Exploring the Tax Perils of Temporary Unallocated Family Support

by Richard I. Zuber

While a rose by any other name may smell as sweet, the same can no longer be said for using the terminology of "temporary unallocated family support."[1] By reason of several 1999 Tax Court decisions,[2] family law practitioners who imprudently seek to Lesterize[3] or use unallocated family support terminology in their temporary orders may subject their clients to serious and unexpected tax consequences. This article explores these tax consequences and suggests possible approaches available to practitioners who wish to maximize tax savings through the use of unallocated family support provisions.

Background

Prior to the enactment of the Tax Reform Act of 1984,[4] and often relying on the 1961 Supreme Court decision of *Commissioner v. Lester*[5] as authority, family law practitioners frequently used provisions in their Separation Agreements calling for the payment of "family support." The "family support" provisions customarily lumped together spousal support and child support without allocating or "fixing" the amount paid for each. In addition, prior to 1984, it also was a common practice for divorce decrees or Separation Agreements to provide that this unallocated family support amount be reduced when the payor's child support obligations would have ended.[6] The primary justification for the use of these unallocated family support provisions was to increase the after-tax dollars available to the parties and to the family unit. This was accomplished by making the recipient's entire combined support amount includable in gross income, as structured alimony, and making it deductible by the payor, thereby maximizing the shifting of income from the spouse in the higher tax bracket to the spouse in the lower tax bracket.[7]

Ignoring what family law practitioners had historically considered to be sensible cash flow planning between separated spouses, Congress sought to override *Lester* by enacting Internal Revenue Code ("Code") § 71(c)(2) as part of the Tax Reform Act of 1984.[8] This Code section sought to eliminate the deductibility (as maintenance) of unallocated family support payments by expanding the concept of what would be considered an amount "fixed" or payable for the support of children. Code § 71(c)(2) provides that:

> . . . if any amount specified in the instrument will be reduced—
> (A) on the happening of a contingency specified in the instrument relating to a child (such as attaining a specified age, marrying, dying, leaving school, or a similar contingency) or
> (B) at a time which can clearly be associated with a contingency of a kind specified in subparagraph (A), an amount equal to the amount of such reduction will be treated as an amount *fixed* as payable for the support of children of the payor spouse.[9]
> (*Emphasis added.*)

While some practitioners initially believed that the statute was broad enough to repeal *Lester* by expanding the concept of what would be considered an amount fixed as child support, both tax commentators and tax courts have now come to realize that the Internal Revenue Service ("Service") has, surprisingly, retained *Lester*.[10] As one commentator notes, "this is especially the case where the parties are willing to structure the payment schedules so as to fall outside the scope of Code § 71(c)(2)."[11] Nevertheless, in 1999, it became clear to Colorado attorneys that structuring the unallocated family support payment schedule to fall outside Code § 71(c)(2) was insufficient to escape the scrutiny of the Service.

The *Miller* Case

On August 12, 1999, the Tax Court in *Miller v. Commissioner*[12] addressed the issue of whether any portion of temporary unallocated family support payments, made pursuant to a written stipulation and a Colorado court order, qualified under the Code as taxable/deductible alimony.[13] The temporary orders stipulation of the parties provided in part that:

> As temporary support . . . [the husband] shall pay . . . [the wife] unallocated child support and maintenance in an amount equal to fifty-five percent of his net income. . . . Payments shall be due . . . commencing immediately after the hearing

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herein and continuing *until further Order of Court*. . . . [The husband's] temporary support payments herein shall include his contributions toward the son's attendance at Denver Academy and toward the skating activities of the daughter. . . .[14] (*Emphasis added.*)

After reviewing the parties' temporary orders stipulation, the *Miller* Tax Court first found that: (1) the unallocated child support and maintenance language used by the parties was to be construed as an attempt to provide for unallocated family support; (2) the temporary orders did not state how the parties were to treat the temporary unallocated payments to the wife for tax purposes; (3) the stipulation did not specify what portion, if any, of the temporary unallocated child support and maintenance payments was for child support;[15] and (4) despite the references to the children, the temporary orders did not include any contingencies related to the children that would "reduce or terminate the payments or any portion thereof."[16]

The Tax Court then focused on whether the *Miller* temporary unallocated family support order satisfied the alimony requirements as defined in Code § 71(b).[17] In making its analysis, the requirement that most concerned the Tax Court was whether the husband would have had liability to make temporary unallocated family support payments after the death of his wife.[18] This concern arose because the temporary orders failed to contain language that provided for the termination of the unallocated family support payments on the death of the wife. Rather, the temporary orders simply provided that the payments would continue until further order of the court.

Although this omission of termination language was problematic, it was not dispositive. The Tax Court acknowledged that under existing law, the *Miller* temporary orders agreement need not expressly state that the payment obligation terminates on the death of the wife if termination would occur by operation of state law.[19] The Tax Court then determined, on a conflict of laws analysis, which state's law was applicable. Both parties in *Miller* resided in Colorado at the time of their temporary orders stipulation. Therefore, the Tax Court found that Colorado law would be controlling on the issue of whether or not temporary unallocated family support payments would terminate immediately upon the wife's death.[20]

Next, the Tax Court noted that Colorado's version of the Uniform Dissolution of Marriage Act ("UDMA") provided for automatic termination of maintenance or alimony provisions on the death of the payee spouse.[21] However, the Tax Court indicated that the Colorado statute did not contain language regarding the automatic termination of provisions calling for the payment of "temporary unallocated family support." Further, the Tax Court determined that, in Colorado, temporary orders, in a generic sense, did not automatically abate on the death of a spouse.[22] The Tax Court found that Colorado's UDMA provided that temporary orders "terminate when the final decree is entered, unless continued by the court for good cause to a date certain or when the Petition for Dissolution or Legal Separation is voluntarily dismissed."[23]

> " . . . [I]t became clear to Colorado attorneys that structuring the unallocated family support payment schedule to fall outside IRC § 71(c)(2) was insufficient to escape the scrutiny of the Service."

Finally, the Tax Court determined that the husband had failed to establish that he would have no liability under Colorado law to make further temporary unallocated family support payments if the wife died during the pendency of temporary orders and prior to the entry of a voluntary dismissal order. The Tax Court held that the husband's failure to satisfy the alimony termination requirements of Code § 71 (b)(1)(D) also was fatal to the Service's argument that the unallocated family support payments to the wife should have been included in her income as alimony under the Code § 71.[24]

Notwithstanding the favorable outcome for the wife, the Tax Court strongly suggested that the taxability issue just as easily could have been decided adversely to the wife.[25] The Tax Court pointed out that neither the wife nor the Service had argued that any portion of the temporary unallocated payments the wife received was "fixed" as child support. Rather, the Tax Court noted that the Service had taken the position that because the payments to the wife were not alimony, by the process of elimination, the payments could only be child support.[26]

However, the *Miller* Tax Court did not accept this reasoning, but declined, with reservation, to decide whether unallocated family support payments would qualify as non-taxable "fixed" child support under Code § 71(c). The Tax Court's reservation was expressed further, when it noted that "no other ground for asserting that the payments are includable in [the wife's] income has been raised by the Respondent in this case."[27]

As a warning to taxpayers, the Tax Court pointed out in a concluding footnote:

> Respondent [Commissioner] did not raise § 61 as an alternative ground for including the unallocated payments in Ms. Miller's income. . . . Since the issue was not raised expressly in the notice of deficiency and since all the parties have tried this case on the assumption that only § 71 applies, we do not address whether family support payments not meeting the requirements of § 71 must be included as income under § 61.[28]

The import to practitioners of the Tax Court in *Miller* suggesting Code § 61 as an alternate ground for inclusion into the wife's income is that it could be used by the Service in the future to circumvent the statutory alimony requirements, under Code §§ 71 and 215, for taxable/deductible alimony.

A New Wrinkle

Two months after deciding *Miller*, a new wrinkle was added to the already perilous minefield of "temporary unallocated family support" orders. Once again, the Tax Court, in the case of *Gonzales v. Commissioner*, considered the issue of whether any portion of "temporary unallocated family support" payments, made to the wife pursuant to a written stipulation and a New Jersey court order, constituted taxable alimony under Code § 71(a).[29]

The parties' temporary orders stipulation (consent order), in relevant part, provided:

> . . . [P]ending the resolution of this matter . . . [the husband] shall pay $7,500.00 per month unallocated . . . as and for the support of [the wife] and the infant children of the marriage, from which sum . . . [the wife] shall pay all family expenses, including the mortgage, children's school expenses and unreimbursed medical expenses and her schooling. . . .[30]

Analogous to its findings in the *Miller* case, the Tax Court in *Gonzales* prelimi-

narily found that the temporary orders stipulation failed to indicate (1) how the payments would be treated for tax purposes; (2) whether the payments would terminate at the payee spouse's death; and (3) what portion thereof represented child support. The Tax Court determined that the termination requirement of Code § 71 (b)(1)(D) was dispositive. In attempting to resolve the termination at death issue, the Tax Court noted that, "[i]f the payor is liable to make even one otherwise qualifying payment after the recipient's death, none of the related payments required before death will be alimony.[31] The Tax Court also stated, "[w]hether such an obligation exists may be determined by the terms of the applicable instrument, or if the instrument is silent on the matter, by looking at State law."[32] (*Citations omitted.*)

In reviewing New Jersey law on the termination at death issue, the Tax Court initially concluded that while "alimony" ends at the recipient's death, there was no statutory authority providing for the automatic termination at death of unallocated family support payments.[33] Thus, the Tax Court implicitly adopted the *Miller* case rationale and suggested that the payor spouse's liability to make temporary unallocated family support payments might continue after the death of the payee spouse, and at least until the entry of permanent orders or a further order of the court after a plenary hearing.[34]

Further, the Tax Court stated that the New Jersey Rules of Court gave additional authority for New Jersey courts to enter, on a showing of good cause, temporary unallocated family support orders in lieu of separate and distinct alimony and child support orders.[35] The Tax Court noted that New Jersey precedent existed to permit a domestic relations court to *modify* a temporary unallocated family support order based on a change of circumstance occurring as to the children.[36] Thus, the Tax Court reasoned that the husband possibly could be liable to make reduced family support payments under a future *modified* court order for the benefit of his children and after the death of his spouse. However, the identity of the person who would receive such payments for the children was not discussed in the decision.

The Tax Court also relied on authority from Tax Court decisions in other jurisdictions to support its holding that temporary unallocated family support, at least under the facts in *Gonzales*, was not alimony.[37] Finally, in a concluding footnote, the Tax Court stated that it was not going to characterize the wife's payments from the husband other than to hold that they were not alimony.[38]

Tax Perils

The significance of the Tax Court decisions in *Miller* and *Gonzales* should not be minimized. Both cases demonstrate the serious tax perils inherent in using temporary unallocated family support provisions. Some of these perils are evident from the decisions. First, even where both spouses intend to maximize tax savings for the family by shifting, in part, the tax burden to the spouse in the lower tax bracket, drafting errors may result in adverse tax consequences for both spouses.

Second, it appears from both decisions that the Tax Court was not comfortable with the tax uncertainty inherent in the concept of unallocated family support. For example, while acknowledging that the concept is used in domestic relations cases to "encourage sensible cash flow planning between separated spouses," the *Miller* Tax Court showed no hesitancy in suggesting arguments the commissioner could use in the future that would maximize a recovery of tax from these sensible taxpayers.[39] Similarly, the *Gonzales* Tax Court was willing to speculate on an otherwise remote circumstance; that is, the surviving parent not receiving custody of his children, so as to call into question the potential, but unknown, tax benefit derived by the payor spouse from the unallocated temporary family support provisions.

Third, in addressing the termination-at-death issue, both cases made clear that neither Colorado's nor New Jersey's statutory scheme in the domestic relations area was entirely compatible with the use of unallocated family support terminology. This lack of compatibility was evident further in *Gonzales* when, as precedent, the Tax Court quoted from the *Farmilette v. Farmilette* decision to support its conclusion that the temporary unallocated family support amount could be retroactively modified by the court after the death of the payee spouse.[40] The Tax Court acknowledged that, under New Jersey law at the time of the *Farmilette* decision, retroactive modifications of child support were statutorily prohibited.[41]

Other perils exist to practitioners and their clients that are not immediately apparent from reading the decisions. For instance, in both the *Miller* and *Gonzales* cases, the Tax Court was compelled to interpret a state's domestic relations laws on the termination issue. A real danger exists for the practitioner and client faced with such an eventuality. The basis for this concern could not be more evident than in the questionable result reached by the Tax Court in *Miller*. The *Miller* Tax Court found, after relying on Colorado law, that the husband's liability to make temporary unallocated family support payments could survive the death of the payee spouse, at least until a further order of court was entered in the divorce proceeding. However, the *Miller* Tax Court apparently did not consider Colorado case law on the issue of abatement. The Colorado Supreme Court, in the 1947 case of the *Estate of McLaughlin*,[42] and in the 1997 case of *Estate of Burford*,[43] stated in *dicta*:

> When a party dies prior to the entry of dissolution decree, the general rule of law is that a divorce action immediately abates for the objects sought to be obtained by final decree already is accomplished by the prior death of one of the parties, and there remains no status of marriage upon which a final decree of divorce may operate.[44]

Also, the Colorado Court of Appeals, in the 1994 case of *Marriage of Connell*,[45] directly addressed the issue of whether a divorce court had subject matter jurisdiction to enter further orders after the death of a spouse and prior to the entry of a final decree. The court found no reason why the abatement rule, as set forth in *McLaughlin*,[46] would be altered by Colorado's adoption of the UDMA in 1971. The court held that, " . . . if either spouse dies prior to the entry of a valid decree, the marriage is terminated as a matter of law and the trial court is divested of jurisdiction to proceed further in the dissolution."[47]

It would appear from the foregoing case law authorities that the trial court in the *Miller* dissolution proceeding would have lacked jurisdiction to enter further orders after the death of the payee spouse. Therefore, in *Miller*, the husband's liability to make temporary unallocated family support payments to the wife would terminate by reason of abatement at her death, and thus should have been treated by the Tax Court as taxable/deductible alimony.[48]

Finally, it remains uncertain how the Tax Court would have ruled in the *Miller* case had the Commissioner raised Code § 61 as an alternative argument for including the unallocated payments in the wife's income. Other than citing a case wherein the Commissioner had previously made the argument, the Tax Court failed to cite any precedent that would support such a result. However, it is clear that the *Miller*

Tax Court independently raised the argument in a concluding footnote and cited the Tax Court decision of *Mass v. Commissioner*,[49] where the argument had been raised but not decided. Thus, it can no longer be safely assumed by practitioners, that the recipient spouse will escape tax free should a temporary unallocated family support stipulation fail to qualify under Code § 71 provisions as taxable alimony.

Approaches

Tax commentators who have considered the perils raised by the Tax Court in the *Miller* and *Gonzales* decisions have suggested the following approaches to family law practitioners who contemplate tax savings through the use of temporary unallocated family support provisions:

1. The temporary orders stipulation must unequivocally state that all unallocated family support payments will terminate on the death of the payee spouse, rather than allow the determination imposed by state law to govern by default.[50]
2. "The parties should agree on intended tax consequences and make provisions for an adjustment if the results are otherwise."[51]
3. "If the payments are to be non-taxable/non-deductible, designate as such."[52]

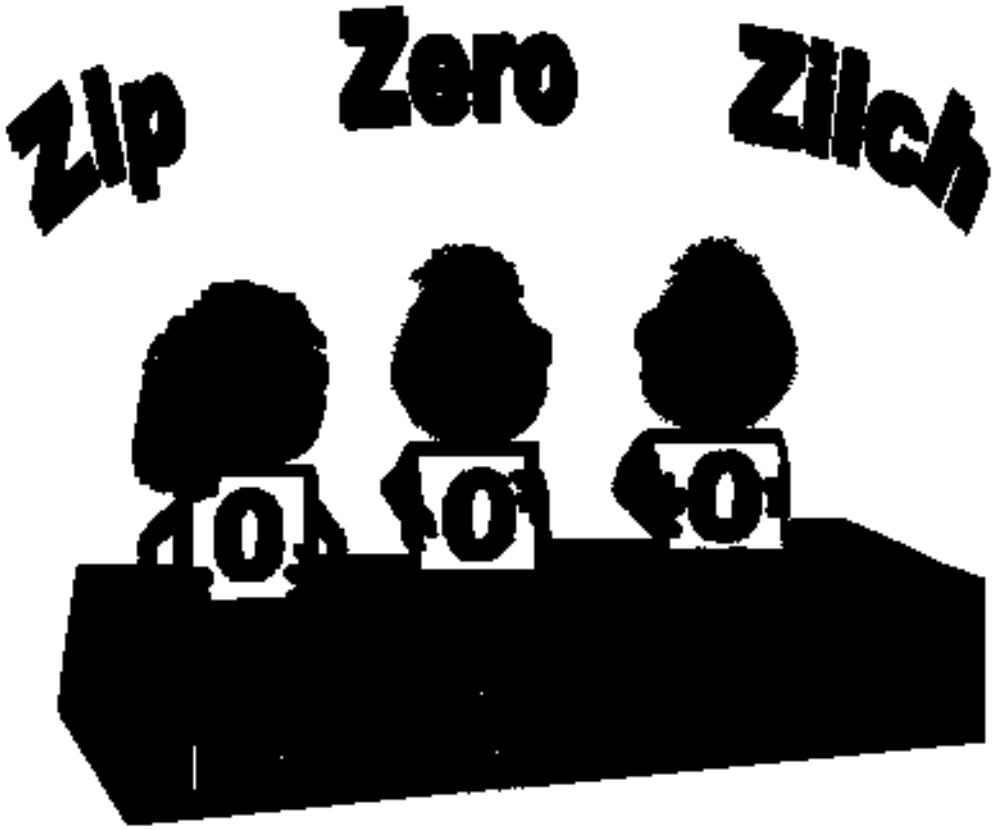
While it is not certain that Tax Court litigation can be avoided through the use of the above approaches, the *Miller* Tax Court suggested that the likelihood of an audit stemming from the filing of inconsistent returns should be minimized.[53]

Conclusion

The family law practitioner who is considering the use of temporary unallocated family support terminology, without negotiating any tax-safe provisions, would be well served to reflect on the possible outcome in the *Miller* case if the Tax Court had determined the unallocated payments to the wife constituted income to her, under Code § 61, without a corresponding deduction to her former spouse. The primary motivation behind practitioners' use of unallocated family support provisions is to increase the after-tax dollars available to the family unit. This objective will be rapidly thwarted by the high cost of tax litigation inevitably resulting from a lack of agreement between counsel as to the tax consequences when negotiating the use of temporary unallocated family support provisions.[54]

NOTES

1. *Comm'r v. Lester*, 366 U.S. 299, 81 S.Ct. 1343 (1961) (held that where a divorce instrument failed to specifically allocate or fix an amount for child support, no portion of the payments under the instrument would be treated as non-taxable child support even if an inference could be drawn by a reduction in payments that some portion of the payments were related to support of children). This case allowed practitioners to structure their divorce agreements creatively, that is, in a way that would realize a tax benefit for payments that would otherwise constitute non-taxable/non-deductible child support.
2. *Miller v. Comm'r*, T.C. Mem. 1999-273; *Gonzales v. Comm'r*, T.C. Mem. 1999-332.
3. *Supra*, note 1.
4. The Tax Reform Act of 1984 was part of the Deficit Reduction Act of 1984 (P.L. 98-369).
5. *Supra*, note 1.
6. Amyx *et al.*, *California Marital Settlement and Other Family Agreements*, § 8.31 (Oakland, CA: CEB, 1999).
7. *Id.*
8. Wofford, *Tax Manangement Portfolios Divorce and Separation*, A-14 (Washington D.C.: BNA, Inc., 1999).
9. IRC § 71(c)(2).
10. *Supra*, note 8 (Wofford states that while the statute was broadly drawn, the temporary regulations read IRC § 71(c)(2) narrowly). *See* Temp. Treas.Reg. § 1.71-1T(c), Q&A-18.
11. *Supra*, note 8.
12. *Miller, supra*, note 2.
13. *Id.* (Commissioner in *Miller* issued separate and inconsistent notices of deficiency to the former spouses, claiming wife failed to report as income alimony payments received and asserting husband's payments to wife were not deductible by husband as alimony).
14. *Id.* at 308.
15. IRC § 71(c)(1) provides that a taxpayer's gross income shall not include as alimony or separate maintenance payments "that part of any payment which the terms of the divorce or separation instrument *fix* (in terms of an amount of money or a part of the payment) as a sum which is payable for the support of the children of the payor spouse." (*Emphasis added.*)
16. *Miller, supra*, note 2 at 308.
17. *See* Frumkes, *On Divorce Taxation*, Chap. 3 (Costa Mesa, CA: James Pub., 2000) for a discussion of seven requirements for taxable/deductible alimony under IRC §§ 71 and 215.
18. *See* IRC § 71(b)(1)(D).
19. IRS Notice 87-9, 1987-1 C.B. 421-22.
20. *Miller, supra*, note 2 at n.6, *citing*, *Napolitano v. Napolitano*, 732 P.2d. 245 (Colo.App. 1986).
21. *Id.* at 310. The Tax Court actually and inaccurately stated that "under the UDMA as enacted in Colorado, the obligation to pay future maintenance terminates on the death of either party or the remarriage of either spouse, (unless otherwise agreed in writing or expressly provided in the decree)." The automatic termination provision of CRS § 14-10-122(2) provides for termination "on the death of either party or *the remarriage of the party receiving maintenance. . . .*" (*Emphasis added.*)
22. *Miller, supra*, note 2 at 311.
23. *Id.*, *citing*, CRS § 14-10-108(5)(c).
24. *See, supra*, note 17.
25. *Miller, supra*, note 2 at 312 (concluding *dicta*).
26. *Id.*
27. *Id.*
28. *Id.* at 312 n.9, *citing*, *Mass v. Comm'r*, 81 T.C. 112 (1983) (where Commissioner raised IRC § 61 as an alternative theory for including support payments otherwise failing to qualify as alimony under IRC § 71 in a recipient's spouses gross income).
29. *Gonzales, supra*, note 2.
30. *Id.* at 527.
31. *Id.* at 528, *citing*, Temp. Treas.Reg. § 1.71-1T(b), Q&A-13, 49 Fed.Reg. 34,456 (Aug. 31, 1984).
32. *Id.*, *citing*, *Morgan v. Comm'r*, 309 U.S. 78, 80 (1940).
33. *Id.* at 529.
34. *Id.* at 530.
35. *Id.* at 529, *citing*, N.J. Ct.R. 5:7-4(a).
36. *Id.*, *citing*, *Farmilette v. Farmilette*, 566 A.2d. 835 (N.J.Super.Ct. Ch.Div. 1989).
37. *Id.* at 530 n.10, *citing*, *Miller, supra*, note 2 ("[H]olding that in Colorado family support paid under a temporary order is not alimony."); *Wells v. Comm'r*, T.C. Mem. 1998-2 ("[H]olding that in California family support payments are not alimony.").
38. *Miller, supra*, note 2.
39. *Id.* at 312 n.9.
40. *Gonzales, supra*, note 2 at 529, *citing*, *Farmilette, supra*, note 36.
41. *Id.*
42. *Estate of McLaughlin*, 184 P.2d. 130 (Colo. 1947).
43. *Estate of Burford,* 935 P.2d. 943 (Colo. 1997).
44. *Supra*, note 42 at 132; *supra*, note 43 at 952.
45. *Marriage of Connell*, 870 P.2d. 632 (Colo. App. 1994).
46. *Supra*, note 42.
47. *Supra*, note 45 at 634.
48. *Supra*, note 17 at § 4.7. "In most jurisdictions, a pending divorce proceeding abates upon the death of either party. Therefore, the liability for payments pursuant to a temporary or pendente lite order or decree in such proceedings, in fact, ceases upon the death of the payee." (*Citations omitted.*) *See also Heckaman v. Comm'r*, T.C. Mem. 2000-85.
49. *Mass, supra*, note 28.
50. *Supra*, note 8 at A-8.
51. *Supra*, note 17 at § 4.7. *See also Miller, supra*, note 2 at 311.
52. *Supra*, note 17 at § 4.7.
53. *Miller, supra*, note 2 at 311.
54. *Id.*, *pending appeal sub nom., Lovejoy v. C.I.R.*, 10th Cir.App.No. 009031 (docketed Sept. 26, 2000). As of the date of publication, the appeal of *Miller* was being briefed and had not been set for oral argument. ■



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