Tax Consequences of Alimony Payments

By Eric Smith

The last thing on most people's minds during a messy divorce is the tax treatment of the support payments that will eventually be made. Unfortunately, many matrimonial attorneys also fail to consider or fully detail the parties' intended tax treatment of these payments. As a result, final settlement agreements between spouses will often provide for different types of support payments (e.g., alimony, child support) from one spouse to the other, but will be silent as to the allocation of such payments and the extent to which such amounts should be tax deductible by the paying spouse. Similarly, prior to a divorce being finalized, it is common for matrimonial judges to issue temporary orders requiring support payments without detailing the proper tax treatment of such payments.

This frequently leaves accountants with the unenviable task of parsing through the settlement agreements or court orders to determine the proper tax treatment. In many circumstances, this results in uncertainty regarding the position taken on the return or a client unexpectedly learning that he is either required to include support received as income or not allowed to deduct support payments made.

When Are Alimony or Support Payments Taxable/Deductible?

Under Internal Revenue Code (IRC) section 71, a payment is treated as alimony or a separate maintenance payment if the following conditions are satisfied: 1) the payment is made in cash; 2) such payment is received by (or on behalf of) a spouse under a divorce or separation instrument; 3) the divorce or separation instrument does not expressly designate such payment as nontaxable to the receiving spouse and nondeductible to the paying spouse; 4) if the spouses are legally divorced or separated, they are not part of the same household; and 5) there is no liability on the paying spouse to make any such payment or substitute payment after the death of the payee spouse. A payment made from one spouse to another that satisfies this definition is taxable to the payee spouse and deductible by the paying spouse. By contrast, if the payment does not satisfy the definition, the payment is neither taxable to the payee nor deductible by the paying spouse.

Specific Requirements of Deductibility

While payments made incident to a divorce or separation may or may not clearly satisfy the requirements of IRC section 71, there are potential pitfalls within each requirement that generally require a CPA to further scrutinize the terms of such payments and the client's circumstances to determine their proper treatment. Some of these potential pitfalls are described below.

Cash payments. As described above, only cash payments qualify as alimony or maintenance payments. Therefore, transfers of services or property other than cash (including a promissory note to pay cash) will not be treated as alimony. A cash payment to a third party at the request of the payee spouse can qualify as alimony or a maintenance payment under certain circumstances. Thus, rent, mortgage, tax, or tuition liabilities of the payee spouse should generally be treated as alimony; however, payments to maintain property that is owned by the paying spouse but used by the payee spouse will not qualify.

Divorce or separation instrument. A divorce or separation instrument can be any of the following: 1) a decree of divorce or separate maintenance or a written instrument that is incidental to the divorce or separation, 2) a written separation agreement, or 3) a decree (other than a decree of divorce or separate maintenance) that requires one spouse to make payments for the support or maintenance of the other spouse. Importantly, this requirement precludes voluntary payments from being treated as alimony or maintenance payments. Therefore, CPAs should always ask to see the date on which the written instrument or decree was executed; payments before that date would be treated as voluntary and would not qualify as alimony or maintenance payments.

Opting out. The requirement that alimony or maintenance payments be included in the payee spouse's return and deducted by the paying spouse is elective; the spouses can designate otherwise-qualifying payments as not alimony or maintenance payments. The designation must be set out in the decree (if payments are made under a decree) or by written agreement between the spouses (if payments are made pursuant to a separation agreement). A copy of the designating instrument must be included with the payee spouse's tax return for each year in which the designation applies.

No liability after payee spouse's death. In order for payments to be treated as alimony or maintenance payments, the requirement of the paying spouse to make such payments must not continue after the death of the payee spouse. If the payments are allowed to continue after the death of the payee spouse, then none of the payments are treated as alimony or maintenance payments, including those made prior to the death of the payee spouse.

IRC section 71 allows the termination of payments to result from the operation of state law; however, the various states differ on the matter. For example, New York Domestic Relations Law provides that the obligation to make maintenance payments terminates upon the death of either spouse. Therefore, it is unnecessary for a separation agreement governed by New York law to also include such a specific provision in order for such payments to qualify as alimony or maintenance payments. In states that do not provide for the automatic termination of maintenance payments, the separation agreement must specifically provide that the payments terminate on the death of the payee spouse. Otherwise, all payments made under such agreement would not qualify as alimony or maintenance payments.

Child support. Child support payments do not qualify as alimony or maintenance payments, and therefore are not deductible by the paying spouse or included in the payee spouse's income. The portion of a payment that is attributable to child support may be designated in the agreement as a fixed amount of money or as a fixed percentage of each payment.

Unfortunately, separation agreements and decrees frequently do not designate what portion of a payment is alimony or child support. For example, an agreement may provide that a spouse is required to pay the other spouse $3,000 per month in combined child support and maintenance. Under those circumstances, CPAs can and should make certain inferences in determining what portion of the payment is child support. First, if the agreement specifies that a payment will be reduced in the event of a certain event relating to a child (e.g., attaining a specified age or marrying), the potential reduction amount is treated as child support on any prereduction payments. Second, if the agreement provides that payments will be reduced at a specified time that can be clearly associated with an event relating to a child (e.g., payments will decline within a specified time of the child reaching the age of maturity), the potential reduction is treated as child support on any prereduction payments.

A Marriage May End, but Taxes Endure

Many individuals and their matrimonial lawyers fail to consider the tax consequences arising from payments made pursuant to a divorce or separation agreement. Even when tax considerations are raised in the divorce or separation agreement, there are numerous pitfalls that may ultimately affect whether alimony or maintenance payments are deductible by the paying spouse or included in the payee's tax return. In those circumstances, it is incumbent on a CPA to understand the terms of the agreement to be able to walk their client through the consequences of these payments. ❑

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