TAX ASPECTS OF DIVORCE SETTLEMENT AGREEMENTS

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I.

INTRODUCTION

Twenty years have now passed since the adoption of the "alimony" provisions in the Internal Revenue Code.[1] In the course of this time most of the uncertainties in this area have been eliminated. Although uncertainties still exist, their area has been clearly narrowed and their pitfalls avoidable by the informed lawyer.

It is the purpose of this article to provide the practicing lawyer with a working guide in the preparation of divorce settlement agreements.

II.

STATUTE LAW AND GENERAL RULE

The specific provisions dealing with "alimony" payments are §§ 71, 215, 682 and 7701(a)(17) of the Code.

Although § 71 is captioned, "Alimony and Separate Maintenance Payment," the word alimony is not used in the body of the sections. Instead the broader words "periodic payments" are used throughout the applicable sections.

The effect of these sections, in general, is to require a divorced wife to include periodic payments in her taxable income and to allow the husband to deduct or exclude these payments from his taxable income. Therefore, in analyzing the problems raised by these sections, one should take the view that *all periodic payments will be income* to the wife unless covered by one or more of the specific exceptions or for other reasons.

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* See Contributors' Section, p. 65, for biographical data.

[1] See glossary and citations *infra*.

III.

Glossary and Citations

Because of the somewhat cumbersome language of the applicable sections it is difficult to discuss the subject with any clarity unless certain definitions and contractions are used. For simplicity the following words will have the following meaning unless the context indicates otherwise.

Husband: Divorced husband.

Wife: Divorced wife.

Agreement: Written instrument incident to a divorce or separation, and the decree itself, where applicable.

Includable: Includable in the wife's taxable income.

Deductible: Deductible from the husband's taxable income.

Excludable: Excludable from the husband's taxable income.

Deductible-Includable: Deductible by the husband and includable by the wife.

Taxable to: Includable in husband's (or wife's) taxable income.

'54 Code: The Internal Revenue Code of 1954.

'39 Code: The Internal Revenue Code of 1939.

All references to code sections are those of the 1954 Code unless otherwise indicated.

IV.

History

Prior to 1942, alimony and like payments were received tax free by the wife and were not deductible by the husband. The Revenue Act of 1942 changed all this and thereafter alimony payments were taxable to the wife. The Congressional Record indicates that the reason for the change was that, due to high wartime tax rates, many husbands could not meet both their alimony obligations and their tax obligations. The fact that this change drastically reduced the wife's spendable income did not seem to concern Congress. For example, a wife with a $24,000 alimony suddenly found this amount reduced to $14,000 after taxes; a wife receiving $12,000 found this reduced to approximately $8,600. One must assume that there were few divorcees in Congress in 1942.

In the early litigation over these sections the Treasury generally took the position that the payments in issue were not deductible by the husband. With income splitting established in 1948 and with the adoption of Subsections (2) and (3) of § 71(a), (allowing separated couples to agree as to what was deductible-includable), the Treasury's approach changed so that we now find the Treasury generally taking the position that the payments are taxable to the wife.

V.

INCOME TAXABLE TO WIFE

In analyzing the detailed language and effect of the alimony sections, the following points should be kept in mind:

A. Although § 71(a) deals with decrees of divorce, separate maintenance, written separation agreements and decrees for support, the discussion in this article will be limited to cases where there is or will be a divorce. Many of the comments may incidentally be applicable to separation agreements, etc., but no attempt will be made to deal with these aspects specifically and the entire article should be read as applying only to divorce and agreements incident thereto.

B. It makes no difference whether the husband or wife is the payor. Under § 7701(a)(17), husband means wife and wife means husband, when the payment flow is the reverse of normal.

C. If the income is taxable to the wife, it will be deductible or excludable by the husband under §§ 215 or 682. By their terms the sections are perfectly keyed one to the other, with the result that there cannot be a situation where the income would be deductible by the husband but not includable by the wife, or alternately taxed both to the husband and the wife.

In order for periodic payments to be taxable to the wife under § 71(a)(1), they must be made

(1) after the decree
(2) in discharge of a legal obligation, which
(3) because of marital or family relationship
(4) is imposed or incurred by the husband under
(5) the decree or
(6) a written instrument incident to such divorce or separation.

In some of the early cases, particularly those involving Texas decrees, the claim was made that these provisions did not apply where the state law did not provide for alimony. This argument quite properly was not accepted. The language of the statute is very broad and if the obligation is incurred (by the husband) because of the marital relationship, the statutory requirement is literally met and the payments become taxable to the wife.[2]

Frequently settlement agreements were amended after the decree of divorce had been entered. For some time the courts wrestled with the problem of whether the amendments had the effect of shifting the tax burden. It is now clear that the word "incident" in the phrase "a written instrument incident to such divorce means "incident" to the *status* of a divorce rather than incident to the *decree* of divorce.

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[2] Thomas E. Hogg, 13 T.C. 361 (1949).

Under this case[3] and the cases therein cited, it is now clear that a settlement agreement can be amended so as to shift the tax burden in accordance with its terms.

In this area the only question not yet ruled on by the courts is the effect of a post-divorce agreement where there is no agreement entered into at the time of the divorce and where the decree made no provision for any payment to the wife.

VI.
SUPPORT OF CHILDREN

§ 71(b) excludes from the operation of §71(a) payments to support minor children. The key word in this subsection is the word "fix" and in order to prevent the payments being deductible-includable the agreement must "fix" the amount as a sum which is payable for the support of such children.

For some time the courts were in disagreement as to the meaning of the word "fix." Some courts took the position that if the amount intended as child support could be computed, this amount would not be taxable to the wife.

Last year this problem was pretty much laid to rest by the United States Supreme Court in *Commissioner v. Lester.*[4]

There were three children in *Lester* and the agreement provided that the monthly payment to the wife was to be reduced by one-sixth when a child died or married. It was thus clear that one-half of the monthly payment was for the wife's support and a one-sixth of the monthly payment for each child. The Treasury rulings in effect prior to this decision took this position.

The Supreme Court took the other view and held that this agreement did not "fix" in terms or "amount of money or a part of the payment, as a sum which is payable for the support of a minor child. . . ."

The Treasury has just amended its rulings to comply with *Lester.*[5]

Although *Lester* and the above ruling do not solve all of the problems in this area, they do provide a sufficient guidepost so that careful drafting will achieve the desired results. If payment for the support of the child is to be tax free to the wife, the agreement should be clear that the payment is being made to the wife for the support of the child (naming the child) and stating its amount in dollars. Out of an abundance of caution, the agreement might contain a provision obligating the wife to spend all of these amounts on the child.

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[3] Newton v. Pedrick, 212 F.2d 375 (2d Cir 1954).
[4] 366 U.S. 299 (1961).
[5] Rev. Rul. 62-53, 1962 INT. REV. BULL. No. 16, at 8.

VII.

Principal Sum Paid in Installments

§ 71(c) excludes from the operation of § 71(a) installment payments discharging a part of an obligation, the principal sum of which is specified in the decree instrument or agreement. Paragraph (2) provides that the above rule shall not apply where the installments are or may be (by the terms of the agreement) payable over a period of more than ten years.

If the installments extend over more than ten years, the deductible-includable portion of a payment is limited, in any one year, to ten per cent of the principal amount.

The provisions of § 71(c) seem clear enough. Nevertheless, they have given the courts considerable difficulty and the decisions are far from uniform in their results.

One of the difficulties stems from the meaning of the word "specified" in the phrase "principal sum which is . . . specified in the . . . agreement." The other involves the question of whether the payment is occasioned "because of the marital or family relationship."

As with the cases dealing with payments to support minor children (§ 71(b)), the earlier cases here held that if the amount of the principal sum could be computed and was not subject to any contingencies it fell within the general rule of Subsection (c) and was not deductible-includable. Nevertheless, in *Myers v. Commissioner*,[6] the 9th Circuit held that the payments under an agreement (with no contingencies) to pay $250 per month for six years were deductible-includable because the principal sum was not *expressly* specified in the agreement. In view of its holding in *Lester*, it would seem that the Supreme Court would follow *Myers* should the matter come before it.

A much more difficult problem is presented where it is asserted that the payments are not made "because of the marital or family relationship" but are made as payments for property retained by the husband which was earlier the wife's separate or community property prior to the divorce. Thus the 5th Circuit holds that an agreement to pay $1,000 a month until $125,000 had been paid was not deductible-includable as it was a payment to the wife for her share of the community property.[7] As the principal was specified and as the payments were to continue for over ten years, the payments would seem to fall within Paragraph 2 of § 71(c) and be periodic payments within the meaning of § 71(a). The holding, in effect, is that § 71

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[6] 212 F.2d 448 (1954).

[7] Campbell v. Lake, 220 F.2d 341 (1955).

and the related sections are not applicable *at all* because these payments were not made because of the marital relationship, but were, in effect, the purchase price paid by the husband to the wife for her share of the community property. Viewed in this light the 9th Circuit's recent decision in *Riddell v. Guggenheim*,[8] is correct and not inconsistent with *Campbell*. In *Guggenheim* the payments were to be made over a period of less than ten years but were contingent upon the wife not remarrying. Because the 9th Circuit could not determine the nature of the payments from the record, it remanded the case to the Trial Court for determination as to whether the payments were in the nature of alimony or were payments for property owned by the wife prior to the divorce.

Although the point has not been raised in the reported cases, it seems to the writer that there is a possible distinction between a payment to the wife for her interest in community property on the one hand and a payment to her for her interest in noncommunity property on the other. If § 71(a) be construed broadly to apply to any payment made "because of the marital relationship," periodic payments to the wife which (in effect) purchase her interest in the community property would fall within § 71(a) as there can be community property only where there is a "marital relationship."

If § 71(a) were held applicable to payments to a wife for her interest in community property another and broader problem would be presented. It is a very basic concept of income taxation that no taxable income is realized until the taxpayer has received something more than the cost of his investment, *e.g.*, has recognized gain. If these payments were fully taxable to the wife under § 71(a), this rule would be violated. The wife would be doubly penalized. She would not only have to pay tax on all the receipts (rather than on just the gain) but at ordinary rates instead of at capital gains rates.

The Treasury seems to recognize that payments otherwise deductible-includable are not so if the payments are, in fact, payments for a property interest. Reg. 1.71-1(d) provides where the payments are to be made within ten years they will not be installment payments enjoying the benefit of § 71(c) if they are both subject to contingencies and are in the nature of "alimony or an allowance for support." Thus the Treasury appears to take the position that even though there is a specified amount payable in installments and even though there are contingencies, the payments will not be deductible-includable unless they are also in the nature of "alimony or allowance for support."

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[8] 281 F.2d 837 (1960).

The writer cannot resist recounting a personal experience. A Revenue Agent had under review both the husband's and the wife's return. The writer was representing the wife and the husband was represented by a lawyer who was well versed in tax law. The husband and wife had not been able to agree as to the division of their property, all of which was community, and the court in the divorce decree had itself allocated the properties among the parties. After making the allocation the court in this decree added the following: "As a further division of the community property the husband shall pay to the wife $40,000 in monthly installments of $200." (Neither the writer nor the other lawyer represented the parties in the divorce proceedings.)

The husband had deducted all of the payments made but the wife had not included any of them. The writer, of course, was arguing that the payments were payments for the wife's interest in the community property. The other lawyer was arguing that payments extended over ten years and were consequently periodic payments. The Agent, having a keen sense for compromise, advanced the argument that if all of the installments were truly payments for her interest in the community property, the full $40,000 would have all been due at the time the decree was entered, and, if so, the deferred balance should have borne interest. He further suggested that perhaps the court had added in an interest factor in arriving at the gross sum. He offered to settle both cases on the basis of a four per cent interest factor being taken up as income by the wife and deductible by the husband. The lawyers were able to convince their respective clients of the virtues of this compromise and both cases were settled on this basis.

In order to avoid all these uncertainties in cases where the principal sum is in fact being made as a payment for the wife's property rights, the agreement should contain a recitation clearly stating this, and, in addition, this principal sum should be stated in dollars. Also, the payments should be completed within the ten year period. It is also the writer's opinion that the agreement should provide for interest on the unpaid balance. This would under different rules be deductible-includable.

Whether or not the wife recognizes capital gains or losses on such a transaction is discussed below.

VIII.
Community Income Received After Divorce

It has been repeatedly held that community income earned prior to divorce but received thereafter retains its community characteristics and consequently — and irrespective of the agreement — is taxable one-half to the husband and one-half to the wife.[9]

It is not the purpose of this article to go into the question of whether or not a husband and wife can change the nature of income already earned from community to separate property or to discuss the much-written about problems of the assignability of income. Nevertheless, the knowledgeable lawyer will keep in mind the rule in *Johnson, supra,* and take it into consideration in his bargaining and in the drafting of the agreement. This usually can be covered by providing that the husband shall remain liable for all income taxes resulting from the income-producing activities of the parties prior to divorce.

IX.
Insurance

Quite frequently the parties will own life insurance and it is necessary to make some disposition of it in the agreement.

It is the writer's opinion that life insurance should not be assigned completely to the wife with the husband continuing to be liable for the premium payments. If all rights are assigned to the wife, so that she completely controls the policy, the premium payments will be deductible-includable and the result will be, of course, that the wife will be required to pay income taxes on money that never reaches her bank account, and, in addition, will be making what amounts to enforced savings. Of course, she can cancel out the insurance but this is often done at a sacrifice.

If there is valuable life insurance at the time of the divorce, the wife should either release any interest in it to the husband or it should be used as security for the husband's future obligations, particularly the obligations that will survive his death. In such event, premium payments will not be deductible-includable.

It might be noted that the 2nd Circuit has just ruled that where the life insurance policies have been irrevocably assigned to the wife, the full premium is deductible-includable and not just the part which is reflected in the increase in cash surrender value.[10]

X.
Property Settlements as Taxable Gifts

Prior to 1954, taxpayers were faced with the problem of whether transfers of property under settlement agreements constituted gifts within the gift tax provisions of the Internal Revenue Code. § 2516

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[9] Johnson v. Commissioner, 135 F.2d 125 (9th Cir. 1943).

[10] Hyde v. Commissioner, C.C.H. STAND. FED. TAX REP. ¶9402 (2d Cir. April 5, 1962) (Advance Sheets).

eliminated most of the problems here by providing that transfers made pursuant to a written agreement in discharge of marital rights or for the support of minor children will not constitute taxable gifts if the divorce occurs within two years after the execution of the agreement.

XI.
PROPERTY SETTLEMENT AGREEMENTS CONSTITUTING DEDUCTIBLE CLAIMS FOR ESTATE TAX PURPOSES

Although there has been considerable litigation over whether a husband's unperformed obligations under a settlement agreement constitute a claim against his estate for estate tax purposes, it is now well settled that if the settlement agreement has been incorporated in the divorce decree the agreement will create a claim against the estate which will result in a deduction under § 2053. The 3rd Circuit, in *Beecher v. United States*,[11] held that an agreement, the consideration for which was the wife's release of her marital claims, to bequeath one-fourth of his estate to each of his four sons, resulted in the sons taking as creditors of the estate rather than legatees. In arriving at the decision the court was aided by the fact that a probate court in Pennsylvania had ruled that the effect of the agreement was to make the sons creditors of their father's estate.

XII.
SETTLEMENT AGREEMENTS AS TAXABLE EXCHANGES

The greatest confusion in the divorce tax law is not occasioned by the alimony sections themselves but by other sections, notably those dealing with gain or loss on the disposition of property (§§ 1001, 1002, 1011 and related sections). In this area there are two major problems, one involves the question of whether a taxable exchange has occurred, and the other (assuming a taxable exchange) whether gain must be recognized and in what amount.

The problem is accentuated by the fact that results differ depending on whether the settlement involves community property or noncommunity property.

In noncommunity property settlements the question is simply a question of whether a husband recognizes gain and if so how much gain, if he transfers to his wife low costs assets which have substantially increased in value. In community property settlements this same problem may exist but more usually a second problem is present. A

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[11] 280 F.2d 202 (3rd Cir. 1960).

wife may recognize gain by releasing her interest in community property in exchange for the husband's promise to pay her a fixed amount, either in a lump sum or in installments. Her gain is the difference between the tax cost of her community interest and the fair market value of the husband's promise.

The leading case in the noncommunity property area is *Mesta v. Commissioner.*[12] Pursuant to the agreement, the husband had transferred to the wife securities which had substantially increased in value. At the time of the transfer there was no question as to the value of the securities. The court held that there was a taxable exchange and that the husband recognized a gain.

Under § 1001, the gain is the difference between the tax cost of the asset and the amount realized on the exchange. § 1001(b) defines the amount realized as the sum of any money received plus the fair market value of the property (other than money) received. *Mesta* did not receive cash but received relief from the obligation of supporting his wife, etc. As the securities transferred had a clear fair market value, the court held that the value of the support rights, etc., were the same as the value of the securities.

Mesta was thought to set forth the applicable law until the 6th Circuit in 1960 decided *Commissioner v. Marshman.*[13] In *Marshman,* the court followed *Mesta* to the extent of holding that there was a taxable exchange. Nevertheless, it held that it was impossible to determine the value of what the husband received. This impossibility was due to the fact that there was a genuine dispute between the husband and the wife over some prior contractual relations, and a dispute as to the value of the assets transferred. In addition, the court pointed out there were intangible values involved in settlements that could not be measured in dollar amounts. Last year the Court of Claims decided *Davis v. United States*[14] in accordance with *Marshman,* holding that the value which the husband received was not susceptible to precise evaluation and consequently that the gain could not be measured.

The *Davis* decision has been appealed to the United States Supreme Court and was argued before the Court in March of this year, so that this conflict may shortly be resolved.[14a]

As pointed out above, a *Mesta* type situation can be present in community property settlements. Nevertheless, the reverse situation

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[12] 123 F.2d 986 (3rd Cir. 1941).
[13] 279 F.2d 27 (6th Cir. 1960).
[14] 287 F.2d 168 (Ct. Cl. 1961).
[14a] See Addendum, p. 38, for Supreme Court action.

occurs more often as the wife frequently surrenders an interest in community property in exchange for cash or a promise to pay a fixed sum in installments.

It has repeatedly been held, and the Treasury agrees, that if the property settlement agreement merely calls for the division of the community property no taxable exchange occurs. It is also clear that such a division does not require splitting each asset in half. Thus, if the community property consists of a house worth $20,000 and marketable securities worth $20,000, the husband may take the house and the wife the securities without either recognizing gain. It should be borne in mind that the basis of these properties to the recipients continues to be the tax costs to the community.

Unfortunately such an equal division is usually not possible nor desirable. This is particularly true where the principal asset of the community is an interest in a business either in the form of stock or a partnership or a sole proprietorship. Usually the wife does not want to be involved in the business and the husband wants to continue it without interference from her. The result is that the parties will agree to the division of certain assets and in addition, the husband will agree to pay the wife a fixed amount representing roughly one-half the difference between the assets taken by him and the assets taken by her. It has been repeatedly held that in such settlements the wife recognizes gain to the amount of the difference between her basis in the property released and the value of the husband's promise.[15]

Under another line of cases, if the husband's promise has no fair market value the gain may not be realized.[16]

Under § 1031, property held for productive use or investment may be exchanged for other property held for like use. A confused situation could be further confused if the settlement agreement involved the exchange of this type of property.

§ 453 permits the reporting of gain from certain sales on the installment basis. Subsection (d) provides that the deferred gain is immediately realized if the installment obligation is disposed of. If the community owns such obligations and the wife releases her interest in these to the husband, she would forthwith recognize a gain to the difference between her basis in the installment obligations and the value of what she received. This might be a substantial hardship on her if what she received was also a promise to pay a fixed sum in installments over a period of years.

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[15] Johnson v. Commissioner, 135 F.2d 125 (9th Cir. 1943).
[16] Clarence W. Ennis, 23 T.C. 799 (1955).

It is the writer's considered opinion that gain should not be recognized under these circumstances. Although an exchange does occur, it is not an ordinary business transaction and is more akin to an involuntary conversion. Under the Code, many completely voluntary exchanges may be made tax free and it would seem to be just as equitable to defer gain here as in corporate reorganization.

In *Davis, supra,* the Supreme Court has an opportunity to abolish or drastically soften the rule of *Mesta.* If it does so, legislation may not be necessary. If it reverses *Davis,* it will then be up to Congress to amend the Code so as to provide that these exchanges may be made tax free. In such cases the old tax basis should be carried forward. Gain would then be postponed until the transferred assets were sold by the transferee.

XIII.

Recommendations and Conclusions

In order to draw a proper agreement it is first necessary to make a full analysis of the parties' properties. In doing so the tax costs of each important item should be determined, particularly those where there has been a substantial increase in value. Wherever possible, these items, if owned as community property or in joint tenancy, should be divided equally between the parties. If the parties are reporting earlier sales on the installment basis, ownership of these should not be disturbed. Future collections can be handled by directing the obligator to make the installment payments to a bank or title company which concern can remit each party's share of the collection directly to them.

If the principal asset consists of stock in a closely held corporation owned as community property and if the draftsman concludes that the husband must "buy" the wife's interest in the stock in a taxable transaction, the agreement should provide for payments in such a fashion as to allow the wife to report the gain as she receives the payments on the installment basis.

Where the payments are deductible-includable, the draftsman should make it clear that the payments are primarily for support, and, in addition, introduce as many contingencies as possible confirming this.

If the payments are not to be deductible-includable, the principal sum should be stated, the payments completed in less than ten years and interest on the unpaid balance provided for.

If payments for support of the children are not to be deductible-includable, the agreement should clearly fix the amount payable for each child, recite that they are for the support of the child and further that they must be spent by the wife for the child's support.

Consideration should be given to providing for both deductible-includable and non-deductible-includable payments. This can give flexibility and may permit the husband to apply all payments to the principal sum in low income years where deductions are not needed by him. Also, where both types of payments are provided for there is less likelihood of effecting a taxable exchange with a measurable gain.

It is recognized that it is difficult to prepare an ideal agreement where relations are as strained as they usually are when there is a divorce pending. Nevertheless, it is the author's experience that it is much easier to bring about an agreement if it can be demonstrated that careful tax planning has been done and that the proposed agreement will bring about the lightest possible tax load.

ADDENDUM

On June 4, 1962, the U. S. Supreme Court handed down its decision in *United States v. Davis,* 82 Sup. Ct. ——, (No. 13), 62-2 USTC 5909, reversing the Court of Claims. In so doing it makes several interesting points.

1. It holds that there was a taxable exchange (citing *Mesta* and related cases) and not a non-taxable division of property. The property was not community property.

2. It holds that the value of the "property received," (release of the wife's support rights) equalled the value of the property transferred. The property transferred was DuPont stock and consequently there was no evaluation problem.

3. It holds that the above proposition will be true in the absence of evidence to the contrary.

4. By way of dicta, it states that the wife's basis will be the value of the property at the time of transfer.

5. In a footnote, the Court gives tacit approval of the present administrative practice which treats the wife's release of marital rights in exchange for property as a non-taxable event as to her.

Under this case it would now seem clear that in simple cases where properties of readily ascertainable value are transferred, *Mesta* is reaffirmed. In cases where determining the value of the properties transferred is complicated and confused, the *Marshmann* rule may still come into play.

As indicated in the body of the article, it is felt that legislation making these exchanges tax free exchanges is the most desirable solution. Absent such legislation, the cautious lawyer will check carefully the cost of the husband's securities, and, in, general, should recommend the use of high cost assets. Particular care should be used to avoid using property which might result in ordinary income rather than capital gains.