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## FEDERAL TAXATION IN SEPARATION AND DIVORCE

EDWARD S. GRAVES\*

While the marital relation is proceeding normally and husband and wife<sup>1</sup> are living together, taxation affects few, if any, of the ordinary transactions<sup>2</sup> involving the family. For example, no tax consequences result from the husband's meeting family expenses such as rent, mortgage, or other bills. Or he may give the wife money and have her pay the bills. Expenses of support and education of the children are simply met as a matter of course from the family budget and they can be listed as dependents on the joint return.

Equally free of tax consequences are transfers to the wife of the husband's group life insurance, outright or in trust.<sup>3</sup> Other types of trusts are available as estate planning measures; of course the husband must pay a gift tax if sufficient property is transferred, but he realizes no taxable gain on these or any other transfers to her.

No tax consequences result when a spouse acquires inchoate rights of dower, curtesy, or inheritance in the other's property. And in community property states, each may obtain a property interest in assets accumulated

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<sup>1</sup>Strictly speaking, writers in this field should use the word "spouse" or "ex-spouse" instead of "husband". Since generally the husband is the one obligated to pay support, it is believed that the substitution of terms may be made without too much difficulty. The same practice is followed in Internal Revenue Code of 1954, § 7701. See also Lagomarcino, *The Divorced Husband and the Dependency Exemption Mirage*, 12 TAX. L. REV. 85 (1957).

<sup>2</sup>Where transfers are made as *inter vivos* or testamentary gifts, of course gift or estate taxes must be paid. Such transfers may be made as a step in carrying out an estate plan, or "accidentally on purpose" if the husband gives to his wife or children amounts in excess of his duty to support them. See, e.g., *Rosenthal v. Commissioner*, 205 F.2d 505 (2d Cir. 1953).

<sup>3</sup>Rev. Rul. 68-334, 1968-1 CUM. BULL. See also Walzer, *The Disposition of Life Insurance in Divorce Settlements*, 46 TAXES 248 (1968).

during matrimony. In some states each may acquire the right to a portion of the property standing in the name of the other.<sup>4</sup>

To be contrasted with this virtual "tax tranquility" of the marital status is the situation created by separation and divorce. More than one taxpayer has found out the hard way that a change in marital circumstances may entail a marked change in taxation. Federal tax consequences, some of which may unpleasantly surprise a spouse who has not been well informed, flow from all of the previously mentioned transfers (and others), and their nature and amount may substantially influence negotiations between the parties, affect the provisions of the property settlement agreement or decree and even render impossible otherwise desirable arrangements.

Although many of the facets of the subject are interrelated, subdivisions by topic will be made in the interest of greater clarity.

## I. ALIMONY TREATMENT—PERIODIC PAYMENTS

### A. *General; Direct and Indirect Payments*

Prior to the Revenue Act of 1942,<sup>5</sup> payments for the support of the wife and children were not deductible by the husband nor taxable to the wife.<sup>6</sup> Two substantially correlative provisions, appearing in the present Code as sections 71 and 215, provide for the taxation of periodic payments to the wife, and for the husband's deduction of such of these payments as are made by him.<sup>7</sup>

The Code provides that payments must be "periodic," but need not be made at regular intervals. The term is not otherwise expressly defined either in the statute or the regulations. To get the alimony treatment set forth above, the payments must be made pursuant to one of four documents: a decree of divorce or separate maintenance;<sup>8</sup> a written agreement incident to such decree;<sup>9</sup> a written separation agreement entered into after August 16, 1954;<sup>10</sup> or a decree for support entered after March 1, 1954.<sup>11</sup> Husband and wife must be separated; and joint returns may not be filed.<sup>12</sup>

There is one other requirement in order that payments to the wife be

<sup>4</sup>See generally H. CLARK, LAW OF DOMESTIC RELATIONS §§ 7.1, 7.2 (1968) (hereinafter cited as CLARK).

<sup>5</sup>Act of Oct. 21, 1942, ch. 619, § 120, 56 Stat. 816.

<sup>6</sup>Gould v. Gould, 245 U.S. 151 (1917).

<sup>7</sup>Payments made to the wife from other sources (such as trusts) are not included in the husband's income, and are reported by the wife. INT. REV. CODE OF 1954, § 71(d).

<sup>8</sup>INT. REV. CODE OF 1954, § 71(a)(1).

<sup>9</sup>INT. REV. CODE OF 1954, § 71(a)(1).

<sup>10</sup>INT. REV. CODE OF 1954, § 71(a)(2).

<sup>11</sup>INT. REV. CODE OF 1954, § 71(a)(3).

<sup>12</sup>INT. REV. CODE OF 1954, § 71(a).

taxable to her. They must be for certain purposes. Payments under the first two documents mentioned above must be made in discharge of "a legal obligation which, because of the marital or family relationship, is imposed on or incurred by the husband . . ." <sup>13</sup> Payments made pursuant to a written separation agreement entered into after August 16, 1954 must be made "because of the marital or family relationship." <sup>14</sup> And payments to the wife under a support decree entered after March 1, 1954 must be "for her support or maintenance". <sup>15</sup> The term "marital or family relationship" is not defined. Little tax difficulty arises insofar as payments are made by the husband, at more or less regular intervals, to the wife for her support, even though the payments may vary in accordance with such objective standards as the husband's earnings, <sup>16</sup> and even though the payments are made indirectly, for the wife, instead of directly to her. <sup>17</sup> Thus, payments by the husband for utilities, real estate taxes, casualty insurance premiums, and repairs on a residence occupied by the wife are indirect payments which receive alimony treatment. <sup>18</sup> Payments by the husband on joint indebtedness secured by such residence also receive alimony treatment if the wife owns the house. <sup>19</sup> Payments upon indebtedness secured by a residence owned by husband and wife as tenants by the entirety or equal co-owners are 50% deductible by the husband and taxable to the wife. <sup>20</sup> Where the residence is owned solely by the husband, his payment for utilities still receives alimony treatment as an indirect pay-

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<sup>13</sup>INT. REV. CODE OF 1954, § 71(a)(1).

<sup>14</sup>INT. REV. CODE OF 1954, § 71(a)(2).

<sup>15</sup>INT. REV. CODE OF 1954, § 71(a)(3). The fact that payments or transfers may be made because of rights (dower and inheritance) which disappear on divorce, whether obtained by the husband or wife, may trouble lawyers schooled in the concept of consideration. The tax provisions are not, however, based upon consideration.

<sup>16</sup>See, e.g., *Holloway v. United States*, 428 F.2d 140 (9th Cir. 1970); *Van Orman v. Commissioner*, 418 F.2d 170 (7th Cir. 1970).

<sup>17</sup>Internal Revenue Service, *Income Tax Deductions for Alimony Payments*, Publication 504 at 7 (10-68) (hereinafter cited as Publication 504). If the husband permits the wife to live in his house, the fair rental value is not considered a payment in kind and does not get the alimony treatment. R.I.A., 4 TAX COORDINATOR ¶ K-6125 (1967); *Pappenheimer v. Allen*, 164 F.2d 428 (5th Cir. 1947); Annot., 4 A.L.R. 2d 252 (1949).

<sup>18</sup>Publication 504 at 7. See also *Commissioner v. Lester*, 366 U.S. 299 (1961); see note 25 and accompanying text *infra*. Unless part of such payments are "fixed" for the children that live with the wife, they are still entitled to alimony treatment under the *Lester* case.

<sup>19</sup>See Rev. Rul. 62-39, 1962-1 CUM. BULL. 17. There may be a question whether these payments are periodic, although it may be argued that since the rate of interest on the unpaid balance might be subject to change, a principal sum could not be calculated. A further question is whether the husband in such cases is really discharging the wife's indebtedness. It is true that the indebtedness is secured by real estate owned by her; but this does not automatically transform his obligation or a joint obligation into her sole obligation, even though the payments will release her property.

<sup>20</sup>Rev. Rul. 67-420, 1967-2 CUM. BULL. 63. See also Publication 504 at 7.

ment for the support of his wife,<sup>21</sup> but payments in discharge of indebtedness secured do not get such treatment. But the husband may deduct real estate taxes and interest under other provisions of the Code.<sup>22</sup> If the husband pays premiums on policies insuring his life, an interest in which is assigned to the wife, deductibility may be subject to some question.<sup>23</sup> If the policy is entirely owned by the wife, it is clear that such payments receive alimony treatment.<sup>24</sup>

In order to avoid all questions of indirect payments, the husband may increase the payments made to the wife for her support by the amount necessary to pay for all services and obligations. Of course he must be willing to trust her to make the payments or be indifferent as to whether she does so or not. Such an arrangement may be considered advantageous irrespective of tax considerations.

#### B. *Payments for the Support of the Wife and Children*

If payments are made to the wife for her support and that of the children, tax problems arise which are simultaneously solved and accentuated by sections 151 and 152 of the Code, and section 71(b) as interpreted by the United States Supreme Court in *Commissioner v. Lester*.<sup>25</sup>

Sections 151 and 152<sup>26</sup> govern the allocation of the dependency exemption to one or the other of the parents. The general rule is that the person providing more than half the support of a dependent gets the exemption. Where the children of the parties are in the custody of the wife, two problems were often encountered by the husband prior to the enactment of sections 151 and 152. In the first instance, there was no provision in the law for the parties to settle by agreement the question of who would take which child as a dependent. And secondly, it was often difficult for the husband to find out whether he had contributed more than half of a child's support because he was unable to ascertain how much the wife had contributed. The amendment of section 152 in 1967 by the addition of subsection (e) attacked both of these problems in the course of providing new rules in this area. Now if the husband and wife are divorced or legally separated under a court decree or a written separation agreement, if they do not file a joint return, if their child is in the custody of one of them

<sup>21</sup>Rev. Rul. 62-89, 1962-1 CUM. BULL. 17; Rev. Rul. 58-52, 1958-1 CUM. BULL. 29. See also Publication 504 at 7.

<sup>22</sup>See Rev. Rul. 62-39, 1962-1 CUM. BULL. 17; INT. REV. CODE OF 1954, §§ 163, 164.

<sup>23</sup>See, e.g., Walzer, *The Disposition of Life Insurance in Divorce Settlements*, 46 TAXES 248 (1968); Wenig, *Use of Life Insurance and Separation Agreements*, N.Y.U. 28TH INST. ON FED. TAX. 837 (1970). These articles discuss at length the problems incurred in property settlements relating to the use of life insurance.

<sup>24</sup>I.T. 4001, 1950-1 CUM. BULL. 27.

<sup>25</sup>366 U.S. 299 (1961).

<sup>26</sup>§ 152 was amended in 1967.

for more than half of the year, and if they furnish more than half of his support, the exemption is allocated to the parent having greater custody unless it is otherwise provided. It may be otherwise provided either by decree or agreement of the parties if the "non-custodial" parent<sup>27</sup> contributed \$600 for the child. If, however, the non-custodial parent contributed \$1200 or more for child support (regardless of the number of children) and the custodial parent does not "clearly establish"<sup>28</sup> that he contributed more than the non-custodial parent, the custodial parent gets the children as dependents despite the agreement. If there is a dispute over the amounts respectively contributed, each parent may obtain from the other an itemized statement of his expenditure for the child's support.

The so-called multiple support agreements provided for in section 152(c) prevail over section 152(e). Consequently if no one person contributed over half of the child's support, if over half of the child's support was contributed by those in a position to claim the child as a dependent, if one of these taxpayers contributed over 10% of this support, and the other contributors mentioned agree that this taxpayer will be entitled to the child, then he gets the dependency exemption. These Code provisions may not strike all parties as entirely equitable, but they have a quality, rare in federal income tax law, of definiteness.

In *Commissioner v. Lester*, the Supreme Court, cutting what Mr. Justice Douglas termed in his concurring opinion "square corners," held that an amount payable to the wife for herself and three children, with a reduction of 1/6 thereof when each child died or was emancipated, was all includible in the wife's income and deductible by the husband. The *Lester* case, concerned not with the determination of who is entitled to the dependency exemption, but whether the alimony treatment is to be accorded payments made by the husband to the wife for the support of the children, has created some difficulties and opportunities by its literal interpretation of section 71(b). Section 71(b) provides that periodic payments made to the wife are to be included in her gross income except as to any part of a payment which the terms of the decree, instrument, or agreement "fix" as payable for the support of the children.

Two recent cases, *West v. United States*<sup>29</sup> and *Commissioner v.*

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<sup>27</sup>Treas. Reg. § 1.152-4(b) provides in part:

In the event of so-called "split" custody, or if neither a decree or agreement establishes who had custody, or if the validity or continuing effect of such decree or agreement is uncertain by reason of proceedings pending on the last day of the calendar year, "custody" will be deemed to be with the parent who, as between both parents, has the physical custody of the child for the greater portion of the calendar year.

<sup>28</sup>"Clearly establish" is interpreted as "by a clear preponderance of the evidence." T.D. 7145, cited at 36 FED. REG. 20039 (1971). See Note, *The Burden of Proof Required of a Parent Claiming Child Exemption*, 29 WASH. & LEE L. REV. 29 (1972).

<sup>29</sup>41 F.2d 294 (4th Cir. 1969).

*Gotthelf*,<sup>30</sup> distinguishing *Lester* on insubstantial factual differences, appear to have relaxed the "square corners" approach of *Lester* in favor of holding that an agreement or decree "fixes" the amount payable for the children when it does so by necessary implication. By denying certiorari in the *Gotthelf* case,<sup>31</sup> the Supreme Court has indicated enough of a retreat from the *Lester* case for the parties to determine with considerable assurance whether the alimony treatment will be accorded to payments made to the wife for the children. Following the *Lester* formula assures that the alimony treatment will follow; making modifications in accordance with *Gotthelf* and *West* should assure that it will not. Husbands in higher income tax brackets may insist on *Lester*-type provisions; those in lower brackets may be content with the modifications.

The application of *Lester*, on the one hand, or *Gotthelf* and *West* on the other, determining which of the parents obtains the dependency exemption for the children, is important for reasons other than the allocation of the dependency exemption, since the parent entitled to the exemption may also be entitled to deductions for medical expenses for the dependent child, and the parent with more custody and a dependent in the house may be entitled to head of household rates.<sup>32</sup>

### C. Transfers to or for the Wife in Addition to Regular Payments

Neither the Code nor the Regulations define two of the crucial terms used in section 71: "Marital or family relationship" and "periodic payments." This failure has caused no difficulties, as noted above,<sup>33</sup> where the property transferred to or for the wife is a series of payments either substantially uniform or varying pursuant to such an objective standard as a husband's income. Litigation has been caused, however, where there

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<sup>30</sup>407 F.2d 491 (2d Cir. 1969). In *Gotthelf* the agreement provided for the husband's paying \$12,000 for the support of his divorced wife and two minor children, with additional provisions that the total would be reduced by \$5,000 if the wife remarried and by \$3,500 per child as he was emancipated. The Court held that \$7,000 of the \$12,000 was for child support. In *West* the Court held that \$30 of a \$35 per week payment to the wife for her support and that of their three children was for the support of the children in view of the provisions that the weekly sum was to be reduced by \$10 upon a child's becoming emancipated and \$5 if the wife remarried, and also that the wife undertook to spend at least \$30 per week for the support of the children.

<sup>31</sup>396 U.S. 828 (1969).

<sup>32</sup>INT. REV. CODE OF 1954, §§ 213 and 1(b) respectively. A question raised under the *Lester* doctrine has recently been solved by cases decided in the Fourth and Tenth Circuits. If payments made to the wife for her support and that of the children are continued in whole or in part after the wife's right to any alimony has ceased, as upon her remarriage, the payments are thereafter not entitled to alimony treatment, since they are made solely for the support of the children. *Brown v. Commissioner*, 415 F.2d 310 (4th Cir. 1969); *Maytag v. Commissioner*, 370 F.2d 914 (10th Cir. 1966).

<sup>33</sup>See text accompanying note 16 *supra*.

is either a payment of substantially greater size than others in a series, or the agreement or decree contains one provision governing the series of uniform payments and another separate provision governing the transfer of additional property such as corporate stock<sup>34</sup> or payments on a house for the wife.<sup>35</sup> Since subsections 71(a)(1) and (2) use the broad language of payments "because of the marital or family relationship," as contrasted with the narrow language of "support or maintenance" in subsection 71(a)(3), it would appear that payments by the husband because of the wife's dower rights,<sup>36</sup> rights of inheritance,<sup>37</sup> right to a portion of the husband's property,<sup>38</sup> or right to community property<sup>39</sup> would qualify under the first two subsections, as well as payments made under these subsections for her support. The Regulations are, however, inconsistent.<sup>40</sup> The cases are also in conflict, some indicating that payments for the wife's marital rights in property qualify,<sup>41</sup> and others taking the position that only payments made for the wife's support<sup>42</sup> qualify for alimony treatment. Cases have also denied alimony treatment on the ground that a payment substantially larger than others in a series is not "periodic," but is an installment payment upon a lump sum.<sup>43</sup> The commissioner has taken inconsistent positions in at least one case, denying deduction of payments to the husband and taxing the same payments to the wife.<sup>44</sup>

While the reasoning of the authorities and the results in the cases are certainly debatable, the objective of an equitable apportionment of taxes between the parties in this situation should be kept in mind. Unless the parties intend the result (and when they have engaged in litigation concerning the deduction it is obvious that they did not), it may be unfair in many situations to permit the husband an unusually large deduction at the price of including an unexpectedly large sum in the wife's income. The unfairness is illustrated by the settled doctrine that, there the husband

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<sup>34</sup>Lewis v. United States, 292 F. Supp. 310 (E.D. Mich. 1968).

<sup>35</sup>Van Orman v. Commissioner, 418 F.2d 170 (7th Cir. 1969).

<sup>36</sup>See note 4 *supra*.

<sup>37</sup>*Id.*

<sup>38</sup>*Id.*

<sup>39</sup>*Id.*

<sup>40</sup>Compare Treas. Reg. §§ 1.71-1(a) and 1.71-1(b)(4) (1957) with Treas. Reg. § 1.71-1(b)(6), ex.(1) (1957).

<sup>41</sup>See Brown v. Commissioner, 415 F.2d 310 (4th Cir. 1969); Phinney v. Mauk, 411 F.2d 1196 (5th Cir. 1969).

<sup>42</sup>See Van Orman v. Commissioner, 418 F.2d 170 (7th Cir. 1969); McCombs v. Commissioner, 397 F.2d 4 (10th Cir. 1968); Solterman v. United States, 272 F.2d 387 (9th Cir. 1954); Lewis v. United States, 292 F. Supp. 310 (E.D. Mich. 1968).

<sup>43</sup>See Van Orman v. Commissioner, 418 F.2d 170 (7th Cir. 1969); Tate v. United States, 207 F. Supp. 426 (E.D. Tenn. 1962); Knowles v. United States, 182 F. Supp. 150 (S.D. Miss. 1960); Wilma E. Thompson, 50 T.C. 522 (1968).

<sup>44</sup>Gordon L. Munderloh, 48 T.C. 452 (1967).



pays the wife arrears of periodic payments in a lump sum, the entire amount is taxable to her and deductible by him in the year paid.<sup>45</sup>

The terms "marital or family relationship" and "periodic payments" used in section 71 should be defined in the Regulations. In drafting the definitions, it should be borne in mind that variations determined by objective standards in the amount of individual payments in a series should not affect their being accorded alimony treatment; that what are essentially capital transactions, that is, one-time transfers of substantial property by the husband to the wife in recognition of her contributions to the accumulation of property during the marriage,<sup>46</sup> should not be accorded alimony treatment; that installment payments of a principal sum should be governed by existing law; but that one unusually large initial payment or several unusually large initial payments in a series should not be denied alimony treatment if the persons intend them to be periodic payments for the wife's support.<sup>47</sup>

#### D. *The Principal Sum Payable in Installments*

It may happen that the husband desires to have a ceiling on at least some of his payments to the wife, and she may agree.<sup>48</sup> The principal sum can be stated as such, or may be arrived at by requiring a fixed number of installments each of a specified amount. In this event, questions arise as to whether the installment payments are "periodic" within the meaning of section 71.<sup>49</sup>

##### 1. The more-than-10-year rule

Section 71(c), the source of the more-than-10-year rule, specifies that the principal sum may be either in money or property. The principal sum must be fixed by a decree of divorce or separation, a written instrument incident thereto, or a written separation agreement. A decree for support, pursuant to section 71(a)(3), may not be used to create periodic payments deductible under section 71(c).

<sup>45</sup>See *Holloway v. United States*, 428 F.2d 140 (9th Cir. 1970).

<sup>46</sup>See *United States v. Davis*, 370 U.S. 65 (1962); *Collins v. Commissioner*, 412 F.2d 211 (10th Cir. 1969); *Phinney v. Mauk*, 411 F.2d 1196 (5th Cir. 1969).

<sup>47</sup>See *Collins v. Commissioner*, 412 F.2d 211 (10th Cir. 1969); *Phinney v. Mauk*, 411 F.2d 1196 (5th Cir. 1969); *Lewis v. United States*, 292 F. Supp. 310 (E.D. Mich. 1968).

<sup>48</sup>An example of such an arrangement would be where the regular payments made to the wife for her support and that of the children are insufficient to cover their education. The husband may be willing to add a fixed sum, payable in installments during these years, sufficient to cover the educational expenses. If set up properly the payments would receive the alimony treatment. See INT. REV. CODE OF 1954, § 71(c); note 49 *infra*.

<sup>49</sup>See INT. REV. CODE OF 1954, § 71(c); Treas. Reg. § 1.71-1(d) (1957); and Publication 504 5-6. These sources succinctly clarify the circumstances under which installments paid by the husband get the alimony treatment.

If the principal sum is to be paid at all events, then alimony treatment is not accorded to any installment unless the payments run over a period in excess of 10 years from the date of one of the instruments<sup>50</sup> requiring the payments. Despite the clarity of the language, more than one taxpayer has been caught by his failure to fix the payments so that the last would be more than 10 years after the critical date.<sup>51</sup>

The fact that one installment is unusually large does not have the same effect of creating uncertainty as does an unusually large payment in a series of periodic payments under section 71(a). It is expressly provided in section 71(c) that the husband may deduct the lesser of payments made in the tax year or 10% of the principal sum. Consequently, if he pays an excess amount in any year, he does not receive full tax benefit from it.<sup>52</sup> This may constitute a small tax trap for husbands who wish to make larger installment payments during the first few years followed by smaller payments in later years.

## 2. The contingency rule

The Regulations<sup>53</sup> create the so called contingency rule in which installment payments of a principal sum fixed by decree, instrument, or agreement receive the alimony treatment. Such payments must, however, be in the nature of alimony or an allowance for support.

The contingency rule is that installments of a principal sum are entitled to alimony treatment, irrespective of the more-than-10-year rule, if the discharge of the sum is subject to any one of the following contingencies, created either by the decree or instrument, by agreement establishing the obligation, or by local law: first, the power of the court to change the obligation;<sup>54</sup> second, the remarriage of the wife; third, the death of either party; or fourth, a change in the economic status of either party. The contingency rule takes precedence over the more-than-10-year rule; and the amounts of the installments are deductible without limitation to 10% of the principal sum.

The contingency rule is a notable example of logic in the tax laws. If

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<sup>50</sup>Notes 8-10 *supra*.

<sup>51</sup>See *Joslin v. Commissioner*, 424 F.2d 1223 (7th Cir. 1970); *Furrow v. Commissioner*, 292 F.2d 604 (10th Cir. 1961). The *Joslin* case illustrates the importance of local law, since it was held that an agreement providing for the payments over more than a 10-year period was not effective under Nevada law until it had been approved by the Court, and since the decree was within the 10-year period, alimony treatment was not accorded to the payments.

<sup>52</sup>See Treas. Reg. § 1.71-1(d)(5), ex. (4) (1957).

<sup>53</sup>Treas. Reg. § 1.71-1(d)(3) (1957).

<sup>54</sup>Under some statutes, the Court may be precluded from changing the provisions of a property settlement agreement or decree. See VA. CODE ANN. § 20-109 (Repl. Vol. 1960) and *Dienhart v. Dienhart*, 210 Va. 101, 168 S.E.2d 279 (1969); NEV. REV. STAT. § 125.170 (1967).

the number of installments is not fixed, then no principal sum is specified; and so section 71(c)(1) does not render the installment payments non-periodic. The effect, nevertheless, is to make it possible for the parties to agree upon alimony payments with a ceiling. Both of the principal sum rules are notable for another reason. The statute, the Regulations, and the supplementary explanation in Publication 504 are concise, well drafted, and reasonably comprehensive.<sup>55</sup>

There is, however, one question which is not covered by the principal sum rules, and that is whether payments of a principal sum in installments are subject to the rule of the *Lester* case. The Court in *Lester* was specifically concerned with the meaning of the word "fixed" in section 71(b), but the decision essentially required an interpretation of what constituted a periodic payment within the meaning of section 71(a). Since section 71(c), governing the deductibility of installments on a principal sum, also refers to and depends upon the meaning of the same phrase in section 71(a), it appears clear enough that installments on a principal sum designated for the wife and children, but not "fixing" the amount for the children, would receive alimony treatment if otherwise qualifying under either of the section 71(c) rules. If the wife dies before all payments are made, then any amount payable to her estate in satisfaction of her marital rights would presumably be deductible by the husband, and any amount payable to the children would not receive alimony treatment.<sup>56</sup> While the conclusions expressed seem sound, it is submitted that the matter should be clarified by the Regulations.

## II. TRANSFERS OF PROPERTY OTHER THAN CASH: RECOGNITION OF GAIN OR LOSS

### A. *Property other than Life Insurance*

Gain or loss will ordinarily be recognized if a taxpayer discharges an obligation by the delivery of property at a value other than his basis.<sup>57</sup> On the other hand, if a taxpayer delivers property to its owner, or partitions property with his co-tenant, no transaction has been accomplished by which gain or loss is recognized.<sup>58</sup>

The application of the second of these principles to the husband-wife situation is attended with difficulty because of the inexact nature of some

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<sup>55</sup>This observation cannot, unfortunately, be accurately made respecting other areas of the income tax law. See Choka, *The Sheer Hell of the Internal Revenue Code*, 56 A.B.A.J. 762 (1970), a devastating but perfectly fair criticism of the manner in which many provisions of the Code are drafted.

<sup>56</sup>See note 32 *supra*.

<sup>57</sup>See e.g., *United States v. Davis*, 370 U.S. 65 (1962); *Rogers v. Commissioner*, 103 F.2d 79 (9th Cir.), *cert. denied*, 308 U.S. 580 (1939).

<sup>58</sup>See 370 U.S. at 67.

marital property interests.<sup>59</sup> Of course if the husband has registered in his name stock or any other property belonging to the wife, no transaction of gain or loss has been accomplished by the delivery of her property to her. If, at the other extreme of this particular spectrum, the husband makes one of his periodic payments to the wife for her support in appreciated stock rather than in cash, he recognizes gain.

The problem of whether gain is realized when other rights of the wife are satisfied is illustrated by two leading cases, *United States v. Davis*<sup>60</sup> and *Collins v. Commissioner*.<sup>61</sup> In *Davis*, the husband and wife, both Delaware residents, had entered into a property settlement agreement, later approved by the divorce court, providing for periodic support payments for the wife and minor child; and also, as a "division in settlement of their property,"<sup>62</sup> the husband transferred to the wife certain shares of stock which had appreciated in value. The division was accepted by the wife in full satisfaction of her "claims and rights against the husband," including without limitation dower and inheritance. Under Delaware law, the wife also had a right upon divorce to share in the husband's property to an extent deemed reasonable by the court.<sup>63</sup> The Court held that the husband recognized gain upon the transfer of the stock, saying that the wife's rights did not put her in the position of a co-owner of the husband's property, but rather in the position of one whose rights had imposed a personal liability upon him.

In *Davis*, the Court recognized that a different result would be reached in community property states; but said that different results in tax consequences could be caused by local laws such as those applicable to marital property in community property states and those applicable in common law states.<sup>64</sup> The Court summarily settled a problem that had given concern to the lower courts, namely what value to assign to the transfer,<sup>65</sup> holding that the market value on the date of transfer was determinative.

The scope of the *Davis* doctrine was tested in the *Collins* case, in which the husband was held not to have recognized gain on the transfer to his wife of stock in a closely held corporation. The wife had "brought into the marriage" some \$10,000; the corporation in which the husband was a major stockholder had greatly prospered during the marriage; and as part of the property settlement agreement, approved by the divorce

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<sup>59</sup>See note 4 *supra*.

<sup>60</sup>370 U.S. 65 (1962).

<sup>61</sup>412 F.2d 211 (10th Cir. 1969).

<sup>62</sup>370 U.S. at 66.

<sup>63</sup>*Id.* at 67, 70.

<sup>64</sup>*Id.* at 71.

<sup>65</sup>*Compare* *Commissioner v. Marshman*, 279 F.2d 27 (6th Cir. 1960) *with* *Commissioner v. Halliwell*, 131 F.2d 642 (2nd Cir. 1942) *and* *Commissioner v. Mesta*, 123 F.d 986 (3rd Cir. 1941).

court,<sup>66</sup> the husband had transferred to her a part of his stock which had substantially appreciated. There was apparently no effort to follow the *res* by showing that the wife's \$10,000 had been invested in corporate stock registered in the husband's name; and the court in its first opinion<sup>67</sup> held that the transfer was sufficiently similar to that in the *Davis* case for the husband's gain to be recognized. While the case was on appeal to the Supreme Court, the Oklahoma court decided that a State tax should not be collected on the transfer of the stock to the wife, because the transfer was a delivery to her of her interest in property jointly acquired during the marriage.<sup>68</sup> The case was consequently remanded<sup>69</sup> to the Court of Appeals for reconsideration in the light of this Oklahoma decision. On remand, the Court of Appeals held that it should "look to the law of the State," and that under such law the present transfer more nearly resembled a division of property between co-owners than it did a transfer in satisfaction of a legal obligation, and consequently no gain was recognized.

Although the *Collins* case has been termed an exception to the *Davis* principle,<sup>70</sup> it demonstrates that there may be an area where the wife is not a co-owner by virtue of community property laws, but, because of a combination of circumstances including the power of the court to make an equitable allocation to her of property standing in the husband's name, she is more like a co-owner than one who has the power to impose personal liability on the husband. It is highly doubtful that this area can be clarified, in the absence of a change in the law, except by litigation.

The combination of the current practice of putting real and personal property in the names of husband and wife with survivorship, the automatic transformation of a tenancy by the entirety into a tenancy in common upon divorce,<sup>71</sup> and the strong presumption that payments by the husband upon property taken in a co-tenancy with his wife constitute gifts<sup>72</sup> may lead to fairly substantial divisions of property between husband and wife without recognition of gain. Where, however, property is so held and the husband decides to convey his one-half interest after divorce to the wife, the *Davis* doctrine would apply, and the husband must recognize any gain.

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<sup>66</sup>The divorce court in Oklahoma can allocate to the wife an equitable share of jointly acquired property whether registered in the husband's name or not. The court takes into consideration, among other factors, the wife's frugality and economy in the home. See *Collins v. Commissioner*, 388 F.2d 353, 354-58 (10th Cir. 1968). The court in discussing the Oklahoma laws on this subject indicated that other states have similarly empowered their courts.

<sup>67</sup>*Collins v. Commissioner*, 388 F.2d 353 (10th Cir. 1968).

<sup>68</sup>*Collins v. Oklahoma Tax Commission*, 446 P.2d 290 (Okla. 1968).

<sup>69</sup>*Collins v. Commissioner*, 393 U.S. 215 (1968).

<sup>70</sup>*Wallace v. United States*, 309 F. Supp. 749, 759-62 (S.D. Iowa, 1970).

<sup>71</sup>See, e.g., VA. CODE ANN. § 20-111 (Repl. Vol. 1960).

<sup>72</sup>See, e.g., *Smith v. Smith*, 200 Va. 77, 104 S.E.2d 17 (1958).

### B. *Transfer of Insurance*

The *Davis* doctrine may be more of a tax trap where the parties are not aware of it, or a deterrent where they are, in the event the parties transfer or wish to transfer to the wife policies of insurance on the husband's life. In addition to the recognition of gain,<sup>73</sup> there may be ordinary income tax consequences where interest has been accumulated with the insurer.<sup>74</sup>

Section 101(a) of the Code provides the general rule that life insurance proceeds are not taxable to the recipient. Where, however, the owner trafficks in the policy, transferring it for value, there is excluded from gross income of the transferee only his basis; and his basis would be what he paid for the assignment plus premiums subsequently paid by him.<sup>75</sup>

Section 101(a)(2)(B) exempts from the transfer for value rule a transfer to the insured, to a partner of the insured, to a partnership in which he is a partner, or to a corporation in which the insured was stockholder or officer. Transfer for value to a wife or ex-wife is not included in the exemption. The *Davis* rule consequently seems to apply; and presumably an ex-wife to whom insurance has been transferred will report as income the excess over the value of the policy at the time of transfer plus any premiums subsequently paid by her.<sup>76</sup>

It has been suggested that the wife who wants the additional security of a policy of life insurance on her husband take out a new policy on his life at the time of divorce,<sup>77</sup> and pay the premiums on it herself.<sup>78</sup> The wife being the owner of the policy, the *Davis* doctrine would not apply. Since, however, the lack of money is endemic in divorce situations where two households must be maintained in place of one, since the husband may be uninsurable, and since the age of the husband may make the cost of a new policy on his life beyond the parties' means, the suggested solution may not be feasible. As a result, the parties may be practically compelled

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<sup>73</sup>See *United States v. Davis*, 370 U.S. 65 (1962). See also *Wenig, Use of Life Insurance in Divorce and Separation Agreements*, note 23 *supra*.

<sup>74</sup>See *Gallun v. Commissioner*, 327 F.2d 809 (7th Cir. 1964). Making the wife irrevocable beneficiary of insurance on the husband's life does not trigger the *Davis* rule; and the parties may be satisfied with such an arrangement instead of a transfer of ownership.

<sup>75</sup>INT. REV. CODE OF 1954, § 101(a)(2).

<sup>76</sup>INT. REV. CODE OF 1954, § 101(e) assures that the wife will report for income tax purposes amounts received from an insurance policy payable in installments, or from an insurance trust. See also *Treas. Reg. § 1.101-5* (1957).

<sup>77</sup>See note 21 *supra*. It has also been suggested that in community property states life insurance policies on the husband's life may be divided like other community property or a single policy may be split.

<sup>78</sup>If the wife has all of the incidents of ownership, amounts furnished her by the husband to pay the premiums on the policy will be subject to alimony treatment. *Hyde v. Commissioner*, 301 F.2d 279 (2d Cir. 1962); *Turpin v. United States*, 240 F. Supp. 171 (W.D. Mo. 1965).

to abandon any efforts to obtain the additional security which the husband's life insurance might afford.

It is surprising, to say the least, that Congress regards the preservation of a business for former partners or corporate associates as more important than furnishing security for a family, even if an ex-wife is included.

### C. *The Inequities of the Davis Principle*

As has been indicated, the law recognizes that a wife who has contributed to the establishment and maintenance of the marital home has quite often made a contribution, direct or indirect, to the accumulation of property during the marriage.<sup>79</sup> In community property states, this has resulted in giving the wife a species of co-ownership. In some states, courts are empowered to accord legal recognition to her contribution. In other states, where the wife's rights are inchoate rights of dower and inheritance only, the parties and their counsel may feel that a satisfactory arrangement should include the transfer of some property in the husband's name to the wife, including life insurance. While it is permissible for tax consequences to be different because of differences in local law, it is certainly desirable that there be uniformity in the various states;<sup>80</sup> it seems inequitable for essentially the same transactions to cause recognition of gain in some states and not in others.

It is submitted that the *Davis* doctrine should be reversed by statute, and section 101(a)(2)(B) should be amended to exempt from the transfer-for-value-rule a transfer of life insurance for value to a wife or ex-wife as a part of a property settlement agreement or decree of divorce or separation. Care should be taken in drafting such legislation to continue the recognition of gain from transfers of appreciated property in satisfaction of the husband's obligation to make periodic payments.

## III. DISTRIBUTIONS TO THE WIFE FROM A TRUST

Two sections of the Code provide for taxability to the wife of distributions to her from trusts. Sections 71(a)(1) and (2) provide for the inclusion in the wife's income of periodic payments to her attributable to property transferred in trust, made pursuant to a written separation agreement or a decree of divorce or separate maintenance.<sup>81</sup> Section 682(a) provides for

<sup>79</sup>See *Estate of Morrison T. O'Nan*, 47 T.C. 648, 657 (1968).

<sup>80</sup>Transfers in trust to the wife are taxable under the *Davis* doctrine. See Rev. Rul. 59-47, 1959-1 CUM. BULL. 198; Rev. Rul. 57-507, 1957-2 CUM. BULL. 511. Where, however, the transfer is made as security for the husband's discharging a continuing obligation to make periodic payments for support, the *Davis* doctrine does not apply. See Rev. Rul. 57-506, 1957-2 CUM. BULL. 65. It is therefore possible in some situations to avoid the application of the *Davis* doctrine while at the same time recognizing the wife's contributions by making a capital transfer for her benefit.

<sup>81</sup>The other subsections of § 71, including subsection (a)(3) dealing with decrees for support, do not affect the present question.

including in her gross income the amount of any income from a trust which she is entitled to receive and which (except for section 682) would be included in the husband's income. Subsection (b) of section 682 provides that the wife shall be considered, for purposes of computing the taxable income of the trust and of the wife, as the beneficiary specified "in this part."<sup>82</sup>

The Commissioner has consistently taken the position that amounts distributed from a trust to which section 71 is applicable are included in the wife's gross income, irrespective of their nature.<sup>83</sup> On the other hand, the Commissioner has made it clear that distributions to the wife governed by section 682 are taxable to her only pursuant to the rules applicable to other trust beneficiaries.<sup>84</sup> Thus capital distributions, if section 71 is applicable, are includible in the wife's gross income, whereas they are not includible if section 682 applies. It is consequently important to the wife to determine which section of the Code governs, or, in the jargon of the trade, whether there is involved a section 71 or a section 682 trust. No answer is furnished by the past litigation, the legislative history, the language of the Code sections, the Regulations, or the authorities.

The enactment of sections 71 and 215 was sparked by the decision of *Gould v. Gould*.<sup>85</sup> Two other Supreme Court decisions, *Douglas v. Wilcutts*<sup>86</sup> and *Helvering v. Fuller*,<sup>87</sup> led to the enactment of section 682. In *Douglas*, the Supreme Court applied in the divorce field the principle that payments in discharge of one's obligations must be included in one's income. The husband in the *Douglas* case contemplated a divorce,<sup>88</sup> and in an effort to avoid taxation upon the payments to his prospective ex-wife, he created a trust and provided that certain amounts were to be paid to the wife out of the trust income. Excess income was to be paid to the husband; and on the wife's death the trust property was to revert to the husband. All interests of the wife in the husband's property and earnings were to be discharged by the agreement, which was approved by the divorce court. Under applicable state law, however, the court was empowered to revise its decree and the provisions for the wife. The Supreme Court held that the trust income distributed to the wife was taxable to the husband.

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<sup>82</sup>The reference is to Part I, entitled "Estates, Trusts and Beneficiaries," of Subch. J of the Code. See *Ellis v. United States*, 416 F.2d 894, 898 (6th Cir. 1969).

<sup>83</sup>Treas. Reg. §§ 1.71-1(c)(2)-(3), 1.682(a)-1(a)(2) (1957).

<sup>84</sup>Treas. Reg. §§ 1.682(a)-1(a)(2), 1.682(b)-1(a) (1957).

<sup>85</sup>245 U.S. 151 (1917).

<sup>86</sup>296 U.S. 1 (1935).

<sup>87</sup>310 U.S. 69 (1940). See also S. REP. NO. 1631, 77th Cong., 2d Sess. 83 (1942); H.R. REP. NO. 2333, 77th Cong., 2d Sess. 46, 71 (1942); H.R. REP. NO. 2586, 77th Cong., 2d Sess. 38 (1942).

<sup>88</sup>The divorce was obtained three days after the trust agreement was executed.



In the *Fuller* case, decided five years later, it was held that the husband was not taxable on trust income from an irrevocable trust, established pursuant to an agreement in contemplation of a divorce, which was to continue for 10 years during which all income was to be used for the support of the wife or, if she died within the 10 years, of the children. At the end of the 10 years, the trust property was to be delivered to the wife. The divorce court (Nevada) had no power to change the decree approving the property settlement agreement. The Supreme Court held that, since under local law and the provisions of the trust the husband's obligations were fully discharged by its establishment, the income from the trust was not taxable as in discharge of his obligations, but was taxable to the wife just as would be the income from any property belonging outright to her.

In order to abolish this distinction between payments to the wife from a trust where the husband's obligations had ended and where they were continuing,<sup>89</sup> Congress enacted legislation, included as section 171 of the 1939 Code, which is now set out in substantially the same language in section 682 of the Code.

Inssofar as the husband is concerned, the relief given him from the doctrines enunciated in *Gould* and *Wilcutts* is clear. He does not include in his income distributions made to his wife from a trust, whether or not the establishment of the trust completely discharges his obligations to the wife, irrespective of his control over the trust, and irrespective of the nature of the payment.<sup>90</sup>

Even though almost 30 years have elapsed since the enactment of sections 71, 215 and 682, taxability of trust distributions to the wife has not been clarified. Of course, she would be taxed on the taxable income; but the question remains as to whether her gross income includes distributions of corpus or tax-free income. Many commentators have said that section 682 is applicable to this situation and that section 71 is not, if the trust

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<sup>89</sup>See Treas. Reg. § 1.682(a)-1(a)(3) (1957).

<sup>90</sup>§ 71(d) expressly provides that the husband does not include in his income periodic payments made to his wife from a trust. § 682(a) is to the same effect. This may limit the husband's deductions for charitable contributions and increase his deductions for medical expenses. See further, as to the taxability of the husband, Treas. Reg. § 1.682(a)-1(a)(3) (1957), reading in part as follows:

(3) Section 682(a) is designed to produce uniformity as between cases in which, without Section 682(a), the income of a so-called alimony trust would be taxable to the husband because of his continuing obligation to support his wife or former wife, and other cases in which the income of a so-called alimony trust is taxable to the wife or former wife because of the termination of the husband's obligation. Furthermore, Section 682(a) taxes trust income to the wife in all cases in which the husband would otherwise be taxed not only because of the discharge of his alimony obligation but also because of his retention of control over the trust income or corpus. Section 682(a) applies whether the wife is the beneficiary under the terms of the trust instrument or is an assignee of a beneficiary.

was established prior to and not in contemplation of divorce or separation.<sup>91</sup> This position seems unsound for three reasons: first, both the *Douglas* and *Fuller* decisions, which led to the enactment of section 682, concerned trusts which were created as a part of divorce settlements, not trusts theretofore created; second, the Regulations, although ignoring the factual situation in *Douglas* and *Fuller*, are opposed;<sup>92</sup> and third, the distinction would depend upon happenstance alone.<sup>93</sup>

It may next be suggested that the distributions are governed by section 682 if the establishment of the trust finally discharges the husband's obligations arising out of the marriage, whereas section 71 applies if the trust distributions are in discharge of any of the continuing obligations.<sup>94</sup> This does not seem sound, however, since the very purpose of the enactment of section 682 was to abolish the distinction made by the *Douglas* and *Fuller* decisions.

There was little consideration of the question by the courts prior to *Ellis v. United States*.<sup>95</sup> In the *Ellis* case, the trust corpus consisted in part of tax-free municipals; and the wife took the position that she could exclude from her gross income<sup>96</sup> the part of the distribution attributable to interest on such securities. The court, rejecting the Commissioner's argument that section 682(b) referred only to the accounting year, approached the problem as one of resolving conflicting policies expressed in neighboring provisions of the Code. Since section 682(b) expressly provides that the wife should be considered as a beneficiary specified in Part I of Subchapter J of the Code, the court held that the wife was, indeed,

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<sup>91</sup>See note 23, *supra*; CLARK § 14.12; O'Byrne, *Escape from Holy Deadlock*, 45 TAXES 63, 75 (1967); Peschel, *Income Taxation of Alimony Payments Attributable to Transferred Property: Congressional Confusion*, 44 TUL. L. REV. 223, 234 (1970); Note, *Alimony Trust Income: A Challenge to Taxability*, 4 VALPARAISO U.L. REV. 181, 190 (1969); Note, *Tax Aspects of Alimony Trusts*, 66 YALE L.J. 881, 892 (1957).

<sup>92</sup>Treas. Reg. § 1.682(a)-1(a)(2) states in part as follows:

Section 682(a) does not apply in any case to which section 71 applies. Although section 682(a) and section 71 seemingly cover some of the same situations, there are important differences between them. Thus, section 682(a) applies, for example, to a trust created before the divorce or separation and not in contemplation of it, while section 71 applies only if the creation of the trust or payments by a previously created trust are in discharge of an obligation imposed upon or assumed by the husband (or made specific) under the court order or decree divorcing or legally separating the husband and wife, or a written instrument incident to the divorce status or legal separation status, or a written separation agreement. (emphasis added).

<sup>93</sup>While no one even slightly acquainted with internal revenue laws expects them to be logical, all taxpayers assume that none of the provisions is based upon whim.

<sup>94</sup>See, e.g., Treas. Reg. § 1.682(a)-1(a)(2) (1954), quoted note 92 *supra*.

<sup>95</sup>416 F.2d 894 (6th Cir. 1969).

<sup>96</sup>See INT. REV. CODE OF 1954, § 103(a)(1).

despite section 71, taxable in the same manner as other trust beneficiaries; thus, she was not required to include in her gross income the distribution based upon the trust's receipt of tax-free interest.

The *Ellis* case raises an interesting speculation touched upon but not discussed in depth by some of the commentators,<sup>97</sup> the "creation of income" in this field. Income is often "created" where it did not exist before, as where a taxpayer discharges an obligation out of principal rather than income. Except for capital gains realized, the payer-taxpayer has no obligation to include in his gross income any capital so used; the payee-taxpayer, however, even though he has received capital, must report it as ordinary income.

Where husband and wife are married, they do not report any capital received any more than they report tax-free income. When they are divorced, the wife must report as income under section 71 periodic payments made to her by the husband under that section, whether the source of the payments is capital, tax-free income,<sup>98</sup> or taxable income. Thus income is "created" for tax purposes where none existed before. In deciding tax consequences in the domestic relations field, Congress could have treated the two taxpayers, after the divorce, in the same manner tax-wise as if they were still married; and could have taxed the wife only upon payments made to her by the husband out of his reportable income. Where no trust is involved, Congress clearly did not choose to adopt this approach.

When, however, the question is of taxability because of distributions from trusts, Congress has spoken in sections 641 to 668. The wife is expressly given the benefit of these sections in section 682(b). With one authority already resolving the question in favor of consistency in the treatment of trust income, even though the beneficiary is a divorced wife, it appears desirable that the provisions of section 71(a)(1) and (2) should be similarly brought into line. The effect will not be to diminish taxable income; it will only be that taxable income is no more "created" where the trust benefits a divorced wife than where the beneficiary is not so related to the settlor or assignor.

#### IV. GIFT AND ESTATE TAXES

Since property settlement agreements and divorce decrees generally provide for transfers to the wife and the children, some of which may commence upon or continue after the husband's death, questions arise concerning the imposition of gift or estate taxes.

These questions are answered against the background of sporadic ef-

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<sup>97</sup>See, e.g., Peschel, *supra* note 91, at 227.

<sup>98</sup>See *Neeman v. Commissioner*, 26 T.C. 864 (1956). See also *Treas. Reg. § 1.71-1(c)(2)* (1957).

forts by husbands, where no marital discord exists or is in prospect, to avoid or minimize such taxes by making conveyances purporting to be in discharge of obligations arising out of the marital relation.<sup>99</sup> The gift<sup>100</sup> and estate tax statutes<sup>101</sup> both exempt transfers made "for adequate and full consideration in money or money's worth . . ."; and arguments have been made that transfers by husbands to the wife or children during or in contemplation of marriage fulfilled the statutory requirements.<sup>102</sup>

These efforts led to the enactment of section 2043(b) which provides that the relinquishment of dower or curtesy (or a statutory estate in lieu thereof) or "of other marital rights . . ." did not constitute statutory consideration insofar as the estate tax was concerned, and the U.S. Supreme Court held that, estate and gift taxes being *in pari materia* and the respective statutes using the same phrase to define consideration, the provisions of section 2043(b) would be effective in the gift tax field as well.<sup>103</sup>

Also in the background is recognition of the fact that, where the marriage has ended, transfers provided by agreements or decrees are not made in the same voluntary way as *inter vivos* or testamentary gifts are.<sup>104</sup> The Courts and the Commissioner have followed what appear to be somewhat oblique methods to carve out two limitations upon gift and estate taxes in this field.

#### A. The "Decree" Way of Avoiding Gift and Estate Taxes

The first is the so-called "decree" limitation. If the transfer is ordered by a decree, even though based upon an agreement and even though the agreement and decree both provide that the provisions of the agreement shall survive the decree, there is no gift or estate tax.<sup>105</sup> The principle was

<sup>99</sup>Merrill v. Fahs, 324 U.S. 308 (1945); Commissioner v. Wemyss, 324 U.S. 303 (1945); Dwight W. Ellis, Jr., 51 T.C. 182 (1968). The above cases all involved property settlements. The question may also arise in connection with routine transfers. If the husband makes excessive transfers to his wife and children to reduce his estate, beyond what is necessary to "keep up with the Joneses," he may have made a series of gifts. See the discussion in Commissioner v. Rosenthal, note 2 *supra*.

<sup>100</sup>INT. REV. CODE OF 1954, § 2512(b). See also § 2516.

<sup>101</sup>INT. REV. CODE OF 1954, §§ 2035-38.

<sup>102</sup>See cases cited in note 99, *supra*; H. Rep. No. 1337, S. Rep. No. 2543, 1954 U.S. CODE CONG. & AD. NEWS (1954).

<sup>103</sup>See Harris v. Commissioner, 340 U.S. 106 (1950); Commissioner v. Wemyss, 324 U.S. 303 (1945); Merrill v. Fahs, 324 U.S. 308 (1945).

<sup>104</sup>See discussion in Robert Rodger Glen, 45 T.C. 323, and the cases cited, including Commissioner v. Davis, 370 U.S. 65 (1962). The requirement that the transferor have a donative intent for the gift tax to apply was repudiated in Commissioner v. Wemyss, 324 U.S. 303, 306; see Harris v. Commissioner, 340 U.S. 106, 113 (1950) (Frankfurter, J., dissenting).

<sup>105</sup>Harris v. Commissioner, 340 U.S. 106 (1950); Morrison T. O'Nan, 47 T.C. 648 (1968); Rev. Rul. 68-379, 1968-2 Cum. Bull. 414. There is authority that the transfer has to be made after the decree, Commissioner v. Barnard's Estate, 176 F.2d 233 (2d Cir. 1949); but in the O'Nan case, the transfer was held not subject to the estate tax although made before the decree, where the court was considered to have power to order reconveyance.

established in *Harris v. Commissioner*,<sup>106</sup> but again the holding was based upon a provision of the estate tax law<sup>107</sup> limiting deductions of claims against the estate, when founded on a promise or agreement, to the extent that they were for the statutory consideration. The dissenting opinion did not complain of this legalistic sleight of hand, and remarked that the gift tax should not apply to transfers "in obedience to law . . .";<sup>108</sup> but stated that the transfer in question was really made pursuant to the agreement and not to the decree, since both provided that the agreement should survive the decree.

The power of the divorce court to decree the transfers involved in the *Harris* case was not questioned. The authorities developing the law further<sup>109</sup> have made it clear that the court entering the decree must have the power to do so independently of the property settlement agreement; and so, while the court may adopt the agreement, it also has the power to reject or incorporate its provisions only in part in the decree.

The position has consequently been taken<sup>110</sup> that since the divorce courts generally lack the power to order the support of adult children, transfers made pursuant to a decree providing for their support are not shielded from the gift or estate taxes. This seems to be improper in two situations, first, where the child is so handicapped as to remain the responsibility of the parents;<sup>111</sup> and second, where the decree provides, in accordance with a growing tendency, for the child's higher education.<sup>112</sup>

A strict interpretation of the decree limitation might also result in an inappropriate failure to enforce it in some of the states which lack power to order transfers of property except for periodic alimony.<sup>113</sup> The discussion in *Morrison T. O'Nan*<sup>114</sup> points out that a practice by Courts of approving property settlement agreements is not an indication that the

<sup>106</sup>340 U.S. 106 (1950).

<sup>107</sup>INT. REV. CODE OF 1939, § 812(b). The same provisions are substantially contained in INT. REV. CODE OF 1954, § 2053(e).

<sup>108</sup>Frankfurter, J., 340 U.S. at 115.

<sup>109</sup>See *Morrison T. O'Nan*, 47 T.C. 648 (1967); *Hartshorne v. Commissioner*, 402 F.2d 592 (2d Cir. 1968) (estate tax).

<sup>110</sup>See *Rosenthal v. Commissioner*, 205 F.2d 505 (2d Cir. 1953); *Hartshorne v. Commissioner*, 402 F.2d 592 (2d Cir. 1968); Rev. Rul. 68-379, note 109 *supra*. The same policy is reflected in INT. REV. CODE OF 1954, § 2516, discussed note 123 and accompanying text *infra*.

<sup>111</sup>*Wells v. Wells*, 227 N.C. 614, 44 S.E.2d 31 (1947); Annot., 1 A.L.R. 2d 910 (1948).

<sup>112</sup>*Calogeras v. Calogeras*, 100 Ohio 2d 441, 163 N.E.2d 713 (1959); see Annot., 56 A.L.R. 2d 1207 (1957).

<sup>113</sup>See CLARK § 14.8.

<sup>114</sup>In the *O'Nan* case the court stated:

. . . it is obvious as a practical matter that divorce courts are not going to freely and wantonly change or vary settlement agreements reached by the parties just to prove their undoubted authority . . .

47 T.C. at 660.

Courts are not adjudicating the propriety of the provisions. Since under Kentucky law the divorce court has the authority to order property transfers at least to some extent, this discussion may not be helpful to an avoidance of the taxes in jurisdictions where the Courts lack power to order any capital transfers, at least unless the principle is established that a court's power to order the enforcement of provisions in a decree entered by consent makes the transfers provided for judicially sanctioned. Until this principle is so established—and if it is, the law respecting transfers of property to adult children ordered by a consent decree would also be logically repudiated—counsel would be well advised to depend upon the limitation next following, or upon the statutory avoidance of gift tax.<sup>115</sup>

### B. *The Support Way of Avoiding Gift and Estate Taxes*

The second limitation is that transfers are free from gift and estate taxes to the extent that they are made in satisfaction of the husband's obligation to support his wife and children.<sup>116</sup> As pointed out above,<sup>117</sup> section 2043(b) provides that transfers for the relinquishment of dower or equivalent statutory rights or "of other marital rights . . ." do not satisfy the statutory requirements for consideration in this situation. It would certainly have been thought, *a priori*, that marital rights would include the right to support.<sup>118</sup> However, the Commissioner, and subsequently the Courts,<sup>119</sup> have repudiated this assumption. Yet it seems obvious that the assumption is sound; no husband is either practically or legally making a gift either during or after the marriage to the extent that he supports his dependents, and no danger of evasion of transfer or succession taxes is reasonably to be anticipated by his satisfaction of this obligation.

Complications may arise when there are taken into consideration in valuing the support rights the life expectancies of all concerned and the prospect of the wife's remarriage, which generally terminates her right to support. Fortunately for the instruction of the bar, an agreement involving many such factors was entered into between Donald M. Nelson and his

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<sup>115</sup>The power of the court to refuse a property settlement agreement when it is initially offered is to be distinguished from the inability of the court to change such an agreement once it is admitted to record without objection. *See, e.g.,* VA. CODE ANN., § 20-109 and *Dienhart v. Dienhart*, 210 Va. 101, 168 S.E.2d 279 (1969). If a court is by statute precluded from amending a property settlement agreement which has been judicially accepted, then gift and estate taxes would not be avoided by a subsequent decree which the court has no power to enter.

<sup>116</sup>E.T. 19, 1946-2 CUM. BULL. 166, *superseded by* Rev. Rul. 68-379; *Commissioner v. Nelson*, 396 F.2d 519 (2d Cir. 1968). Again the authorities mean minor children.

<sup>117</sup>Text accompanying note 103 *supra*.

<sup>118</sup>Periodic payments for support satisfy the requirements of §§ 71(a)(1) and (2) providing for obligations arising out of the marital relation.

<sup>119</sup>Note 116 *supra*.

wife, and the opinions in the Tax Court and the 2d Circuit provide valuable guidance.<sup>120</sup>

The two limitations (the "decree" limitation and the "support" limitation) on gift and estate taxes do not exhaust the possibilities. The recent case of *Robert Rodger Glen*<sup>121</sup> demonstrates that where a transfer is made in consideration of the wife's relinquishment of vested property rights created in her as a result of the marriage, the statutory requirement of full and adequate consideration is fulfilled. The principle would, of course, apply either in states where the wife obtained a vested interest in community property, or vested interests pursuant to laws such as were involved in the *Collins*<sup>122</sup> case.

### C. *The Statutory Way of Avoiding the Gift Tax*

According to section 2516,<sup>123</sup> the gift tax is not applicable to transfers made pursuant to a written property settlement agreement to the extent that the transfers are made to the wife in settlement of her marital or property rights, or are made to provide an allowance for the support of issue of marriage during minority. The section only applies where the divorce occurs within two years of the approval of the agreement and it applies irrespective of the approval of the agreement by the divorce decree. It should be noted that, again, transfers for the support of dependent adult children are still subject to the tax. Congressional action would be required to include in the statutory exemption transfers for the support of handicapped children or for the higher education of children over 21.

The statutory method should make it possible to assure the avoidance of gift taxes in most states, even though the written agreement is required. Situations in which a no-fault divorce is granted on the ground of the two-year separation<sup>124</sup> would well accommodate the statutory method. Some maneuvering might be required, under laws such as that recently enacted in New York<sup>125</sup> enabling the husband to obtain a divorce *after* he has

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<sup>120</sup>47 T.C. 279; 396 F.2d 519. In *Hartshorne v. Commissioner*, 402 F.2d 592 (2d Cir. 1968), there was a promise to create a trust by will for the wife for life and then for the children. There is a discussion in the footnotes of the case from which it may be inferred that the court thought it arguable that the valuation of the property transferred and the valuation of the wife's support rights should be made as of the husband's death and not as of the time of transfer. The Commissioner took but later relinquished this position in the *Nelson* case, note 116 *supra*. Both valuations should be made as of the time of transfer. Otherwise, the Service would largely have its cake and eat it too; since inflation and the diminishing value of the wife's support rights as she got older would both work in its favor.

<sup>121</sup>Robert Rodger Glen, 45 T.C. 323 (1966).

<sup>122</sup>Note 46 *supra*. This case involved a situation where the wife had substantially contributed to the accumulation of property during marriage.

<sup>123</sup>Act of Aug. 16, 1954, c. 736, 68A Stat. 409.

<sup>124</sup>*See, e.g.*, VA. CODE ANN., § 20-91(9) (Supp. 1971); CLARK § 12.6.

<sup>125</sup>*See* Gleason v. Gleason, 26 N.Y.2d 28, 256 N.E.2d 513, 308 N.Y.S.2d 347 (1970).

fulfilled for two years the requirements of a separation agreement. Perhaps amendment of the agreement within the two-year period would be sufficient.

#### V. ATTORNEYS' FEES

One might think that lawyers, upon ascending the bench as judges, would remain sympathetic toward the deduction of legal fees and costs—perhaps because of a lingering fellow-feeling for their former clients if not for their former associates. The contrary has proven to be true. The courts have inclined in the other direction, and, at times, ascended to metaphysical realms in requiring capitalization of legal expenses rather than allowing them as ordinary deductions.<sup>126</sup>

Amendments of the Internal Revenue Code were intended to counter this tendency in two areas: expenses for the management, conservation, maintenance of property held for the production of income; and expenses for tax services.<sup>127</sup> The first of these amendments has been only partly successful in the separation and divorce field.

In two companion cases,<sup>128</sup> the United States Supreme Court substantially made section 212(2) inapplicable to the legal expenses of the husband in protecting his income-producing property against the demands of his wife. Although a considerable portion of these expenses was clearly attributable to efforts to procure the reduction of these demands, the Court refused to allow the claimed deduction, and the husband was relegated in one case to the course, unsatisfactory both from the point of view of tax minimization and of sensible accounting principles, of obtaining the approval of the lower court for a capitalization of the expenses.<sup>129</sup>

The wife meets less resistance to the allowance of her legal expenses, since her attorney is working with almost irrefutable obviousness towards securing income or income producing property for her.<sup>130</sup> Both spouses have little difficulty, of course, in obtaining a deduction of expenses for tax advice, since section 212(3) expressly requires such allowance.

It is believed that two methods may be used to facilitate the allowance of legal expenses under section 212(2) as ordinary deductions. First, bills should be rendered for expenses related to the production of income for the wife or the conservation of income-producing property for the husband; and these bills should be rendered in advance of or prior to the completion of actual divorce litigation. Separate bills should then be ren-

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<sup>126</sup>See 4 R.I.A., TAX COORDINATOR ¶ L-1905 (1967).

<sup>127</sup>INT. REV. CODE OF 1954, § 212(2), (3).

<sup>128</sup>United States v. Gilmore, 372 U.S. 39 (1963); United States v. Patrick, 372 U.S. 53 (1963).

<sup>129</sup>Gilmore v. United States, 245 F. Supp. 383 (N.D. Cal. 1965).

<sup>130</sup>4 R.I.A., TAX COORDINATOR ¶ L-1921 (1972); Treas. Reg. § 1.262-1 (1958).



dered for the divorce or separation proceeding. Second, the husband's contribution toward the wife's legal expenses, which is not deductible as such,<sup>131</sup> may be reduced to a monetary amount and the first installments to the wife increased so as to include these expenses in the periodic payments to her. The Commissioner may assail this as an effort to do indirectly what cannot be accomplished directly; but since the soundness of the *Patrick* and *Gilmore* cases is questionable, the taxpayer may prevail.

#### CONCLUSION

The overall efficiency and honesty with which the United States income, gift, and estate tax laws have been administered, with the collection from millions of taxpayers of billions of dollars over a period of many years, irrespective of changes of administration, are certainly one of the current financial wonders of this century. To a greater extent than in other fields of the law,<sup>132</sup> progress has been made toward the end that the provisions particularly applicable to taxes upon divorce and separation are clearly drafted, express a sensible policy, are properly coordinated with related provisions, and are properly administered.

It seems especially important that taxation in this particular field, unfortunately involving so many families at a time of stress and strain and

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<sup>131</sup>See *United States v. Davis*, 370 U.S. 65 (1962).

<sup>132</sup>Note 55 *supra*. Examples of baffling draftsmanship recur in the Code; a recent one, hardly more noteworthy than others, is § 4947(a)(2) of the Tax Reform Act of 1969, which reads as follows:

(2) Split-Interest Trusts. In the case of a trust which is not exempt from tax under section 501(a) not all of the unexpired interests in which are devoted to one or more of the purposes described in section 170(c)(2)(B) and which has amounts in trust for which a deduction was allowed under section 170, 545(b)(2), 556(b)(2), 642(c), 2055, 2106(a)(2), or 2522, section 507 (relating to termination of private foundation status), section 508(e) (relating to governing instruments) to the extent applicable to a trust described in this paragraph, section 4941 (relating to taxes on self-dealing), section 4943 (relating to taxes on excess business holdings) *except* as provided in sub-section (b)(3), section 4944 (relating to investments which jeopardize charitable purpose) *except* as provided in subsection (b)(3), and section 4945 (relating to taxes on taxable expenditures) shall apply as if such trust were a private foundation. This paragraph shall not apply with respect to—

(A) any amount payable under the terms of such trust to income beneficiaries, unless a deduction was allowed under section 170(f)(2)(B), 2055(e)(2)(B), or 2522(c)(2)(B),

(B) any amounts in trust other than amounts for which a deduction was allowed under section 170, 545(b)(2), 556(b)(2), 642(c), 2055, 2106(a)(2), or 2522, if such other amounts are segregated from amounts for which no deduction was allowable, or

(C) any amounts transferred in trust before May 27, 1969.

when financial problems are accentuated, should be simple and clear, so that tax minimization may not only be achieved, but achieved with assurance and without the need for the added expense and harassment of litigation. It is hoped that the suggestions made in this article may be of some service in achieving greater clarification and more equitable application of the federal income tax laws.



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