COMMENTS

POSTMARITAL SETTLEMENTS AND THE GIFT TAX

The estate tax is designed to reach the net worth of an individual at death. In determining net worth, deductions are allowed for claims arising out of an exchange which, if carried through during the decedent's life, would not have depleted his estate. Thus, claims based on business transactions are deductible, since an even exchange may be presumed. In contrast, the father who gives his son $1,000 in return for the son's promise to abstain from smoking, enters into a transaction which depletes his estate without any corresponding monetary return.

In the gift tax, the net worth concept assumes the form of this depletion theory. Making a gift appears comparable to satisfying a claim for which the estate tax would allow no deduction. However, it is not feasible to condition gift tax liability solely on the basis of depletion. While it is true that where there is no depletion there can be no gift, it is not always true that where there is depletion, there must be a gift. This is exemplified by at least two types of situations. First, an individual makes expenditures on himself and his family in order to maintain a certain standard of living. Expenditures of this nature may be termed "consumption." Second, an individual makes disbursements which are imposed on him as a result of his day-to-day contact with other members of society. These disbursements include those arising from taxes, thefts and tort judgments, and may be termed "societal expenses."

Each of these situations results in a depletion; yet, in neither would it be claimed that a gift has been made. Thus, since it must be determined in which area a particular disbursement lies, the classification of transactions, or transfers, is of central importance in the gift tax. In comparison, the estate tax is not concerned with whether property comprising the estate is transferred by will, intestacy, claims of inheritance rights, or as the result of a will contest. This difference in approach and the difficulties inherent in classifying transfers are implicit in the development of the estate and gift taxes.

The estate tax of 1916 allowed the deduction from the gross estate of bona fide claims contracted for a "fair consideration in money or money's worth." Claims based on dower and other marital property rights were specifically declared not deductible by the 1918 act. This provision is consistent with the theory of the estate tax, since dower is only a method by which property is transferred at death. However, the courts held that an agreement in which the

2 Revenue Act of 1918, at § 402(b), 40 Stat. 1097 (1918). This provision was inserted for the purpose of clarifying existing law. H.R. Rep. No. 767, 65th Cong. 2d Sess. 21 (1918).
wife relinquished her marital property rights in return for a specified share of her husband’s estate at his death, was supported by “fair consideration.” Thus, contrary to legislative intent, the courts made it possible for spouses to transform dower into a deductible claim and, in effect, to remove it from the husband’s estate. In order to nullify this judicial interpretation, the 1926 act replaced “fair consideration” with the phrase “adequate and full consideration.” This was made specific by the Revenue Act of 1932, which provided that relinquishment of marital property rights was not “adequate and full consideration.” Further, the requirement of “adequate and full consideration” was limited to claims founded on a “promise or agreement,” in order to make it clear that “liabilities imposed by law or arising out of torts” were deductible. Implicit in this provision was a legislative recognition of the nature of “societal expenses.”

Also in 1932, Congress enacted the present comprehensive gift tax. The statute is couched in terms of depletion theory, and provides that “where property is transferred for less than an adequate and full consideration in money or money’s worth,” the excess in money value, “shall ... be deemed a gift.” Consistent with this theory, the Treasury, in 1936, issued a Regulation which exempted from the gift tax transfers made “in the ordinary course of business.” These were defined as bona fide transactions, “at arm’s length, and free from donative intent.”

The Supreme Court was faced with the task of interpreting these provisions in the companion cases of Commissioner v. Wemyss and Merrill v. Fahs, each involving the gift tax liability of transfers pursuant to a premarital property settlement. In the Wemyss case, the taxpayer had made transfers to his prospective wife in consideration of her promise of marriage and to compensate her for the loss of trust income granted to her by a prior husband. The Court declared that Congress had chosen not to condition gift tax liability on so elusive a cons-

7 H.R. Rep. No. 708, 72d Cong. 1st Sess. 48 (1932); Sen. Rep. No. 665, 72d Cong., 1st Sess. 51 (1932). It should be noted that dower is not a liability imposed by law, but only a method of transfer imposed by law.
10 Ibid.
11 324 U.S. 303 (1945).
12 324 U.S. 308 (1945).
cept as donative intent. Rather, it had devised the more objective standard of taxing, in a non-business transaction, the excess in money value of the transfer over the money value of the consideration. The Court argued that the purpose of this definition of gift was to "reach those transfers which are withdrawn from the donor's estate," and thus that the test of "adequate and full consideration" must be financial benefit to the transferor and not merely detriment to the transferee. Therefore, since marriage is a consideration not reducible to a money value, and the prospective wife's relinquishment of trust income was merely detriment to the transferee, the Court held that the Wemyss transfers were taxable gifts.

In the Fahs case, the taxpayer had made transfers to his prospective wife in consideration of her relinquishment of marital property rights. The majority bypassed the taxpayer's contention that this relinquishment was a consideration reducible to money value and of financial benefit to him. It argued that the estate and gift taxes were to be construed together, and since relinquishment of marital property rights is not "adequate and full consideration" for purposes of the estate tax, neither is it for purposes of the gift tax. Finally, having found that the Fahs, like the Wemyss, transfers were not made "in the ordinary course of business," the Court held them to be taxable gifts.

The Fahs and Wemyss decisions expressly adopted a depletion theory as the basis of gift tax liability. It should be noted that the transactions before the Court were not complicated by elements of "consumption" or "societal" expenses. Once the Court had rejected the test of donative intent, it was faced with only a depletion problem.

The Court of Appeals for the Second Circuit had declared: "A donative intent followed by a donative act is essential to constitute a gift; and no strained and artificial construction of a supplementary statute should be indulged to tax as a gift a transfer actually lacking donative intent." Wemyss v. Comm'r, 144 F. 2d 78, 82 (C.A. 2d, 1944).

The Supreme Court declared that Treas. Reg. 79, Art. 8 (1936), now Treas. Reg. 108, § 86.8 (1943), correctly interpreted § 503 (now Int. Rev. Code § 1002) of the gift tax. The Regulation reads: "A consideration not reducible to a money value, as love and affection, promise of marriage, etc., is to be wholly disregarded, and the entire value of the property transferred constitutes the amount of the gift."

Reed, J., dissenting, stated: "Through the tables of mortality, the value of a survivor's right in a fixed sum receivable at the death of a second party may be adequately calculated. . . . The trial court thus found the present value of the release of the taxpayer's estate from the wife's survivorship rights largely exceeded the amount paid by the taxpayer. . . ." 324 U.S. 308, 314 (1945).


The Court brushed this contention aside summarily and declared: "To find that the transaction was 'made in the ordinary course of business' is to attribute to the Treasury a strange use of English." 324 U.S. 308, 313 n. 1 (1945). To be contrasted with this is the statement made by Judge Disney of the Tax Court, dissenting in Taurog v Comm'r, 11 T.C. 1016, 1025-26 (1948): "Though . . . sweethearts may, romantically speaking, be thought not to deal 'at arm's length,' in any realistic business sense the transfers between them in the Wemyss and Merrill v. Fahs cases were . . . precisely the antithesis of gifts in the ordinary sense. . . . Sweethearts wishing to make gifts do not coldly require quid pro quo. . . ."
Previous to the Supreme Court’s decisions in the *Faks* and *Wemyss* cases, the Tax Court had held, in *Jones v. Comm’r*,¹⁹ that transfers pursuant to a pre-divorce settlement were not taxable gifts, on the grounds that they were made in satisfaction of the wife’s right to support. The court argued that since the parties had dealt at arm’s length, without donative intent, it would be presumed that the sum agreed upon reflected the actual value of these support rights, and thus that the transfers were founded on “adequate and full consideration.”

Since, by law, the husband is obligated to support his wife, spouses may be considered a consuming unit. Expenditures of this nature, made by the husband during coverture, fall in the class of “consumption expenses” rather than in the class of gifts. Consequently, the transfer of a lump sum in satisfaction of the wife’s right to support, pursuant to a postmarital agreement, should not be considered a gift, since it represents the present value of a “consumption expense.”

In cases involving pre-divorce agreements which followed the *Faks* and *Wemyss* decisions, the Tax Court accepted the Supreme Court’s position that it is not necessary to find donative intent in order to impose the gift tax. However, the court went on to argue that where it was apparent, in a divorce situation, that the parties had not acted with such intent, there could not be a taxable gift.²⁰

The Treasury then issued E.T. 19.²¹ This Regulation accepted the Tax Court’s position as to support rights, but stated that relinquishment of marital property rights was not to be considered the “adequate and full consideration” necessary to exempt a transfer from the gift tax. The Tax Court repudiated this distinction and refused to follow the ruling.²²

Another analysis of the divorce situation was developed in the 1947 case of *Commissioner v. Converse*.²³ The divorce court had rejected the separation agreement made by the parties, and decreed instead a vastly different lump sum settlement. The Tax Court reiterated its argument that postmarital settlements were arm’s length transactions, and held that the *Converse* transfers were not taxable gifts.²⁴ The Court of Appeals for the Second Circuit affirmed the Tax Court’s decision, but on decidedly different grounds.²⁵ The appellate court pointed out that this settlement had been litigated in the divorce action, and that the court had decreed a settlement differing from that made by the parties.

¹⁹ *I T.C. 1207* (1943).
²³ 163 F. 2d 131 (C.A. 2d, 1947).
²⁴ *Converse v. Comm’r*, 5 T.C. 1014 (1945).
²⁵ The appellate court declared: “We find no occasion to attempt to resolve the dispute in [the Tax Court] as to any distinction between antenuptial and postnuptial agreements....” 163 F. 2d 131, 133 (C.A. 2d, 1947).
It therefore held that the *Converse* transfers were not taxable, since they were effectuated by the court's decree rather than by the agreement of the parties. Payments pursuant to divorce decrees were thus included in the class of "societal expenses."

In late 1950, the problem of imposing the gift tax on transfers pursuant to divorce agreements finally reached the Supreme Court, in the case of *Harris v. Commr.* The taxpayer and her husband had entered into a property settlement, the execution of which was conditioned upon a decree of absolute divorce between the parties in their then pending Nevada action. By the terms of this settlement, each spouse agreed to transfer to the other property of substantial value, and to release completely the property of the other from all claims arising out of their marriage. Although the parties provided that their agreement should be submitted to the divorce court for its approval, they made the further proviso, which the divorce court specifically adopted, that the covenants in their agreement should survive any decree of divorce which might be entered. The value of the property transferred to the husband exceeded that received by the wife by more than $100,000, which amount the Commissioner attempted to tax as a gift.

It is not surprising that the Court split five to four, since each of three divergent lines of precedent was applicable to the *Harris* situation: 1) the deple- tion rationale of the *Fahs* and *Wemyss* cases; 2) the business transaction analogy of the Tax Court; 3) the "societal expense" theory of the *Converse* decision.

The majority opinion accepted the theory of the *Converse* case. It contended that the decree of the divorce court is not a "promise or agreement." Therefore, since the requirement of "adequate and full consideration" is limited to transfers effectuated by a "promise or agreement," the majority held that the *Harris* transfers fell outside the scope of gift tax liability. The Court bolstered this position with an argument like that previously advanced by the Tax Court. It declared that divorce is like the dissolution of a partnership, and since the unscrambling of such business interests would be tax exempt as a transaction "in the ordinary course of business," "[n]o reason is apparent why husband and wife should be under a heavier handicap, absent a statute which brings all marital property settlements under the gift tax." 27

Speaking for the minority, Justice Frankfurter, who had written the *Fahs* and *Wemyss* opinions, declared that the *Harris* settlement was no more a business transaction than the premarital agreements taxed in those cases. He further contended that, since the parties had stipulated that the covenants in their agreement should survive the divorce decree, these transfers were founded on a "promise or agreement" rather than on a court decree. 28 Finally, Justice Frank-

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28 "One of the transfers required by the agreement... was not incorporated into the divorce decree and therefore is presumably enforceable only under the contract. If enforceability under the decree is the criterion, a gift tax is due to the extent this indebtedness is reflected in the amount determined by the Commissioner to represent the value attributable to release of marital rights." Ibid., at 188 n. 3. Consult text, infra, at note 29.
furter argued that the Harris transfers, like those in the Faks and Wemyss cases, depleted the estate of the transferor, and should be subject to the gift tax.

The Harris case by no means solves all the gift tax problems which confront a lawyer when he arranges a divorce settlement. Unanswered is the question of whether it is sufficient merely to incorporate the agreement in the decree. It would appear, from the Tax Court's interpretation of the Harris case in McMurry v. Comm'r, that this in itself will not suffice. Rather, execution of the agreement must be expressly conditioned upon entry of the decree.

In addition, the Harris case gives no indication as to whether any settlement between the parties which is conditioned upon and incorporated in a divorce decree will be exempted from the gift tax. In some jurisdictions the divorce courts are not empowered to compel a settlement of marital property rights between the parties. The Illinois courts, for example, are limited to a decree of support rights; they "may make such order touching the alimony and maintenance of the wife or husband, the care, custody and support of the children, or any of them as, from the circumstances of the parties and the nature of the case, shall be fit, reasonable and just." This does not prevent the court from incorporating in its decree a settlement made by the parties greater than it could legally compel. The Commissioner might well maintain that the difference is a taxable gift. Hooker v. Comm'r offers support to this position. In this case, the divorce court incorporated in its decree, a separation agreement which in part provided for support of the taxpayer's minor children. In holding that the difference between the amount decreed and the value of these support rights was a taxable gift, the Tax Court argued that "[a] divorce court would certainly not prevent a father from making greater provision for his minor children than the minimum required by law or more than the court could require." The Tax

29 The Harris situation involves a number of income tax problems. The decision encourages lump sum divorce settlements, since a husband may transfer property free from the gift tax (upon complying with certain conditions), and his wife may receive it free from the income tax. Gould v. Gould, 245 U.S. 151 (1917).

Should the Commissioner attempt to tax as income to the husband the property which he received in the Harris settlement, the husband might claim (1) that he received it in lieu of curtesy, which is exempt from the income tax, Int. Rev. Code § 22(b)(3), 26 U.S.C.A. § 22(b)(3) (1949), or (2) that even though this transfer was not a gift within the gift tax definition, it was one for purposes of the income tax, and thus not income taxable to him. Ibid.

In Farid-Es-Sultaneh v. Comm'r, 160 F. 2d 812 (C.A. 2d, 1947), it was held that the gift and income taxes were not to be construed together, and therefore, that the definition of gift was not the same for both taxes. However, under this decision, the gift tax definition is broader. In the Fahs case it was held that that transfers pursuant to an antenuptial settlement, in consideration of the relinquishment of marital rights in the transferor's property, was a taxable gift. The Sultaneh opinion declared that such relinquishment, though not "adequate and full consideration" for the gift tax, was "fair consideration" for purposes of the income tax. Thus, in the Harris situation, the husband may have received a taxable gain if the value of his relinquishment was less than the difference between the market value of the property transferred to him, and his basis for the property transferred in return.

31 10 T.C. 385 (1948).
Court further declared that it would not presume that Congress "intended to pass a law which could be circumvented by the clever process of entering into an agreement to make a transfer, supported by an inadequate money consideration, and then making a transfer to satisfy a judgment on the agreement."\(^{34}\)

In essence, this approach requires that a court look behind the decree in order to determine whether a taxable gift has been made. This was the view taken by the Court of Appeals for the Seventh Circuit in *Markwell's Estate v. Comm'r*,\(^{35}\) when it held that a claim founded on inadequate money consideration was not deductible from the gross estate, even though it had been reduced to a judgment.

However, if a court must look behind the decree, further complications arise. First, the incidence of the gift tax would be made largely dependent on local law. This, in turn, would offer spouses additional incentive to seek divorce in the most favorable forum. Second, this approach necessarily involves a determination of what is meant by the "power" of a divorce court. Does the word "power" refer to that which a court may, by statute, formally compel, or does it refer to that which a court can effectively enforce? For example, a divorce court may incorporate in its decree a settlement made by a defaulting defendant, over whom the court has no jurisdiction in personam. In all probability, settling this jurisdictional problem would necessitate a further decision by the Supreme Court.

Another interpretation of the *Harris* decision is possible. In view of complexities involved in transfers incident to divorce, it may well be that the Supreme Court intended to exempt from the gift tax all such transfers settling the rights between the parties, when made under the aegis of a divorce decree. On the other hand, the *Harris* decision, by implicitly rejecting E.T. 19,\(^{36}\) discarded a theory which offers a satisfactory solution to the problem of taxing postmarital property settlements. Following the Treasury regulation would result in a consistent treatment of dower interests, whether transferred previous to marriage, incident to divorce or at death.\(^{37}\)

At any rate, in order to circumvent the problems of the divorce situation, legislative intervention appears necessary. Either the theory of E.T. 19 must be incorporated in the gift tax, or divorce must be treated as an anomalous situation with rules of its own.

\(^{34}\) Ibid.

\(^{35}\) 112 F. 2d 253 (C.A. 7th, 1940).

\(^{36}\) Since the transfer sought to be taxed in the Harris case passed to the husband from the wife, who was under no obligation to support him, the problems involved in the distinction made by the Treasury Regulation between support and marital property rights was not before the Court. See Frankfurter, J., dissenting, 340 U.S. 106, 110 n. 1 (1950).

\(^{37}\) In a divorce situation the wife may refuse to accept the sum offered to her in lieu of dower, and instead elect to receive her statutory share at her husband's death. Since, in the latter situation, this dower interest would be taxed, it is arguable that a transfer of such interests pursuant to a divorce agreement should also be taxed.