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Taxation -- Alimony Trusts -- Power of Divorce Court to Modify as Determining Settlor's Taxability

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and a previous one,[29] has added a third exception, namely, that if the court feels an operating receivership will enure to the benefit of the secured creditors by making the liquidation of the assets more successful, either by selling them in the usual course of business rather than by a forced sale or by caring for them pending the sale, then the court is justified in granting a receivership with the expenses being first paid out of the fund realized by the sale, although the secured creditor did not consent thereto.

Where the majority rule is ignored, as in the *Armour* case, general creditors of a private corporation are allowed to try the experiment of a receivership with authority to operate the business in the hope that the business can be made to pay under the receivership, although it failed to do so under its officers. This is done at the expense of the non-consenting secured creditors if the experiment is a failure.

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Taxation—Alimony Trusts—Power of Divorce Court to Modify as Determining Settlor's Taxability.

In the recent case of *Helvering v. Fuller*,[1] a wife obtained a Nevada divorce, the decree incorporating and approving a pre-divorce agreement. The agreement provided for an irrevocable trust, created by the husband, income from which was payable to the wife for ten years for her support and maintenance, when the corpus was to become hers absolutely; for other property settlements; and for waiver by each of all claims against the other. *Held:* Trust income was not taxable to the husband.

In the companion case of *Helvering v. Leonard*,[2] a wife obtained a New York divorce, the decree incorporating and approving a pre-divorce agreement. The agreement provided for the creation by the husband of an irrevocable trust comprised partly of bonds the principal and interest of which he guaranteed. The trust income[3] was payable to the wife for life for her support and maintenance, corpus to be held for their children on her death. *Held:* The trust income was taxable to the husband.

Why this disparity in tax liability growing out of facts essentially similar, differing only in minor detail? The opinion in the *Leonard* case relies on two distinguishing characteristics which determine the issue: 1st—Taxpayer Leonard guaranteed the principal and interest on

[29] Bank of Pinehurst v. Mid-Pines Country Club, Inc., 208 N. C. 239, 179 S. E. 882 (1935).

[1] 310 U. S. 69, 60 Sup. Ct. 784, 84 L. ed. 715 (1940).
[2] 310 U. S. 80, 60 Sup. Ct. 780, 84 L. ed. 721 (1940).
[3] $5000 a year was to be paid to each of three children, remaining amount to the wife.

the trusteed bonds; 2nd—he was a party to a divorce obtained in New York. Obviously the former, subject to the acquiescence of the wife, was at the outset within his control; and had he chosen to be less generous, that decisive element would have been eliminated. The latter suggests, at least, the advisability of a more discreet choice of jurisdiction.

There is no attempt here to extol the virtues of a tax policy which in all cases so outlines its requisites as to leave the incidence to the free discretion of the taxpayer, nor to determine the justice or advisability of taxing one rather than the other party to similar transactions. However, there is a provocative implication, worthy of pursuit, in the dissent of Mr. Justice Reed that "Fine distinctions are necessary in reasoning but most undesirable in a national tax system."[4]

The controversy centers around the application of the doctrine of *Douglas v. Willcuts*[5] to these fact situations. That principle,[6] arising wholly without the express aid of statute,[7] has represented an effort by the Court to supplement the work of Congress in reducing the effectiveness of the trust as an instrument of tax avoidance. Briefly stated, it taxes the settlor on the income of any trust, not otherwise so taxable, which is applied to discharge his legal obligations. Underlying is the doctrine of "constructive receipt"[8]—that having received the benefit of the income, settlor may not now escape its attendant liabilities merely because it was directed through the medium of a trust to the payment of an otherwise non-deductible expense. Hence, the primary requisite is a "continuing obligation", running from settlor to beneficiary, to which the income is devoted. In the *Douglas* case, such an obligation was found in the general duty of husband to support wife, made specific by a divorce decree and continuing thereafter. Amounts paid in discharge of that duty are not deemed income to the wife,[9] and a hus-

[4] Helvering v. Fuller, 310 U. S. 69, 60 Sup. Ct. 784, 789, 84 L. ed. 715, 720 (1940).

[5] 296 U. S. 1, 56 Sup. Ct. 59, 80 L. ed. 3 (1935).

[6] See generally MERTENS, LAW OF FEDERAL INCOME TAXATION (1939 Cum. Supp.) §34.168; Bloomenthal, *Income Tax Aspects of Alimony Trusts* (1939) 17 TAX MAG. 455; Paul, *Five Years With Douglas v. Willcuts* (1939) 53 HARV. L. REV. 1; Tye, *Federal Taxation of Irrevocable Trusts Reëxamined* (April 1940) 18 TAX MAG. 216, 220; Notes (1937) 23 CORN. L. Q. 178, (1939) 52 HARV. L. REV. 804, (1939) 87 U. OF PA. L. REV. 337.

[7] Income not received by settlor is expressly taxed to him only under §§166, 167 of the Federal Revenue Act. 52 Stat. 519 (1938), 26 U. S. C. §166 (1940); 52 Stat. 519 (1938), 26 U. S. C. §167 (1940). The Court has construed the "gross income" provision, 52 Stat. 457 (1938), 26 U. S. C. §22a (1940) as well as 52 Stat. 464 (1938), 26 U. S. C. §24 (1940), relating to non-deductible items, as covering the maintenance trust situation.

[8] See Burnet v. Wells, 289 U. S. 670, 675, 679, 53 Sup. Ct. 761, 763, 764, 77 L. ed. 1439, 1442, 1444 (1933): Paul, *supra* note 6, at 6, n. 17.

[9] Douglas v. Willcuts, 296 U. S. 1, 8, 56 Sup. Ct. 59, 62, 80 L. ed. 3, 8 (1935) citing Audubon v. Shufeldt, 181 U. S. 575, 577, 21 Sup. Ct. 735, 736, 45 L. ed. 1009, 1010 (1901) and Gould v. Gould, 245 U. S. 151, 153, 38 Sup. Ct. 53, 62 L. ed. 211, 213 (1917).

band may receive no deduction for them.[10] There the decree of divorce incorporated the terms of a trust agreement under which the wife would receive a stipulated annual income "in lieu of, and in full settlement of alimony, and of any and all dower rights or statutory interests in the estate of" her husband, and "in lieu of any and all claims for separate maintenance and allowance for her support." Holding the husband taxable on this income, the Court points out that "the income of the trust fund . . . stands substantially on the same footing as though he had received the income personally and had been required by the decree to make the payments directly."[11] Further, "upon the pre-existing duty of the husband the decree placed a particular and adequate sanction, and imposed upon the petitioner the obligation to devote the income in question, through the medium of the trust, to the use of his divorced wife."[12] The Court dwelled at length on the legal status of such a decree in Minnesota, pointing out, although not elaborating upon, the power of the court later to modify the award. That the husband had agreed to make up deficiencies in the trust income and the property was to revert to him free of the trust on his wife's death received no consideration in the opinion.

Subsequently, in *Helvering v. Fitch*,[13] the Supreme Court disclosed the importance of the elements undiscussed in the *Douglas* case, indicating definite limitations to the once broad doctrine.[14] Here the trust, providing for the separate maintenance of the wife, comprised certain property, the rent from which was to be paid to her each month during her life. The corpus was irrevocably alienated by a provision that it should go to the children on the death of wife and settlor; and no portion of the monthly payments was guaranteed. The divorce decree confirmed the property and alimony settlement. The Court points out two factors, absent here, which they feel influenced the result of the *Douglas* case: (1) Douglas agreed to make up any deficiencies in the income; (2) the corpus was to revest in him on the death of his wife. These, it is said, made it evident that the "alimony trust, which was approved by the decree, was merely security for a continuing obligation of the taxpayer to support his divorced wife."[15] A third factor which they feel conclusively determined the status of the Douglas trust was the power of the Minnesota court subsequently to alter and revise its

[10] 52 Stat. 464 (1938), 26 U. S. C. §24a (1940).
[11] Douglas v. Willcuts, 296 U. S. 1, 9, 56 Sup. Ct. 59, 63, 80 L. ed. 3, 9 (1935).
[12] *Id.* at 8, 56 Sup. Ct. at 62, 80 L. ed. at 8.
[13] 309 U. S. 149, 60 Sup. Ct. 427, 84 L. ed. 399 (1940).
[14] See Bloomenthal, *supra* note 6, at 457 where it is indicated that the Board of Tax Appeals has in the past disclosed a tendency to follow the first broad implications of the doctrine.
[15] Helvering v. Fitch, 309 U. S. 149, —, 60 Sup. Ct. 427, —, 84 L. ed. 399, 400 (1940).

decree and the provisions therein for the wife's benefit. After surveying the law of Iowa, state of the Fitch divorce, they find the husband taxable, since he has at least not sustained the burden of proving that no such power exists in the divorce courts of that state.

"If we were to conclude that this case is an exception to that rule *(Douglas v. Willcuts)* we would be acting largely on conjecture as to Iowa law. That we cannot do. For if such a result is to obtain it must be bottomed on clear and convincing proof, and not on mere inferences and vague conjectures, that *local law and the alimony trust* have given the divorced husband a full discharge and leave no continuing obligation *however contingent.*[16] Only in that event can income to the wife from an alimony trust be treated under the revenue acts the same as income accruing from property after a debtor has transferred that property to his creditor in full satisfaction of his obligation—unless of course Congress decides otherwise."[17]

Thus, the principle seems to have these limits: 1—The pre-existing obligation may be terminated; and if it is, the settlor will not be taxable since there is no longer an obligation to which the trust income is devoted. Consequently, where this result obtains, the nature of the trust is altered, and the income therefrom becomes analogous to that accruing from property which has been transferred from debtor to creditor in full payment of a debt—which, as the Court implies, would certainly not be taxable to the debtor.[18] 2—But whether the obligation is so terminated depends upon (a) stipulations in the trust agreement itself, such as a covenant to make up deficiencies, which leave an obligation continuing after the divorce; or (b) provisions in the state law, such as the power to modify the decree, which have a like effect. If these factors, or either of them, exist the trust becomes "merely security for a continuing obligation" to support.

Carried to its logical extreme, and supported by the actual result of the *Fitch* case, the ultimate criterion of taxability thus becomes the power of the divorce court to modify its decree. More than that, the issue may finally turn upon the ability of the settlor to convince the Court that no such power exists, for as said in the *Leonard* case, "all

[16] Italics supplied.

[17] Helvering v. Fitch, 309 U. S. 149, —, 60 Sup. Ct. 427, —, 84 L. ed. 399, 403 (1940).

[18] Although there has been no express holding, dictum in the *Fitch* case (see note 15, *supra*) indicates that a husband's reversionary interest in the corpus might prevent the trust from assuming this character. This factor alone might determine his taxability, since the trust would then seem more nearly a "channel for the application" of his income than an outright transfer of property. It may be significant that in the *Fuller* case, the only one of this series in which the husband escaped tax, the corpus was to be transferred outright to the wife after ten years. The effect of remainders over to others than the husband or wife, such as to their children who would otherwise be the object of his bounty, remains to be disclosed by future cases where that point alone is present.

we do hold is that respondent has not shown by 'clear and convincing proof' that the court lacks the power. . . ."[19] Thus, two trusts,[20] identical in every detail, incorporated in decrees granting divorces based on the same facts, but decided in different states, may have opposite tax results merely because of fortuitous distinctions in local law.

Recently in *Lyeth v. Hoey*,[21] the Court reiterated the rule under which it adverts to state law in construing the Federal Revenue Act:[22]

"In dealing with the meaning and application of an act of Congress enacted in the exercise of its plenary power under the Constitution to tax income and to grant exemptions from that tax, it is the will of Congress which controls, and the expression of its will, in the absence of language evidencing a different purpose, should be interpreted so as to give a uniform application to a nation-wide scheme of taxation. . . . Congress establishes its own criteria and the state law may control only when the federal taxing act by express language or necessary implication makes its operation dependent upon state law."[23]

Obviously, where the statute is expressly dependent upon state law, the Court is powerless to avoid any inequities which may result from local legal divergencies. However, when the statute is silent and the question becomes one of legislative intent, the Court is in a favorable position to effect "a uniform application" of the tax. Thus, where a particular economic result or benefit is the criterion for the tax, state law may be applied to establish its existence; but where the result or benefit exists independently of its characterization in local law, that law may be disregarded.[24] For example, whether title to certain property has passed is, for most purposes, a matter of state law;[25] whether it has passed by "inheritance" or otherwise is exclusively a federal question.[26] However, an anomalous situation has arisen where, in construing the "gross income" provision, the Court has given effect to the characterization of income by the community property states, which is unlike that obtaining elsewhere.[27] As many authorities contend, the

[19] Helvering v. Leonard, 310 U. S. 80, —, 60 Sup. Ct. 780, 784, 84 L. ed. 721, 724 (1940).

[20] Compare Helvering v. Fuller, 310 U. S. 69, 60 Sup. Ct. 784, 84 L. ed. 715 (1940) with Helvering v. Fitch, 309 U. S. 149, 60 Sup. Ct. 427, 84 L. ed. 399 (1940).

[21] 305 U. S. 188, 59 Sup. Ct. 155, 83 L. ed. 119 (1938).

[22] See generally, PAUL, SELECTED STUDIES IN FEDERAL TAXATION (2nd Ser. 1938) 1-52; 5 PAUL & MERTENS, LAW OF FEDERAL INCOME TAXATION (1934) §53.38; Note (1934) 34 COL. L. REV. 526.

[23] Lyeth v. Hoey, 305 U. S. 188, 194, 59 Sup. Ct. 155, 158, 83 L. ed. 119, 124 (1938).

[24] Burk-Waggoner Oil Ass'n v. Hopkins, 269 U. S. 110, 46 Sup. Ct. 48, 70 L. ed. 183 (1925); Burnet v. Harmel, 287 U. S. 103, 53 Sup. Ct. 74, 77 L. ed. 199 (1932).

[25] See 5 PAUL & MERTENS, *op. cit. supra* note 22, at 863.

[26] Lyeth v. Hoey, 305 U. S. 188. 59 Sup. Ct. 155, 83 L. ed. 119 (1938).

[27] Poe v. Seaborn, 282 U. S. 101, 51 Sup. Ct. 58, 75 L. ed. 239 (1930) (holding each spouse taxable on only one-half of community income, since under state

consequence has been gross inequality in tax results although the economic benefits are identical.[28] For the most part, however, the court has achieved singular success in this endeavor to distribute the tax burden equally. Since this expedient is an outgrowth of that judicial and legislative approach to tax questions which seeks substance rather than form of taxable transactions,[29] no definite rules may be evolved as a guide to future cases. The course followed in each case must necessarily vary with the nature of the tax, the subject, and the policy to be effectuated. That the Court should be left free to effectuate a clear policy of Congress is not to be questioned; but where the procedure adapted to that end involves inequities plainly unforeseeable by Congress, the Court should await its more detailed articulation.

In taxing the income from alimony trusts, the statute by whose implication the Court has justified its advertence to state law merely says that no deduction shall be allowed for "family expenses" in computing net income.[30] That this statute covers the present situation is clear when it is recalled that payment of such an expense by the income from an irrevocable trust is, in effect, an attempt by a circuitous route to receive a prohibited deduction. Thus, by indirection, the Court has reasoned that payments to a divorced wife are in discharge of a "family expense" where the obligation to support continues—the continuance of that obligation depending *ultimately* upon the power of the divorce court to modify its decree. Therefore, state law is applied to determine if that power exists.

A general survey will disclose that the conditions under which this power may be exercised vary considerably from state to state and often in a manner wholly unrelated to basic rights or liabilities of the husband.[31] But accepting the basic premise of the Court that the power to modify will render the obligation to support continuing and the trust a mere security for that obligation, a recourse to state law is inescapable since the condition upon which the tax attaches may only be found there. However, such recourse may at the same time result in a lack of uniformity in the incidence of the tax if the power to modify has merely a theoretical rather than a substantial effect on the present relation of the divorced couple.

Whether this effect upon the nature of the "post-marital" relation

law wife technically had a "vested" interest as distinguished from an "expectancy" in the income.) MAGILL, TAXABLE INCOME (1936) 268-274.

[28] See PAUL, *op. cit. supra* note 22, at 40-44; Altman, *Community Property: Avoiding Avoidance by Adoption in the Revenue Act* (1938) 16 TAX MAG. 138.

[29] See Burnet v. Wells, 289 U. S. 670, 677, 53 Sup. Ct. 761, 763, 77 L. ed. 1439, 1443, (1933).

[30] 52 Stat. 464 (1938), 26 U. S. C. §24a (1940).

[31] See Note (1937) 109 A. L. R. 1068; also see Note (1940) 40 COL. L. REV. 677, 679, n. 17.

is substantive or merely formal is a question of the most abstruse logic. However that may be, the *economic* relation of husband to wife is identical except in one respect; *i.e.* where the power exists, the husband may be later called upon to add to the settlement previously approved. As a practical matter, what substantial obligation is being discharged by his trust income which is not also being discharged by that of the husband more fortunately residenced? What benefits accruing to the former are denied the latter? Far from being continuing, the obligation to further contribute has yet to arise. Yet, the Court would answer, "the existence of wholly contingent obligations—is adequate to support the results reached in *Douglas v. Willcuts. . . .*"[32] To the practical mind this might suggest that the contingent obligation is being discharged by trust income; therefore, settlor is taxable. Obviously this is not true in the sense that the specific obligation has arisen. Then does it mean that the contingent obligation is subject to being discharged by trust income once the contingency has occurred? Not only would such reasoning seem to remove the case from the basic rule since in fact the obligation is not now being so discharged, but it also seems, at best, a half-truth since, when the obligation does arise (unless there is a re-allocation of trust income), it might be discharged in ways wholly unrelated to the trust originally set up. Clearly, the meaning is simply that since there is a *possibility* of the husband's having to contribute further, the decree does not make his general duty to support sufficiently definitive to be subject to absolute discharge in the same manner that a liquidated debt is satisfied by a lump sum settlement; thus, the duty to support continues. Certainly there may be contingent liabilities remaining, such as those arising from the trust agreement itself, which lend more definite reality to this position. But granted that where the power to modify exists, the husband is not completely discharged, the possibility of its exercise seems of too little consequence in most cases to justify its being designated as the dividing line between taxability and non-taxability. If the power were never exercised, clearly the *actual* nature of the post-marital relation would have been the same as if no such power had ever existed, whatever its abstract nature might have been. The logic of the Court seems to depend upon a distinction without a substantial difference, and results in a disparity of treatment not justified by a difference in practical enjoyment or benefit.

The Court might well have viewed the power to modify, not as assuming the continuance of an obligation to support, but rather as referable to a public policy which authorizes adjustments of post-marital

[32] Helvering v. Leonard, 310 U. S. 80, —, 60 Sup. Ct. 780, 783, 84 L. ed. 721, 723 (1940).

financial arrangements as exigencies arise. If, in that event, the trust approved by the decree appeared to be in final satisfaction of the obligation made specific by that judgment itself, the continuity of the general duty to support would be broken; and the obligation would exist only as and when declared in a modifying judgment. Should the new decree place burdens upon the husband which are discharged in a manner unconnected with the original trust, it is clear that the trust payments should not have been taxed to him. Thus, not the mere potentiality of its exercise, but the exercise of the power itself in the form of a modifying judgment, which prescribed new obligations and the manner of their discharge, would be looked to in determining taxability. Not only does this view seem to conform more closely to the realities of the situation, but also its adoption would eliminate the inequities which arise from the use of a criterion found in local law, the effect whose existence or non-existence is more often theoretical than real.

Although the uniformity of tax incidence guaranteed by the Constitution is "geographic" rather than "intrinsic",[33] and a statute conforming to the present view of the Court would no doubt be sustained on this ground, it is highly desirable from the point of view of both the Government and the taxpayer to avoid any inequalities not justified by considerations peculiar to the particular tax.[34] No such considerations are apparent here. The uncertainties inherent in the present holdings suggest the need of a statute expressly designed to cover the maintenance trust situation. Meanwhile, rather than to adopt a policy which often permits discrimination, the Court might well have sanctioned a tax upon the settlor in all such cases, an approach which the dissent asserts is most consistent with the choice first made in *Douglas v. Willcuts*.[35] But whether a statute is forthcoming, it should be strongly emphasized that insistence upon highly doctrinary theory will not always assure that reality of treatment which the Court itself has so often encouraged and tax administration demands.

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Torts—Municipal Corporations—Liability for Death or Injury to Prisoner.

Two recent North Carolina cases[1] involve injuries committed by one prisoner on a fellow-prisoner. It is significant to note that on

[33] Knowlton v. Moore, 178 U. S. 41, 20 Sup. Ct. 747, 44 L. ed. 969 (1900); Florida v. Mellon, 273 U. S. 12, 47 Sup. Ct. 265, 71 L. ed. 511 (1927).

[34] See PAUL, *op. cit. supra* note 22, at 49-52.

[35] See Helvering v. Fuller, 310 U. S. 69, —, 60 Sup. Ct. 784, 789, 84 L. ed. 715, 720 (1940).

[1] Dunn v. Swanson, 217 N. C. 279, 7 S. E. (2d) 563 (1940); Parks v. Princeton, 217 N. C. 361, 8 S. E. (2d) 217 (1940).