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NEGOTIATING AND DRAFTING PROPERTY SETTLEMENT AGREEMENTS IN THE REFLECTED LIGHT OF THE DAVIS AND LESTER CASES

JOSEPH N. DUCANTO*

INTRODUCTION

DURING THE early 1960's the United States Supreme Court rendered two decisions which have had a profound impact upon the negotiation and drafting of marital settlement agreements: *United States v. Davis*, 370 U.S. 65 (1962), and *Commissioner v. Lester*, 366 U.S. 299 (1961). Despite the fact that the *Davis* case has been with us for seven years, and the *Lester* case for eight years, there has been surprisingly little effort made in the legal literature to analyze these cases and to relate them directly to the areas upon which they most directly impinge—the negotiation and drafting of property settlement agreements.

It is *not* enough for matrimonial experts, and others who only occasionally enter this field, to know the “black letter” law set forth in these cases. The true “expert” must immerse himself in them. He must acquire an understanding of the implications of these cases and their application to concrete problems. With this knowledge his response to related problems met in face to face negotiations will often appear to be instantaneous. Thus, even though he may frequently be under intense pressure, he can clearly follow the contour lines of these cases without posing insuperable adverse problems or results for either party.

It is my purpose in this article to analyze the aforementioned cases in detail in an attempt to give some practical insight into the application of the principles underlying them. The conclusions reached

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shall be most particularly directed to the many common factual problems encountered in settlement negotiations and drafting of agreements incident to divorce and separation matters.

THE *Davis* CASE¹

Here the United States Supreme Court granted certiorari to review the decision of the Court of Claims reversing the determination of the Commissioner of Internal Revenue regarding taxation of certain transfers made by a husband to his wife in connection with a marital settlement agreement. Mr. Davis had agreed to transfer to his wife one thousand shares of stock in the DuPont Company, "in full settlement and satisfaction of any and all claims and rights against the husband whatsoever (including, but not by way of limitation, dower and all rights under the laws of testacy and intestacy). . . ." The Commissioner of Internal Revenue had determined that the transfer was a "taxable event," but the Court of Claims reversed, basing its conclusion upon previous case law from various Circuit Courts of Appeals. These courts held that the husband's gain realized thereby could not be determined because of the impossibility of evaluating the fair market value of a release of the wife's marital rights.

The Court crosses the threshold question and determines that, in fact, a transfer of property by one spouse to the other in discharge of marital rights *is* a taxable event. The Court summarily rejected any notion that the transaction here really partook of a division of property by co-owners, carefully pointing out that the shares being transferred by Mr. Davis were his personal property and that, in fact, under Delaware law (the local law under which the legal effect of the agreement must be judged) the wife's rights in and to such property related *only* to her indefeasible interest in her husband's estate. Under the divorce laws of Delaware, the Court further pointed out, a court has the right to order financial transactions and transfers on a "reasonable" basis, but that, essentially, Delaware placed a burden of support only on the husband's property, as opposed to making the wife a part owner thereof as in many community property jurisdictions.

The Court next turned its attention to the problem of evaluation of the release of marital rights and held, in effect, that the taxable

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

gain realized upon such a transaction can and will be measured as though the parties were dealing at arm's length, and that the value of the marital rights released will be calculated at the same value as the property transferred in order to obtain the release.² Furthermore, the Court pointed out that failure to fix the basis of the property transferred to the wife at the value as of the date of transfer would pose insuperable evaluation problems for her later, when she sought to dispose of the property.³

One of the equally important aspects of *Davis* is the clear, unambiguous rejection by the Court of the argument that property transferred by a husband to his wife in marital settlement agreements necessarily constitutes a "gift."⁴ Instead the Court decided that for fed-

2. "It must be assumed, we think, that the parties acted at arm's length and that they judged the marital rights to be equal in value to the property for which they were exchanged. There was no evidence to the contrary here. Absent a readily ascertainable value it is accepted practice where property is exchanged to hold, as did the Court of Claims in *Philadelphia Park Amusement Co. v. United States*, 126 Fed. Supp. 184, 189 (1954), that the values of the two properties exchanged in an arm's-length transaction are either equal in fact, or are presumed to be equal. . . . To be sure, there is much to be said of the argument that such an assumption is weakened by the emotion, tension and practical necessities involved in divorce negotiations and the property settlements arising therefrom. However, once it is recognized that the transfer was a taxable event, it is more consistent with the general purpose and scheme of taxing statutes to make a rough approximation of the gain realized thereby than to ignore altogether its tax consequences. Cf. *Helvering v. Safe Deposit & Trust Co.*, 316 U.S. 56, 67 (1942)." *Id.* at 72-73.

3. "Moreover, if the transaction is to be considered a taxable event as to the husband, the Court of Claims' position (which disclaimed any ability to evaluate release of marital obligations by a spouse) leaves up in the air the wife's basis for the property received. In the context of a taxable transfer by the husband, all indicia point to a 'cost' basis for this property in the hands of the wife. Yet under the Court of Claims position, her cost for this property, *i.e.*, the value of the marital right relinquished therefore, would be indeterminable, and on subsequent disposition of the property she might suffer inordinately over the Commissioner's assessment which she would have the burden of proving erroneous, *Commissioner v. Hansen*, 360 U.S. 446, 468 (1959). Our present holding that the value of these rights is ascertainable eliminates this problem; for the same calculation that determines the amount received by the husband fixes the amount given up by the wife, and this figure, *i.e.*, the market value of the property transferred by the husband, will be taken by her as her tax basis for the property received." *Supra* note 1, at 73.

4. "Any suggestion that the transaction in question was a gift is completely unrealistic. Property transferred pursuant to a negotiated settlement in return for the release of admittedly valuable rights is not a gift in any sense of the term. To intimate that there was a gift to the extent the value of the property exceeded that of the rights released not only invokes the erroneous premise that every exchange not precisely equal involves a gift but merely raises the measurement problems discussed, *infra*, p. 71. Cases in which this Court had held transfers of property in exchange for the release of marital rights subject to gift taxes are based not on

eral income tax purposes such a transfer will not be considered a gift, even though it would otherwise be so classed under the gift tax statutes, but for the fact of a divorce.⁵

Initially, the *Davis* case seems direct and clear, and, as "black letter law," would read as follows:

The husband's transfer of property to his wife in settlement of his obligation to support her, as a lump sum alimony payment, or for her release of her rights to his estate, is a taxable disposition of the property in a common-law jurisdiction where the inchoate rights of a wife do not constitute co-ownership. In a community-property state or where the wife does have co-ownership interest in the property, there may be non-taxable disposition of property. The gain to the husband on a taxable disposition is the excess of the value of the rights released by the wife over his basis for the transferred property.⁶

However, the basic defect of "black letter law" is that it often raises more questions than it answers. For example, is *Davis* applicable in situations where a husband transfers solely-owned appreciated property to his wife and there is not a corresponding release by her of her right to support in connection with a divorce? My conclusion is that *Davis* would apply. The concept of a "taxable event" does not hinge upon a precise weighing or evaluation of the consideration received by the husband as a result of the transfer.⁷ Additionally, in these situations the wife generally releases her inchoate rights in and to the husband's estate (even though the legal effect of a decree would presumably bar these rights) by means of the substitution of other benefits she will receive during the husband's lifetime, or from his estate. We must also recognize that the amount of current support agreed upon by the parties is in large measure determined with reference to the size and amounts of the current transfers from the husband to his wife within the property settlement agreement. Hence, it would clearly appear to make no difference as to the taxable

the premise that such transactions are inherently gifts but on the concept that in the contemplation of the gift tax statute they are to be taxed as gifts. *Merrill v. Fahs*, 324 U.S. 308 (1945); *Commissioner v. Wemyss*, 324 U.S. 303 (1945); see *Harris v. Commissioner*, 340 U.S. 106 (1950). In interpreting the particular income tax provisions here involved, we find ourselves unfettered by the language and considerations engrained in the Gift and Estate Tax Statutes. See *Farid-Es-Sultaneh v. Commissioner*, 160 F.2d 812 (2d Cir. 1947)." *Supra* note 1, at 69 n.6.

5. See *Hundley v. Commissioner*, 52 T.C. 495 (1969), for a recent application of this principle, and Rev. Rul. 68-379, replacing ET 19.

6. P-H 1967 FED. TAXES ¶ 31, 111.

7. Solomon, *Property Transfer Pursuant to Divorce—Taxable Event?* 17 STANFORD L. REV. 478 (1965).

character of the exchange whether the wife released all, part, or none of her current right to support.⁸

In the *Davis* case we clearly see establishment of two categories of transfers from husband to wife: 1) a transfer of his solely-owned property in release or relinquishment of marital rights, clearly a taxable transaction; and 2) a *division* of property by co-owners which may or may not constitute a taxable event. It is the second category of transfers to which I shall primarily direct my discussion, since it is this area which is pervaded by the greatest uncertainty of understanding and of result.

WHAT CONSTITUTES A DIVISION OF JOINTLY OWNED PROPERTIES UNDER THE *Davis* CASE?

It is traditional—and indeed institutionalized in large measure in community property states—that husband and wife will, over substantial years of coverture, acquire much property which is held in joint tenancy. In the overwhelming percentage of cases it is exclusively the husband's income which produces the accumulation of wealth in terms of joint bank accounts, checking accounts, jointly owned securities and the marital home. It is equally true that no consideration is given to the gift tax aspects when these joint tenancy arrangements are created. In the majority of these cases the registration of assets in joint names can be characterized as being for the convenience of husband and wife. Such "convenience" extends to the certainty of devolution of these assets to the surviving spouse without the intervention of probate proceedings and the ability of either spouse to attend to alienation or sale of these assets as the agent of the other co-owner spouse. Furthermore, no one should underestimate the powerful forces of resentment, suspicion, and strain which are likely to be created in a marriage by virtue of a husband's attempt not to follow this traditional pattern; one may explain the adverse gift and estate tax consequences of the creation of joint tenancy arrangements to a wife and still not allay her suspicion that registration of assets in her husband's name is meant solely to defeat any possible later claim she may have to such assets.

8. See also text at 15, and discussion of *Pulliam v. Commissioner*, 329 F.2d 97 (10th Cir. 1964).

Notwithstanding absence of recognition or intention on the part of the husband to make a gift of one-half of these assets to his wife, such is often the case for gift tax purposes so far as jointly held securities are concerned.⁹ Additionally, a gift is completed as to bank and checking accounts when the non-contributing spouse actually withdraws or utilizes the funds for her own, non-family-connected, purposes.¹⁰ Registration of real estate purchased subsequent to January 1, 1955 in joint tenancy between husband and wife *does not* result in a gift of an interest to the non-contributing spouse for gift tax purposes, *unless* the spouse furnishing the consideration elected to have the transaction treated as a gift and timely files a federal gift tax return.¹¹ In regard to real estate, the transfer is completed upon death of the purchasing spouse, at which point the survivor has sole legal title. The entire net market value of the real estate is not treated as a "gift" but, in lieu thereof, is fully included in the estate of the decedent for federal estate tax purposes. A gift is also completed when the real estate is sold or otherwise disposed of and the wife receives any portion of the proceeds in excess of the proportion which she originally contributed to its purchase. It is irrelevant for purposes of this analysis that under local law a wife may be treated as actually "owning" a one-half interest for all legal purposes, including payment of local inheritance taxes.¹²

The liability for and payment of gift taxes, and indeed the recognition of any legal duty to do so, is substantially muted and of little practical effect because of the relatively large annual inter-spouse exemption from the gift tax which normally applies because of the operation of the marital deduction to such gifts.¹³ For example, a husband may make a gift of up to \$6,000 annually to his wife without any gift tax liability, because one-half of the gift, \$3,000, is excluded from computation by use of the marital deduction and the other one-half, or another \$3,000, is exempt by use of the husband's annual

9. Treas. Reg. 25.2511-1(h)(5) (1970).

10. Treas. Reg. 25.2511-1(h)(4) (1970).

11. INT. REV. CODE of 1954, § 2515; Treas. Reg. 25.2523 (1970).

12. In Illinois, for inheritance tax purposes, a surviving joint tenant is taxable only on one-half the value of joint tenancy properties. ILL. REV. STAT. Ch. 120, § 375(5) (1969).

13. Treas. Reg. 25.2523 (1970).

gift tax exclusion.¹⁴ This annual amount can be augmented by utilization of the husband's specific lifetime exemption of \$30,000, to permit him to transfer into joint tenancy as much as \$66,000 in a single year without any gift tax liability, although in this case a gift tax return is required.¹⁵

Thus, in any taxable year a husband who saves less than \$12,000 by means of original purchases of securities or other property in joint tenancy has no gift tax liability even though he is technically required to file a return when claiming the marital deduction.¹⁶ Most importantly, however, he achieves no awareness that he has in fact made an effective gift.

It is against the foregoing backdrop that we ought now to apply the *Davis* case to specific factual situations.

(1) Over the 20 years of their marriage, husband and wife have accumulated securities valued at \$150,000 held in joint tenancy, such securities having a cost basis of \$50,000 in their hands. As a part of a property settlement agreement the securities are evenly divided between the parties.

Tax Result: No taxable event. Wife's securities in her hands valued at \$75,000 and have a basis of \$25,000, with the same result for husband.

(2) Same facts as (1), but husband transfers *all* securities to wife and receives a release of her support, dower and inheritance rights in husband's estate.

Tax Result: Husband has incurred, and must pay tax on, a capital gain of \$50,000; wife's basis in the securities transferred to her now amounts to \$100,000, \$25,000 attributable to her own basis in one-half the securities and \$75,000, the appreciated value of her husband's share of the securities transferred to her.

(3) Same facts as (1), but *wife* releases her joint tenancy interests to husband; husband agrees to pay wife \$200,000—\$50,000 immediately and \$150,000 in monthly installments over 150 months, and wife releases all her marital rights.

Tax Result: *Wife* has incurred, and must pay tax on, a capital gain of \$50,000. Husband's basis in the securities is now stepped up to \$100,000. The \$50,000 immediate payment to wife is not deductible by husband and is not taxable per se to wife, although the \$150,000 payable in monthly installments qualifies as "periodic,"¹⁷ hence taxable to wife and deductible by husband.

(4) In 1956 husband purchased a marital home costing \$50,000, with a mortgage of \$35,000, providing \$15,000 by means of sale of securities solely owned by him prior to marriage, placing title in joint tenancy with wife. No election was filed by husband treating the transaction as a gift. In 1969, the home then having a fair market value of \$100,000, husband transfers the home to wife in connection with a marital

14. Treas. Reg. 25.2503-1 (1970).

15. INT. REV. CODE of 1954, § 2513; Treas. Reg. 25.2513-1 (1970).

16. Treas. Reg. 25.6019-1 (1970).

17. INT. REV. CODE of 1954, § 71(c)(2).

settlement agreement, subject to the original mortgage which has been reduced to \$15,000, which wife agrees to assume.

Tax Result: Husband has incurred, and must pay tax on, a capital gain of \$35,000 (fair market value less the original basis of \$50,000 and less the outstanding mortgage assumed by wife). Wife's basis in the property is \$100,000, the fair market value of the home at the date of transfer.

(5) Same facts as (4), but house is sold following the divorce and the resulting net proceeds after payment of mortgage balance (\$85,000) is evenly divided between husband and wife.

Tax Result: Husband has incurred, and must pay tax on, a capital gain of \$35,000, as in (4). The \$42,500 paid to wife, but for the decree of divorce, would have constituted a completed "gift" under Section 2515 at the time the one-half proceeds were delivered to wife. Section 2516, however, exempts the transaction from imposition of the gift tax, but the *Davis* rule nonetheless fully applies.

(6) Same facts as (4), but \$15,000 down payment for house came from liquidation of jointly held securities and home is taken in joint tenancy.

Tax Result: Husband has incurred, and must pay tax on, a capital gain of \$17,500 (one-half of fair market value [\$50,000] less one-half of his original basis [\$25,000], less one-half of the existing mortgage [\$7,500] = \$17,500 capital gain). Wife's basis is, however, *not* increased to \$100,000, the full fair market value of the house, but to \$75,000, the sum of her original basis of \$25,000, plus the \$50,000 basis of her husband's received as a result of the transfer.

(7) Husband and wife own in joint tenancy the following property acquired since 1956: (a) stocks with a basis of \$50,000 having a fair market value of \$200,000; (b) real property with a basis of \$50,000 and a fair market value of \$100,000. A property settlement agreement is executed which provides as follows:

Husband Receives:

The stock, valued at \$200,000 with a basis of \$50,000.

Wife Receives:

The real estate, valued at \$100,000 with a basis of \$50,000, *plus* \$50,000 cash from husband.

Tax Result: *Wife* has incurred, and must pay tax on, a capital gain of \$75,000, since she has "sold" her one-half interest in the stock valued at \$100,000 for \$50,000 in cash, plus \$50,000 received by way of husband's release and transfer of his one-half interest in the real estate to wife. Wife's basis in the real estate is increased to \$75,000.

Husband, too, has incurred, and must pay tax on, a capital gain of \$25,000, since he "sold" his one-half of the real estate valued at \$50,000 to wife which has a basis of \$25,000. Husband's basis in the stock retained by him has, however, been increased to \$125,000, his original basis of \$25,000, plus \$50,000 in cash and \$50,000 in the form of real estate paid to wife.

AVOIDANCE OF LATER CAPITAL GAINS TAX PROBLEMS FOR CLIENTS

All of the foregoing strongly suggests that practitioners in this area seriously attend to and be cognizant of the basic tax ramifications produced by these types of transfers. To do otherwise can only lead

to serious and annoying problems, often many years after the transactions have occurred and the divorce has been finalized. For example, a wife disposes of the real estate some years following the divorce. Is she aware of what her tax basis is? Does the husband know that he has to pay a capital gains tax, and did he do so in the taxable year in which the transfer was completed?

Many of these types of problems arise and plague the client long after he has terminated his contact and relation with his "divorce attorney." Such problems are often observed and rectified by the Internal Revenue Service by assessment of deficiencies for unpaid taxes and payment of appropriate penalties. A claimed deduction for alimony paid during the taxable year is often sustained by proof of payment of the funds in the taxable year and by production of the decree of divorce establishing the obligation. Accordingly, it is a simple matter for the revenue agent to check the payment or non-payment of capital gains taxes upon various transfers called for in the decree. Minimally, the attorney's files should contain a current market appraisal of property transferred from one spouse to the other in connection with these arrangements. In addition a letter to the client outlining the net tax effect of his compliance with any agreement should also be kept. To do less than this is to invite serious future problems for the client and to open the door later, and perhaps justifiably, to criticism of the attorney for failure to advise him of his duty to report and pay taxes upon the transactions involved.

LOCAL LAW AS AFFECTING APPLICATION OF THE *Davis* RULE

I would now like to turn my attention to a number of recent cases which demonstrate how application of the *Davis* rule can differ greatly from state to state because of the range of variations as to how local laws view the basic right of a wife in property acquired during coverture. We all understand that in community property states, such as California, local law generally treats all property acquired by husband and wife during coverture (with specified exceptions, such as inheritances), as community property, thereby subjecting it to equitable division upon a dissolution of the community by way of divorce. In these instances the *Davis* case does not intrude, if the community property is equally divided. The rule in *Davis* also applies to common law states with reference to joint tenancies and tenancies

by the entirety. Moving from here, however, there is a "gray" area with extremely subtle shadings where the question of treating transactions as a "division" versus a transfer, becomes a product of interpretation of local law as applied on a case by case basis.

Initially, two cases from Oklahoma must be examined: *Swanson v. Wiseman*¹⁸, and *Collins v. Commissioner*.¹⁹ An Oklahoma statute confers jurisdiction to a court in divorce actions to make a division of property between husband and wife, whether it is jointly owned or in the name of either party thereto.²⁰ Hence, in every Oklahoma divorce action there are three classifications of property rights as between husband and wife: 1) husband's separate property; 2) wife's separate property; and 3) property acquired during the marriage, whether held jointly or not.

In *Swanson v. Wiseman*, the court found that *all* property owned by the parties had been acquired during the course of a lengthy marriage through the joint industry of the parties and ordered that the property be equally divided, irrespective of how legal title was held. The husband, in compliance with this mandate, and apparently as an aid in effectuating the court's order, transferred assets of a business owned by him as a sole proprietor into a newly created corporation. Immediately thereafter he divided equally the resulting stock between himself and his wife. Ten years later the wife disposed of her stock by sale and attempted to claim as her basis the fair market value of the shares as of the date they were transferred to her by her husband. Furthermore, she contended that the transfer of stock was a transfer in satisfaction of her marital rights and that she became entitled to a new cost basis in the stock as of the date of transfer.

The *Swanson* court rejected the wife's argument, holding that the divorce court had specifically concluded that she had a direct interest in all marital property, irrespective of how it was held. Therefore, the transfer to her under the terms of the decree was a "property division" and, hence, her basis in the stock related back to the original basis of the property transferred by her husband to the corporation in exchange for its shares. The court's decision substantially in-

18. *Swanson v. Wiseman*, No. 8478 (F.T.C., Feb. 23, 1961).

19. 388 F.2d 353 (10th Cir. 1968).

20. OKLA. STAT. tit. 12, § 1278 (1961).

creased the capital gains tax payable by her upon disposition of the shares.

In *Collins v. Commissioner*,²¹ decided in 1968, the Tenth Circuit Court of Appeals was called upon to further interpret the same Oklahoma statute which was applied in the *Swanson* case. In this case the husband brought to the marriage a modest amount of stock in a corporation and, shortly after his marriage, received by inheritance a substantial block of additional stock in the same company. Seventeen years later, at the time of the execution of a property settlement with his wife, his original holdings had increased many times over. The husband transferred a substantial block of the stock to his wife in connection with the settlement agreement, which was later incorporated into a decree of divorce. However, the husband failed to report the transfer or to pay a capital gains tax thereon. The Commissioner duly issued a notice of deficiency and this litigation resulted. The husband strongly contended that under the Oklahoma statute in question, conferring jurisdiction on the court to make a division of property, the wife is given an express interest in husband's property and the transfer of shares to his wife was in recognition and release of the wife's interest in his solely owned property.

The *Collins* court *agreed*, as contended by husband, that under the *Davis* case it must look to the state law controlling disposition of the property to determine the exact nature of the present disposition for tax purposes. The court concluded that Mr. Collins was not a party to a "property division" as interpreted under Oklahoma law, because the statute in question did not vest any property right in the wife to her husband's solely owned property prior to the divorce decree. Her marital rights did not, therefore, resemble those of co-ownership. Also, she had no descendable interest in the stock. Finally, she could not have prevented disposition of the stock by her husband prior to the divorce, having no discernable claim to a fixed percentage of the property. Instead the court decided that whatever claim she had was subject to a judicial determination of what was "just and reasonable," and that the determination depended upon factors other than her efforts during the marriage to enhance the value of the property, *e.g.*, her needs, her station in life, the cost of edu-

21. 388 F.2d 353 (10th Cir. 1968).

cating the children, *etc.*²²

*Pulliam v. Commissioner*²³ is another Tenth Circuit Court tax case interpreting a Colorado divorce statute similar to that of Oklahoma. However, in the *Pulliam* case there was no property settlement agreement and the divorce court was called upon—and did—decree a “division of property.” The *Pulliam* court painstakingly held that the absence of an “agreement” did not affect the application of the *Davis* rule in transfers compelled by court order, *nor did the fact that the decree of divorce specifically failed to bar or release all of the wife's marital rights affect application of the Davis rule.* The court further held that the decree alone served to bar the wife's inchoate rights in the husband's estate, doing in the process no more or less than would have been achieved by an express agreement waiving and releasing these rights.²⁴

22. “In summation, it appears that the division of jointly acquired property pursuant to a divorce decree in Oklahoma is in many instances in direct recognition of the wife's right to a share in the property. This concept, however, is not unique to Oklahoma and Kansas, as claimed by petitioner. Many states confer the power upon divorce courts to transfer to the wife property of the husband. It is true that no other state requires the division or so explicitly develops the concept. Nonetheless, the same principle is recognized in other states (citing NELSON ON DIVORCE, §§ 14.104 and 14.120). . . .’ These rights, such as descendable interest, right to control and disposition of property and vested interest, are set out in the Supreme Court in *United States v. Davis*, *supra*, as factors that distinguish a marital division in satisfaction of a legal obligation from a division between co-owners. Since these traditional elements of co-ownership are lacking, the fact that in making a decision the state courts speak as though they were dividing property between co-owners does not prevent the Federal courts from saying that for tax purposes the division was in satisfaction of a marital obligation and thus taxable.” *Id.* at 357.

23. 329 F.2d 97 (10th Cir. 1964).

24. “. . . The argument of the petitioner based on this difference is not dissimilar to his involuntary transfer or lack of agreement argument. Here again all matters relating to the rights and interests of the parties in property or personal obligations of the husband were covered by the decree or were implicit in the proceedings. It would of course be expected that an express release would be included in a property settlement agreement or at least a mention of such right. Likewise, when the property allocation was submitted for the court's determination, its decree or the legal consequences of its action would cover and include the same matters. The divorce court's decree has completely disposed of the property issue, and the wife's marital rights relating to that subject have been terminated. The property was allocated and we are concerned here only with the value of such property transferred to the wife and to then apply the equal value theory. The divorce decree transferred property to the wife to satisfy whatever rights she was asserting or which were otherwise in issue. The parties asked the divorce court in effect to settle the property matter.” *Id.* at 99-100.

Two related 1968 tax cases²⁵ arising under the divorce laws of Kentucky explain how the application of local law can and does seriously impinge upon and direct the federal income tax results. In these cases, Mildred and Harry Swaim owned real estate in joint tenancy which they sold on an installment basis, obviously looking to spread the capital gain over several years rather than paying it all in the year of actual sale.²⁶ Each of them received one-half of the initial down payment and one-half of various notes representing the balance due, payable at varying times over several years. In the wife's later divorce action in Kentucky the court found that the husband had provided *all* of the money for purchase of the real estate. Therefore, under Kentucky law, before the court could award the wife alimony, it was required to order a conveyance and restoration to the husband of *his* property, that is, the real estate owned in joint tenancy. Without requiring an actual transfer, the court awarded to the wife as a part of a lump sum payment in lieu of alimony, one of several of the installment notes originally delivered to her by the contract purchaser at the time of sale in recognition of her joint tenancy interest in the property. These two actions determined that, under the *Davis* case, the *husband alone* was liable for and taxable upon the *entire* capital gain flowing from the contract sale. Therefore, the wife's basis in the installment note awarded her by the court was its value at the time of its award to her—its face value, which she subsequently received—and, hence, there was no taxable gain *as to her*.

"SPECIAL EQUITIES" UNDER LOCAL LAW

Implicit in several of these cases, particularly those from Oklahoma, lurks the presence of some concept akin to what has become known in Illinois as "special equities." Section 17 of our Divorce Act, which is similar to many other states, provides as follows:

Whenever a divorce is granted, if it shall appear to the court that either party holds the title to property equitably belonging to the other, the court may compel conveyance thereof to be made to the party entitled to the same, upon such terms as it shall deem equitable.²⁷

25. *Swain v. Commissioner*, 50 TC 336 (1968), and *Swain v. Commissioner*, 50 TC 302 (1968).

26. INT. REV. CODE OF 1954, § 453(b).

27. ILL. REV. STAT. CH. 40, § 18 (1969).

This provision has been in the Illinois law since 1874 and is but a re-statement of a similar statute prevalent in the *territory* of Illinois prior to 1818.²⁸ A reliance on this section is predicated upon affirmative pleading of facts which, if established by adequate proof, would enable the court to require a transfer of property from the opposite spouse to the spouse not in title.²⁹ It thus appears that such a finding by the court, particularly where supported by ample testimony and evidence appearing in the record, might well insulate a subsequent transfer made pursuant to the court's decree and finding from imposition of tax. This is warranted because presumably the court's award and decree respecting a conveyance under Section 17 would amount to a "division of property" the same as a straight splitting of joint tenancy properties. Hence, it is quite relevant, in cases where a plea of "special equities" can be asserted and properly documented, to consider *not* entering into a property settlement agreement per se. Instead, permitting the court to *hear* the testimony and evidence and make the finding of "special equities" and, on the basis of such findings, to order the appropriate transfers, should be considered.

CONCLUSION AS TO THE *Davis* CASE

A review of the *Davis* case and its application to varying factual situations has amply demonstrated its disembodied presence in the negotiation and drafting of all marital settlement agreements. The fact that attorneys may not have heretofore been aware of this doctrine is excusable since the complexities surrounding its application have not before been treated in a manner comprehensible by any but the most sophisticated of tax specialists.

*Commissioner v. Lester*³⁰ AND THE DOCTRINE OF LUMPING ALIMONY AND CHILD SUPPORT: ITS DEVELOPMENT AND VALIDITY

Since the onset of World War II and the resulting sizable increase in the level and rates of federal income taxation brought about by the war, there has been a clear trend towards extending "income splitting"

28. See also historical notes to § 18, ILL. STAT. ANN. Ch. 40, § 18 (1956).

29. *Skoronski v. Skoronski*, 395 Ill. 301, 302, 69 N.E.2d 690, 691 (1946); *Stevens v. Stevens*, 14 Ill. 2d 99, 108, 150 N.E.2d 799 (1958); see also WEINBERG, *ILLINOIS DIVORCE, SEPARATE MAINTENANCE AND ANNULMENT*, (2nd ed. 1969).

30. 366 U.S. 299 (1961).

advantages to litigants in divorce actions. Prior to 1942 alimony payments were *not* clearly deductible by the payor. It was not until 1942 that an amendment to the Internal Revenue Code clearly spelled out deductibility of alimony.³¹ Since that time the philosophy of taxation of divorced spouses has changed. Presently the parties in divorce actions can agree upon and set the income tax consequences of support arrangements between themselves. The ability to do so effectively and intelligently, however, is entirely dependent upon familiarity and understanding of the basic tax rules and the tax limitations placed upon formulation of these arrangements.

THE *Lester* CASE

In *Lester v. Commissioner*³² the taxpayer deducted in full sums paid to his ex-wife in 1951 and 1952 under an agreement which provided that the amount of periodic payments to the ex-wife would be reduced by one-sixth upon a successive marriage, death, or emancipation of each of three children of the marriage. The Commissioner sued the father to recover a claimed deficiency in payment of income taxes for those years, contending that, because of the reductions as the children became emancipated, the agreement "specifically designated" one-half of the periodic payments as child support. Hence, as to that one-half, the taxpayer was not entitled to a deduction as in the case of "alimony" payments.

The United States Supreme Court held otherwise, interpreting the 1942 amendments to the Code to require an unequivocal "fixing" of child support within the agreement before that sum could be excluded from the taxable income of the mother.

The agreement must expressly specify or '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 instrument' must 'fix' that 'portion of the payment' which is to go to the support of the children. Otherwise, the wife must pay the tax on the whole payment. We are obliged to enforce this mandate of the Congress.

Thus we see the *Lester* case as the clear, unambiguous authority for the "lumping" of child support and alimony into a unitary weekly, monthly or yearly amount.

31. INT. REV. CODE of 1939, §§ 39.22(k)-1, 39.23(u)-1.

32. 366 U.S. 299 (1961).

WHY LUMP AT ALL?

Since we exist under a steeply graduated income tax system, a modest decrease in "taxable income" often produces a much more dramatic percentage decrease in taxes payable. For example: a single taxpayer pays \$8,030 in taxes on \$24,000 of taxable income (excluding the surcharge and state income taxes), with an effective tax rate of 50% on the last \$2,000 block of taxable income. A single taxpayer with \$12,000 of taxable income pays \$2,830 in taxes, with an effective tax rate of 32% on the last \$2,000 block of taxable income. Therefore, a single taxpayer with \$24,000 of taxable income pays almost three times the amount of taxes which a single taxpayer pays with \$12,000 of taxable income. Thus, between \$12,000 and \$24,000 in taxable income the amount of taxes payable triples while income itself only doubles.

Let us, then, look at a family earning \$24,000 of taxable income, which will soon be divided by divorce. By filing a Joint Return and utilizing the "income splitting" privileges provided by the Internal Revenue Code, the parties pay taxes of \$5,660 on two \$12,000 incomes, instead of \$8,030 on a \$24,000 taxable income basis, for a net tax savings of \$2,370. By "lumping" child support and alimony, and dividing the taxable income—\$12,000 to the father and \$12,000 to mother and the children—we can continue to achieve the tax savings accorded to "income splitting" married couples filing a joint return. Furthermore the mother will qualify to report her \$12,000 of taxable income as "head of household" because she will be claiming the children as exemptions and will, in fact, be providing their full support out of "alimony" income received.³³

These considerations impel the conclusion that the lumping of child support and alimony will often produce the greatest net tax savings, often leaving both the mother and father with more "disposable income" than following the more traditional pattern of allocating a sum certain for the children and an additional set sum as alimony. The limitations inherent in this approach can be easily calculated with reference to any given factual situation by simply charting out the results achieved by means of utilizing varying assumptions as to allocations between alimony and child support.

33. See INT. REV. CODE, Tax Rate Table, Head of Household Chart.

SAMPLE *Lester*-TYPE PROVISIONS

With the foregoing background in mind, let us now turn to a typical *Lester*-type provision and examine its utility and deficiencies.

(1) Husband hereby agrees to pay Wife, as, and for, her support and that of the (two) minor children (a girl 10 years and a boy 8 years of age), the sum of One Thousand Dollars (\$1,000) each and every month commencing the first day of the month following entry of a Decree of Divorce in said pending action and continuing from month to month thereafter until further order of Court.

Tax Result: Husband has a deduction for \$12,000 per year as "alimony;" wife must report entire amount in her gross income, and she has exemptions for children and may utilize "Head of Household tax table."

Deficiencies: Court action, or further negotiations, necessary on changes of circumstances, which can easily be anticipated, *i.e.*, wife's remarriage, or emancipation of any of children, change in husband's ability to pay, or needs of wife and children, etc.

It is because of these easily correctable deficiencies that use of the preceding example is quite limited. Thus, the following example, which anticipates readily ascertainable changes, is usually preferable.

(2) Husband hereby agrees to pay wife, as, and, for her support and that of the two minor children (a girl 10 years and a boy 8 years of age), the sum of One Thousand Dollars (\$1,000) each and every month commencing the First day of the month following entry of a Decree of Divorce in said pending action and continuing from month to month thereafter until further order of Court; provided, however, that the amount of such allowance, as now established or hereafter modified, shall be reduced twenty-five per cent (25%) upon the death, marriage or legal emancipation of each child and shall be further reduced an additional fifty per cent (50%) upon wife's remarriage following a divorce.

Tax Result: Identical to that of Example 1. Upon wife's remarriage, remaining portion of payments (either 25% or 50%) still payable by father reverts to *child support* payments, non-deductible by father, not includible in mother's income.³⁴

Deficiencies: Amounts payable still subject to modification upon changes in circumstances, but intended results following wife's remarriage and successive emancipation of children clearly spelled out, thus avoiding future negotiations and possible need for court action.

There are, of course, any number of variations of the above, relatively simple, formulations which can be effectively employed in given instances as, for example, the coupling of a *Lester*-type provision with

34. Upon wife's remarriage, unless the property settlement agreement provides otherwise, local law generally holds that the ex-husband's obligation to support the ex-wife terminates. Since there is no longer any legal duty to support the ex-wife following a remarriage, any future payments made by the ex-husband under the *Lester*-type provision herein set forth will be ascribed as being made in discharge of his legal obligation to support his children. See *Brown v. Commissioner*, 50 TC 865 (1968); *Hoffman v. Commissioner*, 54 TC — (1970).

a lump sum settlement in lieu of property rights,³⁵ as illustrated by the next example.

(3) (a) Husband hereby agrees to pay wife, as and for a lump sum settlement in lieu of all property rights in and to husband's assets and estate, the sum of Sixty-Two Thousand Five Hundred Dollars (\$62,500), said sum to be payable in monthly installments of Five Hundred Dollars (\$500) for one hundred twenty-five (125) months following date of entry of a decree of divorce in said pending action.

(b) In addition to the amounts hereinabove payable to wife in subparagraph (a), husband hereby agrees to pay wife, as and for her support and that of the [two] minor children the sum of Five Hundred Dollars (\$500) per month commencing the first day of the month following entry of a decree of divorce in said pending action and continuing from month to month thereafter until further order of Court; provided, however, that the amount of such allowance, as now established or hereafter modified, shall be reduced fifty per cent (50%) upon achievement of majority, emancipation or death of each child.

Tax Result: Wife must include payments received under both (a) and (b) above in her income as "periodic" payments received. The amounts received by her under (a) still constitute "periodic" income—and hence continue to be taxable to her—following her remarriage, whereas payments received under (b) following her remarriage become non-taxable to her as "child support."³⁶

Deficiencies: Amount of "child support" still subject to modification upon a change of circumstances. Payments under (a) are *unmodifiable* by any court as constituting a lump sum settlement which merges and becomes a judgment for the sum due.

There is, of course, always the possibility of taking the *Lester* case to its ultimate extreme by projecting the amount of child support to be paid over the minority of each of the children, adding to it the amount of alimony to be paid to the wife, and lumping *all* of it into a lump sum settlement payable over a period of more than ten years. While so far as it is known there is no tax case which has had occasion to examine such a provision, this arrangement would be unobjectionable and would safely produce alimony deductions for husband down the line as to the entire sums payable, both before and after the wife's remarriage. Caution in drafting is required, however, to handle the apparent general prohibition against *either* parent foreclosing the rights of children to support payments. Hence, it would be strongly advisable to insert a form of indemnity agreement whereby the wife binds herself to reimburse her husband for any *additional* sums paid by him under future court orders increasing or establishing separate support payments in behalf of the children.

35. DuCanto, *Tax Benefits of Paying Lump Sum Alimony Settlements in Installments*, 51 CHI. B. REC. 36 (1969).

36. *Supra* note 34.

Care in drafting of a *Lester*-type agreement is, of course, of paramount importance, particularly where the attorney is departing from the more simple formulations as in the first two examples herein set forth. There is always present the danger of inadvertently "fixing" a sum certain when nothing of the sort was originally intended by either party.³⁷ Then, too, there is always the unexpected, strange twist of facts and fate, which eludes consideration by even the most compulsive and careful of draftsmen, such as found in the *Siebert* case³⁸, which held that a second court, acting under the Uniform Reciprocal Enforcement of Support Act, "fixed" child support even though the original court of initial jurisdiction did not do so.

CONCLUSION AS TO THE *Lester* CASE

In concluding this exposition respecting the *Lester* case, I would like to leave with several firm thoughts to be carried by the attorney as he handles matrimonial matters and the inevitable drafting job which goes with them.

First, the *Lester* rule is now well-spelled out and is clearly recognized by the Internal Revenue Service and its agents. Thus there is no risk involved in following the mandate of the *Lester* case precisely. *Second*, be chary when attempting to expand or elaborate upon the *Lester* rule. Curb the natural desire to be creative or to try to make a good thing even better, *unless* you are absolutely clear in what you are doing and what ensuing tax results will be achieved. *Third*, carry knowledge of the *Lester* rule into the formulation of "temporary" or *pendente lite* orders. Remember, temporary orders often have a way of becoming permanent ones despite best efforts to the contrary. *Fourth*, the *Lester* case can assist materially by injecting certainty of results into the lives of *both* litigants. A well-drafted *Lester*-type provision will spell out how much income the mother will have available to her after occurrence of easily anticipated events—her remarriage and successive emancipation of the children. The reciprocal of the above is, of course, also true with respect to the father. Finally, use *Lester* in those cases with limited income to be divided. While the figures might not be nearly as dra-

37 *Commissioner v. Gotthelf*, 407 F.2d 491 (2d Cir. 1969).

38. *Ines Siebert*, 51 T.C.M. 611 (1969).

matic as those I have herein quoted, the tax saving involved is even more important where the economic resources are limited and where whatever is saved in taxes may well be employed in providing the necessities of life rather than economic frills which upgrade the quality of life but which could, nonetheless, be jettisoned without serious concern by anyone.