

Divorce, an Overlooked Tax Planning Tool (Or Gimmick)

Theodore W. Hirsh

Follow this and additional works at: <http://digitalcommons.law.umaryland.edu/mlr>



Part of the [Family Law Commons](#), and the [Tax Law Commons](#)

Recommended Citation

Theodore W. Hirsh, *Divorce, an Overlooked Tax Planning Tool (Or Gimmick)*, 40 Md. L. Rev. 430 (1981)

Available at: <http://digitalcommons.law.umaryland.edu/mlr/vol40/iss3/6>

This Article is brought to you for free and open access by the Academic Journals at DigitalCommons@UM Carey Law. It has been accepted for inclusion in Maryland Law Review by an authorized administrator of DigitalCommons@UM Carey Law. For more information, please contact smccarty@law.umaryland.edu.

DIVORCE, AN OVERLOOKED TAX PLANNING TOOL (OR GIMMICK)*¹

THEODORE W. HIRSH**

Other than the marital deduction allowed for estate tax purposes,² which requires the existence of a surviving spouse, almost all of the alleged federal income and estate tax benefits³ of marriage can be obtained by the effective utilization of divorce as a tax planning tool. The planned divorce allows a taxpayer both to enjoy most of the federal tax benefits obtainable through marriage and also to avoid many of the detriments⁴ that the Internal Revenue Code imposes in other areas of tax planning because of marriage.⁵

To illustrate the various topics under consideration, correspondence has been retrieved from some old files of a law firm, which, as one will understand from the letters, has elected to remain nameless. From these letters it will be discovered that the advice the lawyers have given to their clients, to utilize divorce as a tax planning tool, has enabled the clients to solve otherwise complex and sometimes seemingly unsolvable problems. Perhaps it may seem that they have been overly aggressive in their planning, but one must admit, they have solved some problems to which the more traditional practitioner would have succumbed.

Rather than encouraging the institution of marriage, the Internal Revenue Code has, to the contrary, created certain detriments that arise from the marital status. These detriments can be found in the income

*1. From time to time, a lawyer should look at the law from a perspective other than the lofty perches of scholarship or practicality. The law, even tax law, can be fun if we remove some of our constraints. This article, although founded on sound legal principles, represents an effort to have some fun with the law. I hope it is as enjoyable to read as it was to write.

** Member of the Maryland Bar. Partner, Miles & Stockbridge, Baltimore, Maryland. This article is adapted from a paper delivered at the December, 1980 meeting of the Wranglers Law Club at Baltimore, Maryland.

2. I.R.C. § 2056. Unless otherwise noted, all section references in this article are to the Internal Revenue Code of 1954, as amended.

3. No attempt will be made to list, discuss, or even elude to other benefits (or detriments) that may be obtainable through marriage.

4. See note 3 *supra*.

5. In this article it will be necessary to delve into some of the intricacies of the Internal Revenue Code. However, to spare the reader the torture of actually traversing this statutory morass and the affliction of numerical incantations of sections and subsections of the tax laws, an attempt will be made to summarize briefly the applicable provisions of the Internal Revenue Code in each of the areas discussed. This will be attempted without referring to innumerable statutory sections and subsections, regulations and rulings. However, since this is tax law and its magical properties are hidden from those denied the insight of its cabalistic mysticism, it will be necessary from time to time to invoke these talismanic numbers.

tax rate schedules,⁶ the restrictions on the deduction of losses,⁷ the denial of capital gain treatment in certain transactions between husband and wife,⁸ and in many other areas.⁹ These detriments can be avoided, or at least mitigated substantially, by the institution of the "tax-motivated divorce."

EXAMPLE NO. 1. THE TWO PAYCHECK FAMILY

Mr. and Mrs. George Kantaxus
P.O. Box 7201
Baltimore, Maryland

Re: George, Jr.

Dear George and Helen:

I was upset to learn from you that George, Jr. and his new bride are facing some significant problems in meeting their living expenses. Prior to Junior's marriage, I had suggested that Junior and his prospective bride come to my office for tax counselling; however, they apparently did not deem that to be necessary. As a result of that lack of planning they have now, of course, run into some unforeseen tax problems.

The essence of the problem faced by Junior and his wife is that, as a result of both of them being employed, they have found themselves in a much higher federal income tax bracket than they would have been in had they not been married. Based on the information you gave me the other day, it would seem that the best tax advice to them would be to obtain an immediate divorce, thereby qualifying themselves as unmarried taxpayers who can file separate individual federal income tax returns. The additional funds that will be generated by federal income tax savings should go a long way in solving their current financial problems.

Since I do not engage in a divorce practice, I am enclosing a list of names of various law clinics at which Junior and his bride can obtain a divorce for an advertised price of \$75.00.

Sincerely,

6. I.R.C. § 1(d).

7. I.R.C. § 267.

8. I.R.C. § 1239.

9. *E.g.*, I.R.C. §§ 58(a), 103(b)(3), 121(b)(1), 302(c), 304(b), 306(b), 334(b)(3), 336(c), *et cetera*.

The advice given in this letter deserves analysis. In the recent Tax Court decision of *Boyter v. Commissioner*,¹⁰ the United States Tax Court summarized this problem as follows:

A married couple filing a joint return is taxed on their total combined income and, as for all taxpayers, the marginal tax rate increases as total income increases. Reflecting income splitting enacted in 1948, the rate schedule for married couples filing jointly is somewhat lower than it is for single persons. Consequently, if one partner of the marriage produces all or most of the income, he or she pays less tax than if single. However, if both spouses work, the second income is piled on the first, and is thus in a higher marginal tax bracket than if it stood alone. Because the higher tax bracket can more than negate the lower rate schedule for couples filing jointly, when two people who earn somewhat comparable salaries decide to marry, they unhappily discover that their total tax bill is higher than it was before they were wed.

In the *Boyter* case, the Tax Court was confronted with a married couple from Ellicott City, Maryland, who had fallen into the trap of the rate schedule described by the Tax Court. Both were independently employed and found themselves slowly creeping up that progressive tax schedule under the Internal Revenue laws.

For illustration, I have assumed that each of the members of this dual paycheck household has employment income of \$45,000 per year. As an unmarried taxpayer, each would be subject to a federal income tax of approximately \$13,392, or a combined tax of \$26,784. By entering into the holy bond of matrimony, they immediately increase their federal income tax liabilities to a total of \$30,363, or an additional cost of almost \$3,600. In attempting to mitigate against this problem, this happy couple took annual end of the year vacations to the islands, Haiti and the Dominican Republic, where they obtained annual December divorces. (They also re-wed each January.) Believing that the divorce qualified them for a December 31 status as unmarried taxpayers,¹¹ they filed separate tax returns, thereby saving the \$3,600 extra marriage tax. Unfortunately, the Internal Revenue Service thought otherwise and the case was submitted to the United States Tax Court.

Rather than deny the efficacy of the tax-planning divorce, the Tax Court merely noted that under the laws of the State of Maryland, the

10. 74 T.C. 72 (1980).

11. I.R.C. §§ 2(b)(2) and 143(a).

foreign divorces were invalid, and that at the close of each of the years in question the parties were still bound by the bond of matrimony. As such, they were not eligible to file their returns as single taxpayers.

It is interesting to note that the decision of the Tax Court does not deny the benefit sought, that is, single status, on the ground that the divorce was tax motivated. Although this argument was made by the Internal Revenue Service, the Tax Court never addressed this point. Rather, it stated unequivocally that "the Tax Court is bound by state law rather than federal law when attempting to construe marital status."¹² It is important to keep this point in mind. The Tax Court did not reject divorce as a tax planning device. Therefore, if approached in the right manner, the tax-motivated divorce should achieve the benefits sought.

The couple in the *Boyster* case were really pikers. The tax-benefit divorce, through the expanded use of the federal income tax rate tables, together with the added twist of the alimony deduction, can save far more than the \$3,600 they sought.

EXAMPLE NO. 2. ALIMONY AS AN INCOME SPLITTER

Mr. George Kantaxus
P.O. Box 7201
Baltimore, Maryland

Dear George:

Let me be the first to congratulate you on your recent graduation from medical school. As you are probably well aware from reading *Medical Economics*, you will be earning a great deal of money in the immediate future. I would assume that your annual income during the first year of practice will be approximately \$215,000. This income will be taxed as earned income, subject to the maximum tax on earned income. Assuming that you and Helen file a joint federal income tax return, your combined federal income tax liability will be approximately \$97,500. This, of course, is not an extraordinarily high tax rate (even though it is almost half of your income), when it is compared to the tax that will be levied on your investment income derived from your investment portfolio accumulated during your attendance at medical school. Based on your investments at the present time, you will be realizing income of approximately \$100,000 per year in the form of interest and dividends. Of course, I have excluded from this computation your tax-exempt income. This additional \$100,000 of income will be subject to a tax liability of \$70,000 leaving you a net yield of only \$30,000 on your investments.

12. 74 T.C. at 72, 74 (1980).

I have suggested that you and Helen obtain a divorce and, pursuant to the terms of the divorce decree, you could pay alimony to Helen of \$100,000 per year. The Internal Revenue Code provides for this alimony to be fully deducted by you, although Helen would have to treat it as income to her. Since the deduction for alimony is treated as a deduction in arriving at your adjusted gross income, no adjustments have to be made to your earned income by virtue of taking this alimony off of the top of your tax bracket.

The combined tax liabilities for you and Helen, following the divorce, will be reduced significantly so that your liability for your earnings from your profession would be approximately \$100,000. Although this is \$3,000 higher than your tax on your earnings by filing a joint return, Helen's tax on the \$100,000 that you would pay to her as alimony is only \$50,000 as compared to the \$70,000 tax on this same income prior to divorce.

If you have any questions with respect to this rather beneficial proposal, please feel free to call me.

Sincerely,

Under the provisions of Section 71 and Section 215 of the Internal Revenue Code, alimony and certain periodic payments in lieu of alimony are deductible by the payor spouse and are taxable as income to the recipient spouse.¹³ In the case of a more affluent couple, such as George and Helen, the total dollar benefits of divorce are significantly greater than the mere \$3,600 in Example 1. In the second example, George and Helen have a combined income of \$315,000: \$215,000 of which is earned by George in his occupation as a physician, and the balance of which is investment income. With this level of income, the combined federal income tax liability of George and Helen would be \$167,000, since George's earnings are subject to a maximum tax on earned income of 50%¹⁴ and the earnings from his investments, such as interest and dividend income, are subject to a tax rate of up to 70%.¹⁵ Merely by obtaining a divorce and having George pay that extra \$100,000 as alimony, George and Helen would each be eligible to file separate returns as unmarried taxpayers.¹⁶ Since the alimony would be taxed to Helen under the provisions of Section 71 of the Internal Revenue Code, George becomes entitled to a deduction for this amount under Section 215. This would leave George with a tax liability of

13. These two sections are interrelated. In order to get the deduction provided for in I.R.C. § 215, the income must be taxed to the spouse receiving the payment.

14. I.R.C. § 1348.

15. I.R.C. § 1.

16. I.R.C. §§ 2(d) and 143(a).

\$100,000 and Helen with a tax liability of \$50,000, for a combined tax liability of \$150,000, or a net savings of \$17,000. To retain this additional \$17,000 as an after-tax yield, George and Helen would have to generate additional pre-tax earnings in the form of dividends and interest of over \$56,000. As you can see, this is a rather significant saving.

What gives rise to all of this? As noted earlier, alimony is fully deductible by the spouse paying that alimony¹⁷ and is subject to a tax as income by the recipient spouse.¹⁸ Since George would be paying Helen \$100,000 per year in alimony, he would be entitled to a deduction, under the provisions of Section 215 of the Internal Revenue Code, for that payment. This deduction is taken as a deduction from his gross income in arriving at his adjusted gross income,¹⁹ so that the payment of alimony will have no impact on the computation of the maximum tax on earned income.²⁰

Helen, on the other hand, receives money²¹ which would have been taxed at the 70% bracket had they remained married and can begin the journey up the progressive tax rates schedule as a single taxpayer. Her first \$3,400 would be subject to a tax of only \$154, and throughout the entire rate schedule ascension, her tax liability does not even reach the 70% bracket to which all of that same income would be subject if she and George were still married.²²

Under present law, there are three types of payments that will qualify as alimony payments and thereby become taxable to the recipient spouse and deductible by the paying spouse. Section 71 describes these three types of payments as: (1) those made pursuant and subsequent to a decree of divorce or pursuant to a written instrument incident to such a divorce;²³ (2) payments made pursuant to a written separation agreement executed after the enactment of the 1954 Code, even though the parties are not formally divorced;²⁴ and, (3) payments made after the enactment of the 1954 Code and made pursuant to a

17. I.R.C. § 215.

18. I.R.C. § 71.

19. I.R.C. § 62(13).

20. I.R.C. § 1348(b)(2)(A). Prior to the Tax Reform Act of 1976, alimony was an itemized deduction and could result in the loss of some of the benefit of the earned income maxi-tax. See Pub. L. No. 94-455, § 502(a), 90 Stat. 1559 (1976).

21. Such amount would be taxed, of course, under I.R.C. § 71.

22. The utilization of alimony as an income-splitting device predates the statutory authorization for use of the joint return as a similar device. Alimony was first allowed as a deduction in 1942, whereas the joint return was first authorized in 1948.

23. I.R.C. § 71(a)(1).

24. I.R.C. § 71(a)(2).

decree for support that was entered after March 1, 1954.²⁵ Although no divorce need be obtained for this treatment, under the latter two categories the parties would still be considered married for tax purposes and generally would not be able to file as unmarried persons.²⁶

All three types of payments that qualify as alimony under Section 71 require that those payments be made as periodic payments. The statute does not define precisely what type of payments are periodic payments, but it does indicate that periodic payments need not be made at regular intervals. Section 71 also provides that certain types of installment payments discharging a principal sum specified in a divorce decree or an agreement will not be treated as periodic payments unless those payments are to be paid over a period ending more than ten years from the date of the decree or agreement.²⁷ In this situation, however, the amount that is deductible by the husband in any taxable year is limited to 10% of the total principal sum.²⁸ This may be illustrated by the following example. The divorce decree obligates a husband to pay his former wife \$300,000 over a period of 15 years. He is to pay \$40,000 each year for the first five years and then \$10,000 each year for the remaining years. Under this payment schedule, during the first five years only \$30,000, that is, 10% of the principal sum of \$300,000, will be deductible by the husband. Thereafter he will be entitled to claim a deduction for the entire \$10,000 payment each year.

The courts have generally held that if payments under a divorce decree or separation agreement terminate on the happening of a contingency, such as the remarriage of the recipient spouse (an event which cannot be readily evaluated on an actuarial basis), the payments are not deemed to be payments of a principal sum and may be considered periodic, even though they do not last for ten years.²⁹ This principle has been adopted in Treasury Regulations under Section 71 of the Internal Revenue Code which state that if the payments "are subject to any one or more of the contingencies of death of either spouse, remarriage of the wife, or change in the economic status of either spouse," then the payment shall be considered to be periodic — even though they do not meet the ten year test.³⁰

The Treasury Regulations contain an interesting limitation on the payment of alimony by requiring that those payments must be

25. I.R.C. § 71(a)(3).

26. A separated spouse not divorced may still qualify as unmarried for purposes of federal income taxes if the conditions of I.R.C. § 143(b) are satisfied.

27. I.R.C. § 71(c).

28. I.R.C. § 71(c)(2).

29. See, e.g., *Baker v. Commissioner*, 205 F.2d 369 (2d Cir. 1953).

30. Treas. Reg. § 1.71-1(d)(3) (1960).

attributable to maintenance or support of the recipient spouse rather than to that spouse's rights in marital property.³¹ This regulation is apparently an interpretation of the statutory phrase contained in Section 71 that the payments must be received because of the "marital or family relationship." Although the phrase "marital or family relationship" would seem to include all kinds of payments, including those going beyond the concept of support, courts have held that even payments that would otherwise be treated as periodic payments may not be deductible by the paying spouse nor taxable to the recipient spouse if they are attributable to property rights rather than support.³² For this reason, care should be used in drafting the tax-planned divorce separation agreement to identify the nature of the payments being made so as to qualify them as alimony.

EXAMPLE NO. 3. HOW TO GET OUT OF A TAX SHELTER

Mr. George Kantaxus
P.O. Box 7201
Baltimore, Maryland

Dear George:

I was very disturbed to hear that Tomorrowslums Apartments was the subject of a foreclosure by the mortgage lender. I am certain that you will miss the tax losses generated by Tomorrowslums' Partnership in filing your tax return for the forthcoming year. The absence of this tax loss from your tax return is compounded by the fact that the foreclosure will generate an extremely large tax liability, most of which will be taxed as ordinary income to you without the benefit of the maximum tax on earned income.

As I have noted to you in our earlier correspondence, a foreclosure by a lender is treated as a sale for federal income tax purposes. I have estimated that the federal income tax liabilities that will be generated by the foreclosure are three times the amount of your original investment in the partnership.

You should not be overly concerned about this potential tax liability because of the advance tax planning done at the time you entered into this investment. As you will recall, I had suggested that the partnership interest in Tomorrowslums Partnership be taken in the name of your wife, Helen. Therefore, even though the losses from the partnership were utilized in the filing of joint

31. Treas. Reg. § 1.71-1(b)(4) (1960).

32. *C.f. Joslin v. Commissioner*, 52 T.C. 231 (1969), *aff'd*, 424 F.2d 1223 (7th Cir. 1970).

income tax returns with Helen to reduce your tax liabilities, the tax liability generated by the foreclosure is technically Helen's and not yours. Therefore, should you and Helen be divorced by year end, Helen will be able to file a separate federal income tax return (as will you) and report the gain with a significantly lower federal income tax liability. Since Helen has no funds of her own, she will have to file that tax return without any payment of tax. However, by merely waiting three years Helen will be eligible to file for bankruptcy and discharge these tax liabilities.

I would suggest that the question of divorce be raised with Helen immediately since it is essential that the divorce be concluded prior to year end.

I should note that a similar result can be obtained merely by Helen's filing a separate federal income tax return as a married person filing separately. Unfortunately, this alternative will result in a higher tax liability to you.

Sincerely,

In the income tax area, the effective utilization of marriage followed by a divorce can provide other opportunities. As Example 3 illustrates, the filing of a joint return by a husband and wife allows the income and losses of both to be treated as a single tax unit, thereby allowing the losses and credits of one spouse to offset the income tax liability of another.

In the tax shelter area, if either member of the husband and wife team obtains a tax sheltered investment to generate losses, those losses will shelter the taxable income of one or both of the spouses.³³ In George and Helen's case, during their marriage George was the major earner and it was his earnings that generated the tax liabilities. By acquiring a tax sheltered investment in Tomorrowslums Partnership, he was able to reduce his annual tax liabilities.³⁴ However, this tax sheltering was done with the risk of possible adverse future tax consequences.³⁵ If he had acquired the tax shelters, he would be faced with the possible consequences and tax liability if the tax shelters were to go bad. For that reason, and as a result of long-term planning, George acquired all

33. I.R.C. § 6013(a).

34. I.R.C. § 702.

35. The tax consequences of a tax shelter going bad are themselves worthy of an entire dissertation. Two excellent articles on the tax consequences resulting from the "gone bad" tax shelter are Ginsberg, *The Leaky Tax Shelter*, 53 TAXES — THE TAX MAGAZINE 719 (December 1975); Kanter, *Existing Tax Shelters: Is It Possible To Cope?*, 56 TAXES — THE TAX MAGAZINE 822 (December 1978). Although there have been some legislative changes since these articles were written, especially in the area of carryover basis, they still give a broad and excellent coverage of this complex area.

of the tax shelters during the course of his marriage in Helen's name. Even though George and Helen were able to utilize these losses in the filing of their joint federal income tax returns during the loss years, Helen was the actual owner of the tax sheltered investment and, in the event of a recapture resulting from foreclosure, it is Helen who is subject to the tax liabilities. Therefore, it was suggested to George that prior to the close of the taxable year in which this horrible event occurs, he and Helen divorce. The foreclosure would then generate the tax liability to Helen for the year in question.³⁶ What will Helen do about the tax liability? Merely by waiting the three year period provided for in the bankruptcy act,³⁷ Helen can be discharged of this liability.³⁸ During this period of time, of course, Helen may be subject to collection pressures by the I.R.S.³⁹ This should be taken into account in any alimony arrangement. From a practical standpoint, there should not be too much to worry about. The tax return can be filed on April 15 of the year following the foreclosure, and the bankruptcy can be filed three years later. Since the tax liability would not be a Class Six priority, it would be discharged.⁴⁰

Although the utilization of divorce can be an effective tool for avoiding tax shelter recapture, it should be noted that the mere election of the married couple not to file a joint federal income tax return for the year of the recapture can achieve the same result.⁴¹ They could resume the filing of the joint return in the subsequent year. This eliminates the problems of alimony and divorce but will result in a somewhat higher tax liability since the returns will have to be under the category of married persons filing separately.⁴²

EXAMPLE NO. 4. CORPORATE PLANNING

Mr. and Mrs. George Kantaxus
P.O. Box 7201
Baltimore, Maryland

Re: Stock Redemption by Kantaxus Corporation

Dear George and Helen:

It was delightful meeting with you the other day to discuss the problem of your corporation's over-accumulation of surplus. As I

36. *C.f.* Crane v. Commissioner, 331 U.S. 1 (1947); Millar v. Commissioner, 577 F.2d 212 (3d Cir. 1978).

37. 11 U.S.C. § 507(a)(6)(A)(i).

38. 11 U.S.C. § 727(a).

39. I.R.C. §§ 6331 to 6336.

40. 11 U.S.C. §§ 727(a) and 523(a)(1).

41. The election to file a joint return under I.R.C. § 6013 may be exercised on an annual basis.

42. I.R.C. § 1(d).

mentioned to you, the provisions of the Internal Revenue Code impose an additional tax liability on corporations accumulating income rather than paying that income out in the form of dividends where the purpose of retaining that income is to avoid the tax that would be generated on its shareholders.

In light of the accumulations by your corporation, it will be necessary for your company to pay out a large dividend this year which will be taxed to you at the 70% tax rate.

I have proposed an alternative to the payment of a dividend: a redemption of some of the shares of stock held by you. I have made some computations that will enable your corporation to use all of its accumulated earnings to redeem certain corporate shares and thereby mitigate against the application of the accumulated earnings' tax.

Although the Internal Revenue Code generally treats stock redemptions as a sale or exchange of stock thereby generating a capital gain, the existence of a close relationship between shareholders, such as a husband and wife, will generally prevent that redemption from being taxed as a capital gain and will result in the redemption being taxed as a dividend distribution. This, of course, is not a result that either of you would like.

I have analyzed various provisions of the Internal Revenue Code and have concluded if you two were to be divorced prior to the redemption, the provisions of the Internal Revenue Code that attribute your individual stock ownerships to each other would become inapplicable. The redemption I have proposed, then, could be accomplished without having the proceeds of the redemption being taxed as ordinary income. The difference in the applicable federal tax rates is over 40% and the savings generated by such a divorce would be worthwhile to both of you.

Please let me know how much you expect the corporation to make this year so that I can prepare the necessary divorce and corporate papers to reflect the redemptions.

Sincerely,

The various tax saving devices referred to earlier, that is, the use of the income tax rate schedule, alimony, and the interplay of joint and separate tax returns, are only simple attempts to utilize divorce in obtaining income tax benefits. In the area of corporate tax planning the use of the tax-motivated divorce can achieve goals otherwise unobtainable.

The provisions of Section 318 of the Internal Revenue Code set forth certain rules under which individuals, corporations, partnerships, trusts, and estates are deemed to own shares of stock in corporations

held by other members of families or related entities.⁴³ As a result of these rules, many of the tax planning tools available in the corporate area may be denied to a taxpayer because of constructive ownership of stock brought on by marriage. For example, in determining whether a distribution in redemption of stock is to be treated as essentially equivalent to a dividend,⁴⁴ the constructive ownership rules apply.⁴⁵ In determining whether a redemption can be made through related corporations under Section 304, the constructive ownership rules apply.⁴⁶ In determining whether the disposition of Section 306 stock will be taxed as ordinary income or as a capital gain, the constructive ownership rules apply.⁴⁷ So too, other provisions of the Internal Revenue Code, such as Section 267 providing certain restrictions on losses between related taxpayers, Section 1239 dealing with the treatment of gains on sales of depreciable property between related taxpayers, and many other highly technical sections of the Internal Revenue Code from pension plans to surtax exemption, may depend on attribution of stock ownership. It is clear that the existence of the relationship of husband and wife can have significant adverse tax consequences. In order to reap the beneficial tax rates afforded to redemptions,⁴⁸ to generate losses on sales or exchanges,⁴⁹ to realize capital gains by selling depreciable property,⁵⁰ and to obtain certain pension plan benefits without being required to include a cross-section of employees,⁵¹ all that may be needed is a divorce.

Section 318(a) of the Internal Revenue Code specifically highlights this point in providing that an individual is deemed to own shares of stock owned directly or indirectly by his spouse, *other than a spouse who is legally separated from the individual under a decree of divorce or separate maintenance*.⁵² By avoiding attribution between spouses in the example set forth above, Helen, following the divorce, could have her shares of stock redeemed by the corporation and have that redemption treated as a capital gain.⁵³ All she has to do is meet the requirement of

43. The attribution of ownership under I.R.C. § 318 generally treats the person to whom the ownership of stock is attributed as if that person actually owned such shares. I.R.C. § 318(a)(5)(A).

44. I.R.C. § 302(b)(1).

45. I.R.C. § 302(c).

46. I.R.C. § 304(b)(1) and (c)(2).

47. I.R.C. § 306(b)(1)(A)(ii).

48. I.R.C. § 302(b)(1).

49. I.R.C. § 267.

50. I.R.C. § 1239.

51. I.R.C. §§ 414(b) and 1563.

52. I.R.C. § 318(a)(1)(A)(i).

53. I.R.C. § 302(a).

Section 302 (b) (2), namely, that the redemption be substantially disproportionate. By having at least 20% of her shares redeemed, she would succeed in this objective.⁵⁴ Although this same result might be reached by a complete termination of Helen's interest, it should be noted that, in the absence of a divorce, Helen could not have had her shares redeemed if she had received them as a gift from George within a ten-year period before the redemption⁵⁵ or if within a ten-year period after the redemption Helen has any interest in the corporation as an officer, director, or employee.⁵⁶ By using divorce, these highly technical tax pitfalls can be avoided.

EXAMPLE NO. 5. ESTATE AND GIFT TAX PLANNING —
THE MARITAL DEDUCTION

Mr. George Kantaxus
P.O. Box 7201
Baltimore, Maryland

Dear George:

I was shocked to learn of the sudden terminal illness of Helen. Apart from your deep personal loss in the event of her death, I should note that your entire estate plan has been structured on the assumption that Helen would survive you, since her survivorship is necessary for your obtaining the marital deduction.

I have reviewed your estate plan again and have found that there is a viable alternative to this marital deduction in your Will. One of the alternatives is for you to make a large gift to your wife, claiming a gift tax marital deduction for one-half of the gift and paying the tax on the balance. This would allow some of your estate to pass at a lower tax rate. Unfortunately, your gift would be subject to the gift tax and, at your wife's death, another tax may be due. The use of this type of gift planning would also use up all of the unified credit available for purposes of gift and estate taxes.

A better solution to this problem is the use of a divorce. By divorcing Helen at this time, you can transfer a significant portion of your property to her, free of any gift or estate tax and without using any portion of your unified gift and estate tax credit. In light of the significant tax savings that would result from this type of transfer, I am certain Helen will understand.

Sincerely,

54. I.R.C. § 302(b)(2).

55. I.R.C. § 302(c)(2).

56. I.R.C. § 302(c)(2)(A)(ii).

The estate and gift tax planning between husband and wife probably provides the most effective and truly unique utilization of divorce as a tax-planning vehicle. Although the provisions of both the gift tax⁵⁷ and the estate tax⁵⁸ provide for a marital deduction, the marital deduction does not eliminate the tax in the gift situation; it merely postpones that tax by reducing the at-death marital deduction,⁵⁹ or reduces the gift tax liability to a tax on one-half of the gift.⁶⁰ For example, if all of the assets of the married couple are owned by one spouse, that spouse can die and leave up to one-half of the marital estate to the surviving spouse, thereby avoiding a significant federal estate tax liability. This is a standard estate plan but it presumes the survival of the spouse without the assets. In the unfortunate event of the death of the spouse not owning assets, the marital deduction is lost unless the survivor quickly obtains the benefit of a second spouse.⁶¹ If the spouse owning the assets attempts to make a lifetime gift to the other spouse, gift taxes will be due when the total taxable gifts exceed \$100,000.⁶²

The utilization of divorce can avoid the potential gift taxes and eliminate the problem of the premature death of the spouse without assets. For example, if Helen, the spouse without assets, obtains a divorce from George, the asset-owning spouse, she can, pursuant to the provisions of Section 2516 of gift tax sections of the Internal Revenue Code, receive property from George in satisfaction of marital and other property rights without the imposition of a gift or estate tax.⁶³ It would be possible, therefore, for the healthy spouse owning all of the assets to transfer by divorce an amount equal to what would have been the marital deduction, and thereby preserve the benefit of the marital deduction in the event of the early death of his spouse.⁶⁴ Although part of this benefit might be obtained through the use of the gift tax marital

57. I.R.C. § 2056.

58. I.R.C. § 2523.

59. I.R.C. § 2056(c)(1)(B).

60. I.R.C. § 2523.

61. The obtaining of the benefit of a second spouse for purposes of utilizing the marital deduction may be an extremely expensive method of tax savings.

62. I.R.C. § 2523(a)(2).

63. The provisions of I.R.C. § 2516 specifically exclude from taxable gifts certain payments made in connection with divorces. Although the estate tax provisions of the Internal Revenue Code do not contain any specific provision similar to Section 2516, courts have interpreted the estate tax provisions to allow the divorce to provide the basis for the consideration on which claims may be founded against an estate. *C.f.* Estate of Lester v. Commissioner, 57 T.C. 503 (1972).

64. A warning should be made at this point to alert the reader to the fact that if the property is transferred to a spouse and that spouse suddenly dies, the estate of the deceased spouse will become liable for a federal estate tax, payable generally within nine months of the date of death.

deduction, that deduction is available only for the first \$100,000 of interspousal transfers. In large estate, any transfers to the spouse in excess of the \$100,000 amount would be subject to a gift tax liability. Divorce eliminates this tax in its entirety.

Even if we assume the existence of two very healthy spouses, the utilization of the lifetime divorce transfer can be used to equalize the estates of the spouses, thereby significantly reducing the cash flow requirements in the event of a death of one spouse at an early age. For example, let us assume an estate of \$5,000,000 all held by the husband. If he were to die at an early age, even utilizing the marital deduction, his estate would owe a tax liability of approximately \$1,000,000. However, by utilizing the lifetime gift via a divorce decree, he can reduce his estate to \$2,500,000. In the event of his early death, his estate liability (if he utilized a full marital deduction) would be approximately \$400,000, a cash flow savings of almost \$600,000. With the rate of current inflation, the retention of this \$600,000 would make up for the possible additional tax liability (about \$85,000) at the death of the surviving spouse.

Not only can the divorce be utilized to provide for tax-free transfers between spouses, but the Internal Revenue Code also allows the tax-free transfer of assets for the benefit of minor children, if made in connection with the divorce to discharge support obligations.⁶⁵ In a marital context that would generate a tax liability imposed for the gift and significant income tax liabilities imposed on the subsequent utilization of such funds for the support of such children.

The recent addition of Section 121 to the Internal Revenue Code,⁶⁶ providing an exclusion from income of up to \$100,000 on gains realized on the sale of a principal residence by an individual who has reached age 55, provides a new and interesting area for the use of divorce in tax planning. Under the provisions of Section 121, the utilization of this exclusion is a once in a lifetime event which, if exercised by the taxpayer or his spouse, prohibits its use at a later date.⁶⁷ Therefore, if a husband and wife, who are otherwise qualified for the exclusion under Section 121, sell their principal residence at a gain, they can exclude only \$100,000 of the gain from income even though the actual gain exceeds that amount.⁶⁸ By obtaining a divorce prior to the sale of their home, they would not be deemed to be spouses at the time of the sale and it would appear that each is qualified to claim the full \$100,000

65. I.R.C. § 2516(2).

66. Pub. L. No. 95-600, § 404(a), 92 Stat. 2869 (1978).

67. I.R.C. § 121(b)(2).

68. I.R.C. § 121(b)(1).

exclusion on the sale of each party's one-half share of the residence.⁶⁹ By using the divorce as a planning device, parties selling a highly appreciated personal residence may be able to exclude \$200,000 from their incomes in the year of sale.⁷⁰

The various tax planning alternatives discussed in this article are not without problems. Perhaps the major problem is the possibility of a realization of a gain on the transfer of property between spouses in connection with a divorce. The Supreme Court's decision in *U. S. v. Davis*⁷¹ has now made it clear that the transfer of appreciated property by one spouse to another spouse pursuant to a divorce decree or separation agreement will result in taxable gain measured by the difference between the fair market value of the property at the time of the transfer and the cost basis of that property.⁷² Yet, even in the *Davis* situation, things are not all bleak for the recipient spouse who receives that property with a stepped-up basis corresponding to the fair market value of the property on which the husband's capital gains tax was based. Even though there is a receipt of that step-up in basis, the recipient spouse does not realize gain on the transfer even though she has theoretically relinquished a portion of her marital rights for the receipt of that property. Both the Internal Revenue Service and the courts have agreed with this result.⁷³

Like most other complex areas of the law, one should enter into this new vista of tax avoidance with caution and perhaps a degree of trepidation. Fortunately, most of us will not be required to make these significant decisions. I have found that every client to whom I have recommended⁷⁴ divorce as a tax planning tool has terminated my employment.

69. I.R.C. § 121(d)(6).

70. Care should be taken to avoid the result required by the *Davis* case. See note 71 *infra*. This result would follow if, at the time of the divorce, the personal residence was owned by only one of the spouses. By transferring an interest in the property to the other spouse incident to the divorce, the Supreme Court's conclusion in the *Davis* case would require that transfer to be treated as a sale at the then fair market value of the residence, thereby generating income to the spouse making the transfer equal to the difference between the value of the one-half interest and the basis in that interest. If, however, the property were jointly held at the time of the divorce, regardless of the amount of contributions made by either spouse, the parties would merely sever their interests incident to the divorce rather than create a taxable transfer. See Rev. Rul. 56-437, 1956-2 C.B. 507.

71. 370 U.S. 65 (1962).

72. *Id.*

73. See Rev. Rul. 67-221, 1967-2 C.B. 63; *Howard v. Commissioner*, 447 F.2d 152 (5th Cir. 1971).

74. This article was prepared before the passage of the Economic Recovery Tax Act of 1981. The provisions of this act will significantly affect many of the author's "proposals."