2009

Alimony Treatment for a Single Payment

Douglas A. Kahn
University of Michigan Law School, dougkahn@umich.edu

Recommended Citation

Kahn, Douglas A. "Alimony Treatment for a Single Payment." Tax Notes 125, no. 11 (2009): 1211-5.

Alimony Treatment for a Single Payment

By Douglas A. Kahn

Douglas A. Kahn is the Paul G. Kauper Professor of Law at the University of Michigan Law School.

The author concludes that, contrary to the IRS and the Tax Court's position, a single lump sum payment to a divorced spouse can qualify for alimony treatment in some circumstances subject to the front-loading rules. The author also contends that to conform to the requirement of the alimony provision, a payment of a divorced spouse's legal or medical expenses under a divorce or separation instrument should qualify for alimony treatment even though those payments usually will not satisfy the literal terms of the statute.

Before 1942 alimony paid to a former spouse was not included in the spouse's gross income.[1] In 1942 Congress adopted the antecedent to section 71.[2] Although an alimony[3] recipient must recognize gross income, section 215 provides the payer with a nonitemized deduction for the payment.[4] Therefore, the alimony tax provisions provide a congressionally approved income-splitting arrangement which can benefit the parties by shifting income from a high-bracket taxpayer to one in a lower tax bracket. The parties can divide the resulting savings between them by altering the amount paid to the former spouse.

The alimony provisions were apparently adopted in 1942 because World War II generated a surtax that increased many people's tax liability and reduced their net after-tax income. Income splitting between divorced spouses was adopted to make it feasible for separated spouses to live off of the same income that the couple had before separating. That tax treatment of alimony still exists in the code, although significant changes in the operation of the statutes were made in 1984 and 1986.

Note that the term "alimony" has a special meaning in tax law that is not identical to the use of the term for state law purposes. Thus, an item that is characterized as alimony by state law will not necessarily be characterized as alimony for tax purposes, and vice versa. To qualify as alimony for tax purposes, a payment must be made in cash under a divorce or separate maintenance decree or a

---

[1] *Gould v. Gould*, 245 U.S. 151 (1917); *Douglas v. Willcuts*, 296 U.S. 1 (1935).

[2] All citations to a section number are to sections of the Internal Revenue Code of 1986, as amended.

[3] Section 71 applies to both alimony and to separate maintenance payments. In this article, references to alimony include separate maintenance payments as well.

[4] Section 62(a)(10) makes the section 215 deduction a nonitemized deduction.

written instrument incident to that decree, a written separation agreement, or a decree ordering support or maintenance for a spouse.[5]

In general parlance, alimony refers to support or maintenance provided to a separated or divorced spouse. Congress limited the application of alimony treatment to payments of that nature by denying alimony characterization to payments that appeared more likely to represent property settlements or payments for the support of children of the marriage. The pre-1984 version of section 71 required that the payments be periodic and be in satisfaction of a legal obligation arising out of a marital or family relationship.[6] Those requirements were eliminated in 1984, and there is no requirement that the payments be periodic or that they relate to a legal obligation derived from a marital relationship.[7]

There are provisions in section 71 that are designed to preclude alimony treatment for specific circumstances when it is likely that the payment is a property settlement and not a support payment for the spouse. There is no general provision that excludes a payment from alimony because it looks more like a property settlement. Instead, only those payments that fall within the specified conditions in the statute are precluded from alimony treatment. It is possible, however, that a court or the IRS might be influenced in construing and applying the alimony provisions by its perception that the item in question appears more likely to be a property settlement or more likely to be support for the spouse.

There is no provision denying alimony treatment because an item is a single lump sum payment; those payments will be disallowed only if they run afoul of a provision in section 71. That is one of the consequences of having eliminated the requirement that payments be periodic. The House report on the Tax Reform Act of 1984 contains this statement concerning the amended version of the alimony provisions:

> The committee bill attempts to define alimony in a way that would conform to general notions of what type of payments constitute alimony as distinguished from property settlements and to prevent the deduction of large, one-time lump sum property settlements.[8]

Congress has chosen not to prohibit alimony characterization for one-time lump sum payments, but to deny alimony treatment for part of those payments by adopting a recapture rule — the so-called front-loading rule — if the alimony payment in either of the first two years in which payments are made is significantly larger than the amount of alimony paid in the third year.[9] In the third year, if the front-loading rule applies, the payer spouse is required to take into income an amount equal to some of the deduction he obtained in the first two years of making alimony payments; and the payee spouse is granted a nonitemized deduction for an equal amount of the alimony payments that she took into income in the first two years.[10] The effect of this provision is to reverse the deduction that the payer obtained and the income that the payee recognized for the excessive amount of payments made in the first two years.

Section 71(b)(1)(D) is one of the provisions designed to identify payments that are excluded from alimony treatment because they are more likely to be property settlements. That provision denies alimony treatment to a payment if there is any liability to make the payment after the death of the payee spouse or if, after the death of the payee spouse, there is an obligation to make a payment in substitution for those payments. It is this provision that creates the greatest obstacle for a single lump sum payment, or payments of legal fees incurred in a divorce or of medical expenses. Let us first examine the treatment of a single lump sum payment.

A major case dealing with this issue is *Webb v. Commissioner*.[11] In that case, H and W executed a written separation agreement that required H to pay W a lump sum of $215,000, to be paid on the signing of the agreement. The agreement did not contain a provision terminating H's obligation if W should die before payment was made, nor would local law have done so. The parties executed the agreement and, in accordance with its terms, H simultaneously paid W the required $215,000. Viewing the tax characterization of the payments differently, H sought to deduct the payment as alimony under section 215, and W did not include the payments in her gross income. Taking inconsistent positions, the IRS asserted deficiencies against H and W, both of whom petitioned the Tax Court. The Tax Court sided with W and held that the payments were not alimony so that H was not entitled to a deduction and W had no income. The court held that because the payment would have been required to be made even if W had died after executing the agreement, but before the payment was made, the payment did not constitute alimony because of section 71(b)(1)(D). The court deemed it irrelevant that the payments were made simultaneously with the signing of the agreement that created the liability and that W was alive then. The court indicated that it was influenced in its decision by the fact that the $215,000 payment clearly was not made for the support or maintenance of W. It obviously was a property settlement. The Tax Court's decision was cited with approval by the IRS in TAM 9542001 (July 10, 1995), *95 TNT 206-32*. I will discuss that technical advice memorandum later.

---

[5]Section 71(b)(1)(A) and (2).

[6]*See* reg. section 1.71-1(b)(1)(i).

[7]Temp. reg. section 1.71-1T(a), Q-3 and A-3.

[8]H.R. Rept. No. 98-432, Part II, 1498 (1984).

[9]Section 71(f). As originally adopted in 1984, section 71(f) would have denied an alimony deduction for a payment in excess of $10,000 unless the payment was required to be made in each of six consecutive years. That provision would prevent alimony treatment for that amount of a single lump sum payment that exceeded $10,000. However, that requirement was eliminated by the amendment to section 71(f) that was made in 1986. The only limitation on a lump sum payment is the front-loading recapture rule described in the text.

[10]*Id*.

[11]T.C. Memo. 1990-540; *see also Sperling v. Commissioner*, T.C. Memo. 2009-141, *Doc 2009-13721*, *2009 TNT 114-6*.

While one can sympathize with the court's desire in *Webb* to deny alimony treatment to what obviously was a property settlement, the decision does not comport with the policy of the statute. More importantly, if the reasoning of that case were followed in other circumstances, it would disallow alimony treatment for most of the situations in which Congress intended the provisions to apply.

The literal thrust of section 71(b)(1)(D) is that when a liability is created in a divorce or separation instrument to make payments to a spouse, none of those payments (or substitutes for them) can be payable after the spouse's death. How does that apply to the payments involved in *Webb*? The payments in *Webb* were required to be made simultaneously with the execution of the instrument creating the liability, and W had to be alive to have executed the agreement. Of course, the payment might have been made a few minutes after the execution of the agreement, W could have died in that brief interim period, and the payment would have to be made even though W was no longer alive. There is a twofold problem with construing the provision to apply in that case. First, it is inconsistent with the tax principle treating events that are made under a single plan as having occurred simultaneously even if there was a time lag between their actual occurrences.[12] More importantly, if the court's cramped construction were applied elsewhere, it would eliminate from alimony treatment payments that are clearly made for the support and maintenance of a separated spouse. If so applied, the most common circumstances for which the provisions were adopted would not qualify.

For example, under a divorce decree issued in year 1, H is required to make monthly payments of X dollars to W on the 20th day of each month. H's liability ceases on W's death. The decree does not state that the payment must be made at any specific time of the day for payment. W dies at noon on November 20, year 10, and H makes the required payment at 2 p.m. of that date. Local law provides that if the payment is required to be made on a specified date, it must be made even if the payee spouse is alive for only part of that day and is not alive when the payment is actually made. If the reasoning of the *Webb* decision were applied, not only would the payment made on November 20, year 10, be denied alimony treatment, so would all of the payments that were made to W before that date because there was the possibility that W could die on the day a payment was due before the payment was actually made. That construction unreasonably narrows the scope of the statute.

If an alimony payment is not made on time and if the payee spouse dies before a late payment is made, the IRS implicitly agrees that the liability of the payer to make the payment in arrears to the payee's estate after the payee's death does not trigger the prohibition against a liability being payable after the payee's death. In TAM 9542001,[13] the IRS indicated that a payment after the death of a payee of alimony that was in arrears "is simply a payment made late for an already existing obligation. This obligation must terminate no later than the death of the payee spouse in order to meet the requirement of section 71(b)(1)(D)." That last sentence is bewildering because the liability to pay the amount in arrears did not terminate on the death of the payee spouse. How is that late payment different from the payment involved in *Webb*? The technical advice memorandum attempts to distinguish the late payment from other liabilities that arose before the payee's death "and will continue to exist in the event [the payee] died before [the payer] made the payment." But that assertion fails to distinguish the late payment from the facts of the *Webb* case or from the facts involved in the technical advice memorandum. A payment of alimony in arrears is a payment of a liability that arose before the payee's death that continues to exist after the payee dies. The asserted distinction that the IRS made in the technical advice memorandum applies equally to payments in arrears and to the other situations that it sought to distinguish. Contrary to the IRS's assertion, there is no meaningful distinction.

The only possible distinction with the *Webb* situation is that the payment in *Webb* would not necessarily be deemed to be late if made only a few minutes after the instrument was executed. But lateness is not the critical factor. What should the critical factor be? It cannot be sufficient that a liability arose before the payee's death. If the amount was not payable before the payee's death, the fact that the liability to make a future payment arose before the payee's death cannot be enough to avoid section 71(b)(1)(D). For example, if X is required to pay Y or Y's estate $40,000 a year for 10 years, with no termination if Y dies before the expiration of that period, none of the payments would be alimony because X would be liable to continue to make them if Y died within the 10-year period. X's liability to make payments arose before Y's death, but if Y died within 10 years, payments to be made after her death were not payable before she died. Because it was possible for payments to first become payable after Y died, all of the payments made to Y or Y's estate would not qualify as alimony. The payments that might be made after Y's death would be treated as substitutes for the payments made before Y's death, and so all of them would fail to be treated as alimony.

The critical element that permits alimony in arrears to be paid after the payee's death is that the liability was payable before the payee died, regardless of whether the payment would be labeled as tardy if made later. Similarly, in the *Webb* situation, the $215,000 amount had to become payable while W was still alive, and so the possibility that payment might be made after her subsequent death should not affect the characterization of the payment as alimony.

[12]*See, e.g.,* reg. section 1.351-1(a)(1), effectively treating transfers by multiple parties to a controlled corporation as having been made simultaneously if made under a plan.

[13]That TAM held that the payer spouse's payment of a portion of the attorney fees the payee spouse incurred in a divorce case was not alimony.

While the statute requires that there be no liability to make a payment after death, that language cannot be applied literally without eviscerating the provision. Literally construed, it would deny alimony treatment in any situation in which the death of a payee before receiving a defaulted payment does not discharge the payer of that liability. It is always possible that a typical alimony payment might not be made on time, and there is always the possibility that the payee will not be alive when the payer makes the late payment. If, as is typically the case under local law, the payer's liability to make that late payment is not terminated by the payee's death, a literal construction of the statute would prevent *all* of the payments that were made to the spouse from qualifying as alimony. If a payment could be made after the death of the payee, which would make it a substitute for the liability to make payments while the payee was alive, all of the payments would fail to qualify as alimony. If the statute were so construed, there would be few circumstances in which the alimony provision would apply, and the statute would lose virtually all of its significance.

To give the statute meaningful significance, the language should be construed to require only that the liability be *payable* before the payee's death. That construction conforms to the policy behind the statute. The objection to there being a liability that first becomes payable after the payee's death is that the liability appears more like a property settlement arrangement than a provision for the support of the payee. For convenience, let us refer to the type of expenses for which support or maintenance payments are provided as ''support or maintenance expenses.'' No support or maintenance expenses of a payee can arise after the payee's death, but prior support and maintenance expenses could be unpaid at the payee's death and so still be outstanding. When a payment can first become due after the payee's death, it is likely unrelated to the support or maintenance of the payee.[14] In contrast, a payment that is first due while the payee is alive may very well relate to support and maintenance expenses of that payee, and the subsequent death of the payee before payment is actually made does not indicate that a postdeath payment of that liability is unrelated to support and maintenance expenses that were incurred before that death.

Consider another example of a situation to which the *Webb* rationale would cause an inappropriate result. In Q-7 and A-7 of temp. reg. section 1.71T(b), the regulation provides that alimony includes a payment by the payer spouse to a third party under a written request by the payee spouse if specific conditions are satisfied. Suppose that W complies with that provision and requests H to make a payment to a creditor of W on W's behalf, and H agrees. Let us assume that the agreement constitutes a binding contract. The amount first becomes payable when the contract is made, but it is possible that W could die before H makes the payment. If, under local law, H continues to be obligated to make the payment after W died, the possibility that W might die before payment would prevent the payment from qualifying as alimony. There is no policy reason for disallowing alimony treatment in that case.

Parties in a similar position to the Webbs' can easily finesse the problem created by that case by simply providing in the settlement agreement or divorce decree that no payment will be made if W is not alive. But that makes the *Webb* decision a trap for the unwary. Knowledgeable taxpayers can easily avoid it, but the uninformed can be trapped.

Single lump sum payments such as the one made in *Webb* are almost certainly settlements of the parties' property interests rather than a payment to provide for the support and maintenance of the payee spouse. Congress did not wish property settlements to be treated as alimony. But Congress did not deal with this situation by denying alimony treatment entirely. Instead, Congress chose to prevent alimony treatment for most of a single lump sum payment by reversing most of the tax consequences of treating it as alimony. They accomplished that reversal by adopting the front-loading rules of section 71(f). Instead of a court's resorting to an improper construction of the statute to prevent alimony treatment for lump sum payments, it would be better to adhere to the statutory scheme of denying the benefits of alimony characterization for most of the payment when the front-loading rules apply.

Let us now turn to the treatment of a spouse's payment of the payee spouse's legal expenses that were incurred in a divorce case. Relying on the requirement set forth in section 71(b)(1)(D), the IRS maintains that the payment of those legal expenses does not qualify as alimony.[15] The Tax Court has adopted the IRS's view.[16]

Unlike the case in *Webb*, a construction of section 71(b)(1)(D) that denies alimony treatment to those payments is not unreasonable; but nevertheless, a different treatment is warranted. If a court orders a payer spouse to pay the legal fees incurred by the other spouse in the divorce, the liability to make the payment arises when the court's order is made (or when a written settlement agreement of the parties containing a provision for the payment was executed). Payment of those fees, however, is not due until the attorney bills for the legal services. Unless the attorney's bill already existed when the obligation of the payer spouse first arose, it would be possible for the other spouse to die before the bill is delivered, and then the payment would first become payable after the death of the other spouse. The due date for making the payment cannot arise before the amount of the fee is determined. However, if the court's order or the written agreement stated a specific amount of fee to be paid to the other spouse or in escrow, and if that payment is to be made on the issuing of the order or the execution of the agreement, the payment should then

[14]While it is possible that part of the payments could be for the purpose of satisfying support and maintenance expenses of the payee spouse that were unpaid at the payee's death, it is likely that most or all of the payments have nothing to do with the payee spouse's support and maintenance.

[15]*E.g.*, TAM 9542001.

[16]*Berry v. Commissioner*, T.C. Memo. 2000-373, *Doc 2000-32124*, *2000 TNT 239-11*; *Sperling,* T.C. Memo. 2009-141.

qualify as alimony (for the reasons stated above in the discussion of the *Webb* case).

The payee spouse's legal fees are support and maintenance expenses of that spouse. As a matter of policy, the payer spouse's payment of those expenses should qualify as alimony. The possible death of the payee spouse before the fees become payable does not give an appearance of property settlement to the payment of those fees. The purpose of alimony is to provide the payee spouse the means to meet her living expenses. The attorney fees are one of the spouse's living expenses in that they are part of the cost of terminating an undesirable marital relationship. It would be reasonable and appropriate for the IRS or the courts to give alimony treatment to those payments even though a strict construction of the statutory language provides otherwise. It is not unusual for the IRS to ignore or modify statutory language when the application of that language conflicts with the goals and policy of the statute.[17]

Consider the situation when a payer spouse is required by a divorce decree to pay the payee spouse's future medical expenses, and no provision is made to terminate that liability on the payee's death. The alimony issues concerning payments made under that requirement are identical to those that apply to the payee spouse's legal fees. The payee spouse must be alive to incur a medical expense; but the expenses are not payable until billed; and the payee spouse could die before the bill is delivered. It is obvious that the liability in this case relates to the support of the payee spouse and bears no relationship to a property settlement. Yet, a construction of section 71(b)(1)(D) denying alimony treatment when a liability to make payment is not terminated by the payee's death would prevent alimony treatment for those payments. That situation makes a compelling case for not applying the statute in a manner that frustrates the purpose of allowing the tax treatment accorded to alimony.

If, contrary to the Tax Court cases denying alimony treatment, the payment of a spouse's legal or medical expenses is treated as alimony, and if such expenses are paid in the first two years in which any payments are made to the spouse, the payment of the legal or medical expenses would be vulnerable to recapture through the operation of the front-loading rules. Several exceptions preclude the front-loading rules from applying in circumstances when the presence of larger payments in the first two years is attributable to the occurrence of contingencies over which the payer had no control. One exception is when alimony payments cease because the payer or payee spouse died before the close of the third year or the payee spouse remarried before the close of that year.[18] Another exception excludes from the front-loading rules payments made under a continuing liability of no less than three years to pay a fixed percentage of income from a business or property or compensation from employment or self-employment.[19] One might expect that other circumstances, not mentioned in the statute, in which payments are based on contingencies beyond the payer's control would also be excluded by expanding the statutory exceptions; and the payment of medical or legal expenses would seem to be an appropriate candidate for an expansion. Contrary to that plausible expectation, the temporary regulations state that there are no exceptions to front-loading other than those stated in the statute.[20] While that regulation seems unduly harsh, it is likely valid. Consequently, if, contrary to court decisions, the payment of legal and medical expenses of the payee spouse is treated as alimony, it will be subject to the front-loading rules.

In conclusion, section 71(b)(1)(D) should not be construed to prohibit a liability from continuing to exist after the payee spouse's death if the liability can only first become payable while the payee spouse was alive. Also, a payment of a spouse's legal or medical expenses under a divorce or settlement instrument should be given alimony treatment for tax purposes, even when the payment may not become due until after the death of the payee spouse.

---

[17]*See, e.g.,* Rev. Rul 81-41, 1981-1 C.B. 121, in which the IRS allows the purchase treatment of section 302(b)(2) to a redemption of voting preferred stock of a shareholder who has no actual or constructive ownership of common stock. Such a redemption does not comply with the requirement of section 302(b)(2) that the shareholder's percentage ownership of common stock after the redemption be less than 80 percent of the percentage of common stock that the shareholder held before the redemption. Nevertheless, because the redemption of voting preferred stock does not conflict with the congressional purpose for imposing the requirement of a reduction of common stock, the IRS applies section 302(b)(2) despite that statutory requirement. *See also* prop. reg. section 1.102-1(f)(2) for another example of Treasury's taking a position that conflicts with the express language of a statute.

[18]Section 71(f)(5)(A).

[19]Section 71(f)(5)(C).

[20]Temp. reg. section 1.71-1T(d), A-25.