The Marriage Undone: Taxwise

The Federal Tax Consequences of California Divorce
and Separation: Alimony and Property Settlements

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IN THE daily press, in weekly and monthly periodicals, in learned legal journals, on radio and television panels and in political perorations, we have read and heard of the radical and far-reaching changes which the increase in rates and scope of our Federal tax laws has brought about in the life and activities of our people. Not the least of this pervasive influence has been its application in the field of marital relations. Professor Armstrong's work, which inspired this commentary, has perforce followed a trend begun in modern lawbooks on property: it takes federal tax factors into account in the prescription of a state's family law.¹

The Treasury Department, insofar as we have been able to ascertain, has not evidenced any opinion or bias in favor of or against the sacred institution of marriage but has maintained an impartial attitude and has given substantial encouragement to both sides of the age-old controversy as to its merits. It cannot be questioned that the marriage relationship, for better or worse, has been continued, in some cases, by reason of "split income" provisions.² On the other side of the picture, there is at least some evidence that divorces have been hastened because the paying spouse has been willing to act in a more generous manner by reason of the income tax provision relating to the deduction of payments for maintenance and support.³ In common with many sections of the Internal Revenue Code the statutory language relating to the tax aspects of marital dissolutions does not indicate a thorough contemplation of all the nuances which have arisen

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NOTE: The "field" survey conducted in the preparation of this article found that the practitioner has no firm working guide in his approach to the problems discussed. However, it was the belief of sources within the bureau as well as those who practice in the field that the courts are developing a more "liberal" attitude in their application of the statutes to specific situations within the scope of Section 22(k).

¹ 1 ARMSTRONG, CALIFORNIA FAMILY LAW 813-823 (1953).

² INT. REV. CODE §§ 12(d), 51(d).

³ INT. REV. CODE § 22(k). Perhaps the language quoted by Judge Clark of the Third Circuit in *Union Trust Co. v. Commissioner of Internal Revenue*, 115 F.2d 86, 87 (3rd Cir. 1940), that "[P]ure acts of grace and favor, the outcome of goodness of heart, perhaps done at times of rejoicing should not be taxed" would be appropriate in this connection.

and which will arise in the future to haunt the draftsmen and increase the worries and, coincidentally, the fees of the lawyers who are concerned with such statutes.

I. PROBLEMS OF ALIMONY AND THE LIKE

These problems polarize about (1) the federal tax effects, and vice versa, of payments in the nature of alimony and (2) the federal tax effects, and vice versa, of property divisions and re-distributions between the spouses at the time of estrangement. This article is so organized as to reflect this polarization, which, of course, like all such descriptions, begs the fundamental question of the characterization of transactions as at one pole or the other. Even the slippery and difficult issue of characterization will, however, be considered herein. In connection with the preparation of this article it was felt that law-in-books and law-in-statutes-and-regulations was apt to be particularly deficient in describing what actually goes on in the usual, routine marriage break-up and its tax aftermath. Accordingly an effort was made to poll practitioners, for taxpayers and for tax-gatherers, on some pertinent aspects of the basic problem. Our questionnaire is carried, for the information or derision of the reader, as an appendix. At appropriate points in the discussion reference is made to what we gleaned from it.

The Interlocutory Decree

One of the specters which faces lawyers is the effect of the interlocutory divorce decree, used in California and other jurisdictions, on certain tax aspects incident to the dissolution of the marriage relationship. The status of the interlocutory decree in the contemplation or determination of problems incident to the marital relationship is not one which is new or which has not been considered previously by those interested in the tax field. Historically, for the purposes of our tax discussion, it was first considered with the introduction into our Federal tax system of the concept of taxing alimony payments to the wife, which concept was embodied in Section 22(k) of the Internal Revenue Code.⁴ [The use of the word "husband" in this portion of the article and in relation to Section 22(k) should be considered as referring to the paying spouse whether it be husband or wife, it being recognized that on rare occasions it is "the woman who pays."]

That section of the Internal Revenue Code was enacted in 1942 to relieve the hardship upon the paying spouse which arose by reason of the inclusion of the alimony payments in his income, which hardship would have been materially intensified with the increase in rates under the 1942

⁴ This section first was embodied in the Code under the Revenue Act of 1942, § 22(k), 56 STAT. 816 (1942).

Revenue Act.⁵ By the section the relief to the husband was, however, limited to those instances where the parties were "divorced or legally separated under a decree of divorce or separate maintenance." When this statute became effective one of the first queries raised by lawyers practicing in jurisdictions using the interlocutory decree method was whether this decree was "a decree of divorce or separate maintenance" within the meaning of the new section. An examination of the reports of the Congressional Committees gave no indication that there had been any consideration of the problem, for these reports contained no mention of the type of decree to which they were referring and, in fact, simply stated that the section was intended to apply only in "cases of divorce or legal separation." The careful lawyer, faced with this paucity of evidence of legislative intent, was forced to base his determination on the law of each state as to whether the interlocutory decree of divorce constituted a decree of divorce or legal separation. Inasmuch as we have no Federal law of divorce or of legal separation, it would appear that the deductibility of alimony payments would vary from state to state depending upon the particular interpretation given by each state to the word "divorce."⁶

In this connection an examination of Professor Armstrong's work on *California Family Law* reveals that the interlocutory decree system was adopted in California in 1903 by reason of the lack of effectiveness of the provisions of Section 61 of the Civil Code which had been adopted in 1897.⁷ The latter provision had made marriages contracted within one year after divorce invalid, but had been rendered a practical nullity because other states allowed marriages of individuals divorced under the California law before the expiration of a year, and the California courts had held such marriages to be valid.⁸ The interlocutory decree procedure was adopted to meet this problem and to provide what might be called "a cooling off period" between the period of "dissolution" of the relationship and the entry of the final decree under the supposition that the chance of hasty decision as to dissolution would be considerably lessened by this method.

Presently California interlocutory decree procedure in matters of divorce is contained in Sections 131, 131.5 and 132 of the Civil Code. A number of decisions of the California courts have considered the effect of these sections.⁹ Without developing in any detail the determinations embodied

⁵ H. R. REP. No. 2333, 77th Cong., 2d Sess. 71-74 (1942). See also SEN. REP. No. 1631, 77th Cong., 2d Sess. 83-87 (1942).

⁶ Some states use the divorce a mensa et thoro, some provide for a "postponed" decree, some use a variation of the California interlocutory decree, and others a limited decree of divorce. See Oliver, *The Nature of the Compulsive Effect of State Law in Federal Tax Proceedings*, 41 CALIF. L. REV. 638 (1953).

⁷ 1 ARMSTRONG, CALIFORNIA FAMILY LAW 246 (1953).

⁸ *Ibid.*

⁹ Estate of Dargie, 162 Cal. 51, 121 Pac. 320 (1912); Estate of Abila, 32 Cal.2d 559, 197 P.2d 10 (1948).

in these opinions, as they are not within the purview of this paper, at least it can be said briefly but definitely that the interlocutory decree does not connote a dissolution of the marriage.¹⁰ However, such a decree is considered to be a final judgment within its terms and subject to modification or vacation only as provided under California statutes for final judgments.¹¹ In addition, the decree, although not regarded as having the effect of dissolving the marriage relationship, has been held to terminate the personal relations between the parties so as to permit their legal separation.¹² In connection with their consideration of these statutory and judicial precedents California attorneys necessarily gave some effect to the general lay understanding that parties were divorced when an interlocutory decree had been entered and the fact that normally the interlocutory was evidence of a complete separation of the parties and a cessation of marital responsibilities, except to the extent that they were specifically preserved by the provisions of the decree or by agreement of the parties.

For about three years California tax lawyers tried to guess what the position of the Bureau of Internal Revenue would be and how the incongruities of the interlocutory decree would be fitted into the statutory language of Section 22(k). In 1945 this issue was apparently resolved by a very succinct ruling by the Bureau which made no effort to do more than say that payments made pursuant to an interlocutory decree were includible in the gross income of the recipient under Section 22(k).¹³ This ruling was apparently sufficient to settle the fears of the bar insofar as Sections 22(k) and 23(u) were concerned. It left, however, an incidental question under Sections 22(a)(A), 25(b)(2) and 51 whether, under the language of these sections, the parties would be considered as married during the period that the interlocutory decree was in effect.¹⁴ Four years later that question was answered in the negative.¹⁵ The logical result of these rulings and certainly the understanding of counsel was that the doubt was removed as to the applicability of the sections to the interlocutory decree, and that for the purposes of these sections the interlocutory decree was a decree of divorce. Thereafter, it is believed that attorneys justifiably considered that there was no distinction to be made between the interlocutory and the final

¹⁰ Estate of Dargie, *supra* note 9; 1 ARMSTRONG, CALIFORNIA FAMILY LAW 248-250 (1953).

¹¹ Hall v. Hall, 42 A.C. 447, 267 P.2d 249 (1954).

¹² Stauter v. Carithers, 185 Cal. 160, 196 Pac. 37 (1921); London G. A. Co. v. Industrial Acc. Com., 181 Cal. 460, 184 Pac. 864 (1919).

¹³ I.T. 3761, 1945-1 CUM. BULL. 76.

¹⁴ Section 25(b)(2)(B) relates to the determination of status for the purpose of determining the \$600 credit allowed to the taxpayer's spouse; Section 51 to the right of a husband and wife to file a single return and Subsection (5) sets forth the test for determination of that status.

¹⁵ I.T. 3942, 1949-1 CUM. BULL. 69.

decree of divorce in the handling of those tax matters related to the break-up of the marriage relationship.

In March of 1953 this tiny haven of peace and quiet in the tumultuous area of the interpretation of Section 22(k) and related sections was invaded by two decisions of the Tax Court.¹⁶ In the *Eccles* case an interlocutory decree had been entered under Utah law. Despite the entry of the decree Mr. and Mrs. Eccles made a joint return for the tax period which had ended prior to the entry of a final decree. The theory expounded by Eccles in his petition to the Tax Court was that under the language of Section 51(b) Mrs. Eccles and he were not "legally separated under a decree of divorce."¹⁷ The Tax Court, looking to the pertinent provisions of the Utah law, which are not substantially different from those of California, held that Section 51(b)(5)(B) was not applicable under the Utah law. The court held that there was no divorce because the marriage was not dissolved, although the decree was termed in the Utah statute a decree of divorce. It was the contention of the court that the word "divorce" must be considered as a word of art and that so considered it meant only an absolute divorce. The Tax Court, therefore, sustained Eccles' position that he was "married" for the purpose of the filing of a joint return of husband and wife under Section 51. Inasmuch as the provision of Section 22(k) in this regard is nearly identical it appeared obvious that the decision would be applicable to that section. However, any possible doubt was settled by a subsequent decision of the Tax Court in the *Evans* case, which involved the includibility in the return of the wife of alimony payments received during the period between the entry of the interlocutory decree and the entry of the final decree.¹⁸ In that case the court held that the Colorado interlocutory decree did not dissolve the marriage and was not a decree of divorce within the meaning of Section 22(k).

With the affirmance of *Eccles* and *Evans* by the Court of Appeals, there was engrafted on the Income Tax law an interpretation concerning the tax impact of the dissolved or dissolving marital relationship which it is believed does violence to the basic rationale of Section 22(k) and other pertinent sections of the Internal Revenue Code. It is apparent from the committee reports¹⁹ that the purpose of the amendment which made Sections 22(k) and 23(u) a part of the Code was to relieve the husband from an inequitable burden. The fact that under the *Eccles* holding the husband may be better off financially than if he had been regarded as divorced and

¹⁶ *Marriner S. Eccles*, 19 T.C. 1049 (1953), *aff'd*, *Commissioner of Internal Revenue v. Eccles*, 208 F.2d 796 (4th Cir. 1953); *Alice Humphreys Evans*, 19 T.C. 1102 (1953).

¹⁷ *Marriner S. Eccles*, *supra* note 16.

¹⁸ *Alice Humphreys Evans*, *supra* note 16.

¹⁹ See note 5, *supra*.

taxed only on his income less alimony payments should not be a factor entering into consideration of the basic legislative intent implied in Section 22(k) for the joint return-split income sections did not become part of the law until six years after the enactment of Section 22(k).

The inequity with which Congress was concerned when it enacted Section 22(k) was that which imposed a tax on a husband for money he was required to pay a wife, who, as a result of judicial proceedings, was legally separated from him. As the Committee stated in its report, circumstances could easily arise where the husband might not have sufficient income left after paying alimony to meet his own income tax obligation, if a deduction on his return was not allowed for the alimony paid. Thus, as the basic premise of Congress was that there should be relief from that hardship, the question, in the absence of any direct legislative statement of intent, is what tests were provided to bring into operation the exemption from this burden which would be consistent with the over-all legislative intent. It is clear that one test was that the separation be actual and that it be as a result of some legal procedure. Another test expressed in the Code was that legal proceedings should result in a decree of divorce or separate maintenance. As previously observed, there is nothing in the statute or in the Committee reports relating to Section 22(k) which in any way defines divorce or separate maintenance. It is submitted that there is no basis for the conclusion, if we view Section 22(k) alone, that Congress meant, in its use of the word "divorced," to confine the application of the section either to interlocutory decree of divorce or absolute or final decree of divorce.²⁰ The one ground for adopting the "interlocutory decree as a divorce" interpretation is that, from the standpoint of the paying spouse, the legal requirements and burdens upon him are as great, and the marital duties of the wife as small, during the interlocutory period as they are subsequent to the entry of the final decree. In addition, those requirements, burdens and responsibilities are certainly as great during the interlocutory period as they are when a decree of separate maintenance has been entered.²¹ He is required to pay her the specified support and maintenance, and she has the right to live separately in both instances. He apparently has in each instance the burdens but none of the advantages of the marital relationship. It would seem logical that if Congress had intended to use the term "divorce" as the Tax Court held to be the intent in the *Eccles* and *Evans* cases, there would have been no necessity for using the words "legally separated," for both absolute divorce and separate maintenance connote legal separation.²² If we go further than

²⁰ Committee Report, 1942-2 CUM. BULL. 372, 409.

²¹ *Monroe v. Superior Court*, 28 Cal.2d 427, 170 P.2d 473 (1946).

²² 1 ARMSTRONG, CALIFORNIA FAMILY LAW 394 (1953); *Monroe v. Superior Court*, *supra* note 21.

Section 22(k), and the Committee reports relating to it, it is believed that there are indications that the interpretation should not be as set forth in the Tax Court decisions. In the first place we have the administrative rulings that the interlocutory decree constituted a decree of divorce for income tax purposes.²³ This is fortified by the fact that in subsequent legislation Congress used the terms "legally separated," "a decree of divorce," and "separate maintenance" to indicate a status of not being married with the knowledge of the administrative interpretation then in effect. Further, the House Committee report in 1948, in relation to the amendment of Section 25(b) which inserted the same phrase in that section, stated that: "... an individual legally separated (although not absolutely divorced) from his spouse under a decree of divorce or separate maintenance should not be considered as married."²⁴

These factors indicate that there was some lack of thorough consideration by the Tax Court in taking its position in the *Eccles* and *Evans* cases. It is our opinion that the decisions are erroneous and that they disregard the primary reasons for Section 22(k). Any decree which provides for a legal separation of the spouses effectively disrupts the marital relationship and should be the basis for the application of the relief provisions.

We must, however, realize that although it appears to some of us that the legislative history, as well as a proper application of that appears to be the legislative purpose, would compel a conclusion contrary to that of these two cases we are faced with the fact that these cases, and not the writers, state the law. In addition, there would appear to be no indication of a referral of the question to the Supreme Court. Therefore we must give some consideration to the effect of the doctrine set forth in these cases upon the handling of the pertinent problems incident to marital dissolutions.^{24a}

There are three main areas where these decisions are effective and which must be considered in shaping the written understandings entered into as a part of the process of dissolution. The first of these is the question of the nature of the income tax return to be filed during the period of the pendency of the interlocutory decree. Normally in a state such as California,

²³ See notes 13, 15 *supra*.

²⁴ 1948-1 CUM. BULL. 277.

^{24a} Subsequent to the date on which this article went to press the final version of H.R. 8300 was passed by the Congress. Under Section 71(a)(2) of the new Code which is the equivalent of Section 22(k) the problems discussed in the three following paragraphs were solved in respect to agreements executed after the enactment of H.R. 8300. The solution is by the provision that payments made to the wife, after separation of the parties under a written separation agreement are to be included in the wife's income even though no decree has been entered. The advantage in certain cases of a single joint return by the separated husband and wife is apparently preserved by a proviso that Section 71(a)(2) is not applicable if such a single return is filed. Section 71(a)(3) makes a similar inclusion requirement where payments are made for support or maintenance pursuant to a decree entered after March 1, 1954.

when the parties enter into an agreement as a part of the termination of the marital venture, provision is made for the cessation of the community property status of income received by either of the spouses from the date of the interlocutory, and each spouse files a return for income tax purposes reporting the income attributable to such spouse.

Under the doctrine of the *Eccles* case this action would in many instances result in the payment of a larger amount than necessary to the federal government as income taxes. Thought should therefore be given in the drafting of marital dissolution agreements to the inclusion of a provision authorizing the husband to file a joint return with the wife and to the consideration of a provision requiring the wife to contribute the tax she would have been required to pay in the event she had filed a return on her separate income. Some thought should also be given to a proviso such as that the wife's contribution should not be in excess of that percentage of the total tax which her separate income bears to the total gross income. It should be noted that this formula is subject to certain obvious disadvantages and would work inequities in specific cases. Therefore it must be tailored to meet the specific needs which arise by reason of the financial position of particular individuals. The formula idea is mentioned only because it does indicate that some thought must be given by counsel to a proper allocation and that a one-half split or allocation based upon separate return payments may not be adequate or equitable in many instances.

The joint return formula may assist in solving the problem of non-deductibility of support or maintenance, particularly during the interlocutory decree period, but of course there will be cases where the bitterness and vindictiveness stimulated by the circumstances incident to the separation will make its use impossible. In such instances the fact of non-deductibility must be taken into consideration either in negotiations of counsel or at the time of presentation of the matter to the court. It should be a basis for the husband's representative to urge a lesser amount of support and maintenance for the period of the interlocutory decree, and the computations based on the tax brackets of each of the individuals are an essential element here.

Another area in which the *Eccles* and *Evans* cases are pertinent is that of the so-called "installment" payment under Section 22(k). Section 22(k) provides in part:

Installment payments discharging a part of an obligation the principal sum of which is, in terms of money or property, specified in the decree or instrument shall not be considered periodic payments for the purposes of this subsection; except that an installment payment shall be considered a periodic payment for the purposes of this subsection if such principal sum, by the terms of the decree or instrument, may be or is to be paid within a period ending more than 10 years from the date of such decree or instrument, but

only to the extent that such installment payment for the taxable year of the wife (or if more than one such installment payment for such taxable year is received during such taxable year, the aggregate of such installment payments) does not exceed 10 per centum of such principal sum.

If these words mean, as we believe they should, that the ten-year period commences with the date of the execution of the instrument, *Eccles* and *Evans* raise no new problems, with the exception that payments made during the pendency of the interlocutory decree will not be deductible by the husband nor required to be included by the wife. If, however, the ten-year period does not commence until the entry of a final decree of divorce serious complications arise in the case of agreements now in effect, and which were drawn on the basis of ten years and one day lapsing between the date of execution of the agreement and the final payment. If the time for the computation of the ten-year period runs only from the date of the final decree, the entire payments over the ten-year period would be held to be non-deductible and this might well be disastrous to a taxpayer in a high bracket. Certainly, in the drafting of any future agreements, the only safe method is to provide specifically that the payments shall continue for a period in excess of ten years from the date of entry of the final decree.

Segregation

The *Eccles* and *Evans* decisions are not the only instances in the field of marital dissolutions where judicial interpretation of the Internal Revenue Code has indicated a desire to re-examine and revitalize in a slightly different climate the long defunct theory that "two can live [together or separated under a decree of divorce or of separate maintenance] as cheaply as one."

In addition to the burden which the *Eccles* and *Evans* decisions have placed upon lawyers engaged in negotiating and drafting marital dissolution agreements, other decisions have made increasingly necessary an extremely careful statement of the parties' intent and, to some extent, have placed a premium on ingenuity not justified by the statutory requirements.

One problem has arisen because of the *apparent uncertainty* as to the best method of providing for the payment for the support of the wife and minor children so as to clearly express the intent of the parties and allocate the tax liabilities between the husband and wife. The same situation is present when the agreement is intended to settle all rights to property as well as to provide support and maintenance. Section 22(k) specifically eliminates payments for the support of minor children from the amount to be included in the wife's income and excluded from the husband's income by Section 23(u). A mere division of property by the parties whether by cash payments or otherwise is not covered because the section applies only to

"payments in discharge of a legal obligation which because of the marital or family relationship is imposed"

In a simple circumstance, such as one in which the agreement provides a set amount for the support of the wife and a set amount for the support of the children, there is no problem except the requirement of clarity. Similarly the lawyer would have no difficulty in drafting or construing an agreement which specifically divided the property of the parties without provision for support and maintenance. The perplexing problems arise where the agreement merely sets forth a monthly payment as support for the wife and minor children,²⁵ where there is no legal obligation for support after divorce and there are some property rights,²⁶ or where the monthly payment is in consideration of a release of all property rights and for support and maintenance.

It is in these more complicated instances that the lawyer's responsibilities increase and his consequent headaches are apt to become more severe and frequent. Although the courts have varied somewhat in the net result of their decisions on this "segregation" problem it would appear that the basic demand on the lawyer is that he achieve clarity of expression so that the agreement specifically expresses the intent of the parties. The amount which is determined by the parties to be for the support of the children should not be confused or commingled with that for the support of the wife, lest the court rewrite the provision to the possible and unintended disadvantage of either.²⁷ If the agreement relates in part to a settlement of property rights there should not be such failure to adequately differentiate the provision for support or maintenance as to cause all or a portion of the latter to be taxed to the husband.²⁸

Generally the judicial determinations have held that if the agreement provides for support and maintenance of the wife but reduces the amount upon the majority or death of the children, it is this reduced amount which

²⁵ Dora H. Moiteret, 7 T.C. 640 (1946).

²⁶ Floyd H. Brown, 16 T.C. 623 (1951). Where there was a transfer of property and a monthly payment the court held the monthly payment deductible under § 23(u) even in the absence of a specific statutory obligation for support and maintenance after divorce. The court assumed that the payment was in consideration of the relinquishment of the right of support while married. See also Julia Nathan, 19 T.C. 865 (1953); Frank J. DuBane, 10 T.C. 992 (1948); Edward Bartsch, 18 T.C. 65 (1952) (where agreement provided for \$450 monthly payment for life and \$45,000 paid in four yearly installments, latter payment held not deductible under § 23(u)); Thomas E. Hogg, 13 T.C. 361 (1949).

²⁷ Edward Bartsch, *supra* note 26; Dora H. Moiteret, 7 T.C. 640 (1946); Robert K. McBerty, 16 T.C. 968 (1951); Dorothy Newcombe, 10 T.C.M. 152 (1951); Henrietta S. Seltzer, 22 T.C. No. 26 (1954).

²⁸ Edward Bartsch, 18 T.C. 65 (1952); Thomas E. Hogg, 13 T.C. 361 (1949); *Est. of Frank C. Smith*, 11 T.C.M. 1167 (1952), *aff'd*, *Smith's Estate v. Commissioner of Internal Revenue*, 208 F.2d 349 (3d Cir. 1953); Frank J. DuBane, 10 T.C. 992 (1948).

is included in the wife's income under Section 22(k).²⁹ The same result was reached when the agreement provided for a specified monthly sum to the wife but upon her remarriage a lesser sum for the support of a minor child.³⁰ Where the agreement suggested that all payments over a specified sum be saved for the children the Tax Court held that the wife was taxable on the entire amount.³¹ These cases emphasize the previous statement that the agreement should clearly state the intent of the parties, for in each of them we find costly litigation by reason of a contention, at least, that the agreement meant something different than the commissioner believed it did.

We should also take cognizance of an interesting development on the question of "segregation" of attorney's fees. The courts have consistently held that neither husband nor wife can deduct the fees charged by counsel for the services directly relating to the divorce proceeding, and there is no serious contention against this conclusion. The controversy arises where substantial services are rendered in connection with the support and maintenance and property division aspects of the dissolution of the marriage. Insofar as the husband is concerned the decisions have generally been adverse,³² except in the rare instance where the demands could be shown to relate specifically to a defense of the source of income.³³ In the case of the wife the courts have been more ready to consider legal expenses relating to services which result in the acquisition of alimony, or an increase of alimony, as being nontrade or nonbusiness expenses deductible under Section 23(a)(2).³⁴ Without belaboring the point it would seem that a husband whose lawyers by court proceeding or negotiation endeavor to protect his capital from an ex-wife's inroads or to reduce the amount of alimony to be paid such former spouse, should be entitled to deduct the fees for such services as ordinary and necessary expenses "incurred . . . for the management, conservation, or maintenance of property held for the production of income."³⁵ However, in view of the interpretation of this section by the Supreme Court in *Lykes v. United States*,³⁶ the possibility of any increase in the application of Section 23(a)(2) to our husband-wife situation would seem to vanish.

²⁹ *Mandel v. Commissioner of Internal Revenue*, 185 F.2d 50 (7th Cir. 1950); *Warren Leslie, Jr.*, 10 T.C. 807 (1948); *Harold M. Fleming*, 14 T.C. 1308 (1950).

³⁰ *Robert W. Budd*, 7 T.C. 413 (1946), *aff'd*, *Budd v. Commissioner of Internal Revenue*, 177 F.2d 198 (6th Cir. 1947).

³¹ *Robert K. McBerty*, 16 T.C. 968 (1951).

³² *Howard v. Commissioner of Internal Revenue*, 202 F.2d 28 (9th Cir. 1953); *Smith's Estate v. Commissioner of Internal Revenue*, 208 F.2d 349 (3d Cir. 1953); *Thorne Donnelley*, 16 T.C. 1196 (1951).

³³ *Baer v. Commissioner of Internal Revenue*, 196 F.2d 646 (8th Cir. 1952).

³⁴ *Elsie B. Gale*, 13 T.C. 661 (1949); *Barbara B. LeMond*, 13 T.C. 670 (1949); see *Smith's Estate v. Commissioner of Internal Revenue*, 208 F.2d 349, 354, n. 7 (3d Cir. 1953).

³⁵ INT. REV. CODE § 23a(2).

³⁶ 343 U.S. 118 (1952).

The opportunity which seems present, at least momentarily, to obtain a deduction for a part of the wife's expense and, in some rare instances, for the husband, makes it imperative for the lawyer representing either to keep accurate records as to the time spent on those portions of the marital dissolution which deal with the support and maintenance and property division factors. He is derelict in his duty to his client if he does not do so.

Incidence

The phrase "incident to a decree" took on major importance with the enactment of Section 22(k) since this is in part determinative of the deductibility of alimony payments. Such importance was not, however, accompanied by an immediate understanding of its meaning or significance. In our search for the meaning of "incident to a decree," we find from the code section a number of specific requirements which relate to this question. Section 22(k) provides that periodic payments, received subsequent to a decree of divorce or of separate maintenance: "... in discharge of a legal obligation which because of the marital or family relationship is imposed upon or incurred by such husband under such decree or under a written instrument *incident to* such divorce or separation shall be includible in the gross income of the wife, and such amounts received ... shall not be includible in the gross income of such husband" (emphasis added). It is evident that there must be a decree of divorce or separate maintenance;³⁷ mere voluntary separation or living apart by the parties will not suffice. There must be a written agreement,³⁸ and payments must have been received subsequent to the decree.³⁹

The obligation to which the section refers can best be shown by a statement in the Tax Court decision of *Charles Campbell*:⁴⁰ "Congress was not directing its attention to a legal obligation under a written instrument in enacting that section of the Code, but to a legal obligation which arises out of the marital or family relationship. In [a House Report⁴¹] it is stated, '... this section applies only where the legal obligation being discharged arises out of the family or marital relationship in recognition of the general obligation to support, which is made specific by the instrument or decree ...'."

³⁷ *Smith v. Commissioner of Internal Revenue*, 168 F.2d 446 (2d Cir. 1948); *Charles L. Brown*, 7 T.C. 715 (1946); *Frank J. Kalchthaler*, 7 T.C. 625 (1946).

³⁸ *Ben Myerson*, 10 T.C. 729 (1948); however, a letter may suffice for the written agreement, *Floyd W. Jefferson*, 13 T.C. 1092 (1949).

³⁹ *Daine v. Commissioner of Internal Revenue*, 168 F.2d 449 (2d Cir. 1948); payments as alimony *pendente lite* are not deductible, *George D. Wick*, 7 T.C. 723 (1946), *aff'd*, *Wick v. Commissioner of Internal Revenue*, 161 F.2d 732 (3d Cir. 1947).

⁴⁰ 15 T.C. 355, 359 (1950).

⁴¹ H. R. REP. NO. 2333, 77th Cong., 2d Sess. 72 (1942).

Although the above requirements have been firmly established, attempts to define the phrase "incident to" have given rise to a variety of interpretations and conclusions. At times in the past,⁴² and even within the past year,⁴³ courts have determined "incidence" by a subjective examination as to whether the parties had contemplated a dissolution of the marriage at the time of the agreement. The test, "part of a package of divorce," has at times influenced courts in judging the "incidence" of the agreement;⁴⁴ however, it has now been repudiated.⁴⁵ Still other decisions found the agreement to be "incident to" because of the chronological juxtaposition of the factual events between the signing of the agreement and the divorce.⁴⁶ This divergence of judicial thought made nearly impossible the emergence of any adequate guide to the practitioner.

Finally, in 1952 the Court of Appeals for the Second Circuit utilized the opportunity presented by the factual circumstances in *Lerner v. Commissioner of Internal Revenue*⁴⁷ to probe analytically for the logical meaning of the phrase. In the divorce proceeding which gave rise to the subsequent tax litigation the referee noted a support agreement, drawn a year and one-half prior to the commencement of the divorce proceedings, which contained a provision that the agreement was to survive regardless of a divorce. No showing was made that the parties contemplated a divorce at the time when the agreement was made. In discussing, in *Lerner v. Commissioner*, the proper interpretation of Section 22(k) as it relates to such circumstances, the court stated:⁴⁸

The term "written instrument incident to such divorce" was designed, we think, only to insure adequate proof of the existence of the obligation when the divorce has occurred, and not to deny relief to the husband when merely legal formalities have not been rendered their full due. So where the payments obviously take the place of alimony and otherwise satisfy the stringent requirements of I.R.C. § 22(k), although not formally incorporated

⁴² *Jessie L. Fry*, 13 T.C. 658 (1949); *G. T. Brady*, 10 T.C. 1192 (1948); *Robert Wood Johnson*, 10 T.C. 647 (1948); see also, *Florence B. Moses*, 18 T.C. 1020 (1952); *Elizabeth E. Guggenheim*, 16 T.C. 1561 (1951); *Bertram G. Zilmer*, 16 T.C. 365 (1951); *United States v. Parker*, 51-1 U.S.T.C. ¶ 9355 (1951).

⁴³ *Frances Hamer Johnson*, 21 T.C. 371 (1953).

⁴⁴ *Cox v. Commissioner of Internal Revenue*, 176 F.2d 226 (3d Cir. 1949); *Joseph J. Lerner*, 15 T.C. 379 (1950).

⁴⁵ *Lerner v. Commissioner of Internal Revenue*, 195 F.2d 296 (2d Cir. 1952); *Commissioner of Internal Revenue v. Miller*, 199 F.2d 597 (9th Cir. 1952); *Feinberg v. Commissioner of Internal Revenue*, 198 F.2d 260 (3d Cir. 1952).

⁴⁶ *Feinberg v. Commissioner of Internal Revenue*, *supra* note 45; *Irastzoff v. Commissioner of Internal Revenue*, 193 F.2d 625 (2d Cir. 1952).

⁴⁷ 195 F.2d 296 (2d Cir. 1952).

⁴⁸ *Id.* at 298. The court held that "[t]he conjunction of the survival provision in the settlement agreement with the fact that the substance of the decree was geared to its continuing in force in lieu of prescribed alimony should be adequate to satisfy the statutory purpose." *Id.* at 299.

into the decree, they should not be denied effect under the statute merely because there is no evidence that divorce and settlement were not contemporaneously planned and carried out.

Such an interpretation is consistent with the legislative history and has some support in the reported cases.⁴⁹ Congress when it enacted Section 22(k) stressed only the manifest fairness of the charge to the wife and consequent tax relief to the husband by the deduction of payments not only for alimony, but for separate maintenance provisions in the nature of or in lieu of alimony or an allowance for support.⁵⁰ It is noteworthy that until 1942 the drafters of separation agreements had no notice of the eventual requirements of the section, and that Congress, cognizant of the differences in agreements fashioned to the particular circumstances of the parties and of the governing state laws, expressed a desire to produce uniformity in the treatment of amounts paid in the nature of or in lieu of alimony regardless of variance in the laws of different states concerning the existence and continuance of an obligation to pay alimony.⁵¹

And since the enactment of the section, practitioners do not always consider it desirable to follow the "safest" method, that is, incorporating the agreement into the decree, or even having something said in the pleadings or decree.⁵² In some states the presence of an agreement could be interpreted as evidence of collusion which would serve as a basis to deny the divorce;⁵³ by presenting the agreement to the court in a divorce proceeding the court may retain continuing jurisdiction, or at least the question may be raised;⁵⁴ and in some jurisdictions private settlements of property and support matters are within the purview of public policy.⁵⁵

⁴⁹ See *Commissioner of Internal Revenue v. Miller*, 199 F.2d 597 (9th Cir. 1952); *Smith v. Commissioner of Internal Revenue*, 192 F.2d 841 (1st Cir. 1951).

⁵⁰ *Supra* note 41; see also SEN. REP. No. 1631, 77th Cong., 2d Sess. 83 (1942).

⁵¹ See note 50 *supra*.

⁵² *Scofield v. Greer*, 185 F.2d 551 (5th Cir. 1950).

⁵³ *Irastzoff v. Commissioner of Internal Revenue*, 193 F.2d 625 (2d Cir. 1952); *Lerner v. Commissioner of Internal Revenue*, 195 F.2d 296 (2d Cir. 1952); *Hill v. Hill*, 23 Cal.2d 82, 142 P.2d 417 (1943); *Bertram G. Zilmer*, 16 T.C. 365 (1951); 1 NELSON, *DIVORCE AND ANNULMENT* § 13.22 (2d ed. 1945); II *id.* c. 27.06.

⁵⁴ *Smith v. Commissioner of Internal Revenue*, 192 F.2d 841 (1st Cir. 1951); *Adams v. Adams*, 29 Cal.2d 621, 177 P.2d 265 (1947); *Hough v. Hough*, 26 Cal.2d 605, 160 P.2d 15 (1945).

⁵⁵ 1 NELSON, *DIVORCE AND ANNULMENT* § 13.44 (2d ed. 1945). A situation in which an agreement must be used to make financial arrangements is presented by the Pennsylvania rule which prevents the award of alimony by the court in an absolute decree of divorce. Thus, in *Tuckie v. Hesse*, 7 T.C. 700 (1946), payments under an agreement for support were held to be deductible by the husband. *But cf.* *Joseph C. Brightbill*, 8 T.C.M. 112 (1949), *aff'd*, *Brightbill v. Commissioner of Internal Revenue*, 178 F.2d 404 (3rd Cir. 1949).

At the time Section 22(k) was enacted, the requirement of a decree of divorce or legal separation was thought necessary to prevent income tax evasion through fraudulent agreements which would place both husband and wife in lower tax brackets. *Smith v. Commissioner of Internal Revenue*, 168 F.2d 446 (2d Cir. 1948). This possibility has since been materially reduced by the split income provision of Section 51(b) which permits the husband and wife to file a joint return even though living apart.

These factors present real reasons why the procedural safeguards should not be extended so as to thwart the design of the section. And such is the idea expressed by the Ninth Circuit in *Commissioner of Internal Revenue v. Miller*,⁵⁶ "To require . . . proof that the parties mutually planned the divorce and that the instrument was an integral part of the plan would, we think, be to import something into the statute that Congress did not require."

In view of the legislative purposes and more enlightened judicial expressions, "incidence" may logically and properly be extended to include an agreement made in recognition of the marital obligations which arise out of the marriage, and which the court in its *super parentis* capacity approves either by positive action or passively by not exercising its power to provide support in a manner contrary to the agreement of the parties.⁵⁷ Thus, Section 22(k) should be applicable to situations where the payments take the place of the support obligation and otherwise satisfy the requirements.⁵⁸

This interpretation would not open the door to every separation and support agreement. Voluntary agreements made subsequent to divorce⁵⁹ would be ineffective due to the general rule that unless some action is taken by contract between the parties prior to, or by the court in making the decree, the divorce terminates the obligation to support;⁶⁰ nor would this apply to voluntary increases in payments as there is no obligation to increase support payments in the absence of a court order.⁶¹ However, compromises of disputes⁶² and court ordered revisions⁶³ should be given effect.

⁵⁶ 199 F.2d 597, 600 (9th Cir. 1952).

⁵⁷ Not all states authorize permanent alimony to be paid upon an absolute divorce decree, 2 NELSON, *DIVORCE AND ANNULMENT* § 14.11 (2d ed. 1945). But the obligation to support during marriage is uniform, and it is in recognition of this obligation that alimony is decreed.

⁵⁸ A decree of divorce or separate maintenance, text at note 37 *supra*; a written agreement, text at note 38 *supra*; and payments subsequent to the decree, text at note 39 *supra*.

⁵⁹ Frederick S. Dauwalter, 9 T.C. 580 (1947).

⁶⁰ 2 VERNIER, *AMERICAN FAMILY LAW* 309 (1932); as to California, see 1 ARMSTRONG, *CALIFORNIA FAMILY LAW* 368 (1953).

In *Cox v. Commissioner of Internal Revenue*, 176 F.2d 226 (3rd Cir. 1949), no deduction was allowed where the agreement was entered into after divorce. However, it should be noted that when a divorce is granted in another jurisdiction upon constructive service of process without appearance by the wife, she may recover alimony at the matrimonial domicile in an independent action. *Estin v. Estin*, 334 U.S. 541 (1948). The obligation in such a situation continues after the foreign divorce.

⁶¹ *Commissioner of Internal Revenue v. Murray*, 174 F.2d 816 (2d Cir. 1949).

⁶² *Dupont v. United States*, 104 F. Supp. 978 (1952); *Mahana v. United States*, 88 F. Supp. 285, cert. denied, 339 U.S. 978 (1950); *Rowena S. Barnum*, 19 T.C. 401 (1952); *Jane C. Grant*, 18 T.C. 1013 (1952), *aff'd*, *Grant v. Commissioner of Internal Revenue*, 209 F.2d 430 (2d Cir. 1953); but cf. *Commissioner of Internal Revenue v. Walsh*, 183 F.2d 803 (D.C. Cir. 1950). The Tax Court has recently revised its opinion of the Walsh circumstances, *Raoul Walsh*, 21 T.C. No. 120 (1954).

⁶³ *Gale v. Commissioner of Internal Revenue*, 191 F.2d 79 (2d Cir. 1951). In *Smith v. Commissioner of Internal Revenue*, 192 F.2d 841 (1st Cir. 1951) the original agreement was incorporated into the decree. It is noteworthy that the court inferred that a court order might not be necessary.

This interpretation would also provide a workable standard against which objective determinates can readily be applied; an easier and more reliable method than the present search for subjective contemplations as to divorce. Furthermore, this would obviate the necessity of construing "incident to such decree" as pertaining solely to the decree," or to a "continuing status," as has been advocated,⁶⁴ interpretations which fail to answer the essential question of whether the payments are in satisfaction of a marital obligation.

A revaluation by the courts is needed of those decisions⁶⁵ which have denied operation of Section 22(k) where a contract in satisfaction of the marital obligation survived a divorce decree without alteration or comment by the divorce court. And as to those and future cases it is hoped that the courts will follow the lead expressed by the interpretation in the *Lerner* case,⁶⁶ for it is only in that manner that the courts can achieve the tax consequences that Congress sought to impose under Sections 22(k) and 23(u).⁶⁷

Periodic Payments

A comparison of the ostensible characteristics of deductible "periodic payments" and non-deductible "installment payments," as these terms are used in Section 22(k), may reveal a striking similarity as to the amount of the payments; the fact that both are payments made to discharge a legal obligation which, because of the marital or family relationship, is imposed upon or incurred by the husband; and that both are a part of a series of payments made periodically. The variance in tax treatment accorded to each arises from the difference in the fundamental concepts adopted by Congress when it placed these terms in Section 22(k). "Periodic payments" are payments in the nature of or in lieu of alimony or an allowance for support as between spouses who are divorced or legally separated under a court order or decree. They are made at different times, and as to amounts or duration, are indefinite.⁶⁸ "Installment payments" are those which dis-

⁶⁴ Divorce as a decree, *Cox v. Commissioner*, 176 F.2d 226 (3rd Cir. 1949); divorce as a continuing status, see *Smith v. Commissioner of Internal Revenue*, *supra* note 63; and 1 MERTENS, LAW OF FEDERAL INCOME TAXATION § 5.23 (1942) at 133, 134 (Cum. Pocket Supp. 1953).

⁶⁵ *United States v. Parker*, 51-1 U.S.T.C. # 9355; *Frances Hamer Johnson*, 21 T.C. 371 (1953).

⁶⁶ See text at note 47, *et seq.*, *supra*.

⁶⁷ The proposed Internal Revenue Code of 1954, H.R. 8300, 83d Cong., 2d Sess. (1954), answers the question of "incidence" as to the future. Under its provisions periodic payments would be included in the wife's gross income after the husband and wife separate, and the husband agrees in writing to satisfy his obligation which arises because of the marital relationship. And such payments would be includible whether or not the agreement is an instrument enforceable in a court of law.

⁶⁸ INT. REV. CODE § 22(k); 26 CODE FED. REGS. 39.22(k)-1 (1954); *Herbert v. Riddell*, 103 F. Supp. 369 (1952), *but cf. Smith's Estate v. Commissioner of Internal Revenue*, 208 F.2d 349 (3d Cir. 1953).

charge a part of an obligation the principal sum of which is, in terms of money or property, specified in the decree or instrument.⁶⁹

As the wording of the section was not designed to encompass every device which the ingenuity of the legal craftsman could conceive in drafting the agreements incident to marital dissolution, it is not surprising that judicial interpretation has not been consistent in applying Section 22(k) to specific situations. The recent case of *Baker v. Commissioner of Internal Revenue*⁷⁰ illustrates the difficulty in distinguishing between "periodic payments" and "installment payments."

Prior to this decision the Tax Court consistently employed the test adopted by that court in *J. B. Steinel*.⁷¹ There, the husband was to pay \$100 monthly until \$9,500 was paid; and the payments were to cease should the wife die or remarry. The court held that mathematical computations were proper to ascertain the principal sum of payments which were to stop within 10 years.⁷² Thus the payments were not "periodic." As to the uncertainty of the principal sum as computed, the court said, "We are of the opinion that the word 'obligation' is used in Section 22(k) in its general sense and includes obligations subject to contingencies where those contingencies have not arisen and have not avoided the obligation during the taxable year." The Tax Court applied this rationale to a similar factual situation in *F. Ellsworth Baker*.⁷³

The Court of Appeals for the Second Circuit in the *Baker* case stated that it could see no justification for such an interpretation and rejected the reasoning pronounced in *Steinel*.⁷⁴ Although the question of the wife's death as a bar to actuarial computation of a principal sum specified was left open, inclusion of the divorced wife's remarriage as an added contingency, one which "depends upon some elements of her own seemingly unpredictable choosing," was thought to present a circumstance beyond the reach of an

⁶⁹ INT. REV. CODE § 22(k): "[A]n installment payment shall be considered a periodic payment for the purposes of this subsection if such principal sum, by the terms of the decree or instrument, may be or is to be paid within a period ending more than 10 years from the date of such decree or instrument, but only to the extent that such installment payment for such taxable year of the wife (or if more than one such installment payment for such taxable year is received during such taxable year, the aggregate of such installment payments) does not exceed 10 per centum of such principal sum."

⁷⁰ 205 F.2d 369 (2d Cir. 1953), *reversing in part*, *F. Ellsworth Baker*, 17 T.C. 1610 (1952).

⁷¹ 10 T.C. 409 (1948). *Accord*, *Harold M. Fleming*, 14 T.C. 1308 (1950); *Estate of Frank P. Orsatti*, 12 T.C. 188 (1949).

⁷² The court reasoned that there is only a formal difference between specifying payment of \$9,500 in monthly installments of \$100 and a decree specifying the payment of \$100 per month until \$9,500 is paid.

⁷³ 17 T.C. 1610 (1952), *rev'd in part*, *Baker v. Commissioner of Internal Revenue*, 205 F.2d 369 (2d Cir. 1953) (\$200 monthly payments were to be paid for six years; however, the payments were to stop in the event of the wife's death or remarriage).

⁷⁴ *Baker v. Commissioner of Internal Revenue*, 205 F.2d 369, 370 (2d Cir. 1953).

educated guess for tax computation purposes. The court said: "The language of the statute before us in the instant case—'the principal sum . . . specified in the decree'—clearly implies an amount of a fairly definite character, and thus carries with it no such suggestion of uncertainty." As the principal sum could not be specified, the payments discharging the obligation were considered "periodic payments," constituting income taxable to the wife and deuctible from the husband's gross income.

Even though no specific directions are expressed on the face of the statute, the proper interpretation can be discerned from the legislative purposes and expressed desires in enacting Sections 22(k) and 23(u). As already noted⁷⁵ the section applies only where the legal obligation being discharged arises out of the family or marital relationship in recognition of the general obligation to support. It was intended that only periodic payments in the nature of or in lieu of alimony or an allowance for support would be eligible for Section 22(k) treatment. An exception was made for installment payments of lump sum obligations to be made over a period of more than ten years; in that case each installment to the extent of 10 per cent of the principal sum would be treated as a periodic payment. These rules were to be applied to produce uniformity in the treatment of amounts paid in the nature of alimony regardless of variance in the laws of different states concerning the existence and continuance of an obligation to pay alimony.⁷⁶

In view of these policy expressions we do not believe that Congress intended the section to apply to payments made for a limited period, the duration of which was dependent upon factors within the wife's control. This becomes more evident when it is noted that at the time of the enactment of the statute, even though states did permit alimony to be given for limited periods, it was customary under a decree of divorce or legal separation to require the husband to support the divorced wife during their joint lives or until she remarried.⁷⁷ The court in *Steinel* recognized this problem when it said:⁷⁸ "The apparent probability must have presented itself to Congress that the decrees of the courts of different states rendered in divorce actions dealing with obligations arising from the marital relationship would differ as to the degree of absoluteness and lack of contingency."

As a practical matter, if the divorced wife must wait only a few years before she will receive the total sum to be paid, in all probability the whole sum will be paid. Thus, to allow an arrangement whereby the wife receives all of her payments within a few years and they are declared to be periodic

⁷⁵ H. R. REP. NO. 2333, 77th Cong., 2d Sess. 71, 72 (1942).

⁷⁶ *Ibid.*

⁷⁷ 2 VERNIER, AMERICAN FAMILY LAW (1932) and 1938 Supplement.

⁷⁸ J. B. Steinel, 10 T.C. 409, 412 (1948).

merely because she may or may not remarry within the time specified for the payments would clearly vitiate the requirement that "installment payments" shall be considered as "periodic payments" only if they are to last for ten years.

The Tax Court has refused to follow the Court of Appeals in *Baker* and has reaffirmed its decision in *Steinel*.⁷⁹ However, the Court of Appeals for the Third Circuit in *Smith's Estate v. Commissioner of Internal Revenue*,⁸⁰ approved the reasoning in *Baker*, and, by dictum, interpreted the statute in yet another light. The court said: "... [W]e do not read into the statute a requirement that the terms of payments must run over ten years in order that this become a periodic contract within the terms of the Act."

The result of such an interpretation would be to make every payment in the nature of or similar to support payments includible within Section 22(k), and would, apparently, require a determination in each case as to whether all or part of the payments are for support.⁸¹ Aside from the opportunity for the parties to make a disposition of marital property and other nonsupport items under the guise of periodic support payments, such a result would give effect to the myriad of variances found in divorce settlements, a result diametrically opposed to Congressional desires.

In light of the nature of the customary divorce decree, Congressional declarations, and the results which flow from a practical operation of the section, it is far more reasonable to believe that Congress had in mind the interpretation employed in *Steinel* than that adopted by the court in *Baker*. Furthermore, the interpretation employed in *Steinel* would seem to apply wherever a lump sum can be computed from the terms of the original agreement, and regardless of what the contingencies might be.⁸²

Such an interpretation provides a practical working standard which is important when determination of amounts to be paid for support and in settlement of marital property rights are dependent upon the tax incidence thereof.

⁷⁹ James M. Fidler, 20 T.C. 1081 (1953). The basis of the court's decision was that to do otherwise would not be giving effect to the plain language of the statute.

⁸⁰ 208 F.2d 349 (3d Cir. 1953). In both *Smith* and *Baker* the courts emphasized the fact that other payments had been made for which no deduction was given. This should not affect the courts' determination of the particular payments in question as the operation of the section is not dependent on the number or formalities of payment.

⁸¹ As to the difficulties a court might encounter, see *Adams v. Adams*, 29 Cal.2d 621, 177 P.2d 265 (1947) for a discussion of the types of divorce arrangements and in particular the "integrated bargain"; see also, 1 ARMSTRONG, CALIFORNIA FAMILY LAW 797 (1953); Note, Family Law: Property Settlement and Support Agreements, *infra* this issue.

⁸² In *Roland Keith Young*, 10 T.C. 724 (1948), the payments were to last for fifty months but as the amount each month was based on a percentage of the husband's income no principal sum could be computed. *Accord*, *John H. Lee*, 10 T.C. 834 (1948).

Insurance

Insurance is as much discussed in times of marital difficulties as it is in general family planning since it may be employed in a variety of ways in a divorce settlement. It may be used to benefit the wife directly as a means of support, to secure support after defalcation, death, or incapacitation of the husband, and it may also be given to the wife as a partial settlement in the division of property.⁸³ The tax incidence on premium payments has been decided, in the main, on the issue of whether the insurance policies were employed as "security" for the performance by the husband of his duties under the divorce agreement, or whether policies were intended as a "direct benefit" to the wife. If the policies were considered as "security," the premium payments were not includible by the wife nor deductible by the husband.⁸⁴ However, if the policies were for the benefit of the wife, the payments were held to be deductible by the husband and includible by the wife.⁸⁵

*Seligmann v. Commissioner of Internal Revenue*⁸⁶ was a typical case to which such a test might apply. There, the wife was to receive the proceeds of the policy only in the event that she outlived her husband, and the amount of the proceeds depended upon whether she remarried. However, the Court of Appeals for the Third Circuit chose not to base its decision upon the question of whether the insurance was meant as security or as a benefit to the wife, but chose instead the issue of whether petitioner in the taxable years in question received cash, either actually or constructively, or property of ascertainable value.⁸⁷

In utilizing this test it was admitted that the feeling of peace of mind

⁸³ For a full discussion of property settlements see section II of this article, *infra*.

⁸⁴ *Smith's Estate v. Commissioner of Internal Revenue*, 208 F.2d 349 (3d Cir. 1953); *F. Ellsworth Baker*, 17 T.C. 1610 (1952), *rev'd in part*, *Baker v. Commissioner of Internal Revenue*, 205 F.2d 369 (2d Cir. 1953); *William J. Gardner*, 14 T.C. 1445 (1950), *aff'd*, *Gardner v. Commissioner of Internal Revenue*, 191 F.2d 857 (6th Cir. 1951); *Lillian Bond Smith*, 21 T.C. 353 (1953); *Lemuel Alexander Carmichael*, 14 T.C. 1356 (1950). In *Meyer Blumenthal*, 13 T.C. 28 (1949), *aff'd*, *Blumenthal v. Commissioner of Internal Revenue*, 183 F.2d 15 (3d Cir. 1950), the wife was to receive \$5,200 a year until her death or remarriage. An insurance policy on the husband's life was to continue such payments in the event that he should predecease his wife. The insurance was held to be security for the support obligation, and thus the premiums not includible by the wife, nor deductible by the husband even though the court recognized that the wife might be relegated entirely to insurance for her support.

⁸⁵ *Lemuel Alexander Carmichael*, *supra* note 84; *Estate of Hart*, 11 T.C. 16 (1948); *Anita Quinby Stewart*, 9 T.C. 195 (1947); I.T. 4001, 1950-1 CUM. BULL. 27. In *Hart*, the wife was designated as the irrevocable beneficiary on a policy of the husband's life. Although she could not receive the proceeds until the husband's death, she had the power to reduce the coverage value of the policy and have the amount which would have been paid as premiums paid to her. The Tax Court held this to be part of the periodic payments made by the husband's estate to the wife.

⁸⁶ 207 F.2d 489 (7th Cir. 1953).

⁸⁷ *Id.* at 494.

or the satisfaction which stems from knowledge that protection may be of benefit in the future has a present value. However, this was held not to constitute income as no realization had occurred. The court said:⁸⁸

. . . [R]ealization of taxable gain must occur in the year during which it is sought to be taxed. This is so whether the realization comes from the receipt of cash, actual or constructive, or by the acquirement of property, and in the latter case the realization occurs "when the last step is taken by which he obtains the fruition of the economic gain which has already accrued to him.

The court concluded: "In any event, realization of economic gain as a prerequisite to its taxability must be capable of ascertainment in extent or amount."⁸⁹

Such a rationale is consistent with the history of income and also with the Congressional desires which culminated in the enactment of Section 22(k). In a Senate Finance Report it was stated:⁹⁰

Section 23(u), as well as Section 22(k), contemplates the treatment of alimony payments as if the husband and wife were on a cash receipts and disbursements basis, that is, the deduction is allowed the husband only for actual payment within the taxable year and the wife includes in her income for a taxable year only such periodic payments as are actually received during such taxable year (including, of course, the constructive receipt or payment of amounts unqualifiedly subject to the demand of the wife or husband, as the case may be).

Constructive receipt is defined by the Regulations⁹¹ as income which is credited or set apart to the taxpayer so that it may be drawn at any time without any substantial limitation or restriction as to the time or manner of payment or condition upon which payment is to be made. The definition of constructive receipt includes more than mere money payments; it also includes any property of ascertainable value. Congress contemplated this by requiring that gross income of the recipient be included ". . . whether such amounts are derived, in whole or in part, from income received or accrued by the source to which such payments are attributable. Thus, it matters not that such payments are attributable to property in trust, to life insurance, endowment, or annuity contracts, or to any other interest in property."⁹²

Computing the value of realized present interests will not always be accomplished as easily as in *Seligmann*. There the court reasoned that it

⁸⁸ *Id.* at 494.

⁸⁹ *Id.* at 494.

⁹⁰ SEN. REP. NO. 1631, 77th Cong., 2d Sess. 83 (1942); see also H. R. REP. NO. 2333, 77th Cong., 2d Sess. 71, 72 (1942).

⁹¹ INT. REV. CODE § 42, 26 CODE FED. REGS. 39.42-2 (1954).

⁹² See note 90 *supra*.

could not equate her "peace of mind" to a determinable sum because of the contingencies of the predecease of the husband and the possibility of her remarriage. Clearly, there is no constructive receipt in the present period in the face of such contingencies. However, other factors, which were not present but mentioned in *Seligmann*, would raise difficult problems in computation: an interest in the dominion or control of the policies; the authority to change or appoint a beneficiary; and a right or interest in the increased or loan values of the policies resulting from the payments. All of these factors might well appear in divorce or separation agreements which include insurance.

The effect of the selection of such a basis in *Seligmann* is to remove tax incidence determination from a single issue investigation, the result of which was to place the insurance in one of two rule-of-thumb categories; and instead, to require the court in each case to determine as to the premiums paid whether a monetary equivalent can be placed upon such powers of control and interest in the policy as may be present which can be inferred to the wife. Predictability of the value of such factors may not be easy without clarification by further decisions for those who rely on the incidence of the tax in formulating the amounts to be paid under insurance agreements. Nevertheless, such a test is preferable as it employs a more analytical approach to the vital question of includibility under Section 22(k), that is, the determination of whether income has been received, than can be afforded by the ascertainment of a collateral issue.

Complementary questions to that of the character of premium payments are the tax consequences of a transfer to the wife upon the divorce or decree of separate maintenance and the consequences of receipt of the proceeds by the wife where the policy was irrevocably transferred upon divorce and where she is merely a contingent beneficiary.

Where an absolute assignment is made at the time of the divorce there is, in effect, the equivalent of a transfer for value for all or a part of the policy by the husband to the wife in consideration for the discharge of his obligations arising under the decree.⁹³ The value of the policy upon this assignment is not includible by the wife as income under Section 22(k), nor deductible by the husband under Section 23(u) since it is a lump sum payment. Nor should there be any gain on the assignment since the fair market value of the policy, the cash surrender value,⁹⁴ could not be expected to exceed the aggregate amount of premiums he had paid. No deduction for a loss would be allowed because of Section 24(b). Therefore, the assignment of the insurance to the wife would have no effect on the income

⁹³ See E.T. 19, 1946-2 CUM. BULL. 166, for the Bureau's position on divorce settlements. A full discussion of the consequences of a transfer of assets upon divorce appears *infra*.

⁹⁴ Federal National Bank of Shawnee, 16 T.C. 54 (1951).

tax liability of the husband for the year of the assignment. The wife, as well as husband, should not be subject to any tax on the transfer as she parts with a valuable consideration, the settlement of her marital rights.

In the event of the husband's death, after such a transfer, the wife is taxable on that part of the proceeds of the policy which exceeds her cost thereof, that is, the cash surrender value when it was assigned to her plus the premiums thereafter paid by her or her husband.⁹⁵

Where the wife is a contingent beneficiary under the policy, and as such does not include the premiums as income, she will nevertheless be required to include the proceeds as income to the extent that they qualify as periodic payments under Section 22(k). The life insurance provisions of Sections 22(b)(1) and 22(b)(2)(A) do not apply in such a situation.⁹⁶

However, if she receives the proceeds in a lump sum it is arguable that no tax should arise: the payment to her could be either a lump sum settlement of a part of the husband's support obligation rather than a periodic payment,⁹⁷ or it may be that the lump sum is in payment for the release by the wife of a part or all of her dower or other marital rights and thus not includible in the wife's gross income. In the latter case, the release of marital rights would equal the amount of the proceeds which would be the price paid by the husband for the release.⁹⁸ But should the wife receive the proceeds in installments, then each installment to the extent of 10 per cent of the total proceeds to be received may be includible as the special rule governing installment payments of a principal sum payable over a period of ten years from the time of the divorce will be applicable.⁹⁹

⁹⁵ *Alcy Sivyver Hacker*, 36 B.T.A. 659 (1937); INT. REV. CODE § 22b(2), 26 CODE FED. REGS. 39.22(b)(2)-3 (1954).

⁹⁶ INT. REV. CODE § 22b(2), 26 CODE FED. REGS. 39.22(b)(2)-4 (1954).

⁹⁷ See *Jean Cattier*, 17 T.C. 1461 (1952). But cf. *Jane C. Grant*, 18 T.C. 1013 (1952), *aff'd*, *Grant v. Commissioner of Internal Revenue*, 209 F.2d 430 (2d Cir. 1953).

⁹⁸ The bureau considers such a release as valid consideration for gift and estate tax purposes. E.T. 19, 1946-2 CUM. BULL. 166. The same reasoning should apply to income taxes. See *Commissioner of Internal Revenue v. Mesta*, 123 F.2d 986 (3d Cir. 1941), *cert. denied*, 316 U.S. 695 (1942); *Farid-Es-Sultaneh v. Commissioner of Internal Revenue*, 160 F.2d 812 (2d Cir. 1947).

⁹⁹ While this article was in the process of publication, the Court of Appeals for the Second Circuit decided the case of *Newton v. Pedrick*, 212 F.2d 357 (2d Cir. 1954). The court, in adopting the concept of divorce as a "status," held a voluntary agreement for increased payments made subsequent to the decree to be incident where its purpose was to modify an earlier out of court agreement which was incident to the decree of divorce. We believe this to be an erroneous extension of "incidence" because of the nature of the contract. The obligation arising from the marital relationship, formalized in an out of court agreement between the husband and wife, is crystallized by the divorce. Thus, to treat divorce as a "status" would make Section 22(k) applicable to an increase in payments even where no obligation existed, a circumstance not contemplated by Congress. The only instance in which a modification of payments, made pursuant to an "incident" out of court agreement, can relate to and affect the contract obligation would be where the original agreement can be proven to have been fraudulent or inequitable.

II. PROPERTY DIVISIONS AND THE LIKE

Federal tax law is singularly romantic about transfers between man and maid before marriage. It refuses to consider that cool bargaining and economic motivation may underlie the transaction, as well as sublimations of those drives the movies and Doktor Freud have made us aware of. An antenuptial transfer not compensated (actually) in money or money's worth in property is a taxable gift.¹⁰⁰ But it is not, says federal tax law with gentlemanly avoidance of ribaldry, a transaction out of which there is any immediate realization of taxable income, as on a sale or exchange of assets.¹⁰¹ Quixotically, sometimes, federal tax law rejects straight-line consistency and refuses to hold that a gift for gift tax purposes is also one for income tax basis purposes.¹⁰²

But when a marriage has been celebrated and in the course of time a couple comes to the parting of the ways, federal tax law, like the couple, counsel and the public generally, starts with the assumption that negotiation and hard bargaining are involved. Thus, federal income tax law is potentially a conditioning factor in the application of the state law regarding the redistribution of property interests on divorce and separate maintenance. But, as we shall demonstrate, gift tax factors cannot be entirely ignored either. The nature and extent of the federal intrusion, how practitioners react to it, and some speculations about how characterization of the transaction, in the drafted papers and in the decree of the state court, might have a relevance, are the main themes of this portion of the presentation.

As to characterization, it is to be noted that some redistributions might

¹⁰⁰ Commissioner v. Wemyss, 324 U.S. 303 (1945) and Merrill v. Fahs, 324 U.S. 308 (1945) between them establish that for antenuptial settlements neither an agreement to marry nor a surrender (in a separate property state) of marital property rights not yet *in esse* is "adequate and full consideration in money or money's worth" so as to make the property transfer non-taxable as a gift.

¹⁰¹ That is to say in a typical case, that the transfer pursuant to the antenuptial contract which had some part in inducing the glamorous young woman to marry the older tycoon is not regarded as an economic transaction by her yielding taxable income on receipt. See Farid-Ed-Sultaneh v. Commissioner of Internal Rev., 160 F.2d 812 (2d Cir. 1947).

¹⁰² This was the situation in Farid-Es-Sultaneh, *supra* note 101: pursuant to antenuptial contract S. S. Kresge, then married to another, transferred to his intended future wife 12,000 shares of Kresge common having a basis in his hands of 16 cents and a fair market value of \$330 per share (!) on date of transfer. *Issue*: basis in the transferee's hands. Under the cases cited in note 100 the transfer was a gift for gift tax purposes. Was it also a gift for income tax transferred basis purposes? *Held*: "no." *Titillating question*: what was the other element of the "sale or exchange" which gave the transferee the \$330 basis? *Cf.* dissent of Clark, J., pointing out that the exchange could not have been of Farid-Es-Sultaneh's inchoate dower interest, because at the time of the agreement and the transfer of the stock Kresge was married to another woman and the understanding was that Farid-Es-Sultaneh could keep the stock even if Kresge should die before marrying the younger woman, in which event Farid-Es-Sultaneh would never have had any marital property rights against Kresge at all.

be alimony, if they meet the requirements previously discussed.¹⁰³ Others, similar in economic effect, might be taxable gifts, while still others, also similar in economic effect, might be neither alimony nor taxable gifts, but "partitions" of marital property, resulting in no immediate income tax liability.¹⁰⁴ On the other hand, these latter might be, not "partitions" or gifts or alimony, but "sales or exchanges," resulting in immediate income tax liability. Characterization, in turn, is affected by other questions, such as:

(1) What does it matter from the federal taxation standpoint to a federal court or agency what the state general law says the transaction is?

(2) What about form and substance, sham and reality?

(3) What about policy conflicts? Are there any, between the state system for dealing in socially effective ways with the people involved in the trauma of divorce or separation and the federal system of calling people to tax account at appropriate times? Is it true that, willy-nilly, equal divisions of fairly fungible property are worked out and handed to state courts to rubber-stamp, regardless of real human needs, because of federal tax threats? Or, is it true, that the federal tax compulsion is a GOOD THING, because divisions ought to be equal in nine cases out of ten anyway? Or, is it true, that in most cases, for one reason or another, federal tax law is not much of a problem for splitting couples and their lawyers?

In community property states there is usually separate property and some property traceable to the community, and part or all of both types of property may be subject to the property division transaction, either that agreed by the parties or (more rarely) imposed upon them by the divorce court. To the extent that community is divided, there is a possible income tax liability, because of what each spouse is giving up and (possibly) receiving in turn. There is also a possible gift tax liability, because the receiving spouse may give up nothing (or not enough) for property received from the other. With respect to any particular item of property the two taxes tend, of course, to be mutually exclusive in community property states, except for some particularly complicating factor as where by agreement one spouse sets up a Clifford-type trust in separate property for the benefit of the other.¹⁰⁵ Though one tax or the other will usually be the only one applicable, both taxes must in most community property states be considered by counsel regarding the property division in the aggregate, because of the usually clouded state of title to the spousal property and, also, because both types of property usually exist and may be involved in the property division.

More fortunate are the brethren in the common law states, because

¹⁰³ Part I, *passim*.

¹⁰⁴ See text *infra* at notes 147-149.

¹⁰⁵ *Cf. Lockard v. Commissioner of Internal Revenue*, 166 F.2d 409 (1st Cir. 1948).

usually in such a state the economic adjustment on marriage dissolution is (a) alimony and (b) an uncompensated transfer of separate capital from one spouse to the other. With respect to the latter the only income tax problem is one of basis, and the main problem of immediate taxability comes from the gift tax.

A. UNCOMPENSATED DIVISIONS OF SPOUSAL PROPERTY: GIFT TAX

What characterizes a gift for gift tax purposes? The general philosophic problem, it would seem, if the deliberations of the American Law Institute for the past two years are any criterion,¹⁰⁶ is not so very simple. But our problem is a narrower one, and by now the *Harris* case¹⁰⁷ and the problems of decision-interpreting the Supreme Court opinion presented are too well-known to require much further comment.¹⁰⁸

Suffice it to say that with respect to property transfers incident to divorce, three theories for characterization have been expressed:

1. *The evidential or sometime Tax Court theory*: was the transferor in a "giving mood," or did the parties bargain hard and coolly?¹⁰⁹

2. *The compromise or Bureau theory*: if the uncompensated transfer was not for support rights but in settlement of marital property rights, a gift tax was due.¹¹⁰

3. *The source-of-authority-in-state-law or Circuit Court-Supreme Court theory*: The *Harris* case itself seemed to turn on a rather narrow version of this theory, that the state judicial decree had to be the real effectuating transfer for there to be no taxable gift. *George G. McMurtry* in the Tax Court¹¹¹ applied this narrow interpretation with such meticulousness as to find that where there was both a separation agreement and a not inconsistent decree, it was the separation agreement, not the decree, which worked the transfer. The First Circuit¹¹² reversed this, pointing out that the parties had held up the deeds of transfer until after the entry of the decree; so it must have been the decree that worked the transfer. In dictum the court went farther:¹¹³

¹⁰⁶ The May 1953 floor discussion at the annual meeting of the American Law Institute of "What is a gift?" has been followed up this year with a fairly elaborate report on the topic. Again there was extensive discussion. See A.L.I., Federal Income, Estate and Gift Tax Statute, Tentative Draft No. 9.

¹⁰⁷ *Harris v. Commissioner*, 340 U.S. 106 (1950).

¹⁰⁸ See Pedrick, *The Gift Tax Jurisdiction of the Divorce Court*, 46 ILL. L. REV. 177 (1951); Oliver, *Federal Tax Significance of State Law: A Study of the Areas of Influence*, MAJOR TAX PROBLEMS OF 1953 (Univ. So. Calif. 1953), 483, at 493-496.

¹⁰⁹ Catherine S. Beveridge, 10 T.C. 915 (1948); Edward B. McLean, 11 T.C. 543 (1948); cf. dissent of Disney, J.

¹¹⁰ E.T. 19, 1946-2, CUM. BULL. 166.

¹¹¹ 16 T.C. 168 (1951).

¹¹² *McMurtry v. Commissioner of Internal Revenue*, 203 F.2d 659 (1st Cir. 1953).

¹¹³ *Id.* at 662.

. . . The basic purpose of the gift tax is not served by taxing transfers of this nature [T]he precedent of *Harris v. Commissioner*, holding the particular divorce settlement there involved to be exempt from the gift tax, should not, we think, be applied narrowly and limited to its precise facts. The distinction which the Commissioner has sought to take in the case at bar seems to us unsubstantial, and the product of undue refinement We read *Harris v. Commissioner* more broadly as supporting the proposition that, to the extent that the statute does not explicitly command adherence to meaningless formalities, all transfers agreed upon in contemplation of divorce and executed after approval by a divorce court having jurisdiction to give such sanction or in its discretion to prescribe some different property settlement, should be exempt from gift tax. Some would go even further in exempting these separation agreements from the gift tax. See Pedrick, *The Gift Tax Jurisdiction of the Divorce Court*, 46 Ill. L. Rev. 177 (1951).

The broad view of *Harris* thus expressed, we were informed, now appears to be reflected in Bureau policy.¹¹⁴

A more generous position even than this is found in the House proposals for the Revenue Act of 1954. Section 2516 of H.R. 8300¹¹⁵ reads:

Sec. 2516. Property Settlements Incident to Divorce

Where husband and wife enter into a written agreement relative to their marital and property rights incident to divorce and divorce occurs within a reasonable time thereafter (whether or not such agreement is approved by the divorce decree), any transfers of property or interests in property made pursuant to such agreement—

- (1) to either spouse in settlement of his or her marital or property rights, or
- (2) to provide a reasonable allowance for the support for the issue of the marriage during minority,

shall be deemed to be transfers made for a full and adequate consideration in money or money's worth. [i.e., not gifts]

The House Committee Report¹¹⁶ accompanying the bill states the narrow version of *Harris* (in effect) and explains that the purpose of the change is to resolve the present uncertainty about agreements not incorporated into decrees by providing that transfers made by written agreement shall "not be taxable gifts if followed by a divorce" The qualification and the term "divorce" are worthy of notice. This proposal does not appear adequate to meet the problem of those who do not wish to divorce, unless "divorce" is construed to include an action *a mensa* or its local equivalent in a particular jurisdiction. However, it does not seem that the changed provision requires that the state court have the authority on action for limited divorce to decree the division of the property. This had been a

¹¹⁴ Informal expression of opinion received from within the Internal Revenue Service.

¹¹⁵ H.R. 8300, 83rd Cong., 2d Sess. § 2516 (1954).

¹¹⁶ H.R. REP. No. 1337, 83rd Cong., 2d Sess. at Part XXXII-E (1954).

problem under the *Harris* case in some jurisdictions,¹¹⁷ though, apparently, not in California.¹¹⁸

It will be seen that the approach of the new gift tax statute parallels an earlier statutory pattern regarding alimony:¹¹⁹ the federal statute sets up its own standards and purports to be liberal and to avoid needless tax interference with a state law matter. But like the older alimony provision the new federal statute does not define its crucial terms. What is "incident to divorce"? What is "divorce"? Another uncertainty was removed by the Senate. The House Bill had required divorce to follow in a "reasonable time." The Senate changed this to two years. The Act now awaiting signature incorporates the Senate's preference for certainty—with its attendant inflexibility.

Our field survey among practitioners showed a relaxed attitude regarding the gift tax in the context of this discussion, but for reasons other than those inferable from the report of the Revenue Service's current attitude as to the *Harris* case. The practitioners interviewed were generally of the opinion that the gift tax had not thus far been a matter of weighty consideration, because the Bureau has not made concerted efforts to collect gift taxes. One report put it baldly: "Up to now the Bureau has done nothing as to ordinary transfers which would be subject to gift taxes." These commentaries must be weighed against the plain requirements of the Internal Revenue Code regarding the reporting of individual gifts of \$3,000 or over and the well-known fact that gifts of certain artifacts cherished by women are usually not reported or taxed. As to the latter a possible correction may be hinted by recent newspaper reports of several instances in which the Bureau has "tightened up" on man-woman transfers of expensive automobiles,¹²⁰ furs, jewelry and the like.

It was also observed by one practitioner interviewed that the *Harris* case, even in its narrow version, could be avoided without the necessity of resort to a court decree and to air-tight incorporation of the private agreement therein by characterizing transfers as for support rights. This may indicate that the broad powers asserted by the Commissioner under E.T. 19 to allocate transfers as between non-taxable ones for support rights and taxable ones for marital property rights do not in practice present much of a problem.¹²¹

¹¹⁷ Pedrick, *supra* note 108 at 189-192.

¹¹⁸ 1 ARMSTRONG, CALIFORNIA FAMILY LAW 399 (1953); CAL. CIV. CODE § 146 (1951 amendment); *Finnegan v. Finnegan*, 42 A.C. 779, 269 P.2d 873 (1954).

¹¹⁹ Part I, *passim*.

¹²⁰ See CCH, FEDERAL ESTATE AND GIFT TAX REP. ¶ 8105 (1954) for discussion regarding Christmas gifts of fur coats, jewelry and similar items running over \$3,000 in cost.

¹²¹ See, however, Gould, T.C. No. 775 (1947); Paul Rosenthal, 17 T.C. 1047 (1951), *rev'd on other grounds*, *Rosenthal v. Commissioner of Internal Revenue*, 205 F.2d 505 (2d Cir. 1953), but with these and with the *Wemyss* and *Fahs* cases, *supra* note 100, compare Ruby G. Grigg, 20 T.C. 420 (1953).

B. PARTIALLY COMPENSATED DIVISIONS OF SPOUSAL PROPERTY: INCOME TAX

1. Mutations of Marital Property in California: General Federal Tax Perspective

Under both the federal income and the estate tax laws, state law governs in determining the nature of the property held by husband and wife.¹²² Thus, whether the spouses may by agreement change community property into some form of separate or jointly held property, or vice versa, so as to affect their respective rights under the federal revenue laws, must begin with a perusal of the applicable state rules regarding such changes. This section will discuss the general tenor of the decisions of community property states,¹²³ and the manner in which the federal courts have used such state precedents in determining federal tax cases.

In general, little or no difficulty arises when the attempted changes are made in writing. The public policy of the state is usually clear concerning the propriety of such mutations and the written instrument alleviates any evidentiary difficulties.

Uncertainty, however, clouds the picture when the applicability of the policy underlying the Statute of Frauds on such changes comes into issue. As one would expect from the confidential relationship between husband and wife, many of the agreements made between them are extremely informal. It is to such informal parol agreements that the primary emphasis of this section is directed.

Changes affecting earnings

California has long given cognizance to oral attempts by husband and wife to change the nature of their future earnings. *Wren v. Wren*¹²⁴ in 1893 held valid a verbal agreement whereby the husband relinquished any rights or claims he might have had to the earnings of his wife, which were to be her separate property. The tax cases, despite a long battle by the Commis-

¹²² *Greenwood v. Commissioner of Internal Revenue*, 134 F.2d 915, 918 (9th Cir. 1943) (in determining gross estate, court looks to Arizona law as to whether property held on record in joint tenancy was really community property); *Poe v. Seaborn*, 282 U.S. 101 (1930) (property in name of taxpayer husband alone held to be community property under the laws of Washington).

¹²³ See in general, 1 ARMSTRONG, CALIFORNIA FAMILY LAW 541-565 (1953) for the California rules on mutations of property by agreement between the spouses.

¹²⁴ *Wren v. Wren*, 100 Cal. 276, 279-281, 34 Pac. 775, 776 (1893); 1 ARMSTRONG, *op. cit. supra* note 123 at 546. Likewise, a "mere understanding" between the spouses may be enough to change the wife's earnings into separate estate. *Kaltschmidt v. Weber*, 145 Cal. 596, 599-600, 79 Pac. 272, 273-274 (1904); 1 ARMSTRONG, *op. cit. supra* note 123 at 547.

sioner, follow the state law in this respect.¹²⁵ In *Helvering v. Hickman*,¹²⁶ an oral agreement that the earnings of each spouse were to be separate property of the spouse who earned them was held effective for income tax purposes.¹²⁷ While the *Hickman* case covered earnings made prior to 1927, the year in which the wife in California acquired a vested present interest in the earnings of her husband,¹²⁸ its holding has been extended to cover post-1927 earnings.¹²⁹

Changes affecting realty and personality

California likewise adopts a liberal attitude toward giving cognizance to informal contracts between husband and wife to change the status of

¹²⁵ The tax courts consistently held that the agreements were valid for tax purposes and the Commissioner just as consistently continued his attempts to tax the husband for the wife's salary despite an agreement that the wife's salary was to be separate. See, e.g., Allen Harris, 10 B.T.A. 1374 (1928); F. C. Busche, 10 B.T.A. 1345 (1928); C. R. Davis, 10 B.T.A. 1233 (1928); Francis Krull, 10 B.T.A. 1096 (1928); Hyman Levine, 8 B.T.A. 298 (1927); Harry S. Goldberg, 4 B.T.A. 1073 (1926); Louis Gassner, 4 B.T.A. 1071 (1926).

¹²⁶ 70 F.2d 985 (9th Cir. 1934).

¹²⁷ It should be noted that the *Hickman* case covered the pre-1927 situation of an agreement that the earnings of a spouse should be the separate property of the spouse who earned them. Prior to the 1927 amendment making the wife's interest in the community property vested, the Commissioner successfully attacked a number of agreements regarding earnings as attempted assignments of income within the prohibition of *Lucas v. Earl*, 281 U.S. 111 (1930) (a written contract that any property owned by either spouse including earnings was to be treated as owned in joint tenancy while held to be valid for purposes of state law was ineffective in shifting the burden of the tax on the earnings in question). Thus, where the earnings of each spouse were to go into a joint fund and then be divided into separate property of each (without regard as to who earned them) it has been held an assignment of income and invalid for tax purposes. *Blair v. Roth*, 22 F.2d 932 (9th Cir. 1927), cert. denied, 277 U.S. 588 (1928); *Belcher v. Lucas*, 39 F.2d 74 (9th Cir. 1930); *Florence V. Cruickshank et al.*, 13 B.T.A. 508 (1928); *Erwin Edmund Richter*, 10 B.T.A. 1377 (1928); *Walter B. Maling*, 10 B.T.A. 1237 (1928). For post-1927 earnings there is no question that such equal divisions would be valid, but the problem should not arise in an income tax context since the same advantages will accrue to the spouse if it is considered community in which there is a vested interest as if it is considered separate.

¹²⁸ CAL. CIV. CODE § 161a reads: "The respective interests of the husband and wife in community property during continuance of the marriage relation are present, existing and equal interests under the management and control of the husband . . ." For a brief history of the nature of the wife's interest in the community property in California, and the income tax reasons for which § 161a was passed in 1927, see 1 ARMSTRONG, CALIFORNIA FAMILY LAW 585-589 (1953).

¹²⁹ Cf. G.C.M. 9953, XI-I CUM. BULL. 13 (1932) whereby the Commissioner contended that since the enactment of § 161a giving the wife a vested interest in the community property, a prior agreement that earnings of either husband and wife should be separate property of the spouse who performed the service does not have the effect of shifting the burden of taxation from one to the other. The salaries of both should be treated as community property. For cases refusing to follow the Commissioner's contention, see e.g., *Kate Van Nuys* Page, 1938 B.T.A. Mem. Dec. ¶ 38041, ¶ 38075; *E. L. Brannon Est. et al.*, 6 T.C.M. 334 (1947); *Ethel M. Ford*, 1935 B.T.A. Mem. Dec. ¶ 35032; *Cecil B. DeMille*, 31 B.T.A. 1161 (1935); *C. R. Davis*, 20 B.T.A. 931 (1930). The Commissioner finally gave up under the weight of adverse cases and revoked G.C.M. 9953 in 1937. G.C.M. 18884 1937-2 CUM. BULL. 58 (1937).

their property,¹³⁰ whether in existence or not, particularly as to any agreements which favor the community estate.¹³¹ *Tomaier v. Tomaier*,¹³² one of the leading California cases, allowed the introduction of parol evidence to show that real property purchased with community funds and taken by deed in joint tenancy remained community property by dint of an oral understanding between the spouses.¹³³ The holding of this California case was followed in a federal estate tax case, *United States v. Pierotti*,¹³⁴ where an oral agreement between the spouses that all their property would be post-1927 community property was held to control the nature of real property subsequently taken in joint tenancy by written instrument. The case is particularly interesting due to the inauspicious position of the surviving wife

¹³⁰ It is, of course, without the purview of this article to comment extensively upon the rules of community property states other than California as to such contracts. However, even in those states which in the first instance allow the spouses by contract to alter their legal relations as to their property, generally much more stringent requirements are set up as to the methods by which such alterations may be effectuated, most requiring the same form of conveyance between husband and wife as would be required for a valid conveyance between unrelated parties, viz., a writing. For a discussion and pertinent authorities as to the validity of the parties to a marriage to contract with each other, see 1 DE FUNIAK, *PRINCIPLES OF COMMUNITY PROPERTY* § 136 (1943). As to the requisite form of conveyance, the headnote of G.C.M. 19248 1937-2 CUM. BULL. 59 (1937) appears fairly representative of general community property principles: "Where a husband and wife residing in the State of Washington agree *in writing* that all presently owned property and all property to be acquired thereafter, real and personal, shall be community property, such agreement changes the status of subsequently acquired separate property to community property; if such agreement is entered into *orally*, it changes the status of subsequently acquired personal property to community property, but the status of separate real property in Washington can be changed to community property only by proper agreement or conveyance signed and acknowledged." [Emphasis added.]

¹³¹ *Title Insurance etc. Co. v. Ingersoll*, 153 Cal. 1, 5, 94 Pac. 94, 95 (1908) set down the precept that an informal understanding between spouses was sufficient to transmute separate property into community property. See, 1 ARMSTRONG, *CALIFORNIA FAMILY LAW* 544 (1953). While there may be an unspoken rule favoring the community, this is not apparent in the decided cases (*cf.* Bennett, *infra* note 140). Likewise the tax courts have not followed such a rule. *Commissioner of Internal Revenue v. Mills*, 183 F.2d 32 (9th Cir. 1950) held valid an oral agreement whereby all community property owned at a later date was divided equally and then held as separate property. [This was a gift tax case where in it was held that Int. Rev. Code § 1000(d) providing that gifts of property held as community property shall be considered gifts of the husband did not apply as this property never became community property. Parenthetically, the court also stated that while they thought there was no transfer of interest in the conversion from community to separate property, if there were such a transfer the property received by each is of equal value in money's worth] *Rickenberg v. Commissioner of Internal Revenue*, 177 F.2d 114 (9th Cir. 1949). A change in the form of property from community property to tenancy-in-common in contemplation of death does not require the inclusion of all the property in husband's gross estate under INT. REV. CODE §811(c) and (d)(5) when he predeceases the wife as there was held to be no transfer between the spouses.

¹³² 23 Cal.2d 754, 146 P.2d 905 (1944).

¹³³ The declarations contained in a joint and mutual will may constitute an agreement between the spouses fixing the status of property held on record as in joint tenancy as community property. *Estate of Watkins*, 16 Cal.2d 793, 108 P.2d 417 (1940); *Sandrini v. Ambrosetti*, 111 Cal. App.2d 439, 244 P.2d 742 (1952).

¹³⁴ 154 F.2d 758 (9th Cir. 1946).

who had filed a petition (which was granted) in a California superior court for a "decree establishing death of a joint tenant." Since the effect of such a decree under the state law is only to determine that a person is dead and that the asserted right of another depends upon his death, and not to adjudicate conclusively the validity of the rights asserted, the court denied the Commissioner's contention that the decree was binding on the taxpayer as to the fact of joint tenancy.¹³⁵

Other tax cases, all enunciating the basic idea that state law is controlling, cover different types of property mutations between husband and wife: separate property of husband in partnership acquired prior to inmarriage held converted into community property by oral agreement;¹³⁶ an unwritten understanding between husband and wife that the business of the husband and real estate inherited by the wife belonged to both in equal shares created a community property interest;¹³⁷ stock acquired as community property prior to 1927 was held changed to tenancy-in-common by virtue of an oral agreement that ownership was on a share and share alike basis between the spouses;¹³⁸ an oral agreement prior to the taxable year that whatever property might be acquired with the funds of either spouse would be community property was held sufficient to create a present vested interest in the wife of one-half the annual income the taxpayer husband received from trusts established by his father which were his separate property.¹³⁹

Recently, however, California appears to have carved one exception out of its liberal attitude allowing informal agreements between husband and wife to change the nature of their property. In *California Trust Co. v. Bennett*,¹⁴⁰ an unwritten attempt to change separate personalty (the contents of a safe deposit box) into joint tenancy was held ineffective. The court's holding was based upon the statutory language of Civil Code Section 683

¹³⁵ This, however startling, clearly appears to be the California rule even though the property is held in joint tenancy merely for ease of probate. *Sears v. Rule*, 27 Cal.2d 131, 142, 143, 163 P.2d 443, 449, 450 (1945).

¹³⁶ *Helena F. Renick et al.*, 11 T.C.M. 327 (1952); *accord*, *Estate of Joe Crail*, 46 B.T.A. 658 (1942) Acq. (oral antenuptial promise by husband that wife would have half of what he had and half of what he would make in the future—all to be held as community property. *Held*, effective for tax purposes. Although the evidence showed only statements made by the husband and none by the wife, the fact that she acted as if she thought the property was community was sufficient to show an "understanding" between the spouses to transmute the property); *Estate of J. Harold Dollar*, 41 B.T.A. 869 (1940) (oral contract that all property owned by decedent was community property. Income from such property was therefore held to be divisible community income).

¹³⁷ *G. M. Topper Est.*, 5 T.C.M. 697 (1946).

¹³⁸ *Helen H. Bullis*, 32 B.T.A. 501 (1935); *accord*, *Stanley S. Anderson*, 33 B.T.A. 88 (1935) pursuant to remanding of 28 B.T.A. 179 (1933), *Anderson v. Commissioner of Internal Revenue*, 78 F.2d 636 (1935) (oral contract that all properties owned or subsequently acquired by spouses to be in tenancy-in-common rather than community property).

¹³⁹ *Samuel S. Berger*, 1940 B.T.A. Mem. Dec. 40,411.

¹⁴⁰ 33 Cal.2d 694, 204 P.2d 324 (1949).

requiring a writing for the creation of a joint tenancy interest in personal property.¹⁴¹

No tax cases have been found concerning such oral attempts to change property into joint tenancy.¹⁴² Generally, the advantage to the taxpayer is to hold property as community property rather than in joint tenancy, so it seems doubtful for the most part that any such informal agreements would be mentioned by the taxpayer, even if the doctrine of the *Bennett* case should be held not controlling.

The California law on mutations of property thus seems to afford to the taxpayer a pleasant one-way avenue of tax avoidance: if a change was actually made, it may be claimed by the taxpayer if to his tax advantage, and forgotten if it is not saving in taxes. The very informality of the agreements makes it almost impossible for the Commissioner to catch such changes.

While the field research indicates that the Commissioner is likely to view any such agreements, particularly oral ones, with a jaundiced eye, the problem presented seems to be entirely one of fact.¹⁴³ Once the agreement is proved, the law is clear that the Commissioner must recognize its effectiveness in changing the nature of the property involved. Taxpayers should expect, however, a fairly unrelentless attitude on the part of the Bureau and a large amount of litigation on the factual problems presented due to the wide scope the state law offers to the wiles of potential fraud-feasors. It is reported, as of possible significance to later discussion, that on the interviews the point was made that it was highly desirable to have the transmutation made a matter of state judicial determination, as in probate. The interviews also indicated the possibility of slightly different attitudes toward proof of the transmutation as between the principal Revenue Service Offices in California: that is, that San Francisco would accept a written record of the transmutation but put the taxpayer to his proof in court on an oral agreement, whereas Los Angeles might make difficulties even about a writing, resting upon record title.

¹⁴¹ *Accord*: Estate of Horn, 102 Cal. App.2d 635, 228 P.2d 99 (1951); see 1 ARMSTRONG, CALIFORNIA FAMILY LAW 560 (1953) wherein it is suggested that the holding in the *Bennett* case may be extended to disallow informal attempts to create a joint tenancy in community personality, separate realty and perhaps community realty.

¹⁴² However, where the attempt to change separate property into joint tenancy is in writing, it meets the California requirements and will be binding. Thus, where separate property of the wife was changed to joint tenancy with the husband by written instrument, it was held joint tenancy for estate tax purposes despite wife's protestations, and decedent's interest, given to his children in a gift in contemplation of death situation, was included in his gross estate. Estate of Don Murillo Brockway, 18 T.C. 488 (1952).

¹⁴³ On the converse side of the factual problem, California allows income tax returns made prior to 1948 as evidence of conversion of separate property into community property. See 1 ARMSTRONG, *op. cit.* *supra* note 141 at 562-564 and cases there noted.

2. Division of the Community Property and its Attendant Income Tax Liability

Whether or not a division of the community property of the spouses in connection with a divorce or separation decree will result in income tax liability has long been the subject of conjecture.¹⁴⁴ A theoretical justification for such liability was set forth in the early cases dealing only inferentially with the subject of income tax liability,¹⁴⁵ and the potentialities of such taxation have been recognized by many members of the tax bar.¹⁴⁶

The law as it has been developed by the courts seems to be that if there was an equal division or partition of community property in which each of the spouses held a vested interest there will be no taxable moment at the time of the division. On the other hand, if the division was unequal, or if the court feels that the property settlement was in effect a sale or exchange, something of tax significance will have occurred at the time the settlement was executed.

Whether the facts of the eight cases in this field affect the potential income tax situation is a question that should be of important present interest not only to the tax practitioner but also to the divorce attorney who usually is largely instrumental in the drawing up of such settlements.

Equal Divisions

Two earlier Tax Court cases were to the effect that where there was an equal partition of the community property, no taxable gain or change in basis resulted. In *Ann Y. Oliver et al.*,¹⁴⁷ the community property was split equally, each party getting different community property assets. The Commissioner's position was that the cost basis to the husband of certain stock he had received in the division was *one-half* of the original cost.¹⁴⁸ The court rejected this rather surprising contention of the Commissioner and held for the taxpayer husband, giving him the adjusted cost basis to the community. The court stated that where there was an equal division of com-

¹⁴⁴ See, e.g., Taylor and Schwartz, *Tax Aspects of Marital Property Agreements*, 7 TAX L. REV. 19, 52 (1951); Kent, *Property Settlement Agreements in Community Property States*, MAJOR TAX PROBLEMS OF 1949 (So. Calif. Tax Inst. 1950) 9, 25-34; Halpern, *Income Tax Effect of Community Property Divisions Incident to Divorce*, 23 CAL. ST. B. J. 128 (1948).

¹⁴⁵ In the cases, *infra* text at notes 151, 153, 154, 155, holding a taxable gain, all except *Johnson* concerned basis problems.

¹⁴⁶ While the field research indicated a surprising lack of practical first-hand information concerning this aspect of divorce and income tax liability, all the tax practitioners questioned were aware of the fact that there was a possibility of liability and so informed the comparatively few clients who consulted them regarding this problem.

¹⁴⁷ 8 T.C.M. 403 (1949).

¹⁴⁸ The Commissioner's theory was that each spouse had a community interest in one-half of the remaining cost and since the taxpayer had paid nothing for the basis of his former wife, he did not acquire her basis in the property settlement agreement.

munity property there was no resulting taxable gain or loss and hence no change in basis.

The *Frances R. Walz, Administratrix* case,¹⁴⁹ on the other hand, is not so easy to reconcile with the law the court purported to follow. In that case, the community held assets of approximately \$92,000. It was desired that each spouse should have exactly half of this or \$46,000. Among the assets received by the wife were a home valued at \$4,000, stock valued at \$6,650, and a promissory note of the husband of \$35,350. Since the promissory note could not have been an asset of the community at the time of the division, it would appear that in reality the husband was buying from the wife \$35,350 worth of her share of the community assets. The Board of Tax Appeals, however, held that this was merely an equal partition of the community property which did not result in a recognized gain or loss.¹⁵⁰

Unequal Divisions

Where the court has found the division to have been unequal, it has been held to have resulted in a taxable gain. Three early cases are authority for this:

In *Johnson v. United States*¹⁵¹ the community property consisted of approximately \$132,000 and each spouse was to receive \$66,000 in community assets. In addition, the taxpayer husband also covenanted to pay certain of the wife's debts arising from income tax liability. The district court reversing the court below which had held that the settlement was an equal partition,¹⁵² held that this resulted in a taxable gain to the husband, saying: "Here was something more than a mere division of property. The appellant admits that in the transaction so dealing in property he made a gain of over two thousand dollars." It is impossible to tell from the opinion if the district court felt that there was really an unequal division of the community assets due to the gain made soon thereafter, or whether there was an unequal division due to the husband's contract to pay specified debts of the wife.

Citing the *Johnson* case, the Fifth Circuit in *Rouse v. Commissioner of Internal Revenue*,¹⁵³ affirmed a Tax Court¹⁵⁴ finding that where the taxpayer acquired for \$60,000 his wife's interest in the community valued at \$45,000 plus her separate property worth \$27,000, it was in effect a bar-

¹⁴⁹ 32 B.T.A. 718 (1935).

¹⁵⁰ The wife taxpayer in this case was attempting to deduct a loss representing the difference between the cost to the community of some stock shares, and its fair market value, which resulted from the "partition" of the community property.

¹⁵¹ 135 F.2d 125 (9th Cir. 1943).

¹⁵² *Johnson v. United States*, 45 F. Supp. 377 (S.D. Calif. 1941).

¹⁵³ 159 F.2d 706 (5th Cir. 1947).

¹⁵⁴ C. C. Rouse, 6 T.C. 908 (1946).

gain and sale and not a mere division of the community property, hence the husband's basis of the acquired assets would be what he paid for his wife's interest in the community.

In the third case, *Long v. Commissioner of Internal Revenue*,¹⁵⁵ the agreement provided that if the husband purchased an insurance fund for the wife's benefit he would be vested with title to two-thirds of her half of the community property. This also was held to amount to a purchase and sale for the purpose of determining the husband's basis on the portion of the wife's community interest he thus acquired.

Recent Developments

As will be noted from the above cases, the question of whether or not there was a taxable gain has for the most part been considered only for purposes of determining basis of the property held, rather than for determining income tax liability at the time of the exchange. It was generally the opinion of members of the tax bar recently interviewed in the field survey in connection with this article that the likelihood of the Commissioner attempting to collect income tax on such settlements, while certainly to be considered, was negligible. Three recent cases, however, lead one inescapably to the conclusion that the Commissioner has begun a new policy of attempting to tap this hitherto untouched source of revenue.

In July of 1953, a Tax Court memorandum decision came down in *Osceola Heard Davenport*.¹⁵⁶ The settlement between the parties concerned no separate property, the wife receiving all the cash, the auto and certain real property, the husband the remainder of the community property which consisted mainly of realty, oil and gas interests. The intent of the parties, as expressed in the property settlement agreement, was that there should be a fair and equal division of the community property. The equal division was made on the basis of the fair market value of the property at the time of settlement. The Commissioner, relying on this fact, held that the *Rouse* case applied since the taxpayer had received more than half of the *cost* basis of the community assets. (The fair market value of the community assets had risen greatly from their cost to the community, and a division on a cost basis would not have resulted in the equal partition intended by the parties.) This the Commissioner contended, made the transaction really a taxable bargain and sale. The court held in favor of the taxpayer, finding an actual partition of the community property, not in kind but in value.

The Commissioner tried again the next month with greater success. *Maurine DeWolfe Brown*¹⁵⁷ and husband held a ranch and orange grove

¹⁵⁵ 173 F.2d 471 (5th Cir. 1949), cert. denied, 338 U.S. 818 (1949).

¹⁵⁶ 12 T.C.M. 856 (1953).

¹⁵⁷ 12 T.C.M. 948 (1953).

as their principal community property asset. Since the ranch was not by its nature divisible, the agreement provided that the wife was to receive a promissory note from her husband supposedly equal to half of her interest in the community. It cannot easily be ascertained whether the decision of the court, holding this to be a sale, was based on the fact that the separate property of the husband (the promissory note) entered into the agreement, or whether it was because it felt that the assets were not in reality being equally divided.¹⁵⁸ On the facts of the case the court held that the bargaining of the parties before arriving at the "division" helped to characterize this transaction as a sale of the wife's assets to the husband.

Both sides of the argument were espoused by the Commissioner in the *Edwards* cases¹⁵⁹ which were consolidated for hearing because of the Commissioner's inconsistent theories on identical facts. The settlement agreement was carefully couched in terms of a division or partition of the community property rather than in words of sale. Since the wife was inexperienced in business she desired her share in cash, rather than assuming any business risks. However, the community did not have enough cash to cover her share of the assets, so she received a promissory note from her husband plus cash which the husband had to borrow. The Commissioner contended in one case that the wife owed income tax on the gain she had made from the exchange, and in the other contended that the husband should be required to maintain the old community basis for certain of the assets he thereafter sold, rather than a basis figured as of the time of settlement. The adage of the woman always paying held true in this case, the Tax Court holding that the transaction was essentially a bargain and sale, hence the wife was held taxable on her gain and the husband acquired a new basis on his assets.

All of the cases decided to date involved fairly substantial amounts and no cases appear to have been litigated involving the average family assets of a home, auto and little or no cash. Whether this is due to the fact that most families on separation and division of the community would not have

¹⁵⁸ The court stated: "We do not have here a division of community interests in the ranch. Indeed it does not appear that it was feasible to divide the ranch. The evidence suggests rather that the ranch property could be operated efficiently only as a unit, and the sole question as between husband and wife was as to which of them would get the ranch by purchasing the interest of the other and at what price. Nor was this a case in which the community property consisted of the ranch and a large amount of cash and in which it was agreed that the total property would be severed in such manner that the husband would keep the ranch and the wife would keep the cash. Here, the cash that the wife would receive was not community property at all. It was merely the purchase price for her interest in the ranch. The transaction was basically a sale rather than a division or partition. Moreover, we have evidence that petitioner was aware that the entire assets of the community were not being equally divided and that the so-called property agreement of December 14, 1943, represented merely the best bargain that she could drive in the circumstances." 12 T.C.M. 948, 952 (1953).

¹⁵⁹ *Jessie Lee Edwards*, 22 T.C. No. 10 (1954); *Gordon R. Edwards*, 13 T.C.M. 381 (1954).

an inkling that there are potential income tax liabilities and hence would not report such transactions, or because the Commissioner has only in the past few months attempted such taxation, cannot yet be determined. The inequities of the situation seem manifest, however—even where there is a bona fide desire to divide equally the community property, if the assets by their nature are not equally divisible, the payment by one spouse to the other of an amount sufficient to equalize the division will result in taxability. Likewise, this taxation will come in most instances at a time when each spouse will be in a comparatively poor financial situation and conceivably will not have on hand cash to pay any tax liability since there has not been an actual “sale” of any assets as the word sale is commonly used.

Nothing has been found in the Bill for the Revenue Act of 1954 which would appear to relieve the situation.

There are three additional uncertainties, suggested in part by the field interviews, which might well have been considered in connection with tax revision. One is whether taxable realization on division will be asserted only with reference to specific assets and not with reference to an overall receipt of more than one-half the community. There is some evidence that the administrative agents concentrate on the former and tend to let the latter go.

The second is with reference to the possibility that a realization arising from a division of marital property might be taxed under Internal Revenue Code Section 117(o), in the case of depreciable property, at ordinary income rates.¹⁶⁰

The third uncertainty combines the first two. If the property division receives an ultimate tax characterization as a sale or exchange, rather than as a partition, and unless the whole mass of property transferred is taken as the subject of the transfer, rather than individual items, losses regarding such items would probably be disallowed under Internal Revenue Code Section 24(b)(1)(A).¹⁶¹ None of the relevant Revenue Code provisions mentioned has been changed by H.R. 8300, as a glance at Section 1240 and 267 of the latter will indicate. Section 267 as a matter of fact has been tightened in the not entirely unrelated matter of dealings between a fiduciary and the beneficiary of another trust created by the same grantor.¹⁶²

A final uncertainty having, like the others, its effects on the actual plan-

¹⁶⁰ Cf. Taylor and Schwartz, *supra* note 144, at n. 51 and Kent, *supra* note 144, at n. 56, both noting that the decisions then existent involved claims for capital gains deficiencies. The cases since these articles were written do also, but Messrs. Taylor and Schwartz have suggested the ordinary income possibility in their presentations to Estate Planning Seminars at the University of California School of Law, Berkeley, inducing reactions of astonishment, shock, and outrage. See note 169, *infra*.

¹⁶¹ Disallowing losses on sales or exchanges between members of a family, including spouses.

¹⁶² Thus adding a situation not covered by INT. REV. CODE § 24(b)(1)(A-E).

ning of marital property divisions but less susceptible of legislative solution by anything short of statutory declaration that such divisions are not recognized as taxable events when consummated, is that which would arise from "inadvertent inequality," as when the official valuations of life insurance policies and stock in closely held companies vary from the planner's best estimates, thus throwing what was intended to be a non-taxable equal division out of balance.¹⁰³

It is beyond the scope of this paper to deal with the practical accommodations which estate planners in California have to make to take account of the tax situation, actual, potential or emerging, herein described. They are many and complex, but they tend to compel action along these lines,¹⁰⁴ despite the wishes or needs of the parties as determined under local law:¹⁰⁵

(1). Keep divisions equal, nearly exactly so, and avoid dealing in specific assets as much as possible.

(2). Take otherwise allowable losses by third party transactions before division.

(3). Lend every effort, including the purely verbal, to the characterization of the transaction as not a "sale or exchange" but as a "partition" of community into tenancy in common.

¹⁰³ The shift from cash surrender value to replacement cost for the tax valuation of life insurance policies and the old, well-known uncertainties about the valuation of closely held, nontraded stock create situations where negotiating advantage can be taken of the possibility that a fight on valuation might also involve the taxpayer in a fight on the essential equality or not of the split-up of the community assets generally. As we have seen, see text, *infra* at note 152, the accounts do not have to be far out of balance to bring *Johnson* into play.

¹⁰⁴ Thus, H. Randall Stoke reporting in partial fulfillment of the requirements for credit in the 1954 Estate and Tax Planning course at this law school on a plan for dividing California assets in a typical case presented to the class by Guest Lecturer Walter C. Schwartz, Esquire, wrote:

"To minimize the acute danger of taxation on the transfer we have undertaken three measures. *First*: the property was equally divided or at least such an attempt has been made . . .

"*Second*: We utilize the approach suggested by Francis R. Walz, 32 B.T.A. 718 (1935) and Ann Y. Oliver, 8 T.M.C. 403 (1949), cases which dealt specifically with allocation of property between the spouses on divorce. In accordance with these decisions that found no taxable exchange, language of 'partition and divide' is employed and no dollar values are used so in the agreement to avoid the precatory phraseology of sale . . . The supporting argument is that there is merely a partition of property already owned; however, such a formalistic approach cannot be relied upon fully . . .

"*Third*: As the possibility of taxation is present even though the above steps are taken, we chose to limit the transfer of particular items to as few as possible as in consistent with the needs of the parties. [Proceeding, then, to apply these principles, taking calculated risks as to certain items, such as the life insurance on the husband's life, because of over-riding desirability from the family settlement standpoint.]"

Four members of the 1951 Seminar, in dealing with a similar problem presented by Valentine Brookes, Esquire, added the suggestion that unequal division ought to be confined to those assets which would qualify under INT. REV. CODE § 112(b) as nontaxable on exchange, because held for use in trade or business. See, also, Kent, *op. cit. supra* note 144, 33-34, referring specifically to farm property [INT. REV. CODE § 112(b)(1)] and to blocks of stock [INT. REV. CODE § 112(b)(2)].

¹⁰⁵ Cf. 1 ARMSTRONG, CALIFORNIA FAMILY LAW 813-823 (1953).

(4). Organize the economic settlement so as to get as much help as possible as to favorable tax characterization from the local jurisprudence and/or from the particular state judicial proceeding (divorce or separate maintenance).¹⁶⁶

C. SOME PROBLEMS AND POSSIBILITIES REGARDING THE EFFECT OF
CALIFORNIA MARITAL PROPERTY SETTLEMENT LAW ON
INCOME TAX LIABILITY

In a helpful note to Part 6 of her chapter on the California community property system¹⁶⁷ Professor Armstrong has made important suggestions and evaluations regarding tax considerations in the drafting and negotiation of property settlement agreements in California. Especially useful is her appraisal of the conflicts of interest as to the nature of the settlement arising solely from federal tax considerations. This note and the chapter in her work to which it is appended also suggest certain additional problems and possibilities regarding the interactions of California law and federal tax law in relationship to the economic readjustments of the parting couple.

Our interest in this portion of the topic has in some part been due to the fascination of one of us with the extent to which state law can enter into and by characterization control, a federal tax controversy.¹⁶⁸ It has been heightened by the existence of some very real policy problems Professor Armstrong's discussion has suggested, and it has been made somewhat pointed by the almost unanimous "rejection-reaction" of at least three law school generations in advanced taxation and estate planning seminars of the income tax developments reported above.¹⁶⁹ Finally, we were curious as to why, if the taxation situation outlined was generally enforced, there was not more outcry about it, at least in certain situations.

In substantial part the answer to the last question has been given by our

¹⁶⁶ Cf. Oliver, *Nature of the Compulsive Effect of State Law in Federal Tax Proceedings*, 41 CALIF. L. REV. 638, 668-69 (1953).

¹⁶⁷ 1 ARMSTRONG, CALIFORNIA FAMILY LAW 813-823 (1953).

¹⁶⁸ Oliver, *supra* note 166 at 639-643.

¹⁶⁹ Messrs. Edgar Kemp and Arlo Smith, Boalt Hall '52, in reporting for the Taxation Seminar of that year the problem presented by Samuel Taylor, Esquire, wrote:

"The logical cogency of the suggestion that an equal division of community property is subject to income tax as a sale or exchange is not susceptible to *direct* refutation (*italics theirs*). However, in a case of this nature one has a feeling that a weak argument will suffice. One such argument is the analogy to the dissolution of a partnership where an equal division would not result in a taxable event; Douglas relied on this analogy in *Harris v. Comm's* (their citation om.) . . . Furthermore, the policy of the tax law as exemplified by the non-recognition statute (112b) and the involuntary conversion provision (112f) is to postpone a recognition of gain or loss where it would be inopportune to tax the exchange. Thus in the present instance a more or less compulsory division of property occurs and the parties are not in a more propitious position to pay a tax on the gain than before the exchange. As a matter of common sense no gain has been realized . . ."

field research but in the alternative: either there has been accommodation to the tax inhibition against unequal divisions, or the danger has simply been ignored.

But accommodation may not always be the right thing from the standpoint of the couple parting, or from the standpoint of general family law policy. Disregard may, as a result of recent developments, become indefensible, or require intensive efforts at salvage after the fact. Hence we have extended our study to the area described by the title to this part.

1. State Law and Tax Characterization Generally

We have emphasized heretofore the crucial importance of characterization in dealing with federal tax aspects of the marriage undone. To a very considerable degree the federal statute does its own characterizing about those economic arrangements that result in income taxation to the wife and a deduction to the husband, *i.e.*, "alimony" and its statutory sibling, "periodic payments."¹⁷⁰ Where federal tax law explicitly does its own characterizing inconsistent state characterizations fade away, unless there is something left to substantive due process of law in this area.¹⁷¹

However, federal tax law generally draws very heavily on the customary terminology of Anglo-American law, and it is rare indeed that the whole semantic referent is to be found in the federal provision.¹⁷² "Alimony" versus "property settlement" is a case in point: how will it be determined whether a particular reallocation of capital is a periodic payment or whether it is a division of marital property? Certain types of capital transfers are disqualified as "alimony" under Internal Revenue Code Section 22(k), but does that mean that those which do meet the statutory requirements for "alimony" must be treated by the Commissioner and by the taxpayer as "alimony," that is, that they could not be divisions of marital property? No differentiation is possible based on the capital or noncapital character of the source, for "periodic payments," a type of "alimony" for tax purposes, do not have to be made from what is taxable income in the husband's hands.¹⁷³ Differentiation must come from other sources. These sources are nominally federal; but what influences lie behind, bear upon, really control the federal tax differentiation?

It is a matter of observable fact that influences derived from state law are strong in federal tax characterizations. Our interviews bore out that

¹⁷⁰ That is, those periodic payments which qualify are treated for tax purposes just as common law alimony under INT. REV. CODE §§ 22(k) and 23(u).

¹⁷¹ Oliver, *supra* note 166, 639, 660, 661.

¹⁷² *Ibid.*, 655-56.

¹⁷³ But *cf.* Daisy M. Twinam, 22 T.C. No. 13 (1954) where the Tax Court in holding INT. REV. CODE § 22(k) constitutional, carefully confined itself to a situation where the alimony payments taxed to the wife had their source in what would have otherwise been taxable income to the husband.

this was accepted as a vague, general proposition. We got little from our field study as to the manner in which the practice is applying the generalization of California general law and specific decision, especially insofar as the utilization is concerned. If, therefore, what we deal with now seems unrelated to everyday reality, it will not be for want of our searching for it—and in the law as in life, today's conjecture may be tomorrow's practice.

2. *California Law on Marital Property Divisions and Tax Characterization*

Examples of the potentialities just suggested would be expected to arise in connection with the California law on marital property divisions. Professor Armstrong in her book has dealt extensively and analytically with such questions as the power of the court to make unequal awards of community property on divorce in certain instances¹⁷⁴ and with the judicially-developed California doctrine of the "integrated bargain."¹⁷⁵

Also, there have been several developments in California Supreme Court decisions regarding the "integrated bargain" since the publication of Armstrong on California Family Law which may be of significance from the taxation standpoint.

We have, therefore, undertaken to examine briefly the possible inter-relationships between federal taxability and California marital property law in these particulars. We have relied principally on the field investigation and our speculations, for there is little in reported tax cases to guide us.¹⁷⁶

a. *Unequal awards under compulsion of California law*

California Civil Code Section 146 provides that in the case of dissolution of the marriage decreed on grounds of adultery, incurable insanity or extreme cruelty, the community property shall be assigned to the respective parties in such proportions as the court may deem just. In all other cases the authority of the court is specifically limited to equal division.¹⁷⁷ Although some judicial qualifications have been developed regarding the power of the court under this statute, such as that the issue of community

¹⁷⁴ 1 ARMSTRONG, CALIFORNIA FAMILY LAW 791-797, 820 (1953).

¹⁷⁵ *Id.* at 797-813, 820-823.

¹⁷⁶ *Johnson v. United States*, 135 F.2d 125 (9th Cir. 1943) involved a California agreement, but of vintage 1935, considerably before the development of the California doctrine of the integrated bargain in *Adams v. Adams*, 29 Cal.2d 621, 177 P.2d 265 (1947). The Circuit Court, moreover, noted that the appellee offered no authority for his proposition that his support obligation was fixed by the agreement or regarding the effects of CAL. CIV. CODE §§ 158-59, 135 F.2d 125, at 127.

Commissioner of Internal Revenue v. Miller, 199 F.2d 597 (9th Cir. 1952) is typical of several federal tax cases where integrated bargains seem from the facts to have been made; but the tax issues do not turn on this fact.

¹⁷⁷ CAL. CIV. CODE § 146: "Two. If the decree be rendered on any other ground than that of adultery, incurable insanity or extreme cruelty, the community property shall be equally divided between the parties."

division must be presented to the court by the pleadings,¹⁷⁸ it does not appear that under local law it is impossible for division to have its true origin in the court order, rather than in an agreement of the parties rubber-stamped by the court.

In her work, Professor Armstrong suggests that under the local law just mentioned unequal awards based upon the authority of California Civil Code Section 146 (whether taken by the court upon its own motion or by the approval of an unequal settlement negotiated between the parties in a divorce action based on extreme cruelty or adultery) should not result in the realization of taxable income, because in essence the recovery over the vested one-half is in the nature of punitive damages, an item not usually taxable as income under the Internal Revenue Code.¹⁷⁹

As questions B-6, 7 and 8 of our questionnaire¹⁸⁰ show, we undertook to get field information regarding this possibility. Tax practitioners were inclined to be very dubious, especially about the effectiveness of any such theory in a federal tax case in court. The view was expressed by some that if the unequal division was incorporated into the decree of divorce it *should not* result in tax; but it was added that "unequal divisions were very rarely *awarded*" (presumably by the divorce court on its own initiative). The association between the ideas of *incorporation* and of *award* has speculative possibilities and will be returned to shortly.

It was most interesting, in the light of the reactions reported from the taxpayers' bar to have, informally, some indications that on the other side of the tax desk the argument did not seem entirely preposterous as a general proposition where in fact the unequal division was ordered by a court under authority of law and where under that law it was damages in substance.

There seems little doubt under the theory of the California statutory law that the award provided by California Civil Code Section 146 is punitive damages in substance where extreme cruelty or adultery is the ground of divorce. The reason for the authorization to award all the community property to one spouse in the event of incurable insanity would seem to stand on a different footing. It would seem to be associated with the incompetence of the insane spouse, the need for a sane head to administer the family funds, and possibly with the idea that the sane spouse should con-

¹⁷⁸ See 1 ARMSTRONG, CALIFORNIA FAMILY LAW 772-780 (1953).

¹⁷⁹ INT. REV. CODE § 22(b)(5) and 26 CODE FED. REGS. 39.22(b)(3)-1 (1954) do not cover this point explicitly. See, however, the cases holding punitive damages not to be taxable income, 1 MERTENS, LAW OF FEDERAL INCOME TAXATION § 5.23 (1942); Central R. Co. v. Commissioner of Internal Revenue, 79 F.2d 697 (3rd Cir. 1935); Glenshaw Glass Co., 18 T.C. 860 (1952); Obear-Nester Glass Co., 20 T.C. 1102 (1953); Telefilm Inc., 21 T.C. No. 77 (1954), not being in substitution for any item of income plaintiff otherwise would have received.

¹⁸⁰ See Appendix, *infra*.

tribute to the support of the insane spouse.¹⁸¹ It would be speculative, therefore, whether, in the case of a judicial order awarding all the community property to the sane spouse, there would ever be any question, at the bar or in the offices of the Revenue Service, as to the realization, *vel non*, of taxable income. The hunch to a negative, one assumes, would reflect an appraisal of the true social situation involved.

Why, then, would similar appraisals not be made where the award arises from extreme cruelty or adultery? On the face of it, the state statute seems to declare a social policy for these situations, and the federal courts continue to draw precise lines between those judicial awards which sound in recovery of lost profits and the like and are taxable and those which are given for injury to personal rights and to punish the wrongdoer and are not taxable.¹⁸²

In all likelihood, eliminating the element of scepticism arising from the first brush with the unfamiliar, the dubiety we encountered stems from the fact that in reality divorce courts in California do not exercise the powers given to them under Civil Code Section 146. The judge is seen as exercising no true control over the situation. Ergo, practical men familiar with that reality cannot see that the judicial function is anything more than a ritualistic canonization of the agreement of the parties. The student of California Family Law,¹⁸³ on the other hand, sees the system as it ideally should be and draws other conclusions regarding the taxability of the result.

Before final appraisal is made, however, there are two other factors to be considered:

(1). Despite the degree of mechanistic jurisprudence involved in judicial approval of property settlement agreements, the agreement has been arrived at, one assumes, after hard negotiation in which each lawyer has taken every bargaining advantage given to him by the general legal system of the state, including Civil Code Section 146. Thus, it may be argued from the standpoint of adjusting federal tax law policy and state marital status policy to each other, that the statute has had its effect. The broader interpretation of Douglas, J.'s opinion in the *Harris* case¹⁸⁴ (that the general compulsion of the state law out of which the decree issued, rather than the decree itself, was the governing factor), might well be called upon to support Professor Armstrong's position, even though the California court, except where one spouse is insane and cannot contract, does not in fact usually

¹⁸¹ See 1 ARMSTRONG, CALIFORNIA FAMILY LAW 178 (1953), recalling that prior to 1951 the sane spouse, in order to get a divorce for the incurable insanity of the other, had to be able support the insane spouse for life, according to the then wording of California Civil Code § 108. This requirement was held unconstitutional and thereafter dropped.

¹⁸² Note 179, *supra*, contains references to discussion and examples of such situations.

¹⁸³ 1 ARMSTRONG, CALIFORNIA FAMILY LAW 784-787, 791-797, 820 (1953).

¹⁸⁴ See text at note 113, *supra*.

make its own decision as to how much the adulterous or extremely cruel party should be penalized by having his interest in the community given to the other.

(2). The practitioners interviewed may concede too much regarding effective federal tax penetration of the formal characterization made by the decree of a state court. Elsewhere one of us has pointed out certain institutional realities regarding that problem and has suggested that control devices thought to exist in federal tax jurisprudence to disqualify the characterizing state decision are in fact far less effectual than is usually supposed.¹⁸⁵

b. Developments regarding the "integrated bargain" in California

Professor Armstrong has analyzed extensively¹⁸⁶ the judicially-created doctrine that, despite Section 139 of the California Civil Code giving the courts the responsibility to continue to supervise support allowances to the wife where the divorce is granted for the offense of the husband, the parties may make settlements involving both property rights and support rights which cannot thereafter be disturbed by the courts, even as to support rights. The doctrine of "integrated bargain" is explained technically as compelled by California Civil Code Sections 158-59,¹⁸⁷ but its sociological roots go deeper, one feels, especially when comparing the majority and dissenting opinions in the recent *Dexter, Flynn* and *Fox* cases.¹⁸⁸ These three cases and the *Finnegan* case¹⁸⁹ which followed them have developed the doctrine of "integrated bargain" in important particulars regarding (a) proof of intent to integrate;¹⁹⁰ (b) incorporation of the agreement by reference in the divorce decree;¹⁹¹ and (c) availability in separate maintenance proceedings.¹⁹² The rationale of the Supreme Court of California in reiterating the doctrine of the *Adams* case¹⁹³ and extending it as described is potentially of significance regarding the federal taxation effects of the integrated bargain. It is with this aspect of the situation that we propose to deal now.

¹⁸⁵ Oliver, *Nature of the Compulsive Effect of State Law in Federal Tax Proceedings*, 41 CALIF. L. REV. 638, 664-666 (1953).

¹⁸⁶ I ARMSTRONG, CALIFORNIA FAMILY LAW 797-843 (1953).

¹⁸⁷ If husband and wife may validly contract during marriage about their community property, ergo, on divorce they must be permitted to agree as to how it is to be divided. This philosophy runs through the decisions in the *Adams* case line; see text at note 183, *infra*.

¹⁸⁸ *Dexter v. Dexter*, 42 A.C. 35, 265 P.2d 873 (1954); *Flynn v. Flynn*, 42 A.C. 54, 265 P.2d 865 (1954); *Fox v. Fox*, 42 A.C. 48, 265 P.2d 881 (1954).

¹⁸⁹ *Finnegan v. Finnegan*, 42 A.C. 779, 269 P.2d 873 (1954).

¹⁹⁰ See Note, "Family Law: Property Settlement and Support Agreements: Modification: Incorporation in Divorce or Separate Maintenance Decree," *infra* this issue.

¹⁹¹ *Ibid*.

¹⁹² See *Finnegan v. Finnegan*, 42 A.C. 35, 269 P.2d 873 (1954).

¹⁹³ *Adams v. Adams*, 29 Cal.2d 621, 177 P.2d 265 (1947).

The integrated bargain is popular in California divorce settlements because it gives finality by preventing subsequent judicial intervention. One party, usually the husband, is willing to make concessions as to amount in order to get a binding closing agreement with the other party. The supreme court has, with variations, expressed a policy in favor of such agreements.¹⁹⁴

Since under local law the integrated bargain is final an important element related to the realization of income exists. Unless other factors are effectively weighed against this finality, the time for a fiscal accounting has come. Moreover, as Professor Armstrong¹⁹⁵ and other California authors¹⁹⁶ have pointed out, and as practitioners have repeatedly stressed to tax and estate planning seminars in this law school, the agreement is of crucial importance in characterizing "alimony" in the Internal Revenue Code Section 22(k) sense on the one hand and "property division" on the other. To the extent that property divisions become taxable to the party receiving the outsize share, of course, the differentiation ceases to be one between tax and no-tax; but important issues may still turn on the internal characterizations made by the integrated bargain, such as (1) ordinary income versus capital gain to the receiving spouse; (2) deductibility by the transferring spouse; (3) realization of gain by the transferring spouse on settlement of a support obligation in appreciated property; (4) the very equality or inequality of the "property division"; and (5) non-taxable "partition" or (seemingly) taxable "sale or exchange."

Precise characterization in the economic settlement has to some degree been induced in practice in part, one guesses, by the supposed need for a formal inter-relationship in the instrument between the agreement on support and *Flynn* cases, it has been noted in a student appraisal of these cases:¹⁹⁷ "the [California] rule controlling incorporation of property and support contracts in decrees of divorce or divorce or separation . . ." has been liberalized. The note goes on to make the point that prior to these decisions the rationale of the integrated bargain rested on the final support settlement and the property agreement being in consideration of each other, formally and specifically. While raising certain questions from the standpoint of the overall equality or inequality of the property division and further possible questions as to gain from the transferor's discharge of his obligation to support, the law prior to the recent decisions rather compelled the draftsman to be precise in his characterizations in order to achieve the objective of integrated bargain under California law, and this precision was not without its tax significance. The liberalization reported reduces that compulsion under

¹⁹⁴ As in the three cases cited in note 188, *supra*.

¹⁹⁵ 1 ARMSTRONG, CALIFORNIA FAMILY LAW 820-823 (1953).

¹⁹⁶ Citations to Taylor and Schwartz, Kent, and Halpern are in note 144, *supra*.

¹⁹⁷ *Supra* note 190.

California law and may, therefore, unless compensated for by a continuing awareness of inducements to characterize coming from federal tax law, tend to reduce precision in denominating the elements of the bargain, with possible tax complications following.

It must be reported, on the other hand, that the four recent cases from the California Supreme Court might have the effect of making internal characterizations of lesser tax consequence where the parties have settled property interests along with support interests. This suggestion stems from the repeated and strong emphasis of the court in these cases on the overriding importance of the property aspects of the settlement. In *Dexter v. Dexter*, for instance, Traynor, J., said in response to the plaintiff's contention that the "alimony" portion of the bargain should be reopened:¹⁹⁸

Plaintiff contends, however, that since the monthly payments were to terminate on her death or remarriage and were described as alimony in the prayer of her complaint, they should be so treated. She points out that if they were intended as a division of property it would have been more reasonable for the agreement to provide that they should continue until a given amount had been paid. These considerations would be more persuasive if the issue presented was whether, on the *one hand*, the monthly payments were *solely* part of the division of the community property, or, on the other hand, *solely* alimony. When, as in this case, however, the parties have made the provision for support and maintenance an integral part of their property settlement agreement, the monthly payments will ordinarily have a dual character. To the extent that they are designed to discharge the obligation of support and maintenance they will ordinarily reflect the characteristics of that obligation and thus have the indicia of alimony. [citing cases] . . . *On the other hand, to the extent that they represent a division of the community property itself, or constitute an inseparable part of the consideration for the community settlement, they are not alimony . . .*

The question for us is how would support payments constituting "an inseparable part of the community property settlement" be identified for federal income tax purposes? Which of the "on-the-one-hand-this, on-the-other-hand-that" possibilities will the Internal Revenue Service choose? The opportunities for some tax fishing appear to be open if the Commissioner, as he knows well how to do,¹⁹⁹ resorts to local law to aid him in making his tax case. He would be aided by the theme of these cases, which seems to be: "The property settlement is the thing; we must not disturb any portion of the agreement, because that would upset the property settlement; in fact, all of it is a property settlement." Now this is a pretty strong judicial characterization of the transaction, and whether specific denomina-

¹⁹⁸ 42 A.C. 35, 40, 265 P.2d 873, 876 (1954) emphasis added.

¹⁹⁹ Oliver, *supra* note 108, 506-510 and n. 185, 639.

tions pointing anti-taxwise would prevail in the face of it seems conjectural.

Perhaps Justice Traynor's reference in the quotation from the *Dexter* case to "dual character" is the key . . . if it can be made to fit . . . but otherwise the somewhat somber possibility thus developed accentuates the importance of the recent trend in recognizing a taxable gain on unequal transfers when the marriage is ending. The situation is further complicated from the taxation policy standpoint by the underlying emphasis of the California Supreme Court (variously expressed as to the degree of conclusiveness in the majority and concurring-dissenting opinions) on the freedom of husband and wife in California to make property divisions unrelated to a decree of absolute divorce. Certainly it would be less appealing to argue to a federal court, or to Congress, that taxable consequences should not attach to situations where husband and wife rearrange their holdings by bargaining with each other in situations where they are not in marital difficulties forcing them on to absolute divorce, separate maintenance or informal separation and in a jurisdiction where the spousal agreement may be so fantastically informal. Yet it is the somewhat theoretical possibility which local law gives in this regard that the California Supreme Court finds most compelling for its decisions where marriage is actually dissolving. It is to be hoped that in possibly "agonizing reappraisals" to come differentiation in tax treatment based on the very real need for more tolerant tax treatment in the latter situation will be made.

Yet another danger of tax consequences from the California "integrated bargain" remains to be considered. In close association with her discussion of the integrated bargain Professor Armstrong²⁰⁰ makes the point that under California law intervivos division of community property is not subject to the requirement of the "item theory," which obtains on dissolution of the community by death.²⁰¹ The case law this way appears to be reinforced by the bargaining customs of California couples contemplating the ending of their marital relationship. One writer,²⁰² dealing with the situation as it existed a few years ago, has indicated reasons why it would be desirable, indeed, to avoid the division of specific assets, giving the wife, instead, cash arising from the orderly liquidation of portions of the community property. The decision of the Tax Court in *Jessie Lee Edwards*,²⁰³ however, appears in some of its language to make tax-favorable "partition" as distinguished from tax-unfavorable "sale or exchange" turn upon the division in specie of items of community property. In that situation the amounts received by the parties were substantially equal, but the wife got

²⁰⁰ 1 ARMSTRONG, CALIFORNIA FAMILY LAW 784-791 (1953).

²⁰¹ *Dargie v. Patterson*, 176 Cal. 714, 169 Pac. 360 (1917).

²⁰² Kent, *supra* note 144, p. 33, 36.

²⁰³ 22 T.C. No. 10 (1954).

mainly cash and notes, the husband keeping the items of community property. In its opinion the Tax Court uses language, emphasis added, such as:

We think the transaction before us differs from a mere division or partition of the community property, and this is true despite the language used in the settlement agreement and the avoidance, *whether calculated or not, of the usual verbiage connoting a sale*. This is clear from an examination of the items comprising the community property and the result of the "division . . ." ²⁰⁴

After the distribution, we find petitioner possessed of but two items of the community property—the household furniture and the automobile, with a total value of about \$3,600 . . . ²⁰⁵

This transaction did not amount to a *partition of each item* of community property; it was not a complete liquidation of the community property with a consequent division of the proceeds; neither was it an out and out division of the community property with the wife and husband *each taking certain items in kind and of an approximately equal value* . . . ²⁰⁶

As Professor Armstrong would say: "Nota Bene." ²⁰⁷

APPENDIX

MARITAL PROPERTY-TAXATION QUESTIONNAIRE

Name of person interviewed:

Date:

Place:

A. ALIMONY PROBLEMS

1. At the Internal Revenue Service level, what do you regard as the general practice with respect to the tax treatment of periodic payments provided for in interlocutory decrees issued under authority of California law?

2. At the Internal Revenue Service level, what do you regard as the general attitude with respect to the characterization of particular payments on divorce as "periodic"? Are you aware of any unpublished instructions on this subject?

3. Have you had experience with any unusual arrangement (or arrangements) which, at the Internal Revenue Service level, raised a question about its being a periodic payment?

4. At the Internal Revenue Service level, what do you regard as the general attitude with respect to the characterization of particular payments as "incident to divorce"? Are you aware of any unpublished instructions on this subject?

5. Have you had experience with any unusual arrangement (or arrangements) which, at the Internal Revenue Service level, raised a question about whether it was "incident to divorce"?

²⁰⁴ With which compare the verbal approach previously reported in the text at note 164 and note 164 *supra*.

²⁰⁵ Note the emphasis on the things which were community.

²⁰⁶ 22 T.C. No. 10, at p. 4 (1954).

²⁰⁷ 1 and 2 ARMSTRONG, CALIFORNIA FAMILY LAW, *passim*.

B. COMMUNITY PROPERTY DIVISION PROBLEMS

1. At the Internal Revenue Service level, what do you regard as the prevailing attitude or practice regarding the taxability of gain on particular community property assets allocated on divorce, the overall shares or divisions being equal or substantially so?

2. Are there specific instructions to Agents regarding this matter? If so, what are they?

3. At the Internal Revenue Service level, what do you regard as the prevailing attitude or practice regarding the recognition of gain on the unequal division of community assets on divorce?

4. Are there specific instructions to Agents regarding this matter? If so, what are they?

5. In your practice how do you deal with the tax aspects of an unequal division of community property on California divorce?

6. What is your impression of the probable effectiveness, at the Internal Revenue Service level, of an argument that a division of community property to the extent unequal would be non-taxable, because characterized as punitive damages under Civil Code § 146 [in divorce grounded on cruelty or adultery, the court may award the blameless spouse more than one-half]?

7. Do you know of any instances where such an argument has been accepted by the Internal Revenue Service?

8. Would you make such an argument to a federal court in a tax case with any hope of success?

9. With reference to the gift tax, what is your impression of the Internal Revenue Service attitude regarding the gift taxation of marital property transfers incident to California separate maintenance proceedings (Civ. Code § 146)?

10. Do you know of any instances where gift tax deficiencies have been asserted regarding either community or separate property transfers incident to California separate maintenance proceedings?

11. What is your impression of the manner in which the Internal Revenue Service applies the doctrine of the *Harris* case? *I.e.*, does the Service still interpret the *Harris* case narrowly as it sought to do in *McMurty* [203 F.2d 659, 1st Cir. 1953], or does it now accept the more liberal interpretation laid down in the latter case?

12. What is your impression of the manner in which the Internal Revenue Service approaches mutations of marital property between husband and wife in California? For example, suppose H and W held title to realty in joint tenancy, subsequently agreed (a) orally, (b) in writing, that the property was to be treated as community, and the tax issue is stepped-up basis under I.R.C. § 113(a)(5)?