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ALIMONY TRUST TAXATION: EFFECTS OF THE TAX REFORM ACT OF 1984

The Tax Reform Act of 1984¹ (the 1984 Act) made radical changes in the taxation of certain transactions involved in domestic relations.² The law changed taxation of transfers between spouses incident to divorce³ as well as the basic definition of "alimony."⁴ These are two areas in which the law had been established for many years but which were the source of continuing litigation. The 1984 Act sought to simplify the taxation of these transactions in order to effect nationwide uniform treatment.

The 1984 Act affects elements of any transfer at divorce or payment of alimony. This Note will, however, focus on the tax law, before and after the enactment of the 1984 Act, as it affects an alimony trust.⁵ There are potential income, estate, and gift tax consequences involved in using an alimony trust, and each of those areas was changed by the 1984 Act. Some portions of the 1984 Act relating to domestic relations became effective immediately upon enactment on July 18, 1984,⁶ while others became effective on January 1, 1985.⁷ Notation is made herein as to the effective date of each section discussed. For clarity, tax laws in effect before the 1984 Act are referred to in this Note as "prior" law.

In recognition of the fact that either spouse may incur the obligation to support the other, the 1984 Act substituted the gender-neutral terms "payor spouse" and "payee spouse" for "husband"

1. The Act is Division A of the Deficit Reduction Act of 1984, Pub. L. No. 98-369, 98 Stat. 494 (codified in scattered sections of 26 U.S.C.).

2. See Pub. L. No. 98-369, §§ 421-426, 98 Stat. 494, 793-805.

3. Pub. L. No. 98-369, § 421, 98 Stat. 494, 793 (creating I.R.C. § 1041 and amending I.R.C. §§ 1001(e), 1015, 1239(b)).

4. Pub. L. No. 98-369, § 422, 98 Stat. 494, 795 (amending I.R.C. §§ 71, 215, 219(b)(4), 682(b), 7701(a)).

5. An alimony trust is a trust created by one spouse for the support benefit of the other spouse. Alimony payments are made directly from the trust.

6. Pub. L. No. 98-369, §§ 421, 425, 98 Stat. 494, 793, 803 (§ 421 creating I.R.C. § 1041 and amending I.R.C. §§ 1001(e), 1015, 1239(b); § 425 amending I.R.C. §§ 2043(b), 2516) (effective July 18, 1984).

7. Pub. L. No. 98-369, § 422, 98 Stat. 494, 795 (amending I.R.C. §§ 71, 215, 219(b)(4), 682(b), 7701(a)) (effective Jan. 1, 1985).

and "wife" in sections 71 and 215 of the Internal Revenue Code⁸ (the Code). This Note also identifies the parties as "payor" and "payee," but for ease of reference it is assumed that the payor is male and the payee is female.

Taxation plays an important part in planning the devolution of property and, of course, should be one element addressed in drafting divorce or separation documents. This Note provides information regarding the tax advantages and disadvantages of using an alimony trust.

I. THE ALIMONY TRUST: A COMPROMISE

The most common method of providing support to a divorced or separated spouse is the payment of alimony.⁹ The definition of "alimony" contained in the Code prior to the 1984 Act required that payments be periodic and made pursuant to a legal obligation imposed by local law due to a marital or family relationship under a decree or written agreement. The 1984 Act changes that definition, but in general the taxation of payments classified as "alimony" remains the same. Under prior law as well as under the 1984 Act, payments received as alimony are generally includible in

8. All Code sections refer to the Internal Revenue Code of 1954 unless otherwise indicated.

9. Property settlements are not the same as alimony, but the two are often confused. A property settlement is a capital transaction which involves an actual division of existing assets and which is made to allocate properly the property interests of each spouse. Usually, the property settlement is contemporaneous with the divorce decree. In some instances, however, the property settlement may be in the form of cash paid over a period of time in installments. Under prior law, the payment of a property settlement in installments inevitably looked like "alimony" and thus confusion often arose. The primary difference between property settlements and alimony was that the total amount to be paid as alimony was an undeterminable sum, while the amount to be paid as a property settlement was a fixed sum. Alimony was usually contingent upon the death or remarriage of the payee; therefore, it was impossible to calculate the exact total amount that would be paid over a certain period, because death or remarriage could occur at any time. For a more complete discussion of property settlements, see M. VOGEL, *DIVORCE TAXATION GUIDE* 229-67 (1984).

In *Lester v. Commissioner*, 366 U.S. 299 (1961), the Court held that unless the divorce documents specifically designated amounts to be paid as "child support," those amounts would be considered alimony. *Id.* at 303, 306. The 1984 Act overrules *Lester* to the extent that if any amount specified in the divorce or separation document is to be reduced upon the happening of a contingency relating to a child (such as the child's reaching majority, marrying, or dying), then the amount of the reduction will be treated as child support when initially paid to the payee. Pub. L. No. 98-369, § 422(a), 98 Stat. 494, 795 (amending I.R.C. § 71). It also provides that if the divorce documents require amounts to be paid as child support after the death of the payee, then those amounts will not be treated as alimony when paid to the payee during life. *Id.*

the gross income of the payee¹⁰ and deductible by the payor.¹¹

Once the legal obligation to support is imposed by a decree or agreement, the payor should determine the most advantageous method by which to meet the obligation. Common methods are direct alimony payments and lump sum distributions for the purpose of support.

The payor's concerns will include the availability and liquidity of his assets, as well as possible tax consequences. He may desire to make periodic alimony payments of a specific sum each month, which would allow him to retain any future increases in income for

10. I.R.C. § 71 (1982); Pub. L. No. 98-369, § 422(a), 98 Stat. 494, 795. Prior to the 1984 Act, I.R.C. § 71(a)(1) (1982) read as follows:

§ 71. Alimony and separate maintenance payments

(a) General rule.—

(1) Decree of divorce or separate maintenance.—If a wife is divorced or legally separated from her husband under a decree of divorce or of separate maintenance, the wife's gross income includes periodic payments (whether or not made at regular intervals) received after such decree in discharge of (or attributable to property transferred, in trust or otherwise, in discharge of) a legal obligation which, because of the marital or family relationship, is imposed on or incurred by the husband under the decree or under a written instrument incident to such divorce or separation.

Section 71(a)(2) was similar, except that it applied to payments made under a written separation agreement unless the separated spouses filed a joint return.

Section 71(a)(3) provided that periodic payments received under a decree for support were also alimony. Apparently, this was the only one of the three subsections that did not apply to alimony trusts, since it did not expressly refer to payments "attributable to property transferred."

Section 71(c)(1) stated a general rule that installment payments of a sum specified in the divorce or separation document were not considered periodic payments.

Section 71(c)(2) made an exception for installment payments of a determinable sum if the payments could be made over a period in excess of 10 years. In such a case, the payee included up to 10% of the total amount in her gross income each year as alimony.

Section 71(d) excluded from the payor's gross income payments attributable to transferred property which were includible in the payee's gross income.

11. I.R.C. § 215 (1982); Pub. L. No. 98-369, § 422(b), 98 Stat. 494, 795. Prior to the 1984 Act, I.R.C. § 215(a) (1982) read as follows:

(a) General rule.—In the case of a husband described in section 71, there shall be allowed as a deduction amounts includible under section 71 in the gross income of his wife, payment of which is made within the husband's taxable year. No deduction shall be allowed under the preceding sentence with respect to any payment if, by reason of section 71(d) or 682, the amount thereof is not includible in the husband's gross income.

himself. If his income then decreases, he may petition the court to reduce the monthly alimony obligation. Another possibility is for the payor to give the payee a percentage of his monthly income, which would vary the payee's income proportionately with that of the payor. The advantage of either of these methods is that the payor retains the use of his income and his income-producing assets and makes the alimony payments from whatever source he wishes. In addition, alimony payments are usually contingent upon the death or remarriage of the payee, and the payor generally receives an income tax deduction for amounts paid as alimony.¹²

The payee will desire a mode of payment that will offer her assurance of support. She will want to be free from worry that her payments might cease should the payor lose his job or capacity to earn. Such risks are inevitable if direct alimony payments are made. The payee will also desire to reach an agreement that will not require her to face the complications of a court battle to enforce compliance with the decree. She might prefer a lump sum distribution for support over alimony payments because she would then have the assets in hand to invest as she desired. She might feel that she would be more free to remarry if she received a lump sum distribution because she would suffer no economic loss upon remarriage. A lump sum distribution could make her financially independent of the payor.¹³

This is the conflict that the spouses face: one prefers direct alimony payments while the other prefers a lump sum distribution for support. An advantage of one system of payments to one spouse meets a corresponding disadvantage to the other spouse.¹⁴ Thus, the method of providing support requires decisions and compromises by both spouses. A method which may serve as a suitable compromise is the alimony trust.¹⁵ The alimony trust will have some features of periodic direct payments and yet have some of the advantages of a lump sum distribution for the benefit of the payee.

The payments from an alimony trust usually consist of trust in-

12. See Boies, *The Use of Trusts in Divorce Settlements*, 30 INST. ON FED. TAX'N 589, 591 (1972). Agreements which provide for continuing alimony payments after remarriage of the payee or death of the payor (from his estate) are enforceable, although not usually ordered by a divorce court. See *id.* at 591 nn.3 & 7.

13. See *id.* at 592-93.

14. See *id.* at 593.

15. See *id.* at 593-94; Gunn, *Douglas v. Willcuts Today: The Income Tax Problems of Using Alimony Trusts*, 63 CORNELL L. REV. 1022, 1022 (1978).

come but may at times be made from trust corpus. The alimony trust will usually have a simple construction, requiring that monthly income be distributed to the payee to the extent of the amount adjudged necessary for her support.¹⁶ The advantage of this to the payor is that the property transferred to the trust is not surrendered outright to the payee. The payor may provide in the trust instrument for the property to revert to him or to pass on to his children when his obligation to pay alimony ceases. This is one way to assure that the payor's children or other chosen beneficiaries receive his property. If the property were transferred to the payee outright, she might dispose of the property by will or during her life in a manner contrary to the wishes of the payor. The alimony trust can act as a protectorate. The payor benefits from the use of the property to meet his alimony obligation and yet still controls the ultimate disposition of the property.

Certainly, more complex schemes may be devised. A trust could be established to meet several obligations, including alimony, child support, school tuition, etc. It could be established so that the trust would pay the payee more than the amount specified as alimony, even though this might have the effect of a gift to the payee in the amount of the excess. Another possibility is for the trust to pay the trust income each month up to the alimony amount, with the payor obligated to pay any deficiencies. For instance, if the alimony obligation is \$1,000 per month, and the trust income for a particular month is only \$900, the payor would pay the \$100 necessary to meet the obligation for that month. The tax consequences of each trust will vary according to the particular terms and conditions of the trust.

If the assets are available to use for this purpose, an alimony trust can meet the needs of both parties to a certain extent. It will offer the payee security for the timely receipt of income with no less favorable tax consequences to her than would result from direct alimony payments. The use of a trust may be less appealing to the payor since he will receive no deduction for payments made from a trust, and he may have no opportunity to seek a lower alimony requirement should his income decrease. However, it will offer the payor assurance that the principal will be prudently in-

16. If the trust is structured so that it will retain and accrue income, it may be liable for income taxes in its individual entity capacity. If such is the case, the trust "throw-back" rules come into play to award a deduction to the ultimate beneficiary upon distribution in the pro rata amount of the tax paid by the trust on the income. *See* I.R.C. §§ 665-668 (1982).

vested and conserved by the trustee of his choice and will give him the opportunity to determine the disposition of any remainder. If carefully planned, a trust may offer advantages for both parties without adverse tax consequences.

Prior to the 1984 Act, the tax consequences of a trust used to pay alimony differed from those of an ordinary beneficial trust because of the interaction of the alimony tax rules with the ordinary trust tax rules. The interpretation of the trust rules in conjunction with the treatment of alimony was the central tax question in much litigation. In order to understand the tax treatment of alimony trust payments under the prior law, it was necessary to understand the interactions of various provisions of the Code regarding alimony.

II. INCOME TAX TREATMENT OF ALIMONY TRUSTS

A. Background and Prior Law

The prior law pertaining to taxation of alimony was embodied in sections 71, 215, and 682 of the Code.¹⁷ Section 71 served as the definition of "alimony,"¹⁸ and section 215 granted a reciprocal deduction to the payor for alimony payments included in the gross income of the payee.¹⁹ The effect of sections 71 and 215 was to tax the payor on the portion of his income which he retained and to tax the payee on the portion she received as alimony. Sections 71 and 215 applied regardless of the payor's source of the funds paid as alimony²⁰ and regardless of the income levels of the respective parties.²¹

17. These sections were originally amendments to the Internal Revenue Code of 1939 as contained in the Revenue Act of 1942, Pub. L. No. 753, § 120, 56 Stat. 798, 816-18 (codified in Internal Revenue Code of 1939 as §§ 22(k), 23(u), 171).

18. See I.R.C. § 71 (1982); *supra* note 10.

19. See I.R.C. § 215 (1982); *supra* note 11.

20. *Neeman v. Commissioner*, 26 T.C. 864, 868 (1956), *aff'd per curiam*, 255 F.2d 841 (2d Cir. 1958), *cert. denied*, 358 U.S. 841 (1958). The Tax Court concluded that the source of the husband's income was immaterial and that taxing the wife on alimony where the husband did not receive any reduction in his tax burden was both within constitutional limits and consistent with the alimony provisions of the Internal Revenue Code of 1939. *Id.* at 867-68. See also Rev. Rul. 65-283, 1965-2 C.B. 25, 27; Harris, *The Federal Income Tax Treatment of Alimony Payments—The "Support" Requirement of the Regulations*, 22 HASTINGS L.J. 53, 59 (1970).

21. See Steines, *A Reappraisal of the Taxation of Wealth Transfers Incident to Divorce*, 56 WASH. L. REV. 217, 223 (1981). Deductions allowed under § 215 do not offset business income for the purpose of generating net operating loss carryovers. See *id.* at 223 n.33; I.R.C. § 172(a), (c), (d)(4) (1982). Therefore, alimony provides a tax benefit only for the year of payment. However, income can be offset by alimony which

Section 682(a) provided that alimony payments from a trust were to be included in the payee's gross income and excluded from the payor's gross income.²² The payor was not allowed to deduct alimony payments excluded from his gross income because made from a trust.²³ Both sections 71 and 682 referred to payments attributable to trusts, but section 682(b) provided that the payee should be treated as a trust beneficiary.²⁴ The Treasury regulations interpreting section 682(a) stated that it did not apply in any case to which section 71 applied. The regulations stated that section 682(a) applied to a trust created before the divorce or separation and not in contemplation of it, while section 71 would apply only if the creation of the trust or payments by a previously created trust were in discharge of an obligation imposed upon or assumed by the payor under court order or decree of divorce or separation.²⁵ Unfortunately, this interpretation only added to the problem of differentiating the two sections. It appeared to put all "alimony" payments (whether made directly or by a trust) under section 71 and thereby to include the total amount of payments from an alimony trust in the payee's gross income. However, when the payor estab-

is paid from preexisting property. *See Steines, supra*, at 223 n.33.

22. Prior to the 1984 Act, I.R.C. § 682 (1982) provided, in pertinent part, as follows:

(a) Inclusion in gross income of wife.—There shall be included in the gross income of a wife who is divorced or legally separated under a decree of divorce or of separate maintenance (or who is separated from her husband under a written separation agreement) the amount of the income of any trust which such wife is entitled to receive and which, except for this section, would be includible in the gross income of her husband, and such amount shall not, despite any other provision of this subtitle, be includible in the gross income of such husband. . . .

(b) Wife considered a beneficiary.—For purposes of computing the taxable income of the estate or trust and the taxable income of a wife to whom subsection (a) or section 71 applies, such wife shall be considered as the beneficiary specified in this part. A periodic payment under section 71 to any portion of which this part applies shall be included in the gross income of the beneficiary in the taxable year in which under this part such portion is required to be included.

23. *See* I.R.C. § 215 (1982).

24. *See* I.R.C. § 682(b) (1982); *supra* note 22. Under prior law, certain trusts established for the benefit of a former spouse were not governed by either § 71 or § 682. A trust created in contemplation of divorce but not used for the payee's support fell under § 61, resulting in tax consequences similar to those of a § 682 trust. *See* R. TAFT, *TAX ASPECTS OF DIVORCE AND SEPARATION* § 5.05[3], at 5-57 (1984).

25. *Treas. Reg. § 1.682(a)-1(a)(2)* (1957). *See also* *Rev. Rul. 74-94, 1974-1 C.B. 26, 27.*

lished a trust for the payee's benefit before any contemplation of divorce, after the divorce the payee was treated for tax purposes as a trust beneficiary under section 682²⁶ and therefore was required to include in her gross income only amounts up to the distributable net income of the trust for any given year.²⁷

Section 682(a) also prevented the payor from being taxed on trust payments to the payee that were deemed made in discharge of his legal obligations. The language of section 682(a) specifically stated that it prevented other income tax provisions from including the payments in the payor's gross income. This referred to the application of the grantor trust rules²⁸ to alimony trusts where the payor had a continuing obligation to support or where he retained certain control over the trust.

Even though the regulations drew distinctions between the trusts to which sections 71 and 682(a) applied, situations continued to arise in which the distinctions were not clear to the courts. In *Daniel v. Commissioner*,²⁹ the Tax Court held that alimony payments made to Mrs. Daniel from a trust in which Mr. Daniel had a beneficial interest prior to divorce fell under section 71 since the payments were in discharge of the support obligation imposed by the divorce decree.³⁰

Daniel demonstrated the breadth of section 71 with respect to the treatment of alimony payments. Section 682(a) applied only in

26. Treas. Reg. § 1.682(a)-1(a)(4) (1957) furnishes the following example to clarify the interpretation of § 682(a):

Upon the marriage of H and W, H irrevocably transfers property in trust to pay the income to W for her life for support, maintenance, and all other expenses. Some years later, W obtains a legal separation from H under an order of court. W, relying upon the income from the trust payable to her, does not ask for any provision for her support and the decree recites that since W is adequately provided for by the trust, no further provision is being made for her. Under these facts, section 682(a), rather than section 71, is applicable.

27. Amounts distributed to beneficiaries are taxable only to the extent of the distributable net income of the trust. See I.R.C. § 652(a) (1982). Generally, the distributable net income of a trust is its taxable income with certain modifications. See I.R.C. §§ 641(b), 643(a) (1982).

28. The grantor trust rules are contained in I.R.C. §§ 671-679 (1982). These rules treat the grantor of a trust as the owner of its income and corpus when he retains certain powers or control over the trust and require that he include those amounts in his gross income even though they are paid to another. The rules encompass reversionary interests, power to control who receives beneficial enjoyment, administrative powers, and power to revoke, as well as use of the income to discharge a legal obligation of the grantor. See *id.*

29. 56 T.C. 655 (1971), *aff'd per curiam*, 461 F.2d 1265 (5th Cir. 1972).

30. *Id.* at 661.

circumstances where the payor set up a trust for the payee's benefit prior to contemplation of divorce and the trust made distributions to the payee after divorce or separation.³¹ Even in those rare instances, the payor and payee had to be careful to ensure that the language of the divorce or separation documents did not impose any support obligation on the payor. Otherwise, section 71 would govern trust payments deemed to be made in discharge of the support obligation.³²

Under prior law, sections 71 and 682(a) both provided for the inclusion in the payee's gross income of amounts paid to her as alimony and, along with section 215, for the exclusion or deduction of those amounts from the payor's gross income. Problems arose with the interpretation and application of section 682(b), which by its terms applied to payments made under both sections 71 and 682(a). Under section 682(b), a payee who was entitled to receive payments attributable to property in trust was considered a beneficiary of the trust. If considered a beneficiary for all purposes, the payee was taxable only to the extent the distributions to her represented taxable income under the normal trust conduit and timing rules.³³ Thus, under a literal application of section 682(b), if payments were made to her from trust corpus or if payments to her exceeded the distributable net income of the trust, she was taxable only on that portion of her payments attributable to the distributable net income of the trust.³⁴ This was inconsistent with the apparent intent of the language in sections 71 and 682(a). The regulations and the legislative history of section 682(a) indicated that all amounts paid from an alimony trust were taxable to the payee.³⁵

Some commentators interpreted the legislative history of section 682(a) to mean that the section subjected alimony trust payments to the timing rules applicable to ordinary trust income³⁶ but did

31. See Treas. Reg. § 1.682(a)-1(a)(2) (1957); Rev. Rul. 74-94, 1974-1 C.B. 26, 27.

32. See Treas. Reg. § 1.682(a)-1(a)(2) (1957); Rev. Rul. 74-94, 1974-1 C.B. 26, 27. Treas. Reg. § 1.682(a)-1(a)(4) (1957) indicated that if the divorce decree stated that no support obligation was imposed on the husband since the wife was adequately provided for under an existing trust, then section 682 applied.

33. See I.R.C. §§ 641-668 (1982) (income taxation of trusts and trust beneficiaries).

34. See I.R.C. § 662(a) (1982).

35. See Gunn, *supra* note 15, at 1025 & nn.12-13.

36. The trust "timing rules" are provisions of the Code which designate when certain amounts received from a trust are to be included in the gross income of a beneficiary. Timing questions usually arise when the beneficiary has a different taxable year than the trust. In a simple trust situation, I.R.C. § 652(c) (1982) provides that the beneficiary must report as income an amount based on the income of the trust for any

not in fact tax the payee "only as a beneficiary."³⁷ This interpretation allowed inclusion of all alimony payments received by the payee in her gross income, rather than limiting inclusion to the distributable net income of the trust.

The Internal Revenue Service (the Service) supported this interpretation. In 1965, the Service issued a ruling which limited the application of section 682(b) to the timing of the inclusion of alimony in the payee's gross income.³⁸ The Service's position was buttressed by the Treasury regulations' interpretation of section 682(b). The regulations set forth an example of the application of section 682(b), applying only the timing rules to an alimony trust payment.³⁹ Even though the interpretations of the section by the Service and the Treasury were consistent, the courts did not uniformly agree with this position.⁴⁰ Therefore, the application of section 682(b) continued to present questions regarding the extent to which alimony payments made from a trust were taxable to the payee.

One element of the ordinary trust rules is that the character of trust income passes through the trust to the beneficiary.⁴¹ There-

taxable year of the trust which ends during his taxable year. For example, assume the beneficiary reports income on a calendar year basis, and the trust has a fiscal year of July 1 through June 30. For 1984, the beneficiary must report the amount of income attributable to him for the trust's fiscal year July 1, 1983 to June 30, 1984. If the trust terminates in the second half of 1984, the beneficiary will also have to include income attributable to him for the portion of the trust's fiscal year from July 1, 1984 through the termination date. See I.R.C. § 652(c) (1982).

Similar timing rules for complex trusts and estates appear in I.R.C. § 662(c) (1982).

37. See Gunn, *supra* note 15, at 1025-26. Gunn's interpretation was supported by Treas. Reg. § 1.682(b)-1(b) (1957).

38. Rev. Rul. 65-283, 1965-2 C.B. 25, 28. The ruling stated:

The trust conduit rules are not applicable to such payments received by the taxpayer, since she is treated as a beneficiary under section 682(b) of the Code merely for the purposes of computing the taxable income of the trust and determining the taxable year in which the alimony payments are to be included in her gross income.

39. Treas. Reg. § 1.682(b)-1(b) (1957).

40. Cf. *Ellis v. United States*, 416 F.2d 894 (6th Cir. 1969) (holding that payee of an alimony trust is not required to include distributions representing tax-exempt income to the trust); *Stewart v. Commissioner*, 9 T.C. 195 (1947) (holding that payee as trust beneficiary was not required to include portions of distributions representing tax-exempt income to the trust).

41. I.R.C. § 652(b) (1982) provides in part:

[A]mounts . . . shall have the same character in the hands of the beneficiary as in the hands of the trust. For this purpose, the amounts shall be treated as consisting of the same proportion of each class of items entering into the computation of distributable net income of the trust as the total of each class bears to the total

fore, in an ordinary trust situation, if the trust earns income on tax-exempt bonds, that income is also tax-exempt to the beneficiary upon distribution. The courts and the Service have been divided on the applicability of this conduit rule to alimony trusts.

In *Ellis v. United States*,⁴² the Sixth Circuit applied section 682(b) and determined that the payee receiving alimony payments from a trust was entitled to exclude from her gross income that portion of the trust distribution which represented interest on tax-exempt municipal bonds. The *Ellis* court held that section 71 was not an exception to the ordinary trust conduit rules.⁴³ The Service rejected the *Ellis* rationale, indicating in a later ruling that alimony payments from a trust created in contemplation of or at the time of divorce were governed by section 71⁴⁴ and that all distributions from section 71 alimony trusts were taxable to the payee.⁴⁵

1. *Property Transfers to a Trust*

The creation of an alimony trust will of course require a transfer of property from the payor to a trustee for the benefit of the payee. Under prior law, it was possible that the payor would realize taxable gain on such a transfer. For many years, courts differed as to the treatment of gain on a transfer of property pursuant to divorce,⁴⁶ prompting a review of the matter by the Supreme Court in *United States v. Davis*.⁴⁷ The Supreme Court concluded that such a transfer was a taxable event⁴⁸ and that the marital rights surrendered by the wife must be presumed equal in value to the fair market value of the property transferred by the husband.⁴⁹ The husband was taxed on the appreciation of the transferred property as

distributable net income of the trust, unless the terms of the trust specifically allocate different classes of income to different beneficiaries.

42. 416 F.2d 894 (6th Cir. 1969).

43. *Id.* at 898.

44. See Rev. Rul. 74-94, 1974-1 C.B. 26, 27.

45. *Id.* See also Rev. Rul. 65-283, 1965-2 C.B. 25, 27-28.

46. See *Halliwell v. Commissioner*, 44 B.T.A. 740 (1941), *rev'd per curiam*, 131 F.2d 642 (2d Cir. 1942), *cert. denied*, 319 U.S. 741 (1943); *Marshman v. Commissioner*, 31 T.C. 269 (1958), *rev'd*, 279 F.2d 27 (6th Cir. 1960), *cert. denied*, 364 U.S. 918 (1960); *King v. Commissioner*, 31 T.C. 108 (1958); *Estate of Stouffer v. Commissioner*, 30 T.C. 1244 (1958), *rev'd sub nom. Commissioner v. Marshman*, 279 F.2d 27 (6th Cir. 1960), *cert. denied*, 364 U.S. 918 (1960); *Mesta v. Commissioner*, 42 B.T.A. 933 (1940), *rev'd*, 123 F.2d 986 (3d Cir. 1941), *cert. denied*, 316 U.S. 695 (1942).

47. 370 U.S. 65 (1962), *rev'g* 287 F.2d 168 (Ct. Cl. 1961).

48. *Id.* at 68-71.

49. *Id.* at 72-73.

if he had sold the property for cash and transferred the proceeds to his wife in satisfaction of his obligation.⁵⁰

Although the *Davis* rule was applied to transfers of appreciated property to a trust,⁵¹ the Service drew distinctions between taxable and nontaxable transfers to alimony trusts. The Service ruled that where the trust was used merely as a vehicle for the payor's support payments under the separation or divorce documents, there was no realization event in the creation of the trust, and therefore the payor was not taxed on the transfer.⁵² However, if the transfer of appreciated property to the trust constituted full or partial discharge of a fixed support obligation, the payor was taxable on the amount by which the value of the property transferred exceeded his adjusted basis in the property.⁵³

Statistics indicate that there are over a million divorces each year in the United States,⁵⁴ and one may assume that many of these involve property transfers. However, from those numbers, only a handful of cases have reached the courts since 1979. Even prior to the enactment of the 1984 Act, it appeared that the Service and the courts were backing away from the *Davis* decision.⁵⁵ For example, the Tax Court did not apply the rule in two 1983 cases which involved *Davis* issues.⁵⁶ The court instead distinguished *Davis*, in each instance determining the transfer to be a nontaxable event in settlement of property rights.⁵⁷

50. See Gunn, *supra* note 15, at 1040.

51. See Estate of Hundley v. Commissioner, 52 T.C. 495, 506 (1969), *aff'd per curiam*, 435 F.2d 1311 (4th Cir. 1971).

52. Rev. Rul. 59-47, 1959-1 C.B. 198 (distinguishing between Rev. Rul. 57-506, 1957-2 C.B. 65, and Rev. Rul. 57-507, 1957-2 C.B. 511).

53. See *id.*

54. BUREAU OF THE CENSUS, STATISTICAL ABSTRACT OF THE UNITED STATES 84 (104th ed. 1984).

55. See M. VOGEL, *supra* note 9, at 208-18.

56. See Cook v. Commissioner, 80 T.C. 512 (1983); Serianni v. Commissioner, 80 T.C. 1090 (1983). (The Commissioner has filed an appeal in the *Cook* case.)

57. In *Cook*, a divorce court ordered Cook to transfer to his wife property that he had received as gifts or purchased from her or her family. The referee who ordered the transfer testified before the Tax Court that he had done so in order to return property to the wife which he felt was "rightfully hers." *Cook*, 80 T.C. at 527. In a single-judge decision, the Tax Court found that Cook solely owned the assets prior to transfer, and yet the court concluded that the transfers were a property division and thus not taxable. *Id.* at 527-28. No review of the decision was conducted by the entire Tax Court. In *Serianni*, the court found the transfer to be in settlement of property rights under a state "special equity" law even though the transferee established that she never contributed any funds or services to the formation or success of the corporation whose stock was ordered distributed to her. *Serianni*, 80 T.C. at 1102.

2. *Basis of Transferred Property*

Under prior law, the *Davis* rule required the payor to recognize any capital gain on the transfer, as discussed in the previous section. If the payor funded the trust with cash or nonappreciated property, he did not realize any gain on the transfer. If the trust was funded with appreciated property, however, the calculation of the payor's gain depended on his basis in the transferred property.⁵⁸ If the payor established an alimony trust and retained a reversion or granted a remainder interest to a beneficiary other than the payee, the payor allocated his basis between the interest transferred for the benefit of the payee and the reversion or remainder interest, in proportion to the fair market values of the separate interests.⁵⁹

The payee also needed to know her tax basis, if any, in the property transferred to her. If a trust was used to pay her alimony, the property transferred to her was an interest (life or term) in the trust. The Supreme Court in *Davis* noted that the same calculation that determined the amount received by the payor fixes the amount surrendered by the payee, and that figure (the fair market value of the transferred property) would be the payee's tax basis in the property received.⁶⁰ The argument that this type of transfer was a "gift" for income tax purposes, as it might have been for gift tax purposes, was rejected by the *Davis* court.⁶¹ Under prior law, the payee took the stepped-up basis (fair market value at the time of transfer) in the interest transferred to her, even if her interest was a life or term interest rather than fee simple ownership.⁶²

58. See I.R.C. § 1001(a) (1982).

59. Cf. Rev. Rul. 77-413, 1977-2 C.B. 298 (allocation of basis in real property between interest sold and interest retained).

60. *Davis*, 370 U.S. at 73. See also *Farid-Es-Sultaneh v. Commissioner*, 160 F.2d 812 (2d Cir. 1947); Rev. Rul. 67-221, 1967-2 C.B. 63.

61. *Davis*, 370 U.S. at 69 n.6. For gift tax treatment of such transfers, see *infra* text, section III.

62. Under prior law, there existed an argument to allow the payee to amortize her cost basis in the property transferred, although the question was never fully explored by any court. See Gerhart, *Substantial Support Exists for Amortizing Life Income Interest in an Alimony Trust*, 44 J. TAX'N 167 (1976). In *Spruance v. Commissioner*, 60 T.C. 141 (1973), the court noted that it would consider a transfer between spouses upon divorce as a sale and allow the payee to amortize her cost basis. *Id.* at 155 n.7. Following the 1984 Act, however, the argument is moot. All interspousal transfers incident to divorce are now treated as gifts for income tax purposes, and I.R.C. § 273 (1982) prevents amortization of life or terminable interests acquired by gift, bequest, or inheritance.

B. *Effects Of The Tax Reform Act Of 1984*

Portions of the Tax Reform Act of 1984⁶³ (the 1984 Act) provide for the simplification of domestic relations tax rules. These provisions of the 1984 Act are designed to clarify the tax consequences of cash and property transfers in connection with divorce.

The prior law was that a transfer of appreciated property from the payor to the payee in connection with a divorce and in exchange for a release of marital rights constituted a sale or exchange, resulting in the recognition of gain to the payor.⁶⁴ In addition, the payee received a basis equal to the fair market value of the property at the time of transfer.⁶⁵

That law governing transfers of property between spouses or former spouses incident to divorce created confusion and led to extensive litigation. In drafting the 1984 Act, the Committee on Ways and Means of the U.S. House of Representatives sought to make the tax laws regarding such transfers as unintrusive as possible and to avoid the various pitfalls that were prevalent under the prior law.⁶⁶

1. *Changes in Transfers as Taxable Events*

The 1984 Act creates a new Code section, section 1041, which provides that "no gain or loss shall be recognized on a transfer of property" between spouses.⁶⁷ The same rule applies for a transfer of property between former spouses if the transfer is "incident to the divorce."⁶⁸ A transfer in trust for the benefit of a spouse or former spouse receives the same nonrecognition treatment as a transfer directly to the spouse or former spouse.⁶⁹ Thus, under the 1984 Act, a payor can establish a trust for the support or benefit of the payee without fearing the consequences of the *Davis* rule.⁷⁰ So long as the transfer occurs during the marriage or is "incident to the divorce," the payor will recognize no gain on the transfer.⁷¹

63. Pub. L. No. 98-369, 98 Stat. 494.

64. *See United States v. Davis*, 370 U.S. 65, 68-72 (1962); *supra* text accompanying notes 46-53.

65. *See Davis*, 370 U.S. at 73; *supra* text accompanying notes 60-62.

66. H.R. REP. No. 432, 98th Cong., 2d Sess. 1491-92 (1984). No Senate report was submitted with this legislation.

67. Pub. L. No. 98-369, § 421(a), 98 Stat. 494, 793 (creating I.R.C. § 1041(a)(1)).

68. *See id.* (creating I.R.C. § 1041(a)(2)).

69. *See id.* (creating I.R.C. § 1041(a)).

70. *Cf. supra* text accompanying notes 46-50 (payor taxed on transfer of appreciated property to payee).

71. There is also no longer the possibility that the payor might claim a loss on a

In the hands of the payee (or trustee, if the transfer was in trust), the property is now treated for income tax purposes as if acquired by gift.⁷² The payee will no longer take the fair market value of the property as her basis. This aspect of *Davis*⁷³ has also been overruled by the 1984 Act, which specifically states that "the basis of the transferee shall be the adjusted basis of the transferor."⁷⁴ Thus, the payor's basis in the property transferred to the payee or trustee is now carried over to the recipient. This is consistent with the general income tax treatment of other gift transfers⁷⁵ and with the nonrecognition of gain or loss at the time of the transfer.

The nonrecognition and basis rules described above apply to a transfer to a *former* spouse only if the transfer is "incident to the divorce."⁷⁶ Such a transfer is defined as one which occurs within one year after the date of divorce or is related to the dissolution of the marriage.⁷⁷

These rules apply regardless of the kind of consideration, if any, granted for the transfer—cash, property, assumption of liabilities, or marital rights.⁷⁸ Therefore, uniform federal income tax treatment is anticipated even though transfers are subject to differing state laws regarding marital rights and property.

This portion of the 1984 Act applies to all transfers occurring after July 18, 1984.⁷⁹ If a transfer is made under an instrument in existence on or before that date, the new law does not apply unless both parties so elect.⁸⁰ The 1984 Act also provides for spouses to

transfer of property which has decreased in value.

72. Pub. L. No. 98-369, § 421(a), 98 Stat. 494, 793 (creating I.R.C. § 1041(b)(1)).

73. *Cf. supra* text accompanying notes 60-62 (discussion of payee's basis under *Davis*).

74. Pub. L. No. 98-369, § 421(a), 98 Stat. 494, 793 (creating I.R.C. § 1041(b)(2)).

75. *Cf. I.R.C. § 1015(a)* (1982) (basis of property acquired by gift). I.R.C. § 1015(a) (1982) provides that the basis of a gift for the purpose of determining loss is the lesser of its fair market value and its carryover basis at the time of transfer. No such rule is provided for interspousal transfers under the new § 1041, and the 1984 Act amends § 1015 to provide that the basis of property transferred under § 1041 is determined by § 1041 alone. Pub. L. No. 98-369, § 421(b)(5), 98 Stat. 494, 794 (creating I.R.C. § 1015(e)).

76. *See* Pub. L. No. 98-369, § 421(a), 98 Stat. 494, 793 (creating I.R.C. § 1041(a)(2)).

77. *See id.* (creating I.R.C. § 1041(c)).

78. This is different from the treatment of such transfers under the estate and gift tax rules. Even under the terms of the 1984 Act, the estate and gift taxation of an interspousal transfer depends upon whether the transfer is made for "adequate and full consideration." *See infra* text, section III.

79. Pub. L. No. 98-369, § 421(d)(1), 98 Stat. 494, 795.

80. Pub. L. No. 98-369, § 421(d)(3), 98 Stat. 494, 795.

make an election that the new rule apply to transfers between them made after December 31, 1983.⁸¹

2. *Changes in the Definition of Alimony*

The 1984 Act changes the statutory definition of "alimony."⁸² Under prior law, in order to be treated as alimony, payments had to be: made in discharge of a legal obligation arising from a marital relationship; imposed by a decree of divorce, a decree of support, or a written separation agreement; and made periodically.⁸³ If the payments were made in discharge of a determinable sum specified in the divorce or separation documents, they did not meet the "periodic" requirement⁸⁴ but were treated as "installments" of a property settlement.

The two major changes made by the 1984 Act are: (1) no legal obligation due to marital relationship under local law is now required; and (2) no requirement exists that the payments be periodic.

Under the 1984 Act, alimony payments must be made in cash and be received by, or on behalf of, the spouse or former spouse.⁸⁵

81. Pub. L. No. 98-369, § 421(d)(2), 98 Stat. 494, 795. Section 421(d)(4) of the 1984 Act requires that elections be made according to procedures prescribed by Treasury regulations.

82. See Pub. L. No. 98-369, § 422(a), 98 Stat. 494, 795 (amending I.R.C. § 71).

83. I.R.C. § 71(a) (1982).

84. I.R.C. § 71(c)(1) (1982). An exception to this rule provided that if a determinable sum could be paid in installments over a period of not less than 10 years, an annual amount not exceeding 10% of the principal sum would be treated as a periodic payment. See I.R.C. § 71(c)(2) (1982).

85. The section of the 1984 Act revising I.R.C. § 71 reads, in pertinent part, as follows:

SEC. 422. TAX TREATMENT OF ALIMONY AND SEPARATE MAINTENANCE PAYMENTS.

(a) **GENERAL RULE.**—Section 71 (relating to alimony and separate maintenance payments) is amended to read as follows:

"SEC. 71. ALIMONY AND SEPARATE MAINTENANCE PAYMENTS.

"(a) GENERAL RULE.—Gross income includes amounts received as alimony or separate maintenance payments.

"(b) ALIMONY OR SEPARATE MAINTENANCE PAYMENTS DEFINED.—For purposes of this section—

"(1) IN GENERAL.—The term 'alimony or separate maintenance payment' means any payment in cash if—

"(A) such payment is received by (or on behalf of) a spouse under a divorce or separation instrument,

"(B) the divorce or separation instrument does not designate such payment as a payment which is not in-

The requirement in amended section 71 for a "divorce or separation instrument"⁸⁶ still demands a writing which establishes the terms of the division and payments. Alimony payments may not be made between legally separated spouses who live in the same household.⁸⁷

In an effort to avoid deductions of amounts unrelated to marital support, the 1984 Act provides that payments are alimony only if there is no liability to make the payments after the payee's death. Any provision for a substitute payment to another after the payee's death (such as an increase in child support) will preclude treatment of that amount as alimony when paid to the payee.⁸⁸ In addition, the 1984 Act provides that payments in excess of \$10,000 per year must continue in each of the six post-separation years (unless payments cease upon the death of either spouse or the remarriage of the payee) in order to be treated as alimony. The 1984 Act provides for recapture of amounts previously deducted as alimony if a yearly amount paid during the six-year period is at least \$10,000 smaller than any previous yearly payment.⁸⁹

The 1984 Act also amended sections 71, 215, and 682 of the Code to produce uniform treatment of alimony paid through a trust.⁹⁰ The prior law created great confusion in this area, since both sections 71 and 682 referred to alimony paid from funds attributable to transferred property. Section 682(b) complicated the area by requiring that the payee be treated as a trust beneficiary, thus contradicting the section 71 and 682(a) provisions that all sums paid as alimony be included in the payee's income.

cludible in gross income under this section and not allowable as a deduction under section 215,

"(C) in the case of an individual legally separated from his spouse under a decree of divorce or of separate maintenance, the payee spouse and the payor spouse are not members of the same household at the time such payment is made, and

"(D) there is no liability to make any such payment for any period after the death of the payee spouse and there is no liability to make any payment (in cash or property) as a substitute for such payments after the death of the payee spouse (and the divorce or separation instrument states that there is no such liability)."

Pub. L. No. 98-369, § 422(a), 98 Stat. 494, 795.

86. *Id.*

87. *Id.*

88. *Id.*

89. *Id.*

90. *See* Pub. L. No. 98-369, § 422, 98 Stat. 494, 795-98.

The 1984 Act simplifies the treatment. All references to payments "attributable to property transferred, in trust or otherwise" have been deleted from section 71.⁹¹ All references to section 71 have been deleted from section 682(b).⁹² The 1984 Act amends section 215 to provide specifically that no deduction will be allowed if the amount of the payment was not includible in the payor's gross income "by reason of section 682 (*relating to income of alimony trusts*)."⁹³ It appears that the overall effect of these changes is that section 71 now governs taxation of all direct alimony payments, while section 682 governs all alimony payments received from a trust. This treatment resolves the confusion occasioned by the prior law. Under the new section 682, the payee is to be treated as a trust beneficiary, and all ordinary trust rules, timing and conduit, should apply.

The amendments made by the 1984 Act to sections 71, 215, and 682 of the Code apply to divorce or separation instruments executed after December 31, 1984.⁹⁴ If a divorce or separation instrument executed before January 1, 1985 is modified on or after that date to so provide, the 1984 Act amendments apply to the modified instrument.⁹⁵

III. ESTATE AND GIFT TAX TREATMENT OF ALIMONY TRUSTS

A. *Background and Prior Law*

Under prior law, transfers by a payor to an alimony trust and other transfers in exchange for certain marital rights could subject the payor to gift tax or result in the inclusion of the property transferred in the payor's gross estate. Planning for estate and gift taxation remains an important consideration in determining how alimony payments and transfers incident to divorce should be managed.

The modern estate tax, first enacted by Congress in 1916,⁹⁶ taxes the value of a decedent's estate at death.⁹⁷ The present gift tax was enacted in 1932⁹⁸ as a complement to the estate tax in order to

91. Pub. L. No. 98-369, § 422(a), 98 Stat. 494, 795-97.

92. Pub. L. No. 98-369, § 422(d)(2), 98 Stat. 494, 798.

93. Pub. L. No. 98-369, § 422(b), 98 Stat. 494, 797-98 (emphasis added).

94. Pub. L. No. 98-369, § 422(e)(1), 98 Stat. 494, 798.

95. Pub. L. No. 98-369, § 422(e)(2), 98 Stat. 494, 798.

96. Revenue Act of 1916, Pub. L. No. 271, 39 Stat. 756, 777-80.

97. See B. BITTKER, 5 FEDERAL TAXATION OF INCOME, ESTATES AND GIFTS ¶ 120.2.2, at 120-10 (1984).

98. Revenue Act of 1932, Pub. L. No. 154, 47 Stat. 169, 245-59.

preserve the revenue generated by the estate tax.⁹⁹ The gift tax functions as a tax on inter vivos transfers which would otherwise reduce the value of a decedent's estate and reduce estate tax liability.¹⁰⁰

The value of property transferred during life is nevertheless included in the gross estate of the transferor in certain circumstances. Section 2036 of the Code generally provides that if the transferor retains possession of, enjoyment of, the right to income from, or the right to designate who will receive the income from the property transferred, the value of the property will be included in the transferor's gross estate.¹⁰¹ This rule does not apply if the transfer is "a bona fide sale for an adequate and full consideration in money or money's worth."¹⁰²

A transferor is considered to retain the "possession or enjoyment of, or the right to the income from, the property"¹⁰³ to the extent that the use or income of the property is applied to discharge a legal obligation of the payor for his pecuniary benefit.¹⁰⁴ The term "legal obligation" is deemed to include support of dependents¹⁰⁵ or any other debts for which the transferor is primarily liable.¹⁰⁶ Therefore, if one transferred property to a trust and directed the trustee to use the income from the transferred property to pay for supporting the transferor's dependents, the value of the property could be included in the transferor's gross estate.¹⁰⁷

The value of the transferred property is included in the transferor's estate only when the transferor retains an interest in the property "for his life or for any period not ascertainable without reference to his death or for any period which does not in fact end before his death."¹⁰⁸ Most transfers to alimony trusts contain provisions which would have limited the applicability of section 2036 under prior law by making the obligation to support the payee terminate upon her remarriage or death. Under such a provision, any

99. See *Harris v. Commissioner*, 340 U.S. 106, 107 (1950); C. LOWNDES, R. KRAMER & J. McCORD, *FEDERAL ESTATE AND GIFT TAXES* ¶ 22.2, at 640 (3d ed. 1974).

100. See C. LOWNDES, R. KRAMER & J. McCORD, *supra* note 99, ¶ 22.2, at 640; Boies, *supra* note 12, at 604.

101. See I.R.C. § 2036(a) (1982).

102. *Id.*

103. *Id.*

104. Treas. Reg. § 20.2036-1(b)(2) (1958).

105. *Id.*

106. C. LOWNDES, R. KRAMER & J. McCORD, *supra* note 99, ¶ 9.13, at 208.

107. See *id.*

108. I.R.C. § 2036(a) (1982).

interest retained by the payor would not be "for his life" or for a "period not ascertainable without reference to his death," and thus section 2036 could have applied only if the payor's interest did not end before his death. Thus, section 2036 might have required including the value of an alimony trust corpus when the payor died before termination of his obligation to pay.

Section 2036 does not require inclusion in the gross estate of the value of property transferred in "a bona fide sale for an adequate and full consideration."¹⁰⁹ Moreover, section 2053 of the Code allows an estate tax deduction for claims against the estate based on a promise or agreement which are "contracted bona fide and for an adequate and full consideration in money or money's worth."¹¹⁰ For estate tax purposes, it is therefore important to know whether transfers incident to divorce or separation, such as transfers to an alimony trust, are made for "adequate and full consideration." If they are, the property transferred would not be included in the payor's estate. If such transfers were considered made for insufficient consideration, then under certain circumstances, the transferred property could be included as an asset of the payor's estate.

The gift tax treats as "gifts" transfers during life made for less than "adequate and full consideration."¹¹¹ Thus, for gift tax purposes as well as estate tax purposes, it is important to know whether transfers incident to divorce are considered made for adequate and full consideration. If not, part or all of the transferred property's value could be taxed as a gift under the general gift tax rules.

Following the reenactment of the gift tax in 1932, the courts were faced with the question of whether the language "adequate and full consideration" should be construed identically in the gift tax and estate tax provisions in which it occurred.¹¹² For example, if it were determined for estate tax purposes that a certain transfer was made for "adequate and full consideration," would that same transfer necessarily have been made for "adequate and full consideration" under the gift tax rules? While it would seem that identical phrases in complementary tax schemes should receive identical interpretation, the courts' construction of these provisions in cases involving interspousal transfers developed in an interesting manner.

109. *Id.*

110. I.R.C. § 2053(a)(3), (c)(1)(A) (1982).

111. I.R.C. § 2512(b) (1982).

112. I.R.C. §§ 2036(a), 2053(c), 2512(b) (1982).

Prior to 1926, a transfer for "a fair consideration in money or money's worth" was not taxable as a gift nor was the property transferred includible in the transferor's gross estate.¹¹³ At this time, courts considered transfers from one spouse to another in return for the relinquishment of marital rights to be supported by "fair consideration," although the dollar value of such consideration might be unascertainable.¹¹⁴

In 1926, Congress repealed the gift tax and changed the estate tax rule by deleting "fair consideration" and replacing it with the current language.¹¹⁵ According to the Supreme Court in *Merrill v. Fahs*,¹¹⁶ this change in language was intended to narrow the class of transferred property excluded from the transferor's estate.¹¹⁷ In *Commissioner v. Wemyss*,¹¹⁸ the Court interpreted the change to mean that only an asset reducible to money or a dollar value should be treated as "consideration" for a transfer.¹¹⁹ The idea was that if the value of the transferor's estate was reduced as a result of the transfer, then the consideration paid by the transferee could not have been adequate and full consideration in money or money's worth.¹²⁰

In 1932, Congress added a provision to the estate tax rules which clarified the meaning of "adequate and full consideration" as it might apply to the relinquishment of marital rights such as dower and curtesy. The new language, which later appeared in section 2043(b) of the Code, stated that for estate tax purposes, "a relinquishment or promised relinquishment of dower, curtesy, . . . or of other marital rights in the decedent's property or estate, shall not be considered to any extent a consideration 'in money or money's worth.'"¹²¹ Thus, property transferred in exchange for such marital rights was includible in the transferor's gross estate. Although the gift tax was reintroduced in 1932, the new gift tax provisions

113. See *Merrill v. Fahs*, 324 U.S. 308, 311-12 (1945).

114. See *id.* at 312.

115. See *id.* at 311-12.

116. 324 U.S. 308 (1945).

117. See *id.* at 312.

118. 324 U.S. 303 (1945).

119. See *id.* at 305-08. *Accord*, *Estate of Goetchius v. Commissioner*, 17 T.C. 495, 503 (1951).

120. See *Goetchius*, 17 T.C. at 505; *cf. Merrill*, 324 U.S. at 312 (to treat relinquishment of marital rights as consideration or as deduction from gross estate would subvert legislative intent) (quoting H.R. REP. No. 708, 72d Cong., 1st Sess. 47 (1932)).

121. Revenue Act of 1932, Pub. L. No. 154, § 804, 47 Stat. 169, 280 (amending § 303(d) of Revenue Act of 1926) (codified as amended at I.R.C. § 2043(b) (1982)). See *Estate of Keller v. Commissioner*, 44 T.C. 851, 857 (1965).

did not specify the extent to which relinquishment of marital rights might be "consideration" for gift tax purposes.¹²²

In 1945, the Supreme Court addressed the question of whether Congress intended its clarified estate tax definition of "consideration" to apply for gift tax purposes as well. The government argued in *Merrill v. Fahs*¹²³ that a transfer to a trust pursuant to an antenuptial agreement was a gift to the wife, who had relinquished all marital rights other than the right to maintenance and support. The government contended that the treatment of relinquishment of marital rights in the estate tax rules should be read into the gift tax rules. The taxpayer argued that there was no gift tax provision which precluded treatment of relinquishment of marital rights as adequate and full consideration.¹²⁴

The Court held that the transfer was a taxable gift, finding that the estate and gift tax provisions regarding "adequate and full consideration" were *in pari materia* and thus to be construed identically.¹²⁵ Relinquishment of marital rights was expressly excluded from being treated as "consideration" for estate tax purposes, and therefore it was likewise excluded for gift tax purposes, even though Congress had not enacted a gift tax rule corresponding to section 2043(b) of the estate tax rules.

After *Merrill*, courts tended to apply the same interpretation of "consideration" in both estate tax and gift tax cases.¹²⁶ Subsequent cases and revenue rulings limited the application of section 2043(b) to the relinquishment of inchoate marital rights which vested only upon the death of the other spouse.¹²⁷ The relinquishment of rights which arose during the life of the other spouse, such as the right to support, were still eligible to be treated as "consideration" for both estate tax and gift tax purposes.¹²⁸ A transfer in settlement of dower rights or rights to a forced share of the transferor's estate, however, was not supported by "consideration" under either estate

122. See *Merrill*, 324 U.S. at 315 (Reed, J., dissenting).

123. 324 U.S. 308 (1945).

124. See *id.* at 309-10.

125. See *id.* at 311-13.

126. See, e.g., *Harris v. Commissioner*, 340 U.S. 106, 107-08 (1950); *Estate of Friedman v. Commissioner*, 40 T.C. 714, 718-19 (1963); *Estate of Goetchius v. Commissioner*, 17 T.C. 495, 502 (1951).

127. See *Estate of Glen v. Commissioner*, 45 T.C. 323 (1966); *Estate of Keller v. Commissioner*, 44 T.C. 851 (1965); *Estate of Fenton v. Commissioner*, 70 T.C. 263 (1978); E.T. 19, 1946-2 C.B. 166; Rev. Rul. 60-160, 1960-1 C.B. 374.

128. See *Estate of Glen v. Commissioner*, 45 T.C. 323 (1966); *Estate of Keller v. Commissioner*, 44 T.C. 851 (1965); *Estate of Fenton v. Commissioner*, 70 T.C. 263 (1978); E.T. 19, 1946-2 C.B. 166; Rev. Rul. 60-160, 1960-1 C.B. 374.

or gift tax rules.

In 1954, Congress enacted a specific gift tax provision, section 2516, defining the extent to which a transfer incident to divorce would be considered a gift.¹²⁹ Unlike section 2043(b) of the estate tax rules, however, the new gift tax section provided generally that interspousal transfers for the support of minor children or in settlement of "marital or property rights" were deemed made for "full and adequate consideration."¹³⁰ Thus, in a divorce settlement, the transfer of property in exchange for inchoate marital rights was not generally subject to gift taxation because the transfer was made for "full and adequate consideration" under section 2516, but the value of the property transferred might still have been included in the transferor's gross estate because the transfer was *not* for "adequate and full consideration" under section 2043(b).¹³¹

After the enactment of section 2516, courts continued to construe the meaning of "consideration" identically for estate and gift tax purposes in most situations. For transfers incident to divorce, however, the express language governing the estate tax treatment of such transfers was sometimes unreconcilable with the express language governing their gift tax treatment.¹³²

Just as the enactment of section 2043(b) was seen as evidence of legislative intent to tax transfers in exchange for marital rights under the gift tax as well as the estate tax, the enactment of section 2516 could be viewed as evidence of Congress' desire to refrain from taxation of divorce transfers under both tax schemes.¹³³ The question addressed by the *Merrill* Court in 1945 was whether the express estate tax rule should be read into the gift tax; more recently the question was whether the sometimes conflicting gift tax rule articulated in 1954 should be read into the estate tax. The courts were divided on the proper resolution of this question.

In *Estate of Friedman v. Commissioner*,¹³⁴ a 1963 case, the Tax Court applied a gift tax regulation¹³⁵ in determining that a transfer

129. Internal Revenue Code of 1954, Pub. L. No. 591, § 2516, 68A Stat. 1, 409.

130. See I.R.C. § 2516 (1982).

131. Cf. *Estate of Satz v. Commissioner*, 78 T.C. 1172, 1183-86 (1982) (refusing to incorporate § 2516 into estate tax rules in relation to divorce agreement).

132. See *id.*

133. Cf. *Natchez v. United States*, 705 F.2d 671, 676 (1983) (stating that § 2516 was adopted "to codify the . . . principle 'of recognizing the reality of consideration in divorce settlements'" (quoting *Estate of Glen v. Commissioner*, 45 T.C. 323, 337 (1966))).

134. 40 T.C. 714 (1963).

135. Treas. Reg. § 25.2512-8 (1958). This regulation provides that a "transfer of

from a woman to her stepchildren was not taxable as a gift because the transfer was made for adequate and full consideration.¹³⁶ There also was a question as to whether the value of the transferred property was subject to estate taxation. Relying on *Merrill's* construction of the gift and estate tax rules, the Tax Court stated, "[I]f the transfer under scrutiny is considered as made for an adequate and full consideration for gift tax purposes it likewise is to be considered for estate tax purposes."¹³⁷ Thus, the *Friedman* court treated its interpretation of the gift tax regulation as controlling both the gift tax and estate tax issues.

Friedman's rationale was criticized by the Ninth Circuit in *United States v. Past*,¹³⁸ a case dealing with estate tax consequences of a transfer incident to divorce. The district court in *Past*, like the *Friedman* court, referred to an established gift tax principle in determining that the transfer had been made for adequate and full consideration.¹³⁹ The district court concluded that the value of the property transferred was not includible in the transferor's gross estate pursuant to section 2036 of the Code.¹⁴⁰ The appellate court remanded for recalculation of the estate tax,¹⁴¹ indicating that the district court's reliance on the gift tax interpretation of "consideration" was misplaced.¹⁴² As viewed by the Ninth Circuit, "[T]he rationale of [*Friedman*] would nullify the effect of section 2036 every time a life estate was retained as a result of a property settlement incident to a divorce."¹⁴³

In other cases involving transfers incident to divorce, the Tax Court avoided deciding whether the gift tax treatment of such transfers¹⁴⁴ should be incorporated into the estate tax rules.¹⁴⁵ In 1982, the Tax Court finally addressed this issue directly in *Estate*

property made in the ordinary course of business (a transaction which is bona fide, at arm's length, and free from any donative intent), will be considered as made for an adequate and full consideration in money or money's worth."

136. *Estate of Friedman v. Commissioner*, 40 T.C. 714, 719 (1963).

137. *Id.*

138. 347 F.2d 7 (1965).

139. *See id.* at 12 & n.2.

140. *See id.* at 12.

141. *Id.* at 15.

142. *Id.* at 12.

143. *Id.* at 12 n.2.

144. Under gift tax § 2516, such transfers were deemed made for adequate and full consideration. I.R.C. § 2516 (1982); *see supra* text accompanying notes 129-30.

145. *See Estate of Fenton v. Commissioner*, 70 T.C. 263, 274 (1978); *Estate of Iverson v. Commissioner*, 65 T.C. 391, 401 n.5 (1975); *Estate of Keller v. Commissioner*, 44 T.C. 851, 861-62 (1965).

of *Satz v. Commissioner*.¹⁴⁶ The court concluded that the gift tax rule was intended by Congress to be limited to gift tax application only.¹⁴⁷ While accepting “the doctrine of *pari materia* applied in *Merrill*,”¹⁴⁸ the court was unwilling to incorporate section 2516 into the estate tax “[i]n the face of congressional intent to the contrary”¹⁴⁹

Even after the Tax Court’s decision in *Satz*, however, the Second Circuit reached the opposite conclusion in *Natchez v. United States*.¹⁵⁰ As an alternate basis for its decision in *Natchez*, the court found that a transfer from an estate pursuant to the decedent’s separation agreement was made for adequate and full consideration under section 2516 and that the amount transferred was therefore allowable as a deduction from the decedent’s gross estate.¹⁵¹ Unlike the Tax Court, the Second Circuit saw “no reason why [section] 2516 should not be read *in pari materia* with [the estate tax rules].”¹⁵²

The meaning of “consideration” for purposes of estate and gift taxation of transfers incident to divorce has been explored on many occasions since the Supreme Court’s treatment of the subject in *Merrill*. As illustrated by the discussion above, however, prior to the 1984 Act the meaning varied from year to year and from court to court.

B. *Effects of the Tax Reform Act of 1984*

The 1984 Act addresses the estate and gift tax treatment of transfers of property incident to divorce. The classification of such transferred property as a gift or as includible in the transferor’s gross estate still depends on whether the transfer is made for adequate and full consideration. Under the 1984 Act, as under prior law, an interspousal transfer incident to divorce is, for gift tax purposes, generally deemed made for adequate and full consideration.¹⁵³ Under prior law, gift tax section 2516 specifically provided that a transfer of property in settlement of marital rights was deemed made for adequate and full consideration if the transfer

146. 78 T.C. 1172 (1982).

147. *See id.* at 1184-85.

148. *Id.* at 1185.

149. *Id.*

150. 705 F.2d 671 (2d Cir. 1983).

151. *See id.* at 675-76.

152. *Id.* at 676.

153. *See* I.R.C. § 2516 (1982).

was made pursuant to a written agreement entered into within two years prior to divorce.¹⁵⁴ The 1984 Act amended section 2516 so as to enlarge the two-year time period. The section now applies when divorce occurs within a three-year period beginning one year before the agreement is made.¹⁵⁵ This amendment is effective for transfers made after July 18, 1984.¹⁵⁶

As under prior law, section 2043(b) still provides that, for estate tax purposes, the relinquishment of dower rights or other such marital rights is generally *not* consideration for an interspousal transfer.¹⁵⁷ The most significant change in the estate tax treatment of interspousal transfers under the 1984 Act is the creation of section 2043(b)(2) of the Code, which provides a broad exception to the general estate tax treatment of transfers related to divorce. The new section provides: "For purposes of section 2053 . . . , a transfer of property which satisfies the requirements of paragraph (1) of section 2516 . . . shall be considered to be made for an adequate and full consideration in money or money's worth."¹⁵⁸ Section 2043(b)(2) applies to the estates of transferors dying after July 18, 1984.¹⁵⁹

Although the new section does not by its terms limit inclusions in a transferor's gross estate under section 2036 or certain other sections, it does allow an estate tax deduction for claims against the estate arising from a written agreement relative to marital and property rights where the associated transfer of property would not be subject to gift tax under section 2516(1). The effect of section 2043(b)(2) is to equalize the estate tax treatment of certain transfers related to divorce with the gift tax treatment received by similar inter vivos transfers under prior law. The new section partially codifies the Second Circuit's ruling in *Natchez* that a transfer which would be considered made for adequate and full consideration under section 2516 should likewise be considered for the purpose of computing an estate tax deduction under section 2053.¹⁶⁰

The rules of section 2036 and other estate tax provisions may

154. *See id.*

155. Pub. L. No. 98-369, § 425(b), 98 Stat. 494, 804.

156. Pub. L. No. 98-369, § 425(c)(2), 98 Stat. 494, 804.

157. *See* I.R.C. § 2043(b) (1982); Pub. L. No. 98-369, § 425(a), 98 Stat. 494, 803 (amending I.R.C. § 2043(b)).

158. Pub. L. No. 98-369, § 425(a), 98 Stat. 494, 803.

159. Pub. L. No. 98-369, § 425(c)(1), 98 Stat. 494, 804.

160. *See Natchez v. United States*, 705 F.2d 671, 675-76 (1983); *supra* text accompanying notes 150-52.

still require inclusion in the transferor's gross estate of the value of certain property transferred incident to divorce, but section 2043(b)(2) should allow an offsetting estate tax deduction, at least to the extent that claims arising from transactions exempted from gift taxation under section 2516(1) are satisfied from the assets of the estate.¹⁶¹ Therefore, if a transferor dies before all agreed-upon transfers to the surviving or former spouse are completed, the transferor's estate will not be taxed on property it subsequently transfers pursuant to the agreement.

Section 2043(b)(2) purports to modify the estate tax definition of "consideration" only for purposes of calculating estate tax deductions under section 2053.¹⁶² It remains to be seen whether some courts will continue to observe distinctions between the meaning of "consideration" under gift tax section 2516 and its meaning in other estate tax provisions not specified in the amended section 2043.¹⁶³

Only transfers satisfying the requirements of gift tax section 2516(1) are expressly made eligible for the estate tax deduction by way of section 2043(b)(2). Under section 2516(1), a transfer must be made "to either spouse in settlement of his or her marital or property rights."¹⁶⁴ Although gift tax section 2516(2) provides that transfers made to provide support for minor children are also deemed made for adequate and full consideration,¹⁶⁵ the estate tax treatment of this class of transfers is not expressly affected by the terms of the new section 2043(b)(2). The courts may interpret section 2043(b)(2)'s specific reference to section 2516(1) as excluding transfers supported by consideration under section 2516(2) from similar treatment for estate tax purposes. However, such a disparate interpretation of "consideration" for estate and gift tax purposes could be rejected by courts still attempting to construe the estate tax and gift tax provisions *in pari materia*.

161. For example, property transferred subject to a life interest in the transferor in settlement of inchoate marital rights could be includible in the transferor's gross estate under I.R.C. § 2036 (1982). If the settlement agreement gives rise to a claim against the estate for the value of the remainder interest, the estate's payment of the claim could be allowed as a deduction under §§ 2043(b)(2) and 2053.

162. The new section is silent regarding the incorporation of the gift tax definition of "consideration" in § 2516 into other provisions of the estate tax.

163. The phrase "adequate and full consideration" is important in determining estate tax effects of transfers under several estate tax provisions, including I.R.C. §§ 2035-2038 (1982).

164. I.R.C. § 2516(1) (1982).

165. See I.R.C. § 2516 (1982).

IV. CONCLUSION

The 1984 Act significantly alters the taxation of alimony and transfers of property incident to divorce. In ascertaining the advisability of using an alimony trust to fulfill a support obligation, those tax aspects should be considered.

The 1984 Act overrules the longstanding *Davis* rule and, for income tax purposes, treats transfers of property between spouses incident to divorce or separation as gifts. This approach is consistent with the estate and gift tax policy of expanded marital deduction, i.e., that transfers between spouses should not be taxable events.¹⁶⁶ The payor recognizes no gain or loss on the transfer, and the payee takes the carryover basis in the property. When appreciated property is transferred directly to the payee or is used to establish a trust for the benefit of the payee, the nonrecognition of gain to the payor is an advantage not always available under prior law. The transfer of appreciated property may be less desirable now from the payee's point of view, because as a result of the carryover basis the payee is likely to recognize a larger taxable gain upon a later sale of the property.

Alimony is now defined as cash payments received by or on behalf of the payee under a divorce or separation instrument. The periodic requirement and the requirement of a legal obligation pursuant to local law have been removed from the definition in section 71 of the Code. The changes in section 71 eliminate the need for complex distinctions between "alimony" and "property settlements" which, under prior law, depended on the application of varying state laws regarding marital and property rights. The new section 71 should make the income tax effects of payments and transfers incident to divorce or separation more predictable and uniform from state to state. Section 71 continues to require inclusion of direct alimony payments in the gross income of the payee, and section 215 still provides for a corresponding deduction from the gross income of the payor.

The confusing references to alimony trust taxation in sections 71 and 682 have been deleted, and section 682 alone apparently governs the income taxation of alimony paid by a trust. Under the new law, the payee of an alimony trust should be treated as any other trust beneficiary, and the normal trust conduit and timing rules should apply. Use of an alimony trust may therefore be of

166. See H.R. REP. No. 432, 98th Cong., 2d Sess. 1491 (1984).

great benefit to the payee when the trust income is tax-exempt to the trust, because the tax-exempt character of the income will pass through to the payee.

The 1984 Act provides an estate tax deduction for transfers made pursuant to instruments qualifying for gift tax exemption under section 2516(1), equalizing estate and gift tax treatment of qualifying transfers. It also extends the time period for gift tax exemption of such transfers from two years to three years, so that the exemption may be available when divorce precedes the agreement by as much as one year.

While the 1984 Act has successfully clarified and simplified most aspects of the income taxation of transactions in connection with divorce, the recapture of certain alimony deductions under the new section 71(f) is relatively complex and confusing. In the estate and gift tax areas, it remains to be seen how the partial statutory incorporation of section 2516 into the estate tax will be treated by the courts and the Service. As questions arise concerning the meaning and effect of the new law, the Treasury Department should promulgate regulations clarifying the amendments made by the 1984 Act.

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