

Simple Answers to Complex Alimony Questions

by
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Introduction

Every time an alimony¹ agreement or order is made, the attorneys are doing a form of tax planning. From the perspective of the Internal Revenue Service (IRS), alimony is just a way of shifting tax responsibility, where taxable income is taken from one party and given to the other. Attorneys can save their clients lots of money by using the tax rules to the maximum advantage. However, if the deal is not structured correctly, nasty surprises can occur years after the representation has concluded, when nothing can be done to change it.

Part I of this article discusses the history of the alimony deduction. Part II explains how the burden of divorce can be reduced by sharing the tax benefits of the alimony deduction. Part III examines the rules for making an alimony agreement or order, so the payments are included in the income of the payee and are deductible by the payor for federal income tax purposes. Part IV reviews the tax withholding and estimated tax payment requirements relating to alimony.

I. Historical Tax Treatment of Alimony

The Revenue Act of 1942, for the first time, treated alimony as taxable income to the payee and deductible by the payor.² The purpose of the law was to remove the burden of paying alimony in after-tax dollars,³ and to recognize that a person who

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¹ References to alimony include spousal support, maintenance, or whatever the individual state calls such payments.

² Revenue Act of 1942 § 210, 56 Stat. 816 (1942) (current version at 26 U.S.C. §§ 22(k), 23(u), 171(a)).

³ Joanne Ross Wilder, *Divorce and Taxes: Fifty Years of Changes*, 24 J. AM. ACAD. MATRIM. LAW. 487, 497 (2012).

receives regular sums of money from a former spouse, for years after the marriage ended, should be regarded as having taxable income.⁴ The 1954 Internal Revenue Code moved the alimony provisions to their current sections: section 71 (which makes alimony includable in the payee's income) and section 215 (which makes alimony deductible to the payor).⁵ The law in 1954, though, was quite different than today. For example, the alimony payments generally had to be paid in installments for more than ten years to qualify for tax treatment.⁶

The current state of the law regarding alimony stems from the Domestic Relations Tax Reform Act of 1984 and the Tax Reform Act of 1986.⁷ These changes gave divorcing spouses tax planning options that never existed before, and required matrimonial lawyers to have a working knowledge of these tax laws as part of their practice.⁸ Indeed, Melvin Frumkes described the 1984 act "as the most monumental change in the tax law for the past 30 years."⁹

II. Free Money

The payor of alimony may take a deduction for those payments,¹⁰ and the payee is required to report the payments as income.¹¹ From this simple concept flows an opportunity to create "free money" between the parties. When the payor is in a higher tax bracket than the payee, the IRS ends up subsidizing part of the alimony payment. Here is how it works:

Tax-Shifting Example. Husband makes \$25,000 per month, and Wife has no income. If Husband lives in a state like California that allows for generous alimony, a court will order him to pay about \$9,000 per

⁴ *Mahana v. United States*, 88 F. Supp. 285, 288 (Ct. Cl. 1950), *cert. denied*, 399 U.S. 978 (1950).

⁵ Wilder, *supra* note 3, at 497.

⁶ *Id.* at 497-98.

⁷ Tax Reform Act of 1984, Pub. L. 98-369, 98 Stat. 583; Tax Reform Act of 1986, Pub. L. 99-514, 100 Stat. 2085.

⁸ Wilder, *supra* note 3, at 499.

⁹ Melvin B. Frumkes, *Effect of TRA 1997 and RARA 1998 on Divorce Taxation*, 16 J. AM. ACAD. MATRIM. LAW. 121, 122 (1999).

¹⁰ I.R.C. § 215(a) (1994).

¹¹ I.R.C. § 71(a) (1986).

month to Wife pending trial in these circumstances.¹² After receiving the tax deduction for the alimony payment, the net cost to Husband is only \$5,000 per month. The \$4,000 savings results from the taxes Husband does not have to pay on the rest of his income for the year. His savings is high because he is taxed at a high rate according to his income. Wife, on the other hand, has no income other than the alimony, so her tax rate is much lower. After paying taxes on the alimony, she nets \$7,000 per month. The parties just created \$2,000 per month, which is the difference between what it costs Husband to make the alimony payment, and what Wife receives, after taxes. This “free money” comes from the taxing authorities. It represents a loss of tax revenue, which otherwise would have been collected from Husband had he not been paying alimony to Wife. The tax savings makes it easier for Husband to provide support to Wife.

This kind of tax savings allows the parties to absorb the shock of the divorce more easily. Easing the tax burden on the payor, for the benefit of both parties, is a legitimate consideration when setting alimony.¹³ Thus, attorneys need to look at taxes carefully when setting alimony to understand the after-tax effects of those payments as to each party. Making the calculation is easy if a state has a child support guideline based on after-tax income, because the computer program used to calculate child support can also be used as a tax calculator to figure out the after-tax cost and benefit of an alimony payment.¹⁴ If a state

¹² For example, the temporary spousal support guideline adopted by the Santa Clara County Superior Court in the State of California states: “Temporary spousal or partner support is generally computed by taking 40 percent of the net income of the payor, minus 50 percent of the net income of the payee, adjusted for tax consequences. If there is child support, temporary spousal or partner support is calculated on net income not allocated to child support and/or child-related expenses. The temporary spousal support calculations apply these assumptions.” Santa Clara Sup. Ct. Local Rules, Fam. Ct. Rule 3(C).

¹³ See *McManus v. McManus*, 39 A.D.2d 775 (N.Y. 1972); ROBERT S. TAFT & LEONARD G. FLORESCUE, *TAX ASPECTS OF DIVORCE AND SEPARATION* § 5.01 (2005).

¹⁴ Some programs automatically show the after-tax cost and benefit of the proposed alimony payment. If the program does not provide that information, then enter the proposed alimony payment as taxable income to the payee in the support calculator, along with any other income and deductions that party may have, to determine the after-tax income of that party with the proposed alimony payment. Run the same calculation again, but this time do not enter the alimony payment as taxable payment to the payee. This second calculation will show the after-tax income of the payee without the proposed alimony payment. Compare the difference in after-tax income between the two calculations to see

does not have a support calculator, then the IRS website has an online tax calculator which can be used for this purpose.¹⁵

The alimony deduction has drawn criticism lately by the U.S. House of Representatives Committee on Ways and Means. In a discussion draft of proposed legislation entitled The Tax Reform Act of 2014, the committee recommends “[e]nding the tax code’s ‘divorce subsidy’ – which benefits divorce lawyers while helping to break up families – that allows divorcing couples to get a tax break for alimony payments.”¹⁶ The draft law would eliminate the tax deduction for alimony and make alimony payments non-taxable to the payee effective after 2014.¹⁷

III. Ten Commandments

The agreement or order for alimony must be written in a certain way for payments to be included as income to the payee and tax-deductible by the payor.¹⁸ There are ten rules for making payments taxable as alimony to the payor and deductible to the payee, which are summarized below. Each rule must be satisfied or the payments will not qualify as “alimony.” In enacting section 71 of the Code,¹⁹ Congress sought to eliminate “subjec-

how much the payee will net after paying taxes on the alimony payment. To find out how much of a deduction the payor will receive by making the alimony payment, two calculations will also be needed. The first calculation will include a tax deduction for the proposed alimony payment. The second calculation will not include the deduction. Compare the two calculations to see the after-tax cost to the payor of the proposed alimony payment.

¹⁵ Go to www.irs.gov and search for the “IRS Withholding Calculator.” The IRS tax calculator estimates the federal taxes a person will pay, based on his or her income, deductions, and tax filing status. Basically, the attorney should run the numbers two ways for each party, one way without considering the alimony income/deduction, and the other way with the alimony income/deduction included, as explained in note 14. If either party lives in a jurisdiction with state income tax, then the same calculation will have to be made at the state level as well.

¹⁶ Executive Summary, The Tax Reform Act of 2014, H. Comm, on Ways and Means, 24. http://waysandmeans.house.gov/uploadedfiles/tax_reform_executive_summary.pdf

¹⁷ Discussion Draft, Tax Reform Act of 2014, 25, § 1411. http://waysandmeans.house.gov/uploadedfiles/ways_and_means_section_by_section_summary_final_022614.pdf

¹⁸ I.R.C. §§ 71, 215.

¹⁹ I.R.C. § 71.

tive inquiries into the intent and nature of payments that had plagued the courts [under prior the rule] in favor of a simpler, more objective test.”²⁰ The beauty of section 71 is that it is a bright-line test: if the agreement or order conforms to the test set forth in section 71, then the payment is considered alimony.²¹ The bad thing about section 71 is that it is a bright-line test: if the strict requirements are not met, then the payments are not income to the payee and are not deductible by the payor.

Attorneys should commit the rules to memory, because often that is all they will have at hand when making an argument in court or trying to hammer out a settlement. Each rule is discussed in detail below.

A. Rule 1: Labels Don't Matter (Usually)

There is no requirement that the alimony agreement or order refer to the payments specifically as alimony, spousal support, or maintenance. The IRS only looks to whether the legal requirements in section 71 have been satisfied; the label attached to payments has little significance in determining whether it qualifies as alimony.²² In other words, the IRS could deem court-ordered payments labeled “alimony” as nontaxable and nondeductible, if the order fails to comply with section 71. Because the focus is solely on whether the section 71 rules have been satisfied, the intent of the court or parties is irrelevant. It does not matter if the payments were, in fact, designed to provide support for a former wife (or as disguised property settlement for that matter).²³

There are times, however, when labels count. If the agreement designates a payment as “child support,” then it cannot be considered alimony.²⁴ Also, if the agreement says that the payments are to be treated as nontaxable income to the payee, then the payments will not be included in the payee’s income and will

²⁰ *Hoover v. Comm’r*, 102 F.3d 842, 845 (6th Cir. 1996).

²¹ MELVIN B. FRUMKES, *FRUMKES ON DIVORCE TAXATION* § 3.1; *Hopkinson v. Comm’r*, T.C.M. 1999-154 (1999).

²² *Hopkinson*, T.C.M. 1999-154; *Cunningham v. Comm’r*, T.C.M. 1994-474 (1994).

²³ FRUMKES, *supra* note 21, at § 3.1.

²⁴ I.R.C. § 71(c)(1).

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not be deductible by the payor.²⁵ Those exceptions are discussed below.

B. Rule 2: In Cash

Section 71 requires that the payment be made “in cash.”²⁶ The term “cash” includes checks.²⁷ Alimony cannot be paid in exchange for services, property, an I.O.U., or for the use of property.²⁸ To be taxable or deductible in a particular tax year, the cash payment must have been actually paid during that year.²⁹

C. Rule 3: To (or on Behalf of) a Spouse or Former Spouse

The payment must be received by, or on behalf of, a spouse or former spouse.³⁰ This rule allows for a lot of creativity, because the payment does not have to be made directly to the spouse or former spouse. The principle of constructive receipt allows the alimony, or a portion of it, to be paid to a third party for the benefit of the payee spouse, if permitted by the order or agreement. “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.”³¹

Attorneys can use the constructive receipt rule to make sure that debts of the payee, which have been guaranteed by the payor, are paid in a timely manner by specifying in the order or agreement that those obligations will be paid directly to the creditor as alimony to the payee.³² Keep in mind that the payor has no unilateral right to pay an obligation of the payee as an offset against alimony owed—the right to make the alimony payment to the third party must be pursuant to an order or agreement.³³ The agreement to pay a third party does not have to be contained

²⁵ *Id.* § 71(b)(1)(B).

²⁶ *Id.* § 71(b)(1).

²⁷ FRUMKES, *supra* note 21, at § 3.3.

²⁸ Treas. Reg. § 1.71-1T (1984).

²⁹ Treas. Reg. § 1.215-1(a) (1984).

³⁰ I.R.C. § 71(b)(1)(A).

³¹ Treas. Reg. § 1.71-1T, Q&A (b)(6) (1984).

³² *Simpson v. Comm’r, T.C.M. (CCH) 1999-251 (1999).*

³³ Treas. Reg. § 1.71-1T, Q&A (b)(6) (1984); *Johnson v. Comm’r, T.C.M. (CCH) 2006-116 (2006).*

in the alimony agreement itself. A payment may be made to a third party on behalf of the spouse or former spouse entitled to alimony “if such payment is pursuant to the written request, consent or ratification of the payee spouse.”³⁴ This might occur, for example, if alimony is normally paid directly to the payee, but the payee asks on one occasion for the alimony to be paid, instead, to a landlord.

The tricky part is to make sure that the payor does not benefit from the payment to the third party; otherwise, the payment will not qualify as alimony.³⁵ In particular, problems arise in the context of making a mortgage payment directly to the creditor as alimony. Deciphering the applicable tax rules in this instance can cause a headache, but it may be worthwhile to consider making such agreements or orders for the tax benefits that can be obtained or for the protection direct payments to a creditor can bring. For example, if one party has exclusive possession of a residence that is encumbered by a loan in the names of both parties, then it is a good idea to ensure that the mortgage gets paid on time. Difficult questions arise regarding (1) whether the payor “benefits” from the use of the alimony to make the mortgage payment, and (2) who gets to claim the tax deduction for the mortgage payment that was made from alimony. Here is the fine print:

First, look at who owns the house and who is liable on the mortgage. If the house and the mortgage are solely in the name of the payor, then the payor cannot take an alimony deduction for paying the mortgage, even if the payee has exclusive possession. “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.”³⁶ The payment, in this instance, is not made “on behalf” of the payee. The payor is solely responsible for making the house payments as the owner of the property or debtor under the mortgage, so the satisfaction of those obligations cannot be treated as alimony on behalf of his or her spouse or former spouse. A per-

³⁴ Treas. Reg. § 1.71-1T, Q&A (b)(7) (1984).

³⁵ See Treas. Reg. § 1.71-1T, Q&A (b)(6) (1984).

³⁶ *Id.*

son cannot get credit for making a payment he or she owed in the first place. Simple enough. The only potential tax benefit to the payor in this example is that the payor can take an itemized deduction for the mortgage interest or property tax payments if the residence is a “qualified residence.”³⁷

The reverse situation is also straightforward—where the alimony *payee* owns the house, the mortgage is in his or her name, and the payee lives in the residence. Since the alimony payee is solely obligated to the creditor for paying the mortgage, the parties can agree that alimony will be paid to the creditor as alimony. The payee spouse can take an itemized deduction for the mortgage interest and property taxes paid, since these payments were made with his or her alimony money.³⁸

The case in which the parties equally own the residence or are jointly obligated on the mortgage is more difficult. If the alimony agreement or order says that the husband will pay the mortgage as alimony for the wife, then the IRS will only recognize one-half of the payments as alimony.³⁹ This outcome is logical because the spouses equally benefit from the payment as co-owners of the property and co-debtors on the mortgage. Therefore, the IRS will only allow the husband to take an alimony deduction for the one-half of the payments that benefitted the wife, which will be treated as taxable income to the wife as alimony. The other one-half of the payment is not income to the wife and is not deductible by the husband as alimony. The itemized deduction for the mortgage interest portion of the payment is divided equally under the same logic, assuming the residence is a

³⁷ I.R.C. § 163(h)(4) (2013); IRS Publ’n 504 (2008), 12. Basically, a party may take a mortgage interest deduction if the party owned and used the residence for periods aggregating two years or more in the preceding five years. I.R.C. § 163(h)(4) (incorporating definition of “qualified residence” in I.R.C. § 121(a) (2010)). An absence from the residence pursuant to a written agreement or order in a divorce or separation action is not counted. I.R.C. § 121(d)(3)(B). When a party is excluded from a residence due to separation or divorce, the attorney should request a finding or agreement granting exclusive possession to the payee spouse to protect the right to claim the mortgage interest deduction and the capital gains exclusion under section 121(a) when the house is sold.

³⁸ IRS Publ’n 504 (2008), 13.

³⁹ IRS Publ’n 504 (2008), 12.

“qualified residence.”⁴⁰ One-half of the mortgage payment was for the husband’s benefit, so he can take a deduction for one-half of the interest paid. The other half of the mortgage payment was effectively made with the wife’s money (her alimony), so she can take the deduction for one-half of the mortgage interest.

Second, different rules apply to the payment of property taxes and home insurance in the form of alimony on a residence held in joint tenancy. If the property is held in joint tenancy, or tenancy by the entirety, then *none* of the property tax or insurance payments qualify as alimony, but the payor can take an itemized deduction for *all* of the property taxes.⁴¹ The form of title counts, so be aware of this special rule when dealing with property taxes and insurance, and do not pay those as alimony if the house is held in joint tenancy or tenancy by entirety.

Note that the agreed payment of utilities as alimony for the benefit of the alimony payee qualifies, even if the utilities are in the payor’s name, provided that the payee has exclusive possession of the residence.⁴²

Third, another situation where alimony payments are sometimes made to a third party involves life insurance. Some states allow for an order requiring the supporting spouse to maintain a life insurance policy on his or her life, for the benefit of the supported spouse, as security for the loss of alimony if the supporting spouse dies.⁴³ If the divorce or separation instrument requires the payor spouse to maintain life insurance for the supported spouse as security for alimony, then the premiums are deductible as alimony (and are included in the supported spouse’s income) provided that the supported spouse is (1) both the owner and irrevocable beneficiary of the policy and has all incidents of ownership under the policy⁴⁴ and (2) all of the elements of section 71 are satisfied.

⁴⁰ *Id.*

⁴¹ IRS Publ’n 504 (2008), 12, Table 5.

⁴² *Simpson*, T.C.M. (CHH) 1999-251.

⁴³ *See, e.g.*, CAL. FAM. CODE § 4360 (1992).

⁴⁴ *Stevens v. Comm’r*, 439 F.2d 69, 71 (2d Cir. 1971); Rev. Rul. 57-125, 1957-1 C.B. 27; Rev. Rul. 70-218, 1970-1 C.B. 19; Treas. Reg. § 1.71-1T, Q&A (b)(6). To avoid uncertainty as to the tax consequences of such premium payments, the agreement should state whether the payments are made on behalf of the supported spouse as additional alimony or if the payments will be treated as non-taxable income.

D. Rule 4: Under a Divorce or Separation Instrument

The payments must be made under a divorce or separation instrument.⁴⁵ This means a divorce decree, a written agreement incident to divorce, a written separation agreement, or a court order requiring a spouse to make payments for the support or maintenance of the other spouse.⁴⁶ A separation agreement does not have to say that the parties are separated.⁴⁷ It is not necessary for the written agreement to be signed by both parties, provided that there is evidence of a binding written contract.⁴⁸ General rules of contract law apply regarding whether a written agreement has been made between the parties for alimony.⁴⁹ The agreement must contain a clear, written statement of the terms of support for the separated party.⁵⁰

A later determination by the court that the alimony order was made in excess of the court's jurisdiction will not affect the tax treatment of the payments made pursuant to that order before it was set aside.⁵¹ Payments made according to a modification to the initial divorce or separation instrument are also deductible.⁵² A significant break in time between the original decree and the agreement to modify that order may raise a question whether the modification is "incident to" the divorce, or is a new agreement between former spouses disguised as alimony.⁵³ The subsequent agreement will be deemed "incident to divorce" if it was made to implement the terms of the original divorce decree or was made in connection with that decree.⁵⁴

⁴⁵ I.R.C. § 71(b)(1)(A).

⁴⁶ I.R.C. §71(b)(2).

⁴⁷ Rev. Rul.73-409, 1973-2 C.B. 19.

⁴⁸ *Leventhal v. Comm'r, T.C.M. (CHH) 2000-92 (2000)* (attorney signed agreement on behalf of the party); I.R.S. Priv. Ltr. Rul. 88-82-1069 (1988) (court reporter transcript of stipulation between parties).

⁴⁹ *Light v. Comm'r, T.C. Summ. Op. 2006-130 (2006)*.

⁵⁰ *Kathmeric v. Comm'r, T.C. Summ Op. 2007-213 (2007)*.

⁵¹ *Dato-Nodurft v. Comm'r, T.C.M. (CHH) 2004-119 (2004)*.

⁵² I.R.S. Priv. Ltr. Rul. 200233022 (Aug. 16, 2002).

⁵³ *Id.* ("Where a significant amount of time elapses between the date of a decree of divorce and the execution of a written agreement, a question is raised as to whether the two instruments are sufficiently related.")

⁵⁴ *Id.*; *Stevens v. Comm'r, 439 F.2d 69, 70 n.4 (2d Cir. 1971)* (paraphrasing "incident to" as "[implementing] the terms of the decree"); *Barnum v. Comm'r, 19 T.C. 401, 407 (1952)* (paraphrasing "incident to" as "related to"); *Hesse v.*

The important thing to keep in mind is that the instrument must be in existence *at the time* the support payments are made.⁵⁵ Payments made before the instrument was executed are not deductible, even if the instrument retroactively characterizes those payments as alimony.⁵⁶

For example, if the husband makes a voluntary payment in the nature of support to the wife in January while their divorce action is pending, then he cannot take an alimony deduction for that payment (and the money is not taxable income to the wife), even if the court subsequently enters an order requiring the husband to pay alimony to the wife for the month of January. This hypothetical fails the section 71 test because no order or written agreement was in existence at the time the husband made the payment.

Here is an example of retroactivity which passes the test: If the wife's motion for alimony is granted in February and the husband is ordered to pay alimony to the wife for the past six months, then his payment to the wife will be deductible to him and includable in her income as alimony. Even though the payment covers a period of support in the past, there was a court order for alimony in existence at the time the husband made the payment.

If the terms of an alimony order fails to meet the requirements of section 71, but the court intended for the payment to qualify as alimony, then a *nunc pro tunc* modification of the order may be allowed to retroactively correct the clerical error.⁵⁷ This exception is limited to correcting clerical errors; the IRS will not recognize a *nunc pro tunc* order correcting errors in judgment of the court or a mistake of the parties.⁵⁸

Comm'r, 7 T.C. 700, 704 (1946) (paraphrasing "incident to" as "in connection with").

⁵⁵ Ali v. Comm'r, T.C.M. (CHH) 2004-284 (2004).

⁵⁶ *Id.*; Rafferty v. United States, Civil Action No. 07-cv-00903-EWN-BNB, 2008 WL 2705192 (D. Colo. July 8, 2008); Treas. Reg. § 1.71-1T, Q&A (a)(4) (1984).

⁵⁷ IRS Publ'n 504 (2008), 11; McDonald v. C.I.R., T.C.M. (CHH) 1994-607 (1994).

⁵⁸ IRS Publ'n 504 (2008), 11.

E. Rule 5: Not Designated as Nontaxable/Nondeductible

If the agreement or order designates the payments as nontaxable and not deductible, then the payments will not qualify as alimony.⁵⁹ This rule is one of the few examples where parties can agree that the payment of money will not be treated as taxable income to the payee. The trade-off is that the payment will not be deductible by the payor either in that instance. Note the “double negative” in the rule –the instrument must *not* state that the payments are *not* included in the payee’s income.⁶⁰ There is no requirement to affirmatively state that the payments will be taxable to the payee.⁶¹

Express language is required to make a payment nontaxable and non-deductible; intent for such treatment will not be implied.⁶² Accordingly, payments will be treated as alimony if the elements of section 71 have been met, unless the parties explicitly state that the payments are nontaxable and nondeductible. A copy of the agreement must be attached to the payee’s tax return each year the designation applies.⁶³

The rule allowing support payments to be treated as nontaxable is not limited to agreements between the parties; courts may also designate payments as nontaxable when making an order for alimony.⁶⁴ The nontaxable designation may be made by the court over the objection of either party.⁶⁵ This rule is an anomaly because, typically, a state court cannot determine issues of federal tax law.⁶⁶ Section 71, however, gives family law courts the authority to make an order of support or maintenance that is not taxable to the payee or deductible by the payee. Frumkes has suggested that courts should consider making non-taxable and non-deductible orders when needed to ensure that the after-

⁵⁹ I.R.C. § 71(b)(1)(B).

⁶⁰ TAFT & FLORESCUE, *supra* note 13, at § 5.03[1][b][iv].

⁶¹ *Cosby v. Comm’r*, T.C. Summ. Op. 2007-8 (2007).

⁶² *Baker v. Comm’r*, T.C.M. (CHH) 2000-164 (2000).

⁶³ Treas. Reg. § 1.71-1T, Q&A (b)(8) (1984).

⁶⁴ I.R.C. § 71(b)(1)(B) (making payments nontaxable if “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”); *Id.* at (b)(2) (defining “divorce or separation instrument” as including court decrees and orders).

⁶⁵ *Hamilton v. Hamilton*, 19 Va. Cir. 241, 241 (Cir. Ct. Va. 1990).

⁶⁶ *Okerson v. Comm’r*, 123 T.C. 258 264 (2004).

tax needs of spouses are met.⁶⁷ Other reasons for making payments nontaxable and non-deductible are when one of the parties is not a U.S. taxpayer⁶⁸ or when the court-ordered payments would result in alimony recapture.⁶⁹

The court may make one stream of payments taxable as alimony and another stream of payments non-taxable.⁷⁰ For example, a court may order the wife to pay the lease on the husband's vehicle as nontaxable and non-deductible temporary spousal support, and may make a separate order for \$2,000 per month in spousal support to the husband, which will be taxable and deductible.

F. Rule 6: The Parties Must Not Be Living Together, Unless the Alimony Is Temporary

If the parties are legally separated under a divorce or separation decree and are members of the same household at the time the payment is made, then the payment will not qualify as alimony.⁷¹ Once a decree of legal separation or divorce is entered, the parties cannot continue to share the same household for more than one month or the support payments will not qualify as alimony.⁷² The parties are not in "separate households," even if they physically separate themselves within the dwelling unit.⁷³

The rule does not apply to agreements or orders for temporary support. Payments made while the parties are not "legally separated . . . under a decree of divorce or of separate maintenance" are deductible if the other requirements of section 71

⁶⁷ FRUMKES, *supra* note 21, at §3.5.1.

⁶⁸ *Lolli-Ghetti v. Lolli-Ghetti*, 165 A.D.2d 426, 434 (N.Y. 1991). If one party is not a U.S. taxpayer, then it is appropriate to make a non-taxable and non-deductible alimony payment because the non-U.S. taxpayer may not be subject to federal income tax on the alimony (if that party is the payee) or receive the benefit of the alimony deduction (if that party is the payor).

⁶⁹ FRUMKES, *supra* note 21, at §3.5.5. The issue of recapture is discussed *infra* in text.

⁷⁰ *Springer v. Comm'r, T.C.M. (CHH) 2003-221* (2003).

⁷¹ I.R.C. § 71(b)(1)(C).

⁷² Treas. Reg. § 1.71-1T, Q&A (b)(9) (1984).

⁷³ *Id.*

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have been met, notwithstanding the fact that the parties are members of the same household when the payments are made.⁷⁴

G. *Rule 7: Payments May Not Be Fixed as Child Support*

Payments specifically designated as child support are not deductible as alimony and are not taxable to the payee.⁷⁵ Still, orders can be fashioned that, in effect, include unallocated child support and alimony, and the payor can deduct 100% of the payment if the requirements of section 71 are met. When child support and alimony are combined into one order, and the payor does not make the full payment, the amount paid is first allocated to child support and the balance, if any, is allocated to alimony for purposes of determining the amount of the alimony deduction.⁷⁶

Agreements to pay unallocated child support and alimony are sometimes referred to as a “*Lester* agreement” or a family support order.⁷⁷ The purpose of such arrangements is to utilize the difference in the parties’ respective tax rates to create free money as discussed above.⁷⁸ The catch, however, is that the payment amount cannot be reduced based on any contingency relating to the child (such as the child reaching the age of majority or graduating from high school).⁷⁹ Any such reduction in amount will be treated as child support and will not be deductible either before or after the contingency occurs.⁸⁰ Therefore, even when a payment is 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, such as the child’s turning age eighteen.⁸¹

There is a safe harbor in the Treasury Regulations for any step-down in amount under a family support that takes place more than six months before or after the date on which the child

⁷⁴ I.R.C. § 71(b)(1)(C); Treas. Reg. § 1.71-1T, Q&A (b)(9) (1984).

⁷⁵ I.R.C. § 71(c).

⁷⁶ *Id.* § 71(c)(3); IRS Publ’n 504 (2008), 12.

⁷⁷ *Comm’r v. Lester*, 366 U.S. 299 (1961).

⁷⁸ *Miller v. Comm’r, T.C.M. (CHH) 1999-273* (1999).

⁷⁹ I.R.C. § 71(c)(2)(A).

⁸⁰ *Id.*

⁸¹ *Id.*

attains age eighteen, twenty-one, or the local age of majority.⁸² Creating a family support order that complies with the safe harbor provision where there are multiple children may be nearly impossible. To do so, 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 entire payment treated as alimony, which could erase the tax benefits of the order. Also, any modification of the order will face the same challenges. In this author's mind, it is difficult to conceive of a situation where the tax-subsidy created by a family support order would be substantial enough to warrant the risk and legal gymnastics involved in structuring the order.

H. *Rule 8: Payments Must Terminate on the Death of the Payee*

There must be no liability to continue making any payments after the death of the payee.⁸³ This requirement was apparently adopted to distinguish between true alimony and a property division disguised as alimony.⁸⁴ An order for maintenance or support should naturally terminate on the death of the supported spouse, as “dead people require little, if any, support.”⁸⁵ By comparison, an obligation to divide marital property survives the death of either party because it creates a vested property right that can be transferred on death. So, if any of the payments are required to be made on or after the death of the supported spouse, then those payments look more like a division of property than for the maintenance of a former spouse. If the rule is violated, then none of the payments before or after the death of the payee spouse qualify as alimony or separate maintenance payments.⁸⁶

Fortunately, the instrument does not have to expressly state that the payments cease upon the death of the payee, if the obligation terminates automatically by operation of state law on the

⁸² Treas. Reg. § 1.71-1T, Q&A (c)(18) (1984).

⁸³ I.R.C. § 71(b)(1)(D).

⁸⁴ FRUMKES, *supra* note 21, at §3.7.

⁸⁵ TAFT & FLORESCUE, *supra* note 13, at § 5.03[1][v].

⁸⁶ Treas. Reg. § 1.71-1T, Q&A (b)(10) (1984).

death of the payee.⁸⁷ Section 71 only requires that there be “no liability” to continue making the payments after the death of the payee.⁸⁸ When the instrument does not contain an express termination provision, the tax court will look to state law to determine if the obligation terminated on the payee’s death.⁸⁹ Therefore, the fact that an agreement or order fails to state that the obligation terminates upon the death of the payee is irrelevant for purposes of section 71, provided that the alimony obligation automatically terminates under state law upon death.

A more difficult question arises when payments are made to a third party on behalf of a supported spouse, but the instrument does not say whether the obligation to make those payments ceases on the death of the supported spouse. For example, the court order states: “Husband is ordered to pay \$15,000 to Wife’s attorney, as a needs-based contribution toward her attorney’s fees.” The following elements of the section 71 test are satisfied: (1) the payment is made to the attorney on behalf of the payee’s spouse because the wife has a contractual obligation to pay her attorney the money; (2) the payment is made pursuant to a divorce or separation instrument; (3) the instruction does not designate the payment as nontaxable; (4) the parties are not members of the same household post-divorce; and (5) the order does not designate the payment as child support. The instrument, however, is silent regarding the final requirement—that there be no obligation to make the payment after the wife’s death.⁹⁰

If state law provides for the automatic termination of alimony on the death of the payee spouse, then the missing element can be supplied by operation of law⁹¹ but this presumes that the payment was alimony in the first place.

Some states allow for an award of attorney’s fees based on economic need, which sounds like an award of maintenance for

⁸⁷ *Johanson v. Comm’r*, 541 F.3d 973, 974 (9th Cir. 2008); IRS Publ’n 504, 14 (2008).

⁸⁸ I.R.C. § 71(b)(1)(D).

⁸⁹ *Johanson*, 541 F.3d at 977.

⁹⁰ I.R.C. § 71(b)(1)(D).

⁹¹ *Johanson*, 541 F.3d at 977. .

that spouse.⁹² If the payment is characterized as spousal support or maintenance, and state law provides for the automatic termination of that obligation on the death of the payee, then all of the section 71 requirements are met and the payment to the wife's attorney is taxable to the wife as alimony.⁹³

This is one of the few instances when the federal tax court will look to state law to determine whether a payment is taxable.⁹⁴ The majority of tax courts that have considered this question have not allowed the law to be stretched so far, and have concluded that the obligation to pay a needs-based attorney's fees order survives the death of the supported spouse and, therefore, is not alimony.⁹⁵ Still, it is a good example to work through the elements of section 71.

It is good practice to include a recital in every order or agreement for spousal support or maintenance that the obligation to make the payment terminates upon the death of the supported party. If the payment is being made to a third party (like the supported spouse's attorney), then that attorney should understand that the payor's obligation to pay the fees will terminate if the payee dies before the payment is made. The risk of death can be minimized by requiring a short payment term.

Section 71 does not permit any "substitute payments" (in lieu of the alimony which would have been made had the payee survived) to be counted as alimony.⁹⁶ To the extent that the obligation to make one or more payments commences, increases in amount, or becomes accelerated in time as a result of the death of the payee, such payments may be treated as a substitute for the alimony payments which were terminated upon the payee's death.⁹⁷ For example: The husband is obligated to make alimony

⁹² For example, under California law, a needs-based attorney fee award requires consideration of the same factors that the court must apply when setting permanent spousal support. CAL. FAM. CODE § 2032(b) (2010) (requiring consideration of relevant spousal support factors under Cal Fam. Code § 4320 (2013) when setting needs-based attorney's fees for a party).

⁹³ *Burkes v. Comm'r*, 75 T.C.M. (CHH) 1772 (1998).

⁹⁴ *Megibow v. Comm'r*, 76 T.C.M. (CHH) 1072 (1998).

⁹⁵ *Berry v. Comm'r*, 80 T.C.M. (CHH) 825 (2000); *Smith v. Comm'r T.C.M. (CHH)*1998-166. *But cf.* *Greer v. Greer*, 130 P.2d 1050, 1052 (Colo. 1942); *Hogsett v. Hogsett*, 409 S.W.2d 232, 238 (Mo. Ct. App. 1966).

⁹⁶ I.R.C. § 71(b)(1)(D).

⁹⁷ Treas. Reg. § 1.71-1T, Q&A (b)(14) (1984).

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payments to the wife in the amount of \$30,000 per year for six years or until the death of the wife, whichever is earlier. The agreement further states that, upon the wife's death, the husband will pay \$10,000 per year to a trust established for the benefit of their children. In this example, taken from the Treasury Regulations,⁹⁸ the husband's liability to make the annual \$10,000 payments in trust for the benefit of his children upon the death of the wife is deemed a substitute for the alimony that terminated as a result of her death. Accordingly, \$10,000 of the \$30,000 annual payments to the wife will not qualify as alimony and will not be taxable to her or deductible to the husband.⁹⁹ Notice that the IRS will disallow \$10,000 of the annual payments from the very beginning of the order, not just upon the wife's death. In effect, the husband can only deduct \$20,000 per year as alimony paid to the wife. The remaining \$10,000 per year is treated as something other than alimony (perhaps as child support or a division of property disguised as alimony).

I. *Rule 9: A Joint Return Is Not Filed*

The final requirement is that the parties file separate tax returns.¹⁰⁰ The parties cannot file a joint tax return together, with one claiming an alimony deduction and the other reporting the alimony income during the tax year.

J. *Rule 10: Recapture*

Recapture is more of a trap than a 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 could be a disguised 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.¹⁰¹ The rule is intended to make it difficult for parties to make a property settlement deductible as alimony.¹⁰²

A formula is used to determine if alimony has been “front-loaded” (i.e., paid in advance for a tax benefit). If the recapture

⁹⁸ *Id.*, Example 2.

⁹⁹ Treas. Reg. §§ 1.71-1T, Q&A (b)(14); Example 2 (1984).

¹⁰⁰ I.R.C. § 71(e).

¹⁰¹ TAFT & FLORESCUE, *supra* note 13, at § 5.03[2].

¹⁰² *Id.*

rule applies, then the amount of alimony 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 the third post-separation year.¹⁰³ To determine whether recapture is required, the focus is whether alimony payments have decreased by a certain amount in the first, second, and third years in which alimony was paid.¹⁰⁴ Any time the amount of alimony reduces within the first three years (whether by the terms of the agreement or order, a failure to pay the full amount due, or due to a modification), the payments should be tested to determine if recapture will occur. Alimony paid in the fourth and subsequent years is not subject to recapture.

The rule is complicated. The IRS has a worksheet, which can be used to make the computation.¹⁰⁵ If the amount paid in year two is \$15,000 or more than the amount paid in year three, there may be a recapture problem.¹⁰⁶ To determine if recapture is required, the next step in the analysis is to compare the amount of alimony paid in years two and three with the amount paid in year one. If the alimony paid in year one is \$15,000 or more than the adjusted average of years two and three, then the excess payments will be recaptured.¹⁰⁷ The excess payments subject to recapture are added back to the payor's income in the third post-separation year (to offset the deductions taken for years one and two) and are allowed as a deduction to the payee (to offset the alimony income reported for those years).¹⁰⁸

There are three exceptions to the rule: (1) recapture does not apply to temporary alimony orders;¹⁰⁹ (2) recapture does not apply when alimony terminates because of the death of either party, or the remarriage of the payee, before the close of the third post-separation year;¹¹⁰ and (3) recapture does not apply when alimony payments fluctuate (over a period of not less than three years) per an order to pay a fixed portion of income from a

¹⁰³ I.R.C. § 71(f).

¹⁰⁴ *Id.* § 71(f)(6).

¹⁰⁵ IRS Publ'n 504 (2008), 18, Worksheet 1.

¹⁰⁶ I.R.C. § 71(f)(4).

¹⁰⁷ *Id.* § 71(f)(3).

¹⁰⁸ *Id.* § 71(f)(1).

¹⁰⁹ *Id.* § 71(f)(5)(B).

¹¹⁰ *Id.* § 71(f)(5)(A).

business, employment, or property.¹¹¹ Accordingly, alimony can be front-loaded as part of a “temporary” order before entry of the divorce decree to circumvent the recapture rule.

When post-decree alimony is modified within the first three years post-separation, the payor may be subject to recapture. The effects of recapture will be particularly harsh on the payor if the reduction in support was due to a loss of the payor’s job.¹¹² Sure, the amount of alimony will be reduced or terminated in the modification proceeding, but the payor may be subject to a large tax bill if the reduction in alimony was large enough to trigger a recapture. Recapture, in these circumstances, would not serve the purpose of the rule, but this author is not aware of any equitable exceptions that would allow the payor to escape the effects of recapture simply because the amount of alimony was reduced due to an unforeseen event, rather than an attempt to disguise a property settlement as alimony. Counsel and the court must take this possibility into consideration when fashioning a modification.¹¹³

IV. Estimated Tax Payments and Withholding of Tax

Once it has been determined that a payment qualifies as alimony, additional thought must be given to whether the payee must make estimated tax payments on the alimony. In limited circumstances, the payor may have a duty to withhold some of the alimony and pay the withheld amount to the IRS to ensure that tax due on the alimony is paid.

A. Estimated Tax Payments on Alimony

The payee must make quarterly estimated tax payments to the IRS on the alimony received throughout the tax year, if the payee will owe more than \$1,000 in taxes for the year, after deducting withholdings and credits.¹¹⁴ Failure to pay the proper

¹¹¹ *Id.* § 71(f)(5)(C).

¹¹² FRUMKES, *supra* note 21, at §3.9.2.2.

¹¹³ *Id.*

¹¹⁴ IRS Publ’n 505 (2014), 23.

amount of estimated taxes will subject the payee to interest and penalties.¹¹⁵

B. *Withholding of Taxes by Payor*

There is generally no requirement for the payor to withhold income taxes from alimony payments. However, when alimony is paid to a nonresident alien, there may be a requirement for the payor of alimony to withhold income tax at the rate of up to 30% per payment.¹¹⁶ Withholding only applies when the payee is a nonresident alien, who is an individual who is not a U.S. citizen or a resident alien.¹¹⁷ Nonresident alien individuals married to U.S. citizens or resident aliens may choose to be treated as resident aliens for certain income tax purposes, but these individuals are still subject to the withholding rules.¹¹⁸

Some countries have a tax treaty with the United States that exempts alimony payments from the withholding requirement or provides for a reduced withholding rate.¹¹⁹ For example, an alimony payment to a nonresident alien who is a citizen of Canada or Indonesia is subject to a 15% withholding requirement.¹²⁰ Nonresident aliens who are citizens of the following countries are subject to a 15% withholding rate: Denmark, France, Armenia, Azerbaijan, Belarus, Georgia, Kyrgyzstan, Moldova, Tajikistan, Turkmenistan, and Uzbekistan. If there is no treaty with the nonresident alien's country of citizenship, then the 30% withholding rate applies.

When a withholding requirement exists, the payor is personally liable for any taxes required to be withheld, independent of the payee's liability.¹²¹ Payments subject to withholding are reported on IRS Form 1042-S and a tax return on IRS Form 1042 is required.¹²²

¹¹⁵ *Id.*

¹¹⁶ IRS Publ'n 504 (2008), 13; IRS Publ'n 515 (2013), 21.

¹¹⁷ IRS Publ'n 515 (2013), 6.

¹¹⁸ *Id.*

¹¹⁹ IRS Publ'n 515 (2013), 39, Table 1 (treaties and withholding rates shown under Income Code Reference No. 14).

¹²⁰ *Id.*

¹²¹ IRS Publ'n 515 (2013), 3.

¹²² *Id.*

V. Conclusion

A working knowledge of section 71 is necessary to make an alimony agreement or order that will be included in the income of the payee and deductible by the payor. Understanding the tax effects of alimony also allows attorneys to structure alimony agreements or orders that are mutually beneficial to the parties. An attorney who knows the tax rules relating to alimony can fashion creative and money-saving agreements, lessening the impact of a divorce.¹²³

¹²³ For additional commentary, see, Christopher C. Melcher, *Make the Tax Code Your Friend—and Alimony More Palatable*, 34 Fam. Advoc. 3, 16-19 (2012), available at http://www.walzermelcher.com/articles-divorce/3win12_melcher.pdf.