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Welcome to the Funhouse: The Incredible Maze of Modern Divorce Taxation

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ARTICLE

WELCOME TO THE FUNHOUSE: THE INCREDIBLE MAZE OF MODERN DIVORCE TAXATION

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The divorce tax laws affect thousands of American taxpayers. The complexity of the current divorce tax system makes it difficult for couples negotiating divorce or separation agreements to account for the tax consequences of their settlements. In addition, the current divorce tax laws intensify the economic hardship generally suffered by women after divorce or separation.

In this Article, Professor Moran evaluates each system of divorce taxation employed in the United States since 1913 and proposes a departure from the existing scheme. She begins by reviewing the substantive provisions of the various systems, focussing on how each system reflected the lawmakers' views of women in marriage. Next she discusses the complications that arise from the existence of multiple systems. Professor Moran then analyzes the roots of complexity and inequity in the various systems and concludes by proposing a unitary divorce tax system that would be more sensitive to the economic plight of alimony recipients.

As of 1986, for every two marriages, there was one divorce.[1] But, while divorce may end a couple's marital relationship, it rarely terminates their economic relationship. Instead, the divorce settlement agreement may dictate that support payments and property distributions continue for years. The tax conse-

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1 BUREAU OF THE CENSUS, U.S. DEP'T OF COMM., U.S.A. STATISTICS IN BRIEF 1988, at 81, table 124 (107th ed.).

quences of these payments must be taken into account when structuring a settlement in order to achieve the economic distribution intended by the couple—a difficult proposition given the current divorce tax framework.

The current divorce tax system is a confusing conglomeration of four different models. Congress has modified the divorce tax system four times since the inception of the modern income tax in 1913. Each wave of reform reflected society's changing views of marriage as an institution and of spousal roles within marriage. With three of the four revisions, however, Congress allowed previous systems to remain intact by grandfathering prior terminations under old law.[2] As a result, four different sets of provisions remain in effect today.

Each of the four statutory systems includes alimony in the payee's income, allowing the payor a corresponding deduction. Because most other distributions incident to divorce or separation are not included in the recipient's taxable income,[3] Congress created a legion of complicated rules to distinguish spouse maintenance payments from property distributions and child support. These rules can be a trap for the unwary and, in many instances, conflict with current trends in divorce law. A more straightforward system of divorce taxation rules would enable divorcing couples, many of whom have no tax sophistication, to understand the tax consequences of their divorce settlements and to negotiate settlements without expensive legal advice.[4]

This Article examines the four systems of divorce taxation and proposes a more equitable and straightforward system. Part I discusses the basic requirements for each system, emphasizing those requirements that reflect American society's changing view of women in marriage. Part II explains which system applies to particular alimony and support payments. Part III evaluates the current multi-system approach in light of trends in divorce law and concludes that a single unified system that shifts the alimony tax burden to payors is preferable.

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[2] *See infra* Part II.

[3] *See infra* Part I(B)(1)(c).

[4] For a discussion of the trend toward "do-it-yourself" divorce, see J. GREEN, J. LONG & R. MURAWSKI, DISSOLUTION OF MARRIAGE 185–86 (1986).

I. System After System—A Review of the Alimony Rules

A. *Till Death Do Us Part: The Early Years—1913 to 1942*

The sixteenth amendment[5] ended controversy regarding the constitutionality of the income tax.[6] However, new issues soon replaced the old ones. The question changed from whether Congress could tax income to how income should be defined for purposes of the tax. One of the first Supreme Court cases to address this concern was *Gould v. Gould.*[7]

The Goulds were legally separated before the institution of the modern income tax. The separation decree awarded Mrs. Gould alimony. After the enactment of the new income tax, Mr. Gould suspected that the alimony arrangement had tax consequences. Accordingly, he wrote to the Commissioner of Internal Revenue to discover which rules applied.

The Commissioner responded that "alimony paid under final decree, or under a decree of separation, is fixed and determinable annual income, and . . . the person paying such alimony is required to withhold the normal tax on same."[8] In other words, the Commissioner believed that alimony was income to the recipient and was therefore subject to the federal income tax. Further, the Commissioner opined that "the amount of alimony

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[5] The sixteenth amendment provides: "The Congress shall have power to lay and collect taxes on incomes, from whatever source derived, without apportionment among the several States, and without regard to any census or enumeration." U.S. Const. amend. XVI.

[6] The first federal income tax appeared during the Civil War to offset an enormous national debt. Act of Aug. 5, 1861, ch. 45, 12 Stat. 292, 309–11. Almost a year later, Congress redesigned the tax, adopting a progressive rate structure. Act of July 1, 1862, ch. 119, 12 Stat. 432, 473–75. Postwar agitation eventually led to the tax's repeal in 1872. Act of June 6, 1872, ch. 315, 17 Stat. 230. In response to populist pressures from the emerging western states, the tax was revived in 1894 as a means of forcing the wealthy to contribute more to the public fisc. Act of Aug. 27, 1894, ch. 349, 28 Stat. 509. However, the constitutionality of this tax was successfully challenged in Pollack v. Farmers' Loan and Trust Company, 158 U.S. 601 (1895). The Supreme Court held that an income tax violated Article I, Section 2, Clause 3 and Article I, Section 9, Clause 4 of the U.S. Constitution, which required direct taxes to be apportioned among the states in accordance with the population. The income tax did not appear again until the passage of the sixteenth amendment in 1913. *See* J. Witte, The Politics and Development of the Federal Income Tax 67–70 (1985); see generally D. Posin, Federal Income Taxation of Individuals 1–8 (1983), for a brief history of federal income taxation.

[7] 245 U.S. 151 (1917).

[8] Record at 4, *Gould* (No. 702) (Affidavit of Owen N. Brown, Commissioner of Internal Revenue).

paid cannot be deducted . . . [by] . . . a person paying such alimony."[9]

Under the Commissioner's analysis, alimony results in two taxes. First, there is a tax on the husband because he earned the income. Then, after a portion of those earnings is transferred to his ex-wife, the government imposes a second tax based on her receipt of "fixed and determinable annual income." This is a two transfer/two tax system, because each transfer (first by a third party to the payor and then by the payor to the payee) is viewed as creating income subject to tax.

In accordance with the Commissioner's opinion, Mr. Gould withheld taxes from Mrs. Gould's monthly payments. That withholding reduced the net amount of each payment. In response, Mrs. Gould sued Mr. Gould for alimony arrears. Because there were no arrears if Mrs. Gould's alimony was subject to tax, as the Commissioner suggested, the New York courts had to decide whether alimony was income for purposes of the new federal income tax.

Theoretically, the Commissioner's analysis had merit, because the receipt of alimony increases the wife's wealth and is, therefore, income to her.[10] Furthermore, the cost of alimony is a personal expense and therefore should not be deducted by the husband.[11] Despite the theoretical purity of this approach, however, the New York courts rejected the Commissioner's position and instead determined that alimony was not income to the payee, because "it is the duty of a husband to support his wife."[12] Accordingly, the courts reasoned, if support was not income to the wife during marriage, it did not become income

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[9] *Id.*

[10] *Cf.* I.R.C. § 61 (1986) (subjects all income "from whatever source derived" to the federal income tax).

[11] *Cf.* I.R.C. § 262 (1986) ("no deduction shall be allowed for personal, living, or family expenses").

An example of how the tax rules normally apply to compensation income will clarify their application to the alimony case. Assume Homeowner earns $150 from her job. She then hires John to help clean her house, paying him $75. The government taxes Homeowner on her full $150 salary, not allowing her to deduct her payments to John because they are considered personal expenses. In addition, the government taxes John on his $75 (compensation income).

Alimony resembles the payment to John; it is not a gift, and it is made outside of the family relationship, because the marriage has been legally dissolved. Thus, alimony could reasonably be treated identically, that is, as income to the payee and no deduction for the payor.

[12] Record at 10, *Gould* (No. 702). This opinion was later affirmed in 168 A.D. 900, 152 N.Y.S. 1114 (1915).

after dissolution, because the right to support continued even if the marriage did not.[13]

The U.S. Supreme Court accepted the New York courts' view that Mrs. Gould was not subject to tax but did not decide whether the payments were income to her under the sixteenth amendment.[14] In addition, the Court approved the denial of a deduction to Mr. Gould, because it believed that alimony is founded on "the natural and legal duty of the husband to support the wife."[15] Thus, the Court rejected the two transfer/two tax system supported by the Commissioner in favor of a two transfer/single tax model, which placed the entire tax burden on the payor,[16] even when he was forced to pay over a portion of his income as a result of the divorce decree.

Husbands reacted to the *Gould* ruling by developing schemes to circumvent the holding. The most popular invention was the alimony trust.[17] In *Douglas v. Willcuts*,[18] the Supreme Court eliminated the tax benefits of the alimony trust by holding that husbands should be taxed on the income generated by the trust property. The Court reasoned that the husband who was obligated to pay alimony had income to the same extent when the trust paid his alimony obligation as he would if he had received the money directly and then paid it over to his ex-wife.[19]

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[13] *Id.* at 11.

[14] Instead, the Court held that the federal tax statute did not apply to alimony, because such receipts are not encompassed by the phrase "gains or profits and income derived from any source whatever" as used in the Income Tax Act of Oct. 3, 1913, 38 Stat. 114, 166. *Gould*, 245 U.S. at 153. Although the *Gould* decision did not explicitly state that Congress lacked the power to tax alimony, it was often understood to imply that alimony did not constitute "income" within the meaning of the sixteenth amendment. The Supreme Court reinforced this belief when it held in Eisner v. Macomber, 252 U.S. 189, 207 (1920), that the sixteenth amendment applied only to "gain derived from capital, from labor, or from both combined."

[15] *Gould*, 245 U.S. at 153.

[16] In most cases the payor is the husband. Without loss of generality, the payor will be assumed to be the husband.

[17] This device was based on the principle that income from property is taxed to that property's owner. For example, if a husband owned stock that paid dividends, and he used those dividends to pay alimony, he was taxed on this dividend income under *Gould*. *See Gould*, 245 U.S. at 153. But, the taxpayers reasoned, if the same stock was placed in a trust, and the wife was the trust beneficiary, those dividends would then be taxed to her, because she was the equitable owner of the trust property.

[18] 296 U.S. 1 (1935).

[19] The Court based its conclusion on its prior decision in Old Colony Trust Co. v. Commissioner, 279 U.S. 716 (1929). *Old Colony* concerned a taxpayer whose employer paid his income tax as part of his compensation package. In that case the Supreme Court held that the discharge of the taxpayer's obligation by a third party was income to him to the same extent as if he had received the payment directly and then used the proceeds to pay the tax himself.

For a discussion of alimony trusts under the Tax Reform Act of 1984, see Hjorth, *Gould* was the controlling precedent for twenty-five years. The ruling comported well with a legal system that viewed marriage as a permanent institution and which attempted to discourage divorce by predicating all divorce decrees on proof that one spouse was at fault for the dissolution of the marriage.[20] Until Congress enacted the Revenue Act of 1942, the courts and the Internal Revenue Code treated couples as if they remained married forever with husbands retaining a lifelong obligation to support their wives. A couple might be divorced under state law, but, under federal tax law, the watchword remained "till death do us part."

B. *If They Can Work in Factories: Alimony Rules from 1942 to 1984*

As the United States entered World War II, the nation's need for revenues increased dramatically. Accordingly, the main aim of the Revenue Act of 1942 was to substantially enlarge the public coffers. Representative Doughton (D-N.C.), who opened hearings on the Act, set the tone by stating:

> We are faced with revenue needs and a tax program of a magnitude unthought of in modern times, and we all realize it is necessary to raise every dollar of additional revenue that can be raised without seriously disturbing or shattering our national economy. Sacrifices never known before will be required of every American citizen if we are to carry on successfully our war effort and our national defense program, which, of course, we all are determined to do.[21]

In the midst of this fund raising frenzy, when the need to "raise every dollar" was paramount, one might expect that the Treasury would advocate the Commissioner's original assertion to Mr. Gould that alimony was subject to a two transfer/two tax system.[22] Given the desperate situation, a two tax system would have served many worthy goals: first, it is a sure way to either increase tax receipts or discourage divorce; second, it is theo-

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Divorce Taxes and the 1984 Tax Reform Act: An Inadequate Response to an Old Problem, 61 WASH. L. REV. 151, 181–84 (1986).

[20] For a discussion of the history of the fault-based divorce system, see J. GREEN, J. LONG & R. MURAWSKI, *supra* note 4, at 15–35.

[21] *Revenue Revision of 1942: Hearings Before the House Ways and Means Committee*, 77th Cong., 2d Sess. 1 (1942) (statement of Rep. Doughton, committee chairman).

[22] *See supra* text accompanying notes 8–11.

retically correct;[23] and third, it would address the concern of some representatives that *Gould* rewarded heartless Jezebels who roamed the country looking for alimony.[24]

In these ways, the Commissioner's long-dormant position presented an ideal solution: tax both sides of the transaction and benefit the war effort as well.[25] However, the Treasury neither suggested such a system to Congress[26] nor recommended preservation of the status quo. Instead, the Treasury proposed that alimony be taxed to recipients with payors receiving a corresponding deduction.[27]

This proposal presented several problems. First, the compelling need to increase taxes would be thwarted by rejecting the *Gould* approach in favor of the Treasury's proposed income splitting. Under the Treasury proposal, the taxable income—and therefore the tax liability—is shared between the former spouses. Although both parties pay tax under this system, when the progressive rate structure is combined with income splitting between the former husband and wife, the total tax liability declines.[28] This change was inconsistent with the revenue raising thrust of the rest of the Revenue Act of 1942.

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[23] *See supra* note 11.

[24] As Rep. Dingell (D-Mich.) opined while examining a witness:

> He [the husband] is not only stuck for the alimony, but she might have been an unscrupulous, scheming woman, who figured him out as being a sucker worth that much in alimony before she ever married him, and then after she gets the alimony it is just so much velvet for her, and she pays no income tax on it. You say it is not income. Well, what is it? It is not outgo, is it?

Revenue Revision of 1942: Hearings on H.R. 7378 Before the House Ways and Means Committee, 77th Cong., 2d Sess. 2164 (1942).

[25] The following example illustrates how efficiently the two transfer/two tax system would raise revenues. Compare the results when a husband with $30,000 a year of taxable income pays his ex-wife alimony of $12,000 a year. Assuming a 25% tax rate on all taxable income, the total tax liability under the *Gould* system is $7,500 ($30,000 x 25% = $7,500). The entire $30,000 is taxed to the husband, while the wife gets a complete exclusion of the $12,000 alimony. This is a two transfer/one tax system, because, although each transfer (third party to payor and payor to payee) generates income, there is only one tax.

Applying the same tax rate to a two transfer/two tax system, the total tax liability jumps to $10,500 ([$30,000 x 25% = $7,500] + [$12,000 x 25% = $3,000] = $10,500). The husband is taxed on his $30,000 earnings, and the wife is taxed on the receipt of the $12,000 alimony.

[26] *See generally* S. Surrey, P. McDaniel, H. Ault & S. Koppelman, Federal Income Taxation Cases and Materials 17–19 (3d ed. 1986) (hearings on tax legislation begin in the House Ways and Means Committee, with the Treasury Secretary reporting the Administration's recommendations.).

[27] *Revenue Revision of 1942: Hearings Before the House Ways and Means Committee*, 77th Cong., 2d Sess. 92 (1942) (testimony of Randolph Paul, Assistant to the Secretary of the Treasury).

[28] Consider the situation in which the husband with $30,000 income pays his ex-wife $12,000 alimony, but there are two tax rates: 25% on the first $10,000 of taxable income and 50% on each additional dollar.

Second, the fairness of the tax treatment of both parties was questionable. From the husbands' perspective, the higher wartime tax rates caused undue hardship.[29] Many congressmen thought it unfair to force husbands to pay these higher wartime taxes on money they no longer controlled.[30] However, when combined with the progressive rate structure, the new provisions upset the prior order to the detriment of both divorced women and married couples.[31] Moreover, some critics claimed, husbands did not need the benefits provided by the proposal because judges already considered federal taxes when making alimony awards.[32] Thus, any change would discriminate against women who had negotiated awards under the old system. Finally, there was some concern that a tax on alimony was unconstitutional.[33]

Against this background of revenue needs, competing interests, and constitutional concerns, Congress might have post-

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Under the *Gould* system, the husband is taxed on the full $30,000 without any deduction for alimony paid, and the wife receives the full $12,000 alimony without incurring any tax. Therefore, the total tax liability is $12,500, all of which is paid by the husband ([25% x $10,000 = $2,500] + [50% x $20,000 = $10,000] = $12,500).

Under the 1942 Treasury proposal, the husband's tax base is only $18,000 because his $30,000 income is reduced by the $12,000 deduction he receives for alimony paid. His tax liability is therefore reduced to $6,500 ([25% x $10,000 = $2,500] + [50% x $8,000 = $4,000] = $6,500). Although the proposal makes the wife liable for tax on alimony received, her tax on the $12,000 is only $3,500 ([25% x $10,000 = $2,500] + [50% x $2,000 = $1,000] = $3,500). Therefore, the total tax liability declines to $10,000 ($6,500 + $3,500 = $10,000). Although both spouses pay tax under this system, the proposal is still a two transfer/single tax model because the total amount taxed remains $30,000. Under a two transfer/two tax model as originally proposed by the Commissioner, the total amount taxed would be $42,000, which is made up of the $30,000 earned by the husband plus the $12,000 received by the wife.

[29] *See* H.R. REP. NO. 2333, 77th Cong., 2d Sess. 46 (1942), *reprinted in* 1942-2 C.B. 372, 409–10 (increased surtax rates would leave some divorced husbands unable to meet tax obligations after paying alimony).

[30] During the floor debate on the 1942 provisions, Congress was told: "The amount of a husband's income which goes to the wife as alimony under a court order is in reality not income to him at all since he has no control over it as the use to which it is to be put." 88 CONG. REC. 6377 (1942) (statement of Rep. Disney (D-Okla.)).

[31] If a husband and wife remained married and the wife had no independent source of income, all the family proceeds were taxed to the husband, who was subject to the progressive rates. From a tax standpoint, divorced couples did better than married couples under the new law. *See infra* text accompanying notes 40–41.

[32] *See, e.g., Revenue Revision of 1942: Hearings on H.R. 7378 Before the House Ways and Means Committee*, 77th Cong., 2d Sess. 2157 (1942) (statement of Benjamin A. Javits, witness) (courts consider taxes when setting alimony payments; proposal provides relief in excess of hardship).

[33] The proposal raised a constitutional question as to whether alimony is income and therefore taxable under the sixteenth amendment. It was not until 1950 that a court determined that alimony is income under the sixteenth amendment. Mahana v. United States, 88 F. Supp. 285 (Ct. Cl.), *cert. denied*, 339 U.S. 978, *reh'g denied*, 340 U.S. 847 (1950).

poned any major reforms until after the war. Instead, Congress was swayed by arguments that taxing husbands on income enjoyed by their ex-wives was unduly burdensome,[34] and the legislation based on the Treasury's proposal passed.[35] Further, Congress ensured the statute a broad impact by making the legislation retroactive. Thus, Mrs. Gould and all women similarly situated became subject to this new scheme even if the

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[34] *See* H.R. REP. No. 2333, *supra* note 29, at 409–10; S. REP. No. 1631, 77th Cong., 2d Sess. 83 (1942), *reprinted in* 1942-2 C.B. 504, 568–70.

[35] The amendment requiring the payee to include alimony payments in income was contained in Revenue Act of 1942, Pub. L. No. 77-753, § 120(a), 56 Stat. 798, 816 (current version I.R.C. § 71 (1986)) and provided that a new section be added to § 22 of the Code:

> (k) ALIMONY, ETC., INCOME. — In the case of a wife who is divorced or legally separated from her husband under a decree of divorce or of separate maintenance, periodic payments (whether or not made at regular intervals) received subsequent to such decree in discharge of, or attributable to property transferred (in trust or otherwise) in discharge of, a legal obligation which, because of the marital or family relationship, is imposed upon or incurred by such husband under such decree or under a written instrument incident to such divorce or separation shall be includible in the gross income of such wife, and such amounts received as are attributable to property so transferred shall not be includible in the gross income of such husband. This subsection 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. Installment payments discharging a part of an obligation the principal sum of which is, in terms of money or property, specified in the decree or instrument shall not be considered periodic payments for the purposes of this subsection; except that an installment payment shall be considered a periodic payment for the purposes of this subsection if such principal sum, by the terms of the decree or instrument, may be or is to be paid within a period ending more than 10 years from the date of such decree or instrument, but only to the extent that such installment payment for the taxable year of the wife (or if more than one such installment payment for such taxable year is received during such taxable year, the aggregate of such installment payments) does not exceed 10 per centum of such principal sum. For the purposes of the preceding sentence, the portion of a payment of the principal sum which is allocable to a period after the taxable year of the wife in which it is received shall be considered an installment payment for the taxable year in which it is received. (In cases where such periodic payments are attributable to property of an estate or property held in trust, see section 171(b).)

The amendment giving the payor a corresponding deduction was contained in Revenue Act of 1942, Pub. L. No. 77-753, § 120, 56 Stat. 798, 817 (current version I.R.C. § 215 (1986)) and provided that Code § 23(u) read as follows:

> (u) ALIMONY, ETC., PAYMENTS. — In the case of a husband described in section 22(k), amounts includible under section 22(k) in the gross income of his wife, payment of which is made within the husband's taxable year. If the amount of any such payments is, under section 22(k) or section 171, stated to be not includible in such husband's gross income, no deduction shall be allowed with respect to such payment under this subsection.

alimony payments they received stemmed from divorces that took place long before the enactment of the income tax.

The *Gould* system painted a portrait of women attached to men, of women who could not support themselves and could not even be expected to pay taxes on the support they received. From this perspective, the 1942 legislation might be viewed as democratic—a reflection of the independence women had achieved in the workplace during the war. Yet, on reflection, the legislation seems more to disregard divorced women's situations than to sincerely acknowledge their new place in American society. For example, although Congress was explicitly concerned with the harsh effect of wartime tax rates on men, Congress never considered the harsher effect of these same rates on women who presumably had received smaller alimony awards from courts due to the payee exclusion under *Gould*.[36]

Rather than reflecting a respect for women, the 1942 legislation instead gave women an Orwellian equality under the taxing statutes. They were no longer treated like children who could exclude their mandated support from income whether the marriage survived or not.[37] Instead, Rosie the Riveter took her place beside men in the factories and at the Treasury.

1. The 1942 Act's Statutory Scheme

Once Congress decided to shift from the single taxpayer approach of *Gould* (in which the payor bore the entire tax burden) to the forced sharing of tax liability between former spouses, it had to decide which husbands would qualify for the alimony deduction and what type of payments wives would have to include in income. The 1942 alimony system provides that payments are taxed to the payee and deducted by the payor where the payments: (1) are formalized by a decree of divorce or separate maintenance or a written instrument incident to such a decree; (2) serve to discharge the payor's obligation of support (as contrasted with gifts and payments settling the payee's property rights); (3) constitute "periodic payments" (as contrasted with a lump-sum settlement); and, (4) are not earmarked for

[36] *See supra* text accompanying notes 29–32.

[37] Under the 1942 Act, child support is taxed to the payor. 1942 Act § 22(k). This treatment continues today under I.R.C. § 71 (1986).

support of the payor's minor children.[38] Although some of these requirements were simply technical means of dealing with the payor deduction/payee inclusion system, others continued to reflect Congress' view of women.

a. *Can this marriage be saved? The decree requirement.* The first issue facing Congress in 1942 was who would qualify for the alimony deduction. The question proved difficult, because income splitting was not widely available to married couples until the joint return was authorized in 1948.[39] Before the 1942 Act, all taxpayers, whether married, divorced, or single, filed separate returns and were taxed separately on their individual incomes.[40] The enactment of the new alimony rules, however, gave the divorced the opportunity to income split. Because the former husband's income was reported on two returns instead of one, it was subject to lower marginal rates, and the overall tax liability decreased. As a result, under the 1942 Act, couples were better off for tax purposes if divorced instead of married.[41]

To prevent exploitation of this opportunity to split income, Congress limited the 1942 legislation to payments received after an actual decree of divorce or legal separation.[42] Payments made under a private separation agreement or pursuant to a court-

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[38] 1942 Act § 22(k). For the text of section 22(k), see *supra* note 35. Under the Internal Revenue Code of 1954 the section of the statute dealing with child support payments was renumbered as Internal Revenue Code of 1954, ch. 736, § 71(b), 68 A Stat. 19, which provided:

> (b) PAYMENTS TO SUPPORT MINOR CHILDREN. — Subsection (a) shall not apply to that part of any payment which the terms of the decree, instrument, or agreement fix, in terms of an amount of money or a part of the payment, as a sum which is payable for the support of minor children of the husband. For purposes of the preceding sentence, if any payment is less than the amount specified in the decree, instrument, or agreement, then so much of such payment as does not exceed the sum payable for support shall be considered a payment for such support.

[39] Revenue Act of 1948, Pub. L. No. 80-471, §§ 301–05, 62 Stat. 110, 114–16 (1948).

[40] Although payees did not include marital support in income whether those payments were made as a result of marriage or divorce, other types of income had to be reported. Until 1948, these income items appeared on separate returns whether the earner was married, single, or divorced.

[41] Couples with two working partners had less incentive to divorce for tax purposes, because they already split income due to the requirement that each person make an individual return as opposed to the joint returns available today. For a discussion of the joint return, see *infra* text accompanying notes 72–76.

[42] The relevant language contained in 1942 Act § 22(k) provided:

> In the case of a wife who is divorced or legally separated from her husband under a decree of divorce or of separate maintenance, periodic payments . . . received subsequent to such decree . . . shall be includible in the gross income of such wife, and such amounts . . . shall not be includible in the gross income of such husband.

ordered support decree (for example, in the case of abandonment without an accompanying divorce or legal separation) remained subject to the *Gould* inclusion-by-payor/exclusion-by-payee rules.[43]

There were clearly alternative solutions to the problem of tax-motivated divorce. For example, rather than limiting the alimony deduction to court-ordered divorces and separations, Congress could have allowed married couples to use joint returns. This would have reduced the appeal of divorce as a tax planning device. At the same time, the joint return would have continued Congress' tradition of treating divorced and married couples similarly, although single people would have received different treatment for the first time. Furthermore, if Congress had wanted to encourage marriage, as opposed to simply maintaining equality between divorce and marriage, it could have applied the *Gould* system to divorced couples and limited income splitting to married people through the privilege of filing a joint return. In this way, all the tax benefits would flow to marriage, thereby completely eliminating the problem of tax-motivated divorce.

Another alternative would have been to allow couples to make their own decisions on reporting their income by extending the income splitting alimony rules to informal support agreements. For example, if it wanted to increase the bargaining power of women within the marital relationship, Congress could have extended the payor deduction/payee inclusion rules to payments made under written separation agreements. These agreements would have allowed wives to negotiate for fixed levels of support, which their husbands could then deduct.

By limiting income splitting to alimony payments resulting from a court-ordered decree of divorce or separation, Congress provided an economic underpinning for the stereotype that men want divorces and women want to remain married. When the benefits of income splitting are limited to the legally divorced or separated, tax conscious payors are motivated to seek the benefits of divorce, while tax conscious payees ask themselves: "Can this marriage be saved?"

b. *The net widens.* Even after Congress approved income splitting for divorced (but not married) couples, there was still

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[43] For an examination of which payments are still subject to this restriction, see *infra* Part II.

the question of whether the new system would be retroactive or merely prospective. If the changes were made prospective, couples could bargain around the tax results of alimony payments. By making the payor deduction/payee inclusion system retroactive, however, Congress took this power away from couples.[44] Payors, who were not forced to give up anything in exchange for a valuable deduction, benefited from this system, while payees lost income to taxes without receiving any other form of compensation.

c. *Jumping hurdles: getting in and staying in the system.* Another question raised by the new legislation was what type of payments would fall under the deduction-to-payor/inclusion-by-payee rules of the 1942 Act. After all, in addition to spouse support, former spouses often make payments to an ex-spouse as a result of gifts, sales, debts, child support, and divisions of marital property. Congress could have allowed all of these payments to fall under the new alimony rules, thereby placing the entire tax burden on payees. Alternatively, Congress could have allowed couples to choose which payments would be taxed to the payor and which would be taxed to the payee.[45] Instead, Congress decided to limit the new payor deduction/payee inclusion rules to spouse support payments. As a result of this decision, the prior treatment for all other transactions remained intact.[46]

Once Congress decided to limit alimony treatment to spouse support payments, the question of how to distinguish these transfers from all others arose. Because it decided to maintain as much control as possible over the payor deduction/payee inclusion system rather than allowing couples to shape their own tax treatment, Congress had to develop detailed standards to distinguish alimony payments from other types of disbursements.[47]

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[44] 1942 Act § 22(k). For the text of section 22(k), see *supra* note 35.

[45] To a certain extent, this is the approach that Congress finally adopted in 1984. *See infra* Section I(D)(1).

[46] Specifically, divisions of marital property did not subject either spouse to the income tax, child support was still taxed to the payor, gifts were excluded from the payee's income, and sales produced gain or loss for the seller. The treatment of these payments is discussed below. *See infra* notes 68–69 and accompanying text.

[47] Congress changed this prohibitive attitude in 1984 when it decided to create a divorce tax system in which most of the decisions about how to label payments are made by the couple. *See, e.g.*, STAFF OF JOINT COMMITTEE ON TAXATION, 98TH CONG., 2D SESS., GENERAL EXPLANATION OF THE REVENUE PROVISIONS OF THE DEFICIT

Instead, Congress tried to increase its control by limiting the alimony rules to spouse support and then enforced this limitation by requiring payments to result from an "obligation to support."[48] In addition to the decree requirement noted above, the legal obligation imposed on the payor had to arise "under the decree or under a written instrument incident to such divorce or separation."[49] This requirement served as a reminder that the payor deduction/payee inclusion rules of the 1942 Act presup-

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REDUCTION ACT OF 1984 714–15 (Comm. Print 1984) (purpose of 1984 Act is to make rules more objective and easier to apply so self planning is encouraged).

[48] Under the 1942 Act (and its 1954 amendments), payments cannot fall under the payor deduction/payee inclusion provisions unless made in recognition of an obligation of support. Except in the case of court-ordered support decrees, the statute does not explicitly use the term "support," but it does require payments to be made "because of the marital or family relationship," 1942 Act § 22(k), a phrase interpreted by the regulations to refer to "the general obligation to support" and not to payments settling the couple's property rights, such as the repayment of funds lent by one to the other. Treas. Reg. §§ 1.71-1(b)(4), 1.71-1(c)(4) (1957) (1954 Code §§ 71(a)(1) and 71(a)(2) not applicable to property originally owned by wife unless received in contemplation of divorce or separation for less than adequate consideration); *see* Warnack v. Commissioner, 71 T.C. 541, 550 (1979) (focus is not on support alone, but on "whether payments are for support in contradistinction to being in exchange for the wife's release of some property interest;" extensive review of facts and cases).

See also Hoffman v. Commissioner, 54 T.C. 1607 (1970) (acq.), *aff'd per curiam*, 455 F.2d 161 (7th Cir. 1972) (wife not taxed on payments for period after remarriage, since husband's legal support obligation had terminated under Illinois law). *But see* Mass v. Commissioner, 81 T.C. 112 (1983) (distinguishing *Hoffman* in situation involving Illinois law and holding payments deductible by husband and includible in gross income of remarried wife; payment agreement was made with both parties when both parties knew of wife's intended remarriage, and Illinois law recognized husband's continuing payment obligations despite general rule denying alimony to remarried spouse). Rev. Rul. 81-8, 1981-1 C.B. 42 (payments after legal obligation ceases are not alimony, but, rather, are includible in ex-spouse's gross income under I.R.C. § 61); Rev. Rul. 82-155, 1982-2 C.B. 36 (support agreement was incorporated into divorce decree, which was sole source of payor's obligation; pursuant to state law, legal obligation to make payments ceased upon remarriage of payee; held, no deduction under I.R.C. § 215 for payments after payee's remarriage; payments not includible in payee's gross income if payor knew that obligation had ceased and facts otherwise indicate payments to be gifts; but if payor was unaware of payee's remarriage, payments remain taxable to payee under I.R.C. § 61 despite payee's potential obligation to repay; Rev. Rul. 81-8 amplified and superseded; disallowance of deduction under I.R.C. § 215 pursuant to ruling will not apply to payments made on or before January 12, 1981). Rev. Proc. 82-53, 1982-2 C.B. 842 (guidelines for determining whether payments pursuant to decree of divorce or separate maintenance are includible in gross income of payee and deductible by payor under I.R.C. §§ 71(a)(1) and 215, with sample clauses for inclusion in written instruments; revenue procedure is effective September 7, 1982); *see generally* Regan & Erbacher, *When is "Alimony" Not Alimony Under Kansas Law?*, 20 WASHBURN L.J. 495 (1981).

[49] 1954 Code § 71(a)(1). For the text of this provision, see *infra* note 76.

This "incident to" the divorce mandate causes problems, however, for payments that continue to fall under the 1942 rules. For example, the Service has ruled that a post-divorce agreement for support payments does not qualify for the payor deduction/payee inclusion rules if no obligation to support survives the dissolution of the marriage. Rev. Rul. 60-142, 1960-1 C.B. 34.

posed legal compulsion and did not embrace voluntary arrangements.[50]

Next, Congress devised a means of distinguishing property settlements from payments of untaxed income. These provisions ensured the integrity of the single taxpayer model, first propounded by *Gould* and then continued by the 1942 legislation, by guaranteeing that income would not be taxed twice.[51] In order to preserve the single taxpayer approach, the statute included rules to distinguish payments of already taxed property (presumably part of a property settlement) from payments of never taxed current income (presumably alimony). Because it is often difficult to distinguish between property settlements and payments of future income, Congress adopted the periodic payment rule—a device that created irrebuttable presumptions. If a payment was not "periodic," it could not qualify for alimony treatment.[52]

The periodic payment rule is designed to separate divisions of property from spouse support. The rule operates by taxing the payee on transfers that qualify as periodic payments.[53] Conversely, if the transfer is not a periodic payment, the income splitting rules of the 1942 Act do not apply. In order to qualify

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[50] *See* Baker v. Commissioner, 37 T.C.M. (CCH) 475 (1978) (deduction denied absent evidence of legal compulsion).

[51] To understand the concern, consider Rosie the Riveter who earns $100 in year 1. Rosie is taxed on that $100 income in the year it is received. If Rosie then takes her after-tax income and places it in a bank account, she should not be taxed again when she withdraws her principal in year 10. The principal is not taxed in year 10, because Rosie has already paid a tax in year 1.

If Rosie withdraws her principal in year 10 and transfers the funds to Spouse *X*, however, *X* should be taxed on the receipt because he has never paid a tax on the income generated to him by the transfer. *See supra* note 11. This is the two transfer/two tax result that the Commissioner asserted when first considering the Gould alimony payments. *See supra* text accompanying notes 8–10.

Using the two transfer/one tax model, *X* will avoid any tax in year 10 when he receives Rosie's transferred principal, because Rosie has already paid the single tax due in year 1. The transfer from Rosie to *X* in year 10 is treated as a part of a property settlement incident to the divorce. Still under the single taxpayer model, a different result occurs if Rosie transfers income earned in year 10 to *X* in that year. The reason for different tax treatment is that Rosie has never paid a tax on these earnings, because income is usually earned before a tax is due. When neither Rosie nor *X* has ever paid tax on the income, the issue under a single tax model is whether to tax the payor (as under the *Gould* model) or the payee (as in the modern approach). Since 1942, the Code has imposed this tax on the payee and provided the payor with a corresponding deduction.

[52] The periodic payment rule, as enacted in 1942, did not clearly define the term "periodic payment," though the rule did give examples of payments that would not qualify as periodic payments. 1942 Act § 22(k), *supra* note 35. The 1954 Act included a "periodic payment" definition. 1954 Code § 71(a), *supra* note 76.

[53] The relevant language is contained at 1954 Code § 71(a)(1)–(3). *See infra* notes 76–78.

as spouse support, payments must be periodic, although they need not be paid at regular intervals. A series of payments are not considered to be periodic if they are merely installments on a larger amount specified in the decree or instrument. The fact that the decree requires a lump sum payment in a fixed amount leads to the conclusion that the payments really constitute a property settlement paid over time. Lump sum payments do not qualify as periodic payments because they simply look too much like property settlements.

However, the rule prohibiting deductions for lump sum payments is subject to an interesting exception. Even if the decree requires a lump sum payment and even if the payment is characterized as a property settlement by both husband and wife, the payor is allowed a deduction if he transfers the property through a series of payments that stretch over a decade or more.[54] Thus, husbands are rewarded with a deduction that circumvents the underlying policies of the statute when they arrange to support their ex-wives for a long period of time rather than for a few years. This perpetuates the original view under *Gould* that a husband's duty to support his wife continues forever. The difference is that Congress preferred to use the carrot of a deduction rather than the stick supplied by the *Gould* Court.

On the other side of the support versus property question is the problem of how to deal with transfers of property that are actually sales rather than mere divisions of marital property. At the same time that the new divorce tax system was introduced in 1942, the courts were grappling with the question of whether transfers of appreciated property between divorcing spouses should be considered taxable events. After some initial uncer-

[54] The major wrinkle in the periodic payment scheme comes when these installment payments are treated as periodic even though they amortize a principal sum. The exception is known as the ten year/10% rule.

The ten year/10% rule starts with the directive that "installment payments discharging a part of an obligation the principal sum of which is, in terms of money or property, specified in the decree or instrument, shall not be considered periodic payments." 1942 Act § 22(k). The statute then provides an exception if the decree allows the payor to fulfill his obligation over a ten-year period. The presumption shifts, and the formerly excluded payments are brought back into the payor deduction/payee inclusion rules, provided that no one payment exceeds 10% of the total amount due. *Id.*

For example, if the divorce decree requires a total payment of $100,000, five payments of $20,000 each will not qualify as periodic because the total payments are to be completed before expiration of the required ten-year period. If, however, the same $100,000 is paid at a rate of $15,000 annually for four years and $5,000 annually for the following eight years, $10,000 (10% of the principal sum) of each of the first four payments and all of the remaining eight payments are periodic under the ten year/10% rule. Treas. Reg. § 1.71-1(d)(2) (1957).

tainty, at least two courts of appeals concluded that, despite claims that such transfers were nontaxable divisions of marital property, gain to the transferor was subject to tax.[55] This issue remained resolved until 1960, when the Sixth Circuit Court of Appeals held that transfers of appreciated property in exchange for a release of marital rights did not subject the transferor to tax.[56] This decision led the Supreme Court to take its first look at this issue in *United States v. Davis*.[57]

Davis upheld the tax on transfers of property in exchange for marital rights in states where the transferee had no vested interest in the transferred property.[58] This decision created a conflict in the treatment of these transfers, because community property states gave a wife a vested interest in her husband's property, while common law states did not.[59]

The *Davis* decision to tax exchanges of appreciated property for marital rights supports the view held by the Court and by Congress that spouses should be treated as a single unit for tax purposes. Outside of the divorce context, this transaction would result in two taxes.[60] The person transferring the property would have a taxable gain of the difference between the amount realized and his adjusted basis, and the person transferring the marital rights would have a taxable gain on the fair market value of the property received.[61] This is the classic two transfer/two tax approach first suggested by the Commissioner to Mr. Gould but rejected by the Supreme Court and Congress. Under *Davis*, however, only the spouse transferring appreciated property is subject to a tax on the gain; the spouse transferring the marital

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[55] *See, e.g.*, Halliwell v. Commissioner, 44 B.T.A. 740 (1941) (transfer of appreciated property between divorcing spouses was not a taxable event, because the transfer represented a nontaxable division of property), *rev'd per curiam on this issue*, 131 F.2d 642 (2d Cir. 1942), *cert. denied*, 319 U.S. 741 (1943); Mesta v. Commissioner, 42 B.T.A. 933 (1940) (same) *rev'd on this issue* 123 F.2d 986 (3d Cir. 1941), *cert. denied*, 316 U.S. 695 (1942), *reh'g denied*, 317 U.S. 704 (1942).

[56] Commissioner v. Marshman, 279 F.2d 27 (6th Cir. 1960), *cert. denied*, 364 U.S. 918 (1960) (transferor could not be taxed because the value of his receipt—the release of marital rights—could not be valued).

[57] 370 U.S. 65 (1962).

[58] *Id.* at 68–71.

[59] The Supreme Court recognized this problem but refused to change its position. *Id.* at 71. In fact, as the Court itself noted, there were other occasions when it had treated couples differently under the federal tax laws depending on whether or not they lived in a community property state. *See, e.g.*, Lucas v. Earl, 281 U.S. 111 (1930) and Poe v. Seaborn, 282 U.S. 101 (1930).

[60] *See* Rev. Rul. 59-47, 1959-1 C.B. 198.

[61] The basis for marital rights would be zero.

rights avoids tax liability.[62] This spouse also receives a fair market value basis in the property received, thereby ensuring that there will never be more than one tax on the exchange.[63]

The *Davis* ruling incorporates the two transfer/one tax approach that the Supreme Court created in *Gould* and that Congress continued in the 1942 Act. However, as opposed to the 1942 Act, *Davis*, like *Gould*, places the tax burden on the transferor rather than the transferee. In this way, *Davis* is at odds with the congressionally created divorce tax system, which places the tax burden on the transferee.[64]

As a result of its decision to limit the use of the alimony deduction, Congress also had to decide how to treat child support payments. On the one hand, the point of the 1942 Act was to shift the tax burden of payments from the payor to the recipient.[65] Given that child support payments are actually received by payees rather than the supported children, there is some foundation for the position that child support and spouse support should receive the same tax treatment. On the other hand, divorce does not terminate the personal relationship between the supporting parent and child as it does the personal relationship between the husband and wife. Thus, child support remains a personal obligation of the payor and therefore should not be deductible.[66] If one accepts that divorce does not end parents' personal obligations to support their children, child support should have the same tax treatment regardless of whether the parents are married or divorced.

Congress decided to continue to treat married and divorced parents equally by denying payors a deduction for child support payments and allowing payees a corresponding exclusion.[67]

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[62] Following the *Davis* decision, the Service issued Rev. Rul. 67-221, 1967-2 C.B. 63, which opined that, where the wife receives property in exchange equal in value to her marital rights, she is subject to no gain or loss and her basis in the property received in the exchange is its fair market value.

[63] If the spouse transferring the marital rights kept her zero basis, then there would be a mere deferral of gain rather than a complete exclusion of the gain.

[64] Despite this conflict, it was not until 1984 that Congress finally rejected *Davis* and decided that the tax burden should be placed on the transferee. *See* I.R.C. § 1041 (1986); *see also infra* text accompanying notes 168–177.

[65] *See* H.R. REP. No. 2333, *supra* note 29, at 409; S. REP. No. 1631, *supra* note 34, at 568–70.

[66] The disallowance results from the general prohibition of I.R.C. § 262 (1986) and its precursors, which disallow deductions for personal, living, or family expenses. Married parents have never received a deduction for child support.

[67] For the text of the Code's child support provision, see *supra* note 38 (1942 Act and 1954 Code) and *infra* note 147 (1984 Act).

Consequently, from a tax standpoint, payees are better off if they receive large child support awards and smaller alimony payments. Of course, this advantage ends when the children come of age and the payments are reduced.

Under the 1942 Act, child support is defined as payments fixed in the decree or written instrument for the support of minor children.[68] The 1942 Act also protects the payee from a tax standpoint in the case of incomplete payments; if the payor transfers less than the full amount of alimony and child support due in any given period, the amount actually paid is first attributed to child support.[69]

Alimony trusts were also covered by the 1942 legislation;[70] the rules are fairly straightforward. Income from the trusts is taxed to the beneficiaries even when the payments relieve a former spouse of an obligation to pay alimony. Thus, the alimony trust rules equalize treatment between payors who use current earnings to pay alimony and wealthier taxpayers who can set aside income producing property to satisfy their obligations.[71]

C. *"I'm Lucky, You're Lucky, We're All Lucky." — Expansion of the Alimony Rules in 1954*

From 1942 until 1954 the divorce tax system remained stable. Couples who divorced or legally separated split their income under the payor deduction/payee inclusion rules of the 1942 Act.[72] Couples who terminated their marriages without benefit

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[68] *See* 1942 Act § 22(k).

[69] *Id.* For example, if the decree requires $100 monthly alimony and $200 child support and only $250 is paid, the first $200 is attributed to child support and only $50 is treated as alimony.

[70] *See* Revenue Act of 1942, Pub. L. No. 77-753, § 171, 56 Stat. 798, 817, which states in relevant part:

> There shall be included in the gross income of a wife who is divorced or legally separated under a decree of divorce or of separate maintenance the amount of the income of any trust which such wife is entitled to receive and which, except for the provisions of this section, would be includible in the gross income of her husband . . . .

The alimony trust rules are now contained at I.R.C. § 682 (1986).

For a discussion of alimony trusts under the Tax Reform Act of 1984, see Hjorth, *supra* note 19, at 181–84.

[71] Because income is attributed directly to the payee, the trust income is never included in the payor's gross income. This eliminates the need to give the payor a deduction.

[72] For a discussion of the provisions of the 1942 Act, see *supra* text accompanying notes 21–38.

of a decree continued the payor inclusion/payee exclusion pattern first established by *Gould*. Until 1948, however, all married couples who were not legally separated were taxed in a manner consistent with *Gould*: married couples were not allowed to reduce their tax liability through income splitting,[73] whereas divorced couples could reduce their overall tax liability by using alimony payments to split their income. As a result, from a tax standpoint, divorce was better than marriage.

In 1948, this anamoly was eliminated when the joint return became available to all married couples.[74] From a tax standpoint, the joint return makes the choice of marriage versus divorce almost tax neutral because married couples receive benefits similar to the alimony deduction.[75] Further, the tax benefits of the joint return are not limited to the happily married—a husband and wife can hate one another or live apart and still take advantage of statutory income splitting.

The joint return eliminated the 1942 Act's major inequity of greater tax benefits for divorced couples than for married couples. Legally separated and divorced couples could split their income through the payor deduction/payee inclusion rules of the 1942 Act while married couples could use the joint return. Yet, when Congress adopted the Internal Revenue Code of 1954, it broadened the payor deduction/payee inclusion rules in the new section 71 to include informal marital terminations within the alimony tax rules.[76]

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[73] *See, e.g.*, Lucas v. Earl, 281 U.S. 111 (1930) (husband could not contractually shift income to his wife for tax purposes). *But see* Poe v. Seaborn, 282 U.S. 101 (1930) (income splitting allowed when it resulted from community property laws).

[74] *Revenue Act of 1948*, Pub. L. No. 80-471, §§ 301–05, 62 Stat. 114 (1948) which was codified at I.R.C. § 51(b) (1948). With limited exceptions, the joint return remains available to all married couples. *See* I.R.C. § 6013 (1986).

[75] In many cases, even with the higher rates for married people filing joint returns, the payor will be better off with the joint return than with the alimony deduction. The greater tax benefit flows from the fact that, as opposed to the alimony deduction, the joint return is not limited by actual payments. For example, an ex-husband who pays no alimony cannot get the benefit of the alimony paid deduction. Further, his ex-wife will not include any phantom payments in income. But, provided that his wife signs the return, a husband who leaves his wife to starve can get the benefit of a joint filing.

[76] The Internal Revenue Code of 1954 renumbered every section in the statute, even where a substantive provision remained completely intact. With the 1954 Code the sections changed in the following manner:

1. The decree requirement originally contained in 1942 Act § 22(k) and discussed *supra* text accompanying notes 39-43 became 1954 Code § 71(a)(1), which provides:

> If a wife is divorced or legally separated from her husband under a decree of divorce or of separate maintenance, the wife's gross income includes periodic payments (whether or not made at regular intervals) received after such decree in discharge of (or attributable to the propery transferred, in trust or otherwise, in discharge of) a legal obligation which, because of the marital or family

1. Expansion of the Alimony Paid Deduction under the 1954 Code.

Under the 1954 Code, payments made under a written separation agreement,[77] or pursuant to a court ordered decree of support,[78] became eligible for the payor deduction/payee inclusion rules previously restricted to payments made under a decree of divorce or separate maintenance provided that the other requirements of the divorce tax law were met. Accordingly, payments in abandonment cases, temporary alimony, and separate maintenance payments, which did not qualify before 1954

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relationship, is imposed on or incurred by the husband under the decree or under a written instrument incident to such divorce or separation.

2. The provisions excepting child support from the payor deduction/payee inclusion rules originally contained in 1942 Act § 22(k) and discussed *supra* text accompanying notes 63–69 became 1954 Code § 71(b).

3. The ten year/10% rule originally contained in 1942 Act § 22(k) and discussed *supra* note 54 became 1954 Code § 71(c)(2). Section 71(c)(2) of the 1954 Code provides:

> (c) PRINCIPAL SUM PAID IN INSTALLMENTS —
>
> (2) WHERE PERIOD FOR PAYMENT IS MORE THAN 10 YEARS — If, by the terms of the decree, instrument, or agreement, the principal sum referred to in paragraph (1) is to be paid or may be paid over a period ending more than 10 years from the date of such decree, instrument, or agreement, then (notwithstanding paragraph (1)) the installment payments shall be treated as periodic payments for purposes of subsection (a), but (in the case of any one taxable year of the wife) only to the extent of 10 percent of the principal sum. For purposes of the preceding sentence, the part of any principal sum which is allocable to a period after the taxable year of the wife in which it is received shall be treated as an installment payment for the taxable year in which it is received.

4. The deduction for alimony paid originally contained in 1942 Act § 23(u) was included in Internal Rev. Code of 1954, ch. 736, § 215, 68A Stat. 71.

5. The provisions for alimony trusts originally contained in 1942 Act § 171 was transferred to Internal Rev. Code of 1954, ch. 736, § 682, 68A Stat. 234.

[77] 1954 Code § 71(a)(2) provided:

> If a wife is separated from her husband and there is a written separation agreement executed after the date of the enactment of this title, the wife's gross income includes periodic payments (whether or not made at regular intervals) received after such agreement is executed which are made under such agreement and because of the marital or family relationship (or which are attributable to property transferred, in trust or otherwise, under such agreement and because of such relationship). This paragraph shall not apply if the husband and wife make a single return jointly.

[78] 1954 Code § 71(a)(3) provided:

> If a wife is separated from her husband, the wife's gross income includes periodic payments (whether or not made at regular intervals) received by her after the date of the enactment of this title from her husband under a decree entered after March 1, 1954, requiring the husband to make the payments for her support or maintenance. This paragraph shall not apply if the husband and wife make a single return jointly.

because they did not entail a divorce or legal separation, were now subject to the original 1942 rules.[79]

Congress' stated intention in expanding the alimony paid deduction to include payments made as a result of separation and abandonment was to end the perceived discrimination between judicially divorced couples and those whose marriages terminated informally.[80] In operation however, the benefit ran exclusively to payors rather than to the couple as a unit. Though Congress limited the benefit to prospective agreements "to prevent the upsetting of arrangements . . . already . . . worked out with the understanding that the wife would not include the payments in her income,"[81] the bulk of these changes benefitted men at the expense of women by taking away a woman's power to refuse to sign a joint return. Understanding this result requires a review of the 1948 Act and the impact of the joint return upon married couples.

Prior to 1954, couples who terminated their relationships without a formal divorce or separation were not entitled to reduce their tax burden by splitting income.[82] However, after 1948, couples who lacked a divorce decree could use the joint return which provided the desired income split. These couples were not denied the benefits of income splitting when Congress expanded coverage of the alimony rules in 1954. Clearly, the expansion of the alimony rules to cover informal terminations was not needed by most taxpayers. Instead, it only benefitted those payors who could not convince their ex-spouses to sign a joint return.

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[79] *See, e.g.*, Korman v. Commissioner, 36 T.C. 654 (1961), *aff'd per curiam*, 298 F.2d 444 (2d Cir. 1962) (temporary alimony taxable to the wife although no decree of divorce or legal separation); *but see* Boettiger v. Commissioner, 31 T.C. 477 (1958) (acq.) (New Jersey separate maintenance order not legal separation and payment not deductible by husband).

[80] Under 1954 Code § 71(a)(2), payments made under written separation agreements could fall under the payor-deduction/payee-inclusion rules of 1954 Code §§ 71 and 215 provided that the separation agreement was executed after the 1954 Act's enactment date which was August 16, 1954. *See infra* text accompanying notes 208–209. Under 1954 Code § 71(a)(3) however, payments made pursuant to a court ordered support decree could take advantage of 1954 Code § 71 so long as the decree was entered after March 1, 1954 and the payments were received after the 1954 Code's enactment date.

Both the House and the Senate Reports on this matter state that the reason for expanding the scope of the alimony rules is that restricting benefits to payments made under judicial decrees of divorce or separation "discriminates against husbands and wives who have separated although not under a court decree." H.R. REP. No. 1337, 83d Cong., 2d Sess. 10 (1954); S. REP. No. 1622, 83d Cong., 2d Sess. 10 (1954).

[81] S. REP. No. 1622, *supra* note 80, at 10.

[82] H.R. REP. No. 1337, *supra* note 80, at 10.

Joint returns must be signed by both spouses. If one spouse refused to sign, either out of spite or due to fear of liability, neither could use the income splitting joint return. In those cases, absent the amendments to the alimony rules introduced as part of the 1954 Code, payors in informally terminated marriages could not take advantage of either the joint return or the divorce tax rules to reduce their income tax. Thus, the entire thrust of the expansion was to help payors who could not help themselves.

In the expansion of the alimony rules, Congress once again focused on the problems of predominantly male payors rather than on those of predominantly female payees. The major power conferred on women by the 1948 joint return—that is, the power to reduce the payor's tax burden or not by either giving or withholding a signature—was eliminated by the 1954 amendments.

Congress appears to have been more even-handed in its decision to restrict the new rules to prospective separations rather than apply them to all divorced couples. In 1954, Congress provided that payments made as a result of separations or court ordered support decrees entered into prior to the change were grandfathered in order to protect women whose arrangements were based on tax-free alimony.[83] The decision to grandfather is not as sensitive to the needs of women as it first appears however because a couple automatically brings its arrangement under the payor-deduction/payee-inclusion rules by materially altering a separation agreement after August 16, 1954[84] or by modifying a court ordered support decree made after March 1, 1954.[85]

According to the 1954 Code, any material change will bring a pre-1954 separation agreement or support decree under the 1942 rules.[86] Therefore, any increase in a payee's award will automatically make all alimony subject to tax because a change in the amount of an award is material.[87] Given that awards tend to

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[83] S. REP. No. 1622, *supra* note 80, at 10.

[84] Treas. Reg. § 1.71-1(b)(2)(ii) (1960).

[85] Treas. Reg. § 1.71-1(b)(3)(ii) (1960).

[86] 1954 Code § 71(a)(2).

[87] *See* Rev. Rul. 59-248, 1959-2 C.B. 31, 32 (a court's refusal to increase a provisional alimony award does not constitute a modification of the original order and the the amounts paid under that order are not includible in the wife's gross income under section 71 because the court order was entered prior to March 1, 1954). *See also* Rev. Rul. 56-418, 1956-2 C.B. 27 (where a written separation agreement was entered into before August 17, 1954, but was materially revised after that date, the revised agreement

increase only modestly, the negotiating position left to the payee is to fight to preserve the status quo. But this position becomes untenable as inflation makes prior awards paltry compared to the cost of living. Given the conflict between the parties, the effect of the rule is to give payors more power at the expense of payees because time and economic pressures will eventually force payees under pre-1954 arrangements to agree either to the alimony rules or the use of a joint return.

2. Requirements of the 1954 Code Regarding Income Splitting

Under the 1954 amendments, income splitting is triggered when payments are made under three types of decrees or written instruments. These are: (1) a judicial decree of divorce or separate maintenance; 83d Cong., 2d Sess. 10 (1954);[88] (2) a written separation agreement;[89] or, (3) a court ordered decree for support.[90] Thus, as opposed to the system which existed from 1942 to 1953, a decree of divorce or separation is no longer needed for sections 71 and 215 to apply.[91]

For these purposes, a husband and wife are "separated" if they live apart. There is no requirement of a formalized divorce or separation.[92] In fact, the Court of Appeals for the Eighth Circuit held that a couple was separated for purposes of former section 71(a)(3)[93] although they were living in the same house;[94]

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will fall under the payor-deduction/payee-inclusion scheme). For the treatment of this issue under Deficit Reduction Act of 1984, Pub. L. No. 98-369, § 422, 98 Stat. 494, 795 (amending 1954 Code § 71), see Temp. Treas. Reg. § 1.71-1T Answer 26 (1984) which provides in part that a change in the amount of alimony, an addition or deletion of a contingency, or a change in the time for which the payments are to continue are material.

[88] 1954 Code § 71(a)(1) (current version at I.R.C. § 71(b)(2)(A) (1986)).

[89] 1954 Code § 71(a)(2) (current version at I.R.C. § 71(b)(2)(B) (1986)).

[90] 1954 Code § 71(a)(3) (current version at I.R.C. § 71(b)(2)(C) (1986)).

[91] 1954 Code § 215 replaced that portion of 1942 Act § 22(k) which provided for the alimony paid deduction. 1954 Code § 215 provides in relevant part:

> ALIMONY, ETC., PAYMENTS: (a) GENERAL RULE. — In the case of a husband described in section 71, there shall be allowed as a deduction amounts includible under section 71 in the gross income of his wife, payment of which is made within the husband's taxable year. No deduction shall be allowed under the preceding sentence with respect to any payment if, by reason of section 71(d) or 682, the amount thereof is not includible in the husband's gross income.

[92] Treas. Reg. § 1.71-1(b)(3) (1960).

[93] The use of the designation "former" as applied to the cited Internal Revenue Code sections under the 1954 Act should not be read to imply that a particular code section is no longer applicable to payments received in 1988 and beyond. Rather, as pointed out in the text, these provisions may still apply depending on the original execution date of the underlying instrument as well as any subsequent modifications.

[94] Sydnes v. Commissioner, 577 F.2d 60 (8th Cir. 1978). *But see* Lyddan v. United States, 721 F.2d 873 (2d Cir. 1983) *cert. denied* 467 U.S. 1214, *reh'g denied* 468 U.S.

the record showed that this couple had managed their separation by virtually never meeting face-to-face within their shared home.[95]

The "decree for support" requirement is satisfied by any type of court order or decree which requires that a spouse make payments for support or maintenance. This includes an interlocutory decree of divorce, a decree of alimony pendente lite, a nonsupport decree in case of abandonment, and a decree of separate maintenance based on extreme cruelty.[96]

The purpose of the 1954 amendments concerning income splitting was to sidestep the decree requirement of the 1942 Act. However, even under the 1984 and 1986 divorce tax systems, a decree remains a prerequisite for alimony treatment where spouse support payments are made despite the lack of a written separation agreement or court-ordered support decree.[97]

1224 (1984) (rejecting conclusion of Eighth Circuit in *Sydnes*; phrase "separated and living apart" requires geographical separation and "means living in separate residences"); Hertsch v. Commissioner, 43 T.C.M. (CCH) 703 (1982) (husband and wife are not "separated and living apart" for purposes of Treas. Reg. § 1.71-1(b)(3) (1960) if both live under same roof; even if Eighth Circuit holding in *Sydnes* that a geographical separation is not required should be followed, it does not apply when parties share common areas of house, do not anticipate divorce, and plan to remain in same house); Washington v. Commissioner, 77 T.C. 601 (1981), (Tax Court adhered to *Sydnes* with seven judges dissenting despite reversal by the Court of Appeals for Eighth Circuit); Del Vecchio v. Commissioner, 32 T.C.M. (CCH) 1153 (1973) (deduction denied where taxpayer and wife lived under same roof, because state courts would not hold them "separated and living apart.").

[95] Sydnes v. Commissioner, 577 F.2d 60 (8th Cir. 1978). This odd result is now precluded for agreements executed after December 31, 1984, by I.R.C. § 71(b)(1)(C) (1986), which requires that legally divorced or separated spouses reside in different households.

[96] Treas. Reg. § 1.71-1(b)(3) (1960); Korman v. Commissioner, 36 T.C. 654 (1961), *aff'd per curiam* 298 F.2d 444 (2d Cir. 1962) (payments under an "order" rather than a "decree" qualified); Rev. Rul. 58-321, 1958-1 C.B. 35 (abandonment); Capodanno v. Commissioner, 602 F.2d 64 (3d Cir. 1979) (separate maintenance). *But see* Healey v. Commissioner, 54 T.C. 1702 (1970), *aff'd per curiam*, 28 A.F.T.R.2d ¶ 71-5217 (4th Cir. 1971) (not officially reported) (deduction denied for payments made pursuant to state law obligation to support family, where judicial restraining order required taxpayer to live apart from his wife but did not refer explicitly to support); Schaer v. Commissioner, 38 T.C.M. (CCH) 1191 (1979) (payments under a written separation agreement and support order was taxable to the payee as alimony even though divorce terminated support obligation under Pennsylvania law; under state law, order remains in effect until spouse petitions to vacate it and obligations under separation agreement were contractual in nature).

[97] In practice, the decree requirement rarely creates controversy except when one spouse challenges the status of an ex parte decree. For example, in Estate of Borax v. Commissioner, the Court of Appeals for the Second Circuit ruled that a Mexican divorce satisfied the decree requirement even though the non-party wife had obtained a declaratory judgment in New York, where her husband was domiciled, holding that the divorce and his later marriage were invalid. Estate of Borax v. Commissioner, 349 F.2d 666 (2d Cir. 1965), *cert. denied*, 383 U.S. 935 (1966) *acq.in result*, 1968-1 C.B. 2,3 n.4 (acquiescence with respect to taxability of wife on amounts deducted by husband).

3. Problems Created by the 1942 and 1954 Rules

The need to distinguish support payments from other types of payments made the 1942 and 1954 rules difficult to apply.[98] Courts attempting to separate support payments from property settlements must consider a variety of factors and may not rely upon labels affixed by the parties or used by state law.[99] No one factor is conclusive. On occasion, the courts have found that payments were for support even though they had earmarks of a property settlement such as a specified dollar ceiling and an absence of contingencies.[100] Conversely, some courts have characterized payments resembling an ordinary support arrangement as a property settlement.[101] The periodic payment requirement

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The Internal Revenue Service announced in 1967 that it will not follow the *Borax* case as to a divorce decree held invalid by a state court of competent jurisdiction but that it generally would not initiate the question of the validity of a divorce. Rev. Rul. 67-442, 1967-2 C.B. 65. *But see* Gersten v. Commissioner, 267 F.2d 195 (9th Cir. 1959) (husband obtained ex parte Mexican divorce and remarried; held, joint return with new wife not permissible, because former wife could annul divorce in California, where all parties resided); Rev. Rul. 76-255, 1976-2 C.B. 40 (divorce to avoid taxes, followed by prompt remarriage, disregarded as sham).

This issue is moot as to the decree requirement because the ability to fall under the divorce tax rules through the use of a written separation agreement ordinarily comes into play even if 1954 Code § 71(a)(1) or its 1984 counterpart, I.R.C. § 71(b)(2)(A) (1986), are inapplicable for want of a judicial decree.

For cases where the Internal Revenue Service questioned the validity of a divorce in which the issue was filing status, see *Gersten v. Commissioner*; Rev. Rul. 76-255; Boyter v. Commissioner, 668 F.2d 1382 (4th Cir. 1981) (remanding "sham divorce" question to Tax Court).

[98] *See* Lynch, *I.R.C. Section 71: Breaking Up is Hard to Do*, 20 DUQ. L. REV. 173, 198–223 (1982).

[99] *See, e.g.*, Taylor v. Campbell, 335 F.2d 841 (5th Cir. 1964) ("It is clear that the labels attached to an agreement by the parties are not controlling.").

[100] Schottenstein v. Commissioner, 75 T.C. 451 (1980) (acq.) (although periodic payments to ex-wife were characterized and intended as property settlement, she had no property interests that were not accounted for by other parts of agreement, and payments bore no relationship to husband's wealth or net worth increase during marriage; held, payments constitute taxable support to wife and are deductible by husband); Hesse v. Commissioner, 60 T.C. 685, 693 (1973) (acq.), *aff'd without published opinion*, 511 F.2d 1393 (3d Cir.), *cert. denied*, 423 U.S. 834 (1975) (specified principal sum, absence of contingencies, and security provisions, though ordinarily evidence of a property settlement, are not always controlling, because they may merely indicate that wife's bargaining position was stronger than husband's); West v. United States, 332 F. Supp. 1102 (S.D. Tex. 1971), *aff'd per curiam*, 477 F.2d 563 (5th Cir. 1973) (support despite fixed amount and duty to pay regardless of his death or wife's remarriage).

[101] Bolza v. Commissioner, 42 T.C.M. (CCH) 1138 (1981) (husband's payments to discharge mortgage on house, originally in his name but transferred to wife as part of divorce settlement, constituted nondeductible property settlement even though obligation would have terminated on her remarriage); Weiner v. Commissioner, 61 T.C. 155 (1973) (payments allocable to property settlement even though terminable on wife's death and subject to reduction if husband's income declined or ability to support children would be impaired).

might have reduced confusion in this area by providing an objective standard with which to test the property/support distinction.[102] Instead, it created its own set of problems.

For example, if a principal sum is not specified, the periodic payment requirement is readily satisfied by arrangements that call for payments at intervals until the payee's death or remarriage.[103] Indeed, following an important series of litigated cases, the Treasury promulgated a "contingency" standard under which payments qualify as periodic if they terminate upon any one of several contingencies—death of either spouse, the payee's remarriage, or a change in either spouse's economic status.[104] But the contingency standard is fraught with its own complications.[105] Even when the contingency standard helps to reduce the confusion, the periodic payment requirement remains too difficult for the ordinary citizen to apply in a number of typical situations. Thus the periodic payment standard is an obstacle to the majority of divorced people who do not have access to sophisticated tax advice.

As an illustration, consider the uncertainty caused by the periodic payment requirement as it affects the marital home. During many divorce proceedings, one spouse leaves the marital home but retains title to the property. Is the fair market value of the other spouse's rent free occupancy a periodic payment subject to the payor-deduction/payee-inclusion rules? What about mortgage or utility payments? Should all these transfers be treated similarly?

Under both the 1942 and the 1954 rules, rent-free occupancy does not satisfy the periodic payment rules because it involves a single transfer of the right to occupy the property for the stipulated period as opposed to a series of payments.[106] In con-

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[102] For a discussion of the periodic payment requirement under the 1942 Act, see *supra* text accompanying notes 53–54. For the text of 1954 Code § 71(a)(1) (3), see *supra* notes 76–78.

[103] Where a principal sum is specified the payments may still be periodic but only if they meet the 10 year/10% rule discussed *supra* note 54.

[104] Treas. Reg. § 1.71-1(d)(3) (1960) (payments for a period of ten years or less); Treas. Reg. § 1.71-1(d)(4) (1960) (payments for more than ten years). For the origin of the contingency test, see Baker v. Commissioner, 205 F.2d 369 (2d Cir. 1953).

[105] For a discussion of problems created by the contingency standard see Note, *Alimony Taxation—The Contingency Doctrine Challenged*, 9 HARV. J. ON LEGIS. 156 (1971) (contingency doctrine has not promoted uniformity in the application of federal income tax laws because it has not avoided state law variations or granted relief to husbands paying alimony out of their current income).

[106] *See* Pappenheimer v. Allen, 164 F.2d 428 (5th Cir. 1947). *But see* Marinello v. Commissioner, 54 T.C. 577 (1970) (holding payments are periodic where husband con-

trast, payments of utility bills and current repairs during a former spouse's occupancy qualify as periodic payments.[107] When the payor retains title to the home, payments of mortgage principal, property taxes, insurance premiums, and payments for home improvements do not qualify as periodic payments because they protect the owner's interest in the property and because the payments are made to third parties and not to the occupant.[108]

If the occupying spouse retains or receives ownership of the family residence, mortgage payments by the other spouse are treated as alimony if those payments are not part of a property settlement.[109] If, however, the occupying spouse receives the family residence in trust for the couple's children, the mortgage payments increase the children's equity in the house. Accordingly, any incidental benefit to the occupant will not qualify as a taxable payment to the occupying spouse.[110] When the husband and wife retain joint ownership of their home, the treatment of mortgage payments depends on the nature of the joint ownership. Where the spouses hold the property as tenants in common, payments on the mortgage are probably taxable to the payee to the extent of his ownership interest in the property if those payments meet all the other requirements of the divorce tax system.[111] When spouses hold property as joint tenants with a right of survivorship, one spouse ordinarily escapes taxation if the other makes payments on a mortgage for which the payor alone is liable; but, if both are liable, one half of the payments may be taxed to the payee.[112]

Another complication arises regarding the treatment of life insurance. Often a payor will purchase or maintain a policy for the benefit of the payee. One might expect that, if the payee is both the owner and the irrevocable beneficiary, the premiums paid on these policies would be treated as periodic payments.

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trolled the corporation-owned home which the wife resided in and husband made rental payments on the home to the corporation).

[107] Rothschild v. Commissioner, 78 T.C. 149,153 (1982) (repair costs paid by husband on cooperative apartment owned by husband are includible in the wife's income); Rev. Rul. 62-39, 1962-1 C.B. 17,19 (where the wife is in possession of the property, utility bills paid by the husband are periodic payments includible in the wife's income).

[108] Bradley v. Commissioner, 30 T.C. 701 (1958); Gentry v. United States, 283 F.2d 702 (Ct. Cl. 1960).

[109] *See* Rev. Rul. 62-39, 1962-1 C.B. 17.

[110] *See* Isaacson v. Commissioner, 58 T.C. 659 (1972).

[111] *See* Rev. Rul. 62-39, 1962-1 C.B. 17.

[112] *See* Rev. Rul. 67-420, 1967-2 C.B. 63.

Rather surprisingly, one court reached a contrary result in cases involving term insurance policies.[113] The court noted that the policy lacked any cash surrender or loan value and that the wife's rights, though exclusive, were limited to the right to collect the proceeds if her husband predeceased her during the period in which he was required to pay premiums.[114] Further, if the payor continues to own the policy, he receives no deduction for the premiums paid on the theory that the premiums increase the value of the payor's retained rights.[115]

Other typical divorce payments are medical expenses, taxes, and legal fees. If one spouse is obligated to defray the other's future medical expenses or medical and hospitalization insurance premiums, the payments may qualify as alimony.[116] The same is true of tax payments. Where one spouse is obligated to pay the other's income taxes on the basic alimony payments (so as to assure a net amount after taxes) the payments are taxable to the payee and deductible by the payor.[117] In contrast, the payor's defrayal of the payee's legal expenses are not periodic and so the payee need not include those amounts in income.[118]

A not so typical payment is one made by the payor to support the payee's relatives. Nevertheless, the regulations under the 1954 Act provide that "periodic payments described in section 71(a) received by the wife for herself and any other person or persons [except their minor children] are includible in whole in the wife's income, whether or not the amount or portion for

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[113] Wright v. Commissioner, 62 T.C. 377 (1974), *aff'd*, 543 F.2d 593 (7th Cir. 1976). *But see* Stevens v. Commissioner, 439 F.2d 69 (2d Cir. 1971) (economic benefit conferred upon wife even though wife could only exercise rights with approval of divorce court); Turpin v. United States, 240 F. Supp. 171 (W.D. Mo. 1965) (husband allowed to deduct premiums on both whole-life and term policies).

[114] *Wright*, 62 T.C. at 398.

[115] Kiesling v. United States, 349 F.2d 110 (3d Cir. 1965), *cert. denied*, 382 U.S. 939 (1965).

[116] *See* Rev. Rul. 62-106, 1962-2 C.B. 21 (payment of spouse's medical and dental expenses was a periodic under the 1954 Act).

[117] Mahana v. United States, 88 F. Supp. 285 (Ct. Cl. 1950) *cert. denied*, 339 U.S. 978 (1950); Rev. Rul. 58-100, 1958-1 C.B. 31.

[118] Baer v. Commissioner, 196 F.2d 646, 649 (8th Cir. 1952); United States v. Davis, 370 U.S. 65, 74-75 (1962).

As for the payor's legal expenses, the Supreme Court held in United States v. Gilmore, 372 U.S. 39 (1963) that legal expenses incurred in a divorce action are personal or living expenses that cannot be deducted even though the husband's overriding concern was to protect his income-producing assets against the wife's claims rather than to forestall the divorce itself. *But see* Gilmore v. United States, 245 F. Supp. 383 (N.D. Cal. 1965) (husband allowed to add legal expenses to cost of stock in determining basis on later sale).

The cost of tax advice sought by the payor in connection with a divorce or separation, however, is deductible. Rev. Rul. 72 545, 1972-2 C.B. 179.

such other person or persons is designated."[119] Construing this provision, the Tax Court held that if the husband was required to make payments to the wife for the support of her relatives, the wife was taxed as long as she was under a legal or moral obligation to provide for the beneficiaries of the payments.[120]

Child support payments are yet another area of controversy under the 1942 provisions and the 1954 amendments. Under those divorce tax systems, the payee is not taxed on any payment that is fixed as child support by the decree, instrument, or agreement.[121] In *Commissioner v. Lester*,[122] the Supreme Court held that a divorce agreement reducing the amount payable by the husband to the wife when their children married, were emancipated, or died, did not "fix" an amount for child support even where the allocation could be inferred from the arrangement and state law might compel the wife to use that portion for the support of the children.[123] Instead, the Court read the provision as "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," but only if the agreement *explicitly* earmarked a specific portion of the periodic payment for child support.[124] The court's determination comports with Congressional intent to retain control over the use of the alimony system.

D. *"Starting All Over Again"*

1. The 1984 Reform

By the time Congress seriously reexamined divorce taxation in 1984, tax law in the divorce area was in a state of confusion.[125]

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[119] Treas. Reg. § 1.71-1(e) (1960) (last sentence). During this period the regulations and Code used the terms "wife" to refer to the alimony payee and "husband" to refer to the alimony payor. This terminology was eliminated in the 1984 Act and replaced with payor and payee.

[120] Christiansen v. Commissioner, 60 T.C. 456 (1973) (acq.); Faber v. Commissioner, 264 F.2d 127 (3d Cir. 1959). *But see* Emmons v. Commissioner, 36 T.C. 728 (1961) *aff'd*, 311 F.2d 223 (6th Cir. 1962) (payment to the wife on behalf of her adult daughters is neither includible in her income nor deductible by the husband).

[121] 1942 Act § 22(k); 1954 Code § 71(b).

[122] 366 U.S. 299 (1961).

[123] *Id. See also* Treas. Reg. § 1.71-1(e) (1960) (amount paid to support minor children must be "specifically designated").

[124] *Lester*, 366 U.S. at 304.

[125] *See, e.g.*, H.R. REP. No. 861, 98th Cong., 2d Sess. 1116 (1984). *See also Tax Law Simplification and Improvement Act of 1983: Hearings on H.R. 3475 Before the House*

Congress concluded that the alimony tax rules should be simplified in order to make it easier for the parties to a divorce to apply the rules and to reduce litigation.[126] Congress therefore began its next round of reform with the intention of making the alimony tax rules more objective.[127]

The intent of the 1984 divorce tax reforms, introduced as part of the Deficit Reduction Act of 1984,[128] was consistent with substantive divorce law reforms which assume a laissez-faire stance toward divorce.[129] The major development in substantive divorce law was the shift from a fault based to a no-fault based divorce system. In 1971, the National Conference of Commissioners on Uniform State Laws ammended the Uniform Marriage and Divorce Act to eliminate the fault grounds for divorce.[130] In 1972, California became the first state to provide "irreconcilable differences" as a grounds for divorce.[131] By 1984, all states had provided for some form of no-fault divorce,[132] although many states also retained fault grounds.[133] The shift from a fault-based to a no-fault divorce system made divorces easier to obtain while the 1984 tax reforms simplified the settlement negotiation process.

In addition to making the divorce tax rules simpler and more objective, Congress wanted to give couples greater control over the settlement negotiation process.[134] However, the Treasury asked Congress to maintain prior distinctions,[135] fearing that unfettered taxpayer discretion would lead to abuse such as re-

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Ways and Means Committee, 98th Cong., 1st Sess. 203, 263 (1983) (hereinafter *1983 Hearings*) (statements of M. Bernard Aidinoff, Chairman of the Taxation Section of the ABA and Marjorie A. O'Connell, Domestic Relations and Tax Attorney).

[126] H.R. REP. No. 432, Part II, 98th Cong., 2d Sess. 1025, 1495, *reprinted in* 1984 U.S. CODE CONG. & ADMIN. NEWS 697, 1137.

[127] *Id.*

[128] Deficit Reduction Act of 1984, Pub. L. No. 98-369, 98 Stat. 494 (1984).

[129] As author Lenore Weitzman states: "The new divorce laws adopt a laissez-faire attitude toward both marriage and divorce. They leave both the terms of the marriage contract—and the option to terminate it—squarely in the hands of the individual parties." L. WEITZMAN, THE DIVORCE REVOLUTION 368 (1985).

[130] UNIF. MARRIAGE AND DIVORCE ACT § 305, 9A U.L.A. 96 (1971). According to this section, "irretrievable breakdown" is sufficient grounds for divorce.

[131] CAL. CIV. CODE § 4566 (Deering 1972).

[132] Freed & Walker, *Family Law in the Fifty States: An Overview*, 219 FAM. L.Q. 417, 440 (1988).

[133] *E.g.*, ALA. CODE § 30-2-1 (1983); MASS. GEN. LAWS ANN. ch. 208, § 1 (West 1987); N.J. STAT. ANN. § 2A:34-2 (West 1987); W. VA. CODE § 48-2-4 (1986). Common fault grounds include: adultery, abandonment, cruel and inhumane treatment, and habitual drunkenness.

[134] *1983 Hearings*, *supra* note 125 at 163–64.

[135] The Treasury was unwilling to abandon either the periodic payment approach or the 10 year/10% rule which had added so much complexity to the 1942 Act. *Id.* at 153.

characterization of child support payments or property settlements as alimony.[136] This conflict between returning control to taxpayers and restricting the use of taxpayer discretion became the theme of the 1984 divorce tax reform. Over and over again, the 1984 reform shows: (1) an increased emphasis on couples engaging in taxplanning as a unit; and (2) a series of restrictions that keep taxpayers from going "too far" in making their own decisions.

For example, under prior alimony systems payments must be periodic in order to fall under the alimony rules.[137] As a result, a single cash payment can never fall within the payor-deduction/payee-inclusion scheme. In contrast, under the 1984 system, all cash payments are alimony unless the couple specifically designates that the payments are not alimony.[138] By making all cash payments alimony, the 1984 system fulfills its mission in a number of ways. First, it reduces a fair amount of complexity; almost everyone has a sense of the differences between cash and property. Second, it gives control to the couple because the rule is easier to apply than the periodic payment standard and because both parties have to decide how to handle the payment. If a couple chooses to transfer property, they know that the alimony rules will not apply. If they negotiate a cash payment schedule, they know it will fall under the alimony rules. This emphasis on the couple negotiating its tax results is very different from the older systems where choices were limited and often made by only one spouse. Finally, consistent with the cash payment rule, a transfer of property no longer qualifies as alimony under sections 71 and 215. The payor does not have to pay tax on the appreciation and the payee takes a carryover in basis.[139]

Congress tempered the discretion conveyed by the cash payment rule by adopting the complex front-loading rule of section 71(f).[140] The front loading rule is designed to catch property settlements disguised as alimony payments. It is analogous to the lump sum distribution and 10 year/10% rules of the earlier

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[136] *1983 Hearings, supra* note 125 at 163–64.

[137] *See supra* text accompanying notes 53–54.

[138] Deficit Reduction Act of 1984, Pub. L. No. 98-369, § 422 98 Stat. 494, 795 (amending 1954 Code § 71(b)(1)(B)).

[139] *1983 Hearings, supra* note 125, at 163–64.

[140] Deficit Reduction Act of 1984, Pub. L. No. 98-369, § 422 98 Stat. 494, 795 (amending 1954 Code § 71(f)) was itself revised as part of the Tax Reform Act of 1986. Accordingly, there are two front loading rules to contend with depending on the date of the divorce or separation instrument under which the payments are made. *See infra* text at Section II.

systems.[141] The front loading rule prohibits alimony treatment when cash payments are large in the early years but decrease dramatically in later years. The rule is based on the same view that supported the lump sum distribution and 10 year/10% rules—that property settlements are made in large payments over a short period of time while alimony is made in smaller payments over a longer period of time. Today, however, alimony is viewed as a short term means of getting women back on their feet rather than as a life time support measure.[142] Diminishing payments to the dependent spouse is consistent with the modern view. Consequently, the front loading rule is anachronistic.

The 1984 reforms contain two other vital divorce taxation provisions. First, the *Davis*[143] rule, which allowed taxpayers to whipsaw the government by failing to report transfers until it became attractive to do so,[144] was repealed so that all transfers between spouses (and former spouses when incident to divorce) were treated as gifts resulting in a transferred tax basis.[145] Second, Congress continued its practice of grandfathering prior terminations under old law by allowing couples living under the 1942 and 1954 Acts to move into the 1984 system.[146]

In sum, the 1984 reforms maintain the basic structure of the 1942 and 1954 systems while making the rules more objective and easier to apply. Where a marital termination falls under the 1984 divorce tax system all "alimony and separate maintenance payments" are included in the payee's gross income.[147] As under

[141] For a discussion of the lump sum distribution rules and the 10 year/10%, rule see *supra* text accompanying notes 53–54 (lump sum distributions) and note 54 (10 year/10% rule).

[142] *See generally* Malman, *Unfinished Reform: The Tax Consequences of Divorce*, 61 N.Y.U. L. REV. 363 (1986) (under modern concepts of alimony, spousal support is designed to enable the recently divorced recipient to aquire new skills, revive old ones and to reassimilate into the working world).

[143] United States v. Davis, 370 U.S. 65 (1962).

[144] *1983 Hearings*, *supra* note 125, at 162–63. For example, assume that *W* transfers stock she purchased for $5 to *H* at a time when the property's fair market value is $100. Under *United States v. Davis*, *W* should pay tax on $95 of income in the year of the transfer. H now receives a $100 basis in the property received in the exchange. Therefore, if *H* then sells the stock for $100 he will not have a gain or loss. This remains true for *H* even if *W* has avoided a tax on her gain by failing to report the transaction.

[145] Deficit Reduction Act of 1984, Pub. L. No. 98-369, § 421, 98 Stat. 494, 793 (amending 1954 Code § 1041).

[146] *Id.*

[147] Unlike the 1954 Act, the Deficit Reduction Act of 1984 did not change the numbering of Internal Revenue Code sections. However, as noted in the text, many provisions were substantially changed despite the fact that they share the same section number with an earlier provision. Further, even when a rule remained the same, its place within the section was often changed. For example, the decree requirement which was contained in 1954 Code § 71(a)(1) became 1984 Act § 71 (b)(2)(A). 1984 Act § 71 provides:

prior systems, the payor receives a corresponding alimony paid

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SEC. 71. ALIMONY AND SEPARATE MAINTENANCE PAYMENTS.
(a) GENERAL RULE. — Gross income includes amounts received as alimony or separate maintenance payments.
(b) ALIMONY OR SEPARATE MAINTENANCE PAYMENTS DEFINED. — For purposes of this section —
(1) IN GENERAL. The term "alimony or separate maintenance payment" means any payment in cash if —
(A) such payment is received by (or on behalf of) a spouse under a divorce or separation instrument,
(B) the divorce or separation instrument does not designate such payment as a payment which is not includible in gross income under this section and not allowable as a deduction under section 215,
(C) in the case of an individual legally separated from his spouse under a decree of divorce or of separate maintenance, the payee spouse and the payor spouse are not members of the same household at the time such payment is made, and
(D) there is no liability to make any such payment for any period after the death of the payee spouse and there is no liability to make any payment (in cash or property) as a substitute for such payments after the death of the payee spouse (and the divorce or separation instrument states that there is no such liability).
(2) DIVORCE OR SEPARATION INSTRUMENT. — The term "divorce or separation instrument" means —
(A) a decree of divorce or separate maintenance or a written instrument incident to such a decree,
(B) a written separation agreement, or
(C) a decree (not described in subparagraph (A)) requiring a spouse to make payments for the support or maintenance of the other spouse.
(c) PAYMENTS TO SUPPORT CHILDREN. —
(1) IN GENERAL. — Subsection (a) shall not apply to that part of any payment which the terms of the divorce or separation instrument fix (in terms of an amount of money or a part of the payment) as a sum which is payable for the support of children of the payor spouse.
(2) TREATMENT OF CERTAIN REDUCTIONS RELATED TO CONTINGENCIES INVOLVING CHILD — For purposes of paragraph (1), if any amount specified in the instrument will be reduced —
(A) on the happening of a contingency specified in the instrument relating to a child (such as attaining a specified age, marrying, dying, leaving school, or a similar contingency), or
(B) at a time which can clearly be associated with a contingency of a kind specified in paragraph (1), an amount equal to the amount of such reduction will be treated as an amount fixed as payable for the support of children of the payor spouse.
(3) SPECIAL RULE WHERE PAYMENT IS LESS THAN AMOUNT SPECIFIED IN INSTRUMENT. — For purposes of this subsection, if any payment is less than the amount specified in the instrument, then so much of such payment as does not exceed the sum payable for support shall be considered a payment for such support.
(d) SPOUSE. — For purposes of this section, the term "spouse" includes a former spouse.
(e) EXCEPTION FOR JOINT RETURNS. — This section and section 215 shall not apply if the spouses make a joint return with each other.
(f) SPECIAL RULES TO PREVENT EXCESS FRONT-LOADING OF ALIMONY PAYMENTS. —
(1) REQUIREMENT THAT PAYMENTS BE FOR MORE THAN 6 YEARS. — Ali-

deduction.[148] The term "alimony or separate maintenance payments" is limited to *cash* payments which meet four require-

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mony or separate maintenance payments (in excess of $10,000 during any calendar year) paid by the payor spouse to the payee spouse shall not be treated as alimony or separate maintenance payments unless such payments are to be made by the payor spouse to the payee spouse in each of the 6 post-separation years (not taking into account any termination contingent on the death of either spouse or the remarriage of the payee spouse).

(2) RECOMPUTATION WHERE PAYMENTS DECREASE BY MORE THAN $10,000 — If there is an excess amount determined under paragraph (3) for any computation year —

(A) the payor spouse shall include such excess amount in gross income for the payor spouse's taxable year beginning in the computation year, and

(B) the payee spouse shall be allowed a deduction in computing adjusted gross income for such excess amount for the payee spouse's taxable year beginning in the computation year.

(3) DETERMINATION OF EXCESS AMOUNT. — The excess amount determined under this paragraph for any computation year is the sum of —

(A) the excess (if any) of —

(i) the amount of alimony or separate maintenance payments paid by the payor spouse during the immediately preceding post-separation year, over

(ii) the amount of the alimony or separate maintenance payments paid by the payor spouse during the computation year increased by $10,000, plus

(B) a like excess for each of the other preceding post-separation years.

In determining the amount of the alimony or separate maintenance payments paid by the payor spouse during any preceding post-separation year, the amount paid during such year shall be reduced by any excess previously determined in respect of such year under this paragraph.

(4) DEFINITIONS. — For purposes of this subsection —

(A) POST-SEPARATION YEAR. — The term "post separation year" means any calendar year in the 6 calendar year period beginning with the first calendar year in which the payor spouse paid to the payee spouse alimony or separate maintenance payments to which this section applies.

(B) COMPUTATION YEAR. — The term "computation year" means the post-separation year for which the excess under paragraph (3) is being determined.

(5) EXCEPTIONS. —

(A) WHERE PAYMENTS CEASE BY REASON OF DEATH OR REMARRIAGE — Paragraph (2) shall not apply to any post-separation year (and subsequent post-separation years) if —

(i) either spouse dies before the close of such post-separation year or the payee spouse remarries before the close of such post-separation year, and

(ii) the alimony or separate maintenance payments cease by reason of such death or remarriage.

(B) SUPPORT PAYMENTS. — For purposes of this subsection, the term "alimony or separate maintenance payment" shall not include any payment received under a decree described in subsection (b)(2)(C).

(C) FLUCTUATING PAYMENTS NOT WITHIN CONTROL OF PAYOR SPOUSE. — For purposes of this subsection, the term "alimony or separate maintenance payment" shall not include any payment to the extent it is made pursuant to a continuing liability (over a period of not less than 6 years) to pay a fixed portion of the income from a business or property or from compensation for employment or self-employment.

[148] Deficit Reduction Act of 1984, Pub. L. No. 98-369, § 422, 98 Stat. 494, 797 (amending 1954 Code § 215) provides:

SEC. 215. ALIMONY, ETC., PAYMENTS.

(a) GENERAL RULE. — In the case of an individual, there shall be allowed as ments: (1) each payment must be received by or on behalf of a spouse or former spouse under a decree of divorce or separate maintenance, a written instrument incident to such a decree, a written separation agreement, or a decree requiring support or maintenance payments;[149] (2) the instrument must not designate the payment as one to which the tax regime for alimony is inapplicable; (3) if payments are made under a decree of divorce or separation, the spouses must not be members of the same household when the payment is made; and (4) there must be no obligation to continue the payments after the payee's death. A detailed explanation of each of these requirements follows.

a. *Divorce or separation instrument.* Under the 1984 divorce tax system, payments are not alimony (and so are not taxable to the payee and deductible by the payor) unless they are made under a divorce or separation instrument.[150] This term includes the same marital terminations covered by the divorce tax system since 1954, that is, decrees of divorce or separation, written separation agreements and court ordered decrees of support.[151] As under the 1954 system, the existence of a decree of divorce or separation is rarely necessary, although the lack of a decree may cause a problem in certain limited circumstances.[152]

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a deduction an amount equal to the alimony or separate maintenance payments paid during such individual's taxable year.

(b) ALIMONY OR SEPARATE MAINTENANCE PAYMENTS DEFINED. — For purposes of this section, the term "alimony or separate maintenance payment" means any alimony or separate maintenance payment (as defined in section 71(b)) which is includible in the gross income of the recipient under section 71.

(c) REQUIREMENT OF IDENTIFICATION NUMBER. — The Secretary may prescribe regulations under which —

(1) any individual receiving alimony or separate maintenance payments is required to furnish such individual's taxpayer identification number to the individual making such payments, and

(2) the individual making such payments is required to include such taxpayer identification number on such individual's return for the taxable year in which such payments are made.

(d) COORDINATION WITH SECTION 682. — No deduction shall be allowed under this section with respect to any payment if, by reason of section 682 (relating to income of alimony trusts), the amount thereof is not includible in such individual's gross income.

[149] 1984 Act § 71(b)(2).

[150] 1984 Act § 71(b)(1)(A).

[151] *See* 1984 Act § 71(b)(2)(A) (decree of divorce or separate maintenance or a written instrument incident to such a decree); 1984 Act § 71(b)(2)(B) (written separation agreement); 1984 Act § 71(b)(2)(C) (court ordered support decree).

[152] *See supra* text accompanying note 97.

b. *Designation as alimony.* Under section 71 of the 1984 system, cash payments are includible by the payee and deductible by the payor, unless the divorce or separation instrument designates such payments as outside the purview of sections 71 and 215.[153] Thus, under the 1984 system, even cash payments otherwise intended as property settlements are taxed as alimony, unless the divorce or separation instrument specifies that such payments are distributions of property. Similarly, payments provided as support are not taxed as alimony if the instrument so stipulates.

This provision places greater emphasis on the couple's stated preferences. As a consequence, tax-related negotiations take on increased importance. Payors may be more willing to give additional concessions in exchange for valuable deductions. Also, since couples together decide how payments are to be characterized under the alimony tax rules by the designation of payments as alimony or a property settlement or by the transfer of property or cash, payees regain some of the bargaining power lost under prior law.

c. *Obligation to continue payments after death of the payee.* Under the 1984 system, periodic payments are not alimony unless the payor's obligation terminates upon the payee's death.[154] Despite allowing couples to elect into or out of alimony rules through the use of cash payments, Congress remains concerned with property settlements disguised as alimony.[155] Since the dead need no support, payments that do not terminate upon the payee's death are presumed to be part of a property settlement. The requirement that payments cease upon the death of the payee may be provided for in the divorce or settlement agreement or supplied by state law or by oral agreement.[156]

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[153] 1984 Act § 71(b)(1)(B).

[154] 1984 Act § 71(b)(1)(D).

[155] *See, e.g.*, H.R Rep. No. 432, Part II, 98th Cong., 1st Sess. 1496 (in order to prevent deduction of amounts which are in effect the transfer of property unrelated to the support needs of the recipient, the 1984 Act provides that payments qualify as alimony only if the payor has no liability to make payments after death of the payee spouse).

[156] Prior to the Tax Reform Act of 1986, Pub. L. No. 99-514, 100 Stat. 2085, failure to specifically provide for the termination of the obligation in the divorce or settlement agreement resulted in none of the payments being treated as alimony, whether they were made before or after the payee's death. Temp. Treas. Reg. § 1.71-1T(b) Answer 11 (1984). The 1986 Act's transition rules, however, altered this result, at least in some circumstances. For divorce or settlement agreements executed after December 31, 1984, termination of the obligation either by oral agreement or pursuant to state law remedies

d. *Child support.* As under prior law, the 1984 system distinguishes payments fixed by the instrument as support for the payor's children from alimony and separate maintenance[157] and provides that child support is taxable to the payor and excludible by the payee.[158] But there are differences in the 1984 system which attempt to address problems which developed as a result of *Commissioner v. Lester.*[159] Contrary to prior law, under the 1984 Act, payments are considered child support if the payment period is determined with reference to a particular event in the child's life.[160] This rule also applies if payments are to be reduced on a specified date that is "associated" with a particular event related to the child.[161] Thus, couples have more flexibility in negotiating the specifics of their divorce settlements, but cannot completely circumvent the alimony rules by merely labeling child support alimony.

e. *Cash payments.* One of Congress' primary goals in enacting the 1984 Act was to institute a uniform federal definition of alimony that would equalize treatment of transfers between spouses and former spouses.[162] The 1984 Act makes compliance with the alimony rules more straightforward by instituting a cash payment standard to distinguish alimony from divisions of property.[163] Congress intended this change to reduce the administrative burden on the Internal Revenue Service and to make it easier for couples to divorce.[164] The cash payment standard, however, creates inequities when applied to transactions involving the family home. If a family home is owned either by one spouse alone or jointly, the divorce settlement often provides for the rent-free occupancy by the other spouse. Such a transfer of the interest in the residence is not a "cash payment" and

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the failure to provide such termination in the divorce or settlement agreement. Tax Reform Act of 1986, P.L. No. 99-514, § 1843(b), 100 Stat. 2085, 2852.

[157] 1984 Act § 71(c)(1).

[158] *Id.* For a discussion of how child support was treated under prior law, see *supra* notes 65–69 and accompanying text.

[159] The consequences of *Lester* are discussed *supra* notes 122–124 and accompanying text.

[160] For example, if payments to a former spouse will decrease when a child marries or dies, each payment prior to the decrease is considered child support to the extent of the decrease in such payment. 1984 Act § 71(c)(2)(A).

[161] If, for example, a reduction is scheduled to occur on the child's eighteenth birthday, the amount of the reduction is considered to be the amount of child support. *Id.*

[162] H.R. REP. No. 432, *supra* note 155 at 1137.

[163] 1984 Act § 71(b)(1).

[164] H.R. REP. No. 432, *supra* note 155 at 1495.

hence its value is neither taxable to the payee nor deductible by the payor. This treatment is consistent with the policy of not taxing property settlements under alimony rules.

The cash payment standard also means that the spouse occupying the home rent-free is not taxed on the transfer. Although there is no cash payment, rent-free occupancy is more like a support payment than a division of property.[165] When the payor is required by the divorce decree or agreement to pay for utilities, insurance, repairs, property taxes, or mortgage interest on the home, these cash payments may fall under the 1984 system, assuming that other statutory requirements are satisfied.[166]

Many separation agreements provide that the payor spouse must maintain an ordinary life insurance policy with the payee spouse named as beneficiary. Prior to 1984, premiums paid on a whole life insurance policy qualified as alimony while premiums paid on a term life insurance policy did not. The 1984 Act's cash payment standard eliminates this disparity. If the payor spouse is required to maintain either a whole or term life insurance policy on his life, and the payee spouse is both the owner and the irrevocable beneficiary, the premiums are cash payments which fall under the 1984 alimony rules.[167]

f. *Transfers of property incident to divorce.* Until 1984, transfers of property between spouses or former spouses could have very different tax consequences. If the transfer was a sale, the transferor would recognize any gain and the transferee would receive a stepped-up basis in the property.[168] A sale between spouses resulting in a loss, however, would not give rise to a deduction.[169] In an exchange, either spouse or both might re-

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[165] Consider the example of spouse *A* and spouse *B*. Upon dissolution of her marriage, spouse *A* continues to reside in the family home which her former husband continues to own. Under the cash payment standard, she pays no tax on the imputed value of her rent. Spouse *B* moves into a $250 per month apartment which her former spouse is required to pay rent in the form of alimony. Spouse *B* must pay taxes on this amount.

[166] These requirements include: the payment must be designated as alimony in the instrument; payments will not continue after the death of the payor spouse; and the front-loading rules of § 71(f) are not violated. Temp. Treas. Reg. § 1.71-1T Answer 2 (1984).

[167] Temp. Treas. Reg. § 1.71-1T Answer 6 (1984).

[168] *See* I.R.C. § 1001 (1986) (gain recognition); I.R.C. § 1012 (1986) (cost basis).

[169] *See* I.R.C. § 165(c) (1986) (limited deductions for losses on sales outside the business context); I.R.C. § 267 (1986) (disallowance of losses on sales between related taxpayers).

ceive nonrecognition of gain and loss.[170] A gift's tax consequences would depend on whether the couple was married or divorced at the time of the transfer.[171] Moreover, in the divorce context, the Supreme Court held in *United States v. Davis*[172] that the transfer of property in exchange for marital rights was a taxable exchange. In dicta, the Court stated that this would be the result in most common law states, although it might be a tax free division of property in community property states.[173] In addition, differences among states in their definition of alimony made tax planning problematic.[174]

The 1984 Act provides that transfers between spouses when "incident to divorce"[175] result in no gain or loss to the transferor whether the transfer is a gift, sale, or exchange and whether the transfer is of separately-owned property or is a division of community property.[176] The impact of section 1041, however, is to complete the tax burden shift from payors to payees that began with the 1942 Act.[177]

A transfer of property is "incident to the divorce" if the transfer: (1) occurs within one year after the date on which the marriage ceases, or (2) is "related to the cessation of the marriage."[178] Thus, a transfer made within one year of a divorce need not be related to the cessation of the marriage in order to escape taxation under section 1041. In making such determinations, annulments and other actions which void marriages *ab initio* constitute divorces.[179] A transfer is "related to the cessation of the marriage" if it is made pursuant to a divorce or

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[170] *See* I.R.C. § 1031 (1986) (nonrecognition of gain or loss for like kind exchanges of property used in a trade or business or for the production of income).

[171] There are no gift tax consequences for interspousal gifts if a transfer is in fact a gift. I.R.C. § 2523 (1986). For an analysis of the basic requirements for tax-free transfers of gifts between spouses, see R. STEPHENS, G. MAXFIELD & S. LIND, FEDERAL ESTATE AND GIFT TAXATION ¶ 11.03 (5th ed. 1983).

[172] 370 U.S. 65 (1962).

[173] *Id.* at 71.

[174] *See* H.R. REP. No. 432, supra note 155 at 194–96.

[175] 1984 Act § 1041(a)(1) (transfers between spouses); 1984 Act § 1041(a)(2) (transfers between former spouses incident to a divorce).

[176] Temp. Treas. Reg. § 1.1041-1T(d) Answer 10 (1984). However, under 1984 Act § 1041(d), recognition of gain or loss is required (barring the application of another nonrecognition provision) if the transferee spouse is a nonresident alien. In addition, in order for § 1041 to apply, there must be a transfer of property as opposed to services. Temp. Treas. Reg. § 1.1041-1T(a) Answer 4 (1984).

[177] For a more extensive discussion of how section 1041 unfairly shifts the tax burden to the payee spouse, see Lepow, *Tax Policy for Lovers and Cynics: How Divorce Settlement Became the Last Tax Shelter in America*, 62 NOTRE DAME L. REV. 32 (1986).

[178] 1984 Act 1041(c); Temp. Treas. Reg. § 1.1041-1T(b) Answer 6 (1984).

[179] Temp. Treas. Reg. § 1.1041-1T(b) Answer 8 (1984).

separation instrument, as defined by section 71(b)(2), and the transfer occurs within six years of the cessation of the marriage.[180]

By treating such transfers like gifts, section 1041(b) extends the nonrecognition granted the transferor spouse by section 1041(a) to the transferee, who recognizes no income from the receipt. The disadvantage of this income exclusion is that the transferee must take the transferor's basis even if fair market value has been paid for the property.[181]

g. *Restrictions on front-loading payments.* Most of the complexity associated with the 1984 system stems from the restriction on "front-loading" alimony deductions. Front loading is the transfer to the payee of large cash payments in early years followed by significantly smaller or no payments in later years. Because property settlements are more likely to involve a few large transfers, while support is more often characterized by smaller, more numerous payments, the front-loading restriction is designed to prevent property transfers disguised as alimony. Under the 1984 system, alimony payments are subject to two provisions: (1) if the six-year rule is violated, the payments are taxed to the payor;[182] and (2) even if the six-year rule is met, certain payments may be "recaptured" resulting in their inclusion in the payor's income with a corresponding deduction to the payee.

(i) *Requirement of six consecutive annual payments.* When the decree or agreement requires annual payments of more than $10,000 per calendar year, section 71(f)(1) provides that the payments are not "alimony or separate maintenance payments" and, therefore, are neither includible in the payee's income nor deductible by the payor, unless the payments must continue for

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180 The only way to rebut this presumption is to show that the transfer was made to effect a division of property owned by the former spouses at the time of the marriage's cessation. Temp. Treas. Reg. § 1.1041-1T(b) Answer 7 (1984).

181 Temp. Treas. Reg. § 1.1041-1T(d) Answer 11 (1984). Unlike I.R.C. § 1015 (1986) which determines the transferee's basis for other gifts, the carryover basis required by I.R.C. § 1041(b) applies whether the transferor's basis is less than, equal to, or greater than fair market value at the time of the transfer and for purposes of determining the transferee's loss as well as gain. Temp. Treas. Reg. § 1.1041-1T(d) Answer 11 (1984).

182 1984 Act § 71(f)(1).

at least six consecutive calendar years.[183] Arbitrary application of this requirement can produce counterintuitive results.

(ii) *Recapture rules.* If the 1984 system's six-year requirement is met, the recapture rule will apply if payments decline by more than $10,000 over three calendar years.[184] The rule "recaptures" all payments that exceed the lowest amount paid in a later year by more than $10,000.[185] This recapture requires the payor to recognize gross income equal to the recapture amount and allows the payee a corresponding deduction.[186]

E. *One More Time with Feeling—1987 and Beyond*

In the Tax Reform Act of 1986,[187] Congress cured many of the ills associated with the 1984 system. The Act made the alimony tax rules more straightforward by eliminating the re-

[183] The six-year period begins with the year of the first payment and cannot end prematurely without running afoul of the 1984 Act § 71(f)(1) unless the termination is due to the death of either spouse or the payee spouse's remarriage. For example, the six-year rule is violated if the divorce decree requires annual payments of $12,000 for four years. Therefore, none of the payments are included in the payee's income even if made for the payee's support and the payor does not receive an alimony paid deduction. However, the same annual payments made over a seven-year period are alimony even if they are part of a property settlement as long as the other requirements of section 71 are met.

[184] 1984 Act § 71(f)

[185] The recapture provisions are shown below in an example which assumes a divorce decree requiring payments of $50,000 in the first year, $30,000 in the second year, and $1,000 in each subsequent year. In the second year, there is recaptured $10,000 of the first-year payment (i.e., $50,000 minus the sum of $10,000 and the second-year payment of $30,000). In the third year, there is a further recapture of $11,000 of the first-year payment and $1,000 of the second-year payment, computed as follows:

Recapture in Year 2	
First-year payment	$ 50,000
Less: Sum of $10,000 and second-year payment ($30,000)	($ 40,000)
Amount of first-year's payment recaptured in year 2	$ 10,000
Recapture in Year 3	
First-year payment	$ 50,000
Less: Sum of $10,000 plus amount recaptured in year 2 ($10,000) and amount paid in Year 3 ($1,000)	($ 21,000)
Amount of first-year's paymentrecaptured in year 3	$ 29,000
Second-year payment	$ 30,000
Less: Sum of $10,000 and third-year payment ($1,000)	($ 11,000)
Amount of second-year's payment recaptured in year 3	$ 19,000
Total payments recaptured in Year 3	$ 48,000

[186] Under the transitional rules adopted as part of the Tax Reform Act of 1986, the recapture period for payments subject to 1984 Act § 71(f)(2) is reduced to three years. Tax Reform Act of 1986, Pub. L. No. 99-514, § 1843(c)(3), 100 Stat. 2085, 2853–55. Accordingly, a payment of $1,000 in years 4 through 6 will not result in a recapture.

[187] Tax Reform Act of 1986, Pub. L. No. 99-514, 100 Stat. 2085.

quirement that the instrument state that payments will terminate upon the death of the payee. In addition, the Act updates the recapture rules to reflect the trend toward rehabilitative alimony.

Under the 1984 Act, payments were not alimony if the divorce or separation instrument did not provide that the payor's obligation would cease on the payee's death.[188] This requirement became a trap for unsophisticated taxpayers, particularly for those who fashioned their own separation agreements or who appeared before judges using standard preprinted forms for support orders.[189] The 1986 Act retroactively eliminated this requirement.

Long before 1986, the view that husbands were permanently obligated to support their wives, regardless of whether or not the marriage remained intact, began to erode. The courts came to regard alimony as a means of enabling women to become self-sufficient after divorce, rather than as a means of permanent support.[190] The Uniform Marriage and Divorce Act, approved by the National Conference of Commissioners on Uniform State Laws in 1971, supports this view. The Act provides that a court may grant a maintenance order for either spouse only if it finds that the spouse seeking maintenance:

> 1) lacks sufficient property to provide for his reasonable needs; and
> 2) is unable to support himself through appropriate employment or is the custodian of a child whose condition or circumstances make it appropriate that the custodian not be required to seek employment outside the home.[191]

Thus, the legal system began to expect women to become self-sufficient once they were given the opportunity to develop job

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[188] This requirement still appears in the temporary regulations at Temp. Treas. Reg. § 1.71-1T(b) Answer 10 (1984), but has been superceded by transitional rules within the 1986 Act. Tax Reform Act of 1986, Pub. L. No. 99-514, § 1843(b), 100 Stat. 2085, 2853.

[189] *Technical Corrections Act of 1985: Hearings on H.R. 1800 Before the House Ways and Means Committee*, 99th Cong., 1st Sess. 324–26 (1985) (testimony of Marjorie A. O'Connell, domestic relations and tax attorney).

[190] *E.g.*, Turner v. Turner, 158 N.J. Super. 313, 314, 385 A.2d 1280, 1282 (1978); Molnar v. Molnar, 314 S.E.2d 73 (W. Va. Ct. App. 1984); Cathleen C.Q. v. Norman C.Q., 452 A.2d 951 (Del. Supr. 1982) (basic purpose of Deleware Divorce and Annulment Act to award alimony only during continuation of dependency and in manner which will encourage parties to become self-supporting).

[191] UNIF. MARRIAGE & DIVORCE ACT § 308, 9A U.L.A. 147 (1987). Many states adopted the Uniform Act's approach: *e.g.*, KY. REV. STAT. ANN. § 403.200 (1984), MO. REV. STAT. § 452.33 (1986).

skills. Temporary alimony, often referred to as "rehabilitative" alimony, became standard.[192]

The 1984 front-loading rules, which provided for a six-year recapture period, were inconsistent with the move toward rehabilitative alimony. Under the 1984 Act, for example, payments made in years 4 and beyond might be subject to recapture. The 1986 Act shortened the recapture period to three years and made the change retrospective for payments subject to the 1984 system.[193] More complicated changes in the front-loading rules, however, were made prospectively.[194]

Finally, the 1984 Act originally required payments over a six-year period before any amount was deductible by the payor. The 1986 divorce tax system eliminated the possibility that payments would fall outside the payor deduction/payee inclusion rules under the 1984 or 1986 Acts merely because payments were not made over a six-year period.[195] Instead, the only pen-

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[192] *See* Krauskopf, *Rehabilitative Alimony: Uses and Abuses of Limited Duration Alimony*, 21 FAM. L.Q. 573 (1988), for a discussion of how the trend toward rehabilitative alimony has impacted the economic well-being of divorced women.

[193] I.R.C. § 71(f) (1986).

[194] Tax Reform Act of 1986, Pub. L. No. 99-514, § 1843(c)(2), (3), 100 Stat. 2085.

[195] I.R.C. § 71(f) (1986) provides:

(f) RECOMPUTATION WHERE EXCESS FRONT-LOADING OF ALIMONY PAYMENTS. —

(1) IN GENERAL. — If there are excess alimony payments —

(A) the payor spouse shall include the amount of such excess payments in gross income for the payor spouse's taxable year beginning in the 3rd post-separation year, and

(B) the payee spouse shall be allowed a deduction in computing adjusted gross income for the amount of such excess payments for the payee's taxable year beginning in the 3rd post-separation year.

(2) EXCESS ALIMONY PAYMENTS. — For purposes of this subsection, the term "excess alimony payments" mean the sum of -

(A) the excess payments for the 1st post-separation year, and

(B) the excess payments for the 2nd post-separation year.

(3) EXCESS PAYMENTS FOR 1ST POST-SEPARATION YEAR. — For purposes of this subsection, the amount of the excess payments for the 1st post-separation year is the excess (if any) of —

(A) the amount of the alimony or separate maintenance payments paid by the payor spouse during the 1st post separation year, over

(B) the sum of —

(i) the average of —

(I) the alimony or separate maintenance payments paid by the payor spouse during the 2nd post-separation year, reduced by the excess payments for the 2nd post-separation year, and

(II) the alimony or separate maintenance payments paid by the payor spouse during the 3rd post-separation year, plus

(ii) $15,000.

(4) EXCESS PAYMENTS FOR 2ND POST-SEPARATION YEAR. — For purposes of this subsection, the amount of the excess payments for the 2nd post-separation year is the excess (if any) of —

(A) the amount of the alimony or separate maintenance payments paid by the payor spouse during the 2nd post separation year, over alty for failure to comply with the 1986 front-loading rules is the possible recapture of excess payments. This recapture, which first appeared in the 1984 Act, forces a payor to include previously deducted excess alimony payments.[196] In addition, the 1986 front-loading rules replace the $10,000 recapture threshold in the 1984 system with a $15,000 excess amount and replace the 1984 Act's year-by-year recapture with a single recapture of the combined "excess payments" from the first and second year in the third year.[197] This change was prospective only.

(B) the sum of —

(i) the amount of the alimony or separate maintenance payments paid by the payor spouse during the 3rd post-separation year, plus

(ii) $15,000.

(5) EXCEPTIONS. —

(A) WHERE PAYMENT CEASES BY REASON OF DEATH OR REMARRIAGE. — Paragraph (1) shall not apply if —

(i) either spouse dies before the close of the 3rd post-separation year, or the payee spouse remarries before the close of the 3rd post-separation year, and

(ii) the alimony or separate maintenance payments cease by reason of such death or remarriage.

(B) SUPPORT PAYMENTS. — For purposes of this subsection, the term "alimony or separate maintenance payment" shall not include any payment received under a decree described in subsection (b)(2)(C).

(C) FLUCTUATING PAYMENTS NOT WITHIN CONTROL OF PAYOR SPOUSE. — For purposes of this subsection, the term "alimony or separate maintenance payment" shall not include any payment to the extent it is made pursuant to a continuing liability (over a period of not less than 3 years) to pay a fixed portion or portions of the income from a business or property or from compensation for employment or self-employment.

(6) POST-SEPARATION YEARS. — For purposes of this subsection, the term "1st post-separation years" means the 1st calendar year in which the payor spouse paid to the payee spouse alimony or separate maintenance payments to which this section applies. The 2nd and 3rd post-separation years shall be the 1st and 2nd succeeding calendar years, respectively.

(g) CROSS REFERENCES. —

(1) For deduction of alimony or separate maintenance payments, see section 215.

(2) For taxable status of income of an estate or trust in the case of divorce, etc., see section 682.

196 1984 Act § 71(f).

197 I.R.C. § 71(f) (1986). "Excess payments" for the first post-separation year are the amount by which payments in the first calendar year in which alimony or separate support payments were made exceed the sum of $15,000 plus the average of (a) payments for the second post-separation year minus excess payments for that year, and (b) payments for the third post-separation year. Excess payments for the second post-separation year are the amount that payments in the second post-separation year exceed the sum of $15,000 plus payments made in the third post separation year. No recomputation is required if payments do not decline by $15,000 or more per year.

This change under the 1986 divorce tax system is shown in the example below. The example assumes a $50,000 payment in the first year, a $30,000 payment in the second year and a $1,000 payment in the third year.

Excess payment for the second year

Second-year payment	$ 30,000
Less: Sum of $15,000 and third-year payment ($1,000)	($ 16,000)

II. WHO IS TAXED UNDER WHAT SYSTEM? EFFECTIVE DATES

The most complex aspect of divorce taxation is the multitude of effective dates for various provisions. The reason for this complexity is two-fold. First, Congress periodically revised several important divorce tax provisions. Statutory reform is fairly common; but, in addition to updating the divorce tax system for dissolutions occurring after each change, Congress grandfathered prior terminations under older rules. Further, Congress allowed couples who divorced under one set of rules to move forward into more recent systems, but prohibited couples from electing back into older systems. As a result, currently there are couples making and receiving identical payments, but receiving different tax treatment depending on the year of their divorce.[198]

At first blush, it might seem that Congress intended to avoid overlapping systems, even if this meant hardship for taxpayers who would have to adjust their settlements to reflect a change in the law. Such adjustment was made necessary, for example, by the 1942 revisions to the divorce tax system which were imposed on all payments made under a decree of divorce or separation, even if the decree was entered before passage of the 1942 Act.[199] But, Congress created overlap. The 1942 Act continues to remain in effect for some payments made under de-

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Excess payment	$ 14,000
Excess payment for first year	
First-year payment	$ 50,000
Less: Sum of $15,000 and average of (a) second-year payment ($30,000) minus excess payment from second-year ($14,000) plus (b) third-year payment ($1,000)	($ 23,500)
Excess payment	$ 26,500

As a result of the I.R.C. § 71(f) (1986) recapture computation, the payor includes $40,500 in income in the third year and the payee deducts the same amount.

These computations are not required if a decline in payments over the three-year period is due to the death of either spouse or the remarriage of the payee spouse. I.R.C. § 71(f)(a)(5) (1986). Section 71(f)(5)(C) also excludes payments made as a result of a continuing liability to pay a fixed amount.

[198] To illustrate the difference in treatment under the different systems, consider three couples, one divorced in 1983, the second divorced in 1985 and the third divorced in 1987. The disparity in treatment among the couples is significant. In order to come under the payor deduction/payee inclusion rules, payments under the 1983 divorce must satisfy different requirements than payments made under the 1985 decree. 1985 divorce payments must meet different tests than those applicable to the 1987 divorce. In addition, with the grandfathering of old terminations and the ability to elect forward but not back, the couple divorced in 1983 can choose among three systems; the couple divorced in 1985 can choose between two systems; but the 1987 divorce has only one option.

[199] *Id.*

crees of divorce or separation entered into before January 1, 1985.[200] The first disharmony occurred in 1954 when Congress expanded the 1942 provisions to include marital dissolutions which did not result in court sanctioned divorce or separation.[201] Until 1954, those payments remained subject to *Gould*. In order to protect taxpayer expectations, the 1954 expansion only applied to terminations made after 1953.[202] Thus, Congress created the first systemic disparity. Some but not all dissolutions were affected based solely on the timing of the divorce.

Each subsequent alimony tax reform grandfathered prior terminations under prior law, while requiring that alimony payments resulting from more recent dissolutions be made under new rules. Consequently, there are now three divorce tax systems for payments made under a decree of divorce or separation and four systems for payments made under informal separations and court ordered support decrees.

A. *Payments Made Under a Decree of Divorce or Separation*

Payments made under court sanctioned decrees of divorce or separation are taxed under one of three systems. Which system applies depends on the date of the original decree and the date of any relevant modification.

All payments made under court ordered decrees of divorce or separation fall under the provisions of the 1942 Act so long as the decree was entered before January 1, 1985 and the couple failed to modify the decree in order to bring it within the provisions of later Acts.[203] Where the decree of divorce or separation is dated between January 1, 1985 and December 31, 1986, however, payments fall under the 1984 rules unless the couple maneuvers into the 1986 rules.[204] Decrees entered after December 31, 1986 fall under the 1986 rules with no opportunity to elect otherwise.[205]

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[200] Treas. Regs. § 1.71-1(b) (1986).
[201] 1954 Code §§ 71(a)(2) and 71(a)(3).
[202] *See supra* text accompanying note 84–85.
[203] Treas. Reg. § 1.71-1(b)(1) (1960). The regulations refer to the provisions and section numbers of the 1954 Code. However, with the exception of the types of payments that could fall under the payor deduction/payee inclusion scheme, the substantive rules created by the 1942 Act did not change with the 1954 Code. The basic change was in the numbering of the sections. *See supra* note 76.
[204] Temp. Treas. Reg. § 1.71-1T(e) (1984).
[205] Tax Reform Act of 1986, Pub. L. No. 99-514, § 1843(c)(2), 100 Stat. 2085, 2853.

B. *Payments Made Under Written Separation Agreements or Court-Ordered Support Decrees*

Ignoring modifications which can move payments into later systems, payments made under written separation agreements or court-ordered support decrees fall under one of four systems. Where the court-ordered decree of separate maintenance was entered before March 1, 1954, payments fall under the *Gould* system. The same is true for written separation agreements executed before August 16, 1954.[206]

Payments made under a written separation agreement will fall under the 1942 Act as amended in 1954 provided that either the agreement was: (1) executed after August 16, 1954; or, was (2) executed before that date but modified after August 16, 1954.[207] Payments under court-ordered decrees of support follow the same pattern as written separation agreements except that the key date for support decrees is March 1, 1954.[208] Court ordered support decrees and written separation agreements entered into or executed between January 1, 1985 and December 31, 1986, produce payments which fall under the 1984 Act;[209] but those entered after December 31, 1986 fall under the 1986 Act.[210]

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[206] Treas. Reg. § 1.71-1(b)(2)(i) (1960) (payments made under a written separation agreement executed prior to August 16, 1954); Treas. Reg. § 1.71-1(b)(3)(i) (1960) (payments made under a court ordered decree for support entered into before March 1, 1954).

[207] Treas. Reg § 1.71-1(b)(2)(ii) (1986).

[208] 1954 Code § 71(a)(3). A decree or written separation agreement is treated as executed between 1954 and December 31, 1984 if any of the following are applicable: (1) the decree or agreement was actually executed between those dates, Treas. Reg. §§ 1.71 1(b)(2) (1960) and 1.71-1(b)(3) (1960); (2) the decree or agreement, although actually executed after December 31, 1984, incorporates or adopts without change the terms of a decree or agreement executed before January 1, 1985, Temp. Treas. Reg. § 1.71-1T(e) (1984); or, (3) the decree or agreement, although actually executed before the applicable 1954 dates, was materially altered or modified between 1954 and 1985, Treas. Reg. § 1.71-1(b)(2)(ii) (1960). The 1942 rules apply to payments made under a decree of divorce or separation entered before January 1, 1985. Temp. Treas. Reg. § 1.71-1T(e) (1984).

[209] Temp. Treas. Reg. § 1.71-1T(e) (1984). An instrument is treated as executed between these dates if: (1) actually executed during this period (unless a decree executed after December 31, 1984, incorporates or adopts *without change* the alimony or separate maintenance payments of an instrument executed before January 1, 1985); (2) although executed prior to December 31, 1984, the terms of alimony or separate maintenance payments are changed by an instrument executed after that date; or, (3) the instrument is expressly modified to provide that the Tax Reform Act of 1984 applies. *Id.*

[210] Tax Reform Act of 1986, Pub. L. No. 99-514, § 1843(c)(2), 100 Stat. 2085, 2854-55. An instrument is treated as executed after December 31, 1986, if: (1) actually executed after that date; or, (2) executed before January 1, 1987, but expressly modified after December 31, 1986 to fall within the provisions of the Tax Reform Act of 1986. *Id.*

III. Evaluating the Alimony Tax Systems

What does this review of the alimony tax system reveal about the present state of alimony taxation? First, the system is tremendously complex. This complexity is undesirable in an area of the law affecting so many unsophisticated taxpayers, and should be reduced. But, before an effort is made to simplify the system, an understanding of what gave rise to the complexity is necessary. One cause of the complexity is the existence of multiple alimony tax systems. Congress could easily remedy this problem by adopting a single unified system of alimony taxation. Simply discarding the multiple systems and replacing them with a single model, though, will solve only part of the problem.

From 1913 to the present, each system has shared one common feature: the use of a two transfer/single tax model as opposed to a two transfer/two tax approach. Rather than causing complexity however, the single tax model actually simplifies the tax because there is only one taxable event, rather than two. Further, at least in theory, the single tax approach leaves more after-tax income for the family unit because the overall tax burden is lower than under a two transfer/two tax approach.[211] Therefore, the single tax approach is not the villain in this drama.

Since 1942, all alimony systems have shared another common feature: all allow income to be split between divorced spouses. It is this income splitting feature that causes almost all of the complexity in the present divorce tax systems, primarily by necessitating that each system distinguish between spouse support, property settlements and child support. These distinctions require the complex rules reviewed above. As this Article demonstrates, it is the need to distinguish these payments that has plagued alimony taxation.

The complexity caused by the income splitting rules is eliminated by returning to the single tax model adopted by the Supreme Court in *Gould v. Gould*.[212] Under the *Gould* approach, the payee receives an alimony exclusion while the payor is denied an alimony deduction. Because the entire tax burden

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[211] For a discussion of the reduced tax burden produced by a two transfer/single tax model as opposed to the classic two transfer/two tax model, see *supra* text at notes 24–32.

[212] *See supra* notes 7–15 and accompanying text.

rests with one taxpayer, there is no need to distinguish alimony from other forms of support and the confusing front-loading rules of section 71(f) become obsolete. The fact that income splitting causes complexity, however, is not enough standing alone to justify the elimination of this feature of the alimony tax system. It is important to evaluate whether placing the tax burden on the payor comports with both the modern view of alimony and current income tax policy. With this in mind, there are five possible objections to returning to the alimony exclusion of pre-1942 law.

(a) *An alimony exclusion violates our statutory scheme by allowing the payee to completely escape taxation.* One objection to *Gould* is that an alimony exclusion allows payees to completely escape taxation. At first glance, allowing payees to receive tax-free alimony seems logically inconsistent with the Code's assertion that all accessions to wealth are subject to tax.[213] However, closer examination reveals that the alimony exclusion is actually the logical result of the two transfer/single tax approach endorsed by all alimony taxation systems since 1913. By adopting the single tax approach, Congress chose not to exercise its power to tax all income from whatever source derived where alimony payments are at issue. Taxing the payee is inconsistent with the single tax approach because it subjects alimony payments to a double tax.

Under a two transfer/two tax system the payee should be taxed on amounts received as alimony because this model assumes that every transfer should generate a tax, even if the monies used to pay an obligation have been taxed once before.[214] Once Congress adopted a two transfer/single tax model, it became difficult to justify taxing the payee. Given that the objective of a single tax system is to tax income once and only once, the view that the payee should be taxed on alimony must come from the belief that amounts received as alimony have never been taxed before. But is this notion accurate in the context of marriage, divorce and the joint return?

There are two ways of viewing an alimony payment. Either it is a repayment of property paid into a marital partnership or

[213] I.R.C. § 61 (1986) subjects all income "from whatever source derived" to taxation.
[214] *See supra* text accompanying note 9.

it is a payment of support. Under either view, a single tax system cannot coexist with a tax on the payee.

The partnership view of marriage underlies the community property system,[215] is relied on by some courts,[216] and is advocated by many family law commentators.[217] According to this theory, a spouse who devotes her productive efforts to homemaking and childrearing during a marriage invests in her spouse's earning capacity.[218] By freeing her spouse to develop occupational skills and experience in the conventional workforce, the homemaker increases her husband's earning capacity at the expense of her own. The longer the marriage (and the longer the homemaker remains outside the workforce) the more she invests. Therefore, when a marriage of long duration dissolves, the homemaker has a property right to the capital she invested in the marital partnership.

Current divorce law implicitly supports this view. The Uniform Marriage and Divorce Act,[219] and most state divorce statutes direct courts to consider "duration of marriage" as an important factor in determining alimony payments.[220] Empirical evidence demonstrates that duration of marriage tends to increase the amount of the alimony award.[221] In addition, many state divorce statutes cite the homemaker's contribution to the marriage as a factor in fixing the amount of an alimony award.[222]

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[215] L. WEITZMAN, *supra* note 129, at 4–5.

[216] *See, e.g.*, Marcus v. Marcus, 135 A.D.2d 216, 525 N.Y.S.2d 216 (1988) (relative economic and non-economic contributions to lengthy marital partnership considered in determining distribution of marital assets); Woodward v. Woodward, 477 So.2d 631 (Fla. App. 1985) (trial court erred in awarding wife greater share of marital assets where parties were true marital partners in all respects throughout marriage, including share of workload and benefits of partnership).

[217] McLindon, *The Economic Disaster of Divorce for Women*, 21 FAM. L.Q. 351, 394 (1987); Note, *Pension Awards in Divorce and Bankruptcy*, 88 COLUM. L. REV. 194, 196–99 (1988).

[218] A spouse who works part-time in a job that does not enable her to realize her full earning capacity so that she may bear primary responsibility for homemaking activities similarly invests in her husband's earning capacity.

A 1978 survey of divorced men and women in Los Angeles County revealed that 68% of women and 54% of men endorsed the sharing of partnership assets as a rationale for rewarding alimony. That is to say, a majority of both sexes agreed that if a woman helped her husband "get ahead because they are really partners in his work," the woman deserves alimony if the marriage dissolves. L. WEITZMAN, *supra* note 129, at 151.

[219] UNIF. MARRIAGE & DIVORCE ACT § 308(b)(4), 9A U.L.A. 147 (1987).

[220] *E.g.*, COLO. REV. STAT. § 14-10 114(2)(d) (1987); FLA. STAT. § 61.08(2)(b) (1985); ILL. REV. STAT. ch. 40, para. 504(b)(4) (Supp. 1988).

[221] According to a random sample of Los Angeles County court records compiled by Weitzman in 1977, the median monthly award rose from $100 for marriages of one to four years to $299 for marriages of over fifteen years duration. L. WEITZMAN, *supra* note 129, at 172.

[222] *E.g.*, FLA. STAT. § 61.08(2)(f) (1985); GA. CODE ANN. § 19-6 5(a)(6) (1982); MASS.

If marriage is a partnership in which each spouse contributes to the production of income, then how is jointly-earned income taxed? Some of it is subject to tax in the year earned (such as salary earned outside the marriage and brought into the marriage to be shared by the spouses), while some of it should never be taxed given the exclusions accepted as part of the modern income tax system (such as the exclusion for imputed income derived from homemaking services). To the extent that this partnership income is subject to tax, it is taxed to *both* the husband and the wife through the use of the joint return.[223] Thus, combining a marital partnership analysis with the mechanics of the joint return prompts the conclusion that when a payee is awarded alimony she is not awarded future income (*i.e.*, a right to share in income which has yet to be earned and taxed). Rather, she is being repaid monies which she earned in the past and invested in the marital partnership. These repaid funds were either taxed to her in the past through the joint return or should never be subject to tax because they represent income which enjoys an exclusion. Alimony is more like a division of property, therefore, than it is a payment of income.[224] When we look at alimony in this way, it becomes clear that, under a single tax system, the payee should not be taxed on alimony because to do so would subject the income to a double tax (if it was previously taxed as in the case of salary), or to an impermissible single tax (if the payment represents repayment of excluded income as in the case of homemaking services).

No one made this argument when Congress shifted the alimony tax burden from the payor to the payee because the joint return did not exist in 1942 (when the burden was shifted) and therefore, it was harder to argue that both the husband and the wife paid tax on income earned during the marriage. Without the joint return, the husband and wife each paid a separate tax on their separate (for tax purposes) income. Thus, it did not seem as though the payee had already paid tax on these sums. The advent of the joint return, however, made it clear that the payee has already satisfied her tax obligation—now both husband and wife are liable for the amount of tax due on the joint

GEN. LAWS ANN. ch. 208, § 34 (West 1987); TENN. CODE ANN. § 36-5-101(d)(9) (Supp. 1988).

[223] For a discussion of the joint return see *supra* text accompanying notes 74 - 76.

[224] *See* L. WEITZMAN, *supra* note 129, at 360 (alimony represents the repayment for the investment in human capital).

return.[225] In the context of a single tax system, the tax has already been paid. Given this payment, a single tax alimony system cannot require that the payee include alimony in income.

(b) *Alimony as support.* An alternative way to view alimony is not as a repayment of marital property, but rather as support. This approach acknowledges the reality that the women who are most often awarded alimony are those who lack the occupational skills and education to be immediately self-sufficient.[226] Because they have relied on their husbands' promise to support them economically, they have foregone the training and career building that would enable them to be self-sufficient.[227] A husband who encourages his wife to remain a housewife while he pursues a career, assuring her a share of his economic gain, cannot change the rules of the game once the wife's sacrifice is made. While a husband's personal obligation to support his wife may not last forever, it should last until a woman is self-sufficient.

State divorce statutes and courts give credence to this view. The goal of modern alimony is mainly rehabilitative—it provides women with financial support while they acquire the education and job skills that will increase their employability and earning capacity. The legal system clearly expects divorced women to become self sufficient, except where women are near retirement age at the time of their divorce.[228] In fact, the Uniform Marriage and Divorce Act (and state statutes patterned after it) make lack of self-sufficiency a prerequisite for alimony,[229] and, courts uniformly examine the capacity of a spouse to provide for herself

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[225] For the joint liability of spouses using the joint return see I.R.C. § 6013 (1986). There is a limited exception to this joint liability for innocent spouses (i.e., those who did not know of the income and did not benefit from it). I.R.C. § 6013(e) (1986).

[226] L. WEITZMAN, *supra* note 129, at 176–77.

[227] For a discussion of the opportunity costs of homemaking, see Beninger & Smith, *Career Opportunity Costs: A Factor in Spousal Support Determinations*, 16 FAM. L.Q. 203 (1982).

[228] *See, e.g.*, Reback v. Reback, 296 So.2d 541 (Fla. App. 1974) (holding grant of only rehabilitative alimony to 56-year-old wife who had not been employed since 1945 improper).

[229] UNIF. MARRIAGE AND DIVORCE ACT § 308, 9A U.L.A. 147 (1987). *See, e.g.*, COLO. REV. STAT. § 14-10-14(1) (1987); DEL. CODE ANN. tit. 13, § 1512(b) (1981); ILL. REV. STAT. ch. 40, para. 504(a) (Supp. 1988); MINN. STAT. § 518.552 (Supp. 1988); MONT. CODE ANN. § 40-4-203(1) (1987).

before awarding alimony.[230] If alimony is viewed as support, then the payor spouse should not receive an alimony paid deduction; support is a personal expense of the payor spouse and, as such, should be included in the payor's income.[231] Thus, if alimony is support, then the single tax model can only be maintained by excluding alimony from the payee's income.

(c) *An undue burden on payors*? A return to the *Gould* approach is likely to be criticized on the ground that denying payors an alimony deduction would leave husbands with insufficient income to meet both personal needs and income tax obligations.[232] This argument fails because courts do consider the husband's ability to pay in determining the propriety and amount of an alimony award.[233] Further, the overall frequency of alimony awards has dropped since the advent of no- fault divorce.[234] Thus, alimony awards are made only when courts believe that husbands will have sufficient after tax income to support themselves.[235]

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[230] *E.g.*, Hall v. Hall, 363 So. 2d 137 (Fla. App. 1978) (where wife was thirty-eight years of age, in good health and had briefly utilized a teaching degree from another state, the trial judge correctly perceived an opportunity for wife to be self-sufficient after obtaining a Florida teaching certificate, therefore rehabilitative alimony was appropriate until certificate obtained); *In re* Marriage of Weinberg, 125 Ill. App. 3d 904, 466 N.E.2d 925 (1984) (alimony proper where petitioner did not possess sufficient liquid assets or marketable skills to provide for herself or her children); Abuzzahab v. Abuzzahab, 359 N.W.2d 12 (Minn. 1984) (trial court erred in awarding permanent spousal support where wife's ability to support herself was established by record).

[231] I.R.C. § 262 (1986) dictates that personal and family expenses are not deductible from income. *See supra* note 11 and accompanying text.

[232] This argument was made in favor of the payor deduction/payee inclusion scheme in 1942. H.R. REP. NO. 2333, *supra* note 29 at 409.

[233] *E.g.*, Hanson v. Hanson, 404 N.W.2d 460 (N.D. 1987) (upholding trial court order that husband pay wife lump sum of $10,000 where the husband's earnings ability was substantially greater than that of wife); *In re* Marriage of Weinberg, 466 N.E. 2d at 933 (former husband's earnings adequate to meet expenses of both himself and his ex-wife).

[234] The overall frequency of alimony awards in California dropped significantly when the no-fault law went into effect. Thus, between 1968 and 1972, the percentage of wives awarded alimony dropped from 20 percent to 15 percent of the divorce cases in both San Francisco and Los Angeles counties. L. WEITZMAN, *supra* note 129, at 167.

[235] In one study, only 15 percent of men who earned less that $20,000 per year were ordered to pay alimony, in contrast to 62 percent of husbands who earned $30,000 or more. Since only 17 percent of the divorced men in this study reported gross incomes greater than $20,000, it appears that courts view the bulk of divorced men as incapable of paying alimony. L. WEITZMAN, *supra* note 129, at 167. Even when alimony is awarded, the amount of the award is relatively small; the United States Bureau of the Census reports that the mean average income from alimony in 1985 was only $3,733. *See* BUREAU OF THE CENSUS, U.S. DEP'T OF COMM., STATISTICAL ABSTRACT OF THE UNITED STATES 1988 (Table No. 358).

(d) The tax benefits of income splitting. Another objection to *Gould* is that the primary advantage of income splitting comes from a reduction in a couple's total tax liability. This overall reduction in total tax due, however, can only take place in the context of a progressive rate structure.[236] In other words, the tax saving benefits of income splitting are severely reduced, if not completely eliminated, once a progressive rate system is replaced with a flat or modified flat tax.[237] This distinction is important because, although this country has operated under a progressive tax structure for most of the seventy-five years of the modern income tax, the Tax Reform Act of 1986 moved America to a modified flat tax.[238] As a result of the compressed rates adopted by the 1986 Act, the effect of progressive rates becomes less important and the potential tax savings from income splitting is reduced, if not eliminated, for many Americans.

Even if income splitting does reduce a couple's total tax in some situations, this extra income will not necessarily be shared by the couple. Income splitting only provides an *opportunity*—not an *obligation*—to share in any extra after-tax income which might be generated. This opportunity is still subject to the payee's ability to successfully negotiate for a portion of those extra funds. There is evidence to the show that women do not do well in these types of negotiations.[239] Thus, the primary effect of the income split is to give more after-tax income to men rather than creating more money for the couple and its children to share.

(e) Equality as fairness. Finally, though the single tax system supports an alimony exclusion, there are still those who will argue that denying payors an alimony paid deduction violates notions of equality between men and women. This prompts the

[236] For a discussion of the tax saving results of a single tax system combined with income splitting, see *supra* note 25 and accompanying text.

[237] *See supra* note 25 and accompanying text.

[238] *See* I.R.C. § 1 (1986) (rates for individuals now generally fall into two main tax brackets, 15% and 28%, with income under $17,850 falling in the 15% category for single taxpayers).

[239] *See, e.g.*, L. WEITZMAN, *supra* note 129, at 310–18. What little bargaining power women have in the divorce situation they use in order to keep custody of their children, rather than to increase their support awards. This is because the divorce laws do not require alimony to be awarded in most situations and most court awards tend to be modest. *Id. See* BUREAU OF THE CENSUS, *supra* note 235. If a husband knows that he will pay little alimony if he contests a settlement in court, he has no incentive to concede a share of the tax benefits of income splitting during an alimony settlement negotiation.

question whether treating people equally is the same as treating people fairly.[240] In the context of divorce it appears that equality and fairness are two distinct and incompatible notions.

The reality of divorce is that it often throws women into poverty without a social or legal "safety net."[241] Given this situation, should the Internal Revenue Code provide the final blow by taxing income to wives rather than husbands? It seems that the better result is to tax those with the greatest ability to pay and allow couples to fix payments based on the knowledge that the payor will bear the tax burden. If couples can negotiate a fair result when both sides pay the tax, then they should be able to also negotiate when only one spouse pays the tax. The difference is that women will come to these negotiations with some of the bargaining power that the 1942 alimony system and the 1948 joint return took away from them.[242]

V. CONCLUSION

The alimony tax system evolved through a series of policy choices. First, the Supreme Court chose to adopt a two transfer/single tax approach rather than the two transfer/two tax model originally advocated by the Internal Revenue Service, thereby choosing to treat divorced couples as a single tax unit rather than as two separate taxpayers.[243] This result was firmly grounded in the conception of marriage as a lifelong union.[244]

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[240] *See, e.g.*, Prager, *Sharing Principles and the Future of Marital Property Law*, 25 U.C.L.A. L. REV. 1, 5–6 and 11–14 (1977). (Given a perfect system where there is no discrimination, it may be possible to treat men and women equally; however, the realities of social norms makes this choice unfeasible.); Blum, *Sexism in the Code: A Comparative Study of Income Taxation of Working Wives and Mothers*, 21 BUFFALO L. REV. 49 (1971) (treatment of men and women equally through the use of the joint return results in women being treated unfairly because their income becomes subject to higher marginal rates of tax).

[241] Weitzman shows that women's income drops as much as 73% after a divorce while the income of divorced husband climbs by about 42%. L. WEITZMAN, *supra* note 129, at 323. *See also* McLindon, *supra* note 501.

[242] For a discussion of the loss of bargaining power to women, see *supra* text accompanying note 81.

[243] Under the two tax model originally suggested by the Commissioner, there is no need to determine the proper taxpayer because both spouses pay tax.

[244] *See* L. WEITZMAN, *supra* note 129, at 367.

In next deciding who to tax, the Supreme Court determined that the payor must bear the complete alimony tax burden.[245] This result was consistent with the Court's view that husbands had a lifelong obligation to support their wives. This alimony tax treatment was simple to apply but some questioned its fairness. After nearly three decades, during which it became more common for women to be independent wage earners and taxpayers, Congress shifted the alimony tax burden to the payee. Thus, under three of the four present divorce tax systems, alimony is taxable to the payee while other payments—such as child support—remain taxable to the payor.[246]

The second issue raised by the two transfer/one tax model is which payments will be taxed to which spouse. The simplest solution to this problem is to choose one spouse to bear the entire tax burden. Instead, Congress restricted the payee's tax obligation to spouse support payments, leaving the payor with the burden for other payments. This added a layer of complexity to the divorce tax system that was not present under *Gould* and *Davis*. Congress then exacerbated the problem by including optional grandfather clauses in each wave of tax reform after 1942. As a result, payments are taxed under a variety of rules depending on when the original dissolution took place and whether the divorce instrument was modified so as to fall under a different set of rules. Because of Congress' inability to bring all alimony payments within a single unified system—as it did for decrees of divorce and separation in 1942—the alimony tax rules have become a trap for the unwary taxpayer and practitioner alike.

In addition, because payees are usually women and payors are usually men, shifting the tax on alimony to payees meant that the overall tax burden on women increased while it decreased for men. Given the economic hardship that women suffer because of divorce this was not necessarily the fair result. Further, with its expansion of the divorce tax system in 1954, Congress continued this policy by expanding the categories of

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[245] The complete tax burden on the payor comes from a combination of the *Gould* decision (which makes the payor responsible for the tax generated by support payments) and the holding in *Davis* (which makes the payor responsible for the tax on gains generated by the use of appreciated property to pay for the relinquishment of marital rights).

[246] Payments made under written separation agreements and court ordered support decrees entered into before 1954 and not modified to fall within later rules are still taxed to the payor. *See supra* text accompanying note 206.

payees caught in the system without providing them with sufficient negotiating power to offset the increased tax liability. This shift in the tax burden of divorce was completed in 1984 when Congress made payees liable for tax on the built-in appreciation in property transferred as part of a divorce settlement.

Whether alimony is viewed as a return of capital to which the payee spouse has a property right, or as support for those who lack the skills to be self-sufficient, the *Gould* tax treatment of alimony is most equitable, theoretically correct and straightforward. A return to the *Gould* approach also has the practical advantage of eliminating the need to distinguish alimony from other distributions incident to divorce, thereby enabling Congress to get rid of the complicated front-loading, periodic payment and lump-sum rules. If alimony is a distribution of property, it should not be taxed when distributed—to do so would impose a tax on income that has already gone through the income tax system. If alimony is support, it should not be taxable to the payee, for it is in discharge of a personal obligation of the payor.