

THE PRACTITIONER

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Deductibility of Spousal Support

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Ewell v. Commissioner, 71 T.C.M. 3134 (May 30, 1996), underscores the necessity of an order or written agreement in order for spousal support payments to be deductible. The case also sheds light on the issue of deductibility of mortgage and property tax payments during separation.

The parties separated in 1987. A month after separation, the wife gave the husband a list of her expenses. Shortly thereafter, the wife was admitted into the hospital. The husband orally agreed to make the required payments in connection with their business, farm and other community assets while the wife was in the hospital. The wife remained there for two months.

When the wife left the hospital in May 1987, the husband began paying her approximately \$3,700 per month. He wrote the word "alimony" on the checks. He also paid the mortgage and property taxes on the parties' jointly owned property, as well as other payments. The mortgage and property taxes were paid from accounts that contained both community and separate property.

In August 1987, the wife's lawyer sent the husband's lawyer a proposed temporary agreement dealing with several issues, including support and debt payment. The husband's attorney responded that the husband wanted marriage counseling before the divorce would go forward, but stated that some of the proposals were acceptable.

In December 1987, the parties signed a stipulation and order providing for \$2,100 per month spousal support. The stipulation also provided that the husband would pay community obligations when due, but would have a right of reimbursement for the payments he made to satisfy the community obligations.

The husband claimed on his 1987 federal income tax return all the amounts he paid for spousal support for that year, plus all the mortgage interest and taxes he paid on the parties' community property. The Internal Revenue Service challenged these deductions.

With respect to the spousal support, the Tax Court cited Internal Revenue Code Section 71(b)(2)(A), which provides that in order for payments to be deductible as alimony, they must be made pursuant to a written divorce or separation agreement or a support decree. The court explained that while the code does not define the term "written separation agreement," cases hold that there must be a clear statement of

the support terms in a writing that constitutes an agreement.

Applying this standard, the court found that prior to the December 1987 stipulation, no written separation agreement existed. The court denied the deduction for the spousal support made prior to that stipulation.

The husband's oral promise to pay the list of expenses the wife provided was deficient because it was not in writing. The notation on the checks that they were alimony did not satisfy the written agreement requirement. The letters between counsel never constituted

method and was not detailed enough. However, the court applied the family expenditure method to hold that 56 percent of the payments came from the husband's separate property. Accordingly, the husband could deduct 56 percent of the wife's portion of the mortgage interest and tax payments.

With respect to the methods of tracing, the IRS argued that the husband should not be allowed to deduct the wife's half of the payments because there was sufficient community property available to make the payments. The court also rejected this argument because under the direct tracing method, which a taxpayer is allowed to employ, a taxpayer need not show that community funds are exhausted in order to trace payments directly to separate property.

This case provides several important lessons. The attorney representing the party paying, or contemplating paying, support

should advise the client that any payments made before the required written agreement or order exists will not be deductible. Prudence dictates that if a written agreement will provide the basis for the deductibility claim, and not a court order, the parties (and attorneys) should sign the agreement. In this way, disputes with the IRS over whether letters between the parties or between counsel constitute a valid contract will be avoided.

Furthermore, the party paying support would probably prefer a written agreement to an order. With an order, the party receiving support would have access to enforcement remedies, including contempt. On the other hand, if the basis for support is only an agreement, enforcement is much more problematic. In such a case, the party receiving support would have the more cumbersome problem of enforcing the contract either through an independent action or perhaps in the dissolution action.

Ewell also illustrates that when a party has a right to reimbursement, this right could preclude deductibility of payments for community debt. Thus, one approach is to consider the issue of reimbursement and tax deductibility before entering into an agreement or stipulated order. Depending on the facts of the case, it may be more advantageous for the party making the payments to have a reimbursement claim rather than the tax deduction. The agreement or order can specify which party will be entitled to claim the deductions.

The agreement or order should detail the issue of reimbursement. An explicit right to reimbursement could preclude deductibility, and the IRS could always argue that a spouse making the payments has a right to reimbursement as a matter of law, even if the right to reimbursement is not stated in the agreement or order. Thus, the agreement or order could state that the party making the payments, and who is entitled to deduct the entire amount of the payments, also waives any right to reimbursement.

When a party has a reimbursement right, it could preclude deductibility of payments for community debt.

an agreement, because a meeting of the minds was not reached. The letters merely were negotiations.

The husband's claim that he should be able to deduct the entire amount of the mortgage interest and property taxes on the community property raised issues of tracing and the effect of his right to reimbursement. The IRS challenged the husband's right to the deduction for the wife's half of the payments.

The IRS argued that the husband's right to be reimbursed for the debt payments prevented him from claiming the deduction for amounts that he could be reimbursed. The court, however, rejected this argument since the chances of reimbursement were highly unlikely because the wife had filed for bankruptcy with a no-asset case.

Also, since the parties were jointly and severally liable for the interest and taxes on the properties, if the husband had not made the payments, the mortgage could have been foreclosed or the taxing authority may have forced a sale. Thus, the court held that the husband's reimbursement right did not prevent him from claiming the deduction.

The IRS also argued that the husband did not prove he made the payments from his separate property (rather than from the community money available to pay the community debt), a fact that the husband was obligated to prove in order to claim the deduction for the payments that represented the wife's half. When the parties separated, they had approximately \$67,000 in community accounts. Between the date of separation and the end of 1987, the parties added \$77,000 in community property to those accounts. Also, during this time period, the husband deposited at least \$146,000 of his separate property into their joint checking account.

The court held that the husband could prove that he made the payments by either the direct tracing method or the family-expenditure method. In this case, the husband's direct tracing document was only partially admissible, did not properly apply the direct tracing

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