

INTEREST COLLECTED ON PAST-DUE CHILD SUPPORT IS TAXABLE TO RECIPIENT SPOUSE

A recent IRS Chief Counsel Advice memorandum (CCA) concludes interest collected through a state enforcement agency on past-due child support is taxable interest to the recipient-spouse. It also concludes the payor spouse has no reporting obligations for the interest paid but the state enforcement agency may be responsible for reporting the interest payments made on behalf of the payor spouse.

■ **Background**

Amounts received as alimony or separate maintenance payments are deductible by the payor-spouse and taxable to the payee-spouse. A payment under a divorce or separation instrument that's "fixed" (or treated as fixed) as support for a child of the payor spouse isn't alimony. This applies if the instrument designates a specified amount of money or a part of a payment to be child support. The actual amount may fluctuate. If a divorce or separation instrument provides a specified amount for alimony and a specified amount for child support, and the payor spouse pays the payee spouse less than the amount designated for child support, then the entire payment is treated as child support and no part is treated as alimony. Child support payments are excludible from gross income by the payee-spouse and not deductible by the payor-spouse.

The Supreme Court in *Commissioner v. Lester*, 366 U.S. 299 (05/22/1961) 7 AFTR 2d 1445, concluded the exclusion for child support under Code Sec. 71(c) applies only where the instrument explicitly designates an amount for child support. The Tax Court has held, on more than one occasion, that where a husband was obligated to pay his former wife monthly child support, and upon default is sued by his wife, then (1) no part of the alimony payment is deductible and (2) the part of the payment representing interest in default was characterized as interest paid. (see *Borbonus*, 42 TC 983 (1964) and *Smith*, 51 TC 1 (1968)) Fankhanel, T.C. Memo 1998-403, 79 AFTR 2d 97-2038 aff'd 205 F.3d 1333 (CA 4 2/8/2000), held that interest received by a taxpayer wife on child support arrearages was taxable because she failed to prove these payments were fixed child support payments made under a divorce or separation agreement. Rather, the payments were made as court-ordered interest payments.

Any person who pays \$10 or more in interest, etc. (excluding interest on an obligation issued by a "natural person") to another, or who receives such payments as a "nominee" for another person must generally file annual information returns. In addition, persons (including a state or political subdivision) engaged in a trade or business who make payments of \$600 or more of interest, etc. to another person must also file information returns. A person who makes a payment in the course of its trade or business on behalf of another person (i.e., middleman) is the payor required to make an information return, if that person:

- performs management or oversight functions in connection with the payment;

or

- has significant economic interest in the payment.

■ **Facts**

A payor spouse was required to pay interest on past due child support to the custodial parent in a state whose governing law sets an interest rate which accrues beginning 30 days from the day the award or payment is due. The state law applies to all awards, court orders, decrees and judgments pertaining to child support. Also, in this state, the party to whom the child support is due isn't required to reduce any amount to judgment in order to recover the interest. Child support and any required interest payments may go directly to the custodial parent from the payor spouse, may flow through the court which ordered the child support or a state child support enforcement agency may become involved in the collection process at the request of the custodial parent.

The main issue in the CCA was whether interest collected through a state enforcement agency on past-due child support payments is excludible from gross income as part of the sum payable for the support of children.

■ **Interest on past-due child support is taxable**

The CCA holds that interest paid on past-due child support is taxed to the recipient parent as interest. For the exclusion from income as child support to apply, the regulations require the decree, instrument or agreement must specifically designate the sum payable for the support of children. Thus, interest which is assessed later clearly doesn't qualify as an amount specifically designated as child support in a decree, instrument or agreement. The CCA emphasizes the regulation requires a comparison between the amount specified for child support and the total amount due but underpaid and if a portion of the underpayment is interest, the statute and regulations don't provide for its allocation to child support.

The CCA cited *Lester* for the proposition that the exclusion applies only where the instrument explicitly designates an amount as child support. Applying this specificity requirement, along with the basic tenet of tax law that income is taxable unless specifically excluded, it follows that interest paid on past-due child support is income to the recipient parent.

However, the CCA does acknowledge that if a divorce or separation agreement specifically provides for interest on past-due child support and characterizes that interest as payable for the support of children of the payor spouse, then the payments under those circumstances may be considered excludible from the recipient's income.

Recommendation: From the tax standpoint, counsel representing the payee spouse should try to have any interest on past due child support designated as child support. Although it wouldn't necessarily guarantee any amounts attributable to this interest would automatically be treated as tax-free child support to the recipient, arguably the recipient would have a stronger case.

- **Information reporting requirements**

The CCA concludes that payor spouses making interest payments on past-due child support aren't required to report them under Code Sec. 6049 because they are natural persons issuing the underlying obligation. In addition, the collection of interest by a state enforcement agency doesn't change the character of the interest payment and no Code Sec. 6049 reporting obligation arises for the agency.

The payor spouse also has no Code Sec. 6041 reporting obligation because the interest payments for past-due child support aren't made in the course of a trade or business. However, the CCA notes a state enforcement agency collecting the interest payments may have reporting obligations (presumed to be made in the course of its trade or business) under the "middleman rules" if it performs management and oversight functions in connection with the payments, even if the payor spouse doesn't have to report it. It also notes these payments would be reportable under Code Sec. 6041 by the agency only if they are gross income to the recipient, are "fixed and determinable" income, and if the amounts paid to the spouse-recipient in a calendar year is \$600 or more.

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