2000

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Recommended Citation
89 Tax Notes 1073 (November 20, 2000)
$2.98 — almost three times more. It is time that Congress stepped forward to the aid of our young families raising children and gave them at least as good a deal as their parents had under section 21 when it first entered the code. If Congress were to do that, the caps of $2,400 and $4,800 would be adjusted up to $5,969, and $11,938, respectively. Phase-down of the credit mechanism percentage would commence at $29,845 and would be phased down by 1 percent (but not below 20 percent) for each $5,969 or part thereof that income rises above $29,845 with phase-down stopping when the credit percentage reached 20 percent at $83,569.

To get a good idea of just how ridiculous section 21 has become because of congressional failure to provide inflation adjustment, consider this. Because the standard deduction and personal and dependent deductions are inflation adjusted, no one now qualifies for the 30 percent (nonrefundable) credit because even a single parent with one dependent child will not have any tax liability until income exceeds $12,050. As a matter of fact, not only is the 30 percent rate unavailable to any taxpayer because of inflation but so also is the 29 percent rate.

Why, we might ask, has Congress chosen to ignore those with small children, most of whom must work to make ends meet for their families? Perhaps the availability of section 129 childcare spending accounts, which are superior for higher-income taxpayers, has siphoned off the noisy and politically effective middle class. And while it is at it, Congress might as well do something similar for higher-income taxpayers, has siphoned off the noisy and politically effective middle class and upper middle class for whom the spending of pretax dollars is preferable. Perhaps, budgetary concerns until recently made Congress unwilling to inflation adjust section 21. Curiously enough, such concerns did not result in reticence to adjust the rate structure, the standard deduction, personal and dependent deductions, and various phase-out mechanisms such as those for itemized deductions, personal exclusions, and dependent deductions. Perhaps the political weight of conservative Christian groups, who think a mother’s place is in the home with her children, has made Congress reluctant to come to the aid of working moms. Whatever the excuses, they are unacceptable in the current era. It is time for Congress to do its duty for working families and adjust section 21 for inflation, making it as meaningful for the current generation as it was for its parents.

And while it is at it, Congress might as also well adjust for inflation the $5,000 cap on child care spending accounts provided by section 129. That figure has not been adjusted since section 129 was added to the code in 1981. Inflation adjusted, that figure would now stand at $9,240. It is time to act and give this generation the same help in raising its children as its parents’ generation had when it raised them.

1See The Bureau of Labor Statistics Web site at (ftp:///b.l.gov/pub/special.requests/cpi/cpiai.txt) (October 30, 2000). The inflation adjustments were made until the month of September 2000, the last figure available at the time this piece was authored.


Tax Treatment of Defaulted Child Support: The Better Approach

By Richard C.E. Beck

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In these pages (July 24, 2000, p. 577), Professor Donald Morris recommends that we all embrace H.R. 816, which would allow a “bad debt” deduction to persons entitled to defaulted child support (hereinafter, wives), and would impose a corresponding tax on obligors (hereinafter, husbands) for “discharge of indebtedness” (DOI) income. For the reasons explained below, if the IRS should be charged with collecting and distributing child support, it would be far better to do it directly, as S. 2288 proposes, rather than by creating artificial “income” and “deductions.”

Professor Morris is quite right in thinking that defaulted child support is an important issue. And he is also right that allowing a bad debt deduction to the wife (and imposing tax on DOI income on the husband) is not a new idea. The scheme was urged as workable under current law with very little statutory amendment by Professor William Klein in his 1990 article “Tax Effects of Nonpayment of Child Support.” A bill substantially similar to H.R. 816 was introduced in 1993 by Senator Bumpers as the “Child Support Tax Equity Act,” but it failed to win support.

Professor Morris is aware that the issue of the wife’s bad debt deduction has been litigated and lost because the courts have held that the wife has no basis in the debt. He proposes a “theoretical” ground for justifying the wife’s basis in the debt, namely, that by paying for the child’s expenses herself, she creates a “constructive loan” to the husband. The same idea was suggested earlier by Professor Klein. I disagree with the analysis as it applies to the bad debt deduction. But most of all, and quite apart from the distortions of tax doctrine this bad debt/DOI income scheme would require, I think the effort is misguided and would do more harm than good.

As for the bad debt deduction, the courts have long held that the wife has no basis in the debt and that it is therefore not deductible. A bad debt is a loss, and in the memorable phrase of the Board of Tax Appeals, “you can’t lose what you never had.” I think this is correct. Senator Bumpers presented his 1993 bill as if it were simply a matter of applying current section 166 fairly and consistently to everyone. If businessmen can
deduct bad debts, his pitch ran, why not needy women as well? But not all businessmen can deduct bad debts. Those on the cash method who are owed receivables such as overdue rents, doctor’s or attorney’s fees, and so on cannot deduct them for the same reason as the disappointed wife, namely, lack of basis.

Professor Morris thinks that by paying for the child’s expenses, the wife might be deemed to obtain a basis in the debt for unpaid child support. This analysis overlooks some problems. First, the wife’s living expenses are just that, living expenses, and it is difficult to see how they can be capitalized into the basis of anything. Next, assuming the expenditures can be capitalized at all, it is far from clear how they could be capitalized into the basis of the debt. The custodial parent has an obligation to support her children which is completely independent of the husband’s fixed-dollar obligation. No matter how much of her own money she spends on the children, the husband’s obligation remains unaffected.3

Consider an analogy. If uninsured Tortfeasor totals Victim’s car and Victim obtains a worthless judgment debt of $20,000, Victim cannot deduct the debt for lack of basis. Does anything change if Victim replaces the car by investing $20,000 of his own? I think not. Victim obtains basis in the car, not in the debt, and his deduction is limited to the allowable personal casualty loss, if any. If Victim did obtain basis in the debt, he would enjoy two deductions for the same loss. Also, if Professor Morris’s imputed basis works, the wife should logically obtain basis only for the amounts she actually spends on the children, not for the face amount she is owed. This would present very inconvenient problems of administration and record keeping, as well as difficult questions of allocation. How much of the cost of Mom’s car should be allocated to child care expense? Congress wisely ended such problems in the area of child exemptions when it enacted section 152(e) in 1984.

One may disagree about the basis issue. But just about every other aspect of the bad debt/DOI scheme suffers similar problems or worse, and simply cannot be fit into the structure of current law. H.R. 816 seems to acknowledge this by offering explicit statutory amendment at every turn. For example, all other debts must be worthless to be deductible, but the bill would change this requirement for child support by requiring only that the debt be overdue by a full year. The normal treatment of a nonbusiness bad debt as a short-term capital loss is inconvenient, and so the proposed statute makes it an ordinary deduction. This too is inconvenient for nonitemizers, so the bill makes it an above-the-line deduction. By the time we are done there is little left that resembles a nonbusiness bad debt deduction, and no reason at all to shoehorn the new provisions into section 166. It would be less confusing to create, say, a new section 161 “Deduction for Overdue Child Support.”

On the husband’s side, the resemblance between the proposed law and current doctrine is still more tenuous. First, just as the “worthless” debt need not be worthless, the “discharged” debt need not actually be discharged to trigger income. It need only remain unpaid for more than a year. In all probability, none of the qualifying debts will have been discharged.

Second, a child support debt is not the sort of obligation which creates DOI income in the first place. Ever since Ralff Joint,4 it is an essential element of DOI income that the obligor must have originally borrowed something. But the husband never received any loan proceeds. It is not enough merely to be freed of an obligation. Tortfeasor in the above hypothetical cannot be subject to DOI income for the same reason as the child support obligor. He never received anything that leaves him wealthier when the debt is canceled. So this too must be specially provided for in the proposed legislation, which would apply solely to debts for child support. Here again I think it would be better to create a new section of the code, rather than to amend section 108 where it does not belong.

Unfortunately, the practical problems of the bill are likely to be even more troublesome than the theoretical ones. Consider what happens when the husband does finally catch up and pay the child support in a later year. The wife’s deduction must now be reversed, and she must take the previously deducted amount into income under section 111. Quite apart from the problems of record keeping this will cause, the section 111 treatment may prove a painful boomerang. Divorcees are often at their most impecunious immediately after divorce, and generally recover economically only over time. A common result will be that the wife will enjoy her deduction only in the 15 percent bracket, but she will have to take the same amount into income in a later year in the 28 percent bracket. This result is obviously undesirable.

Fairness would seem to require that the husband’s catchup support payments should entitle him to an offsetting deduction in order to reverse the earlier DOI tax treatment. Unfortunately there is no way to get there from here under anything resembling current law. H.R. 816 comes to the rescue by simply creating a deduction by fiat. Note that there is no need for such a rule in any other DOI situation, because all other debts must be discharged before they can create DOI, and so will never be paid (or repaid).

3The analysis would be different if the wife were forced to overpay her share of a joint obligation, and her payment freed the husband from his debt. Then if the wife is entitled to contribution from the husband and cannot collect, she should be allowed a bad debt deduction and he should incur DOI income. See Beck, “The Deductibility of a Worthless Right to Contribution for Joint Income Taxes: The Mistaken Line of Cases Under Rude v. Commissioner,” 9(2) Va. Tax Rev. 313 (1989). Conceivably the same analysis might apply to child support as well in situations where the husband is obligated to pay for specific items of support, say private school tuition, and the wife is forced to pay the item instead.

4Ralff Joint Co. v. Commissioner, 22 B.T.A. 1277 (1931), aff’d 61 F.2d 751 (2d Cir.1932)(repurchase of bonds for less than par does not give rise to DOI income where bonds originally issued as dividends and nothing was borrowed).
These adjustments in later years will have to be made for state and local taxes as well where the state follows the federal income tax rules.

There are a number of arbitrary cutoffs in the bill that seem poorly thought out. Why, for example, should the deduction be denied to wives whose adjusted gross income exceeds $50,000? And why should the deduction be limited to $10,000 per child per year? No such limits apparently apply to the husband’s DOI income.

A possible answer lies in one of the most peculiar aspects of the bill. Its authors think it will raise revenue. This revenue is earmarked in the bill for repayment of the national debt. The expected profit results from the belief that husbands will generally be taxed on their DOI income at 28 percent or higher, whereas wives will take deductions at 15 percent (if at all). I am skeptical about the profit estimate, but if it turns out to be true, it will be a very bad thing. Do we really want to take child support from the mouths of babes to pay down the national debt?

The ultimate purpose of this Rube Goldberg tax bill is apparently simply to collect some child support from husbands and pay it to wives. It is cast as a tax bill, but it makes no sense as one, and despite all the deemed this and constructive that, the proposed tax rules do not and cannot arrive at results that are “correct” in any recognizable tax sense. So if the bill has any merit at all, it can only be as a tool for the collection of child support.

But if it seems desirable as a policy matter for the IRS to collect child support, it should be done directly. Nothing is gained and much is lost by distorting the tax rules to collect child support as taxes on DOI, and to distribute it again in the form of a bad debt deduction. If the IRS collected child support from the husband and distributed it to the wife without the pretense that it involved taxes at all, the proposal would be far simpler and more effective.

For the wives who are most in need of help, H.R. 816 provides nothing because they probably do not pay taxes in the first place and have no use for the “bad debt” deduction. A wife with two children can earn up to about $25,500 before incurring any income tax liability at all. Thus she would receive nothing even if the IRS manages to collect some of her support in the form of “taxes” on “DOI” from the husband. This seems unconscionable.

For women with higher incomes, the benefits are still very small and highly unlikely to make much real difference in children’s lives. If the average amount of child support paid per year is $3,795, a wife would need nearly $29,000 of income to be able to deduct it in full, and at 15 percent, the deduction would generate only $569 in tax reduction, a benefit that increases her net income after tax by less than 2 percent. This seems hardly worth the trouble, and one suspects the real beneficiary will be H & R Block.

If the IRS can find the husbands and get them to pay support as “taxes,” there is no reason to collect only 28 percent of the support. Why not just collect it all, and pay it all over to the wives? (Without the IRS charging a 50 percent profit to pay down the national debt.) The pretense of collecting taxes rather than child support means that the support still has to be collected all over again through some other agency, after which the “tax” transactions must be undone with the absurd corrective adjustments proposed under the bill. In short, H.R. 816 would be very complicated, wasteful, and counterproductive. A much more promising proposal would be for the IRS simply to collect and distribute child support as child support, which S. 2288 would do.

At present, the IRS already does collect some child support through the refund intercept program, without pretending it is a tax, and the program appears to be reasonably successful. One frequent difficulty with the interception regime is caused by the joint return. If the husband has remarried and files jointly with his second wife, some of the intercepted refund may belong to her. Because she does not owe the husband’s child support she has a right to demand and receive her share of the refund. This creates complications, but at least it is fair in principle.

Consider what would happen in the same scenario under the bad debt/DOI scheme of H.R. 816. If the DOI is “income,” then the second wife filing jointly will be personally liable for the “tax” under section 6013(d). This is obviously indefensible.

Many other countries already go farther than our intercept program and use their tax systems to collect child support directly through the same wage withholding as the income tax. Australia and New Zealand have been doing so for some years. That is what S. 2288 would do. I do not know whether the IRS would be able to collect support more efficiently than the current (partially federalized) system of enforcement, which already makes use of wage withholding. But it is certainly worth considering, and H.R. 816 is not.

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5 For 1999, a woman with two children filing as head of household would need to earn more than $14,600 before incurring any income tax liability under the tables, without taking into account the Earned Income Tax Credit worth up to $3,356 and the new Child Tax Credit of $1,000. Taking the credits into account, if the taxpayer has $25,500 of earned income, her entire tax of $1,635 from the tables will be credited by the EITC ($639) and CTC ($1,000), and she will have no use for the deduction.