

## **The Prepayment-of-Maintenance Conundrum: Traps for the Unwary**

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It has been said that "it is the curse as well as the fascination of the law that lawyers get to know more than is good for them about their fellow human beings."<sup>1</sup> This truth is driven home daily to family law practitioners, when they learn that their former clients have ill-advisedly varied maintenance provisions contained in separation agreements or permanent orders.

This article explores the potentially disastrous tax consequences that can arise to either or both former spouses resulting from a prepayment of future maintenance or a lump-sum payment of maintenance arrearages. Because a prepayment of maintenance is often embodied in a negotiated post-decree document mandating a lump-sum maintenance payment, recent developments concerning tax consequences of lump-sum maintenance also are addressed. Finally, this article discusses legally acceptable solutions formulated to eliminate or minimize the tax effects of maintenance prepayments.

### **Prepayment of Maintenance**

It is well established that, for tax purposes, alimony or separate maintenance payments are to be included in income by the payee spouse in the year received and deducted by the payor spouse in the year paid.<sup>2</sup> With some exceptions, this general rule applies "[regardless of the method of accounting used by the taxpayer] for maintenance payments paid for the current year, payments to satisfy arrearages or with certain limitations for payments made in advance of their due date."<sup>3</sup>

The tax treatise *Mertens Law of Federal Taxation* warns that "it is not entirely clear to what extent advance payments of alimony are deductible in the year paid."<sup>4</sup> One of the unstated reasons reflected in the treatise for this lack of clarity is the absence of case law and tax regulations addressing this issue.

Using analogy, one reason expressed in the treatise for uncertainty includes the divergence of opinion in the tax courts concerning the deductibility of advance expense payments by cash-basis taxpayers.<sup>5</sup> Some courts have held that advance payments of future expenses are not currently deductible on the theory that an "expense" cannot be incurred or properly deducted until there actually arises a legal obligation to pay.<sup>6</sup> Other courts have permitted current deductibility of prepaid expenses on a limited basis, relying on what is commonly known as the twelve-month rule.<sup>7</sup> This rule permits "an item" to be treated as a currently deductible expense "only if the paid for benefit will be exhausted completely within 12 months after the close of the taxable year."<sup>8</sup>

In addition, prepayments of maintenance may not qualify as alimony for deductibility purposes in the year paid because such payments are not being made in a manner

contemplated "under" a divorce or separation instrument as required by § 71(b)(1)(A) of the Internal Revenue Code ("Code").<sup>9</sup> This does not mean that a prepayment of maintenance will never qualify for deductibility. Rather, the amount of the deduction and the taxable year in which the deduction will be permitted should be consistent with the payment due dates and amount of the obligation as set forth in the decree and separation instrument.<sup>10</sup>

As a consequence of the foregoing uncertainties, the payor spouse may first learn, via an IRS deficiency notice, that his or her maintenance prepayment was not deductible in the tax year in which payment was made, or that the amount of the deduction in the year of payment will be limited by the twelve-month rule.

Moreover, a lesson awaits the wealthy former spouse who calculatingly decides, shortly after the divorce, that it might be advantageous from a tax planning perspective to prepay a several-hundred-thousand-dollar maintenance obligation at the end of the year. Even though, as previously noted, the payor spouse should be precluded from deducting the entire prepayment of maintenance in the year of payment, the payor may nevertheless subject himself or herself to maintenance recapture under the Code limitations on front loading of alimony payments in the first two post-separation years.<sup>11</sup>

Further, the payee spouse who unexpectedly "receives" the prepayment of maintenance may likewise find a tax trap awaiting him or her, resulting from a huge and unplanned-for tax liability.<sup>12</sup> Mertens makes clear that this liability is not excused by the inability of the payor spouse to deduct the prepayment of maintenance. Rather, "amounts received by the payee spouse as alimony or separate maintenance payments must be included in income in the year received, even if not currently deductible by the payor spouse."<sup>13</sup> (However, if the prepayment occurs during the first two post-separation years, an adjustment to gross income is afforded the payee spouse in the year of recapture.)

### **Maintenance/Alimony Arrearages**

There is a general rule that "payments of back alimony are deductible in the year paid and includable in income by the payee spouse in the year received."<sup>14</sup> It is also clear that where the parties agree to a lump-sum settlement of maintenance arrearages, "the settlement payment retains the character of the original payments for which it is substituted, and if the original payment would have qualified as alimony, the payment of the arrearage also qualifies."<sup>15</sup>

However, a circumstance frequently occurs where former spouses, in settling a dispute as to maintenance arrearages, agree to waive future maintenance obligations in consideration for payment of the arrearages. This fact pattern formed the basis of 1967 Revenue Ruling 67-11. The issue addressed by this Revenue Ruling was whether, in light of the waiver of not only past arrearages but a future alimony claim, the entire amount of the lump-sum settlement payment could be deducted in the year paid.<sup>16</sup>

The Revenue Ruling stated that the payor spouse could deduct, in the year paid, the entire lump-sum payment because it was "less than" the total amount of the arrearages.<sup>17</sup> The Revenue Ruling, despite the explicit language of the waiver, also indicated that such payment would be considered a settlement of the arrearages and would not be treated as a prepayment of future alimony.

"Prudent attorneys are well advised to consider including provisions in the separation agreement that address the frequently overlooked issue of prepayment of maintenance."

Despite the passage of time, Revenue Ruling 67-11 still appears to be authoritative law cited with approval in the 1997 version of the Mertens treatise.<sup>18</sup> However, two possible tax traps exist as to maintenance arrearages. First, an inference can be drawn from Revenue Ruling 67-11 that if the amount that is paid by a taxpayer to settle past arrearages is "in excess" of the amount owed, then the taxpayer, under the prepayment rules discussed above, may be limited in the amount that can be deducted for the taxable year in which payment was made. Second, should a lump-sum payment be made during the first two post-separation years to settle a maintenance arrearage, there could be maintenance recapture.<sup>19</sup>

### **A New Wrinkle?**

The Deficit Reduction Act ("DRA") of 1984 eliminated "periodic payments" as an express statutory requirement for an alimony payment to be taxable to the recipient and deductible by the payor spouse.<sup>20</sup> Prior to the enactment of the DRA, the law was that a lump-sum payment, even if designated as alimony, was neither deductible to the payor nor taxable to the payee unless the lump-sum payment was used to satisfy arrearages.<sup>21</sup> (It should be noted that courts have characterized alimony as lump-sum alimony or alimony in gross even if the lump sum is payable in installments.) Despite the DRA, it remains unclear in Colorado whether lump-sum alimony payments should be includable as income by the payee spouse and deductible by the payor spouse even if the lump-sum payment arguably meets all of the current federal statutory requirements for taxable/deductible maintenance.<sup>22</sup>

One of the current statutory requirements pertinent to this article is that the payor spouse "must have no liability to make such payments after the death of the payee spouse (or a substitute payment)."<sup>23</sup> While this termination requirement appears easy to satisfy in Colorado when a payor spouse is making periodic payments of maintenance, there may still exist termination problems in the context of a lump-sum maintenance payment; a lump-sum prepayment of maintenance; and a lump-sum payment settling past, present, and future maintenance obligations.<sup>24</sup> The problem and corresponding tax trap is with the difficulty a payor spouse could have in Tax Court proving that the payor had no liability to make the lump-sum payment after the death of the payee spouse.<sup>25</sup>

The 1997 Tax Court case of *Ribera v. Commissioner* is illustrative of this potential tax trap.<sup>26</sup> In *Ribera*, a divorce court entered an order garnishing the wages of a spouse who had been ordered to pay spousal support. In addition, the court awarded the payee spouse her attorney fees as a result of the payor spouse's hiding and dissipating marital assets. This attorney fee order resulted in a second order for garnishment of the obligor's wages, with the order for garnishment being designated "Earnings Withholding Order for Support." The attorney fee order ultimately resulted in a levy and sale of real estate owned by the obligor. The obligor sought to deduct the lump-sum proceeds of the levy and sale as either payments for arrearages in alimony or as attorney fees that were in the nature of spousal support.

The Tax Court denied the obligor's entitlement to the deduction on two grounds. First, ignoring the maintenance arrearage argument, the court held that the obligor offered no evidence showing that the attorney fee obligation would have ended at his former wife's death. Second, the *Ribera* court held that it is "well settled that the labels which the parties or a state court attach to payments are not conclusive."<sup>27</sup>

Similarly, in the 1995 case of *Barrett v. United States*, an alimony obligor who was in arrears in the amount of \$25,000 negotiated a settlement of the arrearage and a termination of his future maintenance obligation.<sup>28</sup> The settlement document provided for two separate payments to the former spouse of \$50,000 and mistakenly denominated these payments as an additional property settlement. There was also no indication in the settlement document that the liability to make the two payments would terminate at the death of the payee spouse.

The court held that the two payments constituted a lump-sum alimony payment payable in installments. However, the court found, in the absence of termination language in the settlement document, that the liability to make the lump-sum payments would have continued even after the death of the former wife. In order to arrive at this result, the court, under Mississippi law, distinguished between periodic alimony and lump-sum alimony. The court found that periodic alimony is modifiable and that it terminates automatically at the death of the payor or payee, whereas lump-sum alimony, under Mississippi law, is fixed and irrevocable and is unaffected by remarriage or death of the payee spouse. As a result, the court held that even though the lump-sum payment was a form of "alimony" under state law, it was not deductible under federal law.

Further illustrative of the difficulties a payor spouse could have in proving that the payor had no liability to make the lump-sum payment after the death of the payee spouse is the result reached in a 1990 Tax Court Memo entitled *R.J. Webb v. Commissioner*.<sup>29</sup> In this case, the husband, at the time the separation agreement was executed and pursuant to its terms, paid his wife a lump-sum amount of \$215,000. Absent in the agreement was language that the husband's obligation to make this payment would terminate at his wife's death. The husband then sought to deduct the lump-sum payment as alimony and claimed in the Tax Court "that since the cash payment was made simultaneously with the signing of the agreement, no liability arose which would not have terminated at the payee spouse's death."<sup>30</sup>

The Tax Court disagreed with the husband and found that the language of the separation agreement created a liability that would have been enforceable by the wife's estate had she died after the execution of the agreement but before the payment was made. The Tax Court also found that the fact the payment was made at the time of the execution of the agreement or when the wife was alive to be irrelevant. The court reasoned:

To conclude otherwise would cause any cash payment made simultaneously with the issuance of a decree or the execution of an agreement necessarily to be treated as alimony, even though the provisions of the decree or agreement clearly reveal that the payments were lump sum payments for purposes other than support or maintenance.<sup>31</sup>

In light of the holdings contained in the Ribera and Barrett cases, as well as in the Webb Tax Court Memo, the possibility exists in Colorado that a direct or indirect lump-sum maintenance payment that is not expressly contingent in the decree or separation instrument on the payee spouse "being alive" (or similar termination language) at the time payment is made will not qualify as taxable/deductible maintenance.

Additionally, in light of the Colorado Supreme Court holdings in *Carlson v. Carlson* and *Moss v. Moss*,<sup>32</sup> which held that lump-sum maintenance awards were final judgments, it remains unclear in Colorado whether a lump-sum alimony award is subject to the "automatic termination at death" language of CRS § 14-10-122 (2).<sup>33</sup> While the Colorado Supreme Court, in the case of *Sinn v. Sinn*, held that all maintenance orders (including alimony-in-gross orders) are subject to modification under CRS § 14-10-122, the case did not address the termination at death issue as it might pertain to a single lump-sum maintenance payment.<sup>34</sup> Further, the *Sinn* case factually concerned a maintenance-in-gross order that was payable in installments, as contrasted with a single lump-sum payment.

Finally, the case of *Aldinger v. Aldinger* stated that the maintenance modification provisions of CRS § 14-10-122(1)(a) are applicable only to maintenance installments accruing "subsequent" to the motion for modification.<sup>35</sup> Thus, a post-decree single-payment lump-sum maintenance order that is due and payable immediately on the entry of the order and that is being used to prepay or satisfy a future maintenance obligation may very well be enforceable by the estate of the payee spouse. In the absence of language to the contrary, this would, of course, render the lump-sum payment nontaxable and nondeductible.

Further, should the obligor spouse, even with a termination-at-death clause, prepay in a lump sum his or her future maintenance obligation for five years, and then claim a deduction, the Internal Revenue Service may still take the position that no portion of the prepayment is deductible because the contingency of death has been totally eliminated. In other words, there is no longer any contingency because the payee spouse has already received the payment and the payee's death has become irrelevant.<sup>36</sup>

## **Solutions: Good and Bad**

This article has attempted to point out the potentially disastrous tax consequences that can arise to either or both the payor and payee spouse from the prepayment of maintenance. Legal commentators have offered proposed solutions to this frequently overlooked issue.

The Mertens treatise suggests a drafting solution for lawyers representing the payee spouse:

To protect the payee spouse from having to include prepayments of alimony or separate maintenance payments into income in the year received, the divorce or separation instrument should prohibit prepayments that extend beyond the current year and the instrument should provide for penalties in the event such prepayments are made.<sup>37</sup>

A treatise from the DU Graduate Tax Workshop in 1997 likewise suggests the use of penalty language to protect the payee spouse, but, as an alternative, proposes that the separation agreement treat any prepayment of alimony as an interest-free demand loan.<sup>38</sup> However, the DU treatise raises a concern that the interest-free demand loan solution has potential tax consequences and limitations as set forth in Code § 7872, which addresses the tax treatment of loans with below-market interest rates.<sup>39</sup>

Solutions also are offered to the lawyer representing the payor spouse. As previously noted, a prepayment of maintenance may be only partially deductible in the tax year the payment was made because it was not being made "under" (in conformity with) the provisions of the divorce and separation instrument. It also may be rendered nondeductible as a prepaid expense that violates the twelve-month rule. As a solution, the Mertens treatise suggests that:

It may be advisable to include a provision in the instrument allowing prepayment of alimony or separate maintenance payments of up to 11 months after the close of the taxable year. [Citation omitted].<sup>40</sup>

Further, to circumvent the IRS argument raised in the Barrett case that a prepayment of maintenance to settle future alimony obligations was not taxable or deductible alimony because there was no evidence that the alimony would have ended on the death of the payee spouse, one commentator suggests the following solution:

That some time elapse between the date the divorce instrument is executed and the date the lump sum payment is due so there will be some actuarial probability that the payee could die before the prepayment is due. Also, the instrument should state that the obligation to pay terminates if the payee dies before the designated time for payment.<sup>41</sup>

In regard to the tax trap of maintenance recapture that can result from a prepayment of maintenance, the DU treatise advises that "a payor spouse should never prepay alimony (at least in the first two years)."<sup>42</sup>

In addition, in this author's opinion, other solutions exist, such as the payee spouse refusing to accept the prepayment of maintenance or the parties amending or modifying prospectively the maintenance provisions of the prior separation agreement. Further, to circumvent the government argument raised in Barrett that the alimony payment, if in a lump-sum form, is nonmodifiable and is legally payable after the death of payee, the use of two "periodic" payments should be considered in the drafting of the Separation Agreement, with the last payment being contingent on the payee spouse being alive at the time of receipt. Of course, these solutions may occur only to attorneys and not to their former clients.

The attorney representing a client who has imprudently prepaid or overpaid his or her maintenance obligation may be tempted to consider a retroactive (*nunc pro tunc*) modification of the maintenance provisions in the separation agreement or decree so as to obtain the tax deduction for the client. Courts and legal commentators have found such a solution unacceptable.<sup>43</sup> Mertens states:

As a general rule, the prospective effect of a new decree is accepted. However, decrees by courts to determine retroactively the status of payments as alimony are not accepted because the payments were not made under a decree of divorce or separate maintenance.<sup>44</sup>

However, there is an exception to this general rule: "where an amended order (*nunc pro tunc*) retroactively corrects a mathematical or clerical error, the service will recognize the retroactivity of the correction. . . ." <sup>45</sup>

## **Conclusion**

In light of the high cost of divorce litigation, both financial and emotional, the family law attorney should not be surprised to learn that a former client has elected to exercise self-help in modifying a carefully drafted separation agreement. Given the possibility of this occurrence, the prudent attorney would be well advised to consider including provisions in the separation agreement that address the frequently overlooked issue of prepayment of maintenance.

It is well to remember who has the burden of proof in a civil tax case. The Internal Revenue Service's notice of deficiency is presumed to be correct.<sup>46</sup> The taxpayer has the burden of proving the Internal Revenue Service wrong.<sup>47</sup>

## **NOTES**

1. Mortimer, "Rumpole and the Man of God" in *Trials of Rumpole* (N.Y.: Penguin Books Ltd., 1979).
2. Mertens *Law of Federal Income Tax*, Vol. 8, §31A:95 (July 1997) at 31A-167 [hereinafter "Mertens"]. See also IRC §§ 71(a) and 215, and Treas. Reg. §1.71-1(b)(5).

(Taxability under § 71 to the payee is a condition precedent to an alimony deduction under § 215.)

3. Id. at 31A-168; Treas. Reg. § 1.71-1(b)(5).

4. Id. at 31A-168.

5. Id. at Vol. 2, § 12.35 at 78.

6. Id.

7. Id. at Vol. 8, § 31A:95 at 31A-168.

8. Id.; see also *Zaninovich v. Commissioner*, 616 F.2d 429 (9th Cir. 1980), *Bonaire Development Co. v. Commissioner*, 679 F.2d 159 (9th Cir. 1982), Treas. Reg. § 1.461-1(a).

9. Mertens, *supra*, note 2 at Vol. 8, § 31A:95 (July 1997) at 31A-168, n.84. IRC § 71(b)(1)(A) also provides "that the term alimony or separate maintenance payment means any payments in cash if such payment is received by or on behalf of a spouse under a divorce or separation instrument." See also *Blanchard v. United States*, 424 F.Supp. 916, 919 (D.Md. 1976).

10. Vogel, *University of Denver Divorce Tax Workshop Treatise 1997*, Ch. 3 at 3-20.

11. Mertens, *supra*, note 2 at 31A-167, 168; IRC § 71(f)(3). See also Vogel, *supra*, note 10 at 3-20, which states that "the recapture rules should apply if their purpose is to prevent the payor spouse from converting what would otherwise be a property settlement payment into a deductible alimony payment." [Also citing IRC § 71(f)(3).]

12. Mertens, *supra*, note 2 at 31A-168.

13. Id.

14. Id. at 31A-167.

15. Id.

16. Id.; see also Rev. Rul. 67-11, 1967-1 C.B. 15.

17. Rev. Rul. 67-11, 1967-1 C.B. 15.

18. Mertens, *supra*, note 2.

19. Vogel, *supra*, note 10 at S-10 Q&A #27.

20. Deficit Reduction Act of 1984, Pub. L. 98-369, 98 Stat. 795. See also Clark, *The Law of Domestic Relations In the United States* (Practitioner's 2d Ed.) Vol. 2 at 269, which discusses the various forms that alimony may take.

21. Vogel, *supra*, note 10 at 5-2, citing Rev. Ruling 55-457, 1955-2 C.B. 527, *Loverin v. Comm'r*, 10 T.C. 406 (1948); *Olster v. Comm'r*, 751 F.2d 1168 (11th Cir. 1985); *Bernard v. Comm'r*, 87 T.C. No. 65 (1986). See also PLR 964 4071 (Aug. 7, 1996).

22. The Vogel treatise at p. 5-2 suggests there remains uncertainty as to the tax treatment to be afforded a lump-sum alimony payment and that the lump-sum alimony rules in effect before DRA 1984 "might continue to apply." Vogel believes that the "better answer" is that lump-sum alimony is taxable and deductible subject to tax accounting rules, citing PLR 964 4071 (Aug. 7, 1996), where the Service stated that an anticipated lump-sum payment (to be made pursuant to a pre-1984 separation agreement) was nevertheless taxable and deductible as alimony. See also the Colorado Supreme Court cases of *Carlson v. Carlson*, 497 P.2d 1006 (Colo. 1972), and *Moss v. Moss*, 549 P.2d 406 (Colo. 1976), both of which held that an award of alimony in gross is a final judgment that is not modifiable at a later time, which arguably suggests that a lump-sum alimony award may be enforceable by the payee's estate after the death of the payee spouse. But see *Sinn v. Sinn*, 696 P.2d 333 (Colo. 1985), holding that all maintenance decrees including those awarding alimony in gross are "modifiable" under CRS § 14-10-122(1)(a) unless parties otherwise agree under CRS § 14-10-112(6).

23. IRC § 71(b)(1)(D). The other requirements for a taxable/deductible maintenance order are: (1) "the payment must be made in cash"; (2) the payment must be received by the payee spouse or be paid on behalf of the payee spouse; (3) the payment must be paid under a divorce or separation instrument; (4) the divorce or separation instrument must not designate the payment as not includable in the payee spouse's gross income and not deductible by the payor spouse; (5) in the case of an individual legally separated from his or her spouse under a decree of divorce or separate maintenance, the payor spouse and payee spouse may not be members of the same household at the time such payment is made; and (6) the payor spouse and the payee spouse do not file a joint return. Also note that the statute prohibits any further liability to make any payments after death of the payee spouse. "It is the creation of further liability and not a payment after death of the payee spouse that is prohibited." See Vogel, *supra*, note 10 at 3-8.

24. In Colorado, unless otherwise stated in the agreement, all maintenance payments cease on the death of either party or the remarriage of the party receiving maintenance. See CRS § 14-10-122(2). However, see also Frumkes, *Divorce Taxation Handbook* (Lawyers Cooperative Publishing, 1995) at 66, which states: "A caveat is that including the termination language can never do harm. It can only help in that it can ensure that payments will be 'tax safe' for deductibility/taxability. . . . For example, under the laws of most states, lump sum alimony sometimes called alimony in gross 'is not automatically terminable upon the death of the payee.'"

25. See *Ribera v. Commissioner*, T.C. Memo 1997-38; *Barrett v. United States*, 878 F.Supp. 892 (S.D.Miss. 1995); *Stokes v. Commissioner*, T.C. Memo 1994-456 (temporary maintenance order incorporated into settlement agreement without any termination-at-death language coupled with a survivorship clause, evidence of intent for obligation to survive death of payee). See also Moss, *supra*, note 22 at 406.

26. *Supra*, note 25 at 1808.

27. *Id.*

28. *Barrett*, *supra*, note 25; *R.J. Webb v. Commissioner*, TC Memo 1990-540.

29. *Id.* at 1027.

30. *Id.*

31. *Id.*

32. See note 22, *supra*.

33. CRS § 14-10-122(2) provides that "unless otherwise agreed in writing or expressly provided in the decree, the obligation to pay future maintenance is terminated upon the death of the either party or the remarriage of the party receiving maintenance." [Emphasis added.]

34. *Supra*, note 22.

35. *Aldinger v. Aldinger*, 813 P.2d 831 (Colo. App. 1991).

36. *Mertens*, *supra*, note 2 at 31A-67, which states that "the key to qualification as deductible divorce payments under § 71 is not the decree itself, but the legal obligation underlying the decree."

37. *Id.* at 31A-168.

38. *Vogel*, *supra*, note 10 at 3-20.

39. *Id.*

40. *Mertens*, *supra*, note 2 at 31A-168.

41. Rooney, "Current Developments in Divorce Taxation," presented at AICPA National Conference on Divorce, June 14-16, 1995.

42. *Vogel*, *supra*, note 10 at 3-21.

43. *Van Vlaanderen v. Commissioner*, 175 F.2d 389 (3d Cir. 1949); *Blanchard*, *supra*, note 9 at 919. ("There must be in effect an enforceable obligation when an alimony payment is made to make such a payment deductible. To allow a taxpayer to alter his tax liability for years past by obtaining a nunc pro tunc modification of his alimony obligation would make it possible for a husband to shift income, during years of high earnings by him, to his former spouse without having incurred the type of permanent obligation contemplated by § 71.") Note: The *Blanchard* decision was decided prior to the DRA's 1984 changes to the alimony requirements. However, the *Blanchard* rationale appears to be still valid because it was cited with approval in *Mertens*, *supra*, note 2 at 31A-69.

44. *Mertens*, *supra*, note 2 at 31A-66, citing Rev. Rul. 58-52, 1958-1 C.B. 29.

45. *Id.* at 31-67, citing Rev. Rul. 60-142, 1960-1 C.B. 34.

46. *Id.*, Vol.14, § 50:437 at 50-399 and § 50:438 at 50-401 (Feb. 1998) [citations omitted].

47. *Id.* (Also note there is a bill pending in Congress that would change the burden of proof in the Tax Court to the IRS; the effect such legislation would have on the prepayment of maintenance issue is unknown.)