

CaseStudy

WHEN ARE PAYMENTS TREATED AS CHILD SUPPORT?

Child support payments are not alimony and are not taxable to the receiving spouse or deductible by the payer (Sec. 71(c)). Payments are child support for tax purposes if they are either so designated in the divorce or separation agreement (fixed child support) or deemed to be child support.

Fixed or Deemed Child Support

Fixed child support is an amount designated as such, specifically for a child only, in the divorce or separation instrument. The payment may be a fixed amount or a fixed portion (e.g., 50%) of a payment. Where support was designated in a court order as “for support of spouse and one child,” the Tax Court ruled that the support payments were not child support because the payment was not a designated fixed amount for only the child (*Lawton*, T.C. Memo. 1999-243). Even if all the other criteria for alimony treatment are met, a specific designation in the divorce or separation instrument that the payment is child support causes the payment to fail as alimony (Temp. Regs. Sec. 1.71-1T(c), Q&A-15).

Certain payments not identified in a divorce or settlement agreement as child support are treated as such for income tax purposes if the instrument reduces the payment (1) due to a contingency relating to the child (child contingency) or (2) at a time that is “clearly associated” with a child contingency (Sec. 71(c)(2)). Designating such a payment as alimony in a divorce instrument does not change this result. A contingency relates to a child if it

depends on any event relating to the child, regardless of whether such event is certain or likely to occur. Contingencies related to a child include the child’s reaching age 18, 21, or the local age of majority. They also include the child’s death, marriage, completion of school, leaving the household, reaching a specified income level, or becoming employed (Temp. Regs. Sec. 1.71-1T(c), Q&A-17).

Example 1: Individual *F* has two children, *S* and *D*. *F*’s divorce decree requires him to pay his former wife \$1,000 per month until *S* turns 18. Then he will pay \$600 per month until *D* turns 18. After that, *F*’s payments are reduced to \$200 per month. The payment is reduced by \$400 for each child contingency. Therefore, \$800 of each payment is child support and the remaining \$200 is alimony (assuming all other criteria for alimony are met).

Payments are also deemed child support if they meet either of two mechanical tests. If either of the following tests is met, the payments are considered to be clearly associated with a child contingency and are therefore deemed child support and not alimony (Temp. Regs. Sec. 1.71-1T(c), Q&A-18):

1. Payments are reduced within six months before or after a child attains age 18, 21, or the local age of majority; or
2. The payer has more than one child, payments are reduced more than once, the reductions occur within a year of the same age for each child, and the age is between 18 and 24, inclusive.

This case study has been adapted from *PPC’s Guide to Tax Planning for High Income Individuals, 9th Edition*, by Anthony J. DeChellis, Patrick L. Young, James D. Van Grevenhof, and Delia D. Groat, published by Thomson Tax & Accounting, Ft. Worth, TX, 2008 ((800) 323-8724; ppc.thomson.com).

Note: The presumption that payments are child support can be rebutted by showing that the reduction in payments is not related to a child (*Shepherd*, T.C. Memo. 2000-174). The presumption could also be rebutted if, for example, the taxpayer showed that the payments lasted for a period customarily used in his or her jurisdiction for alimony, such as half the length of the marriage (Temp. Regs. Sec. 1.71-1T(c), Q&A-18).

The first test should be easy to avoid by scheduling reductions outside the one-year window around each of the prohibited dates (reaching age 18, 21, or the age of majority). The prohibited dates for each child can be plotted on a time line, as can the one-year period surrounding each date. Reductions can then be scheduled outside the prohibited periods. The dates at which the child will reach ages 18 and 21 are clear. However, the practitioner may need to consult local law to determine the age of majority.

If a couple has more than one child and payments are reduced at certain dates, the payments must pass both tests described above. Apparently, the IRS assumes in the second test that the divorcing couple has chosen an age at which each child's support will end. The test computes a two-year window around the children's ages at the reduction date associated with each child. If the children are within a year of the same age when the reduction occurs and that age is between 18 and 24, the payments fail the second test. The payment (or the amount of reduction) is deemed child support.

Example 2: *H* and *W* have two children, *S* (born June 19, 1986) and *D* (born March 5, 1989). *H* and *W*'s divorce was effective January 20, 1998. *H* agreed to pay \$2,500 per month until January 20, 2005, when the payment decreased to \$1,500 per month. The \$1,500 payments continue until January 20, 2009, when the payment is reduced to \$500. The \$500 payments continue until January 20, 2018. All payments terminate at *W*'s death.

The age of majority in the state where *H* and *W* live is 18. *S* turned 18 on June 19,

Exhibit 1: Child support payments that fail second test

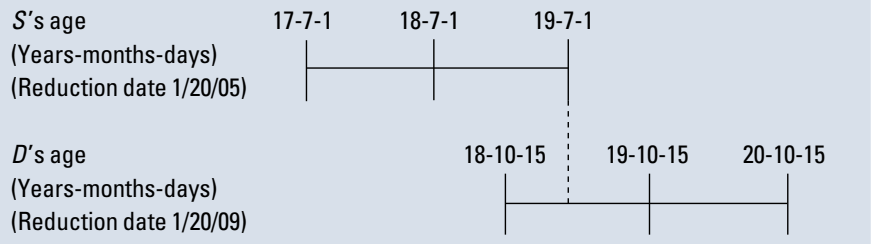
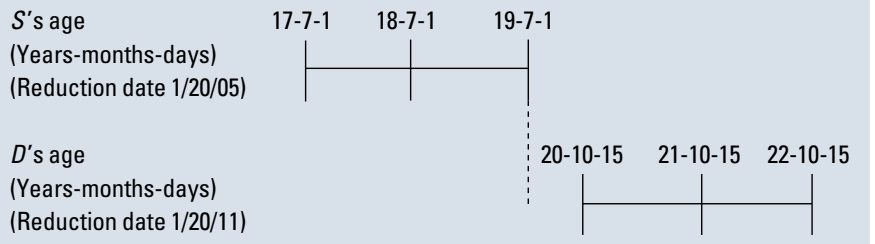


Exhibit 2: Child support payments with second reduction rescheduled



2004, and turned 21 on June 19, 2007. *D* turned 18 on March 5, 2007, and will turn 21 on March 5, 2010. The first test described earlier is passed: The reductions for both children do not fall within six months of turning age 18 or 21 for either child. Based on that test alone, all payments would be treated as alimony.

The second test requires calculating the children's ages at the dates of both reductions. On January 20, 2005, when the first reduction took place, *S* was 18 years, 7 months, and 1 day old. The two-year window for *S* is from 17 years, 7 months, and 1 day old to 19 years, 7 months, and 1 day old. On January 20, 2009, when the second reduction takes place, *D* will be 19 years, 10 months, and 15 days old. Her two-year window is from 18 years, 10 months, and 15 days old to 20 years, 10 months, and 15 days old (see Exhibit 1). Since *D*'s lower limit falls inside *S*'s upper limit, the reductions are presumed to be clearly associated with a child event. Thus, only \$500 of the \$2,500 payment (the amount remaining after both reductions) is alimony.

To avoid failing this test, the second reduction could be scheduled to occur on January 20, 2011 (see Exhibit 2). Since *D*'s lower limit falls outside *S*'s upper limit, the reductions are not presumed to be clearly associated with a child event. The entire \$2,500 is considered alimony (not deemed child support).

Strategies to Convert Child Support Payments to Alimony

As previously discussed, any reduction of an otherwise qualifying alimony payment that is tied to a contingency related to a child will be deemed to be child support and will fail alimony treatment from inception. As a result, a couple wishing to structure an agreement whereby support payments are treated as alimony has limited means of doing so.

Renegotiate Whenever a Child Contingency Occurs

The couple can execute a divorce settlement agreement calling for support payments that are not allocated between alimony and child support and that contain no reduction provisions (*Lawton*). The agreement can, however, provide that the amount of future payments will be renegotiated upon the happening of specified contingencies related to a child. Since no reduction amounts are specified in the instrument, the theory is that an amount of deemed child support cannot be determined. This approach may yield favorable tax results (alimony), at least until the first reduction actually takes place.

Caution: The tax risk with this approach is that the IRS may assert that prior payments were partially child support and deny deductibility for all prior open tax years. Alternatively, the IRS

could assert that a renegotiated amount of alimony could be zero. In that case, all the payments would be treated as child support. The major objection to this alternative, however, is usually more economic than tax oriented. It requires the parties to periodically renegotiate the amount of payments with someone who may be a very bitter adversary. Renegotiations may also require the parties to disclose their financial positions, which they may be reluctant to do.

Reduce Payments on Specified Dates Not Related to a Child

The couple may write the reduction clauses with specific reduction dates that do not violate any of the “clearly associated” factors previously discussed. The dates that children turn age 18, 21, or the local age of majority are known for certain and are easily avoided. In addition, it is relatively easy to estimate when each child should finish high school, attend college, etc. This method, however, will work only if the mechanical tests for age-related child contingencies can be avoided. If the couple has several children born within a few years of each other, this becomes very difficult.

The major risk with this method is that a contingency related to a child may happen before a scheduled reduction date. For example, assume that a child is five years old at the date of the divorce and that the scheduled reduction date is the child’s nineteenth birthday. If the child dies at age 8, the paying spouse could remain obligated under the divorce or separation instrument to continue making the payments for another 11 years until the child would have turned 19.

Practice tip: If the paying spouse is financially able to fund a Sec. 682 alimony trust, reductions of distributions to the receiving spouse can be made without having to consider contingencies related to a child.

TTA

EditorNotes

Albert B. Ellentuck is of counsel with King & Nordlinger, L.L.P., in Arlington, VA.