1978

Douglas v. Willcuts Today: The Income Tax Problems of Using Alimony Trusts

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DOUGLAS v. WILLCUTS TODAY: THE INCOME TAX PROBLEMS OF USING ALIMONY TRUSTS

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Using a trust to satisfy a husband's[1] obligation to support his wife after divorce[2] can be an appealing compromise between the husband's transferring property to his wife and his assuming an obligation to make alimony payments. As in the case of a property settlement, the wife who receives alimony from a trust knows she will receive her payments without regard to her husband's continuing solvency and willingness to sign alimony checks. As in the case of alimony, the husband who creates a trust to support his wife need part with no greater interest in his property than is needed to support her until she dies or remarries.[3] But because the creation of a trust in connection with divorce resembles both a property settlement and an agreement to pay alimony, the principles developed in the "pure" property settlement and alimony cases do not easily answer the tax questions raised by the use of these trusts.

The first problem the courts faced in dealing with alimony trusts was whether to tax the trust income to the husband or to the wife. A series of Supreme Court decisions, beginning in 1935 with *Douglas v. Willcuts*,[4] taxed whichever spouse the court felt had "benefited" from that income. This line of case law proved unsatisfactory and was overruled by Congress in 1942, in the predecessors of

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[1] As in the Code, "husband" may mean "wife," "former wife," or "former husband," and "wife" may mean anything "husband" may mean. *See* I.R.C. § 7701(a)(17). All section references in this Article, except as otherwise indicated, are to the Internal Revenue Code of 1954.

[2] Or legal separation (§ 71(a)(1)), or separation under a written separation agreement (§ 71(a)(2)). Unlike sections 71(a)(1) and 71(a)(2), section 71(a)(3) (providing for alimony treatment of periodic payments received under a decree for support) seems not to apply to alimony trusts, since that section does not expressly refer to payments "attributable to property transferred."

[3] For a more detailed discussion of some of the non-tax considerations involved in establishing an alimony trust, see Peschel, *Income Taxation of Alimony Payments Attributable to Transferred Property: Congressional Confusion*, 44 TUL. L. REV. 223, 223-25 (1970).

[4] 296 U.S. 1 (1935).

sections 71 and 682.[5] But the 1942 legislation was both incomplete and ambiguous. It left in its wake three fundamental questions: (1) whether a wife who receives trust payments meeting the requirements of section 71 is taxed in full on those payments, or taxed only on payments characterized as distributions of trust income under the trust conduit rules;[6] (2) whether the husband or the wife is taxed on the income of a trust created as part of a divorce settlement but not complying with the conditions of section 71;[7] and (3) whether the transfer of property to an alimony trust is a

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[5] Section 71(a)(1) provides:

> (1) **Decree of divorce or separate maintenance**
> 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 property transferred, in trust or otherwise,* in discharge of) a legal obligation which, because of the marital or family relationship, is imposed on or incurred by the husband under the decree or under a written instrument incident to such divorce or separation.

I.R.C. § 71(a)(1) (emphasis added).

Section 71(a)(2) is similar to section 71(a)(1), except that it applies to payments made under a written separation agreement, unless the separated spouses file a joint return.

Section 682 provides, in pertinent part:

> (a) **Inclusion in gross income of wife**
> 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 (or who is separated from her husband under a written separation agreement) the amount of the income of any trust which such wife is entitled to receive and which, except for this section, would be includible in the gross income of her husband, and such amount shall not, despite any other provision of this subtitle, be includible in the gross income of such husband. . . .
>
> (b) **Wife considered a beneficiary**
> For purposes of computing the taxable income of the estate or trust and the taxable income of a wife to whom subsection (a) or section 71 applies, such wife shall be considered as the beneficiary specified in this part. A periodic payment under section 71 to any portion of which this part applies shall be included in the gross income of the beneficiary in the taxable year in which under this part such portion is required to be included.

Note that § 682(a) does not apply to alimony trusts (trusts to which § 71(a) applies) because § 682(a) applies only to trusts whose income would, but for that section, be taxed to the husband. Because § 71(d) provides that the husband is not taxed on the income of a § 71 trust, the first requirement of § 682(a) is not met. Section 682(b), however, does apply to alimony trusts, although in a very limited way. *See* text accompanying notes 9-45 *infra*. Sections 71 and 682 are substantially identical to their predecessors, §§ 22(k) and 171, respectively, of the Internal Revenue Code of 1939. Revenue Act of 1942, Pub. L. No. 77-753, § 120, 56 Stat. 798. Accordingly, hereinafter "section 71" will mean either § 71 or its predecessor, and "section 682" will be used similarly.

[6] *See* text accompanying notes 9-50 *infra*. The trust conduit rules connect payments by trusts to particular items of trust property or income. I.R.C. §§ 641-668.

[7] *See* text accompanying notes 51-69 *infra*.

taxable event, requiring the transferor to pay tax on accumulated gain.[8] The courts and the Service, insensitive to the history of the 1942 legislation and reluctant to discard the "benefit" theory of *Douglas v. Willcuts*, have failed to provide satisfactory answers.

I

Taxation of Payments from a Section 71 Alimony Trust

A. *The Problem*

A wife must include in her gross income all alimony paid directly by her husband, whether or not the husband pays out of or even has any taxable income.[9] But when payments are made from a section 71 alimony trust—a trust established or transferred as part of a divorce settlement and making periodic payments satisfying section 71's definition of "alimony"—courts disagree over whether the wife must include all such payments in her income, or is taxable only "as a beneficiary" of the trust, so that she need not include payments out of trust corpus or tax-exempt trust income.[10]

Were alimony trusts governed solely by section 71, trust payments would be fully includible in the wife's income; section 71

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[8] *See* text accompanying notes 70-112 *infra*.

[9] Neeman v. Commissioner, 26 T.C. 864 (1956), *aff'd mem.*, 255 F.2d 841 (2d Cir.), *cert. denied*, 358 U.S. 841 (1958). The taxpayer in *Neeman* contended that because her husband's gross income was less than his deductions for items other than his alimony payments, these alimony payments were "out of" her husband's tax-exempt interest income. Accordingly, argued the taxpayer, the payments should not be taxable to her since her husband received no benefit from the alimony deduction. The Tax Court held that whether the payments came out of the husband's taxable income was immaterial, and that taxing the wife on alimony where the payments did not reduce the husband's tax burden was both constitutional and consistent with the statute.

[10] Unless there is a rule that connects a payment to a particular income item (as do the trust conduit rules, §§ 641-668), it is almost meaningless to say that a payment is "out of [some particular] income." To be sure, it might be possible to trace the cash used to make a payment to the cash received in an income-producing transaction, but this hardly justifies saying that the payment was "out of that income." There is no difference between a taxpayer who receives $1,000 in cash in an income-producing transaction and pays that cash to his wife, and a taxpayer who receives the same cash, in the same transaction, and pays a different $1,000 to his wife. Therefore, only where the amount of a payment depends upon the amount of income the payor has received (*e.g.*, a husband agrees to pay his wife an amount equal to half the income from some specified property), or where the statute provides a tracing rule, as the trust provisions do, does it make sense to refer to payments "out of income." The phrase is a handy one, however, and I shall use it from time to time in connection with trust payments as shorthand for "payments that are treated as payments of income under the trust conduit rules."

provides that the "wife's gross income includes periodic payments," and draws no distinction between direct payments and trust payments. But payments by alimony trusts are also subject to section 682(b), which provides that for purposes of computing her taxable income, the wife "shall be considered as the beneficiary [of the trust]." Applied literally to a wife receiving payments from an alimony trust,[11] section 682(b) would tax her on trust payments only to the extent they constitute distributions of taxable income under the trust conduit rules. The regulations[12] provide, however, with ample support in the legislative history,[13] that the full amount of any payment from an alimony trust is taxable to the wife.[14] The principal function of section 682(b) is to subject alimony trust payments to the timing rules applicable to income from ordinary trusts;[15] section 682(b) was not, despite its sweeping language, in-

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[11] In this section, "alimony trust" means "a trust making payments that are treated as alimony under § 71." In the next section it will he necessary to distinguish these trusts ("section 71 alimony trusts") from trusts created in connection with divorce that make payments not subject to § 71 ("non-section 71" alimony trusts).

[12] Treas. Reg. §§ 1.71-1(c)(3), 1.682(a)-1(a)(2) (1957).

[13] S. REP. No. 1631, 77th Cong., 2d Sess. 83-84 (1942).

[14] The husband gets no deduction for the payments (*see* note 47 *infra*) but § 71(d) excludes them from his income, a rule that leads to virtually the same result as an inclusion in income followed by an offsetting deduction, at least in the common case in which the trust distributes only ordinary income to the wife. Only in the few cases in which the hushand's *gross* income is material (*see, e.g.*, § 6501(e)(I)(A) (where taxpayer fails to report amount exceeding 25% of his stated gross income, statute of limitation becomes six years instead of three)), or where the parties have been so foolish as to create an alimony trust making payments out of something other than the trust's ordinary income, will the difference between an exclusion from the husband's income and a deduction matter. *See* notes 47-48 and accompanying text *infra*.

Until 1976, the exclusion of alimony trust income from the husband's income meant that, other things being equal, the creator of an alimony trust would have a lower adjüsted gross income than a husband paying alimony directly, since alimony was an itemized deduction. This meant, for example, that a husband could not deduct direct alimony and take the standard deduction. Section 62(13) now makes alimony an "above the line" deduction.

[15] S. REP. No. 1631, 77th Cong., 2d Sess. 85 (1942). The wife receiving direct alimony realizes income when she "receives" each payment, according to the usual tax-accounting rules for cash-method taxpayers; the wife entitled to payments from an alimony trust reports income when the payments are "required to be distributed, whether distributed or not." I.R.C. §§ 652(a), 662(a).

Two functions other than timing are performed by § 682(b)'s description of the wife as a "heneficiary." One is to allow the trust a deduction under § 651 or § 66I. *See, e.g.*, Laughlin's Estate v. Commissioner, 167 F.2d 828 (9th Cir. 1948); G.C.M. 25999, 1949-I C.B. 116, *declared obsolete*, Rev. Rul. 67-406, I967-2 C.B. 420. The Service has declared that the wife is "treated as a beneficiary under section 682(b) of the Code merely for the purposes of computing the taxable income of the trust and determining the taxable year in which the alimony payments are to be included in her gross income." Rev. Rul. 65-283, tended to make the wife taxable only "as a beneficiary."[16]

In spite of section 71, the regulations, and the legislative history, two courts have held that distributions of tax-exempt bond interest from an alimony trust are not taxable to the wife. In *Stewart v. Commissioner*,[17] the Tax Court held that, because the wife was a "beneficiary" under section 682(b), there was "no doubt" that the portion of her payments treated as tax-exempt income under the trust conduit rules was not taxable.[18] The *Stewart* opinion devoted only one paragraph to this issue, and cited neither the regulations nor the legislative history; it hardly qualifies as a definitive rejection of the regulations. A more complete discussion of the legislative history of section 682(b) (but not, inexplicably, of the regulations) was undertaken by the Sixth Circuit in *Ellis v. United States*.[19] The *Ellis* court also relied on section 682(b) to hold distributions of tax-exempt income not taxable to an alimony trust beneficiary. The opinion brushed the legislative history of the alimony trust provisions aside, noting that the committee reports expressly require inclusion of corpus distributions in income but say nothing about tax-exempt interest.[20] An understanding of the error of the *Ellis* case requires a reasonably firm grasp of the history of sections 71 and 682.

B. *The Law Before 1942*

In 1917, the Supreme Court held in *Gould v. Gould*[21] that alimony was not income to the wife who received it, and observed that the husband could not deduct the payments.[22] Although virtually devoid of reasoning, *Gould* at least harmonized with the treatment of analogous situations. Since a married wife was not taxed when she received support, it was not wholly irrational to extend

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1965-2 C.B. 25, 28. The other function of § 682(b), according to Proposed Treas. Reg. § 1.682(b)-1(a), 35 Fed. Reg. 19,757 (1970), is to subject a wife who is treated "as the beneficiary" of a trust under § 682(b) to § 56's minimum tax on tax preferences where the trust has tax-preference items. This proposed regulation is unsound, as applied to § 71 trusts, since the wife who must treat alimony trust payments as ordinary income in full receives no benefit from the trust's tax preference items, and so should not be subject to the tax imposed by § 56.

[16] *See* note 40, notes 42-45 and accompanying text *infra*.

[17] 9 T.C. 195 (1947), *acq.* 1947-2 C.B. 4, *acq. withdrawn and nonacq.* 1965-2 C.B. 7.

[18] *Id.* at 198-99.

[19] 416 F.2d 894 (6th Cir. 1969).

[20] *Id.* at 896-97.

[21] 245 U.S. 151 (1917).

[22] *Id.* at 154.

this treatment to a divorced wife.[23] Even today, something very like the rule in *Gould* applies to payments not taxable to a wife under section 71.[24]

Given *Gould*, how was the income of an alimony trust to be taxed? Had it viewed the "alimony" aspect of the alimony trust as controlling, the Court might simply have held the income of all alimony trusts taxable to the grantor on the ground that the difference between direct payment and payment by means of a trust was not substantial enough to justify a difference in tax treatment.[25] Instead, the Court emphasized the "property transfer" element of the alimony trust and held the husband taxable on trust income paid to the wife only if the trust payments satisfied a support obligation that survived the divorce and the creation of the trust. The Court first dealt with this problem in *Douglas v. Willcuts*,[26] in which it held the grantor of an alimony trust taxable on its income because "through the discharge of his obligation [he] enjoys the benefit of the income as though he had personally received it."[27]

The *Douglas* opinion might have been read as holding that the income of all alimony trusts was taxable to the grantor.[28] In three cases decided in 1940, however, the Court held that the choice of

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[23] An appropriate analogy here is the tax treatment of damages, which are usually taxed like the items they replace. *E.g.*, Raytheon Prod. Corp. v. Commissioner, 144 F.2d 110 (1st Cir.), *cert. denied*, 323 U.S. 779 (1944). Alimony can be regarded as a substitute for the various non-taxable benefits one receives as a result of being married. But the Supreme Court did not use this reasoning (or, for that matter, any other) in *Gould*.

[24] Rev. Rul. 67-221, 1967-2 C.B. 63, holds that a wife who receives property "in exchange for" a release of marital rights has no income. The ruling also holds that the wife's basis is the value of the property at the time of the transfer. *See* Farid-Es-Sultaneh v. Commissioner, 160 F.2d 812 (2d Cir. 1947).

[25] *See* Surrey, *The Supreme Court and the Federal Income Tax: Some Implications of the Recent Decisions*, 35 ILL. L. REV. 779, 809 (1941).

[26] 296 U.S. 1 (1935).

[27] *Id.* at 10.

[28] The quotation in the previous paragraph suggests the rule that eventually developed, but another part of the *Douglas* opinion could have been read as making the income of any alimony trust taxable to the husband. The Court noted that non-trust alimony was not income to the wife, that the payments from the trust in question were "to serve the purpose of alimony," and that the divorce decree "imposed upon petitioner the obligation to devote the income in question, through the medium of the trust, to the use of his divorced wife." 296 U.S. at 8-9. None of these statements seems to distinguish "complete discharge" trusts from others, and all could support the possibility mentioned in the text.

The problems courts faced in applying *Douglas* are discussed in Paul, *Five Years with Douglas v. Willcuts*, 53 HARV. L. REV. 1 (1939).

the person taxable on the trust income depended upon local law and the terms of the agreement establishing the trust. In *Helvering v. Fuller*,[29] the grantor escaped taxation on the theory that, because the Nevada divorce court had no power to modify the trust it had approved and the husband had not guaranteed the trust payments, the divorce and the creation of a trust left him with no continuing obligation. Absent such an obligation, the husband derived no benefit from the payments and thus was not taxable on them. But *Helvering v. Leonard*[30] and *Helvering v. Fitch*[31] held that a husband who guaranteed trust payments, or who failed to prove that local law could not someday compel him to make additional payments, was taxable on the trust income because of his continuing (though contingent[32]) support obligation.[33]

The rule apparently established by *Fuller*, *Leonard*, and *Fitch* allowed a husband to avoid taxation on the income of an alimony trust only if he could show[34] that he had completely discharged his obligation to support his wife by establishing the trust. This test was

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[29] 310 U.S. 69 (1940).

[30] 310 U.S. 80 (1940) (decided the same day as *Fuller*).

[31] 309 U.S. 149 (1940).

[32] Helvering v. Leonard, 310 U.S. at 84.

[33] Helvering v. Fitch, 309 U.S. at 156; Helvering v. Leonard, 310 U.S. at 84-85. In *Fuller*, the husband had agreed to make payments in addition to those to be made from the trust. 310 U.S. at 71. This did not make him liable for tax on trust income. *Id.* at 73. The "continuing obligation" necessary to make the husband taxable on trust income had to be an obligation discharged by the trust income (*id.* at 75-76); thus an agreement to pay the wife $100 a month in addition to the trust payments would not be "continuing obligation [as to the trust payments]" (*id.* at 73), while an agreement to pay her the difference between $100 a month and the trust income would be (*id.* at 75). The effect of this rule, together with that of *Leonard*, was that a husband committed to future payments in addition to those made by the trust was not taxed on the trust income, but one with a wholly contingent duty to make payments was so taxed. The distinction drawn by these cases is consistent with "continuing obligation" theory, which reasoned that generation of income by the trust benefits the guaranteeing husband by relieving him of the necessity of satisfying the guarantee, while the husband who creates a "complete discharge" trust loses interest in whether the trust earns income, and so receives no benefit when the income is earned. As a theory, this is splendidly tidy, but if the "continuing obligation" trust is adequately funded the difference may be of no practical importance whatever. *See* note 37 *infra*.

[34] *Leonard* required the husband to establish by "clear and convincing proof" that his obligation had been terminated; if local law was unclear, he was taxed. 310 U.S. at 84-87. This presumption is inconsistent with current views about determining local law in federal tax cases. Today, a federal court not bound by a ruling of the state's highest court must simply determine local law to the best of its ability. Neither party bears the risk of state law uncertainty. *See* Commissioner v. Estate of Bosch, 387 U.S. 456, 465 (1967). In Pearce v. Commissioner, 315 U.S. 543 (1942), the "husband-must-prove-discharge" theory was carried to its logical conclusion that the wife would not be taxed on the trust income if local law was obscure.

part of the "existing law" that Congress undertook to overrule in 1942; it remains the test used by the Service to identify the person taxable on the income of a trust created in connection with divorce but not covered by section 71.[35]

C. *The 1942 Legislation*

Congress enacted section 71 in 1942 primarily to overrule *Gould v. Gould* and render nontrust alimony taxable to the wife and deductible by the husband. Financing the war effort required a dramatic increase in tax rates, and *Gould v. Gould* could have caused divorced husbands severe hardship. It was possible that the husband's taxes and nondeductible alimony payments could exceed his income.[36] Congress also hoped to solve two problems created by *Douglas v. Willcuts* and its progeny. The first was "geographic discrimination"—under the *Douglas* line of cases a couple

[35] Rev. Rul. 74-94, 1974-1 C.B. 26, *discussed in* text accompanying notes 60-62 *infra.* The ruling cites *Fuller* and *Fitch,* but not Pearce v. Commissioner, 315 U.S. 543 (1942), and it requires the grantor to establish the requisite local law by "clear and convincing proof." *But see* Commissioner v. Estate of Bosch, 387 U.S 456 (1967).

Pearce suggests that the Court might have resolved the *Douglas v. Willcuts* problem on its own. *Pearce* involved an annuity contract, but applied to transfers in trust as well; both the majority and Justice Frankfurter, dissenting, treated the case as one requiring application of the rules of the trust cases. The Supreme Court held that the wife was taxable on the annuity payments unless she could make some showing that the divorce court retained the power to amend the annuity contract or control the income from it; power to require the husband to make additional payments was not enough to make the annuity income taxable to the husband. 315 U.S. at 552-53. This was plainly inconsistent with *Fitch* and *Leonard,* as Justice Frankfurter noted. *Id.* at 557-58. The majority insisted that the trust in *Fitch* was modifiable (*id.* at 550), and distinguished *Leonard* by describing the trust in that case as merely "security" for the husband's continuing obligation (*id.* at 552), although in *Leonard* the Court had described the husband's obligation to make additional payments as "wholly contingent" (310 U.S. at 84). The Court's attempt to decide this question by creating arbitrary categories of "security" and "non-security" trusts (315 U.S. at 552) made the law after *Pearce* arbitrary and uncertain. Had the Court simply overruled *Leonard,* however, it would have held the income of all irrevocable alimony trusts taxable to the wife, a result roughly consistent with the post-1942 rules for direct alimony payments. *Pearce* was decided too late to be considered by Congress.

[36] The Revenue Act of 1942 imposed surtax rates of up to 82%. Revenue Act of 1942, Pub. L. No. 77-753, § 103, 56 Stat. 798. The possible effect of such tax rates upon a husband paying 50% of his income in nondeductible alimony is obvious. *See* Peschel, *supra* note 3, at 225-26. This concern for the husband appeared most clearly in the testimony of Randolph Paul, Tax Adviser to the Secretary of the Treasury, in the House Ways and Means Committee hearings. *See* 1 *Revenue Revision of 1942: Hearings Before the House Comm. on Ways and Means,* 77th Cong., 2d Sess., 80, 92 (1942). Not all the testimony addressed considerations of sound tax policy. Witness the appalling exchange between Benjamin A. Javits, a New York lawyer who thought the proposed legislation would make it financially attractive to break up the home, and Congressman Dingell, who considered alimony an "infernal racket" which enriched unscrupulous wives. 2 *id.* at 2157-67.

could choose to establish an alimony trust the income of which was taxable to the wife only if they could obtain their divorce in a state whose law permitted a divorce settlement to terminate the husband's support obligation. The second was uncertainty—the *Douglas* case bred litigation, as the husband's ability to get a "complete discharge" was often unclear.[37]

In 1941, the Senate had proposed to solve the *Douglas* problem by taxing as a beneficiary any divorced wife receiving payments from a trust, under a provision similar in wording to section 682.[38]

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[37] S. REP. No. 673, 77th Cong., 1st Sess., pt. 1, at 32 (1941) (citations omitted):

> [T]he amended sections will produce uniformity in the treatment of amounts paid in the nature of or in lieu of alimony regardless of the variance in the laws of different States concerning the existence and continuance of any obligation to pay alimony. In this respect the amendments are designed to remove the uncertainty as to the tax consequences of payments made to a divorced spouse out of the net income of so-called irrevocable alimony trusts, arising from the recent Supreme Court decisions in *Helvering v. Fitch* . . . , *Helvering v. Fuller* . . . , and *Helvering v. Leonard* . . . , which decisions make the test of whether such income is taxable to the husband the existence of a continuing legal obligation under State law.

The reasons given for changing the *Douglas v. Willcuts* approach are sound enough, but the "continuing legal obligation" test suffered from defects more fundamental than its unsatisfactory side effects. The Supreme Court's decisions simply made no tax sense:

> [T]he policy judgment made by the Court [in *Fuller*, *Fitch*, and *Leonard*] is of doubtful wisdom. It forces tax conscious prospective divorcés to search for States where the finality of settlements is assured. Moreover, it draws artifical distinctions having no regard to tax criteria. *In each situation the factor of prime importance is that the obligation of support placed upon the husband is being fulfilled. The variety of methods by which that obligation may be satisfied should be no concern of the income tax.* Either the satisfaction of that obligation suffices to warrant taxation of the husband, or it does not. No appreciable advantage is derived from making tax classifications of divorced husbands along the lines chosen by the Court. It is a bit ironical that the husband who obtains the greatest advantage from the alimony trust, that of final satisfaction of his obligation, is the one that is relieved of the tax.

Surrey, *supra* note 25, at 809 (emphasis added) (footnote omitted).

[38] Section 117(a)–(b) of the Senate version of the proposed Revenue Act of 1941 (Senate Comm. on Finance Amendments to H.R. 5417, 77th Cong., 1st Sess., 87 CONG. REC. 7266-67 (1941) [hereinafter cited as Committee Amendments]) would have taxed direct alimony payments (not including payments attributable to transfers in trust) to the wife, and would have given the husband a deduction. *See* S. REP. No. 673, 77th Cong., 1st Sess., pt. 1, at 32 (1941). Section 117(c) would have enacted a new § 171 of the 1939 Code, to read, in pertinent part:

> There shall be included in the gross income of an individual who is divorced or legally separated under a decree of divorce or of separate maintenance the amount of the income of any trust such individual is entitled to receive which, except for the provisions of this section, would be includible in the gross income of such individual's spouse or former spouse, and such amount shall not, despite section 166, section 167, or any other provision of this chapter, be includible in the gross income of such spouse or former spouse.

Committee Amendments, *supra*, 87 CONG., REC. 7267 (1941). Since the direct alimony rules (Committee Amendments, § 117(a)–(b), 87 CONG. REC. 7266-67 (1941) (proposing addition

Congress modeled the 1942 legislation after the 1941 bill, but made one significant change. Unlike the 1941 bill, the 1942 act specifically applied section 71 to payments from alimony trusts. Although the committee reports do not say why Congress chose to govern alimony trusts by section 71, rather than by section 682, it must have considered alimony trust payments so similar to nontrust alimony payments as to merit taxation to the wife in much the same way.[39]

D. *Current Law*

The history of the alimony trust legislation of 1942 does not support the *Ellis* court's distinction between distributions of corpus (which it apparently conceded to be taxable to the wife) and distributions of tax-exempt income. In the first place, the court misconstrued the message of the committee reports. By focusing on the committee's reference to corpus distributions, it treated as exclusive what was merely one of a number of examples illustrating a sweeping rule that all payments described in section 71 are fully taxable; nothing in the report suggests that the committee intended to establish a special rule limited to corpus distributions.[40] Furthermore, *Ellis* and *Stewart*, by exempting some payments by alimony trusts from taxation, create a distinction between trust and nontrust alimony. Such a distinction sabotages Congress's decision to apply section 71 to alimony trusts, a decision surely deliberate, since the 1942 legislation differed from the 1941 Senate proposals principally in this respect. The only conceivable reason

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of §§ 22(k) and 23(a) to Int. Rev. Code of 1939)) would not have applied to payments from an alimony trust, this new trust provision would have applied, and would have made the wife taxable, but only as a trust beneficiary.

[39] The tax consequences are not identical, however. See note 15 *supra*, for the differences from the wife's point of view, and note 47 *infra*, for the even wider possible divergence in the husband's position.

[40] The full amount of periodic payments received under the circumstances described in section [71(a)] is required to be included in the gross income of the recipient whether such amounts are derived, in whole or in part, from income received or accrued by the source to which such payments are attributable. Thus, it matters not that such payments are attributable to property in trust, to life insurance, endowment, or annuity contracts, or to any other interest in property, or are paid directly or indirectly by the obligor husband from his income or capital.

S. Rep. No. 1631, 77th Cong., 2d Sess. 84 (1942). The Report goes on to observe that such specific "full inclusion" provisions as §§ 72(k) and 101(e) were designed to clarify the full-inclusion rule as applied to life insurance and annuities, not to create special rules for annuities or life insurance. *Id.* The Report also explains the limited function of § 682(b). *See* note 15 *supra*. It is unfortunate that Congress was careful enough to clarify the law via §§ 72(k) and 101(e), but left § 682(b) so nebulous.

for Congress's application of section 71 to alimony trusts is its conviction that wives receiving trust alimony should be taxed in the same way as wives receiving direct alimony, a determination that the *Ellis* court, although it echoed the bromide that "[t]axes should be imposed by Congress, and not by the courts,"[41] ignored.

Two Tax Court cases recognize the very limited function of section 682(b). *Welsh Trust v. Commissioner*[42] held that alimony paid out of the corpus of a trust was taxable in full to the recipient, reasoning that "whether the payments are made from income or capital is not significant,"[43] and quoting the legislative history of section 71 in support. Similarly, in *Twinam v. Commissioner*,[44] the Tax Court held section 71 applicable to payments from an estate, observing that section 682(b) only determines the year in which payments are included in the recipient's income.[45]

Requiring full inclusion of trust alimony[46] in the recipient's

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[41] 416 F.2d at 897.

[42] 16 T.C. 1398 (1951), *aff'd sub nom. Girard Trust Corn Exch. v. Commissioner*, 194 F.2d 708 (3d Cir.), *cert. denied*, 344 U.S. 821 (1952). The case involved alimony paid to a non-resident alien pursuant to a court order making the payments a charge against the corpus of a trust. Persons in control of payments of "fixed or determinable annual or periodical . . . income. . . ." of non-resident aliens must withhold a tax equal to 30% of such payments. I.R.C. § 1441(a). The court required that 30% of the total amount of the payments be withheld. 16 T.C. at 1402.

[43] 16 T.C. at 1401.

[44] 22 T.C. 83 (1954), *acq.* 1954-2 C.B. 6.

[45] *Id.* at 90. The Service apparently failed to argue for "full inclusion" in Daniel v. Commissioner, 23 T.C.M. (CCH) 1912 (1964), which allowed a beneficiary of an alimony trust a share of depreciation of trust assets under § 167(h) (under the trust tax-accounting rules, depreciation deducted not by the trust itself, but by the beneficiaries). The "full inclusion" rule of § 71 should preclude such a deduction. *See* Dixon v. Commissioner, 44 T.C. 709 (1965). Section 71 does not, by its terms, compel denial of depreciation, since it only requires inclusion of the amount of payments in the wife's "gross income." Giving the wife a depreciation deduction is technically consistent with requiring inclusion of the full payment in gross income. However, this would differ so radically from the treatment of direct alimony, and would so resemble the prohibited practice of allowing a return of capital to offset gross income where payments issue from corpus or an annuity contract (*see* note 40 and accompanying text *supra*) that it should be prohibited. *Cf.* Treas. Reg. § 1.61-3(a), T.D. 7285, 1973-2 C.B. 163, 164 (certain costs for which § 162(c), (f), or (g) would deny a business expense deduction cannot offset gross receipts in computing gross income).

The *Ellis* and *Stewart* decisions are criticized in Peschel, *supra* note 3, at 239-42, and 23 VAND. L. REV. 466 (1970).

[46] A word about "alimony" payments "attributable to property" transferred outright, rather than in trust, is appropriate. Suppose a divorce decree requires a husband to transfer income-producing property to the wife. Does the "property transferred" portion of § 71 make the income from the property taxable to the wife as alimony? Normally, the income from the property will be taxable to her anyway, but if the transferred property consists of tax-exempt bonds, an attempt by the Service to require alimony treatment

income comports with common sense and with congressional intent. At the same time, this requirement seriously limits the flexibility of the alimony trust as a divorce planning device. Since alimony trust payments in excess of trust income provide no tax benefit to the trust or its creator but are fully taxable to the recipient, any trust payment not out of the trust's ordinary income will "create" income, in the sense that inclusion of the payment in the wife's income will not be matched by a deduction or exclusion for the husband.[47] For this reason, no well-planned alimony trust will permit payments of corpus or tax-exempt income.[48]

A number of commentators have declared that taxing the wife in full on distributions from an alimony trust while denying the husband a deduction for payments out of corpus is "inequitable," since the husband can always deduct directly-paid alimony against his income.[49] The force of this argument depends upon the in-

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would cause a serious problem. Two commentators have said that § 71 might apply to income from property transferred outright to the wife. *See* Peschel, *supra* note 3, at 227-28; Gerhart, *Substantial support exists for amortizing life income interest in an alimony trust*, 44 J. TAXATION 167, 168 (1976). It is reasonably clear, however, that Congress meant the § 71 reference to transferred property to apply not to property transferred outright to the wife, but only to transfers to third persons for the benefit of the wife (for example, to purchase an annuity contract making payments to the wife) and to transfers of income interests in property, since all of the "transferred property" examples in the committee reports involve these kinds of transfers. *See* S. REP. No. 1631, 77th Cong., 2d Sess. 84 (1942) (payments attributable to "property in trust, to life insurance, endowment, or annuity contracts, or to any other interest in property"). "Any other interest" is probably just expansive draftsmanship, but if it really includes absolute ownership, then the wife's tax-exempt bond interest would be included in her income.

[47] Section 71(d) provides that payments attributable to transferred property and taxable to the wife under § 71(a) are not included in the husband's gross income. But an "exclusion" from income of an amount not includible in income in any event (such as a distribution of corpus or tax-exempt interest) is worthless. And the husband gets no deduction for payments attributable to transferred property. Section 215(a) of the Code provides that the husband cannot deduct any payment "not includible" in his gross income by reason of § 71(d) or § 682; Treas. Reg. § 1.71-1(c)(2) (1957) provides that "no part" of a payment under an annuity contract purchased by a husband to meet an alimony obligation is deductible by him, and Treas. Reg. § 1.71-1(c)(3) (1957) applies the "same rule" (as that of § 1.71-1(c)(2)) to alimony trusts. This rule can be viewed as an application of Treas. Reg. § 1.215-1(a) (1957), which allows the husband to deduct under § 215 any alimony he has "actually paid."

[48] Since no competent lawyer would create an alimony trust funded with tax-exempt bonds or permitted to distribute corpus or capital gains, problems in this area are most likely to arise in cases involving transfers of interests in existing trusts, where the transfer may seem such a handy way of satisfying the husband's obligation that it is done without careful planning.

[49] *E.g.*, Hobbet, *Avoiding the creation-of-income trap on a return of capital in alimony situations*, 35 J. TAXATION 384 (1971); Peschel, *supra* note 3, at 246-47. Peschel argues that the present tax structure is inequitable, and that "the trend of the alimony tax law has been

terest the husband retains in the trust. The "simple" solution of allowing the husband a deduction for trust payments not out of income would be satisfactory only when the husband has retained a reversionary interest in the trust. In the common case in which a remainder is given to children or to a charity, a corpus distribution to the wife reduces the wealth of the remainderman, not the husband. The husband should hardly be allowed a deduction for a payment that does not make him poorer. A legislative solution to the "creation of income" problem could take these variations into account; in the meantime the regulations provide a rational if somewhat crude solution to a difficult problem. If contested, these regulations should be upheld. The trust draftsman can easily avoid the "creation of income" problem by providing for direct payment by the husband in the event that the trust has insufficient income, using the trust corpus only as security.[50]

II

Choosing the Person Taxable on the Income of a "Non-Section 71" Alimony Trust

Most of the pre-1942 litigation over alimony trusts involved choosing the person taxable on the trust's income. Facilitating this identification was a major goal of the 1942 legislation. Although it answered most questions concerning alimony trusts, this legislation left a gap. Sections 71 and 682 clearly resolve cases of (1) trusts making payments that fit section 71's definition of alimony ("section 71 alimony trusts"), and (2) trusts in which the wife received

against the wife." *Id.* at 250. This view fails to give proper weight to the benefits that may accrue to either sponse, or both, from the income-splitting allowed by the alimony provisions. The husband may well be willing to make larger dednctible (or excludible) payments than he would (or could) make if the payments were not deductible. The real burden of alimony taxation is borne by the spouse with the lesser bargaining power. A more substantial objection to the "creation of income" possibility is that it discourages some very nseful arrangements. For example, "creation of income" wonld discourage the formation of an alimony trust with a power to invade corpus to meet the wife's extraordinary expenses. But whether discouraging these trusts burdens the husband or the wife depends solely npon what alternative arrangement the parties adopt.

[50] I do not wish energetically to defend a rule that operates as a tax on poor tax planning, but the creation-of-income "trap" does serve one useful function. When a husband transfers appreciated property to an alimony trust, whether the appreciation is thereby realized by the husband becomes a troublesome problem. It is amenable to solution if the wife has only an income interest, but if she has more—for example, an income interest plus a power to invade corpus—it is almost insoluble. *See* notes 103-04 and accompanying text *infra*. The creation-of-income phenomenon discourages the creation of such trnsts.

an interest before divorce was contemplated ("preexisting trusts"). In both cases the wife is taxed. Payments she receives from a "section 71 alimony trust" are income in full, even if out of corpus or tax-exempt income, as explained above. Payments from a "preexisting trust" are taxed to her "as a beneficiary" under section 682(a).[51] Not clearly covered by these rules are "non-section 71" alimony trusts—trusts that are neither "preexisting trusts" (because they were created or transferred as part of a divorce settlement), nor "section 71 alimony trusts" (because the trust payments do not conform to the terms of section 71—for example, trust payments that are not "periodic").[52] There are three possible approaches to taxing the income of these "non-section 71" alimony trusts: (1) taxation to the wife, the result suggested by a literal reading of section 682(a); (2) taxation according to the rule of *Douglas v. Willcuts* (to the husband if the payments discharge his "continuing obligation," otherwise to the wife), the Service's position; or (3) taxation to the husband under section 677, a position suggested by one Tax Court opinion. For convenience of presentation, this Article will first consider trusts in which the wife has only an income interest.

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[51] Because § 71 and § 682(a) operate very differently upon the wife, the problem of distinguishing § 71 trusts from § 682 trusts assumes importance. The regulations (§ 1.682(a)-1(a)(2) (1957)), reflecting the legislative history, provide that § 682(a) applies to a trust "created before the divorce or separation and not in contemplation of it," and that "section 71 applies only if the creation of the trust or payments by a previously created trust are in discharge of [the husband's support obligation]." An example from the regulations under § 71 provides that the mere mention in a divorce decree of a pre-existing trust making payments to a former spouse suffices to make § 71, rather than § 682, apply to the trust, even if the decree alters none of its terms. (§ 1.71-1(b)(6) (ex.2) (1957)). This arbitrary provision serves no useful purpose. Unless the divorce decree or settlement agreement makes a significant change in a previously established trust (for example, by terminating the husband's power to prevent distributions of income or corpus to the wife), the trust performs no alimony function and its payments should not be taxed as alimony under § 71. This regulation would bestow upon the words of the divorce decree an almost magical power—an offhand reference to an irrevocable trust created long before the divorce could change that trust into an alimony trust. Section 71 applies to payments from property "transferred" in discharge of the husband's obligation; a statement in a decree acknowledging that a transfer took place in the distant past should not be treated as a present "transfer" of anything.

[52] In order for § 71 to apply to payments by a trust, those payments must meet all the requirements for direct alimony; they must be "periodic,." they must not have been designated as child support, they must be "for support" (*see generally* Harris, *The Federal Income Tax Treatment of Alimony Payments—The "Support" Requirement of the Regulations*, 22 HASTINGS L.J. 53 (1970)), and they must bear the appropriate relation to a decree or written instrument, and to the status of divorce, legal separation, or separation under a written separation agreement. *See generally* J. Taggart, SOME TAX ASPECTS OF SEPARATION AND DIVORCE (2d ed. 1975); H. GUTMAN & F. SANDER, DIVORCE AND SEPARATION, Tax Mngm't Portfolio (BNA) 95-3d (1975).

The taxpayer in *Daniel v. Commissioner*[53] argued that the wife should be taxed on the income of all "non-section 71" alimony trusts. The trust in *Daniel* did not satisfy section 71 because the payments to the wife were not periodic; the taxpayer argued that section 682(a) required taxing the trust income to the wife. A literal reading of section 682(a) does support that result, because that section requires that a divorced or separated spouse include in her income "the amount of the income of any trust which such wife is entitled to receive and which, except for this section, would be includible in the gross income of her husband." The Tax Court rejected this reading in *Daniel*, relying primarily upon the Senate Report on section 682. This Report noted that section 682(a) "states the rule applicable . . . in the case of trusts created prior to the divorce or separation and to which the provisions of [section 71] are not applicable."[54] The court concluded that this history barred the taxpayer's use of section 682(a), saying: "[W]e feel section 71 is applicable, rendering section 682(a) inapplicable."[55] In fact, section 71 was not "applicable" to the *Daniel* trust, in the sense of making trust payments taxable to the wife, because the payments were not periodic. The court's language may have been infelicitous, but its meaning was plain: A trust created or transferred as part of a divorce settlement is beyond the scope of section 682(a). Therefore, section 682(a) cannot be used as a substitute for section 71 to tax the income of all such trusts to the wife. The Tax Court did not decide how, with section 682(a) inapplicable, the income of "non-section 71" alimony trusts would be taxed, since it determined that the husband had not actually transferred any interest in the trust to his wife.[56] The payments she had received were, therefore, direct payments from her husband, neither taxable to her nor deductible by him because they were not "periodic" and thus not "alimony."

The congressional decision to treat direct and trust alimony equivalently supports the *Daniel* holding that section 682(a) cannot apply to a trust created or transferred as part of a divorce settlement.[57] Had the *Daniel* taxpayer's position been accepted, a tax-

[53] 56 T.C. 655 (1971), *aff'd mem.*, 461 F.2d 1265 (5th Cir. 1972).

[54] *Id.* at 660 (*quoting* S. REP. No. 1631, 77th Cong., 2d Sess. 85 (1942)).

[55] *Id.* at 661.

[56] *Id.* at 659.

[57] The legislative history is not entirely clear. The regulations under § 682 provide that § 682(a) applies "for example" to preexisting trusts. Treas. Reg. § 1.682(a)-1(a)(2) (1957). The committee reports display a bit more conviction; they say that § 682 "states the rule applicable to" these trusts, not merely that these trusts are examples of trusts subject to that section. But the reports go on to say that § 682 applies to "any" trust making pay-

payer could use section 682(a) to achieve alimony treatment for payments that fail to meet section 71's requirements for alimony payments.[58] If these restrictive standards served an important purpose, this argument would be compelling. As it is, section 71's alimony definition, particularly the requirement that payments be "periodic," seems an arbitrary rule, probably enacted more because periodicity is a common feature of what Congress had in mind when it thought of alimony than because there is some good reason for restricting section 71 to payments that are "periodic."[59] Nonetheless, Congress has imposed these requirements for alimony treatment. Congress's decision to treat trust and nontrust alimony similarly supports *Daniel's* conclusion that section 682(a) cannot apply to divorce-settlement transfers in trust.

If section 682(a) does not require taxing the wife on the income of a "non-section 71" alimony trust, how should such income be taxed? In Revenue Ruling 74-94[60] the Service answered this question by reviving the *Douglas v. Willcuts* distinction between a trust whose creation discharges the husband's support obligation and a trust whose payments satisfy a continuing obligation.[61] If the hus-

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ments to a wife, if those payments would, but for § 682, be included in the husband's income. S. REP. No. 1631, 77th Cong., 2d Sess. 85 (1942).

[58] The Tax Court said in *Daniel* that, were it to accept the taxpayer's view of § 682(a), it "would in effect be reading out the parenthetical clause . . . set forth in section 71(a)(1)." 56 T.C. at 661. If the *Daniel* taxpayer's argument had been accepted, taxpayers would be able to agree to transfer to the wife a fixed amount of money over a relatively short period, by putting property in trust to pay income to her until the fixed amount was reached. If applicable, § 682(a) would give this arrangement a tax effect much the same as if the husband had made the payments directly and deducted them. But § 215 would permit no deduction for direct payments made under such an agreement.

[59] For a criticism of some early writers who insisted that regularity of receipt was an essential attribute of income, see H. SIMONS, PERSONAL INCOME TAXATION 65-83 (1938).

[60] 1974-1 C.B. 26. This ruling concerns a trust making payments to a wife for purposes other than "support" (her income from other sources was sufficient to support her). The ruling holds that because the payments were not "for support," the trust was not a § 71 trust. Since the principal purpose of the § 71 "support" requirement is to deny alimony treatment to payments taking the form of alimony, but in fact made to purchase a property interest from the wife (*see* Harris, *supra* note 52, at 58-59), this application of the "support" requirement seems unduly restrictive. Although payments for luxuries may not amount to "support" payments in some contexts (for example, the dependency exemption of §§ 151 and 152), no good reason exists to restrict § 71 to payments for necessities. Another reason given in the ruling for not applying § 71 is that distributions to the wife were discretionary with the trustees. 1974-1 C.B., at 27. The significance of this is not explained; perhaps the Service feels that discretionary distributions are not "periodic."

[61] The ruling cites *Helvering v. Fuller* and *Helvering v. Fitch*, but not Pearce v. Commissioner, 315 U.S. 543 (1942) (*see* note 35 *supra*). 1974-1 C.B. at 28. This omission renders the ruling an incorrect application of pre-§ 71 law, even on the dubious assumption that this law should continue to apply until expressly overruled by Congress.

band creates the trust as part of a settlement that protects him from any additional liability, the wife is taxed on the trust's income, but if the husband remains even contingently liable to support the wife, the trust's income is taxed to him. This distinction was unsatisfactory when it was created; to revive it today, after Congress has rejected the reasoning of its parent cases, is inexcusable.[62] Furthermore, at least in states that allow the husband to terminate his support duty, Revenue Ruling 74-94 is open to the same criticism as the taxpayer's argument in *Daniel*, for it allows some taxpayers to achieve a section 71 result without satisfying section 71's conditions.

Instead of taxing the income of all "non-section 71" trusts to the wife (under the *Daniel* taxpayer's argument) or taxing the income of some of these trusts to the wife and that of others to the husband (under Revenue Ruling 74-94), the income of all "non-section 71" trusts created in connection with divorce might simply be taxed to the husband under section 677.[63] This solution would harmonize the trust rules both with the rules for nontrust payments and with the reasoning of the *Daniel* opinion.[64] Taxing the husband on the income of all "non-section 71" alimony trusts would conflict with some decisions involving the creation of trusts to satisfy obligations other than alimony.[65] But even if those cases

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[62] In Johnson v. United States, 163 F. 30, 32 (1st Cir. 1908), Justice Holmes noted:

> The major premise of the conclusion expressed in a statute, the change of policy that induces the enactment, may not be set out in terms, but it is not an adequate discharge of duty for courts to say: We see what you are driving at, but you have not said it, and therefore we shall go on as before.

[63] Under § 677, income actually distributed to support someone whom the trust grantor is "legally obligated to support or maintain" is taxable to the grantor; this rule is the basis for taxing the husband under Revenue Ruling 74-94 if the divorce proceedings fail to terminate his support obligation. *See* 1974-1 C.B., at 27-28. If the proceedings do terminate his obligation, the local law obligation to support can no longer justify the application of § 677, but the obligation the husband assumed by establishing the trust could serve exactly the same purpose. *Cf.* Taylor v. Campbell, 335 F.2d 841 (5th Cir. 1964) (payments pursuant to support agreement deductible as alimony, even though local law would have imposed no support obligation in absence of agreement).

[64] *See* notes 55-56 and accompanying text *supra*. *Daniel* did not actually reach the issue of how to tax the income of "non-section 71" trusts, since the Tax Court found that the state court proceedings had not actually transferred to the wife any interest in the trust, but had merely awarded her a right to alimony payments, secured by a lien on the husband's interest in the trust. 56 T.C. at 659. The essentially formal distinction between an interest "transferred to" a wife and a "lien" to secure a right against the husband himself is another good reason for refusing, wherever possible, to distinguish trust from direct alimony.

[65] In Helvering v. Blumenthal, 296 U.S. 552 (1935) (per curiam), the Supreme Court, on the authority of *Douglas v. Willcuts*, reversed a court of appeals decision that a taxpayer

are right (or well-entrenched), divorce-related trusts are unique.[66] Congress has determined that since they serve the same purpose as nontrust alimony they should receive the same tax treatment. This determination justifies resolving close cases by choosing the appropriate "nontrust" result, whenever possible.

It is appropriate to tax the husband on the income of "non-section 71" alimony trusts in which the wife receives only an income interest. However, creation of a trust giving her a greater interest, such as income for her life and a testamentary power of appointment over trust corpus, might be treated as an outright transfer of the property to the wife. Such a transfer differs in no

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was not taxable on the income of a trust used to pay her debts, where the taxpayer remained personally liable. The court of appeals had held that the taxpayer was merely a surety after the transfer of the property to the trust, so that she should not be taxed on trust income used to pay the debt. Blumenthal v. Commissioner, 76 F.2d 507, 508 (2d Cir. 1935). *Accord*, Mosby v. United States, 50-1 U.S. Tax Cas. (CCH) ¶ 9120 (W.D. Tenn. 1949) (taxpayer establishing trust providing sister with regular income in exchange for her cancellation of debt held taxable on trust income because he had guaranteed trust income of at least $5,000 per year, thus making his obligation "continuing"). Because taxing the trust's income to the taxpayer is inconsistent with requiring the taxpayer to recognize gain on the transfer, these cases also support the Service's theory that a transfer of an income interest is not taxable unless it relieves the taxpayer of the obligation prompting the transfer. *See* notes 84-86 and accompanying text *infra*.

An analogous problem concerns the recognition of gain on donative transfers of mortgaged property. The law applicable to such transactions remains unsettled. *See generally* Bacas, *Gifts of Property Subject to Indebtedness: Johnson v. Commissioner*, 44 GEO. WASH. L. REV. 86 (1975); Note, *Income Tax Consequences of Encumbered Gifts: The Advent of* Crane, 28 U. FLA. L. REV. 935 (1976). It is, however, reasonably clear that these transfers can be taxable despite the transferor's continued personal liability. *See* First Nat'l Indus., Inc. v. Commissioner, 404 F.2d 1182 (6th Cir. 1968) (transfer of encumbered stock to charity, with mere "understanding" that charity would pay transferor's personal debt with stock or proceeds of its sale resulted in gain to transferor), *cert. denied*, 394 U.S. 1014 (1969); Malone v. United States, 326 F. Supp. 106 (N.D. Miss. 1971) (trustees assumed mortgage, but taxpayer remained secondarily liable, gain recognized), *aff'd per curiam*, 455 F.2d 502 (5th Cir. 1972); Treas. Reg. § 1.1011-2(a)(3) (1972) (amount of indebtedness to which property subject treated as amount realized, for purposes of § 1011(b), "even though the transferee does not agree to assume or pay the indebtedness"); Rev. Rul. 70-626, 1970-2 C.B. 158 (transfer of encumbered stock to charity, taxpayer remained personally liable but charity agreed to pay debt, resulted in gain to transferor).

[66] In Fox v. United States, 510 F.2d 1330 (3d Cir. 1975), the court held § 483 inapplicable to installment payments to a former spouse. The *Fox* taxpayer argued that under § 483 part of each payment was deductible as imputed interest. The court rejected this argument primarily because Congress had, in § 71, spelled out the circumstances under which a spouse was taxable on divorce payments without providing for imputed interest. Since the nonperiodic payments in question were not taxable to the wife under § 71, they were not deductible, in whole or in part, by the husband. If installment payments are made in exchange for property, however, § 483 does apply. Gerlach v. United States, 74-1 U.S. Tax Cas. (CCH) ¶ 9425 (Ct. Cl. 1973).

significant way from an outright transfer of the property, followed by her establishing the trust.[67] No income tax cases have had to deal with such trusts. They are probably very uncommon,[68] since this kind of transfer is little better for the husband,[69] and considerably worse for the wife, than a simple transfer of property.

III

WHEN IS THE TRANSFER OF PROPERTY TO AN ALIMONY TRUST A TAXABLE EVENT?

In *United States v. Davis*,[70] the Supreme Court held that a husband's transfer of appreciated stock to his wife in exchange for her release of marital rights was a taxable disposition of the stock. The Court held the husband taxable on the appreciation, just as if he had sold the stock for cash and transferred the proceeds to his wife.[71] Applying *Davis* to some alimony trusts presents no real problem.[72] Suppose that the wife receives all trust income for life and a testamentary power of appointment over the trust corpus. She becomes the only person with a beneficial interest in the trust. The husband has completely disposed of his property in a taxable transfer and is clearly taxable under *Davis*. But when the husband transfers only an income interest in the property to his wife, and either retains a reversion in the trust corpus or transfers a remain-

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[67] *Cf.* Rev. Rul. 62-106, 1962-2 C.B. 21 (husband who pays wife's medical and dental expenses directly can deduct payments under § 215, in same way he could deduct alimony payments; wife can treat payments as medical expenses paid by her, for purposes of § 213). *But cf.* Jernigan v. Commissioner, 34 T.C.M. (CCH) 615 (1975) (implying that wife gets no deduction for fees paid her lawyer by her husband, even though fee would have been deductible under § 212 if she had paid it herself).

[68] They are not unheard of. See the trust described in Estate of Hundley v. Commissioner, 52 T.C. 495 (1969), *aff'd per curiam*, 435 F.2d 1311 (4th Cir. 1971), a gift tax case.

[69] If local law does not permit the husband to discharge his support obligation completely, he might prefer to establish this kind of trust rather than make a direct transfer to the wife, since the trust arrangement eliminates the danger that the wife may dissipate the property and then sue him for support. The danger may be remote, but people getting divorced sometimes have low opinions of their spouses.

[70] 370 U.S. 65 (1962).

[71] For analyses of the *Davis* rule, see Barton, *Tax Aspects of Divorce and Property Settlement Agreements—The* Davis, Gilmore *and* Patrick *Cases*, 1964 S. CAL. TAX INST. 421; Gunn, *The Federal Income Tax Effects of the Missouri Version of the Uniform Divorce Act*, 1974 WASH. U. L.Q. 227, 230-41; Schwartz, *Divorce and Taxes: New Aspects of the* Davis *Denouement*, 15 U.C.L.A. L. REV. 176 (1967).

[72] The application of the *Davis* rule to the creation of alimony trusts is discussed in O'Byrne, *Escape from Holy Deadlock: Some Current Problems of Divorce*, 45 TAXES 63, 66-71 (1967); Comment, *Tax Aspects of Alimony Trusts*, 66 YALE L.J. 881, 882-85 (1957).

der in it to his children or a charity, it is not clear whether *Davis* applies, or how to measure gain or loss if it does.

Three revenue rulings directly address the question of gain to the husband on a transfer of appreciated property to an income-interest alimony trust. As the only authoritative sources to discuss this troublesome problem, these rulings merit more detailed analysis than is normally appropriate for revenue rulings.

Both Revenue Ruling 57-506[73] and Revenue Ruling 57-507[74] concerned husbands who established alimony trusts under which their wives received income interests and the remainder interests went to charity.[75] Each trust agreement required the husband to make additional payments to the wife if the trust income fell below a designated amount.[76] The agreement in Revenue Ruling 57-507 terminated the husband's obligation to make up deficiencies in trust income if and when he transferred to the trust additional securities to raise the value of the trust corpus to a specified level. Revenue Ruling 57-507 held the husband taxable upon the transfer of appreciated stock to the trust, to the extent that the appreciation was attributable to the wife's income interest. Thus, if the value of the wife's income interest equalled half the value of the property, the husband realized half the appreciation.[77] In contrast, Revenue Ruling 57-506 held that the husband's transfer of property to the trust was not a taxable event, "since no economic benefit inures to him from such transfer."[78]

In Revenue Ruling 59-47,[79] issued to explain the distinction between the 1957 rulings, the Service focused on the "important factual difference" that the husband whose transfer was taxable could have satisfied his support obligation in full by transferring

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[73] 1957-2 C.B. 65.

[74] 1957-2 C.B. 511.

[75] The trust in Revenue Ruling 57-506 limited the wife's income interest to a stated quarterly figure; the wife in Revenue Ruling 57-507 could invade corpus if income after her husband's death fell below a specified figure. These special features apparently affected only the value of the wife's interest.

Under current law, few taxpayers are likely to establish alimony trusts with remainders to charity, since trusts satisfying the post-1969 requirements for the charitable deduction (§ 170(f)) are unlikely to be good alimony trusts. Both the "annuity trust" and the "unitrust" involve a risk of income creation if payments to the wife are taxed under § 71, and a provision for terminating payments upon the wife's remarriage would apparently disqualify a trust under § 664(d)(1)(A), (2)(A).

[76] Rev. Rul. 57-506, 1957-2 C.B. at 66; Rev. Rul. 57-507, 1957-2 C.B. at 511.

[77] Rev. Rul. 57-507, 1957-2 C.B. at 512-13.

[78] Rev. Rul. 57-506, 1957-2 C.B. at 66.

[79] 1959-1 C.B. 198.

sufficient property to the trust, whereas the other husband would always remain liable to make up deficiencies in trust income. This distinction strongly resembles that developed before 1942 under *Douglas v. Willcuts*, although the rulings do not cite that case.

Neither the method described in Revenue Ruling 57-507 for computing the husband's gain nor the distinction drawn by the Service between taxable and nontaxable transfers is sound. In computing the taxpayer's gain, Revenue Ruling 57-507 errs in allocating part of the taxpayer's basis in the property to the income interest. A taxpayer who receives rental income from leasing unimproved land or dividend income from stock cannot offset any of his basis in the property against his receipts in measuring his income. This rule is in part simply a matter of convention, since it would not be absurd to allow some of the basis of nondepreciable property to reduce income other than sale income.[80] However, the current rule is both sensible and well-established.[81] Therefore, a

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[80] *See* Joyce & Del Cotto, *The* AB (ABC) *and* BA *Transactions: An Economic and Tax Analysis of Reserved and Carved Out Income Interests*, 31 TAX L. REV. 121 (1976); Surrey, *supra* note 25, at 788-91.

[81] Joyce and Del Cotto contend that the owner of nondepreciable income-producing property (a bond, for example) should be allowed to offset part of his basis in the property against each receipt of interest, because part of the purchase price of the property was paid for the right to receive that income payment. Joyce & Del Cotto, *supra* note 80, at 182-89. They argue that part of the income a taxpayer "realizes" under current law, each time an interest payment is made, is attributable not to the value of the payment itself, but to a presumed increase in the value of the income-producing property other than the right to receive the particular payment. *Id.* at 124-26. They argue that this represents "unrealized appreciation," upon which the taxpayer should not be taxed. It is true that part of the gain realized on the receipt of every interest payment can be thought of as attributable to the passage of time, making the other interest payments and the return of the principal not so far off as they used to be. It does not follow, however, that this "unrealized appreciation" should not be taxed. Two reasons are usually given for not taxing unrealized appreciation: the difficulty and expense of periodic valuation of unsold property, and the taxpayer's lack of cash with which to pay the tax. Neither applies where the taxpayer is receiving cash interest payments. Indeed, since the appreciation in question is always accompanied by the receipt of cash, it seems somewhat unsatisfactory even to call it "unrealized" appreciation. Nor does the possibility that the underlying property (i.e. a bond, or stock, or land) may be decreasing in value while the taxpayer is paying a tax based on the assumption that its value is constant mean that the present treatment of income from non-depreciable property is incorrect. The decrease in the property's value will be reflected when it is disposed of. Any method of allowing a return of capital that allows a full return produces the correct income figure in the long run. As a result, the choice between one method and another becomes largely a matter of convenience, and of preventing undue deferrals of tax. The present system of taxing income from non-wasting assets is simple, accords with popular understanding of when income is realized, matches the realization of income with the receipt of cash, and tends to attribute income to the taxpayer as he becomes wealthier. In any event, as Joyce and Del Cotto concede, the present treatment of income from non-wasting assets is "embedded in the tax law." *Id.* at 186.

taxpayer who sells his right to the income from property should not be (and usually has not been) allowed to use part of the property's basis to reduce income from the sale.[82] If the taxpayer sells an

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[82] To be consistent, sales of income interests should receive the same tax treatment as receipt of the income. Absence of consistency would provide taxpayers with a strong incentive to sell their income interests in order to defer taxation.

Where the income interest transferred is of short duration, taxpayers have apparently not even argued that part of their basis should reduce receipts in determining gain. *See, e.g.*, Commissioner v. Gillette Motor Transport, Inc., 364 U.S. 130 (1960) (taxpayer argued unsuccessfully for capital gains treatment for compensation for use of taxpayer's business facilities for about ten months); Estate of Stranahan v. Commissioner, 472 F.2d 867 (6th Cir. 1973) (Commissioner argued for loan treatment for sale of right to future dividends); Rhodes' Estate v. Commissioner, 131 F.2d 50 (6th Cir. 1942) (per curiam) (taxpayer argued unsuccessfully for capital gains treatment for sale of right to dividend declared prior to sale). When longer periods were involved, taxpayers have argued that sales receipts should be reduced by their bases in the property, but have failed to persuade the courts. *See, e.g.*, Hort v. Commissioner, 313 U.S. 28 (1941) (no part of consideration paid lessor for cancelling a lease with about eleven years to go treated as a return of capital).

The rule requiring full inclusion of rent in income, without an offset for basis (except for depreciation), is also in point. A lease, like the "sale" of an income interest, is nothing more than a temporary transfer of the right to use property. The appeal of a rule allocating no basis to a transferred income interest decreases as the duration of that interest increases. An assignment of an income interest for a very long time might well be treated as a sale of the property, with a full basis offset, on the ground that the reversion should be ignored because its present value is trivial. *Cf.* Rev. Rul. 55-540, 1955-2 C.B. 49, 42-43 ("rental" for period approximating useful life of property, with rent in early years approximately equal to price for which property could be bought, constitutes a sale). *Accord*, Rev. Rul. 60-122, 1960-1 C.B. 56.

Some cases have allowed a basis offset for sales of life estates. In Estate of Camden v. Commissioner, 47 B.T.A. 926 (1942), *aff'd mem.*, 139 F.2d 697 (6th Cir. 1943), the Board of Tax Appeals refused "lease" treatment on the the technical ground that a life estate was "property," and somehow essentially different from a term of years, but suggested that the result would differ where the life estate consisted "only of the right to receive income." *Id.* at 931. *Accord*, King v. Commissioner, 31 T.C. 108 (1958).

The same basis-allocation problem arises in connection with sales of property in which the seller retains a term interest such as a life estate; the common "sale and leaseback" transaction is one such transaction. Allocating no basis to a life estate or term income interest retained by the seller would permit the seller to offset his revenue from the interest sold by the basis in the entire property. This in turn would require including the value of the retained interest as part of the amount realized on the sale, to prevent the seller from claiming an artificial loss. Some cases support this result. *See, e.g.*, Steinway & Sons v. Commissioner, 46 T.C. 375 (1966), *acq.* 1967-2 C.B. 3. *But see* Hunter v. Commissioner, 44 T.C. 109 (1965) (sale of property with reservation of life estate, basis apportioned between retained and transferred interests according to Treas. Reg. § 1.61-6(a) (1957)); Rev. Rul. 77-413, 1977-45 I.R.B. 18. For a recent discussion of the sale and leaseback cases, see Morris, *Sale-Leaseback Transactions of Real Property—A Proposal*, 30 THE TAX LAWYER 701 (1977).

Because of concessions by the government, no court has had to decide the proper measure of gain on a transfer to a divorce trust in which the wife receives only an income interest. In Gardner Trust v. Commissioner, 20 T.C. 885 (1953), *acq. in part*, 1953-2 C.B. 4, the Commissioner stipulated that the trust's basis in transferred stock was the stock's value at the time of the transfer unless the transfer was a gift; the possibility that the transfer income interest and disposes of the remainder, he has fully disposed of his property and his basis must be taken into account; but if he has given the remainder away all the property's basis should be allocated to the remainder interest.[83] Therefore, if the husband in Revenue Ruling 57-507 should have been taxed, he should have realized gain in the full amount of the value of the transferred income interest, without any offset for basis. But the real problem with the rulings is not the error in measuring gain; it is the conclu-

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was a gift in part and a sale in part was not raised. Spruance v. Commissioner, 60 T.C. 141 (1973), *aff'd mem.*, 505 F.2d 731 (3d Cir. 1974), also required a determination of the basis of trust property. The Commissioner argued, unsuccessfully, that the taxpayer was estopped from claiming any step-up in basis because no gain had been reported at the time of the transfer. The court observed in a footnote that the trust should have only a carryover basis (under § 1015) in the corpus, a result consistent with the argument advanced here, but said that, in view of the Commissioner's concession that Revenue Ruling 57-507 applied in determining the trust's basis, it would not "decide to petitioner's detriment that there is no step-up in basis." *Id.* at 156 n.7. The *Spruance* court seemed willing to give the wife an amortizable basis in her income interest, an approach that is "logical" but wrong. *See* text accompanying notes 97-102 *infra*.

In King v. Commissioner, 31 T.C. 108, 116 (1958), involving the transfer of a legal life estate, the court also made a Revenue Ruling 57-507 basis allocation. Nothing in the opinion suggests that the Service had argued for no basis offset, and its position in Revenue Ruling 57-507 suggests that it did not. Nor did the taxpayer argue that the transfer was not taxable for any of the reasons discussed below (*see* notes 84-102 and accompanying text *infra*); instead he argued that he should not be taxed because the "amount realized" could not be measured, a theory the Supreme Court rejected in *Davis*. Del Cotto, *Sales and Other Dispositions of Property Under Section 1001: The Taxable Event, Amount Realized and Related Problems of Basis*, 26 BUFFALO L. REV. 219, 284-85 (1977), approves of Revenue Ruling 57-507 on the "benefit" theory and cites as authority *King*, *Douglas v. Willcuts*, and *Helvering v. Fuller*.

[83] Under Treas. Reg. § 1.1015-1(b), T.D. 7142, 1971-2 C.B. 295, 298, which may have been drafted with only fully donative transfers in mind, the remainderman's share of the property's "uniform basis" is increased with the passage of time to reflect the increase in the value of the remainder interest. The uniform basis rules operate so that the remainderman will eventually receive the donor's basis in the property (with adjustments not relevant here), just as if the donor had given him the property outright. The life tenant has a share of the uniform basis, but unless the entire property is sold (*see* § 1001(e)(3)), he can neither amortize it against the property's income nor deduct it from the proceeds of the property's sale. (*See* §§ 1001(e), 273). In effect the remainderman receives all the donor's basis, although he does not get it all until the life estate terminates. I see no good reason for treating a donative remainderman differently because the income interest was disposed of in a taxable transaction, rather than by gift. If the transferor can use some of the basis in the property in computing gain on the transfer, allowing the remainderman the usual section 1015 basis would mean that some of the basis would be used twice, once by the transferor in computing gain and again by the remainderman when he gets the property. Taxing the transferor on the full amount received for the income interest prevents this "double benefit." Denying one who sells an income interest any use of his basis is also consistent with the long-standing practice of taxing in full the income of property retained, rather than sold (*see* note 80 *supra*); accordingly the rule suggested in the text produces the correct result whether one looks at the transaction from the point of view of the transferor or of the remainderman.

sion that either husband had effected a taxable disposition of his property.

In drawing its distinction between taxable and nontaxable transfers to alimony trusts, the Service has held that whether the husband is taxable on the transfer of appreciated stock depends upon whether state law can compel him to make additional payments to his wife.[84] In other words, the tax treatment of the stock transfer depends upon whether the transferor may have to transfer something else, some other time. Stated in this simple (but accurate) way, the rule of Revenue Ruling 59-47 is preposterous. Since each husband had disposed of an income interest in his property, any respectable argument for taxing one would require taxing both.

The rationale of Revenue Ruling 59-47 is that the taxed husband could have terminated his support obligation by making further transfers, so that the transfer in question was the first step in a process by which he would "receive a benefit" in the form of relief from his support obligation. Even if the rulings were correct in making receipt of a benefit the test of whether a taxpayer must realize appreciation in his property, they misapplied the test. Even a husband who will always be legally responsible for support receives a benefit to the extent that income from the transferred property meets part of his obligation.[85] As a practical matter, if the husband funds the trust with secure income-producing property, the obligation to make up deficits will be of little or no importance. The fundamental error of Revenue Ruling 59-47, however, is not that it misapplied a sensible test but that it applied a meaningless

[84] In Kraut v. United States, 316 F. Supp. 740 (E.D. Wis. 1970), a taxpayer who had made an outright transfer of appreciated property to his wife argued that *Davis* did not apply because he remained liable for support under local law after the transfer. If the approach of the rulings discussed in the text were sound, this argument should have succeeded. It did not. The only difference between *Kraut* and many transfers to alimony trusts is one of visibility. When the transfer is outright, anyone can see that the taxpayer has disposed of property and so should be taxed, if the disposition was taxable. In contrast, transfers to trusts often involve facts so complex that they obscure the issues.

[85] The essence of the *Davis* decision is simple: anyone who satisfies an obligation by transferring appreciated property realizes that appreciation. 320 U.S. at 71-74. Nothing in the Court's reasoning suggests that the result should differ if the transferor satisfies only part of his obligation. If a taxpayer sold appreciated property and transferred the proceeds to his wife as part of a divorce settlement, no one would doubt that he had realized the appreciation, whether or not the payment fully discharged his obligation. There is no important difference between that case and a direct transfer of the property itself. Suppose a debtor transfers appreciated property to a creditor in partial satisfaction of a claim uncertain in amount, and agrees to pay the balance later: Is there any doubt that he has realized a gain or loss on the transfer?

test. Receipt of a benefit has no bearing on whether a taxable disposition has occurred.[86] Recognition of gain or loss is triggered by disposition of the property in question, not by "receipt of a benefit."

The error of looking for the "receipt of a benefit" as a test of taxability is an old and persistent one, deriving perhaps from *Eisner v. Macomber*,[87] which held a stock dividend constitutionally immune from treatment as income because it did not make the taxpayer richer. Very few taxable dispositions, in and of themselves, enrich the taxpayer,[88] and many make him poorer. A taxpayer who owns a house with a basis of $20,000 and a value of $50,000 has a gain, not a loss (for tax purposes), when it blows away in a storm and the taxpayer receives $40,000 in insurance proceeds.[89] Conversely, a taxpayer may benefit from appreciation of his property without having to recognize gain, as when he leases the property or uses it as security for a loan.[90] Since the receipt of a benefit does not trigger realization of gain if the property is not disposed of, and since a taxable disposition does trigger realization even if no benefit results from the disposition, the rulings applying *Davis* to

[86] The amount of consideration received in a disposition may determine whether it produces a gain or a loss: one who sells property with a basis of $10 for $20 has a gain, while one who sells property with the same basis for $5 has a loss. But the rulings discussed here use "receipt of a benefit" as a test of whether a disposition has been made, not simply whether it produces a gain or loss.

[87] 252 U.S. 189 (1920). For a recent criticism of the proposition that any dividend enriches the recipient and a discussion of some recent errors resulting from a misunderstanding of this point, see Kingson, *The Deep Structure of Taxation: Dividend Distributions*, 85 YALE L.J. 861 (1976).

[88] For example, when a taxpayer sells a house with a basis of $20,000 for $50,000, his gain really comes not from the sale, but from holding the house. The sale merely exchanges a $50,000 house for $50,000 in cash.

[89] *See* § 1001. Similarly, a taxpayer who disposes of property subject to a mortgage on which he is not personally liable must include the unpaid mortgage in his amount realized, even though the disposition cannot be said to have "benefited" him in any immediate sense. Crane v. Commissioner, 331 U.S. 1 (1947). It is true, of course, that this taxpayer has "received a benefit" in the long run. If the mortgage was not a purchase money mortgage, he benefited when he received money upon mortgaging the property; if it was a purchase money mortgage, he still benefited from being able to include the mortgage in his basis and take depreciation deductions upon it. *See id.*, at 3 & n.2. The point here is that the disposition need not (and typically does not) *by itself* enrich the taxpayer. The Service seems to feel (in the alimony trust context) that without a complete release from his support obligation the husband receives no benefit from his transfer of property to an alimony trust, and that absent such a benefit he has made no taxable disposition of his property.

[90] *See, e.g.*, Woodsam Assocs. v. Commissioner, 198 F.2d 357 (2d Cir. 1952) (receipt of cash, in excess of basis, secured by non-recourse mortgage, not taxable event because no "disposition").

transfers to alimony trusts rest on a fundamentally unsound premise. Cases defining capital gains and losses using "receipt of a benefit" to determine whether a disposition is a "sale or exchange"[91] are not inconsistent with this conclusion. Even if those cases are correct, a very dubious assumption,[92] they use the "benefit" approach only to classify a taxable disposition, not to determine whether a disposition has been made.[93]

Since recognition of unrealized appreciation depends upon whether the taxpayer has disposed of property, not upon whether he has benefited by the disposition, the husband who transfers appreciated property to an alimony trust in which his wife receives only an income interest should not be taxed on the appreciation. Since he has disposed of the income interest, he might be taxed upon the value of that income interest, with no offset for basis, and regardless of whether the property has appreciated.[94] But even this limited taxation would be inconsistent with the Code's treatment of trust alimony and nontrust alimony as virtually identical alternatives. Payments from alimony trusts and direct payments must meet the same tests to be treated as alimony, both kinds of payments are taxed in full to the wife, without regard to source, and both reduce (or are excluded from) the husband's taxable income.[95] These similarities, the product of a deliberate Congressional decision to treat trust and nontrust alimony alike, justify

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[91] *E.g.*, Stokes v. Commissioner, 124 F.2d 335, 337 (3d Cir. 1941) (conveyance of mortgaged property to mortgagee not a "sale or exchange" because mortgagor "gets nothing").

[92] From the taxpayer's point of view there is no difference between giving property to a creditor and selling the property and giving the creditor the money; if one of these transactions is a "sale or exchange" both should be. *Cf.* Kenan v. Commissioner, 114 F.2d 217 (2d Cir. 1940) (trust had capital gain on securities distributed in satisfaction of bequest). Recent cases and rulings involving transactions like that in Stokes v. Commissioner, 124 F.2d 335, 337 (3d Cir. 1941), *discussed in* note 91 *supra*, have held, without explanation, that they *are* "sales or exchanges." *See* Bacas, *supra* note 65, at 105-08.

[93] Section 61, which requires the inclusion in income of gain on a disposition of property refers to "gains derived from dealings in property," and section 1001, which covers determination of the amount of gain or loss, covers the "sale or other disposition of property." Both these phrases can be read more broadly than "sale or exchange," the phrase used in § 1222 to describe dispositions that produce capital gains or losses.

[94] *See* notes 80-83 and accompanying text *supra*.

[95] The argument in the text applies only to § 71 alimony trusts. In the case of trusts making payments not covered by § 71, justification for the inapplicability of *Davis* is found in the continued taxability to the grantor of the trust's income. *See* notes 51-69 and accompanying text *supra*. If the income interest has not been transferred to the wife in the sense of making her taxable on that income, the husband should not be considered to have disposed of that interest (for tax purposes), and so should not be required to recognize gain.

making the creation of an income-interest alimony trust a nontaxable event, since the parallel situation—the husband's use of income from property to pay direct alimony—is not taxable.[96]

The effect upon the wife of a rule taxing the creator of an income-interest alimony trust shows the rule's unsoundness. When a husband makes a taxable transfer of property to his wife, she takes it with a basis equal to its value at the time of the transfer.[97] If this rule were applied to the creation of an alimony trust, the wife would have a basis for her income interest, which she could amortize,[98] reducing her taxable income. A wife who is the beneficiary of an alimony trust would have considerably less taxable income than one receiving the same amount in direct alimony. As the only substantial difference between these two wives is that the trust beneficiary is more certain of receiving her payments, granting the trust beneficiary wife a basis in the trust property should be avoided if at all possible. This can be done only by making the transfer a nontaxable event. Furthermore, if the husband is allowed a basis in his income interest, the Service's "benefit" rule can

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[96] *See* Comment, *Tax Aspects of Alimony Trusts*, 66 YALE L.J. 881, 882-85 (1957).

[97] *See* Farid-Es-Sultaneh v. Commissioner, 160 F.2d 812 (2d Cir. 1947) (wife's basis in stock transferred to her in consideration for her release of marital rights equal to value at time of transfer, not husband's basis); Rev. Rul. 67-221, 1967-2 C.B. 63.

[98] *See* Spruance v. Commissioner, 60 T.C. 141, 155 n.7 (1973) (dictum), *aff'd mem.*, 505 F.2d 731 (3d Cir. 1974). The *Spruance* opinion recognized that the transfer to the wife was a transfer of an income interest, not simply of an undivided interest in property, as it was treated in the rulings discussed in the text. Moreover, while the court appeared willing to let the wife amortize the cost of the income interest, it apparently felt that the trust should not receive a basis in the income interest on account of the transfer. But the court gave effect to the Commissioner's concession that the trust's basis should be determined under Rev. Rul. 57-507 unless estoppel barred the taxpayer from using that stepped-up basis.

O'Byrne, *supra* note 72, at 69, recognizes that the wife may have a basis, but suggests that § 71 should prevent amortization in light of the "full inclusion of payments in income" rule discussed in Part I of this Article. He argues, however, that the wife should be able to use her basis if she sells her interest. This rule (basis for sale but not for depreciation) is identical to the rules applicable to holders of donative life estates prior to the enactment of § 1001(e) in 1969. Gerhart, *supra* note 46, argues that § 71 is not inconsistent with amortization because it is concerned with gross income, not taxable income. *But see* note 45 *supra*.

If the husband had to include the full value of the life estate in income, the wife's lessened taxable income during the time she amortized her interest would be matched by an increase in the husband's income in the year of the transfer. The husband's gain would ordinarily be a capital gain under McAllister v. Commissioner, 157 F.2d 235 (2d Cir. 1946), *cert. denied*, 330 U.S. 826 (1947). If, however, he retained a reversionary interest in the trust, Commissioner v. P.G. Lake, Inc., 356 U.S. 260 (1958), would probably require ordinary income treatment. Taxing the husband in full would solve the disappearing income problem, as would reducing the remainderman's basis by the amount of the wife's amortization deductions, but neither of these solutions is satisfactory. *See* note 100 *infra*.

remove income from the tax base.[99] Suppose, for example, that the husband establishes an alimony trust using unappreciated property, so that even though the Service considers the transaction taxable it produces no gain and thus no tax. If the wife's taxable income is reduced by her amortizable basis in her income interest, her total taxable income over her life is the amount of the alimony payments less the value of the right to receive those payments when the trust was created. If the parties establish an alimony trust, instead of having the husband keep the property and use the income to pay alimony, the Service's view of the law enables them to cause a considerable part of the income from the property to disappear.[100] This sort of sorcery has been performed before, with sales of inherited life estates,[101] where it produced the inevitable congressional reaction to a scheme too good to be true.[102] The courts can forestall a similar scheme involving alimony trusts if they avoid the plausible but unsound approach of making taxability turn upon the "receipt of a benefit."

Although this discussion shows that a husband who establishes an alimony trust in which the wife has only an income interest should not be taxed, it does not follow that creation of an alimony trust should never be a taxable event. If the trust gives the wife an interest approaching full ownership of the property, such as an income interest and a testamentary power of appointment over the corpus,[103] the husband has for all practical purposes disposed of all

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[99] *See* McAllister v. Commissioner, 157 F.2d 235 (2d Cir. 1946), *cert. denied*, 330 U.S. 826 (1947) (taxpayer allowed to use her basis in inherited life estate to compute her gain on sale of her interest to remainderman, even though the predecessor of section 273 would have forbidden recovery of her basis through amortization deductions).

[100] Taxing the husband in full would solve the disappearing income problem; as would reducing the remainderman's basis by the amount of the wife's amortization deductions, but neither of these solutions is satisfactory. Taxing the husband would defeat the purpose of § 71 by returning the tax burden to him, and reducing the remainderman's basis would be inconsistent with the normal tax treatment of remainder interests. *See* note 83 *supra*.

[101] Until the enactment of § 1001(e), the holder of a donative or inherited life estate had no depreciable basis (§ 273), but could use his share of the uniform basis to reduce gain on a sale of the interest. By selling his interest, such a taxpayer could exchange a right to future fully-taxable receipts for a lump sum non-taxable (because offset by basis) payment. For a discussion of this disappearing-income problem before the enactment of § 1001(e), see Plumb, *Tax Effects of Sales of Life Interests in Trusts*, 9 TAX L. REV. 39 (1953).

[102] *See* I.R.C. § 1001(e) (holder of donative or inherited life or term interest must disregard basis in determining gain or loss from disposition of that interest, except for dispositions transferring entire interest in property).

[103] In Estate of Hundley v. Commissioner, 52 T.C. 495 (1969), *aff'd mem.*, 435 F.2d 1311 (4th Cir. 1971), a gift tax case, a husband who created such a trust reported the

his interest in the property. *Davis* requires that he be taxed on that disposition regardless of any future obligations.[104] Intermediate cases, such as the husband's retention of a reversionary interest terminable by the wife's power to invade the corpus, could arise. But at least in the normal divorce, where the parties are not well-disposed toward each other, these intermediate types of trusts are unlikely to be used.[105]

An issue closely related to the taxation of transfers of property to alimony trusts is the taxation of divorce-connected transfers of income interests in preexisting trusts. Whether *Davis* requires that these transfers be taxable events is an open question. Suppose, for example, that the husband has a life income interest in a trust, and that he transfers that interest to his wife to satisfy his support obligation. His interest in the trust can be "property,"[106] and a ruthless application of *Davis* would require that the value of the

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transfer of assets to the trustee as a sale on his income tax return, and neither party questioned that treatment. *Id.* at 506.

[104] *See* Kraut v. United States, 316 F. Supp. 740 (E.D. Wis. 1970), *discussed in* note 84 *supra.* A transfer to a wife for life, remainder to children will often present a difficult factual problem: Is the creation of the remainder interest a donative transfer, or is it something the wife bargained for, making the disposition taxable in full? The courts have faced a similar problem in estate and gift taxation. Their approach, which could apply in income tax cases as well, seems to be that the taxpayer can treat a transfer to children as a transfer to the wife if the evidence supports the conclusion that the transfer was forced upon the husband. *Compare* Estate of Glen v. Commissioner, 45 T.C. 323 (1966) *with* Spruance v. Commissioner, 60 T.C. 141 (1973), *aff'd mem.*, 505 F.2d 731 (3d Cir. 1974). Judge Tannenwald, dissenting in *Estate of Glen*, would have beld that transfers to children should never be treated as transfers to a wife:

> It seems to me that we ought not to involve ourselves in whether the transfers for the benefit of the son were motivated by the generosity of decedent or tbat of his former wife. To do so would be an unwarranted probing of tbat "elusive state of mind," which the Supreme Court has held to be contrary to the intent of Congress.

45 T.C. at 351.

One might even argue that the creation of any alimony trust—even one in which the husband retains a reversionary interest—is a fully taxable event, if the wife insisted on the transfer. This solution would have the great virtue of simplicity. On the other band, divorce is not a convenient time to impose a tax, particularly wbere (as here) the transaction gives the taxpayer no money with which to pay that tax. Accordingly, although we seem stuck with *Davis* for the time being, we should not strain to apply it where less than the whole interest in the property is being transferred.

[105] These types of trusts are also undesirable under current law because of "creation of income" problems. *See* notes 46-48 and accompanying text *supra.*

[106] *See, e.g.*, Blair v. Commissioner, 300 U.S. 5 (1937) (donor having only life interest in trust assigned a portion of that interest; "assignment of income" doctrine did not require taxing income to donor); McAllister v. Commissioner, 157 F.2d 235 (2d Cir. 1946) (sale of life tenant's interest in a trust), *cert. denied*, 330 U.S. 826 (1947).

transferred interest be income to the husband.[107] Nevertheless, several courts have dealt with transfers of existing interests without mentioning this problem, apparently assuming that the transfers were not taxable. The Tax Court recognized a similar issue in *Daniel v. Commissioner*,[108] but avoided it by deciding that no interest in the trust had passed to the wife.[109] Another Tax Court case, *Miller v. Commissioner*,[110] held that a husband who transferred his lessor's interest in a seventy-five year lease to an alimony trust recognized no gain because the rents were excluded from his income by section 71(d).[111] Since the effects of transferring an income interest in an existing trust and of transferring property to a new trust in which the wife has an income interest are substantially identical, transfers of existing income interests should be held nontaxable. Alimony treatment for transferred income interests draws support from the same factors that support alimony treatment for payments by alimony trusts,[112] is consistent with the language of section 71, and can be achieved only by making the transfers nontaxable. *Davis* did not appear to consider transfers of bare income interests, and it should not be extended to cover these

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[107] Unless the taxpayer had purchased the interest, he would have no basis to subtract from sales receipts when computing his gain. § 1001(e). *See* notes 101-02 and accompanying text *supra*. The gain could be a capital gain. *See* McAllister v. Commissioner, 157 F.2d 235 (2d Cir. 1946), *cert. denied*, 330 U.S. 826 (1947).

[108] 56 T.C. 655 (1971), *aff'd mem.*, 461 F.2d 1265 (5th Cir. 1972), *discussed in* notes 54-56 and accompanying text *supra*. Before arguing that § 682(a) required taxing the "non-section 71" payments to the wife, Daniel argued that he had "transferred" his income interest in a trust to his wife and was not taxable under Blair v. Commissioner, 300 U.S. 5 1937). *See* note 106 *supra*.

[109] Although the divorce court had impressed a lien upon the trust income, the Tax Court found that this lien had not transferred any interest in the trust to the wife. 56 T.C. at 659.

[110] 49 T.C. 484 (1968), *acq*. 1969-2 C.B. xxiv.

[111] Although the result in *Miller* is consistent with the conclusion reacbed in the text, the court's reasoning is not comforting. The opinion stressed that no property had been transferred to the wife, and suggested that the Commissioner's argument for taxing the value of the transferred lease to the husband might have been accepted if the lease had been transferred outright to the wife, rather than held in trust for her. *Id.* at 487-88. But where only an income interest is involved, there is no substantial difference between an outright transfer to the wife and payment via a trustee. So formal a distinction should not distinguish *Miller* from cases of the kind discussed in the text. In Wright v. Commissioner, 37 T.C.M. (CCH) 372 (1978), the divorce court had awarded a wife a ten-year leasehold estate in her husband's interest in certain rental property. The taxpayer (the wife) argued that the income she received was not taxable to her because the transfer was a property settlement rather than alimony. The Tax Court, rejecting this argument and a contention that the payments were not "periodic," held her taxable on the payments under section 71.

[112] *See* notes 95-102 and accompanying text *supra*.

transfers. As with trusts created in connection with divorce, however, a transfer of an interest that gives the wife full ownership of the trust corpus or its near-equivalent may be taxable under *Davis*.

Conclusion

The error of the Supreme Court in *Douglas v. Willcuts*, and of the Service in its application of that case's doctrine to current problems, is not merely that the distinction between trusts whose creation "discharges" the husband's obligation and other trusts is hard to apply. The real problem is that any attempt to resolve questions by asking which spouse "benefits" from the creation of a trust must fail, for both benefit: he because his obligation is being (or will be) satisfied, at least in part; she because she gets (or will get) money. In effect, the Service has been using a multiple-choice test in which both choices are right. The inevitable result of asking an absurd question has been the drawing of arbitrary lines. When Congress dealt with alimony trusts in 1942, it recognized that creation of such a trust is merely a secure way of providing for alimony payments. Acceptance of this sensible view would put an end at last to the unfortunate doctrine of *Douglas v. Willcuts*, and to the problems caused by Congress's careless draftsmanship when it overruled that case.