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Client Information Bulletin

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When Can You Deduct Alimony Payments?

New case answers this question

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It is well-established that alimony is **deductible** by the payor on a federal tax return and taxable to the recipient. By way of comparison, child support is nondeductible by the payor and nontaxable to the recipient. However, it is not always easy to determine whether a payment constitutes alimony—no matter how it is stated in the divorce decree.

To qualify as deductible alimony, the following requirements must be met:

- The payment must be made in cash or its equivalent.
- The payment must be received by (or on behalf of) a spouse under a divorce or separation agreement.
- Such an agreement cannot designate the payment as being nontaxable to the recipient spouse and nondeductible by the payor spouse.
- The payor spouse and the recipient spouse cannot be members of the same household at the time of the payment.
- There is no liability to make a payment for any period after the death of the recipient spouse or to make a substitute payment in such a situation.
- The spouses cannot file a joint tax return with each other in the year of the payment.

In a new case decided by the Tax Court, an ex-spouse agreed to make an alimony payment out of his company retirement plan, only to be tripped up by one of the tax law requirements (Smith T.C. Summ. Op. 2003-167).

Facts of the new case: Mr. and Mrs. Smith, residents of Florida, were divorced in 2000. As

part of the divorce agreement, they agreed to share custody and responsibilities for their two children; no child support was required of either party. The agreement also divided their property and liability for marital debts.

The main point of contention concerns payments from Mr. Smith's 401(k) account. Mr. Smith agreed to pay his ex-spouse half of the $150,000 balance plus an additional lump-sum of $32,000 under a provision of "alimony." Mr. Smith deducted the $32,000 payment on his 2000 return, but the IRS disputed the deduction.

Reason: The divorce agreement was silent as to whether the obligation would have **continued** in the event of the prior death of Mrs. Smith. Under the IRS interpretation of Florida law, the obligation continues if the agreement is silent. Since the obligation to pay must terminate upon the death of the former spouse, the IRS said that the payment did not constitute alimony.

The Tax Court agreed with the IRS interpretation. It doesn't matter the payment was categorized as "alimony" in the divorce agreement. Furthermore, there were **no reservations** in the document allowing the parties to incorporate the termination of the obligation.

Result: Mr. Smith cannot deduct the $32,000 payment from his 401(k) plan on his income taxes.

This result points out the need to obtain expert tax assistance in the formulation of a legally-binding divorce agreement. Be sure to resolve these issues before you sign on the dotted line.

Does Telecommuting Work for Your Business?

A look at the pros and cons

The business world is rapidly changing. Prime example: **Telecommuting**, which once was relatively rare, has become more prevalent and, in some industries, the norm rather than the exception. It's been estimated that close to 16 million United States workers currently telecommute at least part of the time.

Briefly stated, "telecommuting" is a work arrangement where an employee conducts official duties from a remote location—usually, his or her own home. For the employee, the benefits are obvious. Telecommuting provides flexibility, reduced commuting and wardrobe costs, and greater convenience for a stay-at-home employee. But is telecommuting a good deal for the employer?
Here's a quick look at the main pros and cons.

The pros: With the labor market beginning to tighten, telecommuting becomes a **valuable tool** in attracting and retaining top-quality workers. It is often offered in conjunction with job sharing, flex time or other innovations. Telecommuting can lead to reduced turnover which, in turn, can lead to increased profits.

When an employer uses telecommuters, overhead expenses are generally reduced. Of course, some of the benefits are offset by the cost of providing laptops, separate phone lines, modems, etc. to employees working at home. One possibility is to split certain costs with employees.

Telecommuting enables your business to use **all** the technology at its disposal today, including e-mail, the Internet, fax machines, and teleconferencing. Other innovations are possible and creative thinking can result in solutions.

It's been shown that telecommuting generally increases productivity. When employees are offered the flexibility of telecommuting, they tend to avoid the traditional 9-to-5 routine, but ultimately work more hours on the job. In effect, there is no clock to punch. Furthermore, absenteeism is reduced and workers are more likely to put in time, even if they are slightly under the weather.

Some other potential benefits of telecommuting include more job satisfaction, better teamwork and internal communications, and improved customer service.

The cons: As mentioned above, telecommuting is not exactly a "**no-cost**" option. Setting up an employee in his or her can be costly, especially if the employee terminates employment in the near future. The employer loses a measure of control over the business operation. Employees are not available for face-to-face meetings that can be revealing. In some cases, internal communications can suffer. Employers have to show a high level of trust in employees—which is not always warranted. Frequently, this option is offered only to select employees, which can lead to resentment among other workers. With employees working from home, security and confidentiality often become prime concerns for employers.

In summary: *Telecommuting is not ideal for every business, but it may be suitable for your operation. Weigh the benefits against the drawbacks. Depending on your circumstances, you might start slowly with a handful of employees whom you trust. If it works out, you can offer this option to a larger segment of your workforce.*

Sidestep Tax Pitfalls for Intra-Family Loans

A good gesture can turn into a tax nightmare

Despite the expression, "neither a borrower nor a lender be," you may have good reasons to provide a loan to a close family member. But now that the decision has been made, consider all the potential **tax consequences**. In the worst case scenario, you may end up paying tax on interest income that you never receive.

Typical situation: Your brother needs to borrow money for a new business venture, but he doesn't qualify for a loan from a bank. He turns to you as a last resort and you agree to lend him the money he needs. Assuming that the amount of the loan exceeds $10,000, the IRS **imputes** interest in this fashion—it treats the transaction as if you had charged interest on the loan, received the interest in turn and made the borrower a cash gift of the "**interest element.**"

Therefore, you're facing a huge income tax bill, even though you haven't received any loan payments. To make matters even worse, you might be liable for gift tax.

Key exceptions: (1) The imputed interest rules do not apply to loans of $10,000 or less if the funds are not used to buy income-producing assets. (2) For loans of $100,000 or less, the amount of interest you are considered to have received annually for tax purposes is limited to the borrower's net investment income for the year. If the borrower's net investment income doesn't exceed $1,000, no tax is due. However, this second exception does not apply if you did not charge interest on the loan—or you charged a below-market interest rate—for tax avoidance purposes.

For loans where the imputed interest rules apply, the interest rates are set **monthly** by the IRS and depend on the amount of the loan.
Fortunately, you don't have to fall prey to this tax trap. If you take steps to establish that the transaction is a bona fide loan, you won't be ambushed by the imputed interest rules. Specifically, the loan arrangement should reflect the amount of the loan; the interest rate (reasonable for your geographic area); the time for repayment; and collateral for the loan. Finally, be sure to have the loan document witnessed and notarized.

What happens if you're never paid back? If the arrangement has been properly documented, at least you can salvage a tax benefit. A loss resulting from a personal loan, such as an intra-family loan, is treated as a short-term capital loss when it becomes totally worthless. In contrast, when you lend money in connection with your trade or business, you can deduct the amount you lost as an ordinary loss. **Note:** An ordinary loss can be used to fully offset highly-taxed ordinary income (e.g., your salary).

In any event, the IRS is inclined to examine intra-family loans closely. Make sure that your arrangement can stand up to the scrutiny.

No Tax Mercy on Discharged Debt

What happens if another party forgives part or all of a debt you owe? It's not a complete free ride.

Reason: The tax code says that you still owe tax on the value of the discharged debt.

In a new case, a taxpayer faced an income tax bill relating to a debt that was actually incurred by someone else (Anderson, T.C. Summ. Op. 2003-169)

Facts of the case: Mr. Anderson provided a credit card to his friend, Ms. Feathers, on his existing Citibank account. Although the account was under Anderson's name, Feathers agreed that she would be responsible for the debts she personally incurred. However, liability under the Citibank card arrangement legally attached to Anderson.

Feathers incurred close to $5,000 in charges to the account that she ultimately did not pay. After being contacted by a collection agency, Anderson settled the account for 70% of the amount that was due. Citibank reported almost $1,400 in income resulting from the discharge of the debt. Anderson denied ever receiving the Form 1099-C reporting the income.

Bottom line: The Tax Court had little compassion for Anderson's situation. It said that the full amount was taxable as cancellation-of-debt income (Anderson, T.C. Summ. Op. 2003-169).

Two Choices for Life Insurance Ownership

How to choose the right one for you and your family

If you're like most people, you probably don't need to be convinced about the need for adequate life insurance protection. But who should be the owner of your life insurance policies? Frequently, the decision boils down to a choice between an irrevocable life insurance trust (ILIT) and a family limited partnership (FLP). Let's take a closer look at these two options.

Background: The proceeds of a life insurance policy are not included in your taxable estate as long as you have not retained any "incidents of ownership" in the policy. What does that mean? For starters, you cannot be the owner of the policy and neither can your spouse nor estate. Similarly, if you keep the right to change or revoke beneficiaries, the proceeds will be included in your taxable estate.

Therefore, it makes sense to transfer ownership of existing policies to another entity such as a trust or partnership. However, there's a catch: the tax law says that the proceeds will revert to your taxable estate if the transfer takes place within three years of death. This creates an extra incentive to transfer existing policies as soon as possible.

With a transfer to an ILIT, you cannot act as the trustee or retain other powers in trust administration. Generally, a transfer to an FLP is even more problematic. For instance, say that

you establish an FLP where you retain a 1% interest as the general partner and other family members hold the remaining 99% interest. Under a strict interpretation of the tax code, only the 1% interest should be included in your taxable estate. However, the law can be murky in this area, so careful planning is essential. Furthermore, if the IRS successfully challenges the validity of the FLP, all of the proceeds will be included in your taxable estate.

If you transfer policies to an ILIT, you can provide the trust with cash to pay the premiums. A transfer to a trust that utilizes so-called Crummey powers—the limited right of beneficiaries to withdraw funds--qualifies as a gift of a "present interest." Therefore, the transfers may be completely exempt from gift tax, since the annual gift tax exclusion applies. In comparison, an FLP must provide the limited partners to withdraw funds in order to qualify for the annual gift tax exclusion. Thus, the FLP agreement must be properly structured to accomplish this result.

But there's more to estate planning than just taxes. As a general rule, an FLP will offer greater flexibility to the insured than an ILIT. As a general partner, you may be able to exert more control over the partnership assets, including the life insurance policy. While control of an ILIT is more indirect, the trustee may be granted broad powers of discretion. In either event, the documents can be structured to provide beneficiaries with protection from creditors.

Which option is better for you—the ILIT or the FLP? There is no "wrong" or "right" answer. Consider the potential benefits and drawbacks along with an experienced estate planner.

Facts and Figures

Timely points of particular interest

- **Return Policy**—In a new case, the IRS recomputed a taxpayer's return to provide a child tax credit. When it discovered the child did not qualify, it disqualified the credit. Now the Tax Court has stated that the taxpayer is not entitled to the erroneous credit. Despite the taxpayer's claim, the IRS cannot make "gifts" to taxpayers (Young, T.C. Summ. Op. 2003-170).

- **Tax Viewpoints**—A television cameraman was injured when basketball player Dennis Rodman kicked him during a game. Rodman and the cameraman settled the case before it went to the court. Since the settlement was not received as damages for a physical injury, the lump-sum payment was determined to be taxable to the cameraman (Amos, T.C. Memo 2003-329).