



Breaking Up Is Hard to Tax—Alimony and Recent Cases
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The Definition of Alimony

This week we are looking at a subset of the issues involved in determining whether a payment is alimony, as well as two recent cases that came down on the alimony question. The cases in question are *D.E. Lofstrom*, 125 T.C. No. 13 and *D.K. Vanarsdall*, T.C. Summary Opinion 2005-170 where taxpayers unsuccessfully attempted to have various payments classified as alimony.

Alimony issues are tricky, because in this area of the tax law there's a "mirroring" of the tax treatment. If the payor gets a deduction for alimony, the recipient has to pick it up as income. When the parties disagree on the treatment of payments, the IRS will generally not be the only "adverse" party the payor is going to face in resolving this matter, since the payor must report the name and identification number of the recipient, who will not have reported the sum as income.

For this reason, we tend to see quite a few cases before the Tax Court on alimony issues. And, frankly, most often it's the payor that ends up losing because, under the Internal Revenue Code, it takes little skill to draft a document that *excludes* a payment from treatment as alimony, but great care must be taken to ensure a payment qualifies. Thus, unless there's a clear agreement that a payment is alimony, or the recipient simply had poor or no counsel in dealing with the final document, it's difficult to get a win in these cases for the payor.

The Law

Internal Revenue Code Section 71 governs the definition of alimony. The section starts out deceptively simple with the following single line:

71(a) GENERAL RULE. -- Gross income includes amounts received as alimony or separate maintenance payments.

Related to this provision is the deduction to the payor, which is found in Section 215:

SEC. 215. ALIMONY, ETC., PAYMENTS.

(a) GENERAL RULE. -- In the case of an individual, there shall be allowed as a deduction an amount equal to the alimony or separate maintenance payments paid during such individual's taxable year.

(b) ALIMONY OR SEPARATE MAINTENANCE PAYMENTS DEFINED. --For purposes of this section, the term "alimony or separate maintenance payment" means any alimony or separate maintenance payment (as defined in section 71(b)) which is includible in the gross income of the recipient under section 71.

(c) REQUIREMENT OF IDENTIFICATION NUMBER. -- The Secretary may prescribe regulations under which --

(1) any individual receiving alimony or separate maintenance payments is required to furnish such individual's taxpayer identification number to the individual making such payments, and

(2) the individual making such payments is required to include such taxpayer identification number on such individual's return for the taxable year in which such payments are made.

(d) COORDINATION WITH SECTION 682. --No deduction shall be allowed under this section with respect to any payment if, by reason of section 682 (relating to income of alimony trusts), the amount thereof is not includible in such individual's gross income.

The key factor to note here is that the deduction is only going to be allowed if it meets the definition that requires the amount to be included in income by the recipient—so the real analysis has to begin by looking at Section 71. The major additional requirement imposed by Section 215 is that the payor is going to have to provide the recipient's identification number (which gives the IRS the information necessary to match up the returns).

The major “meat” of Section 71's is found in §71(b) which reads:

71(b)(1) IN GENERAL. -- The term "alimony or separate maintenance payment" means any payment in cash if --

(A) such payment is received by (or on behalf of) a spouse under a divorce or

separation instrument,

(B) the divorce or separation instrument does not designate such payment as a payment which is not includible in gross income under this section and not allowable as a deduction under section 215,

(C) in the case of an individual legally separated from his spouse under a decree of divorce or of separate maintenance, the payee spouse and the payor spouse are not members of the same household at the time such payment is made, and

(D) there is no liability to make any such payment for any period after the death of the payee spouse and there is no liability to make any payment (in cash or property) as a substitute for such payments after the death of the payee spouse.

(2) DIVORCE OR SEPARATION INSTRUMENT. -- The term "divorce or separation instrument" means --

(A) a decree of divorce or separate maintenance or a written instrument incident to such a decree,

(B) a written separation agreement, or

(C) a decree (not described in subparagraph (A)) requiring a spouse to make payments for the support or maintenance of the other spouse.

The key issues are the four criteria found in §71(b)(1)--that is, 1) there must be a proper instrument, 2) the document does not indicate the payment is *not* alimony (so any payment can be made “not alimony” by including this provision in the agreement), 3) if legally separated, the spouses cannot be members of the same household and 4) there is no obligation to make any payment after the death of the recipient spouse. As well, note the general requirement that the payment must be made in cash.

Disguised Payments

In a divorce, essentially there are the following types of “wealth transfers” between spouses:

- Alimony (our issue here)
- Property settlements (to divide what the spouses owned during their marriage)
- Child support

There are two additional provisions in Section 71 that we won’t cover in great detail today that do deal with attempts to “disguise” payments meant to cover the other two details as alimony.

Disguised Child Support

Section 71(c) deals with the problem of “disguised” child support. Child support is not taxable to the recipient spouse and is not deductible to the payor. Note that the dependency exemption is also not impacted directly these payments, so the fact that a payor might end up providing 100% of the child’s support for a year will not give the payor the right to claim the child as a dependent—that issue was covered in an earlier podcast.

The disguised child support provision is found below:

71(c) PAYMENTS TO SUPPORT CHILDREN. --

(1) IN GENERAL. -- Subsection (a) shall not apply to that part of any payment which the terms of the divorce or separation instrument fix (in terms of an amount of money or a part of the payment) as a sum which is payable for the support of children of the payor spouse.

(2) TREATMENT OF CERTAIN REDUCTIONS RELATED TO CONTINGENCIES INVOLVING CHILD. -- For purposes of paragraph (1), if 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), 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.

(3) SPECIAL RULE WHERE PAYMENT IS LESS THAN AMOUNT SPECIFIED IN INSTRUMENT. --For purposes of this subsection, if any payment is less than the amount specified in the instrument, then so much of such payment as does not exceed the sum payable for support shall be considered a payment for such support.

If the “alimony” is reduced by any contingency related to the child, the law provides that the payment is not alimony. This “gotcha” could convert a payment from alimony to something other than alimony, so it’s important to catch any such provision before the documents become finalized.

Disguised Property Settlement

A more complex, though mainly mechanical, provision is found to prevent spouses from disguising property settlement as alimony. What this provision looks for is excessive “front end loading” of alimony payments. Note, though, that if a payment stream meets these tests, the recapture will be triggered regardless of “good faith” on the part of the

taxpayer, or even if the taxpayer's former spouse agrees that the payment is alimony.

The law provides:

71(f) RECOMPUTATION WHERE EXCESS FRONT-LOADING OF ALIMONY PAYMENTS. --

(1) IN GENERAL. --If there are excess alimony payments --

(A) the payor spouse shall include the amount of such excess payments in gross income for the payor spouse's taxable year beginning in the 3rd post-separation year, and

(B) the payee spouse shall be allowed a deduction in computing adjusted gross income for the amount of such excess payments for the payee's taxable year beginning in the 3rd post-separation year.

(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.

(5) EXCEPTIONS. --

(A) WHERE PAYMENT CEASES BY REASON OF DEATH OR REMARRIAGE. --Paragraph (1) shall not apply if --

(i) either spouse dies before the close of the 3rd post-separation year, or the payee spouse remarries before the close of the 3rd post-separation year, and

(ii) the alimony or separate maintenance payments cease by reason of such death or remarriage.

(B) SUPPORT PAYMENTS. --For purposes of this subsection, the term "alimony or separate maintenance payment" shall not include any payment received under a decree described in subsection (b)(2)(C).

(C) FLUCTUATING PAYMENTS NOT WITHIN CONTROL OF PAYOR SPOUSE. --For purposes of this subsection, the term "alimony or separate maintenance payment" shall not include any payment to the extent it is made pursuant to a continuing liability (over a period of not less than 3 years) to pay a fixed portion or portions of the income from a business or property or from compensation for employment or self-employment.

(6) POST-SEPARATION YEARS. --For purposes of this subsection, the term "1st post-separation years" means the 1st calendar year in which the payor spouse paid to the payee spouse alimony or separate maintenance payments to which this section applies. The 2nd and 3rd post-separation years shall be the 1st and 2nd succeeding calendar years, respectively.

The issue here is whether you have a large front end payment. Since the test is mechanical, it's important to "run the numbers" on the agreement draft to make sure that if there is an issue with this matter all parties are aware of it.

Cases

Two cases have come down recently that dealt with the issue of whether a payment was considered alimony. In both cases, the taxpayer (who claimed an alimony deduction), lost the case.

Lofstrom Case

(*Lofstrom*, [125 TC No. 13, 11/22/05](#)) This case is interesting in that it is a *reported* Tax Court case and outlines how a taxpayer managed to convert what was deductible alimony into a nondeductible item (essentially snatching defeat out of the jaws of victory). The

case deals with the cash requirement found in §71(b) for an item to meet the definition of alimony.

Taxpayer transferred \$4,000 in cash and a third party debt (a contract for deed under Minnesota law) for \$29,000 from his son to his former spouse (and mother of his son) in satisfaction of past and future claims for alimony. The contract entitled his former spouse to principal and interest until the note was paid, and payment would continue regardless of whether she survived to the date of final payoff of the debt.

The court ruled that the payment was neither cash nor a cash equivalent as required under IRC §71(b)(1) and Regulation §1.71-1T(b), Q&A 5. The court also noted that the payments would not cease on the former spouse's death, violating another requirement for the classification of the payment as alimony.

Vanarsdall Case

In a more traditional case that was a Summary Opinion (thus not considered setting any precedent) was the *Vanarsdall* case ([TC Summary 2005-170, 11/21/05](#)). In that case, a taxpayer unsuccessfully attempted to use a hypertechnical reading of the divorce decree in conjunction with Section 71, and argued that since the decree didn't state exactly what Section 71(b)(1)(B) required, it wasn't triggered and the payment was alimony.

The decree stated "All payments due from Husband to Wife under the provisions of this Article shall constitute property settlement and not maintenance or alimony." Mr. Vanarsdall argued that since it didn't specifically state that the amounts were not alimony for federal income tax purposes.

The court dealt with the two cases that Mr. Vanarsdall cited in support of his argument that the label shouldn't control by differentiating this case from those two (*Richardson v. Commissioner*, 125 F.3d 551, 556 (7th Cir. 1997), affg. T.C. Memo. 1995-554 and *Baker v. Commissioner*, T.C. Memo. 2000-164).

In *Richardson*, the payments at issue that were made from one ex-spouse to the other were pursuant to a State court's decree that made no mention of the nature or characterization of the payments. *Richardson v. Commissioner*, supra at 553. Consequently, that Court held that, because the court order did not specifically designate the payments as nonalimony, thereby making them tax free to the recipient, the payments would be treated as alimony for Federal income tax purposes. In this case, the Agreement was not silent as to the designation of payments from Mr. Vanarsdall to the former spouse. On the contrary, the Agreement specifically stated that the payments "shall constitute property settlement and not maintenance or alimony". This designation is a "clear, explicit, and express direction" that the payments were not alimony for Federal income tax purposes.

Furthermore, petitioners' reliance on *Baker* in support of their assertion is misplaced. In *Baker*, payments between the former spouses were made pursuant to a Judgment of Divorce that labeled the payments "property settlement". This Court held that this blanket label, without further clarification, "does not clearly inform us that the parties considered the Federal income tax consequences of the payments under sections 71, [and] 215". *Baker v. Commissioner*, supra. Petitioner and the former spouse did not simply label the payments between them a property settlement without further discussion. On the contrary, the Agreement specifically states that such payments are "not maintenance or alimony". The Agreement further provides that the former spouse reimburse Mr. Vanarsdall for her portion of the taxes that Mr. Vanarsdall would have to pay on the income from the partnership. Clearly, unlike *Baker*, petitioner and the former spouse considered the tax consequences of their nonalimony designation and made provisions thereof in the Agreement.