Denver Law Review

Volume 31 | Issue 6 Article 5

June 2021

Tax Aspects of Property Settlements and Alimony in Divorce

J. Nelson Young

Follow this and additional works at: https://digitalcommons.du.edu/dlr

Recommended Citation

J. Nelson Young, Tax Aspects of Property Settlements and Alimony in Divorce, 31 Dicta 224 (1954).

This Article is brought to you for free and open access by the Denver Law Review at Digital Commons @ DU. It has been accepted for inclusion in Denver Law Review by an authorized editor of Digital Commons @ DU. For more information, please contact jennifer.cox@du.edu,dig-commons@du.edu.

TAX ASPECTS OF PROPERTY SETTLEMENTS AND ALIMONY IN DIVORCE*

J. NELSON YOUNG †

In representing a client in a divorce settlement, an attorney must be fully cognizant of the tax incidents of the financial arrangements agreed upon by the parties or imposed by court decree. Failure to consider the tax consequences may materially jeopardize the financial benefits secured for the wife or substantially increase the cost of the settlement assumed by the husband. It is the scope of this paper to outline the principal tax factors to be considered in consummating the financial settlement incident to the divorce or separation.

At the outset, an example may serve to demonstrate the substantial burdens imposed upon the respective parties if the tax consequences are overlooked.[1] Assume that a husband having net taxable income of $16,000 is obligated to pay his divorced wife $6,000 per year. If these payments are not taxable to the wife, the husband obtains no deduction and his tax will total $5,200 leaving a net income after taxes of $10,800. The wife, of course, will enjoy the full benefit of the $6,000 and will not be compelled to discount the amount received to allow for payment of income taxes. On the other hand, if these payments are taxable as alimony to the wife, her tax will approximate $1,048 and the net amount available for her living expenses will be reduced accordingly. The husband, in this case, will gain a deduction in an equivalent amount and his tax will be approximately half the amount otherwise payable, namely, $2,640 rather than $5,200. Anticipation of the tax costs by the attorney for either party may result in shifting the tax incidents to avoid adverse tax consequences to his client.

BACKGROUND OF PRESENT ALIMONY PROVISIONS

Our first concern in the tax problems of divorce is the treatment of continuing payments made by the husband to the wife which are in the nature of alimony. In an early case it was held that alimony received by the divorced wife did not constitute taxable income within the statutory definition of the term, but rather a non-deductible personal expense of the husband incurred in discharging an obligation incident to the marriage relationship.[2] This was the state of the law until the Revenue Act of 1942 was

---

* Reprinted from the April, 1954, issue of the South Dakota Bar Journal.

† Of Urbana; Professor of Law, University of Illinois. Chairman, ISBA Section on Federal Taxation.

[1] The figures used in this illustration are approximate and are based on 1954 tax rates.

[2] Gould v. Gould, 245 U. S. 151 (1917).

adopted. Congress, motivated by the substantial increase in surtax rates, deemed it inequitable to continue the established rule regarding the treatment of alimony and determined that these payments should thereafter be taxed as income of the wife and allowed as a deduction to the husband. This was accomplished by adding sections 22(k), 23(u) and 171 to the code and by amending section 22(b)(2) relating to insurance and annuities. Section 22(k) prescribes the conditions prerequisite to the taxation of alimony payments as income of the wife. If the payments fall within these statutory provisions, the husband is allowed a page 3 deduction by section 23(u).

The constitutionality of treating alimony as income under the Sixteenth Amendment has been sustained in a recent decision. In the *Gould* case,[3] it had been assumed that the treatment of all money as income was a matter of statutory definition and that there were no constitutional limitations or restrictions. The Court of Claims took this position in its recent decision and the Supreme Court denied certiorari.[4]

By the terms of the statute, alimony either as income or as a deduction is placed strictly on a cash basis. The fact hat the taxpayer regularly follows the accrual method of reporting income does not alter the situation—alimony payments are taxed only in the year of receipt and are deductible only in the year of payment.[5]

STATUTORY REQUIREMENTS

To qualify under the provisions of section 22(k) so that the payments will be taxable as income of the wife and deductible as a page 3 deduction by the husband, certain technical requirements must be met. For convenience these are summarized as follows:

(1) there must be a decree of divorce or separation;
(2) the payments must be in satisfaction of an obligation imposed or incurred "because of the marital or family relationship;"
(3) the payments by the husband must be in discharge of an obligation imposed by decree, or incurred "under a written instrument incident to such divorce or separation;"
(4) the payments must be "periodic" and not installment payments of a principal sum; and finally,
(5) the payments must not be for the support of minor children.

It is also provided that periodic payments attributable to property transferred on trust or otherwise shall be taxed to the wife and excluded from the husband's income.

[3] *Supra*, note 2.

[4] Mahana v. United States, 88 F. Supp. 285 (Ct. Cl. 1950), cert. den. 339 U. S. 978 (1950).

[5] Int. Rev. Code, §§22(k), 23(u); Reg. 118, §39.22 (k)-1(a)(6) (1953).

REQUIREMENT OF A DECREE OF DIVORCE OR SEPARATION*

A prior decree of divorce or legal separation is the *sine qua non* for treatment of periodic payments as alimony under the Code provisions. In the absence of a prior decree, the payments made by the husband will not qualify even though clearly intended for the support of the wife. This requirement is strictly enforced by the courts as evidenced by the following instances in which the payments have been held to fall outside the provisions of the statute.

(1) payments under a voluntary separation agreement;[6]
(1947).
(2) payments pursuant to court order enforcing a voluntary separation agreement;[7]
(3) payments pursuant to court order enforcing the husband's legal obligation to support his wife and family;[8]
(4) payments of alimony *pendente lite;*[9]
(5) payments made prior to a decree even though subsequently covered by entry of a decree *nunc pro tunc;*[10] and
(6) payments under an interlocutory decree.[11]

In all these cases the decisions turned on the fact that there had been no decree of divorce or legal separation prior to the time the payments were made. It should be noted that where a qualifying decree of divorce or separation is lacking, the parties may still file a joint return as husband and wife.[12] This was recently permitted in a case where an interlocutory decree had not become final prior to the end of the taxable year.[13]

Anomalous as it may seem, universal validity is not required of a prior decree. Thus it has been held that payments under a separation agreement entered into prior to a foreign decree were deductible by the husband even though the foreign divorce had been held null and void by the domiciliary state.[14] The Bureau has

* Section 71 of the proposed Internal Revenue Code of 1954 (H.R. 8300, 83d Cong., 2d Sess. would abolish the present requirement of a prior judicial decree of divorce or separation. Support payments under a voluntary separation agreement would be treated as alimony taxable to the wife and deductible by the husband where the parties do not file a joint return.

[6] Smith v. Comm'r, 168 F. (2d) 446 (2d Cir. 1948), affirming 6 T.C.M. 1323

[7] Terrell v. Comm'r, 179 F. (2d) 838 (7th Cir. 1950), cert. den. 340 U. S. 822 (1950).

[8] Frank J. Kalchthaler, 7 T.C. 625 (1946); Angelo Frascone, 8 T.C.M. 377 (1949).

[9] Reg. 118, §39.22 (k)-1, Example (1); George D. Wick, 7 T.C. 723 (1946), aff'd per curiam, 161 F. (2d) 732 (3d Cir. 1947); Robert A. McKinney, 16 T.C. 916 (1951).

[10] Daine v. Comm'r, 168 F. (2d) 449 (2d Cir. 1948), affirming 9 T.C. 47 (1947).

[11] Alice H. Evans, 19 T.C. 1102 (1953).

[12] Int. Rev. Code, §51(b)(5)(B).

[13] Marriner S. Eccles, 19 T.C. 1049 (1953).

[14] Feinberg v. Comm'r, 198 F. (2d) 260 (3rd Cir. 1952), reversing, 16 T.C. 1485 (1951). Here the parties, residents of New York, entered into a voluntary separation agreement which provided for weekly support payments to the wife. A few weeks thereafter, the husband obtained a Florida divorce with service by publication. Subsequently the wife obtained a reformation of the separation agreement and a declaratory judgment that the Florida decree was null and void.

also ruled that it will allow a deduction for payments made by the husband under a separation agreement incident to a Mexican divorce decree where the parties resided in a jurisdiction which did not recognize such decrees.[15]

OBLIGATION IMPOSED "BECAUSE OF THE MARITAL OR FAMILY RELATIONSHIP"

In adopting the alimony provisions, Congress studiously avoided incorporation of the term "alimony" in the language of the statute. As indicated in the committee reports, it was intended that the statute should "produce uniformity in the treatment of amounts paid in the nature of or in lieu of alimony regardless of variance in the laws of different states concerning the existence and continuance of an obligation to pay alimony." [16] With this expression of legislative intent to rely upon, it has been held that periodic payments for support are deductible by the husband and taxable to the wife even though the law of the particular state does not impose upon the husband an obligation to pay alimony.[17]

It is still necessary, however, to distinguish between payments which are in satisfaction of property rights and those which are in satisfaction of support rights. Payments in satisfaction of property rights alone will not qualify as alimony payments—that is, such payments will not be taxable as income of the wife, nor deductible by the husband. More frequently, the agreement or decree will provide for settlement of both property and support rights in consideration of periodic payments. Unless the provisions are clearly separable, periodic payments required of the husband will nevertheless qualify as alimony taxable to the wife.

In a very recent case, the divorced wife claimed an interest as a partner in her husband's business in the negotiations leading to the divorce settlement. This claim was based upon the rendition of services in the operation of the business and an alleged understanding that she was to be made a partner. In the settlement concluded by the parties, the wife released her claim to an interest in the business and waived her dower rights and claims for alimony. The principal consideration for the release of these rights was the husband's agreement to provide a home and an automobile for her, the assignment of a 40% interest in some life insurance policies, and the payment of $17,500 per year in equal semi-monthly payments. The wife contended that the periodic payments were made as the purchase price of her ownership in the business and should not be taxable to her. But the Tax Court con-

[15] G.C.M. 25250, 1947-2 Cum. Bull. 32.

[16] H. R. Rep. No. 2333, 77th Cong. 1st Sess. 72 (1942), 1942-2 Cum. Bull. 372, 427; Sen. Rep. No. 1631, 77th Cong. 2d Sess. 83 (1942), 1942-2 Cum. Bull. 504, 568.

[17] Tuckie G. Hesse, 7 T.C. 700 (1946); Thomas E. Hogg, 13 T.C. 361 (1949).

cluded that taking the agreement as a whole the periodic payments were for support and were properly taxable.[18]

OBLIGATION IMPOSED BY DECREE OR WRITTEN INSTRUMENT

Section 22(k) expressly provides that the husband's obligation to make periodic payments must be imposed by decree or by a "written instrument incident to such divorce or separation." In the vast majority of cases, this requirement presents no difficulty for the husband's obligation is generally imposed either by the specific terms of the decree or by the provisions of a written instrument incorporated in the decree. The real difficulty with respect to this requirement arises either where the agreement is made prior to the divorce or separation and is not incorporated in the decree, or where the parties subsequent to the divorce or separation alter or amend the husband's obligation without the benefit of court supervision.

Consider first the situation where an agreement for periodic payments is entered into prior to the divorce or separation, but is not incorporated in the decree. The Tax Court has adopted the view that in such a case the agreement is not incident to the divorce or separation unless the parties mutually contemplated or intended a divorce at the time the agreement was consummated.[19] The Courts of Appeals, however, have not adhered to this restrictive rule of construction and have held that the statute does not require proof "that both parties jointly and positively anticipated legal divorce or separation at the moment they signed the agreement." [20] Instead, these courts have taken a much more liberal position and have adopted the rule that the agreement shall be considered incident to the divorce or separation if the payments thereunder take the place of alimony or support monies which would otherwise be due and payable.[21]

A question also arises where an agreement has been incorporated in the decree but subsequent to the divorce or separation the parties by mutual consent alter or amend the provisions for periodic payments. The trend of the recent cases is that the revised agreement will be considered incident to the divorce or separation provided the original agreement meets this requirement.[22] The moral of the cases in this area points toward the advisability of incorporating a pre-divorce agreement in the decree and of effecting subsequent revisions or amendments under the supervision of

[18] Julia Nathan, 19 T.C. 865 (1953); see also on this point: Floyd H. Brown, 16 T.C. 623 (1951).

[19] E.g., Francis Hamer Johnson, 21 T.C. No. 42 (1953).

[20] Izrastzoff v. Comm'r, 193 F. (2d) 625, 627 (2d Cir. 1952).

[21] Lerner v. Comm'r, 195 F. (2d) 296 (2d Cir. 1952), reversing, 15 T.C. 379 (1950); Comm'r v. Miller, 199 F. (2d) 597 (9th Cir. 1952), reversing 16 T.C. 1010 (1951).

[22] Smith v. Comm'r, 192 F. (2d) 841 (1st Cir. 1951), affirming 16 T.C. 639 (1951); Rowena S. Barnum, 19 T.C. 401 (1952); cf., Comm'r v. Walsh, 183 F. (2d) 803 (D.C. Cir. 1950), affirming, 11 T.C. 1093 (1948); Comm'r v. Murray, 174 F. (2d) 816 (2d Cir. 1949), reversing, 7 T.C.M. 365 (1948).

the divorce court. This should be the *modus operandi* to insure a tax deduction for the husband.

PAYMENTS MUST BE PERIODIC

Lump Sum Payments Do Not Qualify—It is the general scheme of the statute that the payments must be periodic to qualify as alimony. In most cases this requirement poses no problem for it is generally provided by agreement or decree that the husband shall pay the wife a fixed sum per month for her support until her death or remarriage. In that case the payments are taxable to the wife and deductible by the husband. But there are instances where the husband pays a fixed sum to the wife in full satisfaction of his obligations. A lump sum payment clearly does not qualify under the statute and is neither taxable to the wife nor deductible by the husband.[23]

Installment Payments of a Lump Sum—To take another variation, assume that a principal sum is established as a basis for settlement but it is provided that payment shall be by installments. By an exception included in section 22(k), installment payments may qualify as alimony if the payments of the principal sum extend over a period of more than ten years from the date of the decree or agreement. But the amount which may qualify as alimony in any one year may not exceed ten per cent of the principal obligation. From the husband's standpoint, installment payments of a principal sum extending over a period of more than ten years will prove advantageous since such payments will qualify as proper tax deductions.

The statute provides that the ten year period shall be measured from the date of the decree or instrument. In drafting an agreement or decree where it is intended that the payments shall qualify under the statutory exception, care should be taken to avoid skating too closely to the edge of the ten year period.[24]

Rule of Separability and the Drafting Problem—A recent case demonstrates the tax trap which awaits the draftsman under the rule of separability which has been applied to agreements which provide for installment payments.[25] The point can best be made by illustration: Assume an agreement or decree which provides in separate clauses substantially as follows:

(A) H shall pay W $25,000 in semi-annual installments of $2500 for a period of five years beginning January 1, 1954; and

(B) in addition, H shall pay W $5,000 per year in equal monthly installments for a period of 15 years beginning January 1, 1954.

---

[23] As noted later, a lump sum settlement may result in gift tax liability.

[24] E.g., see: Comm'r v. Blum, 187 F. (2d) 177 (7th Cir. 1951), cert. den. 342 U. S. 819 (1951).

[25] Estate of Frank C. Smith, 5 CCH 1953 Fed. Tax. Rep. ¶9616, (3d Cir. November 13, 1953).

The total obligation of the husband is to pay the divorced wife $100,000 over a period of 15 years—$25,000 under clause (A) and $75,000 under clause (B). Combining the payments under the two clauses $10,000 is payable each year during the first five years and $5,000 during each of the last ten years of the fifteen year period. The payments of $10,000 per year do not exceed ten per cent of the total obligation of the husband. But under the rule of separability, the payments required under clause (A) will not qualify under section 22(k) since these payments constitute installment payments of a principal sum due within a period of less than ten years. Consequently, the husband will lose a tax deduction of $25,000. By careful draftsmanship, this result can be avoided.

To obviate the adverse result in the foregoing case, the husband's obligation should be stated in terms of a single principal sum as follows:

> (a) H shall pay W $100,000 over a period of 15 years beginning January 1, 1954, in the following installments: (1) $10,000 per year for the first five years; and (2) $5,000 per year for the last ten years.

By merging the husband's obligation into a single principal sum, the rule of separability will be inapplicable and the payments made during the first five years will qualify as alimony deductions since they do not exceed ten per cent of the principal amount.

The foregoing suggestions are directed toward proper representation of the husband. One representing the wife would, of course, prefer the first form of separately stating the husband's obligations since that would serve to remove $25,000 from the wife's taxable income.

Payments for Periods Less Than Ten Years Contingent Upon Death or Remarriage—As indicated above, installment payments of a lump sum extending over a period of less than ten years do not qualify as alimony payments under section 22(k). It has been contended, however, that if the payments are contingent upon death or remarriage, they are periodic and are not installment payments of a lump sum since the period is indefinite. The Tax Court has consistently refused to bow to this argument and has held that where the payments are for a fixed period of less than ten years, though subject to these contingencies, they constitute installment payments of a readily determinable fixed sum.[26]

In two recent cases, however, the Courts of Appeals for the Second and Third Circuits have held that the probability of remarriage is so uncertain and immeasurable that it serves to convert the fixed term into an indefinite term and the payments become

[26] J. B. Steinel, 10 T.C. 409 (1948); Frank P. Orsatti Estate, 12 T.C. 188 (1949); Frank R. Casey, 12 T.C. 224 (1949); Harold M. Fleming, 14 T.C. 1308 (1950); Benjamin Davidson, 11 T.C.M. 1111 (1952); F. Ellsworth Baker, 17 T.C. 1610 (1952), rev'd, 205 F. (2d) 369 (2d Cir. 1953).

periodic payments taxable to the wife and deductible by the husband.[27] In the light of these decisions, specified payments over a fixed term of less than ten years qualify as alimony if the payments cease upon the wife's remarriage.

The decision of the Third Circuit in the *Smith* case is broad enough to sustain the proposition that payments contingent upon the death of either the husband or wife will constitute periodic payments. This position seems inconsistent with the usual recognition given life expectancies in determining valuation. If the life expectancies of the two parties are at least equal to the term for which the payments are to be made, it is reasonable to conclude that the payments constitute installment payments of a fixed sum. Further developments on this point—either judicial or legislative—can be expected.

Payments Contingent Upon the Husband's Earnings—Where the payments for a term of less than ten years are contingent upon the husband's earnings, the decisions are not consistent in the treatment of such payments as periodic rather than as installment payments of a principal sum.[28] One may, with reasonable safety, postulate the rule, however, that if the payments to the wife vary directly with the husband's income, the payments will be considered periodic. Assume, in a situation where the husband's earnings are normally subject to considerable fluctuation, the wife is to receive 30% of the husband's net income for a period of eight years—but not less than $3,000 nor more than $6,000 per year. Payments under an arrangement of this type should qualify as periodic payments.

PAYMENTS FOR SUPPORT OF MINOR CHILDREN

By express provision in section 22(k), payments made for the support of minor children are not deductible by the husband nor taxable to the wife. This result clearly follows where the agreement or decree expressly stipulates that a certain amount is payable for support of children.[29] But where the decree or agreement fixes a sum for support of both the wife and children without specifying the amount for each, the payments are taxable in their entirety to the wife and are fully deductible by the husband.[30] Under these circumstances, no portion of the husband's payments may be treated as payments for the support of a child in determining the dependency credit.[31] Consequently the benefit of the dependency credit is made available to the wife.

Although the agreement or decree may not designate a specific sum for support of minor children, provisions for adjustment of

---

[27] Baker v. Comm'r, 206 F. (2d) 369 (2d Cir. 1953); Estate of Frank C. Smith, 5 CCH 1953 Fed. Tax Rep. ¶9616, (3d Cir. Nov. 13, 1953).

[28] Roland K. Young, 10 T.C. 724 (1948); John H. Lee, 10 T.C. 834 (1948); James M. Fidler, 20 T.C. No. 149 (1953).

[29] Reg. 118, §39.22(k)-1(d) (1953).

[30] Dora H. Moitoret, 7 T.C. 640 (1946).

[31] Int. Rev. Code, §25(b)(3).

the payments to be made to the wife may result in identification of a portion of the payments as being for that purpose. To illustrate, assume that the wife is to receive $500 per month for the support of herself and a minor child. Without more, the $500 is taxable as income of the wife and is deductible by the husband as alimony. But assume that there is a further proviso that upon the child's reaching majority or in the event of the child's prior death the monthly payments shall be reduced by $100. This latter provision has the effect of identifying $100 per month as payments for the support of the minor child.[32] Thus the wife would be taxed upon income of $400 per month and the husband's deduction would be limited accordingly.

Although the husband is allowed no deduction for payments for the support of minor children, he may be allowed a dependency credit. The burden is upon him, however, to establish that he contributed more than one-half of the support of the child or children.[33] This burden is a difficult one where the payments are made to the wife who is not bound to separately account for the expenditure of the funds. Where the situation is sufficiently amicable, the wife might be persuaded to create a separate bank account so that a detailed report of expenditure of the funds for the support of the children will be maintained.

ALIMONY TRUSTS

Prior to the Revenue Act of 1942, income of an alimony trust was taxable to the husband if it discharged, but did not terminate, a continuing obligation to support the former wife.[34] Under the provisions of Section 22(k), the distributable income of a trust created pursuant to decree or an agreement incident to the divorce or separation is taxable to the wife and excluded from the husband's income. If there is a provision for payment of an annuity to the wife, the full amount is taxable to the wife as a periodic payment even though the distribution is in part from corpus.[35]

There are instances where the husband has created a trust for the benefit of his wife prior to the time a divorce was contemplated. The income of this trust may have been taxable to the husband because it was required by the terms thereof that the income should be distributed for the support and maintenance of his wife (section 167), or because he retained a power of revocation (section 166), or because he retained such powers as to bring the trust within the scope of the *Clifford* doctrine (section 22(a)). In a subsequent divorce or separation, the wife, relying upon the ben-

[32] The following decisions illustrate this point: Robert W. Budd, 7 T.C. 413 (1946), aff'd per curiam, 177 F. (2d) 198 (6th Cir. 1947); Leon Mandel, 8 T.C.M. 445 (1949), aff'd 185 F. (2d) 50 (7th Cir. 1950); Harold M. Fleming, 14 T.C. 1308 (1950).

[33] Richard P. Prickett, 18 T.C. 872 (1952).

[34] E.g., Douglas v. Willcuts, 296 U.S. 1 (1935).

[35] Reg. 118, §39.22(k)-1(b)(2) (1953). The annuity payments in this case constitute periodic payments attributable to property transferred by the husband.

efits provided by the previously created trust, does not seek or obtain provision for her support in the legal proceedings incident to the divorce or separation. Under section 171, the income of the trust will thereafter be taxed to the wife, but distributions from principal will not constitute taxable income.[36]

Consistent with the rule applicable to periodic payments by the husband, trust income applied to the support of minor children is taxable to the husband, not to the wife.[37] But where the trust income includes tax-exempt interest, the husband is entitled to a pro-rata allocation in the determination of his taxable income.[38]

As will be noted later, gift tax liability may be incurred upon creation of an alimony trust. In addition, the trust property may also be included in the husband's gross estate upon his death if he retains an interest in the property or control over its ultimate disposition.

ANNUITY IN PAYMENT OF ALIMONY

Where the wife desires support payments for the duration of her life, a simple solution would be for the husband to purchase an annuity contract and assign it to her. But if this were done, the husband obtains no tax deduction for the consideration paid for the annuity. He is deemed to have made either a lump sum payment or, more properly, a transfer of property to provide periodic payments for the wife. The wife, on the other hand, will be fully taxed upon the annuity payments as periodic payments attributable to property transferred in satisfaction of the husband's obligation. The three per cent rule generally applicable to annuities is inapplicable in this case by express statutory exception.[39] The same result would follow if the husband assigned to the wife an annuity limited by his own life.

The tax cost of employing an annuity can be reduced, however, by altering the form of the settlement. Assume that the wife desires an annuity of $3,000 per year which will cost $50,000. If the husband purchases the annuity contract and assigns it to her, the annual payments of $3,000 will be fully taxable to the wife. But assume that the wife accepts a payment of $50,000 from the husband in satisfaction of his obligation to support her. Later she purchases an annuity with the funds provided. In this case, the wife will be taxed each year only upon $1,500 (3% of $50,000). Where an annuity is desired, it would be preferable for the husband and wife to arrive at a cash settlement and let the wife purchase the annuity after the settlement has been effected. The husband's tax position remains the same, but the wife's tax cost is substantially reduced.

---

[36] Int. Rev. Code, §171(a); Reg. 118, §39.171-1 (1953).
[37] Int. Rev. Code, §§22(k), 171(a).
[38] Arthur Letts, Jr., 3 T.C.M. 377 (1944).
[39] Int. Rev. Code, §§22(k), 22(b)(2)(A); Reg. 118, §§39.22(k)-1(b), 39.22(b)(2)-4 (1953).

LIFE INSURANCE

Life insurance may be an important factor in the financial settlement effected by the husband and wife. These transactions may take several alternative forms, but the more common probably fall into the following patterns:

(a) the husband transfers fully paid-up policies absolutely to the wife; or
(b) he transfers annual premium policies to the wife and continues the premium payments; or
(c) he transfers annual premium policies to the wife who assumes the burden of future premium payments.

These transactions present four problems which should be considered at this point. (1) Does the husband obtain an income tax deduction upon the transfer of insurance policies to the wife? (2) Do the premium payments made by the husband subsequent to the transfer constitute taxable income to the wife so that the husband may take a corresponding deduction? (3) Are the proceeds of the policies received upon the husband's death taxable as income of the wife? (4) Are the proceeds of the insurance policies includible in the husband's gross estate for purposes of the Federal estate tax? A gift tax question also arises with respect to the transfer of the policies, but this point is covered in connection with property settlements.

Transfer of Policies and Payment of Premiums—The transfer of a partially paid or a fully paid-up policy to the wife will not provide the husband with an alimony deduction since this constitutes a lump sum payment or a transfer of property for the purpose of providing the wife with periodic payments—depending upon the settlement provisions of the contract. Conversely the wife does not realize income upon the transfer of the policy.

Whether the premium payments made by the husband subsequent to the transfer are taxable as income of the wife and deductible by him as alimony turns upon the nature of the wife's interest in the policies. If she takes only a contingent or security interest to protect her in the event of the husband's premature death—for example, where the policies are payable to her only if she survives her husband—the premiums are not taxable as alimony income and the husband will not be allowed a deduction.[40] But if she takes an absolute property interest in the policies and is free to change the beneficiary, borrow upon the policies, and surrender the policies for their cash surrender value, the premiums are taxable to her as alimony income and are deductible by the husband.[41] The distinction rests upon the proposition that the wife must actually or constructively receive the periodic payments

---

[40] Estate of Frank C. Smith, 5 CCH 1953 Fed. Tax Rep. ¶9616 (3d Cir. November 13, 1953); Seligmann v. Comm'r, 5 CCH 1953 Fed. Tax Rep. ¶9580 (7th Cir. October 19, 1953); Lilian Bond Smith, 21 T.C. No. 40 (1953); William J. Gardner, 14 T.C. 1445 (1950), aff'd per curiam, 191 F. (2d) 857 (6th Cir. 1951).

[41] Lemuel A. Carmichael, 14 T.C. 1356 (1950); Anita Quinby Stewart, 9 T.C. 195 (1947).

made by the husband. Where her interest is merely a contingent interest, this requirement is not met.

Proceeds of Insurance as Income of Wife—The income tax treatment of the proceeds of life insurance contracts received by the wife following the husband's death is uncertain. The language of the regulations is sufficiently broad to indicate that if the proceeds are received in periodic (installment) payments, they are taxable to the wife as alimony income in any event.[42] This result does not seem unreasonable where the wife's interest under the policies was security against her husband's premature death. In that case the premiums paid by the husband would not have been taxable to her and the policies would serve to continue periodic payments for her after his death. But where the wife held an absolute property interest in the policies prior to her husband's death so that the premiums paid by the husband were taxable as alimony income, the result is harsh indeed. In that case, no deduction would be allowed against the proceeds for the amount of premiums taxed to her as income.

The regulations imply that the proceeds may not be taxed as income in any respect if paid in a lump sum. A question still remains, however, as to whether the wife will be considered a transferee for value so that she will be taxed upon the proceeds to the extent that the amount received is in excess of her cost basis where she took an absolute interest in the policies prior to his death. There is considerable need for legislative clarification in this area.

Inclusion of Proceeds in Husband's Estate—Proceeds of the insurance policies will be included in the husband's gross estate under the Federal estate tax in either of two situations. If the proceeds serve to liquidate an obligation to continue alimony payments to his wife—for example, where the wife's interest is a security interest—they are includible in the same manner as if they were payable to the executor. But an off-setting deduction may be taken as a claim against the husband's estate.[43] The proceeds are also includible in proportion to the premiums paid by the husband where there was a transfer of the policy to the wife in the divorce settlement and the transfer constituted a gift for purposes of the gift tax.[44]

PROPERTY SETTLEMENTS

Gift Tax Consequences—The first question to arise with respect to a transfer of property or lump sum payment of cash in a divorce settlement is the applicability of the gift tax. This turns on whether the transfer is for an adequate and full consideration in money or money's worth. There is no specific provision in the gift tax regarding the treatment of transfers made in considera-

[42] Reg. 118, §§39.22(b)(2)-4; 39.22(k)-1(b)(1) (1953).
[43] Estate of Silas Mason, 43 B.T.A. 813 (1941).
[44] Int. Rev. Code, §811(g)(3).

tion of the relinquishment of marital rights. But section 812(b) of the estate tax provides that relinquishment of "dower" or "other marital rights in the decedent's property or estate" shall not be treated as consideration in money or money's worth in determining allowable claims founded upon a promise or agreement. Applying the rule of *pari materia,* the Supreme Court has adopted this restriction in construing section 1002 of the gift tax in the determination of taxable *inter vivos* transfers of property in satisfaction of a spouse's dower rights.[45]

The rules now applicable to property settlements incident to divorce or separation are these: (1) If a transfer is made pursuant to an agreement not incorporated in a decree, there is a taxable gift to the extent that the transfer is made in satisfaction of the wife's dower or other property rights.[46] (2) If, however, the transfer is made pursuant to decree or an agreement which has been incorporated in a decree, there is no taxable gift regardless of the purpose of the transfer.[47] A transfer in this case is deemed to be one in satisfaction of a decretal obligation and is not made pursuant to a promise or agreement. Consequently the requirement of an adequate and full consideration in money or money's worth is not applicable.

The status of the law in this area leads to this conclusion. To avoid imposition of a gift tax upon a property settlement, withhold transfer of the property until the settlement agreement has been adopted by the divorce court and incorporated in the divorce decree.

Income Tax Consequences—A transfer of property pursuant to a property settlement may also result in the realization of taxable income by the husband. This will follow where the value of the wife's property and support rights exceeds the cost basis of the property transferred.[48] Assume for example that the wife has agreed to accept $150,000 in full satisfaction of her property and support rights and is willing to take securities held by her husband which are currently valued at that figure. The cost basis of the securities in his hands is only $50,000. The husband will realize a taxable gain of $100,000 upon the transfer.

Subsequent to the settlement a question arises as to the cost basis of the property acquired by the wife. Has she acquired the property by gift so that she succeeds to her husband's basis, or has she acquired the property by purchase? Although the transaction may have constituted a gift under the gift tax, it is deemed a purchase and sale for income tax purposes. Consequently the basis of the property in the wife's hands is its fair market value

---

[45] Comm'r v. Wemyss, 324 U. S. 303 (1945); Merrill v. Fahs, 324 U. S. 308 (1945); Harris v. Comm'r, 340 U. S. 106 (1950).

[46] E. T. 19, 1946-2 Cum. Bull. 166.

[47] Harris v. Comm'r, 340 U. S. 106 (1950).

[48] Comm'r v. Halliwell, 131 F. (2d) 642 (2d Cir. 1942), cert. den., 319 U. S. 741 (1943); Comm'r v. Mesta, 123 F. (2d) 986 (3d Cir. 1941), cert. den., 316 U. S. 695 (1942).

at the date of the transfer or the amount of the liquidated obligation satisfied by the transfer.[49]

INCOME TAXES UPON ALIMONY INCOME OF THE WIFE

The taxability of periodic payments to the wife is governed by the conditions imposed under section 22(k). If the payments do not meet these requirements, the wife's erroneous inclusion of the amounts in her taxable income does not validate a deduction taken by her husband.[50] Similarily, the wife's agreement or obligation under a decree to pay income taxes upon payments received from her husband does not render the payments taxable to her or deductible by him if they do not qualify under section 22(k).[51]

Often it will be provided that the husband shall pay the income taxes assessed with respect to the payments made to the wife so that she will be guaranteed a tax-free income. This will not serve to exclude the payments from her taxable income if they are otherwise taxable under section 22(k).[52] The additional amount paid by the husband to defray the wife's income tax constitutes additional taxable income of the wife.[53] In a recent ruling the Bureau has obviated the problem of a "tax on a tax on a tax" by ruling that the amount agreed upon by the parties as payable by the husband in liquidation of this obligation will determine the amount of the wife's additional income in computing her total tax liability.[54]

LEGAL EXPENSES

Deduction of legal expenses incurred by the respective parties in connection with divorce or separation and the financial arrangements incident thereto has caused considerable litigation. But by this time the rules are fairly well established.

Paid by the Husband—The husband may be obligated to pay not only his own legal expenses, but also those of his wife. As a general proposition, neither are deductible. Legal expenses incurred in obtaining a divorce or defending a divorce suit are personal expenses which are non-deductible under section 24(a) (1). In recent cases it has been urged that the portion of the legal expenses allocable to the financial settlement are deductible as non-business expenses "incurred for the production or collection of income." The Courts following the rationale of the *Lykes* case,[55]

[49] Farid-Es-Sultaneh v. Comm'r, 160 F. (2d) 812 (2d Cir. 1947); Edna W. Gardner Trust, 20 T.C. No. 125 (1953); C. de Bourbon Patino, 13 T.C. 816 (1949), aff'd, 186 F. (2d) 962 (4th Cir. 1950); Aleda N. Hall, 9 T.C. 53 (1947).

[50] Van Vlaanderen v. Comm'r, 175 F. (2d) 389 (3d Cir. 1949).

[51] Frank R. Casey, 12 T.C. 224 (1949).

[52] Muriel D. Neeman, 13 T.C. 397 (1949); aff'd per curiam, 200 F. (2d) 560 (2d Cir. 1953), cert. den., 345 U. S. 956 (1953).

[53] Mahana v. United States, 88 F. Supp. 285 (Ct. Cl. 1950), cert. den., 339 U. S. 978 (1950).

[54] Mim. 6779, 1952-1 Cum. Bull. 8, as amended by IR-Mim. 51, 1953-2 Cum. Bull. 65.

[55] Lykes v. United States, 343 U. S. 118 (1952) (denying a deduction under section 23(a)(2) for legal expenses incurred in defending a gift tax deficiency).

have rejected this argument and have disallowed the deduction on the ground that the immediate purpose of the expenditures is to relieve the taxpayer of liability and is not directly related to the production or collection of income.[56]

In one case, however, the fact justified a contrary result. There the husband was serving as president of a corporation in which he held a controlling interest. His wife was negotiating for a property settlement which would have required liquidation of his stock and consequent relinquishment of control of the corporation, loss of dividends, and probable loss of his position as president. The court concluded that the legal expenses were allowable in these circumstances as expenses incurred in "conserving and maintaining property . . . for the production of income." [57]

The wife's counsel fees which are paid by the husband are not deductible by him as alimony payments. These expenses are not in the nature of alimony and if they were such payments would not qualify as periodic payments.[58]

Paid by the Wife—Legal expenses and counsel fees paid by the wife are accorded somewhat different treatment. To the extent that they are allocable to the negotiation or creation of taxable alimony income, they are deductible as non-business expenses under section 23(a)(2), being held ordinary and necessary expenses incurred in the production or collection of income.[59] The same rule previously mentioned applies, however, to fees and expenses allocable to obtaining a divorce or defending a divorce suit. These are non-deductible personal expenses of the wife.

ALIMONY IN KIND

Payment of alimony in kind is certainly not the ordinary situation. It is conceivable, however, that under certain circumstances the husband may furnish groceries, clothing, or fuel to his divorced wife. These items would constitute payments in lieu of money and would qualify as periodic alimony payments under the statute.

It has been held, however, that the rental value of a home furnished by the husband to the wife rent free does not provide an alimony deduction.[60] In the particular case the wife was granted the right to live in the family home until her death or remarriage or until the children reached the age of 23 or left home whichever event was the first to occur. The court concluded that there were no periodic payments by the husband as required by statute; or, in the alternative, that if there were periodic payments, they were

---

[56] Howard v. Comm'r, 202 F. (2d) 28 (9th Cir. 1953), aff'g 16 T.C. 147 (1951); Estate of Frank C. Smith, 5 CCH 1953 Fed. Tax Rep. ¶9616 (3d Cir. November 13, 1953).

[57] Baer v. Comm'r, 196 F. (2d) 646 (8th Cir. 1952).

[58] Baer v. Comm'r, *supra*, note 57; Frank J. Loverin, 10 T.C. 406 (1948).

[59] Barbara B. Lemond, 13 T.C. 670 (1949); Elsie B. Gale, 13 T.C. 661 (1949).

[60] Pappenheimer v. Allen, 164 F. (2d) 428 (5th Cir. 1947).

attributable to property transferred. The former is the preferable view for it is unlikely that it was intended that the wife should be taxed upon the rental value of the property in these circumstances.

ARREARAGES OF ALIMONY

Frequently, the husband will fall behind in his alimony payments and then liquidate the accrued amount by a lump sum payment. It has been held that such payments are to be treated as periodic payments taxable to the wife and deductible by the husband.[61] This rule is also applicable to delinquent installments of a principal sum payable over a period of more than ten years.[62] The ten percent rule is inapplicable in this case and the delinquent and current installments will be taxable to the wife and deductible by the husband in the year payment is made.

CASE COMMENT

COMMENT ON SCONCE V. NEECE: FEES TAIL, THE RULE IN WILD'S CASE, A SIXTEEN DOLLAR QUESTION, AND SOME COPARCENERS.—*Sconce v. Neece*[1] construed this language: "I give, devise and bequeath all my estate, real, personal and mixed, to my daughters, Katie S. Pence and Lulu S. Middleton, and the heirs of their body, share and share alike, provided that, if either of my said daughters shall not be living at the date of my death, without any children surviving her, then, I give, devise and bequeath all my estate aforesaid to the survivor."

Both daughters survived the testatrix and neither had had a child. This circumstance seemed to permit court and counsel to simplify the problem of construction by ignoring the proviso, and upon this basis, the court's application of Chapter 159, section 1, '35 C.S.A. and Chapter 40, section 7, '35 C.S.A. is orthodox, and as to the land, conclusive.[2]

However, it is more usual for the intention of the testator to be sought by an analysis of all the language in the will.[3] What would have been the result if the proviso had been considered? It says, ". . . if either of my daughters shall not be living at the date of my death, without any children surviving her . . ." The first

[61] Gale v. Comm'r, 191 F. (2d) 79 (2d Cir. 1951), affirming 13 T.C. 661 (1949).
[62] Reg. 118, §39.22(k)-1(c)(1) (1953).

[1] 6 Colo. Bar Assoc. Advance Sheets 271, 268 P. 2d 1102 (1954). The case is not stated because it is assumed that the reader of this comment has read the opinion.

[2] Anomalous section 47 of Chapter 40 says that "This article (including section 7) shall not be so construed as to embrace last wills and testaments." This observation was included in a comment on Liebhardt v. Avison, 28 Dicta 216. Since that publication there has been an occasion to subject that comment to careful review, but no occasion for any revision was found.

[3] See, for example, Liebhardt v. Avison, 123 Colo. 338, 229 P. 2d 933 (1951).