Volume 20 | Issue 4 Article 3

January 1966

Tax Planning in Divorce

John L. Bell Jr.

TAX PLANNING IN DIVORCE

by

John L. Bell, Jr.[*]

AS the incidence of divorce in this country continues to grow at an alarming rate, the practicing attorney is experiencing a corresponding increase in the portion of his time spent representing the spouses involved. Traditionally the attorney has been concerned with arbitrating reconciliation, establishing grounds for divorce, and working out the intricacies of child custody, support, and property settlement. Very often little or no consideration is give by the attorneys or the parties to the possible tax ramifications that follow the transfer of property pursuant to the divorce decree. Yet, the tax law applies to transfers of this type as surely as it does to any other transfer of property. As in other transfers of property the problems can be simple or complex, depending upon the facts involved and the planning done prior to the transfer. Once a settlement agreement is reached and the divorce decree entered, tax consequences will flow from their enforcement. It will be discomforting, to say the least, for the client to discover for the first time that he has entered into a taxable transaction. The attorney who recognizes the tax implications involved in divorce, and who plans accordingly during the preliminary stages, will be able to negotiate a settlement which avoids for his client tax pitfalls attendant upon divorce.

I. Pending Divorce

The initial tax problems in counseling a prospective divorcee are encountered while the divorce action is pending. Prior to considering a property settlement, complete information must be gathered concerning assets, liabilities, and recent business dealings of the parties. The attorney must insure that his client faces no tax debt for prior years and that a proper return is filed for the current year. Demand should be made on both parties to produce all financial records, W-2 statements, and tax returns for at least the past two years, or for the period during which they have been separated, if longer than two years. The attorney should verify not only that proper returns have been filed but also that the taxes shown to be due have in fact been paid.

Filing Returns and Liability for Tax The husband and wife, though separated, have a choice of filing either joint or separate re-

* Attorney at Law, Beaumont, Texas; B.B.A., LL.B., University of Texas.

turns for the taxable year prior to the granting of the divorce.[1] If separate returns are filed, neither spouse is entitled to use the so-called "head of household" rate to compute his tax, since the parties are still husband and wife.[2] If a joint return is filed, both spouses become jointly and severally liable for the tax shown by the return and for any deficiencies thereafter assessed.[3] The critical time for determining whether a taxpayer is married or divorced, for tax purposes, is the end of the taxable year.[4] Hence, it will sometimes be wise to delay the divorce until the following January, in order to gain the joint return benefit for the year prior to the divorce.

Community property rules continue to apply until a decree of divorce is entered even though the parties, having filed for divorce, live apart during the taxable year.[5] If separate returns are filed, community income must be split equally regardless of which spouse earned or received the money. Likewise, withholding tax and estimated tax payments attributable to community income must be equally divided between the parties.[6] Even if the husband received almost all of the community income, he is only required to report one-half. If he reports his wife's share as well, he may be entitled to a refund, though a deficiency may be assessed against the wife.[7] The wife is also required to report one-half of the community income, even though she may actually have received only an insignificant amount and has no access to her husband's tax information for purposes of reporting.[8]

A client who is separated from an absent spouse, with no access to that spouse's tax information, and who fails to file a proper income tax return may be subject to the following consequences:

(1) Six per cent interest on the tax deficiency;[9]

---

[1] INT. REV. CODE OF 1954, § 6013(a). The parties are still considered husband and wife for federal income tax purposes until a final decree of divorce is entered. Treas. Reg. § 1.6013-4(a) (1959); Rev. Rul. 57-368, 1957-2 CUM. BULL. 896.

[2] INT. REV. CODE OF 1954, § 1(b)(2), (3)(B); Treas. Reg. § 1.1-2 (1956).

[3] INT. REV. CODE OF 1954, § 6013(d)(3); Treas. Reg. § 1.6013-4(a)(2) (1959).

[4] Treas. Reg. § 1.6013-4(a)(2) (1959).

[5] William E. Grace, 10 T.C. 1 (1948); Kearse v. Kearse, 262 S.W. 561 (Tex. Civ. App. 1924), *aff'd*, 276 S.W. 690 (Tex. Comm. App. 1925). See also Hilley v. Hilley, 342 S.W.2d 565 (Tex. 1961); and TEX. REV. CIV. STAT. ANN. art. 4619 (1948) as to what constitutes community property.

[6] Donald W. Smith, 9 CCH Tax Ct. Mem. 933 (1950). See also Gilmore v. United States, 290 F.2d 942 (Ct. Cl. 1961), *rev'd and remanded on another issue*, 372 U.S. 39 (1963).

[7] Ella E. Harrold, 22 T.C. 625 (1954), *rev'd on other grounds*, 232 F.2d 527 (9th Cir. 1956). The husband's refund cannot, without his consent, be offset against the wife's deficiencies. Gilmore v. United States, *supra* note 6.

[8] Christine K. Hill, 32 T.C. 254 (1959).

[9] INT. REV. CODE OF 1954, § 6601(a).

(2) Six per cent penalty for failure to file a report of estimated tax or for underpayment of the estimated tax;[10]
(3) Five per cent per month delinquency penalty (not to exceed twenty-five per cent) if no return is filed;[11]
(4) Five per cent negligence penalty;[12]
(5) Fifty per cent civil fraud penalty (which, if applicable, eliminates the possibility of 3 and 4 above); and[13]
(6) possible criminal penalties.[14]

In order to avoid these consequences the client should file the best possible return, showing the name of the absent spouse, his or her last known address, and such information as the taxpayer can furnish pertinent to the allocation of community income. The filing of a return will initiate the running of the three-year limitation period, unless the taxpayer's income is understated twenty-five per cent or more, in which case the limitation period is six years.[15] However, failure to file a return or the presence of fraud will indefinitely postpone the commencement of the limitation period.[16]

Where the other spouse is readily available to exchange tax information, a separation agreement can be used most effectively. Parties may agree to file a joint return for the taxable period prior to the granting of the divorce and to provide for apportionment of the tax. Such an agreement should cover the treatment of particular items of income, deduction, and exemption, such as capital gains and losses, alimony pendente lite, medical expenses for the children, and personal exemptions. The agreement should require each spouse to contribute his or her share of the tax for estimated tax and final return purposes, and to cooperate in the prosecution and collection of any refund claims.

Provisions in a separation agreement or divorce decree regarding the payment of tax are not binding on the Internal Revenue Service,[17] and the community property of the parties remains liable for the tax debt resulting from community income.[18] Because the filing of a joint return causes a client to be jointly and severally liable for the tax

[10] INT. REV. CODE OF 1954, § 6654.
[11] INT. REV. CODE OF 1954, § 6651(a).
[12] INT. REV. CODE OF 1954, § 6653(a).
[13] INT. REV. CODE OF 1954, § 6653(b), (d).
[14] INT. REV. CODE OF 1954, § 7203.
[15] INT. REV. CODE OF 1954, § 6501(a), (e).
[16] INT. REV. CODE OF 1954, § 6501(c)(1), (3).
[17] Muriel Dodge Neeman, 13 T.C. 397 (1949); Frank R. Casey, 12 T.C. 224 (1949); John H. Humbert, 24 B.T.A. 828 (1931). See also McMurrey v. Bryant, 281 S.W.2d 198 (Tex. Civ. App. 1955), discussing the enforceability of such agreements as between the parties.
[18] Poe v. Seaborn, 282 U.S. 101 (1930). TEX. REV. CIV. STAT. ANN. art. 4620 (1948). See also Comment, 16 Sw. L.J. 643 (1962).

debt, in many instances the separate return will be preferable. Regardless of the type of return filed, counsel should make every effort to protect his client from contingent liability for tax claims.[19]

Exemption for Children The exemption for children of separated parents involved in a divorce action is a sensitive and often volatile issue where separate returns are filed. The spouse contributing more than fifty per cent to a child's support is entitled to claim the exemption.[20] If all support comes from community property funds, each spouse is deemed to have contributed exactly fifty per cent of the support of the child.[21] However, the Service will not allow a single exemption to be divided between the parties, although it will allow either spouse to take the entire exemption.[22] Where more than one child is involved and all support comes from community property funds, the parties may divide among themselves the individual exemptions on separate returns.[23] Here again the separation agreement will be useful in resolving potential problems.

Alimony Pendente Lite Texas does not recognize permanent alimony;[24] however, a court may award alimony pendente lite for the support of the wife pending divorce.[25] The payment of the alimony pendente lite out of community property funds ordinarily will not alter the tax picture.[26] Nevertheless, it is possible to gain traditional alimony treatment for these payments under sections 71 and 215 of the code to the extent that such payments exceed the wife's share of community property income for the year in which she receives them,[27] or in the event that such payments are made out of the husband's separate income.[28] Should either of these situations exist, the payments will be deductible by the husband and taxable to the wife where separate returns are filed.

II. Divorce and Settlement

Property Settlement The effect of income tax on a property settlement agreement is overlooked or ignored in many divorce cases.

---

[19] One possible solution would be to require an escrow of the estimated tax liability to assure payment of the tax.

[20] INT. REV. CODE OF 1954, §§ 151(e), 152(a).

[21] I.T. 1275, I-1 CUM. BULL. 201 (1922).

[22] *Ibid.*

[23] Int. Rev. Ser. Pub. No. 17, at 146 (1965).

[24] McElreath v. McElreath, 345 S.W.2d 722, 747 (Tex. 1961); McBride v. McBride, 256 S.W.2d 250 (Tex. Civ. App. 1953).

[25] TEX. REV. CIV. STAT. ANN. art. 4637 (1948).

[26] Wren, *Tax Problems Incident to Divorce and Property Settlement*, 49 CALIF. L. REV. 665, 678 (1961).

[27] Rev. Rul. 62-115, 1962-2 CUM. BULL. 23.

[28] See note 26 *supra*.

However, the total economic impact of the agreement cannot be properly evaluated unless consideration is given to the tax consequences resulting therefrom. The amount of property received by a spouse will be reduced by any income tax which that spouse is required to pay on gain resulting from the property division itself or from subsequent sale of items received in the settlement. At present there is much controversy and difference of opinion among tax practitioners as to the income tax consequences resulting from a division of community property. It is often difficult to ascertain whether a property settlement agreement is a totally nontaxable division or a totally taxable division, or whether it falls somewhere in between. Despite this uncertainty, the divorce counsel must attempt to advise his client of the probable tax consequences of any proposed settlement agreement.

1. Nontaxable

Equal Division. An equal division of community property is treated as a partition, rather than a sale or exchange, and is not subject to income tax.[29] Such a nontaxable, equal division of community property may be accomplished in either of two ways:

(1) by actually partitioning each item of property so that the spouses can then become tenants in common; or,

(2) by assigning specific items of property to each spouse so that the total fair market value of all community property is divided as equally as possible.

Rarely, if ever, is a partition of each item of property practical or equitable, unless the community assets consist entirely of cash and marketable securities. In a nontaxable division of the second type seemingly the basis of a specific item of property in the hands of a spouse after the divorce will be considered equal to its basis to the community.[30] Thus, an equal division of community property based on market value alone, though nontaxable, may not be advisable inasmuch as a subsequent disposition of the assets may involve a tax consequence that destroys the equality of the division. The basis of the property as well as its fair market value must be considered in arriving at a fair division of the community estate.

Business and Debt Settlement. Payments made by a husband to his

[29] Clifford H. Wren, 34 P-H TAX CT. REP. & MEM. DEC. 321 (1965); Osceola Heard Davenport, 12 CCH Tax Ct. Mem. 856 (1953); Ann Y. Oliver, 8 CCH Tax Ct. Mem. 403 (1949); C. C. Rouse, 6 T.C. 908 (1946), *aff'd*, 159 F.2d 706 (5th Cir. 1947); Frances R. Walz, 32 B.T.A. 718 (1935).

[30] Swanson v. Wiseman, 7 Am. Fed. Tax R.2d 824 (W.D. Okla. 1961); Ann Y. Oliver, 8 CCH Tax Ct. Mem. 403 (1949).

former wife in discharge of a business obligation or in repayment of a loan may not be deducted by him and are not includable in the wife's income.[31] Likewise, a payment made in discharge of the wife's legal or equitable separate property rights, where there has been commingling, is an accounting to the wife of that which is already hers, and therefore is not taxable.[32] The rules of tracing and reimbursement apply in such situations. Payments of this nature over and above an equal division of the community property will not affect the taxability of the division.

Nontaxable Exchange. The deferral sections of the code, if applicable, may be used to avoid the recognition of gain or loss even though the property settlement otherwise would be a taxable division. Section 1031 of the Internal Revenue Code provides for the nonrecognition of gain or loss where property held for use in a trade or business, or for investment, is exchanged for property of a like kind.[33] In this type of exchange, the parties acquire a substituted basis in the asset received rather than the community basis of the asset.[34] Care must be taken in drafting a property settlement agreement where such an exchange is made to assure that the transaction will qualify.

2. *Taxable*

Unequal Division. When a property settlement agreement ceases to be an equal partition or division of the community estate and begins to take on the characteristics of a sale or exchange of property between the parties, the Service takes the position that a taxable transaction has occurred.[35] The intent of the parties and the nature of the property so passing are important factors in determining whether the property settlement is taxable.[36] Major problems center around the following types of property settlements:

(1) an unequal division of community property where the spouse

[31] Thorsness v. United States, 260 F.2d 341 (7th Cir. 1958); Rush v. United States, 4 Am. Fed. Tax R.2d 5853 (N.D. Ala. 1959). To qualify as alimony, the payments must be made because of the family or marital relationship in recognition of the general obligation of support. INT. REV. CODE OF 1954, § 71(a); Treas. Reg. § 1.71-1(b)(4) (1957).

[32] *Ibid.* See also Norris v. Vaughn, 152 Tex. 491, 260 S.W.2d 676 (1953), and Dakan v. Dakan, 125 Tex. 305, 83 S.W.2d 620 (1935), discussing the right of reimbursement between the separate and community estates upon dissolution.

[33] See also INT. REV. CODE OF 1954, § 1034 (sale or exchange of principal residence), § 1035 (exchange of insurance policies), § 1036 (exchanges of stock for stock of same corporation).

[34] INT. REV. CODE OF 1954, § 1031(d). See Treas. Reg. § 1.1031(d)-1 (1960).

[35] Long v. Commissioner, 173 F.2d 471 (5th Cir. 1949), *cert. denied*, 338 U.S. 818 (1949); Johnson v. United States, 135 F.2d 125 (9th Cir. 1943); C. C. Rouse, 6 T.C. 908 (1946), *aff'd*, 159 F.2d 706 (5th Cir. 1947).

[36] Osceola Heard Davenport, 12 CCH TAX CT. REP. 856 (1953).

receiving the larger share uses "outside" funds to equalize with the spouse receiving the lesser share; and

(2) a truly unequal division of community property involving no attempt to equalize the division from other sources.

Where the agreement calls for a transfer of the husband's separate property to the wife, or where the husband makes a payment to her and uses "outside" funds (borrowed funds or promissory notes), the transaction assumes the appearance of a sale rather than a partition.[37] Where such a payment is made or an obligation is incurred to compensate the spouse receiving the smaller share of the community property, a taxable transaction has occurred.[38]

Taxable property settlements most frequently result from situations where one asset, unsuitable for physical partition, comprises the majority of the community estate. Frequently such asset is a business enterprise, and the parties will enter into negotiations which take on aspects of a bargain and sale. If the husband elects to purchase a portion of the wife's share of the community property at a figure greater than its basis, the wife will be taxed on her gain, which is measured by taking one-half of the difference between the community basis of the property transferred by her and the fair market value of the property she receives in exchange.[39] Whether the gain will be treated as ordinary income or capital gain will depend on the nature of the property which she transfers. The husband's new basis in that interest purchased from his wife will be its purchase price, but his one-half of the community property will retain the community basis.[40]

There remains largely unanswered the question of the taxability of a simple unequal division of community property between the spouses. Property settlements in divorce are generally reached only after considerable arm's-length bargaining in which both parties are represented by counsel. Where an unequal division is caused by a difference of opinion concerning valuations, where one party is anxious to obtain a divorce, at any cost, or where the unequal division is intended to compensate an offended spouse, elements of a true bargain and sale transaction are absent. In addition, such agreements are usually approved by the courts as being fair and equitable and such dec-

[37] See note 35 *supra*.

[38] Long v. Commissioner, 173 F.2d 471 (5th Cir. 1949), *cert. denied*, 338 U.S. 818 (1949); Johnson v. United States, 135 F.2d 125 (9th Cir. 1943); Jessie Lee Edwards, 22 T.C. 65 (1954); Gordon R. Edwards, 13 CCH Tax Ct. Mem. 381 (1954); C. C. Rouse, 6 T.C. 908 (1946), *aff'd*, 159 F.2d 706 (5th Cir. 1947). Where an obligation is incurred represented by a promissory note, the imputed interest rules of INT. REV. CODE OF 1954, § 483 may apply if the stated interest is less than 4%.

[39] Long v. Commissioner, 173 F.2d 471 (5th Cir. 1949), *cert. denied*, 338 U.S. 818 (1949); Rouse v. Commissioner, 159 F.2d 706 (5th Cir. 1947).

[40] *Ibid.*

rees are generally binding on third parties. Likewise, elements of bargain and sale are absent where the judge, using the broad discretion given him under Texas divorce law, awards more than one-half of the community property to one of the spouses.[41] Thus, in a truly unequal settlement where no attempt is made at equalization, the partition should be tax free, even though one of the spouses may have gotten the better of the bargain.

Where a person has become obligated to pay a sum of money to another and then transfers appreciated property in satisfaction of such obligation, a sale occurs and capital gain is realized.[42] Likewise, the United States Supreme Court held in *United States v. Davis*, a case involving a taxpayer residing in a common law state, that the transfer of appreciated property in satisfaction of inchoate rights of the wife, including the support obligation, was a taxable transaction.[43] In such transfers, the amount of the gain realized by the husband-transferor is the same as it would have been had the property been sold for its fair market value. The wife, in such an instance, takes as her basis in the property received the fair market value of the property at the time of the transfer. In the absence of evidence to the contrary, the value of the marital rights surrendered is presumed to be equal to the value of the property transferred.[44]

The applicability of the rules of the *Davis* case in community property divorces is somewhat doubtful. However, some practitioners have warned that the Service may try to apply *Davis* to situations involving an unequal division of community property. In Texas, the legal duty of the husband to support his wife ceases upon the granting of a final divorce, and a court has no power to enter a decree requiring permanent alimony for her further support.[45] The marital property rights of a wife in our community property jurisdiction are vested rights, as opposed to the inchoate rights of a wife in a common law jurisdiction. Thus, the Texas property settlement is merely a division between the spouses of their vested property rights, which should preclude the applicability of the *Davis* rules.

Many practitioners have found fault with the present general rules concerning the taxability of a division of community property upon divorce and the post-divorce basis of the property in the hands of the spouses. It has been suggested that the rules of sub-chapter K, dealing with the dissolution of partnerships and requiring realloca-

[41] TEX. REV. CIV. STAT. ANN. art. 4638 (1948).

[42] Kenan v. Commissioner, 114 F.2d 217 (2d Cir. 1940).

[43] 370 U.S. 65 (1962).

[44] *Ibid.* This repudiates the earlier Sixth Circuit opinion in Commissioner v. Marshman, 279 F.2d 27 (6th Cir. 1960), *cert. denied*, 364 U.S. 918 (1960).

[45] See note 24 *supra*.

tion of basis, should apply upon the transfer of property pursuant to a divorce decree.[46] There also has been advocated the adoption of substituted basis rules similar to those used in section 1031 transfers.[47] Because of growing interest in this area the Section of Taxation of the American Bar Association in 1964 formed a Committee on Domestic Relations Tax Problems. After two years of study, this committee has recommended that legislation be enacted amending the Internal Revenue Code to provide that transfers of property pursuant to a divorce decree or property settlement agreement should not give rise to the recognition of income or gain, or to a change in the basis of the transferred property. The proposals of the committee are designed to overrule the *Davis* case and to make clear the committee's belief that neither marriage nor divorce should be a taxable event.[48]

Until Congress sees fit to adopt a coherent body of rules dealing with the problems involved in transfers of property between spouses pursuant to a divorce, it is incumbent upon counsel for each spouse to make a careful examination and analysis of the code, regulations, and cases in order to determine the tax consequences to his client emanating from a proposed property settlement.

Losses Disallowed. Although gain is recognized upon a taxable transfer between spouses, losses are not. Section 165(c) of the code precludes recognition of a loss resulting from disposition of property held by the transferor for his own personal use.[49] Much of the property involved in a marital settlement agreement, such as household furnishings, the family automobile, and the residence, is of such a nature. An even greater barrier is section 267(a), which disallows losses from sales or exchanges of property between members of a family.[50] The purpose of this section is to prevent an artificial loss recognition wherein property is transferred but the economic benefit remains within the family unit. It could be argued that transfers resulting from a divorce fall outside the ambit of this policy and that section 267 should not apply. However, it is advisable when dealing with depreciated property in a divorce settlement to arrange for the transfer of such property to occur subsequent to the granting of the final divorce decree, *i.e.*, after the parties have ceased to be husband

[46] Brickner, *Basis: Considerations in Planning a Nontaxable Division of Community Property*, 42 TAXES 560 (1964); Jackson, *Community Property and Federal Taxes*, 12 Sw. L.J. 1, 32 (1958).

[47] Brickner, *supra* note 46. See also Burges, *Property Settlement Incident to Divorce*, 43 TAXES 80 (1965).

[48] 19 A.B.A., BULL. OF THE SECTION ON TAXATION 63 (1966).

[49] See David R. Pulliam, 39 T.C. 883 (1963).

[50] See McWilliams v. Commissioner, 331 U.S. 694 (1947).

and wife. Another method of avoiding the applicability of section 267 involves the sale of the depreciated property to an outsider and use of the proceeds of such a sale in settling property rights between the spouses.

Depreciable Property. Under section 1239 a gain recognized upon a sale or exchange between a husband and wife on property subject to the depreciation allowance provided in section 167 is ordinary income to the transferor-spouse.[51] Therefore, where property of this nature is involved, the settlement agreement should be drafted in such a manner that the sale or exchange of this property occurs after the final decree is entered, thus qualifying the transaction for capital gain treatment.

3. *Special Problems*

Accounts Receivable. If the spouses are cash-basis taxpayers and there are accounts receivable due to the community at the time of the divorce, each spouse has a community interest in the receivables upon collection.[52] If the property division is taxable and the receivables are transferred to the husband, the wife is said to have sold or exchanged her community interest and thus realizes ordinary income equal to one-half of the value of the receivables at the time of the division.[53] In such case the husband obtains a new basis for the wife's community interest in the receivables equal to one-half of the value of the receivables at the time of the division.[54] On the other hand, if the division is nontaxable, the wife has made an assignment of income and one-half of the amounts collected by the husband will be taxed to the wife in the year of collection.[55] Thus, where receivables are involved, it is possible that tax consequences may follow a divorce even though the property division is an equal, nontaxable division.

For ease in collecting, setting aside the receivables to one of the spouses will usually prove to be the more desirable arrangement, rather than dividing the proceeds equally when received after the divorce. If the receivables are set aside to the husband, the wife should try to persuade the husband to agree to pay the tax resulting to the wife on her one-half of the receivables.

Pension, Profit-Sharing, and Stock Bonus Plans. When vested interests in pension, profit-sharing, or stock bonus plans are involved

---

[51] See also Treas. Reg. § 1.1239-1 (1966).

[52] Poe v. Seaborn, 282 U.S. 101 (1930); Johnson v. United States, 135 F.2d 125 (9th Cir. 1943).

[53] Helvering v. Smith, 90 F.2d 590 (2d Cir. 1937); Bessie Laskey, 22 T.C. 13 (1954).

[54] See cases cited note 38 *supra*.

[55] Helvering v. Eubank, 311 U.S. 122 (1940).

in a divorce settlement, the situation is analogous to a transfer of accounts receivable. In *Herring v. Blakely*,[56] the Texas Supreme Court held that vested interests in employee profit-sharing and group endowment plans are considered to be property under Texas law and thus comprise part of the community estate at the time of the divorce. If the whole of the proceeds from the plan are set aside to the husband and the division is taxable, the wife is said to have sold or exchanged her community interest in the plan and as a result has realized ordinary income in an amount equal to one-half of the value of the plan at the time of the division.[57] In such case the husband obtains a new basis for the wife's community interest equal to that amount. In the case of a nontaxable division, the wife's transfer of her community interest is an assignment of income and one-half of the amounts credited to the plan at the time of the division will be taxable to the wife in the year the amounts are distributed to the husband.[58] It usually will be advisable to divide this account equally as between the spouses, thereby splitting the income, instead of setting aside the entire account to one spouse. To accomplish this the account could be put in trust so that when withdrawals are made the wife will be paid one-half of all amounts credited to the account at the time of the divorce. Under such an arrangement the proceeds will be taxed to each spouse either as ordinary income[59] or as capital gain,[60] depending upon the manner in which such proceeds are received.[61]

Life Insurance. The family often owns insurance policies on the life of the husband, for which premiums have been paid from community funds. If such policies are set aside to the wife in a taxable division, the husband has sold or exchanged his community interest in the policies and will realize gain equal to one-half of the difference between the cash surrender value and the total premiums paid at the time of the division, if any.[62] The wife would obtain a new basis for the husband's interest equal to one-half of the cash surrender value at the time of the transfer.[63] On the other hand, in a nontaxable division there would be no gain to the husband and the basis of the

[56] 385 S.W.2d 843 (Tex. 1965).

[57] Commissioner v. P. G. Lake, Inc., 356 U.S. 260 (1958). See also note 53 *supra.*

[58] See note 55 *supra.*

[59] INT. REV. CODE OF 1954, §§ 402(a)(1), 72; Treas. Reg. § 1.402(a)-1(a)(1) (1956).

[60] INT. REV. CODE OF 1954, § 402(a)(2); Treas. Reg. § 1.402(a)-1(a)(6) (1956).

[61] See Hughes, *Community-Property Aspects of Profit-Sharing and Pension Plans in Texas —Recent Developments and Proposed Guidelines for the Future*, 44 TEXAS L. REV. 860 (1966).

[62] INT. REV. CODE OF 1954, § 72(e)(1)(B).

[63] INT. REV. CODE OF 1954, § 72(g)(1).

policy in the hands of the wife would be the amount of the total premiums paid.[64]

An even greater danger than the possible taxability of the transfer of insurance policies at the time of divorce is the possible taxability of proceeds at the death of the insured. Where life insurance has been transferred for a valuable consideration, as in a taxable division of community property, the proceeds paid by reason of the death of the insured in excess of the payee's basis in the policy are subject to tax as ordinary income.[65] A different result would occur, however, if the property division were nontaxable—or if the policy were allotted to the insured[66]—inasmuch as there would be no sale or exchange of the policy. In such cases the general rule exempting insurance paid by reason of the death of the insured applies.[67]

The safest practice is to assign each policy to the spouse on whose life the insurance is carried and adjust with other property the community interest in the cash surrender values between the parties. If a policy must be partitioned, it should be surrendered to the insurance company and exchanged for two equal policies, one to be set aside to each spouse as his or her separate property. No gain will result to either spouse in this situation and the "transfer for value" rules will not be applicable to make the proceeds of the policy taxable.

4. *Planning the Property Settlement*

In planning a property settlement agreement the attorney will have to gather full information concerning the fair market value and tax basis of each item of property. In attempting a nontaxable, equal division of the community property, an attorney must make certain that a division is equal as to valuation and to basis. Care should be taken to insure that the settlement agreement appears to be a simple division of community property rather than a type of purchase and sale. Further, the agreement should state that both parties agree that it is a fair and equitable division. This should be reinforced by a court's decree approving the agreement and stating that the settlement is fair, just, and equitable.

If the nature of the assets or the disposition of the parties is such that an equal division of the community property is not possible, it will behoove the attorney to exercise great care in planning and draft-

[64] INT. REV. CODE OF 1954, § 72(e)(1)(B). See Browerman, *A Practical Approach to Tax Problems in Divorce and Property Settlement Agreements*, So. CALIF. TAX. INST. 753, 773 (1960).

[65] INT. REV. CODE OF 1954, § 101(a)(2); Treas. Reg. § 1.101-1(b)(1) (1957).

[66] INT. REV. CODE OF 1954, § 101(a)(2)(B); Treas. Reg. § 1.101-1(b)(2) (1957).

[67] INT. REV. CODE OF 1954, § 101(a)(1).

ing the property settlement agreement in order to minimize the tax consequence to his client. In such case, the property settlement agreement should be divided into taxable and nontaxable segments. The nontaxable segment should take the form of an in-kind exchange, wherein the community property is equally divided to the extent permitted. If possible, appreciated assets should be included in this segment of the agreement to avoid the possibility of tax on the appreciation at the time of the divorce. Such items should be transferred to that spouse most likely to be in the lower tax bracket following divorce, inasmuch as such spouse can best afford to pay tax on the appreciation at a subsequent disposition of the asset.

If excess cash is to be paid to the wife, the agreement should clearly state that such payment represents her one-half interest in specific property or properties being transferred to the husband. Preferably, these properties should have fair market values approximately equal to their respective bases. Thus, even though this segment of the division is taxable, no gain or loss will result to either spouse. Depreciated property should be sold prior to the division and the proceeds divided between the spouses or retained for disposition at a time unrelated to the divorce, in order that maximum tax benefit may be realized from the loss. Likewise, property subject to the depreciation allowance should not be transferred between the spouses until after the final decree has been entered. Attention should also be given to the tax treatment afforded accounts receivable, pension, profit-sharing and stock bonus plans, and life insurance transferred pursuant to a property settlement.

The attorney who becomes fully informed as to the fair market value and basis of each asset, the relative strength and weakness of his client's bargaining position, and the rules of taxation applicable to the division of property pursuant to a divorce is in position to negotiate a property settlement favorable for his client, not only at the time of the divorce but also after it has been through the taxing process.

Child Support Where a divorce is granted and the parties have children under eighteen years of age, it is the duty of the court to make such orders regarding support as are appropriate to the best interests of the children.[68] Where a decree or agreement specifically designates that the husband make periodic payments for the support of a minor child, such payments may not be deducted by the husband and are not taxable to the mother or child.[69] However, the de-

[68] TEX. REV. CIV. STAT. ANN. art. 4639a (1961).
[69] INT. REV. CODE OF 1954, § 71(b); Treas. Reg. § 1.71-1(e) (1957).

pendency exemption will still be available to the husband if he provides more than one-half of the support for such child.[70] If the husband makes payments for the support of an adult child which he has no legal obligation to support, or if support payments are made beyond a child's reasonable needs, the husband exceeds his legal obligation to support the child. Such payments, therefore, constitute taxable gifts.[71]

The net economic burden upon the husband will be reduced if he can obtain an income tax deduction for support payments made in behalf of his children. On the other hand, the net amount available to the wife to be used for support of her children will be reduced should she be required to report such sums as taxable income. Nevertheless, an overall tax saving to the original family unit can be effected by obtaining just such a result, if after divorce the husband is in a higher tax bracket than the wife. This result can be obtained when the payments are for the support of the wife as well as for the children, so long as the agreement or decree does not fix the amount of child support, and so long as the payment qualifies under the alimony rules. The United States Supreme Court in *Commissioner v. Lester*[72] ruled that an agreement or decree does not "fix" the amount of the child support unless it specifies a sum certain or a fixed percentage of the payment as being for the support of the children. Such an agreement or decree granting support payments for the wife and children may even provide for reduction in payments to the wife upon a child's death, his marriage, or his reaching majority, without being deemed to have fixed the amount due as child support.[73] To assure the desired tax consequence, the agreement should be drafted in such a manner as to give the wife absolute control and ownership of the payments, so that she supports the children from her own funds and not from any particular portion of the funds received from the husband.

The parties may share this tax saving by increasing the support payments in an amount which will give the wife a larger sum after taxes than the husband otherwise would have been willing to pay. In such an arrangement, the husband will forego any possibility of obtaining the dependency exemptions for the children, but he will

---

[70] See note 20 *supra.*

[71] Rosenthal v. Commissioner, 205 F.2d 505 (2d Cir. 1953). See generally Beck & Ekman, *Where Does Support End and Taxable Gift Begin?*, N.Y.U. 23D INST. ON FED. TAX 1181 (1965).

[72] 366 U.S. 299 (1961).

[73] *Ibid.*

usually find that the deduction of the support payments more than offsets any loss.

Alimony Payments made to a divorced or legally separated wife pursuant to a written agreement executed incident to the divorce or separation, which constitute periodic alimony payments under tax law, are deductible by the husband[74] and taxable to the wife.[75] Under Texas law, however, a divorce court has no jurisdiction to provide permanent alimony.[76] The court instead is empowered to make such division of the property as to it seems just and equitable including, if the circumstances warrant, awarding more than one-half of the property to one of the spouses.[77] The court may even require one spouse to turn over his separate personal property to the other in a particular case.[78] It is in this manner that Texas law provides for support of the wife following divorce.[79]

Despite the prohibition under local law, many couples still seek, by way of permanent alimony, to achieve some of the income-splitting benefits they previously enjoyed through the filing of a joint return. Such an arrangement may be attractive for a wife, if the husband is otherwise financially reliable, in that the periodic payments provide financial security for her. The husband might likewise agree to an alimony arrangement in order to conserve his capital or to secure his business. The arrangement may even allow him to pay a larger total sum to the wife because of the resulting tax saving.

If the parties desire to use the alimony arrangement, it is possible to draft a provision that will include periodic payments for the wife which qualify under the tax law and yet do not represent prohibited alimony under the state law. This results from the code's being phrased in terms of periodic payments made "because of the marital or family relationship," which is broader than, but still encompasses, alimony and support payments. However, even if the provision in an

[74] INT. REV. CODE OF 1954, § 215. Should a husband, obligated to make alimony payments to his first wife, remarry and make such payments from community funds belonging to himself and the second wife, such payments may be deducted by the husband and second wife for income tax purposes. Robert A. Sharon, 10 T.C. 1177 (1948).

[75] INT. REV. CODE OF 1954, § 71. It is beyond the scope of this Article to discuss the body of law governing the determination payments qualifying as alimony under the tax law. See however Wren, *Tax Problems Incident to Divorce and Property Settlement*, 49 CALIF. L. REV. 665 (1961); and RUDICK, TAX CONSEQUENCES OF MARRIAGE AND ITS TERMINATION (Joint Committee on Continuing Legal Education of the ALI and ABA, 1964).

[76] See note 24 *supra*.

[77] TEX. REV. CIV. STAT. ANN. art. 4638 (1948).

[78] A court cannot compel a spouse to convey his or her separate real estate to the other spouse, but can award the community real estate to one of the spouses. TEX. REV. CIV. STAT. ANN. art. 4638; Hailey v. Hailey, 331 S.W.2d 299 (Tex. 1960); Hedtke v. Hedtke, 112 Tex. 404, 248 S.W. 21 (1923); Grant v. Grant, 351 S.W.2d 897 (Tex. Civ. App. 1961).

[79] Pickett v. Pickett, 401 S.W.2d 846 (Tex. Civ. App. 1966).

agreement or decree requiring periodic payments for the support of the wife is completely unenforceable under controlling state law, alimony treatment is still available under tax law if the payments are in fact made and qualify in all other respects.[80] The agreement should clearly demonstrate the intent of the parties to obtain for themselves the benefits of the alimony provisions of the code, without actually using the word "alimony." This can be done by specifying that the payments shall be made for the wife's support and shall be in addition to her portion of the community property, not in lieu thereof. These support payments and the property settlement provisions should be stated separately to forestall the commissioner's argument that the payments represent installments on the purchase price paid by the husband for a portion of the wife's share of the community property. Finally, the draftsman must carefully check the provisions of the code as well as the language of pertinent cases when preparing an agreement of this sort.[81]

If an alimony arrangement is employed, a trust or annuity plan can provide security for the wife. However, if the husband establishes a trust from which to make periodic payments to his wife he loses the deduction for the payments made,[82] and the wife still must include such trust payments in her gross income.[83] Likewise, when an annuity is used to discharge an alimony obligation the husband receives no deduction for the annuity payment.[84] The income of the trust or the annuity is not included in the husband's gross income; however, this factor is more than offset by his loss of deduction for the payments made, to the extent that they are made out of principal. On the other hand, the wife must include in her income the full amount of the payment received, whether paid out of principal or income.[85] Thus, the

[80] Taylor v. Campbell, 335 F.2d 841 (5th Cir. 1964).

[81] See Campbell v. Lake, 220 F.2d 341 (5th Cir. 1955); Greer v. Scofield, 89 F. Supp. 75 (W.D. Tex. 1950), *aff'd*, 185 F.2d 551 (5th Cir. 1950); Thomas E. Hogg, 13 T.C. 361 (1949); McElreath v. McElreath, 345 S.W.2d 722 (Tex. 1961); McBean v. McBean, 371 S.W.2d 930 (Tex. Civ. App. 1963); Lodge v. Lodge, 368 S.W.2d 40 (Tex. Civ. App. 1963); Bunker v. Bunker, 336 S.W.2d 751 (Tex. Civ. App. 1960); Graham v. Graham, 331 S.W.2d 499 (Tex. Civ. App. 1959); Wilmeth v. Wilmeth, 311 S.W.2d 292 (Tex. Civ. App. 1958); Wilson v. Woolf, 274 S.W.2d 154 (Tex. Civ. App. 1954); McBride v. McBride, 256 S.W.2d 250 (Tex. Civ. App. 1953).

[82] Treas. Reg. § 1.215-1(b) (1957).

[83] INT. REV. CODE OF 1954, § 71(a). Section 682(a) applies to trusts created before the divorce or separation and yet not in contemplation of such event.

[84] See note 82 *supra*.

[85] Treas. Reg. § 1.71-1(c)(2) (1957). If alimony payments are made to the wife from a § 682 trust, they need be included in her income only to the extent that such amounts are from the income of the trust for its taxable year. Treas. Reg. § 1.682(a)-1(a)(2) (1957).

use of a trust or annuity as a device for making alimony payments is not ordinarily desirable from the tax standpoint.[86]

If a straight alimony arrangement is used, the husband can avoid the above tax problems by making the payments out of current income; however, this method provides no assurance to the wife that the payments will be made. An alternative is an escrow arrangement, which can provide the same security without the corresponding tax disadvantages inherent in a trust or annuity. The husband may place securities in an escrow account, pursuant to an agreement, and receive the income therefrom so long as he is not in default in his alimony payments. At the end of the term for which alimony is to be paid, the escrow agreement terminates and the securities are returned to the husband. The agreement could provide that the husband be permitted to withdraw securities annually from the escrow account in an amount equal to the periodic payments he has made for that year. The husband may take his deduction for alimony so long as he makes the required payments, and escrow funds can be available for the wife in case of default.

The Gift and Estate Tax Prior to the enactment of the Internal Revenue Code of 1954 the practitioner sometimes encountered gift tax problems in effecting certain types of property transfers incident to a divorce. These problems centered around whether such transfers were made for a valuable consideration in money or money's worth, and the corpus of case law dealing with the subject provided no clear guidelines. However, in 1954 the promulgation of section 2516 made clear that the gift tax was not intended to apply to transfers of this type. It is now undisputed that when a husband and wife enter into a written agreement setting their marital and property rights and a divorce occurs within two years thereafter, whether or not such agreement has been approved by the divorce decree, any transfers made between the spouses pursuant to such agreement, or made for the reasonable support of minor children, are deemed to be made for adequate consideration in money or money's worth, and are not taxable gifts.[87]

There is no comparable provision in the estate tax sections of the code. It has been held that an obligation incurred under a marital

[86] Frequently, the husband continues to make the premium payments on an insurance policy on his life for the wife's benefit. Such payments may qualify as alimony, otherwise meeting the requirements of the code, if all incidents of ownership in the policies are irrevocably assigned to the wife and she is made the sole beneficiary. I.T. 4001, 1950-1 CUM. BULL. 27. However, as previously pointed out, serious income tax consequences can arise from the assignment of an insurance policy in a taxable divorce settlement.

[87] INT. REV. CODE OF 1954, § 2516.

settlement agreement—though not approved by the divorce decree—was not incurred for a valuable consideration and thus would not be deductible for estate tax purposes under section 2053 of the code.[88] However, an argument was not made in these cases that the obligation was incurred in purchase of the wife's share of community property in a taxable transaction. In Texas the wife's property rights are vested rights, and an obligation incurred by the husband in a property settlement through purchase of these rights presumably should be incurred for a valuable consideration, thereby permitting the husband a deduction for purposes of estate tax. However, all doubt upon the subject can be resolved if the divorce decree approves the settlement agreement.[89] Further, where such result is intended, the agreement should specifically state that the obligation is to be binding on the husband's estate.

Where claim is made against the husband's estate for alimony payments (and the agreement has been approved by the divorce decree to insure deductibility of the claim), the husband's personal representative may deduct the present value of future payments as a claim on the estate tax return.[90] Also, if such payments are made out of income of the estate, he may deduct the payment when made on the income tax return of the estate.[91] A recent Texas case has held that the decedent husband's estate can be held liable on a theory of contractual debt for amounts accruing after his death by virtue of a written agreement for child support payments which has been confirmed and adopted by the divorce decree.[92] Thus, the personal representative also may deduct the present value of future child support payments as a claim against the estate.[93]

It is unlikely that any property transferred pursuant to a settlement agreement would be included in the gross estate of the transferor as having been made in contemplation of death, inasmuch as divorce may be granted a lifetime motive.[94]

III. Post-Divorce

Filing Returns and Liability for Tax The problems encountered in

[88] Rogan v. Riggle, 128 F.2d 118 (9th Cir. 1942); Estate of Chester H. Bowers, 23 T.C. 911 (1955).

[89] Rev. Rul. 60-160, 1960-1 Cum. Bull. 374, *modifying* E.T. 19, 1946-2 Cum. Bull. 166.

[90] Commissioner v. Maresi, 156 F.2d 929 (2d Cir. 1946).

[91] Laughlin's Estate v. Commissioner, 167 F.2d 828 (9th Cir. 1948).

[92] Hutchings v. Bates, 393 S.W.2d 338 (Tex. Civ. App. 1965), *aff'd*, 9 *Tex. Sup. Ct. J.* 530 (1966).

[93] Int. Rev. Code of 1954, § 2053; Treas. Reg. § 20.2053-4 (1958).

[94] Treas. Reg. § 20.2035-1(c) (1958).

filing returns and in determining liability for income tax for the year in which a divorce is granted are similar to those which must be faced while the divorce is pending, with the exception that a joint return cannot be filed. Since the community property rules continue to apply until the date of final decree, each spouse must report on a separate return one-half of the community income from the first day of the tax year to the effective date of divorce in addition to reporting separate income for the balance of the year. This point is often overlooked in drafting settlement agreements, and it is quite difficult to explain to the parties subsequent to the divorce, particularly when such explanation is necessitated by actions of the tax collector. Provision should be made whereby the husband agrees to supply his divorced wife with information necessary for reporting her share of the community income, including, where applicable, receivables and pension, profit-sharing, and stock bonus payments accruing after the final decree. Likewise, the agreement should specify which party has the obligation to pay tax on such income as well as the responsibility for any deficiency. It should also require an escrow of funds sufficient to cover any potential liability. Even though such provisions in the settlement agreement or decree are not binding on the Internal Revenue Service,[95] the parties will have thereby an opportunity to adjust between themselves any inequities brought about by application of the tax law and to ensure relief and/or protection from such inequities while they still are in a bargaining position.

Exemption for Children In an arrangement whereby the husband is to make payments for support of his minor children following divorce, the question often arises as to which parent is entitled to the dependency exemptions. The so-called "over fifty per cent" test is again controlling and governs the allowance of the exemption despite contrary recitals in the agreement or decree.[96] In a situation where the husband, wife, and a third party all contribute to the support of the children, the parties may enter into a multiple support agreement among themselves for claiming the respective dependency exemptions.[97]

In determining the amount of support furnished, expenditures for food, shelter, clothing, medical and dental care, and education, are considered; however, it is not necessary that these items be furnished in cash.[98] Items furnished in kind are included in the computation of support at their fair value. Unless the divorce decree provides

[95] See note 17 *supra*.
[96] Delbert D. Bauner, 39 T.C. 534 (1962); see note 20 *supra*.
[97] INT. REV. CODE OF 1954, § 152(c).
[98] Treas. Reg. § 1.152-1(a)(2) (1957).

designated amounts for each child, support payments are divided equally among all of the children.[99] However, it should be noted that the husband is entitled to use the total amount of child support payments made by him during the taxable year in determining whether he furnished more than fifty per cent of the support, whether or not such payments are actually used in support of the child.[100] The burden is on the taxpayer claiming such exemption to establish the total support furnished the dependent and not merely his part thereof.[101] This requirement can be disadvantageous to the husband who is making child support payments for children in the custody of the wife. Hence, it may be advisable to require the wife to furnish to the husband annual statements for her expenditures in support of the children in her custody in order that the husband may have some basis on which to determine whether he is entitled to the exemptions in a particular year. On the other hand, after the divorce the wife too will be interested in qualifying for the lower head of the household rate.[102]

Attorney's Fees The deductibility of attorney's fees as a business or non-business expense depends upon the type of legal work done in consideration therefor. Fees are fully deductible under the following sections of the code if:

(1) it is an ordinary and necessary business expense (section 162);
(2) it is an expense arising out of the production or collection of non-business income (section 212(1));
(3) it is an expense for the management, conservation or maintenance of property held for production of income (section 212(2)); or,
(4) it is an expense in connection with tax advice (section 212(3)).

In addition, the attorney's fee must also be: ordinary, necessary, and reasonable; paid or incurred in the tax year; an expense rather than a capital expenditure; and, non-personal in nature.[103]

The nature of a divorce action precludes the applicability of section 162 to attorney's fees. Further, section 262 disallows any deduction for personal expenses, the regulations thereunder providing: "Generally, attorney's fees and other costs paid in connection with a

---

[99] Ollie J. Kotlowski, 10 T.C. 533 (1948); YOUR FEDERAL INCOME TAX, at 20 (1964 ed.).
[100] I.T. 3883, 1947-2 CUM. BULL. 38.
[101] Frank P. Gajda, 44 T.C. 783 (1965); Aaron F. Vance, 36 T.C. 547 (1961); Bernard C. Rivers, 33 T.C. 935 (1960).
[102] INT. REV. CODE OF 1954, § 1(b)(2).
[103] INT. REV. CODE OF 1954, §§ 162, 212; Treas. Reg. § 1.212-1(a) (1957).

divorce, separation or decree for support are non-deductible by either the husband or the wife."[104] However, some attorney's fees in connection with a divorce action can be deducted under section 212,[105] even though the United States Supreme Court in *United States v. Davis*,[106] *United States v. Gilmore*,[107] and *United States v. Patrick*[108] severely restricted the application of this section. In both *Gilmore* and *Patrick*, the taxpayers sought current deductions for their legal fees on the ground that they were incurred for the conservation of property held for the production of income.[109] The Supreme Court denied the deduction in both cases, stating that the origin of the claim controls its consequences to the taxpayer and determines its deductibility for tax purposes. The Court held that only the cost of resisting claims arising in connection with business or profit-seeking activities are deductible. That the claims originated in divorce actions, and therefore were personal in nature, precluded a current deduction under section 212(2).

In the *Gilmore* case the taxpayer had argued in the alternative that if the attorney's fees were not a current deduction they should be treated as a capital expenditure and added to his basis in the property. The taxpayer, following the Supreme Court's disposition of the *Gilmore* case, pursued this theory in the Federal District Court for the Northern District of California.[110] In deciding the issue that court held that the legal cost of protecting the husband's interest in stock in a divorce settlement was a capital expenditure. This decision follows the general rule that capitalization is required for legal fees incurred to acquire property (other than property includable in current income) as well as those incurred in protecting the property from adverse claims.[111] The personal nature of an expenditure is not relevant to the test for its capitalization. If such costs are allowed to be capitalized and added to the basis of the property interest protected, the taxpayer can recoup these costs through the depreciation allowance or by utilization of the increased basis upon ultimate disposition of the property.

The decisions in *Gilmore* and *Patrick* do not seem to have affected the deductibility by the wife under section 212(1) of that portion

---

[104] Treas. Reg. § 1.262-1(b)(7) (1958).

[105] Carpenter v. United States, 338 F.2d 366 (Ct. Cl. 1964); Ruth K. Wild, 42 T.C. 706 (1964); Gale v. Commissioner, 13 T.C. 661 (1949), *aff'd*, 191 F.2d 79 (2d Cir. 1951).

[106] 370 U.S. 65 (1962).

[107] 372 U.S. 39 (1963).

[108] 372 U.S. 53 (1963).

[109] INT. REV. CODE OF 1954, § 212(2).

[110] Gilmore v. United States, 245 F. Supp. 383 (N.D. Cal. 1965).

[111] Shipp v. Commissioner, 217 F.2d 401 (9th Cir. 1954).

of her attorney's fees expended to secure alimony in a divorce action,[112] to increase the amount of alimony subsequent to the divorce,[113] or to collect alimony in arrears.[114] In these instances the wife is seeking to obtain new income that will be taxed to her. The "origin of the claim" test appears to apply only to section 212(2).

Section 212(3) permits the current deduction of attorney's fees for tax advice rendered. Even though the propriety of such a deduction was questioned in the *Davis* case, the Supreme Court did not pass on the deductibility of a fee paid by the taxpayer to his own tax counsel. However, the Court held that the taxpayer was not entitled to a deduction under this section for the attorney's fees paid to the wife's tax counsel. In a subsequent case in the United States Court of Claims—the same court that originally heard the *Davis* case[115]—a deduction was allowed under section 212(3) for tax advice given pursuant to the divorce.[116] In order for the taxpayer to be able to deduct any portion of his attorney's fees it is essential that the retained attorney keep full and detailed records of his time spent and work done in connection with the divorce. Such records will enable the attorney to present to his client an itemized statement of services rendered, indicating which portions of his fee, if any, can be deducted or capitalized. Finally, each spouse should pay his or her own attorney.

IV. CONCLUSION

Income tax consequences are inherent in any divorce, regardless of the amount of property involved. Thus, it is incumbent upon counsel for both parties to make every effort to minimize the tax liability and eliminate potential problems for their clients. Informed planning during the pre-divorce stage and employment of the settlement agreement will help to accomplish these objectives. Careful drafting of the settlement agreement is essential. Through awareness of the tax rules applicable to divorce the attorney can prevent his client's marital problems from being compounded following divorce by unexpected and unintended tax consequences.

---

[112] Ruth K. Wild, 42 T.C. 706 (1964).
[113] Gale v. Commissioner, 13 T.C. 661 (1949), *aff'd*, 191 F.2d 79 (2d Cir. 1951).
[114] See note 104 *supra*.
[115] Davis v. United States, 287 F.2d 168 (Ct. Cl. 1961).
[116] Carpenter v. United States, 338 F.2d 366 (Ct. Cl. 1964).