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White Paper

Divorce and Alimony

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Divorce and Alimony

What is alimony?

Generally, alimony is a support payment made to a former (or separated) spouse under a divorce decree (or separation instrument) in an attempt to maintain the pre-divorce lifestyle. Alimony is determined by state law and is sometimes called maintenance. It is based on one party's need and the other party's ability to pay. If you're contemplating a separation or divorce, you should understand the tax treatment of alimony.

What is the basis for receiving alimony?

Deciding whether a spouse should receive alimony (and, if so, how much) is based on certain criteria that can vary from state to state. Alimony essentially allows one spouse with limited means to benefit from the earning power (acquired during the marriage) of the other spouse. In a long-term marriage, for example, often the wife has not worked outside the home or perhaps has spent many years at home caring for the children. As a couple, she and her husband may have decided that she would be responsible for caring for the children and/or running the household. These responsibilities limit her ability to build a career and can leave her in dire straits if the marriage ends.

Alimony is awarded based on any of the following criteria:

- **Need**--One of the most important reasons for alimony is that the recipient-spouse needs enough money to take care of basic needs, such as food, shelter, clothing, and utilities. Obviously, the state has an interest in keeping residents off of public assistance, and although child support is a separate issue, courts will certainly consider the existence of minor children when considering a spouse's financial need for alimony. In considering the appropriateness of alimony, courts will evaluate a prospective recipient's current sources of income, such as wages or salary, earnings from property received in the property division, and earnings from separate property (such as a trust fund).
- **Ability to pay**--The next consideration is whether the payor spouse can afford to pay what is needed and still have enough money left over to live on or to support a lifestyle somewhat similar to his or her previous one. The needs of both spouses are important.
- **Prior lifestyle**--Because courts will also consider how the spouses were accustomed to living during their marriage, it's clear that alimony isn't based simply on need. For example, if John is a Hollywood star earning \$3 million per year, he'll have a hard time convincing a judge that his former spouse, Mary, should only be paid \$35,000 per year in alimony.
- **Length of marriage**--A marriage that lasts for only a year or two may not qualify for alimony, but a 30-year marriage probably will. This is because a longer marriage will illustrate more sacrifice and dependency of the spouses and will likely involve the sacrifice of one career for management of the home and/or child rearing.

- Age and health--Courts will also look at the respective ages and health of the spouses when determining alimony. A judge will want to know whether either party is disabled or retired. If retired, what sources of income exist? If both parties are young, able-bodied, and college-educated, alimony might not be awarded. However, if one spouse is a 58-year-old homemaker with health problems, it might be difficult (if not impossible) for him or her to find adequate employment. In such a case, an award of permanent alimony might be appropriate.
- Contribution to education--The courts will also consider whether a spouse contributed to the education, training, or career advancement of the other spouse. Often, one spouse will work while the other pursues a college or graduate degree. When the degreed spouse obtains a well-paying position, the working spouse might stay home to care for the children or may continue to work in a low-paying job.

What types of alimony exist?

Alimony may be classified as rehabilitative, permanent, modifiable, or non-modifiable.

- Rehabilitative--Rehabilitative alimony may be defined as a temporary financial award to help a spouse until such time as he or she can become self-sufficient. If one party was the primary breadwinner for the couple, it's unrealistic to expect that the other spouse could automatically earn the same amount of money after the divorce. Rehabilitative alimony can help a former spouse get a college degree or take courses to update old skills. Ideally, the payments would continue while the spouse gained some working experience. Note that some states do not allow for rehabilitative alimony.
- Permanent--As was mentioned earlier, permanent alimony may be appropriate when the spouses are older and one party has sacrificed career for family. That party simply doesn't have the ability to get hired late in life (with no experience) in a lucrative position. Permanent alimony may also be appropriate when the recipient spouse is disabled or has health problems.
- Modifiable--Modifiable alimony simply means that the alimony award can be changed (i.e., increased, decreased, or terminated). A change of circumstances can warrant a change in alimony. For example, the payor spouse may become unemployed, or the recipient-spouse may suddenly become disabled or ill and unable to seek employment. Additionally, the recipient-spouse might win the lottery or receive an inheritance. After the divorce is finalized and an order of support has been made, a modifiable arrangement will allow either spouse to go back into court to ask for a modification.
- Non-modifiable--Non-modifiable alimony is not often used, since it is difficult to predict the future. Still, its value is that it provides some security or peace of mind for the recipient. If the divorce decree states that the wife is entitled to ten years of non-modifiable alimony, for instance, she knows she can count on that money and will continue to receive it, even if she gets remarried.

Do relocation and/or remarriage affect alimony?

Relocation of one or both of the spouses doesn't affect alimony. If you obtained a judgment in one state and have since moved to another state, state laws allow you to file the judgment in the second state and enforce it there. However, if the recipient-spouse gets a roommate or shares rent with someone else, the payor spouse might be able to get a reduction in monthly alimony payments. The presumption is that you need less financial support, since your rent has been lowered.

Unlike relocation, remarriage most certainly affects alimony. In fact, remarriage of the recipient-spouse will usually cause a termination of the payor's alimony obligation (unless alimony is non-modifiable). The written agreement between the parties will specify the conditions that will terminate the alimony.

When can alimony be terminated?

Alimony will cease upon the death of the payor or recipient. Alimony can also be terminated on the conditions agreed upon by the parties.

Is it possible to guarantee alimony payments?

Because alimony terminates on the death of the payor, it's advisable for the recipient to take measures to ensure a continued income stream in the event of the payor's death. This can be accomplished by using such tools as life insurance, disability insurance, and annuities.

- Life insurance--You can stipulate in the divorce decree that life insurance will be carried on the life of the payor to replace alimony in the event of his or her death. If you're going to purchase a new policy, be sure you do it before the divorce is final. This is because health and insurability aren't predictable.

The recipient-spouse should either own the life insurance policy or be an irrevocable beneficiary in order to ensure payment of the premiums and to create favorable tax treatment for the payor of the premiums. Regarding the tax aspect, the insurance premiums will be construed as alimony (i.e., they'll be tax-deductible to the payor and income to the recipient) if the beneficiary-spouse owns the policy (or is an irrevocable beneficiary) and the premiums are made under a legal obligation imposed by the divorce decree.

- Disability insurance--While a former spouse can't own a disability policy on his or her ex-husband or ex-wife, the former spouse can pay the premiums on the policy to ensure that it stays in force. Disability insurance can be an important consideration.

Example(s): Assume John agreed to pay his ex-wife, Mary, \$2,000-per-month alimony, based on his \$7,000-per-month salary. John suffers an accident and becomes disabled. If he has no disability insurance and no salary, he can go back to court to get his alimony obligation modified. However, if he had appropriate disability insurance, it's possible that he might receive \$5,000 per month tax free and could continue paying alimony.

- Annuities--The payor spouse can also choose to buy an annuity that pays a monthly sum equal to the alimony payment. For example, the payor spouse can buy a \$200,000 annuity that pays out \$700 per month (the agreed-upon alimony amount) in interest only. If the payments are interest only, they are taxable to the payor spouse as income and are also deductible as alimony. The payments will be treated as income to the recipient spouse.

How is unpaid alimony collected?

Unfortunately, an award of alimony doesn't guarantee the actual receipt of alimony. There are a number of methods for enforcing alimony orders, including contempt of court proceedings, garnishment of wages, and the placement of liens on property. (In those cases where a spousal award contains both a child support portion and an alimony portion, see Child Support for additional methods of collecting past due amounts.)

- Contempt of court--If a judge orders a spouse to pay a particular amount of periodic alimony and that order is ignored, the recipient spouse can file an action, asking that the other party be held in contempt. A hearing will be scheduled, and if the delinquent spouse fails to attend, a warrant may be issued for his or her arrest. The payor spouse can be jailed, or the judge may order him or her to make future payments in a timely manner and to pay the arrearage according to a set schedule. The judge can also order that the payor spouse's wages be garnished or can place a lien on his or her property. The judge may also order the payor spouse to pay the legal fees of the recipient spouse.
- Wage garnishment--With this method, a portion of the payor spouse's wages is removed from his or her paycheck at the source and delivered to the recipient spouse (or to the court). To garnish wages, the recipient-spouse obtains authorization from the court to seize a percentage of wages. Typically, a sheriff notifies the payor-spouse's employer of the garnishment. Once the employer has been instructed to garnish wages, the employee will be informed.

Of course, the payor spouse can request a court hearing to oppose the garnishment, presenting a number of objections. For example, he or she can assert that the amount owed was calculated incorrectly or that the amount to be deducted will leave him or her with an insufficient amount to live on.

- Property liens--In some states, a spouse whose owed alimony can ask the court to grant a lien on the real or personal property of the payor spouse. For example, a real estate attachment may prevent the property owner from refinancing or selling his or her house until the lien has been paid off. Sometimes, the recipient-spouse can even force a sale of this property to satisfy the lien.

What are the tax ramifications of alimony?

Simply stated, alimony is taxable income to the one who receives it and tax-deductible to the one whom pays it. But to be considered alimony under present tax rules, the payments must meet all of the following requirements:

- All payments must be made in cash, check, or money order (alimony payments must take the appropriate form; transfers of services or property don't qualify as alimony)
- There must exist a written court order or separation agreement

Example(s): John is ordered to pay Mary \$800 per month in alimony for seven years. Three years after their divorce, Mary loses her job and convinces John to increase her alimony for six months so she can find a new position. John sends her an extra \$200 per month for the next six months. At tax time, John tries to deduct this extra money as alimony. However, the IRS will disagree. Since the extra payments were not made under the terms of a divorce or separation instrument, John can't deduct the extra money as alimony.

- The couple can't opt out of alimony tax treatment by agreement after the fact--If a recipient of alimony payments doesn't wish to report the money as taxable income and the payor spouse agrees not to take a tax deduction, it doesn't matter; the payments are still taxable to the recipient and deductible by the payor. However, in the divorce decree itself, spouses may designate payments as "not alimony" even though the payments would otherwise qualify as alimony. Such payments are not taxable to the recipient or deductible by the payor.
- The divorced couple can't stay in the same household--Sometimes, a couple gets divorced but neither party can afford to move out. Consequently, they might agree to live together. If alimony is paid, the payor will not be able to deduct it on his or her federal income tax return and the recipient will not include it in income. Living in the same household prevents this tax treatment.
- The obligation to pay alimony must end at death of spouse--The obligation to make payments ceases upon the death of the payor or the recipient.
- The former spouses may not file a joint tax return--Many couples mistakenly file a joint return for the year they get divorced; this is incorrect. Filing status will be determined by their marital status on the last day of the year (December 31).
- If any portion of the payment is considered to be child support, that portion can't be treated as alimony. Sometimes an order for spousal support will not use the words "child support," but a portion of the payment can be inferred to be child support nevertheless. For more information, see Child Support.

Note: Different rules may apply if your divorce was finalized before 1985. For more information about previous rules, contact an attorney.

What are the recapture rules?

The tax deductibility of alimony may encourage the spouses to disguise property settlement payments as alimony, so, the law provides alimony recapture rules. Alimony recapture is calculated by looking only at the first three calendar years during which deductible alimony was claimed. Therefore, any alimony payments made after the third calendar year are not subject to the recapture rules.

Alimony recapture rules require deductible alimony payments during the first three years to be structured so that payments are substantially equal. However, alimony payments of less than \$15,000 per year aren't subject to the recapture rules. The goal is to prevent "front-loading" of alimony. Deductible alimony payments will be recharacterized as nondeductible property settlement payments to the extent that payments made during the first two years are excessively front-loaded. In other words, high sums of alimony are paid during the first two years.

There are four exceptions to the recapture rules. The recapture doesn't apply:

- If either spouse dies during the first three years and the payments cease by reason of that death
- If the recipient-spouse remarries during the first three years and payments cease by reason of the remarriage
- To temporary support payments made pursuant to a court order
- To payments that fluctuate for reasons not in control of the payor spouse

Example(s): Ray agrees to pay Dorothy 25 percent of the net income from his farm each year for three years. In the first year, his net income is \$120,000, so Dorothy gets \$30,000. In the second year, severe weather wipes out many crops, and the net income is only \$32,000, so Dorothy gets \$8,000. In the third year, the farm suffers a loss rather than net income, so Dorothy gets nothing. In this case, no recapture will be required.

Disclosures

This material does not constitute the rendering of investment, legal, tax or insurance advice or services. It is intended for informational use only and is not a substitute for investment, legal, tax, and insurance advice.

State, national and international laws vary, as do individual circumstances; so always consult a qualified investment advisor, attorney, CPA, or insurance agent on all investment, legal, tax, or insurance matters.

The effectiveness of any of the strategies described will depend on your individual situation and on a number of other factors. After reviewing your personal situation, we may recommend that you not use any strategy in this document but instead consider various other strategies available through our practice.

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