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Don't Get (Re)Captured by the IRS: Avoiding Alimony Recapture Tax Issues in Divorce Instruments

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In the taxable year 2010, U.S. taxpayers claimed income tax deductions totaling more than $10 billion on alimony payments made to a spouse or former spouse. However, the Treasury Inspector General has recently concluded that more than $2.3 billion of those alimony payments were never reported as income on a tax return by the alimony recipient.(3) This significant alimony reporting gap has caught the attention of the Internal Revenue Service, who has vowed to review and improve its strategy to reduce the compliance gap and ensure appropriate penalties are assessed.

In addition to noncompliance with tax reporting requirements, Congress has also been concerned that taxpayers may abuse the tax structure of alimony (in some jurisdictions referred to as "maintenance" or "spousal support") by improperly labeling non-deductible property settlements as deductible alimony. Accordingly, Congress and the Internal Revenue Service have created a complex set of rules and regulations, including the recapture rule under section 71(f), to guard against this abuse.(4) This article will discuss the impact of the alimony recapture rule, as well as tips and pitfalls for practitioners, after a general discussion of the alimony framework.

Generally speaking, alimony is a payment to a spouse or former spouse under a divorce or separation instrument.(5) A "divorce or separation instrument" includes a decree of divorce or separate maintenance, a written separation agreement, or any court order (including a temporary or interlocutory order) requiring a spouse to make payments for the support or maintenance of the other spouse.(6) It is important that practitioners distinguish state and local definitions, rules, and requirements from those mandated by the Internal Revenue Code ("Code") when drafting settlement agreements, establishing positions, or making arguments in court to ensure that a divorce or separation instrument comports with the Code and avoid future negative tax ramifications for clients.

Third party payments for items such as: medical expenses, housing costs, taxes, and tuition; may qualify as alimony. Life insurance premiums on a policy owned by a spouse required by a divorce or separation instrument may also qualify as alimony. Questions often arise as to whether payments relating to a jointly-owned home qualify as alimony. Generally, if the payer is responsible for the entire payment (for instance, the mortgage, real estate taxes, or home insurance), then the payer may deduct one-half of the total payments and the other spouse must include as alimony one-half of the total payments.(7)

However, not all payments to a spouse or former spouse are alimony. For instance, voluntary payments or payments not made pursuant to a divorce or separation instrument do not constitute alimony.(8) Child support, noncash property settlements, or payments for the use or maintenance of the payer's property do not qualify as alimony. As will be addressed later in this article, practitioners should focus on the parties' treatment of payments as opposed to the cause of a potential alimony recapture issue. Whether payments pursuant to a divorce or separation instrument are intended as child support, non-taxable alimony, cash payments in lieu of property, any combination of alimony and these types of payments, or otherwise, the only way to prevent improper tax reporting by parties or unintentionally being subject to recapture is by careful drafting and clear definition of the terms of an agreement.

Federal Tax Treatment of Alimony

For federal income tax purposes, an individual may deduct "an amount equal to the alimony or separate maintenance payments paid during the individual's taxable year," regardless of whether the payer itemizes deductions.(9) To deduct alimony paid, the payer must file Form 1040 (U.S. Individual Income Tax Return) and enter the amount of alimony paid on line 31a, along with the social security number of the alimony recipient on line 31b.(10) The recipient of alimony is required to provide his or her social security number to the payer.(11) To qualify as alimony for federal income tax purposes, the payer and recipient of alimony cannot file a joint federal income tax return.

To achieve federal tax parity, alimony is includible in the gross income of the recipient.(12) The recipient must report alimony received on Form 1040, line 11.(13) Note that if a U.S. citizen or resident alien pays alimony to a nonresident alien former spouse, the payer may be responsible for withholding of income tax at a rate of up to 30 percent at the time of each payment.(14) The failure to properly withhold on such alimony payments may result in liability to the payer for the tax due.(15)

Alimony Requirements

To qualify as alimony under section 71 of the Code, the payer and recipient must file separately, the payment must be in cash, the divorce instrument must not designate the payment as not alimony, the spouses may not be members of the same household at the time the payments are made,(16) there is no liability to make any payment after the death of the recipient, and the payments are not non-deductible child support.(17)

An alimony payment must be made in cash, including check and money order. Transfers of services or property, including a debt instrument or annuity contract executed by the payer, do not qualify as alimony. Similarly, an alimony deduction is not permitted for the value of a former spouse's use of the payer's property. However, if all other requirements are satisfied, a payment of cash by the payer to a third party (for instance, for tuition or rent) under the terms of the divorce or separation instrument will qualify as a payment of cash which is received "on behalf of a spouse" and qualify for alimony treatment.(18) Likewise, premiums paid by the payer for life insurance owned by the other spouse are made "on behalf of" such spouse and may qualify as alimony.

Spouses may designate that otherwise qualifying payments are not alimony by including a provision in the divorce or separation agreement. Such an agreement

may be made in any written statement, signed by both the payer and the recipient, which refers to the divorce or separation agreement and states that payments are not deductible as alimony by the payer and are excludable from the recipient's income. The recipient should attach a copy of the statement to each tax return where the payments are excluded from income.

If any part of the claimed alimony payments must continue after the death of the recipient spouse, such continuing obligation does not qualify as alimony regardless of when it is paid. Logically, if all of the payments will continue after the recipient's death, then none of the payments made before or after the death qualify as alimony. It is mandatory to expressly state in the divorce or separation agreement that the payments cease upon death of the recipient to ensure the payments will qualify as alimony.

The most litigated of the alimony qualification factors is whether the payment is really non-deductible child support. Despite a separate provision for child support in the divorce instrument, the Service may attach a putative alimony payment on the basis that it is disguised child support which is always non-deductible. Moreover, if both alimony and child support payments are required under the divorce or separation instrument and the payments are less than the total required, the payments apply first to child support and then to alimony.(19)

A payment will be treated as specifically designated as child support to the extent that the payment is reduced either: (a) on the happening of a contingency relating to a child, or (b) at a time that can be clearly associated with such a contingency. A contingency relating to a child commonly includes the child becoming employed, dying, leaving the household, leaving school, getting married, or reaching a specified age or income level. A payment clearly associated with a contingency relating to the child occurs only when (1) the payments are to be reduced not more than 6 months before or after the date the child will reach the age of 18, 21, or the local age of majority, or (2) the payments are to be reduced on two or more occasions that occur not more than 1 year before or after a different child reaches a certain age from 18 to 24, which is the same for each child.(20) The presumption that the foregoing two contingencies relating to the child result in non-deductible child support payments may be overcome by showing that the time for reduction of the alimony payments was determined independently of any contingencies relating to the child (for instance, based upon the duration of the marriage).

The Alimony Recapture Rule

The alimony recapture rule under section 71(f) of the Code was added in its present form by the Tax Reform Act of 1986.(21) The recapture rule may apply where alimony payments decrease or end during the first three calendar years after the first qualifying alimony payment (as discussed above) under a decree of divorce, separate maintenance, or written separation agreement.(22) Alimony recapture may result from a change in the divorce decree or separation agreement, a failure to make timely alimony payments, a reduction in the payer's ability to provide support due to job loss or other financial or non-financial reasons, a poorly drafted alimony award, or a reduction in the recipient's support needs.

The recapture rule requires the payer of alimony to include in income part of the alimony payments previously deducted in the third taxable year.(23) The recipient is entitled to a corresponding deduction for the portion previously included in income in the third taxable year.(24)

The recapture rule applies in the third calendar year where (a) the alimony paid in the third calendar year decreases by more than $15,000 from the prior (second) calendar year or (b) the alimony paid in the second and third calendar years decreases significantly from the alimony paid in the first calendar year.(25) Payments under a temporary support order(26), payments that vary as a result of a fixed calculation of the payer's income (such as from employment or business or property income)(27), and any decrease in payments due to death or remarriage of a spouse are not taken into account for purposes of alimony recapture.(28)

Moreover, to the extent that alimony increases over the three-year period, no alimony recapture is required. Additionally, the alimony recapture rule is inapplicable where the parties agree that the payments do not constitute alimony for federal tax purposes.

As an example, assume alimony was paid of $60,000 in the first year, $40,000 in the second year, and $20,000 in the third year. The alimony paid dropped $20,000 between the second and third years, which exceed the allowable floor of $15,000, requiring alimony recapture in the difference of $5,000.(29) Further, after subtracting the alimony recapture of $5,000 required for the second year, the average of the second and third year alimony payments ($55,000/2=$27,500) is added to the allowable floor of $15,000, the difference of $42,500 and the first year alimony payment ($60,000-$42,400=$17,500) is includible as additional alimony recapture.(30) Under this example, the total alimony recapture to be reported by the payer as income in the third calendar year is $22,500. The alimony recipient is entitled to a corresponding deduction in the same amount for alimony previously reported in income.

The present recapture rule presents a significant revision from the prior (now repealed) minimum term and recapture requirements.(31) The prior excess front-loading rules required that, to the extent payments in any calendar year exceed $10,000, alimony or separate maintenance payments must be made in at least the first six (as opposed to three years under current law) post-separation years to qualify as alimony. (32) The required six year term began with the first calendar year in which the payer makes a qualifying alimony payment. However, the minimum term rule simply required that a payment be made in each of the six years. (33) For example, where a single alimony payment was made of $25,000, the rule disqualified $15,000 of the payment from qualifying as alimony for federal tax purposes because the payments were not made for the minimum six year term. However, where a $1 payment was made for the following five years, the minimum term rule was satisfied. Nevertheless, a related recapture rule required inclusion in income by the payer (and deduction by the recipient) of previously paid alimony payments where the amount of such payments during any of the six post-separation years was reduced by more than $10,000 (as opposed to $15,000 under current law) from a prior year. For example, where an alimony payment was made of $35,000 in the first year and $22,000 in the second year, the excess amount with respect to the first year recaptured in the second year was $3,000 ($35,000-($22,000+$10,000)).

Quite simply, to determine whether the complex statutory computation of alimony recapture is required look to whether the alimony payments in the first three years decline by more than $15,000 in any one year or over the entire three years. If so, alimony recapture is likely. In establishing alimony payment schedules to avoid recapture, ensure the highest year is not more than $15,000 more than the lowest year, at least for the first three calendar years.

There are a few exceptions to the alimony recapture rules: 1) if either spouse dies or the payee spouse remarries during the three post-separation years causing the alimony

payments to stop (note: this exception does not include the statutory termination in Illinois of cohabitation); 2) temporary support payments; 3) if the payments are based on a percentage of the payor's income from his/her business, property or compensation, if the liability continues for at least three full (not calendar) years; and 4) payments designated as non-deductible by the payor and not includable in gross income of the payee in the separation instrument. But, as will be discussed further below, the focus should still be on preventing any audit or investigation of your clients even if an exception or defense exists.

Alimony Recapture Risk Factors / Avoiding Potential Issues for Your Clients

The alimony recapture issue is a common item for examination by the Service on audit of either of the spouses. The Service views the tax treatment of alimony as a potential "whipsaw" issue, such that an analysis of the tax reporting of both spouses must be examined together. The Service has employed the assistance of its computer systems, including the Dependent Database (DDb), to identify potential alimony recapture issues for further inquiry. The use of correspondence audits and information mismatching notices to taxpayer spouses concerning the reporting of alimony has resulted in significant compliance improvements.

Nonetheless, the IRS continues to identify alimony recapture issues during the examination of the spouse's income tax return. Generally, the IRS agent will conduct an analysis in advance of the initial taxpayer contact concerning "large unusual questionable items." To the extent that alimony is reported as received or paid on the taxpayer's tax return, the IRS agent will research historical tax filings for the taxpayer and the taxpayer's spouse to determine whether alimony recapture may be required. The IRS may also examine the property settlement documents to determine whether such payments have been disguised as alimony. Congress and the Service have long been concerned about this disguise of non-deductible property settlements as deductible alimony. IRS agents are instructed to examine the relevant divorce documents to identify this issue on audit.

Finally, the IRS is increasingly using the information of whistleblowers in targeting and conducting tax audits. To the extent that the whistleblower's information produces a tax recovery, the whistleblower may be entitled to a reward.(34) The examination may be initiated at the instance of the former spouse or a related party providing solid information of noncompliance.

While the IRS is primarily concerned with property payments disguised and treated as alimony payments, many different types of payments could potentially yield a "large unusual questionable item" or other red flag to the IRS for the improper treatment of payments. The payments may not even involve property, and the parties and practitioners might not intend abuse of the tax rules. For the practitioner, this is when careful drafting becomes necessary.

Family law practitioners routinely draft settlement agreements and proposed judgments at the conclusion of divorce, parentage, and other types of family law cases. When designing provisions intended to be tax-deductible by one party and taxable to the other party, practitioners should carefully and explicitly describe the tax treatment for the specific payments referenced, ensuring that the description conforms with the requirements of the Code. A recapture issue could potentially be caused by the intentional or mistaken reporting of one or both parties. In representing the best interests of clients, the goal should be to eliminate the possibility of misreporting with clear terms.

Many jurisdictions recognize the concepts of "unallocated support," "non-taxable alimony," and "alimony in gross," all of which can be paid in installments over time following divorce or legal separation. Each of these types of alimony payments can also be combined or paid on a monthly basis with, or offset by, child support payments or payments relative to property division.(35) It is not inconceivable, depending on the complexity of a judgment or settlement agreement and considering the issues in a given case, that one or both parties makes a mistake in reporting different types of payments or intentionally try to create tax advantages by misreporting. The key is to beware of agreements or potential contingencies that could result in the drastic reduction of alimony related payments in the three years following a divorce or separation instrument.

Unallocated family support payments include an element of spousal and child support. As detailed herein, alimony payments may be deducted from a payer's income, while the payee may be required to report the payments as income. Child support is generally treated by the IRS as non-deductible by the payer and is not included in the payee's income. The concept of "unallocated" support allows the payer the ability to deduct payments that represent support for a former spouse *and children*, while the payee will report the entirety of such payments as income.(36) There can be a combined tax savings when considering the tax brackets of the parties by such characterization of support payments. However, any tax advantages do not come free of potential issues and pitfalls. Practitioners must be careful when the payments will be reduced within the first three years following the order or judgment due to the emancipation(37) of a child. Furthermore, a practitioner must always be conscious of the possibility that parties might form a post-judgment agreement for modification of an order or judgment which results in a reduction in the payments without a separate, subsequent court order or judgment.

Parties may also contract for non-taxable alimony payments, making alimony non-deductible by the payer and not included in the payee's income.(38) Further, jurisdictions recognize the concept of "alimony in gross" or "maintenance in gross," which can sometimes be taxable or tax-free to the support recipient. To avoid potential recapture issues, practitioners will want to pay specific attention to the terminating period or events associated with termination of the payments. Practitioners may also want to explore the possibility of making some of these payments non-modifiable going forward. Again, careful, explicit drafting describing the intended tax treatment of payments, and eliminating contingencies or ambiguities to the extent possible, can substantially reduce the risk that parties fall prey to an alimony recapture issue.

Avoid Assumptions / Best Practices for Your Clients

A key approach for family law practitioners is to keep an open mind. Try to anticipate all of the potential ways and all of the potential types of post-judgment payments that might cause clients and former clients to fall prey to alimony recapture and an IRS audit. Keep your client's best interest, alimony recapture, and the IRS in the back of your mind at all times. And make none of the following assumptions.

The Court Will Catch It

Whether a family law judge is approving a settlement or entering an award following a hearing or trial, he or she will be faced with countless different considerations and findings to make when approving support awards. Divorce and separation laws are created at the state level. When dealing with

divorce or separation issues, a judge might be faced with the interaction of family laws with laws and issues in real estate, bankruptcy, federal retirement rules, contracts, and civil or criminal procedure. The court may make a ruling or approve an agreement involving contingent payments and terminating events that may not be foreseeable. Moreover, in certain jurisdictions and certain types of actions, the court may have a very limited role in the proceedings and may be presented with only a limited, macro level picture of the final settlement terms in a family law case. Practitioners cannot assume, especially when structuring complicated settlements with complicated support provisions, that the Court will catch a potential issue.

One Size Fits All

An alimony recapture issue will not necessarily only arise when divorcing spouses attempt to treat property payments as alimony. The misreporting of child support or unallocated support payments might cause an issue. The combination or off-setting of alimony versus child support or property payments might cause an issue. With recent evolution of same-sex marriage and civil union type laws in different jurisdictions, as well as recent and foreseeable changes to the Defense of Marriage Act(39), issues might arise in the future relative to agreements made by and judgments entered for splitting couples in different types of relationships than initially anticipated by the Treasury. Additionally, some states recognize the concept of "palimony," which is the award of alimony to a party who was never married to the other party.(40) A practitioner simply cannot afford to keep his or her alimony recapture antennae alert only when dealing with one type of agreement (or judgment), one type of action, or one type of payments.

Temporary Orders

When dealing with the stress and details of a final settlement or preparation for trial in a family law case, it is easy to be so focused on final issues and provisions that a practitioner might forget about a temporary support order in place for months, if not years, prior to the entry of judgment. As stated above, a "divorce or separation instrument" includes a decree of divorce or separate maintenance, a written separation agreement, ***or any court order (including a temporary or interlocutory order)*** requiring a spouse to make payments for the support or maintenance of the other spouse.

When preparing tax returns, one or both parties may have been reporting for the tax effect of alimony payments dating back to a temporary or interlocutory order. And it is not uncommon that a final provision for alimony payments differs in quantity or duration from any payments in a temporary order. When dealing with support payments or any payments that could be confused with support payments and misreported by parties, practitioners should be vigilant in taking prior temporary or interlocutory orders into account when fashioning provisions and counseling clients about alimony.

One thing is for certain, the Internal Revenue Service will continue to utilize its resources to close the alimony reporting gap. In so doing, practitioners must place renewed importance on alimony payment provisions and counsel clients on the potential risks of noncompliance.

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(3) Treasury Inspector General for Tax Administration, Report No. 2014-40-022 (issued March 31, 2014), "Significant Discrepancies Exist Between Alimony Deductions Claimed by Payers and Income Reported by Recipients."
(4) *See Walters v. Commissioner*, 106 F.3d 411 (9th Cir. 1997).
(5) *See* I.R.C. § 71(b)
(6) I.R.C. § 71(b)(2). Amendments to a divorce or separation instrument are generally not retroactive for federal tax purposes, unless to correct an error to reflect the parties' original intent.
(7) The payer spouse may also be entitled to claim half of the mortgage interest and real estate taxes as an itemized deduction.
(8) *Id.*
(9) I.R.C. § 215(a)
(10) Failure to provide the alimony recipient's social security number (or individual taxpayer identification number), may result in a $50 penalty and disallowance of the claimed alimony deduction.
(11) The alimony recipient may be assessed a $50 penalty for failure to provide their social security number to the payer.
(12) I.R.C. §§ 71, 61(a)(8)
(13) In the case of a non-resident alien, alimony received is reported on Schedule NEC (Form 1040NR), line 12.
(14) *See* I.R.C. § 1441 and *Howkins v. Commissioner*, 49 T.C. 689 (1968). However, tax treaties may provide for an exemption from withholding for alimony payments.
(15) I.R.C. § 1461
(16) Generally, spouses may not be members of the same household at the time the payments are made. However if the spouses are not legally separated under a decree of divorce or separate maintenance, a payment under a written separation agreement, support decree, or other court order may qualify as alimony even if the spouses are members of the same household when the payment is made.
(17) This article addresses the requirements for post-1984 instruments. The requirements differ for instruments executed before 1985, which differences are generally discussed herein.
(18) Payments to maintain property owned by the payer are never payments "on behalf of" a spouse.
(19) I.R.C. § 71(c)(3)
(20) I.R.C. § 71(c)(2)
(21) *See* Tax Reform Act of 1986, Pub.L. No. 99-514, § 1843(c)(1), 100 Stat. 2085, 2853 (1986).
(22) Payments made under temporary support orders do not constitute a qualifying alimony payment for purposes of the recapture rule under I.R.C. § 71(f).
(23) I.R.C. § 71(f)(1)(A). Recaptured alimony income is reported on Form 1040, line 11 relating to alimony received, with the line modified to reflect "alimony recapture." The spouse's name and social security number should be reflected in the space provided on line 11 as well.
(24) I.R.C. § 71(f)(1)(B). The corresponding deduction for recaptured alimony is reported on Form 1040, line 31a relating to alimony paid, with the line modified to reflect "alimony recapture," and identifying the spouse's name and social security number.
(25) I.R.C. § 71(f)
(26) I.R.C. § 71(f)(5)(B)
(27) I.R.C. § 71(f)(5)(C)
(28) I.R.C. § 71(f)(5)(A)
(29) *See* I.R.C. § 71(f)(4)
(30) *See* I.R.C. § 71(f)(3)
(31) *See* Notice 87-9, 1987-1 C.B. 421, 1987 WL 420118. New recapture requirements generally apply to instruments executed or modified after December 31, 1986.
(32) Minimum term rule was added to the Internal Revenue Code by a Deficit Reduction Act of 1984, Pub.L. 98-369, section 422(a), 98 Stat. 795-796; and repealed by the Tax Reform Act of 1986, Pub.L. 99-514, sec. 1843, 100 Stat. 2853.
(33) *See Berry v. Commissioner*, T.C. Memo. 2005-91, 2005 WL 950117 (U.S. Tax Ct. 2005); Walters v. Commissioner, T.C. Memo. 1994-639, 1994 WL 718491 (U.S. Tax Ct. 1994).
(34) I.R.C. § 7623
(35) *See* Pacione v. Reed, 81 Ill.App.3d 600, 605 (3rd Dist. 1980).
(36) For an explanation, *see* In re Marriage of Gleason, 266 Ill.App.3d 467 (3rd Dist. 1994).
(37) "Emancipation" as the term is used in the law of parent and child, means the freeing of the child for the period of his or her minority from the care, custody, control and service of his or her parents. 29 Ill. Law and Prac. Parent and Child § 15.
(38) *See Wolters v. Johnson*, 114 Ill.App.3d 546, 550 (3rd Dist. 1983).
(39) *See U.S. v. Windsor,* 133 S. Ct. 2675 (2013).
(40) *See Atty. Grievance Commn. of Maryland v. Ficker,* 572 A.2d 501, 508 (Md. 1990)

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