Legally Speaking

NEWSLETTER VOL. 7, NO. 2

Schiller DuCanto & Fleck LLP

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Alimony Recapture-
a trap for the unsuspecting

IN THIS ISSUE

Although it has been approximately twenty-seven years since the current version of the alimony recapture rule went into effect, parties continue to face recapture issues, and practitioners must be as vigilant as ever to attempt to prevent issues for their clients. As referred to in some jurisdictions as "maintenance" or "spousal support," the term alimony generally represents support payments made by a spouse or former spouse to another spouse or former spouse pursuant to a court order. In enacting the alimony recapture rule, Congress originally sought a mechanism to prevent parties from receiving beneficial tax treatment by characterizing property payments as alimony payments.

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It is important that practitioners distinguish state and local definitions, rules, and requirements from those mandated by the Internal Revenue Code ("Code") when drafting temporary court orders or settlement agreements, establishing settlement positions, or even when making arguments in court, so as to ensure that a divorce or separation instrument comports with the rules of the Code to avoid future negative tax ramifications for clients.

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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 definitions within a governing document.

If the statutory requirements of Internal Revenue Code ("Code") Sections 71 and 215 are met, alimony and separate maintenance payments are includable in income by the recipient and deductible by the payor spouse. It is not enough for the payments to meet the requirements under a state statute or for the payments to be characterized or labeled in a settlement agreement or divorce instrument as "alimony" or "maintenance." In order for the payments to be deductible by the payor, the payments must meet **all** of the requirements of I.R.C. Section 71. Like all tax deductions, the party claiming the alimony deduction on his or her tax return has the burden of proving he or she is entitled to the deduction.

Alimony is an "above the line deduction" meaning it is deductible in computing a taxpayer's adjusted gross income. As such, a person does not have to itemize his or her deductions in order to benefit from the alimony deduction as with other personal type deductions.

The party receiving alimony is required to compute and to pay their estimated income taxes on a quarterly basis as the payor spouse is not required to withhold from the alimony payments made to the payee spouse.

The alimony recapture rule, as originally enacted in 1984, focused on a six year period, as well as entailing great complexity and causing severely negative, unexpected results in some cases. Fortunately, the six year rule was overhauled in 1986, with the adoption of a three year approach to determine if any recapture was required. The current version of the recapture rule, applicable since 1987, basically provides that if the alimony payments in the first year (defined as calendar year rather than 12 month period) exceed the average of payments in the second and third years by more than $15,000, the excess amounts are recaptured in the third year. A comparable rule also applies to the extent that alimony payments in the second year exceed third year payments by more than $15,000. Correspondingly, the alimony recipient is entitled to a correlative deduction in the third year as well. The rationale for the recapture rule, coupled with the "taint" rule regarding support payments related to a child-related contingency, was to establish a system that reasonably blocked "property settlement" payments from being structured as alimony. *See* H.R. Rep. No. 98-432, pt. 2, 1495 – 1497 (1984). In 1984, recapture was deemed especially important in light of the elimination of three of the subjective rules previously pertaining to the determination of alimony.

For illustrative purposes, consider the following example: if an ex-husband is ordered pursuant to a divorce decree to pay his ex-wife alimony for five years in the amounts of $4,000 per month ($48,000 annually) in year one, $2,500 per month ($30,000 annually) in year two, and then $1,000 per month ($12,000 annually) each additional year,

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thereafter the support payments will decrease by $18,000 in each of post-separation years two and three. Under this scenario, applying the rules in Section 71(f) of the Code, and assuming the ex-husband makes all the required payments for the first, second, and third post-separation years, the ex-husband would be liable to include in his gross income $16,500 beginning in the third post-separation year, and the ex-wife would be allowed to claim said amount as a deduction from gross income beginning in the third post-separation year. *See* I.R.C. § 71(f)(1-4).

This outcome would obviously provide a benefit to the ex-wife and detriment to the ex-husband, even though no such adjustment might have been intended by the drafters of the divorce decree. Depending on the parties' financial circumstances, this adjustment might be a de minimus outcome. But the key issue is that both parties are now under the watchful eye of the Internal Revenue Service ("IRS"), which could have negative repercussions for either or both parties in the future.

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.

While the IRS is primarily concerned with property payments disguised and treated as alimony payments, many different types of payments could potentially yield a red flag to the IRS for the improper treatment of payments. The payments may not even involve property, and the parties and/or 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 in the governing documents.

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.(1)

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 make a mistake in reporting different types of payments or intentionally try to create tax advantages by misreporting.

Unallocated family support payments include an element of spousal and child support. Although alimony payments are deductible from a payer's income and the payee is required to report the payments as income, child support is not deductible by the payor and is not included in the payee's income. The concept of unallocated support allows the payor 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.(2) 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 of a child.(3) 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 payor and not included in the payee's income.(4) Further, some 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 the 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 laws in different jurisdictions, as well as recent and foreseeable changes to the Defense of Marriage Act, issues may arise in the future relative to agreements made by and judgments entered for separating couples in different types of relationships than initially anticipated by the Department of Treasury.(5) 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.(6) 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 payment.

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 in settlement agreements and final judgments and counseling clients about alimony.

(1) *See* Pacione v. Reed 81 Ill. App. 3d 600, 605 (3rd Dist. 1980).

(2) For an explanation, see In re Marriage of Gleason, 266 Ill. App. 3d 467 (3rd Dist. 1994).

(3) "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.

(4) *See* Wolters v. Johnson 114 Ill. App. 3d 546, 550 (3rd Dist. 1983).

(5) *See* U.S. v. Windsor, 133 S. Ct. 2675 (2013).

(6) *See* Atty. Grievance Commn. of Maryland v. Ficker 572 A. 2d 501, 508 (Md. 1990)

How Executives Can Defer Taxes

The goal of the Internal Revenue Service is to tax all income in the year it is received. One way to defer payment of taxes is by contributing funds to a qualified retirement plan. A qualified retirement plan must meet requirements set forth in ERISA law and the Internal Revenue Code. ERISA Qualified plans limit the sum that can be deferred to $17,500 annually (unless the contributor is over 50 years old, in which case he or she can defer an additional $5,500 annually).

In order to attract and keep top talent, many employers offer their top level executives additional methods to defer compensation. One option is a non-qualified deferred compensation plan, which does not follow ERISA limits on how much can be contributed. Therefore, sums much larger than the ERISA limit can be deferred into a non-qualified deferred compensation plan.

Non-qualified deferred compensation plans must follow Internal Revenue Code rules in order for the funds to be tax deferred. Internal Revenue Code Section 409A regulates non-qualified deferred compensation arrangements. If the employee does not comply with Section 409A, he or she may face tax penalties of an additional twenty percent tax on the income, as well as interest.

The requirements that must be met in order to comply with Section 409A are:

Deferral Election. The executive must make the election to defer income before the beginning of the calendar year or fiscal year in which the compensation will be earned.

Distribution Options. At the time of the deferral election, the employee must select a form of payment and the time of payment of the deferred funds. The plan may provide several options and/or may provide a default option if none is selected. Permissible distribution events are: separation from service, death, disability, change of control of a corporation, a fixed time, a schedule (e.g., reaching the age of 65), or an unforeseeable emergency.

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No Acceleration. Acceleration of benefit payments is prohibited except in very limited circumstances, such as a Domestic Relations Order.

Reporting Requirements. Deferred compensation plans must be in writing and the employer must report the sum on a W-2.

Changing Deferral Election. An employee may change a distribution election in the plan, however, the change must be made at least one year before the distribution is due and the new election must defer the distribution for an additional five years beyond the original payment date.

If the employer holds the funds in a trust, the funds may become taxable income to the employee, which would defeat the purpose of the deferred compensation plan. Most plans will refer to funds allocated to a deferred compensation plan as funds in a bookkeeping or phantom account. The funds are not actually held in a trust fund or account for the employee as is required by a qualified plan. The employer pays the deferred compensation when due from the assets and earnings it has in that year. If the company does not have the funds to pay the individual, then the funds can be forfeited. Executives have lost deferred compensation benefits when the company went bankrupt.

For example, Rand McNally had a Supplemental Executive Retirement Plan ("SERP") and went bankrupt. The Rand McNally executives were told that the plan was terminated and there were no funds to pay the benefits. *See Feinberg v. RM Acquisition LLC*, 629 F.3d 671 (7th Circuit 2011). The executives sued and lost.

One of the exceptions to the anti-acceleration clause allows a plan to accept a Domestic Relations Order ("DRO") and pay an ex-spouse prior to the distribution time period elected. It may be possible for an ex-spouse to receive funds and for the employee to lose benefits if the company later goes bankrupt. Personal experience has demonstrated that most non-qualified deferred compensation plans will not accept a DRO, and if they do, they require the distribution to be paid only if, as and when the participant is paid.

If you are the spouse who does not have a deferred compensation plan, you and your attorney will want to discover if the plan will accept a DRO and what the payment provisions may be. One option is to value the plan and offer to take other assets in return and let the participant take his or her full benefits. If you are the spouse who has the deferred compensation plan that does not accept a DRO, you may want to recommend that you pay your soon-to-be-former spouse the appropriate share once you are paid rather than foregoing other assets at the time of the divorce, just in case you never receive any money from the deferred compensation plan.

At a minimum, it is important for both parties in a divorce to understand what the benefits are that each has because all of these benefits are marital property subject to division if they were acquired during the marriage.

IN THE NEWS

Brett M. Buckley is moderating a panel on the topic: "Tax Issues in Divorce Cases: Mastering the Basics" for the Chicago Bar Association Young Lawyers Section Family Law Committee on April 24, 2014.

Michele M. Jochner spoke at Arlington Heights Chamber of Commerce - Professional Women's Committee on "A History of Women in the Law" on March 19, 2014.

Joshua M. Jackson presented "Divorced But Not Done: Bifurcated Judgments" at the Lake County Bar Association Family Law Conference on March 7, 2014.

Evan D. Whitfield spoke at the 2014 DePaul Journal of Sports Law and Contemporary Problems Symposium on "Issues Arising in the Representation of Professional Athletes" on March 7, 2014.

Patrick T. Ryan presented "Understanding the Affordable Care Act" to the Chicago Bar Association Domestic Relations Committee on February 12, 2014.

Carlton R. Marcyan presented "Recent Developments in Marriage, Divorce and Dispute Resolution" at the Illinois CPA Society North Shore Chapter on February 10, 2014.

Michele M. Jochner was a panelist at the American Bar Association New Partner Conference on the topic of "Transitioning from Mentee to Supervisor: Partner Responsibilities Under the Rules of Professional Conduct" on February 6, 2014.

Meighan A. Harmon was interviewed by Crain's Chicago Business Magazine for an article titled "6 great bars for business."

Timothy M. Daw was named a Director of the Chicago District Golf Association.

The materials contained in this Newsletter are intended for general informational purposes only and not to be construed as legal advice or opinion.

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