

## Income, Gift and Estate Tax Considerations in Marriage and Divorce

G. Van Velsor Wolf

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### Recommended Citation

G. V. Wolf, *Income, Gift and Estate Tax Considerations in Marriage and Divorce*, 14 Md. L. Rev. 3 (1954)

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## INCOME, GIFT AND ESTATE TAX CONSIDERATIONS IN MARRIAGE AND DIVORCE\*

By G. VAN VELSOR WOLF†

### CREATING THE FAMILY UNIT

#### *Tax Benefits of Matrimony*

Although recognized in different countries in quite different ways, the family as an economic unit seems to have

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\* This article will appear as a Chapter in a forthcoming book, *BASIC ESTATE PLANNING*, being compiled and edited by John Alan Appleman, Esq., of the Illinois Bar, to be published (copyright reserved) by The Bobbs-Merrill Publishing Company, Indianapolis, Indiana [final publication to be temporarily withheld, see n. 176, p. 60].

Because the REVIEW feels that the article will be of great value to the many attorneys whose practice or schedule does not enable them to stay abreast of the tax field, the REVIEW is including, as an index, a summary of the section and subsection headings, and a list of abbreviations of the various publications referred to and the technical terminology used.

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become entitled more recently to special, or at least new, benefits. We are told that in some places allowances are made or bonuses are paid for the birth of children, whether or not in wedlock. In the United States the approach is more subtle. The benefits are substantial, but only after the marriage vows have been exchanged.

Contemplation of matrimony, even under a completely valid and binding contract, is not sufficient to secure the tax advantages allowed under our system. But once the knot has been tied income, estate and gift tax-reducing opportunities become available, and they continue even after the parties voluntarily or involuntarily agree to resume their separate ways.

It is inescapable that if certain minimum exemptions are exceeded, which are the same for all individuals regardless of marital status, then whenever a person has income, makes a gift, or dies leaving property of his own, a report thereof must be filed with the appropriate District Director of Internal Revenue. However, whether or not such person is married makes a very considerable difference in the amount of tax to be paid.

The split income provisions for husband and wife<sup>1</sup> are probably familiar to every taxpayer. The marital deduc-

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#### LIST OF ABBREVIATIONS

acq.	Acquiesced in by the Commissioner of Internal Revenue.
B. T. A.	United States Board of Tax Appeals Report.
Cum. Bull.	Internal Revenue Cumulative Bulletin.
E. T.	Estate Tax Ruling.
G. C. M.	General Counsel's Memorandum.
I. R. B.	Internal Revenue Bulletin.
I. R. C.	Internal Revenue Code.
I. T.	Income Tax Unit Ruling.
non-acq.	Not acquiesced in by the Commissioner of Internal Revenue.
Regs.	United States Treasury Regulations.
Rev. Rul.	Revenue Ruling.
T. C.	United States Tax Court Report. In the as yet unpublished Volumes, the cases are referred to by number.
T. C. M.	United States Tax Court Memorandum Decision.
T. D.	Treasury Decision.
USTC	United States Tax Cases, published by Commerce Clearing House in its Standard Federal Tax Reporter, annually, the volumes of said Tax Reporter being designated by year, i.e., 53-1 or 53-2.

<sup>1</sup> I. R. C., Sec. 51(b).

tion under the estate taxing laws<sup>2</sup> is undoubtedly less familiar, and is a great deal more complicated. However, we know in general that if the wife<sup>3</sup> is left up to one-half of the husband's estate in such a way that it will be taxable in her estate upon death, unless given away or spent in the meantime, that property will be completely free of tax upon the husband's death.

The least familiar member of the triumvirate is the gift tax. The amendments thereto<sup>4</sup> under the Revenue Act of 1948 are, in conformation, very similar to the estate tax amendments. Where a spouse gives property either to his wife or to a third person, the husband and wife, as a family unit, are entitled to treat such a gift as emanating one-half from the separate ownership of each.

#### *Timing the Marital Status*

Having recognized the advantage of the combination of the husband and wife as one type of family unit under the tax laws,<sup>5</sup> and before considering the specific problems of taxation connected with the creation and the dissolution of this unit, it might be of interest to note the importance of timing. Here again we find the marital status gaining special advantage.

To secure the benefits of the split income provisions allowed under the federal income tax laws the marital status must exist on the last day of the taxable year.<sup>6</sup> This simply means, as a practical matter, and without considering either the weather or any emotional involvements, that late in December is the ideal time for a wedding.

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<sup>2</sup> I. R. C., Sec. 812(e).

<sup>3</sup> Throughout this article, for the sake of convenience it is assumed that it is the husband who has the income, makes the gift, dies, or makes the payment under an ante-nuptial or post-nuptial agreement or divorce decree; but the rules are precisely the same the other way. As to alimony, see I. R. C., Sec. 3797(a) (17).

<sup>4</sup> I. R. C., Secs. 1000(f) and 1004(a) (3).

<sup>5</sup> For a review of some of the special pitfalls created by reason of the existence of the family unit see text, *infra*, ns. 26 to 32, ps. 12-14.

<sup>6</sup> I. R. C., Sec. 51(b) (5) (A) (i). When the State where the marriage is performed recognizes the legality thereof, the marriage is valid for income tax purposes although a divorce may have required a wait. *Rev. Rul. 29*, I. R. B. 1953-6. However, if either party dies during the taxable year, they can still file a joint return for that year, Sec. 51(b) (4) and (5) (A) (ii).

In fact, if a bachelor receives during the year at least 80% of his total compensation on work to which he has devoted more than three years of his time, it appears that prompt wedlock will bring him not only the benefits of split income but also the right to project his income back over the past years for both himself and his bride.<sup>7</sup> The same seems to be true even if such a fee is to be received by a partnership to which he has only just recently been admitted, and he did none of the work.<sup>8</sup>

By the same token the final decree of divorce should be delayed until after the dawn of the new year. Unless the parties, if living, were legally married on the last day of the taxable year there are no consent arrangements, powers of attorney or any other devices available for creating or preserving the split income tax saving for that year no matter how many months of the year the parties were in fact married. However, the Tax Court has held that where the parties have received an interlocutory decree of divorce but must receive a final decree before the matrimonial bonds are legally severed, they can still file a joint return with the full benefits of split income.<sup>9</sup>

The estate tax is similar in operation. If the parties were married at the time of death the marital deduction for estate tax purposes is available. That deduction is not allowable for the inheritance of either fiancées or divorcees. The fact that the parties have long since separated and are living apart under a written agreement providing support rights for the wife and releasing her property rights, makes no difference. The marital deduction is still available.<sup>10</sup>

As for the gift tax, the marital status is essential as of the time of the gift; but it must also be remembered that the provisions permitting one-half of the gift to be con-

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<sup>7</sup> *Hofferbert v. Marshall*, 200 F. 2d 648 (4th Cir., 1952), but note any possible change under the Revenue Code of 1954.

<sup>8</sup> *Marshall*, 14 T. C. 90, aff'd 185 F. 2d 674 (3rd Cir., 1950); *Commissioner v. Nielson*, 187 F. 2d 233 (9th Cir., 1951). The Revenue Code of 1954 may affect the scope of these decisions; but, in any event, the benefits of Sec. 107(a) are not available unless the remuneration has been earned by an entity of which the taxpayer becomes a member. To combine with another in a joint venture after the other, as an individual, has already done considerable work has been held not to meet the required test. *Van Hook v. United States*, 204 F. 2d 25 (7th Cir., 1953), cert. den.

<sup>9</sup> *Eccles*, 19 T. C. 1049 (non-acq.), aff'd 208 F. 2d 796 (4th Cir., 1953).

<sup>10</sup> *Ibid.*

sidered as made by each spouse will not apply if the donor should become married to someone else during the same calendar year.<sup>11</sup>

### *Ante-Nuptial Agreements*

*Gift Taxes.* Although the result of pure judicial legislation, it is now a fact that a transfer of property in consideration of marriage, or in consideration of the release of dower or other marital rights in a spouse's property, is considered a gift for gift tax purposes, even when constituting a part of a valid and binding ante-nuptial agreement.

It makes no difference that the wife is giving up property or income to which she would otherwise be entitled if she remained unmarried. To relieve a transfer from the application of the gift tax there must be a consideration in money's worth of benefit to the donor. Lack of donative intent is immaterial.<sup>12</sup> Likewise, it makes no difference that the wife gives up all the rights that she might otherwise acquire in her husband's property, either as wife or widow, except the right to maintenance and support.<sup>13</sup>

If the wife gives up her right to support by the husband (except for whatever provision may be made for her under the agreement), the situation may be quite different. The Commissioner has ruled with respect to separation agreements, and the logic is equally applicable to ante-nuptial agreements, that the release of support rights is adequate consideration to prevent the application of a gift tax to the extent that the "transfer does not exceed the reasonable value of the support rights".<sup>14</sup>

In some cases it might be desirable to provide in the ante-nuptial agreement for the support of the wife. If so, the question then becomes one of allocation of value between release of support rights and release of property rights, only the latter being subject to the gift tax, and perhaps under such circumstances there should be two agree-

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<sup>11</sup> I. R. C. 1000(f) (1) (A). As to the timing of transfers where ante-nuptial or separation agreements are concerned, see, *infra*, the discussions relating to gift and income taxes under each of these headings, ps. 8, 11 and 49.

<sup>12</sup> Commissioner v. Wemyss, 324 U. S. 303 (1945).

<sup>13</sup> Merrill v. Fahs, 324 U. S. 308 (1945).

<sup>14</sup> E. T. 19, 1946-2 Cum. Bull. 166.

ments so that there can be as between the two types of release of right "a reasonable allocation or separation by the parties" as suggested by the Commissioner in his ruling mentioned just above.

*Gift Taxes — Timing.* In any event, if any part of the agreement involves a release of dower or marital rights in property, the marital deduction benefits for gift tax purposes, granted under the Revenue Act of 1948, should be considered, if feasible. In computing gift taxes an exemption is allowed as to one-half of the value of the gift if the donee "at the time of the gift" is the donor's spouse.<sup>15</sup> Thus, it would seem to be logical to assume that if the actual transfer of the property is made after marriage, the marital deduction should be available, even though the contract is entered into prior to the marriage.

However, that is probably not the law as it stands today.<sup>16</sup> Rather, it appears that the gift is complete when there is an enforceable obligation, and it is subject to the tax at that moment. When the actual transfer of possession occurs is of no significance where the transfer is the mere performance of an existing and legally binding obligation.<sup>17</sup> Thus, to obtain the gift tax marital deduction under the modern day cases it will be necessary to wait until immediately *after* the ceremony before executing the part of the *ante-nuptial* agreement relating to a release of property rights.

*Estate Taxes.* Here we have, primarily, the question of the effect on the husband's estate of a promise to make a transfer, where the husband dies before the agreement can be carried out. If the transfer were actually completed prior to death the only estate tax problem would be whether it was made in contemplation of death. It is unlikely that in the normal case a convincing factual situation could be presented indicating that an agreement entered

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<sup>15</sup> I. R. C., Sec. 1004(a)(3)(A).

<sup>16</sup> In *Archbold*, 42 E. T. A. 453 (1940), it was held that a promise to make a gift in the future, even though enforceable, is not a present gift. But this case seems to have been ignored in the later decisions.

<sup>17</sup> *Commissioner v. Copley's Estate*, 194 F. 2d 364 (7th Cir., 1952); and also see the discussion on the similar problem in considering separation agreements at note 153, *infra*, p. 49.

into on the eve of marriage was made in contemplation of death.

If the death of the husband precedes the transfer, the property will naturally be includable in his estate. The claim of the wife, to the extent that the promise of the husband was given in consideration of the release of dower or statutory rights in his property, cannot be taken as a deduction in determining his taxable estate. This is true even though the claim of the wife may be enforceable in a court of law as a vested contract right.<sup>18</sup>

Also of significance, under the circumstances, might be whether or not the parties had married before the husband's death. If so, the value of the wife's interest under the agreement might qualify for the marital deduction and thereby reduce the estate taxes, whether the payment was to be outright or in trust.<sup>19</sup>

If the agreement contemplates the creation of a trust for the wife and it is carried out, and the parties are married for a while before the husband dies, survived by his wife, the estate tax problems are much the same as those of any other decedent who has created an *inter vivos* trust. The property will be considered as a part of the husband's estate for estate tax purposes depending on the extent to which he has retained any substantial interest therein.<sup>20</sup>

*Income Taxes.* The only serious income tax problems in ante-nuptial agreements are related to the question of whether or not the property, when transferred, acquires a new basis for capital gain and loss purposes, or whether it retains in the hands of the wife the same basis or "cost" that it had when held by her husband.

Thus, when a husband transfers property to his wife, if the transaction is a gift she must adopt as her basis the figure representing the cost of the property to her husband. On the other hand, if the transfer is for a full and adequate consideration there is no gift and the property assumes a new basis in the hands of the wife.

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<sup>18</sup> I. R. C., Sec. 812(b).

<sup>19</sup> I. R. C., Sec. 812(e)(1)(A).

<sup>20</sup> I. R. C., Sec. 811(c).



By the same token, if the husband discharges his contractual obligations under such an agreement, with property having a lower basis in value to him than the market value thereof at the time of transfer, and the transfer does not amount to a gift, he has received a capital gain.

In the only case of any significance dealing specifically with this income tax problem,<sup>21</sup> the owner of a well-known chain of retail stores transferred to his intended bride, in pursuance of an ante-nuptial agreement, a goodly number of shares of his corporation. After a later divorce from the merchant husband, and a subsequent remarriage, the ex-wife sold some of the stock which she had received in the original settlement.

Diametrically opposed to the Supreme Court in the gift tax cases, the Court of Appeals for the Second Circuit held that, for the purposes of the income tax, a promise to marry and a release of dower interests constitute adequate consideration. Having received the stock for a valuable consideration, the taxpayer obtained a new basis therefor equal to the consideration paid.<sup>22</sup>

Also, it was evidently the court's opinion that the value of what the prospective wife contributed, and the consideration for the husband's promise, namely, her promise to marry and the release of her property rights in his estate

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<sup>21</sup> *Farid-Es-Sultaneh v. Commissioner*, 160 F. 2d 812 (2nd Cir., 1947). Consistent with the conclusion in this case are the holdings in *Patino*, 13 T. C. 816, aff'd 186 F. 2d 962 (4th Cir., 1950), and *Gardner Trust*, 20 T. C. ..., No. 125 (1953), dealing with separation agreements.

<sup>22</sup> The opinion in *Farid-Es-Sultaneh*, *ibid.*, expressly denied the reasoning and refused to follow the Supreme Court gift tax decisions in *Wemyss and Merrill*, *supra*, ns. 12 and 13. However, actually the holding may not be as peculiar, or as inconsistent with the gift tax cases, as many writers indicate. The expectant wife released all rights "including the right to her support to which she otherwise would have been entitled as a matter of law when she became his wife". The release of support rights is sufficient consideration to avoid the gift tax. If further analyzed, perhaps the facts would show that Miss Farid received no more than what she could have expected as support alone, in view of her husband's wealth and their joint life expectancies.

The confusion and difficulties attendant to determinations of how much, if any, consideration is being given for release of support rights would be eliminated by the American Law Institute which proposes in Sec. X257 of the February 1954 Draft of its suggested Federal Income Tax Statute that no gain or loss be recognized with respect to property transferred under any marital settlement be it by ante-nuptial or separation agreement or under a decree.

after marriage, were precisely equal to the value of the stock received by her at its then current market.

Although not discussed, since that case was considering the subsequent sale of the transferred securities, it must be remembered by the planner that if the transfer is sufficient to cause the wife to obtain a new basis, then it is equally a "sale or transfer" by the husband which would subject him to capital gain or loss considerations.<sup>23</sup>

*Income Taxes — Timing.* The taxable gain in such a case would be limited in any event by the statutory maximum, 25 per cent for property held more than six months, and so, for substantial settlements, the matter of timing would be immaterial.

In the remaining cases it would undoubtedly be preferable to have the execution of the agreement and the transfer of the property within the same taxable year as the marriage, since it is the marital status on the last day of the taxable year which controls as to whether the benefits of the split income are available.

#### *Summary — Ante-Nuptial Agreements*

The transfer of property by one party to another in anticipation or consideration of a subsequent marriage will undoubtedly subject the transferor to the operation of the gift tax, at least where property rights are relinquished. If the wife releases her support rights then, to that extent, there is no gift.

Since, as the present trend of the cases now seems to indicate, a gift will be considered as having been made at the time of the execution of the contract, it would be preferable if possible, wherever the transfer is to be made in exchange for a release of property rights, to sign the agreement as well as make the transfer immediately after the marriage ceremony, rather than before, so that the benefit of the marital deduction would be available.

As the income tax picture is cloudy, at least where the consideration is a release of dower or property rights, it

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<sup>23</sup> In cases involving a transfer in exchange for a release of the wife's right of support, any capital gain is taxable. *Commissioner v. Mesta*, 123 F. 2d 986 (3rd Cir., 1941), cert. den.; *Commissioner v. Halliwell*, 131 F. 2d 642 (2nd Cir., 1942), cert. den.

would undoubtedly be preferable to have the husband transfer property having a current market value approximately equal to his adjusted basis.

If a gift, property having a basis higher than current market value should not be used in the settlement. No benefit of the loss could be taken by anyone since, in determining capital gains and losses, the wife's basis would be the lower of the basis to her husband, as adjusted, and the value of the property at the time of transfer.<sup>24</sup>

For income tax purposes the husband cannot take a loss on a transfer to his wife.<sup>25</sup> However, if the agreement is entered into before the ceremony she is not then his wife and the loss should be allowable.

If, by the agreement, the wife is to release her rights to support accruing from the marriage, or even if she is merely releasing prospective property rights and the view of the Second Circuit is to be followed, there would be some capital gain tax on the appreciated value of any property transferred, and the use of property with a comparatively low adjusted basis should be avoided.

Furthermore, if the view of the Second Circuit were not followed, there would also be presented the question of allocation. That is, what part of the consideration is to be for a release of support rights and what part for a release of property rights. Thus, where there is to be a release of support rights as well as a release of property rights, two separate agreements might be advisable, each treating one problem and setting forth the separate consideration therefor.

#### USE OF THE FAMILY UNIT

##### *Pitfalls to Watch*

Not being completely blind to the ease of maneuverability in family matters, the taxing laws, through both Congressional and judicial legislation, have adopted certain arbitrary rules or limitations on transactions which

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<sup>24</sup> I. R. C., Sec. 113(a)(2).

<sup>25</sup> I. R. C., Sec. 24(b)(1)(A).

apply only in intra-family matters. Both eyes must be kept open to avoid falling into any of the traps.

A loss on the sale of a capital asset by the husband to his wife, even where he sells securities through an organized stock exchange and she simultaneously buys the same issues, will not be allowed.<sup>26</sup> In the case of a sale of a depreciable asset between husband and wife, or between an individual and his family corporation, any gain is taxable as ordinary income and not as a capital gain.<sup>27</sup>

Where a trust is set up by a husband or father for the benefit of a member of his family, that is, for the benefit of a person for the support of whom the settlor is under a legal duty to provide, such as a wife<sup>28</sup> or minor child, the settlor will be taxed on the entire income where it must be used for such support,<sup>29</sup> or on the part that is so used if there is a discretion,<sup>30</sup> and the corpus will be included in his taxable estate.<sup>31</sup> The personal holding company provisions in the tax laws are related to family unit considerations.

Also, as is apparent in reviewing the cases under family partnerships and leases, which are discussed later in this article, many arrangements fail where entered into within a single family group primarily because the courts have required for such dealings an absolute assurance of businesslike and clearly demonstrable arm's length treatment in order to overcome the natural suspicion that the whole plan is a devious cloak over a simple intra-family gift. In other words, wherever members of a family are involved in a business deal, the entire matter will be subject to very close scrutiny.

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<sup>26</sup> *McWilliams v. Commissioner*, 331 U. S. 694 (1947).

<sup>27</sup> I. R. C., Sec. 117(o).

<sup>28</sup> Except under a divorce or legal separation, discussed, *infra*, p. 25 *et seq.*

<sup>29</sup> *Commissioner v. Dwight's Estate*, 205 F. 2d 298 (2nd Cir., 1953), cert. den.

<sup>30</sup> I. R. C., Sec. 167(c).

<sup>31</sup> *Helvering v. Mercantile-Commerce Bank & Trust Co.*, 111 F. 2d 224 (8th Cir., 1940), cert. den. However, where the income only could be used for the support of the wife or child, but not controlled by the grantor as trustee, the corpus of the trust would not be subject to the estate tax, *Commissioner v. Douglass' Estate*, 143 F. 2d 961 (3rd Cir., 1944). The same is true also where any invasion is subject to a fixed standard, *Estate of Wilson*, 13 T. C. 869, *aff'd* 187 F. 2d 145 (3rd Cir., 1951).

Sometimes the result of an attempted tax saving through a family unit operation can be tragic. A discarded and divorced wife, earning a modest living for herself, has been held personally liable for very substantial deficiencies in the joint income tax return which she innocently filed with her former husband, relating to matters about which she herself had absolutely no knowledge.<sup>32</sup> It was his business and he had vanished, but she was required to make good the default since she had signed the return. The same could happen with joint gift tax returns.

However, the advantages of the many arrangements available to a family unit are so great, particularly in the fields of saving or avoiding unnecessary income and estate taxes, that the estate planner is given wide opportunities to render a valuable service to those who desire to preserve what they can of their estates for their families and descendants.<sup>33</sup>

### *Family Partnerships*

Since 1942 and the advent of the high income tax rates, continuing efforts have been made to spread the income of the earner among as many taxing units as possible in order to keep as much of the income as possible in the lower brackets. One of the most popular devices has been the family partnership.

The Revenue Act of 1948 with its split income and estate marital deduction provisions pretty well eliminated the tax saving value of a family partnership between husband and wife. However, the principle is still important and of great benefit when employed in the case of a cooperative business enterprise with children, or with trusts for children, or with other members of the family.

In view of the confusion in the cases, of which there were legion, even after repeated review by the Supreme

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<sup>32</sup> Jones, 12 T. C. M. 470 (1953).

<sup>33</sup> Gifts of stock, life insurance or other property to minors, either outright or in trust, as well as the use of reciprocal trusts by husband and wife, now declared estate tax free by *Newberry's Estate v. Commissioner*, 201 F. 2d 874 (3rd Cir., 1953), also form a part of the tax savings picture through the family unit.

Court,<sup>34</sup> the Congress lent its assistance through the Revenue Act of 1951.

Up to that time, in brief, the courts had required that a child would have to contribute either "vital services" or "original capital" to the enterprise if it was to be hoped that the income would be taxed to anyone other than the father. The capital interest could not be a gift from the managing partner. It had to represent independent capital, or the donee had to perform active services.

By Code definition now a person may be recognized as a partner who "owns a capital interest in a partnership in which capital is a material income-producing factor", whether or not received as a pure gift.<sup>35</sup> But the courts will undoubtedly require that the evidence clearly indicate that the alleged partners do in fact own, and have the power to exercise unrestricted dominion over, that interest.

The other new partnership section of the Code<sup>36</sup> provides that where an interest in a family partnership has been created by gift, the distributive share of the donee shall be taxed to him rather than to the donor, except (1) that a reasonable allowance must first be made from the partnership profits to compensate the donor for services rendered by him to the partnership, and (2) that the earnings attributed to the donee's capital cannot be greater in proportion than the earnings attributed to the donor's retained capital. The statute further provides that the distributive share of a partner shall not be diminished because of absence due to military service; and that any purchase of an interest in a partnership by one member of a family from another shall be considered an interest created by gift.

As a result of these statutory changes the partnership law has been brought a little more realistically into line with the long standing law relating to closely held family corporations in which shares of stock, and thus percentages

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<sup>34</sup> Commissioner v. Tower, 327 U. S. 280 (1946), and Lusthaus v. Commissioner, 327 U. S. 293 (1946), subsequently followed by Commissioner v. Culbertson, 337 U. S. 733 (1949).

<sup>35</sup> I. R. C., Sec. 3797 (a) (2).

<sup>36</sup> I. R. C., Sec. 191. See, also, the related provisions in the Internal Revenue Code of 1954.

of earnings, can be transferred to minors who are separately taxed thereon.

The first requirement which must be met in order to obtain the benefit of the new provisions relating to family partnerships is that the gift of the partnership capital interest be complete and irrevocable.<sup>37</sup> No current or reversionary interest can be retained in the property, and everything must be done that can be done to vest ownership in the donee, although the retention of the supervision or management in the donor for the benefit of the group will not destroy the intended effect.<sup>38</sup>

Likewise, it is obvious from the existence of such statutory requirements as capital being "a material income-producing factor", and valid distributions of earnings being recognized only after the payment first of "reasonable compensation" to the donor, that there are still very knotty problems to be ironed out in family partnership cases.<sup>39</sup>

Nevertheless, the family partnership appears to be an increasingly more attractive and manageable vehicle to reduce taxes for persons who have businesses that are not strictly personal service. In addition to the estate tax savings, there is the opportunity to split income with other members of a family whom the donor might otherwise be supporting, thereby having the aggregate income taxed in lower brackets.

In this connection the estate planner might well consider the use of trusts for the interests of minor children. It is true that some partnerships with minor children own-

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<sup>37</sup> *Regs.* 118, Secs. 39.191-1 and 2. The principles adopted in *Helvering v. Clifford*, 309 U. S. 331 (1940), will undoubtedly be controlling, that is, does the donor, or the donee, have actual dominion and control over the given interest. Approval will perhaps also require meeting the tests of the *Culbertson* case, *supra*, n. 34, that "the partners really and truly intended to join together for the purposes of carrying on a business".

<sup>38</sup> *Visintainer v. Commissioner*, 187 F. 2d 519 (10th Cir., 1951), cert. den. This involved gifts of sheep from a herd managed by donor, to his minor children. Although not exactly a family partnership case, nevertheless the rationale is probably very similar to the treatment that may be expected of partnerships under the new law. To the same effect is *McQuown*, 12 T. C. M. 654 (1953).

<sup>39</sup> For a more complete and analytical treatment of the family partnership under the Revenue Act of 1951, see Schulman, 1953 *Taxes*, *The Tax Magazine*, 447.

ing outright interests have been recognized,<sup>40</sup> but the obvious infirmities in such a plan cannot be ignored.<sup>41</sup> On the other hand trusts will be recognized as separate entities in a partnership enterprise, although at times corporate fiduciaries and others hesitate to assume the responsibilities of a partner, as distinguished from that of a corporate shareholder.

In several favorable decisions the donor has made himself trustee for his minor children and retained absolute and complete control over the partnership and the trust interests.<sup>42</sup> In each case the court has sustained the arrangement in saying that the donor had divested himself of all personal economic benefit or interest in the trust estate, or in the income. And in one of the cases the court stated that the new Regulations of the Commissioner do not "adhere to the position that there is an absence of required business purpose" if a gift does not necessarily benefit the business. The requirement that there be a business purpose has been eliminated. The principal question now is — was there a completed gift?

In the normal case it would be preferable to use an outside trustee, unrelated to the donor in any way, for better assurance of success. The courts emphasize this independence and responsibility wherever it exists.<sup>43</sup>

On the other hand, the use of independent corporate trustees will not prevent the non-recognition of family partnerships where the proof is not clear that the gifts to the donees are absolute and complete. The donee must have the power to act independently, and with at least some control over the interest.<sup>44</sup> However, it is also possible that some of the recent decisions, which found a lack of business

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<sup>40</sup> *Arnold v. Green*, 186 F. 2d 18 (5th Cir., 1951), and *Culbertson v. Commissioner*, 194 F. 2d 581 (5th Cir., 1952).

<sup>41</sup> Children not recognized as real partners, *Batman v. Commissioner*, 189 F. 2d 107 (5th Cir., 1951), cert. den.; even where guardian appointed, *Giffen v. Commissioner*, 190 F. 2d 188 (9th Cir., 1951), cert. den.

<sup>42</sup> *Armstrong v. Commissioner*, 143 F. 2d 700 (10th Cir., 1944); *Henslee v. Whitson*, 200 F. 2d 538 (6th Cir., 1952); *Miller v. Commissioner*, 203 F. 2d 350 (6th Cir., 1953).

<sup>43</sup> *Sultan*, 18 T. C. 715 (1952, non-acq.); *Brodhead*, 18 T. C. 726 (1952, non-acq.); both cases affirmed (9th Cir., 1954), citations unavailable on going to press.

<sup>44</sup> *Toor v. Westover*, 200 F. 2d 713 (9th Cir., 1952), cert. den.; *Solomon v. Commissioner*, 204 F. 2d 562 (4th Cir., 1953); *West*, 19 T. C. 808 (1953).



purpose fatal, might conclude differently if presented under the new law.<sup>45</sup>

*Summary — Family Partnerships.* In essence the new Code provisions added by the Revenue Act of 1951 harmonize in a workable way the precepts that income from a property right or interest is taxable to the owner thereof, and income attributable to services rendered is taxable to the one who actually performs such services.

This does not mean that a father, as donor, cannot retain the managing control of a family partnership. It simply means that the purported ownership of any donated partnership interest will be carefully examined to determine true dominion and control, and whether the donor exercises his retained managerial dominance for himself, or as a fiduciary.

In any event full payment must be made to the donor for his services rendered, and, where profits are to be allocated to the respective capital interests, the share allocated to a donated interest can be less, proportionately, but not greater, than that allocated to the donor's retained interest.

Developments in further defining and applying the statutory requirement of "reasonable compensation" to the donor will be of great assistance in helping to resolve a very difficult problem in the related field of reasonable compensation for corporate executives. Up to now the Commissioner has enjoyed uninhibited freedom in attacking the salary scale of officers in various types of corporations.

Little that he has argued in one case could be used against him in another, thus allowing the possibility of irresponsibility at administrative levels, unless carefully guarded. Whereas the Commissioner has heretofore been invariably contending for smaller salaries, now, with the new family partnership statute, he will have to consider in many cases insisting on a higher salary for a managing partner, and, perhaps as a result, a little more tangible set of rules may eventually develop in this field of executive compensation.

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<sup>45</sup> Cochran, 10 T. C. M. 675, aff'd 201 F. 2d 365 (9th Cir., 1952), cert. den.; Schallerer v. Commissioner, 203 F. 2d 100 (7th Cir., 1953), cert. den.

### *Gift and Lease-Back*

Another method of spreading income within the family unit, thereby reducing income taxes, and at the same time reducing estate taxes, is the gift and lease-back. Through this arrangement a gift, usually of real estate, is made to another member of the family. A contract is thereupon entered into whereby the use of the property is secured to the donor over a fixed term of years. Where successfully arranged, the rent paid for the use of the property over the stipulated period is a deductible business expense for income tax purposes.

If the gift of the property is outright, and any lease-back arrangement is demonstrably separate and distinct from, and substantially independent of, the gift, the assurance of approval by the Commissioner is naturally greater. On the other hand, where the gift and lease-back appear to be constituent parts of a single transaction, where the rental is high or there is no apparent business purpose, or where the donor retains too complete a dominion and control over the purportedly transferred property during the negotiation, the maneuver will fail.

Thus, if property is irrevocably transferred to a completely independent corporate trustee, exclusively for the benefit of the donor's children, and the trustee then leases the property back to the donor, the donor's payments for rent are business deductions and the reduction thereby made in his business income is paid over to and spread among the children at lower tax rates. Such an arrangement has been approved even where the donor has reserved the right to rent the premises, "at a rental to be determined by the trustee", and apparently as a part of the same transaction the trustee did rent, at a reasonable figure, to the donor for ten years.<sup>46</sup>

The factor upon which the courts place their greatest reliance is the independence of, and the showing of actively assumed responsibility by, the donee or trustee. The rental payments under a lease-back arrangement after gift were

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<sup>46</sup> Skemp v. Commissioner, 168 F. 2d 598 (7th Cir., 1948). See also, Felix, 21 T. C. . . ., No. 90 (1954).

approved as business expenses in a case where property vital to the parents' partnership operation was transferred to a trust pursuant to an understanding that the exclusive use of the property would thereupon be granted to the donors for a considerable period.<sup>47</sup>

However, as in all family transactions, these arrangements are carefully scrutinized, and where rentals are too high or commitments are made which are unbusinesslike and would never have been made with third parties,<sup>48</sup> or where the donor, as a practical matter, never gives up his continuing control over the property,<sup>49</sup> the courts have had no hesitancy in disallowing the deduction.

### *Family Annuities*

A third type of arrangement, albeit much more dangerous in its consequences and in most cases downright inadvisable as a practical matter, is the family annuity. The attraction here is two-fold: lower taxes and more income. Also, the transfer *inter vivos* of property to the natural objects of one's bounty is normally restricted by the fact that the donor does not wish to become dependent upon another.

If the donor makes the transfer in consideration of regular monthly or annual payments by the donee, he will thereby make the desired saving in estate taxes, incur no gift taxes, and at the same time receive a higher income after taxes during the remainder of his lifetime because of the Code provision which permits the receipt of an annuity income tax free over and above an amount equal to three per cent of the cost.<sup>50</sup>

A simple example would be the transfer by a father to his son of cash or property in the amount or value of \$100,000 under an agreement whereby the son would agree to pay

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<sup>47</sup> *Brown v. Commissioner*, 180 F. 2d 926 (3rd Cir., 1950), cert. den.

<sup>48</sup> *Armston Co. v. Commissioner*, 188 F. 2d 531 (5th Cir., 1951).

<sup>49</sup> *White v. Fitzpatrick*, 193 F. 2d 398 (2nd Cir., 1951), cert. den.; Rev. Rul. 54-9, I. R. B. 1954-2; but also *cf. Stearns Magnetic Mfg. Co. v. Commissioner*, 208 F. 2d 849 (7th Cir., 1954), where the court approved the arrangement even though there was no apparent business purpose other than the saving of taxes.

<sup>50</sup> I. R. C., Sec. 22(b) (2) (A). The Revenue Code of 1954, as submitted, contains provisions which would change some of the special features of annuities.

him a certain income a year for life. The father would have to pay an income tax on only \$3,000 annually for many years, that is, until his non-taxable receipts equal the cost of what he paid out to purchase his annuity.

There would be no gift tax. The property would escape the estate tax. The father would not even have to pay a capital gain tax at the time of creation of the annuity if he should transfer appreciated property to his son. The promise of an individual, no matter whether rich or poor, to make continuous payments has no ascertainable value, and so there can be no capital gain or loss<sup>51</sup> upon the inception of the obligation.<sup>52</sup>

However, the difficulties with such a scheme are first of all that it must be worked out with a reasonably businesslike effect as the objective. In the above case if the son could invest the fund at an income which would approximate the amount he has agreed to pay out, he would probably be considered as nothing but a trustee for his father.

If the arrangement is such that the father would never have given away his property to a stranger under similar circumstances, the plan would not be recognized as an annuity for income tax purposes.<sup>53</sup> In fact, the property could even be subject to estate taxes in the father's estate, as being a transfer with the right to income being retained,<sup>54</sup> and also subject, at least in part, to gift taxes.<sup>55</sup>

So, in order to create a family annuity acceptable to the Commissioner it would have to have a seriously actuarial appearance. But, assuming that could be accomplished satisfactorily, there are other practical drawbacks.

First of all the son gets no income tax credit or deduction of his own for the payments he makes annually to his father, until he has paid out the full value of the principal received as the purchase price. He cannot even consider any part of his payments as interest.<sup>56</sup> If he already has

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<sup>51</sup> No capital gains — *Commissioner v. Kann's Estate*, 174 F. 2d 357 (3rd Cir., 1949) ; no loss — *Evans v. Rothensies*, 114 F. 2d 958 (3rd Cir., 1940).

<sup>52</sup> The discussion of annuities in the text is based on the present law, without consideration of proposals in the Revenue Code of 1954.

<sup>53</sup> *Evans v. Rothensies*, *supra*, n. 51.

<sup>54</sup> I. R. C., Sec. 811(c)(1)(B)(i).

<sup>55</sup> *Bartman*, 10 T. C. 1073 (1948).

<sup>56</sup> *Gillespie & Sons Co. v. Commissioner*, 154 F. 2d 913 (10th Cir., 1946), cert. den. However, the Revenue Code of 1954 may change this.

substantial income of his own there will be little additional net income left from which to make his payments, unless he can protect himself by investing the fund in tax-exempt securities.

Likewise, as with the father, the son will have no capital gain tax to pay at the inception of the arrangement; and if the son can prove that he entered into the arrangement as a business venture, he will be entitled to deduct in full, as a tax loss suffered in a transaction entered into for profit, all payments made over and above the value of the consideration received for the purchase of the annuity. But, if the father dies before the son has paid out in the aggregate a sum equal to the full value of the purchase price, the son will be taxed on the difference as having received ordinary income.<sup>57</sup>

As for the income tax position of the father in a normal case, the law seems to be clearly settled, at least under the existing tax laws relating to annuities, that he will pay a tax on 3% of the value of the consideration he transferred as the purchase price of his annuity, assuming his annual receipts are at least that much.

After the father has recouped from his non-taxable income an amount equal to his adjusted basis of the property he transferred to purchase the annuity, he will pay a capital gains tax each year, in addition to the annual income tax at 3% as above, until his annual receipts over and above his income taxable figure aggregate an amount equal to the difference between his adjusted cost and the value of the property at the time it was transferred as the purchase price. Thereafter he will be taxable on his entire receipts as ordinary income.<sup>58</sup>

There are many additional tax problems as yet still unsettled.<sup>59</sup> Actually, for instance, there is no agreement among the courts as to how the cost to the obligor [son] of an annuity shall be determined for capital gain purposes.

<sup>57</sup> Sheridan, 18 T. C. 381 (1952, acq.) ; I. T. 1242, I-1 Cum. Bull. 61.

<sup>58</sup> Hill's Estate v. Maloney, 58 F. Supp. 164 (D. C., N. J., 1944) ; *Rev. Rul.* 239, I. R. B. 1953-23.

<sup>59</sup> For full and helpful discussions on the whole subject of family annuities see Smith, 1952 *Taxes*, The Tax Magazine, 995 ; Burks, 1952 S. Cal. Tax Inst. Proc., p. 225.

Some courts accept what is known as the "annuity venture" theory, others the "capital expenditure" theory. Under "annuity venture" the consideration received is the factor in cost. Under "capital expenditure" it is the amount paid out, with the result that the obligor never knows his cost until the annuitant dies.

If "capital expenditure" is to be adopted generally, and there is considerable support therefor,<sup>60</sup> then (1) what would be the cost to the annuitant father of the annuity on which the 3% rule would operate, since the cost would not necessarily be the value of the property transferred, and the balance would be subject to the gift tax; and (2) what would be the basis of the property in the hands of the obligor son in the event he should sell it before the father's death, or if it is property subject to depreciation?<sup>61</sup>

It would also be appropriate here to raise a danger signal. Although private annuities may be desirable at times, care must be taken not to fall unsuspectingly into the trap of private annuity treatment on the sale of property.

Equal periodic payments for life, given in consideration for the conveyance of property, create an annuity. It makes no difference that the agreement is written as a simple sale of real estate, or that the purchaser has not qualified under state law to sell annuities. The receipts in excess of cost are taxed as ordinary income and not capital gain.<sup>62</sup>

## DISSOLVING THE FAMILY UNIT

### *Death*

The family unit between spouses is obviously terminated upon the death of either. The allowance of the marital deduction under the federal estate tax law,<sup>63</sup> and the split income provisions,<sup>64</sup> illustrate clearly the advantages of being married at death.

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<sup>60</sup> *Steinbach Kresge Co. v. Sturgess*, 33 F. Supp. 897 (D. C., N. J., 1940).

<sup>61</sup> See also, G. C. M. 11655, XII-1 Cum. Bull. 159.

<sup>62</sup> *Ware v. Commissioner*, 159 F. 2d 542 (5th Cir., 1947); see also *Bodine v. Commissioner*, 103 F. 2d 982 (3rd Cir., 1939), cert. den.

<sup>63</sup> I. R. C., Sec. 812(e).

<sup>64</sup> Which are available even though one spouse dies during the taxable year, I. R. C., Sec. 51(b)(4).

*Separation or Divorce*

The other standard method of terminating the husband-wife team is through separation or divorce. The emotions, enmities and recriminations between the principals are often at a high and bitter pitch at this time, and the estate planner's role is therefore doubly difficult. No matter how perplexing the negotiations as to fault, support and custody become, the concomitant tax problems are of at least equal complexity.

After a long period of recognition that alimony payments were not taxable income to the wife,<sup>65</sup> the Congress adopted in 1942 several amendments to the law which have in effect reversed that basic concept.<sup>66</sup> However, the existing statutes are so carefully imbued with limitations, both statutory and administrative, to prevent tax avoidance to too great a degree, that the cases dealing with the various aspects of the problem are almost countless, and the true rules are difficult, if not impossible, in many instances to recognize with any degree of clarity.

The rules vary, not only depending upon how an agreement for the payment of alimony is reached, or a court decree granting alimony is rendered, but also depending upon whether payments are in cash or the use of property, periodic or lump sum, and whether paid by the husband directly or through an annuity or trust, or even through life insurance.

Of perhaps even greater significance is the question of whether the payments by the husband to the wife are to satisfy her rights to support and maintenance, or whether they are made in consideration of her release of her dower and other prospective marital rights in the property of the husband at the time of his death. However, one thing seems certain. For tax considerations it apparently makes no difference whether it is the husband or the wife who ultimately obtains the divorce.

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<sup>65</sup> *Gould v. Gould*, 245 U. S. 151 (1917).

<sup>66</sup> I. R. C., Secs. 22(b)(2)(A), 22(k), 23(u), 25(b)(3), 171 and 3797-(a)(17).

*Alimony Payments — Income Taxes*

Undoubtedly the tax problem of greatest importance, since it recurs every year, is that involving the degree to which alimony is taxed to the wife, and the extent to which the husband is entitled to an income tax deduction therefor.

In planning the dissolution of the husband-wife unit the income, gift and estate tax consequences of each aspect of a separation, whether by agreement or otherwise, must be realized and analyzed. Under some lines of approach there are shifted to or created in the wife certain tax liabilities of which the planner must be aware so that the wife can be warned. At the same time the husband may receive no compensating relief from taxes. Of incidental interest, perhaps, it might be mentioned here that if the husband has been divorced more than once he may have several sets of alimony deductions,<sup>67</sup> and in a community property state a subsequent wife in her separate return is entitled to take as a deduction one-half of the alimony payments by her husband to his former spouse as her community share thereof.<sup>68</sup>

*Decree Necessary.* What amount to split income tax provisions, requiring alimony under certain circumstances to be taxed to the wife and, if so, permitting income tax deductions to the husband,<sup>69</sup> were adopted six years before the split income tax and marital deduction provisions of the Revenue Act of 1948. However, they were not amended to conform to the philosophy of that new law.

As a result, the parties cannot in effect file a joint return as to alimony payments, with the husband getting the benefit of having his wife share in the tax, unless they are

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<sup>67</sup> Hesse, 5 T. C. M. 781 (1946).

<sup>68</sup> Commissioner v. Newcombe, 203 F. 2d 128 (9th Cir., 1953).

<sup>69</sup> I. R. C., Secs. 22(k) and 23(u) which provide in brief that periodic alimony payments received by a wife who is divorced or legally separated under a decree of divorce or separate maintenance, where the payments are required to be made under the terms of a decree or written agreement incident to a decree, are taxable to the wife as ordinary income, and are to the same extent deductible by the husband on his income tax return.

The payments are taxable to the wife as such regardless of whether they represent principal or income, and even where they are paid by a guarantor or surety of the husband, for which there would be no compensating deduction. Luckenbach v. Pedrick, 116 F. Supp. 268 (D. C., N. Y., 1953).



divorced or legally separated "under a decree of divorce or of separate maintenance".

No matter how completely the husband and wife may have gone their separate ways, nevertheless, without a decree, any support payments made by the husband to the wife are not within the alimony tax provisions of the law. Nor will the situation be cured by the entering of a decree of divorce *nunc pro tunc* as of an earlier time when a decree could have been granted.<sup>70</sup> But also it must be remembered that when the decree is once entered the husband is no longer entitled to consider payments to the wife, for support, as made for the support of a dependent.<sup>71</sup>

*Type of Decree.* The parties must be "divorced or legally separated". For this purpose a partial divorce, from bed and board, is as effective as an absolute divorce.<sup>72</sup> But a court order for support is not.<sup>73</sup>

As for an annulment, if it voids the marriage *ab initio* a decree therefor is not sufficient to make available to the husband a tax deduction for any support payments made thereafter. However, if, according to the law of the particular locale, the annulment voids the marriage as of the date of the decree instead, and is in practical effect similar

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<sup>70</sup> *Smith v. Commissioner*, 168 F. 2d 446 (2nd Cir., 1948); *Daine v. Commissioner*, 168 F. 2d 449 (2nd Cir., 1948). Likewise, no deduction where no decree, in spite of written approval of separation agreement by the court, *Portfolio v. U. S.*, 54-1 USTC ¶9192 (Ct. Cl., 1954). But, since husband and wife now enjoy split income tax benefits anyway, the reason for requiring a court decree in order to obtain the alimony tax benefits no longer exists. There is no further danger that the parties might separate formally to obtain a split income tax advantage. The American Law Institute, in its Federal Income Tax Statute, February 1954 Draft, does not require a decree; see discussion at page 263 of Draft.

<sup>71</sup> I. R. C., Sec. 25(b) (3). However, Sec. 71 of the Internal Revenue Code of 1954 [H. R. 8300], pending before the Congress at the time of publication hereof, would eliminate the necessity of a decree of divorce or of separate maintenance; a written separation agreement would be sufficient. If such a change is ultimately adopted a great deal of illogical and unnecessary law on this subject of alimony payments as income tax deductions could be eliminated from consideration. Such an amendment might well reduce the discussion herein with reference to the necessity of a decree, the type of decree, the requirement that the separation agreement be incident to a decree, and the amendment of an agreement after a decree, as being no longer significant.

<sup>72</sup> *Wick*, 7 T. C. 723, *aff'd* 161 F. 2d 732 (3rd Cir., 1947).

<sup>73</sup> *Kalchthaler*, 7 T. C. 625 (1946); *Gerrish*, 12 T. C. M. 594 (1953). Nor is an order of a commanding officer of the Marine Corps even though failure to comply therewith would result in serious disciplinary action, *Jodoin*, 12 T. C. M. ... (1953).

to a divorce, then such a decree will be sufficient to grant the husband his deduction.<sup>74</sup>

Whether or not an interlocutory decree is sufficient is presently somewhat confused.<sup>75</sup> It is probable that where the decree terminates the marital status and the parties merely have to wait for a fixed period before validly contracting another marriage in the same jurisdiction, the payments are deductible by the husband.

On the other hand, it has been held that where the decree itself does not become final, and the marital status does not change as a practical matter for either party, until entry of the final decree, no deduction is allowed.<sup>76</sup> Consistently therewith it has been held that during such period the parties can file a joint income tax return.<sup>77</sup>

The decree need not be valid in any jurisdiction other than that granting it. Assuming that it could be successfully attacked and declared void in another jurisdiction, or even in the state where the parties have always lived, such as a Mexican divorce or an American divorce granted on a minimum period of residence and no appearance by the other spouse, nevertheless, if the parties acted upon it "in good faith" the alimony tax requirements have been satisfied.<sup>78</sup>

*Divorce Immediately.* In addition to the significance of the requirement that any agreement be "incident" to a decree of divorce or separation, as discussed later, the time of seeking the divorce is all important. Only payments "received subsequent to such decree" will qualify. Thus, a husband will get no deduction for payments made before the divorce case is instituted, or where the payments are made under a decree which is merely *pendente lite*.<sup>79</sup>

*Necessity of a Writing.* Except for the relatively few instances where the alimony payments are to be made from certain types of trusts,<sup>80</sup> they must be made in pursuance

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<sup>74</sup> Reighley, 17 T. C. 344 (1951).

<sup>75</sup> I. T. 3761, 1945 Cum. Bull. 76, and I. T. 3934, 1949-1 Cum. Bull. 54, both dealing with California interlocutory decrees.

<sup>76</sup> Evans, 19 T. C. 1102 (1953, non-acq.).

<sup>77</sup> Eccles, 19 T. C. 1049 (non-acq.), aff'd 208 F. 2d 796 (4th Cir., 1953).

<sup>78</sup> G. C. M. 25250, 1947-2 Cum. Bull. 32; *Feinberg v. Commissioner*, 198 F. 2d 260 (3rd Cir., 1952).

<sup>79</sup> Wick, *supra*, n. 72; McKinney, 16 T. C. 916 (1951).

<sup>80</sup> I. R. C., Sec. 171(a), and see text, *infra*, ns. 135 to 140, ps. 41-44.

of a decree or "under a written instrument". If the provisions for such payments are included in the decree of divorce or separate maintenance there is no problem, regardless of whether or not the parties had reached any separate agreement thereon.

However, if no mention thereof is made in the decree, the agreement as to alimony payments must exist at the time of the decree and must be clearly decipherable from one or more paper writings. A husband is not entitled to the deduction where there is only an oral agreement, even if the court is told that the husband will stick to it and there is no need to put anything in the decree.<sup>81</sup> On the other hand, a letter clearly setting out an offer to make support payments, and its acceptance, even though not in writing, is sufficient.<sup>82</sup>

*Payments Must Be For Support.* The statutory provisions under consideration were designed to allow income tax deductions to a husband who makes payments to his wife for her support, if certain formal requirements are satisfied. It was not intended that payments in discharge of business obligations should be so treated, merely because incorporated in a separation agreement or divorce decree; and no deductions will be allowed therefor.<sup>83</sup>

However, it was held in one case that payments made direct to a mother-in-law under a separation agreement approved by a divorce decree were deductible by the husband.<sup>84</sup> The decision seems highly questionable, even though the payments were for her support.

*Support Obligation Must Exist At Time.* To qualify, the payments must be "in discharge of a legal obligation which,

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<sup>81</sup> Myerson, 10 T. C. 729 (1948).

<sup>82</sup> Jefferson, 13 T. C. 1092 (1949, acq.); Campbell, 15 T. C. 355 (1950, acq.).

<sup>83</sup> Du Bane, 10 T. C. 992 (1948). However, where the evidence appears to be insolubly conflicting or unclear the courts seem to indicate a preference that payments, all else being equal, will be presumed to be for support, *Landa v. Commissioner*, 54-1 USTC ¶9169 (C. A., D. C., 1954); *Nathan*, 19 T. C. 865 (1953).

In *Glasgow*, 21 T. C. . . ., No. 25 (1953), fees of the wife's attorneys included in "periodic" payments were held not deductible by the husband, nor, at least as held in that case, were payments for medical expenses either already incurred, or anticipated, by the wife.

<sup>84</sup> *Lehman*, 17 T. C. 652 (1951, non-acq.).

because of the marital or family relationship, is imposed upon or incurred by" the husband.

If an agreement to support his wife is entered into after the divorce has been obtained, any legal obligation which the husband incurs thereunder is not incurred because of the marital or family relationship. The divorce terminated the obligation to support, except for whatever provisions there were in the decree. Payments under an agreement entered into thereafter are not deductible.<sup>85</sup>

On the other hand support payments under an agreement entered into directly in connection with the obtaining of a divorce will qualify for the alimony tax provisions even though the decree is granted in a jurisdiction where the court itself would have no authority, upon the granting of a decree of absolute divorce, to allow to the wife any support payments or alimony arrangement whatsoever.<sup>86</sup> The reason is that before the decree, and at the time of the agreement, the legal obligation to support did exist.<sup>87</sup>

Likewise, the agreement under which the payments are made may be void and unenforceable, as against public policy, but if the duty to support existed at the time it was entered into, and the payments are made in accordance therewith, they are deductible.<sup>88</sup>

*Agreement Incident to Decree.* The statute says that where payments are made under a written instrument, such instrument must be "incident" to the divorce or separation. Just what that means and how it is to be proved has been the subject of considerable litigation. Starting off with a severely strict construction, the attitude of the courts has loosened a great deal in their application of this requirement.

Unchanged has been an insistence that the agreement must be incident to the "decree", and not to the "status", of divorce or separation.<sup>89</sup> Although there have been some rumblings of dissatisfaction with this interpretation of the

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<sup>85</sup> Cox v. Commissioner, 176 F. 2d 226 (3rd Cir., 1949).

<sup>86</sup> Hesse, 7 T. C. 700 (1946); Hogg, 13 T. C. 361 (1949).

<sup>87</sup> As for obligation to support children, see text, *infra*, ns. 112 to 115, ps. 35-36.

<sup>88</sup> Campbell, 15 T. C. 355 (1950, acq.).

<sup>89</sup> Dauwalter, 9 T. C. 580 (1947); Cox v. Commissioner, *supra*, n. 85.

statutory language,<sup>90</sup> wherever of significance to the decision the courts have unanimously insisted that the agreement and the divorce must constitute "a single package".

Likewise, some cases had required proof that both parties contemplated at least the imminent filing of divorce proceedings, if they were not already filed, at the time of executing the agreement.<sup>91</sup> But this super-strict attitude has been substantially ameliorated. The courts now give the factual situation a careful and realistic review, relying on obvious inferences from the chronology of the events, while giving little weight to statements of the parties as to their intent at the time of the agreement.<sup>92</sup> The fact that the agreement says it is to be incorporated into, or survive, any divorce if ever granted is held to be significant.<sup>93</sup>

Undoubtedly one reason for the drift toward relaxation of the original "incident" requirements has been the fear of the charge of collusion.<sup>94</sup> The surest way of meeting the "incident" test would be to make the effectiveness of the agreement contingent upon the granting of a divorce; but in some jurisdictions such a contingency might thereupon avoid the agreement itself forthwith on the grounds of public policy.<sup>95</sup>

In any event the gradual development in the cases shows that the courts have been willing to break away; and now

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<sup>90</sup> *Smith v. Commissioner*, 192 F. 2d 841 (1st Cir., 1951); *Commissioner v. Murray*, 174 F. 2d 816 (2nd Cir., 1949).

<sup>91</sup> *Miller*, 16 T. C. 1010 (1951), since reversed; and *Moses*, 18 T. C. 1020 (1952). However, it made no difference if the divorce was expected to be sought in one jurisdiction and was actually granted in another, as long as both parties contemplated some divorce, *Fry*, 13 T. C. 658 (1949); or that the final decision to seek a decree forthwith was made after the agreement was executed, *Guggenheim*, 16 T. C. 1561 (1951).

<sup>92</sup> *Commissioner v. Miller*, 199 F. 2d 597 (9th Cir., 1952); *Izrastzoff v. Commissioner*, 193 F. 2d 625 (2nd Cir., 1952). But, if the affirmative evidence all points to the conclusion that neither party contemplated divorce at the time of the agreement, although it was actually sought promptly after the termination of the required waiting period (two years), the agreement is not "incident", *Johnson*, 21 T. C. . . ., No. 42 (1953). Likewise, where payments are made pursuant to one court proceeding in which no divorce decree has been handed down, even though there is a divorce decree in another jurisdiction, the payments are not "incident", *Droke*, 12 T. C. M. 702 (1953).

<sup>93</sup> *Feinberg v. Commissioner*, 198 F. 2d 260 (3rd Cir., 1952); *Lerner v. Commissioner*, 195 F. 2d 296 (2nd Cir., 1952).

<sup>94</sup> *Zilmer*, 16 T. C. 365 (1951, acq.); *Johnson*, 10 T. C. 647 (1948, acq.); *Lerner v. Commissioner*, *ibid.*

<sup>95</sup> *Cronin v. Hebditch*, 195 Md. 607, 74 Atl. 2d 50 (1950); see also, *Shankland v. Shankland*, 301 Ill. 524, 134 N. E. 67 (1922).

it is the trend, if not a fact, that an agreement entered into prior to divorce will be assumed to be "incident" thereto unless the evidence is to the contrary. Yet the safer and surer way of avoiding trouble on this point is to introduce the agreement in evidence in the divorce proceedings and have the court either set forth the alimony provisions in full in the decree, or at least have the decree incorporate the arrangement by reference and affirmance as a part of the court's order.

Because of this "incident" requirement, long separated parties may have a problem. In one case, an agreement had been entered into years before, with no thought given by either party at the time to a divorce. The agreement was amended in certain respects and then approved by the divorce court. As the amendment was made in anticipation of the divorce, the court held the entire arrangement to be "incident".<sup>96</sup>

*Payments in Cash or Property; Savings.* The payments will apparently meet the statutory requirements whether made in cash or in property. If in property, additional questions of capital gain or loss will obviously be involved. However, the fair rental value of a home and furnishings will not qualify.<sup>97</sup> If the husband is to provide a home for the wife and he wishes to take a deduction therefor he must either supply the wife with the cash to pay the rent or pay it to a third party himself.

How the wife is to use the funds paid to her is of no significance. Even though the agreement provides that she is to set aside all amounts over a certain figure, to be used only in emergencies or the like, nevertheless, as long as the funds are to be used for her a deduction is allowed the husband.<sup>98</sup>

*Lump Sum — Instalment, Periodic Payment.* In order to qualify for alimony tax treatment the payments of the

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<sup>96</sup> Neeman, 13 T. C. 397, aff'd 200 F. 2d 560 (2nd Cir., 1952), cert. den.; see, also, Holahan, 21 T. C. . . . , No. 57 (1954). But, as indicated, *supra*, in n. 71, if the Congress amends the law to delete the requirement of a divorce decree the discussion and decisions dealing with the problems of whether an agreement is incident to a divorce decree obviously become obsolete.

<sup>97</sup> Pappenheimer v. Allen, 164 F. 2d 428 (5th Cir., 1947).

<sup>98</sup> McBerty, 16 T. C. 968 (1951, acq.).

husband must be "periodic". If they are periodic they then constitute taxable income to the wife and are deductible by the husband. If not, the wife is not taxable thereon and the husband gets no deduction. The statute explains that payments can be defined as "periodic" if they meet either one of two tests.

If there is no obligation under the agreement or decree to pay a specific aggregate total amount which is defined in terms of money or property, that is, a particular lump sum, then all payments made under the agreement or decree are "periodic". And they are considered periodic even though the different payments vary in amount,<sup>99</sup> or are made at irregular intervals, or the obligation to make them at all is dependent upon some condition precedent.<sup>100</sup>

Even where there is an obligation to pay a specified principal sum, if it is also to be satisfied by instalment payments which may be or are to be made over a period ending more than ten years from the date of the decree or instrument, the payments are "periodic". But if the fixed sum is to be paid in one payment or in a series of instalments continuing for ten years or less, the payments are not "periodic" and the alimony tax provisions are not applicable.

In other words, assuming that the husband is to pay the wife \$12,000, either by agreement or decree, then whether this amount is taxable to the wife and deductible by the husband depends entirely upon how the payment thereof is to be made. If the \$12,000 is to be handed over in a single lump sum, or even if it is to be paid in instalments of \$100 a month for ten years from the date of the agreement, the payments will not qualify for any tax deduction for the husband whatsoever.

On the other hand, if the last payment on account of the \$12,000 is to be made at least one day beyond the tenth anniversary of the agreement or decree, then a tax deduction is available. In fact, if the obligation to pay arises out of an agreement executed prior to the decree, then regardless of when the payments are to begin they will be deductible after the passage of the decree, even though they

<sup>99</sup> *Baker v. Commissioner*, 205 F. 2d 369 (2nd Cir., 1953).

<sup>100</sup> *Mahana v. United States*, 88 F. Supp. 285 (Ct. Cl., 1950), cert. den.

expire less than ten years after the date of the decree, provided that the last payment is not due prior to the expiration of ten years and one day after the date of the agreement itself.<sup>101</sup> The only limitation on deductibility in such a case is that when a fixed sum is being discharged through instalment payments for a period of over ten years, the deduction allowed the husband for income tax purposes is limited in each year to 10% of the fixed sum.<sup>102</sup>

Where accumulations of back obligations are paid in one lump sum they are nevertheless treated as a single periodic payment if they represent payments which, if made when due, or when they might have been due, would have been so treated.<sup>103</sup> Yet, when a decree providing periodic payments is amended to substitute a single payment therefor, the latter is not treated the same way but is considered a principal sum.<sup>104</sup>

It seems to be clear that if payments are to be made until the wife dies or remarries the payments qualify as periodic. If payments of a fixed amount are to be made monthly or over other intervals, but to continue for a period less than at least ten years and one day, the payments do not qualify as "periodic".<sup>105</sup> In the latter situation they are in essence merely instalments of a principal sum which can easily be determined by simply adding together all the individual payments; and they will be held to constitute a principal sum even though the divorce court decrees that the payments are periodic and that the wife shall pay the tax thereon.<sup>106</sup>

If payments are to continue for a period shorter than ten years, but are indefinite in amount, such as a percentage of the husband's annual income, which is not fixed, or on some other escalation basis, they will qualify as periodic.<sup>107</sup>

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<sup>101</sup> *Blum v. Commissioner*, 177 F. 2d 670 (7th Cir., 1949); *Commissioner v. Blum*, 187 F. 2d 177 (7th Cir., 1951). See, also, *Reis v. U. S.*, 54-1 USTC ¶9206 (D. C. Kan., 1953).

<sup>102</sup> An example of how this statutory provision is applied is *Le Mond*, 13 T. C. 670 (1949, acq.).

<sup>103</sup> See discussion in text, *infra*, ns. 125 to 127, p. 39.

<sup>104</sup> *Loverin*, 10 T. C. 406 (1948); but *cf.* *Holahan, supra*, n. 96. See, also, *Williams*, 12 T. C. M. . . . (1953), where the Court seems to have missed completely the real point.

<sup>105</sup> *Carmichael*, 14 T. C. 1356 (1950, acq.).

<sup>106</sup> *Casey*, 12 T. C. 224 (1949).

<sup>107</sup> *Young*, 10 T. C. 724 (1948, acq.); *Lee*, 10 T. C. 834 (1948, acq.).



The earlier cases had held that if fixed payments were to continue for a period of less than ten years "or until the wife remarries", the latter contingency did not introduce a sufficient uncertainty as to the ultimate aggregate amount to remove the payments from the classification of instalments on a fixed sum.<sup>108</sup> However, a recent case has held just the reverse, and may well represent a change of position by the courts on this point.<sup>109</sup>

It is interesting to watch the varied arguments of counsel in their well presented efforts to have different types of payments under separation agreements declared to be periodic. Where the agreement provides clearly for periodic payments such as monthly support in one part, and then a substantial single payment as "additional alimony" or for some specific purpose in another part, the courts have no difficulty labeling the special amounts as a principal sum.<sup>110</sup>

On the other hand the Tax Court has strongly intimated in two cases that if a little care is exercised in the draftsmanship, it is possible that a good many extra sums for specific purposes could be included in an agreement and still receive the court's approval as periodic payments.<sup>111</sup>

In other words, periodic payments do not have to be even in amount. In fact they can vary considerably, so long as they appear to be component parts of a single unified plan of payment. When the payments are divided, however, into several systems or methods, in widely separated

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<sup>108</sup> Steinel, 10 T. C. 409 (1948); Orsatti, 12 T. C. 188 (1949).

<sup>109</sup> Baker v. Commissioner, *supra*, n. 99. It is possible that the Ninth Circuit may follow this lead in the appeal of Davidson, 11 T. C. M. 1111 (1952). However, the Tax Court itself has decided Fidler, 20 T. C. . . ., No. 149 (1953), since the Second Circuit's decision in Baker, and although in the later case the contingency is the continued earnings of the husband at a specified level, the principle is similar and the Tax Court has categorically refused to follow the rationale of Baker.

Perhaps the ultimate in confusion is Smith's Estate v. Commissioner, 208 F. 2d 349 (3rd Cir., 1953), in which the majority of the court, on the authority of Baker, held deductible by the husband payments of \$300 per month for five years, provided that in any event they would cease upon the death of the husband or the wife's death or remarriage. But payments of \$25,000 in ten equal semi-annual instalments were not deductible although terminable on precisely the same contingencies. The minority opinion questions Baker but concurs in result on the ground that the \$300 payments were part of a much longer "periodic" pattern.

<sup>110</sup> Norton v. Commissioner, 192 F. 2d 960 (8th Cir., 1951); Baer v. Commissioner, 196 F. 2d 646 (8th Cir., 1952); Haag, 17 T. C. 55 (1951).

<sup>111</sup> Bartsch, 18 T. C. 65, *aff'd* 203 F. 2d 715 (2nd Cir., 1953); Cattier, 17 T. C. 1461 (1952).

paragraphs of the agreement, the court feels required to treat them the same way, that is, as separate principal amounts, and let each stand or fall on its own merits.

*Support of Children.* If the decree or agreement provides that payments are to be made for the support of both the wife and children, without in any way segregating or indicating what part thereof is for the support of the children, the entire amount is deductible by the husband and taxable to the wife,<sup>112</sup> even though she does not wish any part of the payments for herself, and spends them exclusively on the children.<sup>113</sup>

On the other hand if the amounts to be paid exclusively for the children are indicated, either directly or indirectly,<sup>114</sup> then to that extent the payments are not taxable to the wife or deductible by the husband. The statute itself provides that if the husband pays less than the full amount of the periodic payments required under the agreement or decree, whatever payments that are made are to be applied first to the sums specified for the support of the children, and to this extent the husband will get a smaller deduction.

Although under this arrangement the husband would in most cases be entitled to exemptions for the children as dependents, nevertheless, normally it is more beneficial for the husband to ignore those exemptions in order to get a deduction for the full amount of his alimony payments. But in this connection it must be remembered that as alimony is an itemized deduction the husband cannot claim it on his income tax return if he wishes to take the standard deduction, viz., 10% of adjusted gross income up to \$1,000.

In any event the controlling factor is the particular provision as contained in the decree or written agreement. Thus, where a decree requires a husband to pay to his wife \$100 a month for her support and \$50 a month for the sup-

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<sup>112</sup> Johnson, 10 T. C. 647 (1948, acq.).

<sup>113</sup> Moitoret, 7 T. C. 640 (1946). However, the parties were allowed to amend an alimony decree, even dating its effectiveness back, where the court was satisfied that the parties had never intended that any alimony was to be paid for support of the wife but all payments were to be exclusively for the benefit of the child. Sklar, 21 T. C. . . ., No. 39 (1953).

<sup>114</sup> Fleming, 14 T. C. 1308 (1950); Leslie, 10 T. C. 807 (1948); Budd v. Commissioner, 177 F. 2d 198 (6th Cir., 1947); Mandel v. Commissioner, 185 F. 2d 50 (7th Cir., 1950).

port of their son and subsequently he sends the boy to a boarding school where he pays all the bills and so reduces the payments to his wife by \$50 a month, unless a court order amending the original decree is obtained, his allowable alimony deduction will be reduced by \$50 a month.<sup>115</sup> Since the wife was no longer supporting the son there was no reason to continue the payments for him, for which the husband incidentally got no alimony deduction anyway. But until the decree is amended the statute requires that payments be applied first to the provisions allowing for the support of children as required by the decree, regardless of how the parties may have otherwise agreed between themselves.

*Life Insurance Premiums.*<sup>116</sup> Where, under the separation agreement or decree, the husband is to keep life insurance in force for the wife, the premiums thereafter paid may be taxable income to the wife and deductible by the husband, even though paid by the husband direct to the company. The determining consideration appears to be whether the insurance is carried merely to secure the performance of the husband's obligations after his death, or whether the insurance is unconditionally assigned to the wife in such a way that she receives a tangible economic benefit or gain capable of measurement or of reasonably precise valuation at the time of each premium payment.

Thus, where the policies are to be kept in force merely to provide the wife with continuing payments, after the husband's death, either in the form of more instalments or even as a single sum to discharge all further obligations, but she must survive her husband in order to capitalize in any way on the value of the policies, no deduction is allowed to the husband for premiums paid.<sup>117</sup>

On the other hand, where policies are absolutely assigned to the wife, or where she is made an irrevocable

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<sup>115</sup> Blyth, 21 T. C. . . ., No. 31 (1953). And, likewise, see Sklar, *supra*, n. 113, and *cf.* Williams, 12 T. C. M. . . . (1953).

<sup>116</sup> For discussion of estate tax and surviving wife's income tax problems relating to life insurance see text, *infra*, ns. 166 to 175, ps. 53-56.

<sup>117</sup> Blumenthal v. Commissioner, 183 F. 2d 15 (3rd Cir., 1950); Carmichael, 14 T. C. 1356 (1950, acq.); Gardner, 14 T. C. 1445, *aff'd* 191 F. 2d 857 (6th Cir., 1951); Taylor, 16 T. C. 376 (1951); see also Baker, 17 T. C. 1610, *aff'd* 205 F. 2d 369 (2nd Cir., 1953).

beneficiary and is likewise made the substantial owner of the policies so that she can exercise rights of ownership for her own benefit at any time, such as receiving the cash surrender value, or where she has control over whether the particular funds are to be paid to her or used to satisfy insurance premiums, it has been held that the premiums paid under such circumstances are deductible by the husband.<sup>118</sup>

Perhaps the real test, which would not lead to conclusions inconsistent with the above but which might make the answers more easily recognizable, should be and is whether the wife either actually or constructively has received anything of immediately liquidatable cash value at the time a premium is paid. That is, since the wife must be subject to income tax upon the amount of any alimony payment in order for the husband to receive a deduction, under this rule the husband would get no tax benefit unless the wife receives something, in the year in which she is to be taxed, which has a readily ascertainable value at that time.<sup>119</sup> Therefore, until clarified, the tax planner must keep in mind that perhaps premiums on term insurance could never be deducted by the husband, since it has no current cash value — unless it is purchased and carried by the wife with monies paid by the husband to her rather than to the insurance company.

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<sup>118</sup> I. T. 4001, 1950-1 Cum. Bull. 27; Carmichael, *ibid*; Stewart, 9 T. C. 195 (1947, acq.); Estate of Hart, 11 T. C. 16 (1948, acq.).

<sup>119</sup> Seligmann v. Commissioner, 207 F. 2d 489 (7th Cir., 1953). In this case the court noted that the earlier decisions had all dealt with whether or not a husband should be entitled to a deduction, not whether the wife should bear the tax. Actually, the husband of the petitioner in this very case had previously won a deduction [not appealed] in the Tax Court, Mandel, 8 T. C. M. 445 (1949). In Seligmann the court held that the wife could not be taxed on premiums paid for insurance held by a trustee to pay income to her after the husband's death since, at the time of premium payment, "it was a matter of rank speculation as to whether the Petitioner would ever realize any economic gain". To the same effect is Smith, 21 T. C. . . ., No. 40 (1953).

As indicated in the text following the reference to this footnote, a case decided after Seligmann and involving another Smith, seems to suggest an even more stringent rule to the effect that the mere fact that a wife must survive her husband in order for the insurance money to be payable to her is "enough to preclude deduction [by the husband] of payments no matter when made". Smith's Estate v. Commissioner, 208 F. 2d 349 (3rd Cir., 1953).

It has even been suggested that, in addition, the mere appointment of a contingent beneficiary, or the retention of a reversionary interest in the husband in the event the wife does not survive him, would prevent the allowance of a deduction to the husband.

*Attorneys' Fees.* Finally, in so far as the original separation negotiations are concerned, there is the question of whether the payment by the husband of attorneys' fees, his own or his wife's, will be deductible by him either as an alimony payment or as a non-business expense. In almost all cases the answer is in the negative.<sup>120</sup>

However, where the attorneys devote time exclusively to a negotiation to preserve, from a valid but wholly destructive claim of the wife, the property upon which the husband's entire financial independence is based, the fee therefor is a proper non-business expense.<sup>121</sup> But the danger to the husband's income-producing capacity must be imminent and of serious magnitude. To warrant a deduction the services must be rendered in vital financial negotiation, not merely in defending against an ordinary claim of support or default.<sup>122</sup>

By the same token, where the attorneys for the wife have devoted time solely in negotiating for her special financial advantage, in the way of greater income either prior or subsequent to the decree, she may deduct these charges.<sup>123</sup> But, even where the fees are exclusively for negotiations relating to an increase in alimony payments, no deduction is allowed if the amount received by the wife is not taxable to her. If the payments she receives are partially lump sum and partially periodic, a deduction is allowed in proportion to the taxable amount.<sup>124</sup>

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<sup>120</sup> I. T. 3856, 1947-1 Cum. Bull. 23; *Howard v. Commissioner*, 202 F. 2d 28 (9th Cir., 1953); *Glasgow*, 21 T. C. . . ., No. 25 (1953).

<sup>121</sup> *Baer v. Commissioner*, 196 F. 2d 646 (8th Cir., 1952).

<sup>122</sup> *Donnelley*, 16 T. C. 1196 (1951); *Smith Estate v. Commissioner*, *supra*, n. 119.

<sup>123</sup> *Gale*, 13 T. C. 661 (1949); *Reighley*, 17 T. C. 344 (1951); except, of course, that she gets no deduction where she is a non-resident alien and her aggregate income, including alimony payments, from sources within the United States is less than \$15,400, *Dupre v. United States*, 53-2 USTC ¶9613 (S. D., N. Y., 1953).

<sup>124</sup> *Le Mond*, 13 T. C. 670 (1949, acq.). After this decision the Commissioner amended his Regulations, T. D. 5889, 1952-1 Cum. Bull. 31.

In cases where the wife is allowed at least some deduction it might be well, in order for someone to get an income tax advantage therefrom, to work out in the settlement a payment to the wife so that she, rather than the husband, would pay her attorneys.

*Accumulating Deductions.* Although the parties may be on an accrual basis, as far as alimony payments are concerned they are treated as being on a cash basis except for prepayments of instalments on a fixed sum.

The ability to accumulate and throw several years' payments into one taxable year obviously gives the husband what at times might amount to a very substantial tax-saving opportunity. By the same token it places the wife, quite unfairly in many cases, in a position of great disadvantage over which she has no control. If the husband wishes a large deduction in a later year, and if he makes no payments until then, he gets the increased deduction, and the wife must pay the tax at the higher rates on the entire accumulation in that one year.<sup>125</sup> The same conclusion has been reached where the aggregate payments are collected by the deceased wife's executor in a lump sum.<sup>126</sup>

Where the separation agreement provides that an increase in payments can be requested if the husband's income exceeds a certain figure, and the court awards additional payments for the previous years *nunc pro tunc* in a lump sum, it has been held that the wife is taxed on the entire amount in the year of receipt.<sup>127</sup>

There is one slight variation in this rule and that is where instalment payments over a period of more than ten years are involved. In such a case it is still true that if a husband fails to make payments for several years and then

<sup>125</sup> Reighley, 17 T. C. 344 (1951); Welsh Trust, 16 T. C. 1398, aff'd 194 F. 2d 708 (3rd Cir., 1952), cert. den.; Grant v. Commissioner, 209 F. 2d 430 (2nd Cir., 1953). And see Dupre v. United States, *supra*, n. 123, which also holds that periodic alimony payments do not qualify either as a life annuity or as a pension under the tax treaty between France and the United States.

It has even been held by the Tax Court in a recent case that where there is a compromise settlement of arrearages on alimony payments, which arrearages had accrued even prior to the passage in 1942 of the statute which first made such payments taxable to the wife, she is still taxable on receipt of the ancient accruals in a lump sum after 1942, Holahan, 21 T. C. . . ., No. 57 (1954).

<sup>126</sup> Estate of Narischkine, 14 T. C. 1128, aff'd 189 F. 2d 257 (2nd Cir., 1951).

<sup>127</sup> Gale v. Commissioner, 191 F. 2d 79 (2nd Cir., 1951).

makes them all at once, the single payment will not be treated as a non-deductible lump sum, but rather as a deductible periodic payment. However, since no more than 10% of instalment payments on a principal sum are deductible in any one year under any circumstances, any payments in excess of that figure are not taxable to the wife nor deductible by the husband. By the terms of the statute itself no part of a prepaid instalment on a lump sum is deductible regardless of over how long a period the payments are to be made.

*Amendment of Agreement After Decree.* One of the most unsettled problems relating to alimony deductions for income taxes is the proper application of the requirement that payments must be pursuant to an agreement or decree "incident" to the divorce, where the terms of the agreement are changed after the decree.

If the original agreement and decree provide that the stipulated payments for support can be modified by the parties in the future, with the court to do so if the parties cannot agree, it is clear. The subsequent agreement is "incident" to the prior decree even though the later arrangement is not submitted to the court for approval.<sup>128</sup> Likewise, where the subsequent agreement is merely a clarification or construction of a prior decree, or of a prior agreement which was incident to a divorce granted perhaps many years before, the amending agreement is "incident". In such a case neither the original nor the amendment would have to be approved or adopted by any court.<sup>129</sup>

But where the parties change the terms of their original agreement without the compulsion of either of the foregoing situations, the cases are not completely clear,<sup>130</sup> although it can probably be categorically stated that in the

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<sup>128</sup> *Smith v. Commissioner*, 192 F. 2d 841 (1st Cir., 1951); *Gale v. Commissioner*, *supra*, n. 127.

<sup>129</sup> *Barnum*, 19 T. C. 401 (1953); *Mahana v. United States*, 88 F. Supp. 285 (Ct. Cl., 1950), cert. den.; *Holahan*, *supra*, n. 125.

<sup>130</sup> Perhaps the most confusing situation grows out of the fact that precisely the same agreement and circumstances have been presented to the courts in two different jurisdictions — in one case by the husband and in the other by the wife. The Commissioner thus far has lost both ways. *Commissioner v. Walsh*, 183 F. 2d 803 (C. A., D. C., 1950); *Walsh v. Westover*, 53-1 USTC ¶9283 (D. C., Cal., 1953).

simple case where the husband increases his payments voluntarily, no deduction will be allowed,<sup>131</sup> and where the new agreement reduces payments, with the original decree still in force, the revised payments are deductible.<sup>132</sup> And, likewise, even if the court has retained jurisdiction to modify the terms of the alimony, or if the decree is significantly amended with the consent of the parties, a court cannot project the effectiveness of its new order *nunc pro tunc* in such a way as to permit increased payments to be deductible for any period prior to the actual date of the entry of the new order;<sup>133</sup> and without at least a subsequent decree at some time, no part of the revised increases can ever be deducted.<sup>134</sup>

Undoubtedly the safest procedure is always to have any variation or amendment to the original agreement approved and adopted by the same court which originally granted the decree. Whether or not the court had retained jurisdiction over the granting of alimony, so that the necessary marital obligation is still there, is a matter of local law in each jurisdiction; and this is true whether or not alimony was awarded in the original decree.

*Providing for Alimony Through a Trust.* In many instances the husband makes the payments of alimony to his wife out of his own pocket and it is of no consequence whether he uses income or principal therefor. The wife is taxable on everything she receives, as ordinary income, and

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<sup>131</sup> *Dauwalter*, 9 T. C. 580 (1947). Nor did the court here retain jurisdiction over alimony.

<sup>132</sup> *Commissioner v. Murray*, 174 F. 2d 816 (2nd Cir., 1949). However, as indicated, *supra*, in note 71, if the Congress amends the law to delete the requirement of a divorce decree the problems herein discussed with regard to amending the agreement would probably cease to exist.

<sup>133</sup> *Van Vlaanderen v. Commissioner*, 175 F. 2d 389 (3rd Cir., 1949); unless the controlling language in the original order was inserted by mistake, and can therefore be merely corrected through a *nunc pro tunc* order, *Sklar*, 21 T. C. . . ., No. 39 (1953).

<sup>134</sup> *Newton v. Pedrick*, 115 F. Supp. 368 (D. C., N. Y., 1953). Notice should be taken here of *Smith v. Commissioner*, 192 F. 2d 841 (1st Cir., 1951), which held that amended payments are taxable to the wife even where the subsequent agreement expressly cancelled and terminated the original agreement. The court so held because "the genesis of the 1937 and the 1944 agreements was the same — a satisfaction by the husband of his marital obligation". This is not in line with other Circuits, but the decision could probably be supported on other grounds.



the husband gets a deduction on everything he pays. However, the husband can arrange to be relieved of this continuing responsibility by providing for the payments to be made from a trust, or even through the purchase of an annuity, if desired.

As far as trusts are concerned, there are two entirely separate and distinct types recognized under the alimony taxing provisions of the Internal Revenue Code.<sup>135</sup> One of these Code sections is designed to cover the usual situation where a husband provides for his alimony payments through the use of a trust which he creates expressly for that purpose. The section relating to the other type of trust is merely to pick up the few instances, and give to the husband the full income tax benefit of alimony payments to the wife, where trusts are used for that purpose but they are not the usual type of trust otherwise covered.

To be specific, what is known as a Section 22(k) trust is one that is normally set up under the provisions of a separation agreement or divorce decree. The sole purpose for its creation and existence is to satisfy the support obligations of the husband. In the words of the statute it is a trust that is set up by the husband to discharge a legal obligation which is imposed upon or incurred by him under a divorce decree or separation agreement.

On the other hand there are times when a trust which is already in existence, and on the income of which the husband is now taxable, can be used for this purpose. It may have been created at some prior time by the husband, or it may have been created by someone else. Thus, the husband's grandmother may have set up a trust to pay the income to him for life, but the provisions may be such that he can assign his interest therein to take care of his obligations to his wife. Other examples of what are known as Section 171 trusts are where the husband has himself created a trust prior to marriage, or earlier in his married life, under which the income is payable to his wife expressly for her support, and therefore the income thereon is taxable to him since it is discharging his legal obligation; or where

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<sup>135</sup> I. R. C., Secs. 22(k) and 171(a).

the husband has set up a trust but reserved the right to change the beneficiaries.

In all of these cases the income either already is, or can be made, payable to the wife to satisfy the husband's support obligations. At the same time the separation or the negotiations between the parties leading up to a divorce actually had nothing whatsoever to do with the creation of the trust. The provisions of Section 22(k) would not apply. The additional statutory relief was therefore necessary in order to exempt the husband from a continuing tax liability on income where the particular trust is thereafter used to satisfy his alimony obligations.

The chief practical difference between the two types of trusts is the tax treatment of any corpus or principal, as distinguished from income, paid to the wife in partial satisfaction of the husband's support obligations. In one case the wife is taxable thereon, and there is no one who can take the compensating income tax deduction; whereas in the other case the wife is only taxable at most on her proportionate share of the taxable income of the trust, regardless of how much of the corpus she may receive.

In other words, in a Section 22(k) situation the wife is taxable on all amounts paid to her whether the payments are from income or principal.<sup>136</sup> At the same time the trust will only get a deduction to the extent of the income that is paid out. The benefit of any deduction on account of principal that is paid by the trust is completely lost.

Under a Section 171 trust, on the contrary, the wife pays a tax only on the income she receives.<sup>137</sup> In fact, she only pays a tax upon her share of the taxable income of the trust. Thus, if any part of the amount paid to her is taken from principal she is not taxable thereon. Likewise, if the trust from which she receives her payments has tax free income, such as from municipal bonds, the wife will be taxed on her receipt of income only in proportion to the ratio of the taxable to the non-taxable income of the entire trust.<sup>138</sup>

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<sup>136</sup> *Welsh Trust*, 16 T. C. 1398, aff'd 194 F. 2d 708 (3rd Cir., 1952), cert. den. Likewise, they are taxable to a non-resident alien even where also taxable by a foreign country, *Rev. Rul.*, 54-53, I. R. B. 1954-6.

<sup>137</sup> *Regs.* 118, Sec. 39.171-1(a)(2).

<sup>138</sup> *Stewart*, 9 T. C. 195 (1947, acq.).

Since the Section 171 situation only comes up, as a practical matter, where there is an already existing trust which can be made use of, it is relatively infrequent. However, where available it should probably be employed. The only requirements are a divorce and a trust of which the income is taxable to the husband.<sup>139</sup> Nothing could be simpler. But it must also be remembered that, except with one very minor exception, a trust cannot qualify for Section 171 treatment if it likewise comes within the provisions of Section 22(k), which it usually does.<sup>140</sup>

*Payment of Alimony Through an Annuity.* Providing for the discharge of alimony through the use of an annuity payable to the wife would be one of the most undesirable ways it could be done. The purchase of the annuity by the husband would be a lump sum or specified amount. The cost would not be deductible by him.

Although there is a special rule for the payment of income tax on only that part of annuity receipts during the taxable year which equal 3% of the cost of the annuity, there is a special exception as to payments which are subject to the alimony taxing provisions of the Code. All payments to the wife under such an annuity would be taxed to her in full,<sup>141</sup> without any deduction available to the husband.<sup>142</sup> Thus, all the disadvantages would accrue, with none of the advantages.

If for special reasons in a particular case it is decided that an annuity is the best solution, it should be paid, if feasible, to the husband who could then make the payments to the wife. In this way the wife would still be taxed on the whole amount, but the husband would have the advantage of the 3% rule plus a deduction in full for the payments to his wife.

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<sup>139</sup> *Mahana v. United States*, *supra*, n. 129.

<sup>140</sup> "Section 171(a) does not apply in any case to which Section 22(k) applies", *Regs.* 118, Sec. 39.171-1(a)(2); *Welsh Trust*, *supra*, n. 136; except that when support of the wife is provided in a trust created by ante-nuptial agreement, the payments to the wife after divorce will be subject to the provisions of Sec. 171 unless the decree, as originally passed or amended, refers to the agreement; see *Regs.* 118, Sec. 39.22(k)-1(a)(4) ex. (3).

<sup>141</sup> I. R. C., Sec. 22(b)(2)(A).

<sup>142</sup> *Regs.* 118, Sec. 39.22(k)-1(b)(1).

*Marital Settlements Involving  
Property Rights*

The problems relating to alimony agreements exclusively for support, which must be thoroughly known and understood by any participating tax planner, have been discussed in some detail because this type of agreement is the most commonly used tool in cases dealing with divorce or legal separation. The normal concept of alimony payments is that they are for the support and maintenance to which the wife is entitled under the marriage contract.

In addition, however, the wife usually has some right in her husband's property. Depending upon the particular jurisdiction this might be common law dower, or a statutory share, or some other similar form of claim. When negotiating for a permanent separation agreement between the parties it is customary to provide for mutual releases of these respective rights in each other's property and estate. Unfortunately, the tax problems involved in such arrangements are much less definitely settled.

*Gift Taxes.* Where a transfer is made by one spouse in consideration of the release by the other spouse of her future or inchoate marital rights in her husband's property, there is not a sufficiently adequate and full consideration to avoid the application of the gift tax. Except to the extent that the consideration represents a release of support rights, a gift tax is payable on the full value of the property so transferred.<sup>143</sup>

There is one exception. If the transfer in consideration of a release of property rights is made under the mandate, and in accordance with a specific decree, of a court of competent jurisdiction, the transfer does not constitute a gift for gift tax purposes.<sup>144</sup>

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<sup>143</sup> E. T. 19, 1946-2 Cum. Bull. 166.

<sup>144</sup> *Harris v. Commissioner*, 340 U. S. 106 (1950). Although that sounds simple enough, just what it means as a proposition of law is hard to tell. It was the pronouncement of the Supreme Court of the United States, but the other courts, as well as annotators and law review contributors, ever since have failed to agree on just how far that principle extends, or just what was really meant by the majority of the court in its meanderings through unrelated statements of inconsistent suggestions of controlling principles.

*Gift Taxes — Transfers Under a Decree of Court.* It has been stated by many text writers that the law on gifts to spouses for release of property rights is now clear. If the arrangement is affirmatively approved by the divorce court, and incorporated in its decree, there is no gift tax problem. There is considerable doubt about that proposition in the mind of this writer.

It is unfortunate that the leading cases on the subject all involved Nevada decrees of divorce, obtained at a time when the law of that State provided that in a divorce proceeding "the court may award such alimony to the wife and shall make such disposition of the community and separate property of the parties as shall appear just and equitable, having regard to the respective merits of the parties and the condition in which they will be left by such divorce".<sup>145</sup>

The significant language in that statutory provision has since been deleted,<sup>146</sup> and few other states have a statute giving to their courts the kind of authority upon which the leading cases have so heavily relied.<sup>147</sup>

From a careful analysis of the decisions cited and approved by the majority opinion in the one case decided on this subject by the Supreme Court, and from a reading of subsequent decisions which have tried to rationalize some of the statements in that opinion, or interpret what must have been meant, it is believed by this writer that the only absolutely safe avenue to follow in reaching for non-taxable

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<sup>145</sup> Nevada Compiled Laws (Supp. 1931-1941), Sec. 9463.

<sup>146</sup> The words "and separate" were not included in the amending statute. Nevada Stats. 1943, 117. It would thus appear that the Nevada court can no longer determine how the rights of each party in the property of the other should be divided.

<sup>147</sup> In *Commissioner v. Maresi*, 156 F. 2d 929 (2nd Cir., 1946), and *Estate of Watson*, 20 T. C. 386 (1953), pertaining to the estate tax, and in *Commissioner v. Converse*, 163 F. 2d 131 (2nd Cir., 1947), and *Harris v. Commissioner*, *supra*, n. 144, dealing with the gift tax, the courts seemed clearly and explicitly to conclude that this particular provision of the Nevada law made all the difference; and to the same effect see also the later cases of *McMurtry v. Commissioner*, 203 F. 2d 659 (1st Cir., 1953), and *Rosenthal v. Commissioner*, 205 F. 2d 505 (2nd Cir., 1953).

But, on the other hand, the Commissioner of Internal Revenue currently seems to attach no significance whatever to this special provision which existed in the Nevada law, *Rev. Rul.* 54-29, I. R. B. 1954-3. His present conclusion appears to be that if the effectiveness of a separation agreement depends on the approval of a divorce court, and that approval is given, there can be no gift. However, in the situation presented in the Ruling, there may well have been no gift involved anyway since there was probably a release of support rights.

transfers in consideration of a release of property rights, is: (1) the court passing the decree should be located in a jurisdiction where the law provides that in a divorce case the court "shall determine how the rights of each party in the property of the other shall be divided", or have some other similar but absolute authority; (2) the transfer of the property should be withheld until the passage of such a decree; and (3) the agreement should provide that its effectiveness and enforceability are dependent upon the approval thereof by the divorce court, and that it be incorporated in the decree.

That the court must have some power and responsibility over the property of the parties as indicated in (1) above is at least a justifiable conclusion from the cases. That the transfer must await the decree seems clear, for otherwise it could not be said to be made in pursuance thereof.<sup>148</sup>

The real problem is the apparent requirement that the agreement must provide that its effectiveness and enforceability are dependent upon the approval of a divorce court. The difficulty is, as heretofore discussed in connection with proving that an agreement is "incident" to a decree of divorce, that such a condition might well have the effect in some jurisdictions of invalidating the agreement completely, as being contrary to public policy. However, this writer does not believe that such a condition must be satisfied in order to obtain a non-taxable transfer, although to be "absolutely safe" under the present decisions it should be satisfied if practicable.

The majority opinion of the Supreme Court, standing by itself, apparently does require the conditioning of the agreement on the approval of the divorce court. But its authorities do not support its conclusion. The Court cited with approval a case in which the effect of the agreement was not made dependent upon the subsequent entry of a decree.<sup>149</sup>

Since the Supreme Court decision, but with it consciously in mind, a Circuit Court of Appeals has held that there

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<sup>148</sup> Commissioner v. Barnard's Estate, 176 F. 2d 233 (2nd Cir., 1949).

<sup>149</sup> Commissioner v. Maresl, *supra*, n. 147.

is no gift tax if the divorce is obtained where the court "had the jurisdiction to grant or impose property rights and obligations among the parties". The agreement did not state that its effectiveness was subject to the approval of a divorce court. On the contrary the agreement provided that it "shall remain in full force and effect, and the provisions may be embodied" in the decree if the court shall deem the same proper.<sup>150</sup>

Thus, for draftsmen in states where care must be taken not to invalidate their own agreements through some violation of public policy growing out of an alleged collusion to seek a divorce, it seems at least arguable, if not a strong possibility, that no reference to dependence upon approval in a divorce decree is necessary.<sup>151</sup> But, in order that rights may be fully and permanently settled, it can do no harm, in fact it might be well, to state that if at any time either party shall file for divorce, the agreement shall be submitted to the court for approval, and that it shall survive any decree, and represent the only binding obligations between the parties.

In substance this simply means that if the court to which is submitted such an agreement is authorized by law to declare rights in the property of the parties, and it approves and adopts the agreement, there is no gift tax. If it does not either have the authority or give its approval, the agreement is still enforceable by the parties, but a gift tax will be due to the extent that the transfer is for a release of property rights rather than support rights.

*Gift Taxes — Transfers for the Benefit of Children.* It has been attempted in several cases to extend to gifts for the benefit of children the doctrine that transfers approved and adopted by a decree of divorce are relieved of gift tax consequences. But the efforts have been unsuccessful.

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<sup>150</sup> *McMurtry v. Commissioner, supra*, n. 147. As a refinement of this thought a recent case has held that a transfer by a wife to a husband in consideration of his willingness to execute a final and binding separation agreement under which he would transfer property to her in exchange for a release of her marital rights, was not a gift, *Grigg*, 20 T. C. 420 (1953, acq.).

<sup>151</sup> This conclusion was not reached by a District Court in the Circuit which seems most strongly to indicate this result. *Bank of New York v. U. S.*, 115 F. Supp. 375 (D. C., N. Y., 1953).

It seems clear that where a separation agreement provides for a transfer of property by a husband, either outright or in trust, for the support and maintenance of his children during minority, there is no gift subject to tax. However, to the extent that such an agreement gives the children interests in property after they have reached majority, or makes provision for them over and above their reasonable needs of support and maintenance until reaching majority, there is a gift subject to the application of the gift tax laws.<sup>152</sup>

*Gift Taxes — Timing of Transfer.* Where the transfer to the wife is contingent upon the approval of the court, or the granting of the decree, it must obviously be made after the marital status has been terminated. If it should then be held to be a gift it would have been made too late to enjoy the tax saving allowance of the marital deduction.

Where the agreement is effective immediately, regardless of any future decree, the transfer should probably be made before the marital bonds are severed in order to be sure of the benefit of the marital deduction. Although the recent cases do hold that the moment at which the gift tax applies is the date of execution of the agreement,<sup>153</sup> not the date of delivery, nevertheless it seems pointless to run any risk since this question of just when the gift is complete for tax purposes does not appear as yet to be finally settled.

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<sup>152</sup> There is no magic in a court decree. In spite of what Harris, *supra*, n. 144, seems to say, a transfer of property does not "obtain exemption from the federal gift tax by simply receiving the court's imprimatur", *Rosenthal v. Commissioner*, *supra*, n. 147; *Hooker v. Commissioner*, 174 F. 2d 863 (5th Cir., 1949).

<sup>153</sup> In an early ante-nuptial gift tax case, *Archbold*, 42 B. T. A. 453 (1940), it was held that a promise to make a transfer, even though enforceable, is not a present gift. However, in the Harris case (*supra*, n. 144), when before the Court of Appeals, *Harris v. Commissioner*, 178 F. 2d 861 (2nd Cir., 1949, rev'd on other grounds), it was held that the wife's promise to pay the husband \$5,000 a year for ten years did not constitute a series of gifts, each taxable when made, but was rather a single gift taxable at full annuity value at the time the promise became enforceable. Then, in *Commissioner v. Copley's Estate*, 194 F. 2d 364 (7th Cir., 1952), in dealing with an ante-nuptial agreement, the court did not even mention *Archbold* but followed the decision of the Court of Appeals in *Harris*. However, the dissenting opinion in *Copley's Estate* is persuasive. To complete the confusion the confused majority in the *Harris* case in the Supreme Court did not intentionally deal with the problem but nevertheless made statements which could easily be construed to mean that the court agreed with the dissent in *Copley's Estate*.



*Gift Taxes — Valuation of Gift in Instalments.* Likewise, the value of a series of transfers, such as annual payments for a period of years in exchange for the release of property rights, is held to be determined by appraising the present actuarial value thereof, and not by multiplying the amount of each payment by the number of payments to be made.<sup>154</sup>

It can probably be assumed, however, that if the rule as to gifts of payments in instalments should be changed to tax each payment as made, the valuation rule would also be changed in order to be consistent.

*Separate Agreements.* In planning the separation there is one further and important consideration. The usual agreement contains provision both for support of the wife and release of property rights. But it is not necessary that all be incorporated in one paper. Substantial benefit might be obtained by not doing so.

Thus, as we have seen, a transfer in consideration of a release of support rights does not involve a gift tax, but where property rights are involved, it does. And, for this situation the Treasury has given the planner a tip to consider. It has stated that an allocation of what can fairly be said to be the true value of relinquished support rights shall be determined by the Bureau, now Internal Revenue Service, "in the absence of a reasonable allocation or segregation by the parties".<sup>155</sup> Separate agreements could be the answer.

By taking the initiative and clearly describing one agreement as being made in consideration of the release by the wife of the valuable support rights to which she would be entitled during the joint lives of the parties, and which she is willing to forego in exchange for varying, albeit smaller payments in the aggregate, for life, or whatever the period may be, the agreement might include not only periodic payments extending beyond the remarriage of the wife and

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<sup>154</sup> Court of Appeals in *Harris v. Commissioner*, *supra*, n. 153. This is consistent with the method of valuing claims of the wife against the estate, continuing after the husband's death. *Commissioner v. Maresi*, 156 F. 2d 929 (2nd Cir., 1946); *Fleming v. Yoke*, 53 F. Supp. 552, *aff'd* 145 F. 2d 472 (4th Cir., 1944).

<sup>155</sup> E. T. 19, 1946-2 Cum. Bull. 166.

the death of the husband, but also perhaps some additional lump sum or instalment payments during the first years.

The other agreement would represent the transfer for the release of property rights, subject to gift tax, but at the low figure of consideration the parties reasonably consider proper.

*Income Taxes.* If property other than cash is transferred, a careful eye must be kept on what is being exchanged for what. The problem which will be presented either immediately or later will be that of capital gains, and the discussion above under the heading "Income taxes" in considering the problems of "Ante-nuptial agreements" is equally pertinent and applicable here.

To repeat, the Supreme Court has held that a release of property rights is not a sufficient consideration to avoid the application of the *gift tax*. On the other hand the Second Circuit Court of Appeals has flatly stated that in its opinion such a consideration is full and adequate for *income tax* considerations.

Were it not for this wholly inconsistent but, for the present at least, authoritative ruling as to the application of the income tax law, a husband might well wish to make use of appreciated property in the course of discharging his obligations under a separation agreement for the release of property rights. The gift tax would be the same whether he should use the appreciated property or cash; whereas if he should liquidate the property first, through a sale, he would then not have that much money available for the purpose, because of the erosion of the capital gain tax.

However, to advise any such procedure under the present state of the law would certainly seem unwise. Until there is more clarification if not an actual reversal of the existing law on the subject, the tax planner must accept at least the possibility that where the income tax is involved a transfer of property in consideration of either a release of support rights or a release of property rights will not be treated as a gift, with the wife taking the husband's basis, but rather, if the property has appreciated above the husband's cost, the husband will have a capital gain tax liability

to the extent of the difference between his adjusted basis and the market value of the property at the time of transfer.<sup>156</sup> Likewise, a new basis would thereby be attributed to the property in the hands of the wife, namely, the market value as of the date of transfer.<sup>157</sup>

### *Death of Wife*

Any accrued payments under a separation agreement which are owing to the wife at the time of her death, and which are collected by her executors, are income in respect of the decedent and taxable to her estate as such.<sup>158</sup> Even though several back payments are received in a lump sum they are still considered periodic and taxable as ordinary income.<sup>159</sup>

### *Death of Husband*

*Income Taxes.* If periodic payments are to be continued to the wife, and are to be paid from the husband's estate after his death, his estate is entitled to take an income tax deduction therefor to the extent of the estate income.<sup>160</sup> But no deduction can be taken by the estate for any principal paid out to help meet such obligations.<sup>161</sup>

Everything received by the wife from the estate, whether income or principal, is taxable to her as ordinary income.<sup>162</sup>

*Estate Taxes.* As in the case of gift taxes, a promise given in consideration of the release by the wife of her rights to support is, to the extent of the reasonable value of the support rights, "to be treated as made for an adequate and full consideration in money or money's worth".<sup>163</sup> Thus,

<sup>156</sup> *Commissioner v. Mesta*, 123 F. 2d 986 (3rd Cir., 1941), cert. den.; *Commissioner v. Halliwell*, 131 F. 2d 642 (2nd Cir., 1942), cert. den.

<sup>157</sup> *Patino*, 13 T. C. 816, aff'd 186 F. 2d 962 (4th Cir., 1950); *Gardner Trust*, 20 T. C. . . ., No. 125 (1953). See also *Farid-Es-Sultaneh v. Commissioner*, 160 F. 2d 812 (2nd Cir., 1947), and the discussion on the similar problem in considering ante-nuptial agreements, *supra*, n. 22.

<sup>158</sup> I. R. C., Sec. 126(a) (1) (A).

<sup>159</sup> *Estate of Narischkine*, 14 T. C. 1128, aff'd 189 F. 2d 257 (2nd Cir., 1951).

<sup>160</sup> In *Laughlin's Estate v. Commissioner*, 167 F. 2d 828 (9th Cir., 1948), it was decided that the estate could not take the deduction under I. R. C. Sec. 23(u) as could the husband, but that the payment would be deductible under Secs. 162(b) and 171(b).

<sup>161</sup> G. C. M. 25999, 1949-1 Cum. Bull. 116.

<sup>162</sup> *Welsh Trust*, 16 T. C. 1398, aff'd 194 F. 2d 708 (3rd Cir., 1952), cert. den.

<sup>163</sup> E. T. 19, 1946-2 Cum. Bull. 166.

a claim of the wife under a separation agreement would normally be deductible in full as a claim against the husband's estate.

It is probable that in most cases the agreement under which the wife has been receiving periodic payments will not be challenged by the Commissioner. But, where it can be demonstrated that the payments represent at least in part a consideration for the release of property rights, then to that extent the claim will not be recognized as a deduction for estate taxes even though it is perfectly enforceable against the estate.

However, the last sentence must be modified as was the case with gift taxes, to the extent that if the claim is supported by a decree of a court of competent jurisdiction which has approved the agreement, then the claim will be recognized as a proper deduction.<sup>164</sup>

When allowed, the claim is valued by determining actuarially the present worth of the stipulated future payments in the light of the life expectancy of the wife and her expectancy as to remarriage, where significant.<sup>165</sup>

*Life Insurance — Income to Wife.* Where life insurance policies are purchased as security for the husband's obligations, to assure the continuance of payments after his death, the payments when received are taxable income to the wife.<sup>166</sup> Even though the payments may in part be made from principal, such as through the exercise of one of the instalment options, the full amount is taxable as ordinary income.<sup>167</sup>

If, on the other hand, the policies are not security for future payments but are absolutely assigned to the wife, there is the question of whether she is taxable on the proceeds to the extent that they exceed the consideration paid by her as the purchase price of the policies through the

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<sup>164</sup> Commissioner v. Maresi, *supra*, n. 154; Fleming v. Yoke, *supra*, n. 154; Estate of Watson, 20 T. C. 386 (1953); and see discussion, *supra*, n. 147.

<sup>165</sup> Maresi and Fleming, *ibid.* Actually the Maresi case was decided on the ground that support rights were not adequate consideration, on which the court subsequently reversed itself. But it is still authority for the propositions for which it is cited.

<sup>166</sup> I. R. C., Sec. 22(k).

<sup>167</sup> Last sentence of I. R. C., Sec. 22(b) (2) (A).

release of her support rights.<sup>168</sup> Added to that is the fact that one court has declared that for income tax purposes the release of property rights is a good and valuable consideration.<sup>169</sup>

If so, what is the value of those considerations? Would the value thereof be the cash surrender value of the policies at the time of transfer, or the premiums theretofore paid by the husband which in each case would be greater or less depending on the age of the contracts? Or would it be zero if a new policy were to be purchased?

Would it make any difference whether or not the policies are only for security? Would the wife be taxable anyway, for periodic payments, on all amounts received under an instalment option? Or, suppose she received the proceeds in a lump sum instead. Would that be considered a "principal sum", thereby relieving her of tax, or would it be considered a group of periodic payments, and therefore taxable as ordinary income?<sup>170</sup>

In order to try to avoid some of these income tax problems for the wife, although they would probably be of little benefit in so far as the estate tax problems of the husband are concerned, there are two possible courses which might be suggested. The first would be to have the husband retain the policies and make the wife an irrevocable beneficiary. At the same time he could release all rights to cash surrender values, to pledge as collateral, and the like. Whether this solution would accomplish the desired results is questionable at best. Also, whether done this way or assigned, there is perhaps a gift tax involved.

A preferable solution would be for the wife to apply for insurance on the husband's life and pay the initial premium from her own funds. Thereafter she should pay all premiums herself. Naturally the husband would have to make larger periodic payments to her than if he were paying the premiums himself, but it would all add up to the same thing. However, if the children are to be the contingent

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<sup>168</sup> I. R. C., Sec. 22(b)(2)(A).

<sup>169</sup> Farid-Es-Sultaneh v. Commissioner, *supra*, n. 157.

<sup>170</sup> See text, *supra*, ns. 125 to 127, p. 39.

beneficiaries, this plan would not give assurance to the husband that the policies will be kept in force.

*Life Insurance — Taxable In Husband's Estate.* To what extent life insurance carried under a separation agreement is taxable in the husband's estate is still an open question in many of its aspects. If the proceeds are payable to the executor to distribute in accordance with the agreement they are probably includable for estate tax purposes.<sup>171</sup>

Likewise, even as to policies which have been absolutely assigned to the wife, a strict reading of the Code sections might lead to the conclusion that the insurance is includable in the husband's estate where he has paid the premiums, either directly, or indirectly by supplying the funds with which the wife has made the payments, as well as where the husband has retained an interest in the policies through a provision in the agreement that if the wife does not survive him the policies will revert to him.<sup>172</sup> However, the Code further provides that insurance proceeds receivable by beneficiaries other than the estate, through policies transferred under conditions whereby the transaction was not a taxable gift, shall not be included in the estate.<sup>173</sup> Under this Section the Commissioner has offered, at least temporarily, a simple solution to the problem for those who can lawfully make their separation agreement dependent upon the granting of a divorce decree. If, under such circumstances, the divorce court approves the arrangement there is no estate tax on the insurance proceeds.<sup>174</sup>

Whether or not that Ruling can be relied on as finally settling all that it seems to include, it is certainly true that if the insurance is purchased in consideration of the release of support rights there should be no problem. Thus, another argument is presented in support of having two separate agreements entered into at the time of divorce.

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<sup>171</sup> I. R. C., Sec. 811(g) (1).

<sup>172</sup> I. R. C., Secs. 811(g) (2) (A) and 811(c) (3), respectively.

<sup>173</sup> I. R. C., Sec. 811(g) (3).

<sup>174</sup> *Rev. Rul.* 54-29, I. R. B. 1954-3. In a convenient, although perhaps not wholly justified, reliance on the Harris decision in the Supreme Court, *supra*, n. 144, the ruling is happily in favor of the taxpayer and, therefore, the fundamental distinctions, as opposed to the superficial similarities, in the two situations will undoubtedly be left to rest without further disturbance by taxpayers' representatives.

The insurance can be tied into the agreement relating solely to the release of support rights. Of course, the Commissioner could still find that the allocation or segregation of value attributed to the release of the support rights is unreasonable. But any fair treatment of the problem might well win the day in view of the impossibility of anyone else coming up with a demonstrably more exact computation.<sup>175</sup>

### *Summary — Separation Agreements*

As the problems between spouses, and their relative interests in different aspects of an agreement, vary so widely it would now be presumptuous to suggest what a planner might consider as a standard of approach. However, there are a few simple rules that might be considered as basic principles upon which the remaining network could be spun.

It is probable that the husband will have the greater income, taxable in higher brackets. Therefore, the emphasis must be on obtaining for him every income tax deduction available. The two will thereby have a larger net income to work out between themselves.

When reconciliation has become impossible and a final meeting of the minds has been reached, the divorce should be sought promptly. There should be two agreements, in writing.

The first, in consideration of the release of the wife's right to support, should account for as much of the consideration to be paid by the husband as possible. It should contain all matters relating to whatever life insurance arrangement there is contemplated.

The second agreement should cover the release of property rights, using as little of the consideration to be paid by the husband as seems reasonable.

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<sup>175</sup> Although methods and bases for granting alimony in different jurisdictions vary greatly, it is traditional that alimony is to continue only during the joint lives of the parties and even then only until the wife remarries. In many separation agreements payments to the wife continue after the husband's death and even sometimes in spite of her remarriage. Unless there is no release of property rights whatsoever in the particular agreement it would be easy for the Commissioner to argue that the extended payments must have been agreed to for such release. The answer may be that the wife is simply taking less over a longer period, but the problem is there.

If the divorce is to be obtained in a jurisdiction where the court is empowered to determine the division and ownership of the parties' separate property, have the decree approve and adopt the agreements and then make the transfer. In fact, if there is no problem of public policy when the agreements are negotiated and executed, the transfer of the property should be made conditional upon the granting of a divorce decree specifically approving and ordering the transfer.

If the decree is to be obtained in a jurisdiction where the court does not have such authority, make the particular transfer in exchange for the release of property rights immediately, and to this extent the marital deduction can be availed of. Except for this, no more payments than necessary should be made until after the decree.

It would be well to work out a plan whereby all payments that are to be made after the granting of the divorce are included within a continuing pattern, so that they can all, both large and small, be considered as integral and related parts of a single arrangement for regular periodic payments.

If either (a) the payments to the wife for the support of each child are expected to exceed \$600 a year, or (b) in spite of the husband's payments the wife will contribute over one-half the support of the children, do not separate or segregate in any way the amounts to be used for their support, or permit a mathematical computation thereof. If payments are identifiable as exclusively for the support of children the deduction is lost, but exemptions should then be claimed for them as the husband's dependents.

As every effort is being made to reduce the husband's tax burden as much as possible it must be remembered that the wife's taxes will be necessarily increased thereby, although not at the same rate. Thus, the payments to her will have to be greater in order for her to be able to retain the same net amount which she needs. In this respect, if life insurance is to be used, the wife should apply for new policies. If the husband is not insurable either the wife should be designated irrevocable beneficiary, provided she



survives, with full rights as owner in the meantime, including the right to take the cash surrender value, or the existing policies should be assigned to her on the same basis. In any event she should receive enough to carry the premiums on the life insurance herself.

Payments to her should be in a sufficient amount so that she can pay her own attorneys, who should bill separately for their services relating to the alimony payment negotiations. She would thereby get at least a partial deduction for these expenses.

The method and breakdown of the alimony payments will vary in every case, but preferably a periodic payment arrangement, or otherwise instalment payments for a period of *more* than ten years, will be essential for the tax plan. As indicated above, instalment payments for less than ten years, where also contingent upon the wife's remarriage, that is, dependent "upon some elements of her own seemingly unpredictable choosing . . . far beyond the reach of an educated guess", will be considered "periodic" in at least one Circuit; but that acceptance is by no means uniform as yet.

In view of the fact that the parties will probably wish to reach final conclusions, leaving nothing to later determination or negotiation, as much flexibility as possible is desirable. Times and the value of money can change so easily. In many cases it would be well to have the payments to the wife governed by some appropriate formula which could be applied to the annual variations in the husband's net income after federal and state income taxes. If based upon such a formula the payments, again being unpredictable in amount, will be considered as periodic even though for less than ten years.

Of practical importance, however, regardless of any other escalation provision is the fact that if a husband through carelessness or design fails to make his periodic payments regularly there can be some relatively disastrous income tax results for the wife. If he defaults in his payments for a while and then brings everything up to date at once the wife will be involved in a very high income tax

bracket for that year; whereas, if the husband had made his payments regularly the tax bite on the wife would have been considerably less in the aggregate. Thus, it might be well to insert in the agreement some penalty provision in the event that the husband should fail to keep his payments up, requiring, perhaps, that he shall reimburse the wife in an additional amount equal to the increase in her income taxes for the year in which any such accumulated payments are received [the payments to include a coverage for any tax on the amount of the reimbursement].

Although the agreement need not mention the imminence or possibility of a divorce, it would probably be preferable to have the agreement recite that it is not to prejudice either party in seeking a divorce, that if proceedings are ever instituted by either party it is to be introduced in evidence and urged upon the court for inclusion in the decree, and if not made conditional on the granting of a decree the agreement should provide that its terms are to survive a divorce decree if ever granted to either party.

Likewise, the agreement does not have to be submitted in evidence or be included in the decree or referred to by the court. But it is preferable that the payment provisions to the wife be affirmatively approved by the court and set out in the decree.

Where it is intended by the parties that special mention is to be given to the fact that the wife is to be liable for income taxes on all payments received by her after the decree, and that the husband shall have a deduction therefor, it might be unwise to insert in the agreement an indemnity undertaking on the part of the wife in case the courts hold the husband liable for any of the taxes. In all probability he would be in higher brackets, and her indemnity payments might make things even worse. It would be better for him simply to reduce future payments by the amount of the tax which the wife would have paid had she been taxable.

On the contrary, however, and perhaps worthy of particular consideration should be a provision in the agreement relieving and indemnifying the wife from any payment on

account of either gift or estate taxes. Where a transfer is subsequently held to be a gift, there may be a substantial tax, with interest and penalties payable. Whether as transferee, or by consent under the gift tax marital deduction, the wife would be liable.

Likewise, where a claim of the wife against the husband's estate is valid and enforceable, and yet is not recognized as a deduction for estate tax purposes because based on a promise given in exchange for a release of property rights, the double blow to the estate could well be crippling. But that would not be the wife's fault and provision should be made to protect her from any apportioned tax liability of the husband's estate, or from being required to contribute in any degree to the husband's estate tax.

#### INTERNAL REVENUE CODE OF 1954

As indicated by references in the footnotes throughout this article, a bill of great importance in the tax field has recently been introduced in the Congress. It is known as the Internal Revenue Code of 1954 [H. R. 8300].<sup>176</sup>

This new statute, if adopted, would completely rearrange and renumber the sections of the present Internal Revenue Code. It would also rewrite many of the existing provisions, and enact many new ones.

As far as the limited subject matter of this article is concerned, two of the significant changes would be the deletion of the necessity of a court decree in order to have the special alimony tax provisions become effective, and a rather complete revision of the tax law relating to annuities, to which attention has previously been called.

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<sup>176</sup> In view of the significance and wide scope of the pending provisions in the proposed new legislation, the publication of *BASIC ESTATE PLANNING*, mentioned in fn. \* at p. 3, will be held up for appropriate revision to accord with any final action taken by the Congress in connection therewith.