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Cash still king for alimony payments

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By Jason Pierce

Alimony is the payment of support from a spouse who has the ability to pay to a spouse in need of support for a reasonable length of time, under a court order. While seemingly simple, this definition can have costly and unintended consequences if not implemented appropriately.

In a recent U.S. Tax Court case, Mehriary v. Commissioner of Internal Revenue, the method of alimony payment was the subject of much debate and resulted in deficiencies of income tax and accuracy-related penalties. This article will review the tax treatment of alimony, discuss the proper method of payments and remind professionals of the important roles they play in the process.

Alimony and separate maintenance payments are deductible from income by the payor and includable in the income of the payee. The key issue in Mehriary was the method of alimony payment.

The couple entered into a marital settlement agreement whereby Christina M. Mehriary was to make $4,000 alimony payments for 60 months. In lieu of a portion of the alimony obligation, the parties signed a modification agreement whereby Mehriary would transfer property worth $80,000 to her ex-husband within one year of the divorce.

At first glance, the parties' separation instrument should have been enough to document their intent and thereby qualify for the appropriate tax treatment. What happened next is a reminder to attorneys, financial planners and accountants that best intentions can be poorly executed.

On her tax return, rather than report the property transfer as an alimony payment, Mehriary deducted the $80,000 as a loss, which the court ruled was improper under §1041(a) of the Internal Revenue Code. This code section provides that no gain or loss is recognized on the transfer of property from one spouse (or former spouse) to another incident to a divorce. When the deduction was challenged, the ex-wife as petitioner argued an alternative theory: alimony deduction.

Under the Internal Revenue Code, alimony and separate maintenance relate only to payments in cash. The court ruled the transfer related to property rather than cash payments and therefore was not considered alimony. Despite the intent of the parties, the transfer of property did not affect the deductibility of the payment as alimony.

Further, the deductibility of alimony is also based on the following:

- Such payment is received by (or on behalf of) a spouse under a divorce or separation instrument.
- The divorce or separation instrument does not designate such payment as a payment which is not includible in gross income under this section and not allowable as a deduction under §215.
- In the case of an individual legally separated from his spouse under a decree of divorce or of separate maintenance, the payee spouse and the payor spouse are not members of the same household at the time such payment is made.
- There is no liability to make any such payment for any period after the death of the payee spouse and there is no liability to make any payment (in cash or property) as a substitute for such payments after the death of the payee spouse.

After the taxpayer failed on both arguments of property loss deduction and alimony characterization, the court then considered the accuracy-related penalties.

The IRS imposes a 20 percent penalty on any portion of an underpayment of federal income tax attributable to, among other things, a taxpayer's negligence or disregard of rules or regulations, or a substantial understatement of income tax.

An understatement of income tax is substantial if it exceeds the greater of 10 percent of the tax required to be shown on the return or $5,000. The penalty can be waived if it was shown there was reasonable cause for such position and the taxpayer acted in good faith. Unfortunately, that was not the case with Mehriary.

While the modification agreement advised the parties to seek the opinion and advice of a tax professional regarding the tax ramifications of the agreement, no such advice was sought or offered as evidence. As a result, Mehriary was found liable for the accuracy-related penalty.

There are many lessons to learn from this case in addition to the reminder that all alimony payments must be specified in the divorce agreement and paid in cash. At a minimum, the parties should seek professional guidance on the payments for the first post-divorce tax filing.

While that recommendation was made in this case, there was apparently no follow-through as Mehriary prepared her own tax return. Attorneys should encourage interactions between clients and tax preparers to improve the likelihood of fulfilling the IRS documentation requirements and accurate tax form preparations.

Relying on the parties' intent — no matter how well documented — is no substitute for following the guidelines of the Internal Revenue Code. MLW

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