

1959

Tax Problems Relating to Separation and Divorce

G. Charles Scharfy

Follow this and additional works at: <https://scholarlycommons.law.case.edu/caselrev>



Part of the [Law Commons](#)

Recommended Citation

G. Charles Scharfy, *Tax Problems Relating to Separation and Divorce*, 10 *Wes. Res. L. Rev.* 200 (1959)

Available at: <https://scholarlycommons.law.case.edu/caselrev/vol10/iss2/4>

This Article is brought to you for free and open access by the Student Journals at Case Western Reserve University School of Law Scholarly Commons. It has been accepted for inclusion in Case Western Reserve Law Review by an authorized administrator of Case Western Reserve University School of Law Scholarly Commons.

Tax Problems Relating to Separation and Divorce¹

G. Charles Scharfy

IT IS PROBABLY not stretching the truth unduly to state that insofar as the average legal practitioner is concerned, the tax problems relating to separation and divorce are limited to a rather narrow field — the deductibility of alimony or support payments by the husband and the taxability of such payments to the wife. It might, therefore, not be amiss to at least alert those who are not already aware of the problems, to the existence of a number of related tax ramifications which may also be present — in some degree — in family separation matters. For

THE AUTHOR (Ph.B., 1938, LL.B., 1940, University of Toledo), is a partner in the law firm of Shumaker, Loop & Kendrick in Toledo, Ohio.

example, in the income tax field, questions arise concerning the tax basis to the wife of property transferred to her by the husband pursuant to a di-

vorice or separation arrangement. Other questions concern the realization of income by the husband upon the transfer of property to the wife, where the value of the property has appreciated over his tax basis. Additionally, the gift tax field is involved in questions concerning the possible application of the gift tax to transfers between the spouses; and the estate tax field is involved in questions concerning the deductibility for estate tax purposes of alimony and child support obligations remaining unfulfilled at the death of the husband.

In the income tax field, the 1954 Internal Revenue Code made a number of significant changes to the alimony rules, and the purpose of this paper will be to summarize the basic alimony and support rules, to discuss the more important changes effected by the new Code, and then to discuss the more "offbeat" or lesser-known income, gift and estate tax ramifications attendant upon separation and divorce situations.

I. INCOME TAX

It is a basic tenet of the statutory scheme involving alimony that a definite interrelationship exists between Section 71 of the Code (dealing with taxability of alimony to the wife), Section 215 (dealing with

1. This article is based upon material presented by the author at the Cleveland Regional Tax Institute in September, 1958.

deductibility of alimony payments by the husband) and Section 682 (dealing with trust income payable to the wife in cases involving separation or divorce). For example, Section 215, the deduction section, states in very simple and concise fashion that the husband shall be allowed as a deduction "amounts includible under Section 71 in the gross income of his wife." Section 71 is considerably more detailed in setting forth rules relating to the includability of alimony payments in the gross income of the wife. And each section makes cross reference to the other and to Section 682.

It may be stated as a general rule, therefore, that in order for an alimony payment to be deductible by the husband, it must be includible in the wife's income. However, it appears that rare exceptions to this general rule may exist, and at least one such exception has already been recognized. Thus, a Revenue Ruling² holds that a citizen and resident of Puerto Rico, earning income subject to the U.S. income tax, may deduct alimony payments made to his former wife, even though such payments are exempt from tax in the hands of the wife by reason of Section 933³ of the Code. The ruling recognizes that Sections 71 and 215 are "intended to be reciprocal and to be correlated where possible" but states that to deny the deduction would not give proper effect to the exclusion provisions of Section 933, and would "not accomplish the end sought by Congress in passing this legislation because the husband would still have to pay alimony and income tax thereon without the offset contemplated by Congress."

The foregoing ruling follows the rationale of an earlier ruling⁴ in a different field, which held that deductions for distributions of income by estates and trusts will not be disallowed merely because the distributees (residents of Canada) did not have to pay income tax thereon by reason of treaty exemptions.

While these exceptions are decidedly narrow in scope, they indicate that under appropriate, albeit rare, circumstances the bonds intertwining Sections 71 and 215 may be severed.

It is clear that Congress intended, by the enactment of Section 71 of the 1954 Code, to afford the husband greater relief with respect to deductibility of alimony payments than had been available under the analogous section of the 1939 Code.⁵ Under the old law only periodic

2. Rev. Rul. 585, 1956-2 CUM. BULL. 166.

3. This section exempts from the U.S. income tax "In the case of an individual who is a bona fide resident of Puerto Rico during the entire taxable year, income derived from sources within Puerto Rico (except amounts received from service performed as an employee of the United States or any agency thereof. . . ."

4. I.T. 4019, 1950-2 CUM. BULL. 58.

5. § 22 (k).

payments made to a wife who was *divorced* or *legally separated* were taxable to her and deductible by the husband. The 1954 Code provides three categories of deductible alimony payments: (a) those made pursuant to a court decree of divorce or legal separation, or under a written instrument incident to a divorce or legal separation, (b) those made pursuant to a written separation agreement, where the parties are actually separated, and (c) those made pursuant to a decree for support or maintenance, where the parties are actually separated. Categories (b) and (c) above are new, and eliminate the old requirement of a decree of *divorce* or *legal separation*.

PERIODIC VS. INSTALLMENT PAYMENTS

As under the old law, the 1954 Code retains the requirement that only "periodic payments" qualify as deductible alimony. While the Code does not define the term "periodic payments," it does specify that installment payments of a principal sum are not "periodic payments" unless they extend for a period ending more than ten years from the date of the decree, instrument or agreement. Whether or not certain payments are "periodic payments," and hence deductible, or installment payments of a principal sum, and hence not deductible, has long been a source of confusion and conflict among the courts. In general the courts are in agreement that a "principal sum" is involved if, by mathematical computation, an aggregate total or sum can be determined. Thus, a requirement that the husband pay \$X per month for Y months — or \$X per month until Y total has been paid — would uniformly be considered as a "principal sum" type of requirement. But there has been wide disagreement as to whether payments which would *not* extend over more than a ten year period would qualify as "periodic" because they were subject to being discontinued upon the happening of future contingencies such as the wife's remarriage, the husband's death, etc. Under the 1939 Code the Tax Court had consistently held that "contingencies" would not convert "installment" payments into "periodic" payments.⁶

The Courts of Appeals, on the other hand, have generally held to the contrary.⁷ The Court of Appeals for the Third Circuit resurrected a distinction which had been earlier rejected by the Tax Court as being artificial and held⁸ that payments of a principal sum of \$25,000 payable

6. See, e.g., J. B. Steinel, 10 T.C. 409 (1948); Estate of Frank P. Orsatti, 12 T.C. 188 (1949); Frank R. Casey, 12 T.C. 224 (1949); Harold M. Fleming, 14 T.C. 1308 (1950).

7. Baker v. Commissioner, 205 F.2d 369 (2d Cir. 1953); Birdwell v. Commissioner, 235 F.2d 112 (5th Cir. 1956); Prewett v. Commissioner, 235 F.2d 250 (8th Cir. 1955); Myers v. Commissioner, 212 F.2d 448 (9th Cir. 1954).

8. Smith's Estate v. Commissioner, 208 F.2d 349 (3d Cir. 1953).

in 10 semi-annual installments (but subject to discontinuance upon the wife's remarriage, or death of either spouse) were *not* periodic, while monthly installments of \$300 per month for a 5 year period (but subject to discontinuance upon the happening of the same contingencies) *were* periodic — the distinction being bottomed upon the *mentioning* of the principal sum in the first instance.

The Commissioner's regulations⁹ under the 1954 Code indicate that he has largely bowed to the reasoning of the Courts of Appeals, and under such regulations payments over a period of 10 years or less will be considered as "periodic" if subject to contingencies such as death of either spouse, remarriage of wife or change in economic status of either spouse, and it will not matter (1) whether the contingencies are spelled out in the decree, instrument or agreement or result from local law, or (2) whether the aggregate amount of the payments to be made in the absence of the occurrence of the contingencies is spelled out or may be mathematically or actuarially computed.

INTERLOCUTORY DECREES

Interlocutory decrees have likewise been a source of considerable litigation under the 1939 Code. The Commissioner had taken the position that such decrees had affected a legal separation under a decree of divorce or separate maintenance, that the parties could not file a joint income tax return, and that the wife was taxable on the periodic payments made during the period of the interlocutory decree.¹⁰

This position was adhered to by the Commissioner despite its rejection by the Tax Court¹¹ and two Courts of Appeals.¹²

It seems probable that this particular area of dispute may have been eliminated — or at least substantially restricted — by the enactment of the 1954 Code, since payments during periods of interlocutory decrees will generally qualify under the new sections which broaden alimony payments to include those made under "support" decrees or "written separation agreements," despite the absence of a decree of divorce or legal separation.

INSURANCE ARRANGEMENTS

The tax effects of insurance provisions which are adopted or incorporated into divorce or separation arrangements have been a source

9. Reg. § 1.71-1(d)(3)(i) and (ii).

10. Rev. Rul. 178, 1955-1 CUM. BULL. 322.

11. *Marriner S. Eccles*, 19 T.C. 1049 (1953); *Alice Humphreys Evans*, 19 T.C. 1102 (1953).

12. Fourth Circuit in *Commissioner v. Eccles*, 208 F.2d 796 (1954), affirming the Tax Court decision at note 11, *supra*; and Tenth Circuit in *Commissioner v. Evans*, 211 F.2d 378 (1954), affirming the Tax Court decision at note 11, *supra*.

of some uncertainty in the past. By reason of the considerable number of decisions and rulings which have been handed down to date, however, certain general conclusions may now be drawn:

(1) Whether or not the husband may deduct, as alimony, premiums which he pays on insurance policies, depends upon the degree of the wife's interest in the policies.

(a) If she is given all or substantially all rights of the *owner* of the policies, the payments of the premiums are considered equivalent to payments directly to her and would qualify as alimony if they meet the general alimony rules (periodic, etc.). The Commissioner has so ruled,¹³ and the courts have so held.¹⁴

(b) If, on the other hand, she is simply made the beneficiary of the policy (even though irrevocably), it is generally considered that she has not realized benefits sufficiently tangible during the current year to warrant taxing her upon the premiums (or allowing the husband to deduct same).¹⁵

(c) Similarly, if the insurance is merely security for the performance of the husband's alimony payment obligations, the premiums thereon will not be treated as alimony taxable to her or deductible by him.¹⁶

(2) Where premiums are includible in the wife's income, they are deductible by the husband. However, in *Seligmann*,¹⁷ the Court of Appeals for the Seventh Circuit held that the allowance of a deduction to the husband, in a separate proceeding, was not *res judicata* of the question of the includability of the premiums in the wife's income, and under the facts of the case the wife was held not taxable on such premiums. The court said:

. . . Moreover, while the rights of the husband to a deduction under § 23(u) are by express language made dependent upon the obligation imposed upon the wife under § 22(k), we do not think it necessarily follows that the converse of that proposition is true. At any rate, there is nothing in the language of § 22(k) which makes the obligation of the wife dependent upon the right of the husband under § 23(u).

13. I.T. 4001, 1950-1 CUM. BULL. 27.

14. Anita Quinby Stewart, 9 T.C. 195 (1947); Lemuel Alexander Carmichael, 14 T.C. 1356 (1950); *cf.* Seligmann v. Commissioner, 207 F.2d 489 (7th Cir. 1953).

15. Rev. Rul. 125, 1957-1 CUM. BULL. 27; Seligmann, note 14, *supra*; Meyer Blumenthal, 13 T.C. 28 (1949); *aff'd* 183 F.2d 15 (3d Cir. 1950); Lillian Bond Smith, 21 T.C. 353 (1953); Beulah Weil, 22 T.C. 612 (1954); Carl G. Ort-mayer, 28 T.C. 64 (1957).

16. William J. Gardner, 14 T.C. 1445 (1950), *aff'd* 191 F.2d 857 (6th Cir. 1951); Halsey W. Taylor, 16 T.C. 376 (1951); F. Ellsworth Baker, 17 T.C. 1610 (1952); *aff'd* 205 F.2d 369 (2d Cir. 1953); Lillian Bond Smith, note 15, *supra*.

17. Seligmann v. Commissioner, 207 F.2d 489 (7th Cir. 1953).

So far as the obligation of the wife is concerned, we think we must treat § 22(k) as if it stood alone, independent of § 23(u). . . .¹⁸

(3) Insofar as the *proceeds* of insurance or annuity policies are concerned, such proceeds would be taxable to the wife if they met the general alimony requirements (*i.e.*, if they are periodic, and in discharge of the husband's alimony obligations). The general exclusion of life insurance proceeds payable by reason of the death of the insured, provided by Section 101(a) of the Code, does not apply to amounts which qualify as alimony, by reason of the specific application of Section 101(e); and the general annuity rules are specifically excepted in the case of payments which qualify as alimony.¹⁹

SUPPORT OF MINOR CHILDREN

Payments by the husband for the support of minor children are not deductible as alimony, nor are they includible in the wife's income. As a practical matter, however, the wording of different divorce decrees or written agreements frequently makes it difficult to determine whether particular payments are alimony payments or child-support payments. Of course where specific amounts are designated as being for child support, no problem is presented. But where the decree or instrument requires a modification to so-called "alimony" payments in the event of the wife's remarriage, or the death or attainment of majority of one or more children, it may be that what superficially purports to be alimony, is in fact child-support money. The Tax Court has rather consistently followed the approach that if, reading the decree or instrument *as a whole*, a portion of the payments can reasonably be said to have been intended for child-support purposes, an allocation should be made.²⁰ The Courts of Appeals, however, have adopted differing approaches to the problem which do not seem capable of reconciliation.

The Second Circuit has taken the position that in order for payments to be considered payable for the support of a child, they must be specifically *restricted* to that purpose.²¹ On the other hand, the Ninth Circuit, although stating that it agreed with the *Weil* decision of the Second

18. This conclusion was adhered to by the same appellate court in *Lehman v. United States*, 239 F.2d 139 (7th Cir. 1956), and has been recognized by the Tax Court, *Estate of Marguerite D. Haldeman*, 25 P-H Tax Ct. Mem. 718 (1956).

19. § 72 (k).

20. *Warren Leslie, Jr.* 10 T.C. 807 (1948); *Harold M. Fleming*, 14 T.C. 1308 (1950); *Truman W. Morsman*, 27 T.C. 520 (1957); *Russell W. Boettiger*, 31 T.C. No. 49 (November 28, 1958).

21. *Weil v. Commissioner*, 240 F.2d 584 (2d Cir. 1957); *Estate of Dorothy R. Hirshon*, 250 F.2d 497 (2d Cir. 1957).

Circuit as applied to its facts, disagreed with the generality of its language and held it to be inapplicable to the facts of the case before it,²² stating:

The general rule which we here approve is that when the settlement agreement, read as a whole, discloses that the parties have earmarked or designated or apportioned or allocated the payments to be made, *one part to be payable for alimony, and another part to be payable for the support of children*, with sufficient certainty and specificity to readily determine which is which, without reference to contingencies which may never come into being, then the "part of any periodic payment" has been fixed "by the terms of the decree or written instrument" and satisfies the statutes and regulations hereinbefore quoted. . . .²³

In our own Sixth Circuit, the Appellate Court has had occasion to consider this problem in two instances. In its earlier decision in *Budd v. Commissioner*,²⁴ the court approved the Tax Court decision²⁵ which made an allocation based upon the following facts: H to pay W \$500 per month for support of W and one child; if W remarries, monthly sum is reduced to \$200; if child goes to private preparatory school, H pays for school expenses plus \$200 per month while the child is on vacation. Upon majority of child (or death prior to majority), H pays \$300 per month to W so long as she remains unmarried. The Tax Court and the Appellate Court allocated \$200 per month to child support, and disallowed this portion as an alimony deduction by the husband.

In its most recent decision,²⁶ however, the Sixth Circuit has apparently considerably restricted its *Budd* holding (without explicitly saying so) and seems to be following the rationale of the Second Circuit to the effect that there must be a clear-cut earmarking of child support funds before the court will disallow any part of the payment as an alimony deduction to the husband. The court construed the statutory word "fix"²⁷ to mean "assign precisely" or "make definite and settled" in accordance with its usual meaning. As the situation stands today in the Sixth Circuit, it seems clear that unless the decree, instrument or agreement clearly allocates portions to the children, and unless there is some restriction upon the use of such allocated portions by the wife, the entire amounts will be taxed to her as alimony, even though they are subject to reduction upon the happening of future contingencies (such as the children's death, etc.),

22. *Jo Eisinger v. Commissioner*, 250 Fed. 303 (1957), *cert. den.* 356 U.S. 913 (1958).

23. *Id.* at 308.

24. 177 F.2d 198 (6th Cir. 1947).

25. *Robert W. Budd*, 7 T.C. 413 (1946).

26. *Deitsch v. Commissioner*, 249 F.2d 534 (6th Cir. 1957).

27. § 71 (b) excludes from the definition of alimony such part of any payments as the terms of the decree, instrument or agreement "fix" as a sum which is payable for child support.

and even though, by reason of such potential reduction it could be "inferred" that the amount of such reduction was intended to reflect an amount for the support of the children. The court will no longer make surmises or inferences on this point but will require a clear-cut earmarking.

DEDUCTIBILITY OF LEGAL EXPENSES

The deductibility of legal expenses incurred in connection with divorce and separation is a matter of great interest and importance to the parties involved, since frequently such expenses are substantial — especially if property settlement arrangements are contested.

Section 262 prohibits a deduction for "personal, living, or family expenses," and it has been held that legal expenses in procuring a divorce, custody of children and other matters of a similarly personal nature fall within this prohibition.²⁸ To be deductible at all, such expenses must come within the purview of Section 212, which allows a deduction for expenses incurred for the production or collection of income, and for the management, conservation or maintenance of property held for the production of income. Despite the earlier, restrictive view of the Commissioner and the Tax Court on the matter, it is now well settled that attorney fees paid by the wife in obtaining *taxable* alimony are deductible by her.²⁹ Court costs and other expenses incurred for the same purposes are given the same treatment.³⁰ Where fees and expenses are attributable to the securing of taxable alimony and *other* services, an allocation must be made and only the portion attributable to the alimony is deductible.³¹

The area of deductibility of similar expenses incurred by the husband is considerably narrower, and still the subject of dispute between the courts. Although expenses of the wife in *obtaining* taxable alimony are deductible, expenses of the husband in *resisting* having to pay such alimony are generally *not* deductible.³² Nor are attorney fees of the wife, paid by the husband, deductible by him.³³ However, a slight chink has developed in this wall of non-deductibility, and the husband has, in certain limited cases, been allowed to deduct legal expenses which arose in

28. Frank J. Loverin, 10 T.C. 406 (1948); Robert A. McKinney, 16 T.C. 916 (1951).

29. Elsie B. Gale, 13 T.C. 661 (1949) acq., 1952-1 CUM. BULL. 2; Barbara B. LeMond, 13 T.C. 670 (1949), acq., 1952-1 CUM. BULL. 3; T.D. 5889, 1952-1 CUM. BULL. 31.

30. Agnes Pyne Coke, 17 T.C. 403 (1951).

31. LeMond, note 29, *supra*.

32. Thorne Donnelley, 16 T.C. 1196 (1951); Lindsay C. Howard, 16 T.C. 157 (1951).

33. Loverin and McKinney, note 28, *supra*.

the course of divorce or separation proceedings. Thus, in *Baer v. Commissioner*,³⁴ in the first of the new and limited line of cases, the Court of Appeals for the Eighth Circuit (one judge dissenting) allowed the deduction of attorney fees paid to protect the husband's most important income-producing asset from his wife's claims. The syllabus of that case provides in part as follows:

Where there was little occasion for services of counsel in divorce proceedings proper and services of taxpayer's counsel were largely devoted to adjusting his liability to his wife so as to prevent break-up of taxpayer's stockholdings and thereby reducing his income by depriving him of control of corporation, attorney's fees did not constitute "personal family expenses" but rather expenses incurred for "conservation of property" held for production of income, and therefore taxpayer was entitled to deduct from his gross income sum paid to his attorneys, notwithstanding fact that same attorneys also acted for taxpayer in connection with his domestic controversy. . . .³⁵

Approving the rationale of the foregoing decision, the Court of Claims subsequently held:³⁶

. . . Generally, fees paid by a husband in resisting his wife's monetary demands incident to a divorce are not deductible under Section 23(a)(2). . . . When the controversy between the spouses goes not to the question of liability but to the manner in which it might be met and, at the same time the wife demands a part of the husband's income-producing property, control over which affects the husband's general income-earning capacity, legal fees incurred by the husband are deductible.

Despite its reversal by the Eighth Circuit in the *Baer* case, the Tax Court decided in *F. C. Bowers*,³⁷ to adhere to its position denying a deduction to the husband under an analogous set of facts. In the *Bowers* case a husband's principal source of income was compensation and dividends from a closely held corporation. In a divorce action his wife asked for a division of property, and claimed a right to a portion of his shares in the company. The husband incurred substantial legal fees in resisting her claims to his stock. The Court of Appeals for the Sixth Circuit, however, reversed the Tax Court's denial of a deduction for the legal expenses,³⁸ holding:

Where taxpayer's wife instituted divorce proceedings which were uncontested and services of taxpayer's lawyers were largely devoted to adjusting taxpayer's liability to wife so as to prevent breakup of his stock holdings and thereby reduce his income by depriving him of cor-

34. 196 F.2d 646 (8th Cir. 1952), *reversing* 16 T.C. 1418 (1951).

35. *Id.* at 646-47.

36. *George McMurry v. United States*, 132 F. Supp. 114, 116 (Ct. Cl. 1955).

37. 25 T.C. 452 (1955).

38. *Bowers v. Commissioner*, 243 F.2d 904 (6th Cir. 1957).

porate control, attorneys fees were, under 139 Internal Revenue Code, incurred for conservation of property held for production of income and were deductible, notwithstanding fact that same attorneys also acted for him in connection with his domestic controversy. . . .

The Court of Appeals for the Second Circuit has sided with the Tax Court, and has disapproved of the *Baer* decision.³⁹

A District Court in California has distinguished the *Baer* decision and held that where a wife in a divorce proceeding claimed that all of the husband's property was community property, while he claimed it to be separate property, his attorney fees were incurred in defending his title to the property, and hence were capital expenditures and non-deductible.⁴⁰

It is believed that the viewpoints of the Tax Court and the Second Circuit are irreconcilable with the viewpoints of the Sixth and Eighth Circuits and the Court of Claims. Little attempt is made by the courts to distinguish the conflicting views, and it appears that the matter will probably not be put to rest until either the Supreme Court or Congress steps in.

BASIS PROBLEMS OF WIFE

Property settlements give rise to questions concerning the wife's tax basis in the property received by her pursuant to such settlements. In the first of a series of cases considered by the Tax Court in recent years,⁴¹ under a separation agreement, a husband agreed to pay his wife \$750,000 in consideration of her releasing her rights in his estate. Subsequently, a method of paying the \$750,000 was agreed upon, pursuant to which various stocks, bonds, an automobile and cash were transferred to the wife at agreed prices per unit. Among the assets so transferred were 6,000 shares of Western Auto stock, at a price of \$60.00 per share. This price was arrived at on the basis of its fluctuating market value over a period of several months preceding the settlement. On the actual date of transfer of the stock to her, the market value was \$56.00 per share. The issue was whether her basis was \$60.00 or \$56.00 per share. The Tax Court held that the transaction was an arms-length one, that in agreeing to accept 6,000 shares in satisfaction of \$360,000 of her \$750,000 claim against her husband, she used up that much of her \$750,000 credit. In other words, the stock "cost" her \$60.00 per share (or \$360,000 in the aggregate), since she consumed that much of her credit or claim to the entire \$750,000 in accepting it at that price.

39. *Lewis v. Commissioner*, 253 F.2d 821 (2d Cir. 1958).

40. *Harris v. United States*, 157 F. Supp. 921 (N.D. Cal. 1958).

41. *Aleda N. Hall*, 9 T.C. 53 (1947).

Subsequently, under somewhat analogous facts, the Tax Court arrived at a similar result in *Christina DeBourbon Patino*,⁴² without, however, citing the *Hall* decision.

In the *Patino* case, however, the Commissioner argued that the transfer of shares to the wife was a gift, and that she therefore obtained the donor's basis. The court, however, held that in accepting the shares she surrendered valuable support and property rights, that the transaction was an arms-length one, and that the \$20.00 per share value placed upon the stock by the parties became her tax basis. The *Patino* decision was affirmed on appeal.⁴³

In *Edna W. Gardner Trust*,⁴⁴ a transfer of stock into a trust created for the benefit of the wife, pursuant to settlement of marital differences and the wife's relinquishment of her dower, support and other marital rights, was held not to be a gift (even though recited in the instrument as being a "voluntary gift"), and the trust's basis was the agreed value of the stock at the time of transfer to the trust.

An interesting and unusual decision in a slightly different context is that of *Farid-es-Sultaneh v. Commissioner*,⁴⁵ in which the petitioner received stock as part of a *prenuptial* settlement. The Commissioner determined that she received it as a gift and that she took the donor's basis. The donor was S. S. Kresge, and the stock was stock of S. S. Kresge Co. The stock had a value when received by her in 1924 of over \$300 per share. The donor's basis was around \$4.00 per share. The Supreme Court, had, in two cases under the gift tax law, held that similar transfers were taxable gifts. The Second Circuit held, however, that although the gift tax and estate tax laws are to be construed *in pari materia*, this did not apply to the income tax law. Since petitioner's marital rights in his property (which she relinquished by the prenuptial agreement) were far in excess of what she received (he was worth about \$375,000,000), she was a "purchaser" of the shares for a fair consideration.⁴⁶

CAPITAL GAINS PROBLEMS OF HUSBAND

The transfer of property to the wife pursuant to divorce or separation agreements presents tax problems to the husband as well as the wife, and

42. 13 T.C. 816 (1949).

43. *Commissioner v. Patino*, 186 F.2d 962 (4th Cir. 1950).

44. 20 T.C. 885 (1953).

45. 160 F.2d 812 (2d Cir. 1947), *reversing* 6 T.C. 652 (1946).

46. The conclusion of the appellate court in the *Farid-es-Sultaneh* case has been criticized by a district court in Pennsylvania as not answering "why" the word "gift" should not be given the same meaning under all revenue statutes. *Dunn v. United States*, 86 F. Supp. 861 (E.D. Pa. 1949).

the Tax Court and Circuit Courts have uniformly held the husband to have realized a capital gain where the property is worth more, at the time of transfer, than the husband's tax basis. Thus, the Third Circuit⁴⁷ has held that where, as part of a divorce settlement, a husband transferred stock costing him \$7,500 to his wife, and the stock had a then value of \$157,000, he realized a capital gain on the difference. The court held he exchanged the stock for a release of his support obligations, and that the parties in an arm's length deal put a value upon such obligations. The court said "We think that we may make the practical assumption that a man who spends money or gives property of a fixed value for an unliquidated claim is getting his money's worth."⁴⁸ (Two of five judges dissented, and agreed with the Tax Court that it was impossible to value the rights of the wife which were surrendered.)

The rationale of the Third Circuit was approved and followed by the Second Circuit.⁴⁹ The Commissioner in a ruling⁵⁰ which deals with a transfer of appreciated property into a trust created for life benefit of wife pursuant to separation agreement, with remainder interest to charity holds the husband taxable on the appreciation reduced by the present value of the remainder interest.

Acceding to the reasoning of the Second and Third Circuit decisions, the Tax Court in the recent *Stouffer*⁵¹ case has held that where a husband, pursuant to a divorce settlement and decree, relinquished an option he had possessed to purchase his wife's shares of stock, such relinquishment caused him to realize capital gain upon the difference between the market value of the stock at the time of relinquishment (\$400,000) and the option price (\$40,000), less the \$1.00 option consideration paid by the husband — or a net gain of \$359,999.

II. GIFT TAX

Transfers of money or property from husbands to wives, pursuant to divorce and separation settlements, frequently raise gift tax as well as income tax questions. As noted above, for *income* tax purposes, the courts have generally held that since the wife surrendered or relinquished valuable support and other marital rights in exchange for such money or property, she in effect "purchased" or gave consideration for such assets, and hence acquired a basis equal to either the fair market value at the time of the property transfer to her, or to an agreed arms length

47. Commissioner v. Mesta, 123 F.2d 986 (3d Cir. 1941).

48. *Id.* at 988.

49. Commissioner v. Halliwell, 131 F.2d 642 (2d Cir. 1942).

50. Rev. Rul. 507, 1957-2 CUM. BULL. 511.

51. Estate of Gordon A. Stouffer, 30 T.C. No. 131 (Sept. 19, 1958).

valuation placed upon the property as part of the settlement arrangement. However, for gift tax purposes, the question has undergone a somewhat confusing development. The earliest decisions and rulings arose as a result of premarital or ante-nuptial agreements. In *Merrill v. Fabs*,⁵² the Supreme Court held that a transfer in trust for the benefit of an intended wife, in exchange for her release of rights she would otherwise acquire in the husband's property, was subject to the gift tax. The gift tax statute taxes transfers made for "less than an adequate and full consideration in money or money's worth."⁵³ The estate tax statutes provide that "a relinquishment or promised relinquishment of dower or curtesy, or of a statutory estate created in lieu of dower or curtesy, or of other marital rights in the decedent's property or estate, shall not be considered to any extent a consideration 'in money or money's worth.'"⁵⁴ The Supreme Court held the gift tax to be supplementary to the estate tax. "The two are in *pari materia* and must be construed together."

In the following year the Commissioner ruled⁵⁵ that transfers made pursuant to an agreement incident to divorce or legal separation were subject to gift tax to the extent they were made in relinquishment of dower, curtesy or other *property* rights, but to the extent they were made in satisfaction of *support* rights they were *not* subject to gift tax.

In 1950, the Supreme Court had occasion to consider the gift tax liability attendant upon a transfer of property in a divorce proceeding, where the property settlement agreement was incorporated in a court decree. The court held that under such circumstances the transfer was not merely pursuant to a promise or agreement, but pursuant to a court decree, and hence not subject to gift tax.⁵⁶ This was so despite a provision of the decree which stated that the provisions of the settlement agreement would survive the decree. Naturally enough, after the above decision, parties in similar circumstances were generally careful to have private divorce or separation property settlement agreements incorporated into the divorce or legal separation decrees! It is to be noted that transfers to or for the benefit of adult children (or to minor children in amounts in excess of their support needs) are subject to gift tax, whether or not pursuant to court decree.⁵⁷

52. 324 U.S. 308 (1945). The companion case of *Commissioner v. Wemyss*, 324 U.S. 303 (1945), had the same general effect.

53. INT. REV. CODE OF 1939, § 1002, [now § 2512(b)].

54. INT. REV. CODE OF 1939, § 812(b), [now § 2043(b)].

55. E.T. 19, 1946-2 CUM. BULL. 166.

56. *Harris v. Commissioner*, 340 U.S. 106 (1950).

57. *Rosenthal v. Commissioner*, 205 F. 2d 505 (2d Cir. 1953); *Karl T. Wiedemann*, 26 T.C. 565 (1956).

NEW PROVISION OF 1954 CODE

Congress stepped into one segment of this field by the enactment of Section 2516 of the 1954 Code. This section removes gift tax liability for transfers made in settlement of marital or *property* rights, or to provide a reasonable support allowance for minor children, if (1) the arrangement is pursuant to a written agreement between the spouses, and (2) *divorce* occurs within two years thereafter. The statute explicitly removes any necessity of approval or incorporation of the arrangement by a court decree. In his proposed Regulations,⁵⁸ the Commissioner has indicated that even in cases *not* covered by the new Code section (e.g., where divorce does not occur within two years, etc.) a transfer in settlement of dower, curtesy or other property rights may nevertheless be gift-tax-exempt if "effected" by court decree. The Commissioner thus appears to be following the distinction laid down by the Supreme Court in the *Harris* case.⁵⁹

III. ESTATE TAX

With respect to the estate tax field, questions have arisen concerning the deductibility of alimony and support claims by the wife or children against the deceased husband's estate. The 1954 Code⁶⁰ allows a deduction for "claims against the estate," but limits such deduction,⁶¹ in the case of claims founded on a promise or agreement, to the extent they were contracted "bona fide and for an adequate and full consideration in money or money's worth." The Code⁶² in turn provides that a relinquishment of dower, curtesy or other marital rights in the decedent's estate shall *not* be considered to any extent a consideration in money or money's worth. As a result (and in line with the rationale of the distinction laid down for gift tax purposes by the Supreme Court in the *Harris* case) alimony claims of the wife may only be deducted if based upon court decree, and not a mere promise or private agreement.⁶³ The footnoted cases indicate the general judicial attitude that the claim is founded on the decree, and not a mere promise or agreement, where the decree incorporates or approves the private agreement, even in cases where

58. Proposed Treas. Reg. § 25.2516-1.

59. 340 U.S. 106 (1950).

60. § 2053(a).

61. § 2053(c).

62. § 2043(b).

63. Commissioner v. State Street Trust Co., 128 F.2d 618 (1st Cir. 1942); Commissioner v. Estate of Angus O. Swink, 155 F.2d 723 (4th Cir. 1946); Commissioner v. Maresi, 156 F.2d 929 (2d Cir. 1946); Commissioner v. Estate of Myles C. Watson, 216 F.2d 941 (2d Cir. 1954).

the agreement or decree specifically notes that the agreement survives or exists independently of the decree. However, the Tax Court has attempted to limit the allowance of the deduction, and in a fairly recent case held that where, in the absence of fraud or compulsion, the court must, under local law, approve or follow a private property settlement agreement, the claim is based upon the agreement and not the decree.⁶⁴ It is perhaps significant that under the Commissioner's proposed Estate Tax Regulations⁶⁵ a transfer in trust *pursuant to a court decree* was not to be considered taxable, insofar as the wife's interest therein was concerned (where such interest was created in consideration of her relinquishment of marital property rights) while the final Regulations omit this provision.

The Tax Court has held⁶⁶ that where a decedent had created a trust for the support of his wife and minor children, pursuant to a separation agreement, and the parties were not divorced, the value of the trust property was includible in his estate as a transfer in which he had retained a life estate. The theory of the holding was that he had an obligation to support his wife during his lifetime, that the trust discharged this obligation, and that as a result he in practical effect retained the right to and enjoyment of the trust income during his lifetime. Further, a *deduction* was denied for so much of the trust value as was attributable to the discharge of his obligation to support his wife, since Section 812(b) of the 1939 Code⁶⁷ provided that relinquishment of marital rights was not a consideration in money or money's worth — and as noted earlier, claims based upon promises or agreements are not deductible unless incurred for full and adequate consideration in money or money's worth. (The claim in this case was founded upon a mere promise, there being no court decree involved.) However, to the extent the transfer was in consideration of the release of the decedent's obligation to support his *children*, it *was* for adequate consideration, and an exclusion was allowed for the commuted value of the children's support. A similar exclusion for that portion of a trust considered attributable to the discharge of a decedent's obligation to support minor children was likewise allowed in *D. G. McDonald Trust*.⁶⁸

The selection of cited decisions in the foregoing discussion was not intended to be exhaustive, since numerous cases support certain of the

64. Estate of Chester H. Bowers, 23 T.C. 911 (1955).

65. Proposed Treas. Reg. § 20.2043-1(b).

66. Estate of Robert Manning McKeon, 25 T.C. 697 (1956).

67. INT. REV. CODE OF 1954, § 2043(b).

68. 19 T.C. 672 (1953); *aff'd sub nom* Chase National Bank v. Commissioner, 225 F.2d 621 (8th Cir. 1955).

stated conclusions, and reference to each such case would serve no useful purpose. The cases cited were selected as being either of a "pioneering" nature, as representative of the holding of a number of similar cases, or as containing a good general discussion of the issues and a helpful reference to prior analogous and supporting decisions. The breadth of the scope of this article has precluded all but the most basic attempt to appraise or evaluate the correctness or legal justification of any one decision. It is hoped that sufficient guideposts have been furnished in the lesser-known tax aspects of divorce and separation to permit anyone interested in a particular phase of the subject matter to pursue same in more detail and with greater refinement or distillation of the applicable legal principles.