14] As a result, the payments are includible in the payee's income only for the taxable year in which they are received unless they are constructively received. These "catch up" or payments of arrearages may provide a trap for unsuspecting taxpayers. The result may be to make even the most properly drafted divorce instruments ineffective if the payments are not made in the year in which they are due.

Illustration
Pursuant to the terms of divorce, Charles will pay Lea $60,000 a year for the next six years or until the death or remarriage of Lea, whichever comes first. In year one, Charles paid the $60,000. The following year, Charles was only able to pay $30,000. In year 3, Charles could only pay Lea $10,000. Charles's economic improved thereafter and he caught up for his arrearages by paying $140,000 in year 4 and continued to make timely payments for the next two years. In each of the first three years, Charles would deduct and Lea would include in her gross income the amounts paid and received. As a result of the application of the front-loading recapture rules, however, there will be recapture in year 3 because the actual payments that were made decreased by more than $15,000. Utilizing the procedures addressed earlier for front-loading of alimony, the tax consequences amount to a recapture in Year 3 of $32,500.

Issues of Remarriage

Up until the Tax Reform Act of 1984 (TRA-84), the concept of alimony was based upon the payor's legal obligation to support the payee spouse. Under post-TRA-84 law, this obligation to support was removed. Accordingly, even though state law may no longer require (or even permit) alimony to be paid after the remarriage of the payee spouse, payments made

[14] Reg. Section 1.71-1(b)(5).

according to the divorce instrument will continue to be alimony as long as the parties have not arranged to provide otherwise.[15]

If the divorce instrument requires that alimony payments cease on the remarriage of the payee spouse and the payor spouse continues to make payments after such remarriage, the amounts paid will not be considered alimony. This is because the payment was not made pursuant to a divorce instrument. In such a situation, the payment will most likely be considered non-deductible to the payor, and in some instances, they might be considered a personal gift.

Illustration

Harold and Maude were divorced in 2004 and according to the divorce instrument, Harold is required to pay Maude alimony until such time as she dies or remarries. In 2008, Maude did remarry and neglected to tell Harold who continues to make payments to her throughout the remainder of the year. Since Harold's obligation to pay alimony ceased on Maude's remarriage, the payments no longer qualify as alimony and are not deductible by Harold. However, these payments may still be includible in Maude's gross income under Section 61. This is because the circumstances do not indicate that the payments were indeed gifts, since Harold was unaware that his legal obligation had ended. If Harold had become aware of Maude's remarriage, and subsequently continued to make the payments, the payments would most likely be construed to constitute a gift.

Alimony in Same Sex Marriages

Although a few states now allow gay and lesbian couples to marry, the majority of states still don't recognize marriages between partners of the same sex. For those states that do recognize same sex marriage, the state law on this subject is as uniform for same-sex couples as it is for heterosexual couples. Where an entitlement to receive spousal support such as alimony is found, laws of those few states generally apply regardless of sexual orientation. Bear in mind, these laws are not for purposes of federal laws, and have no foundation when applying the Internal Revenue Code. Gay or lesbian same-sex couples, whether unmarried or married, are not permitted to enjoy the same federal marriage settlements provided to heterosexual married couples.

According to Section 3 of the federal Defense of Marriage Act (DOMA), the federal government only recognizes marriages between a man and a woman. This means that even if a same-sex couple's marriage is recognized by their home state, it is not recognized for the purposes of accessing marriage benefits in federal law. So, for example, a gay married couple divorcing in Massachusetts may be able to take advantage of state laws conferring the benefits of alimony, but not for the purpose of applying the rules provided by the alimony statutes in the federal tax code. In fact, the transfers between same-sex partners may even be construed as taxable gifts; although no federal tax cases have expressly addressed this issue to date.

Conclusion

Divorce proceedings can be difficult enough without complicating matters with poor or no consideration of the federal tax implications. Therefore, it is important for lawyers and tax

[15] Reg. Section 1.71-1T(a), Q&A 3

practitioners to consider the federal (and state) tax impacts while negotiating the terms of a divorce. Of course, this is more easily accomplished if the spouses are dissolving the marriage with as little acrimony as possible between them. However, proper planning can be effective in even the most difficult of divorces. When approached properly, the divorce agreement may allow for those involved to take advantage of the differing tax situations of the soon to be former spouses.