SECTION A

TAX RULES CONCERNING S/M.

~~ALIMONY AND SEPARATE MAINTENANCE~~

BY MELVIN STERNBERG

Contents

1.

INTRODUCTION

In 1984 Congress mounted its second major attempt at describing the tax treatment of interspousal payments made incident to divorce and separation. Further changes were made with the enactment of the 1987 Tax Reform Act. Basically, alimony and separate maintenance payments remain includible in the gross income of a payee spouse and deductible by the payor. However, many of the standards which must be met to qualify for such treatment were changed by the 1984 legislation and slightly altered yet again in 1986.

2.

COMPARING THE PRINCIPLES OF PRESENT AND PRIOR LAW

Obligatory Payments

It is still required that payments be obligated under the terms of a decree or written agreement, just as under prior law. The three types of instruments pursuant to which a payment obligation must be imposed are the same as those described in the former Code.

(A) A decree of divorce or separate maintenance, or an instrument incident to such a decree

(B) A written agreement between the parties

(C) A support decree

These decrees and agreements are referred to collectively in the revised statute as "divorce or separation instruments."

From Periodic Payments to Terminability of Payments at Payee's Death

Rather than requiring payments to be periodic, the Code now achieves periodicity by mandating that all payments be made expressly <u>terminable upon death of the payee spouse</u>. (The two other common conditions for terminating payments, upon the payor spouse's death or the payee's remarriage, remain available as options for the parties to elect without and adverse tax implications.) Additional ground on which to continue payments are permissible. <u>Should payments be discontinued due to the occurrence of any condition other than the payee's remarriage or either spouse's death</u>, however, a recapture of previously deducted payments may result. If, upon death of the payee spouse, any payments are to continue, or are accelerated, or any transfer or payment to the payee's estate or another person is to be made, then the Code prohibition of substitute payments may be violated. In any such case, some portion or all of the alimony payments that are to be made during the payee's life will be disqualified from includible and deductible treatment; the extent of disqualification in these instances is dependent upon all of the facts and circumstances.

Installment Payments and Property Settlements

Where prior law called for periodic payments and made allowance for installment payments to be treated as periodic, there is no longer any opportunity for unconditional payments. Section 71(b)(1)(D) calls for all payment arrangements to be terminable at the payee spouse's death. This is obviously intended to make it difficult to pass off a property settlement as alimony, notwithstanding that the for support requirement has been eliminated. By calling for payments to be made in cash and imposing payee-death terminability upon them, this objective is fairly assured to be achieved without the old purposive test of whether a support duty is being met by the payments. In light of these codified requirements for alimony treatment, there should no longer be any need for distinctions to be drawn between support payments and property settlements.

As a further bulwark against the deductibility of property settlements, alimony payments made pursuant to pre-1987 instruments were to be made for a minimum term involving six calendar years. Violations of this rule resulted in the denial of includible and deductible treatment for amounts in excess of $10,000 paid during each of the six post-separation years. A revised recapture rule was enacted in 1986, however, and the minimum term requirement was repealed for instruments executed on or after January 1, 1987. Payments made pursuant to post-1986 instruments may decline by as much as $22,500 between the first and third post-separation years, and by as much as $15,000 between the second and third post-separation years, without any recapture consequences.

Deliberate Disqualification of Payments

The Code now provides an outright option in §71(b)(1)(B), whereby the divorce or separation instrument may designate a payment as not includible in the payee spouse's gross income under §71(a) and not allowable as a deduction to the payor under §215(a). This usually undesirable alternative to alimony treatment can be invoked by the parties in a written memorandum making reference to their settlement agreement. Such an election should not affect the availability of alimony treatment for those payments as to which no election is made.

New Methods for Uncovering Child Support

Child support payments remain disqualified from receiving alimony treatment, but the criteria for identifying child support and distinguishing it from alimony were changed markedly by the 1984 legislation. As a result, the prospect of having alimony or separate maintenance payments treated as child support has become a major threat under a new provision. The amount of any reduction in alimony payments that is scheduled to occur in connection with a child's attaining the age of 18, 21 or local majority, or any other specified contingency relating to a child, will henceforth be "treated as an amount fixed as payable for the support of children" and not qualify for includible or deductible treatment. Whenever a child or children of the payor are in the payee spouse's custody, it is necessary to examine very carefully the dates on which a reduction of alimony payments will occur; if payments will drop or stop within six months of a child's eighteenth or twenty-first birthday or the local age of majority, child support will be presumed. Obviously, the dander of a child support characterization is quite great.

3.

GENERAL REQUIREMENTS FOR ALIMONY TREATMENT OF PAYMENTS UNDER POST-1984 INSTRUMENTS

In order for any payment to be taxable to a recipient spouse under §71(a) and thus be deductible by the payor spouse pursuant to §215(a), several requirements must be met.

Payments Must Be Obligated Under a Divorce or Separation Instrument

Just as under prior law, every qualifying payment must be required by the terms of a decree or written agreement. Voluntary payments do not qualify as alimony or separate maintenance.

Payments in Cash

As required by §71(b)(1), payments must be in cash. There appear to be no exceptions, though checks and money orders payable on demand are considered cash for this purpose. Although one objective of the 1984 Act was "to prevent the deduction of amounts which are in effect transfers of property," it would seem acceptable if a cash payment obligation involved a transfer of property -- provided that both spouse's considered (and reported for tax purposes) the transaction as a cash payment and receipt, followed by a sale of property for cash. It could be argued that the substance of this arrangement is a property transfer with the cash aspect susceptible of being disregarded.

No Payment Obligations After Payee Spouse's Death

The divorce or separation instrument should expressly state that "there is no liability for any period after the death of the payee spouse to continue to make any payments which would otherwise qualify as alimony or separate maintenance." The Tax Reform Act of 1986 retroactively repealed a requirement that the instrument itself contain language expressly terminating payments in the event of payee's death, but §71(b)(1)(D) continue to require that there be no obligation if and when the payee dies. An express provision is certainly the most surefire way of satisfying this requirement.

An arrangement for guaranteed payments for a certain term, such as might reasonably re negotiated in order to compensate the payee for property rights recognized under state law, will be rendered completely nonqualifying: "... none of the payments, whether made before or after the death of the payee spouse, will qualify as alimony or separate maintenance payments."

Note that the Code requirement can be satisfied even if the instrument is not explicit on the absence of any postdeath liability to the payee, provided that state law eliminates all liability to make support payments after the payee's death.

Payment Not Designated as Excludible and Nondeductible

A divorce or separation instrument (decree or agreement) can render excludible from income what would otherwise be taxable as alimony to a recipient spouse.

Where the parties have a written agreement between them, any writing signed by both spouses which designates payments as excludible and nondeductible, and which refers to the written agreement, will invoke the disqualifying option of §71(b)(1)(B).

This statutory election under §71(b)(1)(B) opens the door to agreement or decree provisions which can serve to reverse the usually preferable, includible and deductible treatment of payments. An election might be desirable, for example, in the event that the payee spouse's marginal tax bracket were to become higher than the payor's. A designation of payments as excludible and nondeductible may be temporary in its application, covering some years' payments but not others.

Payments Not Child Support

It is a long-standing rule that child support payments do not constitute alimony or separate maintenance. Efforts to maximize the amount of interspousal payments qualifying as includible in the payee's gross income (so as to provide for payor deductibility and thereby take the greatest advantage of any spread between the respective spouse's marginal income tax brackets) have customarily involved blending alimony and child support. However, to do so successfully now presents a major challenge for the draftsperson inasmuch as §71(c)(2) is difficult to sidestep. First, the instrument must not fix an amount or portion of any payment as payable for support of children of the payor spouse. Moreover, if a termination or any reduction in the amount of payments is to occur upon the happening of a specified contingency relating to a child (such as attainment of age 18, 21, or the local majority, or a child's emancipation, marriage or death), or at a time which can be "clearly associated with" such a contingency, then the payments will be treated as child support. To the extent of the amount of any such scheduled reduction in alimony payments that will or may occur upon or in association with an event in the life of a child, alimony treatment will be denied from the outset.

4.

BEWARE OF VOLUNTARY PAYMENTS

One of the real tax traps in the alimony and support payment deductibility is sprung whenever a payment is not expressly obligated to be made pursuant to the terms of a decree of divorce or separate maintenance, a support decree, or a written separation agreement -- whichever it is that controls the parties' rights and duties in any given case.

Note that the existence of a decree or agreement is not enough. For deductibility, the specific payment amount and The time it is to be made must be <u>expressly</u> required by the decree or agreement terms. A dramatic application of this principle is found in <u>Taylor v. Commissioner</u>. A sate court's denial of temporary alimony was there conditioned upon the continuation of voluntary payments already being made by the taxpayer. Obviously, the voluntary payments did not qualify for alimony treatment, but the payor spouse reported the postdecretal payments as deductions on the basis, in effect, of their having been required by a court order. However, because the decree did not actually require such payments to be made, they were held nontaxable to the recipient and nondeductible by the payor. An obvious way to avert such a result would be by obtaining a written separation agreement within §71(b)(2)(B), the form of which may be quite short and the commitment under it fairly general.

Payments are not deductible unless "made in discharge of a legal obligation' <u>at the time they are made</u>." This requirement obviously means that payments made prior to the execution of an agreement, issuance of a decree, or entry of a court order do not qualify as taxable or deductible within §§71 and 215. Moreover, payments made prematurely -- as determined from the directives of an already operative agreement, decree, or order -- are also nontaxable to the recipient and nondeductible by the payor. Moore v. United States illustrates this point. In Moore, an obligor spouse simply prepaid the alimony amount that would have been paid over the course of time pursuant to the interspousal agreement. However, the agreement terms conditioned payments upon the payee spouse's not remarrying. The payee spouse did remarry shortly after receiving the advance payment, thereby rendering the prepayment voluntary in light of all the facts and circumstances. Consequently, the Internal Revenue Service completely denied all alimony deductions, and the court in Moore agreed.

It is imperative that a separation agreement or at least a temporary support order calling for the payments be in effect before the first payment is made. Otherwise, deductibility will be denied to all payments until after the agreement or decree goes into effect. If an interspousal agreement cannot be reached, no payments should be made until a temporary support order is issued.

Write an Agreement Before Writing a Check

Either pressure or moral compulsion might prompt a spouse to make payments before an agreement or decree. But in any such case, a simple writing that functions as both a receipt and an agreement should be considered. The following is an example of such a receipt-agreement:

> Agreement: (H/W) hereby promises to pay (W/H) monthly the sum of $X as support until a final settlement agreement is executed by (H) and (W) or until a court decree or order imposing support payment duties is obtained by either of them, whichever occurs first; provided, however, that no payment duty will continue beyond the life of (H or W, whoever is the payee spouse) in any event.
>
> __________ ________________________ (signature)
> (Date) (W)
>
> __________ ________________________ (signature)
> (Date) (H)

Note that a mere letter reciting the terms of one spouse's unilateral commitment does not suffice. A receipt and brief agreement in writing, complying with §71, would work to render an informal allowance payment deductible.

By the same token, when either an increased or a special supplemental allowance in under consideration, no such payment should be made before a mutual agreement is executed in writing to amend the interspousal agreement if that is the operative instrument. If payments are pursuant to a decree, the securing of a court order that mandates the proposed increase or supplement may be necessary before any extra payment is made, but if the parties mutually agree, it should suffice for them to execute a written agreement providing an increase in support (above the level of court-decreed payments).

Once payments above the level required by a court order have been made, an amendatory order retroactive nunc pro tunc will not be respected for tax purposes to cure the voluntariness of prior payments. Only payments not in excess of the amount required by the then-effective decree or agreement can be taxable to the recipient under §71(a) and deductible by the payor under §215(a).

5.

PAYEE'S DEATH MUST TERMINATE ALL PAYMENT LIABILITIES (WITH NO SUBSTITUTIONS)

Taking the place of former statutory requirements that payments be periodic and for support, there are new safeguards against property settlements qualifying for alimony treatment imposed by the Tax Reform Act of 1984. These require payments to be in cash and made expressly terminable upon the payee's death. The Tax Reform Act of 1986 deleted the requirement that a terminability provision be contained in the divorce or separation instrument itself, but it is nonetheless advisable to include such a provision in order to assure compliance with the §71(b)(1)(D) requirement of terminability.

However, the danger of having payments disqualified by §71(b)(1)(D) must first be averted. Pursuant to that statutory provision, all payment duties must be terminable upon the payee spouse's death in order to qualify as alimony. Be aware that the cost of any failure to comply will involve more than nontaxable/nondeductible treatment of any post-death payment; a corresponding amount of otherwise qualifying payments during the life of the payee spouse will also be denied alimony treatment.

> Illustration: Payments of $10,000 per year are required by the terms of a divorce or separation instrument to continue for three years or until the payee's death, whichever is sooner; in the event of the payee's death, a lump sum payment is to be made, the amount of which will be $30,000 minus the total of payments received by the payee before death.
>
> Note that the annual payments are terminable upon the payee's death. Nonetheless, the overall economic obligation transcends the payee's death. As a result, none of the payments will ever qualify as alimony.

The preceding illustration vividly illustrates the implications of an instrument's failure to comply with §71(b)(1)(D). It serves to point up the need for an express provision in the decree or agreement which clearly states that "anything herein to the contrary notwithstanding, all payment obligations will cease upon the payee's death." There should be little trouble complying with the Code language requiring that "there is no liability to make any ... payment for any period after the death of the payee spouse." Inclusion of a simple provision in the divorce or separation instrument to that effect will suffice.

Substitute Transfer Provisions Disqualify Predeath Payments

The Code prohibition against "any payment (in cash or property) as a substitute for such payments after the death of the payee spouse" can prove troublesome. Regulations interpreting this language threaten to disqualify otherwise includible and deductible alimony payments, under circumstances where a payment or transfer will be treated as a substitute for the continuation of payments.

One example involves as spouse who is obligated by decree to make annual alimony payments of $30,000, terminating at the end of six years or upon the earlier death of the payee spouse. The decree further requires that if any minor children are living in the custody of the payee at such spouse's death, then $10,000 per year is to be paid into a trust for the benefit of such children until the youngest of them attains the age of majority. In analyzing this situation, the regulations state: "These facts indicate that [the payor spouse's] liability to make annual $10,000 payments in trust for the benefit of ... minor children upon the death of [the payee spouse] is a substitute for $10,000 of the $30,000 annual payments to [the payee spouse]." Of significance here is the indication that a payment to some other person -- not the payee's estate -- brings §71(b)(1)(D) into play. Applying the statute in this example results in a disqualification of $10,000 of each year's payments while the payee is alive; only $20,000 per year will obtain alimony treatment. It should be noted that this conclusion does not hinge at all on the fact that benefits inure to children who obviously are natural objects of the payee's bounty.

Any obligation to continue payments after the payee's death, and any duty to initiate payments upon the payee's death, will cause a disqualification in corresponding amounts of predeath payments. Such is the impact of §71(b)(1)(D).

6.

A CHANGE IN MARITAL STATUS COULD DISQUALIFY PAYMENTS

As indicated in §10, payments between members of the same household can qualify for alimony treatment only if those members are not legally separated. Thus, a change in status can obviously bear upon the tax treatment that is accorded payments between parties who are living under the same roof. Relevant state law may also have a bearing upon the tax characterization of payments, in the event of the recipient spouse's remarriage.

If alimony rights cease under local law, there is the danger that any subsequent payments may be regarded as voluntary. In the alternative, a termination of rights to receive alimony might render any further payments nontaxable and nondeductible as child support.

It is important to examine state law closely and be mindful of the local rules relating to support payment obligations when drafting the terms of a divorce or separation instrument. Any payments made after a change in the status of the recipient spouse that affects her or his right to continued alimony under general principles of state law must be made under a binding contractual or judicial decree, the terms of which oblige continuing payments despite the usual local rule. For example, remarriage of a recipient spouse often terminates alimony rights, either according to state law or under the terms of a separation agreement provision. If payments cease, naturally no problem is presented; but ongoing payments raise the issue of whether the payments are either voluntary or have become child support by the change in status under local law, whereupon in either case disqualification of alimony treatment could result.

As a general proposition, state law will respect the spouse's freedom of contract. Accordingly, separation agreement terms should be able to transcend any change in status which might otherwise terminate the obligor spouse's duty to make payments under domestic relations and family law principles. Absent an absolute contractual payment obligation that will override state law provision for its extinguishment upon a change in status, any payments made after such a change in status actually occurs will be voluntary and thus not qualify for alimony treatment.

Taxability to the recipient and deductibility by the payor will generally continue until the right to receive alimony or support is actually extinguished under the local law standard (eg. remarriage of payee).

7.

DIVORCE OR SEPARATION INSTRUMENT: THREE TYPES, COMPARED

In order to be taxable to the recipient and deductible by the payor, a payment must be obligated by the terms of a "divorce or separation instrument." Voluntary payments never qualify.

Section 71 (b)(1)(A) states the requirement and §71(b)(2) contains the definition of divorce or separation instrument by reference to certain decrees and agreements. Brief descriptions of the three classes of such instruments are presented in the three subparagraphs of §71(b)(2), as follows:

(A) A decree of divorce or separate maintenance, or an instrument incident to such a decree

(B) A written agreement between parties

(C) A support decree

Theses are the same types of instruments as were formerly referred to in §71.

Section 71(b)(2)(A) covers payments under a <u>written instrument incident to a divorce</u> or legal separation decreed by a court. There is no need for the court to order any payments, or to make and reference to the written contractual instrument that requires such payments. An instrument may satisfy the <u>incident</u> to requirement of subsection (b)(2)(A) by its referring to (and possible being made contingent upon) the change in marital status that results from a decree of divorce or legal separation.

Supplementing this coverage of payments incident to a change in marital status, §71(b)(2)(B) applies to payments that are required by a written separation agreement. Under subsection (b)(2)(B), there is no need for the contractual writing to <u>be incident to anything</u>, as contrasted with the requirement in subsection (b)(2)(A).

Finally, §71(b)(2)(C) covers payments under a decree of support. There is not need for any legal separation under subsection (b)(2)(C). Under prior law the couple must have been separated and be living apart, but that is no longer the case. As the regulations state,

> if the spouses are not legally separated under a decree of divorce or separate maintenance, a payment under a written separation agreement or decree described in section 71(b)(2)(C) may qualify as an alimony or separate maintenance payment notwithstanding that the payor and

payee are members of the same household at the time the payment is made.

However, membership in the same household, under the 1984 revisions, will disqualify payments once a §71(b)(2)(A) decree is entered.

Where the parties are members of the same household and are also legally separated under a decree or divorced by a decree of divorce or separate maintenance, payments between them will generally be disqualified from receiving alimony treatment.

8.

PAYMENTS ORDERED BY DECREE OF DIVORCE OR SEPARATE MAINTENANCE, OR INSTRUMENT INCIDENT THERETO

The first of three categories of divorce or separation instruments in §71(b)(2) is a "decree of divorce or separate maintenance or a written instrument incident to such decree." This paragraph can only apply when the requisite decree is present. Among the various divorce or separation instruments, only a decree of divorce or separate maintenance renders the parties legally separated, if not divorced.

Whenever the parties are continuing to live under the same roof, albeit that they have separated, it becomes necessary to determine as a preliminary matter whether a decree of separate maintenance effects a legal separation.

Once parties have become legally separated by decree, or divorced, §71(b)(1)(C) imposes an additional requirement upon payments that are intended to qualify as alimony. At that juncture, the parties must no longer be members of the same household. Otherwise, and further payments cannot qualify for taxable and deductible treatment. This problem can only arise when a divorce or separate maintenance decree is entered.

9.

VALIDITY OF DIVORCE OR SEPARATE MAINTENANCE DECREE IS IMMATERIAL

It should not and generally does not matter, for purposes of determining §71(a) applicability, whether the decree of divorce or separate maintenance is valid or unenforceable. The Internal Revenue Service apparently agrees with this reasoning, albeit only to a limited extent. It "will not question for Federal income tax property tax, and insurance premium payments were ruled taxable/deductible only to the extent of the payee spouse's ownership interest in the underlying real estate or insurance policy.)

There is some danger that a temporary support order might fail to make payments terminable upon the payee's death. Then, unless that condition of terminability is supplied by local law, the failure of the order to make all payments conditional upon the payee's surviving (or terminable upon the payee's death) will disqualify the payments.

12.

RECAPTURE OF FRONT-LOADED PAYMENTS

Section 71(f) provides for "recapture" of excessively front-loaded alimony or separate maintenance payments. This is yet another way the Code attempts to bar payments in the nature of property settlements from qualifying for taxable/deductible treatment. Absent some type of recapture rule, the §71(b)(1)(D) requirement that alimony payments be terminable upon the payee spouse's death could be thwarted by a lump sum payment. With a recapture rule in place, the initially taxable and deductible treatment of a lump sum payment can be reversed.

When there is recapture, the payor is required to report some amount of previously deducted alimony as income in the third post-separation year. At the same time, the payee will be granted a deduction of equal amount. To an extent, recapture thereby reverses the earlier tax treatment of the respective spouses. No money changes hands between the parties, however. The payer incurs taxability on income earlier sheltered by an alimony decision, but receives none of the payments back from the payee; when the payee deducts some of the alimony amounts earlier included in income, they are not returned to the payor, either.

The minimum term and recapture rules in former §71(f) (under the 1984 Act) were quite a bit more rigorous than present law. The <u>original recapture period ran for six post-separation years</u>, whereas <u>now it is only three</u>. The front-loading tolerances were also changed. Payments under <u>prior law</u> could decline during the course of the entire recapture period by <u>no more than $10,000</u> with impunity; under post-1986 instruments, alimony or separate maintenance payments may drop by up to <u>$22,500 as between the first and third</u> post-separation years and <u>$15,000 as between the second and third years</u> without occasioning any recapture.

Some vestiges of the earlier recapture rules will continue to haunt pre-1987 instruments, unless such earlier instruments are amended for purposes of making the 1986-revised law control. An amendment would generally be desirable inasmuch as the effect of recapture will be a partial unraveling of the taxable/deductible treatment that presumably is generating tax savings over all.

13.

RECAPTURE TERMINOLOGY/DIFFERENCES UNDER 1984 AND 1986 ACTS

It can facilitate one's understanding of the recapture rules in §71(f) to appreciate that the original thrust of the minimum term and recapture rules as enacted in 1984 was to discourage property settlements from parading as alimony payments. The rules struck out at concentrated or front-loaded early payments because they are most apt to indicate the presence of a property settlement.

The first post-separation year is that calendar year in which the first payment qualifying as alimony is made, although the regulations indicate that a <u>temporary support-ordered payment is not to be taken cognizance of for this purpose</u>.

The initial legislative objective of denying alimony treatment to property settlement remains, although the rigors of 1984 Act law have been ameliorated in several respects. Specifically:

1. The minimum term requirement is repealed for instruments executed after 1986, although it continues to apply with reference to post-1984 instruments

2. The recapture rule is significantly relaxed for all instruments by limiting the relevant period to three post-separation years

3. Greater leniency is extended toward post-1986 executed instruments by allowing recapture-free drops in the payment level of up to $22,500 between the first and third years and up to $15,000 between the second and third years (the former, cumulative $10,000 limitation continues to govern pre-1987 instruments, though only during the first three years)

These changes have by and large blunted the original rules' effect of barring property settlement payments from receiving alimony treatment.

Some additional nomenclature is involved in the recapture rule. The excess payment or excess amount is what gets recaptured as gross income to the payor spouse (and deducted by the payee spouse) in the third post-separation year. Former §71(f)(4)(B) employed the term "computation year," but under the 1986 Code all recapture occurs in the third post-separation year, so the "computation year" reference was dropped from the statute as to post-1986 instruments. Under instruments governed by the 1984 Act, any excess amount of alimony is recaptured in the current computation years, whereas for post-1986 instruments any such excess stands to be recaptured only in the third post-separation year.

Two pairs of Code provisions relate to excess amount calculations. Pre-2987 instruments are governed by the pair comprising former §71(f)(3)(A) and (B); post-1986 instruments come within a pair of 1986 Code provisions, §71(f)(3) and (4).

14.

STEP BY STEP: RECAPTURE FOR POST-1986 AGREEMENTS

It has been observed in the preceding sections that recapture results from a drop in alimony payments. Thus, the recapture rule imposes a retrospective test for determining whether an excess amount of alimony was paid (and deducted) in any prior years. The calculation of an excess amount involves a comparison of the third post-separation year's payment amount with each of the two prior year's payments. Any excess amount(s) which these calculations disclose must be recaptured by being accounted for as an addition to gross income of the payor spouse and as a deduction by the payee. Both of these recapture consequences will occur in the third post-separation year.

There are several sequential steps to follow in applying the recapture rule.

Step 1: Identify the First Post-Separation Year

The first post-separation year marks the beginning of the three-year period of relevance for recapture purposes. According to §71(f)(6), the first post-separation year is that calendar period in which the first payment qualifying as alimony is made. It is therefore necessary to determine when the first payment was made that both qualified as alimony or separate maintenance and was required by the terms of a §71(b)(2)(A) or (B) instrument. The calendar year in which such initial payment was made will denote the first post-separation year for recapture rule application. Note that it does not matter when, during the year, an initial payment was made. For example, if the first qualifying payment under §71 occurred in December of 1990, then the first post-separation year is calendar 1990.

Step 2: Record the Alimony Paid in Each Post-Separation Year

To determine whether there has been an excess payment or excess amount that is subject to recapture, one need only know the amount of alimony actually paid in each year of the relevant three post-separation years. Disregard child support that s nontaxable and nondeductible, disregard as well any payments made pursuant to a §71(b)(2)(C) temporary support order, and record only the amounts qualifying as alimony under §71(a).

Step 3: Calculate Excess Payments for the Second Post-Separation Year

With reference to post-1986 instruments, all recapture calculations are postponed until the conclusion of the third post-separation year. The only years in which "excess alimony payments" could have occurred are the first and second post-separation years. Thus it is necessary to make two calculations in order to determine whether payments dropped by more than the leeway allowed under §71(f). The first such calculation must be made by measuring the amount of any drop-off in alimony payments between the second and third post-separation years, by applying §71(f)(4).

Pursuant to §71(f)(4), subtract the amount of payments made in the third year, plus $15,000, from the amount of payments made in the second year. The remainder, if any, will be "the amount of the excess payments for the second post-separation year," Only if third year payments dropped excessively from the level of second year payments will there be found to be any such excess, that is, where the level of payments dropped by more than $15,000 between the second and third years.

Step 4: Calculate Excess Payments for the First Post-Separation Year

A way of describing the §71(f)(3) computation would be, after reducing the second year's payments amount by any excess determined under §71(f)(4), take one-half the cumulative amount of second and third year payments, add $15,000, and subtract this sum from the payments made during the first post-separation year to determine whether there is any excess for the first year.

Step 5: Combine All Excess Amounts

Finally, add any (f)(3) excess for the first year to any (f)(4) excess for the second year. This addition is in accordance with §71(f)(2)(A) and (B). The payor spouse must report the sum total of excess payments as gross income in the third post-separation year. The payee spouse, in turn, may deduct the same excess payments amount from gross income in the third year.

15.

FORMULAS FOR RECAPTURE CALCULATIONS YEAR BY YEAR FOR POST-1986 INSTRUMENTS

The purpose of this action is to present simple formulations of the statutory recapture rules. It may nonetheless help you to relate these to a hypothetical payments arrangement involving $95,000 of alimony in the first post-separation year, dropping to $80,000 in the second year, and dropping again down to $65,000 in the third year. Assuming timely payments in full, the payment schedule would be:

Post-Separation Year	Qualifying Amount Paid
1	$95,000
2	80,000
3	65,000

In the second post-separation year of a post-1986 instrument, no recapture can occur because all recapture effects are postponed to the third year. Not until the third year when no further payments are expected (usually not until the close of the third year) can recapture calculations be made.

<u>Section 74(f)(4)</u>

First, we must calculate whether there is any §71(f)(4) excess for the second post-separation year.

Formula: Subtract the sum of the third year's payments plus $15,000 from the second year's payments to calculate the excess under §71(f)(4). The calculation under §71(f)(4), using the amounts listed above, is:

$80,000 - ($65,000 + $15,000) = no excess

<u>Section 71(f)(3)</u>

Formula: Average the second year's payments (already "reduced by the excess payments for the second post-separation year") together with the first year's payments, add $15,000 to this average, and subtract the sum from the first year's payments to calculate the excess under §71(f)(3).

The calculation under §71(f)(3) in this case is:

$$\frac{\$95{,}000 - (\$80{,}000 + \$65{,}000 + \$15{,}000)}{(\qquad 2 \qquad)} = \$7{,}500$$

(The result shown in an excess payment for the first post-separation year.)

Both the excess payments under §71(f)(4) and (3) are recaptured. The payor spouse must report the sum total of excess payments in gross income for the third post-separation year. Meanwhile, the payee spouse is entitled to deduct the same amounts from gross income in the third year.

Thanks to the Tax Reform Act of 1986, there are no longer any recapture concerns after the third post-separation year. This is true for pre-1987 instruments and post-1986 instruments alike.

16.

NUMERICAL EXAMPLE OF RECAPTURE FOR A POST-1986 INSTRUMENT

Suppose Gene and Frances separated late in 1986. No payments were made, however, until 1987 when the parties entered into a separation agreement. Actual payments were made pursuant to their written agreement in the following amounts during the years indicated.

Year	Alimony Paid
1987	$36,000
1988	20,000
1989	3,000

The first post-separation year is calendar 1987, when the first qualifying payment within §71 occurred. Given that the relevant instrument was executed and became effective after 1986, the revised recapture rule applies. (It is possible to have the 1986 Tax Reform Act apply to any pre-1987 instrument governed by the Deficit Reduction Act of 1984; this can be accomplished by a simple amendment to the preexisting instrument, whereby the parties express their intent to have Pub L No 99-514, §1843(c)(1) apply.)

The first reference is to §71(f)(4), for purposes of determining whether there were any excess payments for the second year. The formula for doing so involves a straightforward comparison between the second and third year's payments:

Second year payments minus the sum of third year payments plus $15,000 = excess payment

Second year payments		Third year payments plus $15,000		§71(f)(4) excess
		$ 3,000		
		$15,000		
$20,000	-	$18,000	=	$2,000

As this simple calculation shows, there were $2,000 of excess payments in the second post-separation year.

Next, §71(f)(3) is applied to determine whether there were any excess payments for this first year. But as a preliminary step, the excess payment determined under §71(f)(4) must be subtracted from the amount of actual payments made in the second year. This calculation ($20,000 - 2,000 = $18,000) prevents the same $2,000 amount from being recaptured twice. The $18,000 reduced amount of second year payments is now employed in the §71(f)(3) calculation. The statutory formula compares first year payments with the average of second and third year payments:

First year's payments		Average of second and third year payments plus $15,000		§71(f)(3) excess
		($18,000 + $3,000 + 15,000) / 2		
$36,000	-	$25,000	=	$10,500

17.

EXCEPTIONS TO THE RECAPTURE RULE

There are some circumstances in which there will be no recapture simply because the payments are fairly modest in amount or because certain requirements relating to alimony under §71 are not met. For example, under a pre-1987 instrument, unless some payment that qualifies as alimony or separate maintenance is to be made in each of the six post-separation years, there can be no recapture rule application. This is because no payment above $10,000 will be includible or deductible without minimum term rule compliance. Also, if the level of payments during each of the first three post-separation years never exceeds $10,000 in any year (as to a pre-1987 instrument) or $15,000 in any year (as to post-1986 instrument), there can be no recapture.

There are three classes of payments which fall outside the recomputation provisions of §71(f). Two of them have been pointed out previously as well.

Support Payments under a §71(b)(2)(C) Order

Payments pursuant to a court order or decree which des not have the effect of leaving the parties divorced or legally separated are excluded from recapture. Typically, this exception would pertain to temporary support orders, although the order or decree need not be temporary. Any decree or order that requires a spouse to make payments for support to the other spouse may come within §71(b)(2)(C).

Even if support payments made pursuant to court order were to drop precipitously -- as might be the case, for example, if the parties thereafter obtained a decree of divorce or separate maintenance which included no allowance of alimony -- there could be no recapture of the earlier support payments. "The temporary support payments ... would not be recaptured."

Payments That Cease Upon Death or Remarriage

Qualifying §71(a) payments, required under the terms of a §71(b)(2)(A) or (B) type of instrument, face no problems with recapture in the event of a cessation in payments that results from the death of either spouse or remarriage of the payee, that is, assuming occurrences of those contingent events are specified as payment-terminating conditions in the relevant instrument.

Note that the death or remarriage contingencies alone are allowed as the basis for escape from recapture. As the regulations make painfully clear, in the event of decline or termination of payments during the second or third post-separation years for any other reason (including a failure by the payor to make timely payments, a modification of the divorce or separation instrument, a reduction in the support needs of the payee, or a reduction in the ability of the payor to provide support), excess amounts with respect to the prior post-separation year(s) will be subject to recapture.

18.

PRACTITIONER POINTS

The desirability of making payments includible by the payee spouse and deductible by the payor lies in the difference between their respective marginal rates. While the statutory prerequisites to obtaining alimony treatment of payments are reasonably simple, care must be taken that every one of them is met.

1. A written instrument, be it a temporary support order, separation agreement, or decree of divorce or separate maintenance, must mandate that payments be made. No payments beyond those mandated to be paid by the relevant instrument's terms will qualify for alimony treatment.

2. The instrument should expressly provide that all payments are to terminate if the payee spouse dies. No transfer of cash or property can be called for in the event of the payee's death; a provision for any such substitute payment or transfer will have the effect of disqualifying corresponding payments that are to be made during the lifetime of the payee spouse.

3. Qualifying payments may be made between spouses who are living separately within the same household, but only so long as they are not decreed to be divorced or legally separated.

4. For alimony treatment of payment amounts above $10,000 in any year under a pre-1987 divorce or separation instrument (unless it is a support order), some payment must be required to be made in each of six calendar years, starting with that year in which the first payment is made pursuant to the terms of either a separation agreement or a decree of divorce or separate maintenance that is dated before 1987.

5. Payments pursuant to a support order can qualify for alimony treatment despite their being required to be paid only temporarily or for a brief term. However, it may prove disadvantageous to avail of this exception to the minimum term and recapture rules by arranging for such support-ordered payments. In the event further payments are subsequently called for by a separation agreement, or a decree of divorce or separate maintenance that leaves the parties legally separated, or an agreement incident to such a decree, then the payments made under the latter instrument will be subjected to the recapture rule of §71(f) during the first three years of payments thereunder. The period over which support-

ordered payments were made would not count. This problem will be avoided if payments are at first made in accordance with a separation agreement, even if the payments are later required by a divorce or separate maintenance decree; the period of payments per agreement is tacked to the prescribed decretal payment term when testing for front-loading rule compliance. Thus, when payments initially are made pursuant to a support order, the overall period of post-separation payments may consequently be protracted and difficulties encountered in structuring payment terms in any later instrument so as to minimize the exposure to recapture.

6. Recapture was avoided under pre-1987 instruments by limiting the amount of any reduction in each year's payments during the first three years to no more than $10,000. Recapture is avoided under post-1986 instruments by limiting to $22,500 the gap between first and third years' payments, and limiting to $15,000 the drop in the level of payments made from the second year to the third.

19.

CHECKLIST

1. Make no payment without a written obligation to make such payment pursuant to agreement or decree first, as voluntary payments are nondeductible.

2. The controlling decree of agreement terms need not include an express provision for termination of payments in the event of the payee spouse's death, so long as applicable local law assures that result, but it is preferable for the instrument to contain such a provision.

3. Never increase the level of payments without first either obtaining a court order requiring the same or securing a written modification of the agreement pursuant to which payments are being made, so that the increased payment is made under an obligation rather than

voluntarily.

4. While temporary support-ordered payments can qualify for includible/deductible treatment, they will not start the three-year post-separation period running for purposes of the recapture rule.

5. In order to start (and end) the relevant post-separation period as soon as possible, a payment should be made pursuant to a simple agreement entered into when marital difficulties first arise. Promptness of a first payment is especially important if it is late in the calendar year when a breakdown in the relationship develops.

6. A preliminary agreement of separation and support need be little more than a glorified receipt for the first payment with a commitment to make a payment in each of the next two succeeding calendar years or until the payee sooner dies.

7. At worst, recapture of payments or in part will leave the parties with an economic benefit akin to that derived from a rollover tax shelter -- by having moved taxable income into a subsequent accounting period.

8. It is possible to structure cash settlement payments to obtain at least initial treatment of them as alimony.

9. Arrange for a separation agreement payment to be made early on (permissible even while the parties remain members of the same household), so that the portion of the relevant post-separation terms of support payments remaining when the time for any cash property settlement payment is arrived at is short enough so that the payee spouse will be less reluctant to assume the reduced risk of terminability due to her or his death. Where cash property settlement payments are to be divided evenly between the second and third post-separation years, for example, the payee might accept the danger of death terminability if the final year's payment is to be made January 1. This approach also enables the payor to avoid recapture.

10. Payments of arrearages should be provided for in the agreement. It may be appropriate to impose an obligation upon the payor to compensate the recipient spouse for added tax burdens from the resultant lumping of income. The payment that makes up for amounts in arrears, being includible in income when received and deductible in the year paid, can push the payee into a higher tax bracket. Also, remember that includible and deductible arrearage payments in the second year may be recaptured when payments revert to their normal level in the third year.

11. Conditioning payments upon the survivorship of both parties, or upon the payee's not remarrying, is completely accpetalbe from a tax standpoint. The minimum term rule (applicable only to pre-1987 instruments) is not violated thereby, nor is recapture or previously included and deducted payments occasioned if the contingent event occurs.

12. Other contingencies than either spouse's death or payee's remarriage may also be attached to the making of payments over the entire relevant post-separation term. The minimum term rule (applicable only to pre-1987 instruments) is not violated; all payments otherwise qualifying as alimony will therefore be includible and deductible. Occurrence of any such other contingency during the first three post-separation years, which causes a greater than $10,000 overall reduction in annual payments under a pre-1987 instrument, will result in recapture of some previously deducted amounts. (Occurrence of such other contingency in a post-1986 instrument is even less likely to cause recapture.) Even when there is a recapture, however, an economic advantage will have been obtained through deferral of the amount of tax difference between the savings from the payor's initial deduction and the cost of the payee's initial inclusion of alimony when paid and received.

13. Be especially wary of possible child support characterizational consequences when setting the time for any reduction or termination in payments.

14. A provision worth considering for inclusion in the separation agreement in appropriate cases is one that would allow the payor spouse a temporary moratorium in making payments should a decree of divorce or legal separation be entered while the parties are members of the same household. Without such a provision, payments between divorced or legally separated members of the same household would be disqualified from alimony treatment. Alternatively, the payor might go into arrears temporarily until one of the spouses is on the verge of departing from the household in order to preserve the qualified treatment of all payments.

15. Consider amending any pre-1987 instrument that is already subject to the revised §§71 and 215 scheme enacted in 1984, so that the 1986 Tax Reform Act is made applicable, and thereby, reduce the prospect of recapture.