

POST DIVORCE TAX ISSUES

I Have to Pay What?!

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POST DIVORCE TAXES ISSUES – I HAVE TO PAY WHAT?!

I. Introduction

At the conclusion of the divorce process, the last thing your client typically thinks about is tax issues. However, there are several measures a prudent practitioner should take so that there are no surprises for the client when it comes time to pay Uncle Sam.

Before delving into specifics, the best advice I can give you is to CONSULT WITH A TAX EXPERT. You would do well to cultivate a working relationship with a tax accountant and/or a tax attorney to whom you can send clients for consultation on tax issues. While this article is designed to give a working knowledge of relevant tax laws, you cannot be expected to grasp every nuance of the federal tax code. Thus, having a tax expert available to both you and your client is an invaluable resource. Consulting with this expert early and often will help avoid potential problems for your client post-divorce.

To reiterate, this article is not intended to be the only source you consult for tax advice but merely a guide so that you are familiar with relevant terms and issues. Tax issues are very fact specific and the laws are constantly changing. The best advice I can give you is the practice I follow with my own clients: consult with a tax attorney before giving any tax advice.

Finally, I would like to express my gratitude to Edwin W. Davis for the liberal use of his article on taxes which he presented at the 2003 Advanced Family Law Course in the preparation of this paper.

As a brief background, the Domestic Relations Tax Reform Act of 1984 (herein referred to as the “1984 Act”) and the Tax Reform Act of 1986 (the “1986 Act”) completely changed the taxation of parties incident to divorce. Prior law was reversed and a new nonrecognition rule applicable to transfers of property between ex-spouses incident to a divorce was created in Section 1041 of the Internal Revenue Code of 1986. Additionally, the alimony provisions of Section 71 were completely rewritten. While these laws have gone far to clarify the post-divorce tax issues of spouses there are several specific rules that must be followed in order to obtain the desired results for your clients. This paper will review the statutes, regulations and relevant cases regarding the tax provision related to the dissolution of marriage.

II. Alimony and Separate Maintenance Payments

Congress’ goal in revamping Section 71 of the Code dealing with alimony payments was to provide a uniform federal definition of alimony. Previously, the differences in state laws may have resulted in differences in federal tax consequences for parties which lawmakers wished to avoid. Thus, Section 71

creates specific guidelines for practitioners in all states to follow with respect to the treatment of alimony.

A. General Income Tax Treatment

1. Payee – Section 71(a) provides that amounts received as alimony or separate maintenance payments are considered gross income.
2. Payor – Section 215(1) indicates that the payor of alimony or separate maintenance may deduct such amounts paid in a taxable year.
 - a. Above-the-Line Deduction – The payor spouse may take the alimony deduction even if the standard deduction is taken, since the alimony deduction is taken in calculation of adjusted gross income.
 - b. Deduction on Separate Returns – If a spouse makes alimony payments to an ex-spouse from community property (as defined by Texas law) of the spouse and a new spouse, then the spouse and the new spouse must divide the alimony deduction if they file separate returns.

B. Definition of Alimony or Separate Maintenance Payments

An alimony or separate maintenance payment is defined as any payment that meets the following criteria:

1. Payments on behalf of a Spouse or Former Spouse under a Divorce or Separation Instrument – In order to qualify under Section 71(b)(1)(A) such payments must actually be received by or on behalf of a spouse or former spouse under a divorce decree or other separation instrument.
 - a. Definition of “divorce or separation instrument” – decree of divorce or separate maintenance in an written agreement incident to a divorce decree; written separation agreement; any other decree obligating one spouse to make support or maintenance payments to the other spouse; and a court order granting temporary alimony/maintenance.
 - b. Practical tip – In order to deduct alimony payments, such payments must be made in accordance to a *written instrument*. Oral agreements simply will not suffice. However, stipulations read into the record in open court may satisfy this requirement.
 - c. Amounts paid in excess of agreed amount of alimony – Any amounts paid above and beyond of what is required by the written agreement will not be considered part of the alimony payments. Thus, these amounts may not be deductible by the payor and not includable by the payee.
 - d. Payments made prior to the effective date of written instrument – Any payment made prior to the time a decree, agreement, or order of support becomes effective either by

entry with the court or a date certain within the agreement does not qualify as an alimony payment.

- e. Letter proposing a Separation Agreement – Letters that simply outline a proposal for support payments will not constitute an agreement between the parties as to support and thus do not qualify as written separation agreements. However, if such a proposal letter is signed by one spouse and actually signed by the other spouse in agreement it would qualify as a written agreement.
- f. Payments to a Third Party on Behalf of Spouse
 - i. If a payment of cash by the payor spouse to a third party is made under the explicit terms of a divorce or separation instrument then such payment will be construed as a payment of cash that is received on behalf of a spouse and is thus alimony. Examples include cash payments of rent to a landlord, mortgage, tax, school tuition, or other liabilities.
 - ii. Payments to a third party on behalf of a payee spouse may also qualify as alimony even though it is not being made according to the terms of a divorce instrument if the payment is made by the payor spouse upon the written request or consent of the payee spouse. Such written request or consent must specifically state the parties intend for the payment to be treated as an alimony payment pursuant to the rules of Section 71.
- g. Variable Payments – There is no requirement that alimony payments be a fixed sum. Payments qualify as alimony if the written instrument requires the payor spouse to give the payee spouse an amount sufficient to maintain the payee spouse's standard of living and that amount may vary throughout the period that alimony is to be paid.
- h. Lump sum payment does not qualify as alimony – Where the divorce decree obligates the payor spouse to pay the payee spouse a fixed amount for maintenance and the payor spouse pays the full amount in one lump sum, the amount will not qualify as alimony under Section 71. Therefore, the amount of the payment will not be deductible by the payor spouse under Section 215.
- i. Payments must be made in cash – this includes checks and money orders.
- j. Payments stop on Death of Payee – The payor spouse must not have any obligation to make payments for any time after the death of the payor spouse and no obligation to make any other payment in cash or property as substitute for such payments after payee spouse's death.

- k. No requirement that the divorce decree specifically state that there will be no liability of the payor spouse to continue alimony payments upon the death of the payee spouse. Thus, if the decree does not specifically include the “no liability” clause, the parties shall rely upon the termination of the alimony liability by operation of state law or by another document or agreement that provides for termination. However, practically speaking, the divorce or separation instrument should always include a “no liability” clause.
- l. In order for Sections 71 and 215 to apply, the payor and payee may not file a joint tax return.
- m. Payments may not be excessively front-loaded – While there is no longer a minimum term rule for payments to be considered alimony, payments that are front-end loaded may be subject to recapture rules to avoid turning property settlement payments into deductible alimony. Recapture rules require so-called alimony payments to be re-characterized as property settlement payments if payments made in the first post-divorce years are excessively front-loaded. Per the 1986 Act alimony payments are subject to recapture only during the first three post-separation years. Recapture occurs only to the extent that payments during any of the three post-separation years are less than the amount paid during a prior year by more than \$15,000.00. Thus, by definition recapture cannot occur until the third post-separation year. The first post-separation year means the first calendar year in which the payor paid alimony to the payee; the second and third post-separation years are the second and third next following calendar years. For more specific guidance on this issue, you would do wise to refer to a tax expert who can provide you with a formula to determine the maximum front-ending loading possible to avoid recapture.
- n. Exceptions to recapture
 - i. Death of either spouse – recapture rule does not apply if alimony payments cease due to death of either party or remarriage of payee spouse before the end of the third post-separation year
 - ii. Support payments – recapture rule does not apply to any payments received by virtue of temporary orders
 - iii. Fluctuating payments – recapture rule does not apply to any payment if that payment is made pursuant to a continuing liability (which lasts more than three years) to pay portions of income from business, property or compensation for employment or self-employment

- o. Payments Must Not be considered Child Support – Payor spouse is not entitled to deduct and the payee spouse is not required to include in taxable income that part of any payment made pursuant to a divorce decree that is for the support of the children of the payor spouse. Child support payments may be fixed or treated as fixed.
 - i. fixed child support payments – payments specifically designated as child support in divorce decree
 - ii. payments treated as fixed – payments need not be stated numerically but you must be able to determine from the language of the divorce decree how much of each payment is for child support; key is that the expense is fully attributable to the child(ren) and not the payee spouse (an example would be that an agreement to pay college tuition expenses of a child would be sufficient to “fix” the actual tuition payments made by the spouse as child support and thus qualify as a fixed payment)
 - iii. if an alimony payment is reduced at a time that can be correlated with the happening of contingency related to a child, the amount of the reduction in payments may be treated as fixed child support and nondeductible rather than as alimony (such as when a child reaches a certain age)
- p. General rule is that payor spouse is not required to withhold taxes on the payment of alimony
 - i. Payee is responsible to pay proper amount of quarterly estimated taxes
 - ii. If payee is a non-resident but payor spouse is U.S. taxpayer who will deduct alimony payments, payor must withhold 30% of each alimony payment
 - iii. Payor must include payee’s name and social security number on the first tax return in which deduction for alimony is taken

III. Transfers of Property Between Spouses or Incident to Divorce

- A. General Rule – Section 1041 contains a mandatory nonrecognition rule applicable to any transfer of property between spouses during marriage and transfers of property between ex-spouses incident to a divorce. No gain or loss is recognized on transfer of property from an individual to a spouse, or ex-spouse, but only if the transfer to an ex-spouse is made in the context of the divorce
- B. Scope and Applicability – Section 1041 applies to any transfers of property regardless of whether it is a gift, sale or exchange between a husband and wife acting at arm’s length. Additionally, Section 1041 is not limited to transfers

of property made incident to a divorce; a divorce need not be contemplated at the time the transfer is made nor must a divorce ever actually occur between the parties in the future.

1. Section 1041 does not apply to a transfer between an entity and spouse/former spouse
 - a. If Husband's corporation sells property to wife in course of business such a sale would not be subject to rules of Section 1041
 - b. If as part of a divorce settlement husband's corporation agrees to issue wife a long term note such a transfer would not qualify as being between two former spouses
2. Property transferred to a former spouse does not have to have been owned during the marriage for Section 1041 to apply

C. Transfers Incident to Divorce – Definitions

1. "incident to divorce" – if transfer occurs not more than one year after the date on which the marriage ceases or if the transfer is related to the dissolution of the marriage
2. transfer within one year of divorce does not necessarily have to be related to the dissolution of the marriage for Section 1041 to apply (one spouse can sell property to an ex-spouse within one year of the divorce with no tax consequence)
3. transfer of property is treated as related to cessation of the marriage if transfer is made pursuant to divorce decree or if the transfer occurs not more than six years after the date the marriage ended

D. Transfers on Behalf of Spouse

Three situations in which a transfer of property to a third party on behalf of a current or former spouse will qualify under Section 1041 (provided of course that all other requirements of the Code are also met)

1. According to the divorce or separation instrument
2. Written request – when the other current or former spouse formally requests such payment to a third party in writing
3. Written consent – when the transferor spouse receives from the other current or former spouse a written ratification of the transfer to a third party

E. Tax Consequences of Transfer made per Section 1041

1. No Gain or Loss – transferor spouse recognizes no gain or loss on the transfer regardless of whether the transfer is in exchange for the release of marital rights, is of the transferor's separate property, or is a division of community property.
2. Carryover Basis – Transferee likewise does not recognize any gain or loss upon receipt of the transferred property. The property is treated as if it were received as a gift and the basis of the transferred property is the adjusted basis that the property had in the possession of the transferor spouse immediately preceding the transfer

3. Bona Fide Sale – Even if the transfer is a bona fide sale for money consideration, the transferee does not acquire a basis in the property equivalent to the fair market value (what the transferor actually paid)
 4. Carryover basis rule applies whether the adjusted basis is less than, equal to, or greater than the transferred property's fair market value on the date of transfer.
- F. Only transfers of real and personal property (tangible and intangible) are governed by Section 1041 – transfers of services do not qualify
- G. IRS Table – See attached Appendix A for IRS treatment of certain transfers of property

IV. Gift Tax Consequences of Property Settlements

- A. General Rule – any transfer made for less than adequate consideration either in money or money's worth is considered a gift for gift tax purposes to the extent that the value of the property transferred is greater than the value of the consideration received.
- B. Exceptions – Section 2516 provides that if certain specific requirements are met, any transfers of property or interests in property made in accordance with a written agreement entered into by a husband and wife incident to their marital property estate are considered transfers made for full and adequate consideration
1. to qualify, divorce must occur within a three-year period beginning on the date one year before the agreement is executed and transfers of property must be either to a spouse in settlement of marital property rights or to provide a reasonable allowance for the support of minor children of the marriage
 2. only payments designated and required by the agreement will qualify as non-gifts
 3. although payments must be a requirement of the agreement, the payments may be made at any time
 4. in order to receive non-gift tax treatment, a final divorce decree must be entered with the court – no other interlocutory order will suffice
 5. although a final decree must be entered, the agreement incident to divorce need not be approved by the court
 6. direct payment of tuition costs or medical expenses of an individual is not a gift if tuition is paid directly to the education institution and if medical costs are paid directly to the provider

V. Tax Return Issues

- A. IRS Rule – income must be split for the part of the year that the parties were married
1. Split on number of days
 2. Wages and withholding
 3. Investment income
 4. Business income
 5. Estimated tax payment
- B. Reality – parties may file as if they were divorced all year

1. no splitting of income
 2. no splitting of deduction
 3. may use a hybrid method merging rule and reality
- C. File as if you were (either married or divorced) on the last day of year, December 31st
- D. Dependency allocations – income limits, ages of children, number of children, may be possible to file in a way to maximize tax benefit (e.g., higher earning party takes oldest child if each party gets dependency exemption for one of two children)
- E. Allocation of other deductions (generally the party who pays for expense gets to take the correlating deduction)
1. mortgage interest
 2. charitable deductions
 3. childcare expenses
 4. investment expenses

VI. Conclusion

In order to arrive at the desired tax consequence careful consideration of all relevant issues are necessary prior to the entry of a divorce decree or agreement incident to divorce. Clearly it is beneficial for you to explore the tax consequences of all transfers of property incident to divorce as well as the nature of post-divorce payments such as alimony and child support. Hopefully, this article has given you a brief outline of the relevant tax concerns facing all parties upon the dissolution of their marriages.