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PUZZLING PROBLEMS IN PROPERTY SETTLEMENTS— THE TAX ANATOMY OF DIVORCE

WM. DOUGLAS KILBOURN, JR.*

I. THE PROBLEMS

A. *Divorce Settlements*

A husband, in order to rid himself of a nagging wife, agrees to transfer to her 1,000 shares of stock worth 101,000 dollars, for which he originally paid 1,000 dollars. A month later, the couple are divorced, and immediately thereafter the ex-husband transfers the stock pursuant to the agreement.¹

How *should* this transaction be treated for federal gift tax and income tax purposes?

It seems obvious in any normal sense that H has not made a gift. The transaction *should* not be subject to the gift tax. Whether it is free from gift tax will be discussed hereafter.

What about the federal income tax? It also seems obvious that H has secured the benefit of the increment in value of 100,000 dollars by using it to acquire his freedom and that this *disposition of property* results in a *realization* of 100,000 dollars of income which *should* be subject to the federal income tax. Whether this disposition does result in a realization of income, and whether the realized income, if any, is recognized and can be calculated for federal income tax purposes, will also be discussed hereafter.

Does the receipt by the ex-wife of 101,000 dollars worth of stock result in income to her?

In determining whether W realized income when she received the stock, is it relevant that she was twenty-three years old when she married H, that he was eighty at the time, that she was an extremely attractive 100-dollar-a-night call girl prior to the marriage, that the marriage lasted about two months, and that W boasts to all her young and *relatively* poor new "clients" that she married the "old goat" for his money? Is it relevant

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1. The ex-wife and ex-husband will sometimes hereafter be referred to, respectively, as W and H.

that she has married seven men in a row, that none of the marriages lasted more than two months, and that she received a property settlement with respect to each divorce, the amounts ranging from 80,000 dollars to 320,000 dollars?

Let us assume she started with nothing when she was twenty-one years old and is now worth 1,100,000 dollars in cash. Has she amassed this fortune without *ever having had any income* (except for a few thousand dollars from the call girl racket)? Has she not had 1,100,000 dollars of realized income which should have been subjected to the federal income tax when received?

But this is an extreme case. If the marriage has lasted ten years and the spouses are the same age at the time of the divorce, does the ex-wife realize income when *she* receives the 101,000 dollars worth of stock? Does it matter that the couple married for love or that they were very poor for the first seven years of their marriage?

These problems will be explored hereafter.

For the moment, however, and in order to raise a related problem, let us assume that the ex-wife does not realize income when she receives the 101,000 dollars worth of stock. In this case, what basis does she use in determining gain or loss when she later sells the stock?

For example, assume the stock rises in value after she receives it, and she then sells it for 105,000 dollars. Is her taxable gain 4,000 dollars (calculated on a basis of 101,000 dollars, the value of the stock when she received it)? Or is her gain 104,000 dollars (calculated on the basis her ex-husband had, because she acquired the stock by gift)? Or is her gain 105,000 dollars (because the stock she received "cost" her nothing)?

Certainly sufficient problems for the present have been raised. What possible alternative solutions are available?

1. First Possible Solution

1. The transfer by the ex-husband to the ex-wife does not result in a gift subject to the gift tax.
2. The ex-husband realizes 100,000 dollars of income by virtue of the transfer.
3. This income is recognized for federal income tax purposes.
4. The amount of this income can be calculated for federal income tax purposes, despite the holding of the Court of Claims in the *Davis* case.²

2. *Davis v. United States*, 287 F.2d 168 (Ct. Cl. 1961), *cert. granted*, 368 U.S. 813 (1961). This case was argued March 28, 1962. The problem it presents is analyzed in detail in part IV of this article, *infra*.

5. The ex-wife realizes income at the time she receives the stock in an amount equal to its then fair market value.

6. The ex-wife's basis for the purpose of computing her gain or loss on a subsequent sale of the stock is its fair market value on the date she receives it.

2. Second Possible Solution

In this solution, as in the first one, there is no gift for gift tax purposes, and H is taxed on 100,000 dollars of gain. However, it differs from the first one in that:

1. The delivery to the ex-wife of the 101,000 dollars worth of stock does not result in a realization of income to her.

2. *Nevertheless, her basis* for computing gain or loss on a subsequent sale of the stock is its *fair market value* on the date she receives it.

Note that although W receives a "stepped-up" basis for the stock, the appreciation of 100,000 dollars in the value of the stock has not escaped the income tax in this solution. It has been taxed to H.

3. Third Possible Solution

1. The transfer is a gift for gift tax purposes and is subject to gift tax.

2. Nevertheless, it is an exchange for income tax purposes, and H realizes 100,000 dollars of taxable income.

3. Despite the "exchange" for income tax purposes, W realizes no taxable income when she receives the stock.

4. Although it is a gift for gift tax purposes, it is not a gift for income tax purposes.³ Therefore, H's 1,000 dollars basis does not carry over to W (as it would on a gift), and her basis is 101,000 dollars.

Note that in this solution, also, the 100,000 dollars appreciation has not escaped the income tax, despite the "stepped-up" basis to W. It has been taxed to H.

4. Fourth Possible Solution

1. The transfer is a gift for gift tax purposes and is subject to the gift tax.

2. Since it is a gift for gift tax purposes, it is also a gift for income tax purposes. Therefore:

(a). H does not realize any taxable income by virtue of the transaction.

3. Cf. *Farid-Es-Sultaneh v. Commissioner*, 160 F.2d 812 (2d Cir. 1947), reversing 6 T.C. 652 (1946).

(b). W, also, realizes no taxable income when the stock is "given" to her.

(c). W's basis in her stock is 1,000 dollars. (H's basis carries over to W, under the income tax rules, by virtue of the "gift.")

Note that W does not obtain a "stepped-up" basis, and therefore the appreciation of 100,000 dollars in the value of the stock has not escaped the income tax in this solution either—at least it does not escape if the stock is still worth at least 101,000 dollars when W later sells it. In effect, the potential taxable income of 100,000 dollars which "accrued" while H held the stock has been shifted to W.

5. Fifth (and worst) Possible Solution

1. The transfer is *not a gift* for gift tax purposes and is not subject to gift tax.

2. Even if there is a realized gain of 100,000 dollars, it cannot be calculated under the present federal income tax rules. Therefore, the 100,000 dollars appreciation in value is not taxed to H as income even though he disposes of the appreciated property by transferring it to W in a negotiated transaction,⁴ which is *not a gift*.

3. W does not realize any taxable income on the receipt of the 101,000 dollars worth of stock.

4. Since there is no gift, either for income tax or gift tax purposes, W obtains a stepped-up basis, namely 101,000 dollars.⁵

Note that the 100,000 dollars appreciation in value of the stock has *escaped the income tax entirely* in this solution.

Before analyzing the suggested possible solutions in detail, it seems appropriate to mention some problems which arise in a related situation—transfers of property to a future spouse pursuant to an antenuptial contract.

B. Marriage Settlements

Under an antenuptial contract, or marriage settlement, the woman may receive valuable property from the man prior to the marriage in exchange for her relinquishment of "all dower and other marital rights, including the right to her support to which she otherwise would have been entitled as a matter of law when she became his wife."⁶

4. Davis v. United States, *supra* note 2.

5. Whether or not her basis is really \$101,000 under this solution is a problem which will be discussed in detail later. See part V, *infra*.

6. Quoted from Farid-Es-Sultaneh v. Commissioner, *supra* note 3, at 813.

Is this transfer a gift for gift tax purposes? Is it a gift to the future wife for income tax purposes and non-taxable, or is it a taxable exchange resulting in income to her upon receipt? And, if the property transferred has appreciated in value, does the transfer generate taxable income to the transferor? What is the transferee's basis in the property for the purpose of computing gain or loss on its later sale?

The solution to these problems will be discussed in part II, sections A and C, below. However, as an anchor in this sea of confusion, the general rules with respect to antenuptial agreements are:

1. Antenuptial settlements are gifts subject to the gift tax.⁷

2. "An amount of principal paid under a marriage settlement is a gift"⁸ for income tax purposes and is not includible in the income of the future wife, nor does the transfer generate taxable income to the future husband even though he transfers appreciated property.

3. Nevertheless, the basis of the property to the future wife is fair market value on the date she receives it, even though this far exceeds the transferor's basis in the property.⁹

Note that these "general rules" permit a complete escape from income taxation for any appreciation in value of the husband's property prior to its transfer to the wife.

So much for the general presentation of the problems. Let us now analyze them in detail, using the "First Possible Solution" as a point of reference.

II. PROPERTY SETTLEMENTS AND THE GIFT TAX

A. *Marriage Settlements Not Involving Release of Support Rights*

In order to place the problem of gift taxation of *divorce settlements* in proper perspective, it is necessary first to analyze the principles applicable to antenuptial or *marriage settlements*.

If the future wife does not release any marital or support rights, and the transfer of the property by the future husband prior to the marriage is in exchange solely for the agreement of the woman to marry him, the trans-

7. *Commissioner v. Wemyss*, 324 U.S. 303 (1945); *Merrill v. Fahs*, 324 U.S. 308 (1945).

8. *Treas. Reg. § 1.102-1(a)* (1956).

9. As we shall see, this is probably not the general rule for *marriage settlement* transfers, but at least it was held to be the rule in *Farid-Es-Sultaneh v. Commissioner*, *supra* note 3, Judge Clark dissenting.

fer clearly should be subjected to the gift tax, and the Supreme Court has so decided.¹⁰

Moreover, if the marriage settlement is in exchange for the future wife's relinquishment of all dower and other marital rights, except *support*, it again seems appropriate to subject the transfer to the gift tax, and the Supreme Court so held in *Merrill v. Fahs*,¹¹ but with four dissents.

In the first case, simply a transfer to a fiancée, which may be an inducement to marriage, it seems inappropriate for the tax collector to snoop into causes. This is a delicate area; and in the simple antenuptial transfer not involving the release of any rights, it would be inappropriate to have the gift tax hinge on the question whether the wife married the husband in exchange for his payment to her of a sizeable sum of money. We assume that the couple is happily married, and it would be absurd to hold that there would be no gift tax if the wife would swear she was paid to marry and would not have married but for the transfer.

Moreover, in common parlance, when a fiancé simply transfers property to his fiancée, even as an inducement to marriage, he has made a gift, and it ought to be a gift for both gift tax and income tax purposes. In addition, of course, pre-nuptial transfers must normally be subjected to the gift tax in order for that tax to fulfill its function as a bulwark for the estate tax.

In the second case, involving the transfer in exchange for the release by the fiancée of dower and other marital rights, *except support*, the dissenters in *Merrill* felt there had been an *exchange, not a gift*. They thought Mr. Merrill had received adequate and full consideration in money or money's worth for his transfer.

In considering the dissenters' argument, let us suppose that the property transferred had appreciated in value during Mr. Merrill's ownership from 100,000 dollars (its cost to him) to 300,000 dollars (its fair market value on the date of transfer).

In an economic sense this increase in value is income, but it will be subjected to the income tax only when it is realized. Realization is simply an event which triggers past appreciation in value (economic income) into the income tax return as taxable income.¹²

10. *Commissioner v. Wemyss*, *supra* note 7.

11: *Merrill v. Fahs*, *supra* note 7, Chief Justice Stone and Justices Douglas, Reed and Roberts dissenting.

12. Surrey, *The Supreme Court and the Federal Income Tax: Some Implications of the Recent Decisions*, 35 ILL. L. REV. 779, 783-84 (1941). This portion of the article is reprinted in SURREY & WARREN, FEDERAL INCOME TAXATION 1517-18

Under the dissenters' view of the transaction, would Mr. Merrill's exchange of the property for release of survivorship rights be such an event?

In my opinion, if the dissenters' view were controlling, the transfer would be a realizing event for income tax purposes. Mr. Merrill would thus realize 200,000 dollars of taxable income at the instant of transfer.

His fiancée, also, has entered into an exchange under the minority opinion. In line with that opinion, her taxable gain would be 300,000 dollars—the value of the property received (300,000 dollars) less her cost basis in the property given up, which is presumably zero; and her basis in the property received would be 300,000 dollars.

Such results in connection with *marriage settlements* seem absurd, and yet they appear to follow inevitably from the minority reasoning. To state them is to show the soundness of the majority opinion holding that there was a gift at the time of the marriage settlement transfer—not an exchange involving adequate consideration. The Court construed the estate and gift tax statutes in *pari materia*, specifically holding that the release of survivorship rights was not adequate consideration in money or money's worth.

To hold otherwise would have opened the door to escape from both the estate tax and the gift tax. These are transfers normally designed to take the place of death transfers and accordingly should be subjected to the gift tax.¹³

These transfers should also be held to be *gifts* for income tax purposes. That is, the release of survivorship rights in a *marriage settlement* should not be held to be an exchange involving an adequate consideration in money or money's worth. And this should be true even if an old grandfather and a young showgirl are involved. Here, again, it seems inappropriate to inquire into the real motivating causes of the marriage.

If this view is correct, it follows that Mr. Merrill realized no income at the time of the transfer and that his fiancée realized no income on the receipt of the property. Why? Because Mr. Merrill made a *gift* for income tax purposes (not a realizing event); and his fiancée has received a *gift* for income tax purposes, which is excluded from taxable income.¹⁴ More-

(1960). (Since 1952, the *Illinois Law Review* has been entitled *Northwestern University Law Review*.)

13. In a divorce settlement, the reverse should be true. See note 16 *infra*.

14. INT. REV. CODE OF 1954, § 102(a). All section references hereafter in text or footnote will be to the Internal Revenue Code of 1954 unless otherwise stated.

over, her basis in the property received is the same as the donor's, because on a *gift* the donor's basis carries over to the donee.¹⁵

This concludes the analysis of the gift tax as it relates to marriage settlements not involving release of support rights. Marriage settlements involving release of such rights will be discussed in section C, below, immediately following the material on the gift taxation of divorce settlements. Before proceeding to that subject, however, one generalization appears to be in order. As a rule of thumb, and with some exceptions in the divorce area, a transfer that is a gift for gift tax purposes should be treated as a gift for income tax purposes (both for income exclusion purposes and basis carryover purposes); and *whenever possible* a transfer that is an exchange for income tax purposes should not be treated as a gift for gift tax purposes. By and large, fortunately, the courts seem to strain toward constructions which tend to achieve such consistent treatment.¹⁶

B. Divorce Settlements

Divorce property settlements are usually hard-bargained-for exchanges, not gifts; they are not transfers normally designed to take the place of death transfers; and they should *not* be subjected to the gift tax.¹⁷ Nevertheless,

15. § 1015(a). *But see* Farid-Es-Sutaneh v. Commissioner, *supra* note 3. In this case, however, the fiancée agreed to give up her right to *support* as well as dower and other marital rights. Nevertheless, no particular stress was placed on this fact in the opinion. See the detailed discussion of this case in part II, Section C, *infra*.

16. See, for example, Harris v. Commissioner, 340 U.S. 106 (1950), appropriately holding a negotiated and complex property settlement exchange in connection with a divorce *not* subject to the gift tax under a construction necessarily so strained that it generated four dissenters. When the case was in the court of appeals, Learned Hand, although admitting that the payments involved were *not gifts at all*, had felt constrained to hold them subject to the gift tax under the code. Harris v. Commissioner, 178 F.2d 861 (2d Cir. 1949). See also, McMurtry v. Commissioner, 203 F.2d 659 (1st Cir. 1953), giving the Harris case (already rather broad) a very broad interpretation, and stating as a general point of view:

Property settlements in contemplation of *divorce* lack the familiar characteristics of a gift. They are usually the product of *arm's-length bargaining negotiations between the parties . . .* The motive of such transfers is certainly not to deplete the estate *inter vivos*, so as to escape ultimate estate taxes upon death. *The basic purpose of the gift tax is not served by taxing transfers of this nature.*

203 F.2d at 662. (Emphasis added.) Such excellent decisions leave the courts free to decide income tax applicability in divorce settlement cases: (1) without concern whether the transfer involved is also going to be subject to the gift tax, and (2) without having to feel that a transfer which should be subject to the income tax ought to be held a gift and free of income tax because it is a *gift* for gift tax purposes.

17. See note 16 *supra*. And see the majority Tax Court opinion in Edmund C. Converse, 5 T.C. 1014 (1945), holding a divorce settlement transfer not taxable as a gift, distinguishing the *Wemyss* and *Merrill* cases as *antenuptial agreement*

the 1939 Internal Revenue Code *seemed* to make them taxable as gifts under the gift tax.

1. Pre-1955 Transfers

The 1939 Internal Revenue Code estate and gift tax provisions, when read together, provided generally:¹⁸

(1) Property transferred pursuant to a promise or agreement for less than an adequate and full consideration "in money or money's worth" shall *constitute a gift* in the amount by which the value of the property transferred exceeds the value of the consideration.

(2) A relinquishment of dower (or its statutory substitute) or of *other marital rights* in the spouse's *property or estate* is not a consideration in "money or money's worth" for the purpose of the above rule.

Thus, any transfers made under divorce property settlement agreements in exchange for the release of marital rights appeared, at first blush, to be taxable gifts. Nevertheless, frequently, if not generally, such transfers were held to escape the tax.

How was this done?

These settlements usually involve two (and sometimes three) elements: (1) transfers made in exchange for the release of the obligation of support; (2) transfers made in exchange for the release of dower and other marital rights in the property of the transferor; and (3) transfers made to induce a divorce.

A transfer made to the spouse in exchange for the relinquishment of the *right to support* clearly constitutes consideration in money or money's worth in common parlance. Thus there is no gift tax payable if the value of the right to support is at least equal to the value of the property transferred,

cases, and citing the *Mesta* case (Commissioner v. Mesta, 123 F.2d 986 (3d Cir. 1941)), which held a divorce settlement transfer a *taxable exchange* under the *income tax*. Did the Tax Court feel that the income tax and the gift tax ought to be construed in *pari materia*? The *Converse* case was affirmed on appeal, though on a different ground. Commissioner v. Converse, 163 F.2d 131 (2d Cir. 1947).

18. Int. Rev. Code of 1939, ch. 3, § 812(b), 53 Stat. 123 (1939); Int. Rev. Code of 1939, ch. 4, § 1002, 53 Stat. 146 (1939). For a detailed discussion of the various provisions under the 1939 Internal Revenue Code, and how they were construed together, see Harris v. Commissioner, *supra*, note 16. The corresponding provisions of the 1954 Code are sections 2512(b), 2043(b), 2053(a)(3) and 2053(c)(1)(A). Section 2516 modifies these rules to some extent with respect to certain divorce property settlements for the calendar year 1955 and years thereafter. § 7851(a)(2)(B).

unless the right to support is a *marital right* in the spouse's *property*.¹⁹ If it is, it cannot constitute consideration in money or money's worth under the gift tax provisions.

Despite the *United States Trust Co.* and *Meyer's Estate* cases²⁰ holding that the right to support is a marital right *in the spouse's property*, the Internal Revenue Service has ruled it is not such a marital right and constitutes consideration in money or money's worth.²¹ Thus, transfers made in exchange for the release of support rights are not taxable gifts, under the Service view, unless the transfer exceeds the reasonable value of the support rights. Transfers in exchange for the release of property or inheritance rights were ruled to be taxable gifts²² since such transfers involved the relinquishment of marital rights in the spouse's property. In order to avoid gift taxes on such transfers, resort to the courts was necessary.

Under the rule that a taxable gift was made if property was transferred pursuant to a promise or agreement for less than an adequate and full consideration in money or money's worth, how could a court preclude the application of the gift tax when the release of property or inheritance rights could not constitute such consideration? Simply by holding that the transfer was *not pursuant to the agreement* but *was pursuant to the divorce decree* which approved it. And this was the ruling in a case involving an agreement made *contingent on divorce*, even though the agreement survived the decree.²³

But what ruling should have been made in a case in which the agreement was to survive but was *not made contingent on divorce*; the divorce decree was obtained in Nevada seven weeks after the agreement; the transfers were made one week *after* the decree; and the decree simply recited its approval of the agreement? On these facts the court ruled that the transfers were founded on the decree, not on the promise or agreement, and consequently were not taxable gifts.²⁴

19. See *Helvering v. United States Trust Co.*, 111 F.2d 576, 577 (2d Cir. 1940), *cert. denied*, 311 U.S. 678 (1940): "although the wife's release of her right to alimony . . . was a consideration in 'money or money's worth' . . . it was also a 'relinquishment . . . of . . . marital rights in the . . . [spouse's] property . . .'" In this connection the court cited *Meyer's Estate v. Commissioner*, 110 F.2d 367 (2d Cir. 1940), *cert. denied*, 310 U.S. 651 (1940).

20. *Helvering v. United States Trust Co.*, *supra*; *Meyer's Estate v. Commissioner*, *supra*.

21. E.T. 19, 1946-2 CUM. BULL. 166.

22. E.T. 19, 1946-2 CUM. BULL. 166, *modified with respect to this point*, Rev. Rul. 60-160, 1960-1 CUM. BULL. 374.

23. *Harris v. Commissioner*, *supra* note 16.

24. *McMurtry v. Commissioner*, *supra* note 16.

This obviously strained construction laid the groundwork for a very appropriate decision.

These clearly are bargained-for exchanges and not gifts in any sense, and it is impossible to imagine any legislative intention to tax them as gifts. Moreover, the Revenue Service has adopted the court's viewpoint.²⁵

Accordingly, transfers agreed upon in contemplation of divorce and executed *after approval* by a divorce court *having power* to decree a settlement of all property rights, or to vary the terms of a prior settlement agreement, are, in the Service's view, founded upon the court decree and are not considered to be founded upon a promise or agreement. They are, therefore, not taxable gifts. It is the position of the Service, however, that if the court does not have the *power* to disregard the provisions of a previously existing property settlement agreement, the transfer is founded upon a promise or agreement and is a taxable gift to the extent it exceeds the reasonable value of the support rights of the wife.²⁶ Of course, the same would be true if the court were not asked to and did not approve the agreement, even though it had power to do so.²⁷ And there would no doubt be a taxable gift if the agreed transfer were made prior to the divorce, at least to the extent it exceeded the reasonable value of the support rights.²⁸

The strained construction examined above will not be applied out of context, however. For example, if the divorce settlement agreement provides for a transfer for support of a minor child, it will be subject to the gift tax to the extent it exceeds the amount required for the child's support, even though the agreement is approved by the decree.²⁹

25. See Rev. Rul. 60-160, *supra* note 22.

26. Rev. Rul. 60-160, *supra* note 22, would require this result. But note § 2516 with respect to post-1954 transfers.

27. *Ibid.*

28. See the portion of the opinion in *McMurtry v. Commissioner*, *supra* note 16, at 662-63, 665, dealing with the 1933 transfer to the first wife prior to the 1933 divorce. The court comments in general that it would be "*difficult* to escape the conclusion that such transfers . . . [are] founded upon a promise or agreement. . . ." 203 F.2d at 64. (Emphasis added.) In this connection note, however, the following statement appearing in the Senate Finance Committee Report on the 1954 Code: "Under present law property settlements between spouses are not regarded as taxable gifts if the property settlement is incorporated in the decree of divorce. However, the gift-tax status under present law of settlements *not* incorporated in the decree of divorce is *uncertain*." S. REP. NO. 1622, 83d Cong., 2d Sess. 128 (1954). (Emphasis added.)

29. See *Rosenthal v. Commissioner*, 205 F.2d 505 (2d Cir. 1953).

2. Post-1954 Transfers

In 1954, because of the uncertainty surrounding the gift taxation of property settlement transfers incident to divorce,³⁰ Congress enacted section 2516. It was probably enacted, also, to eliminate traps for the unwary. Prior to the enactment of this section, if a transfer was made before the divorce, or if the parties overlooked having the agreement "approved" in the decree, there were gift tax problems. Since these could be avoided by careful planning, "undue weight was accorded the formalities of the transaction and they, therefore, represented merely a trap for the unwary."³¹

Under section 2516, applicable to transfers made after 1954,³² it does not matter whether the transfer is made before or after the divorce, or whether the agreement is or is not approved by the decree.

All that is required under this section is that the parties enter into a written agreement relative to their marital and property rights and that divorce occur within two years thereafter. Any transfers made pursuant to the agreement in settlement of "*marital or property rights . . . shall be deemed transfers made for a full and adequate consideration in money or money's worth.*"³³ (Emphasis added.)

These italicized phrases require examination.

The phrase "money or money's worth" is extremely interesting. It comports with reality, namely, that these are really exchanges for money's worth and should be taxed as such under the income tax and not as gifts under the gift tax. In other words, this language appropriately characterizes the transaction for both income tax and gift tax purposes, and, in this instance, the two statutes should be construed in *pari materia*.

But what about transfers made pursuant to a divorce settlement agreement which are not governed by section 2516? Should the two statutes then be construed in *pari materia*?

If section 2516 were not applicable, as would be the case if divorce occurred more than two years after the agreement, presumably the rules discussed above in connection with pre-1955 transfers would still apply. In most cases, under those rules, the transfers could be arranged so as to avoid characterization as gifts (under the gift tax) and could be construed, appropriately, as taxable exchanges under the income tax. (This would not be a

30. S. REP. NO. 1622, *supra* note 28, at 481.

31. This statement appears in connection with a corporate income tax trap remedied (?) by § 337. S. REP. NO. 1622, *supra* note 28, at 49.

32. § 7851(a)(2)(B).

33. § 2516.

strictly parallel construction because the transfers, other than for support, have had to be characterized as *made pursuant to the decree* and *not the agreement* in order to avoid the gift tax. They are clearly made pursuant to the agreement for income tax purposes, and not the decree.)³⁴

If the transfers which are made in exchange for the release of dower or inheritance rights are made carelessly in a way which does not avoid their characterization as gifts under the gift tax,³⁵ then the gift tax and income tax statutes are simply *not coordinated* with respect to these transfers, and they cannot be construed in *pari materia*. The transaction constitutes an *exchange* under the income tax even though it is, at the same time, a "gift" under the gift tax.

Of course, this unfortunate situation is usually obviated by section 2516 which, when applicable, prohibits gift tax treatment with respect to divorce when transfers are made in settlement of "marital or property rights." This is the other italicized phrase to be examined. It becomes more meaningful when compared with the related language appearing in two other sections: (1) "relinquishment of . . . marital rights in the [spouse's] property" in section 2043(b), an estate (and gift) tax section; and (2) "payments [required] because of the marital or family relationship" in section 71(a) (1), an income tax section relating to divorce.

As we have seen,³⁶ the phrase "marital rights in the [spouse's] property" has been construed to refer only to property (or inheritance) rights, not support rights. Support rights, arguably, are not *rights* in the spouse's *property*.³⁷ However, the phrase "marital or property rights" appearing in section 2516 clearly includes *support* rights as plain "marital rights"—the words "marital rights" are not here modified by the phrase "in the [spouse's] property." Thus, section 2516, when applicable, eliminates the gift tax on agreed transfers in settlement of both *support rights* and *property (or inheritance) rights* of the spouse.

Section 71, referred to above, relates to the income tax treatment of payments made to the divorced wife "because of the marital or family relationship." This language has been interpreted to make taxable to the di-

34. In this connection, see *Commissioner v. Halliwell*, 131 F.2d 642 (2d Cir. 1942), *cert. denied*, 319 U.S. 741 (1943).

35. *E.g.*, divorce occurs more than two years after the agreement and (1) the transfers are made before the divorce, or (2) they are made after the divorce, but "approval" in the decree is neither requested nor obtained.

36. See the text at note 21 *supra*.

37. See Learned Hand's dissent in *Meyer's Estate v. Commissioner*, *supra* note 19, at 369, adopted by E.T. 19, 1946-2 CUM. BULL. 166.

forced wife only payments made "in recognition of the general obligation to support."³⁸ It apparently does not include payments made because of inheritance or property rights.

Two gift tax problems remain for our consideration.

First, what is the gift tax treatment of a transfer made by a husband to *induce a divorce*? (Such a transfer may be made in addition to transfers in settlement of support and property rights.) Second, what is the correct gift tax treatment of *marriage settlements* (antenuptial transfers) involving the *release of support rights*?

The first problem may be of only theoretical significance. A transfer made to induce a divorce is not specifically covered by section 2516 and probably would be governed by the general rules discussed in connection with pre-1955 transfers.

Under these rules, to the extent a transfer does not exceed the reasonable value of support rights, it is not a gift.³⁹ That portion of the transfer allocable to the release of property or inheritance rights is a gift.⁴⁰ The portion of the transfer which pays the wife to give the husband a divorce may be treated as a transfer "allocable to the release of property or inheritance rights," but it is pretty clearly something else. Indeed, it may far exceed in value any dower or other property or inheritance rights the wife might have if she did remain married until her spouse died. The wife is being paid to do whatever is necessary to reach the desired result—which may be positive action on her part or simply an agreement not to contest the divorce.

Such a transfer certainly ought not to be treated as a *gift* from the ex-husband to the ex-wife! (As a matter of fact, it should be treated as *taxable income* to the ex-wife—either on the theory that it is payment for positive action taken or on the same theory that makes covenant-not-to-compete payments taxable as ordinary income. And, if appreciated property is transferred by H to induce a divorce, he should realize income by virtue of the transfer.)

In any event, it would appear that such a payment would not be a gift for gift tax purposes. If it is not made for the release of marital rights in H's property, there is adequate consideration. And even if the portion of the transfer made to induce the divorce were treated as "allocable to the release of property or inheritance rights," it would, presumably, escape the

38. Treas. Reg. § 1.71-1(b)(4) (1957).

39. E.T. 19, 1946-2 CUM. BULL. 166.

40. *Ibid.*

gift tax, for it would then fall under either section 2516 or the general rules. As to the latter, it is presumed the proper precautions have been taken, namely, "approval" by the decree and transfer thereafter.

C. *Marriage Settlements Involving Release of Support Rights*

The second problem raised above—gift taxation of *marriage settlements* involving the release of *support rights*—is somewhat troublesome. As we have seen, the release of support rights is adequate consideration in money or money's worth for gift tax purposes in connection with *divorce settlements*. Should this also be true for *marriage settlements*? If so, a man can transfer a substantial amount of money to his prospective bride free of gift tax. Nevertheless, during the marriage, he will probably continue to support her, so that the transfer is not in reality in lieu of support. Indeed, it may in fact become a payment in lieu of support rights only in the event of divorce.

For these reasons, and for others set forth below, it would seem inappropriate to treat the release of support rights as consideration in money's worth in connection with antenuptial settlements.

If such a release is not treated as consideration, a simple, practical, easily administered rule should apply: an antenuptial transfer is a gift, both for gift tax and income tax purposes, even if a portion of the transfer is *made in exchange for the release of support rights*.

This rule would result in a gift tax on the transfer. Moreover, the appreciation in value of the property would not escape the income tax. The future wife would bear it, eventually, by virtue of the basis carry-over mechanism. How do these results compare with a divorce transfer? On such a transfer there would normally be no gift tax, and the income tax on the appreciation in value would be borne by the husband at the time of the transfer unless the Supreme Court holds in the *Davis* case that the income cannot be calculated; in which case, as we shall see, it would probably escape the income tax altogether.

So far, then, the proposed rule seems eminently fair and sensible, but let us explore a bit further.

In both the divorce and antenuptial situations, on (1) a lump sum transfer or (2) a transfer of property made all at once and not over a period of time, the wife would not realize income on receipt of the property. This would be true even though the transfer were made for the release of both inheritance *and* support rights. Whether W should realize income on receipt of the portion of the property transferred to her in a *divorce settlement*

in exchange for her release of *dower* and *other property (or inheritance) rights*, will be discussed in part VI, below. But even if that discussion indicates she ought to realize income, that result ought not to have any effect on the proposed rule for *marriage settlement* transfers.

Indeed, according to the Revenue Service, *marriage settlement* payments to be made at the rate of 200 dollars a month for the future wife's life do not become income to the wife when made after an eventual divorce but pursuant to the antenuptial agreement, even though they are paid for support and even though they would, therefore, be income to W if paid under a *divorce settlement agreement*.⁴¹ As a matter of fact, the regulations cited take the position that the payments will become income to W if the antenuptial agreement is referred to in a written instrument incident to the divorce status or is referred to in the divorce decree. They then become *divorce* payments and are accorded different *income tax treatment* than *antenuptial* payments.

In short, the proposed rule seems quite proper and appears to receive support from the regulations.

If the alternative rule is chosen; namely, that the portion transferred in exchange for the release of support rights is not a gift because the release is a money's worth consideration, then we immediately run into difficulties.

First, we must allocate a portion of the antenuptial transfer to the release of support rights, a difficult task at best. This portion is not a gift for gift tax purposes—it is an exchange. Is it also an exchange for income tax purposes? If so, it is arguable that the fiancée has income in an amount equal to the portion allocated to release of support rights; and that the fiancé has income if he transfers appreciated property in exchange for such release. These results seem inappropriate in connection with *marriage settlements*.

Second, if under state law the purported release does not relieve the husband of support obligations during marriage, even though effective in event of divorce, the portion of the transfer allocable to the "release" of support rights during marriage would not be based on a consideration in money or money's worth and would be a gift. Only that portion of the transfer allocable to release of support rights after an ensuing divorce would be made for a money's worth consideration. Moreover, to find the portion which would not be a gift would entail a prediction, at the time of the marriage, of the expected duration of the marriage. A short marriage prediction

41. Treas. Reg. § 1.71-1(b)(6)(example 2) (1957).

would result in a smaller gift tax, a long marriage prediction in a larger gift tax, and a marriage until death prediction in a gift tax on the entire antenuptial transfer. As a practical matter, because of lack of proof of value, the entire transfer would probably be subjected to the gift tax in such a state. Of course, if the release of support rights during marriage were valid under state law and the husband actually had no obligation of support to the wife while married, the portion of the transfer allocable to the release of support rights would be based on an adequate consideration in money or money's worth and would not be a gift under the gift tax. In that event, what if the husband actually paid for the support of the wife during marriage? It would seem to follow that every dime paid would constitute a gift under the gift tax.⁴²

The chaotic results are obvious—both from the taxpayer's and the government's point of view.

In short, it seems more appropriate simply to treat the entire antenuptial transfer as a gift, for both gift tax and income tax purposes, even though a portion of the transfer is made in exchange for the release of support rights.

This was the precise issue decided by the Tax Court in *Doris Farid-Es-Sultaneh*,⁴³ a case involving a pre-nuptial transfer of appreciated securities by the future husband and the release of all dower and other marital rights, including the right to support, by the future wife.

The Tax Court held that this type of transfer was a gift under the gift tax and, therefore, was a gift under the income tax for the purpose of determining the transferee's basis, with the result that the donor's low tax basis carried over to the donee.

Moreover, it would follow from the Tax Court's holding that no portion of the transfer would be included in the future wife's income upon receipt—not even the portion transferred in exchange for the release of her support rights.

This position appears to have support in the regulations under section 102, an income tax exclusion section. The regulations provide, "an amount of principal paid under a marriage settlement is a gift," and "property received as a gift . . . is not includible in gross income . . ."⁴⁴

42. Of course the \$3,000 exclusion and gift tax marital deduction would normally be available. §§ 2503(b) and 2523.

43. 6 T.C. 652 (1946), *reversed*, 160 F.2d 812 (2d Cir. 1947).

44. Treas. Reg. § 1.102-1(a) (1956). See also Treas. Reg. § 1.71-1(b)(6) (example 2) (1957).

The 1947 opinion of the Second Circuit,⁴⁵ Chase, C. J., reversing the Tax Court in *Farid-Es-Sultaneh* is not particularly helpful on the gift tax point. It assumed that the marriage settlement transfer would be a gift for gift tax purposes (even though it involved the release of support rights), but this was in a circuit which had held seven years earlier, Chase, C. J., that the right to support was a marital right *in the spouse's property*.⁴⁶ As such, of course, it could not constitute consideration in money's worth under the gift tax.

With respect to the *Farid-Es-Sultaneh* income tax point, the Second Circuit simply stated, "the income tax provisions are not to be construed as though they were in *pari materia* with either the estate tax law or the gift tax statutes."⁴⁷ It then held that the consideration the future wife gave ("her promise to marry him coupled with her promise to relinquish all rights in and to his property which she would otherwise acquire by the marriage")⁴⁸ was a fair consideration which prevented her from taking the shares as a gift under the income tax law. Thus, the "donor's" low basis did not carry over to the "donee," and the appreciation in value of the securities which had occurred while the "donor" held them forever escaped the income tax.

It is important to note that no special stress was laid on the release of support rights. The decision that the transfer was not a gift for income tax basis carry-over purposes would apparently have been the same if *only* dower and other inheritance rights had been released.

Certainly the word "gift" appearing in the *income tax statute* should be given the same meaning in both the basis carry-over section⁴⁹ and the income-exclusion section.⁵⁰

In this connection, the Tax Court stated in *Marshman*,⁵¹ a divorce case involving an antenuptial transfer: "We can think of no reason why what is a gift under the income-exclusion section should not be considered a gift under the capital gains provision."

In *Farid-Es-Sultaneh*, the Second Circuit held that the antenuptial transfer was *not a gift* under the basis carry-over provision. Would it then

45. *Farid-Es-Sultaneh v. Commissioner*, 160 F.2d 812 (2d Cir. 1947).

46. *Meyer's Estate v. Commissioner*, *supra* note 19.

47. 160 F.2d at 814-15.

48. *Id.* at 815.

49. § 1015(a).

50. § 102.

51. *Homer H. Marshman*, 31 T.C. 269 (1958) (holding that the basis *did* carry over in an antenuptial transfer), *reversed on another point*, 279 F.2d 27 (6th Cir. 1960), *cert. denied*, 364 U.S. 918 (1960).

hold, if the issue were presented, that the *transfer* was *not* a *gift* under the income-exclusion section and thus *constituted gross income* to the future wife upon receipt (or at least, gross income to the extent of the excess of the value of what she received over the basis, if any, of what she gave up)?

Or would it hold that the antenuptial transfer was a *gift* under the income-exclusion section and, therefore, was not subject to the income tax on receipt? One would hope it would do the latter and overrule the *Farid-Es-Sultaneh* case, with respect to *marriage settlements*, even though the ruling in that case is probably perfectly appropriate with respect to divorce settlements.

In at least two cases, the courts have simply, and rightly, refused to follow the Second Circuit.⁵² In *Dunn*, the court stated:

However, while it may be true that [the estate and gift tax] statutes are not strictly in pari materia with the Income Tax Law, all are part of a revenue code and it is certainly desirable that a term of such frequent occurrence in ordinary affairs of life as "gift" should mean the same thing for all tax purposes. To give it one meaning for estate and gift taxes and a contrary meaning for income tax simply complicates the taxpayer's problem—a result which should be avoided unless the intention of Congress is unmistakable.⁵³ (Emphasis added.)

III. REALIZATION OF INCOME BY TRANSFEROR IN DIVORCE SETTLEMENT

In order to analyze properly the question whether a transferor of property in a divorce settlement realizes income, it is essential to state two general principles. These principles will also be helpful in solving the problem of the property's basis to the transferee.

A. *First General Principle*

As mentioned earlier, the increase in value of property is income in an economic sense.⁵⁴ Therefore, to measure one's income during a certain period of time with respect to a particular piece of property, it is necessary to know the value of the property at the *beginning* and *end* of the period.

52. *Dunn v. United States*, 86 F. Supp. 861 (E.D. Pa. 1949); *Alice M. Townsend*, 12 T.C. 692 (1949), *aff'd per curiam*, 181 F.2d 502 (6th Cir. 1950). The Tax Court opinion in *Townsend* was written by Murdock, J., who had written the Tax Court opinion in *Farid-Es-Sultaneh*.

53. 86 F. Supp. at 862.

54. *Surrey*, *supra* note 12, at 783-84.

For example, we have certain property on January 1, 1960, and its value is 500 dollars. Two years later, on January 1, 1962, its value is 600 dollars. During the two-year period we have economic income of 100 dollars—the appreciation in value of the property during this period.

If we wished to know the economic income of the owner with respect to the property for the year 1961 only, we would have to know the value of the property on January 1, 1961. If it were 525 dollars, the owner's economic income for 1961 would be 75 dollars. His economic income for 1960 would, of course, be 25 dollars.

B. *Second General Principle*

This *economic income* does not become *taxable income* until a realizing event occurs. The event may not appear to be a very significant one, and yet it may be sufficient to trigger the economic income of the past into the income tax return of the current year—in short, to constitute a *realization* of the economic gain.⁵⁵

In the example given above, if the owner sold the property on January 2, 1962, for 600 dollars in cash, he would realize on that date the 100 dollars of economic income which had accrued to him over the past two years, and he would be required to include the 100 dollars in his income tax return for the year 1962.

C. *Application of the First General Principle*

The first general principle was applied very early in the administration of our tax laws—both by the Treasury Department⁵⁶ and by the courts.⁵⁷

As the Corporation Excise Tax Act of 1909 and the Income Tax Act of 1913 were construed, economic income realized within the year was subject to the tax whether it had accrued within the year of realization or in some preceding year; but all economic income that had accrued prior to the effective date of the act, even though realized while the act was in effect, was excluded.⁵⁸

55. *Ibid.*

56. See Treas. Regs. No. 31, issued December 3, 1909, extracted in *Doyle v. Mitchell Bros. Co.*, 247 U.S. 179, 186 n.1 (1918).

57. See Reiling, *Guarding Against Disposition for Tax Avoidance*, 38 TAXES 763, 765 (1960).

58. *Doyle v. Mitchell Bros. Co.*, *supra* note 56; *Hays v. Gauley Mountain Coal Co.*, 247 U.S. 189 (1918); *Lynch v. Turrish*, 247 U.S. 221 (1918); *Southern Pac. Co. v. Lowe*, 247 U.S. 330 (1918). For a helpful analysis of these cases, see *Merchant's Loan & Trust Co. v. Smietanka*, 255 U.S. 509 (1921).

For example, assume that property was purchased in 1903 for 1,000 dollars and that it was worth 3,000 dollars on March 1, 1913 (the effective date of the Income Tax Act of 1913). Further assume that it continued to appreciate in value until July, 1915, when it was sold for 7,000 dollars cash. Although the seller *realized* income of 6,000 dollars upon the sale, 2,000 dollars of this represented economic income that had accrued prior to the effective date of the act and would have been excluded from his taxable income under the court decisions. Only 4,000 dollars (the increase in value from March 1, 1913, until July, 1915) would have been includible in the seller's 1915 taxable income.⁵⁹

It is particularly worthy of note that the courts arrived at these results by judicial decision in the course of construing the word "income" in the 1909 and 1913 Acts⁶⁰ and not by virtue of any specific provisions on the matter.

Indeed, the relevant portions of the Income Tax Act of 1913 simply taxed gains, profits and income derived from sales or dealings in property, and gains or profits and income derived from any source whatever, including the income from, but not the value of, property acquired by gift.⁶¹ No method of calculating the income from sales or dealings in property was established.

It was not until the enactment of Section 2(c) of the Revenue Act of 1916 that any statutory provision was made with respect to the basis to be used in determining the gain derived from "the sale or other disposition of property"—and then only with respect to "property . . . acquired before March 1, 1913." For such property the statutory basis appropriately provided was fair market value on March 1, 1913.⁶²

It seems appropriate at this point to review the facts and holding in *Rice v. Eisner*⁶³ before proceeding to the specific problem of realization of income in connection with divorce settlements.

59. This same device of attributing a portion of realized income to the prior period when it actually accrued economically, has been applied in other situations. Reiling, *supra* note 57, at 765, stresses the fact that in applying the World War II and the Korean War excess profits taxes, we attributed "to the years prior to the year of sale the appreciation occurring during the prior years."

60. Ch. 6, § 38, 36 Stat. 112 (1909); ch. 16, § 2, 38 Stat. 166 (1913); and cases cited note 58 *supra*.

61. *Rice v. Eisner*, 16 F.2d 358, 359 (2d Cir. 1926), *cert. denied*, 273 U.S. 764 (1927).

62. SEIDMAN, LEGISLATIVE HISTORY OF FEDERAL INCOME TAX LAWS: 1938-1861, at 957-59 (1938).

63. *Supra* note 61.

On October 10, 1914, the taxpayer received certain securities as a gift from her husband. The securities thereafter appreciated in value, and the taxpayer sold them in the summer of 1915. She was assessed an additional income tax of over 250,000 dollars, based on the difference between the value of the shares on October 10, 1914, and the amount she received on their sale in 1915.

The taxpayer clearly had *economic income* with respect to the property *because of its appreciation in value* during her ownership. When she sold the property, this appreciation in value was *realized*. It was clear that this amount was a gain derived from a sale of personal property within the meaning of the 1913 Act, but the question presented was whether that act taxed such gains when they were derived from sales of personal property *acquired by gift*. The court, Hand, C. J., held the appreciation in value from October 10, 1914, to the date of sale subject to tax under the 1913 Act, using language which is very illuminating:

[After 1915, the year in issue, the revenue laws] provided that the gain derived from the sale of the property acquired before March 1, 1913, *should be taken as its appreciation since that day . . .* Until 1921 nothing specific was said about computing the gain on gifts and bequests, but by section 202 (a) (2) of the Act of November 23 of that year (Comp. St. § 6336 1/8bb), it was provided that, when gifts were made before January 1, 1921, their value should be taken as of the time of their acquisition, and thereafter at the time when the donor acquired the property. The argument is that then for the first time did Congress mean to tax the profit on gifts at all, since only then did it provide a means for computing it. If so, *Congress did not mean to tax the appreciation of purchased property between 1913 and 1916, because only in 1916 was any rule laid down which professed to cover it, and then only in a form equally applicable to gifts and bequests. The argument proves too much.*

The act of 1921 was apparently passed for quite another reason; that is, in the future to prevent donors from escaping the high taxes prevailing by giving property to their wives or children. *As the latter would be allowed on any subsequent sales to subtract the value of the gift when they received it, and as a gift was not a sale as regards the donors, all increment escaped taxation which had accrued during the ownership of the donors. As to earlier gifts the rule remained as it had been in practice applied before the act of 1921 was passed. From this no inference can be made that, before the statute fixed the rule, gifts were not to be taxed at all, but rather that the computation of profits upon gifts had been left to the*

regulation of the department, *as it had certainly been on purchases for the first three years.*⁶⁴ (Emphasis added.)

D. *Application of the Second General Principle*

So much for the basic framework. The problem of realization of income by a transferor of property in a divorce settlement will now be analyzed.

Assume that a husband owns property which has appreciated in value over the years. He has had income in an economic sense, but this income has not been taxed because it has not been "realized." Assume further that he transfers this property to his ex-wife under a divorce settlement agreement. The question is whether or not the transfer is a *realizing event*.

It is essential to isolate this issue and discuss it separately. After that, we will see whether the *realized* income is *recognized* and whether or not the *amount* of income can be *calculated*. If the transfer is not a realizing event, of course, we do not reach the problems of *recognition* and *calculation*.

Section 61 subjects to the income tax "all income from whatever source derived." This is a broad and sweeping provision. It is the heart of the income tax code and establishes the overriding principle.

In the assumed example above, the economic income accruing to the husband, through appreciation in the value of his property, *is to be taxed to him.*⁶⁵ Taxability is only awaiting a realizing event. If his transfer to his ex-wife is not a realizing event, the *income* which has accrued to him will escape the income tax altogether.⁶⁶

Normally a disposition of property is a realizing event. If I buy an

64. 16 F.2d at 360.

65. Unless, of course, he dies or makes a gift of the property. In the first case, the income escapes the tax altogether. In the second case, it is shifted to the donee by virtue of the basis carry-over provisions.

66. As will be developed more fully in part V, the ex-wife in a *divorce settlement* will obtain a stepped-up basis. *Edna W. Gardner Trust*, 20 T.C. 885 (1953), *acq.*, 1953-2 Cum. BULL. 4; *Aleda N. Hall*, 9 T.C. 53 (1947), *acq.*, 1947-2 Cum. BULL. 2. Cf. *Farid-Es-Sultaneh v. Commissioner*, 160 F.2d 812 (2d Cir. 1947) (an appropriate decision in the divorce area though inappropriate in the antenuptial area); *Philadelphia Park Amusement Co. v. United States*, 126 F. Supp. 184 (Ct. Cl. 1954). *Commissioner v. Marshman*, 279 F.2d 27 (6th Cir. 1960), is not to the contrary. This case involved an antenuptial transfer of stock, and the later release by H, in connection with the divorce, of an option on the stock which may have been invalid and unenforceable, and was difficult, if not impossible, of valuation. On an antenuptial transfer, H's basis should carry over. In *Marshman*, the husband's basis, which carried over to the wife, should probably be increased by the value, if any, of the option released in the divorce settlement. And this should be true, even though the court held the husband free of income tax on his "transfer."

apple for one cent, if it increases in value to five cents, and if I then exchange it for an orange, this exchange is a realizing event, and I have taxable income of four cents—equal to the economic income which has accrued during my ownership of the apple.

If I exchange the apple for an apple, this is also probably a realizing event resulting in taxable income of four cents,⁶⁷ although the regulations do not go this far. They provide, “the gain . . . realized from the . . . exchange of property for other property *differing materially either in kind or in extent, is treated as income.*”⁶⁸ (Emphasis added.)

This regulation may, in part, explain why a property division in a divorce, in a community property state, is assumed to be non-taxable under the income tax, if *each piece* of community property is split—the wife taking her share of each piece, the husband his.

But it cannot explain non-taxability in a case in which the community has 100,000 dollars worth of General Motors stock and 100,000 dollars worth of American Telephone stock; and where, instead of H and W each taking 50,000 dollars worth of General Motors stock and 50,000 dollars worth of American Telephone stock, W takes all of the General Motors stock and H all of the American Telephone stock. This exchange should be a taxable event for both H and W, and it is hard to believe that a contrary opinion like the *Walz*⁶⁹ opinion will stand the test of time much longer. Indeed, that opinion already has been subject to considerable erosion.⁷⁰

Basically, the word “realization” is simply the label given to an identifiable event. When an identifiable event has occurred, the postponement of taxability of past income (appreciation in value) ends, and the past income becomes taxable. Such an event need not be an exchange—a simple

67. Cf. §§ 1036, 1031. These sections provide for *nonrecognition* of *realized* gain on exchanges of *like* property. Section 351, on the other hand, provides for *nonrecognition* of *realized* gain on exchanges of *unlike* property. But all the sections perform the same function, namely, *nonrecognition* of *realized* income. Concomitant basis carry-over mechanisms are provided by the code.

68. Treas. Reg. § 1.1001-1(a) (1957). See also Rev. Rul. 56-437, 1956-2 CUM. BULL. 507, holding that the conversion of a joint tenancy in *stock* of a corporation into a tenancy in common is nontaxable, and that the severance of a joint tenancy in *stock* of a corporation, under a partition action, resulting in the issuance of two separate stock certificates in the names of each of the joint tenants, is nontaxable, *because there are no exchanges*. Were there really exchanges governed by section 1036, with resulting *nonrecognition* of *realized* gain?

69. *Frances R. Walz*, 32 B.T.A. 718 (1935).

70. See the language and approach in *C. C. Rouse*, 6 T.C. 908 (1946), *aff'd*, 159 F.2d 706 (5th Cir. 1947); *Jessie Lee Edwards*, 22 T.C. 65 (1954), and cases there cited; holding certain community property settlements taxable exchanges. Note especially *Johnson v. United States*, 135 F.2d 125, 130 (9th Cir. 1943).

disposition of property will do, and the person disposing of the property need not receive "money" or "property" in connection with the disposition.

In *International Freighting Corp. v. Commissioner*,⁷¹ a company awarded stock bonuses to certain of its employees, though it had no legal obligation to do so, as compensation for services previously rendered. The stock delivered to the employees was worth about 24,000 dollars on the date of delivery but had a basis to the company of only about 16,000 dollars.

The court held that the company *realized* income thereby, of about 8,000 dollars—the difference between the value of the stock on the date of delivery and its tax basis to the company. This figure, of course, represents prior appreciation in value of the stock; *i.e.*, past economic income.

This case was followed in *United States v. General Shoe Corp.*,⁷² a Sixth Circuit case on all fours, decided September 2, 1960. And it was followed despite the fact that on May 31, 1960, in *Commissioner v. Marshman*,⁷³ the Sixth Circuit had refused to tax a transferor of appreciated property in a divorce settlement. This refusal, however, was not based on a theory that no *realization* had occurred by virtue of the divorce transfer but on the ground that the "economic gain" could not be "valued."⁷⁴

It is true that the appreciated property owned by the husband in *Marshman* was an option on some stock (he had originally given the stock to his wife before their marriage), and that the "transfer" was accomplished by releasing the option. It is also true that it was difficult to determine the worth of the option. But the court's primary concern was not with the worth

71. 135 F.2d 310 (2d Cir. 1943).

72. 282 F.2d 9 (6th Cir. 1960), *cert. denied*, 365 U.S. 843 (1961).

73. *Supra* note 66.

74. The court in *Marshman* stated: "Helvering v. Horst dealt with the *realization* of economic gain, not the *valuation* of such gain." 279 F.2d at 32. And after quoting this language in *General Shoe*, the court added: "The difficulty inherent in the application of the economic gain theory in *Mesta*, in *Halliwell*, and in *Marshman* [all divorce cases] is directly related to the *valuation* of the gain rather than its *realization*." 282 F.2d at 13. The *Marshman* case was followed in *Zimmers v. United States*, 8 Am. Fed Tax R.2d 5859 (W.D. Ky. 1961). In this case the transfer of shares of stock which had appreciated in value was ordered by the divorce court in contested proceedings. The district court said that it was impossible to *value* what was received by the husband, and therefore the transfer was not taxable.

Another extremely interesting case on realization in connection with the disposition of property is *Williamson v. United States*, 292 F.2d 524 (Ct. Cl. 1961), holding that a cash basis corporation *realized* income *the instant* it distributed its receivables in liquidation, though they were not collected by the shareholder until after the dissolution of the corporation.

of the option; but whether, in a divorce settlement, it was proper to "value" the "economic gain" by subtracting the basis of the property transferred from *its value on the date of transfer*.

Since this is exactly what was done in *General Shoe* by the Sixth Circuit, why had it refused to do so in *Marshman*? Probably because it felt that the husband was not really getting his money's worth, and that the "taking" by the wife of a part of the property of the husband was not an event which should generate taxable income to the husband.

Nevertheless, the "property" was "delivered" pursuant to an arm's-length bargain to satisfy all the wife's claims (support and inheritance) and was clearly a realizing event. Of course, the Supreme Court can hold in *Davis* that there is no "realization" in a divorce transfer. But in view of the Supreme Court's past decisions, the only way the Sixth Circuit could avoid taxing the prior appreciation in value was to say that the gain could not be calculated in divorce settlements because of all the emotional factors involved.

In direct opposition, of course, are the *Mesta*⁷⁵ and *Halliwell*⁷⁶ cases—both holding that the transferor of appreciated property in a divorce settlement *realizes* gain, that the gain can be calculated, and that it equals the prior appreciation in value. These two cases have been thought to represent the law for twenty years.

The *Marshman* opinion sums up the *Mesta* case (and this part of this Article) beautifully:

The majority opinion . . . held that Mesta received an economic gain even though he may not have received payment in money or property from Mrs. Mesta; that the *disposition* of the *securities* was the taxable event which *converted unrealized economic gain into realized economic gain*; and that Congress intended a measurement of values under such circumstances, notwithstanding difficulties in determining those values.⁷⁷ (Emphasis added.)

This completes the discussion of *realization* in connection with divorce transfers.

We now turn to the problems of recognition and calculation of the gain.

75. *Commissioner v. Mesta*, 123 F.2d 986 (3d Cir. 1941), *cert. denied*, 316 U.S. 695 (1942).

76. *Commissioner v. Halliwell*, *supra* note 34.

77. 279 F.2d at 31.

IV. RECOGNITION AND CALCULATION OF TRANSFEROR'S REALIZED GAIN IN DIVORCE SETTLEMENT

As we have seen, except for the 1916 basis provision relating to sales or other dispositions of property acquired prior to March 1, 1913, no method was provided in the early years for calculating the gain derived from dealings in property. Nevertheless, the gain was intended to be taxed under the predecessors of section 61, and *was calculated and taxed*.

Finally, Section 202(a) of the Revenue Act of 1918 established "cost" as the basis of property acquired after March 1, 1913, and section 202(b) of that act undertook to deal with the calculation of gain on *exchanges of property for other property*: "When property is *exchanged for other property*, the property received in exchange shall . . . be treated as the equivalent of cash to the amount of its fair market value. . . ." ⁷⁸ (Emphasis added.)

But it was not until the adoption of Section 202 of the Revenue Act of 1924 that a method of calculating the gain on the sale or other disposition of property, whenever acquired, was provided by statute. Nevertheless, throughout the eleven-year period from 1913 to 1924, the predecessors of section 61 intended to, and did, tax such gains.

Then why was a method of calculation enacted in 1924? In the words of the Senate Finance Committee:

There is no provision of the existing law which corresponds to this section of the bill. The *purpose in embodying* in the law *this section* is to *show clearly* the method of determining the amount of gain or loss from the sale or *other disposition* of property.

(1) Subdivision (a) of this section . . . *merely embodies* in the law the *present construction* by the department and the courts of the existing law. ⁷⁹ (Emphasis added.)

Subdivision (a) of Section 202, Revenue Act of 1924, referred to above, provided: "the gain from the sale or other disposition of property shall be the excess of the amount realized therefrom over the basis. . . ."

This provision is now section 1001(a). It has not changed since 1924. At the same time, Section 202(c) of the Revenue Act of 1924 (now section 1001(b)) was enacted. It provided: "The amount realized from the sale or

78. For the legislative history of this provision, see SEIDMAN, *op. cit. supra* note 62, at 899.

79. H.R. Rep. No. 179, 68th Cong., 1st Sess. 13 (1913), reprinted in SEIDMAN, *op. cit. supra* note 62, at 684.

other disposition of property shall be the sum of any money received plus the fair market value of the property (other than money) received.”

With respect to this provision, the Senate Finance Committee said:

(3) subdivision (c) does not correspond to any provision of the existing law but embodies in the law what is and has always been the construction of the law adopted by the department and by the courts; that is, *that where income is realized in the form of property*, the measure of the income is the fair market value of the property at the date of its receipt.⁸⁰ (Emphasis added.)

There had been no such provision in the law because Section 202(c) of the Revenue Act of 1921 had changed the 1918 provision dealing with exchanges of property for property⁸¹ into a nonrecognition provision. It provided: “On an exchange of *property . . . for any other . . . property*, no gain or loss shall be recognized unless the property received in exchange has a readily realizable market value.”⁸² (Emphasis added.)

When the Revenue Act of 1924 eliminated this wording, it took great pains not only to make sure that *realized gains* on *exchanges of property for property* would be *calculated* but that they would be *recognized*. Section 203(a) stated out of abundance of caution: “Upon the sale or exchange of property the entire amount of the gain or loss determined under section 202, shall be recognized.”

The Ways and Means Committee and Senate Finance Committee said:

It appears best to provide generally that gain or loss is recognized from *all exchanges* and then except specifically and in definite terms those cases of exchange in which it is not desired to tax the gain.⁸³ (Emphasis added.)

Although section 202(c), above, attempted to make clear the method for calculating gains on sales or *other dispositions*, it did not do so because Congress was primarily concerned with changing the 1921 nonrecognition rule on *exchanges of property for property*. Note that section 203(a), above, attempts to make clear that gain will be recognized, but it only deals with sales or *exchanges*—it omits any reference to *other dispositions*.

80. H.R. Rep. No. 179, *supra* note 79, at 13, reprinted in SEIDMAN, *op. cit. supra* note 62, at 686-87.

81. Quoted *supra*, at note 78.

82. For the rather extensive legislative history of this provision, see SEIDMAN, *op. cit. supra* note 62, at 790-97.

83. H.R. Rep. No. 179, *supra* note 79, at 13, reprinted in SEIDMAN, *op. cit. supra* note 62, at 687.

Nevertheless, a *realized* gain resulting from a *disposition* of property will be taxed unless there is some specific code provision establishing non-recognition. This doctrine is, of course, one of the cornerstones of the entire tax structure. Section 203(a) was enacted to make abundantly clear that realized gains from *exchanges would be* recognized—not to establish, by inference, that gains realized on *dispositions* of property would go unrecognized. *Nor was it intended to establish by inference that gains would go unrecognized which could not be calculated* under section 202(c), a section intended to deal only with exchanges of *property for property*.

This legislative history is extremely important because of its bearing on the *Marshman* case, followed by the Court of Claims in the *Davis* case.

Marshman held that gain realized by the transferor of property in a divorce settlement could not be measured under Section 111(b) of the 1939 Internal Revenue Code because it was impossible to value "the property received" from the transferee; namely, the relinquishment of rights of support and inheritance. Section 111(b) of the 1939 Code provided: "The amount realized from the sale or other disposition of property shall be the sum of any money received plus the *fair market value* of the *property* (other than money) *received*."⁸⁴ (Emphasis added.)

This is, of course, our old friend Section 202(c) of the Revenue Act of 1924; Section 1001(b) of the 1954 Code.

Said the court:

What Congress intended in the present case is shown by section 111(b). By reason of the specific provisions of that section there is no *taxable* gain unless the amount of such economic gain is measured in a certain way. Congress did not intend or authorize that the measurement of taxable gain be made in any other way than that based on the fair market value of the *property received*. That requirement has not been complied with. If it has no fair market value . . . it may be economic gain but it is not taxable gain by reason of the express provisions of Section 111(b).⁸⁵

In the light of the legislative history of section 111(b) set forth above, the court's statements about what Congress intended are clearly wrong. Section 111(b) was only intended to provide a method of calculating gain with respect to exchanges of *property for property*, not for the *release of rights or claims*.

84. Int. Rev. Code of 1939, ch. 1, § 111(b), 53 Stat. 37 (1939).

85. *Commissioner v. Marshman*, *supra* note 66, at 32.

Section 61 intends to tax realized gains. So did its predecessors, and for eleven years they operated effectively without a "section 111(b)." If section 111(b) (now section 1001(b)) does not measure the gain, then the measurement is simply the appreciation in value of the property during the transferor's ownership of it. This is the intent of section 61.⁸⁶ The transferor's gain will be the excess of the value of the property on the date of transfer over his basis, just as the Sixth Circuit held in *General Shoe*.

It is exciting to await the Supreme Court opinion in the *Davis* case. Nevertheless, it is unfortunate that the "clarifying" language of 1924 muddied the waters of the fifties and sixties.

V. BASIS OF PROPERTY ACQUIRED IN DIVORCE SETTLEMENT

For the purposes of this discussion, we will assume the couple involved had made no antenuptial transfers before their marriage and that appreciated property was transferred by H to W after their divorce and pursuant to a pre-divorce property settlement agreement. We will assume also that under the agreement W gave up her inheritance and support rights.

What is the basis to W of the property transferred to her? If W had been required to include the value of the property in her income, her basis would clearly be the fair market value of the property on the day she received it.

However, in order to place the real issue in proper perspective, we will assume that she does not have to include anything in income upon receipt of the property. We will also assume that H was not required to pay a tax at the time of the transfer on the appreciation in value which had occurred while the property was his.

If H was not taxed because the transfer was a gift (and, therefore, not a realizing event), it would follow that his basis would carry over to W under section 1015(a), and the appreciation in value would not escape the income tax. But enough has been said heretofore to show that these divorce settlement transfers are not gifts and that the basis carry-over rule for gifts will not apply.

Thus we will have to *assume* that H *was not taxed* either because the "gain" to him could not be "valued" or because the transfer was not a *realizing* event. Since H was not taxed, this appreciation in value will forever escape the income tax *unless* H's basis carries over to W.

86. *Commissioner v. Mesta*, *supra* note 75.

Nevertheless, this appreciation in value *will* forever escape the income tax because W will have a basis equal to the fair market value of the property on the day she receives it. Why?

As we have seen, in order to determine W's *economic income* with respect to the property three years hence, *its value on the date she received it* must be compared with its value at the end of the three-year period. This can be done by determining its then value or, as a practical matter, if it is exchanged for other property at that time, by determining the value of the property received in the exchange. Income is measured in the same way for income tax purposes, absent a special basis carry-over provision. This will become clear upon a brief review of the history of the basis provisions.

Until 1918, there were *no* provisions dealing with the basis of property acquired after March 1, 1913. Finally, Section 202(a) of the Revenue Act of 1918 provided that the basis of property acquired after that date "shall be the *cost* of such property." (Emphasis added.)

This simple provision was inadequate. As we have seen, it was necessary to enact a special basis carry-over provision in 1921, with respect to gifts, since the recipient of a gift took as his basis fair market value on the date of receipt, and all prior economic income thus escaped the tax.

A series of similar basis carry-over provisions had to be enacted over the years to plug up similar loopholes. A few examples will suffice. In 1924 the Senate Finance Committee had this to say:

Under the existing law, if A owns an asset which cost him \$10,000 and is now worth \$50,000, he may transfer it to the X corporation in exchange for all the stock of the X corporation (no gain or loss from the exchange being recognized either under the existing law or under the bill) and the new corporation may take up the asset on its books for the purpose of determining gain or loss from subsequent sale and depreciation and depletion at \$50,000, its fair market value at the date of transfer. Paragraph (8) of the bill provides that the basis of the asset so transferred shall be \$10,000.⁸⁷

And even this provision was inadequate. In 1931, the decision in *Rosenbloom Fin. Corp.*⁸⁸ was handed down. This case involved a transfer by a stockholder of valuable property to a corporation as paid-in surplus. The stockholder received no stock, money, or other property as consideration. Nevertheless, the court held that the transfer was *not* a gift, that the basis

87. S. Rep. No. 398, 68th Cong., 1st Sess. 18 (1913), reprinted in SEIDMAN, *op. cit. supra* note 62, at 704.

88. 24 B.T.A. 763, 774 (1931), *rev'd*, 66 F.2d 556 (3d Cir. 1933), *cert. denied*, 290 U.S. 692 (1933).

was therefore "cost," and that "cost" was the *fair market value* of the property when the corporation *acquired* it.

Congress promptly provided a carry-over basis for this situation in Section 113(a)(8) of the Revenue Act of 1932.⁸⁹

Rosenbloom was reversed on appeal on the ground that the transfer was a gift and the basis therefore carried over. The court stated that if the transfer were not held to be a gift, basis would be "cost" to the corporation, namely, fair market value of the property on the date received by the corporation.

A similar situation was described in 1934 in a memorandum of the staff of the Joint Committee on Internal Revenue Taxation:

Corporation A owns all the stock of corporation B. Corporation B has a surplus of \$1,000,000, and included among its assets are distillers' warehouse receipts, which cost it \$100,000, but which are now *worth* \$500,000. It is desired to sell these warehouse receipts without the payment of any tax. This can be done in the following manner:

Corporation B distributes the warehouse receipts to corporation A by declaring a dividend in kind. This being a dividend from one corporation to another, corporation A pays no tax upon its receipt. *The cost basis* for these warehouse receipts in A's hands *is now* \$500,000. A sells the warehouse receipts for \$500,000 (its cost basis) and, therefore, pays no tax on the sale.⁹⁰ (Emphasis added.)

Another example is revealed by the following:

Two individuals each owned 300 shares of corporate stock with a cost basis of \$8,000, but a total market value of almost \$1,000,000. In contemplation of a sale, they transferred the shares to a partnership, which promptly sold the shares and retained and reinvested the proceeds. Under the *Walbridge* case [70 F.2d 683 (2d Cir. 1934), L. Hand, C. J.], the partners did not realize gain either when the firm was formed or when it sold the stock (except to the extent that the property increased in value from the date it was contributed to the date it was sold).⁹¹

89. Ch. 209, § 113(a)(8), 47 Stat. 200 (1932). For the legislative history of this provision, see SEIDMAN, *op. cit. supra* note 62, at 455.

90. SEIDMAN, *op. cit. supra* note 62, at 332.

91. BITTKER, FEDERAL INCOME, ESTATE AND GIFT TAXATION 599 (2d ed. 1958), citing *Chisholm v. Commissioner*, 79 F.2d 14 (2d Cir. 1935), *cert. denied*, 296 U.S. 641 (1935).

This situation has been corrected by providing a carry-over basis to the partnership.

And finally, we come to the *Bankers Trust Co.*⁹² and *Francis Francis*⁹³ cases.

In the *Bankers Trust* case, an individual transferred some Gaines Company stock to the trust company as trustees. The stock was worth about 325,000 dollars on December 23, 1922, the date of the transfer, but it had cost the trustor only 235,000 dollars. The trust was irrevocable but the trustor retained a life interest in the entire income.

Three days after the transfer, the corporation liquidated. If the trustor's basis carried over to the trust, the trust had a gain of about 90,000 dollars. If the "cost" to the trust was *fair market value of the stock* on the date the trust *acquired* it, the 90,000 dollars completely escaped the income tax.

The court stated:

Clearly, this transfer in trust was not a gift *inter vivos*. The trustee (petitioner) did not take the property as a present or donation, but only under a contract to assume certain duties of management in exchange for certain commissions. Nor was the transfer a present gift to the beneficiaries named in the indenture, for they, except the grantor himself, took absolutely nothing until the grantor's death, and even then would receive nothing in case their deaths occurred prior to his. The final reversionary interest was to the grantor's estate.⁹⁴

Since this transfer was not a gift, the basis carry-over provision did not apply. Basis was therefore "cost," and "the *cost* basis to the trustee is the *value of the property at the time acquired*."⁹⁵ (Emphasis added.)

This situation was corrected in 1924. Section 204(a)(3) of the Revenue Act of 1924 provided for a carry-over basis on certain transfers to trusts.

Francis Francis held that remaindermen, who received property in 1921 when the 1892 Jabez Bostwick trust terminated, took the property pursuant to "a vested legal right"⁹⁶ and not by gift. Since the basis carry-over rule for gifts did not apply, their basis was "cost." And their "cost" was held to be the *fair market value* of the property *when they received it* from the trust, despite the fact that "*they paid nothing for it*."⁹⁷

92. *Bankers Trust Co. v. Commissioner*, 24 B.T.A. 10 (1931).

93. *Francis Francis v. Commissioner*, 15 B.T.A. 1332 (1929).

94. 24 B.T.A. at 13.

95. 24 B.T.A. at 14.

96. 15 B.T.A. at 1340.

97. *Ibid.*

The "cost" provision has been carried forward into Section 1012 of the 1954 Code, and it seems fairly clear that W's basis, in our problem, would be fair market value on the date she acquired the property. It has been so held.⁹⁸

If the divorce settlement agreement establishes a dollar figure, and the property is delivered in satisfaction of that amount, then its "cost" to W is probably that amount, even though its fair market value may be somewhat less.⁹⁹

If the property is transferred to W pursuant to the settlement agreement in exchange for her relinquishment of inheritance and support rights, and no dollar figure is mentioned, then her basis is no doubt the fair market value of the property she *receives*, not the *fair market value* of what she *gives up*.¹⁰⁰

This completes the discussion of W's basis in the property she receives. We now turn to the question whether she realizes income when she receives the property in exchange for her relinquishment of support, dower and inheritance rights.

VI. REALIZATION OF INCOME BY TRANSFEREE IN DIVORCE SETTLEMENT

We have previously established that a transfer to W pursuant to a divorce settlement is not a gift for income tax purposes.¹⁰¹ Since the transfer is not a gift, the amount W receives is not excluded under section 102.

98. Edna W. Gardner Trust, *supra* note 66. Cf. Farid-Es-Sultaneh, 160 F.2d 812 (2d Cir. 1947), which is certainly an appropriate decision in the divorce settlement area, even if it is *not* appropriate with respect to antenuptial transfers.

99. Aleda N. Hall, *supra* note 66.

100. See the respondent's argument in Aleda N. Hall, *supra* note 66, at 55 (3d para.). Cf. Philadelphia Park Amusement Co. v. United States, *supra* note 66.

101. See part II, sections B, C; and part III of this article, especially at note 76 *supra*. See also the lower court opinions in Harris v. Commissioner, 340 U.S. 106 (1950), a case involving negotiated and complex property settlement transfers in connection with a divorce, the *wife's transfer exceeding the husband's* by \$107,150. Her transfer included cash (\$50,000 to be paid over a ten-year period) and the equivalent of cash (assumption of \$47,650 of debt), a total of \$97,650. The divorce settlement agreement *did not involve* release of support rights—only release of "marital rights in the spouse's property." *The wife was under no obligation to support the husband prior to, or after, the divorce.* 340 U.S. at 113 n.1.

L. Hand, C. J., in his opinion in the court of appeals states, "although the payments were subject to a gift tax, they were not gifts at all, the [\$50,000] annuity was a contract made for a valid consideration, and it is classed as a gift only because the statute says so." 178 F.2d at 865. Indeed, the Tax Court had

Since it is not excluded under that section, we must make an analysis of the transfer—first with respect to the portion transferred in exchange for the release of support rights, and second with respect to the portion transferred in exchange for the release of dower or inheritance rights.

Does W realize income when she receives money or property in exchange for her release of support rights? Let us assume that she is to receive 3,000 dollars per month for the rest of her life “for her support and maintenance,” as in the *Gould* case.¹⁰² Let us look at her situation some twenty years later. She is still receiving 3,000 dollars per month; 36,000 dollars per year. This is not a gift! Is it income? “In everyday usage the [ex-wife] receiving large sums of money currently from a man who ceased to be her husband more than twenty years ago, would be regarded as having an income.”¹⁰³

Nevertheless in 1917, when *Gould* was decided, it was held that W did not realize taxable income when she received the 3,000 dollar monthly payments. The Court was apparently strongly influenced by the fact that H could not reduce his taxable income by the amounts paid. In any event, this was merely an early construction of the statutes¹⁰⁴—and no doubt an erroneous one. Despite this, it remained the law until Congress changed it during the period of high tax rates in the Second World War.

The current provision governing the matter is section 71. It includes in W's taxable income only periodic payments made “because of the family or marital relationship in recognition of the *general obligation to support*.”¹⁰⁵ A corresponding deduction is granted to H.¹⁰⁶

If H is to make one payment to W of a specified principal sum, even though it is made because of the support obligation, it will not be taxed to W. However, if payment of the sum extends over a period of time, W may be taxed. If the payment period for the specified sum does (*or may*) extend

held that the transfers were made for adequate and full *consideration in money or money's worth* (10 T.C. at 746), relying on *Mesta*.

Moreover, the Commissioner and the ex-wife apparently assumed that the ex-husband was going to have to *pay income tax on the \$50,000 of payments which he was to receive from his ex-wife*. See the fifth issue listed in 10 T.C. at 742.

102. *Gould v. Gould*, 245 U.S. 151 (1917).

103. *Mahana v. United States*, 88 F. Supp. 285, 288 (Ct. Cl. 1950), *cert. denied*, 339 U.S. 978 (1950).

104. *Fairbanks v. Commissioner*, 191 F.2d 680, 681 (9th Cir. 1951), *cert. denied*, 343 U.S. 915 (1952).

105. Treas. Reg. § 1.71-1(b)(4) (1957); Thomas E. Hogg, 13 T.C. 361 (1949), *nonacq.* 1950-1 CUM. BULL. 7; Julia Nathan, 19 T.C. 865 (1953); Rev. Rul. 58-192, 1958-1 CUM. BULL. 34.

106. § 215.

over more than ten years, installment payments discharging the sum will be taxed to W with certain limitations.¹⁰⁷ And H will receive a corresponding deduction.¹⁰⁸

Payments made to W in exchange for her release of property (or inheritance rights) are not governed by section 71.¹⁰⁹ Are such payments includible in her income? They are not gifts, and they should be includible.

The clear case is one in which the *wife*, owing no obligation of support to the *husband*, agrees to pay *him* 250 dollars a month for life, or to pay him a specified sum over a period of time, whereupon she obtains a divorce. Certainly the payments are includible in H's income. These very fact situations occurred in the *Sokol*¹¹⁰ and *Harris*¹¹¹ cases.

The payments should be includible whether they are made to induce a divorce¹¹² or are in payment for the release of marital rights in the spouse's property. As to the latter, certain claims are being relinquished for money payments. The basis in the claims is presumably zero, and the entire amount received should be taxable income.

Such payments should not be gifts under the gift tax because "the motive of such transfers is certainly not to deplete the estate *inter vivos*, so as to escape ultimate estate taxes upon death."¹¹³ Nor should the amounts be received tax-free under the income tax on some theory that had the couple stayed married, the wife (or husband) would have inherited them without payment of an income tax.

The fact is that this transaction is complete. Someone comes away with some money in exchange for the relinquishment of claims; and this is income in common parlance, if it is paid over a twenty-year period.¹¹⁴ If so, it is also income if paid in a lump sum.

Moreover, if H transfers appreciated property to W, it is a taxable transaction for him.¹¹⁵ What insulates W from the tax?

107. § 71(c)(1) and (2).

108. § 215.

109. See note 105 *supra*.

110. Elinor Stewart Sokol, 7 T.C. 567 (1946) (\$250 per month for life to be paid to a healthy ex-husband by his ex-wife).

111. See note 101 *supra* for a full discussion of the agreed payments in *Harris* and, apparently, the presumption by the ex-wife and the Commissioner that they would be includible in the ex-husband's taxable income.

112. See part II, section B, *supra*, following note 38.

113. *McMurtry v. Commissioner*, 203 F.2d 659, 662 (1st Cir. 1953).

114. See the quotation from the *Mahana* case at note 103 *supra*.

115. Unless the Supreme Court in *Davis* holds to the contrary.

VII. CONCLUSIONS

A. *Divorce Settlements*

An ex-husband who transfers appreciated property to his ex-wife pursuant to a pre-divorce property settlement agreement does not make a taxable gift. He does, however, realize taxable income. The amount of income is equal to the excess of the value of the property at the time of transfer over his basis.

However, the ex-wife will obtain a stepped-up basis in the property received, whether or not the ex-husband is taxed.

Therefore, if H is not taxed on the transfer, the appreciation in value of the property while in his hands will forever escape the income tax. For this reason, among others, a decision refusing to tax H at the time of transfer is probably wrong.

If it is really inappropriate to tax the ex-husband at the time of transfer, Congress should enact a nonrecognition provision coupled with a corresponding basis carry-over provision.

The ex-wife may not be taxed on the receipt of property transferred to her in exchange for her release of property (or inheritance) rights—but she should be. If the transfer is made because of the obligation of support, its taxability to W is governed by section 71 of the 1954 Code.

B. *Marriage Settlements*

Antenuptial transfers made in exchange for the release of inheritance and support rights are gifts, for both gift tax and income tax purposes.

Therefore, the transfer is subject to the gift tax; the transferor does not realize taxable income even if he transfers appreciated property; the transferee does not realize taxable income on the receipt of the property; and the transferor's basis carries over to the transferee for the purpose of computing gain (and loss, usually) on a later sale.