# Top 10 Spousal Maintenance Tax Rules

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Most family law practitioners are familiar with the general rule that spousal maintenance is treated as income to the recipient (or payee) spouse, and deductible to the payor spouse. However, many practitioners are not as well-versed in the finer nuances in the Internal Revenue Code (IRC) that must be followed in order for this general rule to apply. This article will dissect the rules that must be satisfied in order for spousal maintenance to be deemed taxable to the recipient spouse and thus tax deductible by the payor spouse.

Before we begin, it is important to know that the Internal Revenue Service (IRS) does not require that a payment be specifically referred to as spousal maintenance (or alimony/spousal support) in an agreement or order. The IRS only looks to see whether the requirements set forth in IRC section 71 have been met. If the agreement or order doesn't comply with all of the requirements in section 71, the IRS could deem the payments to be nontaxable and nondeductible. A stream of payments which conforms with the requirements section 71 will be referred to as "taxable/deductible" and "nontaxable/nondeductible" if the payments do not conform to the requirements of section 71.

To help illustrate the rules outlined within the article, examples are provided using a hypothetical divorced couple, "Ben" and "Jennifer." In each of the examples, assume that Ben was ordered to pay spousal maintenance to, or on behalf of, Jennifer.

**IRC section 71**

**(b) Alimony or separate maintenance payments defined.—For purposes of this section—**

- **In general.**—The term "alimony or separate maintenance payment" means any payment in cash if—
- such payment is received by (or on behalf of) a spouse under a divorce or separation instrument,

- the divorce or separation instrument does not designate such payment as a payment which is not includible in gross income under this section and not allowable as a deduction under section 215,

- in the case of an individual legally separated from his spouse under a decree of divorce or of separate maintenance, the payee spouse and the payor spouse are not members of the same household at the time such payment is made, and

- 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.

## RULE #1: THE PAYMENT MUST BE "CASH"

Checks and money orders payable on demand are treated as cash for purposes of section 71, but spousal maintenance cannot be paid in exchange for services, property, a debt instrument, or for the use of property.

For example, if Ben is awarded the family cabin in a divorce and decides to allow Jennifer to use the cabin, Ben cannot deduct the value of the fair market rent for use of the cabin as a spousal maintenance payment.

## RULE #2: THE PAYMENT MUST BE RECEIVED BY (OR ON BEHALF OF) A SPOUSE OR FORMER SPOUSE

While spousal maintenance is most commonly paid directly to a spouse or former spouse, the IRS allows the payor spouse to make the spousal maintenance payment, or a portion of the payment, to a third party for the benefit of the recipient spouse. "For example, cash payments of rent, mortgage, tax, or tuition liabilities of the payee spouse made under the terms of the divorce or separation instrument will qualify as alimony or separate maintenance payments." This rule is helpful in situations where the payor spouse has guaranteed debts of the recipient spouse because the payor spouse can ensure that the debt is paid in a timely fashion by making the payment directly to the creditor. A

payment to a third party will also qualify as spousal maintenance even if the payment to the third party was not required under the agreement or order so long as the "payment is pursuant to the written request, consent or ratification of the payee spouse."

The IRS also allows the payments that the payor spouse pays for premiums for term or whole life insurance on the payor's life to qualify as payments on behalf of the recipient spouse so long as the payments are required under the terms of the divorce or separation instrument and the recipient spouse is the owner of the policy, the irrevocable beneficiary of the policy, and has all the incidents of ownership under the policy. The payor spouse cannot deduct the premium payments for a life insurance policy that the *payor spouse* continues to own after the divorce, even if that policy is used to secure the payor spouse's spousal maintenance obligation.

However, there is an **exception to Rule #2**. "Any payments to maintain property owned by the payor spouse and used by the payee spouse (including mortgage payments, real estate taxes and insurance premiums) are not payments on behalf of a spouse even if those payments are made pursuant to the terms of the divorce or separation agreement." Id.

Practice Tip: An easy way to remember this exception is to recognize that the IRS won't provide a spousal maintenance tax deduction to the payor spouse if the payor spouse will also benefit from payment.

For example, Ben purchased a house before he married Jennifer, and the house and mortgage are only in Ben's name. At a temporary hearing, Jennifer was awarded exclusive use and occupancy of the house. Even if Ben was ordered to continue making the mortgage payments on Jennifer's behalf, Ben cannot take the spousal maintenance deduction for paying the mortgage.

In the reverse situation, where Jennifer purchased a house before she married Ben and the mortgage was only in her name, Ben would be entitled to take the spousal maintenance deduction if the parties agreed or the order required that Ben would make the mortgage payments directly to the mortgage company. In this scenario, Jennifer could still take the itemized deduction for the mortgage interest and property taxes paid, since the payments were made with her spousal maintenance money.

If Ben and Jennifer equally owned the home or are jointly obligated on the mortgage, and the agreement or order requires Ben to pay the mortgage as spousal maintenance on behalf of Jennifer, the IRS will only recognize one-half of the payments as tax-deductible spousal maintenance. In this situation, both Ben and Jennifer could each deduct one-half of the mortgage interest.

Please note that in order for a party to deduct mortgage interest, the house must be his or her qualified residence under IRC section 163, subdivision (h)(4). However, a party who has not resided in the house for more than two years can still take the mortgage interest deduction if the spouse or former spouse is granted use of the property under a divorce or separation instrument. When parties have been physically separated for a while before initiating the divorce process, it is important to affirmatively award exclusive use and occupancy of the house to the spouse who did not move out in order to ensure that both spouses will still qualify for the mortgage interest deduction and the capital gains exclusion under section 121.

The IRS has different rules for the payment of property taxes in the form of spousal maintenance. If Ben and Jennifer hold the home in *joint tenancy*, none of the property tax payments will qualify as tax-deductible spousal maintenance, but Ben can take an itemized deduction for *all* of the property taxes. If the parties hold the home as *tenants in common*, Ben can treat one-half of the payment as tax-deductible spousal maintenance and he may claim one-half of the property taxes as an itemized deduction.

Under Minnesota law, a marriage dissolution automatically severs all joint tenancy interests in real property between the parties to the marriage unless the decree specifically provides that the parties shall continue to hold their interest in the real property as joint tenants. Once the joint tenancy is severed, the parties hold title to the real property as tenants in common.

## RULE #3: PAYMENTS MUST BE PURSUANT TO A WRITTEN DIVORCE OR SEPARATION INSTRUMENT

The IRS requires that agreements or orders to pay spousal maintenance be in writing in order to be deemed taxable/deductible.

**IRC section 71(b)(2) Divorce or separation agreement.**—The term “alimony or separate maintenance payment” means any payment in cash if—

- A decree of divorce or separate maintenance or written instrument incident to such a decree, or
- A written separation agreement, or
- A decree (not described in subparagraph (A)) requiring a spouse to make payments for the support or maintenance of the other spouse.

Under subdivision (b)(2)(A), a “decree of divorce or separate maintenance” means a divorce or legal separation.

Under subdivision (b)(2)(B), there does not have to be a formal court order so long as there is a written agreement between the parties (or their attorneys) that one spouse will pay spousal maintenance to the other. A letter or e-mail from one spouse to the other which proposes spousal maintenance terms will not qualify as a written agreement, even if the other spouse acquiesces and receives the payment, unless the second spouse agrees to the terms in writing.

A voluntary payment from the payor spouse to the recipient spouse will not qualify as tax-deductible spousal maintenance if there was not a written agreement. Likewise, any amounts paid in excess of the amount in the agreement in order will not be tax deductible.

The subdivision (b)(2)(C) type of divorce or separation instrument includes a temporary support order.

Under all three subdivisions, the written agreement or court order must be in place *before* the payments are made in order for the spousal maintenance payments to be tax deductible. The agreement or order cannot retroactively characterize prior payments as spousal maintenance. An exception to this rule is when a nunc pro tunc order retroactively corrects a clerical error to reflect the true intention of the court at the time it was rendered.

## RULE #4: THE AGREEMENT OR ORDER CANNOT SAY THAT THE PAYMENTS ARE NONTAXABLE/NONDEDUCTIBLE

If the parties or the court specifies that the payments are nontaxable/ nondeductible, the parties can't later change the classification of the payment, and a copy of the agreement or order must be attached to the recipient's tax return each year the designation applies. If different types of payments are made pursuant to the agreement or order, each type of payment is analyzed separately to determine its proper characterization.

Practice Tip: If the payor spouse is obligated to make different types of periodic payments to the recipient spouse, such as child support or a property settlement paid out over time, it is important to specify the amount that is taxable/deductible spousal maintenance versus the amount that is non-taxable/non-deductible child support, etc.

For example, Ben and Jennifer specified in their divorce decree that Ben would pay to Jennifer $10,000 of non-taxable/non-deductible spousal maintenance each month for five years. Ben can't change his mind in the third year and deduct the payments from his income, even though the payments would have qualified as tax-deductible spousal maintenance payments under section 215 if the parties hadn't made this designation in their divorce decree.

## RULE #5: THE PARTIES CANNOT LIVE TOGETHER

In order for the payments to qualify as taxable/deductible spousal maintenance, the parties cannot live in the same household, even if they physically separate themselves within the dwelling.

There are **exceptions to Rule #5.** The parties are allowed to live together if they are not yet legally separated or divorced. In addition, the "spouses will not be treated as members of the same household if one spouse is preparing to depart from the household of the other spouse, and does depart not more than one month after the date the payment is made."

## RULE #6: THE PAYMENTS MUST END UPON THE DEATH OF THE RECIPIENT

The recipient spouse's need for spousal maintenance terminates upon his/her death and thus the obligation to pay spousal maintenance also must end upon the recipient spouse's death. Conversely, a property settlement creates a vested property right that can be transferred on death. If the spousal maintenance payments do not end upon the recipient spouse's death, none of the payments made before (or after) the death of the recipient spouse qualify as tax-deductible spousal maintenance.

## RULE #7: THE PAYMENTS CANNOT BE DISGUISED CHILD SUPPORT

When there is a significant difference in incomes between the payor spouse and the recipient spouse, and thus a significant difference in tax brackets, some families negotiate "family support" instead of a combination of taxable/deductible spousal maintenance and child support (which is tax neutral) so that the entire payment is deductible/taxable. The difference in the parties' tax rates creates more cash flow for the family because the payor spouse will have a greater savings from the tax deduction than the recipient will owe from the liability on the additional income. When employing this strategy, the family law practitioner must be careful not to run afoul of the bright-line rules established by the Internal Revenue Code and the Treasury Regulations.

**IRC section 71**

**(c) Payments to support children.—**

- **In general.**—Subsection (a) shall not apply to that part of any payment which the terms of the divorce or separation instrument fix (in terms of an amount of money or a part of the payment) as a sum which is payable for the support of children of the payor spouse.

- **Treatment of certain reductions related to contingencies involving child.**—For purposes of paragraph (1), if any amount specified in the instrument will be reduced—

  - 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

  - 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 the children of the payor spouse.

- **Special rule where payment is less than amount specified in instrument.**—For purposes of this subsection, if any payment is less than the amount specified in the instrument, then so much of such payment as does not exceed the sum payable for support shall be considered a payment for such support.

If a payment that is designated as spousal maintenance reduces or terminates upon some contingency relating to the child, such as attaining a specified age or income level, dying, marrying, leaving school, leaving the spouse's household, or gaining employment, the payment must be treated as disguised child support and should not be deducted as spousal maintenance. This is true even if the event is unlikely to occur.

There are two situations in which a contingency will be presumed to be clearly "relating to the child". The first situation is where the payments are reduced within six months before or after the date on which the child attains age 18, 21, or the local age of majority. The second situation arises when there are two or more children and "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 must be the same for each such child, but need not be a whole number of years. If multiple reductions in spousal maintenance occur when the children

are between the ages of 18 and 24, you must be careful that the reductions do not coincide with the children reaching that same age (within a year before or after the age).

For example, Ben and Jennifer have two children, Matt and Katie, and Ben is paying $5,000 per month in spousal maintenance to Jennifer. Ben's spousal maintenance obligation is scheduled to be reduced to $4,000 per month when Matt turns 22 years and 4 months, and to $3,000 per month when Katie turns 23 years and 1 month. If the presumption that the reduction related to the child isn't rebutted, the payments under the divorce decree equal to the sum of the reduction will be treated as child support and will not be tax deductible as spousal maintenance. In this example, unless this presumption is rebutted, $2,000 of Ben's monthly spousal maintenance obligation will be presumed to be disguised child support because the age, 23 years and 1 month, is within one year of the age, 22 years and 4 months. Due to the complexity of this rule, practitioners need to take special care when advising clients about multiple spousal maintenance reductions when there are two or more children from the marriage. Please refer to Treasury Regulation section 1.71-1T(c), Q&A, A-18 for more detail on this rule and an additional hypothetical or discuss the same with a tax advisor.

The presumptions in these two situations may be rebutted by showing that the time at which the payments were reduced was determined independently of any contingencies relating to the children of the payor spouse. For example, a reduction that is triggered by the recipient spouse's cohabitation with another adult may rebut the presumption that the excess payment was deemed child support—despite a child having turned 18 within 6 months of the cohabitation.

Note that if the payor spouse has both a spousal maintenance obligation and a child support obligation, and he or she makes a partial payment, the IRS will allocate the payment to the child support obligation before the spousal maintenance obligation.

## RULE #8: THE PARTIES CAN'T FILE JOINT TAX RETURNS

In order for the payor spouse to deduct the spousal maintenance payments, the parties must file separate tax returns, regardless of whether their divorce is final.

## RULE #9: THREE-YEAR RECAPTURE RULE FOR FRONT-LOADED SPOUSAL MAINTENANCE

In order to discourage parties from disguising property settlements as spousal maintenance, Congress has imposed a three-year recapture rule which is directed primarily at spousal maintenance *reductions* which exceed $15,000 during the first three post-separation years.

**IRC section 71**

**(f) Recomputation where excess front-loading of alimony payments**

- **In general.** If there are any excess alimony payments—
  - the payor spouse shall include the amount of such excess payments in gross income for the payor spouse's taxable year beginning in the 3rd post-separation year, and
  - the payee spouse shall be allowed a deduction in computing adjusted gross income for the amount of such excess payments for the payee's taxable year beginning in the 3rd post-separation year.
- **Excess alimony payments.** For purposes of this subsection, the term "excess alimony payments" mean the sum of—
  - the excess payments for the 1st post-separation year, and
  - the excess payments for the 2nd post-separation year.
- **Excess payments for 1st post-separation year.** For purposes of this subsection, the amount of the excess payments for the 1st post-separation year is the excess (if any) of—
  - the amount of the alimony or separate maintenance payments paid by the payor spouse during the 1st post-separation year, over
  - the sum of—
    - the average of—

- the alimony or separate maintenance payments paid by the payor spouse during the 2nd post-separation year, reduced by the excess payments for the 2nd post-separation year, and

- the alimony or separate maintenance payments paid by the payor spouse during the 3rd post-separation year, plus

- $15,000.

- **Excess payments for 2nd post-separation year.** For purposes of this subsection, the amount of the excess payments for the 2nd post-separation year is the excess (if any) of—

- the amount of the alimony or separate maintenance payments paid by the payor spouse during the 2nd post-separation year, over

- the sum of—

- the amount of the alimony or separate maintenance payments paid by the payor spouse during the 3rd post-separation year, plus

- $15,000.

Practice Tip: A good rule of thumb is to calculate whether the payments made in the third calendar year are no more than $15,000 less than the payments made in the second year *and* whether the payments made in the second year are no more than $7,500 less than the payments made in the first year. If the payments have been reduced by less than these thresholds, there will not be alimony recapture.

Below is a helpful worksheet from IRS Publication 504 to determine whether there is any alimony recapture:

**ALIMONY RECAPTURE CALCULATION**

1

Alimony paid in **2nd year**

2

Alimony paid in **3rd year**

3

Floor

**$15,000**

4

Add lines 2 and 3

5

Subtract line 4 from line 1*

6

Alimony paid in **1st year**

7

Adjusted alimony paid in **2nd year** (line 1 less line 5)

8

Alimony paid in **3rd year**

9

Add lines 7 and 8

10

Divide line 9 by 2

11

Floor

**$15,000**

12

Add lines 10 and 11

13

Subtract line 12 from line 6*

14

**Recaptured alimony.** Add lines 5 and 13**

*Do not enter less than $0 on any line.

**If you deducted alimony paid, report this amount as income on Form 1040.

If you reported alimony received, deduct this amount on Form 1040.

Example: Ben pays Jennifer spousal maintenance as follows:

- Commencing January 1, 2010 and continuing until December 31, 2010: $3,000 per month;
- Commencing January 1, 2011 and continuing until December 31, 2011: $2,000 per month; and
- Commencing January 1, 2012 and continuing thereafter: $1,000 per month.

| | | |
|---|---|---|
| 1 | Alimony paid in **2nd year** | $24,000 |
| 2 | Alimony paid in **3rd year** | $12,000 |
| 3 | Floor | **$15,000** |
| 4 | Add lines 2 and 3 | |

$27,000

5

Subtract line 4 from line 1*

$0

6

Alimony paid in **1st year**

$36,000

7

Adjusted alimony paid in **2nd year** (line 1 less line 5)

$24,000

8

Alimony paid in **3rd year**

$12,000

9

Add lines 7 and 8

$36,000

10

Divide line 9 by 2

$18,000

11

Floor

**$15,000**

12

Add lines 10 and 11

$33,000

| 13 | Subtract line 12 from line 6* | $3,000 |
| --- | --- | --- |
| 14 | **Recaptured alimony.** Add lines 5 and 13** | **$3,000** |

The recaptured alimony is treated as income to Ben and as a deduction to Jennifer in the third year.

The three-year period begins with the first calendar year in which a qualifying spousal maintenance payment is made, i.e., none of the above rules are violated. The second and third years are the next two calendar years, regardless of whether any spousal maintenance payments are made during those years.

<u>Practice Tip</u>: Be sensitive to alimony recapture issues when spousal maintenance reductions or non-payments occur because of a modification or failure by the payor spouse to make the payment.

There are **exceptions to Rule #9.** The above recapture rules do not apply in three situations. The first is when the spousal maintenance payments stop by reason of the death of either party or the remarriage of the recipient spouse. The second is when spousal maintenance payments are paid under a temporary order. The third is when the spousal maintenance payments are ordered for at least three years but the payments fluctuate because the payor spouse is ordered to pay a fixed portion of his or her income from a business or property or from compensation for employment or self-employment. This third exception is particularly helpful if there is a genuine possibility that the payor spouse will become disabled due to an illness or accident which would reduce the payor spouse's ability to work.

**<u>RULE #10: THE RECIPIENT SPOUSE MAY BE ABLE TO DEDUCT THE ATTORNEYS' FEES FOR PURSUING SPOUSAL MAINTENANCE</u>**

The general rule is that legal fees related to marriage dissolution are personal and therefore nondeductible. However, legal fees incurred for tax planning and for *obtaining* taxable income (such as spousal maintenance or income from a pension plan) are deductible. Fees incurred for obtaining child support or for resisting spousal maintenance are not deductible.

So long as the recipient spouse is not subject to the alternative minimum tax, he or she may deduct the fees as a miscellaneous itemized deduction, to the extent that the fees coupled with other miscellaneous itemized deductions exceed two percent of the recipient spouse's adjusted gross income.

Failure to follow these 10 rules can create significant adverse tax consequences for your clients. When in doubt, you should always consult with a tax adviser to ensure that your proposed language complies with the requirements in the Internal Revenue Code.