Volume 4
Number 1 *Fall 1969*

*pp.*181-204

Fall 1969

Alimony Trust Income: A Challenge to Taxability

ALIMONY TRUST INCOME: A CHALLENGE TO TAXABILITY

INTRODUCTION

There are two ways by which periodic alimony payments may be made to the divorced or separated wife.[1] The husband may directly pay the required amount to the wife or he may create a trust with the wife as the beneficiary of the income. When these payments are made directly by the husband, they represent taxable income to the wife.[2] The full amount of all periodic payments made to the wife must be included in her gross income, regardless of whether it is paid from taxable or tax-exempt income or from the liquidation proceeds of the husband's capital.[3]

When an alimony trust is used as the medium for these payments, however, a different result can ensue. In the recent decision of *Ellis v. United States,*[4] the court allowed a wife as the beneficiary of an alimony trust to exclude tax-exempt income from her gross income, even though the income flowed to her in the form of alimony payments. Through this indirect method the wife gained a tax advantage over the wife who is a recipient of direct alimony payments. Although this case is presently the center of controversy in the field of alimony trust law, the questions posed therein do not have the quality of exclusiveness.

The Internal Revenue Code has created two different types of alimony trusts;[5] however, each type of trust embraces different tax consequences to the wife as beneficiary.[6] Whether discriminating tax consequences should flow from their mere existence necessitates a comparison between the two types of trusts and the direct payment method.

This discussion is limited only to the federal tax aspect of income flowing from these alimony trusts. No attempt is made herein to deal with the estate and gift tax consequences of their creation or dissolution.[7]

ALIMONY TRUSTS BEFORE THE REVENUE ACT OF 1942

Before 1942, direct alimony payments were not taxed to the wife nor

1. INT. REV. CODE of 1954, §§ 71(a)(1)-(2), 682(a).
2. Treas. Reg. § 1.71-1(b)(1)-(2) (1954).
3. *See* notes 80-82 *infra* and accompanying text.
4. 288 F. Supp. 168 (W.D. Tenn. 1968). After this note went to press, the Sixth Circuit Court of Appeals affirmed the district court decision. *See* Ellis v. United States, 38 U.S.L.W. 2241 (6th Cir. Oct. 10, 1969).
5. INT. REV. CODE of 1954, §§ 71(a)(1), 682(a).
6. *See* notes 80-103 *infra* and accompanying text.
7. *See* Note, *Tax Aspects of Alimony Trusts,* 66 YALE L.J. 881, 885 (1957) for a discussion of the estate and gift tax consequences of an alimony trust.

deductible by the husband.[8] The policy arguments given were consistent in reaching this result, but varied as to their explanation. Perhaps the simplest reason was that the husband's payments should be, and were, treated as a non-deductible personal expense.[9] This appears, however, to be a mechanical tax rule rather than a reason. The United States Supreme Court in *Gould v. Gould*[10] gave two reasons to justify the nontaxability of the wife's alimony payments. First, the payments merely represented the equitable portion of the wife's estate arising from her husband's legal and moral obligation to support his wife imposed upon him as an incident of their marriage.[11] Although this explanation has some substance, the sum total of the payments could easily be greater than her potential estate had the husband died rather than obtained a divorce. The more practical reason espoused by the Court was to avoid double taxation, since no deduction was given to the husband by the revenue statutes.[12]

If the avoidance of double taxation was the main thrust of *Gould,* then alimony payments through a trust could shift the tax liability to the wife without imposing double taxation. In theory, if the wife were considered a beneficiary, the trust income would be taxable to her and excludible by her husband.

A conflict soon developed as to whether income from an alimony trust should be treated as ordinary trust income or as alimony under the direct payment method. The revenue laws provided a designated plan for the taxation of trusts under which distributable net income was taxable to the beneficiaries.[13] The Board of Tax Appeals and the circuit courts adopted a distinction between the husband's retention of a mere reversionary interest[14] and the husband's retention of administrative powers

---

8. Gould v. Gould, 245 U.S. 151 (1917). No trust agreement between the parties was involved in this case. The Court concerned itself only with a periodic payment arrangement.

9. Act of Oct. 3, 1913, ch. 16, § 2, 38 Stat. 166. This statute prohibited deductions for personal expenses, and the regulations subsequently provided that alimony was included in that category. Treas. Reg. § 24-1 (1916).

10. 245 U.S. 151 (1917).

11. *Id.* at 154.

12. The Court concluded its decision by stating:

> The net income of the divorced husband subject to taxation was not decreased by payment under the court's order; and on the other hand, the sum received by the wife on account thereof cannot be regarded as income arising or accruing to her within the enactment.

Id.

13. INT. REV. CODE of 1954, §§ 651, 652, *formerly* INT. REV. CODE of 1939, §§ 161, 162.

14. S. A. Lynch, 23 B.T.A. 435 (1931). The wife was taxed on the income of an alimony trust because of an irrevocable transfer of bonds with all the income flowing from such bonds to be paid to her and the children for an extended period of time.

over the income and corpus without making an irrevocable transfer.[15]

The Court attempted[16] to resolve this conflict in *Douglas v. Willcuts*[17] by applying the broad doctrine of constructive receipt. The Court held that the income from the alimony trust created by the taxpayer for the support of his wife was taxable to him.[18] The Court dismissed the argument that the wife as beneficiary of this alimony trust should be taxed on the income. The particular section of the statute[19] for the taxation of beneficiaries was not intended "to apply to cases where the income of the trust would otherwise remain, by virtue of the nature and purpose of the trust, attributable to the creator of the trust and accordingly taxable to him."[20]

Three central factors induced the Court's application of the constructive receipt doctrine. First, a legal obligation was imposed upon the husband to support his divorced wife. Second, the state court had continuing jurisdiction to revise the provisions of the trust agreement or its decree; therefore, the husband had a continuing obligation to pay alimony. Thirdly, the trust agreement was incorporated into the divorce decree.[21] Apparently, the Court did not hold that income from all alimony trusts would be taxable to the husband. Therefore, these three central factors became the basic standards for determining whether the husband

---

15. John M. Longyear, Jr., 28 B.T.A. 1086 (1933), *aff'd*, 77 F.2d 116 (D.C. Cir. 1935); Frank Turner, 28 B.T.A. 91 (1933), *aff'd*, 71 F.2d 1018 (2d Cir. 1934).

16. The word "attempted" is used because the problem was apparently aggravated rather than resolved. *See* Gornick, *Taxation of Alimony Trusts—A Need for Congressional Reform*, 20 TAXES 529 (1942); Paul, *Five Years with Douglas v. Willcuts*, 53 HARV. L. REV. 1 (1939); Note, *Taxing Income Received from an Irrevocable Trust in Satisfaction of the Settlor's Legal Obligations: The Aftermath of Douglas v. Willcuts*, 52 HARV. L. REV. 804 (1939).

17. 296 U.S. 1 (1935).

18. Commissioner v. Nicolai, 126 F.2d 927, 928 (9th Cir. 1942). This example substantiates the theory that a person may have taxable income without having personally received it. If A owes a debt to B (which if paid to B would be income taxable to him), and B owes a debt to C, B derives taxable income when A pays C to discharge B's debt to C. The same principle applies where a divorce decree imposes an obligation on B to pay alimony to C. If B then transfers property to A, as trustee, who pays the income from such property (which if paid to B would be income taxable to him) to C in discharge of the alimony award, the proceeds are taxable to B.

19. INT. REV. CODE of 1954, §§ 651, 652, *formerly* INT. REV. CODE of 1939, §§ 161, 162.

20. The Court stated:

> The net income of the trust fund, which was paid to the wife under the decree, stands substantially on the same footing as though he had received the income personally and had been required by the decree to make the payment directly.

296 U.S. 1, 9 (1935).

21. The basic thought stressed by Douglas v. Willcuts is that the creation of the trust there involved did not release the husband from the duty of supporting his wife, rather it was simply a device to discharge an obligation to support her which continued even after the divorce.

Paul, *supra* note 16, at 8.

constructively received such income.[22]

A provision in the trust agreement that the husband would guarantee and personally make up any income deficiency below a prescribed minimum was not mentioned in the Court's opinion, except in setting out the facts.[23] It appears that this provision could have been used by the Court as an additional factor to support the continuing obligation principle,[24] for in a later decision[25] this guarantee provision provided an open door by which the Court taxed the husband on income from an alimony trust.

The *Douglas* case was followed by confusion and uncertainty. The presence or absence of one or more of these factors created either detrimental or advantageous tax consequences to the divorced husband as settlor, or to his divorced wife as beneficiary of the alimony trust.[26] The taxability of income from alimony trusts became dependent upon these unnecessary, complex and technical considerations.[27] In many cases the local law was obscure.[28] Sometimes the court's decree was unclear, and coupled with the ambiguously written trust agreement, the only element of certainty was that there was no certainty or reliability where planned tax consequences were involved.[29]

More than five years passed before the Supreme Court considered the problem again in the related cases of *Helvering v. Fitch,*[30] *Helvering v. Fuller*[31] and *Helvering v. Leonard.*[32] These cases indicated that the development of the constructive receipt doctrine established in *Douglas* was more a hinderance than an improvement to the field of alimony trust law. The majority of the Court in *Fitch* implicitly agreed that not all alimony trust income was taxable to a husband as settlor.[33] Such income was taxable only when applied to discharge a "continuing obligation of the

---

22. *See* Gornick, *Alimony and the Income Tax*, 29 CORNELL L. REV. 28, 30 (1943).

23. 296 U.S. 1, 3 (1935).

24. Glendening v. Commissioner, 97 F.2d 51 (3d Cir. 1938); Alsop v. Commissioner, 92 F.2d 148 (3d Cir. 1937), *cert. denied,* 302 U.S. 767 (1938). In these later opinions it was held that this provision manifested the husband's desire to support his divorced wife and he should therefore remain taxable on such income.

25. Helvering v. Leonard, 310 U.S. 80 (1940). *See* notes 38-39 *infra* and accompanying text.

26. *See* Bloomenthal, *Income Tax Aspects of Alimony Trusts,* 17 TAXES 455 (1939); Note, *Taxation—Federal Income Tax—Taxation to Settlor of Income from Trust Established to Discharge a Legal Obligation,* 34 MICH. L. REV. 443 (1936).

27. *See* note 16 *supra.*

28. Pearce v. Commissioner, 315 U.S. 543 (1942); Glendening v. Commissioner, 97 F.2d 51 (3d Cir. 1938); Alsop v. Commissioner, 92 F.2d 148 (3d Cir. 1937), *cert. denied,* 302 U.S. 767 (1938).

29. *See* 6 J. MERTENS, LAW OF FEDERAL INCOME TAXATION § 37.48 at 113, 118 (1957).

30. 309 U.S. 149 (1940).

31. 310 U.S. 69 (1940).

32. 310 U.S. 80 (1940).

33. 309 U.S. 149, 157 (1940).

husband to support his divorced wife."[34] However, "the burden of establishing that his case falls outside the general rule expressed in *Douglas v. Willcuts*" is on the husband to render "clear and convincing proof" that "local law and the alimony trust have given the divorced husband a full discharge and leave no continuing obligation, however contingent."[35] The husband in *Fitch* could not prove that the local law of the state where the couple procured their divorce gave him such a discharge and was, therefore, taxed on the trust income that was paid to the wife-beneficiary.[36]

The majority of the Court in *Fuller* stated that the local law of Nevada where the divorce was procured, and the trust agreement, completely discharged the husband. The trust agreement did not impose a "continuing obligation on the husband because he did not underwrite the principal or income from the trust or any part thereof or make any commitments, contingent or otherwise, respecting them . . . ."[37]

In the *Leonard* case, the majority ruled that the husband had not rendered "clear and convincing proof" that the local law of New York gave him a full discharge of his obligation.[38] In the trust agreement, the husband guaranteed a certain amount of income from the principal and interest of specific oil company bonds. The husband was held taxable on "that portion of trust income which was received from the guaranteed bonds, because such a guarantee evidenced a continuing obligation."[39]

The Court's guidelines were clearly inadequate.[40] It became necessary, when determining whether the husband had a "continuing obligation" to support his divorced wife, to focus on the three previously mentioned factors.[41] The aggregate of these factors led to much con-

34. *Id.* at 152.
35. *Id.* at 156.
36. The requirement that the taxpayer show by "clear and convincing proof" that under local law his obligation is fully discharged imposes an unreasonable burden on the husband. The Court, itself perplexed, stated that "on the state of Iowa authorities we can only speculate as to the power of the Iowa court to modify the alimony awarded . . . ." *Id.* at 155. If the law of a state is thus unsettled, how can it be expected that a husband could ever sustain such a burden?
37. 310 U.S. 69, 73 (1940).
38. 310 U.S. 80, 82 (1940).
39. *Id.* at 84. The majority of the Court, however, held that all of the income from the alimony trust was taxable to the husband. Chief Justice Butler, Justice McReynolds and Justice Roberts were of the opinion that the circuit court of appeals' ruling that the husband should not be taxed on the trust income, should have been affirmed.
40. Buchanan v. United States, 164 F.2d 710 (D.C. Cir. 1947), *discussing* Douglas v. Willcuts, 296 U.S. 1 (1935) and the subsequent alimony trust cases in the Supreme Court. *See* Tye, *Federal Taxation of Alimony Trusts,* 19 TAXES 19 (1941); Note, *Taxation—Income Tax—Taxability of Income of Alimony Trust to Husband—Settlor—Rule of Douglas v. Willcuts,* 38 MICH. L. REV. 1285 (1940); *see* note 16 *supra.*
41. Justice Reed dissenting in Helvering v. Fuller, 310 U.S. 69 (1940) stated:
Two trusts both irrevocable, in words precisely the same, drawn for the purpose

fusion and uncertainty,[42] as well as discrimination between husbands who were financially incapable of creating such a trust and those who were financially capable.[43]

Further complications in the taxation of alimony trust income resulted from restrictions imposed by the Internal Revenue Code upon trusts generally.[44] Although a husband might have been given a full discharge by local law and by the trust agreement, he might still have been taxed under section 166[45] or section 167[46] of the Internal Revenue Code of 1939. The husband could also incur tax liability under section 22(a) where the income could have been taxed to the settlor if he had retained sufficient control to justify treating him as the owner of the trust corpus under the doctrine of *Helvering v. Clifford*.[47]

As Justice Reed indicated in *Fuller*:

> We are now at the point where the taxability of the settlor depends not only on the clear and convincing proof of the finality of the decree, but the ability to produce that proof depends upon the skill of the draftsman of the settlement. Fine distinctions are necessary in reasoning but most undesirable in a national tax system.[48]

Congressional reform was urgently needed to eliminate these inequities and uncertainties which surrounded the taxation of alimony trust income.[49] This was apparent to the Court in *Fuller* as Justice Douglas specifically noted:

> This is not to imply that Congress lacks authority to design a

---

> of providing maintenance for a former wife, recognized or approved by divorce decrees identical in form, are to have different tax results upon the settlor. If income taxes are predominately important, prospective divorcees must locate in the states where the finality of the settlement is clearly established.

Id. at 76. *See* note 21 *supra* and accompanying text.

42. *See* Pearce v. Commissioner, 315 U.S. 543 (1942), where another fine distinction was introduced, namely, upon which person (husband or wife) the commissioner seeks to impose the tax.

43. The divorced wife would probably not accept an alimony trust arrangement, where the income is taxable to her, if it were for the same amount as she would receive in the direct payment method where such income would be non-taxable. *See* notes 8-15 *supra* and accompanying text.

44. *See* notes 13 and 19 *supra* and accompanying text.

45. INT. REV. CODE of 1954, § 676, which states that if the husband retains the power to revert the corpus in himself, he might be taxed on such income.

46. INT. REV. CODE of 1954, § 677 states that if the income of the trust might be distributed, or held or accumulated for future distribution to the husband, he might be taxed on such income.

47. 309 U.S. 331 (1940).

48. 310 U.S. 69, 78 (1940).

49. *See* note 40 *supra* and accompanying text.

different statutory scheme applying uniform standards for the taxation of income of the so-called alimony trusts.[50]

ALIMONY TRUSTS AFTER THE REVENUE ACT OF 1942

Congress in 1942 reversed the tax effect of direct alimony payments through various amendments by shifting the tax liability to the wife. Section 22(k) provided for the inclusion of alimony payments in the gross income of the divorced wife.[51] Section 23(u) allowed the husband a deduction for alimony payments that were includible in his divorced wife's gross income under section 22(k).[52] Congress expressed its intent by stating:

> These amendments are intended to treat such payments as income to the spouse actually receiving or actually entitled to receive them and to relieve the other spouse from the tax burden upon whatever part of the amount of such payments is under the present law includible in his gross income.[53]

The 1942 alimony tax law was amended and recodified in 1954. Section 71(a)(1) now applies to any alimony trust created pursuant to a divorce or separate maintenance decree or pursuant to a written agreement "incident" to the divorce or separation.[54] Thus, the section does not apply to trusts that have been created prior to a divorce or legal separation, or to that part of any periodic payment attributable to any interest in the property so transferred if the interest originally belonged to the wife.[55] Section 71(a) (2) was drafted as part of the general recodification of 1954 and applies to alimony trusts created through a voluntary or informal written separation agreement executed after December 31, 1954.[56] As noted above,[57] section 71(a)(1) or (2) does not apply to a trust created prior to, or in contemplation of, the divorce, legal separation or written separation agreement. Section 71(a)(1) or (2) is also inapplicable where alimony trusts were taxable to the husband under sections 166 or 167 of the Internal Revenue Code of 1939[58] or under the

50. 310 U.S. 69, 75 (1940).
51. INT. REV. CODE of 1939, § 22, *as amended*, 1942, § 22(k).
52. INT. REV. CODE of 1939, § 23, *as amended*, 1942, § 23(u).
53. S. REP. No. 1631, 77th Cong., 2d Sess. 83 (1942); H.R. REP. No. 2333, 77th Cong., 2d Sess. 46 (1942). For an excellent discussion of the congressional history behind these amendments *see* 1 J. SEIDMAN, LEGISLATIVE HISTORY OF FEDERAL INCOME AND EXCISE PROFITS TAX LAWS 1275-85 (1954).
54. INT. REV. CODE of 1954, § 71(a)(1).
55. S. REP. No. 1631, 77th Cong., 2d Sess. 83, 84 (1942); Treas. Reg. § 1.71-1(c)(1) (1956).
56. INT. REV. CODE of 1954, § 71(a)(2).
57. *See* note 55 *supra* and accompanying text.
58. *See* notes 44-46 *supra* and accompanying text.

doctrine of *Helvering v. Clifford,* which applied section 22(a) to short-term family trusts.[59] Therefore, to provide uniformity for the taxation of all alimony trusts, Congress in 1942 added section 171 to Supplement E of the Internal Revenue Code of 1939, which related to the taxation of trusts, estates and beneficiaries.

The provisions of section 171 are now embodied in section 682 of the Internal Revenue Code of 1954 and provide in part:

> There shall be included in the gross income of a wife who is divorced or legally separated under a decree of divorce or of separate maintenance (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 sub-title be includible in the gross income of such husband.[60]

This section and the applicable subsections of section 71 were intended to produce uniformity in all alimony trusts regardless of the variance in state laws concerning the existence and continuance of an obligation to pay.[61] If alimony trusts were not given preferential tax treatment with regard to the husband, as grantor, then only an irrevocable, non-reversionary trust with the trustee as an independent or "adverse party" would qualify for special tax treatment. Section 682(a), however, allows a husband to meet his support obligation with only temporary and minimal loss of control over his property.[62] Section 71(d) provides that the husband has a right to exclude from his gross income amounts received that, under subsection (a), are includible in the gross income of his wife and attributable to transferred property.[63] Section 215 complements section 71(d) and prohibits a deduction by the husband if, by reason of section 71(d) or section 682, the amount thereof is not includible in the husband's gross income.[64]

In essence, the income flowing from any alimony trust is includible in the gross income of the wife and only excludible from the husband's gross income—it is never deductible. All alimony trusts must be formed according to the provisions either of section 71 or section 682. Although

59. *See* note 47 *supra* and accompanying text.
60. INT. REV. CODE of 1954, § 682(a).
61. Treas. Reg. § 1.682(a)-1(a)(3) (1954).
62. *Id.*
63. INT. REV. CODE of 1954, § 71(d).
64. INT. REV. CODE of 1954, § 215.

these trusts might be expected to be treated similarly with respect to the taxation of trust income, there are significant differences.

DISTINCTION BETWEEN SECTION 71 AND SECTION 682 ALIMONY TRUSTS

Section 682(b) classifies the wife as the beneficiary of any alimony trust rather than the husband, regardless of whether the payments are made for the benefit of the husband in discharge of his support obligation.[65] The section states:

> For purposes of computing the taxable income of the estate or trust and the taxable income of a wife to whom subsection (a) of section 71 applies, such wife shall be considered as the beneficiary specified in this part.[66]

Taxation of a wife as beneficiary under section 682(a) is mutually exclusive of section 71.[67] Section 682(a) does not apply to an alimony trust if section 71 is deemed applicable.[68] This interpretation, however, is difficult to glean from the language of the two code sections alone.[69] An alimony trust falls within the purview of section 71 only if the periodic payments to the wife qualify as alimony under section 71 without regard to the trust. This result obtains even though payments may be made through a previously created trust.[70] One authority defines alimony under section 71 as:

> 1. Payments (periodic) made to discharge a legal obligation based upon a marital or family relationship and imposed on or incurred by the husband under a divorce or separate maintenance decree or under a written instrument incident to a divorce or separation or payments attributable to property transferred in trust in discharge of such obligation.
>
> 2. Payments made under a written separation agreement or payments attributable to property transferred in trust under such an agreement because of the marital or family relationship.[71]

---

65. Treas. Reg. § 1.682(b)-1(a) (1954).
66. INT. REV. CODE of 1954, § 682(b).
67. Treas. Reg. § 1.682(a)-1(a)(2) (1954).
68. *Id.*
69. *Id.*
70. 3 CCH 1968 STAND. FED. TAX REP. ¶ 3776.01, at 39,103. *See* Treas. Reg. § 1.682(a)-1(2) (1954), which states that section 71 applies only if the creation of the trust or payments by a previously created trust are in discharge of an obligation imposed upon or assumed by the husband (or made specific) under the court order or decree divorcing or legally separating the husband and wife.
71. 3 CCH 1968 STAND. FED. TAX REP. ¶ 3776.01, at 39,103.

In either situation, the payments must be received by the divorced wife after either a court decree or the execution of the written separation agreement to qualify as alimony.[72]

Section 682 only applies to a trust created prior to a divorce or a written separation agreement and the trust must not be mentioned in any decree, instrument or agreement incident or pursuant to the divorce or separation.[73] Section 71 applies to a trust created by the husband incident or pursuant to the divorce or separation. Apparently the presence or absence of the trust agreement in the decree, instrument or agreement is not a significant factor.[74]

The problem of whether the only distinction between section 71 and section 682 is the time of creation seems to be unsettled.[75] As one

---

72. Treas. Reg. § 1.71-1(c)(1) (1954).

73. Treas. Reg. § 1.71-1(c)(3) (1954) states that section 71(a)(1) or (2) would not apply to the situation where the husband's obligation is not specified in the decree or an instrument incident to the divorce status or legal separation status. Treas. Reg. § 1.682(a)-1(4) (1954) gives the following two examples of the necessary silence required to fulfill the prerequisite of a section 682 alimony trust:

> Example (1). Upon the marriage of H and W, H irrevocably transfers property in trust to pay the income to W for her life for support, maintenance, and all other expenses. Some years later, W obtains a legal separation from H under an order of court. W, relying upon the income from the trust payable to her, does not ask for any provision for her support and the *decree recites that since W is adequately provided for by the trust, no further provision is being made for her.* Under these facts, section 682(a), rather than section 71, is applicable. Under the provisions of section 682(a), the income of the trust which becomes payable to W after the order of separation is includible in her income and is deductible by the trust. No part of the income is includible in H's income or deductible by him.
>
> Example (2). H transfers property in trust for the benefit of W, retaining the power to revoke the trust at any time. H, however, promises that if he revokes the trust he will transfer to W property in the value of $100,000. The transfer in trust and the agreement were not incident to divorce, but some years later W divorces H. *The court decree is silent as to alimony and the trust.* After the divorce, income of the trust which becomes payable to W is taxable to her, and is not taxable to H or deductible by him. If H later terminates the trust and transfers $100,000 of property to W, the $100,000 is not income to W nor deductible by H.

Id. (emphasis added).

74. Treas. Reg. § 1.71-1(c)(1) (1954) only requires that the property must have been transferred in discharge of a legal obligation imposed upon or incurred by the husband because of the marital or family relationship.

75. 3 CCH 1968 STAND. FED. TAX REP. ¶ 3776.01, at 39,103. In *Mahana v. United States*, 88 F. Supp. 285, 289 (Ct. Cl. 1950), the court stated that section 682 requires only that there be a divorce; an existing trust and the receipt of income from the trust would have been taxable to the husband had it not been made taxable to the wife by the section.

Treas. Reg. § 1.682(a)-1(2) states that a section 682 trust applies to a trust created before the divorce or separation and not in contemplation of it. It is indirectly implied that since a section 71 trust is in discharge of an obligation imposed upon or assumed by the husband, then a section 682 trust can only apply when no obligation is imposed upon or assumed by the husband or made specific under a court order or decree. However, Treas. Reg. § 1.682(a)-1(3) (1954), which attempts to clarify the congressional intent behind section 682, states that section 682(a) taxes trust income to the wife in all cases commentator stated:

> Where the income either already is or can be made payable to the wife to satisfy the husband's support obligations and the creation of the trust was not connected with the divorce or separation then section 71 would not apply.[76]

Wolf indicated, however, that there is one minor exception. When a trust is created by an antenuptial agreement for support of the wife and the payments continue to the wife after the divorce, the trust will fall within section 682, unless the decree, as originally passed or amended, refers to the agreement.[77]

Whether the decree, instrument or written separation agreement mentions the trust as the means by which payments are to be made seems only important in determining whether the payments should qualify as alimony. If a specific plan is designated because of the husband's obligation or the previously created trust is altered or amended to meet a new obligation imposed upon the husband, section 71 would apply. A casual remark by a court that a previously created trust is used as a substitute for alimony should not change a section 682 trust into a section 71 trust[78] with drastic tax consequences accompanying such change.[79] Where the wife agrees that such a pre-existing trust is sufficient to provide for her support, no fresh obligation is imposed or incurred by the husband. Therefore, such a statement by a court or in the agreement should not affect the existence and the consequential tax treatment of a pre-existing trust.

Each of the alimony trusts embrace different tax consequences to the wife. The provisions of section 71 require that the full amount of alimony payments be included in the wife's gross income regardless of their source.[80] It is irrelevant whether the payments are attributable to property in trust (or to life insurance, endowment, annuity contracts or any other

---

in which the husband would otherwise be taxed not only because of the discharge of his alimony obligation but also because of the retention of control over the trust income or corpus. There seems to be a variation between the implied and the expressed intent behind the statute.

76. Wolf, *Income, Gift and Estate Tax Considerations in Marriage and Divorce*, 14 Md. L. Rev. 1, 43 (1954).

77. *See* note 73 *supra*, example (1), which states that the decree recites that since the wife is adequately provided for by the trust (pre-existing) no further provision is being made for her. Query, that in substance the court is relieving the husband of an alimony obligation through a pre-existing trust; however, in form the decree or order of the court does not disclose this fact. *See* Treas. Reg. § 1.71-1(b)(6) ex. (2) (1954) where the wording of the decree or court order is the controlling factor.

78. Treas. Reg. § 1.682(a)-1(4) (1954).

79. *See* notes 80-94 *infra* and accompanying text.

80. Treas. Reg. § 1.71-1(c)(2) (1954).

interest in property) or paid directly or indirectly by the husband from his income or capital.[81] The full amount of such payments must be included in the wife's income regardless of whether the payments are made out of trust income or corpus.[82]

Taxing the wife on the full amount of alimony payments has been deemed a valid exercise of congressional taxing power. This is true even though the payments may be made from capital rather than from trust income or from trust income which would otherwise have been taxable to the husband.[83]

If alimony payments are made through a trust, they are includible in the wife's income for the taxable year according to the rules of sections 652, 662 and 682(b).[84] These rules, however, only effect the year in which the wife must include such income. It is irrelevant whether such payments are made out of the income or corpus of such a trust.[85]

For purposes of computing the taxable income of a trust and of a wife to whom section 71(a) applies, the wife is considered a trust beneficiary.[86] Sections 652 and 662 require a trust beneficiary to include in her gross income all trust income which is required to be distributed currently, whether or not it is actually distributed.[87] Therefore, a wife can be taxed on alimony as undistributed trust income before actually receiving payment from the trust. The same reporting rules apply to any part of the wife's alimony that may be payable out of the trust corpus rather than out of distributable net income of the trust.[88] Section 682(b) provides that the full amount of a periodic payment must be included in the wife's gross income for the taxable year in which any part of it is includible under the above rules.[89] If the wife's taxable year differs from that of the section 71 alimony trust, the amount includible in her gross income is based upon the income of the trust for the taxable year or years

81. *Id.*

82. *Id.*

83. Mahana v. United States, 88 F. Supp. 285, 288 (Ct. Cl. 1950); Neeman v. Commissioner, 26 T.C. 864, 866 (1956), *aff'd*, 255 F.2d 841 (2d Cir. 1958); Twinam v. Commissioner, 22 T.C. 83, 85 (1954).

84. Treas. Reg. § 1.71-1(b)(5) (1954).

85. *Id.*

86. Treas. Reg. § 1.682(b)-1(a) (1954).

87. INT. REV. CODE of 1954, §§ 652, 662. If a certain payment is required to be distributed from trust income in December of 1968, but the payment is not actually received until January of 1969, then the wife must include the payment as part of her 1968 gross income.

88. Treas. Reg. § 1.71-1(b)(5) (1954).

89. Treas. Reg. § 1.682(b)-1(b) (1954). A trustee is required to make a payment of $3,000 from distributable net income in December 1968. Only $2,000 is available from such income and the remainder must be drawn from the corpus. Although the wife may only receive $2,000 in December 1968 and the $1,000 in January 1969, the whole amount is includible in her gross income for the year of 1968.

ending with or within her taxable year.[90]

Section 682 gives the wife-beneficiary the most favorable tax treatment for numerous reasons. Only distributable net income of the trust is included in her gross income. The wife includes in gross income amounts paid, credited or required to be distributed to her only to the extent they are includible in the taxable income of a trust beneficiary.[91] Distributions from the trust corpus in excess of the distributable net income defined by section 662(a)(1) are not taxable to her.[92] Section 662(b) further provides that her income retains the same character it had when received by the trust, which entitles the wife to benefit from any tax-exempt income flowing from the alimony trust in the form of payments.[93] These two provisions in section 662 are referred to as the trust conduit rules. The following example illustrates the effect of the trust conduit provisions in contrast to a section 71 alimony trust:

> Shortly after marriage the husband establishes a trust for his wife in lieu of alimony and for her support, maintenance and all other expenses. The annual payments are to be $20,000 from income if possible, but if not, then from the corpus. A divorce is procured after a few years of marriage. For the calendar year 1969 the distributable net income of the trust was $16,000, including $8,000 of interest from tax-exempt securities and dividends of $2,000 from domestic corporations. The divorced wife's payment in 1969 consists of $16,000 distributable net income plus $4,000 distribution from the trust corpus. The wife's gross income for 1969 is only $8,000. She is entitled to exclude the $8,000 of interest from the tax-exempt securities besides the $4,000 from the trust corpus.[94]

In light of the interrelated and contrary provisions of the two alimony trust sections, it is necessary to note similarities as well as differences between the two. The wife is not taxed on child support

90. INT. REV. CODE of 1954, §§ 652(c), 662(c). If the trust has a taxable year ending on January 31, 1969, and the income is to be distributed currently to the wife, then any amount so distributed is includible in her gross income for the year ending December 31, 1969. No amount is includible in the year ending December 31, 1968, although she may have actually received payments during that year.

91. INT. REV. CODE of 1954, § 662(a)(1); Treas. Reg. § 1.682(a)-1(2) (1954). The provisions of section 652 of the Code apply to an alimony trust which distributes current income *only*. If an alimony trust distributes current income, accumulates income or distributes corpus, then the provisions of section 662 would be applicable. Since section 662 includes provisions for distributing current income, section 662 seems more appropriate and therefore, will be used in this note.

92. INT. REV. CODE of 1954, § 662(a)(2).

93. *Id.* at § 662(b).

94. 3 CCH 1968 STAND. FED. TAX REP. ¶ 3776.013. at 39,109 (the dates and dollar amounts have been changed).

payments made by the husband through either type of alimony trust.[95] The trust accounting rules determining the year of inclusion and the amounts attributable to ordinary beneficiaries are also applicable to the wife of either type of alimony trust.[96] The husband is allowed to exclude income payments, which the wife must include in her gross income by either type of alimony trust.[97] Either type of alimony trust immunizes the husband from tax liability, while allowing him to keep substantial control over the trust corpus. Otherwise, he would be taxed on the trust income.[98]

A section 71 alimony trust requires that the "full amount" of payments to the wife be included in her gross income regardless of whether they are made from taxable income of the trust or from the trust corpus.[99] The wife-beneficiary of a section 682 alimony trust is treated as a beneficiary of this alimony trust for all purposes. This means that the trust conduit rules, as well as the trust accounting rules,[100] fully apply to her.[101] Specifically, the conduit rules of section 662(a) and (b) exclude from her gross income payments which are in excess of the distributable net income and the tax-exempt income retains the same character in her hands as it had in the trustee's hands. The wife is treated as a beneficiary of a secton 71 alimony trust only for purposes of the trust accounting rules.[102] The excess of distributable net income must be included in her gross income regardless of whether the payments are made from the corpus. The trust conduit rule of section 662(a) does not apply to her.[103]

CONFLICT REGARDING THE "CHARACTER RULE"

The conduit rule of section 662(a), which taxes only currently distributable net income of a trust, is not applicable to the wife-beneficiary of a section 71 alimony trust.[104] The other trust conduit rule, section 662(b), is known as the "character rule." The "character rule," in conjunction with the provisions of a section 71 alimony trust, presents the controversial question of whether tax-exempt income to the wife as a beneficiary of a section 71 alimony trust, although treated as non-

95. INT. REV. CODE of 1954, §§ 71(b), 682(a).
96. Treas. Reg. § 1.682(b)-1(a) (1954).
97. Treas. Reg. § 1.71-1(c)(3) (1954); Treas. Reg. § 1.682(a)-1(a)(1) (1954).
98. Treas. Reg. § 1.682(a)-1(a)(3) (1954).
99. *See* notes 80-82 *supra* and accompanying text.
100. *See* notes 91-94 *supra* and accompanying text.
101. *Id.*
102. Twinam v. Commissioner, 22 T.C. 83, 90 (1954); Treas. Reg. § 1.682(b)-1(b) (1954); Rev. Rul. 283, 1965-2 CUM. BULL. 25, 27.
103. *See* notes 80-82 *supra* and accompanying text.
104. *Id.*

taxable to the trustee, should retain this same character when payments are made from the trust to the wife.

In a hypothetical case of *Taxpayer v. Commissioner,* one could expect to find the following arguments advanced by the Internal Revenue Service. The government's proposition might be stated as follows: The trust conduit rules of section 662(a) and (b) are not applicable to a wife who is classified as a beneficiary of a section 71 alimony trust.

The government would argue that payments made from the corpus of the trust which exceed the distributable net income must be included in her gross income.[105] Clearly, the conduit rule of section 662(a) does not apply to her. The Treasury Regulations state that "the source of payments to the wife is immaterial;"[106] therefore, the full amount of any payment must be included in her gross income. Courts must examine the source to determine the make-up or character of the trust fund in order to invoke the "character rule" of section 662(b). This appears to be an implicit violation of case law and the Treasury Regulations. Furthermore, the wife is treated as a beneficiary of a section 71 alimony trust only for the limited purpose of applying the rules of trust accounting.[107] Therefore, neither of the conduit rues apply to her.

The arguments by the wife-beneficiary of a section 71 alimony trust contain more substance. First, though the trust conduit rule of section 662(a) does not apply to her, she is taxable on a distribution of the corpus;[108] the character rule pertaining to tax-exempt income from a trust should apply to her as an applicable trust conduit rule. In *Stewart v. Commissioner,*[109] the Tax Court reached a favorable result although a fallacy may be discernible in the court's reasoning. In *Stewart,* a divorced wife was an assignee (beneficiary) of a pre-existing trust. The trust in question was a testamentary trust established by her father-in-law, with her husband being the original beneficiary. The Tax Court may have confused the distinction between section 71 and section 682 alimony trusts.[110] Although the court improperly decided that section 71 was

105. Luckenbach v. Pedrick, 116 F. Supp. 268 (S.D. N.Y. 1953), *aff'd,* 214 F.2d 914, 917 (2d Cir. 1954); Girard Trust Corn Exchange Bank v. Commissioner, 16 T.C. 1398, 1401 (1951), *aff'd,* 194 F.2d 708 (3d Cir. 1952), *cert. denied,* 344 U.S. 821 (1952); Treas. Reg. § 1.71-1(c)(3) (1954); Rev. Rul. 283, 1965-2 CUM. BULL. 25, 27; S. REP. No. 1631, 77th Cong., 2d Sess. 84 (1942).

106. Treas. Reg. § 1.71-1(c)(2) (1954); S. REP. No. 1631, 77th Cong., 2d Sess. 84 (1942).

107. *See* note 102 *supra* and accompanying text.

108. *See* note 105 *supra* and accompanying text.

109. 9 T.C. 195 (1947).

110. Although the facts are sparse, it should be noted that a like assignment, if made in discharge of the husband's obligation to support, could create a section 71 trust [then section 22(k)] under a literal interpretation of Treas. Reg. § 1.682(a)-1(a)(2) (1954). The regulation states that section 71 applies only if the creation of the trust or

applicable, it reached the proper result by allowing the petitioner to exclude that portion of the payment which was attributable to tax-exempt income.[111]

The taxpayer, to further support her contention, could argue that *Ellis v. United States*[112] is controlling. In the *Ellis* case, the alimony trust was established in conjunction with the divorce agreement. All of the prerequisites of a section 71 alimony trust were fulfilled. The district court applied section 682(b) which states:

> For purposes of computing the taxable income of the estate or trust and the taxable income of a wife to whom subsection (a) of Section 71 applies, such wife shall be considered as the beneficiary specified in *this part*.[113]

The court reasoned that "this part" refers to sections 641 through section 683 of the Internal Revenue Code of 1954 and furthermore, that "this part" provides that distributions of income from a trustee "shall have the same character in the hands of the beneficiary as in the hands of the trust."[114] The court therefore permitted the taxpayer to exclude from her gross income her pro-rata share of the tax-exempt income flowing from the trust. In *Ellis*, the court cited the *Stewart* case as precedent; however, there was no attempt to distinguish the Tax Court's questionable application of the distinction between the two alimony trust sections.[115]

By allowing the "character rule" to apply to wives as beneficiaries of a section 71 alimony trust, equal treatment will be given to both

---

payments by a previously created trust are in discharge of an obligation imposed upon or assumed by the husband under the court order or decree. Under these facts the Tax Court could have properly regarded this alimony trust as coming within the provisions of section 71 [then section 22(k)].

111. The Tax Court reasoned that the last sentence of section 22(k) directed that all alimony trusts were covered by section 171(b) [now section 682(b)]. Section 22(k) stated in relevant part that "for the amount includible under the subsection in case the property is held in trust, see section 171." The logical conclusion would result in no tax liability to a wife under a section 71 alimony trust which was distributing payments from the trust corpus. This apparent confusion by the Tax Court makes the Commissioner's acquiescence unclear. 1947-2 CUM. BULL. 4. The Commissioner apparently intended to limit his acquiescence to a pre-existing trust which the facts of the case did embrace. The Commissioner finally withdrew his acceptance in 1965-2 CUM. BULL. 7. Although the result would be the same had the Tax Court applied section 682(a) [then section 171(a)], one can only speculate had the facts permitted the application of section 71 [then section 22(k)]. Whether the Tax Court believed that this assignment was in discharge of the husband's obligation is doubtful. *See* note 110 *supra* and accompanying text.

112. 288 F. Supp. 168 (W.D. Tenn. 1968).

113. INT. REV. CODE of 1954, § 682(b) (emphasis added).

114. *See* note 112 *supra*, at 170.

115. *See* notes 110-11 *supra* and accompanying text.

types of alimony trusts in one respect.[116] The district court in *Ellis* specifically pointed out that there were no cases on this particular issue which were decided against the taxpayer.[117] Therefore, only by extending the Treasury Regulations and the case law can this particular issue be decided against the wife who falls under the provisions of a section 71 alimony trust.

Case law and the Treasury Regulations directly prohibit only the trust conduit rule of section 662(a) from applying.[118] There is no clear indication that the "character rule" should not apply. Indeed, the opposite result may be reached by literally applying the language of section 682(b). The government claims that the "source of payments is immaterial,"[119] but the meaning of the phrase seems vague and of little practical value. One certain source of payments is an alimony trust. Does the meaning of this well-quoted phrase prohibit a court from looking at the character or make-up of the trust? Assuming the make-up of the trust has application in determining the amount to be included in the wife's gross income, then this specific right appears to be given to the "beneficiary" of an alimony trust under section 682(b).[120]

The government claims that the wife is "only" a beneficiary for the limited purpose of applying the rules of trust accounting.[121] The Treasury Regulations, however, do not specifically make such a plain and unequivocable statement.[122] The phrase "whether or not such payments are made out of the income of such estates or trusts" qualifies

---

116. The district court in *Ellis v. United States*, 288 F. Supp. 168 (W.D. Tenn. 1968) stated:

> This is consistent with the treatment afforded former wives who are beneficiaries of trusts created not in contemplation of or incident to divorce and who are divorced or legally separated subsequent to the creation of the trusts.

Id. at 170.

117. The district court's opinion distinctly indicated that none of the cases cited to them have ruled that tax-exempt income to a wife-beneficiary of a section 71 alimony trust should be included in her gross income. 288 F. Supp. 168, 170 (W.D. Tenn. 1968).

118. *See* notes 105-06 *supra* and accompanying text.

119. *See* note 106 *supra* and accompanying text.

120. In *Ellis v. United States*, 288 F. Supp. 168 (W.D. Tenn. 1968) the court stated:

> The right of beneficiaries to treat tax-exempt interest earned and distributed by trusts as tax-exempt interest in the hands of the beneficiaries is a specific right created by Part I of Subchapter J of the Code. This Court is of the opinion that section 682(b) gives this specific right to beneficiaries of section 71 alimony trusts as well as beneficiaries of other types of trusts.

Id. at 170.

121. *See* notes 102 and 107 *supra* and accompanying text.

122. *See* Treas. Reg. § 1.71-1(b)(5) (1954), which states in part:

> However, if the periodic payments described in section 71(a) are to be made by an estate or trust, such periodic payments are to be included in the wife's taxable year in which they are includible according to the rules as to income of estates and trusts provided in sections 652, 662 and 682, whether or not such payments are made out of the income of such estates or trusts.

the rules of trust accounting and, therefore, implies that a distribution of corpus is the only other situation. There is no reference to alimony payments in the form of tax-exempt income which flow from the alimony trust.[123]

At the very least, the language of the Treasury Regulations and of congressional reports is ambiguous in this respect. Their reiteration that it is immaterial whether payments are made indirectly or directly from the husband's income or capital provides no insight into this specific issue.[124] Only the *Ellis* case seems clear and consistent in allowing the wife to exclude from her gross income the tax-exempt income of a section 71 alimony trust.

Congressional reform is urgently needed, because considerable inequities exist with two types of alimony trusts. Whether a husband and wife fall within the purview of a section 71 alimony trust or a section 682 trust is unclear and confusing to the taxpayers, their attorneys and the courts.[125] An in-depth study should be made to gain decisional predictability. The attorney's research should not only encompass the law, but also the decree or separation agreement, the trust agreement itself and the trust provisions. This enormous workload for practitioners can not be justified merely because of the infrequent use of alimony trusts as compared with the direct payment method.

No policy justification for different tax consequences can be found for treating section 71 alimony trusts differently from section 682 alimony trusts. Although their creation is explained by history,[126] different tax consequences which follow their creation are neither explained nor explainable.

For a wife to obtain preferential tax treatment under an alimony trust, two prerequisites must be fulfilled. First, the husband must be the beneficiary of a trust and must assign this interest, which is hopefully sufficient to meet the needs of his wife. The husband may also create a trust with the wife as beneficiary through an antenuptial agreement, postnuptial agreement or otherwise. Either of these two methods must be accomplished *before* contemplation of divorce or separation.[127] Secondly, when divorce or separation becomes final, the divorce decree or separa-

---

123. *See* notes 118-20 *supra* and accompanying text.

124. The district court accepted the ruling that distributions from the corpus are taxable to the wife-beneficiary of a section 71 alimony trust; the court, however, stated:

> This court is of the opinion that this determination [tax-exempt income is excludible] is not inconsistent with the holdings requiring the wife-beneficiary to report distributions of trust corpus as income.

Ellis v. United States, 288 F. Supp. 168, 170 (W.D. Tenn. 1968).

125. *See* notes 110-11 *supra* and accompanying text.

126. *See* notes 58-61 *supra* and accompanying text.

127. *See* notes 73-76 *supra* and accompanying text.

tion agreement must not incorporate the previous trust agreement or make any specific statement that the trust agreement is in lieu of alimony. Such payments would then be in discharge of a legal obligation imposed upon or incurred by the husband because of the marital or family relationship.[128]

To create a section 682 alimony trust, technical considerations must be given by both parties' attorneys to the highly complex tax consequences. Tax planning in this situation is of little value because the trust must be created at a time when the parties have no thoughts of divorce or separation. To gain a tax advantage the husband and wife must create a trust on the probability that at a future date they may be divorced or separated. This is a useless act in marital relationships if the contingency never occurs, as well as a psychologically depressing prospect to contemplate.

The direct payment method allows the husband a deduction from his taxable income whether the payments are made from taxable income, from liquidated capital or from tax-exempt income which he receives and distributes to his wife. The creation of a section 71 alimony trust discriminates against the husband in the latter two aspects.[129] If the trustee is directed to liquidate a portion of the corpus when the income falls below the prescribed amount and to remit the proceeds to the wife, the husband is given no deduction for such a liquidation of his capital.[130] Furthermore, if the wife is a beneficiary of a section 71 alimony trust, and if the husband and wife are considered as one entity, they are taxed on more income than they have actually received. The following hypothetical exemplifies this point:

> The husband's sole income in 1969 is a salary of $12,000. An alimony trust was created pursuant to a divorce in which the wife was to receive $5,000 annually from the income. If the income from the trust were less than $5,000, then the deficiency was to be made up from the corpus. In 1969 the income from the trust was only $2,000; hence, $3,000 was distributed from the corpus, the wife is taxed on $5,000 and the husband is taxed

128. *See* notes 76-79 *supra* and accompanying text.

129. Although the *Ellis* case has allowed the wife to exclude tax-exempt income under a section 71 alimony trust, the next case may not go unchallenged because there has been no acquiescence by the Commissioner to the *Ellis* case.

130. If the deficiency payments are made personally by the husband, either directly to the wife or to the trust for immediate payment to the wife, such payment would be deductible by the husband. *See* Mahana v. United States, 88 F. Supp. 285, 289 (Ct. Cl. 1950). Although no case has been decided on this specific issue, nowhere in the Code or the treasury regulations is the husband allowed or prohibited a deduction when the trustee is required to make up the deficiency from the corpus with a promise by the husband to reimburse the trust.

on $12,000; a total of $17,000. However, their actual combined income was only $14,000.[131]

If the husband were allowed a deduction of the $3,000 payment from the corpus, the result would be equitable. In the alternative, if the wife were allowed to exclude this portion as a wife under a section 682 alimony trust could do, uniformity and equity would result.[132] The inequitable result of the above example can be avoided even though the trust is a section 71 alimony trust. If the trust income in some years proves insufficient for discharging the wife's alimony payments, the deficiency could be made up by the husband personally, rather than from the trust corpus. By adopting this procedure, the husband can deduct the deficiency. If the wife demands greater security, the husband may furnish a bond to guarantee punctual payment of such deficiency.[133] To avoid this two-step process and to allow the trust to function normally, an amendment is needed to allow the husband and the wife under a section 71 alimony trust the corresponding benefits now given to husbands and wives of either the direct payment method or the section 682 alimony trust.

A deduction is given to a husband who makes direct alimony payments from tax-exempt income.[134] With an alimony trust, however, an exclusion is given to the husband, *even though* the corpus is funded with tax-exempt securities. Such an exclusion appears to be worthless to the husband.[135] By the very nature of the securities the income is originally excluded from the husband's gross income, regardless of a trust situation. Therefore, to give the husband a second exclusion is of no practical value. The exclusion of income to the husband only has merit where such income is taxable to him. The exclusion given to the husband for taxable trust income and the deduction of direct alimony payments by non-trust husbands is perhaps the *only* equitable part of the alimony trust in a tax sense.

The tax consequences to the husband and wife would no longer be inequitable if there were only one kind of alimony trust. Uniformity and certainty would be accomplished regardless of when the trust was created, what the decree or separation agreement embodied or what the language of the trust agreement provided. A provision is needed which

131. Gornick, *supra* note 22, at 44 (the dates and dollar amounts have been changed).

132. *See* notes 92-93 *supra* and accompanying text.

133. *See* note 130 *supra*. Whether the alimony payments are paid through the proceeds of the bond or the trust corpus, should be of little importance to the divorced wife, since she is fully taxed on the income regardless of the source.

134. INT. REV. CODE of 1954, § 215.

135. INT. REV. CODE of 1954, § 682(a).

would either allow a wife as beneficiary of a section 71 alimony trust the same benefits that are now given to a section 682 wife or, in the alternative, which would abolish the trust conduit rules with all payments includible in the gross income of the wife and permit the husband a deduction when part of the corpus or tax-exempt income is paid to the wife. Either method would produce uniformity and remove the incongruous and inequitable situation that now exists. Although uniformity may not be the sole criterion for an equitable tax system, the lack of it is the most patent defect in the taxation of alimony trust income.

Until these amendments are enacted, alternatives are necessary to avoid adverse tax consequences to either the husband or wife or both.

Tax Suggestions for an Alimony Trust

An alimony trust may be used in lieu of the direct payment method for reasons other than tax advantages. The alimony trust offers security to the wife against fluctuations in the hubsand's income and against enforcing compliance with the financial provisions of the decree or separation agreement. The trust arrangement allows maximum flexibility to both the husband and wife by naming an independent trustee. Securities may be substituted and periodic withdrawals or additions may be made to the corpus. The trust permits the husband to retain maximum control over the ultimate disposition of the transferred property. Also, the trust can terminate upon the wife's remarriage, death or any other contingency which may make its continuance unnecessary.[136]

The following tax suggestions may enable the husband-settlor and wife-beneficiary of a section 71 alimony trust to gain a specific tax advantage. First, the trust should be funded with securities that produce taxable income rather than non-taxable income. This practice would have merit even though the tax-exempt income is not taxable to the wife because of the "character rule" of section 662(b).[137] The exclusion of these payments from the wife's gross income may result in less money saved by the husband than by periodic payments without a trust. Thus, the husband gains a deduction and the wife is required to include the payments in her gross income. The following example illustrates this proposal:

> A husband has taxable income of $28,000. Pursuant to a divorce his attorney advises him to create an alimony trust which yields $10,000 tax-exempt annually. The wife has no

136. Johnson, *Divorce and Federal Income Taxes*, 37 Minn. L. Rev. 413, 424 (1953); Rosenkranz, *Divorce and the Federal Income Tax*, 28 U. Fla. L. Rev. 1, 28 (1963).

137. *See* notes 112-20 *supra* and accompanying text.

income and demands $10,000 after taxes. If the husband creates the trust his tax will be $10,090 and her tax will be zero. However, if he pays the wife $14,000 from his taxable or non-taxable income and does not create the trust, his tax will be $3,550 and the wife's tax will be $3,940 leaving her with more than $10,000 after taxes. By adopting the latter method the husband will gain $2,540 more dollars after taxes.[138]

The husband should bind himself personally to pay any deficiency in trust income if that income fails to meet the objective standard set by the parties in the trust agreement.[139] If the wife demands additional security, a bond could be placed in the hands of an independent third party, to become payable to the extent of the deficiency in case of default. This arrangement should not be objectionable to the wife, since she would still be fully taxed on a corpus distribution. It will, however, enable the husband to gain a deduction to the extent of the deficiency. This would not be true if the trustee were directed to pay the deficiency out of the corpus.[140]

Since direct alimony payments are deducted from the husband's gross income, whereas alimony trust income is merely excluded, this difference influences other deductions. One example to illustrate this influence is that a husband who habitually has large charitable contributions should use the direct payment method to maximize his adjusted gross income,[141] whereas a husband who habitually has large extraordinary medical expenses should use the trust payment method to minimize his adjusted gross income.[142]

An escrow agreement could be the most beneficial to provide the security which the wife demands. Such an agreement would cure the defect of the insecure arrangement in the previous example,[143] where the husband makes periodic payments to gain a deduction rather than the exclusion. This method would provide an additional alternative for a husband who creates a trust funded with taxable securities which binds him personally to pay any deficiency in the trust income, with or without the placement of a bond as additional security. The following example illustrates an escrow arrangement:

The husband and wife agree that periodic payments in the

138. Note, *Tax Aspects of Alimony Trusts*, 66 YALE L. REV. 881, 894 (1957) (the dates and dollar amounts have been changed).

139. *See* notes 129-33 *supra* and accompanying text.

140. *See* note 130 *supra* and accompanying text.

141. INT. REV. CODE of 1954, § 170(b).

142. INT. REV. CODE of 1954, § 213.

143. *See* note 138 *supra* and accompanying text.

> amount of $500 a month are necessary. However, in order to secure these payments the wife demands additional security. The husband deposits in escrow with an independent third party stock certificates aggregating in market value of $75,000. The escrow agreement provides that the husband is entitled to the dividends annually from these securities as long as he is not in default in making the periodic payments from his personal income each year to his wife. The husband is entitled to the dividend income to the extent of his total payments made to his wife during the year. The excess accumulation of dividend income is not to be paid out to the husband nor can he invade the corpus of the escrow. If a default occurs the dividend income is used to cure the default. At the designated time when the periodic payments are to cease or when such contingency occurs as the wife's death or remarriage, the escrow agreement is terminated and the securities revert back to the husband.[144]

This arrangement allows the husband a deduction for his periodic payments and provides security for the wife.

In a section 682 alimony trust the wife is given preferential tax treatment in contrast to the wife-beneficiary of a section 71 alimony trust. This favorable tax aspect, however, is frequently a mere product of the situation existing at the time of the divorce and not the result of any tax planning between the husband-settlor and wife-beneficiary.[145]

One consideration in a section 682 alimony trust is whether the prerequisites can be fulfilled by an existing trust when divorce or separation is imminent. Whether the husband has certain powers over the trust which have been reserved to him, or whether it is a sterile trust from which the income can only be assigned, will be additional factors in determining its use.[146] One final determination is whether the distinction between the deduction and the exclusion will be crucial to both parties in the tax sense.[147]

Conclusion

Without clarity and predictability in the field of alimony trust law, one can only expect a further compounding of already complex and technical concepts. Although the wife-beneficiary of a section 71 alimony trust may exclude tax-exempt income from her gross income under the

144. Hull, *Federal Tax Problems in Marriage, Divorce and Separation*, 41 TAXES 722, 730 (1963) (the dates and dollar amounts have been changed).
145. *See* notes 73-79 *supra* and accompanying text.
146. *Id.*
147. *See* notes 91-93 *supra* and accompanying text.

Ellis decision,[148] many other tax inequities remain unresolved. A taxpayer must often use either a multistep process or a partial alimony trust in order to avoid these adverse tax effects. This is apparent in the situation where the alimony trust income is insufficient to meet the objective standard established by the husband and wife.[149]

Although the income tax is of primary concern to the husband-settlor and the wife-beneficiary, the estate and gift tax consequences must also be considered in determining whether the trust should be established. A capital gains tax may likewise be incurred by the husband when there is a transfer of appreciated property to the wife and such a transfer discharges the wife's marital rights.[150] An alimony trust may be a "loophole" in this situation, but due care must first be given to the prerequisites of establishing such a trust to avoid the capital gains tax. The income, estate, gift and capital gains taxes should be weighed and balanced in accordance with the parties' objectives before a rational decision can be made to proceed with an alimony trust.

148. *See* notes 112-14 *supra* and accompanying text.

149. *See* notes 129-33 *supra* and accompanying text.

150. Note, *Selected Tax Aspects of Divorce and Property Settlements,* 41 IND. L.J. 732, 749 (1966); Note, *The Tax Consequences of Divorce and Property Settlement,* 1963 DUKE L.J. 365.