

VALUATION OBSERVATIONS

*Some practical observations from a practicing
business appraiser.*

VLC

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FRONT-LOADING ALIMONY

As we all know, alimony is a taxable event, whereas property division is not. Oftentimes, characterization of cash payments to an ex-spouse as a taxable event (i.e. alimony) can provide tax savings to the individuals collectively due to the recipient being in a lower tax bracket.

In an attempt to discourage characterization of property settlements as alimony as a tax savings mechanism, Congress enacted IRC §71(f) in 1984. Several technical changes were made to this Code section in 1986, most important of which was to remove the minimum term rule which required that alimony be paid for a minimum of six years.

The current excess alimony rule operates on a three calendar year basis, beginning with the first calendar year in which the payor spouse makes alimony payments to the payee spouse, also referred to as the first post-separation year. It is also important to note that only payments made in the first and second post-separation years are subject to recapture. Payments made in the third and subsequent post-separation years are not subject to recapture.

So how does this recapture calculation work? It is a two step process. We will use the example of alimony payments of \$60,000 in the 1st year, \$45,000 in the 2nd year, and \$10,000 for the next 8 years.

Step One

The total amount of alimony paid in the 3rd year is compared to the total amount of alimony paid in the 2nd year. If the payments in the 2nd year exceed the payments in the 3rd year by more than \$15,000, the excess over \$15,000 is subject to recapture in the 3rd year. The payor includes this recaptured excess amount in to income and the payee gets a corresponding deduction.

$$\$45,000 - \$10,000 = \$35,000 - \$15,00 = \$20,000 \text{ (2}^{\text{nd}} \text{ year excess payment)}$$

Step Two

The total amount of alimony paid in the 1st year (\$60,000) is compared to the average of the total amount of “non-excessive” alimony payments made in the 2nd (\$45,000 - \$20,000) and 3rd years (\$10,000). If the payments in the 1st year exceed this calculated average amount by more than \$15,000, the excess over \$15,000 is subject to recapture in the 3rd year.

$$\$60,000 - \{(\$25,000 - \$10,000)/2\} = \$42,500 - \$25,000 = \$17,500 \text{ (1}^{\text{st}} \text{ year excess payment)}$$

In this example, the total excess payments subject to recapture by the payor and allowable as a deduction to the payee in the 3rd year is \$47,500, which is \$20,000 + \$27,500.

IRC §71(f)(5) does incorporate four exceptions to the rule where no recapture is required:

- ✓ Payments cease due to death of either spouse during these 3 years.
- ✓ Payments cease due to the payee spouse's remarriage during these 3 years.
- ✓ Payments made pursuant to a pendente lite order.
- ✓ Payments made pursuant to a continuing liability over the period of the first 3 post-separation years to pay a fixed portion (which may be determined by a formula) of the payor spouse's income from a business, property or from compensation for employment or self-employment. The payments can vary with the payor's income so long as the percentage used is fixed by the pre-existing formula. And, a variable payment agreement is exempt only if it is effective for at least 3 years.

An example of the 4th exception is where the payor agrees to pay the payee 30% of the net rentals of an office building owned by the payor for the first 3 years following the divorce. Even if the payments decrease each year, the payments are fixed by formula, and thus not subject to the recapture rule.

With proper planning, these front-loading rules can be avoided. But the best laid plans can still trigger recapture inadvertently. Late payments/arrearages are an example of this unfortunate trigger. Payment of alimony arrearages in year 2 for alimony owed in year 1 may trigger recapture if the resulting amount paid in year 2 is more than the calculated allowable amount in year 3.

If you would like additional information, or have a question, please do not hesitate to call.

Very truly yours,

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Terri Lastovka is the founder of Valuation & Litigation Consulting, LLC. Her practice focuses on business valuations and litigation consulting in the areas of domestic relations, gift and estate tax, probate, shareholder disputes, economic damages, and forensic accounting. She draws from a wide range of experiences, including public accounting, law, banking, and CFO. She has received extensive training from the American Society of Appraisers in the area of business valuation and works closely with members of the bar to effectuate practical settlements. Terri also serves as the Director of Legal & Finance for Journey of Hope, a grass roots non-profit organization providing financial support to cancer survivors.