DIVORCE AND SEPARATION: INCOME TAX CONSEQUENCES

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In planning the income tax consequences attendant to a divorce or separation the tax planner can structure the transactions so that the best possible tax consequences result to the parties. There are two principal areas in which tax planning is necessary. First, the treatment of periodic payments or alimony must be provided for and second, any property settlements should be so structured that the tax consequences which result effectively implement the desires of the parties.

ALIMONY

The taxation of periodic payments or alimony may be shifted from the party making the payment (referred to in the Internal Revenue Code as the husband) to the recipient (referred to as the wife)\(^1\) under §§ 71 and 215. If one party is in a lower income tax bracket than the other it will frequently be desirable to shift the taxation of income to the lower-bracket taxpayer on the theory that the resulting tax savings frees assets which can be made available to either or both. For purposes of this discussion the term alimony is defined as periodic payments which are taxable to the recipient under § 71 and deductible by the party making the payment under § 215. It should be noted that the designation of payments as alimony in an agreement or divorce decree does not control the taxation of the payments. Regardless of nomenclature payments must meet the following criteria to constitute alimony for purposes of taxation. The payment must be made pursuant and subsequent to a decree of divorce or separate maintenance or a written separation agreement,\(^2\) the payment must be periodic, and the payment must be in discharge of a legal obligation arising from the marital or family relationship.\(^3\) Periodic payments made pursuant to a written separation agreement or support decree are deductible by the payor and includable in income by the payee whether or not there has been a divorce or court order. While the regulations take the position that such payments are alimony under § 71(a) only if the parties are

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\(^1\) Internal Revenue Code of 1954, (hereinafter cited as I.R.C.) §§ 71(a), 215 and 682. Section 7701(a) (17) provides “As used in sections 71, 152(b) (4), 215, and 682, if the husband and wife therein referred to are divorced, wherever appropriate to the meaning of such sections, the term “wife” shall be read “former wife” and the term “husband” shall be read “former husband”; and, if the payments described in such sections are made by or on behalf of the wife or former wife to the husband or former husband instead of vice versa, wherever appropriate to the meaning of such sections, the term “husband” shall be read “wife” and the term “wife” shall be read “husband”.

\(^2\) I.R.C. § 71(a).

\(^3\) id.
“separated and living apart”,⁴ a recent decision held that a husband and wife do not necessarily have to be living in separate residences to be considered “separated and living apart.”⁵ If the payments in question are made under an agreement rather than a decree or court order, the agreement must be in writing. An oral agreement does not qualify.⁶ Further, purely voluntary payments (not provided for by a court order or written separation agreement) are not deductible by the payor and are not income to the payee.⁷

In characterizing payments as alimony the most important requirement is that the payments must be periodic. The term periodic is not defined, but § 71 does provide that payments need not be made at regular intervals to be considered periodic. The first determination to be made is whether the payment(s) constitute periodic payments or the payment of a principal sum. A principal sum is not a periodic payment and thus not income to the recipient or deductible by the payor. Section 71(c) specifically provides that installment payments discharging a part of an obligation the principal sum of which is, either in terms of money or property, specified in the decree, instrument or agreement shall not be treated as periodic payments, unless the principal sum may be paid over a period ending more than ten years from the date of the agreement or decree. A principal sum is one in which the total amount payable is either stated or is capable of mathematical computation.⁸ Upon determining that a principal sum is involved, the next step is to ascertain the period over which the amount may be paid. Installment payments of a principal sum which may be paid over a period extending more than ten years from the date of the decree, instrument or agreement are periodic to the extent of ten percent of the principal sum.⁹

Installments payments of $9,000 payable $1,000 per year for a nine-year period would therefore constitute payments of a principal sum and not be treated as periodic (alimony).¹⁰ On the other hand, if the $9,000 were payable over a twelve-year period, the payments received in any taxable year would be considered periodic to the extent of ten percent of the principal sum. Frequently the manner of computing

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⁴ Treas. Reg. § 1.71-1(b) (2) (1960).
⁵ Syndes v. Comm. 42 AFTR 2d 78-5143 (8th Cir. 1978). cf. Marion S. Del Vecchi, T.C. Memo 1973-245. Where a husband could not afford to move out of the house, but took up separate quarters in the living room of the couple’s jointly owned house, he was held not to be living separate and apart.
⁸ See Treas. Reg. § 1.71-1(d) (5) Ex. 3, providing that payments under a written instrument in the amount of $100 per month over a period of nine years are not periodic.
⁹ I.R.C. § 71(c) (2).
¹⁰ The statement in the text assumes that the payments are not subject to any contingency such as death, remarriage or change in economic status.
the ten-year period will be critical and the precise method of computing this period is an unsettled question. For example, if the payments are made with respect to a written separation agreement which is then incorporated into a divorce decree, should the ten-year period be computed with reference to the date of the written separation agreement or the date of the decree? If more than one series of payments are involved it may be difficult to ascertain the appropriate date for commencing the ten-year period. The determination of the period during which payments may be made is controlled by state law and may turn on the phrasing of the instrument. The court may also look to the intent of the parties. For example in *Suarez v. Commissioner* an agreement provided for the payment of $60,000 over sixty-one months. However the monthly payments specified in the agreement were equal to a total of only $30,000. The Tax Court looked to the intent of the parties and held that the payments were intended to be made over a period of one hundred twenty-one months. Therefore the payments were periodic. The tax planner must consult local law in order to insure that the instrument does result in the desired tax consequences. Further it is not advisable to use a period that approaches the ten-year limitation too closely. Payments should either clearly extend beyond ten years if intended to be periodic or if the intent is to use installment payments of a principal sum, the payment period should clearly be less than ten years.

It may be desirable to use a combination of principal sum and periodic payments. For example, the parties may agree that the husband is to pay $20,000 initially and then pay a stated monthly sum for ten years. If the intent of the parties is that the $20,000 be treated as a principal sum (not deductible by the husband and not income to the wife) followed by periodic payments which are income to the wife and deductible by the husband, the terms of the agreement or decree should specify that two separate categories of payments are intended. Further, the period for the monthly payments should clearly exceed ten years. If on the other hand the $20,000 is to be the first of a series of payments all of which are periodic the instrument should specify that all payments are part of one series.

Under the second test for periodicity installment payments of a sum may be considered periodic if the payments are subject to a contingency such as death, remarriage, or change in economic status. If for example the decree or agreement provides for the payment of $10,000 annually for eight years, the payments are not periodic. However, if the payments are to terminate upon the recipient’s remarriage, the total

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11 For a discussion of the cases on this issue see Gutman and Sander, 95-3rd T.M. Divorce and Separation, A-5 and 6 (1975).
amount payable cannot be ascertained. If the total amount payable cannot be determined no principal sum is involved, therefore the payments are periodic even though payable in less than ten years. The regulations provide that payments are periodic even if the contingency arises by operation of state law rather than being expressed in the decree or agreement.\(^4\) This may make it difficult for parties to provide for installment treatment. For example, if the parties agree that certain payments are to be made over an eight-year period and that the payments are not contingent in any manner it would seem apparent that the payments are not periodic. However, if the agreement is subsequently incorporated into a divorce decree, state law may render the payments subject to a contingency and therefore periodic.\(^5\) Apparently one test is whether or not the payments or agreement are subject to judicial modification. If so, they may be contingent and periodic regardless of the intent of the parties. This of course poses planning problems and again the tax planner must be familiar with local law.

If payments extending beyond the ten-year period are deemed periodic because contingent, the ten percent limitation of § 71(d)(2) does not apply.\(^6\) Assume that payments are periodic because they exceed the ten year period. Husband is to pay wife $150,000—payable $30,000 in the first year and $12,000 in each of the next ten years (an eleven-year period). Of the $30,000 payable in the first year only $15,000 (ten percent of the principal sum) will constitute periodic payments (deductible by the husband and income to the wife). But if the $150,000 were considered periodic because contingent—payments to cease on the death or remarriage of the wife—then in the first year the full $30,000 would be income to the wife (periodic) as the ten percent limitation does not apply.

Not only must the payment be periodic to constitute alimony, it must also be in discharge of a legal obligation arising from the marital relationship. While § 71(a) refers to the “discharge of . . . a legal obligation, which because of the marital or family relationship is imposed on or incurred by the husband . . .”, the regulations incorporate a support requirement providing that “Section 71(a) applies only to payments made because of the family or marital relationship in recognition of the general obligation of support which is made specific by the decree, instrument or agreement.”\(^7\) Payments attributable to the spouse’s property rights are not alimony.\(^8\) Thus payments of $100 per

\(^4\) Treas. Reg. § 1.71-1(d) (3) (ii) (a).
\(^5\) See Rev. Rul. 59-190, 1959-1 CB 23 which provides that payments of a stated monthly sum for four years is a periodic payment where the court has jurisdiction to modify a decree upon a change in economic circumstances and a state statute provides for the termination of alimony upon the death of either party.
\(^6\) Treas. Reg. § 1.71-1(d) (4).
\(^7\) Treas. Reg. § 1.71-1(a) (4).
\(^8\) Treas. Reg. § 1.71-1(b) (4).
month for thirty years would not be alimony if the payments were founded on property rights rather than support or other marital rights. Whether payments are attributable to support or to property rights may be determined by the intent of the parties, and the court may consider negotiations prior to the agreement or divorce. In *West v. U.S.* the court looked to the intent of the parties to determine that payments were attributable to support rather than the property rights of the wife. In *West* the language of the agreement was ambiguous. There was evidence that the husband intended the payments to be support rather than in settlement of property rights and that the wife, having relied totally upon her attorney, had formed no intent with respect to the nature of the payments. This evidence coupled with lack of proof as to the value of the wife's property rights caused the payments to be treated as support and therefore alimony to the wife. The tax advisor has a responsibility to discuss the question of intent with the client and to provide that client with sufficient data to form an intent. Further that intent should be clearly expressed in the instrument.

Frequently the difficult problem is not in applying the principles of taxation to a property settlement as opposed to payments in satisfaction of a support obligation, but to determine whether payments are attributable to property or to support. While the courts consider the intent of the parties as determinative, that intent must be supported by objective criteria. Thus an agreement by the parties to treat certain payments as alimony when those payments are in fact attributable to property interests will not serve to generate a § 215 deduction for the payor, nor taxable income to the recipient. The courts may consider the following criteria in characterizing payments:

1. Long-term payments which are terminable upon death or remarriage appear to be support payments, while short-term or lump sum payments which are not contingent appear to be payments for property. Contingencies appear not only to render payments periodic, but also to be a strong indication that payments arise from the support obligation.

2. Payments geared to the income of the party required to make the payment or subject to modification upon change in economic circumstances may be viewed as support obligations.

19 *Phinney v. Mauk*, 411 F.2d 1196 (5th Cir. 1969). The court refused to determine whether certain weekly payments were in discharge of marital or property rights, holding that this would be determined by the intent of the parties and remanding the case for further proceedings.


(3) The extent and nature of the wife's property interest and the manner in which title is held may be determinative of the nature of the payments. Thus if property is jointly owned or if a state statute vests a property interest in the spouse (e.g., community property) payments may be for the surrender of property rights. On the other hand, if the parties fail to establish the existence and/or value of any property rights, payments may be viewed as support.

(4) Transfers in recognition of a wife's contribution to the family business may or may not be treated as transfers in settlement of property rights. If the parties have formally recognized the wife's interest prior to the separation or divorce, or the wife has contributed property to the business, her property rights are more likely to be recognized. Some courts have been reluctant to recognize a settlement of property rights based on a contribution of the wife's services to the business, or in those situations where the agreement and negotiations have not dealt with the question.\(^2\)

(5) Provisions of state law may have an impact on the characterization of payments. For example, it has been held that certain payments were in settlement of property rights where the recipient as the party at fault was not entitled to support under local statutes.\(^3\)

(6) Support paid prior to the divorce may be considered in characterizing post-divorce payments. Similarity in amount and timing of the payments may be persuasive that the post-divorce payments are also support.

Of course both property and support payments may be provided in the same instrument. There may be more than one series of payments or one series of unequal payments. When this occurs a question may arise as to whether (1) property or support payments are involved and (2) the payments are principal sum or periodic. In Knowles v. U.S.\(^4\) the Chancery Court had awarded the wife $25,000 "lump sum alimony" plus $300 per month. The payments were set forth in separate portions of the decree and the monthly payments were subject to judicial modification. No property settlement agreement had been negotiated by the parties. The court held that there were two separate payments, the former being a principal sum and the latter periodic. However, the court did recognize that parties could structure a series of unequal

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\(^2\) Harris, supra note 21, at 69-73

\(^3\) Lewis B. Jackson, Jr., 54 T.C. 125 (1970). This case involved a division of property jointly acquired during marriage; however the court allocated all of the payments to the property settlement partly because the wife as party at fault was not entitled to support under state law.

payments so that all would be periodic in nature. While the nature of the payments (property versus support) was not addressed in Knowles, the tax planner must be aware that payments must pass a two-pronged test to be deductible: they must be periodic and must result from a legal obligation arising from the marital relationship. Non-periodic payments are not income to the recipient under § 71(a) regardless of the nature of the underlying obligation. Periodic payments are income under § 71(a) only if made in satisfaction of marital rather than property rights. The determination as to whether payments are alimony and therefore deductible by the party making the payment may be made on either or both bases. Thus in William F. Hagenloch an agreement provided for the payment of $400 per month to the wife for her life or until remarriage, plus a series of four annual payments in specified amounts. The court found two series of payments; the monthly payments were contingent and therefore periodic and deductible by the husband, but the annual payments were not contingent and were therefore nondeductible installments of a principal sum. The court found in the alternative that the monthly payments were for support (deductible) while the annual payments were for property rights (not deductible).

Arrearage and Advance Payments

A lump sum payment in discharge of an arrearage of periodic payments is a periodic payment. Since both spouses are treated as cash basis taxpayers for purposes of §§ 215 and 71, this can result in bunching of income and a greater tax impact to the recipient. It has been suggested that the payee might require a liquidated penalty provision to discourage the payor from making late payments and to mitigate the tax impact of such payments to the recipient. Since a lump sum payment may be only partially in satisfaction of a periodic arrearage, it is necessary that a clear allocation of the periodic and non-periodic payments be made.

A lump sum advance payment of periodic alimony may retain its periodic character. An advance payment of an installment treated as periodic under the ten-year test of § 71(c) is treated as the current year's payment for purposes of the ten-percent limitation. Assume that a principal sum of $100,000 is to be paid in twenty equal annual in-
stallments. Since each installment is less than ten percent of the principal amount, the full amount of each installment is periodic. If, however, in the taxable year the party pays $20,000 ($15,000 of which is an advance payment) only $10,000 (ten percent of the principal amount) is treated as periodic.

On the other hand a lump sum advance payment of periodic alimony may be treated as a voluntary payment not in discharge of a legal obligation and therefore not alimony under § 71(a). In a recent case the husband was required to make periodic payments of $250 per month until the wife remarried or the youngest child reached the age of 18. In three consecutive years the husband paid a total amount equal to the amount that would have been paid that the monthly payments been paid until the youngest child attained the age of 18. Shortly after the final payment the wife remarried. The court held that only $250 per month was deductible under § 215. Payments in excess of the amount owed at the time of the payment are not deductible. In another recent case the husband voluntarily increased his alimony payments under a court decree. Following an audit by the Internal Revenue Service the husband obtained a retroactive modification of alimony by the state court which had granted the divorce. The district court limited the husband's deductions to the amount he was legally obligated to pay at the time of the payment, refusing to recognize an asserted oral agreement modifying the written decree or to give retroactive effect for tax purposes to the state court's modification of the alimony award. Apparently a different result follows if the retroactive increase in alimony by the State Court precedes the payment.

If the parties do effect a change in an agreement or decree, it must be determined whether that change involves a modification of the existing agreement or substitution of a new agreement. If an existing agreement is modified, then a lump sum payment may be at least partially periodic. A retroactive increase of periodic payments may be treated as periodic alimony even if satisfied by a lump sum payment. If a payment of $50,000 is made under a modification of an existing agreement that payment is periodic to the extent of any arrearages and would therefore constitute taxable income to the recipient in the year paid. But if a new agreement is substituted for the old, the issue of whether or not a payment is periodic should be decided solely with reference to the terms of the new agreement. Thus a $50,000 lump sum payment under a new agreement should not

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32 Virginia B. Davis, 41 T.C. 815 (1964) future periodic payments reduced and lump sum found to be in settlement of periodic payments.
33 Gale v. Comm. 191 F.2d 79 (2d Cir. 1951).
34 Frank J. Loverin, 10 T.C. 406 (1948), Marvin Ansel Young, 58 T.C. 629, aff'd 485 F.2d 422 (10th Cir. 1973).
be considered periodic. However, a new agreement should clearly specify the payment attributable to arrearages, if any, and the payment attributable to future payments. Absent a specific allocation, all or a portion of the lump sum payment may be attributed to arrearages to the extent thereof.\textsuperscript{3} As the tax consequences may be dramatically affected, it is critical that the instrument contain a clear allocation.

**Principal Sum**

The payment of a principal sum is not income to the recipient under §71(a) because it is not a periodic payment. A principal sum is an amount which is either in terms of money or property specified in the decree or agreement or may be readily ascertained from the terms of the instrument. Thus a provision requiring the payment of $25,000 is a principal sum. On the other hand, a provision providing for the payment of "$5,000 annually for five consecutive years" is also a principal sum unless the payment is subject to a contingency. While a periodic payment is not alimony or income to the recipient under §71(a) unless it is in satisfaction of a legal obligation arising from the marital relationship, the fact that a lump sum payment is in satisfaction of such legal obligation does not cause the lump sum payment to be treated as alimony to the recipient. The regulations concede that a lump sum payment of a principal sum is not income to the recipient even if made in satisfaction of a legal obligation arising from the marital or family relationship.\textsuperscript{30}

The principal sum may be paid in installments without affecting the tax consequences to either party if the period during which payments are made may not extend more than ten years from the date of the decree, instrument or agreement.\textsuperscript{37} Thus if under the terms of a written instrument A is to pay B $100 per month over a period of nine years and the monthly payments are not subject to any contingencies, the payments are installments of a principal sum and are not alimony to the recipient, nor or they deductible by the payor.\textsuperscript{38}

If the payment period may extend more than ten years, payments in a taxable year are considered to be periodic to the extent of ten percent of the principal sum. Thus if the instrument provides for five non-contingent annual $20,000 payments followed by ten non-contingent payments of $5,000 each, there is a principal sum ($150,000).

\textsuperscript{35} Rev. Rul. 67-11, 1967-1 CB 15. cf. Elinda W. Parker, T.C. Memo 1061-123, 20 TCM 597 involving a lump sum settlement of past and future alimony. The court found that husband was willing to pay something for a release of future obligations and that it was unrealistic to assume value was only the excess of the amount paid ($2200) over arrearages ($1940). Court used Cohan rule to allocate $1400 to lump sum.

\textsuperscript{36} Treas. Reg. § 1.71-1(d) (1).

\textsuperscript{37} I.R.C. § 71(c). Treas. Reg. § 1.71-1(d) (1).

\textsuperscript{38} Treas. Reg. § 1.71-1(d) (5), Ex. 3.
Since the payment period exceeds ten years the ten percent limitation applies. Therefore in the first five years each payment would be treated as periodic to the extent of $15,000 and $5,000 would be treated as an installment of a principal sum. The ten payments of $5,000 would be fully includible in the recipient’s income and deductible by the party making the payment. Advance payments are treated as current payments in the year made for purposes of the ten percent limitation. Thus if $40,000 were paid in one year ($20,000 current and $20,000 advance) only $15,000 would be treated as periodic. It should be noted that payments attributable to property rights rather than to an obligation arising from the family or marital relationship are not income to the recipient even if they extend more than ten years.

As discussed above if the payments are subject to a contingency such as the death of either spouse, remarriage of the recipient, or a change in economic status of either spouse, no principal sum can be ascertained. Therefore payments may constitute alimony even though payable in less than ten years if the payments are subject to a contingency and in the nature of alimony or support. Since these payments are not considered installments of a principal sum, the ten percent limitation of § 71(c) does not apply and the payments are periodic in full. Thus in the above example, a timely payment of $20,000 which is considered periodic because subject to a contingency would result in the inclusion of the full $20,000 in the recipient's income.

**Child Support**

Section 71(b) provides that any amount which is payable for the support of minor children of the party making the payment is not alimony (income to the wife) and is not deductible by the party making the payment. The Supreme Court has indicated that payments are not treated as child support unless expressly so designated. Thus a payment of $1,000 per month “for the support of wife and children” is considered to be alimony and not child support. The full $1,000 is includible in the wife’s income, and for purposes of taxation, any portion of that $1,000 expended for the support of children is deemed to be support provided by the wife. Apparently no allocation between alimony and child support is to be inferred from the terms of the instrument. A payment of “$1,000 per month for the support of wife and child to be reduced to $600 per month when the child attains age

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39 Treas. Reg. § 1.71-1(d) (5), Ex. 4.
40 I.R.C. § 71(c) (2). Treas. Reg. § 1.71-1(d) (2).
41 Treas. Reg. § 1.71-1(b) (4).
42 Treas. Reg. § 1.71-1(d) (3) (i).
21" also results in the full $1,000 being treated as alimony. If the parties wish to provide separately for child support, then the agreement would provide "$600 per month for the support of the wife and $400 per month for the support of the child until the child attains age 21". Where a specific provision is made for both child support and alimony, payments are allocated first to child support.\textsuperscript{44} Thus if in the above example a payment of $700 were made, only $300 (the excess over the child support) would constitute alimony.

Frequently the agreement or the divorce decree will specify the party entitled to dependency exemption under § 151. To qualify for the exemption a dependent must be related to the taxpayer or a member of the taxpayer's household, have gross income of less than $750 for the year, and more than one-half of the support of the dependent must be provided by the taxpayer.\textsuperscript{45} The limitation on the dependent's gross income does not apply to a child of the taxpayer who has not attained the age of 19 or who is a student.\textsuperscript{46} Section 152(e)(1)(A) sets forth the general rule that the parent having custody for a greater portion of the calendar year is deemed to provide more than one-half of the support of the child is therefore entitled to the dependency exemption. Special rules further provide that the parent not having custody is treated as having provided more than one-half of the support of the child if (a) the decree or separation agreement so provides and (b) that parent provides at least $600 for the support of such child.\textsuperscript{47} Where the decree or agreement is silent the parent not having custody is deemed to have provided more than one-half of the support if (a) he/she provides $1,200 or more support for each child and (b) the parent having custody does not clearly establish that he/she provided more for the support of such child than the parent not having custody.\textsuperscript{48} It should be noted that three threshold requirements must have been met in order for the above provisions to apply. There must be a decree or written separation agreement, the combined support furnished by the two parents must equal more than one-half of the total support of the child, and the child must be in the custody of one or both of the parents for more than one-half of the year.\textsuperscript{49} Thus if the child lived with a grandparent for more than one-half of the year or if the grandparent provided more than one-half of the support of the child, § 151(e) does not apply. If § 151(e) does not apply, the exemption should be claimed by the party providing more than one-half of the support of the child or if no one person did so, by the

\textsuperscript{44}I.R.C. § 71(b), Treas. Reg. § 1.71-1(c).
\textsuperscript{45}I.R.C. §§ 151(e) and 152(a).
\textsuperscript{46}I.R.C. § 151(e) (1) (B).
\textsuperscript{47}I.R.C. § 151(e) (2) (A).
\textsuperscript{48}I.R.C. § 151(e) (2) (B).
person, if any, who is entitled to claim the exemption under a multiple support agreement.50

The identification of the party entitled to claim the dependency exemption is also important for purposes of the medical expense deduction. Under § 213(a) a taxpayer is entitled to a deduction for unreimbursed expenses for medical care of his/her "dependents (as defined in section 152)". Thus, if the wife is entitled to the dependency exemption with respect to a child and the husband pays the child's medical expenses, neither party is entitled to deduct the medical expense.51 Care should be taken to insure that the party entitled to treat the child as a dependent is the party who actually pays any medical costs, particularly if it is reasonable to anticipate that substantial medical expenses may occur.

The child care deduction under § 21452 was available for "dependents" of the taxpayer and the regulations specifically incorporated the guidelines of § 152(e).53 The credit for care of dependents54 which has replaced the child care deduction provides that a child who (1) is under the age of 15 or who is physically or mentally incapable of caring for himself, (2) receives over one-half of his/her support from parents who are divorced, legally separated or separated under a written separation agreement, and (3) is in the custody of one or both parents for more than one-half of the year shall be treated as a qualifying individual for such credit. The parent who has custody of the child for the greater portion of the year is entitled to the credit. Accordingly, a parent may treat a child as a qualifying individual for purposes of the child care credit even though that parent is not entitled to a dependency exemption for the child.55

Property Settlements

A transfer of property under the terms of a property settlement may be a mere division of property in which each party is withdrawing his/her property from the marital property. There are no tax consequences to this type of property division. No gain or loss is realized by either spouse and no basis adjustment is permitted. On the other hand, a transfer of property may be in satisfaction of a legal obligation

50 I.R.C. § 152(c). Note that § 152(e) (4) provides that the special rules do not apply if a multiple support agreement is in effect.
51 Jennie S. Meshulam T.C. Memo P-H ¶ 76111.
52 Section 214 was repealed by Sec. 505(b) (1) of Public Law 94-455, 10/4/76 effective for taxable years beginning after 12/31/75.
53 Treas. Reg. § 1.214-1(b) (1).
54 I.R.C. § 44A provides a credit of 20% of certain employment related expenses incurred by a taxpayer who maintains a household for one or more qualifying individuals.
55 I.R.C. § 44A(f) (5), Prop. Treas. Reg. § 1.44A-1(b) (2). Note that the parent must provide over one-half of the cost of maintaining the household.
arising from the marital relationship. The Supreme Court has held that the transfer of appreciated property in settlement of a legal obligation arising from the marital relationship results in a realization of gain to the transferor. The *Davis* case involved the realization of gain on a transfer of certain appreciated personal property to the wife. The Court found that under applicable state law the transferred property was owned by the husband and that the inchoate rights of a wife in her husband's property did not attain the dignity of co-ownership. The Court held that the wife's rights were essentially a personal liability of the husband rather than a property interest of the wife. Prior to the *Davis* case taxpayers had taken the position that it was not possible to determine the gain realized, if any, as it was not possible to value the marital rights surrendered in the exchange. The Supreme Court dealt with this assertion by assuming that those marital rights were equal in value to the property transferred. Therefore for purposes of determining gain or loss the fair market value of the property transferred is treated as the amount realized. The transferee is treated as a purchaser and his/her basis in the transferred property is the fair market value of the property at the time of the transfer. No gain is realized by the transferee. For example, if the husband transferred property with an adjusted basis of $50,000 and fair market value of $80,000 in satisfaction of a legal obligation arising from the marital relationship, he would realize a gain of $30,000. The character of the gain is determined with reference to the nature of the asset (capital or non capital) in the hands of the husband and the length of the husband's holding period. The transfer of the property does not result in the realization of gain by the transferee whose basis in the asset would be the fair market value at the time of the transfer. If the transferee immediately sold the property for its fair market value, he/she would realize no gain or loss in the sale. This is exactly the same consequences that would have occurred had the husband sold the asset for fair market value and transferred cash to the wife.

Of course the transfer may result in the realization of loss by the transferor. If the parties are married at the time of the transfer, § 267 may preclude a deduction with respect to the loss. However, if the transfer occurs after the divorce, the parties are no longer related and the loss should be deductible to the extent that it would have been deductible had there been a sale of the property. Thus a transfer of

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an investment asset resulting in the realization of a loss should generate a deduction for the transferor. On the other hand if the property transferred is personal-use property such as a residence, no deduction is permitted because the sale of the property would not have resulted in a deductible loss.\(^{61}\)

A division of property which is not a transfer in satisfaction of a legal obligation arising from the marital relationship should not be a taxable event. Theoretically each party is removing from the marital pool only his/her share of the property and therefore any property transfer should not trigger a realization. Unfortunately this is not always true. The form of ownership of the property may affect the income tax consequences of a property division. If the property is owned as joint tenants, community property, or as tenants in common an equal division of property should result in no gain or loss and no basis adjustment if each asset is partitioned.\(^{62}\) On partition neither party realizes income and of course neither is entitled to a deduction under § 215.

But if the property is not partitioned there is a question as to whether there could be a realization of income to one or both parties. Assume that the parties own assets as tenants in common or as joint tenants and that the marital property consists of securities valued at $100,000 (adjusted basis $40,000) and real property valued at $100,000 (adjusted basis $50,000). If the parties partition both assets, each taking one-half there is no realization of gain or loss. Each has securities valued at $50,000 (adjusted basis $20,000) and real property valued at $50,000 (adjusted basis $25,000). However, if A takes the securities and B the real property has a taxable event occurred? Arguably there has been a taxable exchange in which A exchanged his/her interest in the real property for B's interest in the securities. If this is a taxable exchange A has realized a gain of $25,000 (the difference between the fair market value of the interest in the securities, $50,000, and the adjusted basis in the portion of real property surrendered, $25,000). B's realized gain would be $30,000 (the excess of the value of one-half of the real property, $50,000, over one-half of the basis in the securities, $20,000). However, a division of property held in some form of co-ownership, even if not a partition of each asset, has been held not to result in a taxable event. In Beth W. Corp. v. U.S.\(^{63}\) certain real property which had been held as tenants by the entirety was

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\(^{61}\) David R. Pulliam, 39 T.C. 883, 329 F.2d 97 (10th Cir. 1964), cert. denied, 379 U.S. 836 (1964). Section 165(c) limits deductions for losses of individuals to losses incurred in a trade or business, transaction entered for profit or resulting from a casualty.


distributed to the spouse under the terms of a property settlement. In determining the basis with respect to that property the court found that the distribution was a non-taxable division of property. In another case the court held that a division whereby the husband received all of the jointly owned property and the wife received cash and promissory notes from the husband constituted a sale of the wife's interest to the household. The court stated in *dicta* that in a division of jointly owned property no sale is involved regardless of whether each asset is partitioned or each party receives different assets, citing a situation in which the husband received real property and the wife securities as an example of a nontaxable division of jointly held property. It should be noted that a division of jointly owned property in which one party receives more than the value of his/her interest in the property may be found to be partially a transfer in satisfaction of a legal obligation and therefore may trigger a partial realization of gain. For example, in one case in which jointly owned property was transferred to the wife, the husband was required to recognize gain on the transfer of his one-half interest in the property under the *Davis* rationale.

If there is a transfer of separately owned property, the probability of triggering a realization is greatly enhanced. Assume that the parties own real property as joint tenants with right of survivorship and that under state law each is deemed to own one-half of the property. A wants to obtain sole ownership of the real property. If upon a divorce or separation A transfers certain securities owned by A in exchange for B's interest in the real property, the transfer is probably a taxable exchange and each will realize a gain or loss. If A acquires B's one-half of the real property in a taxable exchange, A's basis in the portion of real property acquired from B will be the fair market value at the time of the exchange and A's basis in the portion he/she had owned prior to the exchange will remain unchanged. B's basis in the securities acquired will be stepped up to the fair market value if B is required to recognize gain on the transfer. On the other hand, if A and B had merely partitioned the real property, no taxable exchange would have occurred.

Many common law property states do not recognize a vested property interest of each spouse in the property acquired during the marriage if the title to that property is held separately. In those jurisdictions it is very difficult to establish that a division of property rather than a taxable transfer in satisfaction of a legal obligation has occurred upon the transfer of separately owned assets. Married couples frequently tend to view assets as held in some form of co-ownership regardless of the state of title. The title to all of the assets may be in A, but A and B may regard B as a co-owner who as such is entitled to a portion of the assets. Absent proof of a vested property interest under state

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law, any transfer of property to B pursuant to a divorce or separation will trigger a realization of gain or loss under the *Davis* rationale. In *Richard E. Wiles, Jr.*66 the property settlement provided for an equal division of all property regardless of the form of ownership. Since more assets were owned by the husband than by the wife, she retained most of her property and he transferred to her sufficient property to equalize their holdings. The Tax Court found that the property rights of a spouse under applicable state law did not constitute a form of co-ownership and that a taxable transfer had occurred. The determinative factor in characterizing a taxable transfer is whether the recipient of the transferred property is a co-owner under local law. A few states have a quasi-community property approach under which a vested property interest with respect to property acquired during the marriage is recognized.67 Partition of this jointly acquired property has been held to result in no realization of gain or loss, regardless of the actual state of title. In *Collins v. Commissioner*68 the husband transferred certain appreciated stock to the wife pursuant to a written property settlement agreement. Following a determination by the Tax Court and the Tenth Circuit69 that the transfer resulted in a taxable gain, the Supreme Court of Oklahoma held that under the applicable Oklahoma statute a separate class of property known as jointly acquired property had been created. The nature of the wife's interest in jointly acquired property is "... similar in conception to community property and is regarded as held by a species of common ownership."70 Following this determination the Tenth Circuit on rehearing held that the transfer was a nontaxable division of property rejecting the Commissioner's contention that *Davis* had established certain federal criteria which must be met before rights conferred by state statute constitute co-ownership.71 In a similar case72 involving property rights in Colorado the Supreme Court of Colorado in response to a request by the federal district court held that a wife had a species of common ownership of...

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69 *George F. Collins, Jr. 46 T.C. 461 (1966)* aff'd 388 F.2d 353 (10th Cir. 1968) vacated and remanded per curiam 393 U.S. 215 (1968).
70 *Collins v. Oklahoma Tax Commission*, (Okl.) 446 P.2d 290, 295.
71 For an analysis of *Davis* as establishing federal criteria see 29 Maine L. Rev. 73, supra note 67, at 82-7.
the marital estate which vested at the time of the filing of the divorce action. The Tenth Circuit then held that since under state law the wife was a co-owner, the transfer of appreciated property constituted a non-taxable property division. It should be noted that Rev. Rul. 74-3473 provides that “property may be co-owned where (1) title to it is taken jointly under State property law, (2) the State is a community property law State, or (3) State property law is found to be similar to community property law.” Apparently the Service will recognize co-ownership created by statutes similar to those in Collins and Imel.

The tax consequences of a transfer of a property in satisfaction of a property settlement agreement as controlled by the nature of the property interests of the transferee. In those jurisdictions in which the highest state court has ruled on the question, the tax planner can act with some degree of certainty as to anticipated tax consequences. In those jurisdictions in which the state court has not determined the nature of the wife’s interest, the federal court will make the determination. This lack of certainty poses additional planning problems for the tax planner. In those common law states in which the highest court has not recognized this new species of common ownership attributable to the marital estate or jointly acquired property, the planner must advise the parties that any transfer of appreciated property may result in additional tax costs to the transferor. The determination as to whether or not such transfers should be made can only be made on an ad hoc basis and is frequently influenced by non-tax considerations. However, decisions which are based on non-tax considerations must always be made in the light of anticipated tax consequences.

**Trusts**

In arriving at a property settlement and providing for alimony, the parties may find it desirable to use an existing trust or to create a trust to implement the terms of an agreement.74 The trust does not offer any unique tax advantages, but may be attractive in that the future payment of alimony is secured, property settlements may be implemented, provision may be made for securing expertise in the management of the trust assets, and the disposition of those assets upon the termination of the beneficiary-wife’s interest may be provided for.

Frequently the transferor of the property (referred to as the husband for convenience) may have reserved powers or interests that would normally result in the transferor being treated as the owner of the

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income,\(^76\) however, § 71(d) provides that the income attributable to transferred property shall be excluded from the transferor's income. Since the payments are excluded from the transferor's income, no § 215 deduction is permitted.\(^76\) Trusts used in providing for alimony and property settlements are sometimes classified as alimony trusts and pre-existing trusts. The tax treatment of the two varies somewhat. Periodic payments from an alimony trust, like direct payments, are includible in the income of the beneficiary-wife as alimony only if in satisfaction of an obligation incurred because of the marital or family relationship.\(^77\) The periodic payments to a beneficiary-spouse from a so-called alimony trust are taxable to the spouse under § 71(a) regardless of whether paid from income or principal.\(^78\) The Service takes the position that the alimony trust is not a conduit and therefore the character of the income to the trust is not passed through to the beneficiary. Thus income which is tax-exempt to the trust is taxable as alimony to the beneficiary-wife of an alimony trust. It should be noted that it has been held that payments from the tax-exempt income of an alimony trust retain their tax-exempt character,\(^80\) however, the more widely accepted view is that distributions from a § 71(a) trust should be taxable as alimony.\(^81\) This view is consistent with the proposition that all distributions to the beneficiary, including those from corpus, constitute alimony to the recipient.

Somewhat different treatment is accorded trusts established independently of the divorce and having no relations thereto. These are sometimes referred to as pre-existing trusts. Under § 682 the income is taxable to the wife-beneficiary rather than the husband-grantor regardless of any beneficial interest that may be retained by the grantor. However, under the § 682 or pre-existing trust the beneficiary-wife is taxed as a trust beneficiary. Thus under the normal trust accounting rules,\(^82\) distributions are included in income only to the extent of the distributable net income of the trust, and the trust is a conduit. It is

\(^{76}\) I.R.C. §§ 671-678.
\(^{77}\) Treas. Reg. § 1.71-1(c) (1). Regulation § 1.71-1(c) (4) provides alimony does not include that part of any periodic payment attributable to that portion of any property or interest transferred which interest originally belonged to the wife unless she received such interest from her husband in contemplation of the divorce or separation without adequate and full consideration in money or money's worth.
\(^{78}\) Treas. Reg. § 1.71-1(c) (2).
\(^{79}\) Rev. Rul. 74-94, 1974-1 CB 26. Note that this ruling also provides that if a portion of the distribution is designated as child support, that portion is includible in income by the transferor to the extent of the distributable net income of the trust which is not considered to have been distributed to the wife.
\(^{81}\) See Peschel, supra note 74.
\(^{82}\) I.R.C. §§ 641 et.seq.
clear that tax-exempt income of the trust would retain its tax-exempt character in the hands of the beneficiary. While § 71 applies to a trust created pursuant to or in contemplation of a decree or written separation agreement, § 682 is frequently said to apply to pre-existing trusts or trusts in existence prior to the divorce or separation. This is an over-simplification of the distinction between §§ 71 and 682. A trust created for the benefit of the wife which was created during the marriage when no divorce or separation was contemplated should be taxed under § 682. However, payments from a pre-existing trust may be taxed under § 71 rather than § 682 if “in discharge of an obligation imposed upon or assumed by the husband (or made specific) under the court order or decree . . . or a written instrument incident to the divorce status or legal separation status or a written separation agreement.”

The Tax Court has held that payments to the wife from a husband's income interest in a pre-existing trust constituted alimony because the payments satisfied the husband's support obligation.

Although under both §§ 71 and 682 the trust income is excluded from the husband-grantor's income, it may be advantageous to both parties to attempt to secure the benefits of § 682 for the wife-beneficiary. Since the income tax consequences may be less severe to the wife, it may be possible to fund the trust with fewer assets. Generally § 682 applies only where the trust was created prior to and not in contemplation of a divorce and does not satisfy the support obligations imposed by a divorce or separation. It has been suggested that the regulations may be interpreted as indicating that § 71(a) does not apply to payments from a trust where the separation agreement or divorce decree does not itself require the creation of the trust in discharge of the husband's obligation, and that the advantages of § 682 might be secured either (1) by making no provision for support in the separation agreement or (2) by providing for support payments without reference to a trust.

The transfer of appreciated property to a trust may result in the realization of gain by the transferor under the Davis rationale. If the creation of the trust constitutes a full discharge of the transferor's support obligation, gain is realized. On the other hand, if the transferor's support obligation is not fully discharged, the transfer of property to the trust does not trigger a realization. In Rev. Rul. 57-506.

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83 Treas. Reg. § 1.682(a)-1(a) (2). In Rev. Rul. 65-283, 1965-2 CB 25, the transfer by a husband of his income interest in a trust created by his father pursuant to a separation agreement resulted in income to the wife under § 71 rather than § 682.


85 Boies, supra note 74, at 600.


the Service held that a provision requiring a husband to make certain alimony payments in the event that the trust income was less than a specified amount resulted in a continuing obligation on the part of the husband; therefore the husband's transfer of appreciated property to the trust did not result in the realization of gain. The transferred property is not income to the beneficiary-spouse and results in no § 215 deduction for the transferor. For example, if the husband transfers $100,000 to an alimony trust for the benefit of the wife, the $100,000 is not income to her nor deductible by him; the periodic payments from the trust to the wife are income to her, and excluded from the husband's gross income. If the trust is for the support of the spouse for his/her life with remainder to the children, the transfer may be treated as part sale, part gift. Therefore in a taxable transfer of appreciated property to a trust, the transferor may be required to realize only a portion of the gain.

Since there are no unique income tax advantages in using a trust rather than direct payments of alimony, the decision to use a trust to implement the provisions of the property settlement or support agreement must be predicated upon non-tax considerations. Further, the uncertain tax consequences may render the use of trusts inadvisable.

**Miscellaneous Transactions**

On occasion the parties agree that the wife is entitled to the rent-free use of the family residence or that the husband is to pay the wife's rent. The tax consequences may then be controlled by the ownership of the property. If the wife is entitled to the rent-free use of a residence owned by the husband, the husband is not entitled to treat the fair rental value of the residence as a deductible alimony payment. Apparently the husband must incur an actual out-of-pocket expenditure in order to generate a deduction. On the other hand, if the husband does in fact pay the wife's rent, those payments are periodic and are income to her and deductible by him; further certain payments which are periodic such as expenses for utilities constitute alimony.

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89 Transfers of property pursuant to a written agreement are not subject to gift tax if the transfer occurs within two years of a divorce. I.R.C. § 2516. If there are transferees other than the wife, a portion of the property may be subject to the gift tax. Further a retention of a reversion or of any of the §§ 2035—2038 type powers may result in the imposition of the estate tax. See Howard B. Solomon, "The Balance Sheet Liabilities: Divorce, Maritals, and Their Agreements" 35 N.Y.U. Institute on Federal Taxation 1315 (1977). For a discussion of the income tax treatment see Roland J. Hjorth "Tax Consequences of Post-dissolution Support Payment Arrangements" 51 Wash. L. Rev. 233, 257-9 (1976).
90 Pappenheimer v. Allen, 164 F.2d 428 (5th Cir. 1947).
Questions may arise as to the treatment to be accorded the payment of a mortgage by the husband where the wife is entitled to the use and possession of the property. The tax consequence of mortgage payments is controlled by the form of ownership of the property. If the property is owned by the husband, payment of the mortgage by the husband does not constitute alimony to the wife. The mortgage payments are considered to inure ultimately to the benefit of the husband. The husband would of course be entitled to deduct interest and taxes with respect to the property. If the property is owned as joint tenants or as tenants in common and the husband makes the mortgage payments, one-half of the payment is alimony to the wife if the periodic requirement is met. The husband is considered to pay one-half on his own behalf and one-half on behalf of the wife. Each party is then entitled to deduct the interest and taxes attributable to his/her share of the property.

The agreement may provide that the home is to be transferred to the wife and that the husband is to continue to make the mortgage payments. In this situation the transfer of the home may result in a realization of gain by the husband under the Davis rationale. Where the property is transferred to the wife, any subsequent periodic payments with respect to the mortgage should be deductible as alimony by the husband. The wife as the owner of the property should be entitled to deduct any interest and taxes. However, if the payments are not in the nature of support they will not constitute alimony. For instance, if the husband as part of a lump sum payment is to transfer a residence to the wife, he may not transform this lump sum into periodic payments by electing to pay the cost over a period of time.

A divorce or separation may result in the transfer of life insurance on the husband's life to or for the benefit of the wife. This is frequently deemed desirable by the wife as she desires protection against the loss of income which might result from the premature death of the husband. The husband may either purchase a new life insurance policy or be required to transfer an existing policy to the wife and continue to pay the premiums. If the husband is required to continue to pay premiums on a policy on his life, he will prefer that those payments be alimony and therefore deductible by him. The current position of the Service is that premiums paid by the husband on an ordinary life insurance policy absolutely assigned to the wife in which

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she is irrevocable beneficiary and which payments are made pursuant to a settlement agreement are deductible as alimony by the husband and includible in the wife’s income.\textsuperscript{95} Apparently all three conditions must be met. The wife must be the irrevocable and not merely a contingent beneficiary. It has been held that premiums are not deductible if there is any contingency under which the wife may lose some economic benefit from the policy. If premium payments are to constitute alimony, it is necessary that the payment of premiums by a husband confer on the wife a presently ascertainable economic benefit.\textsuperscript{96} The courts have been reluctant to recognize this economic benefit unless the wife is not only the irrevocable beneficiary, but also the owner of the policy. The Service has ruled that where the husband retains the ownership of the policy the fact that he is restricted from exercising the incidents of ownership by the terms of the decree or separation agreement is sufficient to qualify the premium payments as alimony to the wife.\textsuperscript{97} Further, it has been held that premiums paid by the transferor are not deductible if the transferee is to own the policy for only a specified period of time,\textsuperscript{98} and that premium payments on a decreasing term policy are not deductible as any benefit to be received by the wife is too contingent to have a present direct economic value.\textsuperscript{99} One case has held that premiums on whole life insurance are deductible recognizing that “death protection” is a valuable asset flowing to the spouse.\textsuperscript{100} The tax adviser must be careful not to overlook the third requirement, that the premiums must be paid pursuant to a settlement agreement or divorce decree. A voluntary transfer of a policy to the wife may be disregarded, resulting in nondeductible premium payments.\textsuperscript{101}

The transfer of a policy to the spouse by the insured may result in the realization of gain by the transferor if the value of the policy transferred exceeds its cost. Of course, it may be possible to use an insurance policy as one of the assets to be transferred as part of a tax-free division of property, or it may be advisable to have the wife acquire a new policy on the life of the husband in order to avoid the realization of income. If the policy is transferred to the wife, the value of the policy at the time of the transfer should not be treated as income to the wife, however she may realize income upon the collection of the proceeds. If the wife is treated as a transferee for value she may

\textsuperscript{95} Rev. Rul. 70-218, 1970-1 CB 19.
\textsuperscript{96} See \textit{Wright v. Comm.}, 62 T.C. 377 (1974), aff’d 543 F.2d 593 (7th Cir. 1976).
\textsuperscript{97} Rev. Rul. 57-125, 1957-1 CB 27.
\textsuperscript{100} \textit{Stevens v. Comm.}, 439 F. 2d 69 (2d Cir. 1971).
\textsuperscript{101} \textit{Cole}, T.C. Memo 1971-74.
realize income to the extent that the proceeds exceed her basis. Further if the proceeds are received in periodic payments § 101(e) may result in the payments being treated as income fully taxable to the recipient.

It may not be advisable to attempt to treat the payment of premiums as alimony. The insured may be unwilling to surrender ownership and control of the policy. The possibility of a realization of gain to the husband at the time of the transfer and of the proceeds being included in income by the wife at the death of the insured may make the transfer of the policy even less attractive. It will frequently be more beneficial to have the husband retain ownership of the policy with provision for any appropriate restrictions of his exercise of the incidents of ownership contained in the agreement or decree. A corresponding adjustment in the amount of alimony payments may be effected. Or, if the parties do agree that an existing policy is to be transferred or a new policy purchased by the wife, the husband should not pay the premiums. If the wife's alimony is increased and she makes the premium payments then the question of deductibility of premium payments is avoided. Of course, she should not be required to apply a portion of the alimony to the payment of premiums as that may revitalize the whole issue.

Conclusion

It may not be possible to obtain the best of all possible worlds for both parties, but the tax planner can assure that they are aware of the tax consequences of their separation agreement or divorce decree. The impact of state law in determining the characterization of payments as periodic and in distinguishing divisions of property from taxable transfer in satisfaction of obligations arising from the marital relationship cannot be overemphasized. Nor can one underestimate the value of careful and explicit drafting of instruments. The advisor must develop expertise not only in the area of taxation but also in the applicable state law. Having done so he/she is then able to predict tax consequences with accuracy, identify those areas in which results cannot be predicted with certainty, structure transactions to achieve the desired tax results, and where it is not possible to achieve the desired results, the advisor can minimize possible adverse tax consequences.

102 I.R.C. § 101(a) (2).
103 See Cosman v. U.S., 27 AFTR 2d 71-1108 (Ct. Cl. 1971) where alimony deduction was denied. Wife was conduit for transmission of premium payments.