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# Make the Tax Code Your Friend—and Alimony More Palatable

*By* CHRISTOPHER C. MELCHER

**Every time** we negotiate an alimony agreement or argue over alimony in court, we are doing a form of tax planning. Alimony is a way of shifting taxes, where taxable income is taken from one party and given to the other. When the tax rules are used to the advantage of our clients, we can save our clients lots of money. **However,** if the deal is not structured correctly, nasty surprises also can occur years after our representation has concluded when nothing can be done to change it.

## FREE MONEY

Federal tax law allows the payor of alimony to take a deduction for those payments, and requires the recipient (or "payee") to report those payments as income. From this simple rule flows an opportunity to create "free money" between the parties, assuming they are in different tax brackets. 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:**

> **Husband makes $25,000 per month,** and Wife has no income. Assuming Husband is unlucky enough to live in a state such as California, he will pay about $9,000 per month in alimony to Wife pending trial (what we in California call "temporary spousal support" and what others might call ridiculous). 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. So, we just created $2,000 per month, which is the difference between what it costs Husband to make the 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.

This kind of tax savings allows the parties to absorb the shock of the divorce more easily. Thus, we 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 your state has a child support guideline based on after-tax income. If so, the computer program you use to calculate child support also can be used as a tax calculator to figure out the after-tax cost and benefit of an alimony payment. If not, the IRS website has a tax calculator. (Go to www.irs.gov and search for the "IRS Withholding Calculator.") This calculator estimates the taxes a person will pay, based on his or her situation. Basically, you run the numbers two ways for each party, one without the alimony and the other with the alimony income/deduction. By comparing the differences, you will see if any free money results from tax savings. If either party lives in a jurisdiction with state income tax, run the same calculation at the state level.

## EIGHT SIMPLE RULES

The agreement or order for alimony must be written in a certain way for payments to be tax-deductible to the payor. The requirements are listed in 26 U.S.C. § 71. Each rule must be satisfied or the payments will not be tax-deductible to the payor and will not be reportable as income by the payee. See 26 U.S.C. § 215. Commit these rules to memory, because often that is all you will have at hand when you are making an argument in court or trying to hammer out a settlement.

### RULE 0: The label doesn't matter (usually).

There is no requirement that the agreement or order refer to payments as alimony, spousal support, or maintenance. The IRS only looks to whether the requirements of section 71 have been satisfied; the label attached to payments has little significance in determining whether it qualifies as alimony. *Hopkinson v. Comm'r*, T.C. Memo 1999-154; *Cunningham v. Comm'r,* T.C. Memo 1994-474. The IRS could deem payments labeled as alimony as nontaxable and nondeductible if the agreement or order fails to comply with section 71.

Note, however, there are a couple of exceptions to this rule that the label does not count. As will be discussed later in this article, payments designated as "child support" cannot be considered alimony. Also, an agreement or order for "alimony," which is silent as to whether payments cease on the death of the payee, may still be treated as alimony if state law provides that an alimony obligation automatically terminates on the payee's death. Other than in these examples, the alimony label does not count for much.

### RULE 1: The payment must be made in "cash."

Checks are treated as cash. However, alimony cannot be paid in exchange for services, property, an I.O.U., or for the use of property. Treas. Reg. § 1.71-1T.

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

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." Treas. Reg. § 1.71-1T, Q&A, A-6.

We can use this 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. Because the payor has no unilateral right to pay an obligation of the payee in lieu of alimony, the payment to the third party must be pursuant to an order or agreement. Treas. Reg. § 1.71-1T, Q&A, A-6. There is, however, an exception: "if such payment is pursuant to the written request, consent or ratification of the payee spouse." Treas. Reg. § 1.71-1T, Q&A, A-7. This might occur, for example, if alimony is normally paid directly to the payee, but he or she asks on one occasion for the alimony to be paid, instead, to a landlord.

The tricky part in these arrangements is to make sure that the payor does not benefit from the payment; otherwise, the payment will not qualify as alimony. Paying a mortgage as alimony can cause headaches in later deciphering the applicable tax rules, but often such arrangements or orders are worth considering. If one party has exclusive possession of a residence, which is encumbered by a loan in the names of both parties, it is a good idea to ensure that the mortgage gets paid on time and that the parties understand who will get the tax deduction for those mortgage payments.

Here is the fine print. Look at who owns the house and who is liable on the mortgage. If the house and the mortgage are in the name of the payor, 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." Treas. Reg. § 1.71-1T, Q&A, A-6. This follows because the payment is not made "on behalf" of the payee. The payor is responsible for making those payments as the owner of the property or debtor under the mortgage and, thus, payment of those obligations cannot be treated as alimony to his or her spouse or former spouse. Simple enough.

The reverse situation also is simple, where the *payee* owns the house and the mortgage is in his or her name. Since the alimony recipient is solely obligated for paying the mortgage, the parties can agree that his or her alimony will be paid to the mortgage company. 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. IRS Publ. 504, p.13 (2008).

Okay, now for the case in which the parties equally own the residence or are jointly obligated on the mortgage. If the alimony order says that Husband will pay the mortgage as alimony to Wife, the IRS will only recognize one-half of the payments as alimony. IRS Publ. 504, p.12 (2008). This is because Husband benefits from the payment. As a co-owner, he benefits from the principal payments. He also benefits from having the mortgage paid on time, since he is a co-borrower. Therefore, the IRS will not allow Husband to take an alimony deduction for one-half of the payments. The other half of the mortgage payments are deemed to be made "on behalf of" Wife, and will be treated as taxable income to Wife, and tax-deductible to Husband, as alimony.

Who gets the itemized deduction for the mortgage interest? Can Husband claim the entire interest deduction, since he made the mortgage payments? No. The mortgage deduction is divided using the same logic. One-half of the mortgage payment was for 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 Wife's money (her alimony), so she can take the deduction for one-half of the mortgage interest.

Please note, though, that a party can deduct mortgage interest only to the extent that the house is his or her "qualified residence." 26 U.S.C. § 163, subd. (h)(4); IRS Publ. 504, p.12 (2008). Basically, if the party has not resided in the house for more than two years, he or she cannot take the interest deduction, unless the absence was pursuant to a written agreement or order in a divorce or separation action. 26 U.S.C. § 121, subd. (d)(3)(B). Therefore, you should include a provision in the alimony agreement or order granting exclusive possession to the payee, since divorce cases may last more than two years. This also ensures that the out-spouse will qualify for the capital gains exclusion under section 121 when the house is sold, but I leave that for another article.

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. IRS Publ. 504, p.12, Table 5 (2008). I know, this is crazy, but who ever said things always have to make sense, especially in the world of taxes. I would just be aware of the special rule dealing with property taxes and insurance, and don't pay those as alimony if the house is held in joint tenancy.

Lastly, we sometimes see agreements requiring life insurance as a form of security for the loss of alimony if the payor dies. If the divorce or separation instrument requires the payor spouse to maintain life insurance for the supported spouse as security for alimony, the premiums are deductible *if* the supported spouse is both the owner and irrevocable beneficiary of the policy and has all incidents of ownership under the policy. *Stevens v. Comm'r,* (1971) 439 F.2d 69; Rev. Rul. 57-125; Rev. Rul. 70-218; Treas. Reg. § 1.71-1T, Q&A, A-6.

**RULE 3: Payments must be made under a divorce or separation instrument.**

This means a written agreement or court order. The important thing to keep in mind is that the instrument must be in existence at the time the support payments are made. *Ali v. Comm'r,* T.C. Memo. 2004-284 (2004). Payments that were made before the instrument was executed are not deductible, even if the instrument retroactively characterizes those payments as spousal support or maintenance. *Id.; Rafferty v. U.S,.* 2008 WL 2705192 (D. Colo. 2008); Treas. Reg. § 1.71-1T(a), Q-4, A-4.

If an alimony order fails to meet the requirements of section 71, but the court intended for the payment to qualify as alimony, a *nunc pro tunc* modification of the order may be allowed to retroactively correct the clerical mistake. IRS Publ. 504, p. 11 (2008); *McDonald v. C.I.R.,* T.C. Memo. 1994-607 (1994). This exception is limited to correcting clerical errors. IRS Publ. 504, p. 11 (2008).

**RULE 4: The instrument does not say that payments are non-taxable/non-deductible.**

If the parties designate the payments as nontaxable, they will be bound by the agreement, and a copy of the agreement must be attached to the payee's tax return each year the designation applies. 26 C.F.R. § 1.71-1T (b), A-8. Note that a state court's finding that the alimony payment will be taxable or deductible is not binding on the IRS because state courts cannot determine issues of federal tax law. *Okerson v. C.I.R.,* 123 T.C. No. 14 (2004). Saying that a payment will be taxable doesn't make it taxable—the IRS only looks to see if the requirements of section 71 have been met.

**RULE 5: The parties must not live together, unless the alimony is temporary.**

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

ties cannot continue to share the same household for more than one month or payments will not qualify as alimony. The parties are not in "separate households," even if physically separated within the home. 26 C.F.R. § 1.71-1T, A-9.

**RULE 6: Payments must terminate on the death of the payee.**

This requirement was apparently adopted to distinguish between true alimony and a property division disguised as alimony. An order for maintenance or support should naturally terminate on the death of the supported spouse, as "dead people require little, if any, support." See Taft, *Tax Aspects of Divorce and Separation*, § 5.03[1][v]. An obligation in connection with the division of marital property, on the other hand, survives the death of either party because it creates a vested property right that can be transferred on death. So, if any of the payments are required to be on or after the death of the supported spouse, the payments look like a property division, rather than for maintenance.

If the rule is violated, "[n]one of the payments before (or after) the death of the payee spouse qualify as alimony or separate maintenance payments." Treas. Reg. § 1.71-1T, Q&A, A-10. "The divorce or separation instrument does not have to expressly state that the payments cease upon the death of your spouse if, for example, the liability for continued payments would end under state law." IRS Publ. 504, p. 14 (2008). In *Johanson v. Comm'r,* 541 F.3d 973 (9th Cir. 2008), alimony payments were deemed taxable to the payee, even though the instrument failed to state that payments would terminate on death, because California law provides that spousal support terminates on death, absent clear and convincing evidence of a written agreement to extend support beyond the payee's death.

If the instrument requires a spouse to pay the other's attorney's fees "as alimony," the amount paid should be deductible as alimony, provided that either the instrument itself or state law requires payments to terminate automatically on the death of the supported spouse. *Smith v. C.I.M.,* T.C.M. 1998-166 (1998); *Johanson v. Comm'r,* 541 F.3d 973 (9th Cir. 2008). The payor spouse has no contractual obligation to his or her spouse's attorney and receives no benefit by making the payment. Instead, payment to the attorney is made "on behalf" of the supported spouse. The nonclient payor's obligation to pay the fees will terminate if the payee dies before the payment is made. *Burkes v. Comm'r*, T.C. Memo 1998-61.

**RULE 7: Payments may not be fixed as child support.**

Payments designated as child support are, of course, not deductible as alimony. 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 18.

Still, orders can be fashioned which, in effect, include unallocated child and spousal support, and the payor can deduct 100 percent of the payment if the bright-line rules established by the Internal Revenue Code and Treasury Regulations are met. These are referred to as a "*Lester* agreement" or a family support order. Pursuant to *C.I.R. v. Lester,* 366 U.S. 299 (1961), the entire amount of such payment is deductible as spousal support. The purpose is to use the difference in the parties' tax rates to create free money.

For the payor to receive the deduction, the payment amount cannot be reduced, based on any contingency relating to the child or the amount so reduced will be treated as child support and will not be deductible either before or after the contingency occurs. There is a safe harbor that provides that a stepdown will not be treated as "relating to that child" so long as it takes place more than six months before or after the date on which the child attains age 18, 21, or the local age of majority. Treas. Reg. § 1.71-1T, A-18.

**Use the difference in the parties' tax rates to create free money**

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

**RULE 8: A joint return is not filed.**

The final requirement is that the parties file separate tax returns. They cannot file a joint tax return together, with one claiming an alimony deduction and the other deducting the alimony paid.

## THAT WASN'T SO HARD

The rules are laid out clearly in section 71, so it is a good reference to keep handy. A working knowledge of these rules will benefit your clients, and everyone will be impressed by how smart you are (even if you are just faking it, like me). FA

**CHRISTOPHER C. MELCHER** is a partner in the family law firm of Walzer & Melcher LLP in Woodland Hills, California. He focuses his practice on complex family law litigation, premarital agreements, and appeals, and he is chair of the State Bar of California Family Law Section for the 2011–12 term.