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# Taxation -- Alimony Payments -- State and Federal Income Tax Consequences

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selling expenses to a minimum. To the newcomer in the field, such contracts offer the possibility of a predictable market on the basis of which he may estimate what capital expenditures are necessary. Still more important to the newcomer is the opportunity these contracts may provide to establish a foothold against the counter-attacks of entrenched competitors. However, requirements contracts deny retailers the opportunity to deal in the products of competing suppliers. Since these suppliers are excluded from access to the outlets subject to such contracts, the new supplier may find himself foreclosed from any substantial market.

Whatever the commercial merits and demerits of the contract involved, the North Carolina statute in making requirements contracts illegal, *per se*, precludes any rule of reason which might otherwise be applied. The statute leaves no room for evidence as to a defendant's competitive position in the industry nor for testimony as to commercial justification of the contract in the particular case. While such a situation may seem undesirable, it must be remembered that the test of reasonableness places a tremendous burden on the courts to interpret complicated economic data—an undertaking for which courts are not particularly well suited.<sup>17</sup>

If all lease-sublease arrangements are held within the purview of the statute, suppliers might turn to the use of ordinary long-term contracts in which the purchaser agrees to buy a denominated amount of goods rather than his specific requirements.<sup>18</sup> Or, the supplier might simply refuse to deal with any retailer who has not shown a willingness to deal exclusively in the supplier's product.

On the other hand, there is a strong possibility that in so far as oil companies are concerned, prohibition of the lease-sublease arrangement would force them to resort to agency arrangements or to the outright acquisition of filling stations, either of which means increasing control over the retail field and forcing the independent owner to exchange his status for that of employee. Regardless of the possible consequences, this most recent decision on the point by the North Carolina court indicates that such lease-sublease contracts will be held illegal.

JOSEPH F. BOWEN, JR.

### Taxation—Alimony Payments—State and Federal Income Tax Consequences

No attorney can properly settle a separation or divorce case involving alimony or payments under a separation agreement, without con-

<sup>17</sup> See *Standard Oil Co. of Calif. v. United States*, 337 U. S. 293, 310 (1949).

<sup>18</sup> Some courts find this method less objectionable than requirements contracts.  
*Ibid.*

sidering the income tax consequences. This necessarily entails close scrutiny of both state and federal statutes.

The North Carolina income tax statutes provide that effective January 1, 1949, payments for the separate support and maintenance of a divorced or estranged spouse, who is living apart from the spouse making such payments, will be an allowable deduction. The payment may be made pursuant to a court order or under terms of a written or oral agreement of the parties. The deduction is limited, however, to the amount of the payment or one thousand dollars, whichever is smaller. Where payments are made to more than one spouse, then a similar limited deduction may be taken for each spouse. Support payments to a dependent or to a spouse for a dependent cannot be included in this deduction.<sup>1</sup> It appears that alimony or separation payments received are not taxable as income.<sup>2</sup> Since the state statute is applicable to all types of alimony payments, problems seldom arise in this area.

The Revenue Act of 1942 completely revised the federal tax treatment of alimony.<sup>3</sup> This changed the earlier rule under *Gould v. Gould*<sup>4</sup> that alimony was not taxable income to the wife nor deductible by the husband. An examination of the legislative history of the alimony sections reveals that Congress hoped to achieve a uniform treatment of amounts paid in the nature of or in lieu of alimony regardless of variance in the laws of the several states.<sup>5</sup>

With one exception, Section 23(u) of the Internal Revenue Code provides if a payment is includible in the income of the wife under Section 23(k) it is deductible from adjusted gross income of the husband.<sup>6</sup> Also where the husband is allowed a deduction, *a fortiori*, it is taxable income to the wife. However, in order for the payments to be deductible by the husband and taxable as income to the wife, they must meet the conditions of Section 22(k) and 23(u) of the Code. These

<sup>1</sup> N. C. GEN. STAT. §105-147(14) (Supp. 1949); P-H N. C. INC. TAX SERV. ¶10,750 (1950).

<sup>2</sup> P-H N. C. INC. TAX SERV. ¶10,485 (1950). Administrative boards have recommended to the present legislature that alimony payments be returned for taxation in the same amount as they are allowed for deductions.

<sup>3</sup> See generally, Kramer, *Alimony and the Tax Law*, 26 TAXES 1105 (1948); Starr, *Alimony as an Income Tax Deduction*, 27 TAXES 975 (1949); Wall, *Alimony and the Income Tax*, 3 MIAMI L. REV. 564 (1949); 34 MINN. L. REV. 280 (1950).

<sup>4</sup> 245 U. S. 151 (1917).

<sup>5</sup> H. R. REP. No. 2333, 77th Cong., 2d Sess. 72 (1942); SEN. REP. No. 1631, 77th Cong., 2d Sess. 83 (1943); *Stanley v. Stanley*, 226 N. C. 129, 37 S. E. 2d 118 (1946) ("Alimony . . . is an allowance made for the support of the wife out of the estate of the husband by order of court in an appropriate proceeding and is either temporary or permanent."); KEEZER, MARRIAGE AND DIVORCE §560 (3rd ed. 1946) (It is that obligation for support which arises in favor of the wife upon the disruption of the marriage relation.).

<sup>6</sup> Taxation of trusts, set up for the wife in lieu of alimony, is not covered in this note.

statutory conditions will be examined in the light of the law of alimony in North Carolina.

(1) *The parties must be divorced or legally separated under a decree of divorce or of separate maintenance.*<sup>7</sup> If the wife applies for divorce from bed and board, divorce *a vinculo*, or alimony without divorce, alimony *pendente lite* is provided for by statute in North Carolina.<sup>8</sup> Alimony payments *pendente lite*, however, are not deductible by the husband nor taxable to the wife because ordered prior to rather than pursuant to a decree by the court.<sup>9</sup>

An alimony without divorce decree, as provided for in North Carolina, seems to be neither a decree of legal separation nor a decree of divorce;<sup>10</sup> therefore, payments made pursuant to a decree of alimony without divorce are not deductible under Section 23(u) nor taxable under Section 22(k).<sup>11</sup>

Since in North Carolina a divorce *a vinculo* cannot provide for permanent alimony, ordinarily no tax problem arises.<sup>12</sup> If, however, a decree of absolute divorce is obtained upon the grounds of two years separation, as provided for in N. C. GEN. STAT. §50-5 or §50-6, such decree does not destroy the right of the wife to receive alimony under

<sup>7</sup> INT. REV. CODE §22(k): "In the case of a wife who is divorced or legally separated from her husband under a decree of divorce or of separate maintenance, periodic payments (whether or not made at regular intervals) received subsequent to such decree in discharge of, or attributable to property transferred (in trust or otherwise) in discharge of, a legal obligation which, because of the marital or family relationship, is imposed upon or incurred by such husband under such decree or under a written separation instrument incident to such divorce or separation shall be includible in the gross income of such wife, and such amounts received as are attributable to property so transferred shall not be includible in the gross income of such husband. . . ." INT. REV. CODE §23(u) provides for a deduction "In the case of a husband described in section 22(k), amounts includible under section 22(k), in the gross income of his wife, payment of which is made within the husband's taxable year. If the amount of any such payment is, under section 22(k) or section 171, stated to be not includible in such husband's gross income, no deduction shall be allowed with respect to such payment under this subsection."

<sup>8</sup> N. C. GEN. STAT. §50-15 (1943) (*a vinculo* and *a mensa* actions); N. C. GEN. STAT. §50-16 (1943) (alimony without divorce actions); *Peele v. Peele*, 216 N. C. 298, 4 S. E. 2d 616 (1939); *Medlin v. Medlin*, 175 N. C. 529, 95 S. E. 857 (1918) (*a vinculo* action by husband, court allowed alimony *pendente lite* to wife).

<sup>9</sup> *George D. Wick*, 7 T. C. 723 (1946), *aff'd*, 161 F. 2d 732 (3rd Cir. 1947). The Pennsylvania statute providing for alimony *pendente lite*, PA. STAT. ANN. tit. 23 §46 (1930) as amended (1933), is very similar to N. C. GEN. STAT. §50-15 (1943). See U. S. Treas. Reg. 111, §29.22(k)-1(a) (1948).

<sup>10</sup> N. C. GEN. STAT. §50-16 (1943) provides for a decree if the husband deserts and fails to provide, or is a drunkard or spendthrift (which would not seem to call necessarily for separate living), or gives cause for divorce, absolute or limited). See, *Shore v. Shore*, 220 N. C. 802, 804, 18 S. E. 2d 353, 354 (1942) (the statute is one solely for support).

<sup>11</sup> *Frank J. Kalchthaler*, 7 T. C. 625 (1946) (status under Pennsylvania law was that he was living apart from his wife, but not legally separated).

<sup>12</sup> N. C. GEN. STAT. §50-11 (1943), *Stanley v. Stanley*, 226 N. C. 129, 37 S. E. 118 (1946).

any judgment or decree of the court rendered before the commencement of the proceeding for absolute divorce.<sup>13</sup> This exception seems to include awards under an *a mensa* divorce,<sup>14</sup> alimony without divorce awards,<sup>15</sup> and separation agreements,<sup>16</sup> entered into prior to the divorce *a vinculo*. As noted above, alimony without divorce awards are not considered taxable under Section 22(k) because the parties have neither a legal separation nor a divorce.<sup>17</sup> On the other hand, if a prior alimony without divorce decree is incorporated into, or is referred to in the *a vinculo* divorce decree, it would seem to meet the requirement that the provision for payment be made in the divorce decree or by a written instrument incident to the divorce or separation. Further, separation agreements entered into prior to a decree of absolute divorce are not invalidated by a divorce *a vinculo*.<sup>18</sup> Thus, if the separation agreement is prepared with the understanding that the parties will be legally separated under a decree of divorce or of separate maintenance, then the payments received after the divorce *a vinculo* are taxable to the wife.<sup>19</sup>

On divorce from bed and board in North Carolina, the court may decree alimony to the wife.<sup>20</sup> Alimony paid pursuant to a decree of divorce from bed and board is deductible by the husband,<sup>21</sup> and such decree may be modified at a later date.<sup>22</sup> But if an agreement is entered into after the divorce, increasing the payments, the increase will not be deductible unless the new agreement is incorporated into the decree.<sup>23</sup> The agreement would not be "incident to the divorce" unless so incorporated. The same grounds which entitle the wife to a divorce *a mensa* entitle the wife to separate maintenance.<sup>24</sup> Therefore, it may be to her financial advantage to refuse to obtain a divorce *a mensa*, payments

<sup>13</sup> N. C. GEN. STAT. §50-11 (1943), *Simmons v. Simmons*, 223 N. C. 841, 28 S. E. 2d 489 (1944) (alimony without divorce); *Dyer v. Dyer*, 212 N. C. 620, 194 S. E. 278 (1937) (action for subsistence).

<sup>14</sup> See, *Stanley v. Stanley*, 226 N. C. 129, 134, 37 S. E. 2d 118, 121 (1946) (a prior award of alimony is protected from annulment by a decree in absolute divorce).

<sup>15</sup> *Simmons v. Simmons*, 223 N. C. 841, 28 S. E. 2d 439 (1944).

<sup>16</sup> *Jenkins v. Jenkins*, 225 N. C. 681, 36 S. E. 2d 233 (1945); *Lentz v. Lentz*, 193 N. C. 742, 138 S. E. 12 (1927) (consent judgment not affected by a subsequent absolute divorce).

<sup>17</sup> See note 11, *supra*.

<sup>18</sup> *Jenkins v. Jenkins*, 225 N. C. 681, 36 S. E. 2d 233 (1945); *Lentz v. Lentz*, 193 N. C. 742, 138 S. E. 12 (1927).

<sup>19</sup> *Tuckee G. Hesse*, 7 T. C. 700 (1946) (Pennsylvania divorce *a vinculo* statute involved, and similar to N. C. GEN. STAT. §50-11 (1943)).

<sup>20</sup> N. C. GEN. STAT. §50-14 (1943), *Silver v. Silver*, 220 N. C. 191, 16 S. E. 2d 834 (1941).

<sup>21</sup> *Accord*, *George D. Wick*, 7 T. C. 723, 728 (1946), *aff'd*, 161 F. 2d 732 (3d Cir. 1947).

<sup>22</sup> *Crews v. Crews*, 175 N. C. 168, 95 S. E. 149 (1918).

<sup>23</sup> *Natalia Danesi Murray*, P-H 1948 TC MEM. DEC. ¶48,097 (1948).

<sup>24</sup> N. C. GEN. STAT. §50-16 (1943).

under it being taxable, and receive tax free alimony under a separate maintenance award.

(2) *The provision for payment of alimony must be made specifically by the divorce decree or by a written instrument incident to the divorce or separation.*<sup>25</sup> When the provision for payment is expressly set out in the decree of divorce, there is no problem. Most of the cases under this section involve the problem of whether the separation agreement is incident to the divorce or separation. If a separation agreement meets certain requirements, it will be enforced in North Carolina.<sup>26</sup> Unless the separation agreement is entered into with a future divorce or legal separation in mind, however, payments received after the divorce are not taxable to the wife under Section 22(k) as not incident to the divorce.<sup>27</sup> A formal agreement of separation providing for payments, drafted after a decree of divorce *a vinculo* or *a mensa*, reducing to writing an oral agreement entered into prior to the decree, is not an agreement incident to the divorce.<sup>28</sup> If the agreement refers to an impending divorce, it might be construed as facilitating the divorce and will not be enforced.<sup>29</sup> Recognizing this, the Tax Court has held that to be incident to the divorce or legal separation, the agreement itself does not have to refer to the divorce or separation because the whole record will be considered.<sup>30</sup> Even payments made by taxpayer-

<sup>25</sup> INT. REV. CODE §22(k); Charles Campbell, 15 T. C. (No. 52) (1950) (letter written by husband stating he would pay a certain amount monthly to his wife if she obtained a divorce met the requirement of a written instrument).

<sup>26</sup> Archbell v. Archbell, 158 N. C. 408, 74 S. E. 327 (1912) (requisites of separation agreement: (1) there must be a separation already existing or immediately to follow the execution of the deed; (2) the separation deed must be made for an adequate reason, of such kind that it is necessary for the health or happiness of one or the other; (3) it must be reasonable and fair to the wife, considering the condition of the parties); N. C. GEN. STAT. §52-12 (Supp. 1947) (statutory requirements of valid agreement).

<sup>27</sup> Charles G. Brown, P-H 1949 TC MEM. DEC. ¶49,195 (1949) (agreement in form of support of wife and children under Pennsylvania law rather than for alimony); Benjamin B. Cox, 10 T. C. 955 (1948), *aff'd*, 176 F. 2d 226 (3rd Cir. 1949) (support agreement seven months after divorce not incident to divorce); Frederick S. Dauwalter, 9 T. C. 580 (1947) (after divorce decree entered, agreed with wife to increase alimony; held not deductible because husband's compliance with the request was gratuitous and without compulsion of any legal obligation arising out of a marital relationship imposed on him under a written instrument incident to such divorce).

<sup>28</sup> Frederick S. Dauwalter, 9 T. C. 580 (1947); U. S. Treas. Reg. 111 §29.22(k)-1 (1948) (Example (3): H and W enter into antenuptial agreement in which H agrees to pay wife \$200 a month for life for release of all dower rights. A divorce is later obtained, but silent as to such agreement and H's obligation to support W. Section 22(k) does not apply. But if the decree is modified to refer to the agreement, or if at time of the divorce, reference had been made to the agreement in the court's decree or in a written instrument incident to the divorce, Section 22(k) would require the inclusion in the income of the wife).

<sup>29</sup> Archbell v. Archbell, 158 N. C. 408, 74 S. E. 327 (1912).

<sup>30</sup> Estate of Daniel G. Reid, 15 T. C. (No. 78) (1950); Robert Wood Johnson, 10 T. C. 647 (1948).

husband to his estranged wife under orders of a New York court, in an attempt to enforce a voluntary separation agreement, were disallowed as a deduction because there was no "decree" as required by Section 22(k).<sup>31</sup>

(3) *The alimony payments must be periodic.*<sup>32</sup> Periodic payments normally state the amount to be paid each period, but neither the total period nor the total amount; whereas lump sum payments generally set forth the total amount that is to be paid. In general, installment payments discharging a part of an obligation, the principal sum of which is specified in the decree of divorce or legal separation or an instrument incident thereto, are not considered periodic payments and are therefore not includible in the wife's gross income under Section 22(k). Installment payments under a lump sum award or agreement may be deductible if the lump sum, by the terms of the decree or written instrument thereto, may be or is to be paid within a period ending more than ten years from the date of the decree or instrument. In such cases, the installment payment is considered periodic payment but only to the extent that such installment payments received during the wife's taxable year do not exceed ten percent of the principal sum.<sup>33</sup> The ten year period commences with the date the legal obligation to make the payments in question was imposed on the husband for the first time.<sup>34</sup> If the payments are contingent on earnings, the payments are considered periodic even though to be paid for a specific number of months.<sup>35</sup>

(4) *The payments must be made solely in settlement of the legal obligation imposed on the husband because of the marital relationship.* In *Frank J. Dubane v. Comm'r.*,<sup>36</sup> the parties orally agreed for alimony payments of twenty dollars a week, but the subsequent written agreement was so phrased that it indicated that the twenty dollar payments were for property that the wife had previously transferred to the husband. The written agreement controlled, and the payments under it were held not to be made solely in discharge of alimony and consequently non-deductible.

<sup>31</sup> Alfred Terrell, P-H 1948 TC MEM. DEC. ¶48,169 (1948), *aff'd*, 179 F. 2d 838 (7th Cir. 1950).

<sup>32</sup> Frank R. Casey, 12 T. C. 224 (1949) (payments in sum of \$100 per month for fifty months not periodic); J. B. Steinel, 10 T. C. 409 (1948) (sum of \$100 per month until the sum of \$9,500 is paid not periodic); INT. REV. CODE §22(k) (though required to be periodic, the payments need not be regular).

<sup>33</sup> U. S. Treas. Reg. 111 §29-22(k)-1(c) (1948).

<sup>34</sup> Tillie Blum, 10 T. C. 1131 (1948).

<sup>35</sup> Roland Keith Young, 10 T. C. 724 (1948) (fixed period of 50 months, but amount contingent on earnings held periodic.)

<sup>36</sup> 10 T. C. 992, 995 (1948) ("The result might be different had Congress chosen to recognize oral agreements or had the petitioner put his oral agreement in writing in a forthright manner.").

Many awards of alimony contain provisions for support of minor children. If a portion of a periodic payment is specifically designated for support of minor children, such portion is neither deductible by the husband nor taxable to the wife.<sup>37</sup> If the decree or separation agreement fails to earmark part of the periodic payment as support of the minor children, the total amount will be taxed to the wife irrespective of how the money was expended.<sup>38</sup> The whole decree or agreement will be examined to see if it furnishes by implication a basis for determining whether a portion is for the children's support.<sup>39</sup> If any periodic payment is less than the amount provided in a decree or written instrument which specified an amount for minor children's support, Section 22(k) provides that the amount paid will be considered first as a payment for support of the minor children and only the remainder is to be included as income of the wife.<sup>40</sup>

When a legal obligation to support a divorced or estranged spouse, living separate from his or her spouse, is satisfied by the transfer of property or payment of a lump sum, under the North Carolina law, the amount of such lump sum payment or the market value of the property at the time of conveyance, or one thousand dollars, whichever is smaller, may be taken as a deduction.<sup>41</sup> Under federal provisions, the rental value of real estate transferred in lieu of alimony is not deductible by the husband because it was never included in the husband's gross income.<sup>42</sup>

Section 22(k) provides that periodic payments received by the wife are includible in her income in the year received, regardless of what system of accounting she normally uses.<sup>43</sup> For the corresponding deduction, the husband is treated as if he makes his income tax return on the cash receipt and disbursement basis.<sup>44</sup> Under North Carolina statutes,<sup>45</sup> any individual who reports his income on an accrual basis may claim the

<sup>37</sup> U. S. Treas. Reg. 111 §29.22(k)-1(d) (1948).

<sup>38</sup> Dora H. Moitoret, 7 T. C. 640 (1946).

<sup>39</sup> Warren Leslie, Jr., 10 T. C. 807 (1948).

<sup>40</sup> U. S. Treas. Reg. 111 §29.22(k)-1(d) (1948). For example, if the husband is required by terms of the decree to pay \$200 a month to his divorced wife, \$100 of which is designated by the decree to be for the support of their minor children, and the husband pays only \$150 to his wife, \$100 is nevertheless considered to be a payment by the husband for the support of the children.

<sup>41</sup> N. C. GEN. STAT. §105-147(14) (Supp. 1949); N. C. GEN. STAT. §50-17 (1943) (provision for writ of possession in all cases where the court grants alimony by the assignment of real estate).

<sup>42</sup> Pappenheimer v. Allen, 71 F. Supp. 788 (M. D. Ga. 1947); *aff'd*, 164 F. 2d 428 (5th Cir. 1947) (By agreement wife lived in home of husband, under prescribed conditions, as part of the alimony settlement. The court indicated that rental value of the house was not taxable to the wife, because such a payment would not be considered periodic as required by Section 22(k).).

<sup>43</sup> U. S. Treas. Reg. 111 §29.22(k)-1(a) (1948).

<sup>44</sup> U. S. Treas. Reg. 111 §29.23(u)-1 (1948).

<sup>45</sup> N. C. GEN. STAT. §105-147(14) (Supp. 1949).

deduction for alimony if the payments claimed as a deduction are actually made within seventy-five days of the close of the taxpayer's fiscal or calendar year, whichever is used. A deduction claimed by a cash basis taxpayer for the transfer of property or lump sum payment must be taken in the income year in which the transfer of property or lump sum payment is effected. No deduction may later be claimed if not taken in that year. But if the taxpayer uses the accrual basis for reporting income the deduction for lump sum payments or transfer of property may be claimed on the accrual basis and no subsequent deduction shall be allowed.

HUNTER DALTON HEGGIE.

### Taxation—Income—Gain from Sale of Land with Growing Crops

Cases involving taxation of gain from the sale of land upon which there are growing crops are recent and in conflict. It seems odd that the tax consequences of such a sale have not been previously settled with finality. The basic facts are simple. Taxpayer is a farmer engaged in growing crops for sale at maturity. He sells land which he has owned for more than six months upon which there is an immature crop. Taxpayer reports his gain as a capital one within §117(j) of the Internal Revenue Code.<sup>1</sup>

Section 117(j) is a relief provision which allows gain from the sale of certain business property, not otherwise considered as a capital asset, to be taxed as a capital gain. To come within this section, the taxpayer must establish that the property sold was (1) used in his trade or business; (2) real estate or property subject to an allowance for depreciation; (3) held for more than six months; (4) not property includible in inventory; and (5) not held primarily for sale to customers in the ordinary course of trade or business.

The Bureau ruled in 1946<sup>2</sup> that upon the sale of a citrus grove having immature fruit on the trees, a portion of the sale price must be allocated to the growing fruit and the gain therefrom taxed as ordinary income. The balance, attributable to the land and trees, was ruled to be a capital gain within §117(j). A majority of the Tax Court has followed this ruling, holding that upon the sale of either an orange grove<sup>3</sup> or land containing an immature wheat crop,<sup>4</sup> an allocation must be made on the basis of the fair market value of the growing crop at

<sup>1</sup> See Hill, *Ordinary Income or Capital Gain on the Sale of an Orange Grove*, 4 MIAMI L. Q. 145 (1950), written prior to the cases commented upon here.

<sup>2</sup> I. T. 3815, 1946-2 CUM. BULL. 30.

<sup>3</sup> Earnest A. Watson, 15 T. C. 104 (1950).

<sup>4</sup> Thomas J. McCoy, 15 T. C. 106 (1950).