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FEDERAL ESTATE AND GIFT TAXATION-ADEQUACY OF CONSIDERATION IN TRANSFERS CONNECTED WITH DIVORCE PROCEEDINGS OR SEPARATION AGREEMENTS

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FEDERAL ESTATE AND GIFT TAXATION—ADEQUACY OF CONSIDERATION IN TRANSFERS CONNECTED WITH DIVORCE PROCEEDINGS OR SEPARATION AGREEMENTS—Today it is common procedure for a husband and wife, contemplating divorce or separation, to make an advance agreement concerning alimony and division of their property. Often this agreement will be adopted by the court in its decree of separation or divorce. It is the purpose of this comment to discuss the estate and gift tax consequences of such agreements. In order to understand properly the problems which have come up in connection with gift tax liability, it is necessary first to chart out the path taken under the estate tax.

A. *Estate Tax Liability*

Commonly a pre-divorce agreement will provide for an annual alimony payment. This agreement may or may not be incorporated into the divorce decree. Upon the death of the person making the payments, the surviving spouse will file a claim against the estate for the amount of alimony owing. In all probability a lump sum settlement will be made. The question then arises whether the sum paid out is deductible from the decedent's gross estate under the provisions of

I.R.C. §812(b). This section provides that any indebtedness of the deceased "founded upon a promise or agreement" shall be deductible from his gross estate only to the extent that the claim was contracted for an adequate and full consideration in money or money's worth. It was amended in 1932 so as to provide that relinquishment or promised relinquishment of marital rights by one spouse is not an adequate and full consideration in money or money's worth for a promise to transfer assets.[1] This section would seem clearly to prohibit any deduction for monies due under a pre-divorce contract, whether or not that contract was made before or after marriage, if the only consideration is a release of marital rights. This is the position taken by the courts.[2] However it is unanimously held that where the agreement is incorporated into the court's divorce decree any sums due under that decree are deductible from the gross estate of the decedent under the provisions of §812(b).[3] The reasoning has been that the court is free to ignore any agreement made by the parties, and can substitute its own order as to distribution of property or alimony. Therefore, upon its adoption, the agreement of the parties becomes an order of the court. It then follows that any obligation created thereby is not one "founded upon a promise or agreement," but instead is founded solely upon the order of the court; and as such it is not within the prohibitions of §812(b) but is deductible as a claim against the estate.

Thus, under the estate tax, the cases are distinguished according to whether or not the agreement has been incorporated into the divorce decree. Unfortunately, the analysis has not been that simple in the gift tax field.

B. *Gift Tax Liability*

I.R.C. §1002 provides that an inter vivos transfer for less than an adequate and full consideration in money or money's worth shall be a taxable gift. Thus the same standard applies to both the gift and estate tax. However, when Congress added the 1932 amendment to the estate tax section it did not see fit to add a like amendment to

[1] "For the purposes of this subchapter, a relinquishment or promised relinquishment of dower, curtesy, or of a statutory estate created in lieu of dower or curtesy, or of other marital rights in the decedent's property or estate shall not be considered to any extent a consideration 'in money's worth.'" This provision was added by §805 of the Revenue Act of 1932. It will hereafter be referred to as the 1932 amendment.

[2] Estate of Eben B. Phillips, 36 B.T.A. 752 (1937).

[3] Comr. v. Maresi, (C.C.A. 2d, 1946) 156 F. (2d) 929; Comr. v. State Street Trust, (C.C.A. 1st, 1942) 128 F. (2d) 618; Young v. Comr., 39 B.T.A. 230 (1939); Estate of Silas B. Mason v. Comr., 43 B.T.A. 813 (1941).

§1002. As a result it was not determined until 1945[4] whether the estate tax provisions in regard to the release of marital rights as adequate consideration were to be read into the gift tax. Prior to 1945, the circuit courts had been in dispute on this question. One line of cases held that the estate and gift tax sections were in pari materia, on the theory that the two taxes were complementary. Thus if a release of marital rights was not a full and adequate consideration in money or money's worth for purposes of estate taxation, it must necessarily follow that it was also not a full and adequate consideration for gift tax purposes.[5] Another line of authority[6] held that Congress purposely failed to add the 1932 amendment to the gift tax sections, and therefore it was to be inferred that the meaning of "a full and adequate consideration" was intended to differ, depending on which tax was in issue.[7]

Thus the background was somewhat confused when the commissioner first attempted to levy a gift tax on an inter vivos transfer pursuant to an agreement made in conjunction with a divorce or separation proceeding.

His first attempt came in 1943 in the case of *Jones v. Commissioner*.[8] In this case *H* sued *W* for divorce in Nevada. Prior thereto a property settlement had been negotiated, which was to become effective upon the granting of the divorce. This agreement was alleged and admitted. After the decree had been granted *H* and *W* executed another instrument bearing witness to the fact that *H* had conveyed certain property to *W* in satisfaction of the earlier agreement. The commissioner contended that the transfer constituted a taxable gift. The Tax Court refused to accept this contention on several alternative grounds. It pointed out that the 1932 amendment to §812(b) had not been carried over into the gift tax provisions, and held that this precluded the court from applying it to gift tax cases. The theory was that if Congress had wanted it applied to the gift tax sections it would have been an easy matter to write it in expressly. Since Congress must have been aware of the identity of the estate and gift tax tests, it was inferable that it purposely amended only the former. The court further said that even if the amendment was applicable to the gift tax sections it was not intended to cover this type of transaction. It

[4] Merrill v. Fahs, 324 U.S. 308, 65 S.Ct. 655 (1945). This case is discussed infra.
[5] Comr. v. Bristol, (C.C.A. 1st, 1941) 121 F. (2d) 129.
[6] Lasker v. Comr., (C.C.A. 7th, 1943) 138 F. (2d) 989.
[7] This line of cases held that "donative intent" was still the test under the gift tax sections.
[8] 1 T.C. 1207 (1943).

distinguished this type of agreement from an antenuptial transfer made in consideration of a release of marital rights, on the ground that this was an arm's length negotiation wherein both parties freely bargained as in any transaction made in the normal course of business. Further the court indicated that this was a legal obligation in the nature of a debt, regardless of whether or not it was incorporated into the divorce decree. These arguments were sufficient to persuade the court that it should presume consideration in a transfer of this nature, thus exempting it from taxability under the gift tax.

The commissioner did not again attempt to reach this type of transfer until 1945. In the interim two cases were decided by the Supreme Court which the commissioner felt overruled the holding in the *Jones* case.

In *Commissioner v. Wemyss*[9] petitioner had transferred stock to his prospective spouse in consideration of her promise to marry him. Also in the picture was the fact that her former husband had set up a trust, the income of which went to her until she remarried. The court held that the transfer was taxable. It threw out the test of donative intent and indicated that in any case where the donor's estate was diminished by a transfer, there was a taxable gift to that extent.

In *Merrill v. Fahs*[10] petitioner transferred funds in trust for his prospective spouse in consideration of her release of all marital rights except those of support and maintenance. The court held that the estate and gift taxes were in pari materia. In an opinion which Randolph Paul calls[11] "a masterpiece of statutory construction," Justice Frankfurter, speaking for the majority, held that the two taxes were to be construed together. Since the same test (an adequate and full consideration) was used in both taxes, the same construction should be placed on each test. Therefore the 1932 amendment to the estate tax qualified the meaning of "an adequate and full consideration in money or money's worth" under both taxes. Thus a release of marital rights could not be a sufficient consideration to exempt a transfer from gift tax liability.

On the basis of these two decisions the commissioner again attempted to reach a transfer incident to a divorce proceeding in *Con-*

[9] 324 U.S. 303, 65 S.Ct. 652 (1945).

[10] 324 U.S. 308, 65 S.Ct. 655 (1945).

[11] 2 PAUL, FEDERAL ESTATE AND GIFT TAXATION §16.15 (1946 Supp.). This text and the supplement are valuable authority on the entire problem. See also MONTGOMERY, FEDERAL TAXES, ESTATES, TRUSTS, AND GIFTS (1947-48 ed.).

verse v. Commissioner.[12] Here *H* and *W* had negotiated a separation agreement prior to *W*'s suit for divorce. The agreement provided for monthly payments from *H*. *W* alleged the agreement, but *H*'s answer claimed that a lump sum payment would be fairer. The parties agreed on a lump sum payment which was incorporated into the divorce decree and which expressly provided that *W* was to accept payment in full discharge of all marital rights. The Tax Court held that its decision in the *Jones* case was controlling. It distinguished the *Wemyss* and *Fahs* cases on the ground that these involved antenuptial agreements. When the agreement is negotiated at arm's length between parties with conflicting interests then the *Jones* case applies. There were strong dissents to this decision. The argument of the dissenters was to the effect that the *Wemyss* and *Fahs* cases had determined that a release of marital rights was not an adequate and full consideration in money or money's worth, whether or not the agreement was made before marriage or incident to a divorce. It was also pointed out that the *Wemyss* case set out a depletion of assets test, and that test was not satisfied under the facts of this case, since the donor's estate was depleted to the extent of the transfer.

The circuit court of appeals affirmed the decision of the Tax Court but on a different theory.[13] It ignored the antenuptial-postnuptial theory and instead analogized the case to the estate tax cases. Since the agreement had been incorporated into the court's decree it would constitute a deductible claim if not paid at death.[14] Therefore the inter vivos transfer should not be taxable as a gift, for the two taxes are in pari materia. The theory was that any obligation constituting a deductible claim under the estate tax, must necessarily be supported by a full and adequate consideration in money or money's worth for purposes of the gift tax.

The Tax Court has passed on this question three times since the *Converse* case. In all three cases, it reaffirmed its prior holding.[15]

[12] 5 T.C. 1014 (1945).

[13] Comr. v. Converse, (C.C.A. 2d, 1947) 163 F. (2d) 131.

[14] Citing Comr. v. Maresi, (C.C.A. 2d; 1946) 156 F. (2d) 929.

[15] In Lahti v. Comr., 6 T.C. 7 (1946), the court held there was no taxable gift where *H* transferred property to *W* pursuant to an agreement negotiated in conjunction with a divorce proceeding. The agreement was incorporated into the decree. The court said the transactions were at arm's length, thus dispelling any notion of donative intent. A mild dissent still maintained that this was contrary to the doctrine set out in the Wemyss and Fahs cases.

In Mitchell v. Comr., 6 T.C. 159 (1946), the court found no tax liability where *H* transferred some funds outright and used others to set up a trust in which *W* was given the life interest. In return *W* gave a release of marital rights. The agreement was incorporated into the decree. The court again stated that where there is an arm's length transaction such

C. *Conclusions*

It is readily apparent that to date the analysis has differed under the gift tax from that adopted under the estate tax. Since the Supreme Court's decisions in the *Wemyss* and *Fahs* cases, the Tax Court has been content to base its determinations almost solely on the arm's length transaction theory. Since this is at best only a presumption of valid consideration, it is, in effect, just another way of stating the antenuptial-postnuptial distinction. As an isolated question the distinction has much to commend it. Undoubtedly one of the primary considerations behind the 1932 amendment was the thought that antenuptial agreements provided an easy method of avoiding the impact of the estate tax. Few men enter the marriage contract with any thought that their path of nuptial bliss may encounter any rocky detours. Certainly it is to be doubted that any transfer made prior to the marriage, in consideration of a release of marital rights, has any object other than to transfer a portion of the donor's estate to the prospective spouse. This method of tax avoidance should be prohibited. However, once divorce is imminent it would seem safe to assume that the parties will then bargain to the best of their ability. Outside factors (such as fear of notoriety) may enter the picture to some extent, but, in general, it would seem safe to assume that the final agreement embodies what each thought was the best arrangement he or she could negotiate. In that sense the distinction drawn by the Tax Court would seem to be a reasonable one.

The "incorporation into the decree" distinction drawn in the estate tax cases seems less logical. However the language of §812(b) seems to require that if any distinction is to be drawn, it must be the one taken in the estate tax cases. Section 812(b) expressly negatives any antenuptial-postnuptial distinction. Therefore, it would appear that

a release is an adequate and full consideration in money or money's worth. In its opinion the court cited two of the taxpayer's arguments with approval. It agreed that if the transfer had not been pursuant to an agreement, but had instead been forced upon *H* by the court, such a transfer would not be taxable; and therefore the same result should be reached when the voluntary agreement is incorporated in the court's decree. The court also agreed that the right to support would probably be valued more precisely when released under a voluntary agreement.

In Estate of Josephine Barnard v. Comr., 9 T.C. 61 (1947), the court again found no tax liability where *W* transferred property to a trust, of which *H* was the beneficiary, pursuant to an agreement between the parties which was incorporated into the divorce decree. The only consideration from *H* was a release of all his marital rights. However, the court did tax another transfer negotiated orally at the same time. It found that the first agreement operated to divest *H* of all marital rights; therefore there could be no consideration for the second agreement.

the analysis of the Tax Court in the gift tax field cannot stand up in view of the *Wemyss* and *Fahs* decisions. If the Supreme Court follows through on the *Fahs* decision it would seem that if a postnuptial agreement, supported only by a release of marital rights, cannot be a full and adequate consideration for estate tax purposes, it likewise cannot be for gift tax purposes.

Therefore the position taken by the circuit court of appeals in the *Converse* case seems the more logical way of denying gift tax liability. It is common practice to incorporate the agreement into the divorce decree. That feature has existed in all of the gift tax cases decided by the Tax Court. Since this theory does not run afoul of the *Fahs* case, this may well be the distinction ultimately adopted in both the estate and gift tax fields.

The "depletion of assets" test set out in the *Wemyss* case presents a more difficult obstacle. So far the Tax Court has not felt it necessary to meet that issue. It has instead presumed an adequate consideration. Certainly this seems the more logical approach. If the court lets itself get involved with questions of valuation in regard to such a nebulous right as the right to support (or other marital rights) there would be no solution to these cases. It is doubtful that the Supreme Court intended any such result when it laid out this test. As has been pointed out, it does not seem impractical to assume that the parties did the best job they could, and certainly they are in the best position to evaluate such interests.

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