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SOCIOLOGICAL aspects of the great national increase in the divorce rate have been dealt with in many publications. The economic result to the parties involved in divorce proceedings is of more immediate consequence to the practicing attorney. The following is a guide to some of the economic changes caused the individual involved by virtue of the Federal taxing statutes and their application.[1]

The INTERNAL REVENUE CODE contains three important provisions dealing with alimony and divorce settlements.[2] Section 22 (k) includes in the gross income of the wife separated or divorced under a decree of separation or divorce:

> "periodic payments . . . received subsequent to such decree in discharge of . . . a legal obligation which, because of the marital or family relationship, is imposed upon . . . such husband under such decree or under a written instrument incident to such divorce or separation."[3]

Section 22 (k) also includes such payments attributable to property transferred (in trust or otherwise) in discharge of the legal obligation. It *excludes* from wife's gross income any amount fixed as support for minor children. Further, where the total amount to be paid is a fixed sum,

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1 Even persons in the lower income brackets have tax problems arising out of divorce decrees. An employed husband must file a new withholding exemption certificate within ten days after entry of the decree—Reg. 116 Sec. 405.206 (as amended by T. D. 5492, Jan. 30, 1946). If self-employed, an amended declaration of estimated tax must be made on Form 1040 ES—Reg. III Sec. 29. 58-7 (F); the time of filing varies depending upon which quarter of the fiscal year the decree is entered. If minor children are involved, the exemption goes to the parent contributing the most towards support.

2 I.R.C. Sections 22 (k), 23 (u), and 171.

3 I.R.C. 22 (k); Reg. III Sec. 29.22 (k)-1.

installment payments of this sum are considered "periodic payments" and includible in the wife's income *only if* the total amount may be paid over a period of ten years or more, and then only, in any one year, to the extent of 10% of the principal sum.[4]

The other side of the coin is section 23 (u), which allows the husband to deduct from his gross income:

" . . . amounts includible under section 22 (k) in the gross income of his wife, payment of which is made within the husband's taxable year."[5]

There have been sufficient decisions under these sections to allow some positive interpretation:

First, there must be a decree of support or legal separation. Payments under a voluntary separation agreement are not covered.[6] Payments made under an order of separate maintenance, or under an annulment decree, are not included, where there is no *legal separation.*[7] And where a prior agreement is included in a decree nunc pro tunc to the date of the agreement, the Tax Court has refused to consider payments actually made between the date of the agreement and date of entry of the decree as being covered by these sections.[8] It is clear that this part of section 22 (k) has been rigidly interpreted.

The word "payments" is apparently restricted to a transfer of cash or its equivalent. Where a wife was awarded permanent occupancy of a home, the husband could not deduct the yearly rental value as a "payment."[9]

Where the agreement or decree is indefinite as to the amount allocated to support of children, but it is clear from the terms thereof that payments are intended to cover such support as well as alimony, then the government has to date advanced the position that all is included in the wife's gross income.[10] This, indeed, would seem to follow

[4] *Supra* note 3, as to the date from which 10 years are counted, see Tillie Blum, 10 T. C.—(No. 59).

[5] I.R.C. 23 (u); Reg. III Sec. 29.23 (u-1).

[6] Charles L. Brown, 7 T.C. 715.

[7] Frank J. Kalchthaler, 7 T.C. 625.

[8] Robert L. Daime, 9 T.C.....(No. 4).

[9] Pappenheimer v. Allen, 71 F. Supp. 788 (D.C. Ga., 1947).

[10] Dora H. Moitoret, 7 T.C. 640.

from a literal reading of the statute. However, it is not difficult to imagine the Bureau of Internal Revenue taking a different stand when the government might profit thereby.

The difference between "periodic payments" and "installment payments of a principal sum" has given rise to some litigation. Even though installment payments of a fixed sum cease upon remarriage, a "principal sum" is nevertheless involved and the payments are not deductible.[11] But where the period was fixed at fifty months, and the amount of payment was to be fixed by the husband's annual income, no "principal sum" is involved and payments are deductible by the husband.[12] The logical difficulty in reconciling these two decisions is the fact that in each case the total amount to be paid is dependent upon future events.

Where a divorced wife is paid the income from a trust, whether the trust was established incident to the divorce or not, the income so paid is included in her gross income and *excluded* from the gross income of the husband, even if it would otherwise have been included in his income.[13] The amount so paid is deductible from the gross income of the estate or trust.[14] This allows the estate of a deceased husband to deduct from income the amounts paid a divorced wife under a decree requiring husband or his estate to support the wife for life.[15]

In the unusual event that the wife pays alimony, the above discussion is nevertheless applicable.[16]

It is clear that lump sum payments under a divorce decree are not deductible by the husband or income to the wife.[17] However, such settlements have income tax aspects when payment is in property. If the cost basis of the property to the husband is $10,000 and the decree calls for a $15,000 payment to the wife, the transfer of this property

11 J. B. Steine, 10 T.C.....(No. 52).
12 Roland K. Young, 10 T.C.....(No. 96).
13 I.R.C. 171 (a).
14 I.R.C. 171 (b).
15 Laughlin's Estate v. Comm., 167 F. 2d 828 (C.C.A. 9th 1948).
16 I.R.C. 3797 (a).
17 Gould v. Gould, 245 U. S. 151; Reg. III Sec. 29.22 (k-1).

results in the husband realizing a $5,000 capital gain.[18] Also, if the fair market value at the time of transfer is only $12,000, and the wife later sells it for $12,000, she realizes a $3,000 capital loss since the value the parties ascribe to the property at the time of transfer is governing, not the fair market value.[19]

As important in many cases as the income tax aspect of such lump sum settlements are the unavoidable encounters with the Federal gift tax. Here we also find a realm of real danger to the client. There is no specific gift tax provision in the I. R. C. covering this situation, but the general provisions of the gift tax sections have been applied in many of these situations.[20]

The general rule is that, in order not to constitute a gift, the transfer of property must be for an adequate and full consideration in money or money's worth.[21] In one of the earlier cases, the parties agreed before commencement of divorce proceedings, that H would, after obtaining a divorce, convey certain property to W in complete settlement of marital rights.[22] After procuring a divorce, H conveyed as he had agreed. The government's attempt to claim a gift tax was denied, a full consideration being found.[23]

But because of the repeated attempts of the Bureau to impose a tax on these transfers, and because certain doubts were raised by Supreme Court cases imposing a tax on certain antenuptial transfers,[24] the Estate Tax division tried to clarify the situation by laying down the following rules:

1. Release of support rights may constitute con-

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18 Commissioner v. Halliwell, 131 F. 2d 642 (C.C.A. 2d 1942); Commissioner v. Mesta, 123 F. 2d 986 (C.C.A. 3d 1941).

19 Aleda N. Hall, 9 T.C.....(No. 5).

20 I.R.C. Sections 1000, 1001, 1002, and 1003.

21 I.R.C. 1002.

22 Herbert Jones, 1 T.C. 1207.

23 *See* also to same effect: Clarence B. Mitchell, 6 T.C. 159; Matthew Lahti, 6 T.C 7; Lewis Cass Ledyard, 3d, 1946 Prentice Hall Tax Court Memo Decisions, No. 46071.

24 Commissioner v. Wemyss, 324 U. S. 303.

sideration in money or money's worth.

2. Bureau will determine the reasonable value of support and maintenance rights, and only the excess will be taxed.

3. Release of dower or inheritance rights is not consideration in money or money's worth.

4. The Bureau will make a reasonable allocation in the absence of such an allocation by the parties.

5. Payment by the husband of wife's counsel fees is not a gift to extent that husband is under obligation.[25]

One more attack by the government, following this statement of position, was attempted when an agreement of settlement prior to the divorce was approved and incorporated in the decree. Under the agreement, the husband transferred $586,000. The Commissioner of Internal Revenue, using life expectancy tables, claimed that the true value of support rights was only $306,630, and that the excess constituted a gift. This position was rejected.[26]

One recent decision, however, appears to hold that a lump sum settlement agreement subsequently adopted and ratified by a divorce decree may nevertheless be taxable as a gift if the agreement does not specifically state it is *in* release of "support" rights.[27] This may prove a future pitfall for the unwary.

In any case involving lump sum settlements, the above principles announced by the Estate Tax division should be carefully considered.

The problem of estate taxes must be considered where the estate of the husband is by the terms of the decree liable for continued support of the wife. If the personal representative, wishing to close the estate, settles all future claims with the wife, he may, under I. R. C. 812 (b) deduct from the gross estate the commuted value of future payments as

[24] Commissioner v. Wemyss, 324 U. S. 303; Merrill v. Fahs, 324 U. S. 308.

[25] E.T. 19; 1946—16—12367.

[26] Estate of Frank W. Gould, 1947 Prentice Hall Tax Court Memo Decisions No. 47,176.

[27] Clarissa H. Thompson, 1947, Prentice Hall Tax Court Memo Decisions No. 47,194.

determined by the Commissioner.[28] This settlement amount or a formula therefor, should be provided for in the decree, since otherwise the Commissioner's determination of the value of future payments may be less than the wife is willing to settle for, and thus part of the payment will not be deductible.

This guide to the present Federal tax status of alimony decrees and lump sum settlements is of course inapplicable in the event pertinent sections of the Internal Revenue Code are revised.

[28] Commissioner v. Maresi, 156 F. 2d 929 (C.C.A. 2d 1946).