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Roland L. Hjorth
University of Washington School of Law

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TAX CONSEQUENCES OF POST-DISSOLUTION SUPPORT PAYMENT ARRANGEMENTS*

Roland L. Hjorth**

The economic settlement[1] accompanying a marriage dissolution may consist of one or both of the following: (1) the initial "property settlement," sometimes referred to as a "division" of property when only community property is involved;[2] and (2) provisions for maintenance payments categorized as alimony, child support, or some combination thereof.[3] The tax problems of property settlements have been analyzed previously by the author.[4] They are considered here only to the extent necessary to distinguish property settlements paid in install-

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* This article makes several assumptions solely for purposes of convenience. It assumes that if payments are made the payor is the husband or former husband. If payments are made by one spouse for a property interest or inchoate right of the other spouse, the husband is presumed to be the buyer and the wife is presumed to be the seller. If payments other than payments for property or for child support are made, the recipient of such payments, characterized as alimony, is presumed to be the wife. Moreover, if there are children the wife is presumed to be the custodial parent, and unless otherwise specified, she is presumed to receive payments specifically designated as child support. These assumptions are made even though federal tax results do not depend upon the sex of the payor or payee. Finally, references in the text to "husband" or "wife" should be read to include "former husband" or "former wife." *See* INT. REV. CODE OF 1954, § 7701(a)(17) [hereinafter cited as I.R.C.] which provides:

> As used in sections 71, 152(b)(4), 215, and 682, if the husband and wife therein referred to are divorced, wherever appropriate to the meaning of such sections, the term "wife" shall be read "former wife" and the term "husband" shall be read "former husband"; and, if the payments described in such sections are made by or on behalf of the wife or former wife to the husband or former husband instead of vice versa, wherever appropriate to the meaning of such sections, the term "husband" shall be read "wife" and the term "wife" shall be read "husband."

** Professor of Law, University of Washington.

1. *See, e.g.*, WASH. REV. CODE § 26.09.050 (1974) which provides that:

> In entering a decree of dissolution of marriage, legal separation, or declaration of invalidity, the court shall consider, approve, or make provision for child custody and visitation, the support of any child of the marriage entitled to support, the maintenance of either spouse, and the disposition of property and liabilities of the parties.

The Washington Dissolution Act of 1973 is discussed in Rieke, *The Dissolution Act of 1973: From Status to Contract?*, 49 WASH. L. REV. 375 (1974).

2. *See* WASH. REV. CODE § 26.09.080 (1974).
3. *See id.* § 26.09.090 (maintenance) and *id.* § 26.09.100 (child support).
4. Hjorth, *Community Property Marital Settlements: The Problem and a Proposal*, 50 WASH. L. REV. 231 (1975).

ments from periodic maintenance payments made for the support of a former spouse, or for children of the marriage, or both.[5] The primary concerns of this article are the tax consequences of alimony[6] and child support payments.

Federal income tax law recognizes marriage as a status involving unique tax benefits and burdens.[7] The following are examples of some of the benefits: (1) a wage-earning spouse is not taxed on the "imputed income" enjoyed from services rendered in the home by the other spouse or by children of the marriage; (2) parents may obtain exemption allowances for their children[8] and certain deductions for expenses of dependents, including expenses for medical care[9] and child care.[10] On the other hand, payments to or for the support of a nonworking spouse or child are not deductible by the payor and are not income to the beneficiaries of such payments.[11] Although this rule may not be a tax burden, it can certainly be considered to be the denial of a plausible tax benefit. Another potential tax burden of marriage was established by the Tax Reform Act of 1969 which applies four separate tax rate schedules[12] in ascending order of severity to: (1) married individuals filing joint returns (and certain surviving spouses); (2) heads of households;[13] (3) unmarried individuals (other than surviving

5. *See* Part I *infra*.

6. The Internal Revenue Code uses the term "periodic payments" rather than the word "alimony." *See, e.g.*, I.R.C. § 71. WASH. REV. CODE § 26.09.090 (1974) refers to "maintenance" instead of alimony. The term "alimony" is used in the text because of its common usage.

7. The impossibility of achieving total tax neutrality in this area is the subject of a superb discussion by Professor Boris Bittker, *Federal Income Taxation and the Family*, 27 STAN. L. REV. 1389 (1975). The article also discusses a recent legislative proposal to achieve a "marriage-neutral federal income tax." *Id.* at 1395 and 1438. *See* H.R. REP. No. 715, 93d Cong., 1st Sess. (1973).

8. I.R.C. § 151(e). Parents need not, of course, be married to obtain exemption allowances for their children. But children are a foreseeable consequence of marriage and exemptions for them are part of the scheme of taxation of the family unit. When the unit is dissolved, the exemptions remain and illustrate the fact that a marriage dissolution is not merely a reversion to the status quo ante for tax purposes.

9. I.R.C. § 213.

10. *Id.* § 214.

11. Gould v. Gould, 245 U.S. 151 (1917)(by implication). The Court in *Gould* held that alimony paid to a divorced wife was not income to her because (a) it did "not arise from any business transaction, but from the relation of marriage," *id.* at 153, *quoting* Audubon v. Shufeldt, 181 U.S. 575 (1901), and (b) "alimony is regarded as a portion of the husband's estate to which the wife is equitably entitled." *id.* at 153. A fortiori, the same is true of payments before divorce. *See* Farid-es-Sultaneh v. Commissioner, 160 F.2d 812 (2d Cir. 1947).

12. I.R.C. § 1.

13. The term "head of household" is defined in I.R.C. § 2(b). A head of household is an unmarried individual who provides over one-half the cost of maintaining a household in which he or she lives with unmarried children or dependents.

spouses); and (4) married individuals filing separate returns (and estates and trusts). Whether or not these new rate schedules make marriage a tax benefit or burden depends on the taxable income of each spouse. The history and effect of these rate schedules have been examined elsewhere.[14] The fourth category does not apply to unmarried individuals, and married taxpayers will not ordinarily use it because of its high rates. It is available in the case where one spouse, for whatever reason, refuses to sign a joint return with the other spouse. Briefly, considering only the first three categories, the aggregate tax for two individuals having equal incomes will be less if they are unmarried than if they marry. Where incomes are widely disparate, or where one spouse has no income and the other spouse has considerable income, marriage will usually cause the aggregate taxes of the two individuals to be reduced. However, marriage has the general effect of increasing aggregate taxable income of two individuals by forcing them to share one standard deduction and by otherwise limiting their deductions.[15]

It is not suggested that couples marry for tax reasons. Even if a decision to marry were influenced by such motives, it would be dangerous to predict whether marriage would create a tax benefit or tax burden. If both spouses intend to remain employed at approximately equal salaries, a marriage tax burden can be expected, but if one spouse becomes unemployed (as the term is commonly used—disregarding employment in the home), marriage may yield a tax benefit.[16] Neither is it suggested that couples divorce in order to lessen aggregate tax burdens. But, at least in theory, divorce almost always can result in a decreased tax burden on the combined income of a former husband and a former wife. It can do so because Internal Revenue

14. *See* Bittker, *supra* note 7.

15. I.R.C. §§ 141(b) & (d), 142.

16. It is easy to assert that existing law imposes a "penalty" on married couples and discourages employment by both spouses. *See* Blumberg, *Sexism in the Code: A Comparative Study of Income Taxation of Working Wives and Mothers*, 21 BUFF. L. REV. 49 (1971); Richards, *Discrimination Against Married Couples Under Present Income Tax Laws*, 49 TAXES 526 (1971). Professor Bittker has summarized the dilemma as follows:

> From 1948 to 1969, the tax differential between single and married taxpayers imposed a "penalty" on being single. In 1969, the penalty was reduced for some single taxpayers and eliminated for others, but this reform had a price—either a penalty on some married couples or abandonment of the 1948 principle of imposing equal taxes on equal-income couples. Given this choice, Congress preferred the marriage penalty.

Bittker, *supra* note 7, at 1431 (footnotes omitted).

Code Sections 71 and 215 permit former spouses to divide aggregate taxable income into two separate taxable incomes that are not widely disparate. Divorce will enable the former spouses to qualify for the more favorable "single taxpayer" rates and may further (if there are children) cause the custodial spouse to qualify for the even more favorable head-of-household rates. Furthermore, divorce will often enable former spouses to obtain increased standard deductions or their equivalent, and to qualify for other deductions not previously available.[17]

The mechanism for decreasing the aggregate tax burden of divorced persons is provided principally (but not exclusively) by Sections 71 and 215. "Periodic payments" made by a husband to a wife are deductible by the husband and are income to the wife under Sections 215 and 71[18] unless the payments are specifically designated as

17. Assume, for example, that husband and wife are married through the 1974 calendar year. The husband's gross income is $30,000 and the wife's gross income is $20,000. Their aggregate adjusted gross income is $50,000. They have two children and incur $4,800 in child care expenses to enable both spouses to be gainfully employed, but because their adjusted gross income exceeds $44,600 no child care expenses can be deducted under I.R.C. § 214. They claim one standard deduction. Tax is computed as follows:

Adjusted Gross Income	$50,000
Standard Deduction (1974)	(2,000)
Exemptions	(3,000)
Taxable Income	$45,000
Tax before Credits (I.R.C. § 1(a))	$14,560

Assume instead that the husband and wife were divorced in 1974 and that the husband pays $8,000 to the wife as alimony, deductible by the husband under I.R.C. § 215 and income to the wife under I.R.C. § 71. Assuming that the husband has no itemized deductions other than the alimony deduction, taxes are as follows:

	Wife	Husband
Gross Income	$28,000	$30,000
Deductions (child care deduction and 3 exemptions for W; alimony deduction and one exemption for H)	(7,050)	(8,750)
Taxable Income	$20,950	$21,250
Tax before Credits (I.R.C. § 1(b),(c))	$ 5,132	$ 5,705

Aggregate tax is thus reduced from $14,560 to $10,837, and the computations do not take into account other itemized deductions that each taxpayer could take in lieu of the standard deduction.

Whether divorce is costly in tax terms depends upon the figures involved. Tax benefits of a divorce will be greatest where post-dissolution incomes are relatively equal, where parties may "double" personal deductions, where one parent may claim a child care deduction that would not have been available to the married couple, and where benefits accrue in terms of head-of-household and single taxpayer. As these factors are eliminated, tax benefits are reduced.

18. I.R.C. § 71(a)(1) applies to payments incident to a "decree of divorce or separate maintenance." This provision, and the corollary deduction section, were

child support payments.[19] Payments must be "periodic." Accordingly, payment of alimony "in gross"[20] or of a lump sum [21] is not deductible. But the deduction-inclusion rules do apply to installment payments on a lump sum if the payments are to be made over a period of more than ten years from the date of the decree, instrument, or agreement, subject to the provisions of Section 71(c)(2).[22]

It must be remembered that periodic payments do not fit within the deduction-inclusion rules if the payments are made for a vested property interest of the former wife.[23] Moreover, periodic payments may fail to qualify under the deduction-inclusion rules even if they are paid for something other than a property interest, if they are in the nature of something other than support payments.[24] Consequently, before

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adopted as § 120(a)-(c) of the Revenue Act of 1942 and incorporated as §§ 22(k) and 23(u) of the Internal Revenue Code of 1939. The provisions were a congressional response to the Supreme Court's decision in Gould v. Gould, 245 U.S. 151 (1917), holding that alimony is not income to the wife and is not deductible by the husband. One must assume that, to the extent the *Gould* case is not specifically reversed by legislation, it applies as a residual rule, *i.e.*, if payments to a wife are not specifically included as income to her in the statute they will not be so taxed. *See, e.g.*, Rev. Rul. 73-392, 1973-2 CUM. BULL. 18; Gordon D. Oxford, 32 CCH Tax Ct. Mem. 1321 (1973); William M. Hardy, 59 T.C. 857 (1973). I.R.C. § 71(a)(2) & (a)(3) was added when the Internal Revenue Code of 1954 was adopted. I.R.C. § 71(a)(2) covers amounts paid "pursuant to a written separation agreement executed after August 16, 1954." Treas. Reg. § 1.71-1(b)(2) (1957). I.R.C. § 71(a)(3) applies to judicial support decrees issued when spouses are not yet divorced and entered after March 1, 1954. It should be remembered that payments are never within the scope of I.R.C. §§ 71 & 215 unless made pursuant to a binding decree or written agreement. Sylvia Taylor, 55 T.C. 1134 (1971). Subsections 71(a)(2) & (3) require that the wife be living separate and apart from the husband, but that fact need not be recited in the agreement or decree. Rev. Rul. 73-409, 1973-2 CUM. BULL. 19.

19. I.R.C. § 71(b); Commissioner v. Lester, 366 U.S. 299 (1961). *See* text accompanying notes 49-51 *infra*.

20. I.R.C. § 71(c); Gordon D. Oxford, 32 CCH Tax Ct. Mem. 1321 (1973).

21. *See, e.g.*, William M. Hardy, 59 T.C. 857 (1973) (husband who agreed to pay alimony until former wife's remarriage, and to then pay her a lump sum of $5,000, could not deduct the $5,000 payment); Rev. Rul. 73-392, 1973-2 CUM. BULL. 18.

22. *See* note 96 and accompanying text *infra*. Payments on a "lump sum" are "periodic" even if they are to be paid over a period of less than ten years if the obligation to pay terminates on the occurrence of some contingency, *e.g.*, wife's remarriage or death. The reason is that there is no specified lump sum. The result follows even if the condition operates by reason of local law rather than by express provision in the decree. Treas. Reg. § 1.71-1(d)(3)(ii) (1957); Baker v. Commissioner, 205 F.2d 369 (2d Cir. 1953). In Washington the obligation to pay alimony terminates on the death of either party or upon the remarriage of the recipient, and child support terminates upon the death of the parent obligated to support the child or emancipation of the child "unless otherwise agreed in writing or expressly provided in the decree." WASH. REV. CODE § 26.09.170 (1974). *See also* George Kent, 61 T.C. 133 (1973); Rev. Rul. 72-133, 1972-1 CUM. BULL. 25.

23. Treas. Reg. § 1.71-1(c)(4) (1957).

24. *See* discussion in Part I *infra*.

examining the details of Sections 215 and 71 and their progeny, it is necessary to determine whether periodic payments are for "support" or for "property."

I. DISTINGUISHING DEDUCTIBLE SUPPORT PAYMENTS FROM NONDEDUCTIBLE PURCHASES OF PROPERTY

A. *The Uncertain Scope of Section 71(c)*

Section 71(c) provides that installment payments on a specified principal sum are "periodic" only if the payments are to be paid or may be paid over a period ending more than ten years from the date of the decree, instrument, or agreement. If that condition is met, payments to the wife in a given taxable year may be deducted in an amount up to ten percent of the principal sum. The condition does not apply if payments terminate on the death or remarriage of the wife because in such a case there is no ascertainable lump sum.[25] But the provision does not give a husband an opportunity to purchase a property interest of the wife on a deductible basis. The Regulations provide that "Section 71 . . . does not apply to that part of any periodic payment attributable to that portion of any interest in property . . .

25. *See* note 22 *supra*. *See also* Baker v. Commissioner, 205 F.2d 369 (2d Cir. 1953) (monthly payments for a specified period or until wife died deductible even though period was less than ten years); Rev. Rul. 59–190, 1959–1 CUM. BULL. 23 (payments to be made over period of less than ten years deductible by husband and income to wife where, under local law, obligation to pay terminates on wife's death or remarriage even if no provision to that effect is in the agreement or decree).

It is now possible in Washington to provide for periodic payments which survive the death of the husband. WASH. REV. CODE § 26.09.170 (1974). The payments to the wife would be income to her. They probably could not be deducted by the husband's estate for income tax purposes because I.R.C. § 215 grants a deduction only to the "husband." It is not clear whether such payments could be deducted for estate tax purposes. Under I.R.C. § 2053(c), deductions based upon a contract are allowable only if supported by full and adequate consideration in money or money's worth. For estate tax purposes, a release of marital obligations does not qualify as such full consideration. Commissioner v. Wemyss, 324 U.S. 303 (1945); Merril v. Fahs, 324 U.S. 308 (1945)(gift tax). When a wife's claim is not based on a contract, but is based upon a court decree, it can be argued that an estate tax deduction should be allowable. McMurtry v. Commissioner, 203 F.2d 659 (1st Cir. 1953). Therefore, if the wife's claim is based on an agreement not incorporated into the decree, the claim is not deductible. If the claim is based upon a decree which has incorporated a separation contract giving rise to such a claim, it is possible that it is not deductible because the court must incorporate the agreement unless it was "unfair at the time of its execution." WASH. REV. CODE § 26.09.070(3) (1974). *See* Rev. Rul. 75–395, 1975–37 INT. REV. BULL. 12.

which . . . originally belonged to the wife."[26] Thus if a former husband purchases a property interest of a former wife (such as the wife's interest in community property or separate property of the former wife), Sections 71 and 215 do not apply even if the payments are made over a period more than ten years or are "periodic" because they terminate on the occurrence of a stated contingency.[27] The wife may realize gain; the husband may adjust basis to reflect cost; the wife may have imputed interest under Section 483[28] and the husband may have a corresponding deduction under Section 163;[29] but Sections 71 and 215 will not apply.

Some courts have adopted the restrictive view that Section 71(c)(2) cannot apply unless payments are in the nature of "alimony or an allowance for support." Under this view Section 71(c) payments are not deductible even if made for something other than a vested property interest of the wife. Numerous cases raise the issue: payments for equitable claims to property that arose by virtue of the wife's efforts but that are not "property" under state law;[30] payments made because of

26. Treas. Reg. § 1.71–1(c)(4) (1957).

27. *See, e.g.,* Ben C. Land, 61 T.C. 675 (1974); John Sidney Thompson, 22 T.C. 275 (1954), *acquiesced in sub. nom.,* Corinne Pope Thompson, 1954–2 CUM. BULL 6. Some of the difficulties involved in valuing community property for this purpose are illustrated in A.J. Roberts, 33 CCH Tax Ct. Mem. 750 (1974), in which certain payments were designated as payments for the purchase of the wife's community property interest and other payments were labeled "alimony." The husband deducted *all* payments on the grounds that the wife actually received one-half the value of the community property in the year of divorce. The husband was successful. If payments for property are to terminate on the former wife's death, the private annuity rules set forth in Rev. Rul. 69–74, 1969–1 CUM. BULL. 43, could apply. The former wife could, of course, argue that she should not be taxed until she recovers her basis. Commissioner v. Kann's Estate, 174 F.2d 357 (3d Cir. 1949).

28. But if payments by a husband are nondeductible because they are installments on a sum certain payable within a period of less than ten years (see I.R.C. § 71(c)(1)), and *not* because they reflect a purchase of property, the imputed interest rules of I.R.C. § 483 have been held to be inapplicable. Fox v. United States, 510 F.2d 1330 (3d Cir. 1975). *See* note 121 *infra.*

29. *See* Gerlach v. United States, 74–1 U.S. Tax Cas. ¶ 9425 (Ct. Cl. 1973) (husband entitled to deduction for imputed interest on payments made for wife's interest in property).

30. *See, e.g.,* McCombs v. Commissioner, 397 F.2d 4 (10th Cir. 1968). Husband and wife worked together to build a profitable business. Despite the wife's efforts, the business was the property of the husband under local law. The divorce court awarded half the business to the wife and the husband agreed to pay for the wife's half over a twelve-year period. Payments made by the husband were *not* deductible by the husband under I.R.C. § 71(c)(2). The *form* of the transaction might make a difference to some courts. Thus if property is first awarded to the wife and the husband then buys it, it seems clearer that I.R.C. § 71(c)(2) should not apply. But if she is awarded no property (and never had any under local law) and instead receives the

personal feelings or to make it easier to obtain a divorce;[31] payments for the release of claims arising out of dower or similar "inchoate" rights; and payments to obtain a release against pension and similar rights that are not "property" for tax purposes. The problem arises whenever the wife is being paid "periodically" if the payments are for something more than her support but are for something less than a vested "property" interest.

B. *Dower and Similar Inchoate Rights*

The prevailing attitude appears to be that Section 72(c)(2) payments made for the release of inchoate dower claims and similar rights are not deductible by the husband even if they are periodic. In *Bernatschke v. United States*[32] the husband used approximately one-third of his total assets to purchase several annuities for his former wife. The annuities paid $25,000 per year. The payments were held to be "periodic" but were not income to the wife because they arose out of a "property settlement" in which the former wife's inchoate interests under Illinois law were extinguished. This case might be distinguished from cases where the husband is actually making periodic payments because the former wife was the taxpayer before the court, and a very substantial part of each payment received by her was principal for which the husband could get no deduction. Although her receipts were periodic (and thus potential income under Section 71(d)), the husband's original payments were a lump sum. In spite of these distinctions, the principle of the case was adopted in *Waller v. United States*,[33] in which the husband agreed to pay the former wife a total of

right to payments over a twelve year period. I.R.C. § 71(c)(2) *might* apply. *See* Hayutin v. Commissioner, 508 F.2d 462 (10th Cir. 1974). The court in *McCombs* may well have been influenced by the fact that the wife made a definite contribution to family wealth which she might have recovered even if the parties had not been married.

31. *See* Marion R. Hesse, 60 T.C. 685 (1973), *aff'd mem.*, 511 F.2d 1393 (3d Cir.), *cert. denied*, 96 S.Ct. 58 (1975), *acquiesced in*, 1974–2 Cum. Bull. 3 (deduction allowed).

32. 364 F.2d 400 (Ct. Cl. 1966). It is interesting to speculate where the decision left the former husband. Presumably, the wife is considered the purchaser of the annuity and should be taxed as an annuitant under I.R.C. § 72. The husband should not be taxed. *See* I.R.C. § 71(d).

33. 75–1 U.S. Tax Cas. ¶ 9180 (W.D. Ky. 1974).

$55,100 over a period of more than ten years to compensate her for her dower interest. Payments were to be made as follows:

1970	$29,000
1971–1975	5,000 per year
1976–1980	200 per year
1981	100

The husband attempted to deduct $5,000 in 1970 (about ten percent of the total payments to be made, as authorized in Section 71(c)(2)), but the deduction was disallowed on the grounds that even though the payments met the literal requirements of Section 71(c)(2), they were not in the nature of an allowance for alimony or support; rather, they were designed to compensate the wife for her dower interest. Although this case, too, might be distinguishable on the grounds that the de minimis payments to be made in 1976–1981 should be disregarded with the result that the "ten year" rule of Section 71(c)(2) was not met, this restrictive interpretation of Section 71(c)(2) was adopted and summarized in *McCombs v. Commissioner*:[34]

> For income tax purposes, Section 71 is directed toward periodic payments made . . . *as alimony or support money*. The prerequisite of alimony or support also applies to the provisions of Section 71(c)[2] for treating installments on a principal sum which may be paid over more than 10 years as periodic payments.

Again, this broad statement may not have been necessary to the holding of the case. In *McCombs* the wife worked actively in the development of a family business and might have had a claim even if the parties had never been married.

Other courts seem content to hold that payments meeting the requirements of Section 71(c)(2) will qualify for the deduction-inclusion rules of Sections 71 and 215 so long as the payments are *not* for a vested property interest of the wife. In *Hayutin v. Commissioner*[35] the Court of Appeals for the Tenth Circuit held that $500 out of each $700 monthly payment was deductible by the husband and income to the wife. The remaining $200 was held to represent a purchase by the husband of a vested property interest of the wife. In response to a con-

34. 397 F.2d 4, 7 (10th Cir. 1968) (emphasis added).
35. 508 F.2d 462 (10th Cir. 1974).

tention that Sections 71 and 215 did not apply at all because the entire amount of each payment represented a "property settlement," the court stated: "A husband's property, in Colorado, is basically free from any vested interest of the wife, except her inchoate rights which vest upon filing of the divorce action."[36] The court concluded that because the wife had no vested interest in the property during the marriage, *i.e.*, there was no element of co-ownership during that time, the payments were made to satisfy a marital obligation, not as part of a division of marital property. The Court of Appeals for the Ninth Circuit also appears to assume that if community property is equally divided, payments are of necessity in the "nature of alimony" unless the payments are for the separate property of the wife.[37]

On balance, it is not safe to assume that any payments qualify for the deduction-inclusion rules of Sections 71 and 215 unless they are in the nature of alimony or an allowance for support.[38] If such payments

36. *Id.* at 469. The Court of Appeals for the Tenth Circuit, interpreting Colorado law, has ruled that a wife's claims against her husband's property become a vested *property* right when the wife files a divorce action, with the result that a "division" of the property is not a taxable event. Imel v. United States, 523 F.2d 853 (10th Cir. 1975). Taxpayers in the Tenth Circuit are in a unique position. Installment purchases of "property" can be income to the wife and deductible by the husband. In other circuits installment payments for assets that are not "property" fall outside the deduction-inclusion rules unless the payments are an allowance in the nature of alimony or support.

37. *See, e.g.*, Riddell v. Guggenheim, 281 F.2d 836 (9th Cir. 1960). After finding that the wife received at least one-half the community property at the time of divorce, the court stated that "if . . . the wife relinquished no separate property in return for the monthly payments, it follows that she gave up nothing in the agreement and the payments could only be in discharge of the marital obligation . . . ." *Id.* at 841. *See also* Nancy Cole Miller, 32 CCH Tax Ct. Mem. 570 (1973) (periodic payments for wife's interest in joint property deductible by husband and income to wife because she did not "contribute" to the cost); A.J. Roberts, 33 CCH Tax Ct. Mem. 750 (1974) (payments designated as "property division and not support or alimony" nevertheless income to wife and deductible by husband because the wife has received her full share of the community property at the time of the divorce). The cases appear to attempt to achieve a kind of parity between common law property states and community property states in this area. That is, if the installment payments in a common law property state are for an interest that is a substitute for a property interest a similarly situated wife would have in a community property state, some courts hold installment payments made in return for that interest to be outside the scope of I.R.C. §§ 71 and 215. Where payments are for neither a property interest nor an interest in the nature of dower, § 71(c)(2) payments are income to the wife and deductible by the husband even if they are not in the nature of "support" payments. *See* Marion R. Hesse, 60 T.C. 685 (1973), *aff'd mem.*, 511 F.2d 1393 (3d Cir.), *cert. denied*, 96 S.Ct. 58 (1975), *acquiesced in*, 1974–2 Cum. Bull. 3.

38. A rule that payments otherwise "periodic" are subject to the deduction-inclusion rules unless the payments reflect the purchase of vested property rights would be preferable to the existing uncertainty. A large part of the current confusion may be attributable to the following statement in the House Ways and Means

do not represent installments on a purchase of a vested property interest and are not in the nature of alimony or an allowance for support, it is possible that the payor would get no deduction under Section 215, could not adjust his basis in the property, and would get no deduction for imputed interest. The payee, on the other hand, would have no income of any kind. She would be better off than one who sells a vested property interest because the latter might recognize gain and realize imputed interest under Section 483. The decisions in the *McCombs, Waller*, and *Bernatschke* cases make Section 71(c)(2) a trap for the unwary. Section 71(c)(2) can literally apply *only* to payments which survive the death or remarriage of either spouse. If the payments terminate upon the death or remarriage of either spouse, there is no payment of an ascertainable principal lump sum and the limitations of Section 71(c) do not apply. If the payments do survive the death of the payee, it is difficult to sustain the argument that they are in the nature of "support" or "alimony." It is accordingly difficult to imagine any Section 71(c)(2) payment that is not subject to attack by the Commissioner.[39]

Attorneys and their clients would certainly feel more secure if they could plan divorce settlements on the safe assumption that the deduction-inclusion rules apply to all periodic payments other than payments for a vested property interest of a recipient spouse. Regrettably, they cannot make such assumptions with certainty. It would therefore seem advisable, in any case where periodic payments meet the literal requirements of Section 71 and are not designed to purchase a property interest of the payee spouse, to include a provision in the separation contract under which the payee agrees to hold the payor harmless from tax liability in the event that the payor is unable to deduct such payments.

Committee report accompanying the predecessor of I.R.C. §§ 71 & 215: "[The provisions apply only to payments made] in recognition of the general obligation to support . . . ." H.R. REP. No. 2333, 77th Cong., 2d Sess. (1942), in 1 SEIDMAN'S LEGISLATIVE HISTORY OF FEDERAL INCOME AND EXCESS PROFITS TAX LAWS 1953–1939, at 1277–78 (1954). However, the Senate Finance Committee amended the original House bill to include § 72(c)(2) installment payments and should therefore modify the House statement that the provisions cover only "support" payments. S. REP. No. 1631. 77th Cong., 2d Sess. (1942), in 1 SEIDMAN, *supra*, at 1279–80.

39. For example, if a wife "sells" her dower or similar inchoate rights to a husband who wants a divorce, she could sell that interest for a private annuity payable by the husband and terminating on her death. Under the *Bernatschke* case, the deduction-inclusion rules of §§ 71 & 215 would not apply.

C. *Assignment of Income Problems*

1. *Vested rights to receive income*

In community property states the assets of a divorcing couple may include rights to receive income which accrued during coverture, but which will not be collected or reported for tax purposes until after the marital community is dissolved. These items might include accounts receivable of cash basis taxpayers, unrealized receivables arising from installment sales reported under the installment method of accounting under Section 453, and vested pension rights. To the extent these items were realized during the existence of the marital community, they will eventually be taxed one-half to each spouse regardless of who in fact collects the income, in accordance with the Supreme Court's decision in *Poe v. Seaborn.*[40] If these items are partitioned equally, the partition is not a taxable event and each spouse reports his or her share of income as it is collected. But where partition is not feasible, one spouse may receive the assets and agree to pay the other spouse for his or her share as the assets are collected or at some other time. These arrangements do not fall within the deduction-inclusion rules of Sections 71 and 215, but the tax results are similar. The initial settlement should not be a taxable event if the payee receives only the payor's unsecured promise to pay.[41] The arrangement should be treated as an open transaction and the payee should report income only as she is paid by the husband.[42] The husband should not deduct the payments as such, but should increase his basis in the underlying assets, thereby reducing his income on collection.[43]

The preceding statements are only generalizations. As to accounts receivable of cash basis taxpayers, the generalizations should apply if the wife receives payments more or less contemporaneously with the husband's collection of the accounts receivable. As to vested pension

40. 282 U.S. 101 (1930). *See also* United States v. Mitchell, 403 U.S. 190 (1971) (Louisiana widow held liable for tax on half the income earned by her deceased husband even though she renounced any claim to such income).

41. *See* Helvering v. Eubank, 311 U.S. 122 (1940).

42. The theory is that the payor's unsecured promise to pay has no market value. Rev. Rul. 69–471, 1969–2 Cum. Bull. 10. *Cf.* C.W. Titus, 33 B.T.A. 928 (1936). On the other hand, where a wife received her husband's note "in payment for" her interest in accounts receivable, she was held to have realized income in the year of sale. Royce Showalter, 33 CCH Tax Ct. Mem. 192 (1974).

43. *See* Johnson v. United States, 135 F.2d 125, 130 (9th Cir. 1943).

rights, the Internal Revenue Service has ruled that the wife should report payments made to her by the husband under assignment of income principles (rather than under Section 71)[44] but has not ruled on the issue of whether the husband may exclude from income the amounts he pays to his former wife. The surrender of rights to receive payments under an installment obligation governed by Section 453 presents a more difficult problem. Section 453 indicates that a transfer of an interest in such an obligation is a taxable event,[45] whether or not the consideration received can be valued at the time of transfer. Rights under such installment contracts should be partitioned if the taxpayers wish to avoid immediate recognition of gain, notwithstanding a 1949 case indicating that transfers of such obligations in equal divisions of community property are not taxable events.[46]

2. *Unvested rights to receive income*

Nothing reflects the unsatisfactory state of the law in this area more than the disposition of unvested or partially vested rights to receive future income. Pension rights, whether vested, unvested, or partially vested, are clearly assets that divorce courts should take into account in determining what payments are to be made to the wife.[47] If periodic payments are made to compensate a wife for an "inchoate" interest in a husband's pension rights in a common law property state, it is exceedingly difficult to say that she is being paid for a "property"

44. Rev. Rul. 69–471, 1969–2 CUM. BULL. 10 (military retirement pay held to be community property; wife gave up her claim to one-half of pension of $30 per month for life of husband in return for payment by husband to her of $30 per month for 36 months; *held* not to be covered by I.R.C. §§ 71 & 215 but that under assignment of income principles the amounts paid to the wife by the husband were her income in the years received).
45. I.R.C. § 453(d).
46. Ann Y. Oliver, 8 CCH Tax Ct. Mem. 403, 430 (1949).
47. *See* Payne v. Payne, 82 Wn. 2d 573, 512 P.2d 736 (1973), *discussed in* Note, *Disposition of Military Retired Pay Upon Dissolution of Marriage,* 50 WASH. L. REV. 505 (1975). Pension rights can obviously be unvested, partially vested, or totally vested at the time of divorce. See I.R.C. §§ 401–415. Even if totally vested, the eventual pension may be increased by reason of continued post-divorce employment. The Washington court has taken unvested pension rights into account in the property division pursuant to a marriage dissolution to the extent of the community's contribution. Wilder v. Wilder, 85 Wn. 2d 362, 534 P.2d 1355 (1975)(pension right contingent upon husband's reenlistment in the Navy for one year or less, court to consider length of time before eligibility would mature and other options available to the husband along with the probability that he might abandon his pension rights to pursue another career).

interest, because the pension right, whether or not vested, is not "property" for general income tax purposes. The *Bernatschke*, *Waller*, and *McCombs* decisions nevertheless make it unwise to assume that periodic payments made in return for the wife's inchoate interest in such items will be governed by the deduction-inclusion rules of Sections 71 and 215. The problem cannot be avoided in community property states because, to the extent a pension is unvested at time of divorce, it is not clear, for federal tax purposes, that it can be said to be earned during coverture and therefore partially taxable to the wife regardless of who collects the pension. To the extent that it was not vested during coverture, payments for the wife's interest might also be subject to the rules set forth in *Bernatschke*, *Waller*, and *McCombs*. Because of existing uncertainty, the parties should arrive at an agreement as to how the periodic payments made in return for the surrender of absolute or inchoate rights in future pensions (whether vested or not) should be taxed. Thus, if a husband agrees (or is required by decree) to pay a former wife $1,000 per year for twelve years in return for her release of any claims to any future pension rights of the husband, the agreement or decree should set forth the intention that the amounts paid to the wife will be taxed to her and not to the husband (either under assignment of income principles or under Sections 71 and 215). The agreement or decree should further provide that the wife will hold the husband harmless against taxes to be paid by him in the event the intentions of the parties are not realized.[48]

II. ALIMONY AND CHILD SUPPORT—CONSEQUENCES OF CATEGORIZATION

A. *The* Lester *Case*

To the extent payments are "in the nature of an allowance for alimony or support," both the Code and the courts provide maximum

48. Usually parties can avoid serious problems if they realize that one spouse is paying the other spouse for the latter's right to income. If Ann Y. Oliver, 8 CCH Tax Ct. Mem. 403 (1949), is still good law, a transfer of rights under I.R.C. § 453 installment obligations is not, per se, a taxable event. Accordingly, if a wife transfers a right to income earned during marriage in return for installment payments to be made by the husband (but is not then taxed), she can report the income from the transfer as amounts are collected from the husband under the "open transaction" doctrine.

flexibility in determining which spouse should be taxed on the income. The deduction-inclusion rules of Sections 71 and 215 do not apply to "that part of any payment which the terms of the decree, instrument, or agreement fix, in terms of an amount of money or a part of the payment, as a sum which is payable for the support of minor children of the husband."[49] But according to the Supreme Court's decision in *Commissioner v. Lester*,[50] the part of the payment attributable to child support must be set forth specifically, and cannot be inferred from the underlying facts and circumstances. For example, if a decree orders a father with two minor children to pay the custodial mother $600 per month, reducible by $200 per month as each child becomes 21, and further reducible by $200 per month when and if the mother remarries, it might reasonably be inferred that $400 of each payment is intended to serve as child support. But under *Lester* the inference is not permissible unless the decree or agreement specifically *fixes* the amount of child support. In the example just given, the wife would include as income and the husband would deduct the full amount of each monthly payment.[51]

At the time the *Lester* case was decided, it was commonly assumed that taxes could be lowered by agreements or decrees similar to the decree in *Lester* as long as the former husband could be expected to be in a higher tax bracket than the former wife. The assumption was generally correct at the time because (1) the standard deduction was

See Rev. Rul. 69–471, 1969–2 Cum. Bull. 10. The *Oliver* case does not inspire confidence, however, as it did not mention the problem created by I.R.C. § 453 and is thus of doubtful validity as a precedent. If the wife receives for her right a promissory note that has market value she might recognize gain upon receipt of the note. Royce Showalter, 33 CCH Tax Ct. Mem. 192 (1974). A transfer of a mere right to income cannot qualify for the installment method of reporting under I.R.C. § 453. *See* Realty Loan Corp., 54 T.C. 1083 (1970), *aff'd,* 478 F.2d 1049 (9th Cir. 1973); Charles Sorensen, 22 T.C. 321, 342 (1954).

49. I.R.C. § 71(b).

50. 366 U.S. 299 (1961).

51. *See, e.g.,* Betty Lou Nelson, 32 CCH Tax Ct. Mem. 356 (1973) (payment of $475 per month, reducible by $137.50 per month when each of two minor children becomes emancipated and by another $200 per month when the wife remarries, all income to the wife under I.R.C. § 71(a)). Sloppiness should nevertheless be avoided. A requirement of "alimony for the support of the children" would be treated as child support. Cleveland J. Harris, 51 T.C. 980 (1969). Similarly, if a husband makes periodic payments to a wife who "undertakes to expend" a specified amount for child support, a portion of each payment will be nondeductible child support. West v. United States, 413 F.2d 294 (4th Cir. 1969). A similar problem was presented in Commissioner v. Gotthelf, 407 F.2d 491 (2d Cir.), *cert. denied,* 396 U.S. 828 (1969), in which the husband was to pay the wife $12,000 per year reducible by $5,000 per year on the wife's remarriage and by $3,500 per year upon the emancipation of each

then a relatively insignificant deduction;[52] (2) the custodial parent would be likely to claim the children as her dependents in any event;[53] and (3) the child care deduction was much less significant than it is now.[54] Because all of these factors have now changed, it is dangerous to assume that payment of alimony as opposed to "specifically designated child support" saves taxes.

B. *Ancillary Considerations*

1. *Standard deduction*

It should first be remembered that the deduction granted for alimony payments is a deduction from adjusted gross income rather than a deduction toward adjusted gross income.[55] As a consequence, the

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of two children. The agreement also provided that if the husband should die, his estate should be bound to pay $7,000 per year "for the benefit of the two children, as in this agreement provided for." The court held that the necessary specificity was present and that $7,000 of each $12,000 payment was nondeductible child support. It is probable that if the quoted statement had been deleted from the agreement, the entire amount would have been treated as alimony. Thus in states where alimony *automatically* terminates on the payor's death, the income splitting potential of the *Lester* case is diminished. The problem could be alleviated by avoiding any requirement of post-death payments, substituting therefor sufficient insurance (in the wife's name) to cover support of the wife and children after the payor's death.

52. 1 S. Surrey, W. Warren, P. McDaniel & H. Ault, Federal Income Taxation 550–54 (1972), wherein the authors review the history of the standard deductions, states:

> With the standard deduction, the taxpayer can choose a blanket fixed amount—prior to 1969, 10% of adjusted gross income up to a maximum of $1,000 ($500 if a separate return were filed by a married person)—or can itemize and claim separately each allowable personal expense. In addition, the Revenue Act of 1964 established a minimum standard deduction equal to $200 ($100 for a married person filing separately) plus $100 for each personal exemption allowed under section 151.

Id. at 550.

53. *See* note 65 and accompanying text *infra*.

54. *See* note 66 and accompanying text *infra*.

55. The deduction authorized by I.R.C. § 215 is not listed as a deduction allowable in computing adjusted gross income. *See* I.R.C. § 62. In discussing the predecessors of I.R.C. §§ 71 & 215, Representative Disney stated:

> The amount of a husband's income which goes to the wife as alimony . . . is in reality not income to him at all since he has no control over it as the use to which it is to be put. The bill recognizes this reality by permitting the husband to deduct so much of his income as is paid out in alimony, and by taxing the alimony payments to the wife.

88 Cong. Rec. 6377 (1942), in 1 Seidman's Legislative History of Federal Income and Excess Profits Tax Laws 1953–1939, at 1280 (1954). If alimony is not the husband's income to begin with, it should at least be deductible from gross income in computing adjusted gross income under I.R.C. § 62. The view that an alimony payment is an item of "consumption" deductible only as a matter of legislative grace

deduction may be taken only in lieu of,[56] *not in addition to,* the standard deduction.[57] Prior to the adoption of the Tax Reduction Act of 1975, the standard deduction was fifteen percent of adjusted gross income with a maximum deduction of $2,000 and a minimum deduction (low income allowance) of $1,300.[58] Under Section 201 of the Tax Reduction Act of 1975, the standard deduction is now sixteen percent of adjusted gross income for an unmarried individual with a maximum deduction of $2,300 and a minimum deduction (low income allowance) of $1,600. The alimony-paying husband whose itemized deductions, other than for alimony, exceed the amount of the standard deduction derives full tax benefit from each dollar of alimony paid, diluted only by the loss of dependency exemption allowances for the children. But a former husband whose itemized deductions are small may derive minimal or no tax benefit from the Section 215 deduction, even though the entire payment will be taxed as income to the wife, because that deduction deprives him of the standard deduction and also generally deprives him of exemption allowances for the children.

2. *Exemption allowances*

Prior to 1967, the designation of payments as alimony or as child support may have had an *influence* on which parent was entitled to the dependency exemption allowances for the children of the broken marriage, but such designation certainly did not settle the question.[59] The parent who in fact provided over half the support of the child or children was entitled to the exemption allowance, regardless of any

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seems to have carried the day. If the "reality" recognized by Representative Disney were recognized in the Code, the § 215 deduction should be one of the deductions listed in I.R.C. § 62.

56. *See* notes 66–73 *infra.*

57. *Id.*

58. I.R.C. §§ 141–144. The increases in the low income allowance, standard deduction, and maximum standard deduction, as well as the $30 credit for personal and dependency exemptions, are stated to be temporary. Tax Reduction Act of 1975, Pub. L. No. 94–12, § 209, 89 Stat. 35 (now codified as I.R.C. § 42). They were extended into the first six months of 1976 by the Revenue Adjustment Act of 1975, Pub. L. No. 94–164, 89 Stat. 970.

59. In fact, the custodial parent was likely to be permitted to take the exemption allowance. *See* Logomarcino, *The Divorced Husband and the Dependency Exemption Mirage: An Outline of the Problem and of a Statutory Corrective Procedure,* 12 TAX L. REV. 85 (1956).

provision in the decree, instrument, or agreement. If neither provided over half of the support, neither would obtain the exemption allowance even if together they provided over half of the support. For taxable years beginning after December 31, 1966, however, Section 152(e) now provides generally that if the former spouses together provide over half the support of a child or children, one of the parents will get the exemption or exemptions.[60] Thus, if a grandparent, a father, and a mother each provide one-third of a child's support, one of the two divorced parents will get the deduction even though neither provides over half the support of the child.[61] If this condition (*i.e.*, that the parents together provide over half the support) is met, the custodial parent is deemed to provide over half the support of the child unless certain other conditions apply. Those conditions are: (1) if the decree, instrument, or agreement awards the dependency exemption for a child to the noncustodial parent and he pays at least $600 per year in designated child support for that child, the noncustodial parent gets the exemption; and (2) if the decree, instrument, or agreement is silent but the noncustodial parent pays at least $1,200 in child support, he is presumed to pay more than the custodial parent (and thus get the exemptions), unless the custodial parent "clearly establish[es]" that she paid more than the noncustodial parent.[62]

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60. If a third party (*e.g.*, grandparent) provides over half the support of a child, I.R.C. § 152(e) does not apply and neither parent can claim the exemption. Harvey Hopkins, 55 T.C. 538 (1970). But if the noncustodial spouse remarries and the amounts are paid by his new spouse or out of the community income of such parent and his new spouse, amounts paid by the new spouse can be taken into account by the noncustodial parent if he and his new spouse file a joint return. Martin Colton, 56 T.C. 471 (1971). *See also* Rev. Rul. 73-175, 1973-1 CUM. BULL. 59 (similar rule applied to custodial parent).

61. Payments designated as alimony cannot be taken into account by the noncustodial spouse in determining which parent provided more support. I.R.C. § 152(b)(4); Lory Buccola, 54 T.C. 1599 (1970).

62. I.R.C. § 152(e)(2). It was hoped that I.R.C. § 152(e), adopted by Act of Aug. 31, 1967, Pub. L. No. 90-78, § 1(a), 81 Stat. 191, would stem the spate of litigation arising from attempts by both parents to claim dependency exemptions where the noncustodial parent paid child support. *See* H.R. REP. No. 102, 90th Cong., 1st Sess. 2 (1967), in 1967-2 CUM. BULL. 590. The Report states that "[t]he number of disputes involving this issue is so great that it has cast a serious administrative burden on the Service and has tended to clog the administrative machinery involved in bringing them to a conclusion." *Id.* at 592. Litigation has abated, but it has not ceased, especially in cases where the noncustodial parent pays more than $1,200 in total child support but no exemptions are awarded to him in the decree, instrument, or agreement. For example, if there are four children and the husband contributes more than one-fourth but less than one-half of their total support, he gets no dependency exemption deductions. Presumably the result would be different if the decree obligated him to support only one child, but in that same amount. Stanley J. Madziarz, 30

The exemption allowance is $750 per person.[63] Under the Tax Reduction Act of 1975, a taxpayer is also entitled to a credit of $30 for each personal and dependency exemption allowance.[64] Thus, in a case where (i) a couple has one child, (ii) the noncustodial father pays $600 of designated child support per year, and (iii) the decree, instrument, or agreement awards the exemption allowance for the child to the father, the father would be entitled to an exemption deduction of $750 and, in 1975, a tax credit of $30. Finally, this deduction and this credit, unlike the deduction for alimony, may be taken in addition to (and not merely in lieu of) the standard deduction or low income allowance. This disparity in exemptions is mitigated somewhat by the fact that the custodial parent can qualify for favorable head-of-household tax rates even if none of the children are her dependents as defined in Section 152, as long as she provides over half the cost of maintaining a household in which an unmarried child lives.[65]

3. *Child care deduction*

The Revenue Act of 1971 substantially increased the significance of the child care deduction.[66] As amended in 1971, Section 214 allows a deduction of up to $400 per month for amounts spent by a parent for the care of her or his dependent children, whether the care is provided inside or outside the home, if the expenses are incurred to enable the parent to be gainfully employed. As further amended in 1975, the deduction is phased out as annual adjusted gross income

CCH Tax Ct. Mem. 1226 (1971). Arrearages in child support paid in a current year cannot be counted in determining the amount of the noncustodial parent's contribution in the current year. Bobby R. Casey, 60 T.C. 68 (1973).

63. I.R.C. § 151.

64. Tax Reduction Act of 1975, Pub. L. No. 94–12, § 203, 89 Stat. 30, *amending* I.R.C. § 42. This provision is stated to be temporary. *See id.*, § 209, 89 Stat. 35.

65. I.R.C. § 2(b). A child must be a dependent to give a custodial spouse head-of-household status only if the child is married. I.R.C. § 2(b)(1)(A)(i). It is therefore unnecessary and ineffective to allocate at least one dependency exemption to the custodial parent if the only purpose is to give the custodial parent head-of-household status.

66. *See* Hjorth, *A Tax Subsidy for Child Care: Sec. 210 of the Revenue Act of 1971*, 50 TAXES 133 (1972). Those interested in examining the life and death of academic debates may wish to compare Feld, *Deductibility of Expenses for Child Care and Household Services: New Section 214*, 27 TAX L. REV. 415 (1972), and Feld, *Another Word on Child Care*, 28 TAX L. REV. 546 (1973), with Schaffer & Berman, *Two Cheers for the Child Care Deduction*, 28 TAX L. REV. 535 (1973), and Schaffer & Berman, *The Child Care Deduction and the Progressivity of the Income Tax, A Reply to Professor Feld*, 28 TAX L. REV. 549 (1973).

begins to exceed $35,000 per year.[67] The phase-out is accomplished by reducing the monthly deduction otherwise available by one dollar for each two dollars of annual adjusted gross income in excess of $35,000. If the parents are married, their incomes are combined[68] in determining the adjusted gross income. For example, if the married parents of two children spend $400 per month for in-home care of their two dependent children (both under the age of 15) in order to enable both parents to be gainfully employed and if their combined adjusted gross income is $35,000 or less, they may deduct $4,800 as an itemized personal deduction on their joint return. Because the monthly deduction is reduced by one dollar for each two dollars of annual adjusted gross income in excess of $35,000, the deduction is phased out completely when combined adjusted gross income equals or exceeds $44,600. In the case of divorced parents, however, only the income of the custodial parent is taken into account in applying the phase-out.[69] Thus, if the parents just described were to divorce and the post-divorce income of the custodial parent was $35,000 or less, the phase-out would not apply. Consequently, divorce might enable affluent taxpayers to obtain a deduction otherwise unavailable because of the amount of their previously combined incomes.

Several additional aspects of Section 214 must be taken into account when planning post-dissolution payment arrangements: (1) the deduction is not available if the custodial parent claims the standard deduction;[70] (2) the deduction is available only to the custodial parent who incurs the expense in order to be able to work outside the home, and may not be claimed by the noncustodial parent even if the children are his dependents for tax purposes;[71] (3) the deduction is available to the custodial working parent only if the expenses are incurred for her dependents for whom she "is entitled to a deduction [or deductions] under section 151(e)."[72] Consequently, if the noncustodial parent pays "child support" and is awarded the dependency exemp-

67. Tax Reduction Act of 1975, Pub. L. No. 94–12, § 206, 89 Stat. 32, *amending* I.R.C. § 214(d). Under prior law the deduction was phased out as adjusted gross income began to exceed $18,000 per year.

68. I.R.C. § 214(d)(last sentence).

69. An individual legally separated from his or her spouse at the end of his or her taxable year is not considered to be married unless a joint return is filed. I.R.C. § 143.

70. *See* I.R.C. § 62.

71. Ignacy R. Skarbek, 29 CCH Tax Ct. Mem. 465 (1970).

72. I.R.C. § 214(b)(1)(A).

tions for the children under Section 152(e), neither the custodial nor the noncustodial parent will be able to deduct amounts spent for child care under Section 214.

The requirement that the children involved be dependents of the working custodial parent appears to discriminate against low-income taxpayers who divorce. High income noncustodial fathers are likely to have itemized personal deductions in excess of the maximum standard deduction even before the deduction of Section 215 is taken into account.[73] Thus payments to the custodial mother will *not* be designated as child support. She will report the payments as alimony and claim the children as her dependents. If she incurs child care expenses to be gainfully employed, she may deduct those expenses subject to the limitations contained in Section 214. However, low income noncustodial fathers, inclined to take the standard deduction because of few itemized personal deductions, may well prefer to designate all payments as child support payments. Such payments are not deductible as such, but may enable the fathers to claim dependency exemption allowances and credits which can be taken *in addition to* the standard deduction. Such a scheme, if adopted, will deprive the custodial parent of an otherwise available child care deduction.

4. *Medical expenses*

Many questions in this area are academic in the sense that the questions exist but are not of sufficient importance for courts or administrators to answer. The first question is whether an employee realizes income under employer plans that provide insurance for the medical expenses of the employee and his or her children if the children are the dependents of the other spouse. This could occur if a noncustodial father pays alimony instead of child support (thereby enabling the custodial mother to obtain dependency exemptions under Section

73. S. REP. No. 91–552, 91st Cong., 1st Sess. 256 (1969) states:

> [The] standard deduction [introduced in 1944] accounts for most of the returns filed for those with adjusted gross incomes below $3,000 and still accounts for three-fourths of the returns for adjusted gross income levels of $3,000 to $5,000 . . . . For those with incomes between $10,000 and $15,000 the standard deduction accounts for only about one-fourth of the returns filed, and above that level it tails off quite rapidly . . . .

Although the standard deduction has been increased in 1969, 1971, and 1975, the basic principle that taxpayers in higher brackets are more likely to itemize deductions remains valid.

152(e)) and is covered by a plan providing health insurance for himself and his children. The same issue is presented if the custodial mother receives child support payments (thereby allowing the father to obtain the dependency exemptions under Section 152(e)) and is similarly covered by a plan for herself and her children. The Regulations under Section 106 indicate that employer contributions to such plans are exempt to the extent health insurance is provided for the employee, his spouse or "his dependents as defined in section 152."[74] It is improbable that an employee would, as a practical matter, report income in either of the examples presented above.

The question of whether or not a parent is entitled to a medical expense deduction for a child appears to be more significant. An obvious but often forgotten point is that a taxpayer may deduct only medical care expenses for that care provided to the taxpayer and his or her *dependents*. If the decree provides that one parent shall provide medical insurance for the children, and that the other parent shall pay all expenses not covered by insurance, only the parent who can claim the children as dependents will be able to deduct any medical expenses under Section 213.[75] Future medical expenses are unpredictable, and it is almost impossible to devise a decree or agreement that would not give rise to substantial inequity. Section 213 should be amended to allow deductions for medical expenses paid by either parent even if the child is the dependent of the other, with an adequate provision to prevent double deductions.

C. *Shortfalls and Arrearages*

If a husband is obligated to pay both child support and alimony and pays less than the total amount due in a given year, payments actually made are applied first to child support and second to alimony.[76] The same rule applies to payments of arrearages. To illustrate: husband is required to pay $1,200 per year in child support

74. Treas. Reg. § 1.106–1 (1956).
75. I.R.C.§ 213(a).
76. I.R.C. § 71(b) (last sentence); Treas. Reg. § 1.71–1(e) (1957).

and $1,200 per year in alimony. The dependency exemption for the one child is awarded to the husband. The husband pays:

(i) In year one	$0
(ii) In year two	1,200
(iii) In year three	6,000

In year one the wife has no income under Section 71. The husband deducts nothing. He cannot claim a dependency exemption because he did not pay at least $600 in child support. In year two the entire payment is considered to be child support. The wife has no income and the husband can claim the child as his dependent. In year three $2,400 is deemed to be child support (even though the husband is considered to have paid only $1,200 in year three for purposes of Section 152(e)) and $3,600 is deemed to be alimony. The child support arrearage payment does not enable the husband to claim a dependency exemption retroactively for year one.[77]

If a husband pays child support and alimony and also makes installment payments on the purchase of a property interest of the wife, the installment payments would presumably rank third in application, absent an agreement to the contrary, but the issue does not appear to have been litigated.[78]

III. MISCELLANEOUS ALIMONY PROBLEMS

A. Annulments and Meretricious Relationships

Sections 71 and 215 treat as alimony periodic payments made "because of the marital or family relationship."[79] The Internal Revenue Service originally ruled that the sections did not apply to cases where

77. *See* William E. Borbonus, 42 T.C. 983 (1964), *acquiesced in,* 1965–2 CUM. BULL. 4; Clarence W. Smith, 51 T.C. 1 (1968), *acquiesced in,* 1969–2 CUM. BULL. XXV.

78. The order of priority of alimony payments and property purchase payments should be set forth in the decree.

79. I.R.C. § 71(a). The statute certainly implies that a legal marriage, or the dissolution of a legal marriage, is a condition precedent to the application of I.R.C. §§ 71 & 215. The 1954 Code applies, as did the 1939 Code, only if "a *wife* is divorced or legally separated from her *husband* . . . ." I.R.C. § 71(a)(1) (emphasis added); Int. Rev. Code of 1939, ch. 1, § 22(k), 56 Stat. 816 (virtually identical wording). One court has stated that it will apply a federal rule in determining whether parties are, or have been married. *See* Estate of Borax v. Commissioner, 349 F.2d 666 (2d Cir. 1965), *cert. denied,* 383 U.S. 935 (1966), in which payments were made to a wife

the parties were never married under local law.[80] Two cases arising under the former Domestic Relations Law of New York nevertheless held that local labels do not control, but it is not clear how far these cases go.[81] Thus payments made because of a marriage that was merely "voidable" from its inception brought Sections 71 and 215 into play upon its termination.[82] One case has applied those sections to payments following a marriage declared void from its inception.[83] It is not yet clear whether payments made to a "wife" in all cases of termination of a void or voidable marriage fit within Sections 71 and 215.

Presumably, in states that recognize common-law marriages payments made pursuant to a dissolution could constitute alimony. It seems unlikely that states not recognizing common-law marriages could compel a consort to pay alimony to a former consort,[84] but the father in a dissolved meretricious relationship can be required to pay

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subsequent to a 1952 Mexican divorce. The court held that payments were "incident" to a divorce even though the divorce was invalid under New York law. The Internal Revenue Service has announced that it will not follow the *Borax* decision. Rev. Rul. 67-442, 1967-2 CUM. BULL. 65.

80. *See* Rev. Rul. 59-130, 1959-1 CUM. BULL. 61, which held that an annulment granted for a spouse's incurable insanity, even though called annulment under New York law, is within the scope of I.R.C. §§ 71 & 215 because the marriage was merely *voidable* and not void from its inception. The ruling implies that payments made pursuant to a marriage determined to be void from its inception are not within I.R.C. §§ 71 & 215.

81. *See* notes 82 & 83 *infra*.

82. George F. Reisman, 49 T.C. 570 (1968), *acquiesced in*, 1971-2 CUM. BULL. 3.

83. Andrew M. Newburger, 61 T.C. 457 (1974), *acquiesced in*, 1974-2 CUM. BULL. 3. In *Newburger*, the wife had been married previously and had obtained an ex parte Nevada divorce. She then married taxpayer. A New York court found that the Nevada divorce was invalid, that the wife had therefore never been married to the "second husband," but that he should nevertheless pay her maintenance of $200 per week. The court held that I.R.C. §§ 71 & 215 applied and implied that they would apply in any case where a local court attaches sufficient "validity" to an annulled "marriage" to require one party to pay maintenance to the other. 61 T.C. at 460.

84. *But see In re* Estate of Thornton, 81 Wn. 2d 72, 499 P.2d 864 (1972). On appeal from retrial on the issue of whether a long-term (14 year) meretricious relationship would give rise to a community property interest in the acquisitions made during the term of the relationship, Division III of the Washington Court of Appeals, subsequent to remand, held that the relationship did not meet the elements necessary to give rise to a property interest, *i.e.*: " '[E]xistence of a relatively long-term, stable meretricious relationship *in which the partners appear to hold themselves out as husband and wife*,' " (italics by court of appeals). *In re* Estate of Thornton, 14 Wn. App. 397, 402, 541 P.2d 1243, 1247 (1975), *quoting* 81 Wn. 2d at 75, 499 P.2d at 866. Presumably, if these elements were present in the event of termination of such a relationship during the parties' lifetimes, there would be community property which would have to be divided between the parties. Furthermore, if there were children of the relationship, the full range of issues with regard to property settlement versus alimony and alimony versus child support would be raised.

child support. If he is required to do so, but the agreement, instrument, or decree does not specify any portion of the payment as being for child support, payments should not be deductible under Section 215. A person does not pay "alimony" to one who was never his or her spouse, but fathers do pay child support for illegitimate children. Although it is not clear whether payments not specified as "child support" would be taxed to the recipient (or deductible by the payor) under these circumstances, the payments should not, under Section 71, be income to the recipient who never would have been a spouse. Under the general principles of *Gould v. Gould*,[85] the payee would not appear to have gross income even under Section 61 and the payor would not be entitled to a deduction.

B. Alimony Trusts

Section 71(d) applies to "periodic payments . . . attributable to property transferred, in trust or otherwise, in discharge of" a legal obligation imposed on the husband and arising out of "the marital or family relationship . . . ."[86] When amounts payable to the wife are attributable to transferred property, the husband does not include such amounts in his income and may not deduct any such payments from gross income. The Internal Revenue Service has taken the position that Section 71 is inconsistent with Section 682 (which deals specifically with the taxation of trust distributions in the event of divorce) and that Section 71 applies when the trust is created "incident to" a divorce.[87] It is the position of the Internal Revenue Service that Section 682 applies only to trusts not created "incident to" the divorce, as, for example, an antenuptial trust for the benefit of the wife where the trust survives the divorce. The difference, in the opinion of the Service, is that the wife's gross income in the case of a Section 71 alimony trust includes the entire amount of each payment, whereas in a Section 682 trust the wife's income is limited to the amount of of distributable net income of the trust.[88] The difference is illustrated in

85. 245 U.S. 151 (1917). To the extent applicable, I.R.C. §§ 71 & 215 overruled *Gould*, but for situations not covered by those sections, *Gould* presumably still applies.
86. I.R.C. § 71(a)(1).
87. Treas. Reg. § 1.682(a)-1(a)(2) (1957).
88. This distinction is supported by the legislative history of the predecessor of

Ellis v. United States,[89] involving a Section 71 alimony trust. The corpus of the trust included a substantial amount of tax-exempt bonds. The Court of Appeals for the Sixth Circuit held that the distributions to the wife from a Section 71 alimony trust were not income to her to the extent they represented tax-exempt interest from municipal bonds. If the trust had been a Section 682 trust, the wife's income would not have included the tax-exempt bond interest. If the husband simply had kept the bonds and paid over the interest to his wife, she presumably would have had income even though the interest would not have been taxable to the husband, and he would have obtained a deduction for payments made.[90]

Although the Internal Revenue Service is not likely to change its position because of the decision in the *Ellis* case, the result in *Ellis* makes a great deal of sense in many contexts. Suppose, for example, that a husband creates an "annuity trust" incident to a divorce decree calling for annual payments to the wife of eight percent of the initial market value of the trust. If the corpus of the trust consists of low-basis, high-value stocks paying small dividends, the trustee may be required to sell some of the stocks to make annual payments. In *United States v. Davis*[91] the court implied that the husband should bear the burden of the tax on the gain. Four different tax consequences are

I.R.C. § 71. The House Committee Report on § 22(k) of the Internal Revenue Code of 1939 provides in part as follows:

> Where the husband's alimony or separate maintenance obligation is discharged through periodic payments attributable to property in trust, life insurance, annuity or endowment contracts, or to any other interest in property, the wife is required to include such payments in gross income, *whether they come from income or capital*. However, in the case of trusts created prior to the divorce or separation and not included thereto, the wife is required to include in gross income only the amount of income of the trust which she is entitled to receive and which, under existing law, would be taxed to the husband.

H.R. REP. No. 2333, 77th Cong., 2d Sess. 46 (1942), in 1 SEIDMAN'S LEGISLATIVE HISTORY OF FEDERAL INCOME AND EXCESS PROFITS TAX LAWS 1953–1939, at 1277 (1954)(emphasis added). Taxing the wife on all proceeds from an alimony trust leads to the creation of income for the wife without an offsetting deduction for the husband.

89. 416 F.2d 894 (6th Cir. 1969).

90. *See* Muriel Dodge Neeman, 26 T.C. 864 (1956), *aff'd per curiam*, 255 F.2d 841 (2d Cir.), *cert. denied*, 358 U.S. 841 (1958).

91. 370 U.S. 65 (1962). The *Davis* case holds that a transfer of appreciated property in satisfaction of a marital obligation is a taxable event. The transfer of appreciated property to alimony trusts creates problems because the transfer may do more than satisfy a marital obligation, *e.g.*, where the transferor retains a reversionary interest or transfers a remainder interest to adult children. The Commissioner has ruled that a transfer to an alimony trust can be a taxable event. Rev. Rul. 57–507, 1957–2 CUM. BULL. 511.

possible from this hypothetical. (1) The husband recognizes a gain when the trust is created, as *implied* by *Davis*. The wife's income under *Ellis* would be limited to dividends plus the excess of the sale price of shares sold over their market value on the date of creation of the trust. (2) Same as (1) except that all payments to the wife are income to her under Section 71. Thus the husband would have a capital gain and the wife would have ordinary income even though payments to her were from the corpus of the trust. (3) Same as (2) except that the husband recognizes no gain on the creation of the trust. (4) Same as (3) except that the wife's income, under *Ellis*, would include the excess of the sale price of shares sold over their basis to the husband.

Because of the uncertain tax consequences, it is dangerous to create an alimony trust. The preferable rule would appear to be the alternative described in (1) above. For the husband, the transfer to the trust is not substantially different than a lump sum transfer of appreciated property. Therefore, he should recognize gain on the transfer. Once this is done, there is no reason to tax the wife differently than she would be taxed if she owned the property outright. The approach suggested would also make it clear that if the divorcing husband purchases an annuity for his wife, she need not report as income that portion of the annuity representing a return of the investment in the contract. The legislative history of Section 71 does not support this approach, however, and there appears to be no case raising the issue of whether the *Davis* case should apply to the transfer of appreciated property to an alimony trust. If the husband retains no reversionary interest in the trust, he should recognize gain if the wife has a general power of appointment over the trust. If the husband retains a reversionary interest or gives a remainder interest, it is unclear whether gain would be recognized. In either event he should consider the possible estate and gift tax consequences.[92]

C. *Arrearages and Settlements*

The Tax Court has taken the position that "alimony in gross" is

92. Transfers made pursuant to written agreement within two years of divorce create no gift tax liability to the extent they are for the support of the wife and minor children. I.R.C. § 2516. Part or all of property transferred in trust might be included in the decedent's gross estate if he retains a reversionary interest, right to income, right to designate who shall enjoy income, etc., I.R.C. §§ 2036–2038, 2043. *But cf.* McMurtry v. Commissioner, 203 F.2d 659 (1st Cir. 1953) (implying a possible exclusion to the extent of the former wife's interest in the trust).

neither deductible by the husband nor income to the wife.[93] For example, if a decree requires a husband to pay a wife $100 per week until her death or remarriage, and to pay her a lump sum of $5,000 upon her remarriage, the $5,000 payment is not within the scope of Sections 71 and 215.[94] Similarly, if payments are to be made over a period of more than ten years from the date of the instrument, agreement, or decree, the amount that is income to the wife (and therefore deductible by the husband) cannot in any one year exceed ten percent of the total amount payable.[95] Thus if a husband agrees to pay to the wife the principal amount of $60,000, payable at the rate of $10,000 per year for five years and then at the rate of $1,000 per year for ten years, the maximum amount deductible in each of the first five years is $6,000 per year.[96] Payments of arrearages, however, do not appear to be subject to these limitations. It seems well settled that arrearage payments are deductible in the year paid to the same extent they would have been deductible if they had been paid when due.[97] This rule gives a former husband the power to pay arrearages in high-income years and, conversely, to bunch the income reportable by his former wife. Perhaps the rule is necessary in order to encourage delinquent former husbands to pay alimony that is in arrears, but the principal should not apply to advance payments. Accordingly, if a former husband pays one lump sum in settlement of past, present, and future alimony claims of his former wife, that portion of the settlement attributable to past and present alimony obligations of the husband is deductible by him (and income to the wife). The portion attributable to future alimony should not be so treated, but the Internal Revenue Service has ruled to the contrary where the nub of the settlement is to compensate the wife for arrearages.[98]

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93. Gordon D. Oxford, 32 CCH Tax Ct. Mem. 1321 (1973).
94. *See* William M. Hardy, 59 T.C. 857 (1973).
95. I.R.C. § 71(c)(2).
96. *See* Treas. Reg. § 1.71–1(d)(5), Example (4) (1957).
97. Rev. Rul. 67–11, 1967–1 Cum. Bull. 15. *See also* Holloway v. United States, 428 F.2d 140 (9th Cir. 1970), in which a husband more than $100,000 behind in alimony payments to his wife agreed to pay her $15,000 per year over a three-year period. The district court held that because the payments were for *future* alimony, they were not deductible. The circuit court of appeals reversed, holding that the nub of the payment was for arrearages and was therefore deductible by the husband and income to the wife.
98. Rev. Rul. 67–11, 1967–1 Cum. Bull. 15.

D. *Indirect Payments*

Indirect payments are often the trivial aspects of a marriage dissolution. A former husband may be required to pay his wife's medical expenses, to pay the attorney's fees incurred by her in obtaining the divorce, to make payments on a home to which he or she has title, or to purchase life insurance designating her as beneficiary in the event of his death. All these matters require attention to detail.

1. *Medical payments*

It seems clear that payments by the husband of the wife's medical expenses, including health insurance premiums, are periodic payments.[99] They are deductible by the husband and are income to the wife. The matter is noted here only to emphasize that even though the wife must report these items as income, she may not deduct them if she does not itemize her personal deductions or if they are made nondeductible by the limitations of Section 213. The inclusion of this item in the scope of Sections 71 and 215 also illustrates the fact that payments need not be made directly to the wife in order to be income to her.

2. *Attorney's fees*

The question of the deductibility of attorney's fees is outside the scope of this article. It is nevertheless considered in general terms because many divorce judgments, decrees, or agreements require one spouse to pay the attorney's fees of the other,[100] presenting the question of whether the person who pays such fees can deduct them under Section 215. As a general rule, one who pays attorney's fees for assistance given in connection with a divorce proceeding cannot deduct those expenses because they are personal in nature.[101] That portion of

99. This result follows even if the payments are irregular in amount and in the times in which they are paid. *See* Rev. Rul. 62–106, 1962–2 CUM. BULL. 21.

100. *See, e.g.,* WASH. REV. CODE § 26.09.140 (1974), authorizing a court to order one party to pay the attorney's fees and costs of the other party under appropriate circumstances.

101. Howard v. Commissioner, 202 F.2d 28 (9th Cir. 1953). Even if the expense is incurred to prevent the other spouse from obtaining the income-producing property

a fee that is attributable to the collection of income (*i.e.*, alimony), however, is deductible as an itemized personal deduction under Section 212(1);[102] and that portion of a fee attributable to tax advice is deductible under Section 212(3).[103] Other legal expenses are not deductible but can sometimes be added to the taxpayer's basis in property to the extent the costs of legal services are " 'incurred in defending or perfecting taxpayer's claim to ownership of capital assets . . . .' "[104] These exceptions should not obscure the fact that attorney's fees incident to a divorce are generally not deductible, and exceptions to the general rule of nondeductibility do not apply to attorney's fees of the wife which are paid by the husband. Even if the husband also pays alimony, his inability to deduct payments to the wife's attorney is part of the more general judge-made rule that extraordinary payments made in one year cannot qualify as "alimony" simply because other periodic payments are also made in that year and in other years.[105] It is also clear, however, that if payments are not "extraordinary," they can come within the scope of Sections 71 and 215. A husband could, for example, agree to pay his wife additional periodic payments (the present value of which is equal to the attorney's fees to be paid by the wife) and let the wife pay the attorney's fees. Under this procedure the husband could deduct payments as they are made.[106] The wife would report such payments as income but could presumably deduct that portion of the attorney's fees allocable to the collection of alimony income.

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of the first spouse, the expense is not one to "conserve or maintain" income producing property because the threat to the property has a *personal* rather than a *business* origin. United States v. Gilmore, 372 U.S. 39 (1963). However, in Carpenter v. United States, 338 F.2d 366 (Ct. Cl. 1964), the court held that the part of the fee attributable to reducing the post-dissolution tax burdens of the payor was deductible under I.R.C. § 212(3).

102. Ruth K. Wild, 42 T.C. 706 (1964), *acquiesced in*, 1967–2 CUM. BULL. 4. *See also* Gerald G. Wolfson, 47 T.C. 290 (1966).

103. *See* note 101 *supra*.

104. Gilmore v. United States, 245 F. Supp. 383 (N.D. Cal. 1965), *quoting* Spangler v. Commissioner, 363 F.2d 913, 919 (9th Cir. 1963). This case involved the same taxpayer who had been before the Supreme Court in 372 U.S. 39 (1963) and is sometimes referred to as the "second *Gilmore* case." The theory of the case is that even personal expenses can be capital expenses. For example, a person who improves his home increases his basis.

105. *See* R. William Johnson, 30 CCH Tax Ct. Mem. 580 (1971). Even if alimony is paid, the additional payment of attorney's fees is nondeductible because it is a "lump-sum payment for a definite nonrecurring purpose . . . ." F. Ewing Glasgow, 21 T.C. 211, 218 (1953), *acquiesced in*, 1954–1 CUM. BULL. 4.

106. *But see* James McEvoy, Jr., 21 CCH Tax Ct. Mem. 1441 (1962).

3. *Insurance*

A husband's obligation to pay alimony to his wife usually terminates upon his death.[107] This is not always true, but where the obligation does terminate upon death, and especially where periodic payments are intended to serve as child support without being specifically so designated, the wife may understandably desire protection against her former husband's death, premature or otherwise. Both parties may desire to insure that post-death obligations will be paid if such obligations do survive the payor. Such protection may be obtained by requiring that the payor obtain a stated amount of insurance designating the payee as beneficiary.

If the wife is the absolute owner of all right, title, and interest in the policy, premium payments made by the husband on the insurance are deductible by the husband and must be reported as income by the wife.[108] However, if the policy was in existence before the divorce, the transfer of the policy to the wife may itself be a taxable event (unless the transfer was part of an equal division of community property).[109] Where the transfer is a taxable event (or even if not taxable where the wife's basis in the policy is determined by reference to its value on the date of transfer), the wife is considered to be a purchaser of the policy. Her basis in the policy is its market value on the date of transfer[110] plus any premiums paid by the husband and taxed to her (or paid by her directly). On the husband's death the excess of proceeds received over her basis in the policy will be income to the wife.[111] However, the wife would not be considered a "purchaser" if she received the policy pursuant to a nontaxable division of community property. In this event, premiums paid by the husband would be deductible by him and in-

107. In Washington the obligation to pay alimony terminates on the death of either party or upon the remarriage of the recipient, and child support terminates upon the emancipation of the child or the death of the parent obligated for support "[u]nless otherwise agreed in writing or expressly provided in the decree." WASH. REV. CODE § 26.09.170 (1974). Thus, alimony and child support obligations can by decree be made to survive the death of the payor in Washington.

108. *See* Weil v. Commissioner, 240 F.2d 584 (2d Cir.) (by implication), *cert. denied,* 353 U.S. 958 (1957); Rev. Rul. 70–218, 1970–1 CUM. BULL. 19.

109. *See* note 91 *supra.*

110. Farid-es-Sultaneh v. Commissioner, 160 F.2d 812 (2d Cir. 1947); Rev. Rul. 67–221, 1967–2 CUM. BULL. 63.

111. Insurance proceeds are generally taxable to third parties who purchase insurance contracts despite the general exclusion of I.R.C. § 101. *See* I.R.C. § 101(a)(2). The gain should be taxed as ordinary income because there will have been no "sale or exchange" of a capital asset. I.R.C. § 1222.

come to her, but she would not realize gain or loss on his death.[112] Similarily, if the policy is initially obtained by the wife, premiums paid by the husband would be deductible by him and income to her, but her collection of the proceeds on his death would not be a taxable event to her.

In many cases life insurance is, in effect, "alimony insurance." In such cases the wife is named as beneficiary only if she survives the husband (or possibly, only until a given number of years have expired or a given number of periodic payments have been made) and the husband retains certain other rights and interests in the policy. Courts have adopted the rather artificial rule that in these cases premium payments by the husband are not deductible by him and are not includible as income by the wife.[113] Where insurance is an important factor and the parties wish to have the premium payments taxed to the wife and deducted by the husband, the wife might purchase term insurance on her husband with the policy expiring on her death or the occurrence of other stated events. Where this is done, the husband could simply agree to pay the wife an additional amount designed to compensate her for premium payments made by her. If the extra payments were specifically earmarked as amounts to be spent by the wife for insurance, the device might be disregarded by the courts, but if no limitation is imposed on the wife's disposition of the excess payments, they should fall within the scope of Sections 71 and 215.

4. *Housing costs*

In many marriage dissolution cases the husband or wife owns an interest in a home. They may own that interest as co-owners or sepa-

112. A transferee whose basis in the policy is determined by reference to the basis of the transferor is not a "purchaser." I.R.C. § 101(a)(2)(A). Basis is not affected by a nontaxable division of community property. *See* Beth W. Corp. v. United States, 350 F. Supp 1190 (S.D. Fla. 1972), *aff'd per curiam*, 481 F.2d 1401 (5th Cir. 1973), *cert. denied*, 415 U.S. 916 (1974).

113. *See* Seligmann v. Commissioner, 207 F.2d 489 (7th Cir. 1953). *See also* William C. Wright, 62 T.C. 377 (1974), in which the husband agreed to pay the wife an amount in excess of $200,000 over a period of more than ten years. To secure payment, he agreed to pay premiums on a policy on his life owned by the wife and to keep the wife as beneficiary until she died, remarried, or attained the age of 65. The premiums were held not to be alimony. Language in *Wright* indicates that premium payments are not income to the wife under I.R.C. § 71 unless they give her a present "taxable economic benefit," *id.* at 399, and that such benefit would always be lacking if the insurance were only term insurance. That is, even if the wife

rately, before or after the dissolution. For convenience, it is assumed that the wife will occupy the home and that, if payments are made in respect of that home, they will be made by the husband. The following three hypothetical situations illustrate the problems created by indirect housing cost payments.

(1) In the first situation, the husband owns the home outright and is required to permit the wife to reside in the home rent free. It is clear that the husband need not report the rental value of the home as income and that he cannot deduct that amount as "periodic payments" made to the wife.[114] The husband will not be allowed a deduction for the depreciation of the home because the rental value of the home is not income to him. Even though the husband may not deduct (and the wife need not include) the fair rental value of the home owned by the husband and occupied by the wife, it is still unclear whether taxes and maintenance payments made by the husband fall within the framework of Sections 71 and 215.[115] Taxes are presumably deductible by the husband in any event, but if they are deductible as alimony, the wife would have income. It is doubtful whether she could in turn deduct taxes paid on property she does not own. Moreover, the deduction would do her little good if her itemized deductions are otherwise very small. The taxes paid by a husband in such a situation therefore should not be treated as alimony but simply as payments of taxes by the husband on his own property. It is not as easy to avoid conflict where the husband is obligated to pay the maintenance and repair costs of a home owned by him and occupied by the wife. Expenses classified as capital expenses would not be income to the wife but would increase the husband's basis in the house.[116] Expenses other than capital expenses should be deductible by the husband and should be income to the wife.[117]

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were the owner of the policy without restriction and if premiums were payable until the husband died, the premium payments might not be alimony. This view seems unduly restrictive. The effect can be avoided simply by paying additional alimony to the wife and allowing her to purchase term insurance or not, as she sees fit.

114. This is so because the property is not held for production of income, I.R.C. § 167(a)(2), and the holding of the house by the husband is not an activity engaged in for profit. *Id.* § 183. *See, e.g.,* Pappenheimer v. Allen, 164 F.2d 428 (5th Cir. 1947).

115. *See* Doris B. Marinello, 54 T.C. 577, 579 (1970). The court held that payments for rent and heat in a home occupied by the wife were income to her, even though no payments were made directly to her. The home was owned by the husband's wholly owned corporation to which he made rental payments.

116. Gentry v. United States, 283 F.2d 702 (Ct. Cl. 1960).

117. Rev. Rul. 62–39, 1962–1 CUM. BULL. 17.

(2) In the second situation, the home is owned by the husband but is subject to mortgage indebtedness. Payments of interest should be deductible by the husband (under Section 163 rather than Section 215). Payments of mortgage principal would not be deductible.[118]

(3) In the third situation, title to the property is in the name of the wife. In this situation all payments made by the husband should fit within the scope of Sections 71 and 215 unless the payments reflect a purchase by the husband of an interest of the wife in other property owned by the husband.[119]

The preceding discussion demonstrates that indirect payments raise numerous problems that are avoided if payments are direct. If the wife is to receive the benefits of payments for medical expenses, insurance on the husband's life, attorney's fees, and housing, increasing the amount of periodic payments, and making direct payments to the wife are usually preferable to making indirect payments. The only possible exception relates to housing. If the husband owns a home, overall taxes might be reduced by permitting the wife to live in the home on a rent-free basis because the imputed income equal to the rental value of the home, in this event would probably be taxed to no one.

IV. PLANNING POST-DISSOLUTION CURRENT PAYMENT ARRANGEMENTS

A. General Limitations

In some cases the form of post-dissolution current payments can shift the burden of taxation from the former husband to the former wife, or vice versa, and, in so doing, can reduce their aggregate tax burden. But there are definite limits on what can be done. It has already been noted that post-dissolution installment payments made in return for a pre-dissolution property interest of a former spouse cannot be made to fall within the deduction-inclusion rules of Sections

118. James Park Bradley, 30 T.C. 701 (1958). *See also* Richards v. Commissioner, 382 F.2d 538 (6th Cir. 1967); Neely B. Taylor, Jr., 45 T.C. 120 (1965), *acquiesced in result only,* 1967–2 CUM. BULL. 3. In *Taylor* the husband deducted interest and taxes. This deduction was not challenged. 45 T.C. at 129–30 (dissenting opinion).

119. *Compare* Elbert G. Sharp, 31 CCH Tax Ct. Mem. 795 (1972)(payments treated as purchase of wife's interest in other property kept by husband), *with* Mace v. United States, 64–2 U.S. Tax Cas. 93,682 (S.D. Cal. 1964) (husband's installment payments deductible under I.R.C. § 71(c)(2)).

71 and 215. The status of payments made for some reason other than support but for something less than a property interest—such as payments in discharge of a wife's dower interest or interest in an unvested pension right—remains unclear. Finally, Sections 71 and 215 cannot override the basic principle of tax law that income realized during the existence of a marital community will be taxed one-half to each former spouse in a community property state, regardless of who collects it.

More generally, current payment arrangements that save aggregate taxes may not be the kind of arrangements that are favored by the spouses or by local law. In high income households it may well be preferable for tax purposes not to specify payments as payments for child support, but both spouses might prefer such specification if, for example, child support payment amounts are modifiable but maintenance payment amounts are not. Finally, it may be virtually impossible in some low income households to determine whether the specification of amounts as child support does or does not save overall taxes because of the interrelationships of the alimony deduction, the child care deduction, the standard deduction, and the deductions for dependency exemption allowances. Despite all these limitations, however, an attorney cannot afford to ignore the tax consequences of post-dissolution current payment arrangements.

B. Families with Substantial Income

Families with substantial income may also have substantial property. Where substantial property is owned prior to dissolution, it is important to ascertain what the property interest of the wife is and whether post-dissolution current payments made by the husband reflect the purchase of a property interest of the wife.[120] The purchase of a vested property interest should clearly be cast in terms of a sale, and adequate interest should be included in the subsequent payments.[121] The wife should also realize that she should elect to report her

120. *See* Part I *supra*.

121. If the husband purchases a *vested* property interest of the wife on the installment basis, I.R.C. § 483 clearly seems applicable. Providing for interest in the settlement agreement brings to the attention of all concerned that a purchase and sale was intended, and alerts both parties to the fact that interest must be reported by the seller (and may be deducted by the buyer). Finally, a provision for interest gives the parties the opportunity to allocate more or less of the purchase price to interest than

gain (if any) on the installment basis, and that she may have to report some imputed interest if an appropriate rate of interest is not provided for separately.

Payments made in return for the release by the wife of her dower rights create greater uncertainty. It is obvious that these payments, if certain in amount, will not be income to the wife unless the requirements of Section 71(c)(2) are met. If the payments are not income to the wife because of the exclusionary rules of Section 71(c), the imputed interest rules of Section 483 do not apply.[122] If the payments are uncertain in amount (*e.g.*, because they will terminate on the wife's death or remarriage), or if they are to be made over a period of more than ten years, existing uncertainty might prompt settlements based on the assumption that the payments are income to the wife and deductible by the husband. In such cases, appropriate provisions should be made for indemnification of the husband or modification of the decree, instrument, or agreement in the event such payments subsequently are held not to be income to the wife or deductible by the husband.[123]

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would be the case if no interest were provided. *See* Treas. Reg. § 1.483–1(b)(2) (1971). Although there is some confusion, it appears that the imputed interest rules apply only to situations where one spouse purchases a vested property interest of the other. Gerlach v. United States, 74–1 U.S. Tax Cas. 84,052 (Ct. Cl. 1973). If §§ 71 & 215 do not apply because one spouse has "purchased" an inchoate property right of the other (*e.g.*, dower or similar interest), one court has held that the imputed interest rules of § 483 do not apply. Fox v. United States, 510 F.2d 1330 (3d Cir. 1975). The *Fox* case implies that I.R.C. § 483 never applies to payments made pursuant to a property settlement, but the facts in *Fox* involved payments made over a period of 9½ years in return for the wife's *inchoate* marital rights. The payments to the wife in *Fox* were not income to her. If the payout period had been more than ten years, the wife would have been subject to tax under I.R.C. § 71(c)(1), and the husband could have deducted the payments under I.R.C. § 215.

122. Fox v. United States, 510 F.2d 1330 (3d Cir. 1975).

123. If an agreement or decree designates maintenance as an installment purchase of property, the purchaser nevertheless later may deduct the so-called installment purchases as alimony. If the wife does not report them as income, the Internal Revenue Service is bound to interfere. *See* A.J. Roberts, 33 CCH Tax Ct. Mem. 750 (1974). Conversely, payments might be labeled alimony, or described in such a way as literally to fit the requirements of I.R.C. § 71(c)(2). If the husband deducts these payments under I.R.C. § 215 but the wife does not report them as income, the Internal Revenue Service again is likely to interfere. *See* Soltermann v. United States, 272 F.2d 387 (9th Cir. 1959). If the parties arrive at an honest agreement that a recipient should or should not report payments as alimony, that agreement does not bind the government. But if the parties also agree that one spouse will indemnify the other for unexpected tax consequences, the indemnitor will be much less likely to report income or deductions in a manner contrary to that implied by the agreement. In close cases of this nature it is doubtful that the government will interfere if *someone* reports the income.

Families with substantial income and dependent children have a further reason to consider the relative merits of labeling current payments as "alimony" or "child support." Assuming the husband will itemize his personal deductions even without an alimony deduction, the deduction for alimony is likely to be of greater tax benefit to him than the dependency exemptions for the children.[124] The children in such event probably would be the dependents of the wife, who would report the alimony as income. Because they are the wife's dependents, she would be eligible for the child care deduction of Section 214. If the payments are specifically labeled as child support, the husband gets no deduction for alimony and is likely to claim the children as his dependents. If his claim is successful, the children cannot be claimed by the wife and, if they cannot be claimed by her, she loses the benefits of the child care deduction of Section 214.[125]

C. *Families with Low Incomes*

As presently written, the tax laws tend to exacerbate conflict between low income parents who divorce. The noncustodial parent in a low income family may well prefer to designate payments specifically as child support, and insist that, in return for such payments, the dependency exemptions be awarded to him because:[126] (1) the amounts paid may be close to the dollar amount of the dependency exemption allowances; and (2) he may utilize the standard deduction (or low income allowance) because he has few itemized personal deductions. Thus the deduction of Section 215 may be of less value to him than the dependency exemption allowance of Section 151 (which can be taken *in addition to* the standard deduction or low income allowance).[127] The wife, however, may insist that the payments to her be designated alimony. She would thus have income but would also usually be able to claim the children as her dependents. If she can

124. This statement is correct provided the husband pays more than $750 per year in child support.
125. I.R.C. § 214(b)(1)(A). *See* notes 66–73 and accompanying text *supra*.
126. This consideration becomes even more crucial under § 203 of the Tax Reduction Act of 1975, Pub. L. No. 94–12, 89 Stat. 29 (now codified as I.R.C. § 42), which (for the 1975 calendar year) grants an additional *credit* of $30 per dependency exemption allowance. This additional credit was extended into the first six months of 1976 by § 2(e) of the Revenue Adjustment Act of 1975, Pub. L. No. 94–164, 89 Stat. 972.
127. *See* I.R.C. §§ 62 & 63.

claim the children as her dependents she will also be entitled to deduct qualified child care expenses under Section 214. In high income families, attorneys may be able to propose a solution which will reduce aggregate taxes and suggest methods of allocating the reduction. It is less clear that this can be done in low income households.[128]

V. CONCLUDING OBSERVATIONS

A. Distinguishing Periodic Payments from Property Purchases

The law in this area should be certain. It has been suggested in this article that "periodic" payments should be governed by Sections 71 and 215 unless they represent the installment purchase of a vested property interest of one spouse. The certainty advocated in this article involves an expense in terms of parity between community property and common law property states in this respect: wives in common law property states will have fewer vested property interests than wives in community property states. If payments for inchoate rights can be made deductible, taxpayers in common law property states will have more flexibility than taxpayers in community property states. A former husband could obtain a deduction for installment payments for an interest that is similar to the "vested" property interest but is not such an interest by accident of local law. This situation may well change, however, as more wives are employed outside the home and obtain property interests that are in fact vested under local law. The *Imel* case discussed in this article may not be an aberration; it may be a harbinger.[129] Moreover, the uncertainty created by *Bernatschke, Waller*, and similar cases can become nearly intolerable in cases involving payments for items that may be property for local law purposes but that are treated as mere rights to income, or even mere expectancies, for federal tax purposes.

B. Maintenance and Child Support

In middle and high income households, divorce can lead to a de-

128. In substantial income households the husband might be willing (and able) to make more and larger payments if the payments are not specifically designated child support. In low income households the reverse might well be the case.

129. *See* note 36 *supra* and Hjorth, *Community Property Marital Settlements: The Problem and a Proposal*, 50 WASH. L. REV. 231, 234–35 (1975).

creased aggregate tax burden if current payments are called maintenance rather than child support. The wisdom of a tax law that arguably favors divorce over marriage is doubtful. The wisdom of a tax law that prefers maintenance over child support is even more doubtful. The problem is more severe in low income households because the interrelationships of the maintenance deduction, child care deduction, standard deduction, and dependency exemption provisions make it almost impossible for even the most sophisiticated tax lawyer to plan post-dissolution payment arrangements that are just and equitable. Many of these problems could be solved by the following legislative changes:

(1) Change the maintenance deduction of Section 215 and the child care deduction of Section 214 to credits, or to deductions that are allowable in computing adjusted gross income. Present law, which allows these items only as deductions in lieu of the standard deduction, discriminates in favor of those with high incomes who would itemize deductions even if they did not have deductions under Section 215 or Section 214.

(2) Grant the deduction (or credit) of Section 214 to the custodial parent who actually pays the expense so long as the child involved is the dependent of one of the two parents. Under this change, a working mother could claim the deduction (or credit) even if she claims the standard deduction and even if the child involved is the dependent of the noncustodial parent by virtue of Section 152(e).

These changes would undoubtedly lead to some loss of revenue. They are required, however, if low income taxpayers are to obtain the same benefits already granted to high income taxpayers.