

# TAX UPDATE

Ed Zollars, CPA

At Death Do Payments Stop? Alimony Revisited  
September 8, 2008



Feed address for Podcast subscription:

<http://feeds.feedburner.com/EdZollarsTaxUpdate>

Home page for Podcast: <http://ezollars.libsyn.com>

©2008 Edward K. Zollars, CPA

*The TaxUpdate podcast is intended for tax professionals and is not designed for those not skilled in independent tax research. All readers and listeners are expected to do their own research to confirm items raised in this presentation before relying upon the positions presented.*

*The Podcast and this document may be reproduced freely so long as no fee is charged for the use of this document. Such prohibited use would include using this podcast or document as part of a CPE presentation for which a fee is charged.*

*This podcast is sponsored by Leimberg Information Services, located on the web at <http://www.leimbergservices.com>. Leimberg Information Services offers email newsletters on tax related matters, as well as access to a library of useful information to tax practitioners that subscribe to their services.*

## Alimony or Not?

The Tax Court, when it issued the initial decision in this week's case, lamented the fact that it was yet again getting stuck with having to deal with a problem that could have been unequivocally resolved by a better drafted provision in the divorce decree:

This case is another chapter in the long saga of cases decided by this Court involving the failure of parties to divorce settlement agreements to specify what happens to payments should the payee- spouse die. See, e.g., *Berry v. Commissioner*, T.C. Memo. 2005- 91; *Kean v. Commissioner*, T.C. Memo. 2003-163, *affd.* 407 F.3d 186 (3d Cir. 2005); *Hoover v. Commissioner*, T.C. Memo. 1995- 183, *affd.* 102 F.3d 842 (6th Cir. 1996). By failing to so specify, the divorce litigants simply abdicate making a serious financial decision that others may then make for them, as here.

The original decision cited above was the case of *Johanson and Melzig v. Commissioner*, TC Memo 2006-105, with a ruling the Ninth Circuit sustained this week in a published

decision. The Ninth Circuit agreed with the Tax Court's conclusion that under the applicable state law liability to make payments by default would cease on death unless the agreement held otherwise—even though the parties had not respected that provision in another circumstance not dealt in with the agreement a similar default “end of liability” event did not cause payments to cease.

We will look at the basic issues, as well as both court's musings on this issue.

## **Alimony in General**

We've dealt with the basic rules for alimony in prior podcasts, so we'll only briefly review here the requirements. The IRC is clear in §71(b) on four requirements for a payment to be treated as alimony:

- (1) In general. -- The term "alimony or separate maintenance payment" means any payment in cash if --
- (A) such payment is received by (or on behalf of) a spouse under a divorce or separation instrument,
  - (B) 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 section 215,
  - (C) 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, and
  - (D) 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.

The issue that has given rise to many court cases, including this one, is the final one. It turns out that many agreements are silent on what happens should the payee spouse die. In such cases, the issue becomes determining what would happen, under applicable state law, in that event given the document the parties entered into.

## **The Agreement and Events**

This case involved former spouses John Weiler and Carol Johanson, and the payment by John to Carol of \$63,000 during 2002. John claimed the amounts represented deductible alimony that would be taxable to Carol, while Carol claimed the payments did not represent taxable alimony. Thus we are faced with the normal set of events that triggers

the case—inconsistent reporting by the former spouses that brings the IRS into the issue. The agreement provided the following provision for payment by John to Carol:

...John agrees to pay spousal support to Carol in the amount of \$5,250.00 per month beginning the first month following the sale of the residence (close of escrow). Spousal support shall be due, one-half on the first of each and every month and one-half on the 15th of each and every month. Spousal support shall continue at this amount through October 31, 2010 at which time Carol's right to collect spousal support from John will permanently terminate. This termination date is absolute and non-modifiable under any circumstances. Spousal support shall be payable by wage assignment which shall be issued along with the entry of the agreement as a Judgment. Service of the wage assignment is stayed unless and until John is ten (10) days or more late with any support payment. In the event John is ever ten (10) days or more late with any support payment, the wage assignment shall be served with no further notice to John.

The agreement went on to lock down the payment of these amounts by provisions contained in the next paragraph of the agreement:

The duration of spousal support is non-modifiable and the court will not have jurisdiction to modify the length of time John will pay spousal support to Carol. Specifically, the court does not have jurisdiction to award any spousal support payable from John to Carol for any period beyond October 31, 2010, regardless of the circumstances that may arise and regardless of whether any motion to modify spousal support is filed before, on or after October 31, 2010. The court also does not have jurisdiction to modify the amount of spousal support payable from John to Carol except for two circumstances, John's death, prolonged unemployment or John's disability. Upon John's death, spousal support will terminate permanently. Upon John's prolonged unemployment, the court has the jurisdiction to lower the amount of support for the length of the unemployment provided appropriate efforts are being made by John to find employment. Upon John's disability, the court has the jurisdiction to lower the amount of support for the length of the disability. Disability is defined as the inability to pursue an occupation because of physical or mental impairment. If such a modification is sought by John and ordered by the court, the court may increase or decrease the amount of support as the circumstances warrant but under no circumstances does the court have the jurisdiction or the authority to raise spousal support over the amount of \$5,250.00 per month.

While we know what happens if John dies, §71(b) is concerned with what happens in the event of the payee spouse, which would be Carol in this case. And it turns out the agreement was silent on this matter.

At the Tax Court, the parties each explained their view of the agreement—views that, not surprisingly did not perfectly agree:

John and Carol both testified in this case, and, unsurprisingly, their testimony was contradictory on most points. The testimony of the respective Parties was, for the most part, aimed at supporting, explaining, or modifying the express terms of the Agreement. Consequently, we base our decision solely on the terms of the Agreement itself, rather than on any extrinsic evidence proffered by the Parties' testimony.

## Applying California Law

In this case, the parties resided in California at the time the divorce was entered into, so we look to how California courts would view the above agreement in the event of Carol's death—or, more appropriate, the Tax Court and Ninth Circuit Court of Appeals attempt to make that call on behalf of the California courts.

Both the Tax Court and the Ninth Circuit found that Section 4337 of the California Family Law Code was the provision that would fill in the blanks. That provision provides:

Sec. 4337. Termination of support order; death; remarriage

Except as otherwise agreed by the parties in writing, the obligation of a party under an order for the support of the other party terminates upon the death of either party or the remarriage of the other party.

Carol attempted to argue the payments were related to the value of her share of the value of Sea Supreme. However, the Tax Court disagreed with that view, noting:

There is nothing in the Agreement that remotely connects the \$5,250 monthly spousal support payments to Carol to her interest in Sea Supreme. The Agreement recites that John estimated the value of Sea Supreme to be "in the vicinity of \$1.2 million", and that "Carol agrees with this valuation". Since, previous to the divorce, Carol owned 25 percent of Sea Supreme, the value of her interest would be in the neighborhood of \$300,000, a far cry from the total support payments Carol expected to receive under the Agreement.

The Court noted that the stream of payments over its term would add up to nearly \$900,000. As well, the Court noted that the agreement indicated that other parts of the agreement represented an equitable split of the couple's assets and liabilities, and provided that John would receive the stock in Sea Supreme as his sole and separate property.

As well, the specific part of the agreement where the \$5,250 payments are outlined in a section of the agreement labeled "SPOUSAL SUPPORT" and which carefully outlines the rights and obligations for spousal support—indicating clearly that these amounts are intended to be treated as such.

The Tax Court thus concluded that the payments constituted alimony as California Family Law Code Section 4337 would service to terminate the liability on Carol's death. Thus, the payments were taxable to Carol and deductible by John.

Carol, as you might expect, wasn't happy with the decision and filed an appeal with the Ninth Circuit Court of Appeals, who this week issued their decision on the matter.

## More Issues

The Ninth Circuit sheds light on a few more facts that Carol believed indicated that the proper reading of the agreement was that liability for payments would terminate on death.

The Ninth Circuit outlines the test for whether Carol can escape the standard rule of Cal. Fam. Code Sec. 4337 as follows:

Here, the Agreement does not explicitly provide whether Weiler's liability to make monthly payments to Johanson continues after her death. Under California law, "[e]xcept as otherwise agreed by the parties in writing, the obligation of a party under an order for the support of the other party terminates upon the death of either party or the remarriage of the other party." Cal. Fam. Code § 4337. A written agreement to waive section 4337 "must be specific and express." *In re Marriage of Thornton*, 115 Cal. Rptr. 2d 380, 383 (Ct. App. 2002).<sup>1</sup> While "[n]o particular words are required . . . silence will not do." *Id.* (quoting *In re Marriage of Glasser*, 226 Cal. Rptr. 229, 230 (Ct. App. 1986)). Mere failure to include death as a terminating event does not constitute waiver of section 4337. *Id.* at 385.

The Court then goes on to review whether Carol can establish such a specific and express intent to have payments continue past her death. The Ninth Circuit does initially give some hope to a reversal, holding:

However, where there is "language in the written agreement reasonably susceptible to interpretation as a declaration of an intent that support continue beyond [death]," extrinsic evidence is admissible in order to determine whether the written agreement waived section 4337. *In re Marriage of Cesnalis*, 131 Cal. Rptr. 2d 436, 439-40 (Ct. App. 2003) (finding a non-modification statement "expressly limited to the . . . 'duration of spousal support'" to warrant such analysis of extrinsic evidence). In *Cesnalis*, the question was whether spousal support payments would continue in the event of the payee spouse's remarriage. *Id.* at 438. Similar to the language in the *Cesnalis* agreement, the agreement here contains specific non-modification statements related to the duration of the spousal support payments that are "reasonably susceptible to interpretation" as an agreement to continue payments after Johanson's death. See *id.* at 439-40. Therefore, extrinsic evidence was admissible on the question of whether the parties waived the statutory termination of spousal support on the payee's death. See *id.* at 439.

However, the Ninth Circuit did note that Carol, under California law, would bear the burden of showing by clear and convincing evidence that the agreement was to continue payments beyond her death.

Carol noted that her former spouse had continued to make payments following her remarriage, even though that was an event that under 4337 would have been an end of liability event, suggesting that it was the intention of the parties that Section 4337 would not govern. However, the Ninth Circuit indicated:

The fact that Weiler continues to pay spousal support after Johanson remarried does not constitute a written agreement regarding the status of payments in the event of Johanson's *death*.

Carol also noted that originally the agreement had contained language that would have clearly terminated payment on her death, but that language had been removed from the final draft. That seemed to be an action that explicitly suggested they did not want that occurrence. However, the Ninth Circuit found this argument inadequate, noting:

That language explicitly providing for the termination of the spousal support payments at "the death of either party" was deleted from a prior version of the Agreement does not clearly and convincingly establish that the parties agreed in writing that the payments to Johanson would continue past her death.

It would appear that the Court's view is that while you would remove that if you didn't want the payments to terminate, it isn't necessarily clear enough to conclude that the intent was to not have that provision apply in the case of Johanson's death—or at least, not clear enough to allow the Ninth Circuit to overrule the Tax Court's original holding in the matter.

## Implications

The Tax Court indicated its frustration with having to deal with this matter—a frustration that is understandable given that it is relatively simple to draft the agreement to clearly fall on one side or the other of the Section 71(b) divide. It also illustrates the importance that clients understand the issue of whether a payment is or is not going to be treated as alimony really needs to be clearly decided up front, rather than shuffled off to the side—inconsistent reporting will tend to bring the issue to the forefront when the IRS comes calling (remember, the payor reports the social security number of the recipient on the payor's return) so it's not a good idea to have a “vague” clause that each party will attempt to independently interpret.

If the goal is to assure a payment is not alimony, the solution is simple and one that Carol should have insisted upon if that was the desired result: invoke §71(b)(1)(B) which tells us, in the negative, how to assure a payment won't be treated as alimony:

(B) 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 section 215,

Clearly, remove the “not” and simply have the instrument designate the payment is not to be “includible in gross income under section 71 and not allowable as a deduction under section 215” and the result has been obtained.

If you want a payment to be treated as alimony things are a bit more complicated—but nevertheless, the issues are not that difficult to deal with. Clearly, as this case points out, it is important to explicitly state in the instrument that there is no liability to pay any amount after the death of the recipient spouse and not to have the clause noted above. But you also have to watch out for not having triggering events that cause §71(c) to apply (disguised child support), don't run afoul of the mechanical alimony recapture rules under §71(f) and remember the basic requirement of Section 71(b)(1) that the payment be in cash.

The issue also makes clear the conflicting interests the soon to be former spouses have in a divorce proceeding—conflicts that would require dealing with Circular 230 §10.29, as well as other applicable professional standards, if, as is often the cause, the spouses initially state they want the tax adviser to continue to work with both of them due to the fact they know you will be “fair.” It's important to remember that fair is a subjective viewpoint, and it's not likely at the end of the process that both parties will share the same view of just what was “fair” in terms of a tax result.