

SHELTON E. & CLAUDIA B. ALLRED	§	STATE OF ALABAMA
Post Office Box 1589		DEPARTMENT OF REVENUE
Ozark, Alabama 36360,	§	ADMINISTRATIVE LAW DIVISION
Taxpayers,	§	DOCKET NO. INC. 95-439
v.	§	
STATE OF ALABAMA	§	
DEPARTMENT OF REVENUE.		

FINAL ORDER

The Revenue Department assessed income tax against Shelton E. and Claudia B. Allred ("Taxpayers") for the years 1991 and 1992.

The Taxpayers appealed to the Administrative Law Division, and a hearing was conducted on January 30, 1996. CPA Jim Ellis represented the Taxpayers. Assistant Counsel Antoinette Jones represented the Department.

The Taxpayer, Shelton Allred, was divorced in 1980 and was required by the divorce decree to pay the monthly mortgage on the marital residence awarded to his ex-wife. The issue in this case is whether those payments can be deducted by the Taxpayer as alimony pursuant to Code of Ala. 1975, §40-18-15(18).

The Taxpayer and his ex-wife were divorced in Dale County, Alabama in 1980. The divorce decree provided in part as follows:

2. The wife shall receive legal title to the residence of the parties known as 447 East Broad Street, Ozark, Alabama free of responsibility for the existing debt up to the present amount. The husband will pay the balance due on the existing mortgage as the debt becomes due.

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8. The husband will pay the wife the sum of \$25,000.00 per year in periodic alimony . . .

The Taxpayer made the payments and then deducted the amounts paid as alimony on his Alabama income tax returns. The Revenue Department audited the Taxpayer for 1982 and 1983, and allowed the mortgage payments as deductible alimony.

The Department audited the Taxpayer for the years in issue and disallowed the payments as alimony in those years. The Taxpayer appealed the resulting final assessments to the Administrative Law Division.

Code of Ala. 1975, §40-18-15(18) allows a deduction for alimony and separate maintenance payments as allowed under federal law at 26 U.S.C.A. §215. That section allows a deduction to the payor spouse to the extent that such payments are includable as income to the payee spouse under 26 U.S.C.A. §71.

The tax rules concerning alimony and separate maintenance payments were substantially altered by the Tax Reform Act of 1984.

The pre-1985 rules apply in this case because the Taxpayer was divorced in 1980. Under those pre-1985 rules, payments by a payor spouse were deductible as alimony if the following conditions were met:

- (1) The payments must have been imposed or incurred by the payor spouse under a decree of divorce or separation, or a written instrument incident to such decree;
- (2) Payments must be made in discharge of a legal obligation based on the marital relation;
- (3) Payments must qualify as periodic payments.

Reg. §1.71-2, ¶6095.023, 1994 CCH Standard Federal Tax Reports.

Under pre-1985 law, installment payments did not qualify as "periodic" if they were in payment of a fixed "principal sum". The mortgage payments in question were for a fixed principal amount. However, such payments still qualified as "periodic" if they extended over a period of 10 years or more. But even if the 10 year exception applied, the payments still could not be deducted if they were in the nature of installment payments in discharge of a property settlement, rather than in the nature of alimony. Riley v. U.S., 649 F.2d 768 (10th Cir. 1981); White v. CIR, 740 F.2d 836 (11th Cir. 1984).

In White, the Court addressed the issue as follows:

Under section 71(a)(1), however, if installment payments under such a divorce decree discharge a part of an obligation, the principal sum of which is, either in terms of money or property, specified in the decree, then the installment payments are not treated as periodic payments, and therefore, are not taxable to the wife. 26 U.S.C. § 71(c)(1). Section 71(c)(2), however, creates an exception to section (c)(1). Section 71(c)(2) states that if by the terms of the decree the principal sum referred to in subparagraph (1) may be paid over a period in excess of ten years from the date of the decree, then the installment payments shall be treated as periodic payments. 26 U.S.C. § 71(c)(2).

In this case, the monthly installments of \$3,000 per month were to continue for 21.9 years - clearly in excess of ten years. Thus, the payments fit within section 71(c)(2) and must be treated as periodic payments. The fact that the payments are periodic, however, does not alone establish that the payments should be treated as alimony. Not only must the payments be periodic, but they must also meet the standard of section 71(a)(1), which requires that such payments be in the nature of support rather than a division of property. Riley v. C.I.R., 649 F.2d 768, 733 (10th Cir. 1981); Lambros v.

*C.I.R.*, 459 F.2d 69, 71 (6th Cir. 1972); *McCombs v. C.I.R.*, 397 F.2d 4, 7 (10th Cir. 1968); *Campbell v. Lake*, 220 F.2d 341, 342043 (5th Cir. 1955); *Joslin v. C.I.R.*, 52 T.C. 231 (1969), *aff'd*, 424 F.2d 1223 (7th Cir. 1979).

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The federal courts have set out certain criteria for distinguishing alimony payments from property settlement payments. In *Riley v. Commissioner*, 649 F.2d 768 (10th Cir. 1981), the Tenth Circuit held that the payment of \$300 per month until \$36,300 had been paid constituted part of a property settlement rather than support payments to the wife. The court found that the following facts to be determinative: (1) the obligation to pay the payments was unconditional; (2) the payments were to continue in the event of remarriage or death; (3) the payments were secured by an insurance policy and the principal of a trust; and (4) the divorce decree characterized the installment payments as a property settlement. *Id.* at 774. The *Riley* court concluded: "These factors, singularly and collectively, indicate that the payments to Ruth were definitely in the nature of a property settlement and not alimony." *Id.*

White, *supra*, at page 840.

In this case, the Taxpayer was unconditionally obligated to make the mortgage payments. Under Alabama law, that obligation would not cease on the death or remarriage of his ex-wife. The decree also made a specific, separate provision for periodic alimony of \$25,000.00 a year. Given those facts, the payments were in the nature of a property settlement, and not alimony. Consequently, they cannot be deducted by the Taxpayer.

However, the failure to timely pay penalty should be waived for reasonable cause. The negligence penalty was also improperly assessed and should be deleted from the assessments.

The Department entered the preliminary assessments for the

years in issue on June 30, 1995. At that time, Code of Ala. 1975, §40-2A-11(b) levied a penalty for failure to timely pay any tax due.<sup>1</sup> Code of Ala. 1975, §40-2A-11(c) also levied a negligence penalty for careless or reckless disregard for a statute or regulation.

The Department had audited Mr. Allred in 1982 and 1983, and had allowed him to deduct the subject mortgage payments as alimony.

The Taxpayer thus had reasonable cause to believe that the payments could be deducted. Based thereon, the Taxpayer in good faith continued to deduct the payments as alimony on his Alabama returns. Reasonable cause thus exists for the failure to timely pay penalties to be waived. The negligence penalties were also improperly assessed for the above reason. The Taxpayers were not negligent and did not carelessly disregard the law in deducting the payments as alimony.

The final assessments, less the penalties, are affirmed. Judgment is entered against the Taxpayers for 1991 income tax in

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<sup>1</sup>Act 95-607, enacted effective July 31, 1995, amended §40-2A-11(b) so that the failure to timely pay penalty now applies only if a taxpayer fails to pay an amount timely reported on a return.

the amount of \$685.24, and 1992 income tax in the amount of \$342.26, plus applicable interest.

This Final Order may be appealed to circuit court within 30 days pursuant to Code of Ala. 1975, §40-2A-9(g).

Entered March 21, 1996.

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BILL THOMPSON  
Chief Administrative Law Judge