1975

# Federal Taxation in Separation and Divorce

Edward S. Graves

# FEDERAL TAXATION IN SEPARATION AND DIVORCE

EDWARD S. GRAVES

Two recent Circuit Court decisions [1] remind the practitioner in the field of separation and divorce that opportunities are open for the minimization, or at least the advance arrangement for the impact, of taxes on husband and wife, and that the failure to make such arrangements sufficiently specific may lead to a court's properly reaching an inexact result.

Before the enactment of the Revenue Act of 1942,[2] there was very little that counsel could do in this area. Even though a trust might be set up to support the taxpayer's wife, so that the income given to her did not pass through his hands, the husband got no tax benefit from funds paid to the ex-wife for her support either by deduction or exclusion [3].

At the present time, counsel, with appropriate knowledge of §§ 71, 215, 682 and 152 of the I.R.C.[4] and, in case of more sophisticated arrangements, of § 101 and § 83, will be expected to make appropriate arrangements for the impact of taxes, and perhaps be responsible for failure to do so.

Ideally, although the temptation in domestic relations matters is to give full vent to lawyer's inclination to play the rôle of an advocate rather than a counsellor, the impact of taxes should be negotiated by the parties and their attorneys with full knowledge of the applicable facts and law. In most cases, the relationship of the parties will be a continuing one, even in the absence of children of the marriage, but more so if there are. While the Virginia Code [5] does permit agreements between the parties which are not subject to change, the wisdom of such arrangements in many instances may be questionable. Obtaining through greater knowledge of tax law or more inflexible negotiation an initial advantage taxwise may, in later years, make the solution of problems subsequently arising, because of changed conditions or otherwise, more difficult.

---

[1] *Fox v. U.S.*, 510 F.2d 1330 (3rd Cir. 1975); *Hayutin v. C.I.R.*, 508 F.2d 462 (10th Cir. 1975). For an interesting contrast of the effect of State Court decisions on tax consequences, compare the *Hayutin* case with the *Collins* case, *infra*, Note 17.

[2] Act of October 21, 1942, Ch. 619, § 120, 56 Stat. 816.

[3] *Gould v. Gould*, 245 U.S. 151 (1917); *Douglas v. Wilcutts*, 296 U.S. 1 (1935). The *Wilcutts* decision and that in *Helvering v. Fuller*, 310 U. S. 69 (1940) had led to the enactment, in the Internal Revenue Act of 1942, of a remedial provision respecting trusts. See discussion concerning trusts, text accompanying Note 31 *et seq.*

[4] This article will use I. R. C. as shorthand for Internal Revenue Code, and will attempt not to confuse this with references to the Code of Virginia.

[5] Code of Virginia, § 20-109 and *Dienhart v. Dienhart*, 210 Va. 101, 168 S.E.2d 279 (1969).

One more preliminary matter: reading or summarizing tax statutes in the abstract is not only difficult but soporific. The writer will therefore embark upon a discussion of the Statutes by taking a specific case, not unrelated to reality, but of course with the names, figures, and situation changed to protect the innocent, which will trigger applicable principles.

Assume that the husband in the case has been earning adjusted gross income of $42,000.00 per year; and that the wife has taxable gross income from investments producing $16,000.00 after taking account of capital gains. There are no children, or all are emancipated; and no other dependents. Making arbitrary assumptions of the total amount of deductions, and using the two exemptions, a joint return would produce a federal income tax of $17,410.00.

The parties have been living apart for approximately a year, and the husband has been paying all expenses, including utilities used by the wife in their former marital home, which is in his name alone, but in which she is, with his consent, continuing to live. According to his checkbook, the wife should be able to meet most of her basic expenses on alimony of $900.00 per month, using some of her income in the future, as she has in the past, for some of her expenditures on herself and gifts to the adult children. If he pays her this alimony, and we continue the arbitrary assumptions, his tax would be $7,702.50, which would leave him $23,498.50. If he paid the entire tax out of his $42,000.00 while he and his wife were living together and filing a joint return, he would have left, after alimony and income tax, $24,590.00. Thus far, and recognizing that his wife would need approximately the amount of alimony stated to continue to live according to the standard established during their marriage, the figures look reasonably palatable to him.

Following the same procedure in estimating the wife's Federal income tax, we would come up with a figure of $6,690.00, which would leave her $20,110.00 from her $16,000.00 plus the assumed alimony of $10,800.00. This would be contrasted with the husband's $23,498.50 after taxes.

She may be somewhat unhappy, not only because he has more money than she does after taxes, but also because she does not like the idea of paying so much income tax. Again, figures may help.

Calculations show that if she paid, at the lower brackets, the tax on her $16,000.00 but required the husband to pay the additional tax on the $10,800.00, he would pay her an additional amount of $3,200.00. This would result in her Federal income tax being $8,017.50; but she would have after taxes $21,982.50. The husband, assuming that he paid her the additional $3,200.00, would pay taxes only in the amount of $6,410.00; and after making payments to his wife totaling $14,000.00, and the tax in the reduced amount of $6,410.00, would have left

$21,590.00 instead of $23,498.50. The wife would have left $21,982.50 instead of $20,110.00.[6]

It is to be noted that the husband is paying the tax in the wife's upper brackets. If her independent income rises, he will be paying taxes on her alimony at even higher rates. He may demand, and be reasonably entitled to, a limit; a suggested, somewhat complicated, provision is set out in Appendix B.

The calculations and negotiations are, of course, based on I.R.C. § 71 for taxation to the wife, and the co-relative I.R.C. § 215 permitting deduction by the husband. The payments by the husband to the wife must be periodic, although, according to the express words of the Statute, they need not be made at regular intervals. They must be made (unless pursuant to a decree for support entered after March 1, 1954) because of the marital or family relationship, so that, as the Regulations point out[7], repayments by the husband to the wife of bona fide debt would not receive the alimony treatment. They must be made, if pursuant to a support decree, under one entered after March 1, 1954, so that amounts ordered to be paid as temporary alimony pendente lite, for example, would be deductible even before regular payments were fixed. If payments are not made pursuant to such a decree, they may receive the alimony treatment if made pursuant to three other documents.

The first of these is a decree of divorce or of separate maintenance which requires periodic payments in discharge of a legal obligation imposed because of the marital or family relationship (§ 71(a)(1)). The second is a written contract incident to a decree of divorce or separate maintenance (§ 71(a)(1)). The third is a written separation agreement, entered into after August 16, 1954 (§ 71(a)(2)). If payments are made pursuant to a written separation agreement or a decree for support entered after March 1, 1954, the Statutes expressly state that the alimony treatment is not accorded if the husband and wife made a single return jointly. They may do so, pursuant to I.R.C. § 6013(d)(2) unless they are "*** Legally separated*** under a decree of divorce or of separate maintenance***". Consequently § 71(a)(1) lacks the words "This paragraph shall not apply if the husband and wife make

[6] More detailed calculations are set out in Appendix A in order to furnish the figures to the reader, and at the same time not to divert his attention from the main stream when he reads the article. It is hardly necessary to say that it might be possible for the husband to pay the entire tax attributable to the receipt of alimony by the wife, but since, as he pays her taxes, he increases her income and thereby increases her tax, the calculations would have to be much more complicated. In addition, the husband will probably resist before he reaches the ultimate point. If he does, Exhibit B, or something like it, may be in order. It is of course assumed that counsel has checked to see that husband and wife are married; if not, a complicated unscrambling of eggs may be attempted. See, e.g., *Borax's Estate v. C.I.R.*, 349 F.2d 666 (2d Cir. 1965).

[7] Treas. Regs. § 1.71-1(b)(94).

a single return jointly"; this provision is included in both § 71(a)(2) and (3), applying to cases in which payments are made pursuant to a written separation agreement or a decree for support entered after March 1, 1954.

Virginia lawyers may be concerned about whether a decree of divorce *a mensa et thoro* is such a decree of divorce or separate maintenance as triggers § 71(a)(1). The Service has taken the position that the statute applies to such divorces as well as to final divorces; and the matter has been successfully ligitated by the Service with respect to a Maryland divorce *a mensa et thoro*.[8]

Turning to another aspect of our assumed case, the residence of the parties belonged to the husband, who was permitting the wife to live there rent free. Thus far, the rental value of the house to the wife is not considered as alimony.[9] If, instead of making payments directly to the wife, the husband were to pay, under these circumstances, for such items as utilities used by her in the home, these payments would receive the alimony treatment, as payments made indirectly, to discharge the wife's obligations, rather than directly to her.[10] Similarly, had the parties entered into a written separation agreement effective after they had separated, payments made pursuant to such an agreement by him to those furnishing other supplies or services to the wife would have been deductible, if the parties did not make a joint return. Complications arise in this area where the home is in the name of both parties, and secures an indebtedness of the parties or of the husband alone. If the husband continues to make payments on the note, one-half of such payments are considered as alimony to the wife.[11] The soundness of this position has been questioned, since the ownership of property given as security for the loan of X does not make the owner of the property an obligor under X's note.[12] That the position of the Service in this regard may be unsound is illustrated by cases holding that the husband is not entitled to alimony treatment for deferred payments made on the security of an automobile in both names, the possession of which is given to the wife.[13] Frequently, an agreement or decree will provide for the husband to pay all joint indebtedness of the parties. Such decrees or agreements may be based upon the knowledge that creditors frequently require joint obligations of husbands and wives, currently, because much of the property paid for by

[8] *Sullivan*, 29 T.C. 71, aff'd., 256 F.2d 664.

[9] *Pappenheimer v. Allen*, 164 F.2d 428 (5th Cir. 1947). As far as the husband is concerned, this may be affected by the provision of § 71(d) that the husband is not required to report income from property transferred for the use of the wife.

[10] See, e.g., R.I.A., 4 Tax Coordinator, ¶ 6023.

[11] See Rev. Rul. 67-420, 1967-2 Cum. Bull. 63.

[12] See Graves, Federal Taxation in Separation and Divorce, XXIX Washington and Lee Law Rev. 1 (1972).

[13] See R.I.A., 4 Tax Coordinator, ¶ K-6125, p. 32,338.

him is placed in the names of both parties as tenants by the entirety, and property so held is not subject to the claims of creditors of the individual husband or wife.[14] The indebtedness may really be that of the husband, the discharge of which should not be attributed as a payment made indirectly on behalf of the wife. This is one of the fuzzy areas in a field of the tax law which is, as above demonstrated, otherwise reasonably clear and well settled; and counsel would be advised to act accordingly in clarifying the agreement of the parties or the order of the court.[15]

In continuing to consider the arrangements made or contemplated by the husband and wife in our assumed situation, the wife and her counsel may be concerned about making provisions in the event of the husband's premature death, or failure of his earning capacity. Several lines may be explored by counsel.

The first would be the possibility that the husband might make a one-time transfer to the wife of property, such as the residence or securities. This, of course, initiates the problem of the lump sum transfer—not entitled to the alimony treatment above discussed—as contrasted with periodic payments. In addition, a decision of the United States Supreme Court[16] should be kept in mind since its effect may be especially troublesome. In the *Davis* case, the Supreme Court held that where property is transferred by the husband to the wife as a part of the settlement of their marital affairs and interests, the transfer is a taxable event, in which capital gain is recognized. The wife receives a new basis in the property, being its market value at the time of transfer. Knowledge of this principle may affect the negotiations, influencing the choice of property to be transferred, or furnishing an occasion to the husband to take offsetting losses in other securities which he holds.

---

14 *Vasilion v. Vasilion*, 192 Va. 735, 66 S.E.2d 599 (1951).

15 Additional problems may arise because of the placing in both names of property purchased by the husband. For example, I.R.C. § 2515 shields the parties from gift tax as to real estate placed in both names; and such property, so held until the death of one of the spouses, is then subject to estate tax based upon its value at date of death and the proportionate part of its cost contributed by the decedent. Sec. 2516 shields from gift tax a transfer of property made pursuant to a written agreement entered into within two years of a divorce decree. If a tenancy by the entirety in real estate is automatically severed, so that the wife becomes a tenant in common of a residence completely paid for by the husband, the transfer of the property interest to her is effected by provisions of law rather than by the written agreement contemplated by I.R.C. § 2516. Is a gift tax due? The question may be more acute when property other than real estate is put into the names of husband and wife. Such a transfer is not shielded from gift tax by I.R.C. § 2515; and dormant questions of gift taxation may be brought to the surface by the separation of the parties. These and other questions, intriguing and perhaps not definitively answered, are beyond the scope of this discussion; but it is hoped that this footnote will alert counsel to their possibility.

16 *United States v. Davis*, 370 U.S. 65 (1962).

In addition, of course, the husband may decide, because of *Davis*, not to make a transfer which he is otherwise willing to do.

The *Davis* case is not applied where the wife receives her pro rata part of property to the acquisition of which she has contributed, whether the property is in the name of the husband alone or in both names. In the *Collins* case,[17] the husband transferred to the wife a substantial amount of closely held stock, but by means of knowledgeable negotiations and agreement between the parties, the court ultimately accepted the argument that the wife had received from the husband only the fruits of her own investment. On the other hand, in the *Hayutin* case,[18] while the fact was undisputed that the wife had from time to time furnished the husband with substantial amounts of money, the parties failed to agree on an allocation to the wife of an interest in the husband's property. Consequently, the lower court made an allocation of current payments between alimony and repayment which evidently impressed husband and wife as arbitrary, since both appealed. The Circuit Court refused to require a further delving into the facts, and affirmed the decision of the lower court, on the ground that the record showed that there was a "rational basis" for its decision. A comparison of the *Collins* and *Hayutin* cases leads to the conclusion that taxes may be minimized, and the husband protected from a capital gains tax if the facts are appropriate.

The *Davis* decision always should be kept in mind where the residence of the parties is in the names of both, and the husband wishes to convey his interest to the wife. If, as in the situation which we have postulated, the home belongs to the husband, and he agrees to convey it to her, he will realize gain if the property has appreciated. If the wife agrees that she will give up the residence if he will furnish her another, serious consideration should be given to his increasing the alimony in the amount necessary for her to rent an apartment, or his paying the rent on an apartment for her. In either case, the payments would get the alimony treatment. On the other hand, if he attempts to buy another house for her, either outright or by assuming payments secured by the new residence, no alimony treatment will be accorded his payments unless arrangements are so made that they may qualify as periodic payments.[19]

This brings us to consideration of I.R.C. § 71(c).

If the husband and wife agree that he will transfer a principal sum to her instead of (or in addition to) the periodic payments which we first discussed, alimony treatment will be accorded to the payment

---

[17] *Collins v. Commissioner*, 412 F.2d 211 (10th Cir. 1969).

[18] See note 1, *supra*.

[19] Ideally from a tax point of view, the husband might rent his house to the wife, giving her additional alimony in the amount of rent and approximately the income tax on the additional alimony. He can then, in addition to deducting the increased alimony, deduct landlord's expenses, including depreciation.

of the principal sum if it is made over more than ten years in equal annual installments, or the full payment thereof is subject to the contingencies of (a) the remarriage of the wife, (b) the death of either party, or (c) a sufficient change in the economic status of either party.[20]

In the *Fox* case,[21] the husband agreed to pay to wife the sum of $1,000,000.00 over a period of 9½ years. The opinion of the Court, while denying what it termed "innovative contentions" of the taxpayer, took note of the fact that the parties contracted with knowledge of the applicable tax statutes, arranging for the wife to receive a lump sum of money without the imposition of tax to her and without a deduction for the husband.

The impact of the two "lump sum" rules permitting alimony treatment to what would not qualify as periodic payments under § 71(a) may be illustrated and clarified by consideration of measures which may be adopted to obtain the deduction of a substantial part of the wife's attorney's fees. Such fees, attributable to the termination of the marital status, may not be deducted by either party; and the husband may not, at least without considerable trouble, get any tax benefit from his payment of attorney's fees for work done on the settlement agreement (except for tax work under § 212(3)).[22] The wife, however, in paying fees to obtain the husband's agreement to pay her alimony, is expending money for the production or collection of income; and her expenses, including counsel fees, are thus expressly deductible under Statute.[23] Her attorney must allocate and bill her separately for the time he has spent in such endeavor; and she may thereupon deduct her payment to him. She can also, like her husband, deduct amounts paid for tax services deductible under I.R.C. § 212(3).[24] If the husband can take a tax deduction for any part or all of the wife's attorney's fees, it is more likely that he will agree to bear all or part of this expense.

There are three possibilities of so arranging these additional payments to the wife as to make them deductible by the husband. First, the husband may agree to pay the full amount over ten years and one month. While lawyers often have to wait a considerable time to be

---

[20] The contingency rule is a creation of the Regulations, § 1.71-1(d)(3). Note the peculiar Virginia Statute, Code of Virginia, § 20-109, which may prevent the court from making a change in the agreement of the parties. See note 5, *supra*.

[21] See note 1, *supra*.

[22] See *United States v. Patrick*, 372 U.S. 53 (1963) and *United States v. Gilmore*, 372 U.S. 39 (1963).

[23] See I.R.C. § 212(1).

[24] For a discussion of the deductibility of costs of advice concerning tax planning, see R.I.A., 4 Tax Coordinator ¶ L-1922, specifically relating to such advice in domestic relations matters, and ¶ L-2001 *et seq.*, discussing the subject generally. Counsel should bill separately for such work and advise his client to deduct it.

paid, they seldom have to spread their compensation over so long a period; and such a possible arrangement would certainly not be popular with the Domestic Relations Bar.

Second, for payments to be periodic under I.R.C. § 71(a), they need not be uniform. They may be pegged, for example, to the husband's earnings, to the cost of living, to other inflationary or deflationary safeguards, or to a combination.[25] It should be recognized by all, including the Service, that a wife will incur some unusual expenses, including litigation costs, when the marriage is ended. If several of the first payments by the husband to the wife are larger than subsequent ones, they may still receive § 71(a) treatment although an astute agent might successfully take the position that they add up to a lump sum payable over ten years or less, and are consequently not periodic. If these first increased payments are markedly greater than subsequent payments, it is believed that the Service may be more likely to take the position that they are disguised installment payments of a lump sum.[26]

The third method is to make these as well as other payments qualify under one of the contingencies referred to in Regulation 1.71-1(d)(3)-(i)(a)(b). If they are subject to termination or change by, for example, the remarriage of the wife or the death of either spouse, then they are periodic, and the Service may not successfully take a contrary position.

The attorney, furnishing the occasion for deduction of his charges by two taxpayers, may not still be fully compensated for his work; but he stands a better chance of submitting a bill satisfactory to him and having it paid; and he should be accorded more appreciation by his client and even his adversary.

There are two more features of the two exceptions providing alimony treatment for lump sum distributions. An annual payment qualifying under the more-than-ten-year rule may not be deducted if it is greater than 10% of the lump sum, unless it is to make up arrears.[27] This limitation does not apply to lump sum payments qualifying under the contingencies rule. If an annual installment of a lump sum payment qualifies under both the more-than-ten-year rule and the contingencies rule, it is entitled to the alimony treatment even though it is more than 10% of the lump sum.[28]

The husband's payment of a lump sum, in addition to or in view of periodic payments, has many uses in the marital settlement. Counsel should be prepared, not only to make knowledgeable use of it (like counsel in the *Fox* case); and should also be sufficiently knowledgeable and on his guard to keep his client from being unwittingly caught with a non-alimony lump sum treatment when alimony treatment was contemplated.

---

[25] For a draft of a combination, see Appendix C.

[26] See *Sechrest v. U.S.*, 490 F.2d 102 (4th Cir., 1974).

[27] See Treas. Regs. § 1.71-1(d)(2).

[28] See Treas. Regs. § 1.71-1(d)(4).

In addition to exploring the possibility of the transfer of property to the wife in a single transaction or by installments spread over ten years or less the wife and her attorney may wish to consider other means of obtaining security for her. One which will frequently be thought of is the transfer of insurance policies on the life of the husband. Unfortunately, Congress has not seen fit to include the transfer of life insurance in domestic relation settlements among the exceptions to I.R.C. § 101(a)(2),[29] and the wife may consequently have to treat insurance proceeds on the husband's death as taxable income. Of course there are worse things than including the net amount of life insurance in the wife's gross income on the death of the husband; one is for the wife to get nothing at all upon his death. A solution which might be appropriate in this situation is for the wife to purchase and pay for term insurance on the husband's life.[30] Especially if the parties are sufficiently advanced in years, such insurance should be obtained to tide over the wife during the years immediately preceding her right to Social Security payments, if this exists, and Medicare. Insurance so acquired would not trigger the tax consequences of I.R.C. § 101(a)-(2), but would comply with the beneficent provisions of § 101(a)(1).

Another possibility is the husband's creating a trust to make payments to the wife as a part of the settlement of marital difficulties; this device is of considerable vintage.[31] I.R.C. § 71 (see especially sub-section (d)) and I.R.C. § 682 were obviously inspired by these efforts. The Service suffered a defeat in the only recent case considering the tax impact upon the wife of the receipt of payments from a trust of which she is made the beneficiary as a result of negotiations to settle marital property rights.[32] It has nevertheless adhered to its position that all payments made under a trust which is to be regarded as a § 71 trust are taxable to the wife, whether they represent payments of principal or interest on tax free securities, as ordinary taxable income.[33] On the other hand, the Service acknowledges that the ordinary Rules applicable to the taxation of the beneficiary of a trust are applicable to the wife if she is beneficiary of a § 682 trust.[34] This would result, if the wife were distributed either principal or tax-free income, in her receiving the funds free from income tax consequences.

The problem, then, is how to tell whether the trust for the wife is a § 71 or a § 682 trust. The Service and a substantial number of com-

---

29 Among the favored exemptions are transfers to a partner of the insured, to a partnership in which the insured is a partner, or to a corporation in which the insured is a shareholder or officer. Why such transfers appealed to Congress as more deserving of favorable tax treatment than the settlement of marital rights remains a mystery.

30 She has an insurable interest.

31 See note 3, *supra*.

32 *Ellis v. United States*, 416 F.2d 894 (6th Cir. 1969).

33 See Treas. Regs. § 1.71-1(c)(2) and (3).

34 See Treas. Regs. §§ 1.682(a)-1(a)(2), 1.682(b)-1(a).

mentators cling to the position that a § 71 trust is one that has been established to discharge a husband's obligation to make alimony payments to his wife, whereas a § 682 trust is one that was established prior to and not in contemplation of the marital difficulties.[35] If the husband is able and willing to provide payments to the wife from a trust and one has not been established, it may be to the wife's interest to negotiate for its establishment. If payments that would be tax-free to her are subsequently made, she may take the position that the *Ellis* case is sound, even though the Service may take the position that a step transaction was involved. It is possible that the Service may be wrong and the *Ellis* Court right. The husband is not affected by the position the wife takes in this situation. All payments made to the wife from property transferred by him, whether in trust for the wife or by his purchase of an annuity for her or otherwise, are excluded from his gross income.[36]

The parties may wish to negotiate the assignment to the wife of an employee plan of which the husband is beneficiary. In view of the recent legislation in this field, and the lack of clear authority, no attempt will be made in this article to discuss the tax implications of the use of such property in marital settlements.[37]

The example of a marital settlement involving husband and wife alone has been thus far treated. In addition to the Statutes and authorities above set forth, additional Rules are brought into play where the support of children[38] is involved.

I.R.C. § 71(b) expressly provides that the alimony treatment shall not apply to payments by the husband to wife which the decree or agreement "fix" as for the support of minor children of the husband.[39]

---

[35] See, as setting out another point of view, XXIX Washington and Lee Law Rev., *supra*, note 12, at pp. 14-17.

[36] I.R.C., §§ 71(d), 682(a). This may adversely affect the amount the husband may deduct for charitable donations, medical expenses, and any other items with a limitation based on his gross income.

[37] The matter was subject of a discussion at the American Bar Association meeting in Montreal in August, 1975.

[38] Most of the rules available concern the support of minor children. The husband and/or wife (see, for example, Code of Virginia, §§ 20-91(9)(c), 20-103, 20-107, 20-109, 20-110, and 20-115 illustrating the recently created obligation of support of a spouse and children irrespective of the sex of the obligor) may have to support an adult child. The question of an exemption based on the support of a child who has reached his majority, when the parent may be required to continue to support him because of his educational requirements or because of his being handicapped, has not as yet been adequately covered in the Federal Tax Statutes. "Minor", determined under Federal law, still means a person under 21. See R.I.A., 4 Tax Coordinator, ¶ K-6130, p. 32,342.

[39] I.R.C. § 682 also so provides. If the husband does not pay the entire amount which he has agreed or been ordered to pay for the wife and children, I.R.C. § 71(b) expressly provides that it is regarded as child support and the excess, if any, as alimony. This is obviously intended to impose a tax penalty on husbands who do not pay the full amount required for the support of the wife and children.

The United States Supreme Court held that the word "fix" means what it says; and that a payment of a sum for the support of the wife and children will all receive the alimony treatment, even though it is decreased by a definite amount as a child is emancipated.[40]

A recent Virginia case[41] involved the efforts of a wife, caught in the toils of the *Lester* doctrine, to extricate herself. Her agreement with her husband approved by the court without objection and therefore unchangeable[42] under § 20-109 of the Code of Virginia, provided $930.00 per month for the support of the wife and three children, which sum would be reduced by $150.00 per month upon the death or emancipation of each child. The wife attempted to "split" the agreement by asking that the support for the children be increased (this not being subject to the inflexible principal of 20-109), and that the trial court, accordingly, determine which part of the $930.00 was for the wife and which part for the children. The husband resisted such allocation on the ground that his tax consequences would be adversely affected. The trial court ruled that the amount being paid for the support of the children was sufficient, but that the wife was nevertheless entitled to have the amount paid as alimony and the amount as child support allocated; and ordered the husband to pay $480.00 per month as alimony and a total of $450.00 per month for the three children. The Supreme Court reversed, saying (p. 697):

> "If (the Trial Court) had decided that more child support was warranted, it could have provided therefor merely by adding to the existing award, increasing the total the husband would be required to pay the wife. This disposition would have retained the unitary character of the award, thus protecting the tax benefits to which the husband was entitled under the agreement. Such disposition also would have avoided a possible violation of Code Sec. 20-109 and would have preserved the court's continuing power to supervise child support under Code Sec. 20-108.
>
> "The Trial Court having determined, however, that circumstances had not so changed as to warrant an increase in child support, there was no necessity even to consider the wife's prayer to apportion the award. The Court should have dismissed the wife's petition."

The soundness of the *Lester* doctrine, even though withstanding such collateral attacks as Mrs. Wickham attempted, is subject to question. This being so, the decision may be, and has been, distinguished on somewhat flimsy grounds.[43] The Fourth Circuit in the *West* case, and

[40] *Commissioner v. Lester*, 366 U.S. 299 (1961).

[41] *Wickham v. Wickham*, 215 Va. 694, 213 S.E.2d 752 (1975).

[42] Code of Virginia, § 20-109; *Dienhart v. Dienhart*, *supra*, note 5. This applies only to alimony for the wife; support for the children may be changed pursuant to Code of Virginia, § 20-108.

[43] *West v. United States*, 413 U.S. 294 (4th Cir. 1969); *Commissioner v. Gotthelf*, 407 F.2d 491 (2d Cir. 1969).

the Second Circuit in the *Gotthelf* case have done so, when, in addition to providing for the termination of a specific amount of the payment to the wife as a child was emancipated, there was some adjuration that the wife should spend a certain amount on the children. Counsel should therefore have all four cases in mind when agreements or decrees are drafted, so that the parties will be assured of the tax impact of payments to the wife which are essentially for the support of the children. If the husband is generous and affluent enough, the payments may be larger and lumped together; if not, the wife may well desire that they be "fixed" in the Lester sense.

I.R.C. § 152(e) provides rules which are of considerable assistance in determining which of the parents is entitled to the exemption for a dependent child, although as the examples set forth in the Regulations illustrate, somewhat surprising results may be produced when the non-custodial parent is entitled to the exemption for a child even though the custodial parent has furnished more of the child's support than the non-custodial parent.[44] At the very least, § 152(e) and the Regulations promulgated thereunder should be helpful in bringing pressure to bear on each of the parents to disclose figures to the other parent in connection with a claim for exemption.

For § 152(e) to apply, four requirements must be met: first, one or both parents must provide more than one-half of the child's total support during the calendar year in question; second, such child must have been in the custody of one or both of his parents for more than one-half of such year; third, there must not be an effective multiple support agreement under I.R.C. § 152(e); and fourth, the parents may not file a joint return for the year in question. If these requirements are met, then the general rule is that the parent having greater custody of the child claims him as an exemption.

As an exception to this general rule, the non-custodial parent may take the exemption for the child if, first, he provides at least $600.00 for the child; second, a decree of divorce, a decree of separate maintenance, or a written agreement between the parents provides that the non-custodial parent shall be entitled to the exemption; and third, the non-custodial parent, where the right to the exemption is created by an agreement, attaches a copy of the agreement to his tax return.

There is another exception. If the non-custodial parent contributes a total of $1,200.00 for the support of the child or children of the parties, he is entitled to the exemption or exemptions, in spite of the contrary provisions of the decree of divorce, the decree of separation, or the written agreement, unless the custodial parent clearly establishes that she provided in fact more for the support of the child claimed by the non-custodial parent than did the non-custodial parent. Failure of either of the competing parents to furnish an itemized statement of

[44] I.R.C. § 152(e); Treas. Regs. § 1.152-4(f).

claimed support authorizes the Service agent to deny the exemption to such non-cooperative parent.[45]

The Statute and Regulations, respectively, attempt to forestall questions and difficulties in two respects. The non-custodial parent often questions whether the amounts of money he has furnished for child support are actually expended for child support. The Statute entitles him to be treated for these tax purposes as if all of the money he furnished the custodial parent was expended for the support of the child, whether it was or not.[46]

The Regulations[47] forestall disputes about the meaning of "custody". Custody is taken to be that fixed by the decree or the agreement; and if the decree or agreement is not definite or may not be in effect, then the term means "physical custody".

Some might say that the treatment of periodic payments of alimony, of lump sums paid in installments, and of exemptions for dependent children permit juggling with respect to taxes. Others would say that such treatment permits varied allocations, in the difficult situation where marriage has ended, directed toward minimizing expenses, facilitating the maintenance of two households, and doing so in a manner that will make each of the aggrieved parties feel that he is being fairly treated and is treating the other fairly: and this is a consummation devoutly to be desired.

Thus far we have considered the income tax aspects of divorce and separation. Gift and Estate taxes will be treated briefly to cover this aspect of the subject.

The estate planner, is, of course, duty bound to consider all possibilities for the minimization of transfer and succession taxes. He need not go as far as one astute lawyer who suggested that it was so easy to avoid Gift taxes in the marital settlement situation that his clients should get a friendly divorce in order to effect tax-free transfers; and then remarry and continue on their happy marital career.

Several have, however, been tempted, by the device of pre-marital agreements, or, less preferably, agreements during marriage, to transform a gift to a widow into an obligation, the consideration furnished by her being the relinquishment of marital rights.[48] Congress decided to block this maneuver by the enactment of what is now I.R.C. § 2043(b), applicable to estate taxes, which provides that the relinquishment of dower or curtesy, a statutory estate in view thereof, or other marital rights does not constitute consideration. Consequently an agreement by the husband to pay the widow a sum of money based on such consideration was ineffective to bar the estate tax.

---

[45] Treas. Regs. § 1.152-4(e)(4).

[46] I.R.C. § 152(e)(2).

[47] Treas. Regs. § 1.152-4(b).

[48] See, e.g., *Dwight W. Ellis, Jr.*, 51 T.C. 182 (1968).

The statutory provision was not applicable to gift taxes; but by two decisions, the United States Supreme Court decided that, since estate and gift taxes were *in pari materia*, the substance of the statute would be used to block the same maneuver in the gift tax field.[49]

Where marriage has run into difficulties, and property settlement agreements are being made, there is obviously little question of a gift. Nevertheless, a transfer by the husband to the wife in relinquishment of her marital rights in his property would, under the Supreme Court decisions, constitute a gift, since this relinquishment is not consideration.

It is, however, easy to avoid the impact of gift taxes in such transactions. The first is another creation of the United States Supreme Court,[50] to the effect that if the transfer of property is made pursuant to a decree of a court which has power to order the transfer, the transfer is not without consideration, and is free from gift tax. This result follows even though the decree is based upon a property settlement agreement which expressly provides that it shall survive a court decree.

The second way of avoiding gift taxes is the support way. Property transferred by the husband, pursuant to an agreement incident to a separation, in satisfaction of his obligation to support the wife, is free from gift tax; the relinquishment of her right to require him to support her is consideration.[51] *A priori* it would have been thought that the phrase "other marital rights" in § 2043(b) and the Supreme Court cases applying the statute to the gift tax field would have included the right of the wife to demand that the husband support her. It is gratifying to see that the statute and the case law have been so intelligently interpreted and applied, since obviously there is no gift in this situation. This interpretation is also a notable example of the application of the *eiusdem generis* rule in the construction of a writing.

The decree and support ways of avoiding gift taxes are equally applicable to the avoidance of estate taxes.

There is one flaw in the principles applicable in this field. Thus far no cognizance has been taken of the obligation of the husband to support his adult children in two situations: supporting a handicapped adult child; and educating an adult child. Amounts furnished by the husband for the support of a child in these two situations have not as yet been held free from gift or estate taxes.

The third way of avoiding gift taxes is applicable only to the gift tax, and is based upon a special statute.[52] This statute provides that where husband and wife enter into a written property settlement agree-

---

49 *Merrill v. Fahs*, 324 U.S. 308 (1945); *Commissioner v. Wemyss*, 324 U.S. 303 (1945).

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

51 Rev. Rul. 68-379, 1968-2 Cum. Bull. 414; *Commissioner v. Nelson*, 396 F.2d 519 (2d Cir., 1968).

52 I.R.C. § 2516.

ment, and divorce occurs within two years thereafter (irrespective of whether the decree approves the agreement), transfers of property pursuant to the agreement either to the wife or for the support of minor children are transfers for consideration, and so are not subject to the gift tax.

Questions may arise that are not strictly in the field of this topic; and a word of warning may be in order. Since World War II, the custom has grown apace of the husband's placing property in the names of himself and his wife as tenants by the entirety. After the practice had been going on for some years, without a correlative filing of gift tax returns, Congress enacted a relief section, I.R.C. § 2515, relieving the husband from the obligation of filing a gift tax return, unless he elected to do so. The difficulty is that this section applies only to real property. The husband may place stocks, bonds, savings accounts, and other personal property, tangible and intangible, in the tenancy by the entirety; and one suspects that many such donors do not file required gift tax returns.[53] This is the kind of question that can be brought to light when the parties separate. The wife may easily demand a portion of the property title to which she shares with her husband, and which is converted by divorce into a tenancy in common permitting her to require partition.[54] Counsel should be alert to the possibility that the filing of gift tax returns may have been or be in order.

## *CONCLUSION*

By and large, Congress and the Service have done a good job in the field of divorce and separation. If there is a reasonably full disclosure of the assets and earnings of the parties, a reasonable recognition by the parties and their counsel that unbridled advocacy will probably not lead to sound results, and a sufficient knowledge of the applicable law to take full advantage of its flexibility so that different arrangements can be made that should come close to satisfying individual personalities with their varying feelings of fairness, considerable constructive work can be done toward minimizing taxes and directing their impact. There are three sets of potential tax traps, one arising out of domestic relations as well as tax laws, one created by Supreme Court decisions, and a third created by Congress. The first set would include the determination whether husband and wife are married, the confusion of the security for an obligation with the obligation itself, and the care required to distinguish numbers such as "more than ten years" from "$1,200 or more". The Supreme Court decisions to watch are *Davis* (creating a capital gains trap in this situation); *Lester* (holding that

[53] See Rev. Rul. 75-507, illustrating how a husband may, perhaps unwittingly, incur gift taxes.

[54] See, e.g., Code of Virginia, § 6.1-73 and § 20.111.

payments not "fixed" for the children may be taxable to the wife); and *Patrick* (making difficult the deduction of counsel fees). Those problems created by Congress are, first, the difficulty of determining whether a trust is a § 71 or a § 682 trust; and, second, the failure to except from income taxes the proceeds of life insurance transferred as a part of a marital settlement.

Avoiding these traps, the careful lawyer can plan with considerable assurance in this area.

## *APPENDIX A*

| | | | | |
|---|---|---|---|---|
| H. | $42,000.00 | | | |
| W. | 16,000.00 | | | |
| | 58,000.00 | | | |
| Minus arbitrary 10% | 5,800.00 | | | |
| | 52,200.00 | | | |
| Minus Exemptions | 1,500.00 | | | |
| | 50,700.00 | | | |
| | 44,000.00 | | 14,060.00 | |
| | 6,700.00 | at 50% | 3,350.00 | |
| | | | $17,410.00 | Tax of H. & W. |
| H. gives W. as alimony | | | $10,800.00 | |
| | $42,000.00 | | | |
| | 10,800.00 | | | |
| | 31,200.00 | | | |
| | 4,200.00 | | | |
| | 27,000.00 | | | |
| | 750.00 | | | |
| | 26,250.00 | | | |
| This would leave H.: | | | | |
| | $42,000.00 | | | |
| Minus alimony | 10,800.00 | | | |
| | 31,200.00 | | | |
| Minus Tax | 7,702.50 | | | |
| | 23,498.50 | | | |
| | $42,000.00 | | | |
| Minus | 17,410.00 | | | |
| | $24,590.00 | (About what H. had left if he paid all of the tax on $58,000.00) | | |
| W. pays on alimony plus her income | | | | |
| | $16,000.00 | | | |
| | 10,800.00 | | | |
| | 26,800.00 | | | |
| | 2,300.00 | | | |
| | 24,500.00 | | | |
| | 750.00 | | | |
| | 23,750.00 | | W.'s tax | |
| | 22,000.00 | | 5,990.00 | |
| | 1,750.00 | x 40% | 700.00 | |
| | | | 6,690.00 | |
| This would leave W.: | | | | |
| | $26,800.00 | | | |
| Minus | 6,690.00 | | | |
| | 20,110.00 | (Less than H.'s $23,498.50) | | |

Many W's are accustomed to H's paying all the income taxes, so that they enjoy their separate income tax free.

But some don't: so let's assume that this W is willing to pay on her income but wants H to pay the tax on her alimony. H doesn't like this, but the figures may help:

| | |
|---|---|
| W. would have to pay on $16,000.00 | $3,830.00 |
| She is having to pay | 6,970.00 |
| | 3,140.00 |

If H pays her taxes, she will of course have to report that, but let's see:

| | | | |
|---|---|---|---|
| | $26,800.00 | | |
| H adds her taxes to alimony | 3,200.00 | | |
| | 30,000.00 | | |
| Minus | 2,300.00 | | |
| Minus | 750.00 | | |
| | 26,950.00 | | |
| | 26,000.00 | W.'s Tax $ | 7,590.00 |
| | 950.00 | x 45% | 427.50 |
| | | | 8,017.50 |
| | | | 30,000.00 |
| | | Minus | 8,017.50 |
| Wife has left | | | 21,982.50 |

Change in H's situation:

| | | | |
|---|---|---|---|
| | $42,000.00 | | |
| Minus Alimony | 14,000.00 | | |
| | 28,000.00 | | |
| Minus 10% | 4,200.00 | | |
| | 23,800.00 | | |
| Minus | 750.00 | | |
| | 23,050.00 | | |
| | 22,000.00 | H's tax $ | 5,990.00 |
| | 1,050.00 | x 40% | 420.00 |
| | | | $ 6,410.00 |
| So H has to spend | $42,000.00 | | |
| Minus | 14,000.00 | | |
| | 28,000.00 | | |
| Minus tax | 6,410.00 | | |
| | 21,590 | instead of | $23,498.50 |
| And W. has | 21,982.50 | instead of | $20,110.00 |

## APPENDIX B

*Alimony.*

The Husband shall pay to the Wife, monthly, as basic alimony for her support, the sum of $1,100.00 beginning August, 1975, and continuing through March, 1976, and $900.00 in April, 1976 and each month thereafter; and will also pay an additional amount because of increased Federal and State Income taxes to the Wife. Such additional amounts shall be calculated each year as follows:

> To the Wife's income for Federal Tax purposes from sources other than such monthly alimony (known as her independent income herein) shall be added the sum thereof, being for example $5,500.00 in 1975; $11,400.00 in 1976, and $10,800.00 thereafter; the Federal Income Tax shall be calculated on such total; the Federal Income Tax shall then be calculated on the Wife's independent income; and the Husband shall pay to the Wife the difference plus the income tax to the Wife because of the receipt of payment for such difference: provided, however, that if the Wife's taxable income in such year (her independent income after subtracting her deductions and her exemptions) shall be greater than $16,000.00, her independent income after subtracting such deductions and exemptions shall nevertheless be fixed at $16,000.00 for the purpose of this calculation. State Income taxes shall be calculated in the same manner and subject to the same proviso.

The payment of such additional amount shall be made quarterly, with adjustments to be made annually.

## APPENDIX C

### *Automatic Increase or Decrease in Basic Alimony.*

The basic alimony fixed in Par. A. hereof is based on the Cost of Living Index of The Bureau of Labor Statistics of the Department of Labor as of July, 1975, when the Index was 162.3. Each year, as of January, beginning January, 1976, the percentage increase or decrease in such Index shall be ascertained, the first period being from July, 1975, to January, 1976, and thereafter for annual periods from January to January. There shall also be ascertained the increase or decrease in the adjusted gross income of the Husband, from one calendar year to the next, the first comparison to be of the years 1974 and 1975. If such Index has by January, 1976, decreased by as much as one per cent (1%) from such figure of 162.3, then the basic alimony for 1976 shall be decreased by the same percentage difference. If, however, such Index has increased by as much as one per cent (1%), the basic alimony for 1976 shall be increased by the lesser of the same percentage or the percentage of increase of the Husband's adjusted gross income for

1975 over 1974. Thereafter said alimony shall be decreased or increased in the same manner for succeeding years in which such monthly payments are required to be made. In ascertaining the Husband's adjusted gross income, no account shall be taken of any amounts credited to any retirement fund for his account.