DEATH, REMARRIAGE AND TAXES: ALIMONY

"Collecting more taxes than is absolutely necessary is legalized robbery."

---Calvin Coolidge (1955)

In structuring or negotiating a property settlement or a division of assets, the income tax consequences of such a division of the assets absolutely must be considered. "[T]o ignore tax consequences is to ignore the economic reality of what each party will actually receive. In any event, tax consequences must always be borne in mind by counsel when negotiating settlements and drafting separation agreements" (Crouch, Family Law Checklists). Recognition of the issues is tantamount to success. If a professional has any hesitation concerning the accounting and tax issues in divorce, a good waiver clause for the body of their settlement agreements or employment contract such as the following should be used:

> The parties acknowledge that there are certain tax consequences pertaining to all divorce agreements, but neither party has been provided tax advice with respect to this Agreement from signed counsel of record. Each party has been informed that they should obtain independent tax information from a qualified tax accountant or tax attorney prior to the signing of this document, and each has been given the opportunity to seek said guidance.

One should also make it common practice to refer clients with sophisticated estates to tax attorneys and accountants to double check the tax consequences of a settlement agreement, even if the drafter feels they have a pretty good grasp of the tax related issues. However, the attorney must remember that in every divorce action there are areas involving tax implications and, consequently, tax advice. Certain clients may be entitled to deduct some of their attorney's fees incurred for these purposes, and the waiver clause may preclude a client from deducting a portion of the fees paid unless attributed to the production of taxable income. This will be discussed in more detail below. Remember! Tax related problems do not arise until long after the ink on the divorce is dry, so carefully consider the tax consequences in all divorce actions and make sure your client is informed as to how these real costs will alter their settlement.

1. Review of Types of Alimony in Mississippi Along with Practical Tips for Drafting Comprehensive Settlement Agreements

"More than any other area of family law, alimony is in a state of transition and uncertainty." Deborah H. Bell, *Mississippi Family Law*, p. 229, (2005). The characteristics of an alimony award are amount, duration, frequency, modifiability, tax consequences and terminating events. Advocating a client's prosecution or defense of an alimony position is one that lends itself to some creativity on the part of the practitioner and an array of subtle tools for the savvy.

Permanent Alimony

Permanent Alimony, the most traditional type of alimony, is awarded as a substitute for the marital support obligation, and is modifiable upon a material change in circumstances. Permanent alimony can be awarded to either spouse, including the spouse who was at fault in the divorce. There is, however, a line of cases which holds that an adulterous spouse should only be awarded alimony if they would otherwise be rendered destitute. *Hammonds v. Hammonds,* 597 So. 2d 653 (Miss. 1992). Permanent periodic alimony payments terminate at the death of either party or upon the remarriage of the payee. Permanent alimony is taxable as income to the payee and is a deduction for the payor. The *Armstrong* factors govern permanent alimony awards and include:

1) the parties' income and expenses;
2) the parties' health and earning capacity;
3) the needs of each party;
4) the obligations and assets of each party;
5) the length of the marriage;
6) the presence or absence of minor children in the home, which may require child care;
7) the parties' age;
8) the parties' standard of living during the marriage and at the time support is determined;
9) tax consequences of the spousal support order;
10) fault or misconduct;
11) dissipation of assets by either party; and
12) any other factor deemed to be "just and equitable"

Typically, the uncertainty of permanent alimony is the reason when representing the spouse with money that we attempt to avoid permanent alimony. Also, when one is representing the prospective recipient of alimony, the strongest factor to consider is the likelihood that your client is a candidate for remarriage. The stronger the candidacy, the more likely you will attempt to avoid a modifiable form of alimony and set a type of alimony at a specified amount and for a specified duration.

The following is a typical provision for permanent alimony contained within a Marital Dissolution Agreement:

> The Husband agrees to pay unto the Wife, as a form of permanent periodic alimony, the sum of Three Thousand Dollars and 00/100 ($3,000.00) per month, beginning on July 10, 2008, and continuing on the tenth (10th) day of each and every month thereafter.

Lump Sum Alimony

Lump sum alimony is used as a final one-time settlement in lieu of a continuing obligation, and is generally a fixed, certain sum awarded to a spouse for the purpose of either substituting for part or all of a permanent or rehabilitative alimony award, offsetting the value of assets awarded to the other spouse to achieve equitable distribution, functioning as an equitable award to a spouse who made substantial long-term efforts to the marriage, but whose efforts cannot be repaid through property division, or bringing "finality to the economic relationship between parties." The award of lump sum alimony is final, and never modifiable, even if awarded in installments. The award does not terminate at remarriage and survives the death of either party as a debt of the payor's estate and an asset of the payee's estate. Lump sum alimony is treated as a property settlement and is paid from the after tax income of the payor and is not taxed as income to the payee. The *Cheatham* factors govern the award of lump sum alimony and include:

1) substantial contribution to the accumulation of the payor's assets by quitting work to become a homemaker or assisting a business;
2) a long term marriage;
3) the recipient spouse has no separate income or the separate estate is meager by comparison; and
4) the recipient would lack financial security without the lump sum award

The following is a typical provision for lump sum alimony contained within a Marital Dissolution Agreement:

> That the Husband agrees to pay unto the Wife, as a form of lump sum alimony, the sum of Three Hundred Sixty Thousand Dollars and 00/100 ($360,000.00), payable in equal monthly installments of Three Thousand Dollars and 00/100 ($3,000.00) per month, beginning July 20, 2008, and continuing on the twentieth (20^{th}) day of each month thereafter for a period of one hundred twenty (120) months or until paid in full.

Obviously, if the payee spouse is receiving a payment over time for a present interest in some component of the marital estate, it is a good idea to use a basic amortization schedule to include a reasonable rate of interest in the lump sum settlement amount. As you can see from the table below, the inclusion of interest can have a significant effect on the monthly payments. However, interest on a payout is also going to entail taxable income to the payee spouse which is not a capital gain- taxed at the recipient spouse's highest marginal tax rate. Further, pursuant to I.R.C. § 163 (h)(1), "no deduction shall be allowed for personal interest paid or accrued during the taxable year." Two possible solutions could be a restructuring of the interest as a deductible interest payment, but this is not usually viable because most situations do not fall into any one of these categories. The other solution is to restructure the payments whereby they meet the alimony requirements under I.R.C. § 71, which is certainly a more likely solution but could shift the tax burden on the entire settlement if the drafter is not careful. Another practice point would be to include a prepayment contingency in the dissolution agreement, as most standard amortization schedules do not automatically include a pre-payment option. See Robert D. Feder & Drew Morris, *Uncle Sam's Share of the Settlement-How Taxes Can Transform Property Distributions,* FAMILY ADVOCATE, Winter 2005- Vol. 27, No. 3at 14-15.

Standard Amortization Schedule

INPUTS		KEY FIGURES	
Loan principal amount	$360,000.00	Annual loan payments	$50,158.92
Annual interest rate	7.000%	Monthly payments	$4,179.91
Loan period in years	10	Interest in first calendar year	$12,416.58
Base year of loan	2008	Interest over term of loan	$141,589.20
Base month of loan	July	Sum of all payments	$501,589.20

PAYMENTS IN FIRST 12 MONTHS

Year	Month	Beginning Balance	Payments	Principal	Interest	Cumulative Principal	Cumulative Interest	Ending Balance
	Jul	$360,000.00	$4,179.91	$2,079.91	$2,100.00	$2,079.91	$2,100.00	$357,920.09
	Aug	$357,920.09	$4,179.91	$2,092.04	$2,087.87	$4,171.95	$4,187.87	$355,828.05
	Sep	$355,828.05	$4,179.91	$2,104.25	$2,075.66	$6,276.20	$6,263.53	$353,723.80
	Oct	$353,723.80	$4,179.91	$2,116.52	$2,063.39	$8,392.72	$8,326.92	$351,607.28
	Nov	$351,607.28	$4,179.91	$2,128.87	$2,051.04	$10,521.59	$10,377.96	$349,478.41
	Dec	$349,478.41	$4,179.91	$2,141.29	$2,038.62	$12,662.88	$12,416.58	$347,337.12
2009	Jan	$347,337.12	$4,179.91	$2,153.78	$2,026.13	$14,816.66	$14,442.71	$345,183.34
	Feb	$345,183.34	$4,179.91	$2,166.34	$2,013.57	$16,983.00	$16,456.28	$343,017.00
	Mar	$343,017.00	$4,179.91	$2,178.98	$2,000.93	$19,161.98	$18,457.21	$340,838.02
	Apr	$340,838.02	$4,179.91	$2,191.69	$1,988.22	$21,353.67	$20,445.43	$338,646.33
	May	$338,646.33	$4,179.91	$2,204.47	$1,975.44	$23,558.14	$22,420.87	$336,441.86
	Jun	$336,441.86	$4,179.91	$2,217.33	$1,962.58	$25,775.47	$24,383.45	$334,224.53

YEARLY SCHEDULE OF BALANCES AND PAYMENTS

Year	Beginning Balance	Payments	Principal	Interest	Cumulative Principal	Cumulative Interest	Ending Balance
2009	$347,337.12	$50,158.92	$26,690.40	$23,468.52	$39,353.28	$35,885.10	$320,646.72
2010	$320,646.72	$50,158.92	$28,620.31	$21,538.61	$67,973.60	$57,423.70	$292,026.40
2011	$292,026.40	$50,158.92	$30,689.28	$19,469.64	$98,662.87	$76,893.35	$261,337.13
2012	$261,337.13	$50,158.92	$32,907.81	$17,251.11	$131,570.68	$94,144.46	$228,429.32
2013	$228,429.32	$50,158.92	$35,286.72	$14,872.20	$166,857.40	$109,016.66	$193,142.60
2014	$193,142.60	$50,158.92	$37,837.60	$12,321.32	$204,695.00	$121,337.98	$155,305.00
2015	$155,305.00	$50,158.92	$40,572.88	$9,586.04	$245,267.88	$130,924.02	$114,732.12
2016	$114,732.12	$50,158.92	$43,505.90	$6,653.02	$288,773.78	$137,577.04	$71,226.22
2017	$71,226.22	$50,158.92	$46,650.94	$3,507.98	$335,424.72	$141,085.02	$24,575.28
2018	$24,575.28	$25,079.46	$24,575.28	$504.18	$360,000.00	$141,589.20	$0.00

Rehabilitative Alimony

Rehabilitative alimony functions similarly to permanent alimony, with the exception that rehabilitative alimony has a fixed ending date and is not intended as a equalizer between parties. Rehabilitative alimony is generally awarded to provide transitional support to a spouse who has the potential to reenter the workforce, and is an “equitable mechanism which allows a party needing assistance to become self-supporting without becoming destitute in the interim.” *Hubbard v. Hubbard*, 656 So. 3d 124 (Miss. 1995). An award of rehabilitative alimony is based upon the same *Armstrong* factors used to award permanent alimony, and is modifiable, based upon a change in circumstances during the term which payment is due. Rehabilitative alimony terminates upon the death of either party, and is therefore taxable as income to the payee; however, whether it terminates upon remarriage is questionable. In previous cases, the Mississippi Supreme Court has held that rehabilitative alimony terminates upon the remarriage of the payee, but in 1999 the Mississippi Court of Appeals held that “automatic termination upon the recipient spouse’s remarriage is not part of the current definition of rehabilitative alimony.”

When representing the prospective payor, rehabilitative alimony should be avoided at all costs. While the stated definition of rehabilitative alimony has a place in Mississippi family law, we have limited case law on the subject and the possibility that it can be extended or converted to periodic alimony is reason enough to keep these awards out of your settlement agreements. See *Oster v. Oster*, 876 So. 2d 428, 431-32 (Miss. Ct. App. 2004). On the contrary, if your representing the non-money spouse, you may consider including what may be deemed to be the ambiguous term of “rehabilitative alimony” if your facts would justify such an award, as a Court may in an eventual modification hearing extend the period of time your client may receive the award or convert the award to permanent alimony or find that the award does not terminate in the event of your client's remarriage.

The following is a typical provision for rehabilitative alimony contained within a Marital Dissolution Agreement:

> The Husband agrees to pay unto the Wife, as a form of rehabilitative alimony, the sum of Three Thousand Dollars and 00/100 ($3,000.00) per month, beginning on July 10, 2008, and continuing on the tenth (10^{th}) day of each and every month for a period of thirty-six (36) months.

Reimbursement Alimony

Reimbursement alimony is generally awarded to a spouse who supported the other through school and whose contributions cannot be recognized through equitable division of property. Reimbursement alimony has the same general characteristics of lump sum alimony, as it is non-modifiable and does not terminate upon the death or remarriage of either party and hence will not be deductible from the gross income of the payor nor includible in the gross income of the payee. The court has not given a specific set of factors governing the award of reimbursement alimony; however, the three main tests appear to be:

1) a spouse's support of the other through school;
2) with the expectation of increased earnings; and
3) a divorce that occurs shortly after schooling and before a financial return on the education is realized

The following is a typical provision for reimbursement alimony contained within a Marital Dissolution Agreement:

> In consideration for the Wife supporting the Husband through medical school, the Husband agrees to pay unto the Wife, as a form of reimbursement alimony, the

> sum of Thirty-Six Thousand Dollars and 00/100 ($36,000.00), payable in equal monthly installments of One Thousand Dollars and 00/100 ($1,000.00) per month, beginning July 1, 2008, and continuing on the first (1st) day of each month thereafter for a period of thirty-six (36) months or until paid in full.

Hybrid Alimony

Traditionally, alimony awards fell into one category or another, and were not allowed to contain elements of both permanent and lump sum alimony. Courts have historically labeled ambiguous awards as permanent, unless the order contains “clear and express” language indicating the award is lump sum alimony and a fixed dollar amount. Mississippi courts do recognize hybrid forms of alimony created by agreement of the parties. In *McDonald v. McDonald*, 683 So. 2d 929 (Miss. 1996), an award for lump sum alimony which terminated at the payor’s death was upheld. Also, the Mississippi Court of Appeals approved an agreement for lump sum alimony that was to terminate at the recipient spouse’s death or remarriage, but which would survive the payor’s death. *Elliott v. Rogers*, 775 So. 2d 1285. The courts have recently gone to certain limits in mixing the traditional characteristics of permanent and lump sum alimony, but parties should proceed with caution in creating hybrid forms of alimony, as it is uncertain to what extent the court will allow these modifications.

The following is a typical provision for hybrid alimony contained within a Marital Dissolution Agreement:

> The Husband agrees to pay unto the Wife, as a form of alimony, the sum of Thirty-Six Thousand Dollars and 00/100 ($36,000.00), payable in equal monthly installments of One Thousand Dollars and 00/100 ($1,000.00) per month, beginning July 1, 2008, and continuing on the first (1st) day of each month thereafter for a period of thirty-six (36) months or until paid in full. Said alimony shall terminate in the event of the remarriage of the Wife, but shall otherwise be

> non-modifiable. Said alimony shall terminate in the event of the death of either party and shall not be payable to the estate of the Wife or from the estate of the Husband, and therefore shall be includable as income to the Wife and deductible as alimony from the income of the Husband.

Practical Application

Both spouses can sometimes benefit from the type of alimony agreed upon or awarded in a divorce based on the possible disparity in the parties' tax rates. For example, in mediation you and the other side are reaching a stalemate with regard to alimony. The Husband is an orthopedic surgeon and the Wife is a stay-at-home mother. The Wife, an RN, intends on getting a job which she can work when the children are in school and visiting their father every other weekend that will pay her $44,000.00 annually. The Husband makes in excess of $500,000.00 per year. Due to the large property settlement and child support, the figure being tossed around with regard to alimony is around $3,000.00 per month. You feel like there is a high possibility that your client will be remarried because of the charming manner that she has handled these difficult circumstances coupled with her new found wealth, and so you are trying to avoid permanent periodic alimony that will terminate upon remarriage. The Husband is also hopeful to avoid paying permanent alimony because he believes that no one would be stupid enough to marry his soon-to-be-ex-wife. Remember, the critical component of customized "alimony" is whether the payments survive the death of the recipient. If they do, they are generally treated as property distribution and not a deduction from the gross income of the payor, which is in this case the Husband. If the payments do not survive the death of the recipient, they will be considered a deduction from the income of the Husband and includable as income to the payee, which is in this case the Wife. For the Husband to pay the Wife $36,000.00 per year with after-tax-dollars at a 40% tax rate (Federal = 35% and State = 5%), the Husband will have to earn

$60,000.00. Conversely, for the Wife to receive the benefit of $36,000.00 annually, if paying taxes upon the funds she would have to make $51,429.00 at her 30% tax rate (Federal = 25% and State = 5%). If the parties are sophisticated enough to understand this phenomenon created by the disparity in their tax rates, they could each share the benefits. For example, the Husband could pay the Wife $55,700.00 and receive these funds as a deduction from his income, which would produce a net benefit to the wife of $38,990.00, which is about $3,000.00 more than she would have otherwise gotten and a saving to the Husband of $4,300.00.

2. Examination of Factors to Qualify Alimony or Separate Maintenance Payments as Deductible

For payments between spouses or former spouses to be considered "alimony" which is deductible for the payor under IRC §215 and includible in the gross income of the payee under § 71 (a), they must file separate tax returns and satisfy all the criteria in § 71 (b), which are as follows:

1. Be made in cash (not property);
2. Be made pursuant to a divorce or separate maintenance decree or written instrument, or written separation agreement;
3. Not be designated anything other than alimony (such as child support);
4. Be made between people living in separate households; and
5. Terminate at the death of the payee

CASH

Payments to a spouse or former spouse must be in cash, which includes checks or money orders. Payments may also be made to someone other than the spouse such as a health-care provider or educational institution, which will be discussed in more detail below.

WRITTEN INSTRUMENT

The term "written separation agreement" is not defined in the Tax Code or regulations. It is sufficient, however, if the writing contains an obvious recognition of the existence of an obligation. Also, the Agreement surprisingly does not have to be valid or enforceable under state law. Typically the requirement of a writing does not cause many problems for the practitioner because in almost all instances people reduce separate maintenance or alimony agreements to writing, and every Mississippi decree would meet this criteria of IRC § 71(b).

The three types of divorce or separation instruments enumerated in the Tax Code are 1) a decree of divorce or separate maintenance or a written instrument incident to such a decree; 2) a written separation agreement, or 3) a decree requiring a spouse to make payments for the support or maintenance of the other spouse. A voluntary payment from one spouse to the other does not qualify nor will an increase in payments pursuant to a divorce or separation instrument.

In *Randall L. Sindelir v. Commissioner* (TC Summary Opinion 2007-136), an oral agreement reduced to writing but never executed did not meet the requirement of a "written instrument", but in *Leventhal v. Commissioner* (TX Memo 2000-92), non-formal correspondence between attorneys was seen as a meeting of the minds which complied with §71(b). Also, in *Ralph F. Osterbauer* (TC Memo 1982-266), a letter directing medical bills be forwarded to the payor was held to be sufficient in that it made an implicit link to an oral agreement. The meeting of the minds appears to override a formal agreement, but the easiest way to avoid uncertainty is through obtaining a court order.

NOT DESIGNATED AS SOMETHING OTHER THAN ALIMONY

Child support is paid from the payor's after-tax-income. Any amounts fixed for the support of the children of the marriage are not included as alimony. An example would be that the "alimony" stopped at the end of the year in which the youngest child reaches age 21.

MADE BETWEEN PEOPLE LIVING IN SEPARATE HOUSEHOLDS

Payments made while the two parties are still occupying the same residence will not be treated as alimony or separate maintenance even when made under a decree of divorce or separate maintenance unless one party is preparing to move from the residence and, in fact, leaves no more than a month after the payment is made. A home will not be considered as two separate households even if the spouses physically separate themselves within the house (Reg. 1.71-1T(b) Q&A 9). There is one exception to the rule disallowing the treatment of alimony payments when spouses are living together. This exception is for payments made pursuant to a written separation or decree described in §71(b)(2)(c) when the parties separate shortly thereafter. These payments may still qualify as alimony or separate maintenance payment even though the payor and the payee are still members of the same household.

TERMINATE AT DEATH OF PAYEE

This is the most important factor and is typically determinative of the tax status of most payments incident to divorce in Mississippi. Payments will not qualify as alimony or separate maintenance unless the requirement to make payments terminates at the payee spouse's death, and there is no liability to make any payment in cash or property to compensate or as a substitute for the alimony after the payee spouse's death. If there is a requirement for the payor spouse to continue to make payments otherwise qualifying as alimony after the payee spouse's death, none of the payments made either before or after the spouse's death will qualify as alimony or separate maintenance payments. While there is no requirement that the agreement states that there is no liability for payments after the payee' s death for the payments to otherwise qualify as alimony, if you intend for these payments to qualify, you should state in the divorce instrument that the payments are to end at the death of the payee.

If it is not specified in the divorce decree that the payments are to end at the death of the payee spouse, state law governs as to whether the payor spouse has any liability to continue the payments after the payee spouse's death. Under state law, the nature of the payment is usually the determining factor as to when the payor spouse's liability to make payments ends. The reasoning behind this difference in income tax treatment is that payments which do not end at the death of the payee spouse, such as lump sum alimony, represent property settlements rather than spousal support or "alimony." The IRS will seek to disqualify payments as alimony if there are payments made after the payee spouse's death which the IRS would suspect are payments as a continuation or substitute for alimony. Any payments which were increased, began, or accelerated because of the payee spouse’s death will be viewed skeptically by the IRS and challenged as to the deductibility as alimony. This provision is an important in that it not only disallows as deductible alimony payments made after the death of the payee spouse, but also all payments made prior to the payee spouse's death. (Reg. 1.71-1T(b) Q&A 10)

3. Tax Implications of Payments to Third Parties and Other Atypical Forms of Alimony

Generally, only cash payments will be treated as deductible alimony or separate maintenance payments. Certain cash payments made to third parties will also be treated as alimony. Therefore, if payments of cash are made to a third party, subject to the terms of a divorce or separate maintenance agreement, and these payments also satisfy the other requirements of alimony or separate maintenance agreements discussed above, then the payments will be treated as alimony and should be deductible by the payor and includible in income by the payee. These type payments may include rent, taxes, home mortgages, medical expenditures and educational costs.

It is also common under the terms of divorce and separate maintenance agreements for the payor to maintain and pay the premiums for life insurance contracts on his or her life. These payments will qualify as deductible alimony <u>if the payee spouse owns the policy</u>. Additionally, it is not uncommon as a part of a divorce or separation agreement for the payor spouse to agree to supply health insurance for the payee spouse. This is particularly true in a case when the payor spouse has previously provided the coverage during the marriage. In this case, premiums paid by the payor spouse for health insurance for the payee spouse should be deductible as alimony as long as the requirement to make the payments is set forth in the divorce decree or separate maintenance agreement. Since the cost of both health insurance and nonpermanent life insurance tends to escalate with time, it may be a smart move for the payor to increase the amount of alimony to the payee and allow the payee to secure their own insurance. The recipient spouse may also feel more secure in this method since they can insure that the payments are made in a timely manner.

Another point of interest is the deductibility of attorney's fees. Fees for the work of a divorce attorney can be deductible only for the rendering of tax advice and with reference to the production of taxable income and only if when combined with other "miscellaneous deductions" exceeds two percent (2%) of the taxpayer's AGI.. This is further subject to other limitations for particular thresholds of income which will decrease the realized deduction. Only fees attributable to alimony which is taxable to the payee qualifies for the production of taxable income, but there are other areas in a standard divorce which involve tax advice according to Christopher Tiso in his article *Are Attorney's Fees Deductible? Not So Fast!,* FAMILY ADVOCATE, Winter 2005- Vol. 27, No. 3at 40-42:

1. The tax implications of the form of alimony provided;
2. The possibility and avoidance of recapture under the rule of recomputation of front-loaded alimony payments in the first three post-separation years;
3. The tax effect of unallocated alimony and child support;
4. The tax impact of child support and its involvement with alimony;
5. The proper structure of temporary alimony;
6. Tax deductibility of a property payout;
7. The tax effect of the distribution of property, including qualified retirement plans and IRAs;
8. The taxability or deductibility of interest payments on installments to equalize distribution of property;
9. The tax consequences of the sale of a principal residence;

10. The deductibility of interest on the mortgage encumbering the marital residence;

11. The transfer or award of stock options;

12. The allocation of the dependency exemption and child tax credit;

13. The execution or refusal to sign a joint tax return; and

14. The deductibility of attorney's fees.

4. The Interplay Between Alimony and Equitable Distribution

As equitable distribution increases, the need for alimony diminishes. However, as is so often the case, when there is little by way of assets to distribute or the assets of the marriage are not liquid, many times there is a need for some form of alimony or as some jurisdictions term "adjusting payments" to simply reach equitable distribution.

The transfer of assets between two parties is normally a taxable transaction. If the transfer of the asset is a sale, then there is either a gain or a loss to the seller which usually must be reported for income tax purposes. If the transfer is a gift between individuals, then there are gift tax consequences for the person making the gift. However, under §1041, transfers between spouses are tax free events for both gift and income tax purposes, and if transfers between former spouses are "incident to a divorce," these transfers are also tax free events.

A transfer between former spouses will be considered to be "incident to a divorce" if (a) it occurs within one year after the date the marriage ceases or (b) it is related to the "cessation of the marriage." Consequently, a transfer of property which occurs within one year of the divorce does not need to be related to the divorce to qualify for §1041.

For a transfer which occurs between one and six years after the conclusion of the marriage, such transfer is treated as related to the ending of the marriage if it is made pursuant to a divorce or separation instrument. Any transfer which is made more than six years after the end of the marriage is presumed to be not related to the cessation of the marriage. However, this presumption may be rebutted if it can be shown that the transfer was made to effectuate the division of property owned by the former spouses at the time their marriage ended.

In planning for the division of property between spouses, one of the most important factors to be considered is the basis of the property in relation to its fair market value. A person's basis in an asset is important for tax reasons because it is what determines the amount of gain or loss when the property is later sold or otherwise disposed. The gain or loss on the disposition of the asset is the difference between the fair market value and the person's basis in that asset. A person's basis in an asset is the cost of the asset less certain adjustments such as depreciation. For example, if Ted purchased property for $10,000 in 1995 and sells it for $18,000 in 2000, his gain on the sale is $8,000 ($18,000 less his basis of $10,000).

If a transfer between former spouses meets the requirements to be a tax-free event, then the spouse who receives the property takes a "carryover basis" in the property. A carryover basis means that the person receiving the property in the transfer takes whatever basis the person transferring the property had in the property. It is not only important to consider the fair market value of an asset but also the asset's basis when dividing marital property. When it is likely that some assets will have to be sold after a divorce in order to payoff debts or to maintain the predivorce standard of living, perhaps the most equitable way to divide the assets would be based on their after-tax value.

"Tax considerations have always been important to family law practice, but with the advent of equitable distribution it becomes absolutely essential that the tax ramifications of property transfers be evaluated with care and outlined to the court with clarity" (L. Golden, Equitable Distribution of Property §8.21 at 270 (1983)).

5. Review of Recent Cases

Okerson v. Commisioner of Internal Revenue, 123 T.C. No. 14 (2004)

The issue at bar in this case involved a State court's intent for a lump sum alimony settlement to be deductible for Federal income tax purposes. The petitioner in this case, John Okerson (Okerson), in accordance with his divorce decree, was ordered to make 113 monthly payments of alimony totaling $117,000 to his ex-wife, and another 42 monthly payments totaling $33,500 to his ex-wife's attorneys as additional alimony. The decree further stipulated that the payments would terminate if Okerman's ex-wife died before the amount was paid in full, but that he would then be required to continue making monthly payments towards the couple's children's education. Additionally, Okerman would still be obligated to make monthly payments to his ex-wife's attorneys until the amount was paid in full, despite his ex-wife's death. In accordance with the divorce decree, Okerman claimed all monthly payments as alimony deductions on his Federal income taxes, which the Internal Revenue Service (IRS) rejected.

In 2004, after Okerman commenced this proceeding challenging the disallowed deductions, the State court issued an order of its intention for all of Ockerman's ordered payments to be deductible for Federal income tax purposes. However, the United States Tax Court disagreed. The Tax court held that in order for an alimony payment to qualify as a deduction for Federal income tax purposes, it must fulfill the requirements set forth in § 71 of the Tax Code. According to § 71, payments may not qualify as alimony if liability to make any payment as a substitute for such payments after the death of the payee. The Tax Court viewed the payments that Okerman was obligated to make upon his ex-wife's death as substitute payments for those which terminated on death. Therefore, the payments made by Okerman failed to meet stated requirements and were not eligible to be claimed as alimony deductions.

In the end, despite the State court's intent, the fact that Okerman was liable for substitute payments meant that he could not deduct any of the year's payments as alimony, even though they would have otherwise been deductible as such. The mere fact that the language of the decree classifies the payments as alimony makes no difference.

Lofstrom v. Commissioner of Internal Revenue, 125 T.C. No. 13 (2005)

The plaintiff in this case, Mr. Lofstrom, transferred a contract for deed to his former wife, Dorothy Lofstrom, in lieu of past and future alimony payments. Following the transfer, Mr. Lofstrom deducted the full value of the contract as an alimony payment on his federal income taxes. The above deduction was disputed by the Internal Revenue Service (IRS), and was the issue at bar in this case.

According to the original divorce decree, Mr. Lofstrom was ordered to pay Dorothy $1,500 per month in alimony. A few years later, on the heels of a State court finding Mr. Lofstrom $18,000 in arrears and a modified reduction in monthly alimony payments, Dorothy agreed to forego all past and future payments owed to her by Mr. Lofstrom in exchange for his interest in a contract for deed valued at $29,000, and an additional $4,000 dollars in cash. Upon filing his federal income taxes in that year, Mr. Lofstrom included deductions for the value of the contract and the $4,000 cash as alimony payments.

The United States Tax Court ultimately held that a contract for deed qualifies as a third party debt instrument, therefore prohibiting it from being deducted as alimony because it does not constitute a cash payment or cash equivalent.

Proctor v. Commissioner of Internal Revenue, 129 T.C. No. 12 (2007)

In accordance with a 1993 divorce decree, the petitioner, Jerome Proctor (Proctor), was ordered to pay 25% of his military retirement pay to his ex-wife. The decree did not however, address whether payments made from Proctor's military retirement were terminable upon the death of the payee or deductible as alimony. Determining whether these payments were deductible was one of the issues at bar in this case.

In order to qualify as alimony, the military retirement payments that Proctor made must meet the four requirements set forth in § 71 of the Tax Code, and the United States Tax Court held that these payments satisfied those requirements. (1) The retirement payments were pursuant to a divorce decree. (2) Although referred to as part of the division of the marital property, the decree did not expressly direct that the payments not be treated as alimony. (3) The parties lived in separate households. (4) Proctor had no liability to make the retirement payments after the death of the payee. Thus, the court found that the payments relating to Proctor's military retirement were deductible as alimony.

Sarchett v. Commissioner of Internal Revenue, T.C. Memo. 2007-180

The issue presented to the Tax Court in this case is whether the petitioner, Toni Sarchett (Sarchett), is entitled to deduct $200,000 in payments that she made to her ex-husband as alimony under § 215 of the Tax Code.

Under the property division section of the original divorce decree, it is stated that Sarchett was obligated to pay her former spouse $225,000, with the first $200,000 to be paid within that first year, in order to equalize the disparity presented in the division of the couple's community property. Sarchett was also ordered to pay permanent alimony to her ex-husband in the form of $4,000 per month, which was modifiable and terminable upon the death of either party or upon the remarriage of the payee. These payments were to be suspended for as long as Sarchett remained in compliance with the equalization payments, but would become due in arrears and be reinstated should she default. Sarchett complied with this order, and deducted the $200,000 in equalization payments as alimony on her Individual Income Tax Return. This deduction was later disputed by the I.R.S. and the reason behind this opinion.

The Tax Court held that the payments ordered by the divorce decree obligated Sarchett to make equalization payments of a fixed amount, which would continue regardless of the death of either party, in order to balance out the disparity in the couple's property distribution. Therefore, the $200,000 that she made in payments are not eligible for deduction.

Perkins v. Commissioner of Internal Revenue, T.C. Memo. 2008-41

The issue before the Tax Court in this case was whether the $26,400 paid to the petitioner, Joyce Perkins (Perkins), from her ex-husband's disability benefits should have been included as alimony in her annual taxable income under § 71(a) & (b) of the Tax Code.

According to the original divorce decree, Perkins' former husband was ordered to pay her 20% of his earned income until the day she reached 59 ½ years of age. These payments were to cease upon the death of either party, as well as upon the payee's remarriage. The decree also stipulated that in the event that Perkins' ex-husband became disabled, she would receive 20% of the disability benefits until the day stated above. Several years later, Perkins' former husband did become disabled, and began receiving payments under his professional disability policy. In accord with the divorce decree, 20% of those benefits ($26,400) were paid to Perkins that year. However, when she filed her federal income taxes that year, Perkins failed to report any of these earnings on her Individual Income Tax Return. The I.R.S. issued Perkins a notice of deficiency, which she petitioned the U.S. Tax Court for redetermination.

As a general rule, payments resulting from a divorce traditionally fall into two categories for Federal Tax purposes. The first is property settlements, which are neither deductible by the payor nor includable as income by the payee. The second is alimony, which is deductible by the payor and includable as gross income for the payee. In order for payments to qualify as alimony for Federal Income Tax purposes, they must fulfill the requirements set forth in § 71(b)(1)(A)-(D). In this case, the first three requirements were clearly met, but the divorce decree failed to state whether payments made from a disability policy were terminable. Due to the decree's silence on this issue, the Tax Court was forced to turn to state law in order to properly characterize the payments at issue.

After analyzing state law on this issue, the Tax Court concluded that the disability payments made to Perkins qualify as alimony. The Court's interpretation of the decree's language was that the payments would serve as an obligation for support, contingent upon her ex-husband becoming disabled, and ultimately would not have survived his death. As a result, all of these payments received by Perkins were taxable as income under § 71.

****THE FOLLOWING ARE SUMMARY OPINIONS, THEREFORE THEY CARRY A LIMITED VALUE OF PRECEDENT****

Webb v. Commissioner of Internal Revenue, T.C. Summary Opinion 2007-91

The issue presented in this case was whether the petitioner, Daniel Webb (Webb), properly deducted payments that he voluntarily made to his former wife as alimony on his Federal Income Tax Return.

Several years after the dissolution of Webb's marriage to his ex-wife, the Superior Court issued a spousal support stipulation. The order left the matter of making any future support payments up to the discretion of Webb, while requiring his former wife to include any such payments that he chose to make as earned income. Two years later, Webb decided to pay his ex-wife $2,000 per month, which he deducted and she included on their respective tax returns. However, the I.R.S. ruled this deduction of $24,000 of alimony payments as a deficiency.

Upon reviewing the matter, the Tax Court set forth a Summary Opinion stating that the order in effect complied with all the alimony requirements of § 71 and were properly deductible.

The Court further expressed that § 71 does not require that payments be legally mandated in order to qualify as alimony. The voluntary payments were inside a written document which was the result of a divorce decree dissolving the marriage.

Salzman v. Commissioner of Internal Revenue, T.C. Summary Opinion 2007-190

This issue before the court in this matter is whether the petitioner's spousal support payments were terminable upon the death of his former spouse, due to the fact that the divorce decree was silent on this matter.

According to a contractual agreement regarding spousal support and property division contained in the original divorce decree, the petitioner, William Salzman (Salzman), was ordered to pay his ex-wife $500 per month for no longer than four years. The issue of whether the payments were terminable at death was not specified in the agreement. Salzman complied with the order, and deducted the payments that he made to his former wife as alimony on his Federal Income Tax Return, which was disallowed by the I.R.S.

It was clear that the payments made by Salzman clearly satisfy the first three requirements of § 71, leaving only the issue of § 71(b)(1)(D) for the Tax Court to decide. According to § 71(b)(1)(D), in order for a payment to be characterized as alimony, there must be no liability on the payor to make any future payments upon the death of the payee. In instances where a divorce decree is silent on this matter, payments qualify as alimony as long as they would be terminable under State law.

Upon reviewing the State law, the Tax Court ruled that contractual support payments are governed by the law of contracts, thus they do not terminate upon the death of the payee absent an agreement to the contrary. Therefore, the payments made by Salzman failed to meet the requirement set forth in § 71(b)(1)(D) and were not deductible as alimony.