



ESTIMATED TAX PAYMENTS PART II:

REQUIREMENTS FOR SPOUSAL SUPPORT RECIPIENTS TO MAKE PAYMENTS—TRAP FOR THE UNWARY

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Last month's column covered the need for divorce attorneys to appropriately "capture" as a marital asset estimated taxes paid or withheld in excess of the actual tax liability for the final year of the marriage, or part of a year, as the case may be.

There is also a need for spousal support recipients to be aware of requirements to make federal and state estimated tax payments on alimony income. Unlike with wages and salaries, tax is not withheld on spousal support payments. And, it is not uncommon for newly divorced spousal support recipients to be unaware of the obligation to make estimated tax payments on alimony income.

For federal, state, and, where applicable, city income tax purposes, estimated tax payments are due by April 15, June 15, September 15, and January 15 of the succeeding year. Forms 1040ES and MI 1040ES are used for this purpose for federal and Michigan estimates.

A consequence of not making required estimated tax payments is an underpayment penalty. In addition, of course, it may also result in an unexpectedly large tax liability when April 15 rolls around.

Two exceptions to the imposition of the underpayment penalty are:

1. The total of tax withheld and timely made estimated tax payments exceeds 90% of the current year's tax liability.
2. The total of tax withheld and timely made estimated tax payments exceeds 100% of the prior year's tax liability.

Example 1 – 90% of Current Year Tax Exception

- W has annual W-2 earnings of \$30,000 and receives spousal support of \$4,000 a month.
- Withholdings of \$3,500 more than cover the tax on her \$30,000 W-2 income (after reducing same by the standard deduction and exemptions). But, her federal income tax on the \$48,000 of alimony income is \$10,000 (all taxed at a higher bracket).

- W should make federal estimated tax payments of \$2,500 quarterly to avoid being subject to the underpayment penalty. She should do the same with respect to her state tax on the alimony income, and her city income tax, if applicable.
- If she does, her \$13,500 combined federal tax withheld and timely made estimated tax payments will exceed 90% of her current year tax liability.

Example 2 – 100% of Prior Year Tax Exception in First Year After Divorce

- Assume the same facts, but add that the current year is the first year W received spousal support and that no one advised her of the requirement to make estimated tax payments.
- She was so advised, however, by her new tax return preparer early the following year and was also informed of the two exceptions to the underpayment penalty.
- She certainly did not pay in 90% of her current year tax, which includes the \$10,000 on her alimony income.
- So, she asked, since she filed jointly with her ex-H last year, how is her prior year tax calculated to determine whether she qualifies for the exception of taxes withheld exceeding 100% of her prior year tax. In this regard, Ex-H's W-2 income was \$70,000 in the prior year. The parties had minimal interest income.
- W's tax preparer told her that Treasury Regulation 1.6654-2(e) provides the method for calculating tax for this purpose in cases of a change from a joint to separate tax return, essentially as follows:
 - The income and deductions on the prior year joint return are allocated between the parties based on to whom the income and deductions were attributable.
 - With income and deductions so allocated, each party's tax is calculated as if he/she had filed a separate return for the prior year.

- The two separate hypothetical tax liabilities are added together.
- The percentage of each party's hypothetical separate tax to the sum of both is then applied to the actual joint tax liability to yield each party's "prior year tax" to determine if the penalty exception applies.
- Applied to W's situation:
 - Prior year joint federal tax liability - \$9,000
 - Ex-H's hypothetical separate return prior year liability - \$7,000
 - W's hypothetical separate return prior year liability - \$4,000
 - W's percentage of total of hypothetical separate return prior year liabilities - $\$4,000/\$11,000 = 36.36\%$.
 - W's share of prior year joint tax - $36.36\% \times \$9,000 = \$3,272$.
 - Since W's \$3,500 tax withheld exceeds 100% of her allocable \$3,272 "prior year tax", she will not be subject to the underpayment penalty for the current year.

Observation: Family law practitioners representing spousal support recipients should advise them to talk to a tax advisor regarding applicable federal, state, and city estimated tax requirements.

About the Author

Joe Cunningham has over 25 years of experience specializing in financial and tax aspects of divorce, including business valuation, valuing and dividing retirement benefits, and developing settlement proposals. He has lectured extensively for ICLE, the Family Law Section, and the MACPA. Joe is also the author of numerous journal articles and chapters in family law treatises. His office is in Troy though his practice is statewide.