# Memo to File from Stuart Student

TO: File

FROM: Stuart Student

RE: Ben (tax year 2016)

**Facts**

Ben, a single taxpayer, divorced his wife, Jennifer. Through a court settlement between Ben and his former spouse, Ben paid Jennifer for alimony and child support. The separation decree included monthly payments made to Jennifer, where Ben pays $500 in alimony and $600 in child support.

Moreover, Ben was unemployed for 3 months of the year and received a total of $3,000 in unemployment benefits. During the 9 months of Ben’s employment, he paid his former spouse $9,900 and stated that $4,500 was for alimony payments and $5,400 was for child support. As a result of his unemployment and lack of sufficient payment, Ben gave Jennifer his home theatre equipment to compromise for the missed payments during 3 months of his unemployment. The theatre equipment has a basis of $6,000 and a market value of $3,300. Furthermore, Ben made $72,000 in earned income during the 9 months of his employment.

**Issue and Conclusion 1**

Can Ben deduct the alimony payments of $500 a month from his income? Can Ben deduct the $600 of child support payments from his income?

Yes, Ben is allowed to deduct the $500 of monthly alimony payments that he makes to his former spouse.

No, Ben cannot deduct the $600 of monthly child support payments.

**Analysis 1**

Alimony payments are fully deductible towards the total income of the individual making the payments and are included in the income of the individual receiving the payments. According to Sec.215(a), alimony payments are deductible towards Ben’s income. Ben can deduce the $500 of monthly alimony payments made to his former spouse in the same year in which he makes the payments. Alimony is strictly defined in Sec.71 of the Internal Revenue Code. In order for the payments to be considered alimony, such payments have to be arranged under a formal divorce agreement. Ben’s cash payments to Jennifer were ordered by the court. Second, Ben and his former spouse cannot reside under the same house, meaning that they cannot file a joint tax return. Also, Ben is not liable for any payments after the spouse’s point of death. After analysis, Ben’s cash payments of $500 are considered alimony and completely deductible. Alimony is considered a *For AGI* deduction, therefore it is subtracted from gross income. The former spouse would have to give Ben her identification number (S.S number) in order for Ben to insert her S.S number in his tax return for the year the payments were made Sec.215(c)(1) and Sec.215(c)(2). This will allow the IRS to confirm the alimony payments by concluding that the former spouse did indeed receive alimony payments, which is included in her gross income. This means that Ben would have a lower Adjusted Gross Income (AGI), if everything else is held equal. The fact that his AGI is lower provides a tax benefit for Ben because most itemized deductions are off of AGI floor limits.

The child support that Ben pays his former spouse during the tax year is not deductible. Payments made towards the care and support of a child are not part of alimony Sec.71(c)(1) and as a result, not allowed to be deduced during any year.

**Issue and Conclusion 2**

Is the $3,000 of unemployment compensation that Ben received for the quarter, taxable?

The $3,000 of unemployment compensation is fully taxable.

**Analysis 2**

Ben is required to include unemployment benefits into his gross income Sec.85(a). Any amount of compensation that Ben received during his three months of unemployment, relating to his unemployment, is considered unemployment compensation under law Sec.85(b). Therefore, the $3,000 of compensation Ben received for his unemployment during the quarter is subject to taxation. However, Reg. Sec 1.85-1 stipulates that Ben could be entitled to limitations that could benefit him. Under this regulation, effective after Dec. 31, 1978, Ben’s modified adjusted gross income would have to exceed the base amount of $20,000. Ben earns $72,000 plus the additional $3,000 in unemployment giving him a total of $75,000 in modified adjusted gross income. The difference between the modified AGI and the base is then divided by two, which will equal to $27,500. The rule states that Ben has to include in gross income the lesser of the $27,500 and the unemployment compensation. In the case of Ben, he would have to include the entire $3,000 of unemployment benefit. In summary, the unemployment compensation of $3,000 is fully taxable for Ben.

**Issue and Conclusion 3**

Does the theater equipment that Ben gave his former spouse as a means of settling the three months of not paying alimony qualify as valid alimony? If it doesn’t qualify, should Ben recognize a gain or loss from the transfer?

No, the transfer of theater equipment does not qualify as an alimony payment, therefore it cannot be treated as an alimony payment for deductibility purposes.

Ben would have to treat the transfer of property as a gift.

**Analysis 3**

One of the characteristics of alimony is that it is a cash payment made to the spouse under a separation decree Sec.71(b)(1). The key word here for Ben is *cash*. The transfer of the equipment is not a cash payment, instead, it is a disbursement of property. Only cash or cash equivalents, such as checks or money orders, are considered a valid form of alimony. A transfer of property is not a valid form of alimony Temp. Reg. Sec 1.71-1T(b).

Furthermore, Ben has made a transfer of property to his former spouse. Under Sec.1041(a)(2), no gain or loss is reported if the transfer was made to a former spouse. The transfer, however, must have occurred because of the divorce. A transfer of property is determined as being caused by the divorce if the transfer occurred within one year of the separation or if the transfer is related to the termination of the marriage Sec.1041(a)(2). Since Ben has been divorced for over two years he doesn’t meet the one-year limit. Therefore, the transfer must be related to the termination of the marriage in order for Ben not to recognize a gain or loss. In order to be related to the “cessation of the marriage”, the transfer must satisfy the two following requirements: (1) the transfer is made in accordance with a separation decree (2) and the transfer occurred within six years of the divorce Temp. Reg. 1.1041-1T, A-7.

The transfer was executed within six years of the divorce and Ben’s reason for the transfer of the music theater property was because of the alimony and child support payments stated in the separation decree. Based on these facts, the transfer resulted from the divorce, therefore, considered a gift.

Instead of Ben transferring the property to his former spouse, he could have sold the property himself and then forfeit the cash value to the spouse as alimony and child support.

**Issue and Conclusion 4**

Since Ben fell short of the payments he was required to make under the separation decree, how should the total payments he made throughout the year be divided between the alimony and the child support?

First, Ben would have to fulfill the required child support payments and whatever remains can be carried over to alimony.

**Analysis 4**

Ben was required to make $500 monthly alimony payments and $600 child support payments to his former spouse. In total Ben would have to pay $6,000 in alimony throughout the year and $7200 in child support throughout the year. Ben only made 9 out of the 12 monthly payments, falling short of the required amount. Ben forfeited to his former spouse a total of $9,900 in alimony and child support. Under Sec.7(c)(3), Ben would have to allocate alimony payments to child support first and then report the remaining amount under alimony. Like in Adrio M. Baur, TC Memo 2014-117, Ben is not entitled to deduct $4,500 in alimony. He would first report $7200 in child support and the remaining $2,700 he would report as alimony. Similarly, In GUTHRIE v. U.S., 19 AFTR 2d 1018 (264 F. Supp. 840) (1967), the court affirmed that alimony should be reduced to satisfy child support payments. The law views the portion of payments towards a minor child as the priority. Whatever remains can be given, as alimony, to the wife. Ben would owe Jennifer $3300 in alimony payments. This revision of Ben’s tax liability would cause Ben to report less alimony, which will inevitably reduce his deductions and increase his Adjusted Gross Income. With a higher AGI, Ben would have to accumulate more miscellaneous itemized deductions to overcome the 2% floor, as explained in Sec 67(a). Most importantly for Ben, he will have to pay more taxes, similar to what happened to Adrio M. Baur in the TC Memo 2014-117. In the court ruling, Baur was not given clearance to report the excess alimony payments under Section 215. The defendant argued that under Section 71, a fraction of the payments must be allocated towards the support of the child.

**Issue and Conclusion 5**

Is the $72,000 of earned income that Ben received during the year taxable, if so at what rate?

The $72,000 of earned income is fully taxable and the income is taxed at the ordinary rate.

**Analysis 5**

Gross income is calculated by adding all of the income received by an individual. In other words, it is income from whatever origin Code Sec.61(a). The definition of gross income is intentionally broadened to include income from anywhere, from any activity. Sources of income include salary compensation, fringe benefits, fees, awards, winnings, income from business, income from investment, trade, illegal activities and many other sources. Ben’s salary of $72,000 fits in this category and should be included in gross income. Salary compensation is classified as earned income Code Sec.32(c)(2)(A)(i). Earned income or income from services is taxed at the ordinary rate; Ben would have to calculate the tax liability of his salary compensation using his current marginal tax rate. He would have to use the tax rate schedule for Single fillers assuming Ben doesn’t remarry or file as head of household.

**Issue and Conclusion 6**

How would the transfer of property (the musical theater equipment) from Ben to his former spouse affect Ben’s income tax.

Sec. 1041(b) explains that the transfer of the equipment must be treated as a gift. Ben does not recognize a gain or loss from the transfer. Moreover, Ben does not pay any additional estate or gift tax.

**Analysis 6**

Ben, the transferor, does not recognize a gain or loss from the transfer of equipment. For a transfer to be called a gift, the transferor must not expect anything in return from his actions. Ben cannot expect the transfer of equipment to supplant the alimony and child support. Also, the transferee, Jennifer, does not recognize any gain or loss when receiving the property. The basis for the property is the basis of $6000 when the transferor, Ben controlled the musical theater equipment.

According to Sec. 2503(b)(1), Ben does not include in the year’s total gifts the first $10,000. This means that Ben has a tax exemption for the gift of $10,000 that would cover the entire basis of the transferred property. Consequentially, Ben is not subject to pay any additional gift or estate taxes from the transferred equipment.