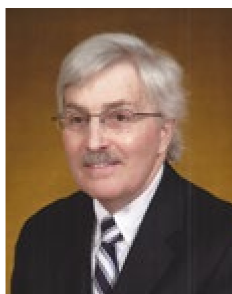

Michigan Court of Appeals Rules on Dispute on Calculation of Interest on a Divorce-Related Installment Obligation and, a Better Way to Do It. *Elam v Elam*, Mich App 348201 (10/15/20)

By Joseph W. Cunningham, JD, CPA

Facts:

- As part of their 2005 Settlement Agreement, H was obligated to pay W $1,000 principal & interest payments a month over 12 years on a $175,000 debt to her.
- The obligation was to be secured by certain real property and, further, H was to sign a "mortgage note" – *which he never did.*
- Interest on the obligation was provided as "accruing interest as a traditional mortgage note in the amount of 3.75%."
- After the final payment in 2017, W claimed that H owed her over $50,000 in accrued interest.
- H claimed that a simple interest rate should apply resulting in accrued interest of $6,250.
- W's expert testified that "a traditional mortgage note meant a bank mortgage calculated under an amortized interest schedule" - which means interest compounded monthly.
- H's expert testified that, without a note, he could not determine the interest owing.
- In short, the trial court applied laches and ruled that, because W did not seek to enforce the provision that H sign a note, H's interest calculation should apply.
- W appealed.

Continued on next page

Court of Appeals Decision

- In pertinent part, the Court ruled that the language in the Settlement Agreement providing for "interest as a traditional mortgage note in the amount of 3.75%" was not ambiguous and, accordingly, that the trial court erred by adopting H's calculated simple interest.
- It also held that the trial court could not sua sponte raise the defense of laches. H had not claimed laches as a defense but rather that W's calculation was incorrect.
- The case was remanded so that the accrued interest owing would be calculated as it would be under a traditional mortgage note.

A Better to Way to Provide for Interest on a Divorce-Related Installment Obligation

- The IRS has ruled that interest on an obligation between divorced spouses is "personal interest" and, hence, not deductible by the payor.
- But, it is nonetheless taxable to the payee.
- To avoid this tax whipsaw, the interest rate can be converted to its lower, after-tax equivalent and "baked in" to the payments.
- For example, 2.5% is the approximate after-tax equivalent of a 3.5% pre-tax rate for an individual in a 25 percent tax bracket.
- The first step is to calculate the payment by running an amortization schedule using the after-tax rate - 2.5% in the above example. Then provide in the divorce document for the payor to make the payments with no stated interest.
- The use of an unstated after-tax rate avoids having the payee pay tax on interest the payor cannot deduct.
- This is a viable approach since the IRS has stated that the imputed interest rules do not apply to divorce settlement obligations. Tech Adv Mem 200624065 (Dec 6, 2005); Priv Ltr Rul 8645082 (Aug 14, 1986).
- Prepayment can be accommodated by providing for a discount equal to the after-tax rate applied to the remaining payments over the period they are scheduled to be paid. Here is a sample clause:

  "Plaintiff is entitled to prepay this obligation, either in full or in part, by making payments in excess of the required payments. If Plaintiff does prepay the obligation, in full or in part, *[he / she]* is entitled to a discount on the remaining balance of the installment payments equal to 2.5 percent of the amount prepaid for each year (prorated for a partial year) between when the prepayment is made and when such amount would otherwise be due pursuant to the terms provided above."

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.

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