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Why is divorce so expensive? Because of the IRS

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The U.S. Tax Court recently issued a summary opinion in the case of *Roscoe Jerome McNealy and Leanna Yvonne McNealy v. Commissioner of Internal Revenue*, granting the commissioner's motion for summary judgment and denying the petitioners' alimony deduction claimed on their 2009 federal income tax return.

On April 6, 2009, Roscoe McNealy and Leanna McNealy entered into a marital settlement agreement, which provided that alimony would be waived by both parties and that the husband would pay the wife \$40,000 as an "equalization payment" to effect the equitable division of marital assets. The agreement was then incorporated into the final judgment of dissolution of marriage and entered by the court.

When the McNealys filed their 2009 taxes, they claimed a \$40,000 alimony deduction under Internal Revenue Code Section 215 for the equalization payment. The commissioner disallowed the alimony deduction, and issued a notice of tax deficiency for 2009.

The McNealys challenged the decision, and the court held that the equalization payment was not deductible since it was a part of the equitable division of marital assets and property settlement transfers are not taxed under IRC Section 1041. Additionally, IRC Section 215(b) provides that the paying spouse may deduct a payment as alimony if the payment is "includible in the gross income of the recipient under section 71." In order to be includible in the gross income of the recipient, the payments must satisfy all of the elements of Section 71.

Section 71(b)(1) lists four requirements for a payment to be considered alimony: (A) the pay-

ment is received by (or on behalf of) a spouse under a divorce or separation agreement; (B) the divorce or separation agreement does not designate the payment as a payment which is not includible in gross income and not allowable as a deduction under section 215; (C) the payee and payor spouses are not members of the same household at the time such payment is made; and (D) there is no liability to make any such payment for any period after the death of the payee.

The court stated, "Section 71 serves to establish an objective standard to distinguish between a payment received in the division of property (which is not includible in gross income) and a payment received as spousal support (which is includible in gross income)." Furthermore, the court held that the agreement failed to meet the criteria for deductibility as alimony. Although the agreement met the requirements of Section 71(b)(1)(A) and (C), the payment did not meet the requirements of sections 71(b)(1)(B) or (D). In fact, the agreement provided that neither party could claim any entitlement to alimony from the other and that each party had waived all rights to alimony in the agreement. The \$40,000 payment was also specifically designated as an "equalization payment." Finally, under the terms of the agreement, Roscoe's obligation to make the equalization payment would not have terminated in the event of Leanna's death — a requirement of deductible alimony that is frequently overlooked.

Although the McNealys argued that they relied on IRS Publication 504, titled "Divorced or Separated Individuals," in determining whether the equalization payment was an alimony payment and thus deductible, and they had spoken with an IRS employee who advised them verbally that the equalization payment qualified as an alimony payment, neither arguments held

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any sway with the court. While those efforts could be relevant in relieving the McNealys of a penalty had been assessed, they were not persuasive to relieve the McNealys of the additional income tax.

As a practical matter, attorneys drafting marital settlement agreements need to be clear not only with their clients, but also in the marital settlement agreement itself, whether an amount paid by one spouse to another as an equalization payment is a nontaxable event, or whether the payment will be taxable to the payee spouse and deductible to the payor spouse as a form of support. If an equalization payment is called for in a marital settlement agreement, specific language should be included to exempt the payment from any tax implications.

Likewise, in the event that spousal support is provided for in an agreement, language which designates the support as taxable to the payee spouse and deductible to the payor spouse should be included, i.e., "The support payments shall be included on federal and state income tax returns filed by Petitioner as 'alimony received' and shall be deductible by Respondent on his federal and state income tax returns as 'alimony paid.'"

Finally, practitioners should include a provision in the agreement that states spousal support will terminate at the death of

the payee spouse, i.e., "Spousal support payable by Respondent to Petitioner shall continue until the death of either party, the remarriage of Petitioner, or further order of Court, whichever shall first occur."

It would behoove all family law practitioners to review their marital settlement agreement templates to make certain they contain spousal support provisions and equalization payment provisions which conform to the requirements contained in *McNealy*.

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