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TAX ISSUES FACING FAMILY LAW PRACTITIONERS WHEN DIVIDING ASSETS OR MAKING SUPPORT ORDERS

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TAX ISSUES FACING FAMILY LAW PRACTITIONERS WHEN DIVIDING ASSETS OR MAKING SUPPORT ORDERS

I. DIVISION OF PROPERTY

A. Tax-free Transfers Incident to Divorce

Although most transfers between spouses or former spouses in the context of a marital dissolution will be non-taxable, there are some important exceptions. For example, this rule does not apply when the recipient spouse is a non-resident alien. Transfers between former spouses which occur more than six years from the date of the divorce will be taxable unless the taxpayer shows that they are incident to the divorce. And, a person cannot avoid paying taxes on a vested right to income by assigning the right to receive that income to his or her spouse. These exceptions are discussed below. The importance of obtaining records showing the tax basis in the asset received through divorce is also highlighted.

1. General Rule

Internal Revenue Code section 1041 provides that a transfer between spouses, or former spouses, "incident to divorce" is not taxable in most circumstances. The transfer is treated like a gift. The transferee takes the transferor's tax basis in the property. The effect of the rule is to defer the tax consequences (recognition of gain or loss) until the transferee disposes of the property.

> *Sec. 1041. Transfers of property between spouses or incident to divorce.*
>
> *(a) General rule.*
> No gain or loss shall be recognized on a transfer of property from an individual to (or in trust for the benefit of)—
> (1) a spouse, or
> (2) a former spouse, but only if the transfer is incident to the divorce.
>
> *(b) Transfer treated as gift; transferee has transferor's basis.*
> In the case of any transfer of property described in subsection (a)—
> (1) for purposes of this subtitle, the property shall be treated as acquired by the transferee by gift, and
> (2) the basis of the transferee in the property shall be the adjusted basis of the transferor.
>
> *(c) Incident to divorce.*
> For the purposes of subsection (a)(2), a transfer of property is incident to the divorce if such transfer—

(1) occurs within 1 year after the date on which the marriage ceases, or

(2) is related to the cessation of the marriage.

(d) Special rule where spouse is nonresident alien.

Subsection (a) shall not apply if the spouse of the individual making the transfer is a nonresident alien.

(e) Transfers in trust where liability exceeds basis.

Subsection (a) shall not apply to the transfer of property in trust to the extent that—

(1) the sum of the amount of the liabilities assumed, plus the amount of the liabilities to which the property is subject, exceeds

(2) the total of the adjusted basis of the property transferred.

Proper adjustment shall be made under subsection (b) in the basis of the transferee in such property to take into account gain recognized by reason of the preceding sentence.

2. Meaning of "Incident to Divorce"

Section 1041 applies to all transfers between spouses and also to transfers between former spouses, to the extent made incident to divorce between the former spouses. (IRC § 1041, subd (a).) A transfer of property is "incident to the divorce" if the transfer (1) occurs within one year after the date on which the marriage ceases, or (2) is related to the cessation of the marriage. (IRC § 1041, subd (c).)

Treasury Regulation 1.1041-IT(b) states that a transfer is "related to" the cessation of the marriage when the transfer is required under the divorce or separation instrument, and the transfer takes place within six years from the date of the divorce." If the transfer is not made pursuant to a divorce or separation instrument, or occurs more than six years after cessation of the marriage, it is presumed to be unrelated to cessation of the marriage. (Treas. Regs. § 1.1041–1T, A–7; see Ltr.Rul. 9306015.) The presumption may be rebutted "only by showing that the transfer was made to effect the division of property owned by the former spouses" at the time their marriage ceased. (Regs. § 1.1041–1T, A–7.)

"For example, the presumption may be rebutted by showing that (a) the transfer was not made within the one-and six-year periods described above because of factors which hampered an earlier transfer of the property, such as legal or business impediments to transfer or disputes concerning the value of the property owned at the time of the cessation of the marriage, and (b) the transfer is effected promptly after the impediment to transfer is removed." (*Id.*)

In Private Letter Ruling 9235026 (May 29, 1992), the IRS ruled that the six-year presumption was overcome when the transfer of the Wife's interest in business property to her ex-husband was incident to divorce even though the transfer occurred more than six years after the divorce. The IRS found that the transfer was delayed because of a dispute over the purchase price and payments terms, and that the transfer was effected promptly after the dispute was resolved. The IRS noted that Temp. Treas. Reg. §1.1041-1T, A-7 specifically provides that the presumption may be rebutted if factors such as "disputes concerning the value of the property" to be transferred prevented an earlier transfer.

3. Transfer to Non-Resident Alien Spouse

When the spouse who receives property incident to divorce is a nonresident alien, taxable gain will be recognized on the transfer. (IRC §1041, subd. (d).) The spouse making the transferor will be taxed on the gain (the difference between the fair market value of the property transferred and his or her adjusted tax basis in the property). The rationale for treating nonresident aliens differently is that the IRS assumes that it will eventually receive taxes on any gain realized when a spouse who receives property incident to divorce sells the property, since the spouse takes the transferor's basis in the property; however, in the case of a nonresident alien, there may be little chance that the gain is ever reported or that tax will be paid.

4. Assignment of Income Doctrine

Income is ordinarily taxed to the person who earns it; one vested with the right to receive income cannot escape taxes by an assignment of the right to receive that income to another. (*Lucas v. Earl* (1930) 281 U.S. 111 (1930); *Harrison v. Schaffner,* 312 U.S. 579, 580; IRS Regulations, § 1.454-1(a).) Under the assignment of income doctrine, the transferor remains obligated to pay taxes on the accrued income he or she has assigned.

The assignment of income doctrine applies when the right to receive the income has already accrued, and the parties assign that right to the spouse who did not earn the income. For example, in a transfer of Series E or EE United States Savings Bonds to a spouse or former spouse, the transferor must include the accrued interest on the bonds in his or her gross income in the year of the transfer. (Rev. Rul. 87-112.) IRC § 1041 cannot be used to avoid recognition of the gain by transferring the right to receive the income already earned.

However, when an income-producing asset is transferred, the right to receive *future* income is transferred along with the underlying asset, such that the spouse receiving the asset is responsible for paying taxes on that income. For example, if a spouse is awarded an apartment building in a divorce, the spouse receiving the building will not recognize any gain on the transfer and will be responsible for reporting the rental income on his or her tax return. On the other hand, if the parties make an agreement that one spouse will be solely responsible for paying taxes on the *past* rental income from the building (when it was held as marital property), the assignment of income doctrine will override that contractual allocation and require both parties to report the taxes.

Another example is where Wife agrees to pay Husband 40% of her bonus income as taxable spousal support. When Wife receives the bonus, she will have to report 100% of it as taxable wages, however she gets a deduction for the portion she pays to Husband as alimony.

Revenue Ruling 2002-22 held that a taxpayer who transfers interests in nonstatutory stock options and nonqualified deferred compensation to the taxpayer's former spouse incident to divorce is not required to include an amount in gross income upon the transfer. The ruling also concludes that the former spouse, rather than the taxpayer, is required to include an amount in gross income when the former spouse exercises the stock options or when the deferred compensation is paid or made available to the former spouse. The ruling states:

> . . . applying the assignment of income doctrine in divorce cases to tax the transferor spouse when the transferee spouse ultimately receives income from the property transferred in the divorce would frustrate the purpose of § 1041 with respect to divorcing spouses. That tax treatment would impose substantial burdens on marital property settlements involving such property and thwart the purpose of allowing divorcing spouses to sever their ownership interests in property with as little tax intrusion as possible. Further, there is no indication that Congress intended § 1041 to alter the principle established in the pre-1041 cases such as Meisner [v. United States, 133 F.3d 654 (8th Cir. 1998] that the application of the assignment of income doctrine generally is inappropriate in the context of divorce.

(Rev. Ruling 2002-22, see also Rev. Ruling 2004-60 (FICA taxes are deducted from the payment is made to the non-employee spouse).)

5. Interest on Equalizing Payments

If a spouse is required to pay interest to the other spouse regarding an equalizing payment, the interest will be treated as income to the spouse who received it. The spouse who pays the interest can take a deduction for those payments only if the debt was incurred to buy-out the other spouses interest in business or investment property. (See *Armacost v. C.I.R.* (1998) TC Memo 1998-150.) The court in *Armacost* held:

> Interest on indebtedness must be allocated in the same manner as its underlying debt. [Citation.] Underlying debt is allocated by tracing specific disbursements of the proceeds to specific expenditures. If the underlying debt is incurred as a personal expenditure, the interest on that debt may not be deducted under section 163 except to the extent such interest is qualified residence interest. [Citations.] But if the underlying debt is incurred to acquire investment property, the interest on that debt is deductible under section 163 as investment interest. [Int.Rev. Code §163 (h)(2)(B).] Investment interest is defined as any interest paid on indebtedness properly allocable to investment property. Section 163(d). Investment property includes property producing gross income from

interest, dividends, annuities or royalties not derived in the taxpayer's trade or business, or property held in the course of the taxpayer's trade or business which is neither a passive activity nor an activity in which the taxpayer materially participates. Section 163(d)(5)(A), 469(e)(1).

6. State Law May be Different

Section 1041 applies only to taxes under federal law. The transfer could still be taxable under state law.

B. Considering Tax Basis When Dividing Property

Community property laws require the court to divide the community estate "equally" unless required otherwise by law or absent the written agreement of the parties. (See, e.g., Cal. Fam. Code, § 2550.) If tax consequences are not considered when dividing assets, the ultimate division is often far from being equal.

It is the attorney's role to investigate the tax implications of the proposed division and to advise the client accordingly. In particular, the difference between the fair market value of an asset and its tax basis must be taken into account when evaluating whether there is an "equal" division of the marital estate. In negotiating settlements, the parties are free to discount property based on built-in tax liability associated with an asset.

1. California Rule

Family courts at least in California, on the other hand, have been reluctant to take tax effects into account except when it is clear that the party will suffer immediate tax consequences from an expected sale of the property or from the transfer itself.

An often-cited case in this area is *In re Marriage of Fonstein* (1976) 17 Cal.3d 738 where the California Supreme Court held : "Regardless of the certainty that the tax liability will be incurred if in the future an asset is sold, liquidated or otherwise reduced to cash, the trial court is not required to speculate on or consider such tax consequences in the absence of proof that a taxable event has occurred during the marriage or will occur in connection with the division of the community property." (*Id.* at p. 749, fn. 5.)

In *Fonstein*, the trial court assigned husband's minority interest in a law partnership to him in a marital dissolution action after discounting its value for future tax consequences when sold. Under the partnership agreement, the husband had the right to withdraw from the partnership voluntarily and would receive a sum of money based on a formula set forth in the agreement. Although the husband had no intention of withdrawing from the partnership, the trial court discounted the value of the partnership interest by the taxes he would have to pay if he later decided to withdraw.

The California Supreme Court phrased the issue before it in the following terms:

> "In valuing Harold's interest in the law partnership on the basis of his contractual right to withdraw from the firm, did the trial court err by taking into account the tax consequences which he *might* incur if he did withdraw at some later time, and by reducing the value of his interest accordingly, *even though Harold was not withdrawing and had no intention to withdraw*?"

(*Id.* at p. 747 (emphasis added).)

The court answered the question as follows: "...[S]ince there is no indication in the record that Harold is withdrawing, must withdraw, or intends to withdraw from his firm in order to obtain the cash with which to pay Sarane her share of the community property, there is no equitable reason for allocating to Sarane a portion of the tax liability which may be incurred if and when he does withdraw. [Citation.] In short, ..., although Harold conceivably may do a number of things concerning his law partnership which may create tax consequences, 'there is no indication that he must or intends to do' any of them." (*Id.* at p. 750.)

In making its ruling, the court referred to the "immediate and specific tax liability" language it used in its earlier decision in *Weinberg v. Weinberg* (1967) 67 Cal.2d 557. (*Fonstein*, 17 Cal.3d at p. 749, fn. 5.) This remains the rule in California, however when property is ordered sold and the proceeds divided, the court must take income taxes on the sale into account. (See *In re Marriage of Epstein* (1979) 24 Cal.3d 76.) In *Epstein*, the trial court ordered the family residence sold and the proceeds divided between the parties in such a manner as to equalize the division of the community property. Since husband received personal property of substantially greater value than that awarded wife, she was due to receive the larger share of the proceeds from the sale of the house. The trial court's order, however, did not mention the possibility that the parties might incur state and federal capital gains tax liability as a result of the sale of the residence. The wife appealed, arguing that the trial court erred by not expressly considering tax liability in its order. The California Supreme Court agreed with wife that the court's division of community property should take account of any taxes actually paid as a result of the court-ordered sale of the residence.

The court explained: "Unlike *Fonstein*, which involved a speculative future tax liability arising on the hypothetical sale of an asset, in the present case the taxable event, the sale of the residence, occurs as a result of the enforcement of the court's order dividing the community property." (*Epstein* (1979) 24 Cal.3d at p. 88.)

2. Exclusion of Gain on Sale of Residence

In calculating gain on the sale of a principal residence, Internal Revenue Code section 121 provides that a taxpayer can exclude up to $250,000 of gain from the sale of principal residence if filing a separate tax return, or up to $500,000 for a joint return, if the following requirements are met:

- During the 5-year period ending on the date of the sale or exchange, the residence must have been owned by either spouse and used by both spouses as their principal residence for periods aggregating 2 years or more.

- An individual shall be treated as using property as such individual's principal residence during any period of ownership while such individual's spouse or former spouse is granted use of the property under a divorce or separation instrument.

- If a residence is transferred to a taxpayer incident to a dissolution of marriage, the time the taxpayer's spouse or former spouse owned the residence is added to the taxpayer's period of ownership.

- The exclusion can only be applied to one residence every two years, excluding pre-May 7, 1997 sales.

(Treas. Regs. § 1.121–2; California has passed conforming legislation, Cal. Rev. & Tax. Code §17152.)

3. Need for Records

Temporary Regulations provide that "a transferor of property under §1041 must, at the time of the transfer, supply the transferee with records sufficient to determine the adjusted basis and holding period of the property as of the date of the transfer.... Such records must be preserved and kept accessible by the transferee." (Temp. Treas. Reg. § 1.1041-1T, A-14.)

The judgment should specifically require the exchange of this information.

C. Carryforwards

The right to deduct losses associated with an asset may be transferred together with the asset which generated the loss, or may be personal to the taxpayer and not subject to transfer, depending on the type of asset transferred. This is a complicated area because the loss carryforward was typically reported on a joint tax return during marriage and then, after the divorce, it may have to allocated between the parties for their separate returns. Still, the effort may be worthwhile due to the value of these carryforwards.

1. Net Operating Losses

A net operating loss from the operation of a business may be carried back to the prior two years (by amending the tax returns for the prior years) or carried over to the succeeding 20 years as a net operating loss deduction. (IRC § 172.) If the spouses filed a joint tax return for each year involved in figuring NOL carrybacks and carryforwards, the NOL is treated as a joint NOL. (IRS Publ. 536, p. 10.) Each spouse may carryover to his or her separate return his or her share of the joint NOL. (*Huckle v. Commissioner*, T.C. Memo 1968-45.)

2. Capital Loss Carry Forwards

For individuals, losses from the sales or exchanges of capital assets are allowed only to the extent of gains from such sales or exchanges plus up to $3,000 of ordinary income ($1,500 if the return is married, filing separate). (IRC § 1211, subd. (b).) Any capital loss that could not be deducted in one year may be carried over for an unlimited time until fully used up. (*Id.*)

If separate returns are filed after a net loss was reported on a joint return, the carryover is allocated to each taxpayer based on their individual net long-term and short-term capital losses for the preceding taxable year. (IRC § 1212, subd. (b)(1); Treas. Reg. 1.1212-1(c).) If incurred in a community activity, the losses are split equally on separate returns. Therefore, each spouse may carry forward his or her half of the loss to post-dissolution income. (See Regs. § 1.172–7; *Rose v. Commr.*, TC Memo. 1973–207.)

3. Suspended Passive Activity Losses

A passive activity is generally any trade or business in which the taxpayer does not materially participate, including rental activity whether or not there is material participation (subject to special rules for real estate rental activities and real estate professionals). (IRC § 469.) As a general rule, losses from passive activities may only be deducted from income from passive activities, and not against other types of income such as wages, interest or dividends. (*Id.*)

If a passive activity loss exceeds passive activity income for the year, the loss is "suspended" indefinitely as a deduction from passive activity income in the next succeeding tax years. (*Id.*)

If the asset which generates the passive activity loss is divided in-kind, the suspended passive activity loss is divided equally between the parties along with the underlying asset. On the other hand, if the passive asset is transferred entirely to one spouse and there is a suspended passive loss associated with that asset, the transferor cannot deduct the accumulated loss but the transferee's basis increases by the amount of the unused suspended loss pursuant to IRC § 469(j)(6)(A). (IRS Publ. 504, p. 19; IRS

Publ. 925; but see Pvt. Ltr. Ruling, Tech. Adv. Mem. 9552001 (dealing with S corporations).)

4. Suspended Loss Carryforwards re Subchapter S Corporations

In a Subchapter S corporation, the taxable income or loss is passed-through to the shareholders. (IRC § 1366.) Losses which exceed the shareholder's basis in stock and debt in the corporation are suspended and carried forward to the succeeding tax years. (IRC § 1366, subd. (d)(1) (aggregate amount of losses and deductions taken into account by a shareholder for any taxable year shall not exceed the sum of the adjusted basis of the shareholder's stock in the S corporation and the shareholder's adjusted basis of any indebtedness of the S corporation to the shareholder).)

When the stock in such a corporation is owned as community property and transferred or divided incident to divorce, the suspended loss carryforwards associated with the stock are transferred along with the stock on a pro rata basis based on the number of shares owned by each spouse during the tax year. (See IRC § 1367.) In an in-kind division of the stock which was equally owned by the parties during marriage, each spouse will receive one-half of the suspended loss carryforward.

However, if the stock is awarded entirely to one spouse, the other spouse's share of the suspended loss carryforward is not transferred to the other spouse. The carryforward is personal (having already passed-through to that spouse's tax return when the loss was realized). (IRC § 1366, subd. (d)(2).) The party receiving the stock will only have the benefit of his or her one-half share of the carryforward; the other half will be lost. It is not added to the basis in the stock, as the loss was disallowed in the year in which it occurred and carried forward. (Pvt. Ltr. Ruling, Tech. Adv. Mem. 9552001.) The spouse receives the transferor's basis in the stock per IRC § 1041, which does not include the loss carryforward associated with the transferee's stock. (See Taft, Tax Aspects of Divorce and Separation, § 5B.03[3][b].)

II. TAX TREATMENT OF ALIMONY/SPOUSAL SUPPORT

In order for alimony or spousal support to be tax-deductible to the payor, the requirements set forth in 26 U.S.C., § 71 must be satisified. Each requirement is discussed below. If the requirements are met, the alimony is included in the payee's taxable income. (26 U.S.C., § 215.)

A. "Alimony" Label Not Required

The agreement or order establishing alimony does not need to refer to the payment as alimony, spousal support, or maintenance. Under prior law, payments were characterized as either alimony or property divisions under the facts and circumstances of

the case, but under current law the focus is whether the requirements of Section 71 have been satisfied. (*Hopkinson v. Commr.*, T.C. Memo 1999-154.)

The label attached to the payment, or the purpose of the payment for that matter, has little significant in determining whether the payment qualifies as alimony. (See *Cunningham v. Commr.*, T.C. Memo 1994-474.) However, there are some exceptions where labels count. As will be discussed, if the payment is designated as "child support" it cannot be considered alimony. Also, an agreement or order requiring payments of "alimony" or "spousal support" but which is silent whether the payments will cease on death of the payee spouse, may be still be treated as alimony if state law provides for the automatic termination of spousal support on the payee's death.

B. Requirements for Payor to Deduct Payments

1. The payment must be made "in cash."

(26 U.S.C., §71, subds. (b)(1) & (d).) A transfer of services or property, execution of a debt instrument by the payor, or the use of property of the payor do not qualify as "cash" payments. (Treas. Reg. §1.71-1T.) Checks are treated as cash.

2. The payment must be received by (or on behalf of) a spouse or former spouse.

(26 U.S.C., §71, subd. (b)(1)(A).) The principle of constructive receipt allows payments to be made to a third party by order or agreement for the benefit of the payee spouse. "For example, cash payments of rent, mortgage, tax, or tuition liabilities of the payee spouse made under the terms of the divorce or separation instrument will qualify as alimony or separate maintenance payments." (Treas. Reg. §1.71-1T, Q&A, A-6.)

There is no right for the payor spouse to unilaterally pay an obligation of the payee spouse in lieu of alimony; the payment to the third party must be pursuant to order or agreement. (Treas. Reg. §1.71-1T, Q&A, A-6.)

If the payor also benefits from the payments, however, the payment may not qualify as alimony, as discussed below.

a. Payments for residence owned 100% by payor spouse, or where payee spouse is not obligated on the mortgage.

"Any payments to maintain property owned by the payor spouse and used by the payee spouse (including mortgage payments, real estate taxes and insurance premiums) are not payments on behalf of a spouse even if those payments are made pursuant to the terms of the divorce or separation instrument." (Treas. Reg. §1.71-1T, Q&A, A-6.)

Therefore, if the order or agreement states that Husband will pay the mortgage on the residence where Wife is living as alimony, there will be no tax deduction for the payment if the residence is owned 100% by Husband or where Wife is not liable on the note secured by the mortgage. (*Picou v. Commissioner*, T.C. Summ. Op. 2006-82; *Zinsmeister v. Commissioner*, T.C. Memo 2000-264.) In this example, Husband may take an itemized deduction to the extent of the mortgage interest paid, provided that the house is his "qualified residence" and the payee's exclusive occupancy is pursuant to agreement or order (See 26 U.S.C., § 163, subd. (h)(4); IRS Publ. 504, p.12 (2008).) To take the home interest deduction

b. Payments on jointly-owned residence, or debt where parties are jointly liable.

Where the parties own the home jointly and both of them are liable on the note securing the mortgage, payments made on the mortgage as spousal support will be treated as follows: one-half of the total payments will be deductible by the payor as alimony and will be included as income to the payee spouse. (IRS Publ. 504, p.12 (2008).) Each spouse may also take an itemized deduction for one-half of the mortgage interest paid, to the extent each spouse meets the requirement that the house is his or her "qualified residence." (See 26 U.S.C., § 163, subd. (h)(4), discussed separately in this outline, and IRS Publ. 504, p.12 (2008).)

Different rules apply to the payment of property taxes and home insurance on a jointly-owned residence in the form of alimony. If the property is held in joint tenancy or tenancy by the entirety, then *none* of property tax or insurance payments qualify as alimony, but the payor can take an itemized deduction for *all* of the property taxes. (IRS Publ. 504, p.12, Table 5 (2008).) If the property is held as tenants in common, then *one-half* of the total payments are deductible as alimony, and each spouse can take an itemized deduction for one-half of the property taxes.

c. Payments for residence owned 100% by payee spouse.

Payments to third parties for mortgage, property taxes, and insurance as alimony per a divorce or separation instrument on a residence owned by the payee spouse are tax-deductible to the payor spouse and included in the payee spouse's income as alimony. The payee spouse can take an itemized deduction for the mortgage interest and property taxes paid. (IRS Publ. 504, p.13 (2008).)

d. Payments on account in payor's name.

In *Simpson v. Commissioner*, T.C. Memo 1999-251, Husband was ordered to pay the utility bill for the residence where Wife resided under a temporary spousal support order. The bill was in Husband's name, but Wife and their children were the only occupants of the residence. Husband was allowed to deduct the payments as alimony even though the bill was in his name, since Wife was the beneficiary of the payments.

e. Payments made on life insurance as security for support.

If the divorce or separation instrument requires the payor spouse to maintain life insurance for the supported spouse as security for spousal support, the premiums are deductible *if* the supported spouse is both the owner and irrevocable beneficiary of the policy and has all incidents of ownership under the policy. (*Stevens v. Commissioner* (1971) 439 F.2d 69; Rev. Rul. 57-125; Rev. Rul. 70-218; Treas. Reg. §1.71-1T, Q&A, A-6.)

In *Stevens*, the Husband was ordered to pay Wife alimony over an 11-year period and to post a $65,000 life insurance policy as security for alimony. Husband obtained the insurance on his life. By agreement, the death benefits were payable as follows: upon Husband's death Wife will receive the remaining alimony payments due under the 11-year support order and the balance of the death benefits will be paid to their children[1]; if Wife predeceases Husband or if Husband is still alive after the 11-year period, their children will be the sole beneficiaries. Ownership of the policy was assigned to Wanda, but all rights incident to that ownership were made subject to provisions of the divorce decree and subject to approval of the court. Husband deducted the premium payments as alimony, but Wife did not include those payments as income on her tax return. The court held that the payments were deductible to Husband and includable in Wife's income as alimony. The court stated:

> Under the provisions of the Special Settlement Agreement Richard irrevocably assigned to Wanda ownership of the Phoenix Mutual policy. By so doing Richard transferred to her all the contractual rights incident to policy ownership and divested himself of the power to change the beneficiary, to borrow against the policy or to surrender the policy for its cash value. We cannot agree with the Tax

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[1] There was apparently no argument made that the provision for payment of the remaining payments due under the support order out of the death benefits was a substitute for the continued payment of alimony, thereby making the payments non-tax deductible. (See IRS Publ. 504, p. 14, Example 2 (2008) & 26 U.S.C., § 71, subd. (b)(1)(D), discussed below.)

> Court that the provision of the agreement making Wanda's exercise of these powers subject to the approval of the divorce court, rendered these contractual rights "entirely inconsequential." We cannot assume that the divorce court would prohibit exercise of ownership powers in situations where prudence dictated such exercise. Rather we believe the first prerequisite to premium deductibility — assignment of policy ownership to the divorced spouse — has been fulfilled.

(*Stevens v. Commissioner* (1971) 439 F.2d 69 (footnote omitted).)

The court in *Stevens* also held that the reversion of the death benefit to the parties' children if Wife predeceases Husband did not make the premium payments during Wife's lifetime non-deductible. The court stated:

> [T]he Commissioner has recognized that the standard death provision is not the kind of contingency which will forestall operation of the constructive receipt principle where the children are irrevocably designated contingent beneficiaries. Rev.Rul. 70-218, supra. To deny constructive receipt of benefit whenever the wife's interest in the proceeds is contingent on her surviving her former spouse is to presume that an insurance policy's only value to the beneficiary lies in receipt of the face amount upon death of the insured. If this analysis were correct, premiums paid on a term insurance policy could never qualify as alimony payments because the protection of term insurance to an irrevocable beneficiary extends only for a specified period rather than over the life of the insured. [Citation.] Rather the contingencies which will deny deductibility are those which might operate to thwart the wife's receipt of the economic benefit the premium payments conferred, that is, the protection, during a limited term, of the wife's right to receive alimony over the full alimony period. Such contingencies include the husband's retention of the power to borrow against the policy, to withdraw its cash surrender value or to substitute himself as beneficiary if the wife predeceases him. [Citation.]

(*Stevens v. Commissioner* (1971) 439 F.2d 69 (footnote omitted).)

f. Payments to other third parties on request of payee spouse.

The payee spouse may request that alimony payments be made to any third party, such as a charitable organization. The payments will qualify as alimony "if such payment is pursuant to the written request, consent or ratification of the payee spouse." (Treas. Reg. §1.71-1T, Q&A, A-7.) The payments must be made in lieu of alimony directly to the payee spouse, the written agreement must state that both spouses intend the payments to be treated as alimony, and payor must receive the agreement before he or she files the tax return for the tax year in which the payments are made. (IRS Publ. 504, p.13 (2008).)

3. The payments must be made under a divorce or separation instrument.

(26 U.S.C., §71, subd. (b)(1)(A).) This includes "a decree of divorce or separate maintenance or a written instrument incident to such a decree, a written separation agreement, or [such other] decree . . . requiring a spouse to make payments for the support or maintenance of the other spouse." (26 U.S.C., §71, subd. (b)(2).) Payments according to a modification to the initial divorce or separation instrument are also deductible. (See Priv. Ltr. Rul. 200233022 (2002).)

The decree or written instrument must be in existence at the time that the support payments are made. (*Ali v. Commissioner* (2004) T.C. Memo. 2004-284.) Payments made before the existence of divorce or separation instrument are not deductible, even if the instruments retroactively characterizes those prior payments as spousal support. (*Id.; Rafferty v. U.S.* (D. Colo. 2008) 2008 WL 2705192; 26 C.F.R., § 1.71-1T(a), Q-4, A-4.)

When an order or agreement calls for the current payment of spousal support covering a period of time in the past, the payment is deductible because it is made under a divorce or separation instrument. For example, Husband makes a motion for spousal support on June 1, which the court grants on September 1. The court orders Wife to pay Husband spousal support in the amount of $1,000 per month commencing September 1 and continuing until death of either party or further order of court. The court also orders Wife to pay Husband an additional $3,000 for the period covering June 1 to August 31, which is to be paid in installments of $500 per month starting September 1 and continuing until paid or the death or either party, whichever occurs first. Wife can deduct the $500 per month installment payments because they are made pursuant to a support order, even though they cover a period of time prior to the existence of the support order. When Wife makes the first payment on September 1, there is an order in existence so the rule is satisfied.

If a spousal support order does not qualify as "alimony" under Internal Revenue Code section 71 but the court intended for the payment to qualify, a nunc pro tunc

modification of the order may be allowed to retroactively correct a clerical mistake and to prevent injustice. (IRS Publ. 504, p. 11 (2008); *McDonald v. C.I.R.* (1994) TC Memo. 1994-607; *Johnson v. C.I.R.* (1989) TCM 1989-415.) However, this exception is limited to correcting clerical errors. Retroactive modification of an order will generally have no effect on the character of the payments for tax purposes. (IRS Publ. 504, p. 11 (2008).)

4. The instrument does not designate payments as non-taxable to the recipient or not allowable as a deduction to the payor.

(26 U.S.C., § 71, subd. (b)(1)(B).) There is no requirement that the instrument state that the payments will be taxable as alimony. If the parties designate the payments as non-taxable, they will be bound by the agreement and a copy of the agreement must be attached to the payee's tax return each year the designation applies. (26 C.F.R., § 1.71-1T(b), A-8.)

Note that a finding by a state court that the support payment will be taxable or tax-deductible as alimony is not binding on the IRS because state courts cannot determine issues of federal tax law. (*Okerson v. CIR* (2004) 123 T.C. No. 14; *Nieto v. C.I.R.* (1992) TCM 1992-296.)

5. The parties must not be members of the same household when payment is made, except for temporary support orders.

(26 U.S.C., § 71, subd. (b)(1)(C).) The parties are not in "separate households" even if the spouses physically separate themselves within the dwelling unit. (26 C.F.R., §1.71-1T, A-9.) If one spouse is preparing to depart the household and actually departs not more than one month after the support payment is made, the parties will not be treated as members of the same household for that period. (*Id.*)

Spousal support payments made while the parties are not "legally separated . . . under a decree of divorce or of separate maintenance" are deductible notwithstanding the fact that the parties are members of the same household when the payments are made. (26 U.S.C., § 71, subd. (b)(1)(C); 26 C.F.R., §1.71-1T, A-9.)

6. There is no liability to make payments after the death of the supported spouse, or make any payments (in cash or property) as a substitute therefor after death of the payee.

(26 U.S.C., § 71, subd. (b)(1)(D).) This requirement was apparently adopted to distinguish between true spousal support orders and a property division disguised as support. An order for maintenance or support should naturally terminated on death of the supported spouse, as "dead people require little, if any, support." (See Taft, Tax Aspects of Divorce and Separation, § 5.03[1][v].) A obligation in connection with the division of

marital property, on the other hand, survives the death of either party because it creates a vested property right which can be transferred on death.

If the rule is violated, "[n]one of the payments before (or after) the death of the payee spouse qualify as alimony or separate maintenance payments." (Treas. Reg. §1.71-1T, Q&A, A-10.)

a. Instrument need not say payments terminate on death.

"The divorce or separation instrument does not have to expressly state that the payments cease upon the death of your spouse if, for example, the liability for continued payments would end under state law." (IRS Publ. 504, p. 14 (2008).) In *Johanson v. Commr.* (9th Cir. 2008) 541 F.3d 973, spousal support payments were deemed taxable to the payee even though the instrument failed to state that the payments would terminate on death, as California law provides that spousal support terminates on death absent clear and convincing evidence of a written agreement to extend support beyond the payee's death.

It is best, however, to state in the instrument that the payments will terminate on death, especially where it is not clear from the instrument itself that the payments are in the nature of support or maintenance of a spouse. Where the instrument is silent whether the payments terminate on the payee's death, the court can interpret the instrument to determine whether the parties intended for the payments to terminate on death (indicating alimony) or for the payments to continue despite the death of the payee (indicating a property settlement). (*Hoover v. Commr.* (6th Cir. 1996) 102 F.3d 842 (Ohio agreement referring to payment as "alimony, as a division of equity," and which did not say whether it terminated on death, held to be a property distribution under facts of case).)

b. Compare – fees paid as support.

If an instrument requires a spouse to pay the other spouse's attorney fees "as spousal support," the amount paid should be deductible as alimony, provided either that the instrument itself or state law provides that payments designated as spousal support terminate automatically on the death of the supported spouse. The payor spouse has no contractual obligation to his or her spouse's attorney and receives no benefit by making the payment. Instead, the payment to the attorney is to a third party "on behalf" of the supported spouse, in lieu of paying alimony to the spouse and the spouse paying his or her own attorney out of those funds. One reason why the court would specify that the payment is to be made directly to the attorney is to protect the attorney's right to be paid.

In *Smith v. C.I.R.* (1998) TCM 1998-166, the court denied treatment of a court-ordered payment by husband to wife's attorney as alimony. The court found that the liability to make the payment did not cease on the wife's death and, therefore, failed to qualify as alimony, even though state law provided that spousal support terminates on

death. The order did not designate the payment to the attorney as a form of spousal support or maintenance. Although there is no requirement that alimony payments be specified as such (*Id.*), the result of the case should have been different if the instrument had designated the payment as alimony. Had it done so, the husband's obligation to make the payment would have terminated under state law upon wife's death, thereby qualifying the payment as alimony. (See *Burkes v. Commissioner*, T.C. Memo 1998-61; *Johanson v. Commr.* (9th Cir. 2008) 541 F.3d 973.)

c. Substitute payments for post-death alimony.

The rule is concerned not only with payments which, by the terms of the instrument, continue after the death of the payee. Payments which are a made in lieu of the support payments which would have been made had the payee spouse survived will also result in the payments being non-deductible. These are called "substitute payments," which mean payments which commence on or as a result of the death of the payee. (26 C.F.R., §1.71-1T(b), A-14.) The regulations state:

> To the extent that one or more payments are to begin to be made, increase in amount, or become accelerated in time as a result of the death of the payee spouse, such payments may be treated as a substitute for the continuation of payments terminating on the death of the payee spouse which would otherwise qualify as alimony or separate maintenance payments. The determination of whether or not such payments are a substitute for the continuation of payments which would otherwise qualify as alimony or separate maintenance payments, and of the amount of the otherwise qualifying alimony or separate maintenance payments for which any such payments are a substitute, will depend on all of the facts and circumstances.

(*Id.*)

For example: Party A is obligated to make spousal support payments to Party B of $30,000 per year for six years or until the death of B, whichever is earlier. B has custody of the parties' children. The agreement states that upon B's death, A will pay $10,000 per year to a trust established for the benefit of the minor children. The regulations state: "These facts indicate that A's liability to make annual $10,000 payments in trust for the benefit of his minor children upon the death of B is a substitute for $10,000 of the $30,000 annual payments to B. Accordingly, $10,000 of each of the $30,000 annual payments to B will not qualify as alimony or separate maintenance payments." (26 C.F.R., §1.71-1T(b), A-14, Example 2.) Notice that the IRS will disallow $10,000 of the annual payments from the very beginning of the order, not just upon B's death. In effect, A can only deduct $20,000 per year as alimony paid to B. The remaining $10,000 per

month is treated as something other than alimony (perhaps as child support or a disguised property division).

7. The payments may not be fixed as child support or subject to a contingency related to a minor child.

(26 U.S.C., § 171, subd. (c).) Payments specifically designated as child support are, of course, not deductible as alimony. Even when a payment is not called child support and is, instead, labeled as "alimony," the payment may nevertheless be treated as disguised child support if the amount of the payment reduces upon some contingency relating to the child, like the child turning 18-years-old.

Still, orders can be fashioned which, in effect, include unallocated child and spousal support and the payor can deduct 100% of the payment if the bright-line rules established by the Internal Revenue Code and Treasury Regulations are met, which are discussed below. These are referred to as a "*Lester* agreement" or a family support order. It is an order where child support and spousal support are combined without any amount being fixed for either. Pursuant to *C.I.R. v. Lester* (1961) 366 U.S. 299, the entire amount of such payment is deductible as spousal support.

For the payor spouse to receive the deduction, the payment amount cannot reduce based on any contingency relating to the child, or the amount so reduced will be treated as child support and will not be deductible either before or after the happening of the contingency. The Internal Revenue Code provides:

> [I]f any amount specified in the instrument will be reduced-
> (A) on the happening of a contingency specified in the instrument relating to a child (such as attaining a specified age, marrying, dying, leaving school, or a similar contingency), or
> (B) at a time which can clearly be associated with a contingency of a kind specified in subparagraph (A), [then] an amount equal to the amount of such reduction will be treated as an amount fixed as payable for the support of children of the payor spouse.

(26 U.S.C., § 171, subd. (c).)

There is a safe harbor which provides that a stepdown will not be treated as "relating to that child" so long as it takes place more than six months before or after a date that the child attains 18, 21 or the local age of majority. (Treas. Reg. 1.71-1T, A-18.)

It is not known whether this safe harbor is affected by state laws, such as California Family Code section 3901, which extend the duration of child support beyond the age of 18 for "an unmarried child who has attained the age of 18 years, is a full-time high school

student, and who is not self-supporting, until the time the child completes the 12th grade or attains the age of 19 years, whichever occurs first."

Creating a family support order where there are multiple children may be nearly impossible. The support obligation may have to be extended beyond the date the payor would normally have to pay child support under state law to have the family support treated as alimony, which could erase the tax benefits of such an order discussed below. Also, modifications to the order may be difficult to accomplish without disrupting the arrangement.

The payee might agree to a family support arrangement if it provides him or her with more support in after-tax dollars than would be paid under separate spousal support and child support orders. The purpose is to utilize the difference in the parties' respective marginal tax rates to create a form of subsidized support. The payor receives a deduction for all of the support paid (including the child support component), and the payee must include all of the payments in his or her income as alimony. If the spouses are in different tax brackets, they realize a benefit. See the tables below.

Separate Spousal and Child Support Orders (Alimony of $15,000/yr and child support of $15,000/yr)		
	Husband	Wife
Wages	$ 115,000	$ 0
Alimony as Taxable Income (Tax-Deduction)	$ (15,000)	$ 15,000
Child Support Received (Paid)	$ (15,000)	$ 15,000
Taxable Income	$ 100,000	$ 15,000
Tax Rate	28%	15%
Taxes Paid	$ (28,000)	$ (3,750)
Net Spendable Income	**$ 57,000**	**$ 26,250**

Family Support Order (Unallocated child and spousal support of $30,000/yr paid as taxable "alimony")		
	Husband	Wife
Wages	$ 115,000	$ 0
Alimony as Taxable Income (Tax-Deduction)	$ (30,000)	$ 30,000
Taxable Income	$ 85,000	$ 30,000
Tax Rate	28%	15%
Taxes Paid	$ (23,800)	$ (4,500)
Net Spendable Income	**$ 61,200**	**$ 25,500**

In this example, Husband has $4,200 per year more money after taxes with the family support order than compared to the traditional order, while Wife received only $750 per year less under the family support order. There is a net savings of $3,450 per year with family support, which could be split between the parties as additional non-taxable support.

However, drafting a family support order which will be tax-deductible as alimony is complex, especially where the parties have more than one child. The legal gymnastics required to make a proper family support order is outweighed by the slight tax advantage. It is difficult to conceive of a situation where the tax-subsidy created by a family support order would be substantial. The higher the family support order, the more income the payee spouse must declare, placing that spouse in a higher tax bracket. The advantage is really only seen where there is a significant difference between the tax brackets for each party.

8. A joint return is not filed.

(26 U.S.C., 71(e).) The final requirement is that the parties file separate tax returns from each other. They cannot file a joint tax return together, with one claiming an alimony deduction and the other deducting the alimony paid.

C. Recapture Rule

The purpose of the recapture rule is to prevent property settlements from being disguised as deductible alimony. The theory is that payments made over a short-term are most likely a form of property division, rather than a redistribution of income for the support of one spouse – so a tax deduction should not be permitted for such payments. (See Taft, Tax Aspects of Divorce and Separation, § 5B.03[2].)

A formula is used to determine if support has been "front-loaded" (i.e., paid in advance for a tax benefit). If the recapture rule applies, the amount of spousal support which is determined to be front-loaded is added back to the income of the paying spouse, with a corresponding deduction to the supported spouse. In order to determine whether recapture is required, the focus is whether spousal support decreases by more than $15,000 between the second and third year, or the spousal support paid in the second and third years is significantly less than what was paid in year one. (Int. Rev. Code §71 (f).) Any time the amount of support reduces within the first three years, the payments should be tested to determine if recapture will occur.

The rule is complicated, and there are several spreadsheets available on the internet which can be used to make the computation. A worksheet is attached at the end of these materials which can be used to determine if the recapture rule applies. The rule is as follows:

> (2) *Excess alimony payments.*--For purposes of this subsection, the term "excess alimony payments" mean the sum of--
>
> (A) the excess payments for the 1st post-separation year, and
>
> (B) the excess payments for the 2nd post-separation year.
>
> (3) *Excess payments for 1st post-separation year.*--For purposes of this subsection, the amount of the excess payments for the 1st post-separation year is the excess (if any) of--
>
> (A) the amount of the alimony or separate maintenance payments paid by the payor spouse during the 1st post-separation year, over
>
> (B) the sum of--
>
> (i) the average of--
>
> (I) the alimony or separate maintenance payments paid by the payor spouse during the 2nd post-separation year, reduced by the excess payments for the 2nd post-separation year, and

(II) the alimony or separate maintenance payments paid by the payor spouse during the 3rd post-separation year, plus

(ii) $15,000.

(4) *Excess payments for 2nd post-separation year.*-- For purposes of this subsection, the amount of the excess payments for the 2nd post-separation year is the excess (if any) of--

(A) the amount of the alimony or separate maintenance payments paid by the payor spouse during the 2nd post-separation year, over

(B) the sum of--

(i) the amount of the alimony or separate maintenance payments paid by the payor spouse during the 3rd post-separation year, plus

(ii) $15,000.

(Int. Rev. Code §71 (f)(2).)

For purposes of the rule, the three-year period starts with the first calendar year in which payments are made under a permanent spousal support instrument. ((IRC § 171, subd. (f)(6).)

There are three exceptions to the recapture rule: (1) Recapture does not apply to temporary support orders; (2) Recapture does not apply when support terminates because of death or remarriage by the third year; and (3) Recapture does not apply when support payments fluctuate over a period of not less than 3 years per an order to pay a fixed portion of income from a business, employment, or property. (Int. Rev. Code §71 (f)(5).)

When a permanent spousal support order is modified due to a decrease in the payor spouse's income, or the payee spouse's need for support, within the first three years of the order, the payor may be subject to recapture. Counsel and the court must take this possibility into consideration when fashioning a modification to the support order. One solution would be to modify the support order to require a percentage of the payor spouse's income, to fall within the exception to recapture. (Int. Rev. Code §71 (f)(5).) Recapture may also occur if the payor falls behind on support payments in the first three years.

D. Under Payments of Spousal Support

When child and spousal support orders are in effect and the payor does not pay the full amount required under each order, the payments are first allocated to child support and the balance, if any, is allocated to spousal support for purposes of determining the amount of the deduction. (IRS Publ. 504, p. 12 (2008).)

E. Estimated Payments

There is generally no requirement for the payor to withhold income taxes due on the alimony payments, but there is a requirement for the payee to make quarterly estimated payments on the alimony throughout the year. If alimony is paid to a non-resident alien, there may be a requirement for the payor of spousal support to withhold income tax at the rate of 30% per payment. (IRS Publ. 504, p. 12 (2008); IRS Publ. 515.)

III. TAX LIABILITY

Parties filing a joint return are jointly and severally liable for taxes due under the return. (26 U.S.C., § 6013, subd. (d)(3); *Ordlock v. Commissioner* (9th Cir. 2008) 533 F.3d 1136.) Care should be taken when agreeing to file a joint return after separation of the parties; the parties should consider indemnifying each other against any failure to report income or failure to pay the share of taxes due.

A. Treatment of Community Income Where Separate Returns Filed

Community income represents a joint tax liability of the parties regardless of their tax filing status. (See *U.S. v. Malcolm* (1931) 282 U.S. 792; Int.Rev. Code §§ 66, subd. (a) & 879, subd. (a); 18 Cal. Code Regs. §18501 (c).) If the spouses file separate returns, each of them has to report 50% of the community income and 100% of his or her separate income. (U.S. v. Mitchell (1971) 403 U.S. 190 (under community property doctrine, spouses have a vested interest in each other's income regardless of whether the income was received or enjoyed by both).)

B. Refunds

Filing of joint return does not itself create an equal interest in any refund. (U.S. v. Elam (9th Cir. 1997) 112 F.3. 1036). The refund is based on each spouse's share of the income earned, as if they filed separate returns. (Rev. Rulings 74-611 & 80-7; *Bour v. Commissioner* (1954) 23 TC 237 (ownership of income determined by state law).)

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C. Readjustment of Taxes Paid

When post-separation income is received 100% by one spouse under a claim of right, and that spouse pays taxes on the income, what happens if the court orders the parties to split the income retroactive to the date of separation? Is the division made on after-tax income? Is the spouse entitled to a credit for the taxes paid?

Internal Revenue Code section 1341 may allow a deduction for the share of income awarded to the spouse, to the extent the other spouse has paid taxes on that income. Internal Revenue Code section 1341 provides:

> If –
>
> (1) an item was included in gross income for a prior taxable year (or years) because it appeared that the taxpayer had an unrestricted right to such item;
>
> (2) a deduction is allowable for the taxable year because it was established after the close of such prior taxable year (or years) that the taxpayer did not have an unrestricted right to such item or to a portion of such item; and
>
> (3) the amount of such deduction exceeds $3,000,
>
> then the tax imposed by this chapter for the taxable year shall be the lesser of the following:
>
> (4) the tax for the taxable year computed with such deduction; or
>
> (5) an amount equal to –
>
> (A) the tax for the taxable year computed without such deduction, minus
>
> (B) the decrease in tax under this chapter (or the corresponding provisions of prior revenue laws) for the prior taxable year (or years) which would result solely from the exclusion of such item (or portion thereof) from gross income for such prior taxable year (or years).

(26 U.S.C. § 1341.)

There is a question whether Section 1341, itself, provides statutory authority for a deduction or whether independent statutory authority is needed. In other words, it is not known whether a deduction is allowed under Section 1341, paragraph (2), for the income paid to the other spouse simply "because it was established after the close of such prior taxable year (or years) that the taxpayer did not have an unrestricted right to such item or to a portion of such item." It is possible that the Internal Revenue Service or a tax court would require independent statutory grounds to make the deduction.

There is no requirement that the payor spouse issue a Form 1099-MISC to the payee spouse for the income paid. Form 1099-MISC is used only to report payments made in the course of a trade or business; personal payments are not reportable. (IRS Instructions for Form 1099-MISC (2009).) Still, issuing a Form 1099 is a good idea because it puts the payee on notice that he or she is expected to report the income received.

NOTICE:
Rules governing our practice before the Internal Revenue Service require that we advise you that any tax advice in this communication (and any attachment hereto) (a) is intended only for the addressee and (b) is not written with the intent that it be used, and in fact it cannot be used, to avoid penalties imposed under the Internal Revenue Code or to promote, market, or recommend to another person any tax-related idea.