Nontaxable/Nondeductible Designation of Payments

By Joseph W. Cunningham, JD, CPA

General

A question put to me recently was, essentially – Can payments that may qualify as taxable/deductible be stipulated as nontaxable/nondeductible with assurance they will be so treated for tax purposes?

The answer is "yes", pursuant to IRC 71(b)(1)(B). Just as it is important to include a "tax intent" provision when payments are intended to be taxable/deductible, the same is advisable when they are intended to be nontaxable/nondeductible. Tax intent provisions prevent misunderstandings down the road. Sometimes a tax preparer may suggest payments are deductible by the payer when such was not intended. A tax intent provision prevents this.

The following is sample generic language for a nontaxable/nondeductible tax intent provision:

> "Defendant's payments of [property/spousal support] to Plaintiff provided in paragraph [ ] are hereby designated by the parties, pursuant to IRC Section 71(b)(1)(B), as not includable in Plaintiff's income under IRC Section 71 and, correspondingly, not deductible by Defendant under IRC Section 215. Plaintiff and Defendant agree that neither will file an income tax return on which subject payments are reported inconsistently with their expressly designated nontaxable/nondeductible status."

Other Uses

Lump-Sum Payable on Death of Payer—The nontaxable/nondeductible designation can be used to ensure that payments of life insurance proceeds or a lump-sum settlement from the estate of a deceased spousal support payer, which is not deductible as alimony on an estate's income tax return, will not be taxable to the payee. This prevents the possibility of one party being taxed on a sizable payment for which there is no corresponding deduction by the other's successor-in-interest.

It is common after the death of an alimony payer to convert the balance of the obligation to its lump-sum, present value, after-tax equivalent (using the payee's tax rate) and pay it in full with insurance proceeds. The nontaxable designation accommodates this practice.

Lump-Sum Payable for Other Reasons—Similarly, the Section 71(b)(1)(B) designation is often advantageous when Section 71 installment payments of property are prepaid in full, often by determining the after-tax, present value of remaining payments. Such lump-sum prepayments may result from an acceleration (1) due to default or (2) pursuant to terms of the settlement – e.g., prepayment option or mandatory lump-sum payment on the sale of a business.

The nontaxable designation provided in the event of an acceleration prevents what might otherwise result in a taxable/deductible amount of a size that propels the payee into a much higher bracket while providing the payer a tax benefit at a low rate.

Sample language for this purpose is as follows:

> "If Defendant elects to prepay the Section 71 payment obligation to Plaintiff under paragraph *[ ]*, the lump-sum prepayment is designated under IRC 71(b)(1)(B) as not includable in Plaintiff's income under IRC 71 and correspondingly not deductible by Defendant under IRC 215. Plaintiff and Defendant agree that they will file tax returns consistent with the nontaxable/nondeductible status of a lump-sum prepayment, if one is made."
>
> It should be noted that this language addresses only the tax treatment of the prepayment. Additional language would be required to convert the remaining stream of payments to its present value, after-tax equivalent as a lump sum.

Avoiding Alimony Recapture—The designation is also a means to avoid the recapture of relatively large amounts of IRC 71 payments made in the first year or two following the divorce.

No Effect on Other Payments—Further, specific payments, such as the lump-sum payments referred to above, may be designated as nontaxable/nondeductible without disturbing the taxable/deductible treatment of regular monthly spousal support or Section 71 payments of property.

Providing for the Designation

The IRS has not issued specific language to use to make the IRC 71(b)(1)(B) nontaxable/nondeductible designation. However, a couple of tax court cases have indicated that the language used should be clear and unambiguous.

The two samples presented above should suffice in this regard. Note, however, that the above sample provisions are offered as generic language which must, of course, be adapted to the specific circumstances of any particular case. The author is not responsible for the correctness or effectiveness of any such adaptation.

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.*