

# VALUATION OBSERVATIONS

*Some practical observations from a practicing  
business appraiser.*

VLC

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## “FAMILY SUPPORT” DEAD OR ALIVE?

Have “lesterized” support payments survived the Uniform Family Support Act? To quiz the domestic relations attorneys, you would think not. But oddly enough, temporary support orders are not always allocated between spousal and child support.

Ohio adopted the Uniform Family Support Act in 1998. The UFSA requires allocation between child and spousal support. This, in conjunction with IRC 71(c)(2), was essentially a legislative overruling to *Commissioner V. Lester*, 366 US. 299 (1961). *Lester* payments are payments comprised of both spousal support and child support in unallocated amounts. However, under temporary orders, the court does not always make the required distinction.

Why is this distinction so important? There is incentive under Federal income tax law for the obligor to characterize marital payments as includable, deductible alimony rather than excludable, nondeductible child support. In the aftermath of *Lester*, it became common practice for spousal support awards to be “loaded.” That is, a theoretically larger than otherwise spousal support payment and a correspondingly adjusted-down child support payment was agreed upon in order to take advantage of the tax laws and, assumedly, to provide adequately for the children through the supported, custodial spouse’s increased income.

Congress made changes in the Internal Revenue Code to address this charade by establishing the four-pronged definition of alimony set forth in IRC 71(b)(1), which includes the proscription of post death liability contained in subsection (D), reinforced by the recapture rule for “front-loaded” alimony. One would think that when the support obligation is not specified to cease upon death, that the obligation would constitute nontaxable child support. But this is not the case at all. In fact, this is where *Lester* was overturned. IRC 71(c)(1) states that if an amount is not “fixed” as support of children, then it is considered alimony. Amounts will not be treated as child support for purposes of section 71 unless specifically designated as such in the governing divorce document. This was the result in *Ambrose v. Commissioner*, T.C. Memo 1996-128, where the Tax Court held that payments of unallocated family support under a temporary support order were taxable to the payee wife as alimony. The court concluded that child support was not fixed in the divorce instrument within the meaning of section 71(c)(1).

Now, let’s put a different spin on family support payments. Take for example a divorce instrument that requires monthly payments of both alimony and child support, where the amounts for each are fixed. But, the payor pays less than the full amount. According to section 71(c)(3), the payment will be allocated to child support first, as was the result in *Blair v. Commissioner*, T.C. Memo 1988-581.

Putting numbers to the above example, under the divorce decree, husband is to pay wife \$1,000 a month until she dies. The decree specifically provides that \$300 a month is for child support. In the 10<sup>th</sup> month, husband pays only \$800. Out of the \$800, \$300 is allocated to child support and the remaining \$500 is allocated to alimony. As has been said many times before – it is all about what is in the best interest of the children.

There are a couple additional nuances that should be kept in mind. If the child for whom support is being paid is a step-child of the obligor, the payments will be treated as taxable alimony since IRC 71(c)(1) only applies with respect to a child of the payor spouse. And, all is for naught if the parties under the temporary support order are filing a joint return, as alimony paid and received will just wash each other out and have a zero taxable effect.

So the lesson of the day is – if the intent is that support is for the child and to be nontaxable, it is imperative that the amount be fixed in amount and specified as such. If you would like additional information, or have a question, please do not hesitate to call.

Very truly yours,

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Terri Lastovka is the founder of Valuation & Litigation Consulting, LLC. Her practice focuses on business valuations and litigation consulting in the areas of domestic relations, gift and estate tax, probate, shareholder disputes, economic damages, and forensic accounting. She draws from a wide range of experiences, including public accounting, law, banking, and CFO. She has received extensive training from the American Society of Appraisers in the area of business valuation and works closely with members of the bar to effectuate practical settlements. Terri also serves as the Director of Legal & Finance for Journey of Hope, a grass roots non-profit organization providing financial support to cancer survivors.