Basic Principles in the Taxation of Alimony and Property Settlements

General Themes of the Current Taxation Structure

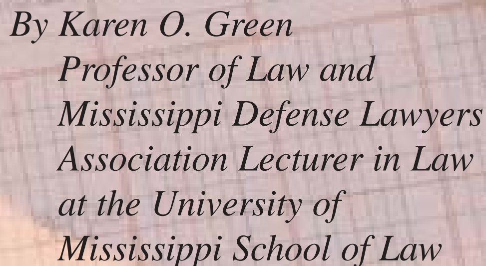
In connection with the dissolution of a marriage, the parties to the divorce must focus on two major issues which will be impacted by taxation. First, the parties must determine the necessity of one spouse providing payments for the support of the other spouse, as well as the children of the marriage. In addition, an equitable division of the couple's property must be accomplished. Several themes dominate the current taxation scheme and provide a framework for the statutory rules.

In the area of support payments, the present taxation structure[1] is designed to permit the parties to choose the tax consequences of those payments. Quite simply, they may negotiate and choose which party will be taxed on the income used to provide that support. The fact that their ultimate choice is based on the goal of allocating taxable income and deductions in the manner that will yield the best overall tax benefits for the parties is irrelevant.

As to property settlements, the current taxation structure is generally designed to allow the division of property without the burden of immediate tax consequences.[2] This structure is not elective and accords nonrecognition treatment for divisions, exchanges, and sales for cash. However, through the accompanying basis provision, the rules simply operate to postpone taxation until the transferee spouse later disposes of the property.

Alimony

It is important to understand at the outset that a tax definition of alimony is made necessary by one of the basic goals of our taxation system—a uniform application of the tax laws among taxpayers in all states. Our current system is designed to achieve this goal through a statutory definition of alimony for tax purposes.



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The alimony tax provisions of the Internal Revenue Code essentially determine who will be taxed on income that is used to provide support payments to the payee spouse. This is accomplished by creating complete correspondence between Internal Revenue Code §71, defining alimony, and §215 of the Code, allowing a deduction for payments qualifying as alimony under §71. Any payment properly characterized as alimony under these provisions will be taxable as income to the payee spouse and will be deductible to the payor spouse. Since the alimony deduction is an above-the-line deduction, the payor spouse can utilize the deduction, regardless of whether he itemizes his deductions or elects to take the standard deduction. Accordingly, the alimony deduction reduces the payor's adjusted gross income, which is an important measure for the allowance of other types

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of deductions, such as medical, charitable, and miscellaneous itemized deductions.

The statutory definition of alimony is designed around the type of payment that is most characteristic of support, as distinguished from a payment for property. However, there is no need to establish that the spouses intended the payments as support payments. As long as the payments satisfy the statutory definition of alimony, that tax treatment will be accorded the payment. In this regard, seven statutory requirements must be met to achieve alimony status for tax purposes.

1. **Payment in Cash.**[3] The payment must be made in cash or by check or money order. Quite simply, nothing else will qualify. The use of property or the taxpayer's own promissory note to satisfy the payment obligation will not qualify as an alimony payment.[4]

2. **Payment to or on Behalf of a Spouse.**[5] Payments must be made either directly to the payee spouse or to another party on behalf of the spouse. Most typically, indirect payments take the form of rent, mortgage payments, taxes, or life insurance premiums.[6] These indirect payments, however, raise some important issues, particularly for mortgage payments and life insurance premiums, discussed later in this article.

3. **Payment Pursuant to a Decree or Separation Instrument.**[7] The payment must be required under a decree of divorce or separate maintenance or a written instrument incident to a decree, a written separation agreement, or a decree of support.

4. **Payment not Designated Nonalimony.**[8] Quite importantly, a payment that would otherwise qualify as alimony can be designated as nonalimony. This provision, thus, allows the parties to determine the tax consequences for the payment. The parties can select alimony treatment or nonalimony treatment, based on how the parties choose to share the tax benefits and tax costs associated with the payment. It is perfectly permissible for this decision to be based on an evaluation of the best overall tax results for both parties, taking account of the particular tax situation of each party. The parties can and should negotiate and choose these consequences after considering potential tax rates, benefits of alimony deductions, and other available tax benefits such as deductions, losses, and credits of the spouses. In summary, the alimony taxation structure allows

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tax planning and taxation minimization as agreed upon by the parties.

5. **Requirement of Separate Households.**[9] If the parties are legally separated pursuant to a decree of divorce or separate maintenance, alimony treatment is only available if the parties are not members of the same household. This requirement is inapplicable to payments between spouses who are neither divorced nor legally separated. Interestingly, regulations issued by the Internal Revenue Service interpret the separate household requirement in a fairly strict manner, taking the position that the requirement is not satisfied even if spouses live separately within the same household.[10]

6. **Termination of Payments at Death of Payee**.[11] Critically important is the need to provide in the governing instrument for the termination of the payment at the death of the payee spouse. Although this requirement can be satisfied by a determination that such payments will terminate under applicable state law, termination should be stated specifically in the governing instrument to ensure certainty of tax treatment. This requirement, however, does not prevent termination of the payment at an earlier specified time. For example, the parties may wish to provide support for a limited period of time to allow the payee spouse to obtain additional education or training. Such an agreement could provide for a payment for a specific term of years, but the agreement must require termination at the death of the payee spouse if that event occurs prior to expiration of the specific term.

7. **No Joint Return**.[12] If the parties file a joint tax return, the alimony income and deduction provisions are not applicable to the payment.

Special Types of Indirect Payments

As previously mentioned, certain indirect payments which otherwise meet the statutory definition of alimony raise special issues. Although benefiting the payee spouse, these payments also generate significant benefits for the payor spouse. These special payments include mortgage payments on a residence, the occupancy of which is granted to the other spouse, and payment of life insurance premiums on a policy insuring the life of the payor spouse.

While the current tax structure affords the parties wide latitude in choosing the tax consequences of any support payments, the statute includes a special recapture provision which may negate the benefit of larger alimony payments in the first two years of payment.

Because mortgage payments on a residence increase the equity of the owner of the residence, alimony treatment for such payments is dependent on the ownership. If the home is owned solely by the spouse granted occupancy, the payment qualifies fully as alimony. However, if the home is owned solely by the payor spouse and is merely occupied by the nonowner spouse, the payment will not qualify as alimony.[13] If the spouses own the property jointly, one-half of the payment should qualify for alimony treatment.

To protect a payee spouse from the loss of support due to the death of the payor spouse, the payor spouse may be required to pay premiums on either an existing or newly-purchased life insurance policy. Payment of these premiums by the payor spouse will qualify for alimony status only if the payee spouse is the owner of the policy.[14] Alimony treatment is not available if the payor spouse continues to be the owner of the policy and merely names the payee spouse as the beneficiary under a policy. Of course, if the policy itself is transferred to the payee spouse, that transfer will not qualify as alimony since it is not a transfer of cash.

Alimony Recapture

While the current tax structure affords the parties wide latitude in choosing the tax consequences of any support payments, the statute includes a special recapture provision which may negate the benefit of larger alimony payments in the first two years of payment.[15] This rule is designed to discourage the practice of frontloading alimony (providing for larger payments in the early years). If these rules are applicable, the payor spouse is required to include an amount equal to the "excess alimony payments" in income and the payee spouse is allowed a deduction of a similar amount.

Quite fortunately, the front-loading provision has very limited application. Recapture under the front-loading provision can only occur in the third post-separation year[16] and only if the payor spouse has made excess payments in years one and/or two.[17] To oversimplify somewhat, recapture occurs if payments in the second year exceed those in the third year by more than $15,000 and/or if payments in the first year exceed the average of the second and third year payments by more than $15,000.[18]

There are several important statutory exceptions to the recapture rules.[19] Recapture is inapplicable to fluctuating payments over a period of not less than three years, if the payments are based on a portion of business income, property income, or compensation income. No recapture is required if either spouse dies during the three-year period or the payee spouse marries during this period. Finally, the recapture rules do not apply to payments made pursuant to a decree for support only.

Child Support

Alimony treatment is specifically denied under §71 for any portion of a payment which is fixed under the decree or

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separation instrument as child support.[20] A payment for child support is not income to the payee spouse and is not deductible by the payor spouse. The difficulty under this provision centers on whether such payments have been sufficiently "fixed" as child support by the governing instrument.

Payments will be treated as sufficiently fixed as child support in three instances. Clearly, the payments constitute child support if designated in terms of amount or portion of a payment under a specific provision of the governing instrument.[21] Further, if a payment reduction is required under the governing instrument at a specified time, which relates to a child reaching a certain age, marrying, dying, or leaving school, the reduction amount constitutes child support.[22] For example, if the payor spouse must make monthly payments of $2,000 to a payee spouse, but the monthly payment will be reduced by $500 upon the spouses' only child reaching the age of 21, the amount of $500 per month will be treated as child support for tax purposes. Child support status will also be accorded to reductions in payments which are required at certain times in the future that can be clearly associated with a contingency related to a child.[23]

Although this latter provision is somewhat vague, the regulations provide two specific examples that will meet this requirement.[24] If a payment will be reduced not more than six months before or after the date a child attains the age of 18, 21, or local age of majority, the amount of the payment reduction will be child support. If payment reductions will occur on two or more occasions, not more than one year before or after different children of the payor attain any specified age between 18 and 24, child support treatment will also be applicable to these amounts. These rules in the regulations are not absolute and may be rebutted by the taxpayer or the Internal Revenue Service. Obviously, good planning dictates inclusion of specific provisions in the governing instrument designating payments intended to constitute child support.

The statutory rules also address the proper characterization of payments made by a payor spouse, required to make both alimony and child support payments, when the payor spouse is unable to make full payment of all amounts due.[25] In these circumstances, payments first will be allocated to child support and characterized as such for tax purposes.

Exemptions and Tax Credits

Related to the issue of child support is the question of entitlement to the personal exemptions and tax credits associated with the children. The custodial parent is generally entitled to the personal exemption for a child.[26] However, this right may be waived by the custodial parent either for a particular year or for a number of years.[27] The custodial parent is the parent having custody of the child for the greater portion of the year.[28] The child tax credit is allowed for the parent who is entitled to the personal exemption for the year.[29] A determination of the best use of these tax benefits by the spouses should take into account statutory income limitations and phaseout rules which may prevent or reduce the tax benefit of this item.[30]

Property Settlements

Internal Revenue Code §1041 governs the proper tax treatment of property transfers between spouses and former spouses incident to divorce. Prior to the enactment of this section, property transfers made in satisfaction of marital rights were treated as taxable sales to the transferor, thereby adding a tax burden to the dissolution of marriage.[31] To eliminate this burden, §1041 was adopted and made applicable to property exchanges and transfers in the context of divorce.

The provision eliminates immediate taxation by providing that neither gain nor loss will be recognized upon the transfer of property between spouses or former spouses incident to divorce. This result is applicable to all such property transfers, including those in which one spouse receives cash in exchange for his property interests. Although this rule removes the immediate tax burden, it simply operates as a deferral mechanism, postponing taxation until the transferee spouse disposes of the property in a later taxable sale or exchange. This postponement of recognition on any gains or losses is achieved through the application of the basis provi-

sions. The transferee of property subject to §1041 receives a carryover basis in the transferred property from the transferor.[32] This basis is similar to that acquired in a gift transaction.[33] However, it is dissimilar in that the transferee acquires the transferor's basis in all events and is not limited in the case of loss property.[34]

Obviously, the property division takes on added importance for future taxation purposes as a consequence of the basis rule. A spouse receiving property having a low basis (as compared to value) will recognize taxable gain when he converts the property to cash. A spouse receiving property with a basis higher than value may recognize a loss upon later conversion of the property to cash. It is, therefore, important to examine the bases of the properties in order to fairly divide the assets and prepare the spouses for potential income tax consequences if the assets are to be liquidated. This requires some valuation of future tax costs and benefits associated with the division and transfers.

An issue may arise under §1041 in identifying whether a particular transfer is "incident to divorce." The statute defines this term to include all transfers occurring within one year after the date the marriage ceases and transfers which are "related to the cessation of the marriage."[35] This latter term is not defined precisely by the statute or the regulations. However, the regulations create a rebuttable presumption that a transfer made pursuant to a divorce or separation instrument and occurring within six years after the marriage ceases is within the coverage of the statute. If both of these conditions are not satisfied, the transfer is presumed to be unrelated to the cessation of the marriage and, therefore, subject to the normal gain and loss recognition rules.[36]

Special Property Issues

Compensation-related benefits create special issues in the context of divorce and require additional attention for proper planning. Since 1984, retirement benefits payable from qualified plans can be divided between the spouses, pursuant to a qualified domestic relations order (QDRO). This is simply a judgment, decree or order issued pursuant to the domestic relations law of the applicable state and related to the provision of support for a spouse, child or dependent of the plan participant.[37] A properly prepared QDRO will specify the amount or percentage of benefits payable to the spouse or other payee.[38] It cannot require a different form of benefit from those provided under the plan.[39]

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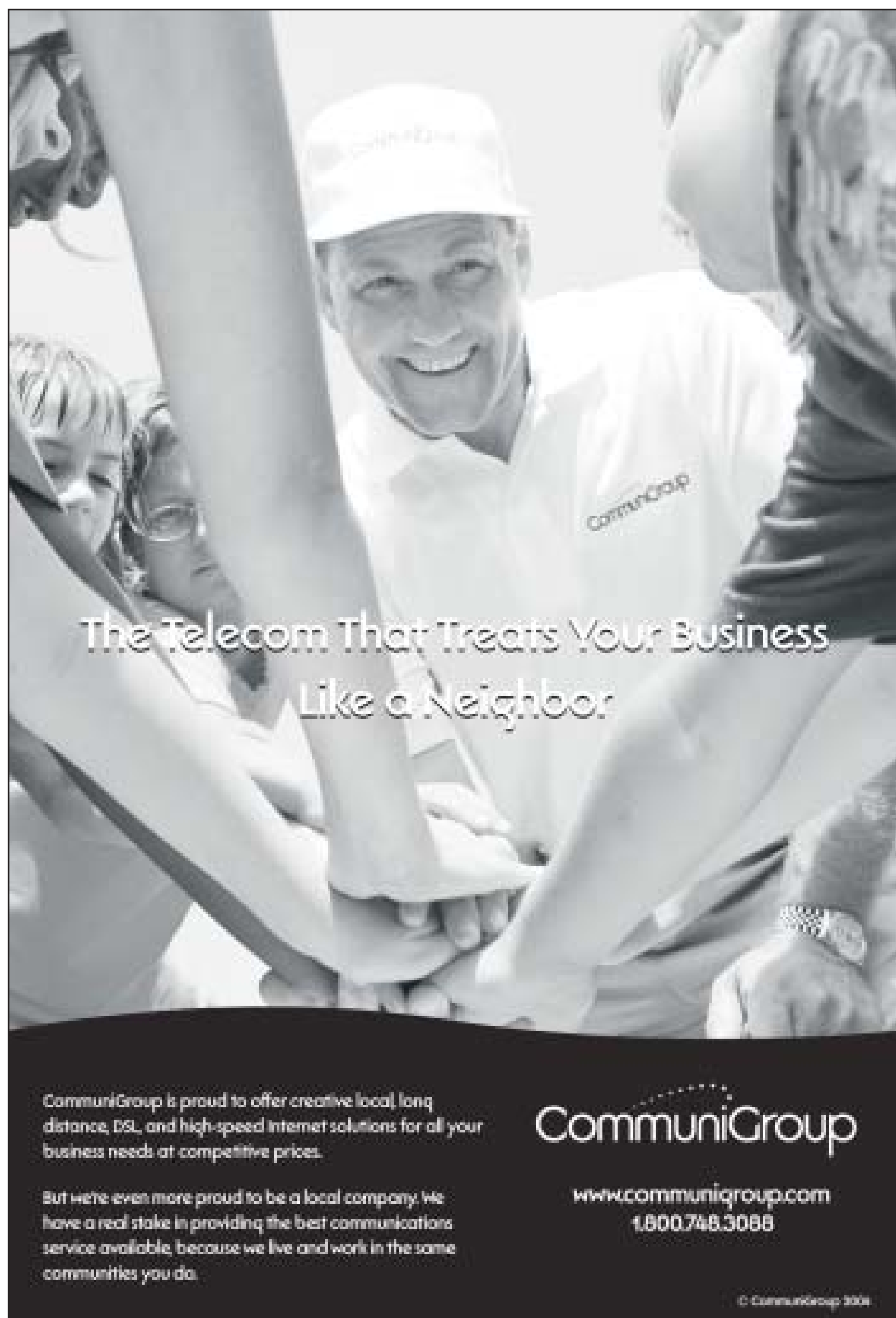
Most importantly, the plan benefits ultimately paid to a spouse or former spouse will be taxable to that spouse rather than the plan participant.[40] This tax treatment is a very significant exception to a most basic taxation principle known as assignment of income. Stated simply, earned income is taxed to the earner and that taxation cannot be avoided through assignments to other parties.[41] The spouse receiving the retirement benefits will also



have the opportunity to avoid immediate income taxation through a rollover of those amounts to certain eligible retirement plans.[42] Somewhat similarly, an interest in an individual retirement account can also be transferred to a spouse pursuant to a divorce or separation instrument without immediate taxation to either spouse.[43]

More complex assets such as business interests held through partnerships, limited liability companies, and corporations may raise complex valuation issues as well as significant taxation issues arising out of proposed redemptions or liquidations of a spouse's interest. Planning for a division of these assets will likely require the services of experts in valuation and taxation.

Summary

Probably the most important conclusion to reach from this basic survey of the tax structure for alimony and property settlements is that advisors should take all steps necessary to achieve certainty for the spouses. Thus, the governing instruments should include all provisions necessary for a clear determination of the tax treatment of each payment and complete listing of all transfers to be made incident to the divorce. If possible, nothing should be left to an interpretation of applicable state law or to a rebuttable position taken by the Service in its regulations. ■

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1 I.R.C. §71, §215.
2 I.R.C. §1041.
3 I.R.C. §71(b)(1).
4 Temp. Reg. §1.71-1T(b), Q&A 5.
5 I.R.C. §71(b)(1)(A).
6 Temp. Reg. §1.71-1T(b), Q&A 6.
7 I.R.C. §71(b)(1)(A), (b)(2).
8 I.R.C. §71(b)(1)(B).
9 I.R.C. §71(b)(1)(C).
10 Treas. Reg. §1.71-1T(b), Q&A 9.
11 I.R.C. §71(b)(1)(D).
12 I.R.C. §71(e).
13 Temp. Reg. §1.71-1T(b), Q&A 6.
14 Temp. Reg. §1.71-1T(b), Q&A 6.
15 I.R.C. §71(f).
16 I.R.C. §71(f)(1).
17 I.R.C. §71(f)(2), (3).
18 For purposes of this computation, the amount of the second year payment must be adjusted by the amount of any excess alimony payment in year two. I.R.C. §71(f)(3)(B)(i)(I).
19 I.R.C. §71(f)(5).
20 I.R.C. §71(c).
21 I.R.C. §71(c)(1).
22 I.R.C. §71(c)(2)(A).
23 I.R.C. §71(c)(2)(B).
24 Temp. Reg. §1.71-1T(c), Q&A 18.
25 I.R.C. §71(c)(3).
26 I.R.C. §152(e)(1).
27 I.R.C. §152(e)(2).
28 I.R.C. §152(e)(1).
29 I.R.C. §24.
30 I.R.C. §24(b), 151(d)(3).
31 This rule was adopted by the Supreme Court in United States vs. Davis. 370 U.S. 65 (1962), reh'g denied, 371 U.S. 854 (1962).
32 I.R.C. §1041(b)(2).
33 I.R.C. §1015.
34 Under the gift rules, a donee's basis, for purposes of determining a loss upon sale, is limited to the value if the fair market value of the gift property is less than the donor's basis at the time of the gift. I.R.C. §1015(a).
35 I.R.C. §1041(c).
36 Temp. Reg. §1.1041-1T, Q&A 7.
37 I.R.C. §414(p).
38 I.R.C. §414(p)(2).
39 I.R.C. §414(p)(3), (4).
40 I.R.C. §402(e)(1)(A).
41 This principle was firmed established by the Supreme Court's decision in Lucas v. Earl. 281 U.S. 111 (1930).
42 I.R.C. §402(c), (e)(1)(B).
43 I.R.C. §408(d)(6).