



The Tax Implications of Divorce Part One— Alimony

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The tax treatment of alimony and child support is more complex than many taxpayers realize.

The tax implications of divorce are varied and significant. This article, part one in a two-part series, is intended to define “alimony” from a tax perspective, including what payments are considered alimony, the tax implications of alimony payments, the recapture rule, and a comprehensive example. The series will continue with a review of the tax implications of transfers of property made as a result of separation and divorce, the sale of the marital home, the dependency exemption and miscellaneous reporting and administrative requirements associated with separation and divorce. These articles are intended to assist those advising divorcing clients.

ALIMONY UNDER THE CODE

The purpose of alimony or separate maintenance payments, generally, is

to ensure a divorced or separated spouse is able to maintain the same or a similar economic lifestyle as that maintained during the marriage.¹ There are significant tax implications to alimony payments.² However, before the tax implications can be addressed, it must be determined if the payments are, in fact, alimony payments, as defined by the Code.

To qualify as an alimony payment, the payment must be made in cash, including checks and money orders.³ Property settlements and performance of services do not qualify as alimony payments.⁴ In addition, the payment must not be a voluntary payment, but rather a payment made pursuant to a divorce decree or a written separation agreement.⁵ Payments made under pendente lite orders and specified as maintenance will also qualify as alimony during the pendency of the di-

orce matter until a divorce decree or written separation agreement is reached. Payments made pursuant to any oral agreement will not qualify as an alimony payment,⁶ even if a subsequent agreement calls for those same payments as alimony payments going forward.⁷ For instance, Husband and Wife separate on 2/1/17. Husband begins making payments to Wife in the amount of \$5,000 per month beginning February 2017. On 7/1/17, the couple enters into a formal written separation agreement that requires Husband to make monthly alimony payments to wife in the amount of \$5,000 per month. Only the payments made after the signing of the agreement will qualify as alimony payments.⁸ Any payments made prior to the agreement will not qualify as alimony payments, and therefore will not qualify for the tax benefits of alimony payments.⁹

Payments by one spouse to another will also fail to qualify as alimony payments if the spouses reside in the same household.¹⁰ If one spouse is preparing to depart from the household of another spouse, and does so not more than one month after the date payment is made, the payment will qualify as an alimony payment if all other requirements are met.¹¹ However, it is not enough to have separate spaces in the same household.¹² Where Husband and Wife occupied separate bedrooms, used separate bathrooms, prepared meals at different places, did not eat together, and did not converse with each other, they were not considered to be living in separate households as defined by the Code.¹³

Payments by one spouse, to a third party, on behalf of the other spouse, may be considered alimony if evidenced in writing.¹⁴ The payments must be made on behalf of the payee spouse and not the payor.¹⁵ For instance, if Husband makes payments on a life insurance policy that he

owns, these payments will not qualify as alimony payments, even if Wife is the named beneficiary.¹⁶ Contrast this with Husband making payments on a life insurance policy that has been transferred to Wife. Now any payments made by Husband after the transfer will be considered alimony payments, because the payments are made on behalf of Wife.¹⁷

In certain situations, payments made by one spouse, related to debts on real property may be considered alimony payments.¹⁸ Generally, joint owners of real property are each fully responsible for the debts related to that property.¹⁹ If the parties separate, and the wife is permitted to reside in the property, and the husband is required, pursuant to a separation agreement, divorce decree or court order, to pay the mortgage on the property, 50% of that payment will be considered alimony to the wife.²⁰

In order to qualify as alimony payments, the payments must also terminate upon the recipient's death.²¹ If payments are to begin, be increased, or be accelerated in time as a result of death, the payments, including those made prior to death, may be treated as a substitute for continuing payments and thus not qualify as alimony.²² For instance, pursuant to a divorce decree, Husband is to pay Wife alimony in the amount of \$5,000 per month. All payments are to terminate on the earlier of 15 years or Wife's death. These payments will be considered alimony payments because they terminate no later than the death of Wife.²³ However, consider this: pursuant to the divorce

decree, Husband is required to pay Wife \$5,000 per month. All payments are to terminate on the earlier of 15 years or Wife's death. If Wife dies before the 15-year term, Husband is to pay Wife's estate the balance of what Husband would have paid Wife if she survived the entire 15 years. Now no portion of the payments will qualify as alimony, not even the payments made prior to Wife's death.²⁴ Because the provision in the divorce decree provides that Husband is required to continue making payments after Wife's death, neither the payments made before, nor the payments made after Wife's death will qualify as alimony payments.²⁵

Similarly, if only a portion of an alimony payment is to continue after the recipient's death, then that portion of the payment will not be considered alimony when made before or after the recipient's death.²⁶ For instance, assume the same facts as the example above, where Husband is to pay Wife \$5,000 per month in alimony for 15 years or until death, but now, if Wife dies prior to the 15 years, the payment will be reduced to \$2,000 per month until the end of the 15-year term. In this example, the IRS views the payments as two separate payments. There is the \$3,000 payment made until Wife dies, which qualifies as alimony. There is also a \$2,000 payment to Wife before her death and then to her estate after her death. This payment will not qualify as alimony either before her death or after.²⁷

A payment that would otherwise qualify as an alimony payment may

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- 1 Donahue, Jr., "Alimony: Who Should Pay It and How Much?" *Transitions Mediation Center*, www.itsmydivorce.com/pg15.cfm.
- 2 See, Section 71 (as amended in 1984); Section 215 (as amended in 1984).
- 3 See, Section 71(b)(1); Reg. 1.71T(b), A-5.
- 4 See, Reg. 1.71T(b), A-5; see also, Section 1041(a).
- 5 *Anderson*, TCM 2016-47; *Mudrich*, TCM 2017-101; See also, Section 71(b)(1)(A); IRS Pub. 504.
- 6 See, Sections 71(b)(1)(A) and 71(b)(2).
- 7 *Alli*, TCM 2004-284.
- 8 *Id.*
- 9 *Id.*
- 10 Section 71(b)(1)(C).
- 11 REG. 1.71T(b), A-9.
- 12 *Id.*
- 13 *Id.* See also, *Washington*, 77 TC 601 (1981).

- 14 Reg. 1.71T(b), A-6.
- 15 *Id.*
- 16 *Id.* See also, IRS Pub. 504 p. 14.
- 17 *Id.*
- 18 *Leventhal*, TCM 2000-92; *Israel*, TCM 1995-500; Ltr. Rul. 8710089; See also, IRS Pub. 504 p. 14.
- 19 See Generally, Hower and Kahn, *Wills, Trusts, and Estates Administration*, 7th Edition (Cengage, 2011).
- 20 IRS Pub. 504, Table 4.
- 21 Section 71(b)(1)(D).
- 22 *Okerson*, 123 TC 258 (2004); IRS Pub. 504 p. 16.
- 23 *Id.*
- 24 *Id.*
- 25 *Id.*
- 26 *Id.*
- 27 *Id.*

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be clearly designated in a written agreement that it will not be treated as an alimony payment.²⁸ This would also hold true for language in a judge's decision after trial. The language must "make known directly" that the payments are not includable as alimony payments.²⁹ It is not sufficient to label the provision in the divorce decree as something other than alimony, such as a "Property Settlement." Although the language does not need to include the exact language of the Code, or even mention the Code sections, it must "contain a clear, explicit and express direction" that the payments are something other than alimony.³⁰ The same does not hold true in the reverse. While a payment that would otherwise qualify as alimony may be designated as not alimony with the proper language in the separation or divorce agreement, a payment that does not qualify as alimony, cannot be converted to alimony by using such language. This is because the requirements set forth in Section 71 must be present for a payment to qualify as alimony.³¹

CHILD SUPPORT

Child support payments do not qualify as alimony payments.³² Unlike alimony payments, which are intended to allow a spouse to maintain the same economic standards they enjoyed during marriage,³³ child support

payments are meant solely for the care of the children of the marriage.³⁴ A payment is considered a child support payment when it is designated as such in the divorce decree or written separation agreement.³⁵ In addition, any payment that reduces on the happening of a child-related contingency specified in the divorce decree will also be considered a child support payment.³⁶ For instance, if a divorce decree calls for Husband to pay Wife \$5,000 per month to be reduced to \$3,000 when their 5-year old child graduates high school, only \$3,000 of this payment will be considered alimony. The additional \$2,000 will be considered child support, as the payment reduces on the happening of a child-related contingency specified in the divorce decree.

Similarly, a payment that reduces at a time tied to certain pivotal birthdays of the child or at a time clearly associated with a child-related contingency will be considered child support.³⁷ Likewise, where payments are to be reduced not more than six months before or after a child's 18th or 21st birthday, the payment is presumed to be associated with the child and will be considered a child support payment.³⁸ This is a rebuttable presumption that can be challenged by the taxpayer or the IRS.³⁹ For instance, Husband is to pay Wife \$5,000 per month for support of Wife and Child, to be reduced to \$3,000 per month on

2/1/17 and continue at \$3,000 per month until Wife's death. Child's birthday is on 7/1/17.⁴⁰ Because the reduction date is less than six months before a pivotal birthday, \$2,000 per month will be presumed to be child support and \$3,000 per month will be presumed alimony.⁴¹ Again, these are rebuttable presumptions that can be challenged by either the taxpayer or the IRS.⁴² Generally, any payment or portion thereof, characterized as alimony in the divorce decree, but with characteristics of child support, will be treated as child support.⁴³

TAX IMPLICATIONS

Why is it important to make the distinction between child support and alimony? It is important because child support does not have the same tax implications as alimony.⁴⁴ So now that it is clear what qualifies as alimony, what are the tax implications?

Pursuant to Section 71(a), alimony and separate maintenance payments are taxable to the recipient.⁴⁵ Pursuant to Section 215, alimony and separate maintenance payments are deductible by the payor.⁴⁶ Generally, there is a mutuality to alimony, in that whatever the payor deducts under Section 215, is included in the gross income of the recipient pursuant to Section 71(a).⁴⁷ However, it does not matter if the recipient actually includes the amount in income, the payor may still

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²⁸ Section 71(b)(1)(B).

²⁹ *Baker*, TCM 2000-164; *Richardson*, 125 F.3d 551 (CA-7, 1997); 26 CFR 1.71-1T(b), A-8.

³⁰ *Id.* at 7.

³¹ Section 71(b)(1).

³² Section 71(c)(1); Reg. 1.71-1T(c), A-15.

³³ Note 1, *supra*.

³⁴ Marquit, "What is Child Support - Laws and Guidelines for Payments." *Money Crashers*. www.moneycrashers.com/child-support-payments-laws-guidelines/.

³⁵ *Simpson*, TCM 1999-251; *Abramo*, 78 TC 154 (1982); Section 71(c)(1); IRS Pub. 504 p. 17.

³⁶ *Hammond*, TCM 1998-53; Section 71(c)(2)(A); Reg. 1.71-1T(c), A-16, A-17; IRS Pub. 504.

³⁷ *Hammond*, Section 71(c)(2)(B); Reg. 1.71-1T(c), A-16, A-17; IRS Pub. 504.

³⁸ Reg. 1.71-1T(c) A-18; IRS Pub. 504.

³⁹ *Id.*

⁴⁰ *Id.*

⁴¹ *Id.*

⁴² *Id.*

⁴³ Section 71(c).

⁴⁴ Section 71(c)(1).

⁴⁵ *Burkes*, TCM 1998-61; Section 71(a).

⁴⁶ *Burkes*; Section 215.

⁴⁷ Sections 71(a) and 215.

⁴⁸ *Christoph*, 919 F.Supp 1576, 77 AFTR2d 96-514 (D.C. GA, 1995).

⁴⁹ *Id.*

⁵⁰ IRS Memorandum No. 200251004 (12/20/02).

⁵¹ Section 933.

⁵² IRS Pub. 504, Table 4.

⁵³ Section 163(h).

⁵⁴ Section 163(h)(3)(A)(i); *Gibbs*, TCM 1997-196.

⁵⁵ Sections 71 and 215.

⁵⁶ IRS Pub. 504, Table 4.

⁵⁷ *Id.*

⁵⁸ Reg. 1.71-1T, A-6; IRS Pub. 504.

⁵⁹ *Id.*

⁶⁰ Carpenter, "Decisions - A Bird in the Alimony." *Taxing Lessons*. www.taxinglessons.com/category/taxing-lessons-from-court-decisions.

⁶¹ *Leventhal*, Note 18, *supra*; *Francher v. Comm'r*, TCM, Docket 10885-14, 11 (6/16/15).

⁶² Section 71(b)(1)(A).

⁶³ *Leventhal*, Note 18, *supra*; *Francher v. Comm'r*, TCM, Docket 10885-14, 17-18 (6/16/15); Reg. 1.71-1T A-6, A-9; IRS Pub. 504, Table 4.

⁶⁴ *Id.*

⁶⁵ *Id.*

⁶⁶ Section 71(f).

⁶⁷ Reg. 1.71-1T(c), A-19.

⁶⁸ Section 71(f); IRS Pub. 504, p. 17.

⁶⁹ *Id.*

⁷⁰ *Id.*

⁷¹ Tax Reform Act of 1986 P. L. No. 99-514, section 1843, 10/22/86.

⁷² Section 71(f).

⁷³ *Id.*

⁷⁴ *Id.*

deduct the payment.⁴⁸ In *Christoph*, where the IRS entered into a settlement agreement with the payee spouse requiring her to report only 50% of the alimony received as income, the payor spouse was entitled to a deduction of 100% of the alimony paid.⁴⁹ The payor spouse can also deduct alimony even if the payee spouse is not required to report the income as a result of a treaty with another country.⁵⁰ Further, the payor spouse can deduct alimony even if the payee spouse is a citizen and resident of Puerto Rico and does not have to report the alimony as income.⁵¹

In the example presented earlier, where Husband and Wife jointly own property and Husband pays 100% of the mortgage on the property that Wife resides in alone, 50% of that payment is considered alimony to Wife. This means that 50% of the payment is deductible by Husband and 50% of the payment is reportable by Wife as income.⁵²

Further, Section 163(h) allows a deduction for interest paid on a *taxpayer's residence* (emphasis added).⁵³ However, in this example, the husband is paying the mortgage on a residence that is no longer his residence. In this case, the husband will not be allowed to deduct the interest portion of the payment.⁵⁴ It may be a better strategy to have the husband make an alimony payment to the wife equal to the amount of the mortgage payment and have the wife make the mortgage payment. Under this plan, the husband making the alimony payment would get a deduction under Section 215, while the wife would have gross income but would get to deduct the interest portion of the mortgage payment.⁵⁵

If the property is owned as tenants-in-common, the real estate taxes and homeowner's insurance payments made by the nonresident husband will be considered alimony payments to the resident wife.⁵⁶ However, if the property is held as joint tenants, no portion of these payments will be considered alimony.⁵⁷ If the property is owned solely by the wife, any payments the husband makes on behalf

of the wife, related to the property, including mortgage payments, tax payments, and insurance payments, will be considered alimony to the wife.⁵⁸ However, if the husband owns the property, even if the wife is the only resident of the property, the payments made by the husband are no longer considered alimony payments because they are no longer being made on behalf of the wife.⁵⁹

A unique, yet increasingly more common, situation occurs when Husband and Wife separate and allow the children to remain in the marital home full-time while the parents take turns rotating between the marital home and another property during their visitation periods. This is known as bird nesting.⁶⁰ Bird nesting complicates the issue of alimony because some of the household payments made by the payor spouse, that would otherwise qualify as alimony to the payee spouse, now benefit the payor spouse "during those periods of time when [the payor spouse is] living in the marital home."⁶¹

In this case, the separation agreement or divorce decree, as well as ownership of the properties and possibly the amount of time each spouse occupies each property, will determine how much of the payments made by the payor spouse are treated as alimony. In order for any payment to be considered alimony, it must be made pursuant to a separation agreement, divorce decree or court order.⁶² Assuming there is an agreement, decree, or order, the next question to address is ownership of the properties. The Tax Court has consistently held that if the payor spouse solely owns either or both properties, no portion of the payments made with regard to the solely owned property will be considered alimony to the payee, regardless of the time the payee spends in either property, as the payments are not made on behalf of the payee.⁶³ Similarly, if the payee spouse solely owns either or both properties, all payments made by the payor spouse with regard to the payee-owned property will be considered alimony, regardless of the time the payor

spends in either property, as the payments are made on behalf of the payee spouse.⁶⁴ Finally, if either property is owned jointly by the spouses, one-half of the payments made with regard to the properties will be considered alimony to the payee spouse.⁶⁵

RECAPTURE

In an attempt to prevent parties from disguising property settlements as payments qualifying as alimony, and therefore qualifying for the tax benefits of an alimony payment, the Code prevents "front loading."⁶⁶ Alimony payments that decrease rapidly in the first three years following separation or divorce may be recharacterized as a property settlement and the spouses may be required to recapture any deduction improperly taken and deduct any income improperly recognized.⁶⁷ Recapture is calculated based only on the alimony payments made in the first and second calendar years in which the payor spouse makes alimony payments to the payee spouse.⁶⁸ Further, recapture is only recognized in the third calendar year.⁶⁹ Any alimony payments made in the third calendar year and beyond are not subject to recapture.⁷⁰ In addition, the recapture rules apply only to divorce instruments entered into or executed after 12/31/86, or those executed prior to that date that expressly elect into the Tax Reform Act of 1986 rules.⁷¹

Section 71(f) provides that if alimony payments decline by more than \$15,000 within three calendar years, the payor spouse must recapture a portion of the previous years' alimony deduction as income.⁷² This three-calendar year period begins with the first calendar year (referred to as the first post-separation year) in which the payor spouse makes alimony payments to the payee spouse.⁷³ The first calendar year following the first post-separation year is referred to as the second post-separation year and the calendar year following the second post-separation year is referred to as the third post-separation year.⁷⁴ The sum of the ex-

EXHIBIT 1**Computation of Excess Payments**

First recapture = \$5,000
 Year 2 - Year 3 + \$15,000
 \$40,000 - \$20,000 + \$15,000
 Second recapture = \$17,500
 Year 1 - (Year 2 + Year 3 - 1 = Recapture) / 2 + \$15,000
 \$60,000 - (\$40,000 + \$20,000 - \$5,000) / 2 + \$15,000
 Total Recapture = \$22,500
 First Recapture + Second Recapture
 \$5,000 + \$17,500

cess alimony payments in the first and second post-separation years, if any, is recaptured and included in gross income by the payor and is deducted in computing adjusted gross income by the payee in the third post-separation year.⁷⁵ Only payments made in the first and second post-separation years are subject to recapture.⁷⁶

The computation of the excess payments in the first and second post-separation years is a two-step sequential process.⁷⁷ First, if the payments in the second post-separation year exceed the aggregate payments in the third post-separation year by more than \$15,000, the excess (re-

ferred to as the "first recapture") is subject to recapture.⁷⁸ Second, if the payments in the first post-separation year exceed the average of the non-excessive payments in the second post-separation year plus payments in the third post-separation year by more than \$15,000, the excess over \$15,000 (referred to as the "second recapture") is subject to recapture in the third post-separation year.⁷⁹ Non-excessive payments refer to the total payments made in the second and third post-separation years reduced by the first recapture.⁸⁰ The payor includes the aggregate of the first and second recapture in income in the third post-separation year and the payee gets a deduction, for that amount, from gross income.⁸¹ Although the recapture calculation is based on the first and second year of alimony payments, the deduction and income are not actually recaptured until the third post-separation year.⁸²

For example: Pursuant to their divorce agreement, Husband pays Wife \$60,000 for 2015, \$40,000 for 2016, and \$20,000 for 2017, the first three years after they are separated. In 2017, Hus-

band can deduct \$20,000 in alimony paid, but must include \$22,500 in income under the alimony recapture rules as computed, see Exhibit 1.

Therefore, in 2017, Husband's taxable income is increased by the sum of the two recapture amounts (\$22,500) and Wife's gross income is reduced by the same amount.⁸³

The recapture rules do not apply if the payments in the first and second post-separation years are reduced due to the death of either spouse, the payee spouse's remarriage when the divorce decree provides that payments cease upon remarriage, temporary support payments, or fluctuating payments from a pre-existing formula when the formula is fixed under the terms of the divorce or separation instrument and is effective for at least three years.⁸⁴ However, reduction for any other reason, including a court-ordered reduction, would be subject to the recapture rules.⁸⁵

CONCLUSION

The concepts and implications of alimony and child support are far more complex than most realize. It is important that professionals and their clients understand how to structure their agreements so that they receive the most beneficial tax consequences. That includes having the proper provisions in the agreements so that the IRS interprets payments as the professional and their client intended. The worst possible outcome for any professional is to have the IRS treat a payment contrary to what was intended, and for that treatment to result in negative tax consequences for the client. ●

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⁷⁵ *Id.*; IRS Pub. 504.

⁷⁶ *Id.*

⁷⁷ *Id.*

⁷⁸ Section 71(f)(4); IRS Pub. 504.

⁷⁹ Section 71(f)(3); IRS Pub. 504.

⁸⁰ Section 71(f); IRS Pub. 504.

⁸¹ Section 71(f)(1); IRS Pub. 504.

⁸² *Id.*

⁸³ Scheid, and Pfanenstiel, "Don't Get (Re)Captured by the IRS: Avoiding Alimony Recapture Tax Issues in Divorce Instruments." *Legally Speaking Client Alert*, www.saflaw.com/files/Alimony-Recapture.pdf; See Generally, IRS Pub. 504.

⁸⁴ *Id.*, Section 71(f)(5).

⁸⁵ *Id.*