www.cpaj.com December 2013

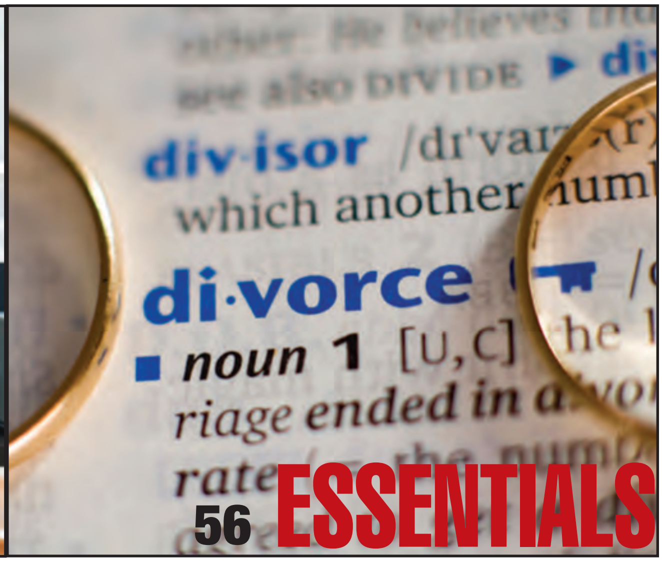
The CPA Journal

ANNUAL TAX UPDATE

Helping Individuals and Businesses Weather Tax Season

Tax Software Survey • Year-End Planning • Preserving Business Deductions • Marriage & Divorce

vol. LXXXIII/no. 12



The Tax and Financial Implications of Divorce

Alimony, Property Settlements, Custody, and Other Considerations

By Ryan C. Sheppard

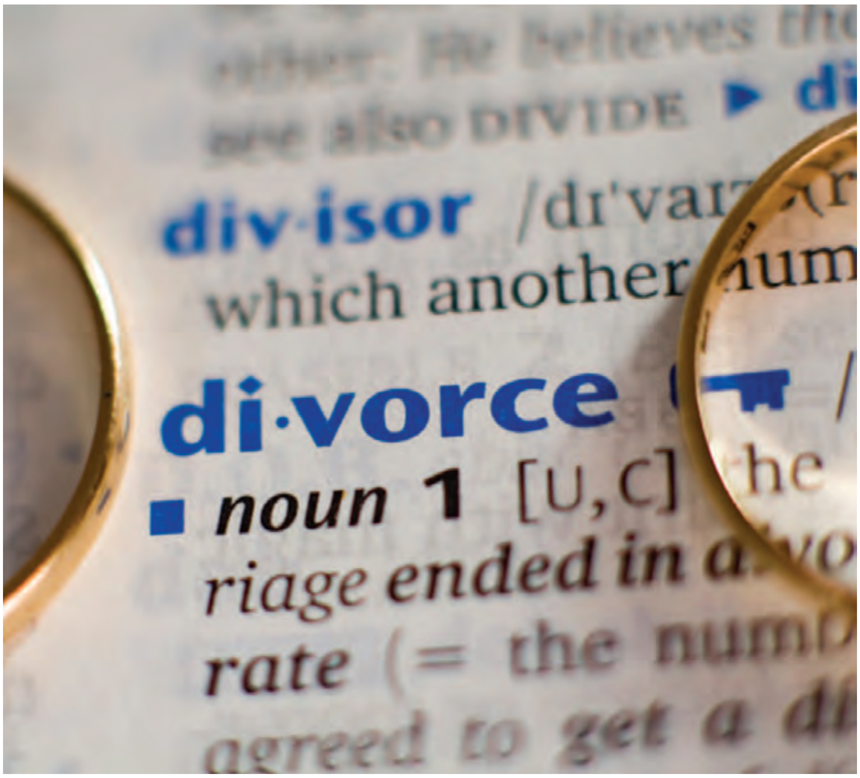
Recently divorced individuals often find themselves unprepared for their new financial landscape—not only with respect to financial matters, such as asset management or budgets, but their tax situation as well. Financial advisors can help such individuals plan for the future. Careful review of the separation agreement is critical in order to determine the tax treatment of support payments or receipts, file an accurate tax return, avoid future problems, and provide advice on an ongoing basis.

Determining Alimony

Alimony is the payment of cash by one spouse to another in order to meet statutory requirements. These payments are taxable to the recipient and deductible to the payer under Internal Revenue Code (IRC) section 71(a). An important distinction between state tax law and federal tax law is the determination of whether a payment is alimony—for example, a payment may be considered alimony for state law purposes but not for federal tax purposes.

The requirements to be treated as alimony for federal tax purposes are as follows:

- Payments must be made in cash (IRC section 71[b][1]).
- Payments must be received by or on behalf of a spouse under a divorce or separation instrument (IRC section 71[b][1][A]).
- The divorce or separation instrument must not designate as payment any payment that is not includible in gross income under IRC section 71(b)(1)(B) and not an allowable deduction under IRC section 215. The payor spouse and payee spouse must not opt out of alimony treatment for federal income tax purposes.
- In the case of individuals legally separated under a decree of divorce or separate maintenance, the payee spouse and the payor spouse may not be members of the same household at the time the payment is made (IRC section 71[b][1][C]).
- There is no liability to make any such payment for any period after the death of the payee spouse, and there is no liability to make any payment (in cash or property) as a substitute for such payments after the death of the payee spouse (IRC section 71[b][1][D]).



Separation agreements often use the term "unallocated alimony." But just because an agreement labels payments as alimony does not make them so for tax purposes. In these agreements, the term "unallocated" will generally denote that payments are treated as alimony for tax purposes, because the written agreement does not specifically allocate them to either alimony or child support.

Contingency payments. Divorced individuals and their advisors must use caution when reviewing the details of a separation agreement in order to support their determination of whether payments should be considered alimony. Although an agreement may not appear to specifically allocate an amount to child support, a change in the payment related to a contingent event of the child changes the tax treatment. Under current law, if any amount specified in the instrument will be reduced by an event relating to the child, then the amount of alimony will also be reduced and considered as child support.

IRC section 71(c)(2) explains as follows:

> If any amount specified in the instrument will be reduced—
>
> (A) on the happening of a contingency specified in the instrument relating to a child (such as attaining a specified age, marrying, dying, leaving school, or a similar contingency), or
>
> (B) at a time which can clearly be associated with a contingency of a kind specified in subparagraph (A),
>
> an amount equal to the amount of such reduction will be treated as an amount fixed as payable for the support of children of the payer spouse.

Interestingly enough, this was not always the case. In fact, for divorces before 1985, the instrument had to specify a designated amount as child support (see *Comm'r v. Lester*, 366 U.S. 299 [1961]); however, the Tax Reform Act of 1984 removed the requirement that payments must be made in discharge of marital obligation imposed under state law in order to qualify as alimony. Even though attorneys or even the courts might call payments alimony, it does not override the contingency rule.

When reading these agreements, CPAs should be aware of other situations surrounding contingency payments. For example, what if a payment contingency does not fall specifically within the descriptions previously outlined? A facts-and-circumstances test can help determine when payments are associated with a contingency relating to a child. The term "associated with" can be applied if the payment reduction happens to occur at about the same time that support payments for a child would normally terminate. Under Treasury Regulations section 1.71-1T(c), there are two specific situations when a reduction of payments will be presumed to be connected with a contingency relating to a child:

> The first situation referred to above is where the payments are to be reduced not more than 6 months before or after the date the child is to attain the age of 18, 21, or local age of majority. The second situation is where the payments are to be reduced on two or more occasions which occur not more than one year before or after a different child of the payor spouse attains a certain age between the ages of 18 and 24, inclusive. The certain age referred to in the preceding sentence must be the same for each such child, but need not be a whole number of years. The presumption in the two situations described above that payments are to be reduced at a time clearly associated with the happening of a contingency relating to a child of the payor may be rebutted (either by the Service or by taxpayers) by showing that the time at which the payments are to be reduced was determined independently of any contingencies relating to the children of the payor. The presumption in the first situation will be rebutted conclusively if the reduction is a complete cessation of alimony or separate maintenance payments during the sixth post-separation year (described in A-21) or upon the expiration of a 72-month period. The presumption may also be rebutted in other circumstances, for example, by showing that alimony payments are to be made for a period customarily provided in the local jurisdiction, such as a period equal to one-half the duration of the marriage.
>
> *Example:* A and B are divorced on July 1, 1985, when their children, C (born July 15, 1970) and D (born September 23, 1972), are 14 and 12, respectively. Under the divorce decree, A is to make alimony payments to B of $2,000 per month. Such payments are to be reduced to $1,500 per month on January 1, 1991 and to $1,000 per month on January 1, 1995. On January 1, 1991, the date of the first reduction in payments, C will be 20 years 5 months and 17 days old. On January 1, 1995, the date of the second reduction in payments, D will be 22 years 3 months and 9 days old. Each of the reductions in payments is to occur not more than one year before or after a different child of A attains the age of 21 years and 4 months. (Actually, the reductions are to occur not more than one year before or after C and D attain any of the ages 21 years 3 months and 9 days through 21 years 5 months and 17 days.) Accordingly, the reductions will be presumed to clearly be associated with the happening of a contingency relating to C and D. Unless this presumption is rebutted, payments under the divorce decree equal to the sum of the reduction ($1,000 per month) will be treated as fixed for the support of the children of A and therefore will not qualify as alimony or separate maintenance payments." (Treasury Regulations 1.71-T[c], A-18)

Even though attorneys or even the courts might call payments alimony, it does not override the contingency rule.

The term "associated with" can be subjective; one cannot presume that any time a payment reduction occurs on or about a child's contingency date, the payment should be considered child support. As stated above, it remains a facts-and-circumstances test. For example, in *Cathleen Shepherd v. Comm'r* (T.C. Memo 2000-174), the settlement agreement of the two parties, who divorced in 1989, required James H. Shepherd to pay $2,400 per month, ending on April 30, 1999. The payment term's ending date fell within six months of their daughter's 18th birthday. Because of this, the plaintiff treated the entire $28,800 of annual payments as nontaxable child support, due to the date of termination coinciding with the daughter's birthday. The court disagreed and held that the payments were taxable to the wife. According to the court, there was no dis-

The parties must designate in the separation agreement that the cash is a transfer of property and is not intended to be alimony.

cussion between the parties of the daughter's 18th birthday; in addition, the court stated—

> Mr. Shepherd's divorce counsel testified that he was "absolutely positive" that there was never any discussion that alimony would terminate on the 18th birthday of either of the parties' two children. He further testified that the 10-year term of alimony was requested when negotiation first began and that the only point of contention regarding alimony was the amount that would be paid.

In a similar case, *Hill v. Comm'r* (T.C. Memo 1996-179), the IRS successfully proved that the parties chose the termination date independent of any contingency related to the child. In both cases, the termination dates were considered completely independent.

As discussed above, Congress enacted IRC section 71(c)(2) in the wake of *Lester*, which changed the application of the rules; thus, a careful review of separation agreements is critical in order to ensure accurate tax treatment of alimony and child support.

Property Settlements

A transfer of assets between spouses occurs in nearly every divorce case. Property transfers cannot be considered alimony, because alimony must be paid in cash. Property settlements can include, among others items, physical property, assets held in a qualified retirement account, and assets held in a nonqualified account. As long as the transfer of property occurs incident to a divorce or while married, no gain or loss is recognized (IRC section 1041[a][2]). The transfer is considered a gift for tax purposes; thus, the basis, in the hands of the transferor, transfers to the recipient.

The timing of the settlement is important. As mentioned previously, as long as the transfer of property occurs incident to a divorce or while married, no gain or loss is recognized. "Incident to divorce" means the following, as noted in IRC section 1041(c):

- If the transfer occurs within one year after the date on which the marriage ceases
- If the transfer is related to the cessation of the marriage.

The first item is relatively straightforward; the second item, however, is less clear. Temporary Treasury Regulations section 1.1041-1T provides some clarity on this issue. The transfer of property is considered related to the cessation of marriage if it is made pursuant to a divorce or separation agreement (as defined in IRC section 71[b][2]; see also Temporary Treasury Regulations section 1.041-1T, Q-7) and the transfer occurs within six years after the date on which the marriage ceased.

What happens when part of a property transfer includes cash? Transfers of cash can be considered part of the property settlement, provided that the provisions of IRC section 71(b)(1)(B) are met. This means that the parties must designate in the separation agreement that the cash is a transfer of property and is not intended to be alimony. This is true in most cases, but there are exceptions; for example, it does not apply for transfer of services or if the spouse is a nonresident alien.

Qualified domestic relations order (QDRO). No discussion of property settlements is complete without mentioning QDROs. In essence, a QDRO creates the existence of an alternate payee's right to receive all or a portion of the benefits payable (IRC section 414[p][1][A]). Interests in a retirement plan may be transferred with no adverse tax effects, provided they are transferred under a QDRO.

Custody of Dependents

Under IRC section 152(e), there is an exception to the standard dependency rules: a child may be treated as a qualifying child of the noncustodial parent for purposes of the child tax credit and dependency deduction if the following occur:

- Step one—the child receives more than one half of its support from the child's parents (IRC section 152[e][1][A]), who are divorced and who live apart during the last six months of the year, and the child is in the custody of one or both parents for more than one-half of the year (IRC section 152[e][1][B]).
- Step two—Once the first step is met, the custodial parent releases the claim to the noncustodial parent, using Form 8332, Release/Revocation of Release Claim to Exemption for Child by Custodial Parent, and files it with the tax return (IRC section 152[e][2]).

Divorced individuals and their advisors should be mindful of Treasury Regulations section 1.152-4. One particular item of interest is the ability of the custodial parent to revoke an assignment to the noncustodial parent, which can also be done on Form 8332. (Treasury Regulations section 1.152-4[e][3] provides additional guidance and examples related to this issue.) Before advising an individual to take this route, CPAs should note that the revocation of this assignment could have other ramifications (e.g., it could violate the separation agreement itself).

Legal Fees

Legal and accounting fees connected with obtaining a divorce are generally not deductible. Alimony expenses incurred with the collection of alimony are considered incurred in the production and collection of income (Treasury Regulations section 1.212-1[a][1]) and thus allowed as a miscellaneous itemized deduction. Tax advice associated with a divorce is a deductible expense, but advice rendered with respect to nontax items is not deductible.

Recapture Rule

CPAs should also be mindful of recaptured alimony provisions (IRC section 71[f]) by tracking year-over-year alimony payments. The three-year recapture rule works as follows: if the first postseparation-year payment exceeds the average payments for the second and third year by more than $15,000, the excess is recaptured as taxable income in the third postseparation year. In addition, to the extent that alimony payments made in the second year exceed alimony payments made in the third year by more than $15,000, the excess is recaptured in the third postseparation year; the amounts from the first- and second-year excess are included in the third year. One item to remember: if the payer has to recapture, then the recipient does receive a deduction on the recaptured amount.

Planning Strategies

Many planning and tax implications of divorce remain outside the scope of this article. Several other matters related to divorce, dependency, and family matters should also be considered in financial planning for divorced individuals. To that end, the following sections discuss some additional tips for advisors.

Read the agreements in detail. It is not uncommon that the tax intention of the legal instrument is in direct opposition to federal law, and the agreement does not overrule the law. Understanding all the provisions of the agreement can avoid future surprises that might arise.

Do the research. Not all agreements are the same; in fact, there is often a wide range of written agreements and rarely boilerplate language. Financial advisors should read each one carefully, along with any corresponding case law, in order to support a position. The fact pattern is important to making a qualified determination, particularly with respect to alimony.

Educate the taxpayer. Divorces can be complicated and confusing; individuals are often unprepared for the ramifications of a recent divorce. A walk-through of each provision from a tax planning perspective can provide useful benefits and avoid future problems.

Work with the divorce attorney in advance, if possible. CPAs who work with divorce attorneys can resolve many of these issues in advance. Divorce attorneys are generally not tax experts; there are several cases in which the legal document's intentions did not comply with the requirements in the IRC. Working in conjunction with the attorney can proactively address many issues that come up during a divorce—not only child support and alimony, but also dependency, itemized deductions, and true-up calculations post-year-end, to name a few. ❑

Ryan C. Sheppard, CPA, CFF, *is a partner with Knight Rolleri Sheppard CPAs LLP, Fairfield, Conn.*