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Divorce Lawyers Must Watch Tax Law

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Family Law

Most divorce settlements provide for the payment of alimony from one ex-spouse to the other for a period of years. The term "alimony" has the same meaning as "spousal support." The former is used in the Internal Revenue Code, the latter in the California Civil Code. The area of alimony payments is one of the many areas in a divorce where the rules of federal taxation have a significant impact. As more fully discussed below, for example, the alimony recomputation rules may result in a significant unexpected addition of income to the payor spouse at the end of the third calendar year following the divorce.

Many lawyers recognize that the divorce arena is fraught with areas where a decision not analyzed for its tax impact may result in significant financial harm to the client. Divorce lawyers often will refer their client to a tax professional such as an accountant or a tax lawyer. An appellate court has held, however, that this is not enough to avert liability for malpractice should the tax professional provide the wrong advice, or should the client never obtain the recommended advice. See *Horne v. Pelham*, 97 Cal. App.3d 404 (1979). What then are the alternatives?

You, as the lawyer, can stop handling divorces. Or, you can become an expert in divorce taxation. The latter alternative requires that you familiarize yourself with the divorce taxation rules in the Internal Revenue Code.

Overhauling the Tax Code

If alimony payments are structured so as to comply with rules contained in the Internal Revenue Code, then the recipient of the alimony payments ("the payee") must include the entire payment in his or her gross income pursuant to IRC sec. 71, and the payor may deduct from income the same payments pursuant to IRC sec. 215.

In recent years, Congress has overhauled the IRC as it relates to the taxation of alimony payments. The basic principle — the payor may deduct the payments, and the payee must include the payments in income — is still good law. The tax reform acts of 1984 and 1986, however, have created several hoops family lawyers must jump through so that the payment will be considered alimony. The purpose of this article is to serve as an overview of the new alimony rules as revised by the 1984 and 1986 tax reform acts.

Two of the changes resulted in amendments that added several complicated provisions to the IRC, namely the "Anti-*Lester*" provisions and the recomputation rules. Both of these provisions are explained below, and they should be carefully considered when structuring an alimony settlement.

Payments must terminate at payee's death: All alimony or separate maintenance payments must terminate at the payee's death. IRC sec. 71(b)(1)(D). This statute provides that if the payor is obligated to make payments for any period past the payee's death, or if there is provision for a substitute payment in cash or property after the death of the payee, these payments are disqualified and are not alimony. It is Congress' position that these types of payments are usually property settlement provisions and, therefore, should not be taxed as alimony.

The temporary regulations, Temp. Reg. Sec. 1.71-1T(b), Q-14, suggest three types of payments that would not qualify as alimony. Those are (1) payments that begin at the payee's death, (2) payments that increase in amount at the payee's death and (3) payments that are accelerated in time at the payee's death.

Often divorce settlements provide that the payor maintain a life insurance policy on the payee's life payable to either the payee's estate or a beneficiary designated by the payee. At first glance, this would appear to be a substitute death benefit, and therefore not deductible. There is an interesting dichotomy between the House report which specifically approves this type of arrangement as alimony, see, H.R. Report No. 98-432, Part 2, 98 T.H. Cong., 2d Sess. 1496 (1984), and the temporary regulations which do not contain any mention of life insurance. Temp. Reg. Sec. 1.71-1T(b), Q-14. Therefore, this issue appears not to be completely settled.

The parties must reside in separate households: The 1984 Tax Reform Act now requires that before the payment will be considered alimony, and therefore deductible and includible under IRC secs. 215 and 71, respectively, that the parties must reside in separate "households" after the entry of the final decree of divorce. This is a departure from the pre-1984 law which only required that the parties be separated. The test now used by the IRS, and which is in the regulations, is whether the spouses are still living under the same "roof." This is a major departure from California law where depending on the facts spouses may still be considered not living separate and apart even though they live under separate roofs, or may be considered separated even though continuing to reside in the same residence. See *In re Marriage of Baragry*, 73 Cal.App.3d 444 (1979).

"Lester" support or "family" support: Since 1942, IRC section 71 has required that the divorce decree, instrument or agreement "fix" the amount of the payment that is for child support, and that portion of the support payment is neither deductible by the payor nor includible in the payee's income. In *Comm. v Lester*, 366 U.S. 299 (1961), the Supreme Court defined the term "fix." There, Lester was obligated to make payments for spousal and child support, and the agreement did not state what portion of his payment, payable to his ex-wife, was for the support of his children. The agreement did provide that as each of his three children married, became emancipated or died, the entire payment would be reduced by one-sixth. The Supreme Court liberally interpreted section 71 and held that in order to "fix" child support the agreement must specify that a certain percentage of the payment is for child support before any of the payment is excluded from the payee's income.

The *Lester* decision enabled spouses to do effective tax planning with alimony. This was accomplished by increasing the amount of the payment to the payee, as fully deductible, unallocated, spousal and child support payments which were then reduced when the payor's child support obligation ended. Often, agreements or decrees lumped together this child support and spousal support obligation and called it "family support."

Unfortunately, the 1984 Tax Reform Act effectively ended this use of the *Lester* ruling by providing that any reductions on events related to a child will "fix" the reduction as child support. IRC sec. 71(c). That portion of the *Lester* or "family" support payment which is reduced on a contingency relating to a child is treated as "fixing" child support in an amount equal to the reduction. IRC sec. 71(c)(2)(A). That portion of the payment equal to the reduction is then treated as child support beginning with the initial payment, and

is not deductible, or is added back into the payor's income if it had been previously deducted. IRC sec. 71(c) also states that the contingency that provides for the reduction in the payment must "clearly be associated" with a child.

Although this statute is somewhat ambiguous about what those contingencies are, the regulations clearly inform us that contingencies may be identifiable as relating to the child, even if they do not specifically mention the child. Under the temporary regulations, they have set out two situations in which payments are presumed to be reduced at times "clearly associated" with the contingency relating to a child. Temp. Reg. Sec. 1.71-1T(c), Q-18. The tests are extremely complicated. It being very difficult to draft an "unassociated reduction," where the payment was originally negotiated to provide for a reduction in the payment which was related to a child. Those lawyers who may continue to attempt to draft a "*Lester*" or "family" support payment under new IRC sec. 71 should closely scrutinize the wording of their payment provision so as to comply with the temporary regulations. The temporary regulations do exclude payments paid prior to the final decree of divorce or legal separation; therefore, "fixed" payments during the pendente lite period may all be "fixed," "family" support payments and are deductible as "unallocated" support.

Three-year recomputation rule: The 1984 Tax Reform Act complicated the taxation of alimony payments by providing for a six-year minimum term rule and a six-year recapture rule. These rules are still effective for divorce decrees entered between Jan. 1, 1985 and Jan. 1, 1987. Beginning Jan. 1, 1987, the 1986 Tax Reform Act replaced these rules with a three-year recomputation rule. This new rule reduces the potential adverse tax effect from the former 1984 tax reform rules; however, all alimony payments should be carefully examined to determine if they are tax affected under this new 1986 rule.

Recomputation only takes place at the end of the third post-separation year. Temporary support payments prior to the entry of the final judgment of divorce or separation are not considered as payments in a post-separation year. The recomputation results in the recomputation amount being added back into the income of the payor at the end of third post-separation year, with a resulting windfall to the payee because this amount is subtracted from his or her income.

The recomputation requires two separate calculations. The first calculation subtracts all of year three alimony plus $15,000 from the year two alimony. The difference is the first recomputation amount. The second calculation consists of the following five steps: (1) Year two and year three payments are added together, (2) the recomputation amount is subtracted from year two and year three total payments, (3) the difference is the second recomputation amount. The total of the two recomputation amounts is income to the payor and a reduction in income to the payee.

There are three exceptions where the recomputation rules are ineffective: (1) The payee remarries, or either spouse dies, IRC section 71(f)(5)(B), (2) the payments are under a temporary order or written agreement, during the period of separation and prior to the entry of the final judgment, IRC section 71(f)(5)(B), and (3) the payor is obligated to pay a fixed portion of his or her income for a business or property, or from compensation; however, this obligation must continue for at least three full years. IRC section 71(f)(5)(C).

If the payor is obligated to make payments for any period past the payee's death, these payments are disqualified and they are not alimony.

Alimony provisions should be drafted to avoid or substantially reduce the impact of these recomputation rules. One way of doing so would be to start the payments at the end of the first calendar year because the recomputation rules apply only on a post-separation year. Therefore, the initial year's payment can be higher and level off over the remaining two calendar years. Also, payments may decline $15,000 or less in each of the three post-separation years without a recomputation.

It is therefore possible to draft an alimony provision that provides for declining payments that avoid the recomputation rules. Also, if the parties are aware that the payee plans to remarry within three years after divorce, then there may be a front-loading of payments during the first three post-separation years without concern to recomputation rules.

Attorneys should keep in mind that the exceptions to the recomputation rules provided for in the regulations do not except a support payment modified by court order. Therefore, a modification by a court in the three post-separation years could result in a recomputation. To avoid this problem, an agreement or court order might provide for an adjustment to the payments if there is a recomputation excess regardless as to how the recomputation resulted.

These alimony rules are a few of the basic tools that divorce lawyers must be familiar with to competently represent individuals where alimony is to be paid incident to a divorce. Federal taxation largely impacts many areas of the dissolution process, and alimony is one of those areas.

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