Document 4

GILLMORE AND TRUSTEE PAY-OVER ORDERS

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A. PAY-OVER TAX TIPS - How to Avoid Loss of Your Client's Tax Relief When Client Directly Pays Pension Benefits - Before and After Retirement

B. Don't Be Done in by Dunkin - A Guide to Avoiding the Loss of a Tax Deduction When Fashioning a Gillmore Order.

Note 1: The trustee pay-over order described in these materials can be used when a Participant, in pay status

(a) pays the Alternate Payee’s share of a benefit to the successor to that deceased Alternate Payee. is governed by the same rules as the constructive trust payment by a Participant to the Alternate Payee when living.

(b) pays the Alternate Payee benefits under a plan which refuses to pay the Alternate Payee directly, e.g. a nonqualified plan. The possibility of enforcing a direct payment against such a nonqualified plan is beyon the scope of this material.

Note 2: The trustee pay-over order is enforceable by contempt per the California case of *In re Marriage of Fithian* [Fithian II] (1977) 74 Cal.App.3d 397, 141 Cal.Rptr. 506.

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Basic Rules

(1) You can prescribe tax treatment in an order but IRS & FTB not bound.

(2) You can use a tax-intent clause with a fix-it clause in case you are wrong.

(3) When one client must pay another, get drafting help!

BEFORE RETIREMENT - Gillmore

(1) Expensive Way: Determine recipients after tax entitlement.[1] Pay that. Problem is getting CPAs and such to agree and also what happens when the tax bracket varies.

(2) Cheap Way: Make it alimony by meeting the requirements.[2] Alimony ≠Support. "Alimony" has nothing to do with support. (IRC § 71) Main requirement - payments must end at death of Gillmore recipient. Problem, in Gillmore period, if A/P dies, P gets a free ride until retirement.[3]

AFTER RETIREMENT
(E.g., Most Nonqualified Plans Won't Pay A/P; CSRS Delay in Payment)

Make the Participant the constructive trustee. Require that P pay over the A/P's share of gross income and that A/P report A/P's share on tax return, and that P will be able to exclude the payments from P's return. See *Poe v. Seaborn* (1930) 282 U.S. 101, 109 as explained in Comm. v. Dunkin (9th Cir., 2007) 500 F.3d 1065.[4]

Withholdings may be transferred to the A/P, but it may be easier to have P reduce his withholdings and have A/P make estimated tax payments to cover her liability.

Such an order is enforceable by contempt as it is not a money judgment, but rather an order to turn over property that belongs to the A/P. *In re Marriage of Fithian* [Fithian II] (1977) 74 Cal.App.3d 397, 141 Cal.Rptr. 506 (1977) .

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[1] *In re Marriage of Gillmore* (1981) 29 Cal.3d 418 says nonparticipant spouse is to be made "whole" --not better than whole. The tax bracket of the payor is irrelevant.

[2] Alimony did not work in 9th Circuit Dunkin case because the document failed to state that the payment obligation ended on death of recipient.

[3] Solutions: trade that small risk away for something else in the case. Or in portion of order binding the plan, multiply benefits payable to successors by 1.06 per year between Gilmore payee's death and commencement of retirement benefits.

[4] The constructive trustee payover method did not work in Dunkin, because the Gillmored employee was not in pay status.

Don't Be Done in by *Dunkin*

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Introduction

In reading the commentary in the August 2008 issue regarding *Commissioner v. Dunkin* (9th Cir. 2007) 500 F.3d 1065, 2007 U.S. App. LEXIS 20955, I realized that practitioners might react with undue despair when their client's obligation under *In re Marriage of Gillmore* (1981) 29 Cal. 3d 418, 174 Cal. Rptr. 493, is invoked.

As you may recall, once a *Gillmore* motion has been filed, the employee who is eligible to retire must either do so, or pay the nonemployee an amount equivalent to the nonemployee's interest in the employee's retirement benefits [*In re Marriage of Cornejo* (1996) 13 Cal. 4th 381, 53 Cal. Rptr. 2d 81, 916 P.2d 476].

Faced with this choice, John Dunkin chose to continue working and pay the *Gillmore* payments. However, the critical issue of tax treatment was apparently ignored in drafting the order. It must have been assumed that John would somehow get fair tax treatment, when, as the *Dunkin* Court noted, "John was required to make payments until he retired, and the pension board was ordered to make payments for as long as benefits were payable, *even if Julie died in the interim*" [*Dunkin* at 1068 (emphasis added)].

Income Tax Law Is Not Fair or Equitable

The problem is that the Internal Revenue Code is not intended to be fair. It is a monster of picky little statutes with which we must literally comply in order to get the outcome that we desire. Apparently, John did not understand the most basic of these picky rules: When one spouse or ex-spouse pays money to another, it will be a tax-free event unless one can find a statute which confers alternative treatment upon it [IRC § 1041].

Community Property Law Is Supposed to Honor Fairness

Although you now are reminded that tax law is not fair, the same does not hold true for the law of community property in California. The *Gillmore* court said: “if he . . . [continues working], he must reimburse Vera for the share of the community property that she loses as a result of that decision” [*Gillmore* at 427]. The source of the *Gillmore* right lies in the principle that one spouse cannot harm the other by an election which keeps that other spouse from receiving the value of that other spouse’s asset. On the other hand, there is nothing in the cases leading up to *Gillmore* which even implies that a spouse invoking this principle is allowed to experience a windfall by receiving tax-free income.

Thus John was absolutely justified in not having to pay more to Julie than was sufficient to compensate her for what she would have received on an after-tax basis. So why did John suffer so?

Alimony Method Did Not Work for John

John claimed his *Gillmore* payments as an alimony deduction. This attempt failed because an alimony tax deduction requires, either in the terms of the agreement/order or by operation of law, that the obligation to make the payments is extinguished on the death of the payee. Note that the fact that this was an obligation to make *property division payments* was not the problem with John’s case. Property division payments can qualify for the alimony deduction as long as the obligation to pay each of the payments terminates on the payee’s death [IRC § 71[1]].

Trustee Payover Method Did Not Work for John

Desperate for any relief once he felt the shock of the denial of alimony treatment, John next tried the trustee payover method. That method applies when the payor spouse receives—partly as trustee—a taxable distribution of assets partly owned by his former spouse. The order or agreement mandates that the trustee spouse pay his former spouse’s share *out of that distribution*. In such cases, the trustee spouse will be able to remove the turned-over payments from his Form 1040 because—once earmarked as the former spouse’s property—the payments never were his income in the first instance. Correspondingly, the former spouse will then have the obligation to report her income on her tax returns.

[1] One should be aware of the other factors required by IRC § 71, such as living in different households, and not violating the front-loading rules, a discussion beyond the scope of this article.

Unfortunately, John was not receiving his pension at the time. Instead, he was paying Julie her equivalent interest in her capacity as his creditor; and he took the payments from wages in which Julie had no property interest. This method was approved for John by the Tax Court, and many practitioners relied on it, until the Ninth Circuit Court of Appeals reversed the Tax Court's decision. However, those who do serious work in dividing community property deferred compensation knew, upon reading it, that the Tax Court's decision was doomed for reversal.

Before I leave off discussing this method, however, please keep its use in mind for those cases in which an employee is in pay status, but a plan refuses to make direct payment to an alternate payee.[2] Allowing the payor to remove (not deduct) the paid-over income from his reported gross income finds its rationale in a case called *Poe v. Seaborn* (1930) 282 U.S. 101, 51 S. Ct. 58, 75 L. Ed. 239, whose precepts every community property lawyer should know by heart. That is, the tax man must honor the allocation of income[3] under the community property laws of a state. So if X% of the pension payment belongs to Spouse 2 and Spouse 1 is just collecting and turning it over to Spouse 2, it is removable from Spouse 1's income. As another bonus, a well-crafted trustee payover order is also enforceable by contempt [In re Marriage of Fithian (1977) 74 Cal. App. 3d 397, 141 Cal. Rptr. 506], and is fairly defensible against a discharge in bankruptcy [11 U.S.C. § 523(a)(5)].

Hindsight—What Should John Have Done?

Here's the part where you can shed your despair. John could have made an alimony arrangement or a tax discount arrangement.

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[2] Also keep its use in mind for cases in which there is a delay in the payment of pension benefits. Payments from the Office of Personnel Management (OPM) under federal civil service orders have been known to be delayed for years. If a retiree pays a spouse in the meantime (as a dissolution order ought to require), the dissolution order should make it clear that the payment will be removed from the retiree's tax return and added to the nonemployee spouse's tax return.

[3] This principle applies to withholding as well as to the income from which it was taken [see IRS Publications 504, *Divorced or Separated Individuals*, "Community Income"; 505, *Tax Withholding and Estimated Tax*,"Separate Returns"; see also Publication 555. *Community Property*, "Separate Return Preparation"].

But how would John be able to profit from an alimony arrangement in light of Dunkin? Simple, the order would provide that his obligation (as distinct from the pension plan's later obligation) to pay the *Gillmore* payment to Julie would terminate on Julie's early death—for example, "John shall pay Julie $1,000 per month plus applicable cost-of-living increases until John's retirement or the death of either party." This inclusion of Julie's death as a terminating event would have provided John with an alimony deduction.

You may have spotted a defect in this approach. It would create a contingent loss of benefits to Julie's successor(s), violating the Family Code Section 2610 provision which says that Julie's pension interest does not terminate on her death.

Julie could be compensated for this "temporary terminable interest" by paying Julie—not her successors[4]—something extra. How much? The best way to measure Julie's terminable interest is by the cost of a life insurance policy which would pay Julie's heirs half of the total *Gillmore* payments foreseeable during the maximum *Gillmore* period. Why half? Because if John dies at any time in the *Gillmore* period, the average loss to Julie's successors will be half of the maximum. Husband gets to name the maximum iperiod by agreeing to retire at or before the end date. Let's say the payments are $1,000 a month and H has agreed to a ten year limit before he finally retires. The total is $120,000. A $60,000 life insurance policy will cost, let's say, $300 per year, i.e., $3,000. Julie doesn't have to actually buy the policy, but simply is paid enough today so that Julie has the option to *insure herself* against that average loss.

Or, alternatively, the $3,000 could be converted to a few more dollars per month of pension interest. For example, if each $1 per month with a 2% cost-of-living feature payable to a male of John's age is valued actuarially at $200 (something that an attorney working seriously with community property pension issues can determine in five minutes), then $15 can be added to Julie's benefit.

As you can see, in most cases this adjustment is trivial and easily made. However, prudence would not lead one to avoid describing such an adjustment as a substitute for the *Gillmore* payments, lest the "end on death" requirement be found not to have been met.

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[4] Make sure that this extra is paid to Julie. Alimony treatment will be lost for <u>all</u> of the payments if John is obligated in any way to pay *any* of the payments to Julie's successors on Julie's early death [Temp. Treas. Reg. A-10, §1.71-1T].

Tax Discount Method is Alive But Not Preferred

Another method is available which should be obvious. The monthly payment can be adjusted to rebate back to John the tax savings experienced by Julie. Why the recipient's (Julie's) tax bracket? Simple. As is mentioned in the quote above, *Gillmore* focuses on making the nonemployee spouse whole and not on guaranteeing tax benefits to the payor. Consider Ralph Moneybags who is in a 40% tax bracket being married to Josephine Baglady who is in a zero tax bracket. Josephine will not be made whole by having 40% of her benefits rebated to Ralph.

The main drawback with this method is that it denies the ameliorative effect of a tax deduction for the person in the high earner's position, a feature which softens the *Gillmore* blow. Thus, using this tax discount method will cost Ralph Moneybags $1,000 in post-tax dollars to pay Josephine Baglady her $1,000 a month payment; as opposed to the alimony method, which will cost Ralph about $600 in post-tax dollars. The effects to Josephine are the same either way.

Another problem with the tax discount method is that (1) hefty arguments can ensue regarding tax brackets, (2) verification of brackets requires giving up privacy, and (3) brackets shift from one year to the next. In order to achieve exactitude, an annual review and adjustment process must be set out in the agreement or order. The method thus creates huge professional expense starting with the attorney's fees for drafting of the order and continuing with the accountant's fees until retirement.

In sum, unless the parties are in similar tax brackets and are brave enough to pick a discount number and stick with it for the entire *Gillmore* period (the KISS, or "keep it simple", variation of this method), the tax discount method is to be avoided.

Tax Intent Clause Is Mandatory

> Rule: Never consider having one spouse pay another without using a tax-intent clause.

In drafting any *Gillmore* order, therefore, one should set out the intended tax reporting rules for each party. One should provide that if the method doesn't work, that the court can modify the order to rectify the past inequity and fix the problem going forward. Apparently, there was no such clause in the *Dunkin* agreement, because wife Julie simply did not report the payments. Had there been such a clause, Julie would have been aware that her failure to report might help her in the short run, but that she could not keep her unjust enrichment for long. (This is not to say that we should ever attempt to lead our clients to use improper tax reporting, since such practices could expose our clients and us to the unwelcome attention of the Internal Revenue Service.)

But there is a caveat. There is a smidgeon of doubt in my mind that the fact that the *Gillmore* payment will ultimately be taken over by the pension plan (which will be obligated to pay the successors on the recipient spouse's death) will provide support for a "sham" defense to allowing alimony treatment. No case to that effect exists, and most people don't have $15,000 handy to obtain a private letter ruling to find out for sure. Having a tax-intent clause will allow the court to readjust a past failure by resort to the tax discount method if the problem ever arises. And the tax-intent clause itself will make it highly unlikely that the problem will ever arise.

Reprise of Basic *Gillmore* Tax Outcome Rules

(1) When one client must compensate another party or successors, understand the taxation effects or get drafting help!

(2) Prescribe intended tax treatment in your order, but understand that the Internal Revenue Service and Franchise Tax Board are not bound by your pronouncements.

(3) If you intend alimony treatment, specify that the obligation to pay any installment is extinguished if the obligee dies before the due date of that installment.

(4) Use a tax-intent clause coupled with a court-fix-it clause in case you are wrong.