Office of Chief Counsel
Internal Revenue Service
memorandum

CC:ITA:03:JCAlbro
PREF-132816-04

Number: **200444026**
Release Date: 10/29/2004

UILC: 71.00-00

date: September 22, 2004

to: Deputy Area Counsel (Tax Exempt/Government Entities) CC:TEGE:GLGC:DAL

from: Christopher F. Kane, Chief Branch 3
Associate Chief Counsel CC:ITA:3
(Income Tax & Accounting)

---

subject: Interest on Child Support

This Chief Counsel Advice responds to your request for assistance dated July 15, 2004. This advice may not be used or cited as precedent.

ISSUE

1. Is interest collected through a state enforcement agency on past-due child support excludible from gross income under I.R.C. § 71(c) as part of the sum payable for the support of children of the payor spouse.

2. Whether any reporting obligation arises with regard to interest paid on past-due child support through a State enforcement agency.

CONCLUSION

1. Such interest is not excludible and is, therefore, taxable income to the custodial parent.

2. Based on the facts submitted, we conclude that the derelict parent has no information reporting requirements under sections 6049 and 6041 as a result of the interest paid. The State enforcement agency has no reporting obligation under section 6049, but may be responsible for reporting under section 6041 if payments are income and the State enforcement agency is considered a middleman pursuant to Treas. Reg. § 1.6041-1(e).

FACTS

A payor spouse is sometimes required to pay interest on past-due child support to the custodial parent. In at least one state a statute sets an interest rate which accrues commencing 30 days from the day such award or payment is due. The statute 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 need not reduce any amount to judgment in order to recover such interest.

Child support and any required interest payments may go directly to the custodial parent from the payor spouse, or 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.

LAW

I.R.C. § 71(a) provides that gross income includes amounts received as alimony or separate maintenance payments. Section 71(b) defines alimony or separate maintenance payments. Section 71(c)(1) provides that subsection (a) shall not apply to 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 children of the payor spouse. Section 71(c)(3) provides that for purposes of this subsection, if any payment is less than the amount specified in the instrument, then so much of such payment as does not exceed the sum payable for support shall be considered a payment for such support.

Section 61(a)(4) provides that gross income includes interest received.

Treas. Reg. § 1.71-1(e) states that section 71(a) does not apply to that part of any periodic payment which, by the terms of the decree, instrument, or agreement under section 71(a), is specifically designated as a sum payable for the support of minor children of the husband. The statute prescribes the treatment in cases where an amount or portion is so fixed but the amount of any periodic payment is less than the amount of the periodic payment specified to be made. In such cases, to the extent of the amount which would be payable for the support of such children out of the originally specified periodic payment, such periodic payment is considered payment for such support. For example, if the husband is by terms of the decree, instrument, or agreement required to pay $200 a month to his divorced wife, $100 of which is designated by the decree, instrument, or agreement to be for the support of their minor children, and the husband pays only $150 to his wife, $100 is nevertheless considered to be a payment by the husband for the support of the children. If, however, the periodic payments are received by the wife for the support and maintenance of herself and of minor children of the husband without such specific designation of the portion for

the support of such children, then the whole of such amounts is includible in the income of the wife as provided in section 71(a). [1]

When interpreting tax laws, exemptions from taxation are to be given a strict interpretation against the assertions of the taxpayer and in favor of the taxing power. 3A Sutherland Statutory Construction at 66.09, p. 327 (4th ed. 1986).

Commissioner v. Lester, 366 U.S. 299 (1961), 1961-2 C.B. 241, holds that section 71(c) applies only where the instrument explicitly designates an amount as child support. In Lester, the support agreement at issue did not specify the amount designated for child support but merely set forth the proportionate reduction should any child marry, become emancipated or die. The Court noted that the statutory requirement is strict and carefully worded. It does not say that a sufficiently clear purpose on the part of the parties is sufficient to shift the tax. If there is to be certainty in the tax consequences of such agreements, the allocations to child support made therein must be specifically designated and not left to determination by inference or conjecture.

Following Lester, Rev. Rul. 62-53, 1962-1 C.B. 41 held that where periodic payments for support are made by a husband and received by a wife under a divorce decree, or an instrument or agreement described in section 71(a), such payments are includible in the gross income of the wife under section 71 and are deductible by the husband under section 215, except to the extent that the terms of the decree, instrument, or agreement specifically designate or fix such payments, or a portion of such payments, as support for minor children of the husband.

All income is taxable unless specifically excluded, and exclusions from income are strictly construed against the taxpayer. In Commissioner v. Jacobson, 336 U.S. 28, 49 (1959), the Court stated that the income tax is described in sweeping terms and should be broadly construed in accordance with an obvious purpose to tax income comprehensively. The exemptions are specifically stated and should be construed with restraint in light of the same policy. See also U..S. Trust Co. v. Helvering, 307 U.S. 57, 60 (1939) (Exemptions from taxation do not rest upon implication); Elam v. Commissioner, 477 F.2d 1333, 1335 (6th Cir. 1973) (Statutes granting tax exemptions or deferments must be strictly construed).

In Borbonus v. Commissioner, 42 T.C. 983 (1964), the husband was obligated to pay his former wife monthly child support, and upon default, his wife sued for back payments. The parties agreed on a settlement amount. In Tax Court, the husband contended that the amount paid was deductible alimony. The court held that no part of the payment was deductible alimony, and the part of the payment representing interest

[1] The regulation follows almost word for word (including the payment example) the discussion of this provision in the Report of the Committee on Finance, U.S. Senate, The Revenue Bill of 1942, H.R. 7378, at 86. (77th Cong., 2d Sess., Rep. No. 1631, Oct. 2, 1942). This enactment of the predecessor of section 71 marked the first provision in the Internal Revenue Code for the treatment of alimony and child support.

on the payments in default was deductible as interest paid. Similarly, in Smith v. Commissioner, 51 T.C. 1 (1968), the Tax Court held that the husband's payment was allocated first to child support, that the amount allocated to alimony was deductible, and the amount allocated to interest was deductible by the husband under section 163.

In Fankhanel v. Commissioner, T.C. Memo. 1998-403, aff'd without published opin., 205 F.3d 1333 (4th Cir. 2000), the court held that interest received by taxpayer wife on child support arrearages was includible in her gross income, citing section 61(a)(4). The court further noted that payments which are made pursuant to an agreement fixing the payments as child support are excludible from income. Petitioner failed to prove that the payments were fixed child support payments under a divorce or separation agreement. Rather, the payments were made as court ordered interest payments.

ANALYSIS

Issue 1

In determining that interest payments received by the custodial parent are taxable income to that parent, we note that Treas. Reg. § 1.71-1(e) requires that for exclusion from income as child support, the decree, instrument or agreement must specifically designate the sum as payable for the support of children. Interest which is assessed later clearly does not come under an amount specifically designated as child support in a decree, instrument or agreement. For the same reason, we do not believe that interest can be excludible from income where, under section 71(c)(3), a payment is less than the amount specified in the instrument but such payment (including an interest portion) does not exceed the sum payable for support. The regulation requires a comparison between the amount specified for child support and the total amount due but underpaid. If a portion of such underpayment is interest, neither the statute nor the regulations provide for an allocation to child support.

Also, as the Court said in Commissioner v. Lester, supra, section 71(c) (payments to support children) applies only where the instrument explicitly designates an amount as child support. Applying this requirement for specificity 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 and is not excludible income in the same manner as amounts designated for child support are excludible.

In Borbonus, supra and Smith, supra, both spouses were required to pay interest on past-due child support. The court noted in each case that the amount allocated to interest was deductible under section 163 which then provided for such a deduction. Child support is not deductible to the payor spouse in the same manner that alimony is deductible. Alimony is taxable income to the recipient, and child support is excludible income for the custodial parent. It follows that deductible interest is not child support, and such interest received on past-due support is taxable income to the custodial parent.

Lastly, Fankhanel, supra, provided that interest received on child support arrearages is income to the recipient. As noted by the Tax Court in Fankhanel, though, and following the wording of section 71(c)(1), if a divorce or separation agreement specifically provides for interest on past-due child support and characterizes such interest as payable for the support of children of the payor spouse, we believe that payments under those circumstances may rightfully be considered excludible from the recipient parent's income. That is apparently not the case here. Also, if interest is provided for in a child support agreement, Lester requires that the amount denoted as interest be specifically designated as child support in the agreement.

In summary, we believe that the statute, regulations and relevant case law all make clear that (absent a specific designation in a divorce or separation agreement) interest paid on past-due child support is taxable income to the recipient parent.

Issue 2

Section 6049

Section 6049(a) requires every person making payments of interest aggregating $10 or more to any other person during any calendar year, or who receives payments of interest as a nominee and who makes payments aggregating $10 or more during any calendar year to any other person with respect to the interest so received, to make a return according to the forms or regulations prescribed by the Secretary.

Section 6049(b)(2)(A) excludes interest on any obligation issued by a natural person from the definition of interest for purposes of section 6049.

Treas. Reg. § 1.6049-4(f)(2) of the Income Tax Regulations defines "natural person" to mean any individual but not including a partnership (whether or not composed entirely of individuals) a trust, or an estate. Treas. Reg. § 1.6049-4(f)(4) defines "middleman" in part as any person, including a nominee, who makes payment of interest or collects interest on behalf of another person or otherwise acts in a capacity as intermediary between a payor and a payee.

Treas. Reg. § 1.6049-5(b)(1) states in part that interest on any obligation issued by a natural person (as defined in Treas. Reg. § 1.6049-4(f)(2)) will not be within the definition of interest for purposes of section 6049 irrespective of whether such interest is collected on behalf of the holder of the obligation by a middleman.

Child support obligations are issued by a natural person as defined under Treas. Reg. § 1.6049-4(f)(2). The collection of interest by the State enforcement agency does not change the character of the payment under Treas. Reg. § 1.6049-4(f)(2). Treas. Reg. § 1.6049-5(b)(1). Therefore, no reporting obligation arises under section 6049 for the interest collected on past-due child-support payments.

Section 6041

Section 6041 requires all persons engaged in a trade or business and making payment in the course of the trade or business to another person of fixed or determinable gains, profits, and income of $600 or more in a tax year to make an information return. Treas. Reg. §§ 1.6041-1(b)(1) and (i) provide that payments made by a state or a political subdivision are subject to this reporting requirement.

Treas. Reg. § 1.6041-1(c) provides that income is "fixed" when it is to be paid in amounts definitely predetermined. Income is "determinable" when there is a basis of calculation by which the amount to be paid may be ascertained.

As used in section 6041, the term "gains, profits, and income" means gross income and not the gross amount paid. A payor generally is not required to make a return under section 6041 for payments that are not includible in the recipient's income, nor is a payor required to make a return if the payor does not have a basis to determine the amount of a payment that is required to be included in the recipient's gross income.

Treas. Reg. § 1.6041-1(e) (the "Middleman Rules") provides:

> (e) Payment made on behalf of another person--(1) In general. A person that makes a payment in the course of its trade or business on behalf of another person is the payor that must make a return of information under this section with respect to that payment if the payment is described in paragraph (a) of this section and, under all the facts and circumstances, that person—
>
> > (i) Performs management or oversight functions in connection with the payment (this would exclude, for example, a person who performs mere administrative or ministerial functions such as writing checks at another's direction); or
> >
> > (ii) Has a significant economic interest in the payment (i.e., an economic interest that would be compromised if the payment were not made, such as by creation of a mechanic's lien on property to which the payment relates, or a loss of collateral).

Assuming the interest payment is gross income, a derelict parent has no reporting obligation under Section 6041 because the payment is not made in the course of the payor's trade or business.

Assuming the interest payment is gross income, each State enforcement agency is considered to make the payments in the course of its trade or business. Treas. Reg. §§ 1.6041-1(b)(1) and (i). If a State enforcement agency is performing management and oversight functions in connection with payment of the interest, then under the Middleman Rules, the State enforcement agency may be considered the payor required

to file under section 6041, even though the payment is being made on behalf of the derelict parent who would not be required to file under section 6041. See Treas. Reg. § 1.6041-1(e). Assuming the payments of interest are gross income, they are "fixed and determinable income" and are generally reportable under section 6041, if the amount paid to a payee in a calendar year is $600 or more.

CASE DEVELOPMENT, HAZARDS AND OTHER CONSIDERATIONS

Under the circumstances of your case, we believe that interest paid on past-due child support is taxable income to the recipient spouse. There may be cases where interest on past-due child support is provided for in divorce or separation agreements, and those cases would need to be evaluated in light of Lester, supra.

This writing may contain privileged information. Any unauthorized disclosure of this writing may undermine our ability to protect the privileged information. If disclosure is determined to be necessary, please contact this office for our views.

Please call Joyce Albro at 202-622-8193 if you have any questions as to issue 1. Please call Donnell M. Rini-Swyers at 202-622-4910 if you have any questions as to issue 2.

Christopher F. Kane
Branch Chief, Branch 3
Associate Chief Counsel
(Income Tax & Accounting)