Simplifying and Rationalizing the Federal Income Tax Law Applicable to Transfers in Divorce

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SIMPLIFYING AND RATIONALIZING THE FEDERAL INCOME TAX LAW APPLICABLE TO TRANSFERS IN DIVORCE

Deborah A. Geier*

Sometimes the complexity in our tax law is defended as a necessary evil to conform the law to the underlying theory informing it. Some also say that, since ours is a complex economy and society, our tax system is necessarily complex, and those engaged in complex transactions can afford to pay for the complex tax advice necessary to navigate successfully through the system. Or so the sayings go.

One area of the tax law, however, remains needlessly complex, not because of any coherent underlying theory but because of history and a series of political compromises. Moreover, the “transaction” at issue is not one engaged in only by the savvy, well-advised, and well-to-do. The “transaction” at issue is divorce. While the tax law applicable to transfers in divorce was, on average, improved (in my view) in 1984, several fundamental incoherencies and unnecessary complexities continue to plague this area, and more recent ambiguities, dealing chiefly with redemptions of stock in closely held corporations and other transfers under the assignment-of-income doctrine, have arisen.¹

One of the biggest sources of complexity in the current regime is the continuing desire (though futile, in my view) to differentiate cash “alimony” from cash “child support”² from cash “property settlements”³ in order to apply different tax

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¹ Professor of Law, Cleveland-Marshall College of Law, Cleveland State University. © Deborah A. Geier 2002. This article was written in my capacity as an “academic advisor” to the Joint Committee on Taxation in connection with a study of the overall state of the tax system, including recommendations with respect to possible simplification proposals, that Congress mandated in section 8022(3)(B). The opinions expressed here are, however, completely my own and should not be attributed to the Joint Committee on Taxation.

² All citations to the Code are to the 1986 Code, as amended, unless citation to an earlier Code is made explicit with an earlier date in parentheses.

³ The specifics of current law will be discussed in more detail later in this article. Briefly stated, cash payments satisfying the federal definition of “alimony” in section 71(b) (regardless of what the payments are called for state law purposes) are includable in gross income by the recipient and deductible by the payor directly from gross income (unhampered by the inability to itemize deductions). See I.R.C. §§ 71, 215, and 62(a)(10). Thus, the tax burden on these cash payments is, at least nominally, borne by the recipient. Cash payments constituting “child support” within the meaning of section 71(c) are neither includable by the recipient nor deductible by the payor. See I.R.C. § 71(c). Thus, the tax burden on these cash payments is, at least nominally, borne by the payor.

³ Cash payments not satisfying the requirements of section 71(b) are neither includable nor deductible. Notice that payments subject to the inclusion/deduction scheme may not actually constitute “alimony” under state law, so long as the payment satisfies the federal tax definition of “alimony” in section 71(b). That is to say, a cash payment constituting a property settlement under state law or upon examination of the particular facts can nevertheless qualify as an includable/deductible payment so long as the federal requirements for “alimony” are satisfied. For example, payments qualifying as tax alimony (and thus subject to the inclusion/deduction system) can be intended to compensate the recipient for her share of vested or inchoate property rights that either go to the payor on the divorce (such as a piece of real estate that was co-owned by the spouses prior to the divorce) or are
rules to each transfers, depending on the label that has been applied. My bottom-line recommendation is that such labels be discarded and that the parties be explicitly empowered to determine whether cash transfers—whether denominated alimony, child support, a property settlement, an "equitable distribution" for state law purposes, or otherwise—are includable by the recipient and deductible by the payor, or excludable by the recipient and not deductible by the payor, with simple and clear default rules for taxpayers who fail to make their wishes known in their divorce, separation, or support instrument. Well-advised taxpayers already have significant freedom to decide who, between them, should be taxed on cash transfers incident to divorce, because they can structure their cash transfers in a form that will implement their agreement. Poorly-advised or unadvised taxpayers do not have the same flexibility, because they are unaware of the various transactional elections effectively available to them if they had cast their cash payments in the proper form.

The reason underlying the different tax treatment applicable to alimony and child support has never been adequately articulated, though it is often difficult to distinguish between the two. The reason underlying the different tax treatment applicable to alimony and many cash property settlements can, in contrast, be articulated as a theoretical matter, but, as Professor Malman noted in 1986, "there is no administratively practical way for the tax system to draw the alimony/property distinction." Payments that would be characterized as "alimony" for tax purposes may constitute "child support" or a "property settlement" under state law, and vice versa. Moreover, an increasing number of states are abandoning such labels altogether. Under "equitable distribution regimes," for example, the cash payment stream can be intended simply to settle all claims for support and property compensation between the parties. Continuing to make the determination of who should be taxed on cash transfers in divorce turn on what label is used to identify the payment, and then having unique tax definitions for those labels that often deviate from state law definitions, causes confusion among taxpayers and traps for the unwary, as case law litigation clearly shows.

The great fear that has driven Congress in the past is that divorcing parties will engage in inappropriate "income-shifting" if left to decide for themselves who should be taxed on cash transfers, with the joint income of the divorced couple being taxed at a lower overall rate than would have occurred absent the divorce, to the detriment of the Treasury. In response, I would argue that such

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4Cf. Marci Kelly, Calling a Spade a Club: The Failure of Matrimonial Tax Reform, 44 TAX LAW. 787, 811-12 (1991) (reaching the same conclusion).
6See infra notes 176-238 and accompanying text (surveying some cases).
tax arbitrage is built into the current system already, that people do not get divorced in order to engage in income-shifting for tax purposes, and that the income-shifting that can occur is likely a good and defensible outcome on public policy grounds in most situations in which it can occur. Such income-shifting encourages the higher-bracket spouse to transfer funds to the lower-bracket spouse (presumably the more needy spouse), often leaving the lower-bracket spouse with more after-tax income than she would otherwise have if income-shifting were disallowed. Unlike other situations in which income-shifting is deemed to be inappropriate, such as in the intact family or in the case of a closely held corporation, divorce is not a transaction that can be entered into lightly, and often, in order to shift income to another in a lower tax bracket and thus reduce overall taxes on a routine basis while retaining effective control over the shifted income. Indeed, "[f]ollowing divorce, the chances of filing bankruptcy triple." To the extent that some additional income-shifting would occur under the proposed simplifications that does not already occur under the current rules, so be it. Even if I am wrong that it would be a salutary result in most cases, it is a small price to pay for the huge simplification gains—and, I believe, the added respect for the tax system by the unfortunate parties who have to deal with these complex provisions—that would occur.

Moreover, as Professor Malman has noted, there is reason to believe that not much aggregate tax would be lost to the Treasury in any event, since every deduction is accompanied by an equal-amount inclusion. Only the rate-bracket differential between the parties, if any, results in a revenue loss, and this loss is self-limiting. As the amount paid to the payee increases, the payee ascends to higher tax brackets until further income-shifting does not produce a revenue loss. Moreover, in the context of a payor in a significantly higher tax bracket than the payee—which is the very context where it would seem that income-shifting would be at its most extreme and therefore result in the most lost revenue—any divorce "bonus" is more illusory than real. This is because the combination of one high-income spouse and one low-income spouse already receives a significant marriage bonus under current law if the couple files a joint return, and this marriage bonus is lost on the divorce. Even with income-

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8See infra note 252 and accompanying text (providing example). As Professor Hjorth put it:

I am not unduly concerned by the specter of a "divorce bonus." For every case of taxes reduced by reason of divorce there is probably at least one case of reduced ability to pay caused by the divorce. Divorce is not something that is welcomed by most persons affected by it. It is a time of trauma, adjustment, and, often, financial difficulty for the spouses and their children.


10Malman, supra note 5, at 410-12.

11Joint filing can generate a "marriage penalty on two-earner couples," with the married couple paying more in tax than they would if they were able to file separately under the rate schedule for unmarried individuals. The marriage penalty is at its peak when each spouse earns the same amount
shifting, the parties are not better off taxwise by much, if any, in the aggregate under the more onerous schedule for single filers that must apply to them after the divorce.

As mentioned above, our current system for taxing transfers in divorce is the result of history and political compromise as much as grand theory. Part I below will recount this history, for it is difficult to understand how we got to where we are today without a working knowledge of this history. Part I will also introduce the various ways to think about these transfers, as it is difficult to discuss how the law evolved without an introduction to these thoughts at the same time. Part II will continue the discussion of what works in the current system, what is fundamentally flawed, and what should be done about it and why. Part III will examine two inextricably related problems that need addressing.

I. THE HISTORY

A. Prior to 1942

The early statute did not address how to treat cash payments (or in-kind property transfers) between divorcing spouses. Hence, it devolved upon the Supreme Court to determine the status of such payments and transfers. The Court tackled cash payments in 1917 in *Gould v. Gould* and in-kind property transfers in 1962 in *United States v. Davis*, discussed in Part I.B.2. below.

The parties in *Gould* divorced in 1909, and the divorce court ordered Mr. Gould to pay Mrs. Gould $3,000 each month for the rest of her life “for her support and maintenance.” The issue before the Supreme Court was whether Mrs. Gould had to include these payments in her gross income. The Court first quoted the predecessor to section 61 as follows:
B. That, subject only to such exemptions and deductions as are hereinafter allowed, the net income of a taxable person shall include gains, profits, and income derived from salaries, wages, or compensation for personal service of whatever kind and in whatever form paid, or from professions, vocations, businesses, trade, commerce, or sales, or dealings in property, whether real or personal, growing out of the ownership or use of or interest in real or personal property, also from interest, rent, dividends, securities, or the transaction of any lawful business carried on for gain or profit, or gains or profits and income derived from any source whatever, including the income from but not the value of property acquired by gift, bequest, devise, or descent ....

The Court then wrote four paragraphs, which comprised the opinion's entire reasoning. Because of their brevity, I quote them in full:

In the interpretation of statutes levying taxes it is the established rule not to extend their provisions, by implication, beyond the clear import of the language used, or to enlarge their operations so as to embrace matters not specifically pointed out. In case of doubt they are construed most strongly against the Government, and in favor of the citizen. [Here, the Court cited three cases in which a tariff was imposed on an item specifically listed in a tariff statute, and the issue was whether the item sought to be taxed by the government qualified as the item listed in the statute as taxable.]

As appears from the above quotations, the new income upon which subdivision I directs that an annual tax shall be assessed, levied, collected and paid is defined in division B. The use of the word itself in the definition of "income" causes some obscurity, but we are unable to assert that alimony paid to a divorced wife under a decree of court falls fairly within any of the terms employed.

In *Audubon v. Shufeldt* ..., we said: "Alimony does not arise from any business transaction, but from the relation of marriage. It is not founded on contract, express or implied, but on the natural and legal duty of the husband to support the wife. The general obligation to support is made specific by the decree of the court of appropriate jurisdiction .... Permanent alimony is regarded rather as a portion of the husband's estate to which the wife is equitably entitled, than as strictly a debt; alimony from time to time may be regarded as a portion of his current income or earnings; ...."

The net income of the divorced husband subject to taxation was not decreased by payment of alimony under the court's order; and, on the other hand, the sum received by the wife on account thereof cannot be regarded as income arising or accruing to her within the enactment. 

As made clear in the first quoted paragraph, one major ground relied upon by the Court was a rule of statutory interpretation borrowed from tariff law that revenue statutes are to be narrowly construed. No such canon of statutory interpretation survives today with respect to the income tax.

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16 Id. at 152-53.
17 Id. at 153-54.
Moving to the exegesis of the terms of the statute itself, the Court concluded that alimony must not have been contemplated by Congress as coming within the ambit of the provision, apparently because alimony is not similar to the items specifically listed in the statute as taxable. This canon of statutory construction sometimes goes by the Latin name of *ejusdem generis*, meaning "of the same kind." Precisely the same reasoning, accepted by the *Gould* Court, was again used by a taxpayer in 1955 in arguing that punitive damages are not includable in gross income because they are not like the items specifically listed as taxable. Rejecting the argument premised on the notion of *ejusdem generis*, the *Glenshaw Glass* Court instead stressed the catchall language at the end of the section—"income derived from any source whatever"—in concluding that punitive damages were includable in gross income by the recipient. The *Glenshaw Glass* Court stated that this catchall language required inclusion of all "undeniable accessions to wealth, clearly realized, and over which the taxpayers have complete dominion." (Indeed, it is an interesting exercise to think about whether the *Gould* Court might have decided differently if the case had arisen in the later era, after *Glenshaw Glass*.)

Notice that this form of analysis focuses on whether alimony comes within some notion of "income." If the analysis is viewed this way, each party is analyzed independently, and a payment of alimony could conceivably be taxable to both the payor and the recipient. For example, if we view the matter from the recipient's side alone, and if alimony is considered within the *Glenshaw Glass* notion of "income" as an undeniable accession to wealth, etc., then it would be includable by the recipient. At the same time, the payor earning wages from which the alimony was paid would have to include the wages in gross income, since compensation for services rendered is specifically listed as "income" in section 61(a)(1). Moreover, the payor would arguably be denied a deduction for the payment under a strict definition of "income" in the familiar Schanz-Haig-Simons sense, under which only outlays incurred to produce includable income are properly deductible (with personal consumption outlays being nondeductible, and thus taxed). Since the payment of alimony is not an outlay incurred

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19Id. at 431.
20In general, a tax on "income" reaches amounts saved and amounts spent on personal consumption. Amounts saved are taxed since the Code generally disallows outlays constituting "capital expenditures," such as the purchase of an asset. I.R.C. § 263. That is to say, outlays that result merely in a change in the form in which wealth is held, rather than a diminution in wealth, are not deductible. Current "expenses" are the opposite of a "capital expenditure" in that current expenses represent a real diminution in wealth in the year spent. If an expense is incurred in income-producing activity, then the expense is generally deductible. See, e.g., I.R.C. §§ 162, 212. If, on the other hand, the expense is spent on personal consumption, it is generally nondeductible. See I.R.C. § 262(a). The only personal consumption expenses that are deductible are those that Congress has specifically allowed, usually as an incentive to engage in certain desirable behavior. See, e.g., I.R.C. §§ 170 (charitable contribution deduction), 163(h)(3) (home mortgage interest deduction).

The reason why expenses incurred to produce includable income (as opposed to expenses incurred to buy personal consumption) should be deductible under an income tax is to avoid double taxation.
directly to produce the payor's wages, it would be nondeductible (and thus remain in the tax base of the payor). Thus, the payment would be taxed twice, as amounts paid by an employee from his wages to his housecleaner are taxed twice (once to the employee and once to the housecleaner). In the housecleaner example, the amounts constitute wages to both, and the payment to the housecleaner would clearly be a nondeductible personal expense of the payor. The only way to differentiate the alimony payment from the housecleaner payment would be to argue that alimony does not really purchase any personal consumption for the payor and thus should be removed from his tax base via a deduction. This means of analysis would define personal consumption not by looking to whether the payment directly contributed to income production of some kind—which defines personal consumption by default—but rather by looking to what is actually purchased with the payment and determining whether it affirmatively qualifies as "personal consumption."²²

Perhaps we do not have to resolve that definitional dilemma, however, for there is another way to view this issue, which was also hinted at by the Gould Court and which is, I think, the more appropriate way to think about the payment. Rather than analyzing the tax consequences to each of these taxpayers independently of the other, i.e., determining whether the receipt qualifies as "income" to the recipient and whether the payment qualifies as a deductible one to the payor under an "income" analysis because it does not purchase discretionary personal consumption, we could view both taxpayers together. In an intact marriage, by analogy, amounts earned by one spouse and paid to another are ignored for tax purposes (i.e., they are neither includable by the recipient nor deductible by the payor), whether or not the couple files a joint return or files separate returns using the rate schedule for married couples filing separately.²³

of the same dollars to the same taxpayer. You can think of it in the following way: If income-producing expenses were not allowed as deductions, then those expenses would create basis (previously taxed dollars). That basis should offset any includible income produced by that outlay, which would result in inclusion of only the "net" receipt in income. But the tax system does not work this way. Instead, section 61 requires the inclusion of every dollar of "gross" receipts. In order, therefore, to prevent the double taxation of those gross receipts to the extent of the outlays incurred to produce them, those outlays must be deductible. See generally Dodge, et al., supra note 12, at 30-33, 39-55.

²²This is the method currently used in the Code. Amounts can be deducted only if they are specifically described in a section containing the words, "there shall be allowed as a deduction . . . ." and, as described supra note 20, most of such provisions allow deduction only for income-producing expenses.

²³One example of this mode of analysis would be to argue that certain types of mandatory payments should not be considered as purchasing personal consumption and thus should be deductible. Payments of certain state and local taxes can be analyzed this way, as can alimony and child support. See generally Joseph M. Dodge, THE LOGIC OF TAX 123 (1989).

²⁴See I.R.C. § 1 (describing the various filing statuses and their related rate schedules). Some couples file separately in order to lower significant state income taxes that use a progressive rate schedule. Filing separately might allow the couple to use the lowest state rate brackets twice, which can more than offset the increased federal tax burden that may arise from using the more onerous schedule (compared to the rate schedule applicable to single taxpayers) applicable to married couples filing separately.

Moreover, if each member of the couple earns approximately half of the couple's aggregate income, the aggregate federal tax should be roughly the same, regardless of whether they file a joint

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Therefore, the amounts are taxed only once between the two.\(^2\) We could reason that the amounts should continue to be taxed only once, even though the family is no longer intact, because of the clear and direct relationship of the payments to the former legal relationship of the parties (or the continuing legal relationship, in the case of a paternity payment to support a child after a divorce or otherwise outside of marriage). These payments would not have been made but for the prior legal relationship. Unless the government wishes to discourage divorce affirmatively via the tax laws (a very unwise choice, in my view), there does not seem to be a persuasive reason to tax such payments more onerously outside marriage (by taxing them twice) than within it (by taxing them once). Viewed this way, the question is not whether the amount conceptually constitutes “income” to both but rather who should be taxed on what is concededly income to someone? That is to say, the question can be viewed not as “what is income?” but rather as “to whom should the income be taxed?” There are two alternative answers to this form of the question: The income could be taxed to the recipient by requiring the recipient to include it and allowing the payor to deduct it. Conversely, it could be taxed to the payor by allowing the recipient to exclude it and disallowing the payor a deduction. In either scenario, the government becomes a mere stakeholder in the matter: The amounts will be taxed to someone (once); the only question is which taxpayer’s marginal rates should apply?

The Gould opinion obliquely picked up on this perspective when it stressed that “[t]he net income of the divorced husband subject to taxation was not decreased by payment of alimony under the court’s order; and, on the other hand, the sum received by the wife on account thereof cannot be regarded as income arising or accruing to her within the enactment.”\(^2\) The thought was written as a single sentence, with a semi-colon connecting the two independent clauses. This form seems to imply a causal link, i.e., that another reason why the amount was not includable by Mrs. Gould was precisely because it was not deductible by Mr. Gould. The Court’s implication was that the amount should not be taxed to both parties, and since the Court cannot create nonstatutory deductions, it exercised its power to define the contours of “gross income” to ensure that the amount was not taxed twice by holding that the recipient need

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\(^2\) This conforms the treatment of support payments within the intact family to the treatment of gifts within a family, which are also excludable by the recipient and not deductible by the donor. I.R.C. §§ 102, 162. Mandatory and legally enforceable support payments would not otherwise qualify as “gifts,” which are generally defined for income tax purposes as transfers made out of “detached and disinterested generosity.” See Commissioner v. Duberstein, 363 U.S. 278, 283 (1960).

not include the payments in gross income. The Court would presumably have come to the same conclusion with respect to child support, if any had been at issue.

With respect to support payments, the one-tax approach has continued to this day. The issues in this area have been how to decide whom to tax between the two and how to differentiate support payments (alimony and child support) from property settlements, a question that first arose with the 1942 legislation.

B. From 1942 to 1984

1. Support Payments

In the midst of World War II, the highest federal income tax marginal rate under the regular tax and a special surtax exceeded 90% in order to finance the war effort. Under such a rate structure, a payor of nondeductible alimony of any significant size could have little left upon which to live once he paid his alimony and then the tax on his income, including the alimony. The legislative history underlying the Revenue Act of 1942 reflected this concern:

The existing law does not tax alimony payments to the wife who receives them, nor does it allow the husband to take any deduction on account of alimony payments made by him. He is fully taxable on his entire net income even though a large portion of his income goes to his wife as alimony or as separate maintenance payments. The increased surtax rates would intensify this hardship and in many cases the husband would not have sufficient income left after paying alimony to meet his income tax obligations.

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26In order to take a deduction, a taxpayer must find a section that contains the words “there shall be allowed as a deduction” and satisfy each of the requirements specified there. He must also survive the gauntlet of provisions that take away “otherwise allowable deductions.” No court, the Supreme Court included, has any power to create a deduction. Only Congress can do that. On the other hand, because present-day section 61 contains the circular definition that gross income means “income from whatever source derived,” the Supreme Court has long exercised its power to construe the contours of “gross income” by creating common law regarding what constitutes gross income. See, e.g., infra notes 260-318 and accompanying text for the cases developing the assignment-of-income doctrine. See generally Deborah A. Geier, Some Meandering Thoughts on Plaintiffs and Their Attorneys’ Fees and Costs, 88 TAX NOTES 531 (2000) (discussing the interplay between the Court’s power to craft the contours of gross income and its inability to create deductions in the context of the treatment of attorneys fees and costs that, though deductible, are subject to deduction restrictions that could be avoided if the plaintiffs could exclude from gross income the portion of taxable litigation awards to the extent paid to their attorneys).

27We all know that payors of alimony can include both males and females. See, e.g., Liesl Schillinger, Divorce Him, Support Him?, THE INDEPENDENT (LONDON), Dec. 14, 1997, at 5 (characterizing “the phenomenon of men seeking alimony” as “becoming rife in the United States” and, more objectively, reporting that “[t]he number of male clients in the [United States] claiming financial support from high-earning exes has doubled in the last five years”). While I know that use of the word “he” as the payor of alimony can perpetuate stereotypes, I think that repeated usage of the terms “he or she” makes for distracting prose, and thus I have chosen to risk the alienation of some readers in the quest for less stilted-sounding sentences.

The bill would correct this situation by taxing alimony and separate maintenance payments to the wife receiving them, and by relieving the husband from tax upon that portion of such payments which constitutes income to him under present law. This treatment is provided only in cases of divorce or legal separation and applies only where the alimony or separate maintenance obligation is discharged in periodic payments. Moreover, the portion of such payments going to the support of minor children of the husband does not constitute income to the wife nor a deduction to the husband. The same is true with regard to payments in discharge of lump sum obligations, even though made in installments.29

Therefore, as described briefly above, the Revenue Act of 1942 switched the answer to the question, "who should be taxed on the amounts paid out as alimony?," from the payor to the recipient by requiring inclusion of alimony by the recipient and allowing a deduction to the payor. But the Act and its legislative history were quite clear that this inclusion/deduction system should not apply to child support or amounts paid to compensate for the transfer of a property interest. Child support and property settlements, in other words, remained excludable by the recipient and nondeductible by the payor, as under pre-1942 law. I shall discuss child support first and then property settlements.

The legislative history is silent with respect to why Congress chose to shift the tax incidence to the recipient only with respect to alimony and not child support. Yet, we can perhaps guess the predominant thinking of the time. In this more traditional era—when it was, indeed, only husbands who paid alimony and child support30—it might have been thought that, while shifting the tax obligation with respect to alimony would help to alleviate the immediate and quite practical problem of a husband being unable to satisfy both his alimony and tax liability if alimony were not deductible, shifting the tax obligation with respect to the man's children would be going too far. A man's financial obligation to his children—including the obligation to pay the income tax on amounts spent to support them—might have been considered to be stronger than that to his ex-wife.

In any event, this new distinction between alimony and child support necessarily required line-drawing for the first time. The statute did so by providing that the recipient's gross income inclusion:

shall not apply to that part of any such periodic payment which the terms of the decree or written instrument fix, in terms of an amount of money or a portion of the payment, as a sum which is payable for the support of minor children of such husband. In case any such periodic payment is less than the amount specified in the decree or written instrument, for the purpose of applying the preceding sentence, such payment, to the extent of such sum payable for such support, shall be considered a payment for such support.31

30Cf. supra note 27.
31I.R.C. § 22(k) (1942).
In other words, an amount “fixed” in the governing documents for child support would not fall under the inclusion/deduction system, and if a payor made only a partial payment, the child support payment would be considered paid first. For example, assume that a husband was ordered to pay $10,000 per year to his ex-wife for the support of her and their minor children, $6,000 of which was explicitly fixed as child support. If the husband paid only $8,000 in a year, $6,000 would be considered nondeductible child support and $2,000 would be considered deductible alimony (so long as the remaining qualifications for deductible “alimony,” described shortly below, were met).

What does it mean for an amount to be “fixed” for child support within the meaning of the statute? Suppose, for example, that John and Mary had three minor children when they divorced, that their mutually negotiated divorce agreement (which the relevant court approved) provided for a “family support payment” of, say, $12,000 per year, but that the payment would be reduced by one-sixth each time a minor child married, became emancipated, or died. In other words, by the time all three minor children married, became emancipated, or died, the annual payments would be reduced to $6,000. Was any amount “fixed” for child support during the years of the children’s minority in this agreement?

On the one hand, the agreement did not overtly fix any amount for child support in the literal sense, though the “substance” of the document seems to indicate that, prior to the time any of the three children married, became emancipated, or died, $6,000 of the payments was really disguised child support. The reduction in amounts payable upon conditions relating to the children’s emancipation, etc., was, after all, captured in language in the agreement itself, and thus the agreement could be said to have adequately “fixed” $6,000 of the payments as child support.

Much litigation ensued in order to determine what the term “fixed” meant in this provision—an example of how the different labels and their different tax treatments inevitably cause litigation. A split among the circuit courts developed and finally went to the Supreme Court for resolution in Commissioner v. Lester, the facts of which are essentially identical to those recited above. The Court quoted both the Senate Finance Report as well as a report of the Office of the Legislative Counsel to the Senate Finance Committee in concluding that no part of an unallocated “family support payment” should be considered “fixed” as child support, even if a portion is scheduled to be reduced on the happening of events related to the children.

“If, however, the periodic payments . . . are received by the wife for the support and maintenance of herself and minor children of the husband without such specific designation of the portion for the sup-

See, e.g., Metcalf v. Commissioner, 271 F.2d 288 (1st Cir. 1959); Eisinger v. Commissioner, 250 F.2d 303 (9th Cir. 1957); Lester v. Commissioner, 32 T.C. 1156 (1959), rev’d, 279 F.2d 354 (2d Cir. 1960).

port of such children, then the whole of such amounts is includable in
the income of the wife as provided in section 22(k). . . ." S. Rep. No.
1631, 77th Cong., 2d Sess. 86.

As finally enacted in 1942, the Congress used the word "fix" instead of the
term "specifically designated," but the change was explained in the Senate
hearings as "a little more streamlined language." Hearings before the Senate
Committee on Finance on H.R. 7387, 77th Cong., 2d Sess. 43. As the Office of
the Legislative Counsel reported to the Senate Committee:

"If an amount is specified in the decree of divorce attributable to the
support of minor children, that amount is not income to the wife . . . .
If, however, that amount paid the wife includes the support of chil-
dren, but no amount is specified for the support of minor children, the
entire amount goes into the income of the wife . . . ." Ibid.

This language leaves no room for doubt. The agreement must expressly "fix" a
sum certain or percentage of the payment for child support before any of the
payment is excluded from the wife's income. The statutory requirement is strict
and carefully worded. It does not say that "a sufficiently clear purpose" on the
part of the parties is sufficient to shift the tax. It says that the "written instru-
ment" must "fix" that "portion of the payment" which is to go to the support of
the children. Otherwise, the wife must pay tax on the whole payment. We are
obliged to enforce this mandate of the Congress.34

Therefore, the entire $12,000 annual payment during the children's years of
minority was includable by the wife and deductible by the husband as alimony.

Thus, a divorce decree that required a husband to pay $100 weekly for the
support of his ex-wife and $50 for the support of their two children would
produce only a $100 weekly income inclusion for the wife and a corresponding
deduction for the husband, since the remaining $50 would be considered "fixed"
for child support and not eligible for the inclusion/deduction system. If the
decree provided instead for a payment of $150 per week for the support of the
ex-wife and the children, no part of it would be considered excludable/nonde-
ductible child support. Similarly, none of the $150 payment would be consid-
ered child support if the decree also provided that the payments would be reduced
by $25 per week upon the death, marriage, or majority of either of the children.

To American tax lawyers accustomed to hearing that "substance" and not
"form" governs the characterization of tax transactions, it might seem odd that,
while the 1942 Code announced that Congress had decided—for whatever rea-
son—to treat child support differently from alimony, the law allowed what was,

34 Id. I have always wondered whether Justice Scalia would have written a dissent in Lester, since
the majority relies so explicitly on legislative history, a tool that Justice Scalia finds illegitimate. See
generally Deborah A. Geier, Textualism and Tax Cases, 66 TEMP. L. REV. 445, 447-55 (1993); see
judgment) ("[Ours is] a Government of laws not of committee reports."). If Justice Scalia would
interpret the word "fix" broadly enough to cover terms explicitly requiring reduction of payments on
the happening of an event linked to the child's leaving the payee's home (such as marriage, death, or
emancipation), then the legislative history to the contrary would have been meaningless to him.
for all intents and purposes, disguised child support to escape characterization as "child support." Yet, what the so-called Lester Rule accomplished was the delegation to the divorcing parties of the authority to decide who, between them, should pay the tax on the amounts used to support the children. If they clearly "fixed" the amount as child support in their agreement, then the payor would pay tax on the payments; if the amount was not explicitly "fixed" but the amount paid was reduced upon the child's marriage, death, or emancipation, then the recipient would shoulder the burden. The Lester Court recognized this when it said:

As we read [section] 22(k), the Congress was in effect giving the husband and wife the power to shift a portion of the tax burden from the wife to the husband by the use of a simple provision in the settlement agreement which fixed the specific portion of the periodic payment made to the wife as payable for the support of the children.35

You might think that I support the outcome of the Lester Rule, since I made plain in the Introduction that I will, in Part II, explicitly argue that the parties should be able to decide for themselves who, between them, should shoulder the burden of paying tax on cash transfers. But the approach embodied in the Lester Rule suffers from a fundamental defect. The election was not explicit; it required the advice of a skilled tax practitioner to alert the parties to this planning device. Ill-advised (or unadvised) parties unlucky enough to call child support "child support" in their agreement were unable to shift the tax burden to the payee under the Lester Rule, even if they wished to (and the reasons they might wish to will be detailed later). Under the Lester Rule, in other words, parties were empowered to decide who should bear the tax burden only if they were aware of the magic formula. If it is true that Congress intended, as indicated by the quoted legislative history, that the parties be able to decide for themselves who, between them, should shoulder the burden of paying tax on amounts paid out as child support, the election should have been made explicit. Effectively burying the election in Committee Reports and then in a Supreme Court opinion discussing what it means to "fix" an amount for child support was not defensible. Then, as now, too many people divorced without tax counsel. Even many family lawyers who were involved in divorce settlements were often not well-versed in tax law and were therefore unlikely to know about the de facto election. Under the Lester Rule the de facto election was, in short, a huge trap for the unwary. There will always be parties who are unwary of the law, but the law should strive as much as possible to keep the traps to a minimum, particularly in an area, such as divorce, where people often go it alone (i.e., without good tax counsel).

In sum, if Congress were serious about taxing child support differently from alimony in 1942, then the term "fix" should not have been interpreted as it was by the Lester Court. Substance should have controlled over form. If, on the other

35366 U.S. at 304.
hand, the *Lester* Rule outcome was deemed desirable because it would allow the parties to decide for themselves who should bear the burden of tax on these cash payments, then the election should have been made much more explicit on the face of the statute and not made contingent on including the right magic words in the divorce settlement.

Amounts "fixed" as child support were not the only payments that fell outside the recipient inclusion/payor deduction system enacted in 1942. Congress intended that payments for the recipient's interest in property should not fall within the inclusion/deduction system as well and, like child support payments, should be tax neutral (i.e., neither deductible by the payor nor includable by the payee). While we were hard-pressed to come up with a reason why Congress chose to treat child support payments as falling outside the new inclusion/deduction system in 1942, it is much easier to identify the thinking behind the distinction between alimony and cash property settlements.

As a simple example, assume that John and Mary owned Blackacre, worth $100,000, as joint tenants when they divorced. John wished to own 100% of Blackacre outright, and he thus agreed to pay Mary $50,000 for her share of the property, either out of his own previously earned funds or in installments from his future earnings. In each of these scenarios, this $50,000 payment should not (as a matter of theory, at least) fall within the inclusion/deduction scheme, if we respect the payment as a purchase of property. Viewed from John's perspective alone, an outlay made to purchase property is properly a nondeductible "capital expenditure."36 Allowing John a deduction for his outlay to purchase property violates the fundamental structure of a tax on "income," effectively garnering John consumption-tax treatment instead.37 Another way to view it (again, from John's perspective) would be to say that if John were allowed to deduct his purchase price of $50,000 for Mary's interest in Blackacre, the Treasury would actually be funding a portion of his purchase price (equal to John's tax savings). On the other hand, we must remember that Mary would be fully taxed on the cash receipt if John gets to deduct it, so the revenue loss to the Treasury by treating this payment under the inclusion/deduction scheme (rather than as a tax neutral payment) would equal only the difference (if any) between John's marginal rate bracket (the tax lost to the Treasury) and Mary's (the tax gained).

Viewed from Mary's perspective, if this payment were respected as a payment for her share of Blackacre, she would measure her realized gain or loss under section 1001 by comparing the $50,000 received for her half interest with her basis in the half interest. Only if her basis were zero would the gain realized equal the entire $50,000 that would be included if the payment were instead 

36See supra note 20.

37Under a consumption tax, all outlays—even those that would constitute nondeductible capital expenditures under an income tax—are deductible so long as the outlay is not for personal consumption. Thus, additions to savings, such as John's purchase of $50,000 worth of Blackacre, would be deductible under a cash-flow consumption tax, even though it would be nondeductible under an income tax. See generally Dodge, et al., supra note 12, at 472-83.
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38 Whether Mary's realized gain or loss would be recognized is discussed in the next subpart.

39 I.R.C. § 22(k) (1942). The language referring to a transfer "attributable to property transferred (in trust or otherwise) in discharge of" a legal obligation ensured that if a payor satisfied his alimony obligation by creating a trust or purchasing a life insurance or annuity contract, etc., with the payments from the trust or insurance company payable to the payee, then that income stream was also includable by the payee. The later language that the amounts "received as are attributable to property so transferred shall not be includable in the gross income of the husband" rendered a deduction unnecessary to the husband to shift the income tax obligation to the payee. The income shifting was accomplished via different means (an exclusion for the husband rather than a deduction) but was nevertheless successfully accomplished. Regulations issued in 1942 give this example:

"If in order to meet an alimony obligation of $500 a month, the husband purchases or assigns for the benefit of his former wife a commercial annuity contract paying such amount, the full $500 a month received by the wife is includable in her income, and no part of such amount is includable in the husband's income or deductible by him."

Reg. 103, § 19.22(k)-1(b) (issued in Treasury Decision 5194, Dec. 8, 1942). This sentence was transposed directly from the legislative history. See H.R. REP. No. 77-2333, reprinted in 1942-2 C.B. 372, 568.

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The statute provided the payor a deduction in section 23(u) for all amounts includable by the recipient.40

The relevant qualifications for an includable/deductible payment could be distilled, therefore, as follows:

1. The payment had to be "periodic," but a payment could be periodic even if not made at regular intervals.

2. The payment had to be made pursuant to a decree of divorce or of separate maintenance.

3. The payment had to discharge a legal obligation imposed on the payor because of the marital or family relationship.

4. The payment could not be an amount "fixed" for child support.

5. If the payment was an installment payment that discharged a principal sum stipulated in the divorce decree, then the payment qualified only if the installment period exceeded ten years from the date of the decree and, even then, the installment payment in any one year could qualify only to the extent that it did not exceed ten percent of the principal sum designated in the decree.

Requirement 2 is straightforward, and I have already discussed requirement 4. I shall now discuss requirements 1 and 5 immediately below and then move to requirement 3.

The implicit assumption underlying requirement 1, that the payment be "periodic," was that a lump-sum obligation (even if paid in installments) looks much more like a property settlement than a support payment out of new (untaxed) earnings of the payor. But while the general idea is fairly easy to grasp, the provision generated much litigation in search of the precise meaning of the term "periodic."41 The cases generally concluded that, to be periodic, the payments had to be either for an indefinite amount or an indefinite period.42 Moreover, as requirement 5 indicates, if the payment was part of an installment stream that discharged a principal sum stipulated in the divorce decree, the payment stream had to exceed ten years to overcome the underlying presumption that it otherwise constituted a payment for the recipient's interest in marital property. A payment was considered to be in discharge of a principal sum if "the final sum to be paid could be definitely determined at the time the decree was executed."43 Even if the ten-year period was met, no more than ten percent of the principal sum could qualify as deductible alimony in any one year.

40I.R.C. § 23(u) (1942).
41See, e.g., Van Orman v. Commissioner, 418 F.2d 170 (7th Cir. 1969); Warnack v. Commissioner, 71 T.C. 541 (1979); Bishop v. Commissioner, 55 T.C. 720 (1971).
43Id.
An example taken from the 1942 regulations illustrates the operation of this rule:

A divorce decree in 1940 provides that H is to pay W $20,000 each year for the next 5 years, beginning with the date of the decree, and then $5,000 each year for the next 10 years. Assuming the wife makes her returns on the calendar year basis, each payment received in 1942 [the first year in which the new rules became effective] 1943 and 1944 is a periodic payment under section 22(k), but only to the extent of 10 percent of the principal sum of $150,000. Thus for such taxable years, only $15,000 of the $20,000 received is includable under section 22(k) in the wife’s income and is deductible by the husband under section 23(u). For the years 1945-1954, inclusive, the full $5,000 received each year by the wife is includable in her income and is deductible from the husband’s income.44

This ten percent rule, in short, discouraged front-loaded payments that might look as though they consisted more of a property settlement than a support payment. Matters could get quite complicated, however. For example, the regulations provided that “[t]his 10 percent limitation applies to installment payments made in advance but does not apply to delinquent installment payments for a prior taxable year of the wife made during her taxable year.”45 The interrelationship between the ten-year rule, the ten-percent rule, and the rules for advance and delinquent payments was illustrated by the following sticky example:

Under the terms of a separation agreement incident to divorce granted in December 1940, H agrees to pay W $500 on the first day of each month, beginning with the month after the decree, for 12 years. W makes her income tax returns on the calendar year basis while H makes his returns on the basis of the fiscal year ending June 30. H makes the promised payments in 1941 and 1942 and, in addition, on December 31, 1942, pays W $1,500 as an advance payment of installments for the next three months. In the calendar year 1943, H makes no payments at all because of financial straits. On January 1, 1944, H inherits $15,000, which he immediately pays to W in satisfaction of not only his back alimony installments for the last 9 months of 1943 but also his alimony installments for the next 21 months. The results as to H and W are as follows:

As to W. In the calendar year 1941, W received $6,000, none of which is includable in her gross income. In the calendar year 1942, W received $7,500. Since 10 percent of $72,000 (the principal sum) is $7,200, only $7,200 of the $7,500 so received is includable in her income for 1942. For 1943, nothing is includable in her income under section 22(k). In 1944, W received $15,000. Of this amount, $4,500 is in payment of back installments and, therefore, is includable without limitation in her income for 1944. Of the balance of $10,500, only $7,200 is includable in her income for 1944.

44Reg. 103, § 19.22(k)-1(c), Ex. 2 (issued in Treasury Decision 5194, Dec. 8, 1942).
45Reg. 103, § 19.22(k)-1(c) (issued in Treasury Decision 5194, Dec. 8, 1942).
As to H. For the taxable year ended June 30, 1941, H paid $3,000 none of which is deductible. For the taxable year ended June 30, 1942, H paid $6,000, of which only $3,000 is deductible by H since only that much of the $6,000 was paid in the wife's first taxable year beginning after December 31, 1941. In the taxable year ended June 30, 1943, H paid W $4,500, which, not being in excess of 10 percent of the principal sum, is deductible for such year. In his taxable year ended June 30, 1944, H paid $15,000, of which $11,700 (the sum of $4,500 and $7,200) is deductible.\(^4\)

The result was clearly not easy or intuitive for the divorcing parties who failed to (or could not afford to) seek advice.

As noted above, payments of less than ten-year duration would not qualify for the inclusion/deduction system at all if they discharged a principal sum that could be computed from the decree at the time of the execution. But, in such a case, a contingency clause inserted into the divorce agreement to increase, decrease, or terminate payments on the happening of certain events, such as death, remarriage, or a change in economic circumstances, was sufficient to make the payments sufficiently indefinite in duration to be "periodic," even if the likelihood of the contingency occurring during the payment stream was low.\(^4\)\(^7\) As one commentator has made the point:

"If [for example] the decree obligated the payor to pay $900 per month for nine years, the obligation was for a principal sum paid in less than ten years and was excludable and nondeductible . . . . However, if the decree inserted the contingency that the payments were to continue for nine years or until the recipient's death, the payments became "periodic" and therefore includable, deductible.\(^4\)\(^8\)"

Moreover, payments under a divorce decree lacking a contingency clause would nevertheless be considered "periodic" if state law would step in and terminate or modify payments.\(^4\)\(^9\) For example, in *Kent v. Commissioner*, the Tax Court held that the possibility that a judge could modify an alimony award under state law if the parties' circumstances changed meant that the payment was sufficiently indefinite as to qualify as "periodic," even though the payment stream mandated by the document itself was less than ten years and was of a principal sum. Based on this and other holdings, one author has concluded:

"The effect of local law on the interpretation of divorce and separation agreements meant that a divorcing couple in one state could use the very same language in their agreement as that used by a couple in another state with entirely different tax results. This lack of uniformity in the divorce tax laws..."
caused by the dependence on state law was one reason the decisions in this area have appeared so contradictory and the tax treatment of divorce settlements has been so unpredictable.\textsuperscript{51}

Requirement 3—that the payment had to discharge a legal obligation imposed because of the marital or family relationship—was another device intended to differentiate support payments from property settlements. Borrowing a sentence directly from the legislative history, regulations issued in 1942 interpreted this requirement as limiting eligible payments to those made “in recognition of the general obligation to support, which is made specific by the instrument or decree.”\textsuperscript{52} If the payment was not made in recognition of the general obligation to support, but rather to execute a property settlement, then it would fail to qualify as a payment made to discharge a legal obligation imposed because of the marital or family relationship and thus fail to qualify for the inclusion/deduction system, even if the payments were “periodic.”\textsuperscript{53} This was true even if the payments were in extinguishment of such an intangible and inchoate property interest as dower or curtesy, since such amounts were not paid for support but rather for extinguishment of those intangible property rights.\textsuperscript{54} This rule caused much confusion.

For example, in Swindler v. Commissioner,\textsuperscript{55} monthly cash payments over a 121-month period qualified as “periodic” (because they exceeded ten years) but were held not to be includable/deductible payments because the amount of the payments was calculated by subtracting the value of the marital property received by the payee pursuant to the divorce from the value of the marital property received by the payor. Thus, the court concluded that the payment stream was a property settlement and not made in discharge of an obligation of support.\textsuperscript{56} Even payments specifically designated as for “support” of the ex-wife in the divorce settlement were recharacterized as a property settlement where the payments represented the wife’s interest in her former husband’s partnership, which was community property under California law.\textsuperscript{57} Conversely, payments specifically found by a state court to be a “property settlement” were held to be

\textsuperscript{51}Taggart, \textit{supra} note 50, at 347.
\textsuperscript{52}Reg. 103, § 19.22(k)-1(a) (issued in Treasury Decision 5194, Dec. 8, 1942). The legislative history stated: “This section applies only where the legal obligation being discharged arises out of the family or marital relationship \textit{in recognition of the general obligation to support}, which is made specific by the instrument or decree.” H.R. REP. No. 77-2333, \textit{reprinted} in 1942-2 C.B. 372, 568 (emphasis added).
\textsuperscript{53}See Taggart, \textit{supra} note 50, at 346. Moreover, a voluntary payment would fail to qualify, since such a payment would not be made “in discharge of a legal obligation.” See, e.g., Moore v. United States, 449 F. Supp. 163 (N.D. Tex. 1978); \textit{see generally} John W. Harris, The Federal Income Tax Treatment of Alimony Payments—The “Support” Requirement of the Regulations, 22 HASTINGS L.J. 53 (1970) (examining the development and then-current contours of the “support” requirement).
\textsuperscript{54}See Swindle v. Commissioner, 35 T.C.M. (CCH) 1, 1976 T.C.M. (RIA) ¶ 76,001.
\textsuperscript{55}Id.
\textsuperscript{56}Id.
\textsuperscript{57}Adam v. United States, 429 F. Supp. 38, 40 (D. Wyo. 1977); \textit{accord} Gammill v. Commissioner, 710 F.2d 607 (10th Cir. 1982); Crouser v. Commissioner, 73 T.C. 1113 (1980).
\textsuperscript{58}See Westbrook v. Commissioner, 74 T.C. 1357 (1980).
“alimony” for federal tax purposes because, according to the Tax Court, the wife did not relinquish anything of value when she transferred her joint tenancy interest in a house to her former husband. In that case, the Tax Court went so far as to say that “the labels given to the payments by the parties or by the [state court decree] do not govern their characterization for tax purposes.”

A further taste of the confused state of the law that emerged from attempts to differentiate “support” payments from “property settlements” under this standard can be found in the following commentary:

The courts were often inconsistent in these recharacterizations. In Ryker v. Commissioner, the husband agreed to pay the wife 25% of this income for more than 10 years as property settlement. The payments were to cease at her death or remarriage. Despite the parties’ express labeling of the payments as property settlement, the Tax Court did not even discuss the wife’s property rights. Instead, the Tax Court recharacterized the payments as alimony because of the death or remarriage contingencies. Conversely, in Riddell v. Commissioner, the Ninth Circuit allowed an express property settlement label to stand, despite the payment’s contingency on the wife’s death. The Tenth Circuit [in Kayutin v. Commissioner] found that payments could not constitute property settlement if the wife had no co-ownership during marriage, even though she had inchoate rights that vested at divorce. The U.S. Court of Claims reached the opposite result in Bernatschke v. Commissioner. The Court of Claims held that annuities exchanged for inchoate dower rights were for property settlement.

When Congress recodified the income tax law in 1954, this treatment of alimony and child support (as well as their definitions) was continued in sections 71 (alimony includable, child support excludable) and 215 (amounts includable under section 71 are deductible).

As this quick perusal of cases and code sections makes clear, the law between 1942 and 1984 with respect to alimony and child support was complex, ambiguous, not uniform from state to state, and replete with a large number of traps for the unwary. Advice of a lawyer well-versed in the tax law was crucial, and even then, labels attached to payments in the agreements and state divorce decrees often were recharacterized by the courts in the ensuing tax litigation. As one writer has noted, “[c]ouples were making significant financial decisions which might bind them for many years, yet were sometimes unable to predict the tax consequences of their decisions with any certainty.” Furthermore, the frequent

59Id. Accord Widmer v. Commissioner, 75 T.C. 405 (1980) (holding that a state court’s characterization of payments under a divorce decree as alimony was not controlling for tax purposes and that, since the payments were not contingent and the wife was required to assign a stock interest to her husband, the transaction was correctly determined to be a property settlement).
need to resort to litigation to deal with some of these complexities and ambiguities made the task of complying with the law all the more expensive and burdensome. It is difficult to believe that all of this confusion could be justified by any argument that the complexity was required in order to get it "right." The law characterized an absolute obligation to pay $10,000 per year for nine years (a total of $90,000) as an excludable/nondeductible property settlement in full, regardless of whether this conclusion was fairly justified by the underlying facts. No judge had the power to make an inquiry into the underlying facts with such terms. At the same time, an absolute obligation to pay $10,000 per year for nine years and $1,000 per year in years ten and eleven was characterized as "alimony" to the extent of $9,200 of each of the payments in years one through nine and the full $1,000 payments in years ten and eleven, with only the remaining $7,200 characterized as "not alimony"—unless the underlying facts convinced a judge that the payment stream really was meant to compensate the recipient for her interest in marital property so that the payment was not made in discharge of an obligation for "support." I think it would be mere happenstance if these tax conclusions labeled the status of these payment streams "correctly."

2. In-Kind Property Transfers

Notice that the definition of includable/deductible "alimony" enacted in 1942 contained no requirement that the payment be made in cash. Thus, a $500 alimony obligation could be discharged with the transfer to the alimony recipient of property worth $500. Moreover, property settlements often required the transfer of property in kind from one spouse to the other. How were these transfers treated for tax purposes?

One result has already been described: If the transfer otherwise qualified as "alimony" under the requirements described in Part I.B.1, above, then the recipient had to include the value of the property in gross income and the transferor could deduct it. Conversely, if the transfer failed to qualify as "alimony," then the recipient would exclude the receipt and the transferor would not be permitted to deduct it. But with an in-kind property transfer, a second question arose in both instances: Was the transfer a realization and recognition event, so that any built-in gain or loss is taken into account for tax purposes? Disagreements on the answer to this question led the Supreme Court to decide Davis v. Commissioner in 1962.

In 1955 and pursuant to a divorce decree, H transferred to his former spouse, W, shares of E.I. du Pont de Nemours & Co. that had a cost basis in H's hands of approximately $75,000 and a fair market value at the time of transfer of approximately $82,250. In return, W released H from all claims, including dower

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62See supra text accompanying note 39.
63370 U.S. 65 (1962). The following paragraphs describing Davis and the evolution of the law in the years following are taken from Deborah A. Geier, Form, Substance, and Section 1041, 60 Tax Notes 519, 520-21 (1993).
and any rights under the laws of testacy and intestacy. Concluding that "the inchoate rights granted a wife in her husband's property by Delaware law do not even remotely reach the dignity of co-ownership," the Court applied the marketplace rule that the transfer of property owned by one taxpayer to another taxpayer in exchange for the release of an independent legal obligation is a realization event. Assuming that the value of the release of the inchoate marital rights equaled the value of the stock, the Court concluded that H realized a gain of approximately $7,250 on the transfer and that W took a cost basis of $82,250 in the stock. The Court noted in a footnote the "administrative practice" of not taxing W on the release of marital rights.

Had W possessed some sort of ownership interest in the stock at the time of the divorce, as in a community-property state, the outcome might have been different. The transaction might have been viewed instead as a division of jointly owned property, which was not considered a realization event. The Court acknowledged, but apparently was not overly troubled by, the disparities that its decision would create between residents of community-property states—in which the division of marital property would generally not be deemed a "transfer"—and residents of common-law states.

As described below, the post-Davis era was one of confusion, uncertainty, and traps for the unwary. It was also an era that witnessed state legislation designed to frustrate a federal tax case, the Davis case, while maintaining a common-law property regime in other respects.

The government eventually conceded that approximately equal divisions of community property or property in states where the law is "similar to community property law" were not taxable; the transferee took a carryover basis and tacked holding period in the property. Similarly, the Service ruled that approximately equal divisions of property owned in joint tenancy or property held as tenants in common were nontaxable divisions of property, even though ownership was not partitioned but, rather, some assets went entirely to one spouse and some went entirely to the other. Not all transfers in community-property states were tax-free events, however. An exchange of separate (nonmarital) property for community property or an unequal division of community property resulted

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[370 U.S. at 70.]

[Id. at 68-70.]

[Cf. International Freighting Corp. v. Commissioner, 135 F.2d 310 (2d Cir. 1943) (holding that a transfer of appreciated property to an employee in payment for services rendered was a realization event for transferor).]

[See 370 U.S. at 71-74; see also Philadelphia Park Amusement Co. v. United States, 126 F. Supp. 184, 187 (Ct. Cl. 1954) (holding the basis of property received in taxable exchange to be the fair market value of the property received).]


in taxation.\textsuperscript{71} Similarly, unequal divisions of jointly owned property in noncommunity-property states resulted in taxation.\textsuperscript{72}

\textit{Davis} thus required an examination of state law in order to determine whether a transferee of property had an existing property interest in the property received at the time of the transfer, notwithstanding that the transferor was titleholder to the property. If the transferee in a common-law state possessed an interest "similar to community property," such as was held under some "equitable distribution" statutes,\textsuperscript{73} the transferor might not realize a gain on the transfer and the transferee would take a carryover basis, even though the property was not in fact community property or jointly held. This reliance on state law enabled states to enact "anti-\textit{Davis}" legislation, exemplified by Oregon's statute: "Subsequent to the filing of a petition for annulment or dissolution of marriage or separation, the rights of the parties in the marital assets shall be considered a species of co-ownership and a transfer of marital assets . . . shall be considered a partition of jointly owned property."\textsuperscript{74} The "equitable distribution statutes" of other states often were interpreted to vest a property interest in the transferee in the case of a "special equity" determination. These eleventh-hour vestings of property rights during the course of divorces in noncommunity-property states were routinely upheld by the courts as effectively eviscerating \textit{Davis}.\textsuperscript{75}

As noted above, this state of affairs resulted in much confusion and costly litigation under \textit{Davis}, many traps for the unwary, and a variety of results for what appeared to be similarly situated taxpayers, all of which hinged on state law. It also resulted in a fair amount of whipsaw for the Federal Treasury, with the transferor spouse claiming a tax-free division of property and the transferee claiming a stepped-up basis under \textit{Davis} on later disposition. This state of confusion thrived until the law was amended in 1984.

\noindent C. From 1984 to the Present

1. Activities Leading to the Tax Reform Act of 1984

In the early 1980s, the American Bar Association (ABA) Tax Section created

\begin{footnotesize}
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\item \textsuperscript{71}See, e.g., Siewart v. Commissioner, 72 T.C. 326 (1979) (holding the receipt by W of noncommunity cash and a personal note of H for transfer of her one-half interest in community property constituted a sale, not a division of community property); Carrieres v. Commissioner, 64 T.C. 959 (1975), aff'd, 552 F.2d 1350 (9th Cir. 1977) (per curiam) (finding a taxable sale to W to the extent H used his separate property to pay for W's community property interest in stock but no taxable sale with respect to the portion of such stock exchanged for H's interest in other community property).
\item \textsuperscript{72}\textit{Rev. Rul. 1974-347, 1974-2 C.B. 26.}
\item \textsuperscript{73}See Cynthia Garrison Lepow, Proposals to Reform the Tax Treatment of Property Division Incident to Divorce—A Splitting Headache, 10 COMMUNITY PROP. J. 237, 250-53 (1983) (describing cases).
\item \textsuperscript{74}OR. REV. STAT. § 107.105(1)(f) (discussed in Laird v. United States, 16 Cl. Ct. 441, 445 (1989)).
\item \textsuperscript{75}See, e.g., Boucher v. Commissioner, 710 F.2d 307 (9th Cir. 1983); Bosch v. United States, 590 F.2d 165 (5th Cir. 1979), cert. denied, 444 U.S. 1044 (1980); Imel v. United States, 523 F.2d 853 (10th Cir. 1975); Collins v. Commissioner, 412 F.2d 211 (10th Cir. 1969); McIntosh v. Commissioner, 58 T.C. 4 (1986) (applying pre-1984 law); Cook v. Commissioner, 80 T.C. 513 (1983), aff'd, 742 F.2d 1431 (2d Cir. 1984); Laird v. United States, 61 Cl. Ct. 441 (1989) (applying pre-1984 law).
\end{itemize}
\end{footnotesize}
the “ABA Domestic Relations Tax Simplification Task Force” to study and make recommendations regarding the taxation of transfers in divorce. It identified six criticisms of the law at that time, as follows:

1. That many of the exiting rules are overly complex, requiring a degree of tax sophistication on the part of taxpayers (or their counsel) that is frequently perceived as too costly to obtain;

2. That some rules, although seemingly relevant in countless cases, are not clearly established by existing authorities;

3. That due to the significance of local law in this area, disparate tax results ensue for substantially comparable transactions occurring in different states;

4. That the triggering of an income tax by some types of property transfers at the time of divorce (as in the case of so-called Davis transfers) may simply be “bad policy,” an unnecessary consequence that in many cases simply depletes overly strained liquidity;

5. That the overall domestic relations tax structure has produced, and continues to produce, far too many tax controversies, causing a serious drain on the manpower and resources of the courts, [the] Service, and state taxing authorities; and

6. That there may be a significant degree of noncompliance with the applicable tax rules, a situation conducive to disrespect for the entire tax system.77

The “basic touchstone” guiding the Task Force’s recommendations was the concept of “private ordering,” under which “parties to a divorce or legal separation, via a written agreement, may set their own tax framework.”78 As discussed in more detail below, this idea was not carried out in the Task Force’s proposals to the maximum extent possible and was largely rejected, with only one small nod to the contrary, in the legislation eventually enacted in 1984.

The Task Force made the following major recommendations with respect to the income tax treatment of transfers in divorce.79 First, it recommended that all in-kind transfers of property under a decree of divorce or written instrument...
incident to such a decree be nonrecognition events, with a carryover basis.80 In other words, the Task Force sought to abandon the Davis approach in the context of divorce.81 The Task Force's approach essentially would allow the pre-1984 treatment that applied to equal divisions of community property in community-property states to apply to all transfers of property in divorce. Thus, the transferor would not recognize the built-in gain or loss embedded in the

80 It recommended that nonrecognition be the norm, whether or not the property is encumbered with debt in excess of basis or incurred on the eve of the transfer in an effort to "cash out" the value while transferring the obligation to repay the encumbering debt to the transferee spouse. See id. at 5. Under some other nonrecognition provisions, where one property is "exchanged" for another, debt in excess of basis, or debt incurred on the eve of transfer, may produce recognized gain on the transfer, notwithstanding the general nonrecognition rule to the contrary. See, e.g., I.R.C. § 357(b), (c). The gain produced under section 357(c) on transfers of property with debt in excess of basis is equal only to that excess amount, and that gain recognition is required solely to avoid the negative basis that would otherwise occur in the property received under the mechanical rules of section 358. There is no such "negative basis" problem in this context, since any property received in exchange takes its own "carryover basis" rather than a "transferred basis" that starts with the basis of the property given up and is reduced by any encumbering debt. Cf. I.R.C. § 358(a)(1), (d).

The gain produced under section 357(b) equals 100% of the transferred debt and is intended to dissuade transferors from "cashing out" the value of the property by encumbering it with debt shortly before the exchange and then transferring the obligation to repay the debt along with the property. Professor Gabinet has questioned whether this aspect of the section 357 approach ought to be extended to transfers in divorce. See Leon Gabinet, Section 1041: The High Price of Quick Fix Tax Reform in Taxation of Interspousal Transfers, 5 Am. J. Tax Pol'y 13, 37-40 (1986). My own view is that divorce is not a transaction, like the corporate reorganizations that are the subject of section 357, undertaken to cash out property appreciation without tax, and that the cooperation of the transferee spouse in accepting the property subject to the debt obligation decreases the likelihood that such transactions could occur on a routine basis. Moreover, in the real world sometimes parties need the flexibility to encumber property immediately prior to a transfer in order to ensure that the divvying up of value is equal, which is irrelevant in the context of corporate reorganization exchanges. As recognized in the Task Force's recommendations:

[A:] the time of marital split-ups assets are frequently not in the most divisible form. For example, if a couple owns $400,000 worth of property, none of which is in the form of cash or cash equivalents, the new rules would permit the couple to encumber the property with a $200,000 liability and then allocate in a nonrecognition transaction the encumbered property (now with a net value of $200,000) to one spouse and the new cash to the other spouse.

Task Force Technical Memorandum, supra note 76, at 10.

I therefore think that the Task Force's recommendation to ignore debt encumbrances in deciding whether in-kind property transfers ought to be taxable events in divorce is defensible. Divorce, where the parties are attempting to divvy up property between them, really is different, in a fundamental way, from corporate reorganizations, where the parties are attempting to continue their ownership in transferred property indirectly via stock ownership. Nevertheless, Congress amended section 1041 in 1986 to provide that transfers of encumbered property to a trust will result in gain recognition to the extent that the debt exceeds the transferor's basis. It also provided that transfers of installment obligations to a trust would result in gain recognition.

See Tax Reform Act of 1986, Pub. L. No. 99-514, § 1842(b), 100 Stat. 2085 (1986). While there is no legislative history underlying these changes, presumably transfers in trust, as opposed to direct transfers, were thought to raise the potential for abuse.

81 It made no recommendations with respect to transfers of property during marriage that are not incident to divorce. When enacted, however, section 1041, which substantially adopts the Task Force's nonrecognition recommendation, was made to apply to transfers during marriage as well, whether gifts or sales for consideration. See Rev. Rul. 1969-608, 1969-2 C.B. 43 (considering whether application of section 1041 should be limited to the divorce context).
property at the time of divorce, and the transferee would take the same basis in the property that it carried in the hands of the transferor. Any built-in gain or loss would be preserved in the hands of (and shifted to) the transferee. Under the "private-ordering" concept, the Task Force did not oppose the possibility that taxpayers be given the choice to "elect out" of nonrecognition treatment (with an ensuing fair market value basis in the hands of the transferee) under Davis.  

It did recommend, however, that if taxpayers were given that option, the election should be on an "all-or-nothing" basis, with no ability to cherry pick which assets would fall under the nonrecognition/carryover basis regime and which would fall under the recognition/fair market value basis regime. 

Second, the Task Force recommended amending sections 71 and 215 in a number of ways. It recommended that the inclusion/deduction system be limited to cash payments so that in-kind property transfers could no longer be deductible as "alimony" by the transferor and includable by the transferee. It also recommended that the "periodic" and "support" requirements, as well as the "principal sum" rules, be eliminated. Most important, the Task Force recommended that the parties be given the freedom (with the exceptions noted below) to designate how much, if any, of such cash payments (including cash payments to third parties on behalf of a spouse) would be includable by the payee and deductible by the payor. Any portion of any payments that was not specifically designated by the parties as being includable by the payee and deductible by the payor would be excludable and not deductible. The private-ordering elections would be respected, regardless of whether or not any contingencies—such as the death or remarriage of the recipient spouse or the ability of a state court to alter awards based on changed economic circumstance—would increase, decrease, or terminate any of the payments in the future. Therefore, in the view of the Task Force, there would be little or no need to resort to litigation to determine whether or not a payment fell within the inclusion/deduction system of sections 71 and 215:

Under private ordering, the parties' explicit choice as to the income tax treatment for their "[s]ection 71 package" would apply irrespective of whether any or all payments are explicitly restricted for child support or whether any contingencies might increase, decrease, or terminate any of the payments in the future. Moreover, the parties could agree to different treatment for different components of their "[s]ection 71 package." For example, they could designate all of the intended spousal support as "includable/deductible" and all of the intended child support as "excludable/nondeductible" or vice versa. As another

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82 Task Force Technical Memorandum, supra note 76, at 11.
83 Id. Cf. Gabinet, supra note 80, at 31-37 (questioning whether the parties ought to be able to decide whether a transfer is a taxable or nontaxable event under the concept of "private ordering"). See also infra note 260 and accompanying text (defending the current rule mandating nonrecognition in all in-kind transfers).
84 See Task Force Technical Memorandum, supra note 76, at 17.
85 Id.
86 Task Force Preliminary Specifications, supra note 76, at 3.
example, the parties might agree to a percentage arrangement, e.g., 30% of the husband's compensation income going to the ex-wife, cast in the traditional unallocated form, but nevertheless designate that the first $1,000 per month would be "includable/deductible," with all payments in excess of this amount as "excludable/nondeductible." Further, if the parties choose, the safe-harbor designations could also cover certain types of cash payments to third parties, such as payments for education, medical costs, or life insurance premiums.87

The Task Force did not see a need to deal specifically with child support, since it believed that the Lester Rule then in force already provided "private ordering," in that any nonallocated "family support" payment would automatically be considered a potentially includable/deductible payment (if so designated by the parties under the proposed system). In contrast, a payment specifically "fixed" for child support would remain the means by which the parties could "elect" to make a payment excludable/nondeductible. Therefore, the Task Force made no recommendations to change the child support rules:

In connection with the above proposals, it should be noted that the Task Force contemplates no basic change to the existing child support rules of [section 71(b)]. Payments "fixed" as child support would continue to be "excludable/nondeductible" under the "fall-back" rules; and, similarly, courts and parties would continue to have flexibility of creating "unallocated" support arrangements under the Lester principle [which could be designated as "includable/deductible" payments under the new rules].88

The Task Force, however, intended that the concept of private ordering be limited to spousal and child support payments—not to cash property settlements. Recall the difficulty under prior law, however, of identifying whether a cash payment was really a property settlement by looking to whether the payment discharged a support obligation of the payor.89 To avert this difficulty, the Task Force recommended implementing the limitation with the adoption of a mechanical, though complex, "netting rule" in order to prevent cash payments to the payee intended to compensate for the payee's interest in property going to the payor from being subject to the inclusion/deduction system of sections 71 and 215.

Consider the example in which a couple jointly owns $400,000 of "hard assets."90 An equal division would direct that $200,000 go to each former spouse. Instead, the parties agree that $100,000 worth of the property will remain with W and that $300,000 will go to H—$100,000 more than he should be entitled to—and that H will make payments to W intended to fall within the inclusion/deduction system. Because the payments will be includable, W will presumably

87 Task Force Technical Memorandum, supra note 76, at 12.
88 Id. at 19.
89 See supra notes 52-60 and accompanying text.
90 The Task Force generally used this term to mean property, whether tangible or intangible, that has a basis for tax purposes. See Task Force Technical Memorandum, supra note 76, at 6-7. It would not include marital rights, such as dower or curtesy, though such rights are "property rights" under state law.

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demand payments exceeding $100,000 (say, $120,000) so that her after-tax position will be the same as if she had simply taken the full $200,000 in property (since in-kind property receipts could not fall within the inclusion/deduction system). The deduction by H of the payments would effectively allow him to deduct his "purchase price" for the $100,000 worth of property that exceeded his one-half interest. The Task Force proposal would have prevented the first $100,000 of payments made by H to W from falling within the inclusion/deduction system. "[T]he 'hard assets' received from one spouse in the property division would first be netted against any [s]ection 71 private ordering payments to such spouse, with only the excess being eligible for an 'includable/deductible' designation." That is to say, the $100,000 worth of property that W transferred to H (the amount in excess of his one-half interest) would be netted against the first $100,000 of cash payments made by H to W, thus preventing the first $100,000 of cash payments from falling within the inclusion/deduction system. H would be able to deduct (and W would have to include) only the remaining $20,000 (the difference between $120,000 and $100,000). The Task Force recognized that the calculation of how much property was "transferred" from W to H (and thus how much cash going from H to W was precluded from entering the inclusion/deduction system) would vary between residents of community-property states and common-law states.

To some extent, though, variances as to the impact of the new rules would still ensue, as the determination of "hard asset interest" will differ, but these variances will be due essentially to differences in state property laws, principally differences between the property laws of community property and common law states. Despite the objective of the Task Force's proposals to establish as much uniformity among the various states as possible, some variances due to differences in state property laws probably remain unavoidable.

Finally, the Task Force recommended that the rules pertaining to who may claim a dependency exemption for minor children of the divorced parents should be simplified. One commentator summarized the pre-1984 authority in this respect as follows:

As a general rule, Congress gave the child exemption to the custodial parent, who will be assumed for the purposes of this discussion to be the wife. The husband, as noncustodial parent, was entitled to the exemption if the divorce or the couple's written agreement named him as the parent entitled to the exemption and he paid at least $600 for the support of the child in the tax year. If the agreement or decree were silent, the husband, as noncustodial parent, might still qualify for the exemption if he provided $1,200 or more in support for the child in the tax year and the wife could not "clearly establish" that she provided

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91 See supra notes 36-40 and accompanying text.
92 Task Force Technical Memorandum, supra note 76, at 17.
93 Id. at 20.
94 See id. at 24-26.
more support. For example, assume that the wife has custody of the child for the entire year and that the divorce decree did not address which parent would claim the exemption. Additionally, assume that the wife provided $700 support for the child, while the husband provided $1,300 in support. Since the husband provided more than $1,200 and the wife could not have clearly established that she paid more, the husband would have been entitled to the child exemption.

Prior to [1984], the statutes established a framework that would have permitted the couple's own agreement to control which spouse would claim the tax exemption for the child. If the couple could not reach such an agreement, difficult questions arose regarding which spouse contributed more "support." The determination of support was the subject of much litigation, for the statutes themselves did not define this critical term. Also, the regulations vaguely defined support as including "food, shelter, clothing, medical and dental care, education, and the like." As a result, much of the interpretation of qualifying expenditures for support was left to the courts.

Courts generally took a broad view of support to include almost any payment made by the parent on behalf of the child. As one court noted, support was more than the necessities and could include extras, such as summer camp payments, that were available at certain stations in life. The courts, though, set some limits on what types of payments did not meet even this liberal interpretation of support. Gifts to the child or visits and telephone calls made by the parent to the child did not qualify as support. Likewise, the value of babysitting or other personal services performed by the custodial parent were not includable in the calculation of support, because a payment had not been made on the child's behalf.

In addition, payments must actually have been made by the parent to be considered support. Unpaid child support was not counted even though it was court ordered and enforceable for the tax period in question. Likewise, arrearages for support relating to prior tax periods, but paid in the current tax year, were not included as support. For example, if the husband failed to pay his $500 a year child support for each of the past two years, his payment of the past due $1,000 and the presently due $500 would not entitle him to the child exemption in the current year. This was true even though he paid over $1,200 and technically met the statutory standard necessary to claim an exemption. Finally, government payments, such as welfare aid, made to the custodial parent on behalf of the child were not considered as support contributions by that parent for the determination of tax exemptions.\(^5\)

At a meeting in April of 1982 of the staff of the Joint Committee on Taxation, representatives of the ABA Tax Section, and representatives of the American Institute of Certified Public Accountants (AICPA) Tax Division to consider the Task Force's recommendations, the point most discussed and questioned was the concept of "private ordering." The Task Force therefore issued another docu-
ment on August 2, 1982, which was intended to clarify the concept and justify its use in the divorce context. In part, it explained:

The advantages to the federal government in adopting the proposed “private ordering” are difficult to quantify in terms of dollars; but, in light of the staggering level of tax controversies generated by sections 71, 215, and 152 and the probable degree of non-compliance, administrative costs and lost revenue to the government attributable to present law are plainly substantial.

... The number of tax cases produced by present rules plainly imposes a heavy burden on the Internal Revenue Service, state taxing authorities, and the courts. Illustrative of this number is the fact that as of June 30, 1982, some 481 cases docketed in the Tax Court involved sections 71, 215, and/or 152. As most cases in this area are probably settled at administrative levels, the foregoing number would appear to be only the “tip of the iceberg.”

The Task Force quoted at length from a Tax Court opinion written by Judge Dawson, as follows:

It is well settled that the determination of whether payments are in the nature of support or part of a property settlement does not turn on the labels assigned to the payments by the court in the divorce decree or by the parties to the agreement... This issue is a factual one and requires an examination of all the surrounding facts and circumstances... Unfortunately, because of the vexing problems which frequently arise in determining the nature and extent of a spouse’s property rights under State law, this supposedly factual inquiry has all too often taken on a metaphysical aura as the courts have struggled to classify a particular payment as either support or property settlement, when, in reality, the payment possesses a hybrid nature sharing characteristics of both. In the process, similarly situated taxpayers have occasionally been accorded disparate treatment merely because of differences in State marital property laws. For this reason, and because the confusion in this area has spawned a relentless stream of litigation, it would appear that legislative reform is warranted. As we stated in Schatz v. Commissioner, some sort of safe harbor is needed so that taxpayers and divorce courts can predict with confidence the income tax consequences stemming from periodic payments occasioned by divorce. Until such legislation is enacted, however, we are left with no alternative but to plunge into the morass of the decided cases, many of them irreconcilable, and resolve this issue as best we can by applying the various factors which have been identified by prior decisions.

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97Id. at 2-3.
98Id. at 3-4 (quoting Beard v. Commissioner, 77 T.C. 1275, 1283-84 (1981)).
The document then addressed the question of whether “private ordering” would undermine the progressivity of the federal income tax system and concluded that it would not, denying that the proposals would entail a “radical change in domestic relations tax law in any substantive sense” in view of the ability—if the divorcing parties knew the appropriate magic words—to accomplish under prior law much of the private ordering that the proposals would make explicit.99 Furthermore:

As noted, “private ordering” in marital settlements substantially exists under present law, although some of the rules are complicated and produce many tax controversies. From the standpoint of practitioners, these rules are frequently viewed as “planning tools;” and, in a large majority of cases, if parties are cooperative and adequately advised, they can “pick and choose” the correlative tax consequences of many aspects of their settlement by utilizing one or a combination of the key planning tools.100

The document then listed some of these “hidden” private-ordering tools. It noted, for example, that under the section 71(c) principal sum rules, the parties could avoid the excludable/nondeductible conclusion that the statute provided normally applies to a principal sum paid out in fewer than ten years “by parties agreeing that payments shall merely be contingent upon the recipient’s survival, a condition that is frequently of little practical or actuarial consequence in the eyes of the parties.”101 Under the Lester Rule, the parties could decide for themselves whether or not child support was includable/deductible or excludable/nondeductible by specifically “fixing”—or not—an amount for child support in the agreement. Even reductions for contingencies clearly relating to the children would not transform a portion of an unallocated “family support” payment into nondeductible “child support.”102 The document also described the use of “ride-throughs,” which were described as follows:

This term refers to various types of arrangements under which parties agree for includable/deductible payments to continue beyond standard terminating events under state law, most typically an ex-wife’s remarriage. By entering into a written agreement that carefully preserves the recipient’s right to support for the desired period, the parties can usually achieve their intended tax consequences, notwithstanding the occurrence of one or more of the standard terminating events. In many cases, the “ride-through” technique is coupled with the Lester principle, with the result that payments to an ex-wife subsequent to her remarriage, plainly and solely intended to benefit the parties’ children, retain their alimony character. See Revenue Ruling 70-557, 70-2 C.B. 10. A “support package” entailing a “ride-through” is often utilized in lieu of a larger property allocation to the recipient, with either or both parties attaining a better after-tax

99Id. at 5.
100Task Force Private Ordering, supra note 96, at 6.
101Id.
102Id.

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result. Tricky questions under state law sometimes arise, and anything less than careful planning and drafting can prove costly. . . .

In addition, the document addressed how the “support” obligation could be used by the parties:

In most cases, includable/deductible treatment under [s]ection 71 is available only for payments based on the payor’s support obligation under state law. In many states, though, this obligation can be met by either a property allocation (perhaps in installments) or includable/deductible periodic payments. Accordingly, parties often attain their objectives by contractually defining the level of the recipient’s support need in the desired manner taxwise and then providing for an appropriate stream of payments in the context of either the support section or the property section of their agreement, depending solely on tax considerations. For example, assume that a wife’s support needs could be met with $5,000 of alimony per month, that the husband could pay this amount, but that $3,000 of alimony per month would bring the parties’ projected taxable incomes into equilibrium. A tax-oriented agreement could provide for the $3,000 monthly alimony, but nevertheless “feather into” the property division an equivalent of the projected after-tax net of an additional $2,000 in monthly alimony.

Summarizing its position, the document further stated:

[Pl]rgrassivity is not, and has not been, a significant element of the present domestic relations tax system. Contrary to undermining the progressivity principle, therefore, the Task Force’s recommendations are intended to simplify the mechanism by which parties may effect the kind of income-shifting sanctioned by present law.

Perhaps it was the explicit use of the term “income-shifting” in the last-quoted sentence that raised red flags. That term has always carried negative connotations involving abuse entailed by shifting income from someone in a higher tax bracket to someone in a lower tax bracket while nevertheless retaining control over it by keeping it “all in the family.” In any event, a subsequent meeting of various government officials, representatives of the ABA Tax Section, and the AICPA Tax Division on November 19, 1982, raised the question of whether “income-shifting” between divorcing spouses under sections 71 and 215 ought to be ended entirely by repealing those sections altogether. This prompted the Task Force to issue yet another report in January of 1983, defending the income-shifting principle in divorce. The members of the Task Force “unanimously

104Id. at 7.
105Task Force Private Ordering, supra note 96, at 8. The document also argued that the “private ordering” proposals were consistent with trends in substantive state domestic relations law, particularly the increasing emphasis on privately negotiated divorce agreements (as opposed to judicially crafted ones). See id. at 8-9.
106See infra notes 260-314 and accompanying text (describing the assignment-of-income doctrine).
concluded (1) that repeal of sections 71 and 215 would not simplify federal tax law, (2) that such a measure would be contrary to other basic tax policies, such as equity and rationality, and (3) that appropriate tax simplification can be achieved without such a drastic step.\textsuperscript{108}

With respect to item (1), the report is not completely persuasive. Making all payments in a divorce tax-neutral should be simple. An argument to the contrary was that states would react by creating property rights in the wife regarding the ex-husband’s income stream that would operate to shift taxation to the wife in any event, thus frustrating the repeal of section 71 and introducing new complexities. The Task Force characterized the argument as follows:

From the standpoint of state legislatures, if the recent “anti-Davis statutes” are viewed as providing any clues—and, in the opinion of the Task Force, they should be so viewed—the repeal of [s]ections 71 and 215 would surely lead to a continuation of efforts to defeat unpopular federal tax rules in the domestic relations tax area via the “back door.” The focus would shift, of course, from the “property rights” of a non-titled spouse in “marital property” to such spouse’s “rights” in the post-divorce income the other party. The consequences—i.e., frequent changes in state property and divorce laws—would likely lead to further complexities, controversy, and uncertainty, as well as to disparate results for essentially comparable transactions occurring in different states. Further, as is the case with present law, the government would simply be whipsawed in a multitude of cases, as many ex-spouses would surely take inconsistent positions on their returns.\textsuperscript{109}

It is difficult to evaluate whether the dire forecasts regarding the reaction of states to such a legislative change would actually transpire. The Task Force’s stronger arguments were that such a change would be contrary to common notions of fairness and flexibility and that repealing sections 71 and 215 in the name of simplification would be tantamount to throwing out the baby with the dirty bath water, as “most of the attainable goals in terms of tax simplification can still be achieved with other reform measures.”\textsuperscript{110}

While the high war-time marginal rates in 1942 surely were the precipitating factor in shifting the tax burden on “tax alimony” (which, as we have seen, is a term that mirrors “alimony” for state law purposes only coincidentally) to the payee, taxation of the recipient also accorded with other commonly held norms of tax fairness. As the Task Force noted:

The commonplace perception that income-shifting under [s]ections 71 and 215 is fair and equitable as a matter of federal tax policy stems from numerous factors. For purpose of clarity, though, it should be noted that the term “income-shifting” is misleading. The question presented is not whether income should be shifted from one spouse or ex-spouse to the other, but whether the income that in fact is shifted between the parties by local law should or should

\textsuperscript{108} Id. at 1-2.
\textsuperscript{109} Id. at 3.
\textsuperscript{110} Id. at 9-10.
not be taxed to the recipient. As indicated, various factors point to an affirmative answer to the foregoing question . . . .  

The Task Force then listed some of these factors. First on the list was the fact that the recipient has control over the cash received, which has always been a prime factor in the income-shifting area in determining who, between two parties, should be taxed on income. "[T]hese elements of control make it far more equitable to tax alimony to the recipient, the party who is actually consuming it and who has the 'cash flow' from which the tax dollars can reasonably be expected to come." The Task Force next contended that eliminating income-shifting would discriminate between well-to-do couples with income-producing property, who would effectively be able to continue to engage in income-shifting by transferring such property in satisfaction of support obligations, and less wealthy couples.  

The Task Force also argued that the collective tax burden on the divorced couple would be higher if sections 71 and 215 were repealed than under either the current law at that time or the proposed changes, since most payors were probably in higher tax brackets than their recipients. Thus, denying a deduction to the higher-bracket taxpayer and allowing an exclusion to the lower-bracket taxpayer would probably result in more dollars going to the Treasury than under either a rigid inclusion/deduction system or private ordering. "Since divorce frequently strains liquidity to the breaking point anyway, in the view of the Task Force, such a harsh result, i.e., divorce per se pushing incomes into higher brackets, should be avoided, if possible." Finally, the Task Force derided the sacrifice in flexibility inherent in a rigid exclusion/non-deduction system:  

[T]he "Lester" principle . . . allows parties with children considerable room for tailoring their own settlements; and this ability for so many divorcing couples to set their own framework to a significant extent is a major factor contributing to settlements of more than 90% of all divorces at a stage short of a full-blown court contest . . . . Thus, elimination of [s]ections 71 and 215 from the Code would not only deprive parties of much flexibility, but would surely prove counterproductive for the settlement process in general. The result, of course, would be an increasing number of cases going to full contest in state courts. Actually, the success generally ascribed to the "Lester" principle—as a rule that maximizes flexibility, as well as one that is generally understood—has been a major factor taken into consideration by the Task Force in developing its recommendations for the "[s]ection 71 private ordering rules."  

After almost six months to the day, the Ways and Means Committee of the House of Representatives introduced H.R. 3475, the Tax Law Simplification and
Improvement Act of 1983, a portion of which dealt with divorce taxation, and convened hearings.\textsuperscript{117} The bill proposed to enact new section 1041, which would provide that "[n]o gain or loss shall be recognized on a transfer of property from an individual to (or in trust for the benefit of) (1) a spouse, or (2) a former spouse, but only if the transfer is incident to the divorce."\textsuperscript{118} The transferee would exclude the value of the property, as though it were received as a "gift,"\textsuperscript{119} and would take a carryover basis in the property. A transfer would be considered incident to divorce if it occurred within one year of the marriage ceasing or was "related to the cessation the marriage."\textsuperscript{120} Section 1015, which normally governs the basis of property received by gift, was proposed to be amended so that transfers described in section 1041 would be governed by the carryover basis rule described there instead of the general gift basis rules.\textsuperscript{121} Thus, \textit{Davis} would be put to rest, with no "private ordering" option provided to the divorcing parties to opt out of the new provision so that a transfer could be a recognition event for the transferor and result in a fair market value basis for the transferee.

With respect to sections 71 and 215, the bill cherry-picked some of the Task Force's recommendations, rejecting others. Consistent with the Task Force's recommendations, it carried forward the \textit{Lester} Rule intact. That is to say, amounts "fixed" for child support would be excludable/nondeductible payments, with no mention that reductions relating to contingencies connected to the children would result in a portion of such payments being labeled as "child support." Thus, private ordering would be \textit{de facto} continued, with parties able to determine for themselves (so long as they knew the magic words) how much of a total "family support" obligation, if any, should be taxable to the recipient and deductible by the payor, or vice versa.\textsuperscript{122}

The bill also accepted the Task Force's view that only cash payments should be eligible for the inclusion/deduction system of sections 71 and 215\textsuperscript{123} but that cash payments intended to compensate the recipient for an interest in property should not fall within it. It rejected, however, the Task Force's suggested means by which to differentiate cash support obligations from cash property settlements. The Task Force's approach\textsuperscript{124} required netting cash payments against the value of any "hard assets" surrendered by the cash recipient, with only the excess amount being eligible for the inclusion/deduction system. Rather, the proposals appear to have attempted to differentiate cash property settlements

\begin{footnotesize}
\begin{enumerate}
\item\textsuperscript{117} \textit{Tax Law Simplification and Improvement Act of 1983: Hearing on H.R. 3475 Before the House Comm. on Ways and Means, 98th Cong. 98-40 (1983) [hereinafter \textit{House Hearing}].}
\item\textsuperscript{118} \textit{Id. at 18.}
\item\textsuperscript{119} Gifts, subject to exceptions not relevant here, are excludable from gross income under section 102(a).
\item\textsuperscript{120} \textit{House Hearing, supra} note 117, at 19.
\item\textsuperscript{121} \textit{See id.; see also infra} note 314 (describing the gift basis rules in connection with considering whether section 1041 should be amended to carve out transfers between spouses not incident to divorce).
\item\textsuperscript{122} \textit{See House Hearing, supra} note 117, at 22-23.
\item\textsuperscript{123} \textit{See id. at 21.}
\item\textsuperscript{124} \textit{See supra} notes 89-94 and accompanying text.
\end{enumerate}
\end{footnotesize}
from support obligations in the following three-pronged manner.

To be eligible for the inclusion/deduction system, the payment could not be "made for a transfer of property by the payee spouse." That, obviously, would constitute an explicit carve-out for cash property settlements. But what if the parties did not label the cash payment as a payment for an interest in property? The following two, more subtle requirements attempted to identify disguised property settlements. First, the liability to make the payment had to end with the recipient's death, and there could not be any obligation to make any substitute payments after the death of the payee spouse. The notion, presumably, was that a recipient spouse would demand that even her estate be entitled to payment after her death if the payment were really a cash property settlement rather than a support payment. Thus, she would agree to the payments stopping on her death only if, in fact, they constituted support payments (which, since she was dead, she would no longer need). One might recall that inserting this kind of contingency clause was one means by which taxpayers could prove that a payment was "periodic" under the 1942 rules, since the contingency transformed the payment amount into an "indefinite" amount. What the drafters did was essentially to incorporate into the statute that one means of proving that a payment was "periodic," removing the "periodic" language itself but keeping its "soul," if you will.

Second, the payment had to be "[one] of a series of cash payments where it is reasonable to expect at least 50 percent of the amount payable under such series will be paid more than [one] year after the date on which the first of such payments is made." The underlying assumption here was that payments concentrated into a short period after the divorce were more likely to constitute a property settlement than a support payment. Instead of the more-than-ten-year payment period required under the 1942 rules, however, the bill proposed to shorten it dramatically to just over a year.

The one new nod to "private ordering" adopted in the proposed bill was that payments otherwise eligible for the inclusion/deduction system could be labeled as excludable/nondeductible payments by the parties in their agreement. In other words, the parties could opt out of the inclusion/deduction system with respect to a payment that would otherwise qualify as a "support" payment (rather than a property settlement) under the tests described above. The parties could not, however, opt "into" the inclusion/deduction system with respect to a payment that did not otherwise qualify because, for example, there was no require-

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125 See supra note 117, at 21.
126 See id. at 22.
127 See supra notes 47-51 and accompanying text.
128 See supra note 117, at 22.
129 For example, suppose that a decree required that a payment of $10,000 be made on January 20 of year one and a second payment of $11,000 be made on January 25 of year two. Both payments could be eligible for the inclusion/deduction system, because at least 50% of the stream of payments was paid more than one year after January 20 of year one, the date of the first payment.
ment that the payment stream stop on the recipient’s death.

Finally, the bill proposed to simplify the rules regarding who was entitled to the dependency exemptions for minor children of the divorced couple by essentially creating a default rule that the custodial parent could take the exemptions, unless she properly assigned them to the noncustodial parent. Thus, all of the litigation over who provided more dollars in support of the children would disappear.

Only three people testified with respect to the portion of the bill dealing with divorce taxation at the hearings, but each of the three was a powerful and respected commentator. The first was Ronald A. Pearlman, Deputy Assistant Secretary (Tax Policy), Department of the Treasury. He spoke forcefully in favor of proposed section 1041, the anti-Davis provision applicable to in-kind property transfers. With respect to the alimony provisions, however, he objected to “the complete elimination of the periodic payment requirement and 10-year rule requirement presently contained in the Code.” He believed the rules adequately distinguished “property settlements” from “support payments” and that only the latter ought to fall within the inclusion/deduction system. He said, “[w]hile the precise application of these requirements has generated a fair amount of controversy in the past, they do remain as important safeguards for preventing nondeductible property settlements from being treated as alimony.”

The changes advocated by Mr. Pearlman included: reducing the ten-year payment period to five years; measuring the period by reference to the first payment instead of the date on which the divorce decree became final; providing that any payments mandated for a period of less than five years would not qualify as “alimony,” even if a “contingency” clause were inserted so that the payments would stop on the death or remarriage of the recipient spouse; providing that any payments that were not mandated for any specific period would qualify as “alimony” if a contingency clause were inserted, even if the payment period turned out to be less than five years because the contingency transpired; and allowing a maximum deduction in any one year of no more than 20% of the total amount of a principal sum provided in the divorce decree. He testified as follows:

We recognize that eliminating the contingency rule might have the effect of denying alimony treatment to some series of payments made over a relatively short period, even where the payments are intended for the support of the

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131 See id. at 26-28.
132 See supra notes 92-94 and accompanying text.
133 See House Hearing, supra note 117, at 150. Mr. Pearlman is now a professor at Georgetown University Law Center. He hopes his testimony 17 years ago will not dissuade Congress and the Treasury Department from taking a “fresh look” at this area of law to determine whether any changes are warranted today.
134 See id. at 152.
135 Id. at 153.
136 Id. at 153.
137 See id. at 153-54.
recipient spouse. We believe these situations will be rare, however, because the proposed rules would be readily understandable by the parties. . . . While we recognize that support payments lasting less than five years would not be deductible, in our view any slight disadvantage from that result would be more than offset by the simplicity and certainty that the proposed system would provide.

We also believe this proposed approach is preferable to the rule of the bill requiring that it be "reasonable to expect" that at least one-half of the amounts payable in a series will be paid more than one year after the first payment. In effect, this reduces the ten year period to two years. We are concerned that such a short time requirement does not provide a meaningful safeguard.\textsuperscript{138}

The second person to testify regarding the divorce provisions was M. Bernard Aidinoff, a partner in the law firm of Sullivan & Cromwell, testifying in his capacity as Chair of the ABA Section of Taxation.\textsuperscript{139} He, too, strongly supported proposed section 1041,\textsuperscript{140} but he disagreed with Mr. Pearlman’s criticisms of the proposed changes to the definition of "alimony."

I would like to comment, however, on the statement made by Deputy Assistant Secretary Pearlman on the elimination of the periodic payment test. We of the section of taxation believe what is in the bill, which is basically an elimination of most of the periodic payment test, is a much simpler provision, a much fairer provision, and one which represents more reality in today’s situation where couples are more anxious to disengage themselves completely when a divorce or separation is involved.

In many respects, the tax section would have gone further than what is in the bill. But we think that the bill in its present form, in dealing with this question, is an appropriate balancing of interests and one that should be adopted.\textsuperscript{141}

Mr. Aidinoff had one strong criticism of his own, however, and that was the proposal that at least 50\% of the total payment amount must be paid more than one year after the first payment if the payments were to qualify as includable/deductible payments. As Mr. Aidinoff explained:

Contrary to an overall purpose of Title II [which contained the proposed amendments regarding divorce taxation], as stated in the technical explanation, [the proposed rule] serves to preserve a "periodicity" requirement for alimony as a result of the proposed "one of a series" language. Such a requirement and the "reasonable to expect" and the "at least 50 percent" requirements also inject subjective tests into the alimony rules, especially in cases involving fluctuating amounts for support (e.g., 30 percent of an ex-husband’s earned income). As

\textsuperscript{138}Id. at 153-54. Mr. Pearlman also strongly supported the proposed amendments concerning which spouse should be entitled to the dependency exemptions for minor children.

\textsuperscript{139}See House Hearing, supra note 117, at 203.

\textsuperscript{140}"At long last the bill presents a legislative solution to the problems created by the Supreme Court in its 1962 Davis decision which made taxable the transfer of appreciated property in a divorce settlement. This alone would be a major accomplishment. . . ." Id. at 204.

\textsuperscript{141}Id. at 204.

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demonstrated by the unfortunate experience under present law, such subjective tests are frequent traps for the unwary, as well as productive of much tax controversy. The effect of [the proposed rule], therefore, would be to continue these extremely undesirable aspects of present law.

Also contrary to an apparent objective of Title II, [the proposed rule] flies in the face of local divorce statutes and trends. The comments in the technical explanation imply that a "one-time lump-sum payment" (or similar payment) can never be intended for support. This perception is erroneous, as in the vast majority of states today support needs of one spouse can be and are frequently met, in whole or in part, with a one-time transfer. Moreover, the trend today (particularly if there are no children involved) is for ex-spouses to "disengage" in their relationships with each other; and support to an ex-spouse for a short period—e.g., 6, 12, 18 months—is common. In this regard, the effect of [the proposed rule] is to militate against Federal tax law harmonizing well with State substantive divorce laws.

One inference that can be drawn from the comments in the technical explanation on [the proposed rule] is that the proposed rule stems from the notion that it is contrary to sound tax policy for a single one-time lump-sum payment to be accorded "includable/deductible" treatment. The [ABA tax] section does not share this view, especially since it believes that the fundamental tax policy for a basic alimony and separate maintenance rule should be that the taxpayer who consumes the payment(s) should be the one to bear the correlative tax. Moreover, in most cases, a one-time lump-sum payment (or a short-term series of payments) involving a relatively small dollar amount is intended to be solely for the recipient's support. On the other hand, if substantial dollars are involved and the payment(s) are plainly intended to meet both support rights and other marital rights, overall tax revenues to the Government would rarely be reduced anyway, due to "bunching of income" for the recipient [which would push the recipient into a higher tax bracket with respect to the payment]. In either case, [the proposed rule] serves no meaningful purpose in relation to the basic objectives of Title II.

Another major weakness of [the proposed rule] would appear to be the ease with which it could be avoided, particularly in cases in which substantial dollars (and sophisticated parties and/or counsel) are involved. Thus, it would seem that the situations that the proposed rule is intended to snare would rarely occur, as taxpayers in those situations would simply "draft around" the rule. Realistically, parties for whom [the proposed rule] would pose the most difficulties are likely to be less substantial and/or less well- advised taxpayers.\footnote{Id. at 209-10.}

Mr. Aidinoff also made the point that the current flexibility represented by the 
\textit{Lester} Rule should continue:

An important interpretation of [the treatment of "child support"] is contained in 
\textit{Lester v. Commissioner}. . . . The Technical explanation, however, does not elaborate on [the treatment of "child support"]). The section suggests, therefore,
that the committee's report on the legislation indicate that no change is intended in the child support area, including the principles enunciated by the U.S. Supreme Court in the *Lester* case.\footnote{143}{Id. at 210. Mr. Aidinoff supported the proposed changes to the dependency exemption provisions as well. See *id.* at 211.}

The final person to testify was Marjorie A. O'Connell, a partner in the law firm of O'Connell & Associates and a member of the ABA Task Force.\footnote{144}{See *id.* at 263.} Like her predecessors, Ms. O'Connell supported proposed section 1041.\footnote{145}{See *id.* at 267.} With respect to the definition of "alimony" eligible for the inclusion/deduction system, she had several suggested changes. First, with respect to the provision that payments for the transfer of property rights not be eligible for alimony status, she urged that the term "property" be defined to include only hard assets: "This rule should not apply to any release of an inchoate property right such as rights under an equitable distribution statute."\footnote{146}{Id. at 267-68.} Ms. O'Connell also urged deletion of the requirement that payments must cease upon the death of the payee:

> While support needs of the recipient is the cornerstone of alimony, death does not always terminate those needs. For example, spouses may value the recipient's support rights for life at $200,000 based on his or life expectancy. Instead of paying this amount for life, the payor may want to pay it over a shorter period. If the recipient dies before the end of the shorter period, any continuing payments would be in respect of a support obligation. The recipient may have post-death obligations that those payments would run to, such as the pay-off of debts incurred to meet support needs during life. This is often the case where serious medical problems cause the recipient's precipitous death. While I understand the genesis of the post-death prohibition, I urge that the committee seriously consider deleting this provision from the bill.\footnote{147}{Id. at 267.}

As did Mr. Aidinoff, Ms. O'Connell also challenged the rule requiring an expectation that at least 50% of the total stated payments would be made more than one year from the first payment.

> This rule is the last vestige of the current periodicity requirements that have caused so many problems. The apparent evil this rule strikes at is a lump sum payment for support in the year of divorce. This type of arrangement is rarely done and virtually never for tax reasons. . . . Nevertheless, I submit that this 50-percent rule is an unnecessary complication. Moreover, the application of this rule would require a subjective evaluation of future events to determine what is the time period in which it is "reasonable to expect" for payments to be made.\footnote{148}{Id. at 268.}

Finally, Ms. O'Connell advocated that the implicit flexibility inherent in the *Lester* Rule be transformed into an explicit election so that all parties, not only those knowing the magic words, could decide for themselves who would pay tax on the amounts paid out as child support.

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\footnote{143}{Id. at 210. Mr. Aidinoff supported the proposed changes to the dependency exemption provisions as well. See *id.* at 211.}
\footnote{144}{See *id.* at 263.}
\footnote{145}{See *House Hearing, supra* note 117, at 267.}
\footnote{146}{Id. at 267.}
\footnote{147}{Id. at 267-68.}
\footnote{148}{Id. at 268.}
Under [Lester], payments made "for the support of a spouse and children" are all alimony. I believe the statute should contain at least this continuation of present law. I urge serious consideration of a further refinement. Parties should also be allowed to designate fixed child support as taxable to the recipient parent and deductible by the payor parent. This would accomplish two beneficial results. First, Lester has proven to be a trap for uniformed taxpayers. Divorcing spouses may enter into arrangements without understanding the tax differences of fixing child support. Second, both state and federal law often give greater protection to enforcing solely child support obligations. For example, the amount designated for support in a Lester arrangement has been held not exempt from a wage levy for federal taxes, while a fixed child support obligation would have been exempt under section 6334(a)(8). Thus a payor's means to pay child support may be removed by the very federal taxing system one would hope would encourage payment or at least be neutral. If parties could fix a separate child support payment but preserve its alimony treatment, they would be more likely to fix an amount for child support payments. This would help enforcement of child support obligations.  

After further negotiations among the staffs of the House Ways and Means Committee and the Joint Tax Committee, the Task Force, and representatives of the Treasury Department, some of these suggestions were taken to heart in the bill actually passed by the House. The bill retained unchanged the proposed section 1041 regarding the nonrecognition of gain or loss on in-kind transfers of property and the simplified dependency exemption rules. The bill also retained unchanged the rule that amounts "fixed" for child support were excludable/nondeductible payments, with the Lester Rule gloss that an unallocated "family support" payment could constitute includable/deductible "alimony" in full, even if the payments were reduced upon events relating to the children. The remaining components of the definition of "alimony," however, did undergo some significant changes.

Under the House bill, "alimony" falling under the inclusion/deduction system had to satisfy the following requirements: It had to be in cash and be received by (or on behalf of) the former spouse; it had to be paid under a decree of divorce or separate maintenance, or under a written instrument incident to the divorce, a written separation agreement, or a decree requiring support or separate maintenance; the divorced or legally separated parties could not be members of the same household at the time of payment; the payment had to terminate at the death of the payee spouse and there could not be any obligation to make a substitute payment after the death of the payee spouse; the parties could not

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149 Id. Ms. O'Connell also urged adoption of the proposed changes to the provisions governing dependency exemptions.

150 See Marjorie A. O'Connell, The Domestic Relations Tax Reform Act: How We Got It and What We Can Do About It, 18 Fam. L.Q. 473, 492-93 (1985) (describing the negotiation of the "recapture compromise").


152 See id. at 197-99.

153 See id. at 195.

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have designated the payment as "not alimony" that was excludable/nondeductible; and the amount could not have been "fixed" as child support. Thus, the language specifying that the payment must not be in payment for property was deleted, as was the language requiring that at least 50% of the payment must be expected to be made more than one year after the first payment. The underlying idea of the latter provision was, however, carried forward in a new (and complicated) "recapture" provision in newly proposed section 71(f).

As described by the House Report:

[If] alimony payments in the first year exceed the average payments in the second and third year by more than $15,000, the excess amounts are recaptured in the third year by requiring the payor to include the excess in income and allowing a payee who previously included the alimony in income a deduction for that amount. . . .

In effect, the prior inclusion of the payee and deduction of the payor would be "reversed" in the third year by allowing the original payee to deduct the "excess" alimony and requiring the payor to include the same amount as "phantom income." Recapture would also apply if payments in the second year exceeded payments in the third year by more than $15,000. The House Report provided the following example:

[If] the payor makes alimony payments of $50,000 in the first year and no payments in the second or third year, $35,000 will be recaptured. . . . If instead the payments are $50,000 in the first year, $20,000 in the second year and nothing in the third year, the recapture amount will consist of $5,000 from the second year (the excess over $15,000) plus $27,500 for the first year (the excess of $50,000 over the sum of $15,000 plus $7,500). (The $7,500 is the average payments for years two and three after reducing the payments by the $5,000 recaptured from year two).156

The Senate had no provisions dealing with the taxation of payments in divorce in its 1984 companion bill. As described by both Marjorie O'Connell and Barb Mattei, the Conference Committee convened to forge a compromise bill became a contentious battleground, where staff members of the Senate Finance Committee strongly advocated complete elimination of the alimony deduction.157

Ms. Mattei reports that the Finance Committee staff members viewed the taxation of support payments from the "what-is-income" perspective, arguing that because support payments (whether child support or alimony) did not con-

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154See id. at 193-96.
155Id. at 195.
156Id. at 196. The recapture rules would not apply if payments decrease because of death or remarriage or because of an obligation to pay a constant percentage from a fluctuating source of income. Nor would they apply to temporary support payments.
157See O'Connell, supra note 150, at 494-97; Mattei, supra note 42, at 193 n.120. Ms. O'Connell, as a member of the ABA Task Force, was a close observer of these events. Ms. Mattei conducted a telephone interview with Mr. Harry Graham, Senate Finance Committee staff tax counsel, for her Note on the topic.
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tribute toward earning the payor's income, it should be considered nondeductible personal consumption.\textsuperscript{158} They argued that the only reason why this approach was abandoned in 1942 was the high war-time marginal rates then in effect and that, with the much lower 50% top marginal rate in effect in 1984, there was no longer any justification for the alimony deduction.\textsuperscript{159} Ms. O'Connell described in detail the machinations that then transpired, which are worth a lengthy quotation to get a flavor of how we ended up with the final product.

On May 23, 1984, the author [Ms. O'Connell] learned from a House member's office that the Finance Committee staff was trying to organize women's groups to support the elimination of the alimony deduction. The next day, O'Connell met with representatives from the Congressional Caucus on Women's Issues, the National Organization of Women, the Women's Equity Action League, the National Association of Business and Professional Women, and the National Women's Political Caucus. The author implored these women to recognize that without the alimony deduction payors would be far less inclined to meet their spousal support obligations as well as their child support obligations for which a deduction was available under \textit{Lester}. She explained the income shifting principle. The author urged the women's groups to oppose the elimination of the deduction and to support the House bill.

Finance Committee staff members met on May 29, 1984, with various women's groups representatives. From several sources, it was reported that the staff members argued that the ABA had never considered if alimony should be deductible, that the ABA had never consulted the Finance Committee about the Task Force's proposals, and that the alimony deduction hurt women. In addition, the staff members suggested that without support from the women's groups for the elimination of the alimony deduction, the Senate conferees might maintain the deduction, but instead, would oppose the repeal of the \textit{Davis} rule. The staff members claimed to have conferred with law professors who called the alimony deduction irrelevant. Indirectly, the Finance Committee staff members raised the specter of trouble for retirement equity provisions pending in the Senate if women's groups did not support the alimony deduction repeal.

On June 4, 1984, the author learned from a Ways and Means staff member that the Finance staff, at a pre-conference meeting, had offered to support [the remaining provisions of the bill, including \textit{Davis} repeal,] in exchange for the elimination of the alimony deduction.

Publicly, at this time, the Finance Committee first claimed that it had no plan to repeal the alimony deduction, but later admitted to considering the proposal, although both the committee chairman's staff and the committee staff demurred that no final decision had been reached about alimony. One factor that drew the staffs out on the issue was that in late May and early June, Divorce Taxation

\textsuperscript{158}See Mattei, \textit{supra} note 42, at 193 n.120.

\textsuperscript{159}It is not clear from the reported discussions whether the Finance Committee staff members also advocated repeal of section 71, so that alimony payments would revert to being excludable, or whether such payments would also remain includable by the payee. \textit{See infra} notes 241-42 and accompanying text.

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Education, Inc. (DTE), plunged into the fray to convince the Finance Committee that opposition to the elimination of the alimony deduction was prevalent and strong. DTE was formed to educate attorneys and other concerned persons about domestic relations tax issues. Free of organizational strictures on lobbying activities and public statements, DTE contacted members of Congress and organized support coverage for the issue to save the alimony deduction and the House bill.

Meanwhile, the conferees from the Ways and Means and Finance Committees convened in early June. . . . On June 7, 1984, the conferees approved the dependency exemption [provisions]. . . . Conferees and staff members from the Senate Finance Committee refused to announce publicly when they would raise the alimony and property provisions.

On Friday, June 15, 1984, the Senate sent an offer to the House via staffs to rescind the House bill's alimony and property provisions if the alimony recapture rules were made more stringent and were extended from three to ten years, and if Lester were restricted. No staff meetings were scheduled for that weekend, but an impromptu (or perhaps late scheduled) meeting on Saturday, June 15, 1984, reportedly resolved the alimony and child support issues in ten minutes.

The discussion of alimony and child support began with an offer from Finance Committee staff members to support the repeal of Davis in exchange for the elimination of the alimony deduction. When Ways and Means staff members rejected the suggestion . . . . Finance countered with an offer that deductible alimony be limited to payments over ten years. Ways and Means rejected the term as too long, and a Treasury representative reiterated the recommendation for a five-year term that Treasury had made at the H.R. 3475 hearings. The staff members agreed to a compromise requirement that payments must extend over sixty years to qualify as alimony unless they were to end on a payee's death or remarriage or a payor's death. Recapture would be calculated over six years as well. In addition, Ways and Means staff members acceded to the Finance staff members' suggestion that the Lester rule be repealed, making all child support nondeductible whether or not commingled with spousal support.

The conferees adopted these staff proposals on Monday, June 18, 1984. Then the staff members, primarily those from the Joint Committee, set out to draft language for the Conference Committee's bill. Not until June 22, 1984, was the language of the Conference Committee's . . . provisions available to the public. The bill provided that to qualify as alimony, support payments must extend for at least six calendar years to the extent that the payments exceed $10,000 per year. The divorce or separation instrument had to provide explicitly that payments end on the payee's death or remarriage or a payor's death. Recapture would be measured over six years. The basic rule would be that the amount of each payment made during the first six post-separation years must not be $10,000 greater than any earlier payment made during that time. To the extent that an earlier payment would exceed a later payment by $10,000, the difference would be income to the payor and a deduction from gross income to the payee. To the extent that any payments would be reduced due to a contingency that related to a child's reaching a specified age, marrying, dying, or leaving school, the payments would be treated...
as fixed for child support, not as alimony. Any contingency that was clearly associated with such an occurrence would have the same effect.

A few days after the Conference Committee report was issued, the Conference Committee’s bill passed both houses. The President signed it into law on July 18, 1984.\(^{160}\)

2. The Final Results

Thus, the Deficit Reduction Act of 1984\(^{161}\) (the “1984 Act”) introduced section 1041, essentially repealing the *Davis* result for all in-kind property transfers, and substantially amended the definition of includable/deductible “alimony” in section 71 and 215.\(^{162}\) The new alimony recapture rules were particularly complex.\(^{163}\)

The criticisms of the new alimony rules began almost immediately.\(^{164}\) The abandonment of the flexibility to create fully deductible unallocated “family support” payments that contained an element of child support was criticized.\(^{165}\)

This proposal, which first surfaced in the Conference Committee, came as a surprise to everyone. The flexibility inherent in the *Lester* Rule was supported by the Task Force’s various reports and was never questioned either in the meetings between the Task Force and government officials throughout the process or in the formal hearings held by the Ways and Means Committee.\(^{166}\)

It seems that revocation of the *Lester* Rule was used solely as a bargaining chip in conference by those who wished to repeal the alimony deduction entirely in the quest to at least narrow the “alimony” deduction. The required six-year payout

\(^{159}\)O’Connell, *supra* note 150, at 494-97.


\(^{161}\)Section 215 continued to provide an alimony deduction for all payments that were includable under section 71 as “alimony.”

\(^{162}\)The Conference Committee Report gave the following example of how the recapture provisions would work.

Thus, for example, if alimony payments of $25,000 are made in year 1 and payments of $12,000 are made in year 2, then $3,000 will be recaptured in year 2. If the payments further decline to $1,000 in year 3, then, in year 3, an addition $11,000 will be recaptured from year 1 and $1,000 will be recaptured from year 2. If, prior to the end of year 6, payments further decline, additional recapture will occur.

\(^{163}\)Ms. O’Connell reports:

At the ABA’s annual meeting in Chicago on August 2, 1984, the Council of the Tax Section adopted a resolution at the task force’s request. This resolution directed the officials of the Section to inform Congress that the new alimony rules create significant technical problems. The resolution further directed these officials to request from Congress either a technical correction in the alimony provisions by the end of 1984 or a one-year delay in the effective date of the provisions. The Tax Section made these requests, but abandoned its efforts on confronting adamant opposition from the Senate Finance Committee staff.


\(^{164}\)See id. at 500-01.

\(^{165}\)See Mattei, *supra* note 42, at 204.
period was also criticized as being inconsistent with the growing trend toward short-term "rehabilitative alimony" to provide the payee with support for a short period while she gained job training or attended college.\textsuperscript{167} Finally, the alimony recapture rules were also criticized as being complex and containing fundamental flaws:

State laws make court-ordered alimony payments subject to change under many circumstances. Recapture could occur if payments were reduced under these laws even though the payor was fulfilling his obligations under state law. Recapture resulting from modifications under state law could produce other anomalous results. For example, in most states a court must modify alimony if the parties' circumstances change. If a payor's obligation is so reduced because the payor's income has decreased, then the payor will be subject to recapture when he or she is already in adverse financial circumstances. Or, for example, an automatic termination of alimony payments occurs in many states when a court finds that the payee is cohabiting, without marriage, with another party of the opposite sex. Such termination could lead to significant recapture with a large deduction for the payee for whom state law intended no further accrual of financial benefits. In addition, a payee in most states may waive his or her right to support. If a payee did so at the end of the fifth year, recapture would occur in the sixth year. . . . [T]he resultant deduction to the payee could be more beneficial than receiving the sixth year of alimony would have been. However, the payor could be forced to include a far larger sum in income than the payor would have paid as deductible alimony.

Finally, factors beyond the control of either party or of a court could cause recapture under circumstances where the recapture hardly seems fair. For example, payors often must bear the costs of their former spouse's post-divorce medical costs. If such costs are large during one year of the first five years after divorce, then a significant recapture amount could result in the following year when normal payments resume. Similarly, if a payor loses his job and misses a payment, recapture based on the earlier year's payment would occur. If the payor made up the arrearage in a later year, thus greatly increasing his payment that year, additional recapture would occur in the following year. Such results seem inequitable, particularly because the payors in both examples meet their obligations under local law and do so by the end of the six-year period.\textsuperscript{168}

Perhaps due in part to such criticisms, the statute did not lie in repose for long. The Tax Reform Act of 1986\textsuperscript{169} (the "1986 Act") amended the alimony definition yet again to eliminate the six-year payment period, to reduce the recapture period to three years, and to increase the recapture trigger amount from $10,000 to $15,000,\textsuperscript{170} exactly like the first compromise recapture rule proposed in the original House bill in 1983.\textsuperscript{171} It also repealed the requirement

\textsuperscript{166}See O'Connell, supra note 150, at 499.
\textsuperscript{167}Id. at 498.
\textsuperscript{169}I.R.C. § 71(f).
\textsuperscript{170}See supra notes 155-56 and accompanying text. The example given from the 1983 House Report is precisely the example given in the 1986 Conference Report regarding how the amended provision would work.
that the divorce or separation instrument explicitly provide that the obligation to make payments otherwise qualifying as "alimony" for tax purposes ends on the payee's death.\textsuperscript{172} The obligation to continue making payments must end, but it is sufficient if state law would automatically require the payments to stop, even if the governing document is silent in this respect. The 1986 Act retained, however, the repeal of the \textit{Lester} Rule, as well as all other aspects of the amended alimony definition adopted in 1984.

\section*{II. THE GOOD, THE BAD, AND THE UGLY}
\subsection*{A. Cash Payments}

So where are we today? While I think the law was, on balance, improved in 1984, it continues to generate an overabundance of confusion and litigation, as briefly described in Part II.A.1 below, an unfortunate and unnecessary cost to both the government and divorcing couples. This is particularly true since, as the discussion below will show, these disputes result not from law that is premised on firm theoretical foundations and the resulting necessary complexity required to successfully differentiate "alimony" from "child support" from cash "property settlements." Rather, the discussion will show that it is \textit{impossible} to differentiate successfully among these payments. Furthermore, state courts and divorcing parties no longer tend to think in terms of the strict definitional categories that historically applied. Indeed, only the drafters of the Code continue to insist on compartmentalizing the world in this fashion. Moreover, the huge costs and frustrations incurred in the classification effort serve \textit{only} to determine which person's marginal tax rate will apply to cash payments transferred between the parties as a result of divorce or child support obligations outside divorce. Very little revenue is likely at stake here. Finally, much misunderstanding and litigation is due chiefly to the Code's insistence on making the parties' flexibility to decide to whom cash payments should be taxed dependent on the transactional form for the payments chosen by the parties, elections effectively available only to those well informed of the proper transactional structures.

As a result of the 1980s legislation, the flexibility to decide to whom cash payments should be taxed flip-flopped by category. Prior to the legislation, there was great flexibility (so long as one knew the magic words) to decide to whom amounts paid out as "child support" would be taxed and little flexibility to determine to whom "alimony," as defined for Federal tax purposes, would be taxed. After the 1980s legislation, in contrast, there was little flexibility to decide to whom "child support" should be taxed and greater (albeit still limited) flexibility to decide to whom "alimony" should be taxed.

Prior to the 1980s legislation, the parties could choose to tax the payor on child support payments by explicitly labeling the payments as "child support," which would then be excludable by the payee and not deductible by the payor.\textsuperscript{173}

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\textsuperscript{172}The Act accomplished this result by deleting the final parenthetical in section 71(b)(1)(D).

\textsuperscript{173}See \textit{supra} notes 32-35 and accompanying text.
The parties could, in contrast, choose to tax the payee by designating the payment a "family support payment," unallocated between "alimony" and "child support." Such an unallocated family support payment would be taxed to the payee because—since no amount was explicitly "fixed" as child support in the agreement—it would be includable as "alimony" and deductible to the payor (so long as the remaining requirements pertaining to "alimony" were satisfied). Under the *Lester* Rule, this would remain true even if the unallocated family support payment was scheduled to be reduced upon events clearly linked to the emancipation or death of the children, which would seem to indicate that a portion of the payment was intended by the parties all along to be, in fact, child support. There was, thus, great flexibility to determine to whom child support payments would be taxed, albeit only for the well-advised.

At the same time, there was much less flexibility regarding "alimony" within the tax definition of that term. If a payment satisfied the tax definition of alimony, it was includable by the payee and deductible by the payor, even if the parties tried to avoid this result and transform the payment into a tax-neutral "property settlement" by calling the payment a cash property settlement in the divorce agreement. If the court was convinced that the payment satisfied a support obligation, rather than a division of property, then it could rule that the payment was includable/deductible "alimony," regardless of the labels attached to the payments by the parties or even by state law, so long as the other statutory requirements were satisfied.174

As a result of the 1980s legislation, the *Lester* Rule was repealed, which meant (on the face of the statute, at least) that the parties should have no flexibility to determine to whom child support payments should be taxed. With the introduction of the rule that amounts should be considered "fixed" as child support if the payments are reduced upon a contingency directly related to one or more of the children, the drafters seemed to have intended that even "disguised" child support should be subject to a strict rule of exclusion on the part of the payee and nondeduction on the part of the payor, regardless of the wishes of the parties.

At the same time, the drafters introduced the rule that payments of "alimony" within the tax definition of that term could be designated by the parties as "not includable" and "not deductible," providing some flexibility for the parties to decide to whom "alimony" should be taxed.175 But the flexibility is constrained: The parties can elect out of the inclusion/deduction system, but they cannot elect into it. To qualify for the inclusion/deduction system, each of the requirements for tax "alimony" must be satisfied, including the requirement that the payments must stop on the payee's death, whether by agreement of the parties or under

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174See supra notes 52-60 and accompanying text.

175While there has not been significant litigation under this new "elect-out" option, a few cases have arisen, where the issue was whether the parties' language was sufficient to trigger the election. See, e.g., Schutter v. Commissioner, 2001-1 U.S.T.C. ¶ 50,142, 86 A.F.T.R.2d 7,292 (10th Cir. 2000); Jaffe v. Commissioner, 77 T.C.M. (CCH) 2167, 1999 T.C.M. (RIA) ¶ 99,196.
state law. This requirement was one means by which the drafters intended to
disallow cash property settlements from qualifying as "alimony," the other means
being the mechanical "recapture" rule that effectively re-characterizes, in the
third year, a portion of prior payments otherwise satisfying the definition of
"alimony" if the payments are excessively frontloaded. Thus, on balance, it
seems that there was little change in the overall amount of flexibility granted to
the parties to decide to whom cash payments should be taxed; only the locus of
the flexibility was flip-flopped from child support to alimony.

Part II.A.1, below, reviews some of the litigation that evidences the contin-
uing weaknesses of current law. Part II.A.2 discusses recommendations for change
regarding the taxation of cash payments in divorce.

1. The Tax Litigation

Even a cursory review of the tax litigation that has occurred since the 1984
Act confirms that change is definitely needed. Family court judges and divor-
cing parties do not themselves extricate mixed payments and categorize them in
the nice, tidy packages envisioned by the federal tax rules. They see payment
streams as mixed. It would be almost sheer coincidence if the labels attached in
section 71 actually corresponded to reality. The reality is that no one, except the
drafters of the Code, thinks that we can adequately distinguish different types of
payments from one another.

The cases also illustrate that real parties in the real world, even when repre-
sented by counsel, do not understand the current rules adequately and do not
draft agreements that reflect them. It is obvious upon reading the cases that the
parties are often taken by surprise when they find out that their assumptions
regarding who will be liable for the tax obligation turn out to be wrong.

While it is not possible to cite every case decided since 1984 dealing with the
problems under these provisions, several of the most authoritative cases are
noted. They represent only the tip of the iceberg, of course, since many more
disputed cases are settled at the administrative level or resolved in the unre-
ported small case docket of the Tax Court than ever reach a reported court
decision. In many of these cases, the government often issues notices of deficiency to both parties, claiming that the payment excluded by the payee should, in fact, have been included and that the payment deducted by the payor should, in fact, not have been deducted (or vice versa). It concedes that only one or the other claim should prevail, that it is merely a stakeholder in the litigation, depending on how the court characterizes the payment. As recited by the Tax Court in one case, the government "has taken the position of a stakeholder and has no preference concerning whether we find that the payments in controversy are alimony includable by [the payee] or property settlement and/or child support not deductible by [the payor]."

What it means to "fix" an amount for child support continues to generate significant litigation. Under the Lester Rule, an amount not specifically denominated as "child support" in the relevant documents was not considered "child support" for tax purposes, even if the surrounding circumstances tied the payments to the children. The 1984 amendments provided that payments that are reduced upon the happening of contingencies relating to the children would be considered "fixed" as child support, but they went no further. That is to say, the statute was not amended to provide that, if surrounding circumstances of any kind indicate that the payments might have been intended as "child support," they should be so treated for tax purposes. What if surrounding circumstances, other than a reduction upon the happening of contingencies related to the children, indicate that an amount might have been intended as child support, though not denominated as such?

In 1988, Congress mandated that each state create and publish child support guidelines. The federal law contains a rebuttable presumption that the amount of child support awarded under the guidelines is correct. My own home state of Ohio has complied by issuing detailed listings of how much child support should be ordered for each child, depending on the income levels of the payor and payee. While a judge can deviate from the guidelines, the judge must
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defend the deviation by reference to the surrounding circumstances that justify it. What happens when a judge makes an unallocated “family support payment” for the support of the ex-spouse and children? Can the recipient spouse argue that the portion of the payment equal to the guideline amount should be considered “fixed” as child support within the meaning of section 71(c)(1)?

The Tax Court has said “no.” In Simpson v. Commissioner,\textsuperscript{183} for example, a Pennsylvania family court issued an order requiring Mr. Simpson to pay a monthly unallocated family support payment of $718 to Mrs. Simpson for the support of her and their minor children. Mrs. Simpson argued that the entire payment constituted child support, since the Pennsylvania child support guidelines would require a monthly payment of $789, which exceeded the unallocated family support payment. The Tax Court, however, concluded that such inferences from state child support guidelines are not permissible in determining whether any amount is “fixed” as child support. According to the Tax Court:

The language of section 71(c)(1) is clear that for payments to be child support, the written divorce instrument by its terms must fix a sum which is payable as child support. It is inappropriate, in light of this clear statutory language, to look beyond the written instrument to examine what effects, if any, are made by operation of State law.

If Congress had intended for us to look beyond the written instrument, it would have amended section 71(c)(1) to so reflect...

We conclude, therefore, that because the court order does not specifically fix a portion of the $718 monthly payment as child support, the entire amount of such payments received by petitioner in 1994 and 1995 is alimony and includable in income.\textsuperscript{184}

In a similar case where the payee made an identical argument, relying on the published state child support guidelines, the Tax Court held:

Even assuming, for the sake of argument, that a simple reference to the grid would produce an accurate figure for what portion of the amounts she received was for child support, petitioner has not satisfied the requirements of section 71(c)(1). The amount of child support must be fixed by the terms of the instrument... The Supreme Court stated in Commissioner v. Lester... that it is the “written instrument” that must ‘fix’ the portion of the payment that is for child support. Petitioner replies that Lester has been overruled by statute. While it is true that the result in Lester has been overruled by section 71(c)(2), the principles of Lester still apply to cases to which the latter provision does not.\textsuperscript{185}

\textsuperscript{183} 78 T.C.M. (CCH) 153, 1999 T.C.M. (RIA) ¶ 99,243. Neither will the “Dissomaster” computer program, which apparently helps family law lawyers compute support payments based on income and other factors, serve to identify how much of an unallocated family support payment constitutes child support. See Wells v. Commissioner, 75 T.C.M. (CCH) 1507, 1998 T.C.M. (RIA) ¶ 98,002.

\textsuperscript{184} 78 T.C.M. (CCH) 191, 1993 T.C.M. (RIA) ¶ 99,251.

\textsuperscript{185} Id. 78 T.C.M. (CCH) at 193, 1993 T.C.M. (RIA) ¶ 99,251.
Surely this result is right as a matter of positive law, but it probably does not accord with what the parties expected if they were told simply by their attorneys that "child support" is excludable/nondeductible. At the least, there remain tremendous traps for the unwary, and the potential for confusion is clear. Furthermore, it does not appear that family law courts are going to abandon their practice of ordering unallocated family support payments simply because the federal tax law prefers to have different tax consequences apply to "child support" and "alimony."

A similar problem in distinguishing alimony from child support often arises in the case of temporary support orders, which quite often take the form of unallocated "family support." In *Heller v. Commissioner*, for example, Lawrence and Madeline Heller divorced in 1986. They divided their community property, and Madeline took custody of the couple's children. The divorce court entered three consecutive orders that defined Mr. Heller's payment responsibilities with respect to Madeline and their children:

1. On February 19, 1986, the court issued a temporary order directing Mr. Heller to pay support of $3,500 per month and reserving "the option to allocate [the payments] between spousal and child support."

2. On August 8, 1986, in an order to take effect on July 1, 1986, the court continued the previous $3,500 amount, but designated $1,000 per month as child support for July through September 1986.

3. On December 17, 1987, the court directed Mr. Heller to continue to make monthly child support payments of $1,000 and spousal support payments of $1,700.

Is any portion of the payments made under the first order nondeductible "child support" in view of the designation in later orders that a specified portion of each payment constituted "child support"? No amount of the payments made in the first order would be considered "child support" under the *Lester* Rule. The entire payment would be considered an unallocated "family support payment" that would fully qualify as "alimony" (so long as the other alimony requirements were satisfied). There were no reductions in the amounts payable under this first order connected with any contingencies relating to the children, which is the only situation involving "disguised child support" addressed in the 1984 amendments. Does that mean that the entire payment should qualify as alimony? Or because the later payments indicated that $1,000 of each monthly payment would be considered child support, should the first $1,000 of each payment made under the first order be considered child support as well?

The Tax Court concluded the latter, but the Ninth Circuit reversed on the issue, concluding that, under *Lester*, the entire payment could potentially qualify as "alimony." According to the Ninth Circuit: "The designation contained in the

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103 F.3d 138 (Table), 97-1 U.S.T.C. ¶ 50,193, 78 A.F.T.R.2d 7610 (9th Cir. 1996).

107 Id.
second order was insufficient to fix $1,000 per month as child support during any time before July 1, 1986. Accordingly, no payment was fixed as child support for February through June, 1986, of the first order.”

The government next argued that Lawrence’s obligation to make the payments would not have stopped if Madeline had died prior to July of 1986, and thus the payments nevertheless failed to qualify as alimony. Under this view, the payments would be considered an excludable/nondeductible property settlement by default—clearly on odd conclusion on the facts, but an inevitable result of the analysis required by the current rules. Again the Ninth Circuit disagreed, finding that the payments would have stopped on Madeline’s death, but the court had to undertake an examination of state law in order to come to this conclusion.

By its terms, the first court order creates a legal obligation for Mr. Heller to pay $3,500 a month “spousal support” to his former wife. The order did not specify that the payments would continue upon the death of Madeline. California law provides that “[e]xcept as otherwise agreed by the parties in writing, the obligation of a party under an order for the support of the other party terminates upon the death of either party or the remarriage of the other party.” . . . California law also provides that in the event a single stated amount covers both alimony and child support in an order, the courts cannot determine, after a terminating event, what proportion of the total award is allocable to alimony and to child support. . . . Mr. Heller’s legal obligation to pay money under the first court order would therefore terminate upon Madeline’s death, and a court would have no ability to allocate retroactively between spousal and child support. Accordingly, the obligation embodied in the first court order would terminate on the death of the payee spouse and meets the test for alimony.

Thus, Ms. Heller had to include the full amount of the unallocated support in her gross income as tax “alimony.”

In contrast, Ms. Gonzales, in Gonzales v. Commissioner, was held to be entitled to exclude temporary unallocated family support on virtually identical facts, because the Tax Court, again after examining state law, concluded that the
temporary support payments would *not* have stopped had Ms. Gonzales died. In other words, amounts received under a temporary support order were considered, by default, to be a cash property settlement—an obvious error if the facts themselves could control the inquiry, but the necessary result of the stop-at-death inquiry.

Mr. and Ms. Gonzales, who had four minor children, were separated in 1992 and divorced in September of 1995. On February 18, 1993, a state court entered a temporary order awarding custody of the children to Ms. Gonzales and directing Mr. Gonzales to make an unallocated family support payment of $7,500 per month, as follows:

> [P]ending the resolution of this matter, [Dr. Gonzales] shall pay $7,500 per month unallocated, commencing on November 1, 1992 as and for support of [petitioner] and the infant children of the marriage, from which sum [petitioner] shall pay all family expenses including the mortgage, children’s school expenses and unreimbursed medical expenses and her schooling.

In the subsequent tax litigation, the court noted that “[t]he temporary order failed to indicate how the payments would be treated for tax purposes, whether the payments would terminate at petitioner’s death, or what portion thereof represented child support.”

The final divorce decree, entered on September 21, 1995, provided for alimony payments of $60,000 per year for nine years, reduced by $10,000 after each three-year segment. If Ms. Gonzales died, remarried, or cohabited with another, the payments would terminate. The divorce decree also provided for child support payments of $40,000 per year for nine years or until emancipation occurred under the terms of the agreement.

The government argued that Ms. Gonzales was required to include the entire unallocated family support payments that she received under the temporary support order because no amount was “fixed” for child support, as required by the *Lester* Rule, in the temporary order. Ms. Gonzales argued that the payments nevertheless failed to qualify as alimony because, under state law, her husband’s obligation to make the payments would have survived her death if she had died during that period. The court concluded that the dispositive issue was whether the stop-at-death requirement was satisfied and noted that “[i]f the payor is liable to make even one otherwise qualifying payment after the recipient’s death, none of the related payments required before death will be alimony.” Because the agreement was silent in this respect, the court had to decipher New Jersey law. It reviewed the relevant state law cases and made a number of extrapolations to decide the case. According to the court:

> Although New Jersey statutes do not say whether unallocated support payments terminate on the death of the payee spouse, a New Jersey case helps reveal the unlikelihood of that result’s occurring.

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192 Id.
193 Id.
194 Id. at 528, 1999 T.C.M. (RIA) ¶ 99,332.
In Farmilette v. Farmillette . . . the New Jersey Superior Court addressed whether unallocated support orders are modifiable. The court held that they are. The Farmilettes . . . obtained a divorce judgment, and Mr. Farmilette was ordered to pay $285 a week to support his ex-wife and their two children. Sometime after one child became emancipated and the other child began living full time with Mr. Farmilette, the latter sought a reduction of his unallocated support obligation, retroactive to the time of the emancipation and change of residency. Before deciding to what extent, if any, the support order should be modified, the court considered its authority to do so. It pointed to a New Jersey statute prohibiting retroactive modifications of child support. The court reasoned, however, that it "will not be so presumptuous as to assume the legislators had in mind unallocated support orders which clearly are not included within the statute." . . . The court then held unallocated support orders modifiable and agreed to review the parties’ submissions to determine whether, and to what extent, a modification is warranted.

Farmilette . . . and the instant case present similar circumstances—albeit the former rests on a real, and not imaginary, event. In each case, a divorced husband (or soon-to-be ex-husband) is ordered to pay family support. And in each case, a terminating event occurred. . . . In Farmilette, the court squarely faced the issue of whether (and, if so, by how much) to vary Mr. Farmilette’s family support payment beyond the terminating event. Significant for our purposes was the court’s willingness to take on that task. . . . The State court’s willingness to do so leads to our affirmative response to the question posed here: Is there good reason to believe that Dr. Gonzales’s family support obligation would continue after petitioner’s death? We think so. Had petitioner died before the superior court entered the divorce decree, Dr. Gonzales, as the non-custodial parent of three children, could have remained liable to pay family support, whether in full or diminished amounts.195

Thus, the court ruled that Ms. Gonzales could exclude the temporary family support payments from her gross income because they neither constituted an amount “fixed” for child support nor qualified as “alimony” for federal tax purposes.196 In other words, the temporary support payments were categorized, by default, as property settlement payments.

On virtually identical facts once again, the payee in Raymond v. Commissioner197 was required to include the full amount of unallocated family support payments under Lester, but not because the court concluded that the payments would have survived the payee’s death. Unlike the Heller and Gonzales courts—both of which recognized that the determinative issue would be whether the payments would have stopped on the payee’s death (even though she did not in fact die) under state law—the Raymond court completely ignored this issue.

Stephen and Sandra Raymond separated in 1990 and divorced in 1992. The couple had two children, one of whom was away at college and one of whom

195Id. at 529, 1999 T.C.M. (RIA) ¶ 99,332.
196Id.; see also Miller v. Commissioner, 78 T.C.M. (CCH) 307, 1999 T.C.M. (RIA) ¶ 99,273.
was 13 years old and living with Sandra. The final divorce decree provided for monthly alimony payments to Sandra of $1,000 per month for two years or Sandra's earlier death or remarriage, as well as child support of $1,600 per month. The tax consequences of these payments were not in dispute. At issue were payments made by Raymond to Sandra in 1991 under a temporary support order entered by a family court in October of 1990, which provided that the children would reside with Sandra and which required Raymond to pay Sandra "his net pay less $900.00 every month on the first day every month commencing November 1, 1990, or thereabouts." During 1991, Raymond paid to Sandra $41,455 under the temporary support order. Sandra did not include these payments in gross income, but Raymond deducted them as tax "alimony."

Sandra argued that at least a portion of the payments constituted nondeductible child support since the surrounding context of the temporary support order reflected that assumption, most of the amounts were in fact spent to support the children, and the final divorce decree ordered more child support than alimony. Like the Heller and Gonzales courts, the Raymond court rejected this inference, relying on Lester:

[S]ection 71(c)(1) nonetheless requires us to find that the terms of the temporary order that incorporated the support stipulation do not fix either in terms of an amount of money or a portion of the 1991 temporary order payments any part of those payments as a sum that is payable for the support of the children of Mr. Raymond. See Commissioner v. Lester . . . . Inferences, intent, or other nonspecific designations of payments as child support are not sufficient to override the mandate of section 71(c)(1) . . . . except as permitted by section 71(c)(2). Section 71(c)(2) does not apply here because there is no amount specified in the temporary order that was to be reduced, let alone upon the occurrence of a contingency specified in that order relating to a child of Mr. Raymond or at a time that can clearly be associated with that kind of contingency.199

What one would expect to find next, of course, is the inquiry made in both Heller and Gonzales regarding whether the payments nevertheless failed to qualify as tax "alimony" because the payment obligation would not have stopped under state law had Sandra Raymond died prior to receipt of the payments. Yet, the opinion is absolutely silent on this issue. Perhaps Ms. Raymond's lawyer did a bad job of lawyering by failing to raise the issue, but then one would expect the court to have raised it on its own, as the stop-at-death requirement is a prerequisite requirement of tax "alimony" that the court cannot ignore simply because the payee party failed to raise it (most likely to the relief of the payor's attorney). Rather, the Tax Court immediately concluded that, since none of the payment was "fixed" for child support, the entire payment qualified as alimony, includable by Sandra Raymond and deductible by Stephen. The Tax Court took

199Id.
199Id. 73 T.C.M. (CCH) at 2754; 2755, 1997 T.C.M. (RIA) § 97,219.
pains to note that the more than $40,000 paid by Stephen in 1991 "constituted approximately 72 percent of the net amount of wages that Mr. Raymond received during 1991 (i.e., approximately 72 percent of his gross wages for that year reduced by federal and state income taxes and Social Security and Medicare taxes that were withheld)." While such numbers are the kind of numbers that first impelled the decision to make alimony includable by the payee and deductible by the payor in 1942, the modern definition takes no account of such realities. Whether the alimony amount is high or low, the stop-at-death requirement must be satisfied under the current statute if payments are to fall within the inclusion/deduction system.

The Heller and Gonzales cases also illustrate how the stop-at-death requirement often requires tax adjudicators to delve into murky state law waters to determine whether stipulated payments would stop at death—and thus whether payments constitute tax "alimony." This is one of the most-often litigated issues in the cases. Is it wise to require federal tax adjudicators to make such state law determinations? And does this not involve just the sort of uncertainty and lack of uniformity from state to state that the 1984 amendments were intended to prevent?

One very common problem with respect to this issue is that family law judges often order the payor spouse, typically the husband, to pay the payee's attorneys' fees and other costs of the divorce proceedings. The order is typically silent regarding whether the payor spouse must make this payment if the payee should die before payment is made. If the judge adjudicating the resulting tax controversy becomes convinced that the payor would have had to pay the payee's attorney fees and costs even if the payee had died in the short interim between the time that the liability accrued and the payment was made, then the payment cannot be considered an includable/deductible alimony payment for support. By default, it would be considered an excludable/nondeductible property settlement. But is it not clear that such a payment does not really constitute a division of marital assets but rather the payment of a personal consumption expense of the payee, i.e., an expense of "support"? Yet, the tax status of these attorneys' fees and costs will hinge on the odd inquiry regarding whether state law would have stepped in and absolved the payor of paying the amount if the payee should happen to die in the short period between the divorce and the payment of the attorneys' fees and costs.

For example, in Smith v. Commissioner, the Georgia Superior Court ordered Lawrence Smith to pay $25,000 in attorneys' fees and costs incurred by Connie Page Smith in connection with their divorce. The order was (not surprisingly)
silent regarding whether Mr. Smith’s obligation would disappear should Ms. Smith die before she received the payment. (What state court judge would think to address such a remote contingency?) Mr. Smith deducted the payment, but the Tax Court, after an examination of state law, concluded that Georgia law would not have absolved Mr. Smith of the payment obligation if Ms. Smith had died during that interim. The Tax Court stated:

While it seems somewhat peculiar to discuss payment of fees made to a former spouse’s attorneys for services in terms of alimony or separate maintenance payments, section 71(b) does not differentiate as to the reasons for the payment. . . .

Petitioner contends . . . that the focus of section 71(b)(1)(D) is whether “the payment was for a period which could not end after [the spouse’s] death,” rather than whether the liability could survive the death of the spouse. We do not agree. . . . It may be that under Georgia law, which controls here, the liability for support or alimony payments would be extinguished by the payee’s death, but the liability here was for attorneys’ fees. Petitioner points us to no authority, and we have discovered none, that such a debt would be extinguished by the wife’s death.

The Tax Court came to the same conclusion in Ribera v. Commissioner, Zinsmeister v. Commissioner, and (most recently) Berry v. Commissioner after examining sometimes murky and ambiguous state law regarding whether the liability would survive the payee’s death.

Other taxpayers have received different treatment with respect to precisely the same payment. In Burkes v. Commissioner, for example, the divorce decree required Mr. Burkes to pay $60,000 to his ex-wife’s attorneys for their work in connection with the divorce. The provision stated: “[Mr. Burkes] shall pay . . . [Mrs. Burkes] the sum of $60,000.00 as additional alimony toward attorney fees, for which sum judgment is rendered and execution may issue.” Once again, the document was silent regarding whether the obligation to pay would disappear if Ms. Burkes died in the short period between the entering of the divorce decree and the payment to the attorneys. Looking to Ohio law, the Tax Court concluded that the term “alimony” can comprise both support payments and property settlements. Alimony constituting support payments stop by reason of the death of the payee; alimony constituting property settlement payments do not. Therefore, the Tax Court had to determine whether the term “alimony” was used here in its “support” sense or in its “property settlement” sense under state law—again, just the kind of inquiry that the 1984 amendments were supposed to

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204 See id. 75 T.C.M. (CCH) at 1774, 1998 T.C.M. (RIA) ¶ 98,061.
205 75 T.C.M. (CCH) 2250, 1998 T.C.M. (RIA) ¶ 98,166.
206 73 T.C.M. (CCH) 1807, 1997 T.C.M. (RIA) ¶ 97,038.
209 75 T.C.M. (CCH) 1772, 1998 T.C.M. (RIA) ¶ 98,061.
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end—and it concluded that the $60,000 constituted a support payment, an obligation which would not survive the payee’s death. Therefore, the payment of the attorneys’ fees constituted deductible alimony for Mr. Burkes, a result strikingly inconsistent with those in Smith, Ribera, Zinsmeister, and Berry.

Many other payments that are clearly support payments and not property divisions in the non-tax senses of those terms suffer the same ambiguity. If a judge orders, for example, the payor to pay the payee’s future medical expenses or car repair expenses (both of which are not unusual terms in the real world), and the agreement is silent regarding whether the payor would have to make these payments if the payee should die after receiving the medical care (or having the car fixed) but before the payor paid the bill, then whether the amount is “alimony” or a “property settlement” will turn on the tax adjudicator’s determination of whether state law would have nevertheless required the payor to pay the doctor bills or the auto mechanic bills if the payee had died (even though she did not die)!

In Preston v. Commissioner, the Eleventh Circuit confronted this set of facts and held that an ex-husband’s payment of his ex-wife’s car-repair expenses, under order of a state court judge, was not “alimony” because state law would not have absolved him of the payment obligation if his ex-wife had died after the car was repaired but before the bill was paid. This result is atrocious; the payment of a payee’s medical and car expenses is not likely part of a disguised property settlement! It is a support payment, at least as that term would be commonly understood by divorcing parties.

In another case, Barrett v. United States, the couple (Pat and Helen Barrett) divorced in 1984. The 1984 Mississippi Judgment of Divorce “provided that the parties had reached a proper settlement of all property rights between them,” and it required Pat to make the following payments to Helen:

(a) monthly commencing November 15, 1984, the sum of $1,900 until her death or remarriage; (b) until her death or remarriage, [Pat] should provide a major medical insurance policy comparable to his present medical insurance for [Helen]; (c) until her death or remarriage, [Pat] should provide $100,000 life insurance coverage on his life naming [Helen] as beneficiary.

There was no dispute that these payments qualified as “alimony” for tax purposes.

Because of a change in Helen’s income and earnings capacity, Pat’s payment obligation was reduced to $1,400 per month by court order in 1985. In 1988, Pat petitioned to have the payments terminated because of a material increase in Helen’s income. The parties settled the matter and entered a consent judgment with the court which provided that Pat must make one $50,000 payment in

209 F.3d 1281, 1285 (11th Cir. 2000).
210 Id. at 661.
211 Id. at 663.
212 Id.
September of 1989 and another payment of $50,000 in September of 1990 (with the second payment carrying an eight percent annual interest rate) and that all prior payment obligations (which were concededly deductible) were cancelled. The parties called this payment a “property settlement,” even though the first agreement had stipulated that all property had been divided. No mention was made whether the payments would be required to be made to Helen’s estate should she die prior to the two payments. Pat sought to deduct these payments as “alimony.”

To determine whether these payments qualified as tax “alimony,” the Fifth Circuit had to delve into Mississippi law, which provided for two kinds of payment streams. One was “periodic alimony” and one was “lump sum alimony.” After examining state law, the Fifth Circuit concluded that “[t]he [Mississippi family] court cannot deprive itself of the power to modify periodic alimony in the future and cannot extend the payments past the remarriage of the payee spouse or death of either spouse. As a result, Mississippi’s periodic alimony falls within section 215’s definition of deductible alimony.”

In contrast, lump sum alimony “is a final settlement, substituting as a division of property, between a husband and wife that cannot be subsequently modified for any reason except fraud. The death or remarriage of the payee spouse does not affect the payor spouse’s obligation. . . . Due to these limitations, lump sum alimony” is not deductible.

Thus, the Fifth Circuit had to determine whether the payments under the consent agreement qualified as periodic alimony or lump sum alimony. In this regard, the Fifth Circuit noted that “[t]he Mississippi Supreme Court has repeatedly announced that an alimony decree is presumed to provide for periodic alimony unless the decree ‘by clear and express language’ provides for lump sum alimony.” Nevertheless, the Fifth Circuit concluded that the consent decree replaced a periodic alimony obligation (deductible) with a lump sum alimony obligation that would survive Helen’s death (nondeductible).

A great case to illustrate how divorcing parties themselves, as well as the law in many states, increasingly recognize that payment streams can contain an inextricably intertwined combination of alimony and property settlement is Pettet v. United States, in which the court’s mandatory exploration of whether state law would stop a mixed payment stream on the payee’s death was a bit surreal. In Pettet, Don and Rosa Bullard divorced in 1989. They decided to divide their property through agreement rather than under the terms of the North Carolina Equitable Distribution statute. Their “Separation Agreement and Property Settle-

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214 While Mississippi had recently created yet a third type of payment stream, called “rehabilitative periodic alimony,” the new law was not applicable to the case at bar, for which I am sure the Fifth Circuit panel was extremely grateful.

215 Barrett, 74 F.3d 661, 664-65 (5th Cir. 1996).

216 Id. at 665.

217 Id.

218 Id.

RATIONALIZING THE FEDERAL INCOME TAX LAW

Husband [Don Bullard] shall pay Wife [Rosa Bullard] the sum of $12,500 per month as alimony, which shall consist in part of the variable first mortgage and second mortgage monthly payments for the residence located at 813 Inlet View Drive, as well as the first mortgage monthly payments for the unit located at Holly Tree Condominiums. It shall be the Wife’s responsibility to tender said monthly mortgage payments for the aforementioned residences from said monthly alimony payment.220

The properties were owned solely by Rosa as a result of the divorce. The tax issue was whether any part of the payment stream mandated by that provision qualified as “alimony” for tax purposes.

Both state and appellate courts in North Carolina, which had been called upon to interpret this agreement in unrelated litigation, characterized this payment stream as “one in which the provisions for alimony and for property settlement were so interrelated that the payments to Rosa were not subject to court modification by reason of changed circumstances, as would be the case for alimony payments standing alone.”221 But, as we all know by now, the only characteristic that really mattered for federal tax purposes was whether the payments would stop if Rosa died prior to full payment of the mortgages. If they would, then this mixed payment stream would be characterized as 100% includable/deductible alimony; if they would not, then it would be characterized as a 100% excludable/nondeductible property settlement. The parties’ agreement, as usual, was silent. As the court observed:

Unfortunately, if the parties fail to expressly specify whether a periodic monthly payment is intended to terminate upon the death of the payee spouse, a court must look to state law to determine whether the fourth factor of the [s]ection 71 definition of alimony is satisfied. See [Cunningham v. Commissioner, 68 T.C.M. (CCH) 801, 804-05 (1994)] (noting that a court is returned “to the vagaries of different State law approaches” to determine if state law terminates a payor’s liability at the death of the payee spouse).222

Thus, the North Carolina District Court had to try to determine whether North Carolina law would terminate these payments on Rosa’s death. (As it happened, Rosa did, in fact, die in an automobile accident just six days before the tax litigation was originally scheduled to start.) The federal court reviewed North Carolina family law decisions, the prior family law litigation that characterized this payment stream as a mixed alimony/property settlement stream, and North Carolina contract law in concluding that the payment stream would not stop on Rosa’s death. In connection with North Carolina contract law, the issue was whether the parties intended the payments to stop at death, even though not

220Id.
221Id.
222Id. at n.1, 80 A.F.T.R.2d at n.1.

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explicitly provided for in their agreement. Under North Carolina law, the court could look to extrinsic evidence to determine the parties' intent with respect to this issue. The court stated:

Like the final version, an early draft of the parties' Separation Agreement did not contain a termination at death clause. . . . However, the draft did contain the following provision: 'Husband and Wife stipulate and agree that in the event that Wife cohabits with a member of the opposite sex who is not a relative, the amount of alimony set forth herein shall be reduced to the exact amount of the first mortgage and second mortgage payments for the residence located at 813 Inlet View Drive.' . . . This provision was struck by Rosa during the parties negotiations. The court finds the language of this clause to be meaningful as the payments would only have been reduced (not terminated) to the amount of the mortgage payments. This evidences an intent that in negotiating the agreement the parties intended the mortgage payment obligation to continue despite the happening of a contingency that Don found undesirable. This provision also demonstrates that Don, whose attorney drafted the Agreement, knew how to terminate his obligations . . . with a contingency clause that would discharge his duty to make the alimony payments upon the cohabitation, remarriage, or death of Rosa.221

Also interesting is the following passage:

Don . . . testified that he was unfamiliar with the federal tax law requirements of [section] 71(b)(1). His attorney, Mr. Davis, testified that he too was unfamiliar with the requirements of this tax provision including the termination at death requirement. Don's accountant, Mr. Thomas May, testified that during the negotiation of the Agreement he advised Rosa and Don of the tax consequences of paying and receiving alimony, i.e., that it was includable as income for Rosa and deductible for Don. But he testified that he was unfamiliar with the termination at death requirement of [section] 71(b)(1) and advised the parties on the tax consequences of alimony according to Don's characterization of the payments as "alimony."

The court finds that use of the term alimony . . . is insufficient to prove the parties' intentions that the payments terminate at Rosa's death. That Don intended the payments to be "alimony" or even intended them to be deductible from his income does not demonstrate that both he and Rosa intended the mortgage portion of the . . . payments to terminate upon her death.224

I have no doubt that other divorcing parties and divorce lawyers not well-versed in tax law do not know that state law (or their agreement) must provide that payments stop at death to qualify as "alimony" for tax purposes. I would bet that divorcing parties are informed, much like Don and Rosa were, that alimony is includable/deductible, but they likely presume that any payment that is called alimony in their agreement (as in this case), or at least that qualifies as alimony under state law, would fall within the inclusion/deduction system for federal tax

221 Id.
224 Id.

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purposes. And they are probably dumbfounded when they find out that a payment stream characterized as "alimony" for purposes of federal bankruptcy law (and thus not dischargeable in bankruptcy proceedings) may not be "alimony" for purposes of federal tax law.225

As the decision in Pettet indicates, there must be an easier way to determine which parties' marginal rate brackets will apply to the payments at issue than requiring federal tax adjudicators to delve into the surrounding circumstances of the parties' negotiations in order to determine whether, under state law, payments would terminate on the death of the payee. The surreal nature of the inquiry in Pettet was exacerbated by the knowledge that the payment stream was intended by the parties, and considered under state law, to be a mixed alimony/property settlement payment stream.

Cunningham v. Commissioner226 provides yet another example of how the difficult interrelationship between the stop-at-death requirement and state law compels tax adjudicators to determine whether payments would qualify as "alimony" under state law—just the kind of inquiry that was supposed to end in 1984. The parties agreed that their divorce agreement should remain a private contract, not a decree entered by order of the court. Mr. Cunningham did not wish the court to be able to increase his alimony and support payments, and Ms. Cunningham did not wish the court to be able to decrease them, as apparently could occur if they had their agreement formally entered as a court order. The agreement was silent with respect to whether 142 monthly support payments of $2,500 made by Mr. Cunningham to Ms. Cunningham would stop at her death. (Child support was dealt with in a separate provision.) Ms. Cunningham privately received a tax opinion stating that, since the proposed agreement did not require the payments to stop on her death, she would be entitled to exclude the payments as "not alimony." She did not include these payments, while Mr. Cunningham sought to deduct them, and both were issued notices of deficiency.227

Since the agreement was silent regarding whether the payments would cease if Ms. Cunningham should die before the end of the 142-month period, the Tax Court had to examine state law, and this was not an easy task. Under North Carolina law, only "alimony" payments stop on the death of the payee, but no payment stream made under a private agreement that is not entered as a court order can qualify as "alimony." Thus, the court had to construe their private agreement under North Carolina contract law in order to determine whether the payments would stop as a matter of contract law. This allowed consideration of parol evidence, which allowed all of the negotiations and prior drafts of the agreement to come into evidence. The court eventually concluded that, while the evidence was ambiguous, the parties did not likely intend the payments to stop at the payee's death, so the payments did not qualify as tax "alimony." To reach

229T.C.M. (CCH) 801, 1994 T.C.M. (RIA) ¶ 94,474.
230On an interesting side point, the case recites that Mr. Cunningham sued his family lawyer for malpractice, claiming that the lawyer told him that the payments would be deductible as alimony.

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this conclusion, the Tax Court had to digest and cite 15 different North Carolina case law decisions, as well as several North Carolina statutes. What a mess!

Another fascinating case is *Christoph v. United States*. Under their original divorce decree, Mr. Dieter Christoph was to pay Ms. Jutta Duse unspecified periodic payments for the rest of her life, which presumably qualified as includable/deductible alimony. In 1988, Mr. Christoph petitioned the court to terminate his obligations based on Georgia’s live-in lover statute. Ms. Duse also sued, claiming that Mr. Christoph breached certain duties owed to her. The suits were consolidated, and the presiding judge encouraged a settlement. The settlement hearing is described as follows:

[The attorney for Mr. Christoph] announced that “Ms. Duse would be paid a sum that would ‘include $250,000 which will be expressly deductible by Mr. Christoph, and it is a contingency of this agreement that that payment of $250,000 will be alimony, will be deductible by Mr. Christoph, and includable in Ms. [Duse’s] income.’ . . . In exchange for this amount of money, Ms. Duse agreed to release Mr. Christoph from future alimony payments. . . .

At the hearing, Ms. Duse testified that she agreed to the terms and conditions of the settlement agreement. . . . Ms. Duse conceded that the payment would be income to her and that she would declare it as income. . . . With that understanding, the parties concluded that they had reached an agreement settling the case.

Judge Cheatham subsequently entered an order on June 1, 1989, adopting the oral settlement agreement as the order of the court . . . Soon after Judge Cheatham adopted the oral settlement agreement, Mr. Christoph transferred the agreed-upon $250,000 to Ms. Duse.229

The $250,000 figure was described as the present, discounted value of the future stream of payments under the original agreement.230

The government disallowed Mr. Christoph’s tax deduction for the $250,000 payment. Mr. Christoph paid the deficiency and sued for a refund. The government moved for summary judgment on several grounds, and Mr. Christoph similarly moved for summary judgment in his favor. Quite surprisingly, there was no discussion of whether Mr. Christoph’s payment obligation would have disappeared if Ms. Duse had died prior to receipt of the payment, as occurs routinely in denying alimony status for lump-sum payments of the payee’s attorneys’ fees and costs relating to the divorce or medical expenses.231 Rather, the court ruled in favor of Mr. Christoph when it found out that Ms. Duse had (unsurprisingly, in my view) excluded the receipt from her gross income (likely on the ground that the stop-at-death requirement was not satisfied) and that the Service had challenged her exclusion as improper. The government settled the case with Ms. Duse under an agreement that essentially split the difference,
with Ms. Duse increasing her gross income by $125,000. The court reasoned:

This information demonstrates to this Court that the [Service] essentially agreed with Mr. Christoph's position regarding who was supposed to claim the $250,000 as taxable income. It is true that the [Service] reached a compromise settlement and, in so doing, only recovered from Ms. Duse half of what she owed. The [Service] did this at its own peril. Mr. Christoph cannot be penalized simply because the [Service] compromised with Ms. Duse.\footnote{See supra notes 201-10 and accompanying text.}

What an odd case! I think it likely that, even though the lump-sum payment was intended to replace a stream of payments that evidently satisfied the tax definition of "alimony," the lump-sum payment itself failed the stop-at-death requirement. That is to say, I would bet that if Ms. Duse had died prior to receipt of the payment, her estate could probably, successfully, have sued to receive the lump-sum amount. As we have seen, the parties have no power to opt into alimony treatment under the statute, as they clearly attempted to do here; they have only the power to opt out of the includable/deductible system under current law.

This case also illustrates that large, lump-sum payments are not always property settlements, contrary to the Code's presumptions. They often, as here, intend to replace an ongoing relationship, which is required with periodic payments, with a lump-sum payment that represents the present, discounted value of the future payment stream. Such a payment can allow the parties to go their separate ways sooner.

Moreover, even if the court order did specify that the payment obligation would disappear if Ms. Duse died before receipt, would this not have been nothing short of a formal "technicality" in the pejorative sense of the term in view of the fact that Mr. Christoph had to—and did—pay the amount as soon as the court entered its order? That Ms. Duse might have died in the few days (or perhaps even hours) between the entering of the court's order and the payment is so unlikely an event that to turn the answer to the question of who should be taxed on such lump-sum payments on such an inquiry seems nothing short of ridiculous.

In short, there is a good chance that this payment did not qualify as tax alimony, even though it was allowed to stand as tax alimony. I find it ironic that the bargaining and agreement between the parties recounted in the quotation above, with the parties themselves deciding who should be responsible for the tax due on these payments, illustrates just the kind of system that I advocate but which is not currently available in all instances (this case notwithstanding).

Another case that demonstrates the depth of misunderstanding on the part of divorcing couples (as well as their family lawyers) is Rosenthal v. Commis-\footnote{919 F. Supp. at 1583.}
sioner.233 In Rosenthal, the parties provided in their agreement that the spousal support payments were intended to be taxable to the wife and deductible by the husband but that the payments would not terminate if the payee wife should die during the 48-month payment period. Needless to say, the stipulation that the payments would not stop if the payee should die prevented these payments from qualifying as “alimony.” The parties apparently believed that they could opt “into” as well as “out of” includible/deductible alimony treatment by private agreement. The result, though mandated by the current Code, upset the parties’ original bargain. “If these payments are not taxed in accordance with the original expectations of the parties . . . then, in essence, the terms of the settlement have been changed. The party who escapes taxation obtains a windfall at the expense of the party who is unexpectedly taxed.”234

On a similar note, the Tax Court held that a $10,000 “lump sum alimony” payment was excludable/nondeductible because the stop-at-death requirement was not satisfied, even though the divorced spouses “stipulated” to the Tax Court during the litigation that it should be includable/deductible.235

The stop-at-death rule surely triggered what should have been unnecessary litigation (in my world) in Ryan v. Commissioner.236 A 1989 divorce court order required Gregory Ryan to pay his ex-wife, Frances Ryan, $700 per month for January, February, March, and April of 1990 and $250 per week thereafter until her death or substantial changed circumstances or until a further court order. In 1991, Gregory appealed the alimony order, claiming that the trial court awarded an amount of alimony in excess of what Frances had requested, since she had requested alimony for a term of only eight years. The appeals court entered a per curiam opinion instructing the trial court to change the lifetime alimony award to an award of “$250 a week for eight years.”237 Frances treated this amendment as removing the stop-at-death provision contained in the original judgment and thus excluded the payments received, while Ryan deducted them, claiming that the amendment meant only that Frances was entitled to the alimony payments for eight years or until her earlier death. The court agreed with Ryan: “[W]e find that the termination upon death provision contained in the Judgment of Divorce was not modified by the higher court’s opinion. The issue raised in the appeal was the length of the alimony payments, not whether the payments were in fact alimony.”238 Gregory Ryan asked the Tax Court to force the government to pay the $15,000 in attorneys’ fees and costs that he had to incur to secure his right to his alimony deduction. The Tax Court directed him to the proper procedural means for making such a request and thus declined to rule on it.

23370 T.C.M. (CCH) 1614, 1995 T.C.M. (RIA) ¶ 95,603.
237Id.
238Id.
I could go on to describe many other similar cases cited in footnotes 176-77, but I fear that I am becoming repetitious. I nevertheless felt that it was necessary to describe a healthy swath of real-world cases, since I think that all too often academic discussions of how “best” to tax transfers in divorce occur in a vacuum in which unrealistic assumptions are made regarding what the terms of real-world divorce agreements look like. They do not order payment streams that fit nicely into the boxes created in section 71. What cases like the ones discussed here show is that the current rules, which were the result of political compromise rather than grand theory, were drafted by people who really had no idea of what real-world divorce agreements and court orders look like. They certainly could not have envisioned the kind of litigation described here as a natural and proper consequence of the rules that they drafted. What the cases show, in fact, is that the rules are broken. Neither divorcing parties nor the government should have to undertake so much litigation in order to determine who, between two parties, shoulders the tax burden on cash payments in divorce that will concededly be taxed to one of them. Divorce, already a stressful and expensive experience, should not be made more stressful and more expensive by the unanticipated intrusion of unnecessary federal tax controversies.

In sum, the House Report leading to the 1984 changes to the definition of alimony complained of the impact of state law on federal tax consequences, the inability to predict with certainty the tax consequences of transfers in divorce, and the high degree of administrative difficulties and resulting litigation in this area involving many individuals (and family law attorneys) who are not well-versed in tax law. As stated by the House Report:

The committee believes that the present law definition of alimony is not sufficiently objective. Differences in State laws create differences in Federal tax consequences and administrative difficulties for the IRS . . . . The committee bill attempts to define alimony in a way that would conform to general notions of what type of payments constitute alimony as distinguished from property settlements and to prevent the deduction of large, one-time lump-sum property settlements.229

The tax landscape has not changed as much as anticipated because the underlying assumptions informing current law were not necessarily accurate. As Professor Berman put it:

The attempts at reform failed because Congress predicated its efforts on false premises. First, there do not exist “general notions of what type of payments constitute alimony as distinguished from property settlements.” True, a single lump sum payment of $1,000,000 appears distinguishable from annual payments of $20,000 “for the life of the payee until she remarries.” But the bulk of payments between divorced spouses do not fit into these neat categories. If they did, much of the reform encompassed in the 1984 Act would have been unnecessary—Tax Court judges could have treated the distinction between alimony

and property settlements the way Justice Stewart treated pornography—they would know it when they saw it.

Even if there were general notions of the distinction between alimony and property settlements, state court judges do not rigidly adhere to the distinctions. Some judges order extended installment payments as a means of giving the wife an interest in the husband’s property which cannot be divided while others fabricate an interest in a professional degree because alimony laws do not adequately compensate the wife.240

2. Discussion and Recommendations

With respect to support payments (as opposed to property settlements), there are two fundamentally different perspectives one can take, as briefly described earlier,241 and they provide different starting points (and thus different likely ending points) for the discussion. One examines each party, the payor and payee, and queries whether the payment (or receipt) should be deductible (or includable) under traditional notions of what constitutes “income” for tax purposes. Under this view, each party is considered independently of the other. The recipient would have to include the amounts in income—at least under Glenshaw Glass notions of the term—since the receipt would constitute an undeniable accession to wealth of the recipient, clearly realized, over which she has complete dominion. Under this perspective, the payor might also remain taxable on the amounts paid out to the recipient if one defines nondeductible “personal consumption” as any outlay not in pursuance of income creation—as is generally the case under current law—rather than an outlay that does, in fact, purchase personal consumption enjoyed by the payor. This approach, in other words, could very possibly result in taxation of amounts paid out as alimony or child support to both parties.

This seems to be the perspective taken by the Finance Committee staff members in 1984 in arguing for nondeductibility of all payments by the payor, since their argument focused on whether the payor’s payment, viewed solely from the payor’s perspective, contributed to earning includable income. As reported by Ms. Mattei as a result of her telephone interview, “Senate Finance committee staff counsel Graham questioned the validity of continuing this major exception to the general rule that only business expenses (in contrast to personal expenses) are deductible. . . .”242 Although it was not clear whether the Finance Committee

241See supra notes 18-26 and accompanying text.
242Mattei, supra note 42, at 193 n.120; see also Berman, supra note 240 (also advocating repeal of the alimony deduction, in conjunction with repeal of section 71). One of Berman’s chief arguments is that, since the precipitating event causing enactment of the inclusion/deduction system was the high marginal rates then in effect, the inclusion/deduction system is no longer needed with the significantly lower marginal rates in effect today and thus should be repealed. I would respond that such an argument presumes that the only justification for an inclusion/deduction system is the presence of high marginal rates of the payor. But it is often true that a provision enacted for one
staff members also advocated abandoning the alimony inclusion, under their approach of questioning whether the amounts paid out constitute "income," the recipient should also be taxed. After all, it would be inconsistent to use the "what-is-income" approach to this question when considering the taxation of the payor but abandon that approach when considering the taxation of the payee.

A very different approach, which I advocate, is not to query whether the amounts paid out constitute "income" to the payor and payee, independently of each other, but rather to conclude that such payments ought to be taxed only once within the couple—as they are in an intact marriage—because the payments are directly caused by virtue of that marital relationship. The same would be true of child support payments outside of marriage. Under this approach, the only question to consider is to whom should the payment be taxed. The inclusion/deduction mechanism (or exclusion/nondeduction mechanism) simply becomes the tool used to implement the decision regarding who, between the two parties, ought to be taxed on the payment. Under this perspective, the inclusion and deduction do not have independent significance under an "income" inquiry. In other words, the inclusion and deduction are not ends under a "what-is-income" query but only the means used to implement a decision under a "which-party-should-be-taxed" query. The inclusion and deduction (or vice versa) are used purely instrumentally, not theoretically. I call this approach the "pragmatic paradigm."

Since we are not dealing, under this pragmatic paradigm, with something as theoretically fundamental as the question of "what is income," but rather are dealing only with a pragmatic decision as to which of two parties should be taxed on what is concededly income to someone, the main concerns should be what side effects—good and bad—would result from our decision regarding whom to tax.

Since all cash payments incident to divorce will be taxed to one or the other spouse, the federal government is a mere stakeholder regarding the issue of whether a cash payment is includable/deductible or excludable/nondeductible.

The provision was originally adopted in 1918 to allow a reasonable salary to be deducted for purposes of an excess profits tax, even though no salary was actually paid because the profits were being plowed back into the business. The provision's original purpose was entirely pro-taxpayer.

Today, it is a provision raised by the Commissioner against taxpayers to disallow deductions for what are in fact disguised dividends or disguised payments for property. The purpose of the provision has thus evolved over time so that now its purpose is chiefly seen as protecting the double tax in our classical corporate tax structure.

Deborah A. Geier, Interpreting Tax Legislation: The Role of Purpose, 2 FLA. TAX REV. 492, 507 (1995) (citing Erwin N. Griswold, New Light on "A Reasonable Allowance" for Services, 59 HARV. L. REV. 286 (1945); Reg. § 1.162-7). In other words, Berman's argument is persuasive only if there is no sound justification for the inclusion/deduction system apart from high marginal tax rates. For the reasons discussed in the text, I believe that there are convincing justifications for allowing the parties to choose the inclusion/deduction system if they desire.
Only the rate-bracket differential between the parties (if any) can result in a revenue loss, and this loss is self-limiting, as the greater the amount paid to the lower-bracket payee in the includable/deductible system, the higher the tax bracket that will apply to him or her, until further income-shifting would not produce a revenue loss. Moreover, in the context of a payor in a significantly higher tax bracket than the payee in the includable/deductible system—which is the very context that would appear to result in the most lost revenue—any revenue loss is more illusory than real because of the loss of the marriage bonus which occurs on the divorce.

Because little revenue is at stake, the parties should be given full power to decide who, between them, should be taxed on all cash transfers incident to divorce. Well-advised taxpayers already have a great deal of power to decide who is taxed, but that power can be implemented only by choosing the correct transactional form for the payment stream. Transactional elections are (perhaps) defensible in the world of, for example, corporate reorganizations, where choosing one form rather than another can dictate whether or not the transaction is a taxable one, but they are not appropriate in the world of divorce, a common transaction not engaged in for tax reasons, and often not by people well informed of the effective elections available to them by choosing the correct form. Rather than hiding the effective elections, the elections should be made explicit, with simple default rules for those taxpayers who fail to address the issue in their divorce instrument.

An explicit election is preferable to trying to further distinguish, for federal tax purposes, among alimony, child support, and property settlements. Without exception, the difficulties described above in the litigated cases stem from trying to characterize properly the cash payment as "alimony," "child support," or "property settlement" for federal income tax purposes (labels which often deviate from state law characterization of the payment) in order to determine whether they are includable/deductible or excludable/nondeductible. As illustrated by the litigated cases, however, these payments are nearly impossible to distinguish on any consistent basis. And history has shown that any new measures adopted to distinguish among these payments would simply create more transactional forms for the divorcing parties to learn (and more traps for the unwary).

As indicated by the child support guideline controversy and the continuation of the *Lester* Rule in all cases not dealing with a reduction in payments related to the children, child support can still fairly easily be cast as alimony if the right form is used. Cash property settlements are also not easy to identify. The underlying assumption of current law is that cash property settlements can, in fact, be differentiated from support payments on a consistent basis and that the "stop-at-death" rule, coupled with the recapture rule in the case of front-loaded payments, serves to adequately police that line. Both contentions are dubious, at best, and reflect outdated notions that family law is increasingly abandoning. With respect to the recapture rule, for example, property settlements may be paid over several years in level payments. Only the constraints of the tax law require the parties to maintain contact for at least three years in order that the
status of their "alimony" arrangement be respected as such. As one commentator notes:

It would have been hard to have legislated wisely to limit front-loading. First, many legitimate, non-tax-avoidance factors, particularly the rehabilitative alimony award, lie behind front-loaded settlements. Second, there is little economic incentive for front-loading because it often costs the husband more in loss of the use of his money than he saves in taxes. Thus, a reform that limited the tax avoidance potential of front-loading would have to reach a narrow group of cases at the cost of significantly interfering with accepted family law practice.243

Moreover, the "stop-at-death" rule serves only to require judges to delve, once again, into state law to try to determine whether any part of an unallocated payment stream might stop automatically if the payee should die, an actuarially unlikely event that the parties never addressed in their agreements, as described earlier. This inquiry results in many payments that are clearly not property settlements—such as the payment of attorney fees, medical expenses, and auto repair expenses—to be so characterized.

In 1986, Professor Malman persuasively demonstrated how the line between support payments and property settlements could no longer be policed in any rational way in view of the trends in family law, where "equitable distribution" statutes now blend property rights with support payments in an inextricably mixed payment stream. According to Professor Malman:

Often there is not a clear distinction between alimony awards and property distributions. As a result of the adoption of equitable distribution principles, the law in a number of states requires that financial provision for a spouse be made through a property distribution, and that alimony be awarded only if the property that can be divided is insufficient. Other states provide that both alimony awards and property distributions may be used for similar purposes—to provide for support and to provide for an equitable allocation of assets.

The similar criteria used by courts to make both alimony awards and property distributions illustrate the lack of a clear distinction between the two. In both situations, courts may consider the parties' ages, needs, and employment skills; the duration of the marriage; and the presence of children.

In particular, cases where on divorce one spouse, typically the wife, seeks compensation for financial contributions made toward the other's education or attainment of a degree or professional license illustrate the blurring of alimony awards and property distributions. Courts may consider the wife's contributions to the earning of the degree (or the husband's resulting increased earning capacity) as a factor in determining a property division and/or an award of alimony. Alternatively, the courts may formally identify the degree, license, or education as an asset subject to equitable distribution. Recently, the New Jersey courts introduced the concept of reimbursement alimony, which is designed

243Berman, supra note 240, at 69 (footnotes omitted).

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specifically to compensate a spouse for financial contributions to the other spouse's attainments. The choice of a mechanism may affect the amount of compensation. Nonetheless, the results produced by the various approaches are similar because each may be said to stem from the vision of marriage as a partnership or shared enterprise and each compensates a spouse for contributions to the other spouse's career.244

Professor Malman's points have become only more salient in the years since 1986. As just one example, in this dot-com world in which we live, when stock options increasingly are used to compensate workers, family law courts are now arguing that stock options awarded after a divorce do not really represent separate "property" of the stock option owner but rather a future "income" stream that should be factored into the level of support payments.245

Moreover, the difficulties in differentiating support payments from property settlements should not be attempted to be resolved by adopting the Task Force's complex "netting" proposal, under which only "hard assets" are taken into account in determining how much of a cash payment is actually a "property settlement" and under which payments are disallowed from entering into the inclusion/deduction system to the extent that they do not exceed the value of hard assets transferred to the payor spouse as a result of the divorce.246 Not only would this approach ignore state-law trends that increasingly recognize the value of intangible property rights, but it would also impose vast new complexities on every divorcing couple (requiring "tax-defendable valuation" of all "hard assets" without a market transaction at the time of divorce).247 And these complexities would be greatly exacerbated by the fact that each spouse's "interest" in the hard assets would be measured differently in community-property states and common-law states, not to mention states that vest spouses with property rights at the time of divorce under certain equitable distribution or apportionment statutes.

For all of these reasons, the statute should not attempt to identify those payments eligible for the inclusion/deduction system by reference to whether or not they fall into a particular category. Moreover, Congress should also reject treating all cash payments either under a rigid exclusion/nondeduction system or rigid inclusion/deduction system in the name of simplification. A mandatory exclusion/nondeduction system for all cash payments is not wise for the following reasons.

First, mandatory exclusion/nondeduction for all cash payments would likely increase the aggregate tax burden on divorcing couples, since the couple in different tax brackets (where substantial cash payments are more likely) would

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244Malman, supra note 5, at 379-80 (footnotes omitted).
246See supra notes 89-94 and accompanying text.
247While at least informal valuation of all property surely occurs in most divorces, these valuations may not be arrived at by formal appraisals that could be defended in the inevitable tax litigation, when the payor and payee spouses disagree over the valuations used to arrive at how much of the cash payment stream is eligible for the inclusion/deduction system.
lose their marriage bonus at the same time that more of the couple's income would be taxed at the payor's higher marginal rate under the schedule for single filers. Divorce is usually accompanied by financial hardship (and it triples the chances of bankruptcy). Therefore, Congress should avoid adopting what would amount to a mandatory divorce tax "penalty" in many cases.

Second, a mandatory exclusion/nondeduction rule would also introduce a disparity between less wealthy couples, where support payments must come from future wages of the payor, and wealthy couples, who could still engage in significant income-shifting by transferring income-producing assets to the payee to fund support. It would also be inconsistent with the income-shifting allowed under section 1041, discussed below in Part III, so there would be a new and dramatic difference between the two areas, whereas both now contemplate income-shifting.

Third, a rigid exclusion/nondeduction rule would decrease flexibility in settling other matters in the divorce, with the likelihood of increasing the number of cases that go to full contest in state court.

Fourth (and perhaps most important), when the payor is in a higher tax bracket, a mandatory exclusion/nondeduction system would erase the current-law bias that encourages the payor to make larger payments than he or she would otherwise make and that leaves the payee with more after-tax cash than he or she would otherwise have under an exclusion/nondeduction system.

For example, assume that John and Mary, who have one minor child, age 12, are divorcing. The child will live primarily with Mary, with generous visitation to John. Without taking into consideration the following cash transfers, John, if single, would be in the 36% bracket, and Mary would be in the 15% bracket. Mary demands $1,000 per month in child support for ten years. John does not object to the figure but suggests that they call the payment a "family support payment," with no amount specifically designated as "child support." They agree that if Mary should die before their child is emancipated (an actuarially unlikely event), John will gain full custody.

The intent is to structure the payments as includable/deductible "tax alimony." Economically, it does not matter whether the payment is called "child support" or "family support" or "alimony." "Alimony" sounds mercenary and "child support" sounds benevolent, but otherwise there is no difference; the recipient is typically under no duty to account for how the funds are used.

Mary would reject that offer, since her $1,000 per month would be worth less to her if she must pay the tax on it. John then offers $1,200 per month. After Mary's 15% tax ($180), she has $1,020, which is more than she would have under a rigid exclusion/nondeduction system under which John would agree to pay no more than $1,000 per month. John is willing to do this only because his net outlay is reduced from $1,000 to $768 ($1,200 less $432 tax savings) because of the deduction. John and Mary effectively save $180 net248 and share the

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248 This figure represents the $360 that John will pay on the $1,000 per month if it is designated "not alimony," less the $180 that Mary will pay on that $1,200 per month if the definition of alimony in section 71 is satisfied.

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spoil. (Mary should claim more of the spoils than $20.)

As indicated by this example, which uses current law, flexibility is already incorporated into the statute, so long as the parties agree that the payments would end on the payee's death and are not excessively front-loaded. Why not make the flexibility explicit? Failing to do so simply rewards the well-advised over the ill-advised. The election is one dependent on knowledgeably structuring the transaction in a certain manner (increasing attorneys' fees and penalizing the ill-informed) rather than one that can be simply made explicit in the divorce agreement.

Moreover, since Mary is in a lower tax bracket than John, it would be reasonable to assume that she is in greater need of the funds than John and that structuring the tax system so that she could end up with more after-tax cash is good policy, particularly since payees after divorce do tend to have a lower standard of living than payors. According to one authority:

[W]omen face longer terms of low wealth and consumption when they divorce because they are less likely to remarry than their former husbands. . . . This lower remarriage rate is exacerbated when the wife has custody of the children. Part of the reason for this disparity is that a woman's value on the marriage market tends to depreciate with time, while her husband's tends to appreciate.

That John must be given a deduction to encourage him to provide Mary with more after-tax cash bothers some commentators who just do not like to see the Johns of the world reduce their taxes in this manner. But such a view reverts to a different paradigm—asking whether John, viewed independently, should be able to deduct an amount that is not made in pursuance of income—rather than the more pragmatic paradigm of deciding simply who should be taxed on these payments by looking to the side effects of the various possible decisions. I admit that I like the fact that Mary ends up with more after-tax cash here under the inclusion/deduction system, and the bald fact is that John would not be willing to provide her with more after-tax cash if he were not better off as well, i.e., if it were not for the tax savings that he enjoys from the deduction under his higher rate bracket. In short, this side effect is one that tends to encourage the higher-income spouse to provide more after-tax income to the lower-income spouse, which might be a good side effect for society in general, at a cost to the fisc that is self-limiting.

249 In 1985, Lenore Weitzman published a book that argued that, following divorce, the average divorced woman's standard of living dropped by 73%, while the average divorced male's standard of living increased by 42%. See Lenore Weitzman, The Divorce Revolution 323-56 (1985). Since then, her numbers have been successfully attacked as severely overstated, and even Ms. Weitzman herself admitted that a research assistant made an error. See Sanford L. Braver, The Gender Gap in Standard of Living After Divorce: Vanishing Small?, 88 Fam. L.Q. 111, 115-16 (1999). But only the degree, and not the direction, of the numbers were challenged. A later study using Ms. Weitzman's sample and records found a 27% drop in women's standard of living and 10% increase in men's after divorce. See id.; see also Margaret F. Brinig & Douglas W. Allen, "These Boots Are Made for Walking": Why Most Divorce Filers Are Women, 2 Am. J.L. & Econ. 126, 127-28 (2000).

250 Brinig & Allen, supra note 249, at 128 (citations omitted).

251 See Berman, supra note 240.
Finally, John’s deduction would encourage him to satisfy his $1,200 per month payment obligation, rather than renege on his $1,000 per month obligation that he would otherwise agree to under an exclusion/nondeduction system, an all-too-common occurrence in the real world.\(^\text{222}\)

The problem of nonsupport of children by their parents has become a serious one for this country. . . . Of the 8.8 million mothers with children whose fathers were not living in the home in the spring of 1986, 3.4 million, or nearly 40 percent of these mothers, had never been awarded support for their children. Fewer than one in five mothers who had never been married had been awarded support. Of those who had been awarded and were due support in 1986, only half received the full amount they were due.\(^\text{253}\)

Why don’t I simply advocate that all cash payments fall within the inclusion/deduction system, with no ability on the part of the parties to agree to exclusion/nondeduction? I think that such a system would be less optimum than one preserving the effective flexibility of current law (for the well-advised). First, for parties who will not be in different tax brackets after divorce—which may be the case more often with lower- and middle-income taxpayers who are both in the 15% bracket or both in the 28% bracket—it would be defensible to allow them to decide who should be taxed on these payments simply because no revenue is at stake. The greater flexibility to designate tax responsibility for cash payments can grease the wheels of negotiation with respect to many other matters on the table, such as who gets the car. Parties who are in different tax brackets should, if well-advised, not wish to opt out of the inclusion/deduction system in most cases, since both can usually be made better off (after taxes) under that system, as illustrated in the John/Mary negotiations. But some of these parties may agree to hard numbers independent of the tax consequences. If John refuses to pay more than $1,000 per month in any event, then I think that it is good policy to provide Mary some leverage in the divorce negotiations with respect to other matters. She may agree to give up the car, in other words, if John agrees that the firm $1,000 per month will be excludable by her (and thus nondeductible to him). In other words, if they nevertheless wish to agree to exclusion/nondeduction in a manner that would benefit the Treasury, there is no compelling reason to prevent them, and providing taxpayers explicit authority to decide for themselves the tax status of these cash payments can help the parties negotiate other matters that are not directly related to the tax responsibility for cash payments. Moreover, having the “tax system” interfere as little as possible (by declining to decide for the parties themselves who is responsible for the tax on the cash


payments except in the absence of agreement)—when the Treasury is only a stakeholder—should increase respect for the tax system, which I also perceive as a good side effect.

The flexibility allowed to the parties to decide to whom cash payments should be taxed is not the cause of confusion under current law. Rather, as illustrated by the cases discussed above, the confusion under current law arises because the flexibility provided to the parties is dependent on them knowing and understanding the various transactional forms and requirements available to them. It is not necessary to eliminate the flexibility available to the parties under current law in the name of simplification; rather, it is necessary only to allow the parties to exercise their flexibility explicitly, rather than indirectly, by allowing them to designate for themselves the extent to which some or all cash payments incident to divorce should be includable/deductible or excludable/nondeductible.

In such a system, the only remaining issue is which default rule should govern in case of silence or a failure to reach agreement. The default rule should ideally provide the outcome that the parties might have agreed to if they had thought about it, i.e., the default should not be counterintuitive or surprising. I believe that the payee likely would not be surprised to find out that cash that he or she receives and controls and spends is includable. But if the payor pays a child’s tuition or summer camp fees directly to a third party, with no control by or direct consumption by the payee, the payee might likely be surprised to find that such a payment is includable (absent a designation otherwise). Thus, I recommend that the default rule should be inclusion/deduction unless the payment is made to a third party on behalf of a child. Such payments should be relatively easy to distinguish. This default rule would step in, however, only in cases in which the parties fail to stipulate how their cash payments should be treated for tax purposes. For example, if the parties so choose, they can agree that payments to a third party on a behalf of a child are includable/deductible payments.

At bottom, the appropriate reform analogy is the 1984 reform to the dependency exemption pertaining to the minor children of divorced spouses. Recall that, prior to 1984, the spouses often had to engage in protracted litigation to determine who provided the greater amount of support for the children in order to determine who was entitled to the dependency exemptions. While such an approach was surely theoretically defensible, it was impractical when applied to the real world, and it resulted in an overabundance of costly litigation for both the divorced parties and the government, while little, if any, federal revenue was at stake. The 1984 reform simply assigned a default rule that the custodial parent gets the exemption, in the absence of an agreement by the parties that the non-custodial parent should get it. Thus, the parties could negotiate out of the default rule by explicitly agreeing on who would get the dependency exemption. This resolution might not be theoretically pure, but it was an absolutely defensible simplification that should provide the ready touchstone for simplification of the

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254 See supra notes 94-95 and 131-32 and accompanying text.
I therefore recommend that the title of section 71 should be changed from "alimony and separate maintenance payments" to "payments pertaining to children and former spouses." Subsections (c) (dealing with "child support" payments) and (f) (dealing with recapture of front-loaded payments) should be repealed entirely. Subsections (a) through (c) should be amended as follows:

Sec. 71. Payments Pertaining to Children and Former Spouses.

(a) General Rule.—Payments pertaining to children and former spouses, whether those payments constitute alimony, child support, property settlement, or an equitable distribution or apportionment under state law, shall be includable in the gross income of the payee under this section and deductible by the payor under section 215, or excludable from the gross income of the payee under this section and nondeductible by the payor under section 215, as designated by the parties in a divorce or separation instrument or support instrument. The divorce or separation instrument or support instrument may designate some payments or portions of payments as includable in the gross income of the payee and deductible by the payor and other payments or portions of payments as excludable by the payee and not deductible by the payor.

(b) Default Rule.—Payments pertaining to children and former spouses that the parties fail to designate in the divorce or separation instrument or support instrument as either includable or excludable by the payee shall be includable in the gross income of the payee under this section and deductible by the payor under section 215 unless the payment is made to a third party on behalf of a child of the payor, in which case the payment shall be excludable from the gross income of the payee under this section and not deductible by the payor under section 215.

(c) Payments Pertaining to Children and Former Spouses Defined.—For purposes of this section—

(1) In General.—The term "payments pertaining to children and former spouses" means any payment in cash if—

(A) such payment is received by (or on behalf of) a spouse under a divorce or separation instrument or by a parent under a support instrument, and

(B) the payee and the payor are not members of the same household at the time such payment is made.

By these words, this section would also apply to a support decree that orders a biological father to make cash payments to the child's mother, whom he never married.

In section 71, the requirement that the payor and payee not live in the same household is required only in the case of "an individual legally separated from his spouse under a decree of divorce or of separate maintenance." I.R.C. § 71(b)(1)(C). That is to say, this requirement does not apply to individuals who simply enter into their own, private agreement, without supervision or approval of a court, when they separate for a time in the hopes of eventually reconciling. The thought is that requiring such individuals to cease living together in order to gain the advantages of the inclusion/deduction system would discourage reconciliation. See generally Paul C. Feinbert & Toni Robinson, A Household Is Not a Home: "Not Members of the Same Household" in the Tax Treatment of Alimony Payments, 6 VA. TAX REV. 377 (1986) (generally discussing this requirement).
(2) Divorce or Separation Instrument or Support Instrument.—The term “divorce or separation instrument” or “support instrument” means—

(A) a decree of divorce or written instrument incident to such a decree,

(B) a written separation agreement,

(C) a decree (not described in subparagraph (A)) requiring the payor to make payments to the payee for the payee’s benefit and/or the benefit of the children of the payee and payor.257

B. In-Kind Property Transfers

The rule enacted in section 1041(a), that in-kind property transfers should be nonrecognition events if the transfer is incident to divorce, turned out, in my view, to be an overwhelming success. Moreover, I believe that it was the right decision to resist the Task Force’s tentative proposal that the nonrecognition rule be made elective.258 I believe that the valuation headaches that would arise if non-marketplace transfers in divorce were deemed to be realization events more than justifies a flat nonrecognition rule for such in-kind transfers. Valuation litigation would no doubt explode if parties were given this option, with transferors claiming low value for built-in gain property for purposes of measuring their gain and transferees claiming high value for purposes of their fair-market-value basis. Even if the parties were required to stipulate jointly to a single value in order to elect out of nonrecognition treatment, the government might wish to argue that the stipulated value is deflated (to generate less gain or a greater loss), particularly if the transferee does not plan on selling the property and thus would be willing to stipulate to a low value (and thus basis). In my view, this aspect of

I believe that under a system in which parties will be entitled to designate all cash payments as includable/deductible payments, without limit, this flexibility must be sacrificed in order to prevent happy couples who have no intention of actually separating from attempting to take advantage of the inclusion/deduction system on a wholesale basis while continuing to live together, filing separate returns. Subsection (e) of section 71 already prevents couples filing a joint return from taking advantage of the inclusion/deduction system. This is the one area where the abuse potential could be great. For this reason, I believe that couples should have to live apart to take advantage of the inclusion/deduction system. That would mean that couples who continue to live in the same household, even in separate bedrooms, would not be entitled to take advantage of the inclusion/deduction system for any payments made pursuant to a private agreement that they undertake together, but I believe that such a restriction is nevertheless justified in view of the larger potential for abuse. The justification for income-shifting is much less pugent in the case of a still-married couple, living in the same household. The payments made from one spouse to another would still be taxed only once; the only consequence of this rule would be that it would always be the payor that is taxed, with no ability to choose to tax the payee instead. These temporary separations should, in any event, be self-limiting in time (assuming the couple reconciles or divorces within a year or two).

257 Conforming amendments would be required to be made to sections 61(a)(8) and 215, as well as section 682, so that payments satisfied by the creation of a trust would effectively receive the same treatment as would apply to direct payments under section 71. See generally Martin J. McMahon, Jr., Tax Aspects of Divorce and Separation, 32 Fam. L.Q. 221, 243-44 (1998) (describing alimony and child support trusts).

258 See supra note 82 and accompanying text.
"private ordering" must give way to easy-to-administer rules in a transaction like divorce, which affects so many individuals. And after all, the reduction in flexibility is not terribly severe; if the transferor wishes recognition, he or she may sell the property to a third party, which would provide a marketplace transaction that resolves the valuation question, and then transfer the cash to the transferee spouse.

While section 1041 has generally been a success, two serious issues nevertheless have arisen under it, both of which are addressed in the next section. The first is whether the common-law, assignment-of-income doctrine trumps this nonrecognition rule. The second is how stock redemptions in closely held corporations incident to divorce should be analyzed.

III. ISSUES UNDER SECTION 1041

A. The Assignment-of-Income Doctrine and Section 1041

Under the assignment-of-income doctrine, developed in such hoary cases as *Lucas v. Earl*, *Poe v. Seaborn*, *Commissioner v. Horst*, *Blair v. Commissioner*, *Harrison v. Schaffner*, *Commissioner v. Clifford*, *Commissioner v. Eubank*, and others, the Supreme Court developed a common-law doctrine that prevents the shifting of income for tax purposes from one taxpayer to another in many circumstances—at least, in the absence of a nonrecognition provision that would otherwise apply. Taken together, the cases might be summarized (if somewhat simplified) to mean that an assignor cannot shift the tax burden with respect to income produced by a mechanism over which she retains control. Because services income is created by one's body, it is just about impossible to shift services income to another, since one cannot effectively give up control over one's own body; the assignor can turn the income spigot on and off at will by performing services or not. Thus, services income is essentially always taxed to the person or entity who provided the services that earned the income, whether the services income attempted to be assigned is already earned or to be earned in the future.

For example, in *Commissioner v. Earl*, the Supreme Court held that a contract entered into between a married couple that required the husband, who was the sole income earner, to share one-half of his earnings with his wife did not operate to shift the tax burden of those earnings to his wife. This case was decided at a time when all individuals, including married couples, were required

259 The description in the next two paragraphs was taken from Geier, *Some Meandering Thoughts*, supra note 26, at 536-37.
260281 U.S. 111 (1930).
261282 U.S. 101 (1930).
262311 U.S. 112 (1940).
264312 U.S. 579 (1941).
265309 U.S. 331 (1940).
266311 U.S. 122 (1940).
267281 U.S. 111 (1930).
to file individual tax returns. If the Court had held otherwise, the resulting income-splitting would have allowed the married couple to use the lowest marginal rate brackets twice, instead of once, thus lowering the couple's aggregate tax liability.

During the same term, however, the Court also decided *Poe v. Seaborn*,268 which similarly dealt with a husband who was the sole breadwinner who attempted to split his income with his wife for tax-reporting purposes. Because the state's community-property laws in that case considered the husband's earnings to have been earned by the marital community, rather than solely by the husband, the court blessed the income-splitting in this context. Since the marital community earned the income under state law, the marital community properly reported it. Indeed, the differing treatment between married couples who could not split their income under state law and those who could eventually prompted the enactment of the joint-return option to, in essence, extend the advantages of income-splitting to those not living in community-property states.269

The *Poe v. Seaborn* Court also held that the couple's return on investment assets owned as community property should be split between them for purposes of tax reporting.270 That is to say, just as services income is typically taxed to the person or entity that earned it, income earned with respect to property is generally taxed to the person who owns the property (though the titleholder under state law might not be considered the owner for tax purposes). Unlike one's own body, the property owner can give up control over property producing income. Thus, assignments of income from property can be successful for tax purposes if the assignor gives up sufficient control over the property producing the income to the assignee. The disputes in this area typically center around the issue of whether sufficient control over the property producing the income was surrendered to the assignee.

The possible interrelationship between the assignment-of-income doctrine and section 1041 has produced confusion.271 The issue typically arises when a property interest is transferred in divorce, and then cash, producing an ordinary income inclusion, is subsequently received with respect to that interest by the new owner. It also arises when compensation income already earned by one spouse but not yet received or taxed is assigned in the divorce to the other spouse. The question, as with alimony and child support, is which party must include the income, i.e., which party's marginal rate bracket will control. For the reasons described in Part II, very little revenue (if any) is at issue here, since the government is once again merely a stakeholder.

If a property right is transferred and the income earned on that property is considered as having been earned after the property transfer, the new owner

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268282 U.S. 101 (1930).
269See generally Zelenak, *supra* note 11, at 344-48 (reviewing the history of the joint return).
271See generally Geier, *Form, Substance and Section 1041, supra* note 63 (generally discussing this problem).
must include the income under the assignment-of-income doctrine, as owner of the property interest. This is an uncontroversial application of the doctrine originally created in Poe v. Seaborn. For example, in Kenfield v. United States, 272 H was a 50% partner in a partnership engaged in land sales, and the divorce decree provided that W was entitled to one-half of H’s partnership interest (i.e., a 25% interest in the partnership). Because valuation was difficult, the court awarded W 50% of all “future net proceeds received” by H with respect to his original partnership interest. H duly paid over the amounts every year. The issue was whether H must include the full 50% of the partnership’s income on his own return or whether H need include only 25%, with W including the remaining 25%, because of the court order vesting one-half of H’s partnership interest in W.

The Tenth Circuit concluded that the transfer gave W ownership of one-half of H’s partnership interest, and thus W must include in her gross income the income attributable to that property that accrued after the transfer. “After the settlement, Kenfield did not own the asset that produced his ex-wife’s share of the 1977 post-divorce income, i.e., his ex-wife’s half of the partnership income. Kenfield thus also is not taxable on the partnership income earned by that asset.” 273 If the court had concluded as a factual matter that W did not really receive an interest in the partnership, but rather was merely compensated for her marital interest in the partnership, then the results would likely have been different, as they would have been analyzed under sections 71 and 215. H would have had to include the full 50% share of the partnership’s profits on his own return, and the installment payments received by W would (under current law, at least) have been excludable by her and nondeductible by H, if H’s obligation to make the stream of payments would not terminate on W’s death. 274 (Under the proposals advanced in Part II, which obliterate the distinction between cash “alimony,” “child support,” and “property settlements,” the parties would be free to designate whether cash payments incident to divorce are includable/deductible or excludable/nondeductible.)

But what if a property interest is transferred but the income subsequently received by the new property owner accrued prior to the transfer? Or what if accrued-but-not-yet-taxable compensation income is assigned to the other spouse? If the income is considered as accruing prior to the property transfer, and particularly if the income is attributable to the personal services of the transferor,

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272 783 F.2d 966 (10th Cir. 1986).
273 Id. at 968; see also Schulze v. Commissioner, 46 T.C.M. (CCH) 143, 1983 T.C.M. (RIA) ¶ 83,263. (holding that W was taxable on one-half of the amounts collected on a claim arising from W’s one-half interest in husband’s law partnership received by W in divorce).
274 See, e.g., P.L.R. 1991-23-053 (Mar. 13, 1991) (concluding that, because the divorce instrument did not give W a 50% interest in H’s business, but rather only required H to make cash payments to compensate W for her interest in his business, the payments were excludable by W and nondeductible by H, since W’s payment rights would not terminate on her death). Accord P.L.R. 1991-43-050 (July 26, 1991) (concluding that W did not receive an interest in certain patent lawsuits that H was prosecuting at the time of their divorce but rather only cash payments representing an excludable cash property settlement since her payment rights would not terminate on death).
then the government sometimes argues that the income, even though received and consumed by the transferee spouse, must be included by the transferor spouse under the assignment-of-income doctrine, notwithstanding section 1041, a practice excoriated by Professor Michael Asimow in his definitive article on the topic. Professor Asimow calls these “sensitive assets,” and they include accounts receivable of an unincorporated, cash-basis, service business; an interest in a partnership that holds unrealized receivables or contracts to render personal services in the future; rights to royalties; and investment assets with accrued but not-yet-recognized income.

For example, in Kochansky v. Commissioner, the government argued, and both the Tax Court and Ninth Circuit agreed, that Mr. Kochansky, a lawyer, must include in gross income the portion of a contingent fee in a medical malpractice action that was pending at the time of the divorce and that the divorce decree required to be paid to his ex-wife, because the income was earned by the personal services of Mr. Kochansky.

Probably the most common type of accrued income subject to assignment-of-income arguments is deferred compensation income, such as retirement savings, that is not subject to a “qualified domestic relations order” (QDRO). There is no question about who gets taxed on pension benefits that are covered by a valid QDRO, which was created in section 414(p) as part of the Retirement Equity Act of 1984. Prior to creation of the QDRO, it was possible to split pension assets in a divorce, but the court order was directed at the spouse with the pension, rather than at the pension plan itself. For example, H might have been ordered by the court to pay one-half of his monthly pension payments to W when he began to receive them—perhaps 20 years in the future. If H died before retirement, W received nothing. Under section 414(p), in contrast, the pension plan administrator is the subject of the court order, and W receives vested rights. The administrator is ordered to treat W in our scenario just as if she were a plan participant. While the primary purpose of the QDRO was to recognize these pension assignments and to protect W’s interest in the plan, even if H should pre-decease W, the provisions also ensure that W, as the “alternate payee” under a QDRO, is taxed on the payments when ultimately paid by the pension, not H.

QDRO’s can apply only to defined benefit and defined contribution plans such as 401(k) and profit-sharing plans. They cannot apply to individual retirement accounts (IRAs) or other kinds of deferred compensation arrangements,

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2772 F.3d 957 (9th Cir. 1996), aff’d 67 T.C.M. (CCH) 2665, 1994 T.C.M. (RIA) ¶ 94,160.
279See infra note 313 and accompanying text.
though section 408(d)(6) provides similar treatment for IRA transfers in divorce. It is with respect to other, so-called nonqualified arrangements that the government has argued, albeit inconsistently, that transfers of rights to receive income (or surrenders of community property interests in such income) cannot shift the burden of including the income that has already accrued. That is to say, in our situation in which H transfers to W rights to future payments that represent H’s accrued interest in deferred compensation that cannot qualify for a QDRO (considered owned solely by him in a common-law state), the government might argue that, even though W receives the cash, H is taxed when W receives the cash years later.

For example, in *Darby v. Commissioner*, a case pre-dating adoption of the QDRO, the divorce court ordered Mr. Darby to assign to his ex-wife a $75,000 portion of his vested interest in a qualified plan that could today qualify for a QDRO, a profit-sharing fund of his employer. The $75,000 amount was one-half of the estimated value of Mr. Darby’s interest in the plan at the time of the divorce. The court ordered that the $75,000 payment should be made as follows: $60 per week until Mr. Darby died or retired, the balance due paid in a lump sum at that time. The decree also provided that Mr. Darby “shall notify said Fund of the above Assignment, and the Assignment, or this Judgment in lieu thereof, may be recorded in the County Register of Deeds or appropriate office, wherein the Fund is located so as to give notice of the same.” Mr. Darby complied by submitting a document to the plan informing the plan administrators of the court-ordered assignment and attaching a copy of the court’s order. Mr. Darby paid a total of $22,030 in installments toward the $75,000 total before he retired, and the profit-sharing plan paid him a lump sum of more than $182,000 at that time. A few days later, he wrote a check to Ms. Darby for the $52,970 that represented her remaining interest in the plan.

While Mr. Darby did not deduct the prior $60 weekly payments as “alimony,” he did not include $75,000 of the lump-sum distribution that he received upon his retirement, arguing that the divorce decree and court order resulted in a legal transfer of $75,000 of his interest in the profit-sharing plan to his ex-wife. The government made both a statutory argument and an argument under the common-law assignment-of-income doctrine in concluding that Mr. Darby was not entitled to exclude $75,000. The statutory argument was that only Mr. Darby could qualify as a “distributee” within the meaning of section 402(a)(1), who is the person required to include in gross income amounts deferred under a qualified pension plan. The government further argued that, even if the plan had paid the $75,000 directly to Ms. Darby, “the payment was compensation for services rendered by petitioner and, as such, is taxable to him under the assignment of income doctrine.” The Tax Court agreed on both counts.

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282Id. at 54.
283Id. at 57.

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Another instance in which the government raised the assignment-of-income doctrine, but this time eventually lost before the Tax Court, began as a private letter ruling request in 1987. W’s marriage was dissolved in a community-property state in December of 1981. At that time, the Supreme Court’s ruling in McCarty v. McCarty was in effect, which held that a military spouse’s retirement benefit was that spouse’s separate property in community-property states and thus not subject to division as part of the community property. Pursuant to the McCarty decision, the divorce decree stated that H’s military retirement plan was the separate property of H. The McCarty decision was subsequently overruled by statute in the Uniformed Services Former Spouses’ Protection Act. W moved to modify the divorce decree to recognize her interest in H’s military retirement plan and then agreed to relinquish her claim in exchange for three payments by H: $15,000 in 1986, $14,000 in 1987, and $13,000 in 1988. W requested a ruling that the payments were nontaxable transfers under section 1041 (since they would fail to satisfy the stop-at-death requirement for includable “alimony”).

The ruling concluded that, because the interest surrendered by W was a right to future income already earned under the community-property laws, the surrender constituted an impermissible assignment of income by her. The payments from H to W were thus includable in W’s gross income in the year received, notwithstanding that they failed to qualify as tax “alimony” under section 71. The ruling stated that “[W] cannot escape the taxation of ordinary income by recharacterizing her assignment of the income as a nontaxable transfer of property under section 1041(a).” The government argued, in essence, that one could never surrender the tax consequences of a community-property interest in deferred compensation. It argued that whatever one received in exchange for the interest was taxable at that time, whether or not the receipt qualified as “alimony.”

The taxpayer then went to the Tax Court, which ruled in her favor in Balding v. Commissioner. The Tax Court concluded that the cash payments to W were “property” within the meaning of section 1041, and thus excludable, notwithstanding the argument made by the government that the assignment-of-income doctrine required taxation of the three payments made to W. In a footnote, the Tax Court expressly declined to rule on whether W would be taxable under the assignment-of-income doctrine in future years when actual payments were made under the plan to H, but it cited Professor Asimow’s article “for an argument that petitioner is not required, under the Assignment of Income Doctrine, to take into income any portion of the retirement benefits. . . .”
The government's inconsistency in this arena can be explored by examining another private letter ruling\(^2\) which also involved a couple who lived in a community-property state and which was issued in 1989. This ruling was issued after the ruling that was litigated in *Balding* but before the *Balding* case itself was decided. The couple owned two IRAs: one for the sole benefit of H and one for the sole benefit of W. In a transaction not related to a divorce, they executed a written agreement that transmuted the IRAs from community property to separate property, under which W transmuted her community-property interest in H's IRA to the separate property of H, and H transmuted his community-property interest in W's IRA, as well as some additional assets to even up the deal, to the separate property of W. The government concluded that section 1041 applied and prevented the recognition of any gain by either party, even though each received valuable property for their community-property interests in deferred compensation that they each surrendered. The ruling quoted the legislative history of section 1041 that emphasized that the section extends literally to all transfers between spouses. There was no mention of the assignment-of-income doctrine.

Not only is this ruling inconsistent with the government's position in the prior ruling that led to *Balding*, where it argued that whatever value is received for a surrender of a community-property interest in deferred compensation is taxable, notwithstanding section 1041, it was also inconsistent with the position taken in a yet another ruling issued just the year before in 1988.\(^2\)\(^1\) In that ruling, H proposed to transfer an undivided one-half interest in an IRA to the IRA of his spouse, W. As in the 1989 ruling described above, the transfer was not in contemplation of divorce. No mention was made regarding whether the state in which H and W resided was a community-property state. H requested a ruling that the transfer would not be considered a taxable distribution from his IRA subject to inclusion in H's gross income under section 408(d)(1).

Section 408(d)(6) provides that a transfer of an individual's interest in an IRA to a spouse or former spouse under a divorce or separation instrument is not to be considered a taxable transfer, notwithstanding any other provision, and that the transferred interest is to be considered owned by the transferee. That provision was originally introduced as part of ERISA in 1974, a time when *Davis* made many such transfers taxable. The section was not repealed when section 1041 was introduced in 1984; in fact, a technical correction was made to it in the same act to delete a reference to the obsolete "qualified retirement bonds" repealed by the 1984 Act.

The government interpreted section 408(d)(6) as limiting nonrecognition for inter spousal transfers of IRAs to the divorce context. It did so by citing the rule of statutory construction that a specific rule (section 408(d)(6)) controls over a general one (section 1041(a)) and by citing the decision by Congress to retain

section 408(d)(6) when it enacted section 1041(a) as evidence that Congress intended that section 408(d)(6) nonrecognition be limited to the divorce context. The negative implication, it argued, was that transfers during marriage are not subject to nonrecognition treatment. Thus, the government ruled against H.

How can these two rulings, only a year apart, be reconciled? There are several possibilities: (1) The government changed its position between the two rulings regarding whether nonrecognition can apply to IRA transfers only in divorce; (2) the authors of the two rulings did not communicate; or (3) the government believes that the two situations are substantively different because the one in which it ruled the transfer to be taxable involved the transfer of record title while the one in which it ruled the transfer not to be taxable involved only the surrender of a community-property interest to the record titleholder. That last view is the most troubling, as it reintroduces the distinction between community-property states and states with laws “similar to community property” on the one hand, and other states on the other hand—a distinction that Congress clearly intended to obliterate with the enactment of section 1041. Furthermore, the view lends inordinate distinction to whether there is a transfer of record title instead of merely a surrender of an interest in community property. Perhaps more to the point, the government does not always heed that distinction, as we saw in Balding, since it argued there that the mere surrender by W of her community-property interest in exchange for cash payments resulted in taxation to W of those cash payments.

The confusion deepens further when we return to reconsider the Kochansky decision with this discussion of the impact of community-property law in mind. Recall that Kochansky was the case in which the Tax Court and Ninth Circuit held that the lawyer husband’s contingent fee in a medical malpractice case, which was pending at the time of the divorce proceedings, was taxable entirely to the husband, even though the divorce decree required that he pay one-half of the fee to his ex-wife when received. As Ms. Sarah Dods noted, the taxpayers in Kochansky lived in Idaho, a community-property state, where even earned income is permissibly split by a married couple for tax purposes under Poe v. Seaborn. How could Mr. Kochansky possibly be considered to have impermissibly shifted income to his ex-wife that, by definition, would have been required to be included by her under Poe v. Seaborn? In Johnson v. United States, for example, W had a vested right to one-half of her husband’s income under community-property law that was earned prior to their divorce. In the divorce settlement, she assigned her community-property interest in this accrued

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293 See supra notes 267-69 and accompanying text.

295 135 F.2d 125 (9th Cir. 1943); see Dods, supra note 293, at 881.

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income to H. When H collected the accrued fees after their divorce, the Johnson court held that W was taxable on one-half of them under Poe v. Seaborn. The Kochansky case is also consistent with the government’s own conclusion in the private letter ruling described earlier, eventually litigated in Balding, in which the government argued that any cash received in exchange for relinquishing a community property interest is includable by the recipient, in this case, Mrs. Kochansky. So how could Kochansky come out differently?

Perhaps the answer lies in the fact that the medical malpractice case generating the fee was not settled until after the divorce, so that the income could be considered as accruing at least partly, if not entirely, after the divorce, which would mean that the earned income was the separate property of the husband, not the community property of the marital unit. Under that scenario, Mr. Kochansky would have to include the full amount, but then the cash payment to Ms. Kochansky should be analyzed under the income-shifting system of sections 71 and 215, but it was not. If (under current law) the payment obligation would not have disappeared if Ms. Kochansky had died prior to settlement of the suit and payment to her of her portion of the contingent fee, i.e., if we assume that her estate would have had the right to sue for payment if she had pre-deceased the payment, then the payment would not qualify as alimony under current law. Therefore the cash receipt by Ms. Kochansky would be excludable by her and not deductible by Mr. Kochansky (and thus taxable to him) in any event. But this was not the analysis undertaken by the Kochansky court.

In other words, the assignment-of-income doctrine should not have been raised in any event. If, on the one hand, the income was considered earned prior to the divorce, Ms. Kochansky would properly have been taxed on her one-half interest under Poe and Johnson, since she would have been considered to have earned that one-half under community-property law. If, on the other hand, the income was considered earned after the divorce, so that it was the separate property of Mr. Kochansky, then it would have been a plain-vanilla cash payment of post-divorce earnings that should have been analyzed under sections 71 and 215, where income-shifting is clearly permissible and contemplated, so long as the requirements for tax “alimony” are satisfied. Recall that the “labels” applied to such cash payments for state law purposes (whether “alimony” or “property settlement”) are irrelevant for purposes of the federal income tax analysis applicable to such cash payments.

But even if this analysis is correct, this reasoning once again reintroduces the very distinction between community-property states and common-law states that was clearly intended to be obliterated by the 1984 amendments, since the outcome under community-property law if the income is considered as accruing prior to the divorce can be different, under assignment-of-income norms, than under noncommunity-property law. Moreover, it would require, in community-

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296 See supra notes 287-89 and accompanying text.
297 See Dods, supra note 293, at 880 n.49.

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property states, an analysis in situations like that in Kochansky of how much of the contingent fee was earned prior to the divorce (and thus was community property taxable in part to Mrs. Kochansky) and how much was earned after (and thus was the separate property of Mr. Kochansky). This would undermine the purpose of Congress’s actions in the 1984 Act, as Ms. Dods observed:

When Congress expressed a desire to make the tax laws “as unintrusive as possible with respect to relations between spouses” [quoting the 1984 legislative history accompanying enactment of section 1041], it had in mind a broad, simple rule under which spouses could easily determine, by the structure of their property settlement, who would bear the latent tax burdens of the marital assets distributed at divorce, regardless of variations in state property law.

Finally, Ms. Dods noted that the Kochansky decision, accepting the government’s argument that the assignment-of-income doctrine trumps section 1041, is inconsistent with other Tax Court decisions, such as Balding, rejecting it. She also argued that the doctrine is inconsistent with the purposes underlying section 1041. She is right.

The latest foray by the Service into this morass is found in a Field Service Advice that deals with the transfer of nonqualified stock options in divorce. Although the ruling provided no numbers, let me use some simple ones for illustration. Assume that the corporation for which H works transfers to him, as part of his compensation package, stock options at no charge. Assume further that H is not taxed on the receipt of the options under section 83, because the options do not have a “readily ascertainable fair market value” at that time. H thus takes a zero basis in the options. If H were to exercise the options for a strike price that is less than the fair market value of the stock, he would include, as ordinary compensation income, the spread. For example, if H were able to exercise the options for $100 at a time when the stock had a fair market value of $150, H would include $50 of ordinary compensation income at that time under section 83(a). If H were instead to sell the options for cash in an arm’s-length transaction, the difference between H’s zero basis in the options and the sales price would produce ordinary compensation income for H, and he would realize

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298Id. at 898.
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no further tax consequences when the option buyer exercised the option. Thus, for example, if H sold the options in an arm's-length transaction for $50 (because the strike price was $100 and the fair market value of the stock was $150), he would similarly include $50 of ordinary compensation income at the time of sale. He would realize no further tax consequences if the buyer were able to exercise the option for $100 at a time when the stock had a fair market value of, say, $175.

What happens if H and W divorce and their divorce decree requires H to transfer these unexercised stock options to W at a time when the strike price is $100 and the fair market value of the stock is $150? In the field service advice, the Service concluded that H realizes $50 of consideration on the transfer under the Davis approach of assuming that the release of marital rights by W has a value to H equal to the value of the options transferred to W. The ruling concludes that the $50 of cash deemed received by H results in $50 of ordinary income to H under section 83 at the time of the transfer. W would take a $50 basis in the options. If she were to exercise the options for $100, she would take a $150 basis in the stock, and H would realize no tax consequences at the time of exercise. In other words, the Service determined that the same rules that would apply to H if he were to sell the options to an unrelated third party for $50 cash apply when H transfers the options to W pursuant to a divorce decree.

The Service rejected the argument that section 1041 prevents this result by once again asserting that the assignment-of-income doctrine trumps section 1041. Moreover, in support of this position, it cited the private letter ruling discussed earlier that concluded that when W surrenders her community-property interest in a pension plan in exchange for cash payments, the cash payments received from H are includable in her gross income, notwithstanding section 1041. The Service neglected to mention that the taxpayer who requested the ruling and received an unfavorable result then went to the Tax Court, which in Balding v. Commissioner agreed with her that the transaction was, indeed, a nontaxable one under section 1041! According to the Service:

Although private letter rulings may not be cited as precedent, [P.L.R. 1988-13-023], involving a military pension[,] again illustrates [the] Service position. In this ruling a divorce originally awarded the pension entirely to H because the Supreme Court had held in McCarty v. McCarty, 453 U.S. 210 (1981)[,] that military pensions could not be treated as community property. After Congress overruled McCarty, 10 U.S.C. § 1408 (1982), the state enacted a statute providing for the reopening of divorce decrees so that military pensions could be treated as community property. H then purchased W's community property interest in the pension by agreeing to pay her cash in three annual installments. The ruling held that W must include the cash in income at the time she receives it. . . . [T]he Service declared W [had] in effect assigned to H her right to receive payments over H's lifetime in exchange for payments from H over

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304 See Reg. § 1.83-7(a).
305 See supra notes 287-89 and accompanying text.
three years. W could not escape the taxation of ordinary income by recharacterizing her assignment of income as a nontaxable transfer of property under section 1041.\textsuperscript{306}

There is simply no mention of the subsequent Balding litigation, in which the Service's position was rejected. In other words, the Service cited, in effect, its litigating position in a case that it lost in support of its conclusion in the field service advice! The Service also cited another private letter ruling,\textsuperscript{307} which it asserted "contains broad dictum stating that assignment-of-income principles override section 1041."\textsuperscript{308}

All of this inconsistency and confusion is completely unwarranted and unnecessary. First, the assignment-of-income doctrine did not grow up in contexts involving statutory nonrecognition rules. Which should control in cases of overlap, if indeed there is considered to be an overlap? In no other nonrecognition context—except section 1041, and even there we have seen that the record is quite inconsistent—has the assignment-of-income doctrine been held to trump a specific nonrecognition rule created by Congress. The argument has been raised in at least one other nonrecognition context, but the Third Circuit held that the nonrecognition rule should take precedence.

In Hempt Brothers, Inc. \textit{v. United States} ,\textsuperscript{309} a partnership using the cash method of accounting transferred all of its business assets, including its accounts receivables and payables, to a newly formed corporation in exchange for all of its stock. Each of the requirements of section 351 were satisfied on the transfer, which meant that none of the built-in gain or loss in the transferred assets, including the difference between the fair market value of the receivables and their zero basis, was recognized on the transfer. The issue was whether, notwithstanding the nonrecognition rule in section 351, the partnership should be taxed on the ordinary income collected by the corporation with respect to the transferred accounts receivables under the assignment-of-income doctrine. The Third Circuit rejected that argument, concluding that the policies underlying the nonrecognition rule in section 351 would be frustrated if the assignment-of-income doctrine were applied.

If the assignment-of-income doctrine is thought to be inconsistent with the nonrecognition rule in section 351, it should surely be held to be inconsistent with the nonrecognition rule in section 1041, since Congress evidenced an intent that the nonrecognition rule in the latter have even greater depth than thought appropriate in other nonrecognition contexts. In transfers under section 351, for example, the nonrecognition rule does not apply to the extent that the property that is transferred is subject to a debt in excess of the property’s basis or was encumbered with debt on the eve of the transfer in an attempt to cash out the 


\textsuperscript{308}F.S.A. 2000-05-006 (Feb. 4, 2000).

\textsuperscript{309}490 F.2d 1172 (3d Cir. 1974).
property's value while shifting the obligation to repay the loan to the transferee. The 1984 House Report accompanying enactment of section 1041 explicitly recognized that such exceptions should not apply in the context of transfers under section 1041. "This nonrecognition rule applies whether the transfer is for the relinquishment of marital rights, for cash or other property, for the assumption of liabilities in excess of basis, or for other consideration and is intended to apply to any indebtedness which is discharged." This intent shows the depth of section 1041 compared even to other nonrecognition provisions.

Second, the assignment-of-income doctrine is an anti-avoidance tool intended to ferret out and prevent inappropriate "income-shifting." Income-shifting that would be considered a mortal sin elsewhere in the tax realm, however, simply should not be considered improper in the context of divorce, for the reasons elaborated upon throughout this article, and specifically should not be considered improper under section 1041. After divorce, a couple is no longer a unit, where the person who earned the services income or owned the property that accrued investment income can retain effective control and enjoyment of the income while having it taxed at a lower rate. Furthermore, there will be no revenue loss unless the person who receives and enjoys the income is in a lower bracket than the transferor. Finally, and most importantly, section 1041 (as well as sections 71 and 215, for that matter) contemplates and condones income-shifting on its face. It was the Davis rule, under which built-in gain that accrued prior to the divorce had to be recognized by the property transferor rather than being shifted to the transferee, that prevented shifting. Under the nonrecognition rule of section 1041, in contrast, any built-in gain that accrued prior to the transfer is not recognized by the transferor but rather is shifted to the transferee, to be recognized by her when realized. The shifting of ordinary income accompanying property in this context is not different in kind from the shifting of built-in gain. Indeed, the shifting of ordinary income not accompanying property is clearly contemplated and condoned in sections 71 and 215, and there can be no logical reason to impose a different rule with respect to an ordinary income interest accompanying a property interest—especially since any built-in gain or loss in the property itself is explicitly shifted to the transferee under section 1041. In short, the assignment-of-income doctrine should be viewed as being fundamentally inconsistent with section 1041, not trumping it. Certainty should attach to the form the parties negotiate between themselves, a form that they understandably believe will dictate the tax consequences. Therefore, I recommend that a new Treasury Regulation be issued to confirm that the assignment-of-income doctrine does not trump section 1041.

Would such a new regulation be invalid as inconsistent with Congressional intent, as evidenced by the enactment of the QDRO option in one context in

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310See I.R.C. § 357(b), (c).
311H.R. REP. No. 98-432, at 1492 (1984). Cf. Reg. § 1.1031(d)-2 (providing that the excess of liability relief over liability assumed in a like-kind exchange of property otherwise qualifying for nonrecognition under section 1031 will be considered "boot" that triggers gain recognition).

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which the assignment-of-income doctrine has otherwise been raised, as evidenced in Darby.\(^{312}\) In other words, do the QDRO amendments carry with them the negative implication that the assignment-of-income doctrine continues to apply as the background rule in divorce, since it was overturned only in the context of a QDRO in connection with qualified plan assignments?

This problem of the "negative implication" in statutory interpretation is a common one. When Congress amends the law in one specific context, many argue that Congress must have intended just the opposite rule with respect to all other contexts not covered by the legislation. Might it not be just as reasonable, however, to argue that such shifting was permissible in other contexts prior to the adoption of the statutory mechanism and that Congress merely had to clarify the mechanism by which the shifting was to occur in the context of qualified pension plans because of the specific statutory language at issue defining the "distributee"? This argument is particularly persuasive because the QDRO involves only qualified pension plans, which were subject to anti-alienation rules imposed by ERISA in 1974—the so-called spendthrift provisions—that prevented plan participants from assigning away their interests in the plan to other parties, as Mr. Darby attempted to do. This handicap does not apply to other kinds of income assignments, so Congress did not need to clear away any obstacles in any other context—only in the context of qualified plan assignments. To accomplish the income-shifting in the qualified plan context that arguably was already permissible in other contexts under section 1041, Congress had to amend the law in order to provide that alienation in divorce was permissible, notwithstanding the ERISA spendthrift provisions, and that the transferee should be provided all of the protections provided to the original plan participant. This seemed to be the primary purpose of the QDRO legislation, as indicated by its legislative history:

IN GENERAL

The bill clarifies the spendthrift provisions by providing new rules for the treatment of certain domestic relations orders. In addition, the bill creates an exception to the ERISA preemption provisions with respect to these orders. The bill also provides procedures to be followed by a plan administrator (including the Pension Benefit Guaranty Corporation (PBGC)) and an alternate payee (a child, spouse, former spouse, or other dependent of a participant) with respect to domestic relations orders.

Under the bill, if a domestic relations order requires the distribution of all or a part of a participant’s plan benefits under a qualified plan to an alternate payee, then the creation, recognition, or assignment of the alternate payee’s right to the benefits is not considered an assignment or alienation of benefits under the plan if and only if the order is a qualified domestic relations order . . . .

\(^{312}\)See supra notes 281-83 and accompanying text.
PRESENT LAW

Generally, under present law, benefits under a pension, profit-sharing, or stock bonus plan (pension plan) are subject to prohibitions against assignment or alienation (spendthrift provisions). A plan that does not include these required spendthrift provisions is not a qualified plan under the Code, and State law permitting such an assignment or alienation is generally preempted by ERISA.

Several cases have arisen in which courts have been required to determine whether the ERISA preemption and spendthrift provisions apply to family support obligations (e.g., alimony, separate maintenance, and child support obligations). In some of these cases, the courts have held that ERISA was not intended to preempt State domestic relations law permitting the attachment of vested benefits for the purpose of meeting these obligations. Some courts have held that the ERISA preemption provision does not prevent application of State law permitting attachment of nonvested benefits for the purpose of meeting family support obligations. There is a divergence of opinion among the courts as to whether ERISA preempts state community property laws insofar as they relate to the rights of a married couple to benefits under a pension, etc., plan.

The [Service] has rules that the spendthrift provisions are not violated when a plan trustee complies with a court order requiring the distribution of benefits of a participant in pay status to the participant’s spouse or children in order to meet the participant’s alimony or child support obligations. The [Service] has not taken any position with respect to this issue in cases in which the participant’s benefits are not in pay status.

REASONS FOR CHANGE

The committee believes that the spendthrift rules should be clarified by creating a limited exception that permits benefits under a pension, etc., plan to be divided under certain circumstances. In order to provide rational rules for plan administrators, the committee believes it is necessary to establish guidelines for determining whether the exception to the spendthrift rules applies. In addition, the committee believes that conforming changes to the ERISA preemption provision are necessary to ensure that only those orders that are excepted from the spendthrift provisions are not preempted by ERISA.

This legislative history makes it clear that the reason why Congress had to act was because the plans involved were qualified pension plans subject to ERISA’s spendthrift and preemption provisions. The amendments were necessary in order to carve out assignments in divorce from the statutory restrictions that otherwise prohibited such assignments. In other words, the statute itself, not the assignment-of-income doctrine, prevented the transferees from gaining a property interest in the transferor’s qualified pension plan interest, since the statute defined the “distributee” who must include qualified plan distributions in gross income to be the service provider who earned the income. In short, the statutory amend-

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ments creating the QDRO (so that the Mr. Darbys of the world can now avoid taxation on qualified plan distributions to their ex-spouses under a QDRO) do not mean that the assignment-of-income doctrine otherwise should be considered to trump section 1041 in contexts not involving qualified pension plans. If anything, the QDRO legislation implies that Congress felt it necessary to act to bring assignments of qualified plan interests into conformity with assignments of other kinds of accrued income interests that presumably succeeded in shifting the tax obligation to the transferee under section 1041.

In short, I believe that Treasury has the power to issue the regulation proposed below even without any statutory amendment to section 1041. All it takes is the political will. Nevertheless, I recommend that Congress enact new section 1041(f) to provide that "the assignment-of-income doctrine developed at common law shall not apply to transfers of income rights incident to divorce" in order to ensure that Treasury issues the required guidance. I want to make clear, however, that statutory amendment is not, in my view, a necessary prerequisite for issuance of the proposed regulation.

The regulation might look something like this:

§ 1.1041-x. The Assignment-of-Income Doctrine and Section 1041. (a) In General. The assignment-of-income doctrine developed at common law by the courts, which generally provides that compensation income is taxed to the service provider, and that property income is taxed to the property owner, even if the rights to receive the services or property income are assigned to another, shall not apply to transfers of such income rights incident to divorce. The assignment-of-income doctrine can apply to transfers between spouses that are not incident to divorce, unaffected by section 1041.

The assignment-of-income doctrine should continue to apply to transfers between spouses who are not in the process of divorce but who nevertheless file separate tax returns under section 1(d). The proposed regulation assumes that section 1041 will continue to apply both to transfers during marriage, as well as transfers incident to divorce. An equally justifiable approach, however, would be to amend section 1041 to repeal its applicability to transfers during marriage that are not incident to divorce. If that were done, this second sentence of the proposed regulation would not be necessary.

Amending section 1041 in this manner would make sense for two reasons. First, nonrecognition of gain is not justifiable in the case of sales for valuable consideration. For example, assume that John owns a business that supplies other businesses with office supplies. Mary, his wife, opens a new business as a sole proprietor and purchases office supplies from her husband's business. There is no good reason why John's gain on the sale of office supplies to Mary should garner nonrecognition treatment, but it does under current section 1041. Spouses attempting to recognize built-in losses without selling the property to a third party, but rather to each other, would be prevented from doing so by section 267. Second, other transfers between spouses, i.e., gifts, do not need section 1041 to garner nonrecognition treatment, because gifts are not generally realization events. Indeed, having section 1041 apply to transfers that are gifts injects a discontinuity between spousal gifts and gifts among others, because the basis rules are different if the gifted property has a built-in loss. Under section 1041, the transferee spouse takes a carryover basis in all cases, even when the gifted property has a built-in loss at the time of the gift. Gifts of loss property between others, in contrast, are saddled with the basis rule in section 1015(a), which provides that the transferee, for purposes of calculating later gain or loss on a transfer of the gifted property, uses the lower of carryover basis or the fair market value at the time of the gift. This lower-of-basis-or-value rule prevents the shifting of built-in losses to someone (presumably a family member) who is in a higher tax bracket and can thus

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(b) **Examples.** The following examples illustrate this paragraph.

**Example 1.** H is a lawyer who uses the cash method of accounting and who is owed $50,000 under a contingent-fee contract for services already rendered. H and W divorce, and their divorce settlement requires that one-half of any money recovered under H's contingent-fee contract be paid to W. H receives the $50,000 owed to him under the contract and pays $25,000 to W. The assignment-of-income doctrine does not require that H must include the entire $50,000 in gross income. H must include $25,000 in gross income, and W must include $25,000 in gross income.

**Example 2.** W, who uses the cash method of accounting, enters into a nonqualified deferred compensation arrangement with her employer, such as a so-called rabbi trust arrangement. At the time of her divorce with H, $50,000 of compensation income has been earned under the arrangement but has not yet been received by or included by W in her gross income. Under the terms of the divorce decree, W must pay one-half of the compensation accrued at the time of the divorce, or $25,000, to H when her right to distribution under the arrangement ripens. Several years later, W receives $100,000 under the terms of the rabbi trust and pays $25,000 to H. The assignment-of-income doctrine does not require that W must include the entire $100,000 in gross income. W must include $75,000 in gross income, and H must include $25,000 in gross income. See section 414(p) regarding assignments of interests in qualified plans.

**Example 3.** W, who uses the cash method of accounting, enters into a nonqualified deferred compensation arrangement with her employer, such as a so-called rabbi trust arrangement. At the time of her divorce with H, $50,000 of compensation income has been earned under the arrangement but has not yet been received by or included by W in her gross income. Under the community-property laws in the state in which H and W live, H would have a right to one-half of the compensation accrued at the time of their divorce, or $25,000, when the money is distributed to W several years later. Under the terms of their divorce decree, W pays H $10,000 immediately at the time of the divorce in exchange for his agreement to forego his rights under state law to collect in the future any amount with respect to W's deferred compensation arrangement. The assignment-of-income doctrine does not require that H include the $10,000 received in gross income. Rather, H's $10,000 receipt will be analyzed under sections 71 and 215.

**Example 4.** H receives from his employer nonqualified stock options that do not have a readily ascertainable fair market value and thus are not includable in his gross income as compensation at the time of receipt. Under the terms of their divorce decree, H transfers these options to W at a time when the strike price is $100 and the fair market value of the stock is $150. Neither the assignment-of-income doctrine nor section 83 requires that H must include $50 in his gross income as compensation at the time of transfer. Allowing spouses to take a carryover basis in all cases, even with loss property, allows just such a shifting for spouses who file separate returns. Thus, it would make sense to consider amending section 1041 so that it applies only to transfers incident to divorce. See Gabinet, supra note 80, at 43-46. This issue is, however, generally beyond the scope of this paper, which focuses on simplifying the tax consequences of transfers in divorce.
gross income at the time of the transfer. W takes a zero basis in the options. If W exercises the options for $100 at a time when the fair market value of the stock is $150, W must recognize $50 of ordinary income under section 83. H realizes no tax consequences, and W takes a $150 basis in the stock.

B. Divorce Redemptions of Stock in Closely Held Corporations

The issue of how to treat redemptions of stock in closely held corporations that occur pursuant to the terms of a divorce settlement or decree has given courts some pause since the enactment of section 1041. To put the issue in perspective, I shall first describe the normal "background rules" governing the tax treatment of stock redemptions in closely held corporations outside the divorce context. I shall then turn to the issue within the context of divorce.

Assume, for example, that Ann and John, who are siblings, each own 50% of the stock in a corporation through which they operate the family business begun by their father and handed down to them. Further assume that the corporation has $50,000 in cash as well as $50,000 in operating assets when Ann retires, and the corporation redeems Ann's stock (which has a basis to her of $10,000) by distributing to her the $50,000 in cash in exchange for all of her stock in the corporation. The redemption leaves sole ownership of the corporation, now worth $50,000 (instead of $100,000) in John's hands. Thus, while his ownership interest increases from 50% to 100% because of the redemption, the value of his interest remains unchanged at $50,000, since prior to the redemption he owned 50% of the stock of a corporation worth $100,000, and after the redemption he owns 100% of the stock of a corporation worth $50,000.

While the sale of appreciated stock held by nondealers normally triggers capital gain (after the tax-free recovery of basis), Congress enacted section 302 in order to ensure that this treatment will apply when shareholders sell their stock back to the corporation itself only if the transaction sufficiently resembles a sale to a third party and is not a ruse to extract earnings from the corporation without dividend treatment. If a redemption results in little or no diminution in the redeemed shareholder's interest in the corporation, then the transaction will not be respected as a sale but rather will be treated as the distribution of a cash dividend—ordinary income to the recipient with no tax-free basis recovery.

Since Ann's stock is completely redeemed in our hypothetical, she has clearly reduced her interest in the corporation, and thus her sale will be respected as a true sale rather than a disguised dividend distribution. She thus will realize a

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316See I.R.C. § 302(d).

317See I.R.C. § 302(b)(3), (a). While section 302(c) provides that the attribution rules of section 318 apply in determining the extent to which a shareholder's interest has actually decreased, the family attribution rules do not operate to attribute John's stock to Ann. See I.R.C. § 318(a)(1) (failing to mention sibling attribution).
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$40,000 capital gain ($50,000 amount realized less her $10,000 stock basis).

John might also realize tax consequences on Ann's redemption. Even though the value of his economic interest in the corporation remains unchanged before and after the redemption, John would nevertheless be treated as realizing a dividend of $50,000 if he had actually had the "primary and unconditional obligation" to purchase Ann's stock upon her retirement, and the corporation satisfied that obligation in his stead.\(^\text{318}\) The transaction would be treated, in that case, as if John had received a $50,000 cash distribution (a dividend to him\(^\text{319}\)), which he then used to purchase Ann's stock interest (resulting in $40,000 of capital gain for her, as before). If John did not have the primary and unconditional obligation to purchase Ann's interest, then he would realize no tax consequences on Ann's stock redemption. Notice that Ann's tax treatment is not affected by John's tax treatment. She realizes $40,000 of capital gain, whether she is deemed to transfer the stock to the corporation or to John.

John's tax treatment, deriving from whether he had the "primary and unconditional obligation" to purchase Ann's stock at the time of the redemption, was developed in a series of litigated cases\(^\text{320}\) that resulted in the issuance of Revenue Ruling 69-608, which summarized the case law and provided guidance regarding the tax consequences of common buyback agreements among shareholders when a closely held corporation redeems its stock. The ruling makes clear that form will govern in this context. If, for example, John and Ann had entered into an agreement under which either would purchase the stock of the other upon the other's death or retirement, and that agreement remained outstanding at the time of Ann's retirement and redemption of her stock by the corporation, then John would realize a dividend.\(^\text{321}\) If, in contrast, John and Ann had amended such an agreement prior to her retirement to provide that the corporation would assume the obligation to redeem her stock upon her retirement, then John would avoid dividend treatment, so long as the amendment did, indeed, occur prior to Ann's retirement (when John's obligation would have ripened).\(^\text{322}\) If the buyback agreement between John and Ann provided that the corporation would have the primary obligation to redeem the stock interest of each upon death or retirement, with a secondary obligation imposed on the remaining shareholder to purchase the stock if the corporation were unable to fulfill its obligation, then John would avoid dividend treatment, since his obligation would not be "primary" but only "secondary."\(^\text{323}\) Because form controls in this context, the parties are given absolute power to determine what the tax consequences will be through their choice


\(^{319}\)This assumes that the corporation has sufficient earnings and profits so that the entire cash distribution qualifies as a dividend. See I.R.C. §§ 301(a), (c), 316.

\(^{320}\)See, e.g., Sullivan v. United States, 363 F.2d 724 (8th Cir. 1966); Holsey v. Commissioner, 258 F.2d 865 (3d Cir. 1958); Wall v. United States, 164 F.2d 462 (4th Cir. 1947); S.K. Ames, Inc. v. Commissioner, 46 B.T.A. 1020 (1942); Kobacker v. Commissioner, 37 T.C. 882 (1962).


\(^{322}\)Id. (discussing Situations 6 & 7).

\(^{323}\)Id. (discussing Situation 5).

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of form.

It is not my purpose to analyze whether this form-sensitive approach makes sense as the general background rule. Rather, my goal is to note that it has been well accepted for more than three decades and to consider how it ought to affect the tax treatment of redemptions in divorce.

Now assume the same facts as above, except that Ann and John are married, and Ann's 50% stock interest in the corporation is required to be redeemed for $50,000 in their divorce agreement. Suppose instead that the divorce decree actually required John, not the corporation, to purchase Ann's stock, but the corporation nevertheless redeems the stock. How should Ann and John be treated for tax purposes in these situations?

There are two possibilities. Ann's stock transfer could be respected as a direct transfer to the corporation. Under this view, Ann would realize a $40,000 capital gain when she receives the $50,000 cash payment, and John would have no tax consequences. In the second situation, in particular, however, John may be considered to have had the "primary and unconditional obligation" to purchase Ann's stock but instead caused the corporation to redeem it. Should we deem the $50,000 cash payment to have gone first to John (dividend to John), and then to Ann as consideration for John's purchase of the stock, as we do outside the divorce context? Or, to put the steps in a different order (though it makes no difference in end result), should we deem Ann to have transferred to John her stock since he was, in fact, required to purchase it, which was then redeemed (dividend to John\textsuperscript{326}), followed by the payment by John to Ann of the redemption proceeds? Ann's deemed transfer to John in that case would be nontaxable under section 1041. This would be the one big difference in tax consequences, as compared to the same transaction occurring outside the divorce context, where Ann would realize capital gain in any event (either on the transfer to the corporation or on the transfer to her fellow shareholder), since no nonrecognition provision would be available for the redeemed shareholder outside the divorce context.\textsuperscript{325}

Is that the proper approach? Would it make sense to deviate from the current practice outside the divorce context (\textit{i.e.}, essentially allowing the parties to designate to whom the corporate distribution should be taxed by their choice of form) if the redemption happens to occur pursuant to divorce? Might not the divorce context actually provide the more persuasive context for maximum flexibility for the parties to decide to whom the distribution should be taxed? Before addressing these questions, consider another possibility.

\textsuperscript{324}See United States v. Davis, 397 U.S. 301 (1970) (holding that when one person owns 100% of the stock of a corporation, actually or constructively, any redemption distribution is taxable as dividend unless the transaction qualifies as a partial liquidation under section 302(e)).

\textsuperscript{325}Ann's receipt of the cash, which would then be deemed to come from John instead of the corporation, would be tax-free to her as well as "not alimony" (under current law, at least), except in the extremely unlikely event that her estate's right to receive the cash would disappear if Ann died prior to receipt. Under the proposals advanced in Part II, John and Ann could decide whether the cash transfer from John to Ann would be includable/deductible or excludable/nondeductible.
A common fact pattern in divorce is that only one spouse, say John, actually owns 100% of the couple's interest in the corporation, but Ann is entitled to a $50,000 cash payment representing her marital property interest in the stock. In the simplest case, John can pay Ann cash directly from other resources, and the tax consequences of that cash payment would be analyzed under section 71, as described in Part II. But suppose John has his wholly owned corporation redeem one-half of his stock for $50,000, which he then transfers to Ann? Because the redemption would not reduce his percentage interest in the corporation (since John would own 100% both before and after the redemption), John would be treated as receiving a $50,000 dividend. The cash transfer to Ann would again be analyzed under section 71.

Finally, suppose that John actually transfers 50% of his stock (with a $10,000 basis) to Ann under the divorce decree, which then requires that the corporation redeem Ann's 50% interest for $50,000. If the form of the transaction were respected, i.e., if Ann's perhaps momentary ownership of the shares were respected, then John's transfer of stock would be a nonrecognition event under section 1041(a). Ann would exclude the value of the stock under section 1041(b)(1), take John's basis in the stock under section 1041(b)(2), and recognize $40,000 of capital gain on the redemption.

The government's ruling and litigating position in these contexts is that form governs the tax consequences. The government argues that actual transfers of stock between the spouses should succeed in shifting the tax consequences when the stock is transferred to the third party (the corporation), even if the stock so transferred is held for only a moment before redemption. Moreover, it argues that a direct redemption of stock without an actual transfer between the spouses should also be respected as a direct redemption, with no implicit transfer between spouses prior to the redemption, absent facts ensuring that the nonredeemed spouse knew of and directed such a deemed stock transfer prior to the redemption. This approach not only happens to accord with the law that applies outside the divorce context in the case of such stock redemptions but also is clearly consistent with section 1041 itself.

For example, in one private letter ruling, H owned 90% of the stock in a family corporation. (The remaining stock was owned by H's brother and son.) The corporation's bylaws and articles of incorporation required shareholders to offer to sell stock to the corporation and fellow shareholders before a sale of stock to a third party. Pursuant to a divorce decree, H made an actual transfer of stock (amounting to 39% of the outstanding stock of the corporation) to W without first offering it to the corporation or other shareholders. The stock was then immediately redeemed under the terms of the divorce decree. The corpora-

\[\text{See Davis, 397 U.S. at 313.}\]
\[\text{See infra notes 336-37 and accompanying text (describing the government's litigating position in Ames).}\]
\[\text{See T.A.M. 1990-46-004 (July 20, 1990).}\]
tion issued a promissory note to W, guaranteed by H, as payment for the stock. The ruling reasoned that, absent section 1041(a), this transaction would be viewed as a redemption of stock owned by H, followed by a transfer of the note from H to W, who would be considered a mere conduit. The ruling concluded, however, that the transfer to W should be respected for tax purposes, shifting the tax burden of the redemption to W, because section 1041 was intended by Congress to allow the parties to decide who between themselves should be taxed on the built-in gain in property, including stock, when it is transferred outside the marital unit. According to the Service:

The spouses are thus free to negotiate between themselves whether the “owner” spouse will first sell the asset, recognize the gain or loss, and then transfer to the transferee spouse the proceeds from that sale, or whether the owner spouse will first transfer the asset to the transferee spouse who will then recognize gain or loss upon its subsequent sale.  

That argument is persuasive. In light of the actual stock transfer from H to W, the parties agreed that W should be the one to dispose of the stock outside of the marital unit, with the tax consequences of that disposal falling on her, and they structured the transaction accordingly. We should assume that the amount of stock transferred, as well as other terms of the divorce decree, took into account that the tax liability accompanying the built-in gain should be W’s responsibility, and to rule otherwise would upset the economic terms of their settlement. To have the negotiated arrangement disrupted with a “substance-over-form” argument undermines one of the animating purposes behind section 1041—that the parties be given the power to decide between themselves who should carry the tax consequences regarding property dispositions—and radically changes, after the fact, the nature of the “deal” made by the parties.

But the government’s position as reflected in Temporary Regulation section 1.1041-1T is arguably more ambiguous and has resulted in some courts, when implored to do so by one of the divorcing spouses, deciding that form will not be respected, undermining both the government’s litigating position and the certainty of the law for divorcing taxpayers. In its entirety, Treasury Regulation section 1.1041-1T(c), Q&A 9, provides:

(c) Transfers on behalf of a spouse.

Q-9. May transfers of property to third parties on behalf of a spouse (or former spouse) qualify under section 1041?

A-9. Yes. There are three situations in which a transfer of property to a third party on behalf of a spouse (or former spouse) will qualify under section 1041, provided all other requirements of the section are satisfied. The first situation is where the transfer to the third party is required by a divorce or separation instrument. The second situation is where the transfer to the third party is pursuant to the written request of the other spouse (or former spouse).
The third situation is where the transferor receives from the other spouse (or former spouse) a written consent or ratification of the transfer to the third party. Such consent or ratification must state that the parties intend the transfer to be treated as a transfer to the nontransferring spouse (or former spouse) subject to the rules of section 1041 and must be received by the transferor prior to the date of filing of the transferor’s first return of tax for the taxable year in which the transfer was made. In the three situations described above, the transferor of property will be treated as made directly to the nontransferring spouse (or former spouse) and the nontransferring spouse will be treated as immediately transferring the property to third party. The deemed transfer from the nontransferring spouse (or former spouse) to the third party is not a transaction that qualifies for nonrecognition of gain under section 1041.

Focus for a moment on the third situation described above, which refers to a consent or ratification explicitly mentioning section 1041 and explicitly stating that the property transferred directly from one spouse to a third party outside the marital unit should be considered first as going to the nontransferring spouse (before going to the third party). This rule has a built-in safeguard to ensure that the parties understand the consequences of their agreement. An example of situation three would be one in which John transfers property directly to Bill only after receiving a consent signed by Ann that explicitly says that she should be considered as having received the property first under section 1041 and then transferring the property to Bill directly. In light of their explicit agreement, Ann should have little cause to complain when any built-in gain in the property that is realized on the transfer to Bill is held to be her tax responsibility. This portion of the regulation has prompted no litigation—for good reason, I think. The parties have necessarily had a meeting of the minds regarding who should be taxed, and thus there is no room for each to point at the other party later and claim that the other is responsible for the tax liability arising on the transfer to the third party. I believe this is a good rule that should be continued in any revamped version of this regulation, though I would add that this meeting of the minds could be evidenced by a statement in the divorce agreement itself providing that the property should be considered transferred by Ann, rather than John, to the third party.

Why does John not simply transfer the property to Ann first, to ensure that there can be no misunderstanding, as in the ruling described earlier? One reason might be cost. Transferring title for state law purposes, even if it involves no more than drawing up an agreement, takes time and usually requires at least some money. It might actually cost quite a bit of money if the property at issue is real estate and the state in which John and Ann live imposes a real estate transfer tax. Transferring title twice (once from John to Ann and then again from Ann to Bill) can be much more expensive than a single transfer from John to Bill (on behalf of Ann). This portion of the regulation therefore can be seen as consistent with the overall goal of allowing the parties to decide for themselves.

[^33]: See supra notes 336-38 and accompanying text.
who should be responsible for the tax consequences of built-in gain (or loss) when property leaves the marital unit (Ann, in this case), while at the same time allowing the parties to reduce the costs that might attend an explicit transfer to Ann that would ensure that result. Situation three, in other words, explicitly provides the parties with the flexibility knowingly to shift the tax responsibility to Ann without having to incur the burden of, say, two real estate transfer taxes.

But now focus on the regulation language describing the first situation. It seems to provide that any transfer of property from one of the spouses to a third party should be considered instead to be a transfer first to the other spouse, and then a transfer from that spouse to the third party, so long as "the transfer to the third party is required by a divorce or separation instrument." Notice that it does not provide that the divorce decree stipulate that the transfer should be considered as made first to the other spouse under section 1041 before leaving the marital unit. It says only that the transfer outside the marital unit itself must be required in the divorce decree. That potentially includes every single property transfer (including, but not limited to, stock redemptions) required to be made to a third party outside the marital unit by a divorce decree. In other words, it appears to say that every time a divorce decree requires a transfer of property to someone outside the marital unit, such as with a stock redemption, the property should be considered as going to the other spouse first as a matter of course, shifting the tax consequences of the disposition to the other spouse in every case, regardless of the intention of the parties. Unlike in situation three, where the parties must clearly indicate their intent that a transfer between the spouses be deemed to occur, this rigid reading of the language describing situation one implies that property (and its attendant tax liabilities) should be deemed to have been shifted between spouses prior to the taxable transfer outside the marital unit when the spouses themselves did not knowingly intend that result. If this is the right way to read that language, it is a huge trap for the unwary.

Such a reading is inconsistent with the government's rulings and litigating position, i.e., that section 1041 allows the parties to decide for themselves who, between them, should be responsible for the built-in gain or loss with respect to property transferred outside the marital unit. It also is inconsistent with the overall flavor of Regulation section 1.1041-1T(c), Q&A 9 itself, taken as a whole, which seems intended primarily to provide some flexibility to the parties to have a direct transfer outside the marital unit be considered as first going to the other spouse and then outside the marital unit, without incurring the associated costs attending an actual transfer to the other spouse. As stated by the

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332 Temp. Reg. § 1.1041-1T(c), Q&A 9.
333 See, e.g., Berger v. Commissioner, 71 T.C.M. (CCH) 2160, 1996 T.C.M. (RIA) ¶ 96,076 (discussing these issues within the context of a transfer of an unincorporated cemetery business directly from one spouse to a third party outside the marital unit, as required by a divorce decree).
334 It also makes situations two and three entirely redundant. If every single transfer made to an outside party under a divorce instrument is deemed to be first transferred to the other spouse, it seems to me that there could be no situation where the consent of the other party would be necessary to shift the tax liability.
government in a Technical Advice Memorandum: "Q&A 9 is based on the premise that the transferee spouse [Ann, in our John-directly-to-Bill transfer posed above], by directing that the property be transferred to a third party, has exercised sufficient ownership over the property to be considered a transferee for purposes of section 1041 of the Code."\textsuperscript{335} Ann's direction is assumed to be present. Such an assumption is not warranted, however, simply because the transfer is required to be made by the divorce decree, with no showing that the transfer is actually made on Ann's behalf, as would occur with the documentation described in situation three.

In other words, the overall flavor of Q&A 9 is pro-taxpayer, to provide the divorcing parties with the flexibility to achieve their desired ends through more efficient means. Situation three clearly assumes that the deemed transfer will be a knowing one, i.e., that the spouse who is deemed to have received the property from the other spouse (and thereafter transferred it outside the marital unit) directed the transfer to the third party on her behalf. A rigid reading of the language describing situation one, to the effect that any transfer to a third party under a divorce decree first involves a deemed transfer to the other spouse, lifts those words out of context and imbues them with a meaning that does not sit well within the larger framework. But that reading has nevertheless essentially been seized upon by some courts. At the least, the language has caused confusion.

In \textit{Arnes v. United States},\textsuperscript{336} for example, Joann and John Arnes each owned one-half of the stock of Moriah, a corporation formed to operate a McDonald's franchise. The couple agreed to divorce in 1987, and the settlement agreement required that Joann's stock be redeemed for $450,000, since McDonald's informed John Arnes that it required 100% ownership of the equity and profits to be owned by the owner/operator and that their joint ownership must terminate on the divorce. Joann surrendered her 2,500 shares to the corporation in exchange for cash and other consideration, and the corporation shortly thereafter issued an additional 2,500 shares to John.

The divorce settlement agreement did not state that Joann's stock, which she transferred directly to the corporation, should first be viewed as going to John under section 1041. The decree required only that the redemption occur so that Joann would no longer be involved with the corporation, pursuant to McDonald's franchise requirements. Joann nevertheless took the position, first at the District Court level and then before the Ninth Circuit, that she should be considered to have first transferred the stock to John, which was then redeemed by the corporation, because she argued that the redemption was made "on behalf of" John within the meaning of Regulation section 1.1041-1T(c), Q&A 9.

In other words, Joann seized upon the inartful language in the regulation to argue that John should shoulder the tax consequences of the redemption (even though Joann received the cash)—\textit{regardless} of whether there was a meeting of

\textsuperscript{335}T.A.M. 1990-46-004 (July 20, 1990) (emphasis added).
\textsuperscript{336}981 F.2d 456 (9th Cir. 1992).

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the minds that Joann should be deemed to have transferred the stock to John before the redemption occurred. Joann, in short, used the regulation offensively as a tool, as though the regulation were intended to encapsulate a normative decision that John ought to be taxed in these situations (regardless of what the parties intended), rather than merely to provide flexibility to parties to agree between themselves to shift the tax burden of the transfer to the other spouse without having to undertake an actual property transfer to the other spouse first.

Under this approach, Joann’s deemed stock transfer to John would be considered a tax-free transfer to Joann under section 1041. Joann’s actual receipt of the cash that is then deemed to have come from John would also be tax-free, since her right to these receipts would presumably not terminate on her death. The cash payments would thus be tax-neutral payments outside the inclusion/deduction system of sections 71 and 215. Under this view, Joann implicitly argued that John (who was not a party to the litigation) should be deemed to have transferred the stock to Moriah, producing a constructive dividend for John.

The government disagreed, arguing that the form of the transaction as a redemption of Joann’s stock directly by the corporation should be respected in the divorce context, resulting in the tax consequences of the redemption falling on Joann, not John. She would be entitled to exchange treatment under sections 302(a) and (b)(3). Thus, the difference between the consideration that Joann received and her basis in the surrendered stock would produce capital gain or loss for her.

The Ninth Circuit agreed with Joann, interpreting Regulation section 1.1041-1T(c), Q&A 9, to mean that the transfer made directly by Joann to the corporation should be deemed to have been made to John instead, since the transfer outside the marital unit was required by their settlement agreement. The court reasoned that the transfer by Joann to Moriah was made “on behalf of” John because the redemption was mandated by an agreement that was executed in settlement of any community property claims that Joann might otherwise have been able to assert against John. Since virtually any property transfer mandated by a divorce decree or settlement is part of an agreement that, by its nature, settles all claims between the parties that each can otherwise possibly assert against the other under state law, such an approach essentially means that any transfer of property that the divorce decree or agreement requires to be made to a third party outside the marital unit (for any reason, including franchise contract requirements) should first be deemed made to the other spouse before leaving the marital unit, regardless of whether the parties are aware of or intend such a deemed transfer at the time.

The bizarre uncertainty and unintended tax surprises that such an approach creates for divorcing parties was made clear when Mr. Arnes, in a separate Tax Court case brought by the government against him after it lost the case against Joann, argued that the form of the transaction should be upheld, with the tax consequences of the redemption falling on Joann.\textsuperscript{337} The Tax Court agreed—a

\textsuperscript{337}Id.
position that I think to be correct—with the result that neither party was held responsible for the tax consequences of the redemption.338

The Tax Court also originally held that the law outside the divorce context that can impose a constructive dividend on the nonredeemed spouse339 should inform when transfers are made “on behalf of” the other spouse within the meaning of Regulation section 1.1041-1T(c), Q&A 9. In Hayes v. Commissioner,340 for example, H was required to purchase W’s stock under the terms of their divorce settlement. Instead, however, the corporation redeemed W’s stock. Because H had the “primary and unconditional obligation” to purchase the stock under the divorce settlement at the time of the redemption, the Tax Court concluded that H should, as in the non-divorce context, be deemed to have received a constructive dividend under the cases summarized in Revenue Ruling 69-608. In other words, W was deemed to have transferred her stock to H, since H had a legal obligation to purchase it, before it was redeemed by the corporation. W’s transfer would be a nonrecognition event under section 1041, H’s deemed redemption would trigger a constructive dividend for him, and the deemed transfer of the redemption proceeds from H to W would likely not fall within the inclusion/deduction scheme of sections 71 and 215.

I think that Hayes was rightly decided. I cannot see that H should have been surprised by the conclusion that he was responsible for the tax consequences of the stock disposition outside the marital unit, since the divorce agreement actually required him to purchase the stock from W. The tax results should have come as no surprise in view of the form chosen by the parties, unlike in Ames, where H did not have a legal obligation to purchase W’s stock and yet was held (by the Ninth Circuit) to have been the object of a deemed transfer of the stock from W, which was then redeemed, with the redemption proceeds then deemed transferred from H to W. (Lots of deemed transfers!)

In February of 2000, the full Tax Court, in a lengthy reviewed decision, with one concurring and four dissenting opinions, revisited its approach in this respect in Read v. Commissioner341 and essentially abandoned the approach of Hayes, which looked for guidance regarding the meaning of the terms “on behalf of” by looking to the law outside divorce. In Read, Carol Read owned about 48% and William Read owned about 52% of all of the stock of Mulberry Motor Parts, Inc., when they decided to divorce. Under the terms of their divorce agreement, William Read was required either to purchase Carol’s stock or to cause Mulberry Motor Parts to redeem the stock. If he chose the latter, which he did, he would guarantee the payment and would become secondarily liable for the payment under state law. Carol Read did not include any capital gain regarding the stock redemption, and William Read did not include any construc-

338See id.; see also Blatt v. Commissioner, 102 T.C. 77 (1994) (also respecting the form of a transaction and taxing W on a direct redemption of her stock).
339See supra notes 315-23 and accompanying text.
340101 T.C. 593 (1993).
tive dividend equal to the consideration received by Carol. The issue, of course, was whether the direct redemption should be respected for tax purposes or whether Ms. Read should be considered as having transferred the stock to the corporation "on behalf of" Mr. Read, thus shifting the tax consequences of the redemption to him. To protect its interest as stakeholder, the government issued notices of deficiency to both parties. The opinion relates: "[The government's] role here is that of a stakeholder. Nonetheless, [the government] has indicated that 'Ms. Read has the better argument that she should not recognize any gain from the sale of her stock pursuant to [section] 1041.'"\textsuperscript{342}

It is fairly clear that William did not have a "primary and unconditional obligation" to purchase Carol's stock at the time of the redemption, since the divorce settlement required \textit{either} William \textit{or} the corporation to purchase Carol's stock. This is similar, though not precisely on point, to Situation 5 in Revenue Ruling 69-608, where the Service concluded that the nonredeemed shareholder did \textit{not} realize a dividend when he was only secondarily obligated to purchase the shares if the corporation failed to redeem them.\textsuperscript{343}

But all of that is irrelevant under the Tax Court's decision, because the Tax Court majority concluded that the standard developed outside the divorce context for measuring when a nonredeemed shareholder should be considered to have received a constructive dividend—\textit{i.e.}, the "primary and unconditional obligation" standard—should not be considered commensurate with the standard determining whether a property transfer is made "on behalf of" the nontransferring spouse within the meaning of Regulation section 1.1041-1T(c), Q&A 9. A quick reading of the case might first imply that the case stands for the proposition that satisfaction of the primary-and-unconditional-obligation test is but one means by which a transfer will be considered "on behalf of" the other spouse but that the latter language can go much further as well. But the court explicitly disclaimed any relevance of the primary-and-unconditional-obligation standard to stock redemptions in divorce. According to the court:

We hold that the primary-and-unconditional-obligation standard is not an appropriate standard to apply in the instant cases in order to determine whether Ms. Read's transfer of her . . . stock to [the corporation] was a transfer of property by the transferring spouse (Ms. Read) to a third party ([the corporation]) on behalf of the nontransferring spouse (Mr. Read) within the meaning of Q&A-9. We further hold that the primary-and-unconditional-obligation standard is not an appropriate standard to apply in any case involving a corporate redemption in a divorce setting in order to determine whether the transfer of

\textsuperscript{342}Id.

\textsuperscript{343}See \textit{supra} note 323 and accompanying text. The ruling cites S.K. Ames, Inc. \textit{v.} Commissioner, 46 B.T.A. 1020 (1942). In that case the nonredeemed shareholder entered into a contract under which he had the obligation "to purchase or cause to be purchased" the shares of the redeemed shareholder. Under this language, the nonredeemed shareholder was held not to have had the "primary and unconditional obligation" to purchase the shares that were instead redeemed.

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property by the transferring spouse to a third party is on behalf of the nontransferring spouse within the meaning of Q&A-9.\textsuperscript{344}

In short, the meaning of "on behalf of" in Q&A 9 should be determined afresh, without regard to the primary-and-unconditional-obligation test that is applied outside of the divorce context.

The Tax Court concluded that, although the stock redemption did not satisfy a legal obligation of Mr. Read, the stock transfer was nevertheless made "on behalf of" him under the "common, ordinary meaning" of those words.\textsuperscript{345} Parsing the language "on behalf of" as though it appeared in the statute itself, rather than in a regulation that apparently attempted simply to provide some planning flexibility to the parties, the Tax Court majority quoted Webster's Ninth New Collegiate Dictionary (1990) and concluded that "on behalf of" meant "in the interest of" or "as a representative of."\textsuperscript{346} Applying those standards, the Tax Court held:

Ms. Read was acting as Mr. Read's representative in transferring her . . . stock to [the corporation], and Ms. Read was acting in the interest of Mr. Read in making that transfer to [the corporation], in that she was following and implementing Mr. Read's direction as reflected in his election under the divorce judgment that she transfer her . . . stock to [the corporation].\textsuperscript{347}

The Tax Court further concluded that the transfer came within Situation 1 of the Q&A 9 regulation, since the transfer was made pursuant to the divorce decree.

The most recent case addressing this issue is Craven v. United States,\textsuperscript{348} in which the Eleventh Circuit confirmed that any transfer made directly to a third party pursuant to a divorce decree should be deemed to be made "on behalf of" the other spouse, regardless of whether the parties knowingly intend that result. Billy Joe and Linda Craven started and subsequently incorporated a pottery business, with 51% of the stock owned by Billy Joe, 47% owned by Linda, and the remaining 2% owned by their two children, 1% each. Under the terms of their 1991 divorce agreement, Linda was obligated to sell her stock to the corporation for a promissory note of $4.8 million, guaranteed by Billy Joe, who acknowledged that the terms of the arrangement were of "direct interest, benefit and advantage" to him. Linda argued "that the transfer of stock to the corporation was done pursuant to her divorce agreement and therefore was on behalf of

\textsuperscript{344}Read, 114 T.C. at 14.
\textsuperscript{345}Id. at 37.
\textsuperscript{346}Id. at 36. The phrase "on behalf of" is not in the statute, though the court parses that language as though it were. The phrase is in a regulation that attempts to further the purpose of the statute by giving effect to the parties' agreement that a deemed transfer between spouses, prior to the transfer outside the marital unit, should be respected when the parties' intent is clear. The court's approach, by excising those words and analyzing them independently of the entire context of Q&A 9, as well as section 1041 as a whole, may result in a holding that a deemed transfer occurred, \textit{even if neither of the parties intended or bargained for such a transfer}, if the court believes that the transfer by one spouse was nevertheless made "as a representative of" the other.
\textsuperscript{347}Read v. Commissioner, 114 T.C. 14, 36-37 (2000).
\textsuperscript{348}215 F.3d 1201 (11th Cir. 2000).
her former spouse within the language and purposes of the temporary regulations." The government argued that the form of the transaction should be respected and that Linda be taxed on the redemption.

Both the District Court and the Eleventh Circuit held in favor of Linda, in opinions that confirmed the scope of the Q&A 9 language to include virtually all transfers of property outside the marital unit to third parties, without regard to the parties' apparent or actual intent, so long as the transfers are required by the divorce decree. The District Court held that the transfers were made "on behalf of" Billy Joe "because the redemption came as a result of Billy Joe's obligation under Georgia law to equitably divide all marital assets." You cannot get any broader than that. Virtually all such transfers are made as part of the parties' property settlement. The Eleventh Circuit recounted with approval the Tax Court majorities' opinion in Read, including its reading of the terms "on behalf of" to mean "in the interest of" or "as a representative of." The Eleventh Circuit then cited three factors as supporting Linda's position: (1) that the redemption was mandated by the divorce decree, (2) that Billy Joe guaranteed the redemption note issued by the corporation, and (3) that he acknowledged that the terms were of "direct interest, benefit and advantage to him." But, and this is critical, the court made it clear that, even if the second and third factors were entirely absent, Linda would win simply because the redemption was mandated by the divorce decree.

This myopic reading of the "first situation" in Q&A 9 (that any transfer to a third party required by a divorce decree should be considered as made by the other spouse), lifted from its surrounding context, is just the sort of reading that not merely drains the pro-taxpayer regulation of the very ability to specify who should be responsible for the tax consequences of a third-party transfer but actually mandates a "one-size-fits-all" approach that can require precisely the opposite result that the parties intended. There is no reason to believe that simply because a divorce decree requires one of the spouses to transfer property outside the marital unit that the parties will understand that to mean that the transferring spouse should first be deemed to have transferred it to the other spouse, shifting the tax responsibility to her. Indeed, if a divorce decree explicitly requires John to transfer property that he owns to someone outside the marital unit, the natural assumption on the part of the divorcing couple would quite likely be just the opposite—that John is responsible for that gain—since he owned the property, and the decree could have just as easily required John to transfer it to Mary first but did not.

349Id.
350Id. at 1203 (citing Craven v. United States, 70 F. Supp. 2d 1323, 1329 (N.D. Ga. 1999)).
351Id. at 1207.
352Id.
353The court stated: "The first fact enumerated above [that the redemption was required by the divorce decree] would be enough on its own to qualify Linda's transfer to the corporation for nonrecognition under section 1041. The other two factors simply add strength to this conclusion. Id.

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It should be fairly obvious that the primary-and-unconditional-obligation test cannot provide the outer reaches of the standard regarding when a transfer is made “on behalf of” a spouse, if for no other reason than that the Q&A 9 regulation applies to transfers of all kinds of property to all kinds of third parties—not simply stock transfers to corporations. Nevertheless, I think it should be clear that whenever H is required by a divorce settlement to purchase W’s stock, but instead the corporation redeems W’s stock, W should be considered as transferring the stock to H first. This would result in the tax consequences of the redemption falling on H, consistent with the parties’ apparent agreement that H should take ownership of the stock, so that when it is transferred to the corporation, he should be deemed to have made that transfer. This tax treatment also happens to be the same tax treatment that would arise outside the divorce context under the primary-and-unconditional-obligation test. In other words, I think it should be clear that satisfaction of the primary-and-unconditional-obligation test should also satisfy the standards of the on-behalf-of test in the stock-redemption context, since the on-behalf-of test under section 1041 ultimately turns on the parties’ intent, and when the nonredeemed spouse is legally obligated to purchase stock that is instead redeemed, the parties’ intent that he should take title before the stock leaves the marital unit is sufficiently clear.

But if W and H state in their divorce settlement that Blackacre is required to be transferred by W directly to a third party, and further state that it should be considered first as going to H, thus shifting the tax liability to H (even though the transfer is made directly to the third party for the sake of expediency), that agreement should be respected—even if H did not have a scintilla of legal obligation to purchase Blackacre from W at the time she made the transfer, let alone a “primary and unconditional obligation.”

In short, the overarching consideration that should inform interpretation of section 1041 is that the parties’ bargain should be respected; their agreement regarding who should bear the burden of taxation on a transfer of property outside the marital unit should be respected. This value should be respected even if the nontransferring spouse does not have a legal obligation to purchase property from the other spouse but nevertheless agrees that the tax obligation attending the transfer of the property outside the marital unit should be his. This allows the parties to bargain for a fair and equitable division of marital property by taking into account the tax consequences that will attend disposition of property outside the marital unit. Protecting the “deal” made by the parties is a value in the divorce context that should be paramount.

The agreements in Read and Craven were not, unfortunately, crystal clear, and it is on this issue that the discussion should center regarding how the regulations should be amended to fix these ambiguities. How clearly should the regulations require the parties’ intent to be stated regarding deemed transfers between the spouses prior to a transfer outside the marital unit before that intent is given effect? The agreement in Read did not—as it should have, in my opinion—explicitly provide that the stock should be considered as being transferred to Mr. Read first, even though that formal step was omitted in the interest of expedi-
ency, with a direct transfer from Ms. Read to the corporation, instead. Should we nevertheless try to extract the parties' intent as best we can in such ambiguous circumstances? Or should we require a higher degree of proof before we consider deemed transfers to occur, since, after all, the parties could have gone to the bother of actually transferring the property to the other spouse first? If they want the luxury of dispensing with that intermediate step, but nevertheless have it deemed to have occurred, perhaps they should have the burden of making that intent sufficiently clear. Regulation section 1.1041-1T(c) was apparently intended to provide pro-taxpayer flexibility, not a straightjacket. On the other hand, the regulation should not provide standards that are so vague that it will continue to require courts to struggle in gleaning the parties' unclear intent.

This is all the more true because of one more important point that needs to be made. The lack of clarity in the current regulations is in dire need of a fix, not only to provide clear guidance to divorcing couples, but also to eliminate the good chance of whipsaw that the Treasury can experience. As was the case in the confusion under Davis before section 1041 was enacted, each party can take advantage of this ambiguity by taking reporting positions that the other is responsible for the tax consequences of the transfer outside the marital unit. Moreover, unlike under sections 71 and 215, there is no information-reporting requirement under section 1041 that can decrease the chance of such a whipsaw that goes unnoticed by the government.

This concern for whipsaw, as well as a desire to decrease the chances for litigation, leads me to recommend completely rewriting Regulation section 1.1041-1T(c), Q&A 9, so as to both create bright-line, understandable rules that should accord with common presuppositions of divorcing parties and reinforce the notion that was likely intended by that regulation, i.e., that the parties can explicitly agree to shift the tax responsibility attending property owned by one spouse to the other spouse (without actually having to transfer the property to that other spouse prior to the transfer outside the marital unit) so long as the parties make their intention sufficiently clear that an implicit transfer should be deemed to occur (in order to shift the tax responsibility) prior to the transfer to the third party. The bottom line is that there should be as little chance for surprises and uncertainty as possible, while at the same time there should be the maximum flexibility possible for the parties to decide who, between them, will be responsible for the built-in gain or loss with respect to property transferred outside the marital unit. With that in mind, I would advocate that any doubt from the face of the divorce documents about whether the parties intended a deemed transfer between the spouses to precede the transfer outside the marital unit should be resolved in favor of not deeming such a transfer to have occurred—which is precisely opposite to the presumption that the Read and Craven courts derived from Situation 1 of the temporary regulations—since the parties usually have the freedom to arrange an actual transfer between them prior to the transfer to the

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354 See supra notes 63-75 and accompanying text.
third party if they so desire.

The revised regulation might look something like this:

§ 1.1041-x. Transfers to Third Parties.—(a) In General. Transfers of property by one or both spouses to a third party outside the marital unit are not entitled to nonrecognition treatment under section 1041, regardless of whether the transfer is incident to divorce. If, for example, H transfers property with a basis of $10,000 to a third party for $50,000, as required under a divorce decree, H's $40,000 realized gain is not entitled to nonrecognition under section 1041, absent application of one of the exceptions noted below. If H makes an actual transfer of the property to W, who then transfers the property to a third party for $50,000, H's $40,000 realized gain is not recognized under section 1041(a), W excludes the $50,000 value of the property under section 1041(b)(1), W takes H's $10,000 basis in the property under section 1041(b)(2), and W realizes and recognizes the $40,000 gain on the subsequent transfer to the third party for $50,000, even if the transfer to the third party is contemplated at the time of the transfer to W. In the three limited circumstances described below, property transferred directly by one spouse to a third party will be deemed to have first been first transferred to the other spouse, thus shifting the tax consequences of the transfer outside the marital unit to the other spouse, without an actual prior transfer to that other spouse. Such an implicit transfer between the spouses preceding the transfer to the third party will be deemed to occur only if: (1) the parties explicitly agree in the divorce or separation instrument or in a later separate agreement that such a transfer to the other spouse should be deemed to occur under section 1041, (2) the other spouse had a primary and unconditional obligation to purchase the property that was instead directly transferred to the third party, or (3) the transfer directly to the third party satisfied a debt or other obligation owed by the other spouse to the third party.

(b) Examples. The following examples illustrate this paragraph.

Example 1. H owns Blackacre, with a basis of $10,000 and fair market value of $50,000. The divorce settlement between H and W requires H to sell Blackacre and divide the proceeds equally between H and W. In order to equitably divide the value in all the marital property, after taking into account the tax consequences of the disposition, H and W agree that W should be responsible for recognizing the $40,000 gain with respect to Blackacre for tax purposes. The divorce settlement therefore also provides that the property transferred directly from H to the third party should be considered first as having been transferred from H to W. H transfers the property directly to the third party for $50,000 and transfers $25,000 to W. Even though H transfers the property directly to the third party, he will be considered for tax purposes as having first transferred the property to W, and W will be considered as having transferred the property to the third party and subsequently transferring one-half of the sales proceeds to H. H's $40,000 realized gain is not recognized under section 1041(a), W excludes the $50,000 value of the property under section 1041(b)(1), W takes H's $10,000 basis in the property under section 1041(b)(2), and W realizes and recognizes the $40,000 gain on the transfer to the third party for $50,000. W's deemed $25,000 cash payment to H is ana-
lyzed under sections 71 and 215.

Example 2. H owes $50,000 to a third party. Pursuant to the terms of their divorce decree, W transfers Blackacre, which has a basis of $10,000 and a fair market value of $50,000, directly to the third party in satisfaction of H's debt. The property transferred directly to the third party will be deemed to have been first transferred to H. W's $40,000 realized gain is not recognized under section 1041(a), H excludes the $50,000 value of the property under section 1041(b)(1), H takes W's $10,000 basis in the property under section 1041(b)(2), and H realizes and recognizes the $40,000 gain on the transfer of the property to the third party in satisfaction of his debt.

Example 3. H and W each own 50% of the stock in a corporation through which they operate the family business. The terms of their divorce settlement require W to transfer her stock, which has a basis of $10,000 and a fair market value of $50,000, to the corporation in exchange for $50,000. The corporation redeems W's stock in exchange for $50,000. W's $40,000 realized gain is not entitled to nonrecognition under section 1041, and W's tax consequences on the redemption will be governed by section 302. H realizes no tax consequences on the redemption.

Example 4. H and W each own 50% of the stock in the corporation through which they operate the family business. The terms of their divorce settlement require H to purchase W's stock, which has a basis of $10,000 and a fair market value of $50,000. H does not purchase W's stock, but the stock is instead redeemed for $50,000 by the corporation. Because H had the primary and unconditional obligation to purchase W's stock, the stock transferred directly to the corporation will be deemed to have been first transferred to H. W's $40,000 realized gain is not recognized under section 1041(a), H excludes the $50,000 value of the stock under section 1041(b)(1), H takes W's $10,000 basis in the stock under section 1041(b)(2), and H's tax consequences on the redemption will be governed by section 302.

Example 5. H and W each own 50% of the stock in the corporation through which they operate the family business. The terms of their divorce settlement require H to purchase W's stock or, at H's election, to have W's stock redeemed by the corporation. W's stock has a basis of $10,000 and a fair market value of $50,000. H does not purchase W's stock, but the stock is instead redeemed for $50,000 by the corporation. Because H did not have the primary and unconditional obligation to purchase W's stock, the stock transferred directly to the corporation will not be deemed to have been first transferred to H. W's $40,000 realized gain is not entitled to nonrecognition under section 1041, and W's tax consequences on the redemption will be governed by section 302. H realizes no tax consequences on the redemption.

There is an alternative solution that would overturn the approach of the Tax Court and Eleventh Circuit in Read and Craven, respectively, that every single transfer of property outside the marital unit should first be considered as involving a deemed transfer to the other spouse, so long as the divorce instrument requires the transfer. The alternative is to provide that no deemed transfers are ever implied, i.e., that the actual transferor of the property outside the marital

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unit is always the taxed party. I reject this alternative because I think that it contains a serious trap for the unwary.

Consider, for example, Mary and John. Mary owns 40% of the stock (worth $40,000) of the corporation containing the family business, and John owns the remaining 60%. Since John and Mary are divorcing, John wants Mary to sell her stock and completely disassociate herself from the business, thus consolidating ownership in John. Mary is agreeable to the proposition, but she is unwilling to have her stock redeemed directly by the corporation, for then she would be taxed on the transfer. She knows that section 1041 provides that if she transfers her stock to John, instead, which would accomplish the same consolidation of ownership in John as would a redemption of her stock, the transfer would not be recognition event for her. She would not be taxed on the receipt of cash, and John would take a carryover basis in the stock that he would be obligated to purchase.

John is not agreeable to this, because he knows that if he then causes the corporation to redeem the stock purchased from Mary, the $40,000 that he receives from the corporation would be taxed as a distribution to him under section 301. He therefore insists in the divorce negotiations that Mary agree to have her stock redeemed directly. When she resists because of the resulting tax bill, John offers to agree to her demands and purchase the stock from her if she agrees to reduce her demands for support payments from $1,000 per month to $700 per month for five years. She agrees that this is a fair tradeoff, and thus the divorce instrument provides that John must buy Mary’s stock, and John must pay Mary $700 per month for five years in support payments.

Since John controls the corporation, however, he causes the corporation to redeem Mary’s stock directly for $40,000. Mary receives the same $40,000 that she was supposed to receive from John, but now the Service tells her that she is taxed on the transfer, that there can be no deemed transfer to John, even though he had the legal obligation to buy the stock under the divorce instrument and she gave up $300 per month in additional support payments to induce John to agree to the provision requiring him to purchase the stock instead of the corporation. Imagine Mary’s surprise when the Service tells her that the clause that she negotiated so long and hard over and for which she gave up other valuable consideration—that John buy the stock instead of the corporation—is completely meaningless for tax purposes. So long as John was able to force a redemption because of his control of the corporation, Mary is taxed, regardless of whether or not the parties had agreed that John had the obligation to purchase, not the corporation. The Service would tell Mary, in effect, that all of her negotiations were meaningless, and that it did not matter that she agreed to give up $300 per month in support payments in order to ensure that she would not be taxed on the transfer of her stock. Understandably, Mary would be furious. Since John had the legal obligation to purchase the property, I believe he should be deemed to have purchased the property, relieving Mary of any tax liability on the transfer of the property.

If Treasury nevertheless decides that a rule providing that no deemed transfers
should generally be considered to occur prior to a transfer outside the marital unit, I would at the least urge that this rule not apply—and an implicit transfer be deemed to occur—if the parties explicitly agree to such a deemed transfer in the divorce instrument or subsequent instrument. This is certainly a second-best approach, in my view, to my preferred solution, since it works only for well-advised divorcing couples. If Mary, in the hypothetical above, is not advised by an attorney, I would think that it would never occur to her that she should insert in her divorce agreement a clause providing that if John fails to buy her stock, and arranges instead for the corporation to buy it, there should nevertheless be considered to have been a deemed transfer to John first so that Mary is not taxed. If Mary expects John to honor his obligation to buy the stock, why would she think to insert such a clause? In any event, it would at least help well-advised taxpayers to protect their interests.

In short, I believe that my preferred solution provides fewer surprises to ill-advised taxpayers, since I think that John could hardly claim surprise in finding out that he is deemed to have bought Mary’s stock when he was under a legal obligation in the divorce instrument to purchase it. Nevertheless, a rule that no deemed transfers can occur under section 1041 is clearly better than what we have now: a rule that every transfer outside the marital unit first involves a deemed transfer to the other spouse. Current law clearly needs to be changed.

IV. CONCLUSION

I am of the opinion that the law pertaining to transfers of cash and property incident to divorce was substantially improved in 1984, particularly with respect to the enactment of section 1041 to overturn the Davis result involving in-kind property transfers. But problems remain, and much too much litigation continues to plague this area, an area that ensnares ordinary citizens in all walks of life and income levels. These transactions are not multinational corporate reorganizations involving sophisticated counsel and planning. Divorce is a common, personal transaction, not engaged in for tax reasons, which results in significant non-tax events, such as the parties separating their households. In most respects, the problems arise not as the necessary and right consequences of a coherent theory but because of history and political compromise or the blind application of doctrines that grew up in other contexts that are not appropriate or well suited to the unique context of divorce. Moreover, though enactment of section 1041 should be applauded, it has raised new issues that need particular redress now.

The current mechanisms that must be applied to determine which party will be taxed on a cash receipt or on a stock redemption are not only ambiguous in many respects but also resolve the question in ways that often make no sense (e.g., characterizing as “property settlements” the payment of attorneys’ fees, medical expenses, or unallocated support payments). The resolution also often requires federal tax adjudicators to delve into murky state law in order to determine the answers to these ambiguities, a practice that was heavily criticized before 1984 and was supposed to end with the 1984 legislation.

As I have argued throughout this article, little revenue is at stake in our
system of how to tax cash transfers incident to divorce. Similarly, the answers to whether transfers of accrued income rights ought to be taxed to the transferee or transferor, and whether stock redemptions incident to divorce ought to be taxed to the shareholder whose stock is redeemed or the other spouse, pose minimal revenue concerns. In each and every possible scenario posed, one of the spouses will be taxed; the only question is which spouse's marginal rate bracket will apply. The government is a mere stakeholder. Unlike other areas of tax, the question is not merely whether a deduction will be allowed or whether a receipt should escape taxation. In the context of divorce, every deduction is necessarily accompanied by a corresponding inclusion, so that the only revenue at stake is measured by the difference in rate brackets (if any) between the payor and payee. Similarly, there is no question that assigned income rights and stock redemptions are taxable, even though incident to divorce. The only question is which spouse will realize those tax consequences.

As I have argued throughout this article, the parties' agreement regarding who, between them, should be taxed on income items, whether income accrued prior to the divorce but paid after, or income earned after, should be respected. With no significant revenue streams at stake, there is no compelling reason why the law ought to be otherwise. The parties reach agreement on how to equitably divide their assets and income streams by (if well advised) taking the resulting tax consequences into account. When the government steps in and upsets these expectations after the fact, it upsets the bargain reached between the parties, often for no net revenue gain and often at substantial litigation expense for both the government and the divorced couple.

In many respects, sections 71, 215, and 1041 already recognize and intentionally implement this bedrock value. The time has come to finally abandon the remaining remnants of our futile attempt to differentiate "alimony" from "child support" from cash "property settlements," distinctions increasingly abandoned under state law in this era in which an equitable and fair apportionment of all undifferentiated income and property rights is the goal. The parties should be permitted to designate whether any cash payment should be includable by the recipient and deductible by the payor, on the one hand, or excludable and nondeductible, on the other, with the default rule (in the case of silence) being that such payments are includable by the recipient and deductible by the payor, unless the payment is to a third party on behalf of a child. Treasury should also make it clear by issuing a new regulation (perhaps pursuant to a new Congressional directive in section 1041, though I do not believe that statutory amendment is absolutely necessary) that the assignment-of-income doctrine, which is fundamentally inconsistent with the premises underlying section 1041, does not trump the nonrecognition rule of section 1041 in the context of divorce. Finally, Treasury ought to issue a new regulation to replace Regulation section 1.1041-1T(c), Q&A 9, to specify clearly when property transferred directly from one spouse to a third party outside the marital unit will be considered as having been transferred first to the other spouse before the transfer outside the marital unit, thus shifting the tax consequences to that other spouse.
ADDENDUM

On August 3, 2001, after this article was completed for the Staff of the Joint Committee on Taxation, the Treasury published proposed regulations under section 1041 pertaining to the taxation of stock redemptions incident to divorce. See 66 Fed. Reg. 40659 (Aug. 3, 2001). The excerpt quoted below, from formal comments that I submitted to the Treasury Department concerning those regulations, both describe the approach taken by the proposed regulations and indicate my points of agreement and disagreement with that approach.

The preamble to your notice of proposed rulemaking notes that one of the serious problems that stems from the current ambiguity of the “on behalf of” language in Treas. Reg. § 1.1041-1T(c), Q&A 9, is whipsaw, with each spouse claiming that the other is responsible for the tax consequences of the redemption. To clarify the law so that parties can no longer each have a colorable claim that the other party is the responsible party, you propose that the standards that apply outside the divorce context in determining whether the nonredeemed spouse has realized a constructive distribution should equally apply in the divorce context in determining whether a transfer of the stock between the spouses under section 1041 should be deemed to occur prior to the redemption. In particular, you import the standards found in Revenue Ruling 69-608, which essentially provide that the nonredeemed spouse will be deemed to have received the stock from the other spouse prior to the redemption (and thus will be responsible for the tax consequences of the redemption) if that nonredeemed spouse actually had the “primary and unconditional obligation” to purchase the stock from the other spouse, but the stock was instead redeemed.

Because whipsaw can be avoided by clear rules of any sort, it does not necessarily follow that the rules that apply outside the divorce context should control the question of whether a transfer of property (including stock) should be deemed to occur between the spouses prior to a transfer to a third party in the divorce context. The ambiguity that creates the possibility for whipsaw can be equally killed with a clear rule that no transfers between the spouses should be deemed to occur prior to the redemption, with the consequences of the redemption thus always falling on the redeemed spouse. It therefore becomes necessary to articulate why your proposed solution to the problem of whipsaw-creating ambiguity is the preferred solution.

I suppose that a desire for consistency between the divorce and non-divorce contexts supports your approach, but I do not see a desire for consistency to be a strong reason. If the context of divorce justifies a departure from the “usual rules,” I would advocate a departure (as I do, for example, when it comes to applying the assignment-of-income doctrine to transfers in divorce). Nevertheless, I, too, recommend that the “primary-and-unconditional-obligation test” be imported into the divorce context, because I believe that it is consistent with the chief purpose of the “on-behalf-of” test that has created these problems in the first place.

I believe that the guiding goal should be to allow the maximum flexibility to the divorcing parties to decide for themselves who, between them, should be
responsible for the tax consequences attending a disposition of property to a third party incident to a divorce. Indeed, the overall content of their divorce settlement may often take into account who will be responsible for these tax consequences, and these expectations should not be upset "after the fact," if at all possible. I believe that the original (and laudable) intention behind the "on-behalf-of" language in Q&A 9 was to allow divorcing parties to avoid the additional transaction costs (and sometimes time, if we are talking about a transfer of real estate title) that can arise on an actual transfer between the spouses prior to the transfer to a third party, while nevertheless providing them the flexibility to decide for themselves that the tax consequences of the transfer should, in fact, fall on the nontransferring party, as though the property were first transferred to that party before the transfer to the outsider.

I support the importation of the "primary-and-unconditional-obligation test" in the divorce context, because I believe that the nontransferring spouse (call him H) should not be surprised to learn that he is taxed on a transfer from W directly to a third party if H agreed, in the divorce settlement, to purchase that property from W. In other words, since H had the obligation to purchase, it should not surprise him to learn that he is deemed to have taken title to the property and sold it to the outsider, with the tax consequences of that sale falling on him.

Similarly, if H did not have the primary and unconditional obligation to purchase the property, H should not be taxed on the transfer by W to the outsider, even if the transfer is mandated by the divorce decree and H can be said to benefit in some way by the transfer. Shifting the tax consequences to H simply because the divorce decree mandated that W sell the property to a third party, with no more, would likely cause unadvised parties to be quite surprised. Indeed, the natural assumption on the part of unadvised parties in that context would likely be that W is taxed, since she owned the property and did not transfer it to H in the divorce for him to sell it to the outsider.

If, however, this approach makes sense, then it makes sense across the board for transfers of all kinds of property, not simply stock. In other words, if the primary goal is to draft a regulation that likely embodies the expectations of the parties regarding which, between them, should shoulder the tax consequences of a property sale to an outsider when they fail to make those expectations clear, then the same rule should apply to a sale of, say, real estate that is mandated by a divorce decree. The primary context in which this problem has arisen has been in sales of stock to a corporation, but the same analysis should control with respect to any property. See, e.g., Berger v. Comm'r, 71 T.C.M. (CCH) 2160 (1996) (discussing these issues within the context of a transfer of an unincorporated cemetery business directly from one spouse to a third party outside the marital unit, as required by a divorce decree). Once the underlying value is seen as trying to draft a regulation that provides clear rules that allow the parties, with minimum transaction costs and maximum time savings, to decide for themselves which, between them, should shoulder the tax consequences of a transfer to an outsider—and not as simple consistency with a rule that applies only to stock redemptions outside the divorce context—then there is no reason not to apply this rule to transfers of other property, as well.
(Similarly, there is no reason to limit these rules, as you do in subsection (d) of your proposed regulations, to instances in which the nontransferor spouse owns, either immediately before or immediately after, stock in the redeeming corporation.) I do not think it wise to maintain the ambiguous “on behalf of” language in Q&A 9 for all property transfers except stock redemptions, as you do. I recommend that Q&A 9 be completely repealed and replaced with a new regulation that applies to all property transfers to third parties, whether that property is stock, real estate, or other property. The underlying issue is the same in all cases: intent of the parties.

Once this animating value is made explicit, it should become apparent that the rules should also explicitly confirm, as my shot at proposed regulations do, that an actual transfer between the spouses prior to a transfer to an outsider will be respected, even if the second spouse owns the property only momentarily and the transfer is one that could be ripe for attack under the step-transaction doctrine outside the divorce context. An actual transfer between the spouses prior to the outsider transfer is simply one more method that unadvised taxpayers might use in order to ensure that the tax consequences of the outsider transfer attach to the second spouse, and these expectations should not be upset. See, e.g., PLR 9046004 (July 20, 1990) (concluding that the policy underlying I.R.C. § 1041 supported respecting a momentary transfer between the spouses prior to an outsider transfer, even though the transfer might not have been respected outside the divorce context). In order to allow divorcing spouses to keep transaction costs low and time delays to a minimum, however, I do not recommend that all spouses must make an actual transfer of the property between themselves if they wish to shift tax consequences. Deemed transfers in this context are economically efficient, so long as the regulations are very clear (as the “on-behalf-of” language is not) regarding when such deemed transfers will be inferred.

Finally, each of these positions (that an actual inter-spousal transfer prior to an outsider transfer will be respected and that a deemed inter-spousal transfer will be inferred if the non-transferring spouse had the “primary-and-unconditional obligation” to purchase the property from the other spouse) should be seen as void-filling rules. That is to say, the primary rule should be that the parties can always specify in their divorce agreement who should shoulder the tax consequences of a transfer of property to an outsider. It is only in the case of silence on the part of the parties that these rules should step in to fill the silence in a way that most likely embodies their unspoken expectations.