

1958

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Recommended Citation

William E. Mooney Jr., *Property Settlements and the Federal Gift Tax—A Survey*, 37 Neb. L. Rev. 639 (1958)

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Property Settlements and the Federal Gift Tax—A Survey

This paper is intended as a survey and analysis of the potential federal gift tax liability created by property settlements incident to marriage, divorce, and separation. Attention will be given to the historical development of the applicable tax law, the actual application of that law, and to some of the problems created by the latter. It is hoped that the following discussion also makes clear the necessity for the attorney handling marital difficulties to be familiar with the federal gift tax law. There are, of course, other tax problems present in the creation and dissolution of the family unit; these problems exist primarily in the area of federal income taxation and are beyond the scope of this survey.¹

I. ANTENUPTIAL AGREEMENTS

An antenuptial agreement is a contract completed before marriage and pursuant to which one prospective spouse transfers property to the other.² The validity, for all but federal tax purposes, rests upon local law.³

The consideration, allegedly supporting these contracts, may rest on one of two general grounds: (a) One of the parties may be entering marriage for the second or third time and is unwilling to subject all his property to the statutory rights which will vest in his prospective spouse after the wedding. Therefore, in return for a lump sum settlement prior to marriage (and pursuant to the antenuptial agreement), the other spouse relinquishes all statutory property rights in the other's estate prior to the ceremony.⁴ (b)

¹ For excellent discussions of income tax problems as related to separation and divorce see: Powell, *Separation and Divorce: Income, Gift and Estate Tax Consequences*, Proc. N.Y.U. 15th Ann. Inst. on Fed. Tax 763 (1957); and Comment, *Federal Taxation of Alimony Payments and Property Settlements*, 29 Rocky Mt. L. Rev. 368 (1957).

² Black Law Dictionary (4th ed. 1951); Neb. Rev. Stat. § 30-105 and §30-106 (Reissue of 1956); Reiger v. Schaible, 81 Neb. 33, 115 N.W. 560 (1908); Price, *Gift Tax Considerations in Divorce Settlements Depend on Section 2516*, 3 J. Taxation 367 (1955); and Lindey, *Separation Agreements and Ante-Nuptial Contracts* 782 (1953).

³ Neb. Rev. Stat. § 30-106 (Reissue 1956); In re Estate of Maag, 119 Neb. 237, 243, 228 N.W. 537 (1930); Lindey, op. cit. supra note 2 at 784.

⁴ Commissioner v. Bristol, 121 F.2d 129 (1st Cir. 1941), reversing Bennet B. Bristol, 42 B.T.A. 263 (1940).

One spouse may lose a right to certain income or property, established vis-a-vis a prior marriage, if he or she enters into a subsequent marriage. Therefore, in return for a lump sum settlement (and pursuant to the antenuptial agreement), the party who will suffer the prospective loss enters into the subsequent marriage.⁵

Assuming the agreement is completed before marriage, and the property is transferred, the Commissioner will assert a gift tax due based upon the full value of the property changing hands.⁶ The basis for the imposition of this tax is the provision in the Int. Rev. Code of 1954, § 2512, to the effect that transfers without adequate consideration in money or money's worth are subject to the gift tax.⁷

In the first context, mentioned as (a) above, taxpayers have alleged that the release of statutory property rights vesting on marriage is sufficient consideration in money or money's worth so as to avoid any gift tax.⁸ The Commissioner early countered this argument by asserting that all the settlor received for the property under such circumstances was love and marriage, and that neither the release of dower or statutory property rights arising out of marriage, nor love and affection, were reducible to precise monetary value.⁹ Unfortunately for the taxpayer the Commissioner's view has withstood the test of time and is the law today.¹⁰

In the second instance mentioned above as (b), the Commissioner has again been successful in imposing a gift tax utilizing the same analysis; i.e., love and affection is not consideration for this purpose because it cannot be reduced to money or money's worth.¹¹

⁵ *Commissioner v. Wemyss*, 324 U.S. 303 (1945).

⁶ Subject of course to the annual exclusion of IRC § 2503(b) and the specific exemption of IRC § 2521, which are available to the donor spouse. Also see Proposed U.S. Treas. Reg. § 25.2512-8 (1957).

⁷ Int. Rev. Code of 1954, § 2512 (b) provides: "Where property is transferred for less than an adequate and full consideration in money or money's worth, then the amount by which the value of the property exceeded the value of the consideration, shall be deemed a gift, and shall be included in computing the amount of gifts made during the calendar year."

⁸ *Merrill v. Fahs*, 324 U.S. 308 (1945).

⁹ *Commissioner v. Bristol*, 121 F.2d 129 (1st Cir. 1941); U.S. Treas. Reg. 108 § 86.8 (1943); and Proposed U.S. Treas. Reg. § 25.2512-8 (1957).

¹⁰ *Merrill v. Fahs*, 324 U.S. 308 (1945); Proposed U.S. Treas. Regulations § 25.2512-8 and § 25.2516-1(a) (1957); Kutz, *Inter Vivos Marital Dispositions*, Proc. N.Y.U. 14th Ann. Inst. Fed. Tax 431, 432 (1956).

¹¹ *Commissioner v. Wemyss*, 324 U.S. 303 (1945).

Note that in the (b) example, it is indeed clear that there is no quid pro quo in the tax sense. Donee spouse has certainly suffered a measurable detriment (loss) for which she is reimbursed. Donor spouse has also suffered a detriment (transferred property), but his only benefit is love and marriage.¹² As between Donor and Donee, Donee is no better nor worse off than she was prior to the agreement (other than having a new husband), and yet Donor has parted with something of value and is worse off than before (other than from the aspect of having a new wife). The only imbalance of the scale, therefore, is in respect to Donor having transferred property and received nothing in return (love and marriage cancelling each other out)—hence, a gift tax should be due.

It is possible, of course, that a given antenuptial agreement could embrace both of the motives considered as example (a) and (b), but clearly the argument favoring the imposition of a gift tax is in no way weakened by such a merger.

A. HISTORY

In the earliest case discussing the taxability of antenuptial agreements, *Commissioner v. Bristol*,¹³ the Commissioner maintained the position that payments under these contracts, in return for which the wife surrendered certain marital rights, were subject to the gift tax since no consideration was present. This case, decided in 1941 by the 1st Circuit Court of Appeals, was plainly within the factual assumption mentioned as type (a) above; the prospective husband involved desired to retain control of stock in a closely held family corporation so that upon his death his children by a prior marriage would acquire the control.¹⁴ Here the Court agreed with the Commissioner, held that a gift tax was due, and said that consideration as defined in the Revenue Act of 1932¹⁵ was dissimilar to common law consideration.¹⁶ In order for the transfer to escape tax, said the Court, the wife must replace the husband's consideration with money of equal value or goods or services capable of monetary valuation. The wife's mere release of her statutory

¹² *Id.* at 308.

¹³ 121 F.2d 129 (1st Cir. 1941).

¹⁴ *Id.* at 131.

¹⁵ Revenue Act of 1932 § 503, 47 Stat. 247, Int. Rev. Code of 1939. § 1002, 52 Stat. 146, and presently § 2512 of Int. Rev. Code of 1954.

¹⁶ For discussion of this consideration concept see Lowndes and Kramer, *Federal Estate and Gift Taxes* 736-740 (1956).

rights has no market value and cannot be sold, hence there is no consideration.¹⁷

In 1943, the 7th Circuit in *Lasker v. Commissioner*¹⁸ refused to follow the *Bristol* decision. The antenuptial agreement involved in this case was also within the context of type (a) mentioned above; it was, however, coupled with a divorce settlement agreement executed only two months after the premarital contract, and which was later approved by a Nevada divorce court. Here the court decided that the husband was actually settling an existing legal liability to the wife and therefore no gift tax was due.¹⁹ The combination of events involved in this case (antenuptial agreement, divorce settlement, and divorce decree) distinguishes it from the *Bristol* case setting forth the basic rule on the taxation of antenuptial agreements. The Court construed all three things together, and decided that since the marriage was terminating the parties should be allowed a tax-free settlement. Indeed, the Court believed that the husband had struck a good bargain in making the divorce settlement, in that the divorced wife might well have secured a larger court judgment which would have been, of course, a legally binding obligation.²⁰ In effect, settlement of a legally enforceable obligation constituted consideration.²¹

Yet observe that neither "death" rights nor "divorce" rights in a husband's property are rights which can be reduced to precise amounts *in advance*, and both constitute incipient legal obligations. Nonetheless, the Court in *Lasker* was willing to regard a settlement of inchoate divorce rights as consideration, but the Court in *Bristol* held a settlement of "inchoate" death rights was not!

¹⁷ 121 F.2d at 134.

¹⁸ 138 F.2d 939 (7th Cir. 1943). For discussion of this case see Paul, *Federal Estate and Gift Taxation* 711 (1946 Supp.).

¹⁹ The *Lasker* case was followed by a District Court decision in *McWilliams v. Harrison*, where the transfer of property in discharge of the wife's support and marital rights was said to be "... a bona fide transaction at arm's length for a full and adequate consideration in money or money's worth and cannot be taxed as a gift. . . ." CCH 44-1 USTC para. 10,119 (N.D. Ill. Mar. 7, 1944). It is not clear from the opinion whether an antenuptial agreement or a settlement contract incident to divorce was involved in this case.

²⁰ *Lasker* case at 991 stated: "We think there can be no doubt but that petitioner's escape and release from his unfortunate matrimonial adventure constituted adequate and full satisfaction for the payment thus made. In fact, it appears that his liability was settled on a bargain basis. Certainly he was not short-changed." This case in effect foreshadowed the holding in *Harris v. Commissioner*, 340 U.S. 106 (1950) and IRC § 2516 both discussed post § IV.

Protection of the family unit probably justifies, to a mild degree, the existence of both "death" and "divorce" rights in a spouse's property, but whatever the soundness of public policy underlying each, the only manner by which husbands can alter these rights before they vest (via death or court order, respectively) is through antenuptial and ante-divorce agreements. It seems strange, therefore, that in the former case no consideration is found because inchoate rights cannot be reduced, in advance, to money or money's worth (or cannot be sold),²² while inchoate divorce rights are held, *in effect*, to be subject to such reduction and sale.²³ We shall see, however, that the Internal Revenue Code of 1954 has, by legislative fiat (and where logic is not necessarily appropriate) solved the logical inconsistency in the judge-made law.²⁴

In 1944, the 5th Circuit concluded in *Fahs v. Merrill*,²⁵ that an antenuptial agreement of type (a) above, creating a trust for the prospective wife, was a taxable transfer under the gift tax. Approximately three months later the 6th Circuit issued its opinion in *Wemyss v. Commissioner*.²⁶ In this case the court was faced with an antenuptial contract of type (b) mentioned above, by which the transfer of property to the wife under the agreement was to compensate her for the loss of income from a trust established for her by a former husband. The Court considered the reasoning in the *Lasker* case to be pertinent, even though the factual situation was clearly distinguishable, and held that the transfers by the premarital agreement were not taxable—saying that § 503 of the Revenue Act of 1932²⁷ intended to tax transfers only when a donative intent existed.²⁸

Wemyss was consistent with *Lasker* insofar as net result is concerned—both cases finding no gift tax due on a transfer involving an antenuptial agreement. But from that point onward, the cases are strikingly dissimilar. *Wemyss* involved a type (b) antenuptial settlement whereas *Lasker* involved a type (a). Further, *Lasker* rested, really, upon the divorce settlement and decree being

²¹ *Id.* at 992.

²² 121 F.2d at 133, 134.

²³ 138 F.2d at 991.

²⁴ Int. Rev. Code of 1954 § 2516, discussed post § IV.

²⁵ 142 F. 2d 651 (5th Cir. 1944).

²⁶ 144 F. 2d 78 (6th Cir. 1944).

²⁷ 47 Stat. 247.

²⁸ 144 F.2d at 82. Cf. *Commissioner v. Greene*, 119 F.2d 383, 386 (9th Cir. 1941).

present. These elements were not present in *Wemyss*. It might be thought that *Wemyss* and *Lasker's* consistency could be justified through the analysis brought forth in the *Bristol-Lasker* comparison. Unfortunately this thread of consistency was not mentioned in *Wemyss*. Rather, the Court read into the gift tax statute a requirement that donative intent be present before the transfer could be taxed—this in spite of the language in the statute taxing *all* transfers without consideration in money or money's worth.²⁹

The United States Supreme Court granted certiorari in the *Wemyss* and *Merrill* cases³⁰ in order to settle the conflicting decisions among the Courts of Appeal, and to establish a definite rule as to the taxability of antenuptial contracts under the federal gift tax. The Court reversed the *Wemyss* case,³¹ and affirmed the 5th Circuit opinion in *Merrill v. Fahs*.³² These companion cases, issued in 1945, have in effect adopted the Commissioner's early theory that property transferred under an antenuptial agreement should be subject to the gift tax, as being a transfer without consideration in money or money's worth.³³

In the *Wemyss* case, the alleged consideration for the transfer was the marriage itself and the wife's loss of income from a former trust (type b). Although this was adequate legal consideration under the law of Florida, the Court held that it was not enough to prevent the imposition of a gift tax. In the *Merrill* case, the consideration was also the marriage itself and the wife's release of her rights in her husband's property except for maintenance and support. The Supreme Court again concluded that the transfer was not for adequate and full consideration in money or money's worth.³⁴

The reasoning in the *Merrill* case was as follows: Ever since *Sanford v. Commissioner*,³⁵ the gift tax has been construed to be supplementary to the estate tax statutes, and the two have been

²⁹ Id. at 81. However the Treas. Reg. 79 Art. 8 (1936) contained the words, "free from any donative intent" and this was read into the code. The same phrase is contained in Proposed U.S. Treas. Reg. § 25.2512-8 (1957).

³⁰ 323 U.S. 686 and 323 U.S. 703.

³¹ 324 U.S. 303 (1945), 156 A.L.R. 1022.

³² 324 U.S. 308 (1945). Justice Frankfurter wrote the majority opinions in both cases.

³³ See text at note 13, *supra*.

³⁴ *Merrill* case was a 5-4 opinion. Dissenting opinion by Justice Reed appears at 313 of volume 324; Rabkin and Johnson, *Federal Income Gift and Estate Taxation* 5151-5156 (1954).

³⁵ 308 U.S. 39,44 (1939).

read *in pari materia*.³⁶ In reviving the gift tax in 1932, Congress realized that a donor could avoid a gift tax if he claimed that his gift amounted to a sale, because the donee had given some consideration in return for the gift. Congress therefore attempted to close the loophole by passing § 503 [former version of IRC § 2512 (b)], and including the words "... adequate and full consideration in money or money's worth. . . ." The estate and gift tax statutes are to be read *in pari materia* and have the common phrase "adequate and full consideration in money or money's worth," but the estate tax statute alone provides in § 812(b) [former version of IRC § 2043(b)] that the relinquishment of marital rights is not consideration.³⁷ Nevertheless, the statutes should be similarly construed and this last sentence of § 812(b) should be read into the gift tax section, leading to the construction that the release of marital property rights under the gift tax is not consideration within the statute.

Underlying both of the above Supreme Court decisions was the basic doctrine of "Estate Depletion." The original purpose of the gift tax was to make certain *inter vivos* transfers taxable so that the estate tax could not be evaded through ante-mortem gifts. Prior to the enactment of the gift tax in 1924, it was possible for a person to make an *inter vivos* transfer of property to those who would take by devise or inheritance if the property were retained until death, without the payment of any federal tax. Thus, upon death, the gross amount of the estate would be greatly depleted, and the government would fail to receive a "proper" amount of estate tax revenue.³⁸

It is evident that the presence or absence of donative intent

³⁶ For legislative history of the idea that the gift tax supplements the estate tax, see: S. Rep. No. 665, 72nd Cong. 1st Sess. 40 (1932), and H.R. Rep. No. 708, 72nd Cong. 1st Sess. 28 (1932). Black Law Dictionary (4th ed. 1951) defines *in pari materia* as "upon the same matter or subject." So statutes which are concerned with the same matter or subject should be construed together. The basis for the doctrine is the desire for systematization, for a unified system of taxation, and for a method of avoiding discrepancies between statutes. Lenhoff, Comments, Cases, and Materials on Legislation 554, 555 (1949).

³⁷ Comment, Tax Aspects of Alimony Trusts, 66 Yale L.J. 881, 885 (1957).

³⁸ Sanford's Estate v. Commissioner, 308 U.S. 39 (1939); Commissioner v. Bristol, *supra* note 4; 2 Paul, Federal Estate and Gift taxation 962-964 (1942). It should be noted parenthetically, that the Estate Depletion theory has been dealt a serious blow in connection with alleged gifts made pursuant to divorce, and a new test has arisen in regard to the same. This will be discussed below in Section IV.

with respect to antenuptial agreements after *Wemyss* and *Merrill* is totally irrelevant. Regardless of proof that the contract was entered into without any donative intent, a gift tax will be imposed on the ground that the transfer was not for adequate consideration in money or money's worth.³⁹

B. 1954 CODE

There is no provision in the present IRC which specifically covers the area of transfers by antenuptial agreement. However, the substance of the *Wemyss* and *Merrill* rules has been incorporated into the Proposed U.S. Treasury Regulations,⁴⁰ and the Commissioner has taken the position that a transfer of property in consideration of marriage or in consideration of the release of dower, curtesy, or other marital property rights is a taxable gift even though based upon a binding premarital agreement. The Regulation states in part that:

A relinquishment of dower or curtesy or of any other marital rights is not consideration in money or money's worth, and the transfer of property in return for such a relinquishment constitutes a gift of the entire value of the property transferred.⁴¹

The American Law Institute has taken a position which is consistent with that of the Commissioner in regard to antenuptial agreements. The Institute's reason was that ". . . ante-nuptial settlements do not seem to provide the appropriate moment for a final accounting under the gift tax. If these transfers were freed of the gift tax it would be difficult, if not impossible, to prescribe a logical and equitable treatment for further interspousal transfers."⁴²

A completed antenuptial agreement will create a federal gift tax liability, therefore;

(a) even though a prospective spouse releases statutory rights in the property of the other prospective spouse; or

(b) even though a prospective spouse relinquishes valuable income or property to marry; or

³⁹ See *Merrill v. Fahs*, 324 U.S. at 313; *Wemyss v. Commissioner*, 324 U.S. at 306.

⁴⁰ Proposed U. S. Treas. Regulations § 25.2512-8 and 25.2516-1(a) (1957).

⁴¹ Proposed U.S. Treas. Regulations § 25.2512-8 (1957).

⁴² ALI, Federal Income, Estate and Gift Tax Statute (Tent. Draft No. 10 p. 107 1955). Quoted in Warren and Surrey, Federal Estate and Gift Taxation, Cases and Materials 228 (1956).

(c) even though no donative intent exists on the part of the donor spouse, and

(d) even though cases (a) and (b) above would be sufficient consideration to support a contract under local law.⁴³

C. A PARTIAL SOLUTION

Even though a federal gift tax will be due on a transfer pursuant to an antenuptial agreement, when such agreements are desired by the parties entering into a marriage, it is possible to minimize the tax. The key to the tax mitigation lies in the use of the marital deduction which is, of course, available for gifts between spouses. The marital deduction provides that one-half of a gift to a spouse is exempt from tax.⁴⁴

It has been held that a transfer for federal gift tax purposes occurs at the moment when all conditions to an antenuptial agreement have been satisfied.⁴⁵ If an antenuptial contract is, therefore, made *contingent* upon marriage, and delivery is postponed until *after* the ceremony, the marital deduction will spare one-half of the transfer from the gift tax. However, if it is merely stated that delivery is *postponed*, a gift tax will be imposed upon the whole amount on the ground that a valid and enforceable contract existed prior to the marriage.⁴⁶

II. SUPPORT AND PROPERTY RIGHTS

What are the gift tax problems when the wife releases the husband from his duty to support, or when the husband pays an amount under a divorce or separation agreement for a release of all the wife's rights—both marital and support? Are these taxable transfers under the gift tax? To answer these questions, let us look to the development of the law and then to the 1954 Code.

⁴³ Wolf, *Income, Gift and Estate Tax Considerations in Marriage and Divorce*, 14 Md. L. Rev. 3,7 (1954); Kutz, *op. cit. supra*, note 10 at 433,434.

⁴⁴ Int. Rev. Code 1954 § 2523(a).

⁴⁵ *Commissioner v. Copley's Estate*, 194 F.2d 364, 366 (7th Cir. 1952).

⁴⁶ *Ibid.* The early case of *John D. Archbold*, 42 B.T.A. 453 (1940) has been ignored by the later decision in the *Copley* case as to the time when a transfer will be determined to be a present gift. The *Archbold* case concluded that a promise to make a gift in the future, even though enforceable, was not a present gift. See also Durbin, *Tax Consequences in Marriage, Separation, and Divorce Settlements*, U. Ill. L. Forum 489, 492 (1955).

A. HISTORY

In *Herbert Jones*,⁴⁷ the Commissioner contended by the authority of the *Bristol* case⁴⁸ that payments made by the husband pursuant to divorce proceedings, in settlement of the wife's support and maintenance rights were taxable gifts.⁴⁹ This was the initial effort of the Commissioner to tax such transfers, and he was unsuccessful, the Tax Court ruling that the settlement agreement was an arm's length business transaction totally without donative intent.⁵⁰ Two years later in 1945 the Tax Court followed the above rule and held in *Edmund C. Converse*⁵¹ that the *Wemyss* and *Merrill* Supreme Court decisions, *supra* Section I, did not apply as they dealt with antenuptial agreements. These two early tax court cases were cited as authority and followed in *Matthew Lahti*⁵² and *Clarence B. Mitchell*,⁵³ both decided in January, 1946.

Later in 1946, the Commissioner acquiesced in the above position of the Tax Court and published the now famous ET 19.⁵⁴ The Commissioner therein distinguished both the *Merrill* and the *Wemyss* cases.⁵⁵ He ruled that a transfer contained in a separation agreement or divorce decree whereby the wife released support rights may be full and adequate consideration in money or money's worth to remove it from the gift tax, provided that such transfer did not exceed the reasonable value of the support rights. However, the release of marital rights was not such consideration, and if the transfer were made as a release of both marital and support rights, the Commissioner would make an allocation.

The Commissioner in ET 19 reasoned that taxability under the

⁴⁷ *Herbert Jones v. Commissioner*, 1 T.C. 1207 (1943).

⁴⁸ 121 F.2d 129 (1st Cir. 1941). This case was distinguished in *Jones* on the ground that it involved an antenuptial agreement whereas *Jones* involved a settlement agreement incident to divorce.

⁴⁹ *Jones* case at 1209.

⁵⁰ *Id.* at 1212.

⁵¹ 5 T.C. 1014, 1016 (1945) (3 judges dissenting) *aff'd on other grounds*, 163 F.2d 131, 174 A.L.R. 199 (2d Cir. 1947).

⁵² 6 T.C. 7 (1946) (3 judges also dissented).

⁵³ 6 T.C. 159 (1946); 2 Rabkin and Johnson, *op. cit.* *supra* note 34 at 5153.

⁵⁴ ET 19- 1946 2 Cum. Bull. 166-169. This was issued by the Commissioner in reliance upon the decisions of the Supreme Court in *Wemyss* and *Merrill*. It was expressly made applicable to both the estate and gift taxes. See Lowndes and Kramer, *op. cit.* *supra* note 16 at 741-43.

⁵⁵ The Supreme Court's reasoning in these two cases would seem to apply equally well to marital agreements other than antenuptial types.

context of the gift tax statute is largely determined by the presence or absence of financial benefit to the donor. A husband who has a duty under a decree of divorce or legal separation to support his "ex"-wife, is under a legal obligation, the satisfaction of which does not amount to a financial benefit to him.⁵⁶ Also the payments under this obligation do not diminish or deplete the husband's estate any more than the payment of any current debt or expense.⁵⁷ On the strength of the above arguments, the Commissioner concluded that the surrender of support rights was not among the "other marital rights" provision of § 812(b) [former version of IRC § 2042(b)], and therefore the *in pari materia* argument would not apply. The Commissioner thereby deftly avoided the construction used in the *Merrill* case.⁵⁸ The 2d Circuit in a series of cases had taken the position that the right to support was an "other marital right" and so was not consideration.⁵⁹ Judge Learned Hand's dissent in one of the cases was evidently the basis for the ruling in *ET* 19.⁶⁰

Furthermore, the Commissioner was of the opinion that an allocation must be made to determine what part of a transfer contained in a separation or divorce settlement was in satisfaction of support rights and what part was in satisfaction of property rights. To the extent that the transfer was made for the fulfillment of the former, it was exempt from the gift tax. It was to be the function of the bureau to make a determination of the reasonable value of the support rights as a question of fact. The reasonable value was to be determined by a consideration of the following elements: (a) Husband's income and station in life, (b) The extent of his assets and the standard of living, (c) The life expectancies of the parties based on actuarial tables, and (d) The probability of the wife's remarriage—also based on actuarial principles.⁶¹ However, the

⁵⁶ 3 Vernier, American Family Laws 108-116 (1935); ALI, Committee on Continuing Legal Education, Family Law, by Winnett & Gibson, pp. 32 and 62 (1952); Neb. Rev. Stat. § 42-318 (Reissue 1952).

⁵⁷ *ET* 19 *supra* at 168.

⁵⁸ Text at notes 35-37 *supra*.

⁵⁹ *Meyer v. Commissioner*, 110 F.2d 367 (2d Cir. 1940); *Adriance v. Higgins*, 113 F.2d 1013 (2d Cir. 1940); *Helvering v. U.S. Trust Co.*, 111 F.2d 576 (2d Cir. 1940). Cf. *Robert McKeon*, 25 T.C. 697 (1956). Also see *Lowndes and Kramer*, *op. cit. supra* note 16 at 318, 319.

⁶⁰ *Meyer v. Commissioner*, 110 F.2d 367, 369 (1940).

⁶¹ *ET* 19 *supra* note 54.

Commissioner's determination is not conclusive and is subject to review by the courts.⁶²

The rule in the *Converse* case⁶³ that payments made under an order of a divorce court were not taxable as gifts since the incorporation of the agreement into the decree gave it the character of a judgment debt was carried forward and expanded in *Edward B. McLean*,⁶⁴ and *Norman Taurog*.⁶⁵ In these two cases, the Tax Court said that ET 19 was invalid insofar as it did not exempt transfers made to settle presently enforceable claims.

In 1949, the 2d Circuit, in *Commissioner v. Barnard's Estate*⁶⁶ threw some cold water on the expanded notion of the *Converse* case, saying that it had "been cited beyond its scope in some decisions below." The *Barnard* case held that the *Converse* rule did not apply to the situation where the settlement was made prior to the decision to divorce, and the settlement agreement provided that its terms would be unaffected by inclusion in the separation or divorce decree. Under this factual situation, the wife's transfer to the husband by a written agreement whereby he released any claim on her property was not adequate and full consideration. Important also was the court's conclusion that there was no business transaction here even though there was a lack of donative intent.

We can see the trend in these cases not only toward the idea that payments to the wife in satisfaction of her support and maintenance rights should not be taxed, but also toward the notion that

⁶² Paul Rosenthal, 17 T.C. 1047 (1951), *rev'd on other grounds*, 205 F.2d 505 (2d Cir. 1953).

⁶³ See note 51 *supra*. *Converse* could have been distinguished as there the wife received an absolute interest in a lump sum, whereas in *McLean*, the obligation would cease (defeasible) upon the death of either spouse. *McLean's* obligation was contingent upon survival.

⁶⁴ 11 T.C. 543 (1948). *McLean* entered into divorce settlement negotiations with his wife. Resulting agreement provided for lump-sum settlement of \$100,000, payable in monthly installments over a 12 year period. The agreement was later incorporated into a divorce decree. The agreement provided that the payments to the wife should continue even if she remarried, and the obligation was to end upon the death of either party. The Commissioner said that the portion of the settlement relating to the remarriage provision was without adequate consideration. But the Tax Court held the transfer was in consideration of the release of a presently enforceable claim.

⁶⁵ 11 T.C. 1016 (1948).

⁶⁶ 176 F.2d 233, 236 (2d Cir. 1949). Taylor, Federal Gift Tax Aspects of Release of Dower and Other Marital Rights Under Divorce or Separation Agreements, 6 S.C.L.Q. 359, 360. (1954).

perhaps settlement agreements (fulfilling certain conditions) incident to divorce should also be tax free.

B. 1954 CODE

The concession as to support payments contained in ET 19 is applicable today when the transfer does not come within the provisions of IRC § 2516. Although ET 19 was not mentioned in the Proposed U.S. Treas. Regulations under § 25.2516-1, it would still remain the law as to any transfer not covered by that section, e.g., a transfer followed by a divorce *after* the two-year period. Under IRC § 2516, it would seem to be important to determine only whether the payment to the spouse was in settlement of her marital or property rights and a divorce occurred within two years. One such right would be the obligation to support and maintain, but it would be unnecessary for the court to separate and allocate amounts to these various rights as they would all be exempt if the requirements of IRC § 2516 were met [§ 2516(1)].

One further problem arises when the husband pays the wife's attorney's fees in the separation or divorce settlement. Is this a taxable gift? The Commissioner in ET 19⁶⁷ established the rule that such payments are not taxable if the husband is under an obligation to pay the fees. In Nebraska and most other states, such an obligation exists by statute,⁶⁸ and it is therefore logical to assume that no payment would be taxed. The ET 19 rule would still apply as IRC § 2516 and its Proposed Regulations do not discuss the matter of attorney's fees.

III. SUPPORT FOR MINOR CHILDREN

It is clear that property which is transferred by a husband to discharge his obligation to support his minor children is not a taxable gift and is deemed to be "adequate and full consideration in money or money's worth."⁶⁹ A transfer, however, for the benefit

⁶⁷ See *supra* note 54 at 169.

⁶⁸ Neb. Rev. Stat. § 42-308 (Reissue 1952); *Nickerson v. Nickerson*, 152 Neb. 799, 42 N.W.2d 861 (1950); *Lindey*, *op. cit.* *supra* note 2 at 419, 422.

⁶⁹ Int. Rev. Code of 1954, § 2516(2); *Roland M. Hooker*, 10 T.C. 388, *aff'd*, 174 F.2d 863 (5th Cir. 1949); *Helvering v. U.S. Trust Co.*, 111 F.2d 576 (2d Cir. 1940); *Commissioner v. Weiser*, 113 F.2d 486 (10th Cir. 1940); and *McDonald Trust*, 19 T.C. 672, *aff'd* 225 F.2d 621 (8th Cir. 1955). Husband has an obligation to support in Nebraska, see Neb. Rev. Stat. § 28-449 (Reissue 1956). Generally on support of children, see *Lindey*, *op. cit.* *supra* note 2 (1954-1957 Supp.) at 148.

of adult children is a taxable gift as there is no remaining duty to support.⁷⁰ Also, the value of property transferred in excess of that which is reasonably necessary to discharge the support obligation is a taxable gift.⁷¹ In addition, a transfer in discharge of support obligation which vests in minor children after they have reached majority would be a taxable gift.⁷²

There is a gift tax due on the remainder interest where a trust is created pursuant to a divorce decree ordering the husband to establish a trust in support of his wife for life and remainder to his adult daughter and her children.⁷³ Here the distinction between transfers founded on obligations imposed by law and those imposed by agreement breaks down, and it appears that the support exemption does not apply to transfers for the benefit of adult offspring.⁷⁴ By the *Rosenthal* decision⁷⁵ payments to minors beyond their needs for support were held taxable. The court found, in this case, that the particular divorce decree provisions depended wholly on the consent of the husband and were not the result of court litigation.

In the 1954 code, § 2516(2) is apparently a codification of the various court decisions exempting support payments to minor children. It provides that reasonable support payments for minor children of the marriage are deemed adequate consideration and are exempt from the gift tax. Here a transfer either presently or in trust⁷⁶ is not a taxable gift, but under IRC § 71(b), the income from such a trust or property would be taxable to the husband, for the reason that it satisfies his legal obligation to support his children.⁷⁷ Also, a trust, created in a separation agreement, for a minor child is taxable to the extent that the corpus of the trust exceeds a reasonably required amount for support.⁷⁸ This is true of IRC § 2516 and any amount above the reasonable limit is taxed.

The American Law Institute believes that this subsection of IRC § 2516 is unnecessary and possibly misleading. The Institute

⁷⁰ Karl T. Wiedemann, 26 T.C. 565, 569 (1956).

⁷¹ *Rosenthal v. Commissioner*, 205 F.2d 505 (2d Cir. 1953).

⁷² *Hooker v. Commissioner*, 174 F.2d 863 (5th Cir. 1949).

⁷³ Karl Wiedemann, 26 T.C. 565, 569 (1956).

⁷⁴ *Rosenthal v. Commissioner*, 205 F.2d at 508.

⁷⁵ *Ibid.*

⁷⁶ U.S. Treas. Reg. 108 § 86.2 (1943); Lewis, *Trusts in Divorce Settlements, Trusts and Estates*, Oct., 1956, 884-892.

⁷⁷ *Budd v. Commissioner*, 177 F.2d 198 (6th Cir. 1947).

⁷⁸ T.C. opinion in *Converse* case, note 51 supra. See also Proposed U.S. Treas. Reg. § 25.2511-1 (f) (1) (1957).

reasons that, "Under prior law, transfers for support of minors were not subject to gift tax where within the legal obligation of support; and where in excess thereof were not protected whether or not contained in a decree of divorce."⁷⁹

Two questions, however, do arise as to the terms used in the subsection [§2516(2)]. What is meant by the word "minority?" No definition appears, but perhaps the age should depend upon state law or some theory of federal common law. Frequently, a minor is thought to be a male under the age of 21 years, and a female under the age of 18 years. But would this apply to the gift tax law? Apparently not. Although no definition of minor or minority appears in IRC § 2516, the word is defined in IRC § 2503(c) as an "... individual who has not attained the age of 21 years. . . ." Granted that § 2503(c) applies to a determination of when a gift to a minor is to be considered a future interest; nevertheless it must be taken as a legislative declaration that for gift tax purposes a minor is either a male or female under the age of 21 years.

The second problem arises as to the meaning of the term "issue of the marriage" found in IRC § 2516(2). Would step-children and adopted children be considered issue for the purposes of the section, and therefore would payments to them under a separation settlement incident to a divorce be exempt? The Commissioner has included legally adopted children within the meaning of "issue" in IRC § 2516(2), and so reasonable payments to them during minority would be tax free. (Proposed U.S. Treas. Reg. § 25.2516-2). Payments to step-children, however, are not freed from the gift tax. Technically "issue" has been defined as limited to heirs of the body or as lineal descendants,⁸⁰ and this might be construed to prevent adopted or step-children from coming within the scope of the word. But the Commissioner wisely realized that a father who has adopted a child would have a definite legal duty to support that child upon a divorce or separation of the parents.

IV. SEPARATION AND DIVORCE AGREEMENTS

What gift tax liability is created when a husband and wife enter into a separation agreement settling their marital property rights other than support, and the agreement is approved or incorporated into a divorce or separation decree? Here again we will

⁷⁹ ALI (Tent. Draft No. 10) *op. cit. supra* note 42 at 108.

⁸⁰ Black Law Dictionary (4th ed. 1951); *Wilkins v. Rowan*, 107 Neb. 180, 185 N.W. 437 (1921).

briefly trace the development of the law and then analyze the 1954 Code and its regulations.⁸¹

A. HISTORY

The rationale of the early Tax Court decisions, *supra*, Part II, was that antenuptial agreements should be taxed as they were fraught with donative intent and the marriage was just beginning, whereas divorce settlements should not be taxed as there was more of an arm's length transaction involved—a type of bargained-for compromise.⁸² As previously discussed, the Commissioner exempted reasonable support payments in ET 19, *supra* Part II, but still maintained that the release of all marital rights other than the support rights was not consideration and therefore taxable.

A year later, the 2d Circuit in *Converse* decided that no gift tax was due where the separation agreement was approved and made enforceable by the divorce court.⁸³ There the agreement was not conditioned upon the entry of the decree, but the conclusion was reached at p. 133 that the husband's payment was to satisfy and discharge a money judgment and so was adequate consideration. Subsequent Tax Court opinions followed the earlier cases and held that these transfers were not taxable as long as the agreements were merged and incorporated into the divorce decrees; even though the decrees merely approved a prior agreement by the parties.⁸⁴

However, this last mentioned tax court rule was limited and held inapplicable in *Commissioner v. Barnard's Estate*,⁸⁵ and *Krause v. Yoke*.⁸⁶ In *Barnard's Estate*, the 2d Circuit distinguished its previous decision in *Converse* and declared that a gift tax was due. It concluded that there was no adequate consideration where the divorce court merely approved a property settlement agreement which provided (a) for transfers before the decree and (b) was

⁸¹ For other discussions of the problems herein see Hill, *The Present Status of Alimony Payments*, Proc. N.Y.U. 13th Ann. Inst. on Fed. Tax 31 (1955); Lewis, *op. cit.* note 76 *supra* at 887-888; Note, *Tax Aspects of Alimony Trusts*, 66 Yale L.J. 881 (1957); and McDonald, *Tax Aspects of Divorce, Separation, Alimony and Support*, 17 Univ. Pitt. L. Rev. 1, 17 (1955).

⁸² Text at notes 47-53 *supra*.

⁸³ 163 F.2d 131 (2d Cir. 1947).

⁸⁴ Wm. B. Harding, 11 T.C. 1051 (1948); Albert V. Moore, 10 T.C. 393 (1948); Clarence B. Mitchell, 6 T.C. 159 (1946); and Ed. B. McLean, 11 T.C. 543 (1948).

⁸⁵ See note 66 *supra*.

⁸⁶ 89 F. Supp. 91 (N.D. W. Va. 1950). This case was decided before the Supreme Court decision in *Harris v. Commissioner*, 340 U.S. 106 (1950).

effective without the decree and survived the decree. The *Barnard* rule was cited with approval in *Krause v. Yoke*, where the agreement was completed prior to the entry of the decree and the decree merely recited compliance by the parties and ratified the agreement. So the decree was not a court command or order for the parties to obey the agreement.

Up to this time then, three varying rules were established: (a) The Tax Court rule that payments made incident to a divorce decree were not taxable because the agreement was made in an arm's length transaction;⁸⁷ (b) The *Converse* rule that payments made under an order of a divorce court were tax free;⁸⁸ and (c) The *Barnard's Estate* and *Krause* exceptions cited in the preceding paragraph.⁸⁹

In 1950, the Supreme Court handed down its first opinion on the subject of settlement agreements incident to divorce in *Harris v. Commissioner*.⁹⁰ There the question was raised whether the *Merrill* and *Wemyss* decisions could be applied to impose a gift tax on a postnuptial property settlement incident to a divorce. Simply stated, the facts in the *Harris* case were that a husband and wife transferred property to each other pursuant to a property settlement agreement conditioned on and subject to the approval of a final divorce decree. They each released marital rights in the other's property, and it was provided that the agreement would survive the divorce decree. The Supreme Court held that there was no gift tax due as this transfer was not based on an agreement or promise, but was pursuant to a court decree. By this decision, the Supreme Court sustained the Treasury ruling in ET 19,⁹¹ and refused to follow the Tax Court's distinction between divorce settlements and antenuptial agreements.

⁸⁷ Text at notes 47-53 *supra*.

⁸⁸ See text at note 83 *supra*.

⁸⁹ See also *Hooker v. Commissioner*, 174 F.2d 863 (5th Cir. 1949).

⁹⁰ 340 U.S. 106 (1950). This was a 5-4 opinion. For an excellent discussion, see Pedrick, *Gift Tax Jurisdiction of the Divorce Court*, 46 Ill. L. Rev. 177 (1951); Lowndes and Kramer, *op. cit.* 743-746; and annotation in 95 L. Ed. 121-141. The court construed *Commissioner v. Maresi*, 156 F.2d 929 (2d Cir. 1946) to the gift tax field. That case allowed a deduction from the value of the gross estate of an amount claimed as future payments due the decedent's divorced wife under a divorce decree incorporating a prior settlement agreement. The court held that consideration was not involved as there was no promise or agreement.

⁹¹ Actually expanded ET 19 to recognize the immunity of transfers made to discharge obligations imposed by law.

Justice Douglas, speaking for the majority, recognized a distinction between transfers founded on obligations imposed by agreement and those imposed by law. As to the former type of voluntary contractual settlement, he said that unquestionably a gift tax would be imposed as it was based solely on a promise, while in the latter case, the decree "creates the rights and the duties" and so no tax is due (based on the idea of legal compulsion).⁹²

The difficulty in the *Harris* case arose from the fact that the settlement agreement stated that it would survive any divorce decree entered. This provision evidently meant that the parties might sue to enforce either or both the agreement or the decree. However, the majority felt that this provision was unimportant saying, "... that the gift tax statute is concerned with the source of rights, not with the manner in which rights at some distant time may be enforced." In other words, the transfer and not the sanctions involved was the important thing, and here the transfer was by court decree.⁹³

The *Harris* case has evidently rejected the "Estate Depletion" theory, *supra* Part I, and has adopted in its place the idea that the concept "gift," within the meaning of the gift tax statute, is limited to voluntary transfers.⁹⁴ It follows, of course, that a transfer which is based upon a Court decree would not be considered "voluntary."

It should be pointed out at this juncture that the goal of the Commissioner over the years has been to tax all transfers unsupported by adequate consideration.⁹⁵ Many taxpayers attempted to meet this approach by arguing that even if no consideration were present, the transfer must rest upon donative intent before gift tax liability could be created. The courts, as we have seen, finally rejected a possible requirement of donative intent, at least as far as antenuptial agreements were concerned.⁹⁶ Starting with the *Harris* case, however, the Courts have developed this new alternative (voluntary vs. involuntary), which pays lip service to consideration but is, in effect, a new test.⁹⁷ This alternative is the notion that even though no consideration is present in the transfer, the transfer

⁹² Lowndes & Kramer, *op. cit.* *supra* note 16 at 320-23.

⁹³ *Harris* case at 111.

⁹⁴ Pedrick, *op. cit.* *supra* note 90 at 179-180; 66 Yale L.J. *op. cit.* *supra* note 37 at 887.

⁹⁵ IRC § 2512; see text at notes 13, 55 *supra*.

⁹⁶ See text at note 39 *supra*.

⁹⁷ 340 U.S. at 111.

must be "voluntary" (pursuant to a promise or agreement) before a gift tax liability arises. It is true that the courts *say* the involuntary transfer is in effect adequate consideration, but, such a definition of consideration seems rather unconventional, to say the least.⁹⁸

The American Law Institute has concisely stated the present theory in the following language: "The estate tax permits a decedent to transfer to his spouse up to one-half the value of his adjusted gross estate tax-free. Divorce, like death, marks a point at which a marriage is dissolved."⁹⁹ Hence, it can be argued, the parties should be allowed some sort of property dividing privilege at the time of divorce as well as at the time of death.¹⁰⁰ It would seem that when the courts discuss the problem, and conclude that transfers incident to or incorporated into divorce decrees are not taxable as they are involuntary, they actually mean that a legal dissolution of a marriage is a proper time for allowing the parties to make a tax-free property division.

To be logically consistent with the Estate Tax statute,¹⁰¹ perhaps all transfers (antenuptial and ante-divorce), in settlement of marital property rights, should be subject to the gift tax with an allowance of the marital deduction to each settlement. Thereby only one-half of each transfer would be subject to the gift tax, and the minimum social need for protection of the family unit would be met—yet the government would receive some revenue.

The *Harris* doctrine has been broadened or distinguished in several subsequent cases:

(a) *McMurty v. Commissioner*.¹⁰² Husband and wife executed a separation agreement and it was later incorporated in a divorce decree. The agreement was effective irrespective of divorce and was not conditioned upon entry of a divorce decree. However transfers were not to be made until after the divorce decree approving the settlement. The court held that no gift tax was due as this was not a voluntary agreement (p. 662) and the *Harris* rule was limited to include "All transfers . . . in contemplation of divorce

⁹⁸ *Id.* at 112.

⁹⁹ ALI (Tent. Draft No. 10) *op. cit.* supra note 42 at 104.

¹⁰⁰ *Ibid.*

¹⁰¹ IRC § 2056.

¹⁰² 203 F.2d 659 (1st Cir. 1953). The court seemed to emphasize the fact that the motivating principle of the transfer was the power of the court to make a property settlement in lieu of and in spite of the voluntary arrangement of the parties. Cf. *Commissioner v. Blum*, 187 F.2d 177 (7th Cir. 1951). For two other cases discussing *Harris*, see *Ruby G. Grigg*, 20 T.C. 420 (1953); and *Estate of Chester H. Bowers*, 23 T.C. 911 (1955).

and executed after approval of the divorce court having jurisdiction. . . ."

(b) *Rosenthal v. Commissioner*.¹⁰³ Here the rationale of the *Harris* case was held inapplicable to a divorce decree ordering payments to adult offspring or to minors beyond their needs. The court felt that this would be carrying the "involuntary" argument too far. It was also thought important that the state court have the duty to make an equitable distribution of the property involved.¹⁰⁴

(c) *Hardenbergh v. Commissioner*.¹⁰⁵ The wife and daughter renounced their statutory interests in the estate of the father in favor of the son. Probate court awarded the intestate's property to the son. The court ruled that the *Harris* doctrine does not apply and a gift tax was due. The source of the son's rights, pursuant to local law, came from the acts of the wife and daughter in renouncing their shares, and so the probate court's decree was conditioned on the consent of the wife and daughter.

(d) *Chase Nat'l Bank v. Commissioner*.¹⁰⁶ A trust for the benefit of children executed in connection with and embodied in the divorce decree was not entitled to the same construction as a settlement of property interests under the *Harris* rule. The court held that the assets of the trust on the death of the husband were includible in his gross estate.

(e) The rule in the *Harris* case has also been applied to § 812 (b) of the federal estate tax statute [former version of IRC § 2043 (b)].¹⁰⁷

¹⁰³ 205 F.2d 505, 508 (2d Cir. 1953).

¹⁰⁴ *Newman v. Commissioner*, 222 F. 2d 131, 136 (9th Cir. 1955), held that where there is a mere private agreement between the parties and operative only by that agreement, a gift tax is due.

¹⁰⁵ 198 F.2d 63, 67 (8th Cir. 1952).

¹⁰⁶ 225 F.2d 621, 626 (8th Cir. 1955).

¹⁰⁷ *Bank of N.Y. v. United States*, 115 F. Supp. 375, 383 (S.D. N.Y. 1953). Held that a separation agreement between husband and wife under which the wife was given certain life insurance policies and which was binding and enforceable regardless of any later divorce decree, was not found on adequate consideration in money or money's worth within § 812 (b). The court construed *Harris* to require the transfer to be effected by the divorce decree in order for tax relief to apply. *Commissioner v. Watson*, 216 F.2d 941, 943 (2nd Cir. 1954). Here a separation agreement provided that it would survive the divorce decree and be the "sole measure of financial obligation" regardless of provisions of divorce decree. Later it was incorporated into a divorce decree. Wife claimed amount under the agreement was not includible in the gross estate of her former husband. Held for the taxpayer—broadly construing *Harris* and *McMurty* cases.

B. 1954 CODE

The 1954 Code contains a new provision for gift tax exemption of certain property settlements relating to divorce.¹⁰⁸ The general rule under IRC § 2512 is that transfers in settlement of dower, curtesy, or other statutory property rights are not made for adequate and full consideration in money or money's worth and are therefore taxable.¹⁰⁹ But such a transfer is exempt from tax if it fulfills the requirements of IRC § 2516 or the Proposed U.S. Treas. Regs. § 25.2516-1(c). This section provides in effect that written marital and property settlement agreements between husband and wife are regarded to be made "for full and adequate consideration in money or money's worth," if a final decree of divorce is obtained within two years thereafter. The gift tax immunity of the section also includes transfers of property to provide "reasonable" support allowances for minor children of the marriage. (§ 2516(2) discussed *supra* Part III.) It is to be noted that as of the date of this writing, IRC § 2516 has not been interpreted by any of the courts.

Fortunately, IRC § 2516 has eliminated certain superficial tests formerly used by the courts.¹¹⁰ The drafters of this section attempted to remove from consideration any argument as to (a) donative intent, (b) bona fide transaction, (c) adequate consideration, (d) arm's length transaction, (e) ordinary course of business, and (f) involuntary transaction. Here the gift tax exemption is not dependent upon whether the divorce decree approved or incorporated the antecedent property settlement agreement, and actually the agreement need not even be submitted to the divorce court for approval. The only criterion now applied is that a divorce occurs some time within two years after the agreement has been made, and this two-year requirement is merely to insure that the settlement is legally binding and not a method for tax avoidance. Of course, if there is no divorce, then IRC § 2516 is inapplicable, and the transfer would be taxable as a gift under IRC § 2501 and § 2512.

It can be stated unequivocally that the section makes no distinction as to who obtains the divorce or for that matter to whom the money or property is paid. IRC § 2516 would seem to apply to both lump sum and periodic payments under the settlement agreement. Happily for the taxpayer, the agreement may be drawn and

¹⁰⁸ Int. Rev. Code of 1954 § 2516; Lowndes & Kramer *op. cit.* *supra* note 16 at 746; Kutz, *op. cit.* *supra* note 10 at 441-444.

¹⁰⁹ Proposed U.S. Treas. Regulations, § 25.2512-8 and § 25.2516-1(a) (1957).

¹¹⁰ Harris case note 90 *supra*; Powell, *op. cit.* *supra* note 1 at 784. However, the drafters of the Regulations were very adept at including certain other superficial tests.

executed prior to the divorce decree and before the bonds of matrimony have been severed. Naturally, the provisions of IRC § 2516 are applicable only to transfers of property made after January 1, 1955.¹¹¹

True it is that there are many reasons why people desire to make property settlement agreements prior to divorce; however, four such reasons are readily apparent from the cases: (a) As an actual bargained compromise, (b) As adequate compensation for expected inheritance rights, (c) As a generosity settlement, or (d) As a ransom settlement through which one spouse forces the other to purchase his freedom. The provision (§ 2516) is apparently a legislative recognition that a divorce is not always a family-type transaction including donative intent, but more often includes many of the same elements as an arm's length business transaction and is made under the cloud of an impending family upheaval. The drafters of IRC § 2516 decided that whatever the reason or motive for the transfer was, it should be exempt from taxation.

One question arises as to the meaning of the word "spouse" in IRC § 2516(1). It would seem that persons who are legally separated are still spouses while those who are divorced are not. Persons would still be technically married even after the entry of an interlocutory decree,¹¹² and until the decree becomes final.

Second, would it still be important that the divorce court have jurisdiction and authority by state law to make a distribution of the parties' property rights? No, since IRC § 2516 does not require that the settlement agreement be submitted to the divorce court for approval, the court's authority would not be a determining factor. However, the court must have had jurisdiction over the parties in order for the decree to be valid and binding. On the other hand, transfers made in fulfillment of the requirements of Proposed U.S. Treas. Reg. § 25.2516-1(c) would be effective only if the court had jurisdiction and authority by state law to make equitable distributions of property. Here the difference is based on the language of the Proposed Regulation that the transfer must be made pursuant to, binding upon, and incorporated in the decree. [Reg. § 25.2516-1(c)].

¹¹¹ Int. Rev. Code 1954, § 2501.

¹¹² Int. Rev. Code 1954, § 2513(a)(1); *Commissioner v. Eccles*, 208 F.2d 796 (4th Cir. 1954); and *Evans v. Commissioner*, 211 F.2d 378 (10th Cir. 1954). The Commissioner has taken the contrary position for income tax. Rev. Rul. 55-178 (CB 1955-1, 322); *Keezer, Marriage and Divorce*, 305 (3d ed. 1946).

Lastly, would the Government be able to question the amount agreed upon in the settlement agreement as being in excess of legal requirements? Yes, it seems that the words "pursuant to" contained in IRC § 2516 were intended "... to restrict amounts which can be transferred tax-free."¹¹³ The American Law Institute has taken the position that this provision was unnecessary as it is highly "... unlikely that more than one-half of the transferor's property will be turned over to his spouse on the occasion of a divorce...."¹¹⁴

Recently the Commissioner has had an opportunity to interpret IRC § 2516 in connection with a trust (Rev. Rul. 57-506 I.R.B. 1957, 44, p. 10, issued Nov. 4, 1957). Advice was requested on the following facts: A husband and wife entered into a property settlement agreement pursuant to a divorce, by which the husband transferred irrevocably certain preferred stock to a bank as trustee for the wife. The wife was to receive the entire trust income (with certain upper limits) for life or until remarriage. After her death or remarriage, the trust terminated and the corpus was to be paid over to a charitable organization. The Commissioner held that the provisions of § 2516 applied and that there was no gift tax due as to the wife's income from the trust. Here the wife was the beneficial owner of the life interest and the agreement was within the requirements of IRC § 2516.¹¹⁵

By way of summary, therefore, it is necessary that the following requirements be fulfilled in order that a property settlement incident to divorce will come within the provisions of IRC § 2516:

- (a) There must be a written agreement.
- (b) The agreement must concern marital or property rights.
- (c) The divorce must occur within two years after the agreement.
- (d) The transfer must be pursuant to the settlement agreement.
- (e) The transfer must be made to a spouse for settlement of property or marital rights, or reasonable support allowance for minor children of the marriage.¹¹⁶

¹¹³ ALI (Tent. Draft 10) op. cit. supra note 42 at 108.

¹¹⁴ Ibid.

¹¹⁵ See discussion of beneficial ownership in Id. at 105.

¹¹⁶ Lowndes & Kramer, op. cit. supra note 16 at 317. Curiously enough, it would seem that an antenuptial agreement would fit these tests if followed by a divorce within two years.

C. LEGISLATIVE HISTORY OF IRC § 2516

It is interesting to note certain aspects of the legislative history of IRC § 2516. The House Report accompanying H.R. No. 8300 (House version of IRC 1954) stated that:

Under present law property settlements between spouses are not regarded as taxable gifts if the property settlement is incorporated in the decree of divorce. However, the gift tax status under present law of settlements not incorporated in the decree of divorce is uncertain. The bill provides that property settlements involving transfers between spouses are not to constitute taxable gifts if followed by a divorce within a *reasonable time*.¹¹⁷ [Emphasis added.]

Obviously, therefore, the purpose of the House bill was to clarify the law concerning transfers not incorporated in the divorce decree and make them exempt if followed by a divorce within a reasonable time. The drafters wished to remove the incorporation or approval test of *Harris*. This bill was passed by the House and sent to the Senate.¹¹⁸

Following the usual practice on Revenue Bills, the Senate Committee on Finance held numerous hearings on the House bill during the spring of 1954, and many written reports and letters were submitted to the Committee proposing modifications and changes to the House version.

One such report was presented by the Committee on Taxation of the New York City Bar Association.¹¹⁹ This comprehensive study proposed several changes to the House draft and in connection with IRC § 2516 stated:

... the provisions for a divorce occurring 'within a reasonable time' after the agreement of settlement would give rise to extensive litigation on the question of what is a 'reasonable time.' In the circumstances, it is suggested that a stated period of say two or five years be placed in the statute.¹²⁰

Apparently the Senate Committee believed that the New York City Bar Committee was correct (as this was the only discussion of IRC § 2516 contained in the Hearing Reports), and in its report on the bill to the Senate said that the term "reasonable time" would be too indefinite, create uncertainty in the law and lead to protracted liti-

¹¹⁷ H.R. Rep. No. 1337, 83rd Cong. 2d Sess. 94 A323 (1954); Senate Finance Committee, Hearings on IRC 1954, pt. I p. 76; U.S. Code Cong. & Admin. News, 1954, 83rd Cong. 2d Sess. 4467.

¹¹⁸ S. Rep. No. 1622, 83rd Cong. 2d Sess. 128 (1954).

¹¹⁹ First Report on H.R. No. 8300 by the N.Y. City Bar Assoc., Committee on Taxation, p. 73-74 (April 8, 1954), contained in Hearings on IRC 1954, Senate Committee on Finance, 83rd Cong. 2d Sess., Pt. I pp 580-581.

¹²⁰ Ibid.

gation.¹²¹ The Committee proposed that the period be set at two years for allowance of gift tax exemption.¹²² The other amendment concerned the House provision that IRC § 2516 would apply to written agreements relative to marital and property rights *incident to the divorce*. Both the reasonable time and the incident to divorce provisions were eliminated by the Senate and the House agreed.¹²³

D. SITUATIONS WHERE § 2516 DOES NOT APPLY

(a) The provision is inapplicable to transfers made in years prior to January 1, 1955, the effective date of the 1954 Code for gift tax purposes. (IRC § 2501). Since there was no previous version of IRC § 2516 in the 1939 Code, the *Harris* case and other related cases discussed *supra* apply.

(b) Proposed U.S. Treas. Reg. § 25.2516-1(c) provides for gift tax exemption even when a transfer by a property settlement agreement does not qualify under IRC § 2516, “. . . if the transfer is effected by a court decree rather than by a promise or agreement between the spouses.” (Emphasis added.) In defining the term “effected by a court decree” the Regulation states:

A transfer is deemed to be effected by a decree if: (i) the transfer is *pursuant to* an agreement which is *binding only* upon the entry of a decree of divorce, separate maintenance, or annulment, and such decree is subsequently granted *incorporating* the terms of the agreement, or (ii) the transfer is solely pursuant to a divorce, separation, maintenance, or annulment decree as, for example, where there has been no prior out-of-court agreement between the spouses. [Emphasis added.]

This regulation incorporates the rule of the *Harris* case, with the modification that the decree must be the operative fact, and slightly broadens the harsh limits set forth in IRC § 2516. It would appear that the two-year limit is not applicable as long as the transfer is pursuant to, binding upon, and incorporated in the decree.

Formerly property settlements in connection with separate maintenance and annulment decrees did not qualify for gift tax

¹²¹ U.S. Code, Cong. & Admin. News, 1954 83rd Cong. 2d Sess. 5125.

¹²² *Ibid.*

¹²³ Amendment No. 281 to the IRC 1954, H. Conf. Rep. No. 2543, 83rd Cong. 2d Sess. 75, and contained in U.S. Code & Admin. News, 1954, 83rd Cong. 2d Sess. at 5337: “This amendment strikes from section 2516 of the House bill the provision that the section will not apply unless the property settlement was incident to divorce, and substitutes for the provision that the property settlement must be followed by divorce ‘within a reasonable time’ a provision that the divorce must occur within 2 years. The House recedes.”

exemption and IRC § 2516 is expressly limited to divorce settlements. Both the American Law Institute and the Committee on Taxation of the New York City Bar Association have criticized IRC § 2516 for its failure to include separation and annulment transfers.¹²⁴

Apparently, the above regulation is a partial agreement on the part of the Commissioner with the position of these critics of IRC § 2516. For by the terms of subsection (c), transfers under separate maintenance and annulment decrees may also have tax exemption if they are made strictly pursuant to, binding upon, and incorporated in the decree. In other words, if the decree is the operative fact and the agreement has no extra-judicial force, it will also be exempt from the gift tax. However, the meaning of the words "pursuant to" and "binding upon" are vague and uncertain and could lead to extensive litigation and judicial construction.

There seems to be no valid reason why annulment and separation agreements should be subjected to a more strict set of requirements than divorce agreements. One argument is that the possibility of reconciliation exists in separation, but the American Law Institute has pointed out that, "Separation or annulment would seem to be as appropriate a time for a tax-free settlement as divorce, however, since the possibility of reconciliation exists in all events."¹²⁵ Moreover, the marital deduction provision in IRC § 2056 allows the husband to leave one-half of his remaining property to his wife when the marriage is terminated by death without the imposition of an estate tax. The notion seems to be that if a tax is not levied on transfers under legal separation agreements, the parties would or could reunite, and then the husband at his death could effect another tax-free transfer by bequeathing one-half of his remaining property to his wife under IRC § 2056. But this could also be true of a divorce situation for the parties would be perfectly able to remarry.¹²⁶ The only necessary requirement for gift tax exemption should be that the parties have formalized their intention to dissolve the marriage by having a court enter a decree of divorce, separation or annulment within a certain period of time.

¹²⁴ ALI op. cit. supra note 42 at 108. The Committee on Taxation of the N.Y. City Bar Assoc. note 119 supra, stated: "Many couples, particularly those of advanced years, do not desire a divorce, but instead live apart. It would seem, therefore, that provision should be made for a transfer free of gift tax if a decree of divorce or a decree of separation is entered."

¹²⁵ ALI op. cit. supra note 42 at 108.

¹²⁶ 66 Yale L.J. supra note 37 at 888.

Many other reasons have been offered to show that separation and annulment agreements should be given the same treatment as divorce agreements. The consideration is much the same, being an arm's length transaction between the parties in terminating their marital relationship. The policy of the court is the same in these cases, looking to the protection of the standard of living of the wife and children and the ability of the husband to pay. It recognizes that women after years at home are often ill-fitted and unprepared for other vocations. The distinction would also penalize members of certain religious faiths in that they are unable to obtain divorces, but are permitted to obtain legal separations.¹²⁷ A further argument is made that a legal separation decree does not terminate the wife's inheritance rights in her husband's property, but the fact remains that most separation agreements would provide for the compensation and satisfaction of such rights.¹²⁸

(c) The above quoted Regulation [25.2516-1(c)(ii)] also exempts transfers made either contemporaneously with a decree of divorce, separation, maintenance, or annulment or subsequently to the decree if made "solely pursuant to" the decree. So the Commissioner takes the position that there need be no prior agreement between the parties, and the gift tax exemption will apply when the property settlement is litigated in court. This would truly be an example of an involuntary agreement enforced by command of the court. Here again the words "pursuant to" are ambiguous and may lead to confusion among the courts as to their actual meaning and intent.

(d) Although not mentioned in the proposed regulations, ET 19 would still be applicable to transfers founded on a promise or agreement and to allocations between marital and support rights for transfers not mentioned in IRC § 2516 or its Proposed Regulations.

(e) Where for some reason the settlement agreement does not come within the terms of either the statute or the Proposed Regulations, the Commissioner, in all probability, will declare a gift tax due. Although it may be illogical to say that § 2516 and its regulations are intended to be exclusive, it is submitted that this would be the Commissioner's contention and his position would be firmly supported by the apparent inclusion of the *Harris* rule and a limited

¹²⁷ Encyclical Letter, Pope Pius XI, 1930, contained in *Selected Essays on Family Law*, Association of American Law Schools, 1950, pp. 132-172, at 157.

¹²⁸ 2 Vernier, *American Family Law* 482 (1932).

separation and annulment exemption into the regulations.¹²⁹ However, the gift tax may be greatly minimized if the agreement is executed and the transfer occurs prior to the entry of the divorce, separation, or annulment decree. Then the parties would still be "spouses" at the time of the transfer, and might use the marital deduction provisions of IRC § 2523. This section provides that transfers of property to a spouse are eligible for the marital deduction, and a tax would be levied on one-half of the value of the property transferred instead of the full value. Further, the transferor's gift tax may be reduced by using the \$3,000 annual exclusion of IRC § 2503 and the special \$30,000 specific exemption of IRC § 2521.

In conclusion, there are only three methods by which a property settlement agreement incident to divorce or separation can escape the gift tax. The transfer must come within the provisions of (a) IRC § 2516, (b) Reg. § 25.2516-1(c)(i), or (c) Reg. § 25.2516-1(c)(ii). The *Harris* rule would seem to have no effect except as it has been incorporated into the Regulations, and as to transfers prior to the 1954 Code. It is important that the attorney choose the method which is best suited to the needs and abilities of his client, and then carry out the plan by following both the letter and the spirit of the statute and the regulations. The ambiguous phrases in the statute and the regulations should be construed strictly in order to protect the client's interest and to avoid unnecessary litigation.

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¹²⁹ Powell, *op. cit.* supra note 1 at 784-85.