

Proper wording in divorce documents is crucial.

# Divorce Agreement Language

BY LARRY MAPLES

**C**PA's who prepare tax returns for divorced individuals must properly report transactions such as alimony and nonalimony payments, retirement benefits under qualified domestic relations orders (QDROs) and dependency exemptions. The CPA should examine divorce documents to decide the tax

treatment rather than rely on the client's characterization of the tax effects of divorce-related agreements. This article will help CPAs evaluate the tax effects of divorce documents and give tax advice to clients in divorce-settlement negotiations. Remember that the results in the cases discussed here may not hold true in other jurisdictions.

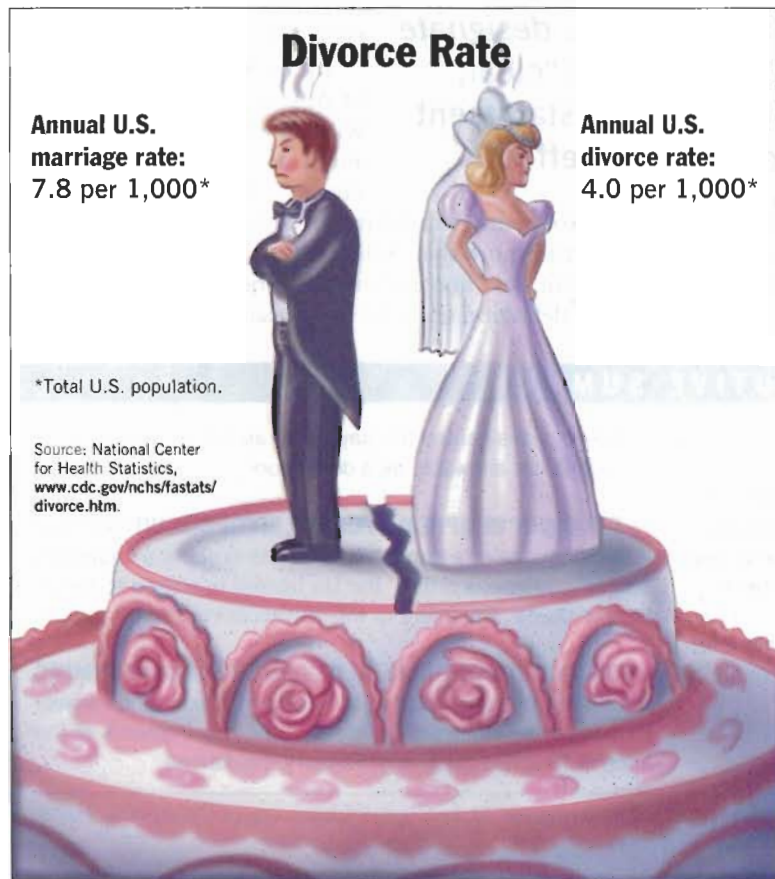
## DEFINING ALIMONY

Divorcing clients must meet the requirements of IRC section 71(b) if the payments from the split are to be classified as alimony for tax purposes. Specifically,

- The payments must be in cash and must be received under a divorce or written separation instrument.
- The spouses must reside in separate households.
- The payor's liability must not continue after the payee's death.
- The payor and payee must file separate returns.
- The divorce or separation instrument must not designate nonalimony treatment.

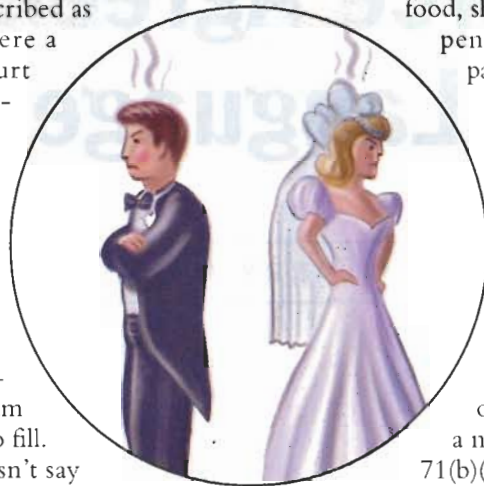
What qualifies as alimony? Several important cases can guide CPAs who interpret divorce documents or give advice in divorce negotiations.

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In *Nelson* the Tax Court held that payments that meet the requirements of section 71(b) are deductible as alimony even though, under local law, the payments might have represented a division of marital assets. After the husband sued for reduction of his "alimony" payments, the divorce court said that payments described as alimony in the divorce decree were a property settlement. The Tax Court said the divorce court's property settlement designation was irrelevant in determining the tax consequences of the payments. Since the requirements under section 71 were met, the payments were alimony for tax purposes in spite of the divorce court's language.

omissions in the divorce instrument may create a vacuum that state law may rush in to fill. Suppose a divorce instrument doesn't say whether payments will continue after the payee's death. In states in which alimony terminates at the payee's death by statute, there is no problem qualifying the payments as alimony for tax purposes if they are alimony under state law. But if this is not the case, the state statute that terminates alimony at death is not applicable. For example, the Third Circuit Court of Appeals in *Hawley* recently decided whether an unallocated support order terminates on the custodial parent's death under Pennsylvania law. The payor lost a substantial alimony deduction because he was unable to prove that Pennsylvania law required unallocated payments to cease at death. This makes it crucial for the



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lawyer preparing the divorce decree to ensure it contains a termination-at-death clause for federal tax purposes. If the decree has no such clause and state law does not terminate the payments at death, a CPA might take a tax-return reporting position that payments for items such as food, shelter, medical care and education expenses must, of necessity, end with the payee's death and thus satisfy the requirements for alimony.

CPAs advising clients who seek alimony treatment should not rely on language used in agreements or decrees. Payments are alimony only if the requirements of section 71(b) are met.

#### NONALIMONY DESIGNATIONS

The choice of language by the parties or the divorce court is crucial for taking a nonalimony tax position. IRC section 71(b)(1)(B) permits nonalimony treatment if the divorce agreement designates the payments as not includable in income under section 71(a) and not allowable as a deduction under IRC section 215. The courts have recently grappled with how the word *designate* should be construed under the tax code.

In the Seventh Circuit Court of Appeals case *Richardson*, the wife received \$10,000 a month and some of her other expenses under a separation agreement. In later proceedings the state divorce court increased this amount to more than \$26,000, holding that the original agreement was "unconscionable." The Seventh Circuit provided a definition of the term *designate* that has been used as

#### EXECUTIVE SUMMARY

■ **FOR ALIMONY TO BE TAX DEDUCTIBLE**, payments must be made in cash under a divorce or written separation instrument, the spouses must reside in separate households, the payor's liability must end with the payee's death, the payor and payee must file separate returns and the divorce or separation instrument can't designate nonalimony treatment.

■ **IT'S CRUCIAL FOR THE DIVORCE DECREE** to contain a termination-at-death clause to assure alimony treatment for income tax purposes.

■ **NONALIMONY TREATMENT IS PERMITTED** if the divorce

agreement designates the payments as not includable in income and not allowable as a deduction.

■ **THE COURT OF APPEALS FOR THE SIXTH CIRCUIT** held that if the language of a domestic relations order is a "qualified domestic relations order," the tax burden is shifted to the alternate payee. The intent of the parties is irrelevant.

■ **TAX COURT DECISIONS ILLUSTRATE THAT CONFORMING** completely to every detail of a dependency exemption waiver form is not as important as meeting the requirements of the Internal Revenue Code and Treasury regulations.

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a touchstone to solve tax dilemmas in several recent cases. According to the court, *designate* means to include a “clear, explicit and express” statement regarding the tax effect. The wife had argued the payments weren’t alimony because the divorce court had ruled that a reasonable payment would constitute 40% of her spouse’s aftertax income. Thus, she reasoned her husband already would have paid tax on the money paid her. The Seventh Circuit resisted defining *designate* in such an indirect way because it then would be necessary to pick apart the assumptions of a divorce court in future cases. The Seventh Circuit pointed to the dictionary’s definition of the word *designate* “to make known directly, to point out, to name, to indicate,” and concluded the divorce instrument must contain a clear, explicit and express statement regarding the tax effect. The decree in *Richardson* lacked such an express statement. It said only the husband’s aftertax income was to be used to determine the reasonableness of the proposed alimony amount. Therefore, the payments were considered alimony.

In contrast to *Richardson*, in which the divorce court merely implied who would bear the tax burden, in *Jaffee* a temporary order by the state court clearly showed the husband would be responsible for income taxes on his wife’s “alimony pendente lite,” that is, alimony while the suit was in progress. Ms. Jaffee was permitted to withdraw \$18,500 from their joint brokerage account for her support while the divorce was being finalized. Half the amount was deemed to come from her own funds, but the issue was whether the statement that “he was responsible for taxes” meant Mr. Jaffee’s half was properly designated as nonalimony. The Tax Court said such language was not a sufficient nonalimony designation, allowed Mr. Jaffee’s alimony deduction and required Ms. Jaffee to include the withdrawals in income.

Language which clearly establishes that a property settlement is to occur does not create a nonalimony designation unless tax consequences are clearly stated, according to the IRS. In letter ruling 200141036, a taxpayer and spouse entered into an agreement which stated in part:

“[Former spouse] agrees to...deliver to [Taxpayer] a deed conveying to [Taxpayer] all her rights, title and interest in and to the farm...[Taxpayer] agrees...to provide [Former spouse] with an income of \$x per month...continuing as

long as she lives. That income will constitute [Former spouse’s] separate property.”

The IRS said that the lack of “clear, explicit and express direction” concerning the tax consequence made the payments alimony. A simple statement that the parties designate the payments as excludable/nondeductible under code sections 71 and 215 would have avoided this result.

In *Baker* the judgment of divorce said the husband would pay his former wife “50% of his monthly gross military retirement pay from the U.S. Army each month as a property settlement.” Mr. Baker deducted these payments as alimony, but Ms. Baker did not report them as income. The Tax Court said they should be treated as alimony because a label of “property settlement” is not the clear and explicit direction required by *Richardson*. The wife argued that her half of the pension was not alimony because a property settlement in a divorce clearly comes under the nontaxable umbrella of section 1041—yet another taxpayer learned the hard way that labeling carries no weight unless it is explicit “tax labeling.” Again, a statement

that the parties designate the payments as excludable/nondeductible under code sections 71 and 215 would have avoided this result.

**T**he tax language in an agreement has to be explicit. In *Baker* the Tax Court said using the term *property settlement* alone “does not clearly inform us that the parties considered the federal income tax consequence of the payments under sections 71, 215 and/or 1041.” But explicit mention of these code sections is not a hard and fast requirement, because both the IRS and the Tax Court have upheld nonalimony designations in the absence of specific tax code references. In *Maloney* the husband separated but did not retire from the U.S. Navy and was paid a lump-sum separation amount. An Illinois court had awarded Ms. Maloney about 40% of the payment, noting that the “transfer shall not be considered a taxable event.” The Tax Court held that the transfer was not alimony.

It would be tempting to deduce from these examples that CPAs could be comfortable advising their clients to take nonalimony positions when no code provisions are mentioned. But this conclusion may not be warranted. Compare the *Baker* case with *Estate of Goldman*, *aff’d sub.*

## Case Citations

These cases are listed in the order of their appearance in the article.

- *Thomas H. Nelson, et ux. v. Commissioner*, TC Memo 1998-268.
- *Hawley v. Commissioner*, 94 FedAppx 126 (3rd Cir. 2004), *aff’g Gilbert v. Commissioner* TC Memo 2003-92.
- *Richardson v. Commissioner*, 125 F3d 551 (7th Cir. 1997).
- *Irv C. Jaffe, et al. v. Commissioner*, TC Memo 1999-196.
- *Marilyn J. Baker v. Commissioner*, TC Memo 2000-164.
- *Thomas Clarence Maloney, et ux., v. Commissioner*, TC Memo 2000-214.
- *Estate of Monte H. Goldman v. Commissioner*, 112 TC 317 (1999), *aff’d sub. nom. Shutter v. Commissioner*, 242 F3d 390 (10th Cir. 2000).
- *Randolph S. Simpson I, v. Commissioner*, TC Memo 2003-294.
- *Hawkins v. Commissioner*, 86 F3d 982 (1996).
- *Golsen v. Commissioner*, 54 TC 742 (1970).
- *Michael Kevin Boltinghouse, et ux. v. Commissioner*, TC Memo 2003-134.
- *Joann Bramante v. Commissioner*, TC Memo 2002-228.

*nom. Shutter v. Com'r.*: Both clearly involved property settlements, but the Tax Court characterized the payments as nonalimony only in *Goldman* because the boilerplate language mentioned section 1041. CPAs comparing these two cases might conclude the mention of a code section may be crucial to a nonalimony designation when the agreement describes the transfer as a property settlement. However, in the recent *Simpson* case, the Tax Court made a nonalimony decision when the decree specified the division was a property settlement but did not mention tax implications or code sections.

To help clients accomplish nonalimony treatment, CPAs can avoid the interpretive difficulties discussed above by suggesting to the divorce lawyers this simple language be used in divorce documents: "The parties designate the payments as excludable/nondeductible under IRC sections 71 and 215."

### QUALIFIED DOMESTIC RELATIONS ORDERS

The 10th Circuit Court of Appeals in *Hawkins v. Commissioner* held that express tax language in a QDRO is not necessary to shift the tax consequences of a distribution. At stake was whether the husband or the wife should bear the tax burden of a \$1 million pension distribution made to the wife. The key issue was whether a valid QDRO existed. The wife argued and the Tax Court concurred the settlement agreement did not satisfy the statutory definition of a QDRO; therefore, the husband should pay the tax. Generally, the plan participant (here, the husband) pays the tax on distributions.

**B**ut section 402(e)(1)(A) (formerly 402(a)(9)) provides the exception whereby an "alternate payee who is the spouse or former spouse of the participant shall be treated as the distributee...under a qualified domestic relations order." Such an order is a QDRO under the tax code if it assigns benefits under a plan to an alternate payee, clearly specifies certain information and does not alter the amount or form of benefits under the plan (IRC section 414(p)). In *Hawkins* the agreement said the wife "shall receive as her separate property cash of one million dollars from her husband's share" of the plan. The wife argued that such language did not establish that benefits under the plan were assigned to her as an alternate payee. Rather, the language made her former husband personally

liable to her for \$1 million and merely identified the pension plan as the source of the \$1 million cash. The Tax Court, in agreeing with her, pointed out that the QDRO did not refer to her as an alternate payee.

The 10th Circuit believed the Tax Court took too narrow an approach because it assumed that a valid QDRO must express the parties' intent to reallocate the tax burden of a pension distribution and must use the exact statutory terminology. The appeals court pointed out that section 414(p) requires neither step. The court then clearly stated

the principle it believes should govern the relevancy of tax language in a QDRO:

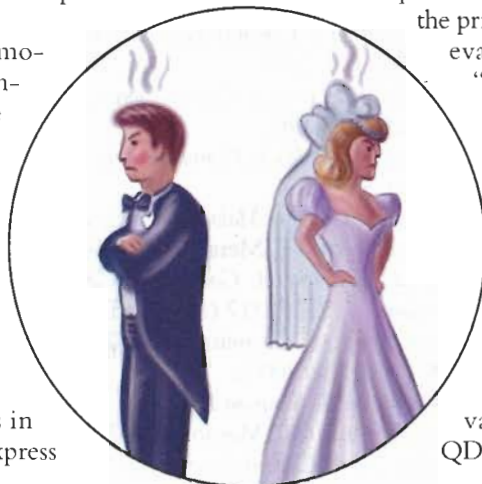
"Nothing in the statute requires the parties to a marital settlement agreement to indicate unambiguously their desire to shift the tax consequences of a particular distribution. Allocation of tax liability between the parties is a consequence of having a QDRO; yet it is not a prerequisite to the creation of a QDRO." Therefore, the appeals court's view clearly is that the tax intent of the parties is irrelevant. If the language qualifies as a QDRO, the tax burden is shifted to the alternate payee. This view stands in marked contrast to alimony issues, where, as we've seen, tax language or the lack thereof may be the determining factor in whether a payment qualifies as alimony for tax purposes.

A CPA trying to decide on a tax-return position may not have to be overly concerned about tax language in a QDRO if the client is in the 10th Circuit. But in jurisdictions where the issue has not been explicitly addressed, the Tax Court under the *Golsen* rule may not follow *Hawkins*.

(Under the *Golsen* rule, the Tax Court may decide to follow its own precedent if the court of appeals of the appropriate jurisdiction has not passed on this issue.)

### DEPENDENCY EXEMPTION WAIVERS

Another crucial document in many divorces is IRS Form 8332, *Release of Claim to Exemption for Child of Divorced or Separated Parents*. Since current law gives the dependency exemption for children to the custodial parent unless he or she waives that right, the information included in form 8332 has been at issue in several recent disputes before the Tax Court. Specifically, how literally must the form's requirements be met in order for the noncustodial parent to claim the exemptions? Two recent cases illustrate the tension between the IRS and the petitioning taxpayer. In one the IRS argued unsuccessfully that omission of certain de-



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tails on the form defeated the release of the exemption. In another the IRS argued successfully that omission of certain details did not change the substance of the release.

In *Boltinghouse* a couple executed a separation agreement saying that Michael, the noncustodial parent, could claim one of their daughters as a dependent. The IRS argued the agreement did not meet the requirements because it was not incorporated in the final divorce decree and did not conform to the substance of form 8332 because it didn't reflect the years for which the exemptions were to be released or provide Social Security numbers for the parents.

**T**he court disposed of the first argument by pointing out that requiring the release to be incorporated in the decree would mean that form 8332 did not stand on its own. Thus, CPAs can be sure a release, whether executed on form 8332 or not, will suffice if it conforms in substance to the form's requirements. But what about the details in the release?

The IRS argued the agreement did not explicitly state the tax year to which the taxpayer wanted it to apply and pointed to cases where the Tax Court had rejected agreements that were ambiguous about the year involved. But the court found no ambiguity existed in *Boltinghouse* because the agreement clearly said it applied to years starting when the parents began filing separate returns. The lack of Social Security numbers was not crucial, according to the court, because neither statute nor the regulations require them, and, in any case, they were furnished on the tax return.

In *Bramante* a custodial parent executed a release of exemptions on form 8332. Later, when her income increased, she had second thoughts and argued that the form 8332

## RESOURCES

### AICPA Conference

AAML/AICPA National Conference on Divorce  
May 13-14, 2004  
For a copy of a multimedia CD, contact Conference Copy Inc. at [www.conferencemediagroup.com](http://www.conferencemediagroup.com) or 800-575-0580. For a manual only, contact Melissa Estrin at the AICPA at 201-938-3566.

### Other

*Divorce Taxation* by Marjorie O'Connell, Warren, Gorham and Lamont.

was not a valid release because it did not include her Social Security number and her ex-husband (the noncustodial parent) had dated it in his own handwriting. Again, as in *Boltinghouse*, the Tax Court was not overly concerned about details on the release form that were not required by the code and regulations. The court would not allow the custodial parent to wriggle out of the exemption release.

Apparently, the only way a custodial parent can change his or her mind and void form 8332 is to convince the noncustodial parent to forfeit the exemption (see IRS Chief Counsel Advice 200007031). A real inequity can exist when a noncustodial parent fails to make child-support payments yet continues to claim the exemption under

the waiver. CPAs should advise clients to sign waivers only on a year-to-year basis to guard against this problem.

In disputes about the tax effect of a dependency release, the CPA should remember that omitted details are not nearly as crucial as whether the requirements of the tax code and regulations are met. A release will be effective, whether form 8332 is used or not, if the agreement conforms to the law's requirements. When form 8332 is used, omission of information called for on the form will not void the release unless the omitted details are called for in the code or regulations.

### WHAT LANGUAGE IS NEEDED

CPAs may find themselves searching the language of divorce-related agreements to support a tax position. If a client wants an alimony deduction, the CPA should scrutinize the agreement to determine whether it meets the requirements of section 71. No tax language is necessary to characterize payments as alimony. In fact, case law demonstrates that words such as *alimony* or *property settlement* are irrelevant in determining whether payments qualify as alimony for federal tax purposes. On the other hand, if a CPA is gathering support for a tax position that payments received are not alimony, more specific language is required. The degree of specificity has been at issue in several recent court cases. A CPA looking to the language of a QDRO to shift the burden of taxation should be forewarned: The 10th Circuit has held that such tax language in a QDRO is irrelevant. Under *Hawkins* the tax impact is based solely on whether the order qualifies as a QDRO. If it does, the tax burden shifts to the alternate payee regardless of the tax language used. Finally, when exemption waivers have been executed, the CPA should carefully note any missing information on form 8332 and the duration of the waiver. ■

## PRACTICAL TIPS TO REMEMBER

- Payments to former spouses are deductible alimony only if the requirements of IRC section 71(b) are met. Don't rely on statements in divorce agreements or decrees that describe payments as alimony; rely instead on how the code requirements have been applied by the courts.
- To accomplish nonalimony treatment, recommend using this language: "The parties designate the payments as excludable/nondeductible under IRC sections 71 and 215."
- In disputes about the tax effect of a dependency release (form 8332), remember that omitted details are not nearly as crucial as whether the requirements of the tax code and Treasury regulations are met.