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Editor-in-Chief's Column

Proper Use of UTMA'S in Marital Settlement Agreements

by Charles F. Vuotto Jr.

Most of us have drafted martial settlement agreements (MSAs) including provisions that apply all or some children's custodial funds to defray the cost of educational expenses or other child-related obligations. This column addresses the propriety of doing so when those custodial funds are held in an account created under the New Jersey Uniform Transfers to Minors Act (UTMA).[1]

The Appellate Division recently addressed the responsibility of parents to their children as it pertains to UTMA accounts in the unreported case of *Rosemary Ferraro v. Guy Ferraro.*[2] In *Ferraro*, the appellate court stated that the UTMA allows for the "transfer by irrevocable gift to…a custodian for the benefit of a minor."[3] For securities, such a gift occurs when the transferor registers the property in his or her own name, "followed in substance by the words: 'as custodian for __________ (name of minor) under the New Jersey Uniform Transfers to Minors Act."[4] Any transfer so made "is irrevocable, and the custodial property is indefeasibly vested in the minor."[5]

Once the gifted property is delivered, "acting in a custodial capacity, [the custodian] has all the rights, powers, and authority over custodial property that unmarried adult owners have over their own property."[6] The custodian has the responsibility to "[c]ollect, hold, manage, invest, and reinvest custodial property."[7] However, custodial property must at all times be kept "separate and distinct from all other property in a manner sufficient to identify it clearly as custodial property of the minor."[8]

Although the UTMA invests the custodian with discretion to "pay to the minor or expend for the minor's benefit so much of the custodial property as the custodian considers advisable for the use and benefit of the minor,"[9] such a payment or expenditure "is in addition to, not in substitution for, and does not affect any obligation of a person to support the minor."[10] Unless the terms of the gift expressly state otherwise, the custodian must "transfer the custodial property to the minor or to the minor's estate upon the earlier of" 1) "[t]he minor's attainment of 21 years of age"; or 2) "[t]he minor's death."[11]

If the custodian is suspected of violating his or her fiduciary obligations, the minor's guardian, legal representative, or adult relative "may apply to the court to remove the custodian for cause and to designate a successor custodian."[12] These individuals may also "apply to the court for...[a]n accounting by the custodian."[13]

In the trial level case of *Roberts v. Roberts*,[14] the court addressed the issue of whether a parent-custodian can be compelled to use custodial assets to defray private secondary school costs. The court concluded that the custodian's exercise of discretion is entitled to the same respect accorded a trustee,[15] and that, under the circumstances of that case, the court would not override the custodian's refusal to use UGMA or UTMA assets. The court reached this conclusion without deciding whether the parents in that case would be deemed obliged to pay for the child's schooling from their own funds.[16] However, this begs the question of whether it is appropriate to use those UTMA funds to defray a parent's legal obligations to his or her child.[17]

The *Roberts* court referred to the holding in *Cohen v. Cohen*,[18] which addressed the limitations on the use by a parent-custodian of the assets held under the UGMA and UTMA. The court held that such assets may not be used to fulfill a financially able parent's support obligation. The *Cohen* court held that "despite the broad language of the statute purporting to confer wide discretion on the custodian, a custodian who is also a parent cannot properly use assets of a UGMA account to defray the parent's legal obligations to a child if the parent is financially able to support the child."[19] However, referring to persuasive out-of-state authority construing the uniform law of their states, the *Cohen* court noted that a custodian of a UGMA account may nonetheless not pay, or reimburse him or herself for expenditures that he or she was "legally obligated to make from...own funds for the benefit of the minor who is the beneficiary of the custodial account."[20]

The *Roberts* court further clarifies (citing to *Cohen*) that, "the prohibition of using UTMA custodial funds to defray a parent's legal support obligation derives not from the UTMA, but from the general principle that the estate of a minor may not be used for his support and maintenance if those who are legally responsible for the minor have sufficient funds to enable them to fulfill their responsibilities."[21] The property of a minor held in a custodial account is indefeasibly granted to that child.[22] Notwithstanding the foregoing, the *Cohen* court qualifies that the limitation of use of a minor's estate applies only "if the parent is financially able."[23] A parent's support obligation adapts to the parent's ability to pay under the child support guidelines.[24]

It is unclear whether *Cohen* would allow invasion of custodial funds when a parent is temporarily unable to pay for tuition, inasmuch as temporary reductions in income generally do not adjust a parent's support obligation.[25]

The *Roberts* court notes, however, that the extent of a child's resources is a factor to be considered in the analogous determination of parents' obligation to pay for college pursuant to the Supreme Court decision in *Newburgh v. Arrigo*.[26] Our Supreme Court specifically addressed consideration of assets of the child "held in custodianship or trust," presumably contemplating possible use of those funds in appropriate cases, even though the parents would otherwise be obliged to pay the balance of costs.[27]

As a practical matter, as matrimonial practitioners we often represent divorce clients who have created UGMA or UTMA accounts for their children. Often both parties agree they intended these funds to be used for their children's educational expenses, and more than likely did not realize they were making irrevocable gifts to the children, and that the funds may not necessarily be applied as the grantors desired. It may very well be that a compromise, so to speak, may be struck between these opposing principles by careful drafting of our agreements.

Perhaps language as follows satisfies all concerns:

> The parties acknowledge that they have maintained UGMA/UTMA accounts for the benefit of their children as follows: _______. The parties recognize that the aforementioned UGMA/UTMA accounts were created under New Jersey Uniform Transfers to Minors Act, N.J.S.A. 46:38A-19(A)(1), and are the property

of the children in accordance with applicable New Jersey law and do not represent marital assets subject to equitable distribution incident to their divorce. Therefore, the parties do not intend to allocate or distribute those accounts, which belong to the children. Nevertheless, the parties also acknowledge that, with regard to their respective responsibilities for educational expenses for the children, that the Supreme Court in *Newburgh v. Arrigo*, 88 N.J. 529 (1982), provided various factors to be included by the court including the following: "The financial resources of the child, including assets owned." As such, the parties contemplate, (although do not designate hereby) that the children will use their various custodial accounts for their post high school educational expenses and that the parties' respective obligations to contribute to the children's post-high school educational expenses shall only arise after those custodial accounts have been duly applied as is anticipated. If the children do not act as anticipated, such event shall constitute a change in circumstances requiring a review of the provisions of this Agreement allocating the parties' respective responsibilities for post high school educational expenses or an application to the court to determine how much should be contributed by the child.

This proposed language may or may not satisfy the competing interests at play. It still may go too far in compelling a child to apply his or her funds. On the other hand, it may unnecessarily restrict the application of funds that, in all honesty, were always intended for the stated purpose (*i.e.*, educational expenses for the child in most instances).

I do believe that the protocol created by this proposed language, however, is consistent with the trend in the Appellate Division cases, which is starting to take note of the *Newburgh* factor more so than in the past. Practitioners should be warned, however, that the case law is still not clear on whether it is reasonable or permissible to let the parents decide that the children have to contribute before either parent has to do so. That portion of the above language should probably be modified depending upon the facts of any particular case including, for example, how much money is in the identified UTMA/UGMA accounts and possibly depending upon whether the parents reduced their own ability to pay for college by making gifts to the child.

Also, just for the sake of argument, it will be interesting to see if the Appellate Division ever addresses whether the parent's expectations should be different if the funds in the UTMA/UGMA account being identified in the divorce agreement were not gifted by the parents and/or if neither parent is the custodian of the account(s) in question. The above language, therefore, should be viewed as a starting point for discussion in the hopes that a consensus may be reached regarding the appropriate manner in which children's funds may be referenced in our divorce agreements.

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Endnotes

1. N.J.S.A. 46:38A-1, *et. seq.*
2. Docket No. A-3844-09T2.
3. N.J.S.A. 46:38A-8.
4. N.J.S.A. 46:38A-19(A)(1).
5. N.J.S.A. 46:38A-24.
6. N.J.S.A. 46:38A-31.
7. N.J.S.A. 46:38A-26.

8. N.J.S.A. 46:38A-29.
9. N.J.S.A. 46:38a-32.
10. N.J.S.A. 46:38A-34; *see also Colca v. Anson*, N.J. Super. 405, 416 (App. Div. 2010) ("A child's assets may not be used to fulfill a financially able parent's support obligation."); *Cohen v. Cohen*, 258 N.J. Super. 24, 30-31 (App. Div.) ("[A] custodian who is also a parent cannot properly use assets of a UGMA account to defray the parent's legal obligations to a child if the parent is financially able to support the child."), *certif. denied*, 130 N.J. 596 (1992).
11. N.J.S.A. 46:38A-52(a),(c).
12. N.J.S.A. 46:38A-47.
13. N.J.S.A. 46:38a-48(a).
14. 908 A.2d 1273, 388 N.J. Super. 442 (Ch. Div. 2006).
15. The discretion afforded a trustee will not be disturbed so long as a fiduciary acts in good faith with care, prudence and ordinary discretion, within the scope of his powers, his actions cannot be assailed. *See generally In re Wehrhane's Estate*, 41 N.J. Super. 158, 166 (Ch. Div.) 1956), *affirmed on other grounds* 23 N.J. 205 (1957).
16. The *Roberts* court stated that the UGMA and UTMA as construed by our courts, it is uncertain whether UGMA or UTMA assets may be used for the child's tuition under the circumstances of this case. However, the court need not resolve that issue because, more importantly, Ms. Roberts has failed to establish the grounds for overriding Mr. Roberts' decision as custodian. *Roberts v. Roberts, Id.* at 443.
17. *Roberts v. Roberts, supra*. at 443.
18. 258 N.J. Super. 24, 609 A.2d 57 (App. Div.), *certif. denied*, 130 N.J. 596, 617 A.2d 1219 (1992).
19. *Id*. at 30-31, 609 A.2d 57. In reaching that conclusion, the court affirmed a trial court decision that compelled a mother to reimburse her daughter for withdrawals from a UGMA account that were used for the child's living expenses, including clothes, food, shoes, dry cleaning bills, medical insurance and doctors' services. Also inappropriate were withdrawals to reimburse the mother's attorneys' fees, incurred in connection with her custody dispute with the child's father. The daughter did not contest the custodian's use of UGMA assets for camp and schools. *Id*.
20. *Cohen v. Cohen, supra*, 258 N.J. Super. at 29-30, 609 A.2d 57. *Roberts v. Roberts, supra*. at 443.
21. *Cohen v. Cohen, supra*, 258 N.J. Super. at 30, 609 A.2d 57.
22. N.J.S.A. 46:38-24 (stating that transfer is irrevocable and property is indefeasibly vested in the minor, subject to the custodian's powers outlined in the act).
23. *Id*. at 31, 609 A.2d 57.
24. *See generally* Child Support Guidelines, Appendix IX-A to R. 5:6A.
25. *See Innes v. Innes*, 117 N.J. 496, 504, 569 A.2d 770 (1990) as cited in *Roberts v. Roberts, supra.* at 444.
26. 88 N.J. 529, 545, 443 A.2d 1031 (1982) (stating that the court should consider, among other factors, "the financial resources of the child").
27. *Roberts v. Roberts, supra*. at 445.

Inside this issue

UIFSA and the Evolving Nature of Continuing, Exclusive Jurisdiction

by Robert H. Siegel

The provisions of the Uniform Interstate Family Support Act (UIFSA)[1] can often seem difficult to navigate. Despite the substantial length of the statute, and its multitude of provisions and subsections, there remain enormous gaps in the enforcement and practical use of UIFSA. This article shall examine the practical and strategic implications of enforcing an out-of-state support order in the state of New Jersey. With enforcement of any order under UIFSA, a host of related issues arise that must be reconciled with the vague language of the statute itself.

UIFSA originated as a uniform act drafted by the National Conference of Commissions on Uniform State Laws.[2] In 1996, the federal government enacted the Personal Responsibility and Work Opportunity Act,[3] which required every state to adopt UIFSA by 1998 in order to continue to receive federal funding for child support enforcement. UIFSA was enacted in New Jersey on March 5, 1998.[4] Its intended goal was to provide for uniform enforcement of support orders by establishing continuing, exclusive jurisdiction over interstate child support orders.[5] UIFSA also standardized how courts across the country implement child support orders.

N.J.S.A. 2A:4-30.72(a) states:

> A tribunal of this State issuing a support order consistent with the law of this State has continuing, exclusive jurisdiction over a child support order: (1) as long as this State remains the residence of the obligor, the individual obligee, or the child for whose benefit the support order is issued or (2) until all of the parties who are individuals have filed written consents with the tribunal of this State for the tribunal of another state to modify the order and assume continuing, exclusive jurisdiction.

When a state transfers continuing, exclusive jurisdiction to another state, it is said to have "relinquished" jurisdiction over the matter. With more litigants moving from state to state after their divorce, issues are becoming more prevalent surrounding the exact nature of *what* the originating states are actually relinquishing when jurisdiction is transferred.

Despite the text of N.J.S.A. 2A:30.72(a), significant steps must be taken in order to enforce an out-of-state support order that have never been clarified by statute or New Jersey case law. First, the out-of-state support order must be registered. N.J.S.A. 2A:4-30.105, titled "Procedure for registration," states:

> A support order or income-withholding order of another state may be registered in this State by sending the following documents and information to the appropriate tribunal in this State:
>
> (1) a letter of transmittal to the tribunal requesting registration and enforcement;
>
> (2) two copies, including one certified copy, of all orders to be registered, including any modification of an order;
>
> (3) a sworn statement by the party seeking registration or a certified statement by the custodian of the records showing the amount of any arrearage;
>
> (4) the name of the obligor and, if known:
>
> a. the obligor's address and social security number;
>
> b. the name and address of the obligor's employer and any other source of income of the obligor; and
>
> c. a description and the location of property of the obligor in this State not exempt from execution; and
>
> (5) the name and address of the obligee and, if applicable, the agency or person to whom support payment are to be remitted.
>
> b. On receipt of a request for registration, the registering tribunal shall cause the order to be filed as a foreign judgment,

together with one copy of the documents and information, regardless of their form.

c. A complaint, petition or comparable pleading seeking a remedy that must be affirmatively sought under other laws of this State may be filed at the same time as the request for registration or later. The pleading must specify the grounds for the remedy sought.

Absent registration, New Jersey courts will neither enforce nor modify an out-of-state support order.[6] Registration is normally a straightforward process, as the Family Division in each county is adept at registering foreign (out-of-state) divorce judgments. The modification of foreign judgments once they are registered, however, presents complicated issues that are in need of clarification, either by the Legislature or the courts.

The Modification of Out-of-State Child Support Orders

The enforcement of an out-of-state order has not presented New Jersey courts with significant difficulties. The issue of modification of an out-of-state order, however, has proved to be a source of great confusion for New Jersey courts. As explained further below, case law has not clarified the crucial question of how, and to what extent, New Jersey courts have the discretion to modify the provisions of out-of-state divorce decrees. Without greater guidance from the courts, both litigants and attorneys are severely disadvantaged as they seek redress under appropriate circumstances.

N.J.S.A. 2A:4-30.114 addresses the modification of an out-of-state order once it has been registered. It states:

> After a child support order issued in another state has been registered in this State, the registering tribunal of this State may modify that order only if section 52 of this act does not apply[7] and after notice and hearing it finds that:
>
> (1) the following requirements are met:
>
> a. the child, the individual obligee, and the obligor do not reside in the issuing state;
>
> b. a petitioner who is a nonresident of this State seeks modification; and
>
> c. the respondent is subject to the personal jurisdiction of the tribunal of this State;
>
> ***or***
>
> (2) the child or a party who is an individual is subject to the personal jurisdiction of the tribunal of this State and all of the individual parties have filed written consents in the issuing tribunal for a tribunal of this State to modify the support order and assume continuing, exclusive jurisdiction over the order. However, if the issuing state is a foreign jurisdiction which has not enacted a law or established procedures essentially similar to the procedures under this act, the consent otherwise required of an individual party residing in this State is not required for the tribunal to assume jurisdiction to modify the child support order.
>
> b. Modification of a registered child support order is subject to the same requirements, procedures, and defenses that apply to the modification of an order issued by a tribunal of this State and the order may be enforced and satisfied in the same manner.
>
> c. A tribunal of this State may not modify any aspect of a child support order that may not be modified under the law of the issuing state. If two or more tribunals have issued child support orders for the same obligor and child, the order that controls and shall be recognized under the provisions of section 10 of this act establishes the unmodifiable aspects of the support order.
>
> d. On issuance of an order modifying a child support order issued in another state, a tribunal of this State becomes the tribunal of continuing, exclusive jurisdiction.

Long-Arm Jurisdiction and the Origins of N.J.S.A. 2A:4-30.114(c)

Having set forth the modification provision of UIFSA above, it is important to detail the process by which New Jersey courts have arrived at their current (though, this author believes, flawed) understanding of how to enforce UIFSA in a uniform fashion across the state. As set forth below, the courts initially attempted to utilize the principle of long-arm jurisdiction to subject out-of-state litigants to New Jersey law. UIFSA was amended in 2001, ostensibly to protect out-of-state litigants from being dragged into the home state courts of their respective former spouses. However, due to the ambiguous and contradictory wording of N.J.S.A. 2A:4-30.114(c) (the amendment to UIFSA), the courts were unable to apply a uniform approach to UIFSA modification cases. The resulting patchwork approach has done little to instill confidence in those seeking to enforce and modify out-of-state orders, creating more confusion than clarity.

In *Sharp v. Sharp*,[8] relying on N.J.S.A. 2A:4-30.68, the trial court held that New Jersey could exercise personal jurisdiction over the father despite the fact that all prior child support orders had been issued by California courts.[9] The Appellate Division reversed, holding that the trial court did not have personal jurisdiction over the father, and that the mother's reliance on a choice-of-law rationale was misplaced.[10]

The *Sharp* decision is critical for two reasons. First, it ended the ability to make choice-of-law arguments in support of the position that New Jersey could assume continuing, exclusive jurisdiction to modify support issues based on public policy concerns. As such, New Jersey's liberal child support laws could not be used to form the basis of an argument that a parent could be compelled to pay an extended form of child support, such as college expenses, that other states did not require.

Second, it illustrated why UIFSA was in need of amendment to prevent the use of long-arm jurisdiction to compel out-of-state litigants to address modification matters in New Jersey.

UIFSA was ultimately amended in 2001 with the addition of N.J.S.A. 2A:4-30.114(c). This amendment limited the ability of the courts of New Jersey to modify "any aspect of a child support order that may not be modified under the law of the issuing state."[11] The practical effect of the amendment was to instruct New Jersey courts that New Jersey law could *not* be applied to cases originating in states with strict cut-off dates for child support. For example, where divorce agreements are entered in states such as Pennsylvania, Maryland, and Florida, where child support automatically terminates upon the child attaining the age of 18,[12] New Jersey's support laws cannot supersede the laws of foreign states. Even where a party to a divorce litigation has been residing in New Jersey for 10 years or more, New Jersey child support laws will not be applied in place of the strict cut-off laws of foreign states where the divorce was entered.[13]

UIFSA was also amended in 2001 with the addition of Section 611(d),[14] which states, "In a proceeding to modify a child support order, the law of the State that is determined to have issued the initial controlling order governs the duration of the obligation of support. The obligor's fulfillment of the duty of support established by that order precludes imposition of a further obligation of support by a tribunal of this State."[15]

In 2007, the Appellate Division addressed this amendment in *Marshak v. Weser.*[16] *Marshak* has become the seminal New Jersey UIFSA case by default. However, rather than clarifying the modification provisions of UIFSA, *Marshak* has led to further confusion and ambiguity, primarily due to the unique factual circumstances of the case.

In *Marshak*, the parties were divorced in June 1999 in Pennsylvania, with the initial child support order entered in Pennsylvania as part of the parties' divorce agreement.[17] After their divorce, the parties moved to New Jersey, but a second child support order was entered in Pennsylvania in 2000.[18] On June 12, 2002, the parties entered into a consent order in New Jersey recalculating child support for their younger child in anticipation of their older child's emancipation.[19]

The parties' consent order stated, "Nothing herein shall be construed to affect the nature, term, duration or extent of child support *under the laws of the State of Pennsylvania.*"[20] On June 21, 2002, the Pennsylvania court issued an order emancipating the older child when he reached the age of 18.[21]

When the parties' younger child turned 18 and graduated from high school, the father filed a motion in New Jersey to emancipate him.[22] The mother opposed the motion and sought to compel the father to contribute to the child's college expenses under New Jersey law.[23]

Relying on the Appellate Division's decision in *Philipp v. Stahl*,[24] the trial court in *Marshak* held that New Jersey law should be applied on the issue of college expenses, as long as both parties were residing in New Jersey.[25] The Appellate Division reversed the trial court, holding that since Pennsylvania law did not require parents to contribute to college expenses, the initial Pennsylvania child support order could not be modified to require the father to contribute to college expenses.[26] The *Marshak* court noted the amendment to UIFSA codified at Section 611(d), stating that New Jersey could not extend the father's child support obligation beyond what he was required to pay under Pennsylvania law, where the initial order was entered.[27]

The *Marshak* decision has been heavily relied on. This reliance has been problematic, however, due to the facts of the case, which do not lend themselves to an easy application with respect to future matters. Specifically, in *Marshak*, despite the fact that both parties relocated from Pennsylvania to New Jersey after they were divorced, they entered into a consent order explicitly stating that Pennsylvania's child support laws *would continue to apply notwithstanding their new residency in New Jersey*. By doing this, the parties in *Marshak* essentially memorialized the terms of N.J.S.A. 2A:4-30.114(c) in their consent order. This made it certain that New Jersey's more liberal child support laws would never apply to their case. Once the parties in *Marshak* consented to the application of Pennsylvania law moving forward, they eliminated any need for a discussion of UIFSA's continuing, exclusive jurisdiction statute or its modification provisions. This fact is often overlooked when analyzing *Marshak*.[28]

While no published cases have expressly overruled *Marshak*, the Appellate Division demonstrated a desire to move beyond its limitations in an unpublished 2008 decision. In *Kacmarcik v. Kacmarcik*,[29] the Appellate Division upheld the trial court's decision, which denied the father's motion to emancipate the parties' 19-year-old son, with the appellate court stating that the father was attempting to "forum shop" to obtain a favorable outcome.

The parties in *Kacmarcik* were married in New Jersey in 1987, moved to Pennsylvania in 1990, and were divorced in Pennsylvania in April 1994.[30] The parties' separation agreement, entered into in Pennsylvania, stated that their son would be emancipated upon the "attainment of the age of 18 years…or completion of high school education, whichever event first occurs, but no event beyond the normal date of graduation from high school of the class of the child."[31]

The parties entered into an amended separation agreement in 1998, which addressed custody, child support, medical insurance, and school tuition.[32] It also stated, "This Agreement shall be governed by and interpreted in accordance with the laws of the State of New Jersey."[33]

In May 2006, the mother filed a motion seeking for the father to provide increased child support and contribute toward the child's college expenses.[34] At that time, the parties' Pennsylvania divorce decree, separation agreement, and amended separation agreement were docketed and registered in New Jersey.[35]

The parties initially entered into a consent order that provided that the father would pay one-third of the cost of his son's college expenses.[36] In 2007, after obtaining new counsel, the father ceased making college tuition payments and moved to emancipate the parties' son.[37] Relying on *Marshak*, the father argued that the parties' amended separation agreement changed custody and established a new child support obligation, but did not change jurisdiction.[38]

The trial judge in *Kacmarcik* held that "New Jersey should exercise continuing and exclusive jurisdiction over the parties' disputes arising with respect to custody and child support."[39] The trial court also distinguished the case from *Marshak*, noting that the parties in *Marshak* had "continued to avail themselves of Pennsylvania courts and law for modification of child support."[40] The trial judge specifically noted the parties' June 2002 consent order in *Marshak*, noting how it set that case apart from the facts in *Kacmarcik*.[41] Finally, the trial court stated it believed the father was attempting to "forum shop" in order to take advantage of Pennsylvania law that did not require him to contribute to his children's college expenses.[42]

The Appellate Division affirmed the trial court's ruling, holding that the parties' August 1998 amended separation agreement constituted the necessary written consent under N.J.S.A. 2A:4-30.114(2) to allow New Jersey to modify the child support order, originally entered in Pennsylvania.[43] Though the consent order in *Kacmarcik* gave the Appellate Division a clear basis for their decision, they expressly noted the trial court's concern for forum shopping, providing tacit approval for such an argument.[44]

Kacmarcik suggests that New Jersey courts may have started to realize that the true concern for forum shopping exists not with those who seek to enforce and/or modify out-of-state divorce agreements in New Jersey, but instead, with parties who deliberately move to states where they seek the safe haven of lax child support laws. The author hopes that ideally, *Kacmarcik* will serve as the intellectual foundation for future cases where an out-of-state litigant attempts to avoid financial obligations by using UIFSA as a shield. New Jersey courts can signal a new approach to the modification provision of UIFSA by expounding upon the *Kacmarcik* holding in a clear and forceful manner.

The practical effects of N.J.S.A. 2A:4-30.114(1)(b) have not been those that were originally intended. Rather than preventing litigants from moving to states with more liberal child support laws, the author believes, they have merely protected those seeking to avoid paying much-needed support to their children.

Developing Case Law and the Consent Provision of UIFSA

As previously noted, N.J.S.A. 2A:4-30.72(a)(1) states that New Jersey maintains continuing, exclusive jurisdiction over support matters as long as the obligor, obligee, or child(ren) continue to reside in the original state. Pursuant to N.J.S.A. 2A:4-30.72(a)(2), New Jersey (and any other state) relinquishes its continuing, exclusive jurisdiction where the parties to the action file written consents to transfer continuing, exclusive jurisdiction to another state to modify all support orders.

However, once a state relinquishes its continuing, exclusive jurisdiction under N.J.S.A. 2A:4-30.72(a)(1) or (2), a 'legal limbo' is created, as the state that assumes jurisdiction often does not know whether they have the discretion to modify, or merely enforce, the original order. While New Jersey has lagged behind in its recognition of the inherent flaws in the design of UIFSA, other states have attempted to interpret the statute in a precedent-setting manner.

For example, in *Basileh v. Alghusain*, the Indiana Supreme Court addressed the issue of whether a state can relinquish its continuing, exclusive jurisdiction by virtue of the fact that no parties involved continue to reside in the original divorce state, without the parties having consented to a transfer of jurisdiction to another state.[45] Basing its ruling on similar cases in Arizona,[46] Oklahoma,[47] Delaware,[48] and Kansas,[49] the Indiana Supreme Court held that only one of the two conditions set forth in I.C. §31-18-2-5(a) (identical to N.J.S.A. 2A:4-30.72(a)) must be met in order for a court to relinquish its continuing, exclusive jurisdiction. Indiana's version of UIFSA, just like New Jersey's, states that Indiana retains continuing, exclusive jurisdiction if a party or related child remains in Indiana, *or* until each party has filed written consent to transfer jurisdiction elsewhere. The Indiana Supreme Court held that if *either* condition is met, Indiana loses its continuing, exclusive jurisdiction, and the new state vested with jurisdiction is permitted to enforce *and* modify the initial Indiana divorce decree.[50]

While New Jersey has enforced the terms of N.J.S.A. 2A:4-30.72(a) without ambiguity regarding the "either/or" language within the statute, the courts have not yet provided the clarity other states are trying to provide with respect to assuming jurisdiction over support matters. The author believes that where no parties reside in the original divorce state, New Jersey should not hesitate to assume continuing, exclusive jurisdiction over support matters; jurisdictional limbo should be avoided for residents of the state of New Jersey simply exercising their rights to child support, in any form.

Additionally, when parties expressly consent to transfer jurisdiction to New Jersey, meeting the requirements of *both* N.J.S.A. 2A:4-30.72(a)(2) and N.J.S.A. 2A:4-30.114(a)(2), the author believes New Jersey courts should have the discretion to modify support outside the scope of the originating state's child support laws.

New Jersey Cases Have Addressed What Constitutes Consent, but Have Failed to Explain Its Ramifications

Though the legal impact of consenting to a transfer of continuing, exclusive jurisdiction has been clouded by New Jersey case law, the courts have outlined the parameters of what constitutes written consent under UIFSA. In *Teare v. Bromley*,[51] the Burlington County trial court emphasized that there is a "strict requirement for the entry of written consent."

In *Peace v. Peace*,[52] the Atlantic County trial court held that consent to allow a subsequent court to modify an original state's child support order should be found "only upon a clear showing that the parties knowingly and voluntarily desired that result."

The author believes it is imperative that the courts understand and enforce the written consent provisions of UIFSA so that cases where both parties consent to New Jersey assuming continuing, exclusive jurisdiction can be properly adjudicated. For instance, where both parties provide their written consent to New Jersey assuming continuing, exclusive jurisdiction, New Jersey courts can then set the tone for subsequent cases that may have more ambiguous factual circumstances.

Once New Jersey courts clearly establish the ramifications of submitting to the state's jurisdiction in writing, courts can extend the underlying basis for application of New Jersey law to similar factual scenarios. Before New Jersey can have its own case like *Basileh*, the seminal Indiana case, the implications of the consent provisions of UIFSA need to be clearly demonstrated.

The Chilling Effect of Certain Provisions of UIFSA

The home state provision of UIFSA, codified at N.J.S.A. 2A:4-30.65, states that a child's home state is the "[s]tate in which a child has lived with a parent or a person acting as parent for at least six consecutive months immediately preceding the time of filing of a complaint or comparable pleading for support."

Unless N.J.S.A. 2A:4-30.72(a)(2) and N.J.S.A. 2A:4-30.114 are revised in the spirit of the home state provision of N.J.S.A. 2A:4-30.65, UIFSA could continue to serve as a safe harbor for delinquent payor spouses. As the statute is currently constituted, and as New Jersey courts have interpreted it, a spouse who is owed significant child support from his or her obligor spouse must travel to the obligor spouse's home state to enforce and/or modify a divorce judgment, unless each party has consented to New Jersey assuming continuing, exclusive jurisdiction.

Under the express provisions of N.J.S.A. 2A:4-30.114(b), unless the parties consent to the modification in express written terms, a foreign state divorce agreement cannot be modified unless a "nonresident petitioner" seeks modification, along with meeting the criteria in factors (a) and (c).

Thus, even if a spouse has lived in New Jersey for over 10 years since a divorce was entered in a different state, he or she will have to travel to the new home state of the obligor spouse, no matter how far that state may be from New Jersey, or how briefly that spouse has lived in the new state, in order to seek support. The author believes this scenario punishes litigants who have sought, in good faith, to enforce divorce agreements, and rewards those who have avoided their support responsibilities by moving between states with disregard for the support of their children. The author believes N.J.S.A. 2A:4-30.114(b) has a dangerous, chilling effect on litigants who are seeking a modification of support from their former spouses, but do not have the means to pursue litigation outside New Jersey.

In order for New Jersey to keep pace with other states that are tackling the fundamental deficiencies of UIFSA, the courts should state with specificity the impact of consent between parties to transfer continuing, exclusive jurisdiction. Only the Legislature can amend the statute to implement a home state provision that would allow litigants to modify initial divorce orders once they have resided continuously in New Jersey for a significant period of time.

New Jersey courts can provide much-needed clarification regarding the effects of transferring jurisdiction here where the parties consent to the transfer. The courts can put teeth into a statute that appears to be crumbling under the weight of its own ambiguity.

Once the courts have established a reliable precedent in addressing the simplest UIFSA matters, they will have set the foundation to adjudicate more complex issues, and ultimately keep pace with other precedent-setting states that are proactively addressing UIFSA-related issues, not simply reacting to the inherent complications in the statute. ■

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Endnotes

1. UIFSA is codified at N.J.S.A. 2A:4-30.65 to 30.123.
2. Uniform Interstate Family Support Act 1996, Part 1 U.L.A. Prefatory Notes (1996).
3. 42 U.S.C. § 666.
4. N.J.S.A. 2A:4-30.65 – 30.123.
5. N.J.S.A. 2A:4-30.72(a).
6. N.J.S.A. 2A:4-30.105.
7. N.J.S.A. 2A:4-30.52 was repealed when New Jersey enacted the federal version of UIFSA on March 5, 1998, and is thus no longer applicable.

8. 336 N.J. Super. 492 (App. Div. 2001).
9. *Id.* at 504.
10. *Id.* at 506.
11. N.J.S.A. 2A:4-30.114(c). Additionally, while UIFSA was amended nationwide in 2001, the close chronological proximity to the *Sharp* case in New Jersey should not be ignored.
12. *See* 23 Pa. Cons. Stat. §4327; Md. Code Ann. Article I, §24; Fla. Stat. §743.07.
13. *See* Unif. Interstate Family Support Act §611(d) (2001).
14. *Id.* Section 611(d).
15. Section 611(d) was codified in New Jersey's UIFSA statute as N.J.S.A. 2A:4-30.114(c), which states in pertinent part: "A tribunal of this State may not modify any aspect of a child support order that may not be modified under the law of the issuing state."
16. 390 N.J. Super. 387 (App. Div. 2007).
17. *Id.* at 389.
18. *Id.*
19. *Id.*
20. *Id.* (emphasis added).
21. *Id.*
22. *Id.*
23. *Id.*
24. 344 N.J. Super. 262 (App. Div. 2001).
25. *Id.* at 390.
26. *Id.* at 394.
27. *Id.*
28. The *Marshak* case is the exception, not the rule. In most cases, UIFSA issues arise where neither the obligor, obligee, or child(ren) reside in the original divorce state, or in less frequent instances where the parties have entered into written consents to transfer continuing, exclusive jurisdiction to a different state. Parties rarely, if ever, have the wherewithal and knowledge of the UIFSA statute to expressly note the continued application of the support laws in the particular state in which they were divorced.
29. 2008 N.J. Super. Unpub. LEXIS 1090.
30. *Id.* at 1.
31. *Id.* at 2.
32. *Id.* at 3.
33. *Id.* at 4.
34. *Id.*
35. *Id.*
36. *Id.* at 5.
37. *Id.*
38. *Id.*
39. *Id.* at 6.
40. *Id.* at 7.
41. *Id.*
42. *Id.*
43. *Id.* at 9.
44. *Id.* at 10.
45. *Basileh v. Alghusain*, 890 N.E.2d at 9 (Ind. 2009).
46. *See McHale*, 109 P.3d 89 (Ariz. Ct. App. 2005).
47. *See Etter*, 18 P.3d 1088 (Okla. Civ. App. 2001).
48. *See Linn v. Delaware Child Support Enforcement*, 736 A.2d 954 (Del. 1999).
49. *In re Marriage of Metz*, 69 P.3d 1128 (Kan. Ct. App. 2003).
50. *See Basileh* at 10.
51. 332 N.J. Super. 381, 390 (Ch. Div. 2000).
52. 325 N.J. Super. 122 (Ch. Div. 1999).

Imputing Income to a Non-Working Spouse During the *Pendente Lite* Period: A Violation of the *Status Quo* or a Practical Step Toward the Reasonably Comparable Lifestyle?

by Robert A. Epstein

A *pendente lite* support determination is widely considered one of the most critical a trial judge will render during a divorce proceeding. The outcome, which commonly stems from the matrimonial litigant's first stroke of the paintbrush on the blank litigation canvas, can have a long-lasting impact on the court's view of the case, the tenor of an ongoing matter, and the prospects of settlement. There is little doubt that even though a court may modify interim support awards at any point during a litigation,[1] the party awarded the positive outcome will likely color every subsequent step in the process with a recitation of the result received and preliminary findings made, whether it be custody and parenting time mediation, the early settlement panel, economic mediation, future motion practice, and ultimately, trial.

One notable component of the analysis is the imputation of income to a non-working spouse, *pendente lite*. While often requested in opposition to a *pendente lite* motion, this request is frequently denied because the non-working spouse's unemployed status is deemed part of the 'marital *status quo*' requiring maintenance until the court performs a full investigation and final hearing.

Considering the family court's equitable foundation, the slow economic recovery, and the current calendar backlog in the family part, should trial judges broaden their consideration of this issue? As each case resides on its own facts, rendering a blanket conclusion on this subject ultimately runs contrary to the equitable foundations upon which the family part resides.

This article will examine the legal underpinnings, and practical arguments both for and against such an imputation. Within that framework, the article will briefly address the following:

- Maintenance of the so-called marital *status quo*;
- Consideration, *pendente lite*, of certain factors provided in the alimony statute, including but not limited to: 1) the "earning capacities, educational levels, vocational skills, and employability of the parties"; 2) the parental responsibilities for the children; and 3) the time and expense necessary to acquire sufficient education or training to enable the party seeking maintenance to find appropriate employment, the availability of the training and employment, and the opportunity for future acquisitions of capital assets and income; and
- Analysis of this issue in conjunction with the current economy and calendar backlog in the family part.

Maintenance of the Marital *Status Quo*

Before discussing the imputation of income to a non-working spouse, *pendente lite*, one must first be cognizant of the statutory basis upon which interim support may be granted. Recognizing the need for such relief, the Legislature provides, in N.J.S.A. 2A:34-23:

> Pending any matrimonial action or action for dissolution of a civil union brought in this State or elsewhere...the court may make such order as to the alimony or maintenance of the parties, and also as to the care, custody, education and maintenance of the children, or any of them, as the circumstances of the parties and the nature of the case shall render fit, reasonable and just....[2]

The Supreme Court of New Jersey, in *Crews v. Crews*, provided, "Courts have the equitable power to establish alimony and support orders in connection with a pending matrimonial action, or after a judgment of divorce or maintenance, and to revise such orders as circumstances may require."[3]

The Legislature's statutory authorization of *pendente lite* relief, however, is absent of instruction or definition of "fit, reasonable and just."[4] The Judiciary has, as a result, been called upon to interpret this language and provide guidance to litigants and their legal counsel. There is likely no better, and no more important instruction on this issue than that provided by the Appellate Division in *Mallamo v. Mallamo*.[5]

On the purpose of *pendente lite* support, the *Mallamo* court provided that "[the goal is] to preserve the *status quo* through the device of awarding temporary financial support pending a full investigation of the case."[6] Notable, however, is *Mallamo's* indication that, "The temporary nature of the *pendente lite* support order is illustrated by the general rule that provisions of a *pendente lite* order do not survive the entry of a judgment of divorce unless expressly preserved in it or reduced to judgment prior to entry of final judgment."[7] Determining that *pendente lite* orders are modifiable until the time of final judgment, the Appellate Division recognized the fundamental nature of *pendente lite* matrimonial practice requiring that orders be entered "largely based upon a review of the submitted papers supplemented by oral argument," and that "a judge will not receive a reasonably complete picture of the financial statute of the parties until a full trial is conducted."[8]

While brilliant in its frank recognition of the evidentiary limitations facing courts in rendering *pendente lite* relief, one could also argue that the decision lacks a 'real world' application.[9] Courts may, indeed, modify *pendente lite* orders at any time prior to final judgment, but they often understandably decline to do so because they remain faced with the same evidentiary limitations permeating the original application (*i.e.*, a lack of testimony, the inadmissibility of expert reports, and the like).[10] There is also no guarantee that the trial court will modify its findings, *pendente lite*, even after a final hearing, as it may conclude that its original findings, which were not based on testimony or documents admitted into evidence, should continue post-judgment.[11]

One could argue, though, that it is those very evidentiary limitations that call the entire process of *pendente lite* litigation into question. *Mallamo* acknowledges these limitations by allowing for modification at any time prior to final judgment.[12] Matrimonial attorneys prepare *pendente lite* applications, and oppositions thereto, by providing details on the parties' respective education and employment histories, parenting arrangements, and lifestyles, all in an effort to convince the trial court of what was the marital *status quo*, and how to maintain it by 'slicing up the financial pie.' Matrimonial attorneys also expect the trial court to, impliedly, make credibility findings, despite well-established case law preventing such findings without the taking of testimony.[13] With opposing narratives almost always standing in direct contrast, the trial court will and must, without testimony, utilize this information in rendering a determination.

Thus, while a trial court cannot make findings of fact and conclusions of law prior to trial, practitioners still go to great lengths to detail this information because, preliminarily, implied, and sometimes express, determinations regarding credibility are made in an effort to maintain the marital *status quo*. Otherwise, litigants could approach these motions by simply submitting case information statements and related financial information with a straightforward explanation, since the finite result of the application, rather than the overarching strategic purpose, is to provide financial relief based on existing assets and income.

Established Marital Standard of Living and the Likelihood of Each Party Maintaining It

A trial court must analyze the marital standard of living in rendering an award of *pendente lite* support.[14] As referenced above, the standard of living is simply one puzzle piece of the marital *status quo*. As discussed above, however, the trial court's determination, *pendente lite*, is predicated on competing certifications and case information statements, without the taking of testimony or admission of evidence.[15] Thus, while the trial court is making an early, non-evidentiary determination on what it believes the marital lifestyle to have been, litigants place enormous weight on such findings with the hope of garnering leverage in an ongoing matter.

This weight may carry into the post-judgment period as well, as *Crews* notes that, "The marital standard of living is essential to an analysis of changed circumstances regardless of whether the original support award was entered as part of a consensual agreement or of a contested divorce judgment."[16] As an aside, settlement agreements rarely detail a specific marital standard of living, leaving each party to, again, argue what the standard of living was in the event of a subsequent post-judgment *Lepis* application. In so arguing, parties often revert back to the trial court's findings, *pendente lite* (in the event of such pre-judgment motion practice), which are often the only lifestyle findings rendered in a matter that was resolved before trial. *Crews*, in fact, recognizes this very situation.[17]

Also notable are the lifestyle differences to which the parties are entitled to, *pendente lite*, versus post-judgment. *Pendente lite*, the parties are to maintain the marital *status quo*, as detailed above, seemingly without any eye toward the future establishment of two households.[18] Essentially, the parties are expected to live 'frozen in time,' until the trial court can complete a full investigation of the matter. By contrast, *Crews* requires that the parties, post-judgment, only be able to "maintain a reasonably comparable standard of living" to that lived during the marriage.[19]

Addressing this situation in the context of the parties' respective incomes, *Crews* provides:

> In contested divorce actions, once a finding is made concerning the standard of living enjoyed by the parties during the marriage, the court should review the adequacy and reasonableness of the support award against this finding. *That must be done even in situations of reduced circumstances, when the one spouse's income, or both spouses' incomes in combination, do not permit the divorcing couple to live in separate households in a lifestyle reasonably comparable to the one they enjoyed while living together during the marriage.*[20]

One could argue, as a result, that the *pendente lite* maintenance of the marital *status quo* prevents the parties from proceeding toward the "reasonably comparable standard," likely to exist post-judgment. Further, when these issues arise, *pendente lite*, which party's *status quo* should be of more concern, especially in cases where two households already exist? There is often not enough money to allow both parties to maintain the *status quo* when living apart, yet that is exactly what the parties call upon the court to decide.

Earning Capacities, Educational Levels, Vocational Skills, and Employability

Factors five and six of the alimony statute also merit consideration during the *pendente lite* phase.[21] Based on well-established jurisprudence, earning capacity is, at its core, a determination of what the person is likely *capable* of earning, rather than what they actually earn.[22] A court will generally consider a wide range of details, especially when the person was last employed, if at all, and in what role.[23] A court will also examine the reason proffered for why a party is not working, for example having left the workforce to care for the children and maintain the home, and whether that decision was reached by mutual agreement of the parties during the marriage.[24]

Thus, a court must decide, at trial, what level of income to 'impute' to that person, even though it is not what he or she may actually earn at the time a decision is rendered. *Black's Law Dictionary* defines "impute" as, "to ascribe or attribute...."[25] In calculating a level of income to ascribe or attribute to a litigant, the child support guidelines provide guidance in the form of several factors to consider:

> (1) the employment status and earning capacity of the parent...if the family had remained intact;
> (2) the reason and intent for the voluntary underemployment or unemployment;
> (3) the availability of other assets that may be used to pay support; and
> (4) the ages of any children in the parents' household and child-care alternatives.[26]

Generally, the focus is more on the payor spouse's income and related earning capacity, because the payor spouse provided the greater share of financial support during the marriage.

Crews provides:

> And although the supporting spouse's current income is the primary source considered in setting the amount of the support award, his or her property, capital assets, and "capacity to earn the support awarded by diligent attention to his [or her] business" are all proper elements for consideration. Similarly, the supported spouse's ability to contribute to his or her own support must be made express in the record when the court enters or approves a support award.[27]

In cases where the payee spouse is employed, there seems to exist a tendency, especially in settlement discussions, to simply rely on that party's existing income level without engaging in the same extent of discussion regarding what income should be utilized for that party in calculating support. Moreover, unless the non-working spouse has a substantial, and not too distant, employment history, payor spouses will often agree to impute a nominal level of income to the payee spouse (typically within $10,000 to $20,000 of New Jersey's existing minimum wage) without incurring the expense of a vocational expert, or making reference to other sources of income-based information, such as the New Jersey Department of Labor and Workforce Development's wage compendium.[28]

As a result, cases where an issue arises regarding the imputation of income to a non-working spouse are relatively infrequent. One notable case, however, was the Appellate Division's decision in *Strahan v. Strahan*.[29] There, the trial court, following trial, rejected the payor spouse's request to impute earnings to the non-working, payee spouse in determining support on the basis that she was voluntarily underemployed.[30] The wife had a significant educational background consisting of two college degrees, and had testified at trial that she deliberately chose not to work.

Reversing the trial court, the Appellate Division noted:

> First, we note that the parties separated when the children were a few months old, so there was virtually no history of their conduct vis-à-vis the children. Second, defendant's employment opportunities were, in all likelihood, enhanced by her celebrity marriage. There is no question that as a healthy, educated, forty-one year old, defendant is capable of earning her own income. The court found, however, that defendant was unemployed at plaintiff's request, and had the family stayed together, she would have remained unemployed. There is insufficient evidence to support that conclusion, however. The children were quite young when the parties separated and have had nannies to care for them since they were born.
>
> Although the court did attribute income to defendant from the interest on her investments, it failed to take into consideration the very substantial assets defendant derived from the marriage and divorce, the opportunities for employment available to her as the former wife of a celebrity and the time available to her as a result of the nannies who care for the children. In short, in the remand hearing, the court should consider all possible sources of income for defendant—earned and unearned—as well as her assets in determining her share of child support.[31]

While "voluntary underemployment or unemployment" is commonly associated with some form of wrongdoing, alleging that a party's conduct is deliberately designed to alter a support determination, *Strahan* highlights the more common scenario where the non-working-spouse has the ability to work, but has not done so for a variety of good faith, legitimate reasons.[32] Utilizing the same legal phraseology to describe the two situations is, thus, arguably inequitable, since a non-working spouse who maintains the home and handles the primary caretaking responsibilities for the children generally does so in sacrifice for the family, to assist the other spouse in their career pursuits, and/or with the other spouse's agreement.[33]

As briefly referenced above, *pendente lite* motions typically go to great lengths to expound upon the parties' respective employment and educational histories. To what degree, however, does a court consider this information in rendering an award? More often than not, due to the existing evidentiary barriers referenced in *Mallamo*,[34] a court will award support primarily based upon the parties' tax returns, case information statements, and other underlying financial documentation. Courts are often careful not to make final factual findings, but also understand that a decision must be made to afford necessary relief during the proceeding. Otherwise, the payee spouse has a lesser ability to control the financial situation during the proceeding. Nominal weight, as a result, may understandably be placed on the assertion that a non-working spouse possesses a substantial education and employment background, since the court's primary concern on a *pendente lite* application is to maintain what was the *status quo*, or, for that matter, what remains of the *status quo*.

Parental Responsibilities for the Children

By correlation, the party's parenting responsibilities for the children is a required factor of the alimony analysis, but also merits consideration when determining *pendente lite* support.[35] Primary considerations include, but are not limited to, the history and allocation of primary caretaking responsibilities for the child, and the age and health of the child.[36] Under a specific set of facts and circumstances, the Supreme Court of New Jersey, in *Crews v. Crews*, provided:

> If the original award were found to be set properly in light of the now-determined marital standard of living, the trial court should re-examine Mrs. Crews' demonstration of changed circumstances that she argues would warrant modification of the original rehabilitative alimony award. For instance, Mrs. Crews' child-care responsibilities, especially those associated with the care of her daughter, demonstrate unusual and unfortunate events that should be carefully reviewed to see whether they reasonably prevented Mrs. Crews from achieving the greater level of "self-sufficiency" that was envisioned at the time of divorce. Mrs. Crews was unable to meet the salary goal targeted by Mr. Crews' expert. Her argument that she reasonably believed that she could take only employment positions that provided her with scheduling flexibility so as to be responsive to her children's special needs should be fairly considered.[37]

One could reasonably argue that consideration of this factor is of even greater import during the *pendente lite* phase, especially to facilitate a degree of normalcy for the children. To that end, courts may be more inclined to allow for a period of transition for the non-working spouse to re-enter and rehabilitate him or herself for the workforce.

On the other hand, how should a court treat a situation where the parties have children of an age where they no longer require the level of care and attention dedicated toward a younger child, or a child with special needs? For that matter, does the payee spouse's argument that staying at home with the children was a component of the marital *status quo* carry as much weight when the children are in high school or, for that matter, in college? Ultimately, a court's decision will likely rest on the facts of a given scenario, rather than a blanket determination in favor of, or against, imputation.

Time and Expense Needed to Acquire Education/Training to Find Appropriate Employment; Availability of Training/Employment; and Opportunity for Future Capital Assets and Income

This factor, by its very nature, contemplates a family's transition beyond the marital *status quo* toward what is a 'reasonably comparable' standard of living.[38] Should this factor, though, be part of the court's consideration in determining an award of *pendente lite* support?

The dependent spouse will argue that this factor cannot be analyzed in isolation from those detailed above, and as otherwise set forth in the alimony statute. Until a court can make a full and final determination of the marital lifestyle; what will be required to, at the very least, maintain a reasonably comparable standard of living; the parenting arrangements; and respective incomes and assets, is it appropriate to compel a spouse to undergo efforts to rehabilitate him or herself through education, or procure a new position of employment commensurate with his or her earning capacity (when, in all likelihood, that earning capacity cannot be determined without testimony, potential expert reports, and the like)?

By contrast, the payor spouse will argue that, absent the other factors delineated above, there is no reason why the non-working spouse *cannot* commence such efforts, *pendente lite*, when that is likely the end result. Especially in a situation where two households have been established, *pendente lite*, is it equitable for the supporting spouse to maintain the *status quo* for the dependent spouse when the dependent spouse can potentially be furthering his or her efforts to provide for his or her own support as required post-judgment?

In light of the current economic environment and statewide family part backlog, to what extent do these arguments resonate?

Current Economic Environment and the Family Part Backlog

There has been no shortage of articles addressing the down economy and slow recovery, especially during an election year. There has also been no shortage of articles on the economy and its impact on matrimonial law practice. Fashioning *Lepis* applications on every available piece of information detailing the economy's impact on the job market and, in opposition, relying on any such source suggesting an economic rebound, there is no dispute that the events of the past four years have brought substantial change to support-based litigation postures. To that end, how, if at all, should the economic environment impact the issue of income imputation, *pendente lite*?

Countless individuals have legitimately lost their jobs during the economic downturn. Addressing the issue in the context of an application for *pendente lite* support and related maintenance of the marital *status quo*, the question arises regarding whether a supporting spouse should be expected to maintain a *status quo* based on income that no longer exists. The payor spouse will reasonably argue that, in the event of a job loss, a new *status quo* must be fashioned by the court to account for the situation. As part of that 'new' marital *status quo*, issues arise regarding whether income should be imputed to the dependent spouse, or if the dependent spouse should be compelled to procure necessary education or seek a position of employment to monetarily contribute toward the household.

By contrast, the dependent spouse may counter that the job loss was not legitimate, and, by correlation, the supporting spouse is trying to capitalize on the existing economic environment. Further, even if the job loss were legitimate, the marital *status quo*, and the maintenance thereof, would necessarily involve the supporting spouse engaging in diligent job search efforts to mitigate the resulting damage.[39] Not every situation will involve a dependent spouse entering the workforce, procuring necessary education to do so, or searching for a position with a higher income in the event of the supporting spouse's loss of employment. Further, in light of the existing economy and lack of job opportunities, is it inequitable to impose an income imputation on a supported spouse when that spouse may be unable to find a position of employment at all, let alone one at the imputed income level?

Ultimately, this 'changed' situation simply adds another component to the puzzle, as the court should still consider, *pendente lite*, the parenting arrangements, earning capacities, available assets and the like in fashioning relief at any time during a proceeding. While support is based, in part, on the payor spouse's earning capacity, a job loss, *pendente lite*, can and will likely place the issue of interim relief into a state of turmoil. The situation is also still impacted by the same evidentiary limitations raised in *Mallamo*.[40] Without the ability to render findings of fact and conclusions of law, a court must preliminarily determine the legitimacy of a job loss or income diminution, and, in connection, how to maintain or modify what was the marital *status quo*. A court may impute a level of income to the dependent party, *pendente lite*, if, for no other reason, to compel a more equitable result.

Similar arguments arise regarding the current family part backlog in several counties throughout New Jersey. With litigants facing the stark reality of not receiving a trial date within two years, if not more, from when an action commenced, a question arises regarding whether courts should continue to maintain the marital *status quo* until its conclusion or, perhaps, modify its orders during the course of a matter in a manner suggesting movement toward the 'reasonably comparable' standard, or perhaps as an implied method by which to foster settlement.[41] Unfortunately, the backlog is beyond the litigants' control, and equitable concerns exist regarding whether a dependent spouse should be prematurely imputed a level of income, or compelled to seek a position of employment. Residing on the same spectrum, however, is a supporting spouse facing payment obligations based on competing certifications and case information statements, potentially with no end in sight.

Conclusion

As with many other issues raised in the context of *pendente lite* motion practice, legitimate and reasonable arguments reside in favor of both the supporting and supported spouses on the issue of imputing income to the supported spouse. Analyzing this issue by reviewing the existing evidentiary barriers, the relevant alimony factors, and the current economic environment and existing family part backlog highlight a court's difficult task of fashioning an award of relief, *pendente lite*, that is ultimately equitable to both parties in a matrimonial proceeding.

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Endnotes

1. *See Mallamo v. Mallamo*, 280 N.J. Super. 8, 11-13 (App. Div. 1995).
2. N.J.S.A. 2A:34-23 (West 2012).
3. *Crews v. Crews*, 164 N.J. 11, 24 (2000) (*citing Lepis v. Lepis*, 83 N.J. 139, 145 (1980).
4. *See Id.*
5 *See Mallamo*, 280 N.J. Super. at 11.
6. *See Mallamo*, 280 N.J. Super. at 11 (*citing Crowe v. Di Gioia*, 90 N.J. 126, 132 (1982); *Schiff v. Schiff*, 116 N.J. Super. 546, 562 (App. Div. 1971), *certif. denied*, 60 N.J. 139 (1972) (alteration in original).

7. *Id.* at 12.
8. *Id.* at 16.
9. *See Id.*
10. *See Id.*
11. *See Hughes v. Hughes*, 311 N.J. Super. 15 (App. Div. 1998).
12. *See Id.*
13. *See Hallberg v. Hallberg*, 113 N.J. Super. 208 (App. Div. 1971).
14. *See Crews v. Crews*, 164 N.J. 11, 35 (2000).
15. *See Mallamo*, 280 N.J. Super. at 11-16.
16. *Crews*, 164 N.J. at 25 (*citing Lepis*, 83 N.J. at 148).
17. *See Id.* at 26.
18. *See* N.J.S.A. 2A:34-23 (West 2012; *Mallamo*, 280 N.J. Super. at 11.
19. *See Crews*, 164 N.J. at 25.
20. *Id.* (emphasis added).
21. N.J.S.A. 2A:34-23b(5), (6) (West 2012).
22. *See Storey v. Storey*, 373 N.J. Super. 464, 474 (App. Div. 2005).
23. *See Id.*
24. *See Donnelly v. Donnelly*, 405 N.J. Super. 117, 121 n. 7 (App. Div. 2009).
25. *Black's Law Dictionary*, Second Pocket Edition p. 336 (2001).
26. Child Support Guidelines, Pressler & Verniero, Current N.J. Court Rules, Appendix IX-A(12) to R. 5:6A at 2293 (2012).
27. *Crews*, 164 N.J. at 27.
28. *See Storey*, 373 N.J. Super. at 474.
29. *See Strahan v. Strahan*, 402 N.J. Super. 298 (App. Div. 2008).
30. *See Id.* at 313.
31. *Id.*
32. *See Dorfman v. Dorfman*, 315 N.J. Super. 511, 516 (1998).
33. *See* N.J.S.A. 2A:34-23b (West 2012).
34. *See Mallamo*, 280 N.J. Super. at 11.
35. *See* N.J.S.A. 2A:34-23b(7) (West 2012).
36. *See Id.; Crews*, 164 N.J. at 35.
37. *Id.*
38. *See* N.J.S.A. 2A:34-23b(8) (West 2012).
39. *See Aronson v. Aronson*, 245 N.J. Super. 354, 360 (App. Div. 1991).
40. *See Mallamo*, 280 N.J. Super. at 11.
41. *See Crews*, 164 N.J. at 25.

Tannen Applies Only to Third-Party Trusts, Not Self-Settled Trusts

by Jeralyn L. Lawrence

In divorces involving alimony, N.J. Stat. Ann. § 2A:34-23(b) sets forth a non-exhaustive list of 13 factors that must be considered by a court in determining the duration and amount of alimony, if any, that one spouse must pay to the other after divorce. The 11th factor of this statute, "[t]he income available to either party through investment of any assets held by that party," has become a subject of legal scholarship and debate since the Appellate Division rendered its opinion in *Tannen v. Tannen*, which was summarily affirmed by the Supreme Court of New Jersey in 2011.[1]

In *Tannen*, the husband and wife were married at the end of 1988. Shortly after they married, the couple moved into a large home that was purchased by the wife's father and titled in the wife's name. In 2000, the wife's parents settled an irrevocable trust naming the wife as the sole beneficiary, with the wife's parents as the co-trustees. At the time of trial, the *corpus* of the trust included shares of mutual funds and stock valued at $1,155,877, a commercial property from which the trust received rental income, and the large home in which the couple resided (which had been previously conveyed by the wife to the trust).[2]

The terms of the trust provided, in essence, that the trustees had the sole discretion to determine what portion, if any, of the net income and *corpus* of the trust would be distributed to the wife.[3] In making such a determination, the trustees were obligated to determine what was in the beneficiary's best interest after consideration of a number of factors relating to the beneficiary, not the beneficiary's spouse, children, or any other third party.[4] The terms of the trust also explicitly stated that the beneficiary had no right or authority to compel or influence any distribution from the trust without the written consent of the trustees.[5]

From the proceeds of this third-party trust, the couple paid the real estate taxes on their home and half of the cost of a housekeeper.[6] The proceeds from the trust were also used to pay for improvements on the home, such as a two-story addition, new roof, new driveway, new kitchen, new deck, new floors, landscaping, and pool renovation.[7]

After nearly 18 years of marriage, the husband filed for divorce. As part of the divorce litigation, the wife argued that the income from the trust should not be considered by the court in calculating alimony because she had no discretion whatsoever in how or whether the proceeds from the trust were distributed. Because the trustees (her parents) could decide at some point in the future to cease distributing any proceeds from the trust to her, consideration of this income by the court in calculating alimony would be improper.[8]

The husband, on the other hand, argued that the trust proceeds should be considered by the court in calculating alimony. He noted that his wife, throughout the marriage, received disbursements from the trust that she ceased utilizing.[9] Thus, the court should consider the proceeds of the trust and impute income to the wife as if she was utilizing them.[10] The husband also argued that the wife had an obligation to use the proceeds of the trust toward maintaining her lifestyle after the divorce.[11]

After examining the terms of the trust, the Appellate Division agreed with the wife, and held that the proceeds from the third-party trust of which she had no control could not be considered as her income in calculating alimony, notwithstanding the responsibility of the trustees to distribute proceeds from the trust to the wife in accordance with the trust's terms.[12] The Appellate Division also recognized the broad discretion that trustees of discretionary trusts have, as well as the limited ability of beneficiaries of such trusts to compel an exercise of the trustee's discretion.[13] Thus, the beneficiary interest the wife held in the trust was neither an asset nor an income source for purposes of determining alimony.[14]

It is critical to note that *Tannen* involved a discretionary trust that was established by a third party for the benefit of one spouse. But, the principle elucidated in *Tannen*, specifically that the beneficiary interest of a discretionary third-party trust is not an asset for purposes of calculating alimony, would not apply to a trust that was established by one spouse for that spouse's benefit.

N.J. Stat. Ann. § 3B:11-1 states the following:

> The right of any creator of a trust to receive either the income or the principal of the trust or any part of either thereof, presently or in the future, shall be freely alienable and shall be subject to the claims of his creditors, notwithstanding any provision to the contrary in the terms of the trust.

The New Jersey Legislature enacted this statute to prevent individuals from shielding their assets from creditors by placing them in a protective, self-settled trust and preventing judgments against them from ever being satisfied. The text of this statute makes a trust created by an individual for that individual's benefit fully accessible by law to the beneficiary, notwithstanding the terms of the trust, thus making the trust an asset a court can consider for purposes of imputing income to that individual and determining an appropriate level of alimony.

In a divorce involving a trust for the benefit of a spouse, one must first determine who settled the trust and the nature of the discretion afforded to the trustees to make distributions from it. If the trust is completely discretionary and was settled by a third party for the benefit of one spouse, *Tannen* indicates that such a trust cannot be considered an asset for purposes of imputing income and calculating alimony. If the trust is settled by one spouse for that spouse's benefit regardless of the discretion granted to the trustees under the terms of the trust, then N.J. Stat. Ann. § 3B:11-1 indicates such a trust is an asset for purposes of imputing income and calculating alimony.

This is not the end of the alimony analysis in cases involving a discretionary third-party trust. The fourth factor of the alimony statute,[15] which is the marital standard of living and the likelihood that each party can maintain a reasonably similar standard of living after the divorce, is the 'touchstone' of both an initial alimony determination as well as a decision on a motion to modify alimony after the divorce when either spouse alleges a change in circumstances.[16] This is because the purpose of alimony is to enable the supporting spouse to meet the standard of living enjoyed while living with the supporting spouse during the marriage.[17]

The Appellate Division in *Tannen* reiterated those established principles, and it further stated that the source of the funds used to meet the marital standard of living is irrelevant to a court in ultimately calculating it.[18] Thus, though a court cannot consider a discretionary trust settled by a third party as the beneficiary-spouse's income in making an alimony determination, it must calculate the standard of living enjoyed by a couple during the marriage, even though the funds used to meet that lifestyle originated from such a trust.

The first factor listed in the alimony statute[19] is "[t]he actual need and ability of the parties to pay." The Appellate Division in *Tannen* indicated that the historical record of payments made by a trust must be considered in determining the need of the beneficiary in making an alimony determination.[20] Thus, even though the proceeds from a discretionary trust that was settled by a third party cannot be used to impute income to a beneficiary-spouse in calculating alimony, the historical record of disbursements from such a trust must be considered in determining the beneficiary-spouse's needs.

In conclusion, a discretionary trust that was settled by a third party for the benefit of one spouse cannot be considered as the beneficiary-spouse's asset for purposes of calculating alimony. But, a trust that was settled by one spouse for that spouse's benefit must be considered as that spouse's asset in making an alimony determination. Further, although a discretionary trust that was settled by a third party for the benefit of one spouse cannot be considered an asset for calculating alimony, the historical disbursements from the trust must be considered in determining that spouse's need for alimony. Regardless of the nature of the trust in question, or who settled it, a finding regarding the standard of living enjoyed by the divorcing couple during the marriage must be made by a court in any alimony calculation, irrespective of the source of the funds used to meet the marital lifestyle.

Jeralyn L. Lawrence is a member of the law firm of Norris, McLaughlin & Marcus, P.A. The author would like to thank Rajeh A. Saadeh, an associate of the firm, for his assistance with this article.

Endnotes

1. *Tannen v. Tannen*, 416 N.J. Super. 248 (App. Div. 2010), *aff'd* 208 N.J. 209 (2011).
2. *Tannen*, 416 N.J. Super. at 256-57.
3. *Id.* at 256.
4. *Ibid.*
5. *Ibid.*
6. The house was free of mortgages.
7. *Id.* at 257.
8. *Id.* at 263.
9. *Ibid.*
10. *Id.* at 265.
11. *Id.* at 277.
12. *Id.* at 270-73.
13. *Ibid.*
14. *Id.* at 273.
15. N.J. Stat. Ann. § 2A:34-23(b)(4).
16. *Crews v. Crews*, 164 N.J. 11, 16 (2000).
17. *Steneken v. Steneken*, 183 N.J. 290, 299 (2005).
18. *Tannen*, 416 N.J. Super. at 275.
19. N.J. Stat. Ann. § 2A:34-23(b)(1).
20. *Tannen*, 416 N.J. Super. at 277.

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Navigating a Partnership K-1: The Untold Line Items and What They Really Mean

by Leonard M. Friedman and Lauren E. Koster

For those that are not familiar with the document. However, it is important that family law practitioners understand these forms so they can properly advise clients. A K-1 provides valuable insight about a particular business and how much a person may, in fact, be truly earning. It should be noted that nothing in this article should be interpreted as tax advice; the article is intended to advise the matrimonial practitioner of how each line on a K-1 may be relevant in a divorce action.

Navigating your way through a K-1 can be a daunting task...

Essentially, a K-1 is a document used by partnerships and S-corporations to report a partner's or a shareholder's distributed share of income based upon their percentage of stock or how their partnership agreement reads. Partnerships and S-corporations do not, as an entity, pay income taxes. The net profit of the S-corporation or partnership is 'passed through' to its owners, who pay income tax on their personal tax returns, even if that income is retained by the business and not actually distributed to the owners. Partnership tax returns are required for multi-owner (more than one) unincorporated businesses, such as an LLC or a partnership.

For example, if you own 50 percent of Smith and Jones, LLC, and Smith and Jones, LLC shows a $100,000 profit in 2011, you would receive a K-1 for 50 percent of the net profit (*i.e.*, $50,000). You would then be obligated to claim this $50,000 of income on your personal tax return.

The following is a line-by-line explanation of a Form 1065 (partnership K-1) from a forensic accounting view, not a tax authoritative view. The forensic accounting view provides an understanding of how to extract the important elements of the document to determine what the income and cash flow is of the partner.

Part I: Information about the Partnership, Lines A through D

Part I of the K-1 is straightforward and includes general information about the partnership, such as the name and federal identification number. Part I, Line D, which if checked indicates the person is a partner in a publicly traded partnership, is the only line that is not straightforward. Publicly traded partnerships are partnership interests that can be traded readily on the stock market. For example, most of these types of partnerships come in the form of oil and gas logistics companies. These types of partnerships have different rules governing passive income and losses for the purposes of the passive loss tax rules, which limit losses in passive types of investments (such as real estate rentals and businesses in which a partner is not actively involved).

Part II: Information about Partners

Line G

Indicates whether the partner is active in the business as a general partner or non-active in the partnership as a limited partner or other LLC member.

Line H

Indicates whether the partner is a foreign resident or a domestic resident. Foreign partners have certain tax withholding rules that need to be followed.

Line I

Indicates what type of entity the partnership is, such as an individual, trust or corporation, for example.

Line J

Indicates the partner's share of profits, losses and capital as of the beginning of the tax year and the end of the tax year. It is possible for a partner to have a 50 percent interest in profits and losses and a 0 percent interest in capital. The interest in capital indicates what percentage of the assets the partner would receive if the partnership assets were sold. Of course, there are exceptions, but often partners only share in profits and do not share in the overall equity in the company.

Line K – Partner's Share of Liabilities

There are generally three kinds of liabilities in a partnership, and each one may have an effect on how losses can be permitted on a partner's tax return. These items are informational only.

- *Non-recourse* – This type of liability has no recourse to the partner, and the partner is not personally liable. A common example is trade accounts payable and non-guaranteed bank debt.
- *Qualified non-recourse financing* – This is a rental real estate mortgage loan that is common with real estate rental properties. This has a bearing on how much loss, in excess of capital, a partner can be allowed to claim on their personal tax returns.
- *Recourse* – This is the amount of debt the partner may be personally liable for should the partnership or LLC default on its loans. This also affects how much loss a partner can claim on their personal returns in excess of their partner's capital.

Line L – Partner's Capital Account Analysis

- *Beginning capital* – This should match the ending capital from the prior year.
- *Capital contributed during the year* – This is generally cash or property contributions during the tax year. It will also include increases in capital resulting from other partners leaving with positive capital.
- *Current year increase* – This is generally the profits from the business based on whatever method the partnership is using to prepare the partnership tax returns. This will be the 'income per books.' Generally this line will be the sum of the amounts in Part III of the K-1.
- *Withdrawals and distributions* – This is also listed on Line 19 of the K-1, and includes the payments, in cash and/or property, to the partner during the year. This line, plus Line 4 in Part III, will equal the amount of cash the partner received during the year. However, this amount may not equal the amount of income generated by the partnership or LLC for that partner. Simply because there is income, does not necessarily mean distributions have or will occur. Distributions of income can be temporarily delayed or permanently held back for various reasons.
- *Ending capital* – This line is a function of the math of the other lines.
- *Basis of accounting* – There are four boxes that indicate what method of accounting the capital accounts are kept on for purposes of the tax return. The choices are: 1) tax basis; 2) GAAP (generally accepted accounting principles); 3) Section 704(b) book; and 4) other. Most active trades or businesses, other than professional practices, will utilize the GAAP basis, and most professional businesses will utilize the tax basis. The other two methods will not be seen as often. Sometimes there are significant differences between the two, especially where the books are on an accrual basis and the tax return is on a cash basis of accounting. Generally, the accrual basis of income tax reporting reflects income when earned and expenses when incurred (*i.e.*, there will be accounts receivable and accounts payable on the balance sheet), as opposed to the cash basis, where income is recorded when cash is received and expenses are recorded when expenses are paid.

Part III

Line 1 – Ordinary Business Income

This is simply the taxable income from the business that generally excludes items such as interest, dividends, capital gains, other income, rental income, charity, investment-type expenses and special depreciation deductions such as Section 179 depreciation. This will also include depreciation recapture for the sale of business assets other than real estate.

Line 2 – Net Rental Real Estate Income

This is the net income exclusively from real estate rental activities, either commercial or residential, where average rental is greater than seven days.

Line 3 – Other Net Rental Income

This is rental income from assets other than real estate, such as long-term automobile or equipment rental companies. Long term is considered average rental contracts greater than seven days.

Line 4 – Guaranteed Payments

Some or all partners may receive a special payment in the form of a percentage of capital invested or a guaranteed minimum payment. The amounts on Line 4 are income in addition to all other income items. This line includes a partner's medical insurance payments that have been deducted from Line 1, but are separately listed as income on this line. These medical insurance payments will be deducted on page one of Form 1040 as self-employed medical insurance.

Line 5 – Interest Income

This is interest income that is earned on the partnership's investments in cash, bonds or other interest-bearing vehicles.

Line 6a – Ordinary Dividends

These are dividends from stocks, money market accounts and REITS.

Line 6b – Qualified Dividends

This is the amount on Line 6a that qualifies for the reduced tax rate of 15 percent. These are not in addition to Line 6a, so you cannot add both to yield total income.

Line 8 – Net Short-Term Capital Gains (Losses)

This is capital gains from the sale of assets that are held for less than one year.

Line 9a – Net Long-Term Capital Gains (Losses)

This is capital gains from the sale of assets that are held for greater than one year.

Line 9b – Collectibles (28 Percent) Gain

This is the capital gains on items such as artwork and antiques, which are taxed at a higher tax rate than other capital gains.

Line 9c – Unrecaptured Section 1250 Gain

This is usually only seen with real estate partnerships. This is the portion of the gain on Lines 9a or 10 that is subject to a higher capital gains tax rate (25 percent) and represents the amount of depreciation that was taken for tax purposes since the real estate was purchased. This is not additional income, such as the qualified dividend listed on Line 6b, but rather an information line.

Line 10 – Section 1231 Gain or Loss

Section 1231 assets are business assets that are sold at a gain. For real estate, this will represent the difference between the tax basis (cost less accumulated depreciation) and the sales price. For other business assets, such as equipment, this would be the sale price in excess of original costs (this is rare). The depreciation taken on these types of assets are taxed at ordinary rates if the sales price is greater than tax basis (cost less accumulated depreciation) where the sales price falls between the tax basis and original cost. It is rare that operating fixed assets such as equipment is sold for greater than the original cost.

Line 11 – Other Income

This line has six subcategories (A through F). This line will commonly include income items, which have not yet been discussed, such as cancelled debt (which is more prevalent today), Section 1256 investment contract gains and "other income."

Line 12 – Section 179 Deduction

This is special bonus depreciation that is allowed in the first year that an asset is purchased and placed in service. Years ago, this used to be $10,000, but has gradually increased over the years; in 2011 it was $500,000. This is not the same item as bonus depreciation, which in 2011 was 100 percent of the cost of a new asset placed in service. The affects of bonus depreciation is already subtracted, and included in the ordinary income of Line 1.

Line 13 – Other Deductions

This line has 23 subcategories (A through W). The most commonly used categories where there is a trade or business are subcategory 13A, "Charitable Contributions," and Subcategory 13T "Domestic Production Activities," which is a non-cash allowable deduction equal to nine percent of manufacturing profits. Most of the other categories in Line 13 relate to investment-type expenses as follows: Section 13H – "Investment Interest Expense," which is interest on monies borrowed to make capital investments such as stocks and bonds; and Section 13K – "Deductions," which are related to portfolio income subject to the two percent floor. The most common of these types of expenses are investment expenses such as money management fees and legal and professional fees related to capital investments. The remainder of the subcategories are rarely used.

Line 14 – Self-Employment Earnings

For those partners active in the partnership, (meaning they help run the day-to-day operations) the amount on Line 14 is generally equal to Lines 1 and 4 of the K-1. This is the amount of earned income that is subject to self-employment taxes, or FICA and Medicare taxes for self-employed individuals. LLC members that are not active on a day-to-day basis but nonetheless guarantee debt or make some management decisions, may be subject to self-employment tax, and have the income included on this line. This is not additional income, but includes income that is on other lines of the K-1.

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Line 15 – Credits

There are 15 subcategories for tax credits, but there are likely greater than 30 types of credits. The most commonly seen credits are as follows: Section 15A – "Low Income Housing" credits, which are special types of credits from government-subsidized housing; Section 15J –"Work Opportunity" credits, which are special credits allowed when a business hires certain categories of low-income or disadvantaged workers; and Section 15M – "Research and Development" credits, which are credits allowed for the attempt to create new or improved products. These are likely the most commonly seen credits for active businesses. These credits are not additional income or expenses.

Line 16 – Foreign Transactions

This is not an additional income or loss line, but rather an informational line regarding foreign transactions where a foreign tax credit may be allowed. There are 17 subcategories (A through Q) for foreign transactions. Almost all of them are for informational purposes only.

Line 17 – Alternative Minimum Tax (AMT) Items

There are six subcategories of this adjustment that do not affect income or cash flow, but may affect how much taxes are paid on the income from the partnership due to alternative minimum tax adjustments. An entire complex article can be written on this line alone; however, the most common adjustments are as follows:

Line 17A – Post-1986 Depreciation Adjustment

This item does not affect the cash flow from the business. Post-1986 depreciation adjustment is depreciable fixed assets (such as office equipment) that were purchased after 1986, and therefore are subject to MACRS (double declining balance) deprecation rates. An example of double declining balance is an asset with a five-year life that is depreciated in the first year at 20 percent versus 15 percent for this post-1986 adjustment. To limit these accelerated depreciation deductions, such as double declining balance as opposed to straight line basis to wealthier taxpayers, the IRS forces an adjustment to the double declining balance method to a slower depreciation method. In the year of a sale or disposition of fixed assets subjected to the Line 17A adjustment, the gain for regular tax purposes is generally greater than the gain for AMT purposes. As a result, there is an adjustment to the gain or loss from the sale of these assets for AMT purposes only.

Line 18 – Tax Exempt Income and Other Non-Deductible Expenses

There are three subcategories of this line (18A through 18C), and this line can and does affect cash flow or income from the partnership. The most common in an active trade or business is non-deductible items, such as 50 percent of meals and entertainment and political contributions, which are non-deductible for tax purposes but do reduce income for financial statement purposes. Another common Line 18 item is tax-exempt interest from municipal bonds. Also included on Line 18 is tax timing differences, which are items that effect income of the partnership but are neither taxable nor deductible. A common example of this is unrealized capital gains and losses. For example, when an investment partnership invests in a publicly traded company at $100,000 and the investment is worth $130,000 at year end but has not been sold, then Line 20 may include the unrealized gain of $30,000 if the partnership records the investments at fair or fair market value. This item, however, is not taxable until it is sold.

Line 19 – Distributions

This line will generally be equal to Part II Schedule L – "Withdrawals and Distributions," and is broken into categories such as distributions in cash and distributions in property other than cash. This is the line that reports how much the partner has taken out of the business from distributions.

Line 20 – Other Information

This line has 25 subcategories (20A through 20Y) and is for informational purposes only. None of these items affect income or cash flow. The most commonly used items are: Section 20A – "Investment Income," which advises the partners of how much investment-type of income can be used in order to utilize investment interest expense deductions; and Section 20B – "Investment Expenses," which reduce investment income for measuring the amount of investment interest expense the partner can take. None of the other categories on Line 20 are used very often.

While the above can seem overwhelming, once you have successfully navigated a few K-1s, it will become much easier to understand its nuances, and you will know exactly where to look and what questions should be asked during the discovery process. ■

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Mock Income Statement

The following is a mock income statement of how each line item shows up on the tax return form K-1:

EFG Manufacturing LLC, 2011 Information

GAAP Basis	GAAP	Taxable	Timing Differences	Informational	K-1 Line
Gross Sales	1,200,000	1,200,00			
Cost of Sales	-650,000	-650,000			
Gross Profit	550,000	550,000			
General and Administrative Expenses					
Guaranteed Payment to Partners	100,000	100,000			4
Meals and Entertainment	16,000	8,000	8,000		18C
Depreciation	10,000	10,000			
Section 179 Depreciation		22,000	-22,000		12
Other	240,000	240,000			
Total Gen and Admin Exp	366,000	380,000			
Operating Income	184,000	170,000			1
Interest Income Regular	4,300	4,300			
Interest Income Tax Exempt	3,500	—	-3,500		18A
Dividends Regular	750	750			6a
Dividends Qualified	1,000	1,000			6a, 6b
Long-term Capital Gains Realized	2,200	2,200			9a
Capital Gains Unrealized	7,500	—	7,500		18b
Sale of Rental Property 1231 Gain	40,000	40,000			10
Section 1250 Recapture			25,000		9c
Investment Interest Expense	-1,500	-1,500			13H
Net Income	241,750	216,750	-25,000		Current Year Increase Line L
Other Information					
Research Credits			7,500		15M
WOTC Credits			1,825		15J
SE Income			270,000		14A
Investment Income			6,050		20A