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STUDY OF THE OVERALL STATE OF THE FEDERAL TAX SYSTEM AND RECOMMENDATIONS FOR SIMPLIFICATION, PURSUANT TO SECTION 8022(3)(B) OF THE INTERNAL REVENUE CODE OF 1986

VOLUME III: ACADEMIC PAPERS SUBMITTED TO THE JOINT COMMITTEE ON TAXATION

Prepared by the Staff

of the

Joint Committee on Taxation

April 2001

U.S. Government Printing Office
Washington: 2001

JCS-3-01

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ACKNOWLEDGEMENTS

The Joint Committee on Taxation study of the overall state of the Federal tax system and recommendations to simplify taxpayer and administrative burdens is required by the IRS Restructuring and Reform Act of 1998 and funded by appropriations approved by the Congress.

The study was prepared and produced by virtually the entire Joint Committee staff. Special recognition must be given to Mary Schmitt and Carolyn Smith who helped on every stage of this project, from planning and coordinating staff teams to the final editing of the report. In addition, Rick Grafmeyer, who left the staff last year, was instrumental in assisting in the planning of this report. Cecily Rock, who contributed to various portions of the report, also coordinated the final production of the Joint Committee staff recommendations in Volume II.

This study was prepared by the legislative staff of the Joint Committee on Taxation, each of whom contributed to this final product: Carolyn D. Abraham, Secretary; R. Gregory Bailey, Legislation Counsel; Thomas A. Barthold, Senior Economist; E. Ray Beeman, Legislation Counsel; B. Jean Best, Secretary; John H. Bloyer, Chief Clerk; Michael E. Boren, Administrative Assistant; Mary Ann Borrelli, Economist; Tanya Butler, Statistical Analyst; Roger Colinvaux, Legislation Counsel; William J. Dahl, Senior Computer Specialist; John W. Diamond, Economist; Timothy A. Dowd, Economist; Patrick A. Driessen, Senior Economist; Christopher P. Giosa, Economist; H. Benjamin Hartley, Senior Legislation Counsel; Robert P. Harvey, Economist; Patricia A. Hensley, Data Set Specialist; Harold E. Hirsch, Senior Legislation Counsel; Thomas P. Holtmann, Economist; Melani Houser, Chief Statistical Analyst; Deirdre A. James, Legislation Counsel; Ronald A. Jeremias, Senior Economist; Gary Koenig, Economist; Thomas F. Koerner, Associate Deputy Chief of Staff; Lauralee A. Matthews, Senior Legislation Counsel; Patricia M. McDermott, Legislation Counsel; Debra L. McMullen, Senior Staff Assistant; Neval E. McMullen, Staff Assistant; Brian A. Meighan, Accountant; Pamela H. Moomau, Senior Economist; Tracy S. Nadel, Director Of Tax Resources; John F. Navratil, Economist; Joseph W. Nega, Legislation Counsel; Hal G. Norman, Computer Specialist; Melissa A. O'Brien, Tax Resource Specialist; Samuel Olchyk, Legislation Counsel; Christopher J. Overend, Economist; Lindy L. Paull, Chief of Staff; Oren S. Penn, Legislation Counsel; Cecily W. Rock, Senior Legislation Counsel; Lucia J. Rogers, Secretary; Bernard A. Schmitt, Deputy Chief of Staff; Mary M. Schmitt, Deputy Chief of Staff; Todd C. Simmens, Legislation Counsel; Christine J. Simmons, Secretary; Carolyn E. Smith, Associate Deputy Chief of Staff; William T. Sutton, Senior Economist; Melvin C. Thomas, Jr., Senior Legislation Counsel; Michael A. Udell, Economist; and Barry L. Wold, Legislation Counsel. In addition, the following former staff members contributed to this report: David P. Hering, Paul M. Schmidt, and Melbert E. Schwarz.

The Joint Committee staff gratefully acknowledges the contribution of the academic and tax policy advisors for the significant commitment of time and substantive contributions they made to the development of this report. The tax policy advisors provided guidance on the principal focus of the report, and the academic advisors provided significant input on the recommendations in the report. The meetings with the advisors were a rare opportunity for our staff to engage in informative and thought-provoking discussions with former government officials and scholars. The advisors are listed in Appendices A and B, respectively, of Volume I. Special recognition is given to three of the advisors who spent significant time working as consultants to the Joint Committee staff: Patricia E. Dilley, Christopher H. Hanna, and Frances R. Hill, and to the advisors who prepared papers for inclusion in Volume III of this study: Jonathan Barry Forman, Deborah A. Geier, Frances R. Hill, Annette Nellen, George K. Yin, and David J. Shakow.

The Joint Committee staff also recognizes the significant contributions of the General Accounting Office and the Congressional Research Service to this study. The work of these organizations is reproduced in Appendices C and D, respectively, of Volume I.

Lindy L. Paull
Chief of Staff

CONTENTS

VOLUME I

	Page
PART ONE.--EXECUTIVE SUMMARY AND JOINT COMMITTEE ON TAXATION STAFF STUDY MANDATE AND METHODOLOGY	2
I. EXECUTIVE SUMMARY	2
A. Study Mandate and Methodology	2
B. Background Information on the Federal Tax System	4
C. Sources of Complexity in the Present-Law Federal Tax System	5
D. Effects of Complexity on the Federal Tax System	6
E. Identifying Provisions Adding Complexity	7
F. Summary of Joint Committee Staff Recommendations	9
1. Overview	9
2. Alternative minimum tax	10
3. Individual income tax	10
4. Individual retirement arrangements, qualified retirement plans and employee benefits	15
5. Corporate income tax	18
6. Pass-through entities	19
7. General business issues	20
8. Accounting provisions	22
9. Financial products and institutions	23
10. International provisions	24
11. Tax-exempt organizations	26
12. Farming, distressed communities, and energy provisions	26
13. Excise taxes	28
14. Tax-exempt bonds	31
15. Estate and gift tax	33
16. Deadwood provisions	33
II. MANDATE FOR STUDY AND JOINT COMMITTEE STAFF STUDY METHODOLOGY	34
A. Study Mandate and Legislative Background	34
1. Study mandate	34
2. Legislative background	36
B. Joint Committee Staff Study Methodology	39
1. Review of the overall state of the Federal tax system	39
2. Identifying provisions adding complexity	42
3. Developing simplification recommendations	44
PART TWO.--OVERALL STATE OF THE FEDERAL TAX SYSTEM	48
I. BACKGROUND INFORMATION ON THE FEDERAL TAX SYSTEM	48
A. Sources of Federal Tax Law	48
B. Information Relating to the Filing of Tax Forms	54

Page

C. Taxpayer Assistance Provided by the IRS 55
D. Error Rates and Tax Controversies 56
II. SOURCES OF COMPLEXITY IN THE PRESENT-LAW FEDERAL TAX SYSTEM 58
A. Overview 58
B. Lack of Transparency in the Law 59
C. Use of the Federal Tax System to Advance Social and Economic Policies 68
D. Increased Complexity in the Economy 73
E. Interaction of Federal Tax Laws with State Laws 75
1. State laws generally 75
2. State property rights laws 77
3. State regulatory laws 82
4. State laws concerning entity classification 85
5. State income tax laws 86
F. Interaction of Federal Tax Laws with Other Federal Laws and Standards 88
1. Federal securities laws 88
2. Federal labor laws 89
3. Generally accepted accounting principles 91
G. Interaction of Federal Tax Laws with Laws of Foreign Countries and Tax Treaties 93
1. Laws of foreign countries 93
2. Tax treaties 97
III. EFFECTS OF COMPLEXITY ON THE PRESENT-LAW FEDERAL TAX SYSTEM 101
A. Overview 101
B. Decreased Levels of Voluntary Compliance 102
C. Costs of Complexity 103
D. Effect of Complexity on Perceived Fairness of the Federal Tax System 109
E. Effect of Complexity on Tax Administration 110
IV. EFFORTS OF FOREIGN COUNTRIES TO SIMPLIFY THEIR TAX LAWS 112
A. Simplification by Substantive Tax Reform 113
B. Simplification by Administrative Reform: Rewriting the Tax Law and/or Easing Taxpayer Compliance 115

Appendix A.--Academic Advisors to Joint Committee on Taxation for Study of Overall State of the Federal Tax System A-1
Appendix B.--Tax Policy Advisors to Joint Committee on Taxation for Study of Overall State of the Federal Tax System B-1
Appendix C.--General Accounting Office Materials C-1
Appendix D.--Congressional Research Service Materials D-1

VOLUME II

Page

PART THREE.--RECOMMENDATIONS OF THE STAFF OF THE JOINT COMMITTEE ON TAXATION TO SIMPLIFY THE FEDERAL TAX SYSTEM 2

I. ALTERNATIVE MINIMUM TAX 2

II. INDIVIDUAL INCOME TAX 23

A. Structural Issues Relating to the Individual Income Tax 23
1. Introduction 23
2. Filing status 23
3. Determination of marital status 24
4. Exclusions from income 26
5. Deductions and credits 27
6. Above-the-line deductions and itemized deductions 30
7. Standard deduction 33
8. Dependency exemption, child credit, and earned income credit 35
9. Treatment of capital gains and losses 36
10. Treatment of home mortgage interest of individuals 38

B. Filing Status, Personal Exemptions, and Credits 44
1. Uniform definition of qualifying child 44
2. Dependent care tax benefits 67
3. Modifications to the earned income credit 69
4. Determinations relating to filing status 75

C. Income-Based Phase-outs and Phase-ins 79

D. Taxation of Social Security Benefits 92

E. Individual Capital Gains and Losses 97
1. Adopt a uniform percentage deduction for capital gains in lieu of multiple tax rates 97
2. Definition of "small business" for capital gain and loss provisions 109

F. Two-Percent Floor on Miscellaneous Itemized Deductions 111

G. Provisions Relating to Education 122
1. Overview of tax provisions relating to education 122
2. Definition of qualified higher education expenses 122
3. Combine HOPE and Lifetime Learning Credits 126
4. Interaction among provisions 130
5. Deduction for student loan interest 132
6. Exclusion for employer-provided educational assistance 133
7. Structural issues 135

H. Taxation of Minor Children 144

III. INDIVIDUAL RETIREMENT ARRANGEMENTS, QUALIFIED RETIREMENT PLANS, AND EMPLOYEE BENEFITS 149

A. Structural Issues Relating to Qualified Retirement Plans 149

B. Individual Retirement Arrangements 155

C. Qualified Retirement Plans 166

Page

1. Adopt uniform definition of compensation for qualified retirement plans 166
2. Modifications to minimum coverage and nondiscrimination rules 173
3. Apply uniform vesting requirements to all qualified retirement plans 183
4. Conform requirements for SIMPLE IRAs and SIMPLE 401(k) plans 185
5. Conform definitions of highly compensated employee and owner 188
6. Conform contribution limits for tax-sheltered annuities to contribution limits for qualified retirement plans 192
7. Simplification of distribution rules applicable to qualified retirement plans 194
   a. Simplify minimum distribution rules 194
   b. Adopt uniform early withdrawal rules 198
8. Make 401(k) plans available to all governmental employers 201
9. Redraft section 457 to separate requirements for governmental plans and plans of tax-exempt employers 202
10. Adopt uniform ownership attribution rules for qualified retirement plan purposes 204

D. Basis Recovery Rules for Qualified Retirement Plans and IRAs 211
   1. In general 211
   2. Qualified retirement plans 211

E. Employee Benefits 221
   1. Modify cafeteria plan election requirements 221
   2. Employees excluded from application of nondiscrimination requirements 225

IV. CORPORATE INCOME TAX 229

A. Structural Issues Relating to the Corporate Income Tax 229
   1. Corporate integration 229
   2. Mergers, acquisitions, and related tax-free transactions 238

B. Eliminate Collapsible Corporation Provisions 249

C. Section 355 "Active Business Test" Applied to Chains of Affiliated Corporations 251

D. Uniform Definition of a Family for Purposes of Applying Attribution Rules 253

E. Limit Application of Section 304 259

F. Post-Reorganization Transfers of Assets 261

G. Redemptions Incident to Divorce 263

H. Conform Treatment of Boot Received in a Reorganization with the Stock Redemption Rules 267

V. PASS-THROUGH ENTITIES 269

A. Structural Issues Relating to Pass-Through Entities 269

B. Partnership Simplification Recommendations 277
   1. Modernize references to "limited partner" and "general partner" 277
   2. Eliminate large partnership rules 287

Page

3. Conform timing rules for guaranteed payments and other non-partner payments 291
C. S Corporation Simplification Recommendations 295
1. Excess passive income of S corporations 295
2. Trusts as permitted shareholders of S corporations 296
VI. GENERAL BUSINESS ISSUES 300
A. Section 1031 300
1. Tax-free rollover of like-kind property 300
2. Property held for use in a trade or business or held for investment in a like-kind exchange 303
B. Low-Income Housing Tax Credit 306
C. Rehabilitation Tax Credit 307
D. Orphan Drug Tax Credit 310
E. Work Opportunity Tax Credit and Welfare-to-Work Tax Credit 311
F. Indian Employment Tax Credit 317
G. Electric Vehicle Credit and Clean Fuel Vehicle Deduction 320
VII. ACCOUNTING AND COST RECOVERY PROVISIONS 322
A. Structural Issues Relating to Accounting for Capital Expenditures 322
B. Cash Method of Accounting for Small Businesses 328
C. Amortization of Organization Expenditures 332
D. Depreciation--Mid-Quarter Convention 334
VIII. FINANCIAL PRODUCTS AND INSTITUTIONS 336
A. Structural Issues Relating to Financial Products and Institutions 336
B. Modification of the Straddle Rules 339
C. Provide More Uniform Treatment of Interest Charges 344
D. Redraft Rules for Taxation of Annuities 356
E. Special Rules for Mortgage Guaranty Insurance, Lease Guaranty Insurance, and Insurance of State and Local Obligations 377
F. Special Deduction and Exception to Reduction in Unearned Premium Reserves for Blue Cross and Blue Shield Organizations 379
G. Treatment of Life Insurance Companies 381
IX. INTERNATIONAL TAX 384
A. Structural Issues Relating to International Tax 384
B. Anti-Deferral Regimes Applicable to Income Earned Through Foreign Corporations 398
C. Expand Subpart F De Minimis Rule 419
D. Look-Through Rules for Dividends from Noncontrolled Section 902 Corporations 421
E. Foreign Tax Credits Claimed Indirectly Through Partnerships 424
F. Conform Sections 30A and 936 428
G. Application of Uniform Capitalization Rules for Foreign Persons 432
H. Secondary Withholding Tax on Dividends From Foreign Corporations 436
I. Capital Gains of Certain Nonresident Individuals 440
J. U.S. Model Tax Treaties 445

Page

K. Older U.S. Tax Treaties 448
X. **TAX-EXEMPT ORGANIZATION PROVISIONS** 451
A. Percentage Limits on Grass-Roots Lobbying Expenditures of Electing Charities 451
B. Excise Tax Based on Investment Income 456
XI. **FARMING, DISTRESSED COMMUNITIES, AND ENERGY PROVISIONS** 460
A. Cost Sharing Payments 460
B. Reforestation Expenses 463
C. Capital Gains Treatment to Apply to Outright Sales of Timber by Landowners 465
D. Qualifications for the Zero-Percent Capital Gain Rate in the D.C. Enterprise Zone 466
E. Uniform Rules and Incentives for Economically Distressed Areas 468
F. Permit Expensing of Certain Geological and Geophysical Costs 475
XII. **EXCISE TAXES** 478
A. Highway Trust Fund Excise Taxes 478
B. Airport and Airway Trust Fund Excise Taxes 490
C. Harbor Maintenance Trust Fund Excise Tax and Tax on Passenger Transportation by Water 497
D. Aquatic Resources Trust Fund Excise Taxes 499
E. Federal Aid to Wildlife Fund and Non-Regular Firearms Excise Tax 501
F. Black Lung Trust Fund Excise Tax 503
G. Communications Excise Tax 504
H. Ozone-Depleting Chemicals Excise Tax 507
I. Alcohol Excise Taxes 508
J. Tobacco Excise Taxes 513
XIII. **TAX-EXEMPT BONDS** 516
A. Eliminate Five-Percent Disproportionate Use Limit 516
B. Consolidate Prohibited/Restricted Use Facilities Rules 517
C. Provisions Rendered or Being Rendered Obsolete by the Passage of Time 520
1. Deadwood provisions 520
a. Mortgage revenue bonds--Federal disaster area modifications 520
b. Interim authority for governors regarding allocation of private activity bond volume limits 521
2. Other provisions 522
a. Consolidate qualified mortgage bonds and qualified veterans' mortgage bonds 522
b. Eliminate $150 million limit for qualified 501(c)(3) bonds 524
c. Eliminate qualified small-issuer exception for certain bank-qualified bonds 525
d. Modify public notice requirements 526
D. Arbitrage Rebate Provisions 528

Page

XIV. ESTATE AND GIFT TAX PROVISION--Conform Certain Family-Owned and Small Business Provisions 531

XV. EMPLOYMENT TAX PROVISIONS 539

A. Structural Issues Relating to Worker Classification 539

B. Structural Issues Relating to Determination of Individuals Subject to Self-Employment Tax 551

XVI. COMPLIANCE AND ADMINISTRATION PROVISIONS 555

A. Structural Issues Relating to Alternate Return Filing Systems 555

B. Structural Issues Relating to Judicial Proceedings in Federal Tax Cases 560

C. Penalties and Interest 568

D. Disclosure of Returns and Return Information 572

XVII. DEADWOOD PROVISIONS 579

VOLUME III

		Page
I.	**SUMMARIES OF ACADEMIC PAPERS SUBMITTED TO THE JOINT COMMITTEE STAFF**	2
	A. Jonathan Barry Forman, Simplification for Low-Income Taxpayers: 2001	2
	B. Deborah A. Geier, Simplifying and Rationalizing the Federal Income Tax Law Applicable to Transfers in Divorce	3
	C. Frances R. Hill, Private Benefit, Public Benefit and Exemption	4
	D. Frances R. Hill, Exemption and Commercial Activities: Approaches to Rationalizing Unrelated Business Income Tax	6
	E. Annette Nellen, Simplification of the EITC Through Structural Changes	7
	F. George K. Yin and David J. Shakow, Reforming and Simplifying the Income Taxation of Private Business Enterprises	9
II.	**ACADEMIC PAPERS SUBMITTED TO THE JOINT COMMITTEE STAFF**	10
	A. Jonathan Barry Forman, Simplification for Low-Income Taxpayers: 2001	10
	B. Deborah A. Geier, Simplifying and Rationalizing the Federal Income Tax Law Applicable to Transfers in Divorce	19
	C. Frances R. Hill, Private Benefit, Public Benefit and Exemption	143
	D. Frances R. Hill, Exemption and Commercial Activities: Approaches to Rationalizing Unrelated Business Income Tax	175
	E. Annette Nellen, Simplification of the EITC Through Structural Changes	205
	F. George K. Yin and David J. Shakow, Reforming and Simplifying the Income Taxation of Private Business Enterprises	220

INTRODUCTION

This document,[1] is a report of the staff of the Joint Committee on Taxation ("Joint Committee staff") in connection with a study of the overall state of the Federal tax system. This report is being transmitted, as required under section 8022(3)(B) of the Internal Revenue Code of 1986, to the House Committee on Ways and Means and the Senate Committee on Finance. Under section 8022(3)(B), the Joint Committee staff is required to report at least once each Congress on the overall state of the Federal tax system and to make recommendations with respect to possible simplification proposals and other matters relating to the administration of the Federal tax system.[2]

The Joint Committee staff is publishing this study in three volumes. Volume I of this study contains Part One (Executive Summary and Joint Committee on Taxation Staff Study Mandate and Methodology), Part Two (Overall State of the Federal Tax System), and four Appendices (Academic Advisors to the Joint Committee on Taxation, Tax Policy Advisors to the Joint Committee on Taxation, General Accounting Office Materials, and Congressional Research Service Materials). Volume II of this study contains Part Three (Recommendations of the Joint Committee on Taxation Staff to Simplify the Federal Tax System). Volume III of this study contains papers relating to simplification submitted to the Joint Committee on Taxation by tax scholars in connection with the study.

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[1] This document may be cited as follows: Joint Committee on Taxation, *Study of the Overall State of the Federal Tax System and Recommendations for Simplification, Pursuant to Section 8022(3)(B) of the Internal Revenue Code of 1986* (JCS-3-01), April 2001.

[2] Section 8022(3)(B) was added by section 4002(a) of the Internal Revenue Service Restructuring and Reform Act of 1998.

I. SUMMARIES OF ACADEMIC PAPERS SUBMITTED TO THE JOINT COMMITTEE STAFF

A. Simplification for Low Income Taxpayers: 2001

Summary of Full Report Submitted to the Joint Committee on Taxation For its Study of the Overall State of the Federal Tax System

By Jonathan Barry Forman, Esq.
University of Oklahoma School of Law

According to the Census Bureau, some 32.2 million Americans (11.8 percent) live in families with incomes below the poverty line. The principal federal taxes affecting these low-income individuals are the individual income tax and the Social Security payroll tax. Once the earned income credit is taken into account, however, relatively few low-income individuals actually have a net federal tax liability. Nevertheless, the current federal tax system requires virtually all low-income individuals to file returns, if only to recover refunds of over-withheld taxes.

Simplification of the tax system holds promise for significant economic and equitable gains. It may not be possible to simplify the federal tax system for all individuals, but it should be possible to simplify the tax system for low-income individuals. Changes might include: (1) let the IRS prepare returns for low-income taxpayers; (2) statutory changes to simplify the income tax system; (3) better integration of the income and Social Security tax systems; (4) move to a flat tax; (5) move to a return free tax system; or (6) move to a "final withholding" tax system, similar to those used by the United Kingdom, Japan, Germany, and Argentina.

This paper proposes that changes need to be made to the federal tax system in order to ease the heavy costs and burdens on low-income individuals. Specifically, the article identifies some statutory and regulatory changes that would: (1) reduce the number of low-income individuals required to file tax returns; and (2) simplify the return-filing process for those who must file.

B. Simplifying and Rationalizing the Federal Income Tax Law Applicable to Transfers in Divorce

Summary of Full Report Submitted to the Joint Committee on Taxation For its Study of the Overall State of the Federal Tax System

By Deborah A. Geier, Esq.
Cleveland-Marshall College of Law, Cleveland State University

Sometimes the complexity of the tax law is defended as a necessary evil. But one area of the tax law remains needlessly complex not because of any coherent underlying theory but because of history and a series of political compromises. The "transaction" at issue is divorce. One of the biggest sources of complexity in the current regime is the continuing desire to differentiate cash "alimony" from cash "child support" from cash "property settlement" in order to apply different tax rules to such transfers, depending upon the label that has been applied.

The current mechanisms that must be applied to determine which party will be taxed on a cash receipt or a stock redemption are not only ambiguous in many respects but also resolve the question in ways that often make no sense. The resolution also often requires Federal tax adjudicators to delve into murky state law in order to determine the answer to these questions. It should be noted that an increasing number of states are abandoning such labels altogether and instead applying "equitable distribution regimes."

Although the law pertaining to transfers of cash and property incident to divorce was substantially improved in 1984, problems remain, and much too much litigation continues to plague this area. As is argued throughout this paper, not much revenue is at stake in our system of how to tax transfers incident to divorce. In each and every possible scenario posed, one of the spouses will be taxed; the only question is which spouse's marginal bracket will apply. In the context of divorce, every deduction is necessarily accompanied by corresponding income inclusion, so that the only revenue at stake is measured by the difference in rate brackets (if any) between the payor and payee.

The parties' agreement regarding who, between them, should be taxed on income items, whether income accrued prior to the divorce but paid after, or income earned after, should be respected. With no significant revenue streams at stake, there is no compelling reason why the law should be otherwise. When the government steps in and upsets these expectations after the fact, it upsets the bargain reached between the parties often at substantial litigation expense for both the government and divorced couple.

The time has come to finally abandon the remaining remnants of our futile attempt to differentiate "alimony" from "child support" from cash "property settlements," distinctions increasingly abandoned under state law. The parties should be permitted to designate whether any cash payment should be includable by the recipient and deductible by the payor, on the one hand, or excludible and nondeductible, on the other hand, with the default rule (in case of silence) being that such payments are includable by the recipient and deductible by the payor, unless the payment is to a third party on behalf of a child.

C. Private Benefit, Public Benefit and Exemption

Summary of Full Report Submitted to the Joint Committee on Taxation For its Study of the Overall State of the Federal Tax System

By Frances R. Hill, Esq.
University of Miami Law School

Tax exemption is reserved for organizations that operate for the exempt purposes set out in the Internal Revenue Code (the "Code") and which provide benefits to appropriate recipients defined in relation to an organization's exempt purpose. These exempt purposes define the public benefits of an exempt organization. The public benefit is the benefit arising from the exempt activities. Section 501(c)(3) public charities operate for the benefit of a charitable class defined in relation to the various organizations' particular exempt status. Other exempt organizations also provide public benefits resulting from their various exempt purposes, even though these organizations have a less encompassing scope than do section 501(c)(3) organizations.

A private benefit, in contrast, is a benefit arising from a relationship with the exempt organization not defined by the public or exempt purpose. Private benefits are inconsistent with exempt status. For example, a labor union or trade association that provides football tickets to its members would be providing a private benefit because neither organization is created to provide this kind of benefit.

This paper focuses on the elements of complexity arising from the three private benefit doctrines and identifies four elements of complexity that characterize private benefits concepts under current law: (1) the concurrent existence of three concepts of private benefit-private benefit, inurement, and excess benefit transactions-each of which presents unresolved issues and definitional complexities; (2) different meanings of private benefit and inurement as these apply to different types of exempt organizations; (3) the absence of guidance relating to the scope of private benefit, inurement or excess benefit that jeopardizes exempt status; and (4) overlapping application of two or three of the elements of private benefit to particular types of exempt organizations. The discussion and proposals presented in the accompanying paper are based on the premise that any coherent rationale for exemption from taxation is necessarily based on the provision of a public benefit. It is further argued that much of the incoherence and complexity of the current law of tax exemption arises from the attempt to ground exemption in the absence of private benefit rather than on the provision of public benefit.

A reasonable case could be made that the simplest approach to exemption would be to craft a public benefit standard providing that an organization is exempt if it devotes some defined proportion of its income to exempt purposes. The use of the remaining percentage would have no consequence for exemption, but the organization would be taxed on any amounts not used for exempt purposes. An alternative approach is to attempt to simplify and clarify the three private benefit doctrines and to do so in a way that links them to a public benefit requirement. Exemption would be based on the absence of excess private benefit. This approach might be

consistent with the development of clearer guidelines, but it is far from clear that such an approach would provide a coherent and practical balance among stringent rules, operational necessities and a persuasive rationale for treating certain organizations as exempt from taxation.

The paper concludes that it is time to consider developing a test for exemption based on an affirmative public benefit requirement.

D. Exemption and Commercial Activities: Approaches to Rationalizing the Unrelated Business Income Tax

Summary of Full Report Submitted to the Joint Committee on Taxation For its Study of the Overall State of the Federal Tax System

By Frances R. Hill, Esq.
University of Miami Law School

The unrelated business income tax ("UBIT") provisions of current law rest on three structural elements that are subject to twenty-two modifications and exceptions. In some sense the very scope of the UBIT provisions present issues of complexity, although the particular exceptions and modifications are so targeted that each provision taken alone might not be particularly complex. The central issue relating to UBIT is the relation of the UBIT provisions to the question of exemption. Part of the problem is the absence of any consensus on a rationale for exemption and thus on a criteria that define an exempt organization. Part of the problem arises from the UBIT provisions themselves.

This paper takes the position that the complexity of UBIT provisions arises in part from successful lobbying to define an ever-increasing list of modification and exceptions and, in part, from lack of clarity on the purpose of UBIT and its relation to exemption. Two different approaches are proposed as ways to clarify and/or modify the UBIT provisions.

As is set forth in this paper, the fundamental purpose of UBIT is to protect the integrity of the exemption by distinguishing taxable activities that are not related to an organization's exempt purpose from activities directly related to an organization's exempt purpose. The paper suggests that the absence of any concept of how much commercial activity is consistent with exemption undermines the integrity of the exemption and raises fundamental questions about the usefulness of the current UBIT provisions. Two broad alternatives to the current structure are suggested that would address this issue in different ways. The first is a structure that taxes any commercial activity. The second is a return to an explicit destination of income test.

In the alternative, if the current system is retained, there are elements of simplification that would also prevent the kind of diversion of resources to non-exempt purposes that undermines the integrity of exemption although they would not resolve the fundamental structural issue of the relationship between UBIT and exemption. These would include: (1) repeal the "regularly carried on" element in the definition of an unrelated trade or business and replace it with a small organization exception; and (2) repeal section 514.

This paper has taken the position that Congress did not adequately consider the relationship between UBIT and exemption when it enacted the UBIT provisions. The time for considering the issue of the diversion of resources from exempt to commercial purposes within exempt organizations is long overdue.

E. Simplification of the EITC through Structural Changes

Summary of Full Report Submitted to the Joint Committee on Taxation for its Study of the Overall State of the Federal Tax System*

By Annette Nellen, Esq. CPA
San José State University

The earned income tax credit (EITC) is one of the most complex provisions of the tax law, yet its purpose is to provide a benefit to low-income taxpayers, who should not be facing such complexity. While there have been various proposals over the past several years to simplify the EITC, few changes have been made and recent law changes, such as the enactment of the child credit, have made the EITC even more complex for many of the individuals who claim it. In addition to complexity, the EITC is also prone to fraud and additional provisions have been added to combat this.

At credit levels of 7.65%, 34% and 40% depending on the type of individual claiming the EITC, the credit results in a refund of all or some portion of the employee's share of FICA and Medicare taxes. In these situations, the EITC is basically a mechanism to refund a tax that perhaps just as easily could not have been withheld in the first place. Such a result could be achieved by using a system similar to the income tax withholding system that doesn't begin until a certain income level is reached. If further simplifications were made to conform definitions used for the EITC, such as "qualifying child," to other definitions used in computing federal taxable income, such as "dependent," the structural change would be more feasible and further simplification could be achieved. In addition, if some of the EITC benefit were provided via an increase in the dependent child deduction and/or child credit, the amount of EITC benefit to be delivered through an alternative payroll tax withholding structure would be reduced and simplified.

The current EITC benefit levels could be retained (if desired) through the alternative payroll tax withholding structure. In addition, a "leveling" mechanism could be incorporated into the new withholding structure to level the payroll tax withholding for non-EITC-eligible workers throughout the year and to provide a more constant benefit to EITC-eligible workers in each paycheck throughout the year. This would be similar to the current income tax withholding structure.

Beyond simplification, an additional potential benefit of an alternative structure and simplification of qualifying status requirements would be that it might make it easier to move to a return-free tax system. Structural changes as described above would also serve to provide the EITC benefit to low-income taxpayers in each paycheck without a need for individuals to apply to their employer to receive an advance EITC (assuming they are eligible for the advance EITC).

For background on the EITC that supports making a structural change to how the benefit is delivered through the tax system and for further details of the proposal, please see the complete paper - *Simplification of the EITC through Structural Changes.*

F. Reforming and Simplifying the Income Taxation of Private Business Enterprises

Summary of Full Report Submitted to the Joint Committee on Taxation for its Study of the Overall State of the Federal Tax System

By George K. Yin and David J. Shakow
University of Virginia Law School and Professor Emeritus, University of Pennsylvania Law School, Respectively

Under current law, many private businesses, no matter what their organizational form or characteristics, have the choice of being taxed under one of three possible income tax regimes. In general, they can be taxed under the set of rules traditionally reserved for corporations (subchapter C), for partnerships (subchapter K), or for certain closely-held corporations (subchapter S).

In this paper, we argue that there is no policy justification for permitting firms to continue to choose among these three sets of rules, and that the existence of the choice unnecessarily complicates the law for both taxpayers and the IRS. In general, we recommend that the choice be narrowed to two -- subchapter K and subchapter S -- with the options being reconfigured somewhat to make them more consistent with one another and more rational. Subchapter S is preserved and liberalized because it offers a simplified method of taxing the income of private businesses. We would reserve this option for those firms that are owned exclusively by individuals and that have straightforward economic arrangements, two characteristics that make such firms less susceptible to tax advantage and abuse, and therefore less in need of complicated anti-abuse protections. In general, all other firms, including any eligible firms not choosing the subchapter S option, would be taxed under subchapter K as modified by selected reforms.

Rarely is there an opportunity to adopt a proposal that provides both meaningful reform and simplification of the tax laws. Too often, those objectives are in conflict with one another. While many details need to be carefully considered, we believe that the recommendations outlined in this paper have the potential for achieving that happy combination.

This paper summarizes the principal recommendations of an American Law Institute Reporters' Study prepared by the authors on this topic. Interested readers should consult the Study for the complete set of proposals and a fuller discussion of the issues. Copies are available from the ALI (800-253-6397).

II. ACADEMIC PAPERS SUBMITTED TO THE JOINT COMMITTEE STAFF

A. Simplification for Low Income Taxpayers: 2001

By

Jonathan Barry Forman*

What can be done to simplify the federal tax system for low-income individuals and for the Internal Revenue Service? That was the focus of my 1996 article: Jonathan Barry Forman,

Simplification for Low Income Taxpayers: Some Options, 57 OHIO STATE LAW JOURNAL 145-201 (1996). Specifically, that article identified some statutory and regulatory changes that would: (1) reduce the number of low-income individuals required to file tax returns; and (2) simplify the return-filing process for those who must file. This paper summarizes and updates that 1996 article.

According to the Census Bureau, some 32.2 million Americans (11.8 percent) live in families with incomes below the poverty line.[1] The principal federal taxes affecting these low-income individuals are the individual income tax and the Social Security payroll tax. Once the earned income credit is taken into account, however, relatively few low-income individuals actually have a net federal tax liability. Nevertheless, the current federal tax system requires virtually all low-income individuals to file returns, if only to recover refunds of over-withheld taxes.

For example, consider the tax treatment of a typical low-income married couple with two children in 2001. If their income consists entirely of wages or salaries, the couple will have no net federal tax liability unless they earn more than $23,562.[2] Their $7,600 standard deduction and four $2,900 personal exemptions together will shelter $19,200 from the income tax, and their earned income tax credit and $500 child tax credits will offset the rest of their tax liability.[3] By way of comparison, the poverty level for a family of four in 2001 is just $17,650.[4]

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[1] D'Vera Cohn, Poverty Declines to 20-year Low; Central Cities Account for Most of Drop; Incomes Hit Record, WASHINGTON POST, September 27, 2000, at A2.

[2] See Appendix Table 1.

[3] Rev. Proc. 2001-13, 2001-3 I.R.B.1.

[4] U.D. Department of Health & Human Services, *Annual Update of the HHS Poverty Guidelines,* 66 FEDERAL REGISTER 10,695 (2001).

Indeed, virtually no low-income taxpayers with children will owe federal taxes for the year 2001, and relatively few low-income childless individuals and couples will owe taxes either. Moreover, those low-income taxpayers that do have a net federal tax liability will pay relatively little in federal taxes. For example, of the 53 million taxpayers with adjusted gross incomes of less than $20,000 who filed income tax returns for 1998, only about 8 million actually had any tax due at the time of filing, and the average amount owed by these was just $534.[5]

Unfortunately, the current tax system imposes heavy costs and burdens on both low-income individuals and the IRS.[6] Simplification of the tax system holds the promise for significant economic and equitable gains. It may not be possible to simplify the federal tax system for all individuals. But it should be possible to simplify the federal tax system for low-income individuals. Here are some possibilities.

1. Let the IRS Prepare Returns for Low-Income Taxpayers

To date, low-income taxpayers have benefited from many of the IRS's efforts to simplify the return-filing process, and the IRS should continue with those efforts. In general, the IRS should continue: (1) working to simplify Internal Revenue forms and publications; (2) developing and expanding its taxpayer assistance programs; and (3) exploring alternative filing methods such as electronic filing.

Better still, it might make sense to have the IRS actually prepare income tax returns, at least for low-income taxpayers.[7] Virtually all welfare programs help individuals apply for benefits, and the earned income credit provides a welfare-like benefit. Why not let the IRS help low-income workers claim their earned income credit refunds?

2. Statutory Changes To Simplify the Income Tax

Another way to simplify the tax system for low-income taxpayers would be to raise the standard deduction amounts or the personal exemption, or to enact an exclusion for some modest amount of miscellaneous income.[8]

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[5] Internal Revenue Service, *Selected Historical and Other Data*, 19 SOI BULLETIN 159, 165 (Spring 2000); see also Joint Committee on Taxation, *Distribution of Certain Federal Tax Liabilities by Income Class for Calendar Year 2000* (JCX-45-00), April 11, 2000.

[6] For example, Joel Slemrod has estimated that the total compliance cost of the U.S. income tax system is around $75 billion per year. Joel Slemrod, Which is the Simplest Tax System of Them All?, in ECONOMIC EFFECTS OF FUNDAMENTAL TAX REFORM 355, 367 (Henry J. Aaron & William G. Gale eds. 1996).

[7] See Jonathan Barry Forman, Simplification for Low Income Taxpayers: Some Options, 57 OHIO STATE LAW JOURNAL 145, 176-78 (1996).

[8] Id. at 181-82, 186-88.

3. Better Integrate Income and Social Security Taxes

A more fundamental reform would involve better integrating the income and Social Security tax systems. Much of the complexity of the current tax system results from imposing Social Security taxes on every dollar of earned income and then using the earned income credit to refund much of those taxes to low-income workers. Wouldn't it be simpler if the federal tax system simply did not collect Social Security taxes from low-income workers in the first place?

One approach would be to add standard deductions and personal exemptions to the current Social Security tax system or to allow each worker to exempt, say, the first $5,000 or $10,000 of earnings from Social Security taxes.[9]

A more thorough approach would be to combine the individual income and Social Security taxes into a single, comprehensive income tax.[10] Individuals with incomes below some poverty threshold would be exempt from tax, and tax rates could be increased in order to raise the same amount of revenue. In effect, there would be a single, higher-yield income tax instead of the current bifurcated tax system, and millions of low-income individuals would no longer have to file returns.

4. Move to a Flat Tax

Yet another approach would be to replace the current income tax with some form of "flat tax."[11] The underlying tax base could be either income or consumption. The key is that, above a certain threshold, a single tax rate would apply. To keep the single rate low, most flat tax plans would get rid of many if not all itemized deductions. Proponents of flat taxes are fond of saying that most individuals would be able to file their tax returns on postcards.

5. Move to a Return-Free Tax System

Another approach would be to move toward a return-free tax system.[12] In 1987 the IRS issued a report in which it explored the feasibility of moving to a return-free system.[13] Under the type of return-free system that the IRS envisioned in that report, most Form 1040EZ and Form 1040A filers and a few Form 1040 filers could elect to have the IRS compute their tax liabilities and prepare their returns -- some 55 million taxpayers, in all.

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[9] Id. at 184-86; George K. Yin & Jonathan B. Forman, *Redesigning the Earned Income Tax Credit Program to Provide More Effective Assistance for the Working Poor,* TAX NOTES, May 17, 1993, at 951.

[10] Forman, *supra* note 7, at 192-94.

[11] Id. at 194-97.

[12] Id. at 197-200.

[13] INTERNAL REVENUE SERVICE, CURRENT FEASIBILITY OF A RETURN-FREE TAX SYSTEM (1987).

For a variety of reasons, the IRS decided not to implement this system. In truth, the IRS system was not really "return-free." Rather, at a taxpayer's election, the burden of preparing the return would shift from the taxpayer to the IRS. Taxpayers would save some time filing their returns, but many would have to wait longer to get their refunds. Also, the return-free system would increase the burdens on the IRS and on employers and other filers of information documents. To generate tax returns, the IRS then estimated that it would need to timely receive, verify, and post more than 970 million wage and information documents. And the IRS estimated that it would cost over $1 billion and require about 17,000 additional staff to implement the return-free system.

Another alternative would be to move to a so-called "final withholding" tax system. Final withholding tax systems are similar to return-free systems, except that they rely more heavily on withholding. Under a final withholding system, the amount withheld from employees and other income sources is the tax, thus eliminating the need for many taxpayers to file tax returns. Over 30 foreign countries use some form of final withholding, including the United Kingdom, Japan, Germany, and Argentina.[14]

For example, in the United Kingdom, the income tax is withheld by employers under the PAYE (Pay As You Earn) final withholding system. When an individual first becomes potentially subject to tax, an initial return must be filed so that the Inland Revenue can determine how much the employer should withhold. Thereafter, individuals with simple incomes and modest earnings are normally required to make a return of income only about once every five years. In 1999-2000, about two-thirds of British taxpayers were able to avoid filing returns.[15]

Would a final withholding system work in the United States? A final withholding system could significantly reduce burdens on both taxpayers and the IRS. In its analysis of the issue, the General Accounting Office concluded that most taxpayers who now file 1040EZ returns [about 20 million in 1998] and many of those who now file 1040A returns [about 26 million in 1998] could be served by a final withholding system.[16] Most of these people no longer would have to gather information, become familiar with tax laws, or prepare and file returns. The burden on the IRS also would be greatly reduced.

More recently, pursuant to Section 2004(a) of the Internal Revenue Service Restructuring and Reform Act of 1998, the Secretary of the Treasury is required to develop procedures for

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[14] See, e.g., U.S. General Accounting Office, Internal Revenue Service Opportunities to Reduce Taxpayer Burdens Through Return-Free Filing (GAO/GGD-92-88BR) 22-33, 36 (1992).

[15] Treasury Testimony at Senate Appropriations Treasury Panel Hearing on Return-free Tax Systems, 2000 TAX NOTES TODAY 73-21 (April 14, 2000) (testimony of Treasury Deputy Assistant Secretary for Tax Analysis Leonard E. Burman).

[16] Treasury Testimony at Senate Appropriations Treasury Panel Hearing on Return-free Tax Systems, 2000 TAX NOTES TODAY 73-21 (April 14, 2000) (testimony of Treasury Deputy Assistant Secretary for Tax Analysis Leonard E. Burman).

implementing a return-free system by the year 2008.[17] Also, early in April of 2000, the Treasury Subcommittee of the Senate Appropriations Committee held a hearing on return-free filing systems.[18] In particular, the Subcommittee considered a proposed bill by Senator Byron Dorgan (D-N.D.) that would let millions of taxpayers elect return-free filing.[19]

APPENDIX

The two tables in this Appendix show that hardly any low-income workers will owe federal taxes for the year 2001. At the outset, Table 1 compares the 2001 federal tax thresholds and poverty income guidelines for unmarried individuals and for married couples.[20]

Consider a family of four consisting of a married couple and two children. Row 1 of Table 1 shows that this family unit's poverty income guideline for 2001 is $17,650.[21]

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[17] Rossotti Testimony at Senate Appropriations Treasury Panel Hearing on Return-free Tax Systems, 2000 TAX NOTES TODAY 73-22 (April 14, 2000) (testimony of Commissioner of Internal Revenue Charles O. Rossotti).

[18] Amy Hamilton, IRS Helps Dorgan Develop Return-free Plan, 87 TAX NOTES 335 (2000).

[19] Senator Dorgan=s bill was subsequently introduced as S. 3087, 106th Cong., 2d Sess. (2000), 146 CONGRESSIONAL RECORD S8948-49 (daily ed. Sept. 21, 2000) (statement of Sen. Dorgan).

[20] The table reflects the assumptions that all family income consists of wages or salaries earned by a single worker, that families of two or more include a married couple (rather than an unmarried head of household with one or more dependents), that all family members are under age 65 and not blind, that all family units are eligible for the earned income credit, and that all children qualify for the child tax credit. Also, only the employee's portion of Social Security taxes is considered.

[21] U.S. Department of Health & Human Services, supra note 4.

TABLE 1. POVERTY LEVELS AND NET FEDERAL TAX THRESHOLDS AFTER TAX CREDITS IN 2001, BY FAMILY SIZE, UNMARRIED INDIVIDUALS AND MARRIED COUPLES

[dollars]

	FAMILY SIZE					
	1	2	3	4	5	6
1. Poverty levels:	8,590	11,610	14,630	17,650	20,670	23,690
2. Simple income tax threshold (before credits):	7,450	13,400	16,300	19,200	22,100	25,000
3. Income tax threshold after the earned income and child tax credits:	8,550	13,400	24,095	29,520	32,112	38,333
4. Social Security tax threshold:	0	0	0	0	0	0
5. Combined income and Social Security tax threshold (i.e., net federal tax threshold):	4,760	4,760	19,127	23,562	26,492	28,631

Row 2 of Table 1 shows the simple income tax thresholds for family units of different sizes. These are determined by summing each family unit's standard deduction and its personal exemptions. For 2001, a married couple with two children can file a joint tax return and claim a $7,600 standard deduction and four $2,900 personal exemptions.[22] Consequently, the couple will not have to pay any income tax unless its income exceeds its $19,200 simple income tax threshold ($19,200 = $7,600 + 4 x $2,900).

Row 3 of Table 1 shows each family unit's income tax threshold after taking into account the effects of the earned income credit[23] and the child tax credit.[24] For example, for 2001, a

[22] Rev. Proc. 2001-13, supra note 3.

[23] Internal Revenue Code (I.R.C.) '32. The earned income credit is a refundable credit available to certain low- and moderate-income workers.

For 2001, childless individuals between the ages of 25 and 65 are entitled to an earned income credit of up to $364. The credit is computed as 7.65 percent of the first $4,760 of earned income. The maximum credit is reduced by 7.65 percent of earned income (or adjusted gross

typical married couple with two young children can claim an earned income credit of up to $4,008 and two child tax credits of up to $500. Consequently, taking into account their earned income and child tax credits, a typical married couple with two children will not actually owe any income tax until its income exceeds $29,520.[25]

On the other hand, because the Social Security tax system has no standard deductions or personal exemptions, family units must pay Social Security taxes starting with their first dollar of

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income, if greater) in excess of $5,950 and is entirely phased out at $10,710 of income. Rev. Proc. 2001-13, supra note 3.

Individuals with one qualifying child are entitled to an earned income credit of up to $2,428. The credit is computed as 34 percent of the first $7,140 of earned income. The maximum credit is reduced by 15.98 percent of earned income (or adjusted gross income, if greater) in excess of $13,090 and is entirely phased out at $28,281 of income. Id.

Finally, individuals with two or more qualifying children are entitled to an earned income credit of up to $4,008. The credit is computed as 40 percent of the first $10,020 of earned income. The maximum credit is reduced by 21.06 percent of earned income (or adjusted gross income, if greater) in excess of $13,090 and is entirely phased out at $32,121 of income. Id.

[24] I.R.C. '24. The child tax credit is available to individuals with dependent children under the age of 17. For 2001, the credit is $500 for each qualifying child. The credit begins to phase out when modified adjusted gross income (AGI) reaches $110,000 for joint filers, $55,000 for married couples filing separately, and $75,000 for unmarried individuals.

The child tax credit is generally nonrefundable; however, a portion of the credit may be treated as refundable if a taxpayer has three or more qualifying children and the taxpayer's Social Security taxes exceed any earned income credit that is claimed. This is referred to as the "additional credit for families with three or more children." I.R.C. ' 24(d). A portion of the nonrefundable child tax credit may also be treated as refundable if a taxpayer (irrespective of the number of qualifying children) claims an earned income credit in excess of Social Security taxes paid. This is referred to as the "supplemental" child credit. I.R.C. ' 32(n).

[25] Algebraically, each computation in Row 3 involved determining the appropriate equation for computing each family unit's income tax liability after its earned income and child tax credits and solving for the income level at which that income tax liability is equal to zero.

For example, for 2001, for a married couple with two children with income (I) in excess of its $19,200 simple income tax threshold but less than the $32,121 level at which its earned income credit is fully phased out, the couple's income tax liability (T) can be determined by the following formula:

$$T = .15 \times (I - \$19{,}200) - (\$4{,}008 - .2106 \times [I - \$13{,}090]) - (2 \times \$500).$$

Setting T equal to zero and solving for I shows that the couple's income tax threshold after the earned income and child tax credits is $29,520.

earned income. Hence, Row 4 of Table 1 shows that zero is the Social Security tax threshold for all family units.

Finally, Row 5 of Table 1 shows the combined income and Social Security tax threshold (i.e., net federal tax threshold) for various family units. These thresholds occur at the income level at which a taxpayer's preliminary income plus Social Security tax liabilities minus earned income and child tax credits equals zero. For example, a typical married couple with two children will not actually have a net federal tax liability for 2001 unless its income exceeds $23,562.[26]

Similarly, Table 2 compares the 2000 federal tax thresholds and poverty income guidelines for heads of household with one to four children.

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[26] Algebraically, each computation in Row 5 involved determining the appropriate equation for computing each family unit's combined income and Social Security tax liability after its earned income and child tax credits and solving for the income level at which that tax liability is equal to zero.

For example, for 2001, for a married couple with two children with income (I) in excess of its $19,200 simple income tax threshold but less than the $32,121 level at which its earned income credit is fully phased out, the couple's combined income and Social Security tax liability (T) can be determined by the following formula:

T =.15 x (I - $19,200) + .0765 x I - ($4,008 - .2106 x [I - $13,090]) minus the lesser of ([2 x $500] or [.15 x {I - $19,200}]).

Setting T equal to zero and solving for I in the above manner shows that the couple's combined income and Social Security tax threshold after the earned income and child tax credits is $23,562.

TABLE 2. POVERTY LEVELS AND NET FEDERAL TAX THRESHOLDS AFTER TAX CREDITS IN 2001, BY FAMILY SIZE, HEADS OF HOUSEHOLD

[dollars]

	FAMILY SIZE			
	2	3	4	5
1. Poverty levels:.....	11,610	14,630	17,650	20,670
2. Simple income tax threshold (before credits):.....	12,450	15,350	18,250	21,150
3. Income tax threshold after the earned income and child tax credits:.....	22,231	27,918	30,511	34,483
4. Social Security tax threshold:....	0	0	0	0
5. Combined income and Social Security tax threshold (i.e., net federal tax threshold):.....	17,829	23,032	25,171	27,310

B. Simplifying and Rationalizing the Federal Income Tax Law Applicable to Transfers in Divorce

By

Deborah A. Geier*

Sometimes the complexity in our tax law is defended as a necessary evil in order to conform the law to the underlying theory informing it. Some also say that, since ours is a complex economy and society, our tax system is necessarily complex, and those engaged in complex transactions can afford to pay for the complex tax advice necessary to successfully navigate through the system. Or so the sayings go.

One area of the tax law, however, remains needlessly complex not because of any coherent underlying theory but because of history and a series of political compromises. Moreover, the "transaction" at issue is not one engaged in only by the savvy, well-advised, and well-to-do. The "transaction" at issue is divorce. While the tax law applicable to transfers in divorce was, on average, improved in 1984 (in my view), several fundamental incoherencies and unnecessary complexities continue to plague this area, and more recent ambiguities (dealing chiefly with redemptions of stock in closely held corporations and other transfers under the assignment-of-income doctrine) have arisen.

One of the biggest sources of complexity in the current regime is the continuing desire--though futile, in my view--to differentiate cash "alimony" from cash "child support"[1] from cash "property settlements"[2] in order to apply different tax rules to such transfers, depending on the

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* Professor of Law, Cleveland-Marshall College of Law, Cleveland State University. © Deborah A. Geier 2001. This article was written in my capacity as an "academic advisor" to the Joint Committee on Taxation in connection with a study of the overall state of the tax system, including recommendations with respect to possible simplification proposals, that Congress mandated in I.R.C. § 8022(3)(B). The opinions expressed here are, however, completely my own and should not be attributed to the Joint Committee on Taxation.

[1] The specifics of current law will be discussed in more detail later in this article. Briefly stated, cash payments satisfying the federal definition of "alimony" in I.R.C. § 71(b) (regardless of what the payments are called for state law purposes) are includable in gross income by the recipient and deductible by the payor directly from gross income (unhampered by the inability to itemize deductions). *See* I.R.C. §§ 71, 215, & 62(a)(10). Thus, the tax burden on these cash payments is, at least nominally, borne by the recipient. Cash payments constituting "child support" within the meaning of § 71(c) are neither includable by the recipient nor deductible by the payor. *See* I.R.C. § 71(c). Thus, the tax burden on these cash payments is, at least nominally, borne by the payor.

[2] As described *supra* note 1, payments qualifying as "alimony" under I.R.C. § 71(b) are includable by the recipient and deductible by the payor. Cash payments not satisfying the requirements of I.R.C. § 71(b) are neither includable nor deductible. Notice that payments

label that has been applied. My bottom-line recommendation is that such labels be discarded and that the parties be explicitly empowered to determine whether cash transfers--whether denominated alimony, child support, a property settlement, an "equitable distribution" for state law purposes, *etc.*--should be includable by the recipient and deductible by the payor, or excludable by the recipient and not deductible by the payor, with simple and clear default rules for taxpayers who fail to make their wishes known in their divorce, separation, or support instrument.[3] Well-advised taxpayers already have significant freedom to decide who, between them, should be taxed on cash transfers incident to divorce, since they can structure their cash transfers in the form that will implement their agreement. Poorly advised or unadvised taxpayers are not provided similar flexibility, since they are unaware of the various transactional elections effectively available to them if they had cast their cash payments in the proper form.

The reason underlying the different tax treatment applicable to alimony and child support has never been adequately articulated, and it is often difficult to distinguish between the two in any event. The reason underlying the different tax treatment applicable to alimony and many cash property settlements can, in contrast, be articulated as a theoretical matter, but, as Professor Malman noted in 1986, "there is no administratively practical way for the tax system to draw the alimony/property distinction."[4] Payments that would be characterized as "alimony" for tax purposes may constitute "child support" or a "property settlement" under state law, and vice versa. Moreover, an increasing number of states are abandoning such labels altogether. Under "equitable distribution regimes," for example, the cash payment stream can be intended simply to settle all claims for support and property compensation between the parties. Continuing to make the determination of who should be taxed on cash transfers in divorce turn on what label is used to identify the payment, and then having unique tax definitions for those labels that often

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subject to the inclusion/deduction scheme may not actually constitute "alimony" under state law, so long as the payment satisfies the federal tax definition of "alimony" in § 71(b). That is to say, a cash payment constituting a property settlement under state law or upon examination of the particular facts can nevertheless qualify as an includable/deductible payment so long as the federal requirements for "alimony" are satisfied. For example, payments qualifying as tax alimony (and thus subject to the inclusion/deduction system) can be intended to compensate the recipient for her share of vested or inchoate property rights that either go to the payor on the divorce (such as a piece of real estate that was co-owned by the spouses prior to the divorce) or are extinguished on the divorce (such as dower and curtesy rights or statutory share provisions created under some state intestacy laws). Some cash payments will not satisfy the federal definition of "alimony" or "child support" and thus are considered tax-neutral "property settlements" by default.

[3] *Cf.* Marci Kelly, *Calling a Spade a Club: The Failure of Matrimonial Tax Reform*, 44 TAX. LAW. 787, 811-12 (1991) (reaching the same conclusion).

[4] Laurie L. Malman, *Unfinished Reform: The Tax Consequences of Divorce*, 61 N.Y.U. LAW REV. 363, 367 (1986).

deviate from state law definitions, causes confusion among taxpayers and traps for the unwary, as case law litigation clearly shows.[5]

The great fear that has driven Congress in the past in this area is that divorcing parties will engage in inappropriate "income-shifting" if left to decide for themselves who should be taxed on cash transfers, with the joint income of the divorced couple being taxed at a lower overall rate than would have occurred absent the divorce, to the detriment of the Treasury.[6] In response, I would argue that such tax arbitrage is built into the current system already, that people do not get divorced in order to engage in income-shifting for tax purposes, and that the income-shifting that can occur is likely a good and defensible outcome on public policy grounds in most situations in which it can occur, since it encourages the higher-bracket spouse to transfer funds to the lower-bracket spouse (presumably the more needy spouse), often leaving the lower-bracket spouse with more after-tax income than she would otherwise have if income-shifting were disallowed.[7] Unlike other situations in which income-shifting is deemed to be inappropriate, such as in the intact family or in the case of a closely held corporation, divorce is not a transaction that can be entered into lightly, and often, in order to shift income to another in a lower tax bracket and thus reduce overall taxes on a routine basis while retaining effective control over the shifted income. Indeed, "[f]ollowing divorce, the chances of filing bankruptcy triple ...."[8] To the extent that some additional income-shifting would occur under the proposed simplifications that does not already occur under the current rules, so be it. Even if I am wrong that it would be a salutary result in most cases, it is a small price to pay for the huge simplification gains--and, I believe, added respect for the tax system by the unfortunate parties that have to deal with these complex provisions--that would occur.

Moreover, as Professor Malman noted, there is reason to believe that not much aggregate tax would be lost to the Treasury in any event, since every deduction is accompanied by an

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[5] *See infra* notes 173-230 and accompanying text (surveying some cases).

[6] *Cf.* Wendy Gerzog Shaller, *On Public Policy Grounds, A Limited Tax Credit for Child Support and Alimony*, 11 AM. J. TAX POL'Y 321, 321 (1994) (also referring to the "abuse of income-shifting" in this context).

[7] *See infra* note 240 and accompanying text (providing example). As Professor Hjorth put it,

> I am not unduly concerned by the specter of a "divorce bonus." For every case of taxes reduced by reason of divorce there is probably at least one case of reduced ability to pay caused by the divorce. Divorce is not something that is welcomed by most persons affected by it. It is a time of trauma, adjustment, and, often, financial difficulty for the spouses and their children.

Roland L. Hjorth, Divorce, Taxes, and the 1984 Tax Reform Act: An Inadequate Response to an Old Problem, 61 Wash. L. Rev. 151, 190 (1986).

[8] David Kay Johnston, *Bankruptcy Borne of Misfortune, Not Excess*, N.Y. TIMES, Sept. 3, 2000, § 3, at 7.

equal-amount inclusion.[9] Only the rate-bracket differential between the parties, if any, results in a revenue loss, and this loss is self-limiting, as the greater the amount paid to the payee, the higher the tax bracket that will apply to it, until further income-shifting would not produce a revenue loss. Moreover, in the context of a payor in a significantly higher tax bracket than the payee--which is the very context where it would seem that income-shifting would be at its most extreme and therefore result in the most lost revenue--any divorce "bonus" is more illusory than real. This is because that combination is *just* the combination that enjoys a significant "marriage bonus" under current law if the couple files a joint return,[10] and this marriage bonus is lost on the divorce. Even with income-shifting, the parties are not likely better off taxwise by much, if any, in the aggregate under the more onerous schedule for single filers that must apply to them after the divorce.

As mentioned above, our current system for taxing transfers in divorce is the result of history and political compromise as much as grand theory. Part I below will recount that history, since it's difficult to understand how we got to where we are today without an understanding of it. It will also necessarily introduce the various ways to think about these transfers, as it's difficult to discuss how the law evolved without an introduction to these thoughts at the same time. Part II will continue the discussion of what works in the current system, what is fundamentally flawed, and what should be done about it and why. Part III will examine two inextricably related problems that need addressing.

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[9] Malman, *supra* note 4, at 410-12.

[10] Joint filing can generate a "marriage penalty on two-earner couples," with the married couple paying more in tax than they would if they were able to file separately under the rate schedule for unmarried individuals. The marriage penalty is at its peak when each spouse earns the same amount of income. On the other hand, joint filing can generate a "marriage bonus," with the joint-return tax lower than would arise under separate filing using the individual rate schedule, if one spouse earns significantly more income than the other. *See generally* Lawrence Zelenak, *Marriage and the Income Tax*, 67 S. CAL. L. REV. 339 (1994) (recounting this history and advocating abandonment of the joint return in favor of individual filing for all).

> More married couples obtain a benefit from the marriage bonus than are subject to the marriage penalty. About 51% of married couples enjoy a marriage bonus, whereas about 42% of married couples incur a marriage penalty. In 1996, those enjoying a marriage bonus paid, as a group, $33 billion less in taxes than they would have paid if single, while those incurring the marriage penalty paid, as a group, $29 billion more in taxes than they would have paid if single. Thus, $4 billion of net revenue that would have been collected by the Treasury if all individuals filed separately was lost. *See For Better Or Worse: Marriage and the Federal Income Tax*, CONGRESSIONAL BUDGET OFFICE (June 1997).

I. The History

A. Prior to 1942

The early statute did not specifically address how to treat cash payments (or in-kind property transfers) between divorcing spouses. Hence, it devolved upon the Supreme Court to determine the status of such payments and transfers. The Court tackled cash payments way back in 1917 in *Gould v. Gould*[11] and in-kind property transfers in 1962 in *United States v. Davis*,[12] discussed in Part B.ii., below.

The parties in *Gould* divorced in 1909, and the court ordered Mr. Gould to pay Mrs. Gould $3,000 each month for the rest of her life "for her support and maintenance."[13] The issue was whether Mrs. Gould must include these payments in her gross income. The Supreme Court first quoted the predecessor to § 61 as follows:

> B. That, subject only to such exemptions and deductions as are hereinafter allowed, the net income of a taxable person shall include gains, profits, and income derived from salaries, wages, or compensation for personal service of whatever kind and in whatever form paid, or from professions, vocations, businesses, trade, commerce, or sales, or dealings in property, whether real or personal, growing out of the ownership or use of or interest in real or personal property, also from interest, rent, dividends, securities, or the transaction of any lawful business carried on for gain or profit, or gains or profits and income derived from any source whatever, including the income from but not the value of property acquired by gift, bequest, devise, or descent: ....[14]

The Court then wrote four paragraphs, which comprised the opinion's entire reasoning. Because of their brevity, I quote them in full.

> In the interpretation of statutes levying taxes it is the established rule not to extend their provisions, by implication, beyond the clear import of the language used, or

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Joseph M. Dodge, J. Clifton Fleming, Jr., & Deborah A. Geier, FEDERAL INCOME TAX: DOCTRINE, STRUCTURE, AND POLICY 191 n.11 (2d ed. 1999). The situation in which income-shifting in divorce under an inclusion/deduction system can lose the most revenue is when a high-earning spouse makes payments to a low-earning spouse after divorce, which is precisely the situation where the divorced couple will lose their prior marriage bonus, since after the divorce they must file using the rate schedule for individuals in order for the payments to be eligible for the inclusion/deduction system that generates the income-shifting. *See* I.R.C. § 71(e).

[11] 245 U.S. 151 (1917).

[12] 370 U.S. 65 (1962).

[13] 245 U.S. at 152.

[14] *Id.* at 152-53.

> to enlarge their operations so as to embrace matters not specifically pointed out. In case of doubt they are construed most strongly against the Government, and in favor of the citizen. [Author's note: Here, the Court cited three cases in which a tariff was imposed on an item specifically listed in a tariff statute, and the issue was whether the item sought to be taxed by the government qualified as the item listed in the statute as taxable.]
>
> As appears from the above quotations, the new income upon which subdivision 1 directs that an annual tax shall be assessed, levied, collected and paid is defined in division B. The use of the word itself in the definition of "income" causes some obscurity, but we are unable to assert that alimony paid to a divorced wife under a decree of court falls fairly within any of the terms employed.
>
> In *Audubon v. Shufeldt* ..., we said: "Alimony does not arise from any business transaction, but from the relation of marriage. It is not founded on contract, express or implied, but on the natural and legal duty of the husband to support the wife. The general obligation to support is made specific by the decree of the court of appropriate jurisdiction.... Permanent alimony is regarded rather as a portion of the husband's estate to which the wife is equitably entitled, than as strictly a debt; alimony from time to time may be regarded as a portion of his current income or earnings; ..."
>
> The net income of the divorced husband subject to taxation was not decreased by payment of alimony under the court's order; and, on the other hand, the sum received by the wife on account thereof cannot be regarded as income arising or accruing to her within the enactment.[15]

As made clear in the first quoted paragraph, one major ground relied upon by the Court was a rule of statutory interpretation borrowed from tariff law that revenue statutes are to be narrowly construed. No such canon of statutory interpretation survives today with respect to the income tax.

Moving to the exegesis of the terms of the statute itself, the Court seemed to conclude that, because alimony is not similar to the items specifically listed in the statute as taxable, alimony must not have been contemplated by Congress as coming within the ambit of the provision. This canon of statutory construction sometimes goes by the Latin name of *ejusdem generis*, meaning "of the same kind." Precisely the same reasoning, accepted by the *Gould* Court, was again used by a taxpayer in 1955 in arguing (in part) that punitive damages are not includable in gross income because they are not like the items specifically listed as taxable. That time, the taxpayer lost in the seminal case of *Commissioner v. Glenshaw Glass*.[16] Rejecting the argument premised on the notion of *ejusdem generis*, the *Glenshaw Glass* Court instead stressed the catchall language at the end--"income derived from any source whatever"--in concluding that

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[15] *Id.* at 153-54.

[16] 348 U.S. 426 (1955).

punitive damages were includable in gross income by the recipient. The 1955 Court stated that this catchall language required inclusion of all "undeniable accessions to wealth, clearly realized, and over which the taxpayers have complete dominion."[17] (Indeed, it's an interesting exercise to think about whether the *Gould* Court might have decided differently if the case had arisen in the later era, after *Glenshaw Glass*.)

Notice that this form of analysis focuses on whether alimony comes within some notion of "income." If the analysis is viewed this way, each party is analyzed independently, and a payment of alimony could conceivably be taxable to both the payor and the recipient. For example, if we view the matter from the recipient's side alone, and if alimony is considered as coming within the *Glenshaw Glass* notion of "income" as an undeniable accession to wealth, *etc.*, then it would be includable by the recipient. At the same time, the payor earning wages from which the alimony was paid would have to include the wages in gross income, since compensation for services rendered is specifically listed as "income" in § 61(a)(1). Moreover, the payor would arguably be denied a deduction for the payment under a strict definition of "income" in the familiar Schanz-Haig-Simons sense, under which only outlays incurred to produce includable income are properly deductible (with personal consumption outlays being nondeductible, and thus taxed).[18] Since the payment of alimony is not an outlay incurred directly to produce the payor's wages, it would be nondeductible (and thus remain in the tax base of the payor). Thus, the payment would be taxed twice, much as amounts paid by an employee from

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[17] *Id.* at 431.

[18] In general, a tax on "income" reaches amounts saved and amounts spent on personal consumption. Amounts that are saved are taxed since the Internal Revenue Code generally disallows outlays constituting "capital expenditures," such as the purchase of an asset. *See* I.R.C. § 263. That is to say, outlays that result merely in a change in the form in which wealth is held, rather than a diminution in wealth, are not deductible. Current "expenses" are the opposite of a "capital expenditure" in that current expenses represent a real diminution in wealth in the year spent. If that expense is incurred in income-producing activity, then the expense is generally deductible. *See, e.g.*, I.R.C. §§ 162 and 212. If, on the other hand, the expense is spent on personal consumption, it is generally nondeductible. *See* I.R.C. § 162(a). The only personal consumption expenses that are deductible are those that Congress has specifically allowed, usually as an incentive to engage in certain desirable behavior. *See, e.g.*, I.R.C. §§ 170 (charitable contribution deduction), 163(h)(3) (home mortgage interest deduction).

The reason why expenses incurred to produce includable income (as opposed to expenses incurred to buy personal consumption) should be deductible under an income tax is to avoid double taxation of the same dollars to the same taxpayer. You can think of it in the following way: If income-producing expenses were not allowed as deductions, then those expenses would create basis (previously taxed dollars). That basis should offset any includable income produced by that outlay, which would result in inclusion of only the "net" receipt in income. But the tax system doesn't work this way. Instead, I.R.C. § 61 requires the inclusion of every dollar of "gross" receipts. In order, therefore, to prevent the double taxation of those gross receipts to the extent of the outlays incurred to produce them, those outlays must be deductible. *See generally* Dodge, Fleming, & Geier, *supra* note 10, at 30-33 and 39-55.

his wages to his housecleaner for cleaning his house are taxed twice (once to the employee and once to the housecleaner). In the housecleaner example, the amounts constitute wages to both, and the payment to the housecleaner would clearly be a nondeductible personal expense of the payor. The only means by which to differentiate the alimony payment from the housecleaner payment would be to argue that alimony does not really purchase any personal consumption for the payor and thus should be removed from his tax base via a deduction. This means of analysis would define personal consumption not by looking to whether the payment directly contributed to income production of some kind--which defines personal consumption by default[19]--but rather by looking to what is actually purchased with the payment and determining whether it affirmatively qualifies as "personal consumption."[20]

Perhaps we don't have to resolve that definitional dilemma, however, for there is another way to view this issue, which was also hinted at by the *Gould* Court and which is, I think, the more appropriate way to think about the payment. Rather than analyzing the tax consequences to each of these taxpayers independently of the other, *i.e.*, determining whether the receipt qualifies as "income" to the recipient and whether the payment qualifies as a deductible one to the payor under an "income" analysis because it does not purchase discretionary personal consumption, we could view both taxpayers *together*. In an intact marriage, by analogy, amounts earned by one spouse and paid to another are ignored for tax purposes (*i.e.*, they are neither includable by the recipient nor deductible by the payor), whether or not the couple file a joint return or file separate returns using the rate schedule for married couples filing separately.[21] Therefore, the amounts

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[19] This is the method currently used in the Internal Revenue Code. Amounts can be deducted only if they are specifically described in a Code section containing the words, "there shall be allowed as a deduction ...," and, as described *supra* note 18, most such provisions allow deduction only for income-producing expenses.

[20] One example of this mode of analysis would be to argue that certain types of mandatory payments should not be considered as purchasing personal consumption and thus should be deductible. Payments of certain state and local taxes can be analyzed this way, as can alimony and child support. *See generally* Joseph M. Dodge, THE LOGIC OF TAX 123 (1989).

[21] *See* I.R.C. § 1 (describing the various filing statuses and their related rate schedules). Some couples file separately in order to lower significant state income taxes that use a progressive rate schedule. Filing separately might allow the couple to use the lowest state rate brackets twice, which can more than offset the increased Federal tax burden that may arise from using the more onerous schedule (compared to the rate schedule applicable to single taxpayers) applicable to married couples filing separately. Moreover, if each member of the couple earns approximately half of the couple's aggregate income, the aggregate federal tax should be roughly the same, regardless of whether they file a joint return or file separately, since the joint return mechanism produces a tax "exactly twice the tax that would be due if the [rate schedule for married filing separately] were applied to 50% of the couple's aggregate taxable income." Dodge, Fleming, & Geier, *supra* note 10, at 188. Another reason that some married couples file separately is to enable one to deduct more medical expenses, personal casualty losses, or miscellaneous itemized deductions, all of which are deductible only to the extent that they exceed certain percentages of adjusted gross income, than he or she would otherwise be able to

are taxed only once between the two.[22] We could reason that the amounts should continue to be taxed only once, even though the family is no longer intact, because of the clear and direct relationship of the payments to the former legal relationship of the parties (or the continuing legal relationship, in the case of a paternity payment to support a child after a divorce or otherwise outside of marriage). These payments would not have been made but for the prior legal relationship. Unless the government wishes to affirmatively discourage divorce via the tax laws (a very unwise possibility, in my view), there does not seem to be a persuasive reason to tax such payments more onerously outside marriage (by taxing them twice) than within it (by taxing them once.) Viewed this way, the question is not whether the amount conceptually constitutes "income" to both but rather *who* should be taxed on what is concededly income to someone? That is to say, this question can be viewed not as a "what is income?" question" but rather a "to whom should income be taxed?" question. The income could be taxed to the recipient by requiring the recipient to include it and allowing the payor to deduct it. Conversely, it could be taxed to the payor by allowing the recipient to exclude it and disallowing the payor a deduction. The government, in this scenario, becomes a mere stakeholder in the matter: The amounts will be taxed to *someone* (once); the only question is *which taxpayer's marginal rates should apply*?

The *Gould* opinion obliquely picked up on this perspective when it stressed that "[t]he net income of the divorced husband subject to taxation was not decreased by payment of alimony under the court's order; and, on the other hand, the sum received by the wife on account thereof cannot be regarded as income arising or accruing to her within the enactment."[23] The thought was written as a single sentence, with a semi-colon connecting the two independent clauses. This form seems to imply a causal link, *i.e.*, that another reason why the amount was not includable by Mrs. Gould was precisely because it was not deductible by Mr. Gould. The Court's implication was that the amount should not be taxed to both, and since the Court cannot create nonstatutory deductions, it exercised its power to define the contours of "gross income" to ensure that the amount was not taxed twice by holding that the recipient need not include the payments in gross income.[24] The Court would presumably have come to the same conclusion with respect to child support, if any had been at issue.

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deduct. *See* I.R.C. §§ 67, 165(c)(3) & (h), and 213. Finally, filing separately allows the couple to avoid joint and several liability. *See* I.R.C. § 6013(d)(3).

[22] This conforms the treatment of support payments within the intact family to the treatment of gifts within a family, which are also excludable by the recipient and not deductible by the donor. *See* I.R.C. §§ 102, 162. Mandatory and legally enforceable support payments would not otherwise qualify as "gifts," which are generally defined for income tax purposes as transfers made out of "detached and disinterested generosity." *See* Comm'r v. Duberstein, 363 U.S. 278 (1960).

[23] 245 U.S. at 154.

[24] In order to take a deduction, a taxpayer must find a Code section that contains the words "there shall be allowed as a deduction" and satisfy each of the requirements specified there. He must also survive the gauntlet of provisions that take away "otherwise allowable deductions." No court, the Supreme Court included, has any power to create a deduction. Only

With respect to support payments, the one-tax approach has continued to this day. The issues here have been how to decide between the two whom to tax and how to differentiate support payments (alimony and child support) from property settlements, a question that first arose with the 1942 legislation.

B. From 1942 to 1984

1. Support Payments

In the midst of World War II, the highest federal income tax marginal rate under the regular tax and a special surtax exceeded 90% in order to finance the war effort. Under such a rate structure, a payor of nondeductible alimony of any significant size could have little left upon which to live once he[25] paid his alimony and then the tax on his income, including the alimony. The legislative history underlying the Revenue Act of 1942[26] reflected this concern.

> The existing law does not tax alimony payments to the wife who receives them, nor does it allow the husband to take any deduction on account of alimony payments made by him. He is fully taxable on his entire net income even though a large portion of his income goes to his wife as alimony or as separate maintenance payments. The increased surtax rates would intensify this hardship and in many cases the husband would not have sufficient income left after paying alimony to meet his income tax obligations.

Congress can do that. On the other hand, because present-day I.R.C. § 61 contains the circular definition that gross income means "income from whatever source derived," the Supreme Court has long exercised its power to construe the contours of "gross income" by creating common law regarding what constitutes gross income. *See, e.g.*, the cases developing the assignment-of-income doctrine (discussed *infra* notes 252-301 and accompanying text). *See generally* Deborah A. Geier, *Some Meandering Thoughts on Plaintiffs and Their Attorneys' Fees and Costs*, 88 TAX NOTES 531 (2000) (discussing the interplay between the Court's power to craft the contours of gross income and its inability to create deductions in the context of the treatment of attorneys fees and costs that, though deductible, are subject to deduction restrictions that could be avoided if the plaintiffs could exclude from gross income the portion of taxable litigation awards to the extent paid to their attorneys).

[25] We all know that payors of alimony can include both males and females. *See, e.g.*, Liesl Schillinger, *Divorce Him, Support Him?*, THE INDEPENDENT (LONDON), Dec. 14, 1997, at 5 (characterizing "the phenomenon of men seeking alimony" as "becoming rife in the United States" and, more objectively, reporting that "[t]he number of male clients in the US claiming financial support from high-earning exes has doubled in the last five years"). While I know that use of the word "he" as the payor of alimony can perpetuate stereotypes, I think that repeated usage of the terms "he or she" makes for distracting prose, and thus I have chosen to risk the alienation of some readers in the quest for less stilted-sounding sentences.

[26] Revenue Act of 1942, Pub. L. No. 753, § 120, 56 Stat. 816 (1942) (codified as amended at I.R.C. §§ 22(k) and 23(u) (1942)).

> The bill would correct this situation by taxing alimony and separate maintenance payments to the wife receiving them, and by relieving the husband from tax upon that portion of such payments which constitutes income to him under present law. This treatment is provided only in cases of divorce or legal separation and applies only where the alimony or separate maintenance obligation is discharged in periodic payments. Moreover, the portion of such payments going to the support of minor children of the husband does not constitute income to the wife nor a deduction to the husband. The same is true with regard to payments in discharge of lump sum obligations, even though made in installments.[27]

Therefore, as described briefly above, the Revenue Act of 1942 switched the answer to the question, "who should be taxed on the amounts paid out as alimony?," from the payor to the recipient by requiring inclusion of alimony by the recipient and allowing a deduction to the payor. But the Act and its legislative history were quite clear that this inclusion/deduction system should not apply to child support or amounts paid to compensate for the transfer of a property interest. Child support and property settlements, in other words, remained excludable by the recipient and nondeductible by the payor, as under pre-1942 law. I'll discuss child support first and then property settlements.

The legislative history is silent with respect to why Congress chose to shift the tax incidence to the recipient only with respect to alimony and not child support. Yet, we can perhaps guess the predominant thinking of the time. In this more traditional era--when it was, indeed, only husbands who paid alimony and child support[28]--it might have been thought that, while shifting the tax obligation with respect to alimony would help to alleviate the immediate and quite practical problem of a husband being unable to satisfy both his alimony and tax liability if alimony were not deductible, shifting the tax obligation with respect to the man's children would be going "too far." A man's financial obligation to his children--including the obligation to pay the income tax on amounts spent to support them--might have been considered to be stronger than that to his ex-wife.

In any event, this new distinction between alimony and child support necessarily required line-drawing for the first time. The statute did so by providing that the recipient's gross income inclusion shall not apply to that part of any such periodic payment which the terms of the decree or written instrument fix, in terms of an amount of money or a portion of the payment, as a sum which is payable for the support of minor children of such husband. In case any such periodic payment is less than the amount specified in the decree or written instrument, for the purpose of applying the preceding sentence, such payment, to the extent of such sum payable for such support, shall be considered a payment for such support.[29]

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[27] H.R. REP. NO. 77-2333, *reprinted in* 1942-2 C.B. 372, 409.

[28] *Cf. supra* note 25.

[29] I.R.C. § 22(k) (1942).

In other words, an amount "fixed" in the governing documents for child support would not fall under the inclusion/deduction system, and if a payor made only a partial payment, the child support payment would be considered paid first. For example, assume that a husband was ordered to pay $10,000 per year to his ex-wife for support of herself and their minor children, $6,000 of which was explicitly fixed as child support. If the husband paid only $8,000 in a year, $6,000 would be considered nondeductible child support and $2,000 would be considered deductible alimony (so long as the remaining qualifications for deductible "alimony," described shortly below, were met).

What does it mean for an amount to be "fixed" for child support within the meaning of the statute? Suppose, for example, that John and Mary had three minor children when they divorced, that their mutually negotiated divorce agreement (which the relevant court approved) provided for a "family support payment" of, say $12,000 per year, but that the payment would be reduced by one-sixth each time a minor child married, became emancipated, or died. In other words, by the time all three minor children married, became emancipated, or died, the payments would have been reduced to $6,000. Was any amount "fixed" for child support during the years of the children's minority in this agreement?

On the one hand, the agreement did not overtly fix any amount for child support in the literal sense, though the "substance" of the document seems to indicate that, prior to the time any of the three children married, became emancipated, or died, $6,000 of the payments was really disguised child support. The reduction in amounts payable upon conditions relating to the children's emancipation, *etc.*, was, after all, captured in language in the agreement itself, and thus the agreement could be said to have adequately "fixed" $6,000 of the payments as child support.

Much litigation ensued in order to determine what the term "fix" meant in this provision--an example of how the different labels and their different tax treatments inevitably cause litigation.[30] The split among the circuit courts finally had to go to the Supreme Court for resolution in *Commissioner v. Lester*,[31] the facts of which are essentially identical to those recited above. The Court quoted both the Senate Finance Report as well as a report of the Office of the Legislative Counsel to the Senate Finance Committee in concluding that no part of an unallocated "family support payment" should be considered "fixed" as child support, even if a portion is scheduled to be reduced on the happening of events related to the children.

> "If, however, the periodic payments ... are received by the wife for the support and maintenance of herself and minor children of the husband without such specific designation of the portion for the support of such children, then the whole of such amounts is

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[30] *See, e.g.*, Metcalf v. Comm'r, 271 F.2d 288 (1st Cir. 1959); Eisinger v. Comm'r, 250 F.2d 303 (9th Cir. 1957); Lester v. Comm'r, 32 T.C. 1156 (1959), *rev'd*, 279 F.2d 354 (2d Cir. 1960).

[31] 366 U.S. 299 (1961).

> includable in the income of the wife as provided in section 22(k) ...." S. Rep. No. 1631, 77th Cong., 2d Sess. 86.

As finally enacted in 1942, the Congress used the word "fix" instead of the term "specifically designated," but the change was explained in the Senate hearings as "a little more streamlined language." Hearings before the Senate Committee on Finance on H.R. 7387, 77th Cong., 2d Sess. 43. As the Office of the Legislative Counsel reported to the Senate Committee:

> "If an amount is specified in the decree of divorce attributable to the support of minor children, that amount is not income to the wife .... If, however, that amount paid the wife includes the support of children, but no amount is specified for the support of minor children, the entire amount goes into the income of the wife ...." Ibid.

This language leaves no room for doubt. The agreement must expressly "fix" a sum certain or percentage of the payment for child support before any of the payment is excluded from the wife's income. The statutory requirement is strict and carefully worded. It does not say that "a sufficiently clear purpose" on the part of the parties is sufficient to shift the tax. It says that the "written instrument" must "fix" that "portion of the payment" which is to go to the support of the children. Otherwise, the wife must pay tax on the whole payment. We are obliged to enforce this mandate of the Congress.[32]

Therefore, the entire $12,000 annual payment during the children's years of minority was includable by the wife and deductible by the husband as alimony.

Thus, a divorce decree that required a husband to pay $100 weekly for the support of his ex-wife and $50 for the support of their two children would produce only a $100 weekly income inclusion for the wife and a corresponding deduction for the husband, since the remaining $50 would be considered "fixed" for child support and not eligible for the inclusion/deduction system. If the decree provided instead for a payment of $150 per week for the support of the ex-wife *and* the children, no part of it would be considered excludable/nondeductible child support. Similarly, none of the $150 payment would be considered child support if the decree also provided that the payments would be reduced by $25 per week upon the death, marriage, or majority of either of the children.

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[32] *Id.* at 302-03. I've always wondered whether Justice Scalia would have written a dissent in *Lester*, since the majority relies so explicitly on legislative history, a tool that Justice Scalia finds illegitimate. *See generally* Deborah A. Geier, *Textualism and Tax Cases*, 66 TEMP. L. REV. 445, 447-55 (1993); Wisconsin Pub. Intervenor v. Mortier, 111 S. Ct. 2476, 2487 (1991) (Scalia, J., concurring in the judgment) (ours is "a Government of laws not of committee reports"). If Justice Scalia would interpret the word "fix" broadly enough to cover terms explicitly requiring reduction of payments on the happening of an event linked to the child's leaving the payee's home (such as marriage, death, or emancipation), then the legislative history to the contrary would have been meaningless to him.

To American tax lawyers used to hearing that "substance" and not "form" governs the characterization of tax transactions, it might seem odd that, while the statute announced that Congress had decided--for whatever reason--that child support should be treated differently from alimony, the law allowed what was, for all intents and purposes, disguised child support to escape characterization as "child support." Yet, what the so-called *Lester* Rule (as it came to be known) accomplished was the delegation to the divorcing parties of the authority to decide who, between them, should pay the tax on the amounts used to support the children. If they clearly "fixed" the amount as child support in their agreement, then the payor would pay tax on the payments; if the amount was not explicitly "fixed" but the amount paid was reduced upon the child's marriage, death, or emancipation, then the recipient would shoulder the burden. The *Lester* Court recognized this when it said:

> As we read § 22(k), the Congress was in effect giving the husband and wife the power to shift a portion of the tax burden from the wife to the husband by the use of a simple provision in the settlement agreement which fixed the specific portion of the periodic payment made to the wife as payable for the support of the children.[33]

You might think that I support the outcome of the *Lester* Rule, since I made plain in the Introduction that I will, in Part II, explicitly argue that the parties *should* be able to decide for themselves who, between them, should shoulder the burden of paying tax on cash transfers. But the actual approach embodied in the *Lester* Rule suffers from a fundamental defect: The election was not explicit; it required the advice of a skilled tax practitioner to alert the parties to this planning device. Ill-advised (or unadvised) parties unlucky enough to call child support "child support" in their agreement were unable to shift the tax burden to the payee under the *Lester* Rule, even if they wished to (and the reasons they might wish to will be detailed later). Under the approach of the *Lester* Rule, in other words, parties were empowered to decide who should bear the tax burden *only* if they were aware of the magic formula. If it is true that Congress intended, as indicated by the legislative history, that the parties to be able to decide for themselves who, between them, should shoulder the burden of paying tax on amounts paid out as child support, it should have made that election explicit. Having that election effectively buried in Committee Reports and then in a Supreme Court opinion discussing what it means to "fix" an amount for child support was not defensible. Then, as now, too many people divorced without tax counsel. And even many family lawyers who were not well-versed in tax law were likely unaware of this *de facto* election. The *de facto* election under the *Lester* Rule was, in short, a huge trap for the unwary. There will always be parties who are unwary of the law, but the law should strive as much as possible to keep the traps to a minimum, particularly in an area, such as divorce, where people often go it alone (*i.e.*, without good tax counsel).

In sum, if Congress was serious about taxing child support differently from alimony in 1942, then the term "fix" should not have been interpreted as it was by the *Lester* Court. Substance should have controlled. If, on the other hand, the *Lester* Rule outcome was deemed desirable because it would allow the parties to decide for themselves who should bear the burden of tax on these cash payments, then the election should have been made much more explicit on

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[33] 366 U.S. at 304.

the face of the statute itself and not made contingent on including the right magic words in the divorce settlement to accomplish the same end result as would an explicit election.

Amounts "fixed" as child support were not the only payments that fell outside the recipient inclusion/payor deduction system enacted in 1942. Congress intended that payments for the recipient's interest in property should not fall within the inclusion/deduction system as well and, like child support payments, should be tax neutral (*i.e.*, neither deductible by the payor nor includable by the payee). While we were hard-pressed to come up with a reason why Congress chose to treat child support payments as falling outside the new inclusion/deduction system in 1942, it's much easier to identify the thinking behind the distinction between alimony and cash property settlements.

As a simple example, assume that John and Mary owned Blackacre, worth $100,000, as joint tenants when they divorced. John wished to own 100% of Blackacre outright, and he thus agreed to pay Mary $50,000 for her share of Blackacre, either out of his own previously earned funds or in installments from his future earnings. In each of these scenarios, this $50,000 payment should not (as a matter of theory, at least) fall within the inclusion/deduction scheme, if we respect the payment as a purchase of property. Viewed from John's perspective alone, an outlay made to purchase property is properly a nondeductible "capital expenditure."[34] Allowing John a deduction for his outlay to purchase property violates the fundamental structure of a tax on "income," effectively garnering John consumption-tax treatment, instead.[35] Another way to view it (again, from John's perspective alone) would be to say that if John were allowed to deduct his purchase price of $50,000 for Mary's interest in Blackacre, the Treasury would actually be funding a portion of his purchase price (equal to John's tax savings). On the other hand, we must remember that Mary would be fully taxed on the cash receipt if John gets to deduct it, so the revenue loss to the Treasury by treating this payment under the inclusion/deduction scheme (rather than as a tax neutral payment) would equal only the difference (if any) between John's marginal rate bracket (the tax lost to the Treasury) and Mary's (the tax gained).

Viewed from Mary's perspective alone, if this payment were respected as a payment for her share of Blackacre, she would measure her realized gain or loss under I.R.C. § 1001 by comparing the $50,000 received for her half interest with her basis in the half interest. Only if her basis were zero would the gain realized equal the entire $50,000 that would be included if the payment were instead treated under the inclusion/deduction system, and even then the gain might be lower-taxed capital gain (instead of the ordinary income that arises under the

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[34] *See supra* note 18.

[35] Under a consumption tax, all outlays--even those that would constitute nondeductible capital expenditures under an income tax--are deductible so long as the outlay does not buy personal consumption. Thus, additions to savings, such as John's purchase of $50,000 worth of Blackacre, would be deductible under a cash-flow consumption tax, even though it would be nondeductible under an income tax. *See generally* Dodge, Fleming, & Geier, *supra* note 10, at 472-83.

inclusion/deduction system) or might not be recognized at all.[36] The transaction might also produce a loss if Mary's basis for her half share of Blackacre were higher than $50,000.

In short, in *theory* at least, only the portion of a shared income stream earned by the payor after the divorce and paid to the recipient for support (and not for her share of property or inchoate property rights accrued during the marriage) should be eligible for the inclusion/deduction system. The 1942 legislation attempted to codify this idea in new § 22(k) with the following language:

> 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 instrument incident to such divorce or separation shall be includable in the gross income of such wife, and such amounts received as are attributable to property so transferred shall not be includable in the gross income of such husband.... Installment payments discharging a part of an obligation the principal sum of which is, in terms of money or property, specified in the decree or instrument shall not be considered periodic payments for the purposes of this subsection; except that an installment payment shall be considered a periodic payment for the purposes of this subsection if such principal sum, by the terms of the decree or instrument, may be or is to be paid within a period ending more than 10 years from the date of such decree or instrument, but only to the extent that such installment payment for the taxable year of the wife (or if more than one such installment payment for such taxable year is received during such taxable year, the aggregate of such installment payments) does not exceed 10 per centum of such principal sum.[37]

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[36] Whether Mary's realized gain or loss would be recognized is discussed in the next subpart.

[37] I.R.C. § 22(k) (1942). The language referring to a transfer "attributable to property transferred (in trust or otherwise) in discharge of" a legal obligation ensured that if a payor satisfied his alimony obligation by creating a trust or purchasing a life insurance or annuity contract, *etc.*, with the payments from the trust or insurance company payable to the payee, then that income stream was also includable by the payee. The later language that the amounts "received as are attributable to property so transferred shall not be includable in the gross income of the husband" rendered a deduction unnecessary to the husband to shift the income tax obligation to the payee. The income shifting was accomplished via different means (an exclusion for the husband rather than a deduction) but was nevertheless successfully accomplished. Regulations issued in 1942 give this example. "For example, if in order to meet an alimony obligation of $500 a month, the husband purchases or assigns for the benefit of his former wife a commercial annuity contract paying such amount, the full $500 a month received by the wife is includable in her income, and no part of such amount is includable in the husband's income or deductible by him." Reg. 103, Sec. 19.22(k)-1(b) (issued in Treasury

The statute provided the payor a deduction in § 23(u) for all amounts includable by the recipient.[38]

The relevant qualifications for an includable/deductible payment could be distilled, therefore, as follows:

(1) The payment had to be "periodic," but a payment could be periodic even if not made at regular intervals.

(2) It had to be made pursuant to a decree of divorce or of separate maintenance.

(3) It had to discharge a legal obligation imposed on the payor because of the marital or family relationship.

(4) It could not be an amount "fixed" for child support.

(5) If the payment was an installment payment that discharged a principal sum stipulated in the divorce decree, then the payment qualified only if the installment period exceeded ten years from the date of the decree and, even then, the installment payment in any one year could qualify only to the extent that it did not exceed ten percent of the principal sum designated in the decree.

Requirement 2 is straightforward, and I have already discussed requirement 4.

The implicit assumption underlying requirement 1 that the payment be "periodic" was that a lump-sum obligation (even if paid in installments) looks much more like a property settlement than a support payment out of new earnings of the payor that have not yet been taxed. But while the general idea is fairly easy to grasp, the provision generated much litigation in search of the precise meaning of the term "periodic."[39] The cases generally concluded that, to be periodic, the payments had to be either for an indefinite amount or an indefinite period.[40] Moreover, as requirement 5 indicates, if the payment was part of an installment stream that discharged a principal sum stipulated in the divorce decree, the payment stream had to exceed ten years to overcome the underlying presumption that it otherwise constituted a payment for the recipient's interest in marital property. A payment was considered to be in discharge of a principal sum if "the final sum to be paid could be definitely determined at the time the decree

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Decision 5194, Dec. 8, 1942). This sentence was lifted directly from the legislative history. *See* H.R. REP. NO. 77-2333, *reprinted in* 1942-2 C.B. 372, 568.

[38] I.R.C. § 23(u) (1942).

[39] *See, e.g.*, Warnack v. Comm'r, 71 T.C. 541 (1979); Bishop v. Comm'r, 55 T.C. 720 (1971); Van Orman v. Comm'r, 418 F.2d 170 (7th Cir. 1969).

[40] Barb Mattei, Note, *1984 Deficit Reduction Act: Divorce Taxation*, 1986 WIS. L. REV. 177, 185.

was executed."[41] Even if the ten-year period was met, no more than ten percent of the principal sum could qualify as deductible alimony in any one year.

An example taken from the 1942 regulations illustrates the operation of this rule.

A divorce decree in 1940 provides that H is to pay W $20,000 each year for the next 5 years, beginning with the date of the decree, and then $5,000 each year for the next 10 years. Assuming the wife makes her returns on the calendar year basis, each payment received in 1942 [the first year in which the new rules became effective] 1943 and 1944 is a periodic payment under section 22(k), but only to the extent of 10 percent of the principal sum of $150,000. Thus for such taxable years, only $15,000 of the $20,000 received is includable under section 22(k) in the wife's income and is deductible by the husband under section 23(u). For the years 1945-1954, inclusive, the full $5,000 received each year by the wife is includable in her income and is deductible from the husband's income."[42]

This ten percent rule, in short, discouraged front-loaded payments that might look as though they consisted more of a property settlement than a support payment. Matters could get quite complicated, however. The regulations provided that "[t]his 10 percent limitation applies to installment payments made in advance but does not apply to delinquent installment payments for a prior taxable year of the wife made during her taxable year." [43] The interrelationship between the ten-year rule, the ten-percent rule, and the rules for advance and delinquent payments was illustrated by the following sticky example.

Under the terms of a separation agreement incident to divorce granted in December 1940, H agrees to pay W $500 on the first day of each month, beginning with the month after the decree, for 12 years. W makes her income tax returns on the calendar year basis while H makes his returns on the basis of the fiscal year ending June 30. H makes the promised payments in 1941 and 1942 and, in addition, on December 31, 1942, pays W $1,500 as an advance payment of installments for the next three months. In the calendar year 1943, H makes no payments at all because of financial straits. On January 1, 1944, H inherits $15,000, which he immediately pays to W in satisfaction of not only his back alimony installments for the last 9 months of 1943 but also his alimony installments for the next 21 months. The results as to H and W are as follows:

As to W. In the calendar year 1941, W received $6,000, none of which is includable in her gross income. In the calendar year 1942, W received $7,500. Since 10 percent of $72,000 (the principal sum) is $7,200, only $7,200 of the $7,500 so received is includable in her income for 1942. For 1943, nothing is includable in her income under section 22(k). In 1944, W received $15,000. Of this amount, $4,500 is in payment of back installments and, therefore, is includable without limitation in her income for 1944. Of the balance of $10,500, only $7,200 is includable in her income for 1944.

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[41] *Id.*

[42] Reg. 103, Sec. 19.22(k)-1(c), Ex. 2 (issued in Treasury Decision 5194, Dec. 8, 1942).

[43] Reg. 103, Sec. 19.22(k)-1(c) (issued in Treasury Decision 5194, Dec. 8, 1942).

As to H. For the taxable year ended June 30, 1941, H paid $3,000 none of which is deductible. For the taxable year ended June 30, 1942, H paid $6,000, of which only $3,000 is deductible by H since only that much of the $6,000 was paid in the wife's first taxable year beginning after December 31, 1941. In the taxable year ended June 30, 1943, H paid W $4,500, which, not being in excess of 10 percent of the principal sum, is deductible for such year. In his taxable year ended June 30, 1944, H paid $15,000, of which $11,700 (the sum of $4,500 and $7,200) is deductible.[44] Clearly *not* an easy or intuitive result for the divorcing parties who fail to (or could not afford to) seek advice.

As noted above, payments of less then ten-year duration would not qualify for the inclusion/deduction system at all if they discharged a principal sum that could be computed from the decree at the time of the execution. But, in such a case, a contingency clause inserted into the divorce agreement to increase, decrease, or terminate payments on the happening of certain events, such as death, remarriage, or a change in economic circumstances, was sufficient to make the payments sufficiently indefinite in duration to be "periodic," even if the likelihood of the contingency occurring during the payment stream was low.[45]

For example, if the decree obligated the payor to pay $900 per month for nine years, the obligation was for a principal sum paid in less than ten years and was excludable and nondeductible .... However, if the decree inserted the contingency that the payments were to continue for nine years or until the recipient's death, the payments became "periodic" and therefore includable, deductible.[46] Moreover, payments under a divorce decree lacking a contingency clause would nevertheless be considered "periodic" if state law would step in and terminate or modify payments.[47] For example, in *Kent v. Commissioner*,[48] the court held that the possibility that a judge could modify an alimony award under state law if the parties' circumstances changed meant that the payment was sufficiently indefinite as to qualify as "periodic," even though the payment stream mandated by the document itself was less than 10 years and was of a principal sum.

The effect of local law on the interpretation of divorce and separation agreements meant that a divorcing couple in one state could use the very same language in their agreement as that used by a couple in another state with entirely different tax results. This lack of uniformity in the divorce tax laws caused by the dependence on state law was one reason the decisions in this area

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[44] *Id.*, Ex. 3.

[45] Matei, *supra* note 40, at 186.

[46] *Id.* at 186 n.67.

[47] Rev. Rul. 59-190, 1959-1 C.B. 23.

[48] 61 T.C. 133 (1973); *see also* Marshall v. Comm'r, 35 T.C.M. (CCH) 138 (1976) (ruling similarly); John Y. Taggart, *Economic Consequences of Emotional Choices: Divorce and Separation under TRA 1984*, 15 CUMB. L. REV. 341, 347 (1985) (citing both).

have appeared so contradictory and the tax treatment of divorce settlements has been so unpredictable.[49]

Requirement 3--that the payment had to discharge a legal obligation imposed because of the marital or family relationship--was another device intended to differentiate support payments from property settlements. Lifting a sentence directly from the legislative history, regulations issued in 1942 interpreted this requirement as limiting eligible payments to those made "in recognition of the general obligation to support, which is made specific by the instrument or decree."[50] If the payment was not made in general recognition of the obligation to support, but rather to execute a property settlement, then it would fail to qualify as a payment made to discharge a legal obligation imposed because of the marital or family relationship and thus fail to qualify for the inclusion/deduction system, even if the payments were "periodic."[51] This was true even if the payments were in extinguishment of such an intangible and inchoate property interest as dower or curtesy, since such amounts were not paid for support but rather for extinguishment of those intangible property rights.[52] This rule caused much confusion.

For example, monthly cash payments over a 121-month period (*i.e.*, more than ten years) qualified as "periodic" (because they exceeded ten years) but were held not to be includable/deductible payments because the amount of the payments was calculated by subtracting the value of the marital property received by the payee pursuant to the divorce from the value of the marital property received by the payor. Thus, the court concluded that the payment stream was a property settlement and not made in discharge of an obligation of support.[53] Even payments specifically designated as for "support" of the ex-wife in the divorce settlement were recharacterized as a property settlement where the payments represented the wife's interest in her former husband's partnership, which was community property under

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[49] Taggart, *supra* note 48, at 347.

[50] Reg. 103, Sec. 19.22(k)-1(a) (issued in Treasury Decision 5194, Dec. 8, 1942). The legislative history stated: "This section applies only where the legal obligation being discharged arises out of the family or marital relationship *in recognition of the general obligation to support*, which is made specific by the instrument or decree." H.R. REP. NO. 77-2333, *reprinted in* 1942-2 C.B. 372, 568 (emphasis added).

[51] *See* Taggart, *supra* note 48, at 346. Moreover, a voluntary payment would fail to qualify, since such a payment would not be made "in discharge of a legal obligation." *See, e.g.*, Moore v. United States, 449 F. Supp. 163 (N.D. Tex. 1978). *See generally* John W. Harris, *The Federal Income Tax Treatment of Alimony Payments--The "Support" Requirement of the Regulations*, 22 HASTINGS L.J. 53 (1970) (generally examining the development and then-current contours of the "support" requirement).

[52] *See* Swindle v. Comm'r, 35 T.C.M. (CCH) 1 (1976).

[53] Adam v. U.S., 429 F. Supp. 38 (D. Wyo. 1977); *accord* Gammill v. Comm'r, 710 F.2d 607 (10th Cir. 1982); Crouser v. Comm'r, 73 T.C. 1113 (1980).

California law.[54] Conversely, payments specifically found by a state court to be a "property settlement" were held to be "alimony" for federal tax purposes since the Tax Court found that the wife did not relinquish anything of value when she transferred her joint tenancy interest in a house to her former husband.[55] In that case, the Tax Court went so far as to say that "the labels given to the payments by the parties or by the [state court decree] do not govern their characterization for tax purposes."[56]

A further taste of the confused state of the law in trying to differentiate "support" payments from "property settlements" under this standard was given by one commentator, as follows:

> The courts were often inconsistent in these recharacterizations. In *Ryker v. Commissioner*, the husband agreed to pay the wife 25% of this income for more than 10 years as property settlement. The payments were to cease at her death or remarriage. Despite the parties' express labeling of the payments as property settlement, the Tax Court did not even discuss the wife's property rights. Instead, the Tax Court recharacterized the payments as alimony because of the death or remarriage contingencies. Conversely, in *Riddell v. Commissioner*, the Ninth Circuit allowed an express property settlement label to stand, despite the payment's contingency on the wife's death. The Tenth Circuit [in *Hayutin v. Commissioner*] found that payments could not constitute property settlement if the wife had no co-ownership during marriage, even though she had inchoate rights that vested at divorce. The U.S. Court of Claims reached the opposite result in *Bernatschke v. Commissioner*. The Court of Claims held that annuities exchanged for inchoate dower rights were for property settlement.[57]

When Congress recodified the income tax law in 1954, this treatment of alimony and child support (as well as their definitions) was continued in I.R.C. §§ 71 (alimony includable, child support excludable) and 215 (amounts includable under I.R.C. § 71 are deductible).

As this quick perusal of the law makes clear, the law between 1942 and 1984 with respect to alimony and child support was complex, ambiguous, not uniform from state to state, and

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[54] Westbrook v. Comm'r, 74 T.C. 1357 (1980).

[55] Graham v. Comm'r, 43 T.C.M. (CCH) 15 (1981).

[56] *Id.*; *accord* Widmer v. Comm'r, 75 T.C. 405 (1980) (holding that a state court's characterization of payments under a divorce decree as alimony was not controlling for tax purposes and that since the payments were not contingent and the wife was required to assign a stock interest to her husband the payments were correctly determined to be a property settlement).

[57] Mattei, *supra* note 40, at 186 n.72 (case citations omitted) (citing Stanley M. Grossbard, Comment, *Taxation of Divorce Settlements and the Property/Support Distinction*, 55 S. CAL. L. REV. 939 (1977) and John W. Harris, *The Federal Income Tax Treatment of Alimony Payments--The "Support Requirement" of the Regulations*, 22 HASTINGS L.J. 53 (1970)).

contained a large number of traps for the unwary. Advice of a lawyer well-versed in the tax law was crucial, and even then, labels attached to payments in the agreements and state divorce decrees often were recharacterized by the courts in the ensuing tax litigation. "Couples were making significant financial decisions which might bind them for many years, yet were sometimes unable to predict the tax consequences of their decisions with any certainty."[58] The not infrequent need to resort to litigation to deal with some of these complexities and ambiguities also made the task of complying with the law all the more expensive. And it's difficult to believe that all of this confusion could be justified by any argument that the complexity was required in order to get it "right." The law characterized an absolute obligation to pay $10,000 per year for 9 years (a total of $90,000) as an excludable/nondeductible property settlement in full, period, regardless of whether this conclusion was fairly justified by the underlying facts. No judge had the power to make an inquiry into the underlying facts with such terms. At the same time, an absolute obligation to pay $10,000 per year for 9 years and $1,000 per year in years 10 and 11 was characterized as "alimony" to the extent of $9,200 of each of the payments in years 1 through 9 and the full $1,000 payments in years 10 and 11, with only the remaining $7,200 characterized as "not alimony"--*unless* the underlying facts convinced a judge that the payment stream really was meant to compensate the recipient for her interest in marital property so that the payment was not made in discharge of an obligation for "support." I think it would be almost mere happenstance if these tax conclusions reliably labelled the status of these payment streams "correctly."

2. In-Kind Property Transfers

Notice that the definition of includable/deductible "alimony" enacted in 1942 contained no requirement that the payment be made in cash.[59] Thus, a $500 alimony obligation could be discharged with the transfer to the alimony recipient of property worth $500. Moreover, property settlements often required the transfer of property in kind from one spouse to the other. How were these in-kind property transfers treated for tax purposes?

One result was already described: If the transfer otherwise qualified as "alimony" under the requirements described in subpart 1, above, then the recipient had to include the value of the property in gross income and the transferor could deduct it. Conversely, if the transfer failed to qualify as "alimony," then the recipient would exclude the receipt and the transferor would not be permitted to deduct it. But with an in-kind property transfer, a second question arises in both instances: Is the transfer a realization and recognition event, so that any built-in gain or loss is taken into account for tax purposes? Disagreements surrounding the answer to this question led the Supreme Court to consider it in *Davis v. Commissioner*[60] in 1962.

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[58] Deborah E. Behr, Note, *Tax Planning in Divorce: Both Spouses Benefit from the Tax Reform Act of 1984*, 21 WILLAMETTE L. REV. 767, 773 (1985).

[59] *See supra* text accompanying note 37.

[60] 370 U.S. 65 (1962). The following paragraphs describing *Davis* and the evolution of the law in the years following are taken from Deborah A. Geier, *Form, Substance, and Section 1041*, 60 TAX NOTES 519, 520-21 (1993).

In 1955 and pursuant to a divorce decree, H transferred to his former spouse, W, shares of E.I. du Pont de Nemours & Co. that had a cost basis in H's hands of approximately $75,000 and a fair market value at the time of transfer of approximately $82,250. In return, W released H from all claims, including dower and any rights under the laws of testacy and intestacy. Concluding that "the inchoate rights granted a wife in her husband's property by Delaware law do not even remotely reach the dignity of co-ownership,"[61] the Supreme Court applied the marketplace rule that the transfer of property owned by one taxpayer to another taxpayer in exchange for the release of an independent legal obligation is a realization event.[62] Assuming that the value of the release of the inchoate marital rights equalled the value of the stock, the Court concluded that H realized a gain of approximately $7,250 on the transfer and that W took a cost basis of $82,250 in the stock.[63] The Court noted in a footnote the "administrative practice" of not taxing W on the release of marital rights.[64]

Had W possessed some sort of ownership interest in the stock at the time of the divorce, as in a community property state, the outcome might have been different. The transaction might have been viewed instead as a division of jointly owned property, which was not considered a realization event. The Court acknowledged, but apparently was not overly troubled by, the disparities that its decision would create between residents of community-property states--in which no "transfer" might be deemed to occur on the division of marital property--and residents of common-law states.

As described below, the post-*Davis* era was one of confusion and uncertainty and certainly one full of traps for the unwary. It was also an era that witnessed state legislation that had as its goal the frustration of a federal tax case, the *Davis* case, while maintaining a common-law property regime in other respects.

The government conceded that approximately equal divisions of community property[65] or property in states where the law is "similar to community property law"[66] were not taxable; the transferee took a carryover basis and tacked holding period in the property. Similarly, the Service ruled that approximately equal divisions of property owned in joint tenancy or property held as tenants in common were nontaxable divisions of property, even though ownership wasn't

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[61] 370 U.S. at 70.

[62] *Id.* at 68-70. *Cf.* International Freighting Corp. v. Comm'r, 135 F.2d 310 (2d Cir. 1943) (transfer of appreciated property to employee in payment for services rendered is a realization event for transferor).

[63] 370 U.S. at 71-74. *See* Philadelphia Park Amusement Co. v. U.S., 126 F. Supp. 184 (Ct. Cl. 1954) (basis of property received in taxable exchange is fair market value of the property received).

[64] 370 U.S. at 73, n.7.

[65] Rev. Rul. 76-83, 1976-1 C.B. 213.

[66] Rev. Rul. 74-347, 1974-2 C.B. 26.

partitioned but, rather, some assets went in their entirety to one spouse and some went in their entirety to the other.[67] Not all transfers in community-property states were tax-free events, however. An exchange of separate (nonmarital) property for community property or an unequal division of community property resulted in taxation.[68] Similarly, unequal divisions of jointly owned property in noncommunity-property states resulted in taxation.[69]

Davis thus required an examination of state law in order to determine whether the transferee of property had an existing property interest in the property received at the time of the transfer, notwithstanding that the transferor was titleholder to the property. If the transferee in a common-law state possessed an interest "similar to community property," such as was held under some "equitable distribution" statutes,[70] the transferor might not realize a gain on the transfer and the transferee would take a carryover basis, even though the property was not in fact community property or jointly held. This reliance on state law enabled states to enact "anti-*Davis*" legislation, exemplified by Oregon's statute: "Subsequent to the filing of a petition for annulment or dissolution of marriage or separation, the rights of the parties in the marital assets shall be considered a species of co-ownership and a transfer of marital assets ... shall be considered a partition of jointly owned property."[71] The "equitable distribution statutes" of other states often were interpreted to vest a property interest in the transferee in the case of a "special equity" determination. These eleventh-hour vestings of property rights during the course of divorces in noncommunity-property states most often were upheld by the courts as effectively eviscerating *Davis*.[72]

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[67] Rev. Rul. 81-292, 1981-2 C.B. 158.

[68] *See, e.g.*, Siewart v. Comm'r, 72 T.C. 326 (1979) (receipt by W of noncommunity cash and a personal note of H for transfer of her one-half interest in community property constituted a sale, not a division of community property); Carrieres v. Comm'r, 64 T.C. 959 (1975), *aff'd*, 552 F.2d 1350 (9th Cir. 1977) (*per curiam*) (taxable sale to W to the extent H used his separate property to pay for W's community property interest in stock but no taxable sale with respect to the portion of such stock exchanged for H's interest in other community property).

[69] Rev. Rul. 74-347, 1974-2 C.B. 26.

[70] *See* Cynthia Garrison Lepow, *Proposals to Reform the Tax Treatment of Property Division Incident to Divorce—A Splitting Headache*, 10 COMMUNITY PROP. J. 237, 250-53 (1983) (describing cases).

[71] ORS 107.105(1)(f) (discussed in Laird v. U.S., 16 Cl. Ct. 441 (1989)).

[72] *See, e.g.*, Collins v. Comm'r, 421 F.2d 211 (10th Cir. 1969); Imel v. U.S., 523 F.2d 853 (10th Cir. 1975); Cook v. Comm'r, 80 T.C. 513 (1983), *aff'd*, 742 F.2d 1431 (2d Cir. 1984); Boucher v. Comm'r, 710 F.2d 507 (9th Cir. 1983); Bosch v. U.S., 590 F.2d 165 (5th Cir. 1979), *cert. denied*, 444 U.S. 1044 (1980); McIntosh v. Comm'r, 58 T.C. 4 (1986) (applying pre-1984 law); Laird v. U.S., 61 Cl. Ct. 441 (1989) (applying pre-1984 law).

As stated above, this state of affairs resulted in much confusion and costly litigation under *Davis*, many traps for the unwary, and a variety of results for what appeared to be similarly situated taxpayers, depending on state law. It also resulted in a fair amount of whipsaw for the Federal Treasury, with the transferor spouse claiming a tax-free division of property and the transferee claiming a stepped-up basis under *Davis* on later disposition. This state of affairs remained extant until the law was amended in 1984.

C. From 1984 to the Present

1. Activities Leading to the Tax Reform Act of 1984

In the early 1980s, the American Bar Association (ABA) Tax Section created the "ABA Domestic Relations Tax Simplification Task Force"[73] to study and make recommendations regarding the taxation of transfers in divorce. It identified six criticisms in the law at that time, as follows:

1. That many of the exiting rules are overly complex, requiring a degree of tax sophistication on the part of taxpayers (or their counsel) that is frequently perceived as too costly to obtain;
2. That some rules, although seemingly relevant in countless cases, are not clearly established by existing authorities;
3. That, due to the significance of local law in this area, disparate tax results ensue for substantially comparable transactions occurring in different states;
4. That the triggering of an income tax by some types of property transfers at the time of divorce (as in the case of so-called *Davis* transfers) may simply be "bad policy," an unnecessary consequence that in many cases simply depletes overly strained liquidity;
5. That the overall domestic relations tax structure has produced, and continues to produce, far too many tax controversies, causing a serious drain on the manpower and resources of the courts, Internal Revenue Service, and state taxing authorities; and

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[73] The members of the Task Force were David H. Hopkins (Project Coordinator), Berneice A. Anglea, Joseph N. DuCanto, Steven D. Kittrell, Robert H. Mnookin, Marjorie A. O'Connell, Gary C. Randall, Frank E.A. Sander, Thomas R. White, III, J. Nelson Young, and Michael J. Graetz (Liason with Tax Section Simplification Committee). *See* signatories to *Preliminary Specifications for Simplification of Domestic Relations Tax Law*, *Technical Memorandum to the Report of the American Bar Association's Domestic Relations Tax Simplification Task Force, ABA Section of Taxation* at 28 (May 17, 1981) (copy on file with author) [hereinafter *Task Force Technical Memorandum*]. This "Technical Memorandum" contained a more detailed description of the proposals more concisely summarized in *American Bar Association's Domestic Relations Tax Simplification Task Force, Preliminary Specifications for Simplification of Domestic Relations Tax Law* (copy on file with author) [hereinafter *Task Force Preliminary Specifications*].

6. That there may be a significant degree of noncompliance with the applicable tax rules, a situation conducive to disrespect for the entire tax system.[74]

The "basic touchstone" guiding the Task Force's recommendations was the concept of "private ordering," under which "parties to a divorce or legal separation, via a written agreement, may set their own tax framework."[75] As is discussed in more detail below, this idea was not carried out in the Task Force's proposals to the maximum extent possible and was largely rejected, with only one small nod to the contrary, in the legislation eventually enacted in 1984.

The Task Force made the following major recommendations with respect to the income tax treatment of transfers in divorce.[76] First, it recommended that all in-kind transfers of property under a decree of divorce or written instrument incident to such a decree be nonrecognition events, with a carryover basis.[77] In other words, the Task Force recommended

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[74] *Task Force Technical Memorandum*, *supra* note 73, at 1-2.

[75] *Id.* at 2.

[76] The Task Force also considered issues arising under the estate and gift tax, which are not considered in this paper. *See id.* at 26-28.

[77] It recommended that nonrecognition be the norm, whether or not the property is encumbered with debt in excess of basis or incurred on the eve of the transfer in an effort to "cash out" the value while transferring the obligation to repay the encumbering debt to the transferee spouse. *See Task Force Technical Memorandum*, *supra* note 73, at 5. Under some other nonrecognition provisions, where one property is "exchanged" for another, debt in excess of basis, or debt incurred on the eve of transfer, may produce recognized gain on the transfer, notwithstanding the general nonrecognition rule to the contrary. *See, e.g.*, I.R.C. § 357(b), (c). The gain produced under I.R.C. § 357(c) on transfers of property with debt in excess of basis is equal only to that excess amount, and that gain recognition is required solely to avoid the negative basis that would otherwise occur in the property received under the mechanical rules of I.R.C. § 358. There is no such "negative basis" problem in this context, since any property received in exchange takes its own "carryover basis" rather than a "transferred basis" that starts with the basis of the property given up and is reduced by any encumbering debt. *Compare* I.R.C. § 358(a)(1), (d) The gain produced under I.R.C. § 357(b) equals 100% of the transferred debt and is intended to dissuade transferors from "cashing out" the value of the property by encumbering it with debt shortly before the exchange and then transferring the obligation to repay the debt along with the property. Professor Gabinet has questioned whether this aspect of the section 357 approach ought to be extended to transfers in divorce. *See* Leon Gabinet, *Section 1041: The High Price of Quick Fix Tax Reform in Taxation of Interspousal Transfers*, 5 AM. J. TAX POL'Y 13, 37-40 (1986). My own view is that divorce is not a transaction, like the corporate reorganizations that are the subject of section 357, undertaken to cash out property appreciation without tax, and that the cooperation of the transferee spouse in accepting the property subject to the debt obligation decreases the likelihood that such transactions could occur on a routine basis. Moreover, in the real world sometimes parties need the flexibility to encumber property immediately prior to a transfer in order to ensure that the divvying up of value is equal, which is an irrelevancy in the context of corporate reorganization exchanges.

that the *Davis* approach be abandoned in the context of divorce.[78] The approach essentially would allow the pre-1984 treatment that applied to equal divisions of community property in community-property states to apply to *all* transfers of property in divorce: The transferor would not recognize the built-in gain or loss embedded in the property at the time of divorce, and the transferee would take the same basis in the property that it carried in the hands of the transferor. Any built-in gain or loss would thus be preserved in the hands of (and shifted to) the transferee. Under the "private-ordering" concept, the Task Force did not oppose the possibility that taxpayers be given the choice to "elect out" of nonrecognition treatment (with an ensuing fair market value basis in the hands of the transferee) under *Davis*, though it did recommend that, if taxpayers are given that option, the election should be on an "all-or-nothing" basis, with no ability to cherry pick which assets would fall under the nonrecognition/carryover basis regime and which would fall under the recognition/fair market value basis regime.[79]

Second, the Task Force recommended amending I.R.C. §§ 71 and 215 in a number of ways. It recommended that the inclusion/deduction system be limited to cash payments so that in-kind property transfers could no longer be deductible as "alimony" by the transferor and

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[A]t the time of marital split-ups assets are frequently not in the most divisible form. For example, if a couple owns $400,000 worth of property, none of which is in the form of cash or cash equivalents, the new rules would permit the couple to encumber the property with a $200,000 liability and then allocate in a nonrecognition transaction the encumbered property (now with a net value of $200,000) to one spouse and the new cash to the other spouse.

Task Force Technical Memorandum, *supra* note 73, at 10. I therefore think that the Task Force's recommendation to ignore debt encumbrances in deciding whether in-kind property transfers ought to be taxable events in divorce is defensible. Divorce, where the parties are attempting to divvy up property between them, really *is* different, in a fundamental way, from corporate reorganizations, where the parties are attempting to continue their ownership in transferred property indirectly via stock ownership. Nevertheless, Congress amended I.R.C. § 1041 in 1986 to provide that transfers of encumbered property to a trust will result in gain recognition to the extent that the debt exceeds the transferor's basis. It also provided that transfers of installment obligations to a trust would result in gain recognition. *See* Tax Reform Act of 1986, P.L. 99-514 (1986). While there is no legislative history underlying these changes, presumably transfers in trust, as opposed to direct transfers, were thought to raise the potential for abuse.

[78] It made no recommendations with respect to transfers of property during marriage that are not incident to divorce. When enacted, however, I.R.C. § 1041, which substantially adopts the Task Force's nonrecognition recommendation, was made to apply to transfers during marriage as well, whether gifts or sales for consideration. *See infra* note 301 (considering whether application of I.R.C. § 1041 ought to be limited to the divorce context).

[79] *See Task Force Technical Memorandum*, *supra* note 73, at 11. *Cf.* Gabinet, *supra* note 77, at 31-37 (questioning whether the parties ought to be able to decide whether a transfer is a taxable or nontaxable event under the concept of "private ordering"). *See infra* note 250 and accompanying text (defending the current rule mandating nonrecognition in all in-kind transfers).

includable by the transferee.[80] It also recommended that the "periodic" and "support" requirements, as well as the "principal sum" rules, be eliminated.[81] Most important, it recommended that the parties be given the freedom (with the exceptions noted below) to designate how much, if any, of such cash payments (including cash payments to third parties on behalf of a spouse) would be includable by the payee and deductible by the payor. Any portion of any payments that were not specifically designated by the parties as being includable by the payee and deductible by the payor would be excludable and not deductible. The private-ordering elections would be respected, regardless of whether or not any contingencies--such as the death or remarriage of the recipient spouse or the ability of a state court to alter awards based on changed economic circumstance--would increase, decrease, or terminate any of the payments in the future.[82] Therefore, there would, in the view of the Task Force, be little or no need to resort to litigation to determine whether or not a payment fell within the inclusion/deduction system of I.R.C. §§ 71 and 215.

Under private ordering, the parties' explicit choice as to the income tax treatment for their "Section 71 package" would apply irrespective of whether any or all payments are explicitly restricted for child support or whether any contingencies might increase, decrease, or terminate any of the payments in the future. Moreover, the parties could agree to different treatment for different components of their "Section 71 package." For example, they could designate all of the intended spousal support as" includable/deductible and all of the intended child support as "excludable/nondeductible" or vice versa. As another example, the parties might agree to a percentage arrangement, *e.g.*, 30% of the husband's compensation income going to the ex-wife, cast in the traditional unallocated form, but nevertheless designate that the first $1,000 per month would be "includable/deductible," with all payments in excess of this amount as "excludable/nondeductible." Further, if the parties choose, the safe-harbor designations could also cover certain types of cash payments to third parties, such as payments for education, medical costs, or life insurance premiums.[83]

The Task Force did not see a need to specifically deal with child support, since it believed that the *Lester* Rule then in force already provided "private ordering," in that any nonallocated "family support" payment would automatically be considered a potentially includable/deductible payment (if so designated by the parties under the proposed system). In contrast, a payment specifically "fixed" for child support would remain the means by which the parties could "elect" to make a payment excludable/nondeductible. Therefore, the Task Force made no recommendations to change the child support rules.

In connection with the above proposals, it should be noted that the Task Force contemplates no basic change to the existing child support rules of Section 71(b). Payments

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[80] *See Task Force Technical Memorandum*, *supra* note 73, at 17.

[81] *Id.*

[82] *Task Force Preliminary Specifications*, *supra* note 73, at 3.

[83] *Task Force Technical Memorandum*, *supra* note 73, at 12.

"fixed" as child support would continue to be "excludable/nondeductible" under the "fall-back" rules; and, similarly, courts and parties would continue to have flexibility of creating "unallocated" support arrangements under the *Lester* principle [which could be designated as "includable/deductible" payments under the new rules].[84]

The Task Force, however, intended that the concept of private ordering be limited to spousal and child support payments--*not* to cash property settlements. Recall the difficulty under prior law, however, of identifying whether a cash payment is really a property settlement by looking to whether the payment discharged a support obligation of the payor.[85] The Task Force therefore recommended implementing the limitation with adoption of a mechanical, though complex, "netting rule" in order to prevent cash payments to the payee that are intended to compensate for her interest in property going to the payor from being subject to the inclusion/deduction system of I.R.C. §§ 71 and 115.

For example, assume that a couple jointly owns $400,000 of "hard assets."[86] An equal division would direct that $200,000 go to each. Instead, the parties agree that $100,000 worth of the property remain with W and $300,000 go to H--$100,000 more than he should be entitled to--and that H would make payments to W intended to fall within the inclusion/deduction system. Because the payments would be includable, W would presumably demand payments exceeding $100,000--say, $120,000--so that her after-tax position would be the same as would have occurred if she had simply taken the full $200,000 worth of property to begin with (since in-kind property receipts could not fall within the inclusion/deduction system). The deduction by H of the payments would effectively allow him to deduct his "purchase price" for the $100,000 worth of property that exceeded his one-half interest.[87]

The Task Force proposal would prevent the first $100,000 of payments made by H to W from falling within the inclusion/deduction system. "[T]he 'hard assets' received from one spouse in the property division would first be netted against any Section 71 private ordering payments to such spouse, with only the excess being eligible for an 'includable/deductible' designation."[88] That is to say, the $100,000 worth of property that W transferred to H (the amount in excess of his one-half interest) would be netted against the first $100,000 of cash payments made by H to W, thus preventing it from falling within the inclusion/deduction system. H would be able to deduct (and W would have to include) only the remaining $20,000. The Task Force recognized that the calculation of how much property was "transferred" from W to H (and

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[84] *Id.* at 19.

[85] *See supra* notes 50-57 and accompanying text.

[86] The Task Force generally used this term to mean property, whether tangible or intangible, that has a basis for tax purposes. *See Task Force Technical Memorandum*, *supra* note 73, at 6-7. It would not include marital rights, such as dower or curtesy, though such rights are "property rights" under state law.

[87] *See supra* notes 34-38 and accompanying text.

[88] *Task Force Technical Memorandum*, *supra* note 73, at 17.

thus how much cash going from H to W is precluded from entering the inclusion/deduction system) would vary between residents of community-property states and common-law states.

To some extent, though, variances as to the impact of the new rules would still ensue, as the determination of "hard asset interest" will differ, but these variances will be due essentially to differences in state property laws, principally differences between the property laws of community property and common law states. Despite the objective of the Task Force's proposals to establish as much uniformity among the various states as possible, some variances due to differences in state property laws probably remain unavoidable.[89]

Finally, the Task Force recommended that the rules pertaining to who may claim a dependency exemption for minor children of the divorced parents should be simplified.[90] One commentator summarized the pre-1984 authority in this respect as follows:

> As a general rule, Congress gave the child exemption to the custodial parent, who will be assumed for the purposes of this discussion to be the wife. The husband, as noncustodial parent, was entitled to the exemption if the divorce or the couple's written agreement named him as the parent entitled to the exemption and he paid at least $600 for the support of the child in the tax year. If the agreement or decree were silent, the husband, as noncustodial parent, might still qualify for the exemption if he provided $1,200 or more in support for the child in the tax year and the wife could not "clearly establish" that she provided more support. For example, assume that the wife has custody of the child for the entire year and that the divorce decree did not address which parent would claim the exemption. Additionally, assume that the wife provided $700 support for the child, while the husband provided $1,300 in support. Since the husband provided more than $1,200 and the wife could not have clearly established that she paid more, the husband would have been entitled to the child exemption.

Prior to [1984], the statutes established a framework that would have permitted the couple's own agreement to control which spouse would claim the tax exemption for the child. If the couple could not reach such an agreement, difficult questions arose regarding which spouse contributed more "support." The determination of support was the subject of much litigation, for the statutes themselves did not define this critical term. Also, the regulations vaguely defined support as including "food, shelter, clothing, medical and dental care, education, and the like." As a result, much of the interpretation of qualifying expenditures for support was left to the courts.

Courts generally took a broad view of support to include almost any payment made by the parent on behalf of the child. As one court noted, support was more than the necessities and could include extras, such as summer camp payments, that were available at certain stations in life. The courts, though, set some limits on what types of payments did not meet even this liberal

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[89] *Id.* at 20.

[90] *See id.* at 24-26.

interpretation of support. Gifts to the child or visits and telephone calls made by the parent to the child did not qualify as support. Likewise, the value of babysitting or other personal services performed by the custodial parent were not includable in the calculation of support, because a payment had not been made on the child's behalf.

In addition, payments must actually have been made by the parent to be considered support. Unpaid child support was not counted even though it was court ordered and enforceable for the tax period in question. Likewise, arrearages for support relating to prior tax periods, but paid in the current tax year, were not included as support. For example, if the husband failed to pay his $500 a year child support for each of the past two years, his payment of the past due $1,000 and the presently due $500 would not entitle him to the child exemption in the current year. This was true even though he paid over $1,200 and technically met the statutory standard necessary to claim an exemption. Finally, government payments, such as welfare aid, made to the custodial parent on behalf of the child were not considered as support contributions by that parent for the determination of tax exemptions.[91]

At a meeting in April of 1982 between the staff of the Joint Committee on Taxation, representatives of the ABA Tax Section, and representatives of the American Institute of Certified Public Accountants (AICPA) Tax Division to consider the Task Force's recommendations, the point most discussed and questioned was the concept of "private ordering." The Task Force therefore issued another document on August 2, 1982, which was intended to clarify the concept and justify its use in the divorce context.[92] In part, it explained:

> The advantages to the federal government in adopting the proposed "private ordering" are difficult to quantify in terms of dollars; but, in light of the staggering level of tax controversies generated by Sections 71, 215, and 152 and the probable degree of non-compliance, administrative costs and lost revenue to the government attributable to present law are plainly substantial.[93]
>
> The number of tax cases produced by present rules plainly imposes a heavy burden on the Internal Revenue Service, state taxing authorities, and the courts. Illustrative of this number is the fact that as of June 30, 1982, some 481 cases docketed in the Tax Court involved Sections 71, 215, and/or 152. As most cases in this area are probably settled at administrative levels, the foregoing number would appear to be only the "tip of the iceberg."[94]

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[91] Behr, *supra* note 58, at 802-03 (footnotes with citations omitted).

[92] *See American Bar Association's Domestic Relations Tax Simplification Task Force, The "Private Ordering" Concept in Proposals for Simplification of Domestic Relations Tax Law* (Aug. 2, 1982) (copy on file with author) [hereinafter *Task Force Private Ordering*].

[93] *Id.* at 2.

[94] *Id.* at 3.

The Task Force quoted at length from a Tax Court opinion written by Judge Dawson, as follows:

> It is well settled that the determination of whether payments are in the nature of support or part of a property settlement does not turn on the labels assigned to the payments by the court in the divorce decree or by the parties to the agreement.... This issue is a factual one and requires an examination of all the surrounding facts and circumstances.... Unfortunately, because of the vexing problems which frequently arise in determining the nature and extent of a spouse's property rights under State law, this supposedly factual inquiry has all too often taken on a metaphysical aura as the courts have struggled to classify a particular payment as either support or property settlement, when, in reality, the payment possesses a hybrid nature sharing characteristics of both. In the process, similarly situated taxpayers have occasionally been accorded disparate treatment merely because of differences in State marital property laws. For this reason, and because the confusion in this area has spawned a relentless stream of litigation, it would appear that legislative reform is warranted. As we stated in *Schatz v. Commissioner* ..., some sort of safe harbor is needed so that taxpayers and divorce courts can predict with confidence the income tax consequences stemming from periodic payments occasioned by divorce. Until such legislation is enacted, however, we are left with no alternative but to plunge into the morass of the decided cases, many of them irreconcilable, and resolve this issue as best we can by applying the various factors which have been identified by prior decisions.[95]

The document then addressed the question of whether "private ordering" would undermine the progressivity of the federal income tax system and concluded that it would not, denying that the proposals would entail a "radical change in domestic relations tax law in any substantive sense" in view of the ability--if the divorcing parties knew the appropriate magic words--to accomplish under prior law much of the private ordering that the proposals would make explicit.

As noted, "private ordering" in marital settlements substantially exists under present law, although some of the rules are complicated and produce many tax controversies. From the standpoint of practitioners, these rules are frequently viewed as "planning tools"; and, in a large majority of cases, if parties are cooperative and adequately advised, they can "pick and choose" the correlative tax consequences of many aspects of their settlement by utilizing one or a combination of the key planning tools.[96]

The document then listed some of these "hidden" private-ordering tools. It noted, for example, that under the I.R.C. § 71(c) principal sum rules, the parties could avoid the excludable/nondeductible conclusion that the statute provided normally applies to a principal

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[95] *Id.* at 3-4 (quoting Beard v. Comm'r, 77 T.C. 1275, 1283-84 (1981)).

[96] *Task Force Private Ordering*, *supra* note 92, at 6.

sum paid out in fewer than ten years "by parties agreeing that payments shall merely be contingent upon the recipient's survival, a condition that is frequently of little practical or actuarial consequence in the eyes of the parties."[97] Under the *Lester* Rule, the parties could decide for themselves whether or not child support was includable/deductible or excludable/nondeductible by specifically "fixing"--or not--an amount for child support in the agreement. Even reductions for contingencies clearly relating to the children would not transform a portion of an unallocated "family support" payment into nondeductible "child support."[98] The document also described the use of "ride-throughs," which were described as follows:

> This term refers to various types of arrangements under which parties agree for includable/deductible payments to continue beyond standard terminating events under state law, most typically an ex-wife's remarriage. By entering into a written agreement that carefully preserves the recipient's right to support for the desired period, the parties can usually achieve their intended tax consequences, notwithstanding the occurrence of one or more of the standard terminating events. In many cases, the "ride-through" technique is coupled with the *Lester* principle, with the result that payments to an ex-wife subsequent to her remarriage, plainly and solely intended to benefit the parties' children, retain their alimony character. *See Revenue Ruling* 70-557, 70-2 C.B. 10. A "support package" entailing a "ride-through" is often utilized in lieu of a larger property allocation to the recipient, with either or both parties attaining a better after-tax result. Tricky questions under state law sometimes arise, and anything less than careful planning and drafting can prove costly. *See, e.g.*, *Hoffman v. Commissioner*, 54 T.C. 1607 (1970), *acq'd*, 1981-2 I.R.B. 5, *aff'd*, 445 F.2d 161 (7th Cir. 1972).[99]

In addition, the document addressed how the "support" obligation could be used by the parties.

> In most cases, includable/deductible treatment under Section 71 is available only for payments based on the payor's support obligation under state law. In many states, though, this obligation can be met by either a property allocation (perhaps in installments) or includable/deductible periodic payments. Accordingly, parties often attain their objectives by contractually defining the level of the recipient's support need in the desired manner taxwise and then providing for an appropriate stream of payments in the context of either the support section or the property section of their agreement, depending solely on tax considerations. For example, assume that a wife's support needs could be met with $5,000 of alimony per month, that the husband could pay this amount, but that $3,000 of alimony per month would bring the parties' projected taxable incomes into equilibrium. A

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[97] *Id.*

[98] *Id.*

[99] *Id.* at 6-7.

tax-oriented agreement could provide for the $3,000 monthly alimony, but nevertheless "feather into" the property division an equivalent of the projected after-tax net of an additional $2,000 in monthly alimony.[100]

The document summarized by saying that "progressivity is not, and has not been, a significant element of the present domestic relations tax system. Contrary to undermining the progressivity principle, therefore, the Task Force's recommendations are intended to simplify the mechanism by which parties may effect the kind of income-shifting sanctioned by present law."[101]

Perhaps it was the explicit use of the term "income-shifting" in the last-quoted sentence that raised red flags. That term has always carried negative connotations involving abuse entailed by shifting income from someone in a higher tax bracket to someone in a lower tax bracket while nevertheless retaining control over it by keeping it "all in the family."[102] In any event, a further meeting between various government officials, representatives of the ABA Tax Section, and the AICPA Tax Division on November 19, 1982, raised the question of whether "income-shifting" between divorcing spouses under I.R.C. §§ 71 and 215 ought to be ended entirely by repealing those sections altogether. This prompted the Task Force to issue yet another report in January of 1983, defending the income-shifting principle in divorce.[103] The members of the Task Force "unanimously concluded (1) that repeal of Sections 71 and 215 would not simplify federal tax law, (2) that such a measure would be contrary to other basic tax policies, such as equity and rationality, and (3) that appropriate tax simplification can be achieved without such a drastic step."[104]

With respect to item (1), the Task Force report is not completely persuasive. Making *all* payments in divorce tax-neutral, period, should, in fact, be simple. An argument to the contrary was that states would react by creating property rights in the wife regarding the ex-husband's income stream that would operate to shift taxation to the wife in any event, frustrating the repeal of I.R.C. § 71 and introducing new complexities.

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[100] *Id.* at 7.

[101] *Id.* at 8. The document also argued that the "private ordering" proposals were consistent with trends in substantive state domestic relations law, particularly the increasing emphasis on privately negotiated divorce agreements (as opposed to judicially crafted ones). *See id.* at 8-9.

[102] *See infra* notes 252-301 and accompanying text (describing the assignment-of-income doctrine).

[103] *See American Bar Association's Domestic Relations Tax Simplification Task Force, The "Income-Shifting" Principle in Proposals for Simplification of Domestic Relations Tax Law* (Jan. 20, 1983) (copy on file with author) [hereinafter *Task Force Income Shifting*].

[104] *Id.* at 1-2.

> From the standpoint of state legislatures, if the recent "anti-*Davis* statutes" are viewed as providing any clues--and, in the opinion of the Task Force, they should be so viewed--the repeal of Sections 71 and 215 would surely lead to a continuation of efforts to defeat unpopular federal tax rules in the domestic relations tax area via the "back door." The focus would shift, of course, from the "property rights" of a non-titled spouse in "marital property" to such spouse's "rights" in the post-divorce income the other party. The consequences—i.e., frequent changes in state property and divorce laws--would likely lead to further complexities, controversy, and uncertainty, as well as to disparate results for essentially comparable transactions occurring in different states. Further, as is the case with present law, the government would simply be whipsawed in a multitude of cases, as many ex-spouses would surely take inconsistent positions on their returns.[105]

It's difficult to evaluate whether the dire forecasts regarding the reaction of states to such a legislative change would actually transpire. The Task Force's stronger arguments were that such a change would be contrary to common notions of fairness and flexibility and that repealing I.R.C. §§ 71 and 215 in the stated name of simplification would be tantamount to throwing out the baby with the dirty bath water, as "most of the attainable goals in terms of tax simplification can still be achieved with other reform measures."

While the high war-time marginal rates in 1942 surely were the precipitating factor in shifting the tax burden on "tax alimony" (which, as we have seen, is a term that mirrors "alimony" for state law purposes only coincidentally) to the payee, taxation of the recipient also accorded with other commonly held norms of tax fairness.

The commonplace perception that income-shifting under Sections 71 and 215 is fair and equitable as a matter of federal tax policy stems from numerous factors. For purpose of clarity, though, it should be noted that the term "income-shifting" is misleading. The question presented is not whether income should be shifted from one spouse or ex-spouse to the other, but whether the income that in fact is shifted between the parties by local law should or should not be taxed to the recipient. As indicated, various factors point to an affirmative answer to the foregoing question ....[106]

The Task Force then listed some of these factors. First on the list was the fact that the recipient has control over the cash received, which has always been a prime factor in the income-shifting area in determining who, between two parties, should be taxed on income.[107] "[T]hese elements of control make it far more equitable to tax alimony to the recipient, the party who is actually consuming it and who has the 'cash flow' from which the tax dollars can reasonably be

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[105] *Id.* at 3.

[106] *Id.* at 5.

[107] *See infra* notes 252-301 and accompanying text (describing the assignment-of-income doctrine).

expected to come."[108] The Task Force next contended that eliminating income-shifting would discriminate between well-to-do couples with income-producing property, who would effectively be able to continue to engage in income-shifting by transferring such property in satisfaction of support obligations, and less wealthy couples. "Specifically, a rigidly excludable/nondeductible system would discriminate between wealthy and not-so wealthy taxpayers in that the former could transfer income-producing property or fund certain types of trusts so as to nevertheless effect income-shifting in another manner, whereas less well-to-do taxpayers would simply have to draw upon current income to meet support obligations to ex-spouses."[109] The Task Force also argued that the collective tax burden on the divorced couple would be higher if I.R.C. §§ 71 and 215 were repealed than under either the current law at that time or the proposed changes, since most payors were probably in higher tax brackets than their recipients. That is to say, denying deduction to the higher bracket taxpayer and allowing exclusion to the lower-bracket taxpayer would probably result in more dollars going to the Treasury than under either a rigid inclusion/deduction system or private ordering. "Since divorce frequently strains liquidity to the breaking point anyway, in the view of the Task Force, such a harsh result--i.e., divorce *per se* pushing incomes into higher brackets--should be avoided, if possible."[110] Finally, the Task Force derided the sacrifice in flexibility inherent in a rigid exclusion/nondeduction system.

> [T]he "*Lester*" principle ... allows parties with children considerable room for tailoring their own settlements; and this ability for so many divorcing couples to set their own framework to a significant extent is a major factor contributing to settlements of more than 90% of all divorces at a stage short of a full-blown court contest.... Thus, elimination of Sections 71 and 215 from the Code would not only deprive parties of much flexibility, but would surely prove counterproductive for the settlement process in general. The result, of course, would be an increasing number of cases going to full contest in state courts. Actually, the success generally ascribed to the "*Lester*" principle--as a rule that maximizes flexibility, as well as one that is generally understood--has been a major factor taken into consideration by the Task Force in developing its recommendations for the "Section 71 private ordering rules."[111]

Almost exactly six months to the day later, the Ways and Means Committee of the House of Representatives introduced H.R. 3475, the Tax Law Simplification and Improvement Act of 1983, a portion of which dealt with divorce taxation, and convened hearings.[112] The bill

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[108] *Task Force Income Shifting*, *supra* note 103, at 5.

[109] *Id.* at 6.

[110] *Id.* at 7.

[111] *Id.* at 8.

[112] *See Tax Law Simplification and Improvement Act of 1983: Hearings on H.R. 3475 Before the House Committee on Ways and Means*, 98th Cong. 2d Sess., Serial 98-40 (July 25, 1983) [hereinafter *House Hearing*].

proposed to enact a new Code section, I.R.C. § 1041, which would provide that "[n]o gain or loss shall be recognized on a transfer of property from an individual to (or in trust for the benefit of) (1) a spouse, or (2) a former spouse, but only if the transfer is incident to divorce."[113] The transferee would exclude the value of the property as though it were received as a "gift,"[114] and the recipient would take a carryover basis in the property received. A transfer would be considered incident to divorce if it occurred within one year on which the marriage ceases or was "related to the cessation of the marriage."[115] Section 1015, which normally governs the basis of property received by gift, was proposed to be amended so that transfers described in I.R.C. § 1041 would be governed by the carryover basis rule described there instead of the general gift basis rules.[116] Thus, *Davis* would be put to rest, with no "private ordering" option provided to the divorcing parties to opt out of the new provision so that a transfer could be a recognition event for the transferor and result in a fair market value basis for the transferee.

With respect to I.R.C. §§ 71 and 215, the bill cherry-picked some of the Task Force's recommendations, rejecting others. Consistent with the Task Force's recommendations, it carried forward the *Lester* Rule intact. That is to say, amounts "fixed" for child support would be excludable/nondeductible payments, with no mention that reductions relating to contingencies connected to the children would result in a portion of such payments being labeled as "child support." Thus, private ordering would be *de facto* continued, with parties able to determine for themselves (so long as they knew the magic words) how much of a total "family support" obligation--if any--should be taxable to the recipient and deductible by the payor, or vice versa.[117]

The bill also accepted the Task Force's view that only cash payments should be eligible for the inclusion/deduction system of I.R.C. §§ 71 and 215[118] but that cash payments intended to compensate the recipient for an interest in property should not fall within it. It rejected, however, the Task Force's suggested means by which to differentiate cash support obligations from cash property settlements. The Task Force's approach[119] required netting cash payment paid against the value of any "hard assets" surrendered by the cash recipient, with only the excess amount being eligible for the inclusion/deduction system. Rather, the proposals appear to

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[113] *Id.* at 18.

[114] Gifts, subject to exceptions not relevant here, are excludable from gross income under I.R.C. § 102(a).

[115] *House Hearing*, *supra* note 112, at 19.

[116] *See id.*; *see also infra* note 301 (describing the gift basis rules in connection with considering whether I.R.C. § 1041 ought to be amended to carve out transfers between spouses not incident to divorce).

[117] *See House Hearing*, *supra* note 112, at 22-23.

[118] *See id.* at 21.

[119] *See supra* notes 85-89 and accompanying text.

have attempted to differentiate cash property settlements from support obligations in the following three-pronged manner.

To be eligible for the inclusion/deduction system, the payment could not be "made for a transfer of property by the payee spouse."[120] That, obviously, would constitute an explicit carve-out for cash property settlements. But what if the parties don't label the cash payment as a payment for an interest in property? Disguised property settlements were attempted to be identified through the following two, more subtle requirements. First, the liability to make the payment had to end with the recipient's death, and there could not be any obligation to make any substitute payments after the death of the payee spouse.[121] The notion, presumably, is that a recipient spouse would demand that even her estate be entitled to payment after her death if the payment is really a cash property settlement rather than a support payment. Thus, she would agree to the payments stopping on her death only if, in fact, they constituted support payments (which, since she was dead, she would no longer need). You might recall that inserting this kind of contingency clause was one means by which taxpayers could prove that a payment was "periodic" under the 1942 rules, since the contingency transformed the payment amount into an "indefinite" amount.[122] What the drafters did here was essentially to incorporate into the statute that one means of proving that a payment was "periodic," removing the "periodic" language itself but keeping its "soul," if you will.

Second, the payment had to be "1 of a series of cash payments where it is reasonable to expect at least 50 percent of the amount payable under such series will be paid more than 1 year after the date on which the first of such payments is made."[123] The underlying assumption here is that payments telescoped into a short period after the divorce are more likely to constitute a property settlement than a support payment. Instead of the more-than-ten-year payment period required under the 1942 rules, however, the bill proposed to shorten it dramatically—essentially, to just over a year.[124]

The one new nod to "private ordering" adopted in the proposed bill was that payments *otherwise eligible* for the inclusion/deduction system could be labeled as excludable/nondeductible payments by the parties in their agreement.[125] In other words, the

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[120] *House Hearing*, *supra* note 112, at 21.

[121] *See id.* at 22.

[122] *See supra* notes 45-49 and accompanying text.

[123] *House Hearing*, *supra* note 112, at 22.

[124] For example, suppose that a decree required that a payment of $10,000 be made on January 20 of year 1 and a second payment of $11,000 be made on January 25 of year 2. Both payments could be eligible for the inclusion/deduction system, since at least 50 percent of the stream of payments was paid more than one year after January 20 of year 1, the date of the first payment.

[125] *See House Hearing*, *supra* note 112, at 21.

parties could opt *out* of the inclusion/deduction system with respect to a payment that would otherwise qualify as a "support" payment (rather than a property settlement) under the tests described above. The parties could not, however, opt "into" the inclusion/deduction system with respect to a payment that does not otherwise qualify because, say, there is no requirement that the payment stream stop on the recipient's death.

Finally, the bill would have simplified the rules regarding who was entitled to the dependency exemptions for minor children of the divorced couple by essentially creating a default rule that the custodial parent got them, unless she properly assigned them to the other parent.[126] Thus, all of the litigation regarding who provided more dollars in support of the children would disappear.[127]

Only three people testified with respect to the portion of the bill dealing with divorce taxation at the hearings, but each of the three were powerful and respected commentators. The first was Ronald A. Pearlman, Deputy Assistant Secretary (Tax Policy), Department of the Treasury.[128] He spoke forcefully in favor of proposed I.R.C. § 1041, the anti-*Davis* provision applicable to in-kind property transfers.[129] With respect to the alimony provisions, however, he objected to "the complete elimination of the periodic payment requirement and 10-year rule requirement presently contained in the code."[130] And the reason he did so was because he believed that these rules adequately distinguish "property settlements" from "support payments" and that only the latter ought to fall within the inclusion/deduction system. He said, "While the precise application of these requirements has generated a fair amount of controversy in the past, they do remain as important safeguards for preventing nondeductible property settlements from being treated as alimony."[131] Instead, Mr. Pearlman advocated the following changes:[132]

- reducing the ten-year payment period to five years,
- measuring the period by reference to the first payment instead of the date on which the divorce decree became final,

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[126] *See id.* at 26-28.

[127] *See supra* notes 90-91 and accompanying text.

[128] *See House Hearing*, *supra* note 112, at 150. Mr. Pearlman is now Professor Pearlman of Georgetown University Law Center. He has indicated to me that he hopes his testimony of 17 years ago will not dissuade Congress and the Treasury Department from taking a "fresh look" at this area of law to determine whether any changes are warranted today.

[129] *See id.* at 152.

[130] *Id.* at 153.

[131] *Id.*

[132] *See id.*

- providing that any payments mandated for a period of less than five years would not qualify as "alimony," even if a "contingency" clause is inserted so that the payments would stop on the death or remarriage of the recipient spouse,
- providing that any payments that are not mandated for any specific period would qualify as "alimony" if a contingency clause is inserted, even if the payment period turns out to be less than five years because the contingency transpired, and
- allowing a maximum deduction in any one year of no more than twenty percent of the total amount of a principal sum provided in the divorce decree.

He testified as follows:

> We recognize that eliminating the contingency rule might have the effect of denying alimony treatment to some series of payments made over a relatively short period, even where the payments are intended for the support of the recipient spouse. We believe these situations will be rare, however, because the proposed rules would be readily understandable by the parties.... While we recognize that support payments lasting less than 5 years would not be deductible, in our view any slight disadvantage from that result would be more than offset by the simplicity and certainty that the proposed system would provide.
>
> We also believe this proposed approach is preferable to the rule of the bill requiring that it be "reasonable to expect" that at least one-half of the amounts payable in a series will be paid more than 1 year after the first payment. In effect, this reduces the 10-year period to 2 years. We are concerned that such a short time requirement does not provide a meaningful safeguard.[133]

The second to testify regarding the divorce provisions was M. Bernard Aidinoff, a partner in the law firm of Sullivan & Cromwell, testifying in his capacity as Chair of the ABA Section of Taxation.[134] He, too, strongly supported proposed I.R.C. § 1041,[135] but he disagreed with Mr. Pearlman's criticisms of the proposed changes to the definition of "alimony."

> I would like to comment, however, on the statement made by Deputy Assistant Secretary Pearlman on the elimination of the periodic payment test. We of the section of taxation believe what is in the bill, which is basically an elimination of most of the periodic payment test, is a much simpler provision, a much fairer provision, and one which represents more reality in today's situation where

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[133] *Id.* at 153-54. Mr. Pearlman also strongly supported the proposed amendments concerning which spouse should be entitled to the dependency exemptions for minor children. *See id.* at 154.

[134] *See id.* at 203.

[135] "At long last the bill presents a legislative solution to the problems created by the Supreme Court in its 1962 *Davis* decision which made taxable the transfer of appreciated property in a divorce settlement. This alone wold be a major accomplishment ...." *Id.* at 204.

couples are more anxious to disengage themselves completely when a divorce or separation is involved.

In many respects, the tax section would have gone further than what is in the bill. But we think that the bill in its present form, in dealing with this question, is an appropriate balancing of interests and one that should be adopted.[136]

Mr. Aidinoff did have one strong criticism of his own, however, with respect to the proposed amendments, and that was the rule that at least fifty percent of the total payment amount must be paid more than one year after the first payment if the payments are to qualify as includable/deductible payments.

Contrary to the overall purpose of Title II [authors note: Title II contained the proposed amendments regarding divorce taxation], as stated in the technical explanation, [the proposed rule] serves to preserve a "periodicity" requirement for alimony as a result of the proposed "one of a series" language. Such a requirement and the "reasonable to expect" and the "at least 50 percent" requirements also inject subjective tests into the alimony rules, especially in cases involving fluctuating amounts for support (e.g., 30 percent of an ex-husband's earned income). As demonstrated by the unfortunate experience under present law, such subjective tests are frequent traps for the unwary, as well as productive of much tax controversy. The effect of [the proposed rule], therefore, would be to continue these extremely undesirable aspects of present law.

Also contrary to an apparent objective of Title II, [the proposed rule] flies in the face of local divorce statutes and trends. The comments in the technical explanation imply that a "one-time lump-sum payment" (or similar payment) can never be intended for support. This perception is erroneous, as in the vast majority of states today support needs of one spouse can be and are frequently met, in whole or in part, with a one-time transfer. Moreover, the trend today (particularly if there are no children involved) is for ex-spouses to "disengage" in their relationships with each other; and support to an ex-spouse for a short period--e.g., 6, 12, 18 months--is common. In this regard, the effect of [the proposed rule] is to militate against Federal tax law harmonizing well with State substantive divorce laws.

One inference that can be drawn from the comments in the technical explanation on [the proposed rule] is that the proposed rule stems from the notion that it is contrary to sound tax policy for a single one-time lump-sum payment to be accorded "includable/deductible" treatment. The section does not share this view, especially since it believes that the fundamental tax policy for a basic alimony and separate maintenance rule should be that the taxpayer who consumes the payment(s) should be the one to bear the correlative tax. Moreover, in most cases, a one-time lump-sum payment (or a short-term series of payments) involving a relatively small dollar amount is intended to be solely for the recipient's support. On the other hand, if substantial dollars are involved and the payment(s) are plainly intended to meet both support rights and other marital rights, overall tax revenues to the Government would rarely be reduced anyway, due to "bunching of income" for the recipient [which would push the recipient into a

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[136] *Id.*

higher tax bracket with respect to the payment]. In either case, [the proposed rule] serves no meaningful purpose in relation to the basic objectives of Title II.

Another major weakness of [the proposed rule] would appear to be the ease with which it could be avoided, particularly in cases in which substantial dollars (and sophisticated parties and/or counsel) are involved. Thus, it would seem that the situations that the proposed rule is intended to snare would rarely occur, as taxpayers in those situations would simply "draft around" the rule. Realistically, parties for whom [the proposed rule] would pose the most difficulties are likely to be less substantial and/or less well-advised taxpayers.[137]

Mr. Aidinoff also made the point that the current flexibility represented by the *Lester* Rule should continue.

> An important interpretation of [the treatment of "child support"] is contained in *Lester v. Commissioner*.... The Technical explanation, however, does not elaborate on [the treatment of "child support"]. The section suggests, therefore, that the committee's report on the legislation indicate that no change is intended in the child support area, including the principles enunciated by the U.S. Supreme Court in *Lester*.[138]

The final person to testify was Marjorie A. O'Connell, a partner in the law firm of O'Connell & Associates, who was a member of the ABA Task Force.[139] Like her predecessors, she supported proposed I.R.C. § 1041.[140] With respect to the definition of "alimony" eligible for the inclusion/deduction system, she had several suggested changes. First, with respect to the provision that payments for the transfer of property rights not be eligible for alimony status, she urged that the term "property" be defined to include only "hard assets." "This rule should not apply to any release of an inchoate property right such as rights under an equitable distribution statute."[141] She also urged against the requirement that payments must cease upon the death of the payee.

While support needs of the recipient is the cornerstone of alimony, death does not always terminate those needs. For example, spouses may value the recipient's support rights for life at $200,000 based on his or life expectancy. Instead of paying this amount for life, the payor may want to pay it over a shorter period. If the recipient dies before the end of the shorter period, any continuing payments would be in respect of a support obligation. The recipient may have post-death obligations that those payments would run to, such as the pay-off of debts incurred to meet

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[137] *Id.* at 209-10.

[138] *Id.* at 210. Mr. Aidinoff supported the proposed changes to the dependency exemption provisions as well. *See id.* at 211.

[139] *See id.* at 263.

[140] *See id.* at 267.

[141] *Id.* at 267.

support needs during life. This is often the case where serious medical problems cause the recipient's precipitous death. While I understand the genesis of the post-death prohibition, I urge that the committee seriously consider deleting this provision from the bill.[142]

As did Mr. Aidinoff, she also challenged the rule requiring an expectation that at least fifty percent of the total stated payments would be made more than one year from the first payment.

This rule is the last vestige of the current periodicity requirements that has caused so many problems. The apparent evil this rule strikes at is a lump sum payment for support in the year of divorce. This type of arrangement is rarely done and virtually never for tax reasons.... Nevertheless, I submit that this 50-percent rule is an unnecessary complication. Moreover, the application of this rule would require a subjective evaluation of future events to determine what is the time period in which it is "reasonable to expect" for payments to be made.[143]

Finally, she advocated that the implicit flexibility inherent in the *Lester* Rule be transformed into an explicit election so that all parties, not only those knowing the magic words, could decide for themselves who pays tax on the amounts paid out as child support.

> Under [*Lester*], payments made "for the support of a spouse and children" are all alimony. I believe the statute should contain at least this continuation of present law. I urge serious consideration of a further refinement. Parties should also be allowed to designate fixed child support as taxable to the recipient parent and deductible by the payor parent. This would accomplish two beneficial results. First, *Lester* has proven to be a trap for uniformed taxpayers. Divorcing spouses may enter into arrangements without understanding the tax differences of fixing child support. Second, both state and federal law often give greater protection to enforcing solely child support obligations. For example, the amount designated for support in a *Lester* arrangement has been held not exempt from a wage levy for federal taxes, while a fixed child support obligation would have been exempt under section 6334(a)(8). Thus a payor's means to pay child support may be removed by the very federal taxing system one would hope would encourage payment or at least be neutral. If parties could fix a separate child support payment but preserve its alimony treatment, they would be more likely to fix an amount for child support payments. This would help enforcement of child support obligations.[144]

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[142] *Id.* at 267-68.

[143] *Id.* at 268.

[144] *Id.* She also urged adoption of the proposed changes to the provisions governing dependency exemptions. *See id.*

After further negotiations among the staffs of the House Ways and Means Committee and the Joint Tax Committee, the Task Force, and representatives of the Treasury Department,[145] some of these suggestions were taken to heart in the bill actually passed by the House. It retained unchanged the proposed I.R.C. § 1041 regarding the nonrecognition of gain or loss on in-kind transfers of property[146] and the simplified dependency exemption rules.[147] It also retained unchanged the rule that amounts "fixed" for child support were excludable/nondeductible payments, with the *Lester* Rule gloss that an unallocated "family support" payment could constitute includable/deductible "alimony" in full, even if the payments are reduced upon events relating to the children.[148] The remaining components of the definition of "alimony," however, did undergo some significant changes.

Under the House bill, "alimony" falling under the inclusion/deduction system had to satisfy the following requirements:[149]

- It had to be in cash and be received by (or on behalf of) the former spouse.
- It had to be paid under a decree of divorce or separate maintenance, or under a written instrument incident to the divorce, a written separation agreement, or a decree requiring support or separate maintenance.
- The parties who are divorced or legally separated could not be members of the same household at the time of payment.
- The payment had to terminate at the death of the payee spouse and there could not be any obligation to make a substitute payment after the death of the payee spouse.
- The parties had not designated the payment as "not alimony" that is excludable/nondeductible.
- The amount had not been "fixed" as child support.

Thus, the language specifying that the payment must not be in payment for property was deleted, as was the language requiring that at least fifty percent of the payment must be expected to be made more than one year after the first payment. The underlying idea of the latter provision was, however, carried forward in a new (and complicated) "recapture" provision in newly proposed I.R.C. § 71(f).

As described by the House Report, if alimony payments in the first year exceed the average payments in the second and third year by more than $15,000, the excess amounts are

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[145] *See* Marjorie A. O'Connell, *The Domestic Relations Tax Reform Act: How We Got It and What We Can Do About It*, 18 FAM. L.Q. 473, 492-93 (1985) (describing the negotiation of the "recapture compromise").

[146] *See* H.R. REP. NO. 98-432, at 191-92 (1983).

[147] *See id.* at 197-99.

[148] *See id.* at 195.

[149] *See id.* at 193-96.

recaptured in the third year by requiring the payor to include the excess in income and allowing a payee who previously included the alimony in income a deduction for that amount....[150]

In effect, the prior inclusion of the payee and deduction of the payor would be "reversed" in the third year by allowing the original payee to deduct the "excess" alimony and requiring the payor to include the same amount as "phantom income." Recapture would also apply if payments in the second year exceed payments in the third year by more than $15,000. The House Report provided the following example:

> Thus, for example, if the payor makes alimony payments of $50,000 in the first year and no payments in the second or third year, $35,000 will be recaptured .... If instead the payments are $50,000 in the first year, $20,000 in the second year and nothing in the third year, the recapture amount will consist of $5,000 from the second year (the excess over $15,000) plus $27,500 for the first year (the excess of $50,000 over the sum of $15,000 plus $7,500). (The $7,500 is the average payments for years two and three after reducing the payments by the $5,000 recaptured from year two.)[151]

The Senate had no provisions dealing with the taxation of payments in divorce in its 1984 companion bill. As described by both Marjorie O'Connell and Barb Mattei, the Conference Committee convened to forge a compromise bill became a contentious battleground, where staff members of the Senate Finance Committee strongly advocated eliminating the alimony deduction entirely.[152]

Ms. Mattei reports that the Finance staff members viewed the taxation of support payments from the "what-is-income" perspective, arguing that because support payments (whether child support or alimony) did not contribute toward earning the payor's income, it should be considered nondeductible personal consumption.[153] They argued that the only reason why this approach was abandoned in 1942 was the high war-time marginal rates then in effect and that, with the much lower 50% top marginal rate in effect in 1984, there was no longer any justification for the alimony deduction.[154] Ms. O'Connell described in detail the machinations

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[150] *Id.* at 195.

[151] *Id.* at 196. The recapture rules would not apply if payments decrease because of death or remarriage or because of an obligation to pay a constant percentage from a fluctuating source of income. Nor would they apply to temporary support payments.

[152] *See* O'Connell, *supra* note 145, at 494-97; Mattei, *supra* note 40, at 193 n.120. Ms. O'Connell, as a member of the ABA Task Force, was a close observer of these events. Ms. Mattei conducted a telephone interview with Harry Graham, Senate Finance Committee staff tax counsel, in writing her Note on the topic.

[153] *See* Mattei, *supra* note 40 at 193, n.120.

[154] It is not clear from the reported discussions whether the Finance Committee staff members also advocated repeal of I.R.C. § 71, so that alimony payments would revert to being

that then transpired, which are worth a lengthy quotation to get a flavor of how we ended up with the final product.

> On May 23, 1984, the author [Ms. O'Connell) learned from a House member's office that the Finance Committee staff was trying to organize women's groups to support the elimination of the alimony deduction. The next day, O'Connell met with representatives from the Congressional Caucus on Women's Issues, the National Organization of Women, the Women's Equity Action League, the National Association of Business and Professional Women, and the National Women's Political Caucus. The author implored these women to recognize that without the alimony deduction payors would be far less inclined to meet their spousal support obligations as well as their child support obligations for which a deduction was available under *Lester*. She explained the income shifting principle. The author urged the women's groups to oppose the elimination of the deduction and to support the House bill.

Finance Committee staff members met on May 29, 1984, with various women's groups representatives. From several sources, it was reported that the staff members argued that the ABA had never considered if alimony should be deductible, that the ABA had never consulted the Finance Committee about the Task Force's proposals, and that the alimony deduction hurt women. In addition, the staff members suggested that without support from the women's groups for the elimination of the alimony deduction, the Senate conferees might maintain the deduction, but instead, would oppose the repeal of the *Davis* rule. The staff members claimed to have conferred with law professors who called the alimony deduction irrelevant. Indirectly, the Finance Committee staff members raised the spectre of trouble for retirement equity provisions pending in the Senate if women's groups did not support the alimony deduction repeal.

On June 4, 1984, the author learned from a Ways and Means staff member that the Finance staff, at a pre-conference meeting, had offered to support [the remaining provisions of the bill, including *Davis* repeal,] in exchange for the elimination of the alimony deduction.

Publicly, at this time, the Finance Committee first claimed that it had no plan to repeal the alimony deduction, but later admitted to considering the proposal, although both the committee chairman's staff and the committee staff demurred that no final decision had been reached about alimony. One factor that drew the staffs out on the issue was that in late May and early June, Divorce Taxation Education, Inc. (DTE), plunged into the fray to convince the Finance Committee that opposition to the elimination of the alimony deduction was prevalent and strong. DTE was formed to educate attorneys and other concerned persons about domestic relations tax issues. Free of organizational strictures on lobbying activities and public statements, DTE contacted members of Congress and organized support coverage for the issue to save the alimony deduction and the House bill.

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excludable, or whether such payments would also remain includable by the payee. *See infra* notes 233-34 and accompanying text.

Meanwhile, the conferees from the Ways and Means and Finance Committees convened in early June.... On June 7, 1984, the conferees approved the dependency exemption ... provisions .... Conferees and staff members from the Senate Finance Committee refused to announce publicly when they would raise the alimony and property provisions.

On Friday, June 15, 1984, the Senate sent an offer to the House via staffs to rescind the House bill's alimony and property provisions if the alimony recapture rules were made more stringent and were extended from three to ten years, and if *Lester* were restricted. No staff meetings were scheduled for that weekend, but an impromptu (or perhaps late scheduled) meeting on Saturday, June 15, 1984, reportedly resolved the alimony and child support issues in ten minutes.

The discussion of alimony and child support began with an offer from Finance Committee staff members to support the repeal of *Davis* in exchange for the elimination of the alimony deduction. When Ways and Means staff members rejected the suggestion, and Finance countered with an offer that deductible alimony be limited to payments over ten years. Ways and Means rejected the term as too long, and a Treasury representative reiterated the recommendation for a five-year term that Treasury had made at the H.R. 3475 hearings. The staff members agreed to a compromise requirement that payments must extend over six years to qualify as alimony unless they were to end on a payee's death or remarriage or a payor's death. Recapture would be calculated over six years as well. In addition, Ways and Means staff members acceded to the Finance staff members' suggestion that the *Lester* rule be repealed, making all child support nondeductible whether or not commingled with spousal support.

The conferees adopted these staff proposals on Monday, June 18, 1984. Then the staff members, primarily those from the Joint Committee, set out to draft language for the Conference Committee's bill. Not until June 22, 1984, was the language of the Conference Committee's ... provisions available to the public. The bill provided that to qualify as alimony, support payments must extend for at lest six calendar years to the extent that the payments exceed $10,000 per year. The divorce or separation instrument had to provide explicitly that payments end on the payee's death. Recapture would be measured over six years. The basic rule would be that the amount of each payment made during the first six post-separation years must not be $10,000 greater than any earlier payment made during that time. To the extent that an earlier payment would exceed a later payment by $10,000, the difference would be income to the payor and a deduction from gross income to the payee. To the extent that any payments would be reduced due to a contingency that related to a child's reaching a specified age, marrying, dying, or leaving school, the payments would be treated as fixed for child support, not as alimony. Any contingency that was clearly associated with such an occurrence would have the same effect.

A few days after the Conference Committee report was issued, the Conference Committee's bill passed both houses. The President signed it into law on July 18, 1984.[155]

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[155] O'Connell, *supra* note 145, at 494-97.

2. The Final Results

Thus, the Deficit Reduction Act of 1984[156] introduced I.R.C. § 1041,[157] essentially repealing the *Davis* result for all in-kind property transfers, and substantially amended the definition of includable/deductible "alimony" in I.R.C. §§ 71[158] and 215.[159] The new alimony recapture rules were particularly complex.[160]

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[156] P.L. 98-369 (1984).

[157] New I.R.C. § 1041 read as follows:

Sec. 1041(a) GENERAL RULE.--No gain or loss shall be recognized on a transfer of property from an individual to (or in trust for the benefit of)--

(1) a spouse, or

(2) a former spouse, but only if the transfer is incident to divorce.

(b) TRANSFER TREATED AS GIFT, TRANSFEREE HAS TRANSFEROR'S BASIS--In the case of any transfer of property described in subsection (a)--

(1) for purposes of this subtitle, the property shall be treated as acquired by the transferee by gift, and

(2) the basis of the transferee in the property shall be the adjusted basis of the transferor.

(c) INCIDENT TO DIVORCE.--For purposes of subsection (a)(2), a transfer of property is incident to divorce if such transfer--

(1) occurs within 1 year after the date on which the marriage ceases, or

(2) is related to the cessation of the marriage.

(d) SPECIAL RULE WHERE SPOUSE IS NONRESIDENT ALIEN.--Paragraph (1) of subsection (a) shall not apply if the spouse of the individual making the transfer is a nonresident alien.

I.R.C. § 1041 (1985). The Technical and Miscellaneous Revenue Act of 1988, P.L. 100-647 (1988), amended subsection (d) above so that all transfers, even during marriage, to a nonresident alien are excepted from the nonrecognition rule of subsection (a). The Tax Reform Act of 1986, P.L. 99-514 (1986), added new subsection (e) to provide that transfers of property in trust result in gain recognition to the extent that any encumbering liabilities exceed basis.

[158] Amended I.R.C. § 71 read as follows:

Sec. 71(a) GENERAL RULE.--Gross income includes amounts received as alimony or separate maintenance payments.

(b) ALIMONY OR SEPARATE MAINTENANCE PAYMENTS DEFINED.--For purposes of this section--

(1) IN GENERAL.--The term "alimony or separate maintenance payment" means any payment in cash if--

(A) such payment is received by (or on behalf of) a spouse under a divorce or separation instrument

(B) the divorce or separation instrument does not designate such payment as a payment which is not includable in gross income under this section and not allowable as a deduction under section 215,

(C) in the case of an individual legally separated from his spouse under a decree of divorce or of separate maintenance, the payee spouse and the payor spouse are not members of the same household at the time such payment is made, and

(D) there is no liability to make any such payment for any period after the death of the payee spouse and there is no liability to make any payment (in cash or property) as a substitute for such payments after the death of the payee spouse (and the divorce or separate maintenance instrument states that there is no such liability).

(2) DIVORCE OR SEPARATION INSTRUMENT.--The term "divorce or separation instrument" means--

(A) a decree of divorce or separate maintenance or a written instrument incident to such a decree,

(B) a written separation agreement, or

(C) a decree (not described in subparagraph (A)) requiring a spouse to make payments for the support or maintenance of the other spouse.

(c) PAYMENTS TO SUPPORT CHILDREN.--

(1) IN GENERAL.--Subsection (a) shall not apply to that part of any payment which the terms of the divorce decree or separation instrument fix (in terms of an amount of money or a part of the payment) as a sum which is payable to the support of children of the payor spouse.

(2) TREATMENT OF CERTAIN REDUCTIONS RELATED TO CONTINGENCIES INVOLVING CHILD.--For purposes of paragraph (1), if any payment specified in the instrument will be reduced--

(A) on the happening of a contingency specified in the instrument relating to a child (such as attaining a specified age, marrying, dying, leaving school, or a similar contingency), or

(B) at a time which can clearly be associated with a contingency of a kind specified in paragraph (1) an amount equal to the amount of such reduction will be treated as an amount fixed as payable for the support of children of the payor spouse.

(3) SPECIAL RULE WHERE PAYMENT IS LESS THAN AMOUNT SPECIFIED IN INSTRUMENT.--For purposes of this subsection, if any payment is less than the amounts specified in the instrument, then so much of such payment as does not exceed the sum payable for support shall be considered a payment for such support.

(d) SPOUSE.--For purposes of this section, the term "spouse" includes a former spouse.

(e) EXCEPTION FOR JOINT RETURNS.--This section and section 215 shall not apply if the spouses make a joint return with each other.

(f) SPECIAL RULES TO PREVENT EXCESS FRONT-LOADING OF ALIMONY PAYMENTS.--

(1) REQUIREMENT THAT PAYMENTS BE FOR MORE THAN 6 YEARS.--Alimony or separate maintenance payments (in excess of $10,000 during any calendar year) paid by the payor spouse to the payee spouse shall not be treated as alimony or separate maintenance payments unless such payments are to be made by the payor spouse to the payee spouse in each of the 6 post-separation years (not taking into account any termination contingent on the death of the either spouse or the remarriage of the payee spouse).

(2) RECOMPUTATION WHERE PAYMENTS DECREASE BY MORE THAN $10,000.--If there is an excess determined under paragraph (3) for any computation year--

(A) the payor spouse shall include such excess amount in gross income for the payor spouse's taxable year beginning in the computation year, and

(B) the payee spouse shall be allowed a deduction in computing adjusted gross income for such excess amount for the payee spouse's taxable year beginning in the compuation year.

(3) DETERMINATION OF EXCESS AMOUNT.--The excess amount determined under this paragraph for any computation year is the sum of--

(A) the excess (if any) of--

(i) the amount of alimony or separate maintenance payments paid by the payor spouse during the immediately preceding post-separation year, over

(ii) the amount of alimony of separate maintenance payments paid by the payor spouse during the computation year increased by $10,000 plus

(B) a like excess for each of the other preceding post-separation years.

In determining the amount of the alimony or separate maintenance payments paid by the payor spouse during any preceding post separation year, the amount paid during such year shall be reduced by any excess previously determined in respect of such year under this paragraph.

(4) DEFINITIONS.--For purposes of this subsection--

(A) POST-SEPARATION YEAR.--The term "post-separation year" means any calendar year in the 6 calendar year period beginning with the first calendar year in which the payor spouse paid to the payee spouse alimony or separate maintenance payments to which this section applies.

(B) COMPUTATION YEAR.--The term "computation year" means the post-separation year for which the excess under paragraph (3) is being determined.

(5) EXCEPTIONS.--

(A) WHERE PAYMENTS CEASE BY REASON OF DEATH OR REMARRIAGE.--Paragraph (2) shall not apply to any post-separation year (and subsequent post-separation years) if--

(i) either spouse dies before the close of such post-separation year or the payee spouse remarries before the close of such post-separation year, and

(ii) the alimony or separate maintenance payments cease by reason of such death or remarriage.

(B) Support Payments.--For purposes of this subsection, the term "alimony or separate maintenance payment" shall not include any payment received under a decree described in subsection (b)(2)(C).

(C) Fluctuating Payments Not Within Control of Payor Spouse.--For purposes of this subsection, the term "alimony or separate maintenance payment" shall not include any payment to the extent it is made pursuant to a continuing liability (over a period of not less than 6 years) to pay a fixed portion of the income from a business or property or from compensation for employment or self-employment.

I.R.C. § 71 (1985).

[159] Section 215 continued to provide an alimony deduction for all payments that were includable under I.R.C. § 71 as "alimony." *See* I.R.C. § 215 (1985).

[160] The Conference Committee Report gave the following example of how the recapture provisions would work.

Thus, for example, if alimony payments of $25,000 are made in year 1 and payments of $12,000 are made in year 2, then $3,000 will be recaptured in year 2. If the payments further decline to $1,000 in year 3, then, in year 3, an addition $11,000 will be recaptured from year 1

The criticisms of the new alimony rules began almost immediately.[161] The abandonment of the flexibility to create fully deductible unallocated "family support" payments that contained an element of child support was criticized.[162] This proposal, which first surfaced in the Conference Committee, came as a surprise to everyone. The flexibility inherent in the *Lester* Rule was supported by the Task Force's various reports and was never questioned either in the meetings between the Task Force and government officials throughout the process or in the formal hearings held by the Ways and Means Committee.[163] It seems that the revocation of *Lester* was used solely as a bargaining chip in conference by those who wished to repeal the alimony deduction entirely in the quest to at least narrow the "alimony" deduction. The required six-year payout period was also criticized as being inconsistent with the growing trend toward short-term "rehabilitative alimony" to provide the payee with support for a short period while she gained job training or attended college.[164] Finally, the alimony recapture rules were also criticized as being complex and containing fundamental flaws.

State laws make court-ordered alimony payments subject to change under many circumstances. Recapture could occur if payments were reduced under these laws even though the payor was fulfilling his obligations under state law. Recapture resulting from modifications under state law could produce other anomalous results. For example, in most states a court must modify alimony if the parties' circumstances change. If a payor's obligation is so reduced because the payor's income has decreased, then the payor will be subject to recapture when he or she is already in adverse financial circumstances. Or, for example, an automatic termination of alimony payments occurs in many states when a court finds that the payee is cohabiting, without marriage, with another party of the opposite sex. Such termination could lead to significant recapture with a large deduction for the payee for whom state law intended no further accrual of financial benefits. In addition, a payee in most states may waive his or her right to support. If a

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and $1,000 will be recaptured from year 2. If, prior to the end of year 6, payments further decline, additional recapture will occur.

[161] Ms. O'Connell reports:

At the ABA's annual meeting in Chicago on August 2, 1984, the Council of the Tax Section adopted a resolution at the task force's request. This resolution directed the officials of the Section to inform Congress that the new alimony rules create significant technical problems. The resolution further directed these officials to request from Congress either a technical correction in the alimony provisions by the end of 1984 or a one-year delay in the effective date of the provisions. The Tax Section made these requests, but abandoned its efforts on confronting adamant opposition from the Senate Finance Committee staff.

O'Connell, supra note 145, at 501.

[162] *See, e.g., id.* at 500-01.

[163] *See* Mattei, *supra* note 40, at 204.

[164] *See* O'Connell, *supra* note 145, at 499.

payee did so at the end of the fifth year, recapture would occur in the sixth year.... [T]he resultant deduction to the payee could be more beneficial than receiving the sixth year of alimony would have been. However, the payor could be forced to include a far larger sum in income than the payor would have paid as deductible alimony.

Finally, factors beyond the control of either party or of a court could cause recapture under circumstances where the recapture hardly seems fair. For example, payors often must bear the costs of their former spouse's post-divorce medical costs. If such costs are large during one year of the first five years after divorce, then a significant recapture amount could result in the following year when normal payments resume. Similarly, if a payor loses his job and misses a payment, recapture based on the earlier year's payment would occur. If the payor made up the arrearage in a later year, thus greatly increasing his payment that year, additional recapture would occur in the following year. Such results seem inequitable, particularly because the payors in both examples meet their obligations under local law and do so by the end of the six-year period.[165]

Perhaps due in part to such criticisms, the statute did not lie in repose for long. The Tax Reform Act of 1986[166] amended the alimony definition yet again to eliminate the six-year payment period, to reduce the recapture period to three years, and to increase the recapture trigger amount from $10,000 to $15,000,[167] exactly like the first compromise recapture rule

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[165] *Id.* at 498.

[166] P.L. 99-514 (1986).

[167] Amended I.R.C. § 71(f) now provides:

(f) RECOMPUTATION WHERE EXCESS FRONT-LOADING OF ALIMONY PAYMENTS.--

(1) IN GENERAL.--If there is excess alimony payments--

(A) the payor spouse shall include the amount of such excess payment in gross income for the payor spouse's taxable year beginning in the 3rd post-separation year, and

(B) the payee spouse shall be allowed a deduction in computing adjusted gross income for the amount of such excess payments for the payee's taxable year beginning in the 3rd post-separation year.

(2) EXCESS ALIMONY PAYMENTS.--For purposes of this subsection, the term "excess alimony payments" means the sum of--

(A) the excess payments for the 1st post-separation year, and

(B) the excess payments for the 2nd post-separation year.

(3) EXCESS PAYMENTS FOR 1ST POST-SEPARATION YEAR.--For purposes of this subsection, the amount of the excess payments for the 1st post-separation year is the excess (if any) of--

(A) the amount of the alimony or separate maintenance payments paid by the payor spouse during the 1st post-separation year, over

(B) the sum of--

(i) the average of--

(I) the alimony or separate maintenance payments paid by the payor spouse during the 2nd post-separation year, reduced by the excess payments for the 2nd post-separation year, and

(II) the alimony or separate maintenance payments paid by the payor spouse during the 3rd post-separation year, plus

ii) $15,000.

(4) EXCESS PAYMENTS FOR 2ND POST-SEPARATION YEAR.--For purposes of this subsection, the amount of the excess payments for the 2nd post-separation year is the excess (if any) of--

(A) the amount of the alimony or separate maintenance payments paid by the payor spouse during the 2nd post-separation year, over

(B) the sum of--

i) the amount of the alimony or separate maintenance payments paid by the payor spouse during the 3rd post-separation year, plus

ii) $15,000.

(5) Exceptions.--

(A) Where Payment Ceases by Reason of Death or Remarriage.--Paragraph (1) shall not apply if--

(i) either spouse dies before the close of the 3rd post-separation year, or the payee spouse remarries before the close of the 3rd post-separation year, and

(ii) the alimony or separate maintenance payments cease by reason of such death or remarriage.

(B) Support Payments.--For purposes of this subsection, the term "alimony or separate maintenance payment" shall not include any payment received under a decree described in subsection (b)(2)(C).

(C) Fluctuating Payments Not Within Control of Payor Spouse.--For purposes of this subsection, the term "alimony or separate maintenance payment" shall not include any payment to the extent it is made pursuant to a continuing liability (over a period of not less than 3 years)

proposed in the original House bill in 1983.[168] It also repealed the requirement that the divorce or separation instrument itself must explicitly provide that the obligation to make payments

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to pay a fixed portion or portions of the income from a business or property or from compensation for employment or self-employment.

(6) POST-SEPARATION YEARS.--For purposes of this subsection, the term "1st post-separation year" means the 1st calendar year in which the payor spouse paid to the payee spouse alimony or separate maintenance payments to which this section applies. The 2nd and 3rd post-separation years shall be the 1st and 2nd succeeding calendar years, respectively.

The following example, taken from Dodge, Fleming, and Geier, *supra* note 10, at 202-03, provides an illustration of the current rule. Suppose that a divorce decree requires Burt to pay Loni a total of $200,000, scheduled as follows: $100,000 in year 1, $70,000 in year 2, and $30,000 in year 3. Assume that each payment meets all the requirements of I.R.C. § 71(b). The payments are includable by Loni under I.R.C. § 71(a) and deductible by Burt under I.R.C. § 215 in *each* of the three years. In year 3, however, I.R.C. § 71(f) *also* requires an inclusion by Burt and a deduction by Loni in an amount equal to the "excess alimony payment" as defined in I.R.C. § 71(f)(2): the sum of the excess payments for the first post-separation year and the excess payments for the second post-separation year.

You must begin by computing the excess payments for the second year under I.R.C. § 71(f)(4), because you must have that number in order to compute the excess payments for the first year under I.R.C. § 71(f)(3).

Step 1: The excess payment for the second year =

2d year alimony - (3d year alimony + $15,000) = $70,000 - ($30,000 + $15,000) = $25,000

Step 2: The excess payment for the first year = 1st year alimony - (½[(2d year alimony less 2d year excess payment) + 3d year alimony] + $15,000) = $100,000 - (½[($70,000 - $25,000) + $30,000] + $15,000 = $100,000 - (½[$75,000] + $15,000) = $100,000 - ($37,500 + $15,000) = $47,500

Step 3: Thus, the excess alimony payment includable by Burt and deductible by Loni in year 3 equals $72,500 ($25,000 + $47,500).

Section 71(f) can produce unhappy results for taxpayers by creating a large year-3 income item for the payor, pushing the payor into a higher tax bracket, and by creating a large year-3 deduction item for the payee, which can exceed her year-3 income after all other deductions are taken into account. That excess portion of the payee's § 71(f) deduction cannot be carried to other taxable years and deducted, and thus it is lost for tax purposes if it cannot be used entirely in year 3.

[168] *See supra* notes 150-51 and accompanying text. The example given there from the 1983 House Report is precisely the example given in the 1986 Conference Report regarding how the amended provision would work.

otherwise qualifying as "alimony" for tax purposes ends on the payee's death.[169] The obligation to continue making payments must itself end, but it is sufficient if state law would automatically require the payments to stop, even if the governing document is silent in this respect. It retained, however, the repeal of the *Lester* Rule, as well as all other aspects of the amended alimony definition adopted in 1984.

III. THE GOOD, THE BAD, AND THE UGLY

A. Cash Payments

So where are we today? While I think the law was, on balance, improved in 1984, it continues to generate an overabundance of confusion and resulting litigation, as briefly described in subpart 1 below, an unfortunate and unnecessary cost to both the government and divorcing couples. This is particularly true since, as the discussion below will show, these disputes result not from law that is premised on firm theoretical foundations and the resulting necessary complexity required to successfully differentiate "alimony" from "child support" from cash "property settlements." Rather, the discussion will show that it is *not possible* to differentiate successfully among these payments, and state courts and divorcing parties tend not to think in terms of those rigid categories anymore; only the drafters of the Internal Revenue Code continue to insist on compartmentalizing the world in this fashion. Moreover, the huge costs as well as frustrations incurred in the effort are incurred *only* to determine which person's marginal tax rate will apply to cash payments transferred between the parties as a result of divorce or child support obligations outside divorce. Very little revenue is likely at stake here. Finally, the misunderstanding and litigation is due chiefly to the Code's insistence on making the parties' flexibility to decide to whom cash payments should be taxed dependent on the transactional form for the payment chosen by the parties.

As a result of the 1980s legislation, the flexibility to decide to whom cash payments should be taxed flip-flopped by category. Prior to the legislation, there was great flexibility (so long as one knew the magic words) to decide to whom amounts paid out as "child support" would be taxed and little flexibility to determine to whom "alimony"--as defined for Federal tax purposes--would be taxed. After the 1980s legislation, in contrast, there was little flexibility to decide to whom "child support" should be taxed and greater (albeit still limited) flexibility to decide to whom "alimony" should be taxed.

Prior to the 1980s legislation, the parties could choose to tax the payor on child support payments by explicitly labeling the payments as "child support," which would then be excludable by the payee and not deductible by the payor.[170] The parties could, in contrast, choose to tax the payee by designating the payment a "family support payment," unallocated between "alimony" and "child support." Such an unallocated family support payment would be taxed to the payee because—since no amount was explicitly "fixed" as child support in the

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[169] The Act accomplished this result by deleting the final parenthetical in I.R.C. § 71(b)(1)(D), quoted *supra* note 158.

[170] *See supra* notes 30-33 and accompanying text.

agreement—it would be includable as "alimony" and deductible to the payor (so long as the remaining requirements pertaining to "alimony" were satisfied). Under *Lester*, this would remain true even if the unallocated family support payment was scheduled to be reduced upon events clearly linked to the emancipation or death of the children, which would seem to indicate that a portion of the payment was intended by the parties all along to be, in fact, child support. There was, thus, great flexibility to determine to whom child support payments would be taxed, albeit only for the well-advised.

At the same time, there was much less flexibility regarding "alimony" within the "tax" definition of that term. If a payment satisfied the tax definition of alimony, it was includable by the payee and not deductible by the payor, even if they tried to avoid this result and transform the payment into a tax-neutral "property settlement" by calling the payment a cash property settlement in the divorce agreement. If the court was convinced that the payment satisfied a support obligation, rather than a division of property, then the court could rule that the payment was includable/deductible "alimony," regardless of the labels attached to the payments by the parties or even by state law, so long as the other statutory requirements were satisfied.[171]

As a result of the 1980s legislation, the *Lester* Rule was repealed, which meant (on the face of the statute, at least) that the parties should have no flexibility to determine to whom child support payments should be taxed. With the introduction of the rule that amounts should be considered "fixed" as child support if the payments are reduced upon a contingency directly related to one or more of the children, the drafters seemed to have intended that even "disguised" child support should be subject to a strict rule of exclusion on the part of the payee and nondeduction on the part of the payor, regardless of the wishes of the parties.

At the same time, the drafters introduced the rule that payments of "alimony" within the "tax" definition of that term could be designated by the parties as "not includable" and "not deductible," providing some flexibility for the parties to decide to whom "alimony" should be taxed.[172] But the flexibility is constrained; the parties can elect *out* of the inclusion/deduction system, but they cannot elect *into* it. To qualify for the inclusion/deduction system, each of the requirements for tax "alimony" must be satisfied, including the requirement that the payments must stop on the payee's death, whether by agreement of the parties or under state law. This requirement was one means by which the drafters intended to disallow cash property settlements from qualifying as "alimony," the other means being the mechanical "recapture" rule that effectively recharacterizes, in the third year, a portion of prior payments otherwise satisfying the definition of "alimony" if the payments are excessively front-loaded. Thus, on balance, it seems that there was little change to the overall amount of flexibility granted to the parties to decide to whom cash payments should be taxed; only the locus of the flexibility was flip-flopped from child support to alimony.

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[171] *See supra* notes 50-57 and accompanying text.

[172] While there has not been significant litigation under this new "elect-out" option, a few cases have arisen, where the issue was whether the parties' language was sufficient to trigger the election. *See, e.g.*, Schutter v. Comm'r, 2000 U.S. App. LEXIS 33324 (10th Cir. 2000); Jaffe v.Comm'r, 77 T.C.M. (CCH) 2167 (1999).

Subpart 1, below, will review some of the litigation that evidences the continuing weaknesses of current law. In subpart 2, I shall discuss my recommendations for change regarding the taxation of cash payments in divorce.

1. The Tax Litigation

Even a cursory review of the tax litigation that has occurred since the 1984 Act confirms that change is definitely needed. Family court judges and divorcing parties do not themselves extricate mixed payments and categorize them in the nice, tidy packages envisioned by the Federal tax rules. They see payment streams as mixed. It would almost be sheer coincidence if the labels attached in I.R.C. § 71 actually corresponded to reality. The reality is that no one except the drafters of the tax Code thinks that we can adequately distinguish these payments from one another.

The cases also illustrate that real parties in the real world, even when represented by counsel, do not understand the current rules adequately and do not draft agreements that reflect them. It's obvious upon reading the cases that the parties are often taken by surprise when they find out that their assumptions regarding who will be liable for the tax obligation turn out to be wrong.

While I cannot possibly cite every case decided since 1984 dealing with the problems under these provisions, several dozen representative cases are footnoted here.[173] They represent

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[173] *See, e.g.*, Craven v. U.S., 2000-2 U.S.T.C. (CCH) ¶ 50,541 (11th Cir. 2000); Preston v.Comm'r, 209 F.3d 1281 (11th Cir. 2000); Schutter v. Comm'r, 2000 U.S. App. LEXIS 33324 (Dec. 19, 2000); Ribera v. Comm'r, 98-1 U.S.T.C. (CCH) ¶ 50,260 (9th Cir. 1998); Richardson v. Comm'r, 125 F.3d 551 (7th Cir. 1997); Walters v. Comm'r, 97-1 U.S.T.C. (CCH) ¶ 50,204 (9th Cir. 1997); Hoover v. Comm'r, 102 F.3d 842 (6th Cir. 1996); Murley v. Comm'r, 97-1 U.S.T.C. (CCH) ¶ 50,172 (6th Cir. 1996); Heller v. Comm'r, 97-1 U.S.T.C. (CCH) ¶ 50,193 (9th Cir. 1996); Barrett v. U.S., 74 F.3d 661 (5th Cir. 1996); Arnes v. Comm'r, 981 F.2d 456 (9th Cir. 1992); Kenfield v. U.S. 783 F.2d 966 (10th Cir. 1986); Pettet v. U.S., 97-2 U.S.T.C. (CCH) ¶ 50,948 (E.D.N.C. 1997); Votzmeyer v. U.S., 96-2 U.S.T.C. (CCH) ¶ 50,621 (S.D. Tex. 1996); Christoph v. U.S. 919 F. Supp. 1576 (S.D. Ga. 1995); Barrett v. U.S. 878 F. Supp. 892 (S.D. Miss. 1995); Smith v. Comm'r, 94-2 U.S.T.C. ¶ 50,503 (S.D.N.Y. 1994); Laird v. U.S., 89-1 U.S.T.C. (CCH) ¶ 9,225 (Cl. Ct. 1989); Goldman v. Comm'r, 112 T.C. 317 (1999); Balding v. Comm'r, 98 T.C. 368 (1992); Darby v. Comm'r, 97 T.C. 51 (1991); Zinsmeister v. Comm'r, 80 T.C.M. (CCH) 774 (2000); Berry v. Comm'r, 80 T.C.M. (CCH) 825 (2000); Maloney v. Comm'r, 80 T.C.M. (CCH) 53 (2000); Shepherd v. Comm'r, 79 T.C.M. (CCH) 2078 (2000); Baker v. Comm'r, 79 T.C.M. (CCH) 2050 (2000); Benham v. Comm'r, 79 T.C.M. (CCH) 2054 (2000); Leventhal v. Comm'r, 79 T.C.M. (CCH) 1670 (2000); Heckaman v. Comm'r, 79 T.C.M. (CCH) 1643 (2000); Gonzales v. Comm'r, 78 T.C.M. (CCH) 527 (1999); Miller v. Comm'r, 78 T.C.M. (CCH) 307 (1999); Simpson v. Comm'r, 78 T.C.M. (CCH) 191 (1999); Lawton v. Comm'r, 78 T.C.M. (CCH) 153 (1999); Jaffe v. Comm'r, 77 T.C.M. (CCH) 2167 (1999); Baxter v. Comm'r, 77 T.C.M. (CCH) 2137 (1999); Hopkinson v. Comm'r, 77 T.C.M. (CCH) 1968 (1999); Cologne v. Comm'r, 77 T.C.M. (CCH) 1728 (1999); Anderson v. Comm'r, 77 T.C.M. (CCH) 1447 (1999); Preston v. Comm'r, 77 T.C.M. (CCH) 1437 (1999); Megibow v. Comm'r, 76 T.C.M. 1072 (1998); Medlin v. Comm'r, 76 T.C.M. (CCH) 707 (1998); Ryan v. Comm'r, 76

only the tip of the iceberg, of course, since many more disputed cases are settled at the administrative level or resolved in the unreported small case docket of the Tax Court than ever reach a reported court decision. In many of these cases, the Federal government often issues notices of deficiency to both parties, claiming that the payment excluded by the payee should, in fact, have been included and that the payment deducted by the payor should, in fact, not have been deducted (or vice versa). It concedes that only one or the other claim should prevail, that it is merely a stakeholder in the litigation, depending on how the court characterizes the payment.[174] As recited by the Tax Court in one case, the government "has taken the position of a stakeholder and has no preference concerning whether we find that the payments in controversy are alimony includable by [the payee] or property settlement and/or child support not deductible by [the payor]."[175]

T.C.M. (CCH) 453 (1998); Nelson v. Comm'r, 76 T.C.M. (CCH) 145 (1998); Walker v. Comm'r, 75 T.C.M. (CCH) 2373 (1998); Smith v. Comm'r, 75 T.C.M. (CCH) 2250 (1998); Human v. Comm'r, 75 T.C.M. (CCH) 1990 (1998); Burkes v. Comm'r, 75 T.C.M. (CCH) 1772 (1998); Hammond v. Comm'r, 75 T.C.M. (CCH) 1745 (1998); Peterson v. Comm'r, 75 T.C.M. (CCH) 1620 (1998); Croteau v. Comm'r, 75 T.C.M. (CCH) 1550 (1998); Wells v. Comm'r, 75 T.C.M. (CCH) 1507 (1998); Raymond v. Comm'r, 73 T.C.M. (CCH) 2572 (1997); Ribera v. Comm'r, 73 T.C.M. (CCH) 1807 (1997); Sugarman v. Comm'r, 72 T.C.M. (CCH) 602 (1996); Murphy v. Comm'r, 71 T.C.M. 3144 (1996); Hill v. Comm'r, 71 T.C.M. 2759 (1996); Ambrose v. Comm'r, 71 T.C.M. 2429 (1996); Stewart v. Comm'r, 71 T.C.M. (CCH) 1966 (1996); Rosenthal v. Comm'r, 70 T.C.M. (CCH) 1614 (1995); Richardson v. Comm'r, 70 T.C.M. (CCH) 1390 (1995); Israel v. Comm'r, 70 T.C.M. 1037 (1995); Mercurio v. Comm'r, 70 T.C.M. (CCH) 59 (1995); Heffron v. Comm'r, 69 T.C.M. (CCH) 2849 (1995); Stroufe v. Comm'r, 69 T.C.M. (CCH) 2870 (1995); Hoover v. Comm'r, 69 T.C.M. (CCH) 2466 (1995); Walters v. Comm'r, 68 T.C.M. (CCH) 1533 (1994); Cunningham v. Comm'r, 68 T.C.M. (CCH) 801 (1994); Heller v. Comm'r, 68 T.C.M. (CCH) 730 (1994); Stokes v. Comm'r, 68 T.C.M. (CCH) 705 (1994); Heller v. Comm'r, 68 T.C.M. (CCH) 538 (1994); Fosberg v. Comm'r, 64 T.C.M. (CCH) 1527 (1992).

[174] *See, e.g.*, Richardson v. Comm'r, 125 F.3d 551, 553 (7th Cir. 1997) ("The Commissioner has sent inconsistent notices to protect the government's right to tax revenue. This practice has been recognized as valid."); Murphy v. Comm'r, 71 T.C.M. (CCH) 3144 (1996) ("In the notices of deficiencies and in her pleadings, respondent has taken inconsistent positions, disallowing alimony deductions to Ronald Murphy but requiring Diane Murphy to report alimony income. Respondent, however, does not ask us to sustain inconsistent positions. Respondent is content that we determine the tax consequences of the subject payments ... consistently between petitioners.") *Accord* Leventhal v. Comm'r, 79 T.C.M. (CCH) 1670 (2000); Jaffe v. Comm'r, 77 T.C.M. (CCH) 2167 (1999); Baxter v. Comm'r, 77 T.C.M. (CCH) 2137 (1999); Raymond v. Comm'r, 73 T.C.M. (CCH) 2752 (1997); Richardson v. Comm'r, 70 T.C.M. (CCH) 1390 (1995); Heffron v. Comm'r, 69 T.C.M. (CCH) 2849 (1995). *But see Christoph, infra* notes 220-24 and accompanying text (where government took inconsistent positions and court held that fact to be significant to its decision).

[175] Burkes v. Comm'r, 75 T.C.M. (CCH) 1772 (1998).

What it means to "fix" an amount for child support continues to generate significant litigation. Under the *Lester* Rule, an amount not specifically denominated as "child support" in the relevant documents was not considered "child support" for tax purposes, even if the surrounding circumstances tied the payments to the children. The 1984 amendments provided that payments that are reduced upon the happening of contingencies relating to the children would be considered "fixed" as child support,[176] but they went no further. That is to say, the statute was not amended to provide that, if surrounding circumstances of *any* kind indicate that the payment might have been intended as "child support," they should be so treated for tax purposes. What if surrounding circumstances *other* than a reduction upon the happening of contingencies related to the children indicate that an amount might have been intended as child support, though not denominated as such?

In 1988, Congress mandated that each state create and publish child support guidelines.[177] The Federal law contains a rebuttable presumption that the amount of child support awarded under the guidelines is correct.[178] My own home state of Ohio has complied by issuing detailed listings of how much child support should be ordered for each child, depending on the income levels of the payor and payee.[179] While a judge can deviate from the guidelines, the judge must defend the deviation by reference to the surrounding circumstances that justify it. What happens when a judge makes an unallocated "family support payment" for the support of the ex-spouse and children? Can the recipient spouse argue that the portion of the payment equal to the guideline amount should be considered "fixed" as child support within the meaning of I.R.C. § 71(c)(1)?

The Tax Court has said "no." In *Simpson v. Commissioner*,[180] for example, a family court in Pennsylvania issued an order requiring Mr. Simpson to pay a monthly unallocated family support payment of $718 to Ms. Simpson for the support of herself and their minor children. Ms. Simpson argued that the entire payment constituted child support, since the Pennsylvania child support guidelines would require a monthly payment of $789, which exceeded the unallocated family support payment. The Tax Court, however, concluded that such inferences from state child support guidelines are not permissible in determining whether any amount is "fixed" as child support.

> The language of section 71(c)(1) is clear that for payments to be child support, the written divorce instrument by its terms must fix a sum which is payable as child support. It is inappropriate, in light of this clear statutory language, to look

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[176] *See supra* notes 162-63 and accompanying text.

[177] *See* Child Support Enforcement Amendments of 1984, P.L. 98-378, § 181, 98 Stat. 1305, 1321, amended by the Family Support Act of 1988, P.L. 100-485, tit. I, § 103(a) and (b), 102 Stat. 2346.

[178] *See* 42 U.S.C. § 667(b)(2) (1994).

[179] *See* Ohio Revised Code § 3113.2115 (as amended July 1, 2000).

[180] 78 T.C.M. (CCH) 191 (1999).

> beyond the written instrument to examine what effects, if any, are made by operation of State law.
>
> If Congress had intended for us to look beyond the written instrument, it would have amended section 71(c)(1) to so reflect....
>
> We conclude, therefore, that because the court order does not specifically fix a portion of the $718 monthly payment as child support, the entire amount of such payments received by petitioner in 1994 and 1995 is alimony and includable in income.[181]

In a similar case where the payee made the identical argument, relying on the published state child support guidelines, the Tax Court said:

> Even assuming, for the sake of argument, that a simple reference to the grid would produce an accurate figure for what portion of the amounts she received was for child support, petitioner has not satisfied the requirements of section 71(c)(1). The amount of child support must be fixed by the terms of the instrument.... The Supreme Court stated in Commissioner v. Lester ... that it is the "'written instrument' that must 'fix'" the portion of the payment that is for child support. Petitioner replies that Lester has been overruled by statute. While it is true that the result in Lester has been overruled by section 71(c)(2), the principles of Lester still apply to cases to which the latter provision does not.[182]

Surely this result is right as a matter of positive law, but it probably does not accord with what the parties expect if they are told simply by their attorneys that "child support" is excludable/nondeductible. At the least, there remain tremendous traps for the unwary, and the potential for confusion is clear. And it does not appear that family law courts are going to abandon their practice of ordering unallocated family support payments simply because the Federal tax law prefers to have different tax consequences apply to "child support" and "alimony."

A similar problem in distinguishing alimony from child support often arises in the case of temporary support orders, which quite often take the form of unallocated "family support." In *Heller v. Commissioner*,[183] for example, Lawrence and Madeline Heller divorced in 1986. They divided their community property, and Madeline took custody of the couple's children. The divorce court entered three consecutive orders that defined Mr. Heller's payment responsibilities with respect to Madeline and their children.

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[181] *Id.*

[182] Lawton v. Comm'r, 78 T.C.M. (CCH) 153 (1999). Neither will the "Dissomaster" computer program, which apparently helps family law lawyers compute support payments based on income and other factors, serve to identify how much of an unallocated family support payment constitutes child support. *See* Wells v. Comm'r, 75 T.C.M. (CCH) 1507 (1998).

[183] 97-1 U.S.T.C. (CCH) ¶ 50, 193 (9th Cir. 1996).

> On February 19, 1986, the court issued a temporary order directing Mr. Heller to pay support of $3,500 per month and reserving "the option to allocate [the payments] between spousal and child support." On August 8, 1986, in an order to take effect on July 1, 1986, the court continued the previous $3,500 amount, but designated $1,000 per month as child support for July through September 1986. Finally, on December 17, 1987, the court directed Mr. Heller to continue to make monthly child support payments of $1,000 and spousal support payments of $1,700.[184]

Is any portion of the payments made under the first order nondeductible "child support" in view of the designation in later orders that a specified portion of each payment constituted "child support"? No amount of the payments made in the first order would be considered "child support" under the *Lester* Rule; the entire payment would be considered an unallocated "family support payment" that would fully qualify as "alimony" (so long as the other alimony requirements were satisfied). There were no reductions in the amounts payable under this first order connected with any contingencies relating to the children, which is the only situation involving "disguised child support" addressed in the 1984 amendments. Does that mean that the entire payment should qualify as alimony? Or because the later payments indicated that $1,000 of each monthly payment would be considered child support, should the first $1,000 of each payment made under the first order be considered child support as well?

The Tax Court concluded the latter, but the 9th Circuit reversed on this point, concluding that, under *Lester*, the entire payment could potentially qualify as "alimony." "The designation contained in the second order was insufficient to fix $1,000 per month as child support during any time before July 1, 1986. Accordingly, no payment was fixed as child support for February through June, 1986, of the first order."[185]

The government next argued that Lawrence's obligation to make the payments would not have stopped if Madeline had died prior to July of 1986, and thus the payments nevertheless failed to qualify as alimony. Under this view, they would be considered an excludable/nondeductible property settlement by default--clearly on odd conclusion on the facts, but that is the inevitable result of the analysis required by the current rules. Again the 9th Circuit disagreed, finding that the payments would have stopped on Madeline's death, but it had to undertake an examination of state law in order to come to this conclusion.

By its terms, the first court order creates a legal obligation for Mr. Heller to pay $3,500 a month "spousal support" to his former wife. The order did not specify that the payments would continue upon the death of Madeline. California law provides that "[e]xcept as otherwise agreed by the parties in writing, the obligation of a party under an order for the support of the other party terminates upon the death of either party or the remarriage of the other party." ... California law also provides that in the event a single stated amount covers both alimony and child support in an order, the courts cannot determine, after a terminating event, what proportion

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[184] *Id.*

[185] *Id.*

of the total award is allocable to alimony and to child support. [state case law citations omitted.] Mr. Heller's legal obligation to pay money under the first court order would therefore terminate upon Madeline's death, and a court would have no ability to allocate retroactively between spousal and child support. Accordingly, the obligation embodied in the first court order would terminate on the death of the payee spouse and meets the test for alimony.[186]

Thus, Ms. Heller had to include the full amount of the unallocated support in her gross income as tax "alimony."[187]

In contrast, Ms. Gonzales, in *Gonzales v. Commissioner*,[188] was held to be entitled to exclude temporary unallocated family support on virtually identical facts, since the court--again after examining state law--concluded that the temporary support payments would *not* have stopped had Ms. Gonzales died. In other words, amounts received under a temporary support order were considered, by default, to be a cash property settlement--an obvious error if the facts themselves could control the inquiry, but the necessary result of the stop-at-death inquiry.

Mr. and Ms. Gonzales, who had four minor children, were separated in 1992 and divorced in September of 1995. On February 18, 1993, a state court entered a temporary order awarding custody of the children to Ms. Gonzales and directing Mr. Gonzales to make an unallocated family support payment of $7,500 per month, as follows:

> [P]ending the resolution of this matter ... [Dr. Gonzales] shall pay $7,500 per month unallocated, commencing on November 1, 1992 as and for support of ... [petitioner] and the infant children of the marriage, from which sum ... [petitioner] shall pay all family expenses including the mortgage, children's school expenses and unreimbursed medical expenses and her schooling.[189]

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[186] *Id.*

[187] The same result occurred in *Ambrose v. Commissioner*, 71 T.C.M. (CCH) 2429 (1996), even though the Judge who ordered the unallocated family support payment of $17,500 said: "Because 'family support' is allowed only by stipulation, the court does not to inquire if Ms. Ambrose wishes the $17,500 amount broken down into child support and spousal support. If she does, I propose that it be broken down to $8,000 child support, $9,500 spousal support. If both parties are willing, it will stay as family support." *Id.* Ms. Ambrose included in her gross income only $9,500 of each monthly payment, but the Tax Court concluded that she had to include the entire $17,500. It rejected, under *Lester*, any inference that could be drawn from the judge's precatory language. It also concluded, after examining California state law, that no part of the $17,500 payment obligation would have survived her death, since at least a portion of that payment constituted "alimony" for state law purposes, and if any portion of a mixed payment stream constituted state-law alimony, the Tax Court believed that state law would terminate Mr. Ambrose's payment obligation for the entire amount.

[188] 78 T.C.M. (CCH) 527 (1999).

[189] *Id.*

In the tax litigation, the court further noted that "[t]he temporary order failed to indicate how the payments would be treated for tax purposes, whether the payments would terminate at petitioner's death, or what portion thereof represented child support."[190] The final divorce decree, entered on September 21, 1995, provided for alimony payments for nine years, which would terminate if Ms. Gonzales died, remarried, or cohabited with another, of $60,000 per year, reduced by $10,000 after each three-year segment. It also provided for child support payments of $40,000 per year for nine years or until emancipation occurred under the terms of the agreement.

The government argued that Ms. Gonzales must include the entire unallocated family support payments that she received under the temporary support order because, under the background rule of *Lester*, no amount was "fixed" for child support in the temporary order. Ms. Gonzales argued that the payments nevertheless failed to qualify as alimony because, under state law, her husband's obligation to make the payments would have survived her death if she had died during that period. The court concluded that the dispositive issue was whether the stop-at-death requirement was satisfied and noted that "[i]f the payor is liable to make even one otherwise qualifying payment after the recipient's death, none of the related payments required before death will be alimony."[191] Because the agreement was silent in this respect, the court had to decipher New Jersey law. It had to research state law cases and make extrapolations from them to decide the case.

Although New Jersey statutes do not say whether unallocated support payments terminate on the death of the payee spouse, a New Jersey case helps reveal the unlikelihood of that result's occurring.

> In Farmilette v. Farmillette ..., the New Jersey Superior Court addressed whether unallocated support orders are modifiable. The court held that they are. The Farmilettes ... obtained a divorce judgment, and Mr. Farmilette was ordered to pay $285 a week to support his ex-wife and their two children. Sometime after one child became emancipated and the other child began living full time with Mr. Farmilette, the latter sought a reduction of his unallocated support obligation, retroactive to the time of the emancipation and change of residency. Before deciding to what extent, if any, the support order should be modified, the court considered its authority to do so. It pointed to a New Jersey statute prohibiting retroactive modifications of child support. The court reasoned, however, that it "will not be so presumptuous as to assume the legislators had in mind unallocated support orders which clearly are not included within the statute." ... The court then held unallocated support orders modifiable and agreed to review the parties' submissions to determine whether, and to what extent, a modification is warranted.

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[190] *Id.*

[191] *Id.*

> Farmilette ... and the instant case present similar circumstances—albeit the former rests on a real, and not imaginary, event. In each case, a divorced husband (or soon-to-be ex-husband) is ordered to pay family support. And in each case, a terminating event occurred.... In Farmilette, the court squarely faced the issue of whether (and, if so, by how much) to vary Mr. Farmilette's family support payment beyond the terminating event. Significant for our purposes was the court's willingness to take on that task .... The State court's willingness to do so leads to our affirmative response to the question posed here: Is there good reason to believe that Dr. Gonzales's family support obligation would continue after petitioner's death? We think so. Had petitioner died before the superior court entered the divorce decree, Dr. Gonzales, as the noncustodial parent of three children, could have remained liable to pay family support, whether in full or diminished amounts.[192]

Thus, the court ruled that Ms. Gonzales may exclude the temporary family support payments from her gross income because it was neither an amount "fixed" for child support nor qualified as "alimony" for Federal tax purposes.[193] In other words, the temporary support payments were categorized, by default, as property settlement payments.

On virtually identical facts once again, the payee in *Raymond v. Commissioner*[194] was required to include in full unallocated family support payments under *Lester*, as was Ms. Heller, but not because the court concluded that the payments would have survived her death. Indeed, unlike the *Heller* and *Gonzales* courts--both of which recognized that the determinative issue would be whether the payments *would* have stopped on the payee's death (even though she did not, in fact, die) under state law--the *Raymond* court completely ignored this issue.

Stephen and Sandra Raymond separated in 1990 and divorced in 1992. The couple had two children, one of whom was away at college and one of whom was thirteen years old and living with Sandra. The final divorce decree provided for monthly alimony payments to Sandra of $1,000 per month for two years or Sandra's earlier death or remarriage, as well as child support of $1,600 per month. The tax consequences of these payments were not in dispute. At issue were payments made by Raymond to Sandra in 1991 under a temporary support order entered by the family court in October of 1990, which provided that the children would reside with Sandra and which required Raymond to pay Sandra "his net pay less $900.00 every month on the first day every month commencing November 1, 1990, or thereabouts." During 1991, Raymond paid to Sandra $41,455 under the temporary support order. Sandra did not include these payments in gross income, while Raymond deducted them as tax "alimony."

Sandra argued that at least a portion of the payments constituted nondeductible child support since the surrounding context of the temporary support order reflected that assumption,

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[192] *Id.*

[193] *See also* Miller v. Comm'r, 78 T.C.M. (CCH) 307 (1999).

[194] 73 T.C.M. (CCH) 2752 (1997).

most of the amounts were in fact spent to support the children, and the final divorce decree ordered more child support than alimony. Like the *Heller* and *Gonzales* courts, the *Raymond* court rejected this inference, relying on *Lester*.

> [S]ection 71(c)(1) nonetheless requires us to find that the terms of the temporary order that incorporated the support stipulation do not fix either in terms of an amount of money or a portion of the 1991 temporary order payments any part of those payments as a sum that is payable for the support of the children of Mr. Raymond. See Commissioner v. Lester .... Inferences, intent, or other nonspecific designations of payments as child support are not sufficient to override the mandate of section 71(c)(1) ... except as permitted by section 71(c)(2). Section 71(c)(2) does not apply here because there is no amount specified in the temporary order that was to be reduced, let alone upon the occurrence of a contingency specified in that order relating to a child of Mr. Raymond or at a time that can clearly be associated with that kind of contingency.[195]

What one would expect to find next, of course, is the inquiry made in both *Heller* and *Gonzales* regarding whether the payments nevertheless failed to qualify as tax "alimony" because the payment obligation would not have stopped under state law had Sandra Raymond died prior to receipt of the payments. Yet, the opinion is absolutely silent on this issue. Perhaps Ms. Raymond's lawyer did a bad job of lawyering by failing to raise the issue, but then one would expect the court to have raised it on its own, as the stop-at-death requirement is a prerequisite requirement of tax "alimony" that the court cannot ignore simply because the payee party failed to raise it (most likely to the relief of the payor's attorney). Rather, the Tax Court immediately concluded that, since none of the payment was "fixed" for child support, the entire payment qualified as alimony, includable by Sandra Raymond and deductible by Stephen. The Tax Court took pains to note that the more than $40,000 paid by Stephen in 1991 "constituted approximately 72 percent of the net amount of wages that Mr. Raymond received during 1991 (i.e., approximately 72 percent of his gross wages for that year reduced by Federal and State income taxes and Social Security and Medicare taxes that were withheld)."[196] While such numbers are the kind of numbers that first impelled the decision to make alimony includable by the payee and deductible by the payor in 1942, the modern definition takes no account of such realities. Whether the alimony amount is high or low, the stop-at-death requirement must be satisfied under the current statute if payments are to fall within the inclusion/deduction system.

The *Heller* and *Gonzales* cases also illustrate how the stop-at-death requirement often requires tax adjudicators to delve into murky state law waters to determine whether stipulated payments would stop at death--and thus whether payments constitute tax "alimony." This is one of the most-often litigated issues in these cases. Is it wise to require Federal tax adjudicators to make such state law determinations? And doesn't this involve just the sort of uncertainty and lack of uniformity from state to state that the 1984 amendments were intended to prevent?

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[195] *Id.*

[196] *Id.*

One very common problem with respect to this issue is that family law judges often order the payor spouse, typically the husband, to pay the payee's attorneys' fees and other costs of the divorce proceedings. The order is typically silent regarding whether the payor spouse would have to make this payment if the payee should die before payment is made. If the judge adjudicating the resulting tax controversy becomes convinced that the payor would have to pay the payee's attorney fees and costs even if the payee had died in the short interim between the time that the liability accrues and the payment is made, then the payment cannot be considered an includable/deductible alimony payment for support. By default, it would be considered an excludable/nondeductible property settlement.[197] But isn't it clear that such a payment does not really constitute a division of marital assets but rather the payment of a personal consumption expense of the payee, *i.e.*, an expense of "support"? Yet, the tax status of these attorneys' fees and costs will hinge on the odd inquiry regarding whether state law *would* have stepped in and absolved the payor of paying the amount if the payee should happen to die in the short period between the divorce and the payment of the attorneys' fees and costs.

For example, in *Smith v. Commissioner*,[198] the Georgia Superior Court ordered Lawrence Smith to pay $25,000 in attorneys' fees and costs incurred by Connie Page Smith in connection with their divorce. The order was (not surprisingly) silent regarding whether Mr. Smith's obligation would disappear should Ms. Smith die before she received the payment. (What state court judge would think to address such a remote contingency?) Mr. Smith deducted the payment, but the Tax Court, after an examination of state law, concluded that Georgia law would not have absolved Mr. Smith of the payment obligation if Ms. Smith had died during that interim.[199]

While it seems somewhat peculiar to discuss payment of fees made to a former spouse's attorneys for services in terms of alimony or separate maintenance payments, section 71(b) does not differentiate as to the reasons for the payment....

> Petitioner contends ... that the focus of section 71(b)(1)(D) is whether "the payment was for a period which could not end after [the spouse's] death," rather than whether the liability could survive the death of the spouse. We do not agree.... It may be that under Georgia law, which controls here, the liability for support or alimony payments would be extinguished by the payee's death, but the liability here was for attorneys' fees. Petitioner points us to no authority, and we

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[197] *See, e.g.*, Preston v. Comm'r, 209 F.2d 1281, 1285 (11th Cir. 2000) (holding that ex-husband's payment of ex-wife's attorneys' fees under order of state court judge was not "alimony" because state law would not have absolved husband of payment obligation if ex-wife had died prior to payment). *Accord* Ribera v. Comm'r, 98-1 U.S.T.C. (CCH) ¶ 50,260 (9th Cir. 1998).

[198] 75 T.C.M. (CCH) 2250 (1998).

[199] *See also* Human v. Comm'r, 75 T.C.M. (CCH) 1990 (1998).

have discovered none, that such a debt would be extinguished by the wife's death.[200]

The Tax Court came to the same conclusion in *Ribera v Commissioner*,[201] *Zinsmeister v. Commissioner*,[202] and (most recently) *Berry v. Commissioner*[203] after examining sometimes murky and ambiguous state law regarding whether the liability would survive the payee's death.

Others receive different treatment with respect to *precisely* the same payment. In *Burkes v. Commissioner*,[204] for example, the divorce decree required Mr. Burkes to pay $60,000 to his ex-wife's attorneys for their work in connection with the divorce. The provision stated: "[Mr. Burkes] shall pay to ... [Mrs. Burkes] the sum of $60,000.00 as additional alimony toward attorney fees, for which sum judgment is rendered and execution may issue."[205] Once again, the document was silent regarding whether the obligation to pay would disappear if Ms. Burkes died in the short period between the entering of the divorce decree and the payment to the attorneys. Looking to Ohio law, the Tax Court concluded that the term "alimony" can comprise both support payments and property settlements. Alimony constituting support payments stop by reason of the death of the payee; alimony constituting property settlement payments do not. Therefore, the Tax Court had to determine whether the term "alimony" was used here in its "support" sense or in its "property settlement" sense under state law—again, just the kind of inquiry that the 1984 amendments were supposed to end—and it concluded that it constituted a support payment, the obligation for which would end on the payee's death. Therefore, the payment of the attorneys' fees constituted deductible alimony for Mr. Burkes, unlike in *Smith*, *Ribera*, *Zinsmeister*, and *Berry*.

Many other payments that are clearly support payments and not property divisions in the nontax senses of those terms suffer the same ambiguity. If a judge orders, for example, that the payor pay the payee's future medical expenses or car repair expenses—not unusual terms in the real world—and the agreement is silent regarding whether the payor would have to make these payments if the payee should die *after* receiving the medical care (or having the car fixed) but *before* the payor paid the bill, then whether the amount is "alimony" or a "property settlement" will be determined by the tax adjudicator's determination of whether state law *would* have nevertheless required the payor to pay the doctor bills or the auto mechanic bills if the payee *had* died (even though she didn't).

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[200] 75 T.C.M. (CCH) 2250 (1998).

[201] 73 T.C.M. (CCH) 1807 (1997).

[202] 80 T.C.M. (CCH) 774 (2000).

[203] 80 T.C.M. (CCH) 825 (2000).

[204] 75 T.C.M. (CCH) 1772 (1998).

[205] *Id.*

In *Preston v. Commissioner*,[206] for example, the 11th Circuit held that an ex-husband's payment of his ex-wife's car-repair expenses under order of a state court judge was not "alimony" because state law would not have absolved him of the payment obligation if his ex-wife had died after the car was repaired but prior to his payment of the bill. The payment of the payee's medical and car expenses are not likely disguised property settlements! They are support payments, at least as that term would be commonly understood by divorcing parties.

And the state law inquiries are quite often not easy. Certainly, the divorcing parties themselves, in many of these cases, could have little notion of how state law would affect their payment streams if one should die unexpectedly.

In *Barrett v. United States*,[207] Pat and Helen Barrett divorced in 1984, and the 1984 Mississippi Judgment of Divorce "provided that the parties had reached a proper settlement of all property rights between them." It also required Pat to make the following payments to Helen:

- monthly commencing November 15, 1984, the sum of $1,000 until her death or remarriage;
- until her death or remarriage, [Pat] should provide a major medical insurance policy comparable to his present medical insurance for [Helen];
- until her death or remarriage, [Pat] should provide $100,000 life insurance coverage on his life naming [Helen] as beneficiary.[208]

There was no dispute that these payments qualified as "alimony" for tax purposes.

Because of a change in Helen's income and earnings capacity, Pat's payment obligation was reduced to $1,400 per month by court order in 1985. In 1988, Pat petitioned to have the payments cease due to a material increase in Helen's income, and Helen opposed the motion. The parties settled the matter and entered a consent judgment with the court which provided that Pat must make one $50,000 payment in September of 1989 and another payment of $50,000 in September of 1990 (with the second payment carrying an 8% annual interest rate) and that all prior payment obligations (which were concededly deductible) were cancelled. The parties called this payment a "property settlement," even though the first agreement had stipulated that all property had been divided. No mention was made whether payments would be required to be made to Helen's estate should she die prior to the two payments. Pat sought to deduct these payments as "alimony."

To determine whether these payments qualified as tax "alimony," the 5th Circuit had to delve into Mississippi law, which provided for two kinds of payment streams. One was "periodic alimony" and one was "lump sum alimony." (While Mississippi had recently created a third type of payment stream, called "rehabilitative periodic alimony," the new law was not applicable to the case at bar, for which I'm sure the 5th Circuit panel was very grateful.) After

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[206] 209 F.2d 1281, 1285 (11th Cir. 2000).

[207] 74 F.3d 661 (5th Cir. 1996).

[208] *Id.* at 663.

examining state law, the 5th Circuit concluded that "[t]he [Mississippi family] court cannot deprive itself of the power to modify periodic alimony in the future and cannot extend the payments past the remarriage of the payee spouse or death of either spouse. As a result, Mississippi's periodic alimony falls within I.R.C. § 215's definition of deductible alimony."[209] In contrast, lump sum alimony "is a final settlement, substituting as a division of property, between a husband and wife that cannot be subsequently modified for any reason except fraud. The death or remarriage of the payee spouse does not affect the payor spouse's obligation .... Due to these limitations, lump sum alimony"[210] is not deductible.

Thus, the 5th Circuit had to determine whether the payments under the consent agreement qualified as periodic alimony or lump sum alimony. In this regard, the 5th Circuit noted that "[t]he Mississippi Supreme Court has repeatedly announced that an alimony decree is presumed to provide for periodic alimony unless the decree 'by clear and express language' provides for lump sum alimony."[211] Nevertheless, the 5th Circuit concluded that the consent decree replaced a periodic alimony obligation (deductible) with a lump sum alimony obligation that would survive Helen's death (nondeductible).

A great case to illustrate how divorcing parties themselves, as well as the law in many states, increasingly recognize that payment streams can contain an inextricably intertwined combination of alimony and property settlement is *Pettet v. United States*,[212] where the court's mandatory exploration of whether state law would stop a mixed payment stream on the payee's death was a bit surreal. In that case, Don and Rosa Bullard divorced in 1989. They decided to divide their property through agreement rather than under the terms of the North Carolina Equitable Distribution statute. Their "Separation Agreement and Property Settlement" was incorporated into their divorce decree, part of which provided:

> Husband [Don Bullard] shall pay Wife [Rosa Bullard] the sum of $12,500 per month as *alimony*, which shall consist in part of the variable first mortgage and second mortgage monthly payments for the residence located at 813 Inlet View Drive, as well as the first mortgage monthly payments for the unit located at Holly Tree Condominiums. It shall be the Wife's responsibility to tender said monthly mortgage payments for the aforementioned residences from said monthly alimony payment.[213]

The properties were owned solely by Rosa as a result of the divorce. The tax issue was whether any part of the payment stream mandated by that provision qualified as "alimony" for tax purposes.

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[209] *Id.* at 664-65.

[210] *Id.* at 665.

[211] *Id.*

[212] 97-2 U.S.T.C. (CCH) ¶ 50,948 (E.D.N.C. 1997).

[213] *Id.*

Both state and appellate courts in North Carolina, which had been called upon to interpret this agreement in unrelated litigation, characterized this payment stream as "one in which the provisions for alimony and for property settlement were so interrelated that the payments to Rosa were not subject to court modification by reason of changed circumstances, as would be the case for alimony payments standing alone."[214] But, as we all know by now, the only characteristic that really mattered for Federal tax purposes was whether the payments would stop if Rosa died prior to full payment of the mortgages. If they would, then this mixed payment stream would be characterized as 100% includable/deductible alimony; if they would not, then it would be characterized as 100% excludable/nondeductible property settlement. The parties agreement--as usual--was silent. As the trial court observed,

> Unfortunately, if the parties fail to expressly specify whether a periodic monthly payment is intended to terminate upon the death of the payee spouse, a court must look to state law to determine whether the fourth factor of the Section 71 definition of alimony is satisfied. *See* [another previously cited case] (noting that a court is returned "to the vagaries of different State law approaches" to determine if state law terminates a payor's liability at the death of the payee spouse).[215]

Thus, the North Carolina Federal District Court had to try to determine whether North Carolina law would terminate these payments on Rosa's death. (As it happened, Rosa did, in fact, die in an automobile accident just six days before the tax litigation was originally scheduled to start.) It reviewed North Carolina family law decisions, the prior family law litigation that characterized this payment stream as a mixed alimony/property settlement stream, and North Carolina contract law in concluding that the payment stream would not stop on Rosa's death. In connection with North Carolina contract law, the issue was whether the parties intended the payments to stop at death, even though not explicitly provided for in their agreement. Under North Carolina law, the court could look to extrinsic evidence to determine the parties' intent with respect to this issue. The court stated:

> Like the final version, an early draft of the parties' Separation Agreement did not contain a termination at death clause .... However, the draft did contain the following provision: "Husband and Wife stipulate and agree that in the event that Wife cohabits with a member of the opposite sex who is not a relative, the amount of alimony set forth herein shall be reduced to the exact amount of the first mortgage and second mortgage payments for the residence located at 813 Inlet View Drive." ... This provision was struck by Rosa during the parties negotiations. The court finds the language of this clause to be meaningful as the payments would only have been reduced (not terminated) to the amount of the mortgage payments. This evidences an intent that in negotiating the agreement the parties intended the *mortgage* payment obligation to continue despite the happening of a contingency that Don found undesirable. This provision also demonstrates that Don, whose attorney drafted the Agreement, knew how to

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[214] *Id.*

[215] *Id.* at n.1.

terminate his obligations ... with a contingency clause that would discharge his duty to make the alimony payments upon the cohabitation, remarriage, or death of Rosa.[216]

Also interesting is the following passage:

Don ... testified that he was unfamiliar with the federal tax law requirements of 26 U.S.C. § 71(b)(1). His attorney, Mr. Davis, testified that he too was unfamiliar with the requirements of this tax provision including the termination at death requirement. Don's accountant, Mr. Thomas May, testified that during the negotiation of the Agreement he advised Rosa and Don of the tax consequences of paying and receiving alimony, *i.e.*, that it was includable as income for Rosa and deductible for Don. But he testified that he was unfamiliar with the termination at death requirement of 26 U.S.C. § 71(b)(1) and advised the parties on the tax consequences of alimony according to Don's characterization of the payments as "alimony."
The court finds that use of the term alimony ... is insufficient to prove the parties' intentions that the payments terminate at Rosa's death. That Don intended the payments to be "alimony" or even intended them to be deductible from his income does not demonstrate that *both* he and Rosa intended the mortgage portion of the ... payments to terminate upon her death.[217]

I have absolutely no doubt that other divorcing parties and divorce lawyers not well-versed in tax law do not know that state law (or their agreement) must provide that payments stop at death to qualify as "alimony" for tax purposes. I would bet that divorcing parties are informed, much like Don and Rosa were, that alimony is includable/deductible, but they likely presume that any payment that is called alimony in their agreement (as in this case), or at least qualifies as alimony under state law, would fall within the inclusion/deduction system for Federal tax purposes. And they probably really scratch their heads when they find out that a payment stream characterized as "alimony" for purposes of Federal bankruptcy law (and thus not dischargeable in bankruptcy proceedings) may not be "alimony" for purposes of Federal tax law.[218]

As this decision indicates, surely there has got to be an easier way to determine which parties' marginal rate brackets will apply to the payments at issue than requiring Federal tax adjudicators to delve into the surrounding circumstances of the parties' negotiations in order to determine whether, under state law, payments would terminate on the death of the payee. The surreal nature of the inquiry was exacerbated by the knowledge that the payment stream was intended by the parties, and considered under state law, to be a mixed alimony/property settlement payment stream.

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[216] *Id.*

[217] *Id.*

[218] *See* Votzmeyer v. U.S., 96-2 U.S.T.C. (CCH) ¶ 50,621 (S.D. Tex. 1996).

Cunningham v. Commissioner[219] provides yet another example of how the difficult interrelationship between the stop-at-death requirement and state law requires tax adjudicators to determine whether payments would qualify as "alimony" under state law—just the kind of inquiry that was supposed to end in 1984. The parties agreed that their divorce agreement should remain a private contract, rather than entered as an order of the court. (Mr. Cunningham did not wish the court to be able to increase his alimony and support payments, and Ms. Cunningham did not wish the court to be able to decrease them, as apparently could occur if they had their agreement formally entered as a court order.) The agreement was silent with respect to whether 142 monthly support payments of $2,500 made by Mr. Cunningham to Ms. Cunningham would stop at her death. (Child support was dealt with in a separate provision.) Ms. Cunningham privately received a tax opinion that stated that, since the proposed agreement did not require the payments to stop on her death, she would be entitled to exclude the payments as "not alimony." She did not include these payments, while Mr. Cunningham sought to deduct them, and both were issued notices of deficiency. (The case recites that Mr. Cunningham sued his family lawyer for malpractice, claiming that the lawyer told him that the payments would be deductible as alimony.)

Since the agreement was silent regarding whether the payments would cease if Ms. Cunningham should die before the end of the 142-month period, the Tax Court had to examine state law, and this was not an easy task. Under North Carolina law, only "alimony" payments stopped on the death of the payee, but no payment stream made under a private agreement that is not entered as a court order can qualify as "alimony." Thus, the court had to construe their private agreement under North Carolina contract law in order to determine whether the payments would stop as a matter of contract law. This allowed consideration of parol evidence, which allowed all of the negotiations and prior drafts of the agreement to come into evidence. The court eventually concluded that, while the evidence was ambiguous, the parties did not likely intend the payments to stop at the payee's death, so the payments did not qualify as tax "alimony." If I counted correctly, the Tax Court had to digest and cite fifteen different North Carolina case law decisions, as well as several North Carolina statutes, in reaching its conclusion. What a mess!

Another fascinating case is *Christoph v. United States*.[220] Under their original divorce decree, Mr. Dieter Christoph was to pay Ms. Jutta Duse unspecified periodic payments for the rest of her life, which presumably qualified as includable/deductible alimony. In 1988, Mr. Christoph petitioned the court to terminate his obligations based on Georgia's live-in lover statute. Ms. Duse also sued, claiming that Mr. Christoph breached certain duties owed to her. The suits were consolidated, and the presiding judge encouraged a settlement. In a hearing on the matter,

> [the attorney for Mr. Christoph] announced that "Ms. Duse would be paid a sum that would 'include $250,000 which will be expressly deductible by Mr. Christoph, and it is a contingency of this agreement that that payment of $250,000

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[219] 68 T.C.M. (CCH) 801 (1994).

[220] 919 F. Supp. 1576 (S.D. Ga. 1995).

> will be alimony, will be deductible by Mr. Christoph, and includable in Ms. [Duse's] income.'" ... In exchange for this amount of money, Ms. Duse agreed to release Mr. Christoph from future alimony payments....
>
> At the hearing, Ms. Duse testified that she agreed to the terms and conditions of the settlement agreement.... Ms. Duse conceded that the payment would be income to her and that she would declare it as income.... With that understanding, the parties concluded that they had reached an agreement settling the case.
>
> Judge Cheatham subsequently entered an order on June 1, 1989, adopting the oral settlement agreement as the order of the court.... Soon after Judge Cheatham adopted the oral settlement agreement, Mr. Christoph transferred the agreed-upon $250,000 to Ms. Duse.[221]

The $250,000 figure was described as the present, discounted value of the future stream of payments under the original agreement.[222]

The government disallowed Mr. Christoph's tax deduction for the $250,000 payment. Mr. Christoph paid the deficiency and sued for a refund. The government moved for summary judgment on several grounds, and Mr. Christoph similarly moved for summary judgment in his favor. Quite surprisingly, there was no discussion of whether Mr. Christoph's payment obligation would have disappeared if Ms. Duse had died prior to receipt of the payment, as occurs routinely in denying alimony status for lump-sum payments of the payee's attorneys' fees and costs relating to the divorce or medical expenses.[223] Rather, the court ruled in favor of Mr. Christoph when it found out that Ms. Duse had (unsurprisingly, in my view) excluded the receipt from her gross income (likely on the ground that the stop-at-death requirement was not satisfied) and that the IRS had challenged her exclusion as improper. The government settled the case with Ms. Duse under an agreement that they, essentially, split the difference, with Ms. Duse increasing her gross income by $125,000.

This information demonstrates to this Court that the IRS essentially agreed with Mr. Christoph's position regarding who was supposed to the claim the $250,000 as taxable income. It is true that the IRS reached a compromise settlement and, in so doing, only recovered from Ms. Duse half of what she owed. The IRS did this at its own peril. Mr. Christoph cannot be penalized simply because the IRS compromised with Ms. Duse.[224]

What an odd case! I think it likely that, even though the lump-sum payment was intended to replace a stream of payments that evidently satisfied the tax definition of "alimony,"

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[221] *Id.* at 1578.

[222] *Id.* at 1581.

[223] *See supra* notes 197-206 and accompanying text.

[224] 919 F. Supp. at 1583.

the lump-sum payment itself failed the stop-at-death requirement. That is to say, I would bet that if Ms. Duse had died prior to receipt of the payment, her estate could nevertheless probably have successfully sued to receive the lump-sum amount. As we have seen, the parties have no power to opt *into* alimony treatment under the statute, as they clearly attempted to do here; they have only the power to opt *out* of the includable/deductible system under current law.

I think that this case also illustrates that large, lump-sum payments are not always property settlements, contrary to the Code's presumptions. They often, as here, intend to replace an ongoing relationship that is required with periodic payments with a lump-sum payment that represents the present, discounted value of the future payment stream. Such a payment can allow the parties to go their separate ways sooner.

Moreover, even if the court order did specify that the payment obligation would disappear if Ms. Duse died before receipt, wouldn't this have been nothing short of a formal "technicality" in the pejorative sense of the term in view of the fact that Mr. Christoph had to—and did—pay the amount as soon as the court entered its order? That Ms. Duse might have died in the few days (or perhaps even hours, for all I know) between the entering of the court's order and the payment is so unlikely an event that to turn the answer to the question of who should be taxed on such lump-sum payments on such an inquiry seems nothing short of ridiculous.

In short, I think there is a good chance that this payment did not qualify as tax alimony, even though it was allowed to stand as tax alimony. I find it ironic that the bargaining and agreement between the parties recounted in the quotation above, with the parties themselves deciding who should be responsible for the tax due on these payments, was *just* the kind of system that I advocate but which is not currently available in all instances (this case notwithstanding).

Another case that demonstrates the depth of misunderstanding on the part of divorcing couples (as well as their family lawyers) is *Rosenthal v. Commissioner*,[225] where the parties provided in their agreement that the spousal support payments were intended to be taxable to the wife and deductible by the husband but that the payments would *not* terminate if the payee wife should die during the 48-month payment period. Needless to say, the stipulation that the payments would not stop if the payee should die prevented these payments from qualifying as "alimony." The parties apparently believed that they could opt "into" as well as "out of" includable/deductible alimony treatment by private agreement. The result, though mandated by the current Code, upsets the parties' original bargain. "If these payments are not taxed in accordance with the original expectations of the parties, ... then, in essence, the terms of the settlement have been changed. The party who escapes taxation obtains a windfall at the expense of the party who is unexpectedly taxed."[226]

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[225] 70 T.C.M. (CCH) 1614 (1995).

[226] Stanley M. Grossbard, Note, *Taxation of Divorce Settlements and the Property/Support Distinction*, 55 S. CAL. L. REV. 939 (1982).

On a similar note, the Tax Court held that a $10,000 "lump sum alimony" payment was excludable/nondeductible because the stop-at-death requirement was not satisfied, even though the divorced spouses "stipulated" to the Tax Court during the litigation that it should be includable/deductible.[227]

The stop-at-death rule surely triggered what should have been unnecessary litigation (in my world) in *Ryan v.Commissioner*.[228] A 1989 divorce court order required Gregory Ryan to pay his ex-wife, Frances Ryan, $700 per month for January, February, March, and April of 1990 and $250 per week thereafter until her death or substantial changed circumstances or until a further court order. In 1991, Gregory appealed the alimony order, claiming that the trial court awarded an amount of alimony in excess of what Frances had requested, since she had requested alimony for a term of only eight years. The appeals court entered a per curiam opinion instructing the trial court to change the lifetime alimony award to an award of "$250 a week for eight years."[229] Frances treated this amendment as removing the stop-at-death provision contained in the original judgment and thus excluded the payments received, while Ryan deducted them, claiming that the amendment meant only that Frances was entitled to the alimony payments for eight years or until her earlier death. The court agreed with Ryan. "[W]e find that the termination upon death provision contained in the Judgment of Divorce was not modified by the higher court's opinion. The issue raised in the appeal was the length of the alimony payments, not whether the payments were in fact alimony."[230] Gregory Ryan asked the Tax Court to force the government to pay the $15,000 in attorneys' fees and costs that he had to incur to secure his right to his alimony deduction. The Tax Court directed him to the proper procedural means for making such a request and thus declined to rule on it.

I could go on to describe many other similar cases cited in footnote 173, but I fear that I am becoming repetitious. I nevertheless felt that it was necessary to describe a healthy chunk of real-world cases, since I think that all too often academic discussions of how "best" to tax transfers in divorce occur in a vacuum in which unrealistic assumptions are made regarding what the terms of real-world divorce agreements look like. They do not order payment streams that fit nicely into the boxes created in I.R.C. § 71. What cases like the ones discussed here show is that the current rules, which were the result of political compromise rather than grand theory, were drafted by people who really had no idea of what real-world divorce agreements and court orders look like. They certainly could not have envisioned the kind of litigation described here as a natural and right consequence of the rules that they drafted. What they show, in fact, is that the rules are broken. Neither divorcing parties nor the government should have to undertake so much litigation in order to determine which, between two parties, shoulders the tax burden on cash payments in divorce. Divorce, already a stressful and expensive experience, should not be

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[227] McMahon v. Comm'r, T.C. Summary Op. 2001-6, No. 12148-99S (Jan. 24, 2001).

[228] 76 T.C.M. (CCH) 453 (1998).

[229] *Id.*

[230] *Id.*

made more stressful and more expensive by the unanticipated intrusion of so many Federal tax controversies.

In sum, the House Report leading to the 1984 changes to the definition of alimony complained of the impact of state law on federal tax consequences, the inability to predict with certainty the tax consequences of transfers in divorce, and the high degree of administrative difficulties and resulting litigation in this area involving many, many individuals (and family law attorneys) who are not well-versed in tax law.

The committee believes that the present law definition of alimony is not sufficiently objective. Differences in State laws create differences in Federal tax consequences and administrative difficulties for the IRS.... The committee bill attempts to define alimony in a way that would conform to general notions of what type of payments constitute alimony as distinguished from property settlements and to prevent the deduction of large, one-time lump-sum property settlements.[231]

Things have not changed as much as anticipated because the underlying assumptions informing current law were not necessarily accurate. As Professor Berman put it:

> The attempts at reform failed because Congress predicated its efforts on false premises. First, there do not exist "general notions of what type of payments constitute alimony as distinguished from property settlements." True, a single lump sum payment of $1,000,000 appears distinguishable from annual payments of $20,000 "for the life of the payee until she remarries." But the bulk of payments between divorced spouses do not fit into these neat categories. If they did, much of the reform encompassed in the 1984 Act would have been unnecessary—Tax Court judges could have treated the distinction between alimony and property settlements the way Justice Stewart treated pornography—they would know it when they saw it.
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> Even if there were general notions of the distinction between alimony and property settlements, state court judges do not rigidly adhere to the distinctions. Some judges order extended installment payments as a means of giving the wife an interest in the husband's property which cannot be divided while others fabricate an interest in a professional degree because alimony laws do not adequately compensate the wife.[232]

2. Discussion and Recommendations

With respect to support payments (as opposed to property settlements), there are two fundamentally different perspectives one can take, as briefly described earlier,[233] and they

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[231] H.R. REP. NO. 98-432, at 194 (1983).

[232] Donald H. Berman, *The Alimony Deduction: Time to Slaughter a Sacred Cow*, 5 AM. J. TAX POL'Y 49, 70-71 (1986), *supra* note 173 (footnotes omitted).

[233] *See supra* notes 16-24 and accompanying text.

provide different starting points (and thus different likely ending points) for the discussion. One examines each party, the payor and payee, and queries whether the payment (or receipt) should be deductible (or includable) under traditional notions of what constitutes "income" for tax purposes. Under this view, each party is considered independently of the other. The recipient would have to include the amounts in income—at least under *Glenshaw Glass* notions of the term—since the receipt would constitute an undeniable accession to wealth of the recipient, clearly realized, over which she has complete dominion. Under this perspective, the payor might also remain taxable on the amounts paid out to the recipient if one defines nondeductible "personal consumption" as any outlay not in pursuance of income creation—as is generally the case under current law—rather than an outlay that does, in fact, purchase personal consumption enjoyed by the payor. This approach, in other words, could very possibly result in taxation of amounts paid out as alimony or child support to *both* parties.

This seems to be the perspective taken by the Finance Committee staff members in 1984 in arguing for nondeductibility of all payments by the payor, since their argument focused on whether the payor's payment, viewed solely from the payor's perspective, contributed to earning includable income. As reported by Ms. Mattei as a result of her telephone interview, "Senate Finance committee staff counsel Graham questioned the validity of continuing this major exception to the general rule that only business expenses (in contrast to personal expenses) are deductible ...."[234] Although it was not clear whether the Finance Committee staff members also

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[234] Mattei, *supra* note 40, at 193 n.120; *see also* Berman, *supra* note 232 (also advocating repeal of the alimony deduction, in conjunction with repeal of I.R.C. § 71). One of Berman's chief arguments is that, since the precipitating event causing enactment of the inclusion/deduction system was the high marginal rates then in effect, the inclusion/deduction system is no longer needed with the significantly lower marginal rates in effect today and thus should be repealed. I would respond that such an argument presumes that the *only* justification for an inclusion/deduction system is the presence of high marginal rates of the payor. But it is often true that a provision enacted for one reason can continue to be justified for other reasons even after the conditions originally prompting enactment are no longer present. For example, I.R.C. § 162(a)(1) explicitly allows a deduction for a "reasonable" salary.

The provision was originally adopted in 1918 to allow a reasonable salary to be deducted for purposes of an excess profits tax, even though no salary was actually paid because the profits were being plowed back into the business. The provision's original purpose was entirely pro-taxpayer.

Today, it is a provision raised by the Commissioner against taxpayers to disallow deductions for what are in fact disguised dividends or disguised payments for property. The purpose of the provision has thus evolved over time so that now its purpose is chiefly seen as protecting the double tax in our classical corporate tax structure.

Deborah A. Geier, *Interpreting Tax Legislation: The Role of Purpose*, 2 FLA. TAX REV. 492, 507 (1995 (citing Erwin N. Griswold, *New Light on "A Reasonable Allowance" for Services*, 59 HARV. L. REV. 286 (1945); Treas. Reg. § 1.162-7). In other words, Berman's argument is persuasive *only* if there is no sound justification for the inclusion/deduction system *apart* from high marginal tax rates. For the reasons discussed in the text, I believe that there are

advocated abandoning the alimony inclusion, under their approach of questioning whether the amounts paid out constitute "income," the recipient should also be taxed. After all, it would be inconsistent to use the "what-is-income" approach to this question when considering the taxation of the payor but abandon that approach when considering the taxation of the payee.

A very different approach, which I advocate, is not to query whether the amounts paid out constitute "income" to the payor and payee, independently of each other, but rather to conclude that such payments ought to be taxed only once within the couple--as they are in an intact marriage--because the payments are directly caused by virtue of that marital relationship. The same would be true of child support payments outside of marriage. Under this approach, the only question to consider is *to whom* this payment should be taxed. The inclusion/deduction mechanism (or exclusion/nondeduction mechanism) simply becomes the tool used to implement the decision regarding which, between the two parties, ought to be taxed on the payment. Under this perspective, the inclusion and deduction do not have independent significance under an "income" inquiry. In other words, the inclusion and deduction are not *ends* under a "what-is-income" query but only the *means* by which to implement a decision under a "which-party-should-be-taxed" query. I call this approach the "pragmatic paradigm."

Since we are not dealing, under this pragmatic paradigm, with something as theoretically fundamental as the question of "what is income," but rather dealing only with a pragmatic decision regarding which of two parties should be taxed on what is concededly income to *someone*--the main concerns should be what side effects--good and bad--would result from our decision regarding whom to tax.

Since all cash payments incident to divorce will be taxed to one or the other spouse, the Federal government is a mere stakeholder regarding the issue of whether a cash payment is includable/deductible or excludable/nondeductible. Only the rate-bracket differential between the parties (if any) can result in a revenue loss, and this loss is self-limiting, as the greater the amount paid to the lower-bracket payee in the includable/deductible system, the higher the tax bracket that will apply to it, until further income-shifting would not produce a revenue loss. Moreover, in the context of a payor in a significantly higher tax bracket than the payee in the includable/deductible system—which is the very context that would appear to result in the most lost revenue—any revenue loss is more illusory than real because of the loss of the marriage bonus which occurs on the divorce.

Since little revenue is at stake, the parties should be given full power to decide who, between them, should be taxed on all cash transfers incident to divorce. Well-advised taxpayers already have a great deal of power to decide who is taxed, but the power can be implemented only by choosing the correct transactional form for the payment stream. Transactional elections are perhaps defensible in the world of, for example, corporate reorganizations, where choosing one form rather than another can dictate whether or not the transaction is a taxable one, but they are not appropriate in the world of divorce, a common transaction not engaged in for tax reasons, often by people not well informed of the effective elections available to them by choosing the

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convincing justifications for allowing the parties to choose the inclusion/deduction system if they desire.

correct form. Rather than hiding the effective elections, the elections should be made explicit, with simple default rules for those taxpayers who fail to address the issue in their divorce instrument.

An explicit election is preferable to trying to further distinguish, for federal tax purposes among alimony, child support, and property settlements. Without exception, the difficulties described above in the litigated cases stem from trying to properly characterize the cash payment as "alimony," "child support," or "property settlement" for federal income tax purposes (labels which often deviate from state law characterization of the payment) in order to determine whether they are includable/deductible or excludable/nondeductible. But as illustrated by the litigated cases, these payments are nearly impossible to distinguish on any consistent basis.

As indicated by the child support guideline controversy and the continuation of the *Lester* Rule in all cases not dealing with a reduction in payments related to the children, child support can still easily be cast as alimony if the right form is used. Cash property settlements are also not easy to identify. The underlying assumption of current law is that cash property settlements can, in fact, be differentiated from support payments on a consistent basis and that the "stop-at-death" rule, coupled with the recapture rule in the case of front-loaded payments, serves to adequately police that line. Both contentions are dubious, at best, and reflect outdated notions that family law is increasingly abandoning. With respect to the recapture rule, for example, property settlements may be paid over several years in level payments. Only the constraints of the tax law require the parties to maintain contact for at least three years in order that the status of their "alimony" arrangement be respected as such.

It would have been hard to have legislated wisely to limit front-loading. First, many legitimate, non-tax-avoidance factors, particularly the rehabilitative alimony award, lie behind front-loaded settlements. Second, there is little economic incentive for front-loading because it often costs the husband more in loss of the use of his money than he saves in taxes. Thus, a reform that limited the tax avoidance potential of front-loading would have to reach a narrow group of cases at the cost of significantly interfering with accepted family law practice.[235]

Moreover, the "stop-at-death" rule serves only to require judges to delve, once again, into state law to try to determine whether any part of an unallocated payment stream *might* stop automatically if the payee should die, an actuarially unlikely event that the parties never addressed in their agreements, as described earlier. And it results in many payments that are clearly not property settlements—such as the payment of attorney fees, medical expenses, and auto repair expenses—to be so characterized.

In 1986, Professor Malman persuasively demonstrated how the line between support payments and property settlements could no longer be policed in any rational way in view of the trends in family law, where "equitable distribution" statutes now blend property rights with support payments in an inextricably mixed payment stream.

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[235] Berman, *supra* note 232, at 69 (footnotes omitted).

Often there is not a clear distinction between alimony awards and property distributions. As a result of the adoption of equitable distribution principles, the law in a number of states requires that financial provision for a spouse be made through a property distribution, and that alimony be awarded only if the property that can be divided is insufficient. Other states provide that both alimony awards and property distributions may be used for similar purposes—to provide for support and to provide for an equitable allocation of assets.

The similar criteria used by courts to make both alimony awards and property distributions illustrate the lack of a clear distinction between the two. In both situations, courts may consider the parties' ages, needs, and employment skills; the duration of the marriage; and the presence of children.

In particular, cases where on divorce one spouse, typically the wife, seeks compensation for financial contributions made toward the other's education or attainment of a degree or professional license illustrate the blurring of alimony awards and property distributions. Courts may consider the wife's contributions to the earning of the degree (or the husband's resulting increased earning capacity) as a factor in determining a property division and/or an award of alimony. Alternatively, the courts may formally identify the degree, license, or education as an asset subject to equitable distribution. Recently, the New Jersey courts introduced the concept of reimbursement alimony, which is designed specifically to compensate a spouse for financial contributions to the other spouse's attainments. The choice of a mechanism may affect the amount of compensation. Nonetheless, the results produced by the various approaches are similar because each may be said to stem from the vision of marriage as a partnership or shared enterprise and each compensates a spouse for contributions to the other spouse's career.[236]

Her points have become only more salient in the years since 1986. As just one example, in this dot-com world in which we live, when stock options increasingly are used to compensate workers, family law courts are now arguing that stock options awarded after a divorce do not really represent separate "property" of the stock option owner but rather a future "income" stream that should be factored into the level of support payments.[237]

Moreover, the difficulties in differentiating support payments from property settlements should not be attempted to be resolved by adopting the Task Force's complex "netting" proposal, under which only "hard assets" are taken into account in determining how much of a cash payment is actually a "property settlement" and under which payments are disallowed from entering into the inclusion/deduction system to the extent that they do not exceed the value of hard assets transferred to the payor spouse as a result of the divorce.[238] Not only would this approach ignore state-law trends that increasingly recognize the value of intangible property

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[236] Malman, *supra* note 4, at 379-80 (footnotes omitted).

[237] *See, e.g.*, Kerr v. Kerr, Kerr v. Kerr, 77 Cal. App. 4th 87, 91 Cal. Rptr. 2d 374 (1999); Murray v. Murray, 128 Ohio App. 3d 662, 716 N.E.2d 288 (1999). *See generally* Amy Zipkin, *Stock Option Splitsville*, N.Y. TIMES, Aug. 9, 2000, at C1 (describing these and other cases).

[238] *See supra* notes 85-89 and accompanying text.

rights, but it would also impose vast new complexities imposed on every divorcing couple (requiring "tax-defendable valuation" of all "hard assets" without a market transaction at the time of divorce).[239] And these complexities would be greatly exacerbated by the fact that each spouse's "interest" in the hard assets would be measured differently in community-property states and common-law states, not to mention states that vest spouses with property rights at the time of divorce under certain equitable distribution or apportionment statutes.

For all of these reasons, the statute should not attempt to identify those payments eligible for the inclusion/deduction system by reference to whether or not they fall into a particular category. Moreover, Congress should also reject treating all cash payments either under a rigid exclusion/nondeduction system or rigid inclusion/deduction system in the name of simplification. A mandatory exclusion/nondeduction system for all cash payments is not wise for the following reasons.

First, mandatory exclusion/nondeduction for all cash payments would likely increase the aggregate tax burden on divorcing couples, since the couple in different tax brackets (where substantial cash payments are more likely) would lose their marriage bonus at the same time that more of the couple's income would be taxed at the payor's higher marginal rate bracket under the schedule for single filers. Divorce is usually accompanied by financial hardship (and triples the chances of bankruptcy). Therefore, Congress should avoid adopting what would amount to a mandatory divorce tax "penalty" in many cases.

Second, a mandatory exclusion/nondeduction rule would also introduce a disparity between less wealthy couples, where support payments must come from future wages of the payor, and wealthy couples, who could still engage in significant income-shifting by transferring income-producing assets to the payee to fund support. It would also be inconsistent with the income-shifting allowed under I.R.C. § 1041, discussed below in Part III, so there would be a new and dramatic difference between the two areas, whereas both now contemplate income-shifting.

Third, a rigid exclusion/nondeduction rule would decrease flexibility in settling other matters in the divorce, with the likelihood of increasing the number of cases that go to full contest in state court.

Fourth (and perhaps most important), when the payor is in a higher tax bracket, a mandatory exclusion/nondeduction system would erase the current-law bias that encourages the payor to make larger payments than he or she would otherwise make and that leaves the payee with more after-tax cash than he or she would otherwise have under an exclusion/nondeduction system.

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[239] While at least informal valuation of all property surely occurs in most divorces, these valuations may not be arrived at by formal appraisals that could be defended in the inevitable tax litigation, when the payor and payee spouses disagree over the valuations used to arrive at how much of the cash payment stream is eligible for the inclusion/deduction system. Such a system would be a nightmare!

For example, assume that John and Mary, who have one minor child, age 12, are divorcing. The child will live primarily with Mary, with generous visitation to John. Without taking into consideration the following cash transfers, John, if single, would be in the 36% bracket, and Mary would be in the 15% bracket. Mary demands $1,000 per month in child support for ten years. John does not object to the figure but suggests that they call the payment a "family support payment," with no amount specifically designated as "child support." They agree that if Mary should die before their child is emancipated (an actuarially unlikely event), John will gain full custody.

The intent is to structure the payments as includable/deductible "tax alimony." Economically, it doesn't matter whether the payment is called "child support" or "family support" or "alimony." "Alimony" sounds mercenary and "child support" sounds benevolent, but otherwise there is no difference; the recipient is typically under no duty to account for how the funds are used.

Mary would reject that offer, since her $1,000 per month would be worth less to her if she must pay the tax on it. John then offers $1,200 per month. After Mary's 15% tax ($180), she has $1,020, which is more than she would have under a rigid exclusion/nondeduction system under which John would agree to pay no more than $1,000 per month. John is willing to do this only because his net outlay is reduced from $1,000 to $768 ($1,200 less $432 tax savings) because of the deduction. John and Mary effectively save $180 net[240] and share the spoils. (Mary should claim more of the spoils than $20.)

As indicated by the above example, which uses current law, this kind of flexibility is *already* incorporated into the statute, so long as the parties agree that the payments would end on the payee's death and are not excessively front-loaded. Why not make the flexibility explicit? Failing to do so simply rewards the well-advised over the ill-advised. The election is one dependent on knowledgeably structuring the transaction in a certain manner (increasing attorneys' fees and penalizing the ill-informed) rather than one that can be simply made explicit in the divorce agreement.

Moreover, since Mary is in a lower tax bracket than John, it would be defensible to assume (since assumptions are unavoidable) that she is in greater need of the funds than John and that structuring the tax system so that she could end up with more after-tax cash is good policy, particularly since payees after divorce do tend to have a lower standard of living than payors.[241]

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[240] This figure represents the $360 that John would have paid on that $1,000 per month if they designated it as "not alimony" less the $180 that Mary will pay on that $1,200 per month if they make sure the definition of alimony in I.R.C. § 71 is satisfied.

[241] In 1985, Lenore Weitzman published a book that argued that, following divorce, the average divorced woman's standard of living dropped by 73%, while the average divorced male's standard of living increased by 42%. *See* LENORE WEITZMAN, THE DIVORCE REVOLUTION 323-56 (1985). Since then, her numbers have been successfully attacked as severely overstated, and even Ms. Weitzman herself admitted that a research assistant made an error. *See* Sanford L. Braver, *The Gender Gap in Standard of Living After Divorce: Vanishing Small?*, 88 FAM. L.Q.

> [W]omen face longer terms of low wealth and consumption when they divorce because they are less likely to remarry than their former husbands.... This lower remarriage rate is exacerbated when the wife has custody of the children. Part of the reason for this disparity is that a woman's value on the marriage market tends to depreciate with time, while her husband's tends to appreciate.[242]

That John must be given a deduction to encourage him to provide Mary with more after-tax cash bothers some commentators who just don't like to see the Johns of the world reduce their taxes in this manner.[243] But such a view reverts to a different paradigm--asking whether John, viewed independently, should be able to deduct an amount that is not made in pursuance of income--rather than the more pragmatic paradigm of deciding simply who should be taxed on these payments by looking to the side effects of the various possible decisions. I admit that I like the fact that Mary ends up with more after-tax cash here under the inclusion/deduction system, and the bald fact is that John would not be willing to provide her with more after-tax cash if he weren't better off as well, *i.e.*, if it weren't for the tax savings that he enjoys through the deduction under his higher rate bracket. In short, this side effect is one that tends toward encouraging the higher-income spouse to provide more after-tax income to the lower-income spouse, which might be a good side effect for society in general, at a cost to the fisc that is self-limiting.

Finally, John's deduction would encourage him to satisfy his $1,200 per month payment obligation, rather than renege on his $1,000 per month obligation that he would otherwise agree to under an exclusion/nondeduction system, an all-too-common occurrence in the real world.[244]

> The problem of nonsupport of children by their parents has become a serious one for this country.... [O]f the 8.8 million mothers with children whose fathers were not living in the home in the spring of 1986, 3.4 million, or nearly 40 percent of these mothers, had never been awarded support for their children. Fewer than one in five mothers who had never been married had been awarded support. Of those

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111, 115-16 (1999). But only the degree, and not the direction, of the numbers were challenged. A later study using Ms. Weitzman's sample and records found a 27% drop in women's standard of living and 10% increase in men's after divorce. *See id.*; *see also* Margaret F. Brinig & Douglas W. Allen, *"These Boots Are Made for Walking": Why Most Divorce Filers Are Women*, 2 AM. J.L & ECON. 126, 127-28 (2000) (collecting other consistent studies).

[242] Brinig & Allen, *supra* note 241, at 128.

[243] *See, e.g.*, Berman, *supra* note 232.

[244] *See generally* Jacqueline Pons-Bunny, *Non-Custodial Fathers' Rights: States' Lack of Incentives for the Father to Remain in the Child's Life*, 19 J. JUV. L. 212, 221 (1998) (noting that 65% of absent fathers do not pay alimony or child support).

who had been awarded and were due support in 1986, only half received the full amount they were due.[245]

Why don't I simply advocate that *all* cash payments fall within the inclusion/deduction system, with no ability on the part of the parties to agree to exclusion/nondeduction? I think that such a system would be less optimum than one preserving the effective flexibility of current law (for the well-advised). First, for parties who will not be in different tax brackets after divorce—which may be the case more often with lower- and middle-income taxpayers who are both in the 15% bracket or both in the 28% bracket—it would be defensible to allow them to decide who should be taxed on these payments simply because no revenue is at stake. The greater flexibility to designate tax responsibility for cash payments can grease the wheels of negotiation with respect to many other matters on the table, such as who gets the car. Parties who *are* in different tax brackets should, if well-advised, not wish to opt out of the inclusion/deduction system in most cases, since *both* can usually be better off (after taxes) under that system, as illustrated in the John/Mary negotiations. But some of these parties may agree to hard numbers *independent* of the tax consequences. If John refuses to pay more than $1,000 per month in any event, then I think that it's good policy to provide Mary some leverage in the divorce negotiations with respect to other matters. She may agree to give up the car, in other words, if John agrees that the firm $1,000 per month that he won't budge from is excludable by her (and thus nondeductible to him). In other words, if they nevertheless wish to agree to exclusion/nondeduction in a manner that would benefit the Treasury, there is no compelling reason to prevent them, and providing taxpayers explicit authority to decide for themselves the tax status of these cash payments can help the parties negotiate other matters that aren't directly related to the tax responsibility for cash payments. Moreover, having the "tax system" interfere as little as possible (by declining to decide for the parties themselves who is responsible for the tax on the cash payments except in the absence of agreement)--when the Treasury is only a stakeholder--should increase respect for the tax system, which I also perceive as a good side effect.

The flexibility allowed to the parties to decide to whom cash payments should be taxed is not the cause of confusion under current law. Rather, as illustrated by the cases discussed above, the confusion under current law arises because the flexibility provided to the parties is dependent on them knowing and understanding the various transactional forms and requirements available to them. It is not necessary to eliminate the flexibility available to the parties under current law in the name of simplification; rather, it is necessary only to allow the parties to exercise their flexibility explicitly, rather than indirectly, by allowing them to designate for themselves the extent to which some or all cash payments incident to divorce should be includable/deductible or excludable/nondeductible.

In such a system, the only remaining issue is which default rule should govern in case of silence or a failure to reach agreement. The default rule should ideally provide the outcome that

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[245] William A. Klein, *Tax Effects of Nonpayment of Child Support*, 45 TAX L. REV. 259, 280 (1990) (quoting Senate Report, S. REP. NO. 100-377, at 2776-85 (1988), which accompanied the Family Support Act of 1988, Pub. L. No. 100-485, 102 Stat. 2343 (1988)); *see also* Gerzog Shaller, *supra* note 6, at 332-35 (collecting additional Federal statutes aimed at increasing compliance with child support obligations).

the parties might have agreed to if they had thought about it, *i.e.*, it should not be counterintuitive or surprising. I believe that the payee likely would not be surprised to find out that cash that he or she receives and controls and spends is includable. But if the payor pays a child's tuition or summer camp fees directly to a third party, with no control by or direct consumption by the payee, the payee might likely be surprised to find that such a payment is includable (absent a designation otherwise). Thus, I recommend that the default rule should be inclusion/deduction unless the payment is made to a third party on behalf of a child. Such payments should be relatively easy to distinguish. This default rule would step in, however, only in cases in which the parties fail to stipulate how their cash payments should be treated for tax purposes. For example, if the parties so choose, they could agree that payments to a third party on a behalf of a child are includable/deductible payments.

At bottom, the appropriate reform analogy is the 1984 reform to the dependency exemption pertaining to the minor children of divorced spouses. Recall that, prior to 1984, the spouses often had to engage in protracted litigation to determine who provided the greater amount of support for the children in order to determine who was entitled to the dependency exemptions.[246] While such an approach was surely theoretically defensible, it was impractical when applied to the real world, and it resulted in an overabundance of costly litigation for both the divorced parties and the government, while little, if any, Federal revenue was at stake. The 1984 reform simply assigned a default rule that the custodial parent gets the exemption, in the absence of an agreement by the parties that the non-custodial parent should get it. In that way, the parties could negotiate between themselves who would get the dependency exemption. This resolution might not be theoretically pure, but it was an absolutely defensible simplification that should provide the ready touchstone for simplification of the tax consequences of cash transfers in divorce.

I therefore recommend that the title of I.R.C. § 71 should be changed from "alimony and separate maintenance payments" to "payments pertaining to children and former spouses." Subsections (c) (dealing with "child support" payments) and (f) (dealing with recapture of front-loaded payments) should be repealed entirely. Subsections (a) through (c) should be amended as follows:

Sec. 71. PAYMENTS PERTAINING TO CHILDREN AND FORMER SPOUSES.

(a) GENERAL RULE.—Payments pertaining to children and former spouses, whether those payments constitute alimony, child support, property settlement, or an equitable distribution or apportionment under state law, shall be includable in the gross income of the payee under this section and deductible by the payor under § 215, or excludable from the gross income of the payee under this section and nondeductible by the payor under section 215, as designated by the parties in a divorce or separation instrument or support instrument. The divorce or separation instrument or support instrument may designate some payments or portions of payments as includable in the gross income of the payee and deductible by the payor and other payments or portions of payments as excludable by the payee and not deductible by the payor.

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[246] *See supra* notes 90-91 and 126-27 and accompanying text.

(b) DEFAULT RULE.--Payments pertaining to children and former spouses that the parties fail to designate in the divorce or separation instrument or support instrument as either includable or excludable by the payee shall be includable in the gross income of the payee under this section and deductible by the payor under section 215 unless the payment is made to a third party on behalf of a child of the payor, in which case the payment shall be excludable from the gross income of the payee under this section and not deductible by the payor under § 215.

(c) PAYMENTS PERTAINING TO CHILDREN AND FORMER SPOUSES DEFINED--For purposes of this section--

(6) IN GENERAL.--The term "payments pertaining to children and former spouses" means any payment in cash if--

- such payment is received by (or on behalf of) a spouse under a divorce or separation instrument or by a parent under a support instrument,[247]
- the payee and the payor are not members of the same household at the time such payment is made. [248]

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[247] By these words, this section would also apply to a support decree that orders a biological father to make cash payments to the child's mother, whom he never married.

[248] In current I.R.C. § 71, the requirement that the payor and payee not live in the same household is required only in the case of "an individual legally separated from his spouse under a decree of divorce or of separate maintenance." I.R.C. § 71(b)(1)(C). That is to say, this requirement does not apply to individuals who simply enter into their own, private agreement, without supervision or approval of a court, when they separate for a time in the hopes of eventually reconciling. The thought is that requiring such individuals to cease living together in order to gain the advantages of the inclusion/deduction system would discourage reconciliation. *See generally* Paul C. Feinbert & Toni Robinson, *A Household Is Not a Home: "Not Members of the Same Household" in the Tax Treatment of Alimony Payments*, 6 VA. TAX REV. 377 (1986) (generally discussing this requirement).

I believe that under a system in which parties will be entitled to designate all cash payments as includable/deductible payments, without limit, this flexibility must be sacrificed in order to prevent happy couples who have no intention of actually separating from attempting to take advantage of the inclusion/deduction system on a wholesale basis while continuing to live together, filing separate returns. (Subsection (e) of I.R.C. § 71 already prevents couples filing a joint return from taking advantage of the inclusion/deduction system.) This is the one area where the abuse potential could feasibly be great. For this reason, I believe that couples should have to live apart to take advantage of the inclusion/deduction system. That would mean that couples who continue to live in the same household, even in separate bedrooms, would not be entitled to take advantage of the inclusion/deduction system for any payments made pursuant to a private agreement that they undertake together, but I believe that such a restriction is nevertheless justified in view of the larger potential for abuse. The justification for income-shifting is much less pungent in the case of a still-married couple, living in the same household. The payments made from one spouse to another would still be taxed only once; the only consequence of this

(7) DIVORCE OR SEPARATION INSTRUMENT OR SUPPORT INSTRUMENT.--The term "divorce or separation instrument" or "support instrument" means--

- decree of divorce or written instrument incident to such a decree,
- a written separation agreement,
- payee for the payee's benefit and/or the benefit of the children of the payee and payor.[249]

B. In-Kind Property Transfers

The rule enacted in I.R.C. § 1041(a) that in-kind property transfers should be nonrecognition events if the transfer is incident to divorce turned out, in my view, to be an overwhelming success. Moreover, I believe that it was the right decision to resist the Task Force's tentative proposal that the nonrecognition rule be made elective.[250] I believe that the valuation headaches that would arise if non-marketplace transfers in divorce were deemed to be realization events more than justifies a flat nonrecognition rule for such in-kind transfers. Valuation litigation would no doubt explode if parties were given this option, with transferors claiming low value for built-in gain property for purposes of measuring their gain and transferees claiming high value for purposes of their fair-market-value basis. Even if the parties were required to stipulate jointly to a single value in order to elect out of nonrecognition treatment, the government might wish to argue that the stipulated value is deflated (to generate less gain or a greater loss), particularly if the transferee does not plan on selling the property and thus would be willing to stipulate to a low value (and thus basis). In my view, this aspect of "private ordering" must give way to easy-to-administer rules in a transaction like divorce, which affects so many individuals. And after all, the reduction in flexibility is not terribly severe; if the transferor wishes recognition, he or she may sell the property to a third party, which would provide a marketplace transaction that resolves the valuation question, and then transfer the cash to the transferee spouse.

While I.R.C. § 1041 has generally been a success, two serious issues nevertheless have arisen under it, both of which are addressed in the next section. The first is whether the common-law, assignment-of-income doctrine trumps this nonrecognition rule. The second is how stock redemptions in closely held corporations incident to divorce should be analyzed.

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rule would be that it would always be the payor that is taxed, with no ability to choose to tax the payee instead. These temporary separations should, in any event, be self-limiting in time. Either the couple will reconcile, or they will divorce, within (I assume) a year or two at most.

[249] Conforming amendments would be required to be made to I.R.C. §§ 61(a)(8) and 215, as well as § 682, so that payments satisfied by the creation of a trust would effectively receive the same treatment as would apply to direct payments under I.R.C. § 71. *See generally* Martin J. McMahon, Jr., *Tax Aspects of Divorce and Separation*, 32 FAM. L.Q. 221, 243-44 (1998) (describing alimony and child support trusts).

[250] *See supra* note 79 and accompanying text.

IV. ISSUES UNDER SECTION 1041

A. The Assignment-of-Income Doctrine and Section 1041

Under the assignment-of-income doctrine,[251] developed in such hoary cases as Lucas v. Earl, [252] Poe v. Seaborn,[253] Helvering v. Horst,[254] Blair v. Commissioner,[255] Harrison v. Schaffner,[256] Helvering v. Clifford,[257] Helvering v. Eubank, [258] and others, the Supreme Court developed a common-law doctrine that prevents the shifting of income for tax purposes from one taxpayer to another in many circumstances—at least, in the absence of a nonrecognition provision that would otherwise apply. Taken together, the cases might be summarized (if somewhat simplified) to mean that an assignor cannot shift the tax burden with respect to income produced by a mechanism over which she retains control. Because services income is created by one's body, it is just about impossible to shift services income to another, since one cannot effectively give up control over one's own body; the assignor can turn the income spigot on and off at will by performing services or not. Thus, services income is essentially always taxed to the person or entity who provided the services that earned the income, whether the services income attempted to be assigned is already earned or to be earned in the future.

For example, in *Lucas v. Earl*,[259] the Supreme Court held that a contract entered into between a married couple that required the husband, who was the sole income earner, to share one-half of his earnings with his wife did not operate to shift the tax burden of those earnings to his wife. This case was decided at a time when all individuals, including married couples, were required to file individual tax returns. If the Court had held otherwise, the resulting income-splitting would have allowed the married couple to use the lowest marginal rate brackets twice, instead of once, thus lowering the couple's aggregate tax liability.

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[251] The description in the next two paragraphs was taken from Geier, *supra* note 24, at 536-37.

[252] 281 U.S. 111 (1930).

[253] 282 U.S. 101 (1930).

[254] 311 U.S. 112 (1940).

[255] 300 U.S. 5 (1937).

[256] 313 U.S. 579 (1941).

[257] 309 U.S. 331 (1940).

[258] 311 U.S. 122 (1940).

[259] 281 U.S. 111 (1930).

In the same term of court, however, the Court also decided *Poe v. Seaborn*,[260] which also dealt with a husband who was the sole breadwinner who attempted to split his income with his wife for tax-reporting purposes. Because the state's community-property laws in that case considered the husband's earnings to have been earned by the marital community, rather than solely by the husband, the court blessed the income-splitting in this context. Since the marital community earned the income under state law, the marital community properly reported it. Indeed, the differing treatment between married couples who could not split their income under state law and those who could eventually prompted the enactment of the joint-return option to, in essence, extend the advantages of income-splitting to those not living in community-property states.[261]

The *Poe v. Seaborn* Court also held that the couple's investment return on investment assets owned as community property should be split between them for purposes of tax reporting. That is to say, just as services income is typically taxed to the person or entity that earned it, income earned with respect to property is generally taxed to the person who owns the property (though the titleholder under state law might not be considered the owner for tax purposes). Unlike one's own body, the property owner *can* give up control over property producing income. Thus, assignments of income from property can be successful for tax purposes if the assignor gives up sufficient control over the property producing the income to the assignee. The disputes in this area typically center around the issue of whether sufficient control over the property producing the income was surrendered to the assignee.

The possible interrelationship between the assignment-of-income doctrine and I.R.C. § 1041 has produced confusion.[262] The issue typically arises when a property interest is transferred in divorce, and then cash, producing an ordinary income inclusion, is subsequently received with respect to that interest by the new owner. It also arises when compensation income already earned by one spouse but not yet received or taxed is assigned in the divorce to the other spouse. The question, as with alimony and child support, is which party must include the income, *i.e.*, which party's marginal rate bracket will control. For the reasons described in Part II, very little revenue (if any) is at issue here, since the government is once again merely a stakeholder.

If a property right is transferred and the income earned on that property is considered as having been earned *after* the property transfer, the new owner must include the income under the assignment-of-income doctrine, as owner of the property interest. I think that this is an uncontroversial application of the doctrine originally created in *Poe v. Seaborn* and not troublesome. For example, in *Kenfield v. United States*,[263] H was a 50% partner in a partnership engaged in land sales, and the divorce decree provided that W was entitled to one-half of H's

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[260] 282 U.S. 101 (1930).

[261] *See generally* Zelenak, *supra* note 10, at 344-48 (reviewing the history of the joint return).

[262] *See generally* Geier, *supra* note 60 (generally discussing this problem).

[263] 783 F.2d 966 (10th Cir. 1986).

partnership interest (*i.e.*, a 25% interest in the partnership). Because valuation was difficult, the court awarded W 50% of all "future net proceeds received" by H with respect to his original partnership interest. H duly paid over the amounts every year. The issue was whether H must include the full 50% of the partnership's income on his own return or whether H need include only 25%, with W including the remaining 25%, because of the court order vesting one-half of H's partnership interest in W.

The Tenth Circuit concluded that the transfer gave W ownership of one-half of H's partnership interest, and thus W must include in her gross income the income attributable to that property that accrued after the transfer. "After the settlement, Kenfield did not own the asset that produced his ex-wife's share of the 1977 post-divorce income, i.e., his ex-wife's half of the partnership income. Kenfield thus also is not taxable on the partnership income earned by that asset."[264] If the court had concluded as a factual matter that W did not really receive an interest in the partnership, but rather was merely compensated for her marital interest in the partnership, then the results would likely have been different, as they would have been analyzed under I.R.C. §§ 71 and 215. H would have had to include the full 50% share of the partnership's profits on his own return, and the installment payments received by W would (under current law, at least) be excludable by her and nondeductible by H if H's obligation to make the stream of payments would not terminate on W's death.[265] (Under the proposals advanced in Part II, *supra*, which obliterate the distinction between cash "alimony," "child support," and "property settlements," the parties would be free to designate whether cash payments incident to divorce or includable/deductible or excludable/nondeductible.)

But what if a property interest is transferred but the income subsequently received by the new property owner accrued *prior* to the transfer? Or what if accrued-but-not-yet-taxed compensation income is assigned to the other spouse? If the income is considered as accruing *prior* to the property transfer, and particularly if the income is attributable to the personal services of the transferor, then the government *sometimes* argues (though not consistently) that the income, even though received and consumed by the transferee spouse, must be included by the transferor spouse under the assignment-of-income doctrine, notwithstanding I.R.C. § 1041, a practice excoriated by Professor Michael Asimow in his definitive article on the topic.[266]

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[264] *Id.* at 968; *see also* Schulze v. Comm'r, 46 T.C.M. (CCH) 143 (1983) (holding that W was taxable on one-half of the amounts collected on a claim arising from W's one-half interest in husband's law partnership received by W in divorce).

[265] *See, e.g.*, Priv. Ltr. Rul. 9123053 (March 13, 1991) (concluding that, because the divorce instrument did not give W a 50% interest in H's business but rather only required H to make cash payments to compensate W for her interest in his business, the payments were excludable by W and nondeductible by H, since W's payment rights would not terminate on her death). *Accord* Priv. Ltr. Rul 9143050 (July 26, 1991) (concluding that W did not receive an interest in certain patent lawsuits that H was prosecuting at the time of their divorce but rather only cash payments representing an excludable cash property settlement since her payment rights would not terminate on death).

[266] Michael Asimow, *The Assault on Tax-Free Divorce: Carryover Basis and Assignment of Income*, 44 TAX L. REV. 65 (1988).

Professor Asimow calls these "sensitive assets," and they include accounts receivable of an unincorporated, cash-basis, service business; an interest in a partnership that holds unrealized receivables or contracts to render personal services in the future; rights to royalties; and investment assets with accrued but not-yet-recognized income.[267]

For example, in *Kochansky v. Commissioner*,[268] the government argued, and both the Tax Court and Ninth Circuit agreed, that Mr. Kochansky, a lawyer, must include in gross income the portion of a contingent fee in a medical malpractice action that was pending at the time of the divorce and that the divorce decree required to be paid to his ex-wife, because the income was earned by the personal services of Mr. Kochansky.

Probably the most common type of accrued income subject to assignment-of-income arguments is deferred compensation income, such as retirement savings, that is not subject to a "qualified domestic relations order," or QDRO. There is no question about who gets taxed on pension benefits that are covered by a valid QDRO, which was created in I.R.C. § 414(p) as part of the Retirement Equity Act of 1984.[269] Prior to creation of the QDRO, it was possible to split pension assets in a divorce, but the court order was directed at the spouse with the pension, rather than at the pension plan itself. For example, H might have been ordered by the court to pay one-half of his monthly pension payments to W when he begins to receive them—perhaps twenty years in the future. If H died before retirement, W received nothing. Under I.R.C. § 414(p), in contrast, the pension plan administrator is the subject of the court order, and W receives vested rights. The administrator is ordered to treat W in our scenario just as if she were a plan participant. While the primary purpose of the QDRO was to recognize these pension assignments[270] and to protect W's interest in the plan, even if H should predecease W, the provisions also ensure that W, as the "alternate payee" under a QDRO, is taxed on the payments when ultimately paid by the pension, not H.[271]

QDROs can apply only to defined benefit and defined contribution plans such as 401(k) and profit-sharing plans. They cannot apply to individual retirement accounts (IRAs) or other kinds of deferred compensation arrangements, though I.R.C. § 408(d)(6) provides similar treatment for IRA transfers in divorce. It is with respect to other, so-called nonqualified arrangements that the government has argued, albeit inconsistently, that transfers of rights to receive income (or surrenders of community property interests in such income) cannot shift the burden of including the income that has already accrued. That is to say, in our situation in which H transfers to W rights to future payments that represent H's accrued interest in deferred

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[267] *See, e.g.*, Rev. Rul. 87-112, 1987-2 C.B. 207 (holding that accrued interest on U.S. savings bonds was taxed to the transferor notwithstanding I.R.C. § 1041).

[268] 92 F.3d 957 (9th Cir. 1996), *aff'g* 67 T.C.M. (CCH) 2665 (1994).

[269] P.L. 98-397, § 204, 98 Stat. 1445 (1984).

[270] *See infra* note 300 and accompanying text.

[271] *See, e.g.*, Priv. Ltr. Rul. 8837013 (June 7, 1988). *See generally* Notice 97-11, 1997-2 I.R.B. 49 (sample QDRO text and detailed instructions and explanations of the use of QDROs).

compensation that cannot qualify for a QDRO (considered owned solely by him in a common-law state), the government might argue that, even though W receives the cash, H is taxed when W receives the cash years later.

For example, in *Darby v. Commissioner*,[272] a case pre-dating adoption of the QDRO, the divorce court ordered Mr. Darby to assign to his ex-wife a $75,000 portion of his vested interest in a qualified plan that could today qualify for a QDRO, a profit-sharing fund of his employer. The $75,000 amount was one-half of the estimated value of Mr. Darby's interest in the plan at the time of the divorce. The court ordered that the $75,000 payment should be made as follows: $60 per week until Mr. Darby died or retired, the balance due paid in a lump sum at that time. The decree also provided that Mr. Darby "shall notify said Fund of the above Assignment, and the Assignment, or this Judgment in lieu thereof, may be recorded in the County Register of Deeds or appropriate office, wherein the Fund is located so as to give notice of the same."[273] Mr. Darby complied by submitting a document to the plan informing the plan administrators of the court-ordered assignment and attaching a copy of the court's order. Mr. Darby paid a total of $22,030 in installments toward the $75,000 total before he retired, and the profit-sharing plan paid him a lump sum of more than $182,000 at that time. A few days later, he wrote a check to Ms. Darby for the $52,970 that represented her remaining interest in the plan.

While Mr. Darby did not deduct the prior $60 weekly payments as "alimony," he did not include $75,000 of the lump-sum distribution that he received upon his retirement, arguing that the divorce decree and court order resulted in a legal transfer of $75,000 of his interest in the profit-sharing plan to his ex-wife. The government made both a statutory argument and an argument under the common-law assignment-of-income doctrine in concluding that Mr. Darby was not entitled to exclude $75,000. The statutory argument was that only Mr. Darby could qualify as a "distributee" within the meaning of I.R.C. § 402(a)(1), who is the person required to include in gross income amounts deferred under a qualified pension plan. The government further argued that, even if the plan had paid the $75,000 directly to Ms. Darby, "the payment was compensation for services rendered by petitioner and, as such, is taxable to him under the assignment of income doctrine." The Tax Court agreed on both counts.

Another instance in which the government raised the assignment-of-income doctrine, but this time eventually lost before the Tax Court, began as a private letter ruling request in 1987.[274] W's marriage was dissolved in a community-property state in December of 981. At that time, the Supreme Court's ruling in *McCarty v. McCarty*[275] was in effect, which held that a military spouse's retirement benefit was that spouse's separate property in community-property states and thus not subject to division as part of the community property. Pursuant to the *McCarty* decision, the divorce decree stated that H's military retirement plan was the separate property of

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[272] 97 T.C. 51 (1991).

[273] *Id.* at 54.

[274] *See* Priv. Ltr. Rul. 8813023 (Dec. 29, 1987).

[275] 453 U.S. 210 (1981).

H. The *McCarty* decision was subsequently overruled by statute in the Uniform Services Former Spouses' Protection Act. W moved to modify the divorce decree to recognize her interest in H's military retirement plan and then agreed to relinquish her claim in exchange for three payments by H: $15,000 in 1986, $14,000 in 1987, and $13,000 in 1988. W requested a ruling that the payments were nontaxable transfers under I.R.C. § 1041 (since they would fail to satisfy the stop-at-death requirement for includable "alimony").

The ruling concluded that, because the interest surrendered by W was a right to future income already earned under the community-property laws, the surrender constituted an impermissible assignment of income by her. The payments from H to W were thus includable in her gross income in the year received, notwithstanding that they failed to qualify as tax "alimony" under I.R.C. § 71. The ruling stated that "[W] cannot escape the taxation of ordinary income by recharacterizing her assignment of the income as a nontaxable transfer of property under section 1041(a) of the Code." The government argued, in essence, that one could never surrender the tax consequences of a community-property interest in deferred compensation. It argued that whatever one received in exchange for the interest was taxable at that time, whether or not the receipt qualified as "alimony."

The taxpayer then went to the Tax Court, which ruled in her favor in *Balding v. Commissioner*[276] in 1992. The Tax Court concluded that the cash payments to W were "property" within the meaning of I.R.C. § 1041, and thus excludable, notwithstanding the argument made by the government that the assignment-of-income doctrine required taxation of the three payments made to W. In a footnote, the Tax Court expressly declined to rule whether W would be taxable under the assignment-of-income doctrine in future years when actual payments were made under the plan to H, but it cited Professor Asimow's article "[f]or an argument that petitioner is not required, under the Assignment of Income Doctrine, to take into income any portion of the retirement benefits ...."[277]

The government's inconsistency in this arena can be explored by examining another private ruling,[278] which also involved a couple who lived in a community-property state and which was issued in 1989, after it issued the ruling that was litigated in *Balding* but before the *Balding* case itself was decided. The couple owned two IRAs: one for the sole benefit of H and one for the sole benefit of W. They executed a written agreement that transmuted the IRAs from community property to separate property, under which W transmuted her community-property interest in H's IRA to the separate property of H, and H transmuted his community-property interest in W's IRA, as well as some additional assets to even up the deal, to the separate property of W. The government concluded that I.R.C. § 1041 applied and prevented the recognition of any gain by either party, even though each received valuable property for their community-property interests in deferred compensation that they each surrendered. The ruling quoted the legislative history underlying I.R.C. § 1041 that emphasized that the section extends

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[276] 98 T.C. 368 (1992).

[277] *Id.* at 373 n.8.

[278] Priv. Ltr. Rul. 8929046 (April 25, 1989).

literally to all transfers between spouses. There was no mention of the assignment-of-income doctrine.

Not only is this ruling inconsistent with the government's position in the prior ruling that led to *Balding*, where it argued that whatever value is received for a surrender of a community-property interest in deferred compensation is taxable, notwithstanding I.R.C. § 1041, it was also inconsistent with the position taken in a yet another ruling issued just the year before in 1988.[279] In that ruling, H proposed to transfer an undivided one-half interest in an IRA to the IRA of his spouse, W. As in the 1989 ruling described above, the transfer was not in contemplation of divorce. No mention was made regarding whether the state in which H and W resided was a community-property state. H requested a ruling that the transfer would not be considered a taxable distribution from his IRA subject to inclusion in H's gross income under I.R.C. § 408(d)(1).

Section 408(d)(6) provides that a transfer of an individual's interest in an IRA to a spouse or former spouse under a divorce or separation instrument is not to be considered a taxable transfer, notwithstanding any other provision, and that the transferred interest is to be considered owned by the transferee. That provision was originally introduced as part of ERISA in 1974, a time when *Davis* made many such transfers taxable. The section was not repealed when I.R.C. § 1041 was introduced in 1984; in fact, a technical correction was made to it in the same act to delete a reference to the obsolete "qualified retirement bonds" repealed by the 1984 act.

The government interpreted I.R.C. § 408(d)(6) as limiting nonrecognition for interspousal transfers of IRAs to the divorce context. It did so by citing the rule of statutory construction that a specific rule (I.R.C. § 408(d)(6)) controls over a general one (I.R.C. § 1041(a)) and by citing the decision by Congress to retain I.R.C. § 408(d)(6) when it enacted I.R.C. § 1041(a) as evidence that Congress intended that I.R.C. § 408(d)(6) nonrecognition be limited to the divorce context. The negative implication, it argued, was that transfers during marriage are not subject to nonrecognition treatment. Thus, the government ruled against H.

How can these two rulings, only a year apart, be reconciled? There are several possibilities: (1) The government changed its position between the two rulings regarding whether nonrecognition can apply to IRA transfers only in divorce; (2) the authors of the two rulings did not communicate;[280] or (3) the government believes that the two situations are substantively different because the one in which it ruled the transfer to be taxable involved the transfer of record title while the one in which it ruled the transfer not to be taxable involved only the surrender of a community-property interest to the record titleholder. That last view is the most troubling, as it reintroduces the distinction between community-property states and states with laws "similar to community property" on the one hand, and other states on the other hand—a distinction that Congress clearly intended to obliterate with the enactment of I.R.C. § 1041—as

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[279] *See* Priv. Ltr. Rul. 8820086 (Feb. 25, 1988).

[280] The author of the 1988 ruling was Allen Katz, chief, Employee Plans, Ruling Branch, while the author of the 1989 ruling was William A. Galanko, assistant chief counsel (Income Tax & Accounting), acting chief, Branch 6.

well as lends an inordinate distinction to whether there is a transfer of record title instead of merely a surrender of an interest in community property. Perhaps more to the point, the government does not always heed that distinction, as we saw in *Balding*, since it argued there that the mere surrender by W of her community-property interest in exchange for cash payments resulted in taxation to W of those cash payments.

The confusion deepens further when we return to reconsider the *Kochansky* decision with this discussion of the impact of community-property law in mind. Recall that *Kochansky* was the case in which the Tax Court and Ninth Circuit held that the lawyer husband's contingent fee in a medical malpractice case, which was pending at the time of the divorce proceedings, was taxable entirely to the husband, even though the divorce decree required that he pay one-half of the fee to his ex-wife when received. As Ms. Sarah Dods noted,[281] the taxpayers in *Kochansky* lived in Idaho, a community-property state, where even earned income is permissibly split by a married couple for tax purposes under *Poe v. Seaborn*.[282] How could Mr. Kochansky possibly be considered to have impermissibly shifted income to his ex-wife that, by definition, would have been required to be included by her under *Poe v. Seaborn*? In *Johnson v. United States*,[283] for example, W had a vested right to one-half of her husband's income under community-property law that was earned prior to their divorce. In the divorce settlement, she assigned her community-property interest in this accrued income to H. When H collected the accrued fees after their divorce, the *Johnson* court held that W was taxable on one-half of them under *Poe v. Seaborn*. The *Kochansky* case is also consistent with the government's own conclusion in the private ruling described earlier, eventually litigated in *Balding*,[284] in which the government argued that any cash received in exchange for relinquishing a community property interest is includable by the recipient, which would be Mrs. Kochansky. So how could *Kochansky* come out differently?

Perhaps the answer lies in the fact that the medical malpractice case generating the fee was not settled until after the divorce, so that the income could be considered as accruing at least partly, if not entirely, after the divorce, which would mean that the earned income was the separate property of the husband, not the community property of the marital unit.[285] Under that scenario, Mr. Kochansky would have to include the full amount, but then the cash payment to Ms. Kochansky should be analyzed under the income-shifting system of I.R.C. §§ 71 and 215, and it was not. If (under current law) the payment obligation would not have disappeared if Ms. Kochansky had died prior to settlement of the suit and payment to her of her portion of the contingent fee, *i.e.*, if we assume that her estate would have had the right to sue for payment if

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[281] *See* Sarah Dods, Note, Kochansky v. Commissioner: *The Assignment of Income Doctrine, Community Property Law, and I.R.C. § 1041*, 72 WASH. L. REV. 873 (1997).

[282] *See supra* notes 259-61 and accompanying text.

[283] 135 F.2d 125 (9th Cir. 1943). *See* Dods, *supra* note 281, at 881.

[284] *See supra* notes 274-77 and accompanying text.

[285] *See* Dods, *supra* note 281, at 880 n.49.

she had predeceased the payment, then the payment would not qualify as alimony under current law. Therefore the cash receipt by Ms. Kochansky would be excludable by her and not deductible by Mr. Kochansky (and thus taxable to him) in any event. But this was not the analysis undertaken by the *Kochansky* court.

In other words, the assignment-of-income doctrine should not have been raised in any event. If, on the one hand, the income was considered earned prior to the divorce, Ms. Kochansky would properly be taxed on her one-half interest under *Poe v. Seaborn* and *Johnson*, since she would have been considered to have earned that one-half under community-property law. If, on the other hand, the income was considered earned after the divorce, so that it was the separate property of Mr. Kochansky, then it would be a plain-vanilla cash payment of post-divorce earnings that should be analyzed under I.R.C. §§ 71 and 215, where income-shifting is clearly permissible and contemplated, so long as the requirements for tax "alimony" are satisfied. Recall that the "labels" applied to such cash payments for state law purposes (whether "alimony" or "property settlement") are irrelevant for purposes of the Federal income tax analysis applicable to such cash payments.

But even if this analysis is correct, this reasoning once again reintroduces the very distinction between community-property states and common-law states that was clearly intended to be obliterated by the 1984 amendments, since the outcome under community-property law if the income is considered as accruing prior to the divorce can be different, under assignment-of-income norms, than under noncommunity-property law. Moreover, it would require, in community-property states, an analysis in situations like that in *Kochansky* of how much of the contingent free was earned prior to the divorce (and thus was community property taxable in part to Mrs. Kochansky) and how much was earned after (and thus would be the separate property of Mr. Kochansky).

> When Congress expressed a desire to make the tax laws "as unintrusive as possible with respect to relations between spouses" [quoting the 1984 legislative history accompanying enactment of I.R.C. § 1041], it had in mind a broad, simple rule under which spouses could easily determine, by the structure of their property settlement, who would bear the latent tax burdens of the marital assets distributed at divorce, regardless of variations in state property law.[286]

Finally, Ms. Dods noted that this Tax Court decision (as well as the Ninth Circuit decision affirming it), accepting the government's argument that the assignment-of-income doctrine trumps I.R.C. § 1041, is inconsistent with other Tax Court decisions, such as *Balding*, rejecting it.[287] She also argued that the doctrine is, in any event, inconsistent with the purposes underlying I.R.C. § 1041. She is right.

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[286] *Id.* at 898.

[287] For example, she described the Tax Court decision in *Schulze v. Commissioner*, 46 T.C.M. (CCH) 143 (1983), in which a couple agreed to split any proceeds resulting from a pending legal claim of the husband. The Tax Court held that the husband was not taxable on the portion of the proceeds received with respect to the claim that were paid to his ex-wife pursuant

The latest foray by the IRS into this morass is found in a field service advice[288] that deals with the transfer of nonqualified stock options in divorce. Although the ruling provided no numbers, let me use some simple ones for illustration. Assume that the corporation for which H works transfers to him, as part of his compensation package, stock options at no charge. Assume further that H is not taxed on the receipt of the options under I.R.C. § 83, because the options do not have a "readily ascertainable fair market value" at that time.[289] H thus would take a zero basis in the options. If H were to exercise the options for a strike price that is less than the fair market value of the stock, he would include, as ordinary compensation income, the spread. For example, if H were able to exercise the options for $100 at a time when the stock had a fair market value of $150, H would include $50 of ordinary compensation income at that time under I.R.C. § 83(a).[290] If H were instead to sell the options for cash in an arm's-length transaction, the difference between H's zero basis in the options and the sales price would produce ordinary compensation income for H, and he would realize no further tax consequences when the option buyer exercised the option.[291] Thus, for example, if H sold the options in an arm's-length transaction for $50 (because the strike price was $100 and the fair market value of the stock was $150), he would similarly include $50 of ordinary compensation income at the time of sale. He would realize no further tax consequences if the buyer were able to exercise the option for $100 at a time when the stock had a fair market value of, say, $175.

What happens if H and W divorce and their divorce decree requires H to transfer these unexercised stock options to W at a time when the strike price is $100 and the fair market value of the stock is $150? In the field service advice, the IRS concluded that H realizes $50 of consideration on the transfer under the *Davis* approach of assuming that the release of marital rights by W has a value to H equal to the value of the options transferred to W. The ruling concludes that the $50 of cash deemed received by H results in $50 of ordinary income to H under I.R.C. § 83 at the time of the transfer. W would take a $50 basis in the options. If she were to exercise the options for $100, she would take a $150 basis in the stock, and H would realize no tax consequences at the time of exercise. In other words, the IRS determined that the same rules that would apply to H if he were to sell the options to an unrelated third party for $50 cash apply when H transfers the options to W pursuant to a divorce decree.

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to the divorce agreement. *See* Dods, *supra* note 281, at 879. *See also id.* at 888-89 (discussing other inconsistent Tax Court opinions).

[288] IRS FSA 200005006 (Feb. 4, 2000), 1999 FSA LEXIS 270.

[289] Few stock options are taxed on receipt, as the standards for determining whether stock options have a "readily ascertainable fair market value" are quite stringent. Options that are not actively traded on an established market are deemed not to have a "readily ascertainable fair market value" on receipt "unless its fair market value can otherwise be measured with reasonable accuracy." Treas. Reg. § 1.83-7(b)(2).

[290] *See* Treas. Reg. § 1.83-7(a).

[291] *See id.*

The IRS rejected the argument that I.R.C. § 1041 prevents this result by once again asserting that the assignment-of-income doctrine trumps I.R.C. § 1041. Moreover, in support of this position, it cited the private letter ruling discussed earlier that concluded that when W surrenders her community-property interest in a pension plan in exchange for cash payments, the cash payments received from H are includable in her gross income, notwithstanding I.R.C. § 1041.[292] The IRS neglected to mention that the taxpayer who requested the ruling and received an unfavorable result then went to the Tax Court, which in *Balding v. Commissioner* agreed with her that the transaction was, indeed, a nontaxable one under I.R.C. § 1041!

> Although private letter rulings may not be cited as precedent, *PLR 8813023*, involving a military pension[,] again illustrates [the] Service position. In this ruling a divorce originally awarded the pension entirely to H because the Supreme Court had held in *McCarty v. McCarty*, 453 U.S. 210 (1981)[,] that military pensions could not be treated as community property. After Congress overruled McCarty, 10 U.S.C. § 1408 (1982), the state enacted a statute providing for the reopening of divorce decrees so that military pensions could be treated as community property. H then purchased W's community property interest in the pension by agreeing to pay her cash in three annual installments. The ruling held that W must include the cash in income at the time she receives it.... [T]he Service declared W [had] in effect assigned to H her right to receive payments over H's lifetime in exchange for payments from H over three years. W could not escape the taxation of ordinary income by recharacterizing her assignment of income as a nontaxable transfer of property under section 1041.[293]

There is simply no mention of the subsequent *Balding* litigation, in which the IRS position was rejected. In other words, the IRS cited, in effect, its litigating position in a case that it lost in support of its conclusion in the field service advice! The IRS also cited another private ruling[294] that it said "contains broad dictum stating that assignment-of-income principles override section 1041."[295]

All of this inconsistency and confusion is completely unwarranted and unnecessary. First, the assignment-of-income doctrine did not grow up in contexts involving statutory nonrecognition rules. Which should control in cases of overlap, if indeed there is considered to be an overlap? In no other nonrecognition context—except I.R.C. § 1041, and even there we've seen that the record is quite inconsistent—has the assignment-of-income doctrine been held to trump a specific nonrecognition rule created by Congress. The argument has been raised in at least one other nonrecognition context, but the Third Circuit held that the nonrecognition rule should take precedence.

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[292] *See supra* notes 274-77 and accompanying text.

[293] IRS FSA 200005006 (Feb. 4, 2000), 1999 FSA LEXIS 270.

[294] Priv. Ltr. Rul. 8842072 (July 29, 1988) (cited *infra* note 314).

[295] IRS FSA 200005006 (Feb. 4, 2000), 1999 FSA LEXIS 270.

In *Hempt Brothers, Inc. v. United States*,[296] a partnership using the cash method of accounting transferred all of its business assets, including its accounts receivables and payables, to a newly formed corporation in exchange for all of its stock. Each of the requirements of I.R.C. § 351 were satisfied on the transfer, which meant that none of the built-in gain or loss in the transferred assets, including the difference between the fair market value of the receivables and their zero basis, was recognized on the transfer. The issue was whether, notwithstanding the nonrecognition rule in I.R.C. § 351, the partnership should be taxed on the ordinary income collected by the corporation with respect to the transferred accounts receivables under the assignment-of-income doctrine. The Third Circuit rejected that argument, concluding that the policies underlying the nonrecognition rule in I.R.C. § 351 would be frustrated if the assignment-of-income doctrine were applied.

If the assignment-of-income doctrine is thought to be inconsistent with the nonrecognition rule in I.R.C. § 351, it should surely be held to be inconsistent with the nonrecognition rule in I.R.C. § 1041, since Congress evidenced an intent that the nonrecognition rule in the latter have even greater depth than thought appropriate in other nonrecognition contexts. In transfers under I.R.C. § 351, for example, the nonrecognition rule does not apply to the extent that the property that is transferred is subject to a debt in excess of the property's basis or was encumbered with debt on the eve of the transfer in an attempt to cash out the property's value while shifting the obligation to repay the loan to the transferee.[297] The 1984 House Report accompanying enactment of I.R.C. § 1041 explicitly recognized that such exceptions should *not* apply in the context of transfers under I.R.C. § 1041. "This nonrecognition rule applies whether the transfer is for the relinquishment of marital rights, for cash or other property, for the assumption of liabilities in excess of basis, or for other consideration and is intended to apply to any indebtedness which is discharged."[298] This intent shows the depth of this nonrecognition provision compared even to other nonrecognition provisions.

Second, the assignment-of-income doctrine is an anti-avoidance tool to ferret out and prevent inappropriate "income-shifting," but income-shifting that would be considered a mortal sin elsewhere in the tax realm simply should not be considered improper in the context of divorce, for the reasons elaborated upon throughout this article, and specifically should not be considered improper under I.R.C. § 1041. The couple is no longer a unit, where the person who earned the services income or owned the property that accrued investment income can retain effective control and enjoyment of the income while having it taxed at a lower rate. There won't even be a revenue loss unless the person who receives and enjoys the income is in a lower bracket than the transferor. But, most important, I.R.C. § 1041 (as well as I.R.C. §§ 71 and 215, for that matter) contemplates and condones income-shifting on its face. It was the *Davis* rule,

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[296] 490 F.2d 1172 (3d Cir. 1974).

[297] *See* I.R.C. § 357(b), (c).

[298] H.R. REP. NO. 98-432 at 1492 (1984). *Cf.* Treas. Reg. § 1.1031(d)-2 (providing that the excess of liability relief over liability assumed in a like-kind exchange of property otherwise qualifying for nonrecognition under I.R.C. § 1031 will be considered "boot" that triggers gain recognition).

under which built-in gain that accrued prior to the divorce had to be recognized by the property transferor rather than being shifted to the transferee, that prevented shifting. Under the nonrecognition rule of I.R.C. § 1041, in contrast, any built-in gain that accrued prior to the transfer is not recognized by the transferor but rather shifted to the transferee, to be recognized by her when realized. The shifting of ordinary income accompanying property in this context is not different in kind from the shifting of built-in gain. Indeed, the shifting of ordinary income *not* accompanying property is clearly contemplated and condoned in I.R.C. §§ 71 and 215, and there can be no logical reason to impose a different rule with respect to an ordinary income interest accompanying a property interest—*especially* since any built-in gain or loss in the property itself is explicitly shifted to the transferee under I.R.C. § 1041. In short, the assignment-of-income doctrine should be viewed as being fundamentally inconsistent with I.R.C. § 1041, not trumping it. Certainty should attach to the form the parties negotiate between themselves, a form that they understandably believe will dictate the tax consequences. Therefore, I recommend that a new Treasury Regulation ought to be issued to confirm that the assignment-of-income doctrine does not trump I.R.C. § 1041.

Would such a new Treasury Regulation be invalid as inconsistent with Congressional intent, as evidenced by the enactment of the QDRO option in one context in which the assignment-of-income doctrine has otherwise been raised, as evidenced in *Darby*?[299] In other words, do the QDRO amendments carry with them the negative implication that the assignment-of-income doctrine continues to apply as the background rule in divorce, since it was overturned only in the context of a QDRO in connection with qualified plan assignments?

This problem of the "negative implication" in statutory interpretation is a common one. When Congress amends the law in one specific context, many argue that Congress must have intended just the opposite rule with respect to all other contexts not covered by the legislation. Might it not be just as reasonable, however, to argue that such shifting *was* permissible in other contexts prior to the adoption of the statutory mechanism and that Congress had to merely clarify the mechanism by which the shifting was to occur in the context of qualified pension plans because of the specific statutory language at issue defining the "distributee"? This argument is particularly persuasive because the QDRO involves *only* qualified pension plans, which were subject to anti-alienation rules imposed by ERISA in 1974—the so-called spendthrift provisions—that prevented plan participants from assigning away their interests in the plan to other parties, as Mr. Darby attempted to do. This handicap does not apply to other kinds of income assignments, so Congress did not need to clear away any obstacles in any other context—only in the context of qualified plan assignments. To accomplish the income-shifting in the qualified plan context that arguably was already permissible in other contexts under I.R.C. § 1041, Congress *had* to amend the law in order to provide that alienation in divorce was permissible, notwithstanding the ERISA spendthrift provisions, and that the transferee should be provided all of the protections provided to the original plan participant. This seemed to be the primary purpose of the QDRO legislation, as indicated by its legislative history.

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[299] *See supra* notes 272-73 and accompanying text.

IN GENERAL

The bill clarifies the spendthrift provisions by providing new rules for the treatment of certain domestic relations orders. In addition, the bill creates an exception to the ERISA preemption provisions with respect to these orders. The bill also provides procedures to be followed by a plan administrator (including the Pension Benefit Guaranty Corporation (PBGC)) and an alternate payee (a child, spouse, former spouse, or other dependent of a participant) with respect to domestic relations orders.

Under the bill, if a domestic relations order requires the distribution of all or a part of a participant's plan benefits under a qualified plan to an alternate payee, then the creation, recognition, or assignment of the alternate payee's right to the benefits is not considered an assignment or alienation of benefits under the plan if and only if the order is a qualified domestic relations order....

PRESENT LAW

Generally, under present law, benefits under a pension, profit-sharing, or stock bonus plan (pension plan) are subject to prohibitions against assignment or alienation (spendthrift provisions).... A plan that does not include these required spendthrift provisions is not a qualified plan under the Code, and State law permitting such an assignment or alienation is generally preempted by ERISA.

Several cases have arisen in which courts have been required to determine whether the ERISA preemption and spendthrift provisions apply to family support obligations (e.g., alimony, separate maintenance, and child support obligations). In some of these cases, the courts have held that ERISA was not intended to preempt State domestic relations law permitting the attachment of vested benefits for the purpose of meeting these obligations. Some courts have held that the ERISA preemption provision does not prevent application of State law permitting attachment of nonvested benefits for the purpose of meeting family support obligations. There is a divergence of opinion among the courts as to whether ERISA preempts State community property laws insofar as they relate to the rights of a married couple to benefits under a pension, etc., plan.

The IRS has rules that the spendthrift provisions are not violated when a plan trustee complies with a court order requiring the distribution of benefits of a participant in pay status to the participant's spouse or children in order to meet the participant's alimony or child support obligations. The IRS has not taken any position with respect to this issue in cases in which the participant's benefits are not in pay status.

REASONS FOR CHANGE

The committee believes that the spendthrift rules should be clarified by creating a limited exception that permits benefits under a pension, etc., plan to be divided under certain circumstances. In order to provide rational rules for plan

administrators, the committee believes it is necessary to establish guidelines for determining whether the exception to the spendthrift rules applies. In addition, the committee believes that conforming changes to the ERISA preemption provision are necessary to ensure that only those orders that are excepted from the spendthrift provisions are not preempted by ERISA.[300]

This legislative history makes it clear that the reason why Congress had to act was because the plans involved were qualified pension plans subject to ERISA's spendthrift and preemption provisions. The amendments were necessary in order to carve out assignments in divorce from the *statutory* restrictions that otherwise prohibited such assignments. In other words, the *statute itself*, not the assignment-of-income doctrine, prevented the transferees from gaining a property interest in the transferor's qualified pension plan interest, since the statute defined the "distributee" who must include qualified plan distributions in gross income to be the service provider who earned the income. In short, the statutory amendments creating the QDRO (so that the Mr. Darbys of the world can now avoid taxation on qualified plan distributions to their ex-spouses under a QDRO) do not mean that the assignment-of-income doctrine otherwise should be considered to trump I.R.C. § 1041 in contexts not involving qualified pension plans. If anything, the QDRO legislation implies that Congress felt it necessary to act to bring assignments of qualified plan interests into conformity with assignments of other kinds of accrued income interests that presumably succeeded in shifting the tax obligation to the transferee under I.R.C. § 1041.

In short, I believe that Treasury has the power to issue the regulation proposed below even without any statutory amendment to I.R.C. § 1041. All it takes is the political will. Nevertheless, I recommend that Congress enact new I.R.C. § 1041(f) to provide that "the assignment-of-income doctrine developed at common law shall not apply to transfers of income rights incident to divorce" in order to ensure that Treasury issues the required guidance. I want to make clear, however, that statutory amendment is not, in my view, a necessary prerequisite for issuance of the proposed regulation.

The regulation might look something like this:

§ 1.1041-x. **The Assignment-of-Income Doctrine and Section 1041.**—(a) *In General.* The assignment-of-income doctrine developed at common law by the courts, which generally provides that compensation income is taxed to the service provider, and that property income is taxed to the property owner, even if the rights to receive the services or property income is assigned to another, shall not apply to transfers of such income rights incident to divorce. The assignment-of-

[300] S. REP. NO. 98-575, at 18-19, *reprinted in* 1984-2 C.B. 447, 456.

income doctrine can apply to transfers between spouses that are not incident to divorce, unaffected by section 1041.[301]
(b) *Examples*. The following examples illustrate this paragraph.

Example 1. H is a lawyer who uses the cash method of accounting and who is owed $50,000 under a contingent-fee contract for services already rendered. H and W divorce, and their divorce settlement requires that one-half of any money recovered under H's contingent-fee contract be paid to W. H receives the $50,000 owed to him under the contract and pays $25,000 to W. The assignment-of-income doctrine does not require that H must include the entire $50,000 in gross income. H must include $25,000 in gross income, and W must include $25,000 in gross income.

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[301] The assignment-of-income doctrine should continue to apply to transfers between spouses who are not in the process of divorce but who nevertheless file separate tax returns under I.R.C. § 1(d). The proposed regulation assumes that I.R.C. § 1041 will continue to apply both to transfers during marriage as well as transfers incident to divorce. An equally justifiable approach, however, would be to amend I.R.C. § 1041 to repeal its applicability to transfers during marriage that are not incident to divorce. If that were done, this second sentence of the proposed regulation would not be necessary.

Amending I.R.C. § 1041 in this manner would make sense for two reasons. First, nonrecognition of gain is not justifiable in the case of sales for valuable consideration. For example, assume that John owns a business that supplies other businesses with office supplies. Mary, his wife, opens a new business as a sole proprietor and purchases office supplies from her husband's business. There is no good reason why John's gain on the sale of office supplies to Mary should garner nonrecognition treatment, but it does under current I.R.C. § 1041. Spouses attempting to recognize built-in losses without selling the property to a third party, but rather to each other, would be prevented from doing so by I.R.C. § 267. Second, other transfers between spouses, *i.e.*, gifts, do not need I.R.C. § 1041 to garner nonrecognition treatment, since gifts are not generally realization events. Indeed, having I.R.C. § 1041 apply to transfers that are gifts injects a discontinuity between spousal gifts and gifts among others, since the basis rules are different if the gifted property has a built-in loss. Under I.R.C. § 1041, the transferee spouse takes a carryover basis in all cases, even when the gifted property has a built-in loss at the time of the gift. Gifts of loss property between others, in contrast, are saddled with the basis rule in I.R.C. § 1015(a), which provides that the transferee, for purposes of calculating later gain or loss on a transfer of the gifted property, uses the lower of carryover basis or the fair market value at the time of the gift. This lower-of-basis-or-value rule prevents the shifting of built-in losses to someone (presumably a family member) who is in a higher tax bracket and can thus enjoy more value from the loss deduction. Allowing spouses to take a carryover basis in all cases, even with loss property, allows just such a shifting for spouses who file separate returns. It thus would make sense to consider amending I.R.C. § 1041 so that it applies only to transfers incident to divorce. *See* Gabinet, *supra* note 77, at 43-46. This paper does not press that issue only because its focus is on simplifying the tax consequences of transfers in divorce.

Example 2. W, who uses the cash method of accounting, enters into a nonqualified deferred compensation arrangement with her employer, such as a so-called rabbi trust arrangement. At the time of her divorce with H, $50,000 of compensation income has been earned under the arrangement but has not yet been received by or included by W in her gross income. Under the terms of the divorce decree, W must pay one-half of the compensation accrued at the time of the divorce, or $25,000, to H when her right to distribution under the arrangement ripens. Several years later, W receives $100,000 under the terms of the rabbi trust and pays $25,000 to H. The assignment-of-income doctrine does not require that W must include the entire $100,000 in gross income. W must include $75,000 in gross income, and H must include $25,000 in gross income. *See* section 414(p) regarding assignments of interests in qualified plans.

Example 3. W, who uses the cash method of accounting, enters into a nonqualified deferred compensation arrangement with her employer, such as a so-called rabbi trust arrangement. At the time of her divorce with H, $50,000 of compensation income has been earned under the arrangement but has not yet been received by or included by W in her gross income. Under the community-property laws in the state in which H and W live, H would have a right to one-half of the compensation accrued at the time of their divorce, or $25,000, when the money is distributed to W several years later. Under the terms of their divorce decree, W pays H $10,000 immediately at the time of the divorce in exchange for his agreement to forego his rights under state law to collect in the future any amount with respect to W's deferred compensation arrangement. The assignment-of-income doctrine does not require that H include the $10,000 received in gross income. Rather, H's $10,000 receipt will be analyzed under sections 71 and 215.

Example 4. H receives from his employer nonqualified stock options that do not have a readily ascertainable fair market value and thus are not includable in his gross income as compensation at the time of receipt. Under the terms of their divorce decree, H transfers these options to W at a time when the strike price is $100 and the fair market value of the stock is $150. Neither the assignment-of-income doctrine nor section 83 requires that H must include $50 in his gross income at the time of the transfer. W takes a zero basis in the options. If W exercises the options for $100 at a time when the fair market value of the stock is $150, W must recognize $50 of ordinary income under § 83, H realizes no tax consequences, and W takes a $150 basis in the stock.

B. Divorce Redemptions of Stock in Closely Held Corporations

The issue of how to treat redemptions of stock in closely held corporations that occur pursuant to the terms of a divorce settlement or decree has given courts some pause since the enactment of I.R.C. § 1041.[302] To put the issue in perspective, I shall first describe the normal

[302] *See, e.g.*, Craven v. U.S., 2000-2 U.S.T.C. (CCH) ¶ 50,541 (11th Cir. 2000); Arnes v. U.S., 981 F.2d 456 (9th Cir. 1992); Read v. Comm'r, 114 T.C. 14 (2000); Arnes v. Comm'r, 102 T.C. 522 (1994); Blatt v. Comm'r, 102 T.C. 77 (1994); Hayes v. Comm'r, 101 T.C. 593 (1993).

"background rules" that dictate the tax treatment of stock redemptions in closely held corporations *outside* the divorce context. I'll then turn to the issue within the context of divorce.

Assume, for example, that Ann and John, who are siblings, each own 50% of the stock in a corporation through which they operate the family business begun by their father and handed down to them. Further assume that the corporation has $50,000 in cash as well as $50,000 in operating assets when Ann retires, and the corporation redeems Ann's stock (which has a basis to her of $10,000) by distributing to her the $50,000 in cash in exchange for all of her stock in the corporation. The redemption leaves sole ownership of the corporation, now worth $50,000 (instead of $100,000) in John's hands. Thus, while his ownership interest increases from 50% to 100% because of the redemption, the value of his interest remains unchanged at $50,000, since prior to the redemption he owned 50% of the stock of a corporation worth $100,000, and after the redemption he owns 100% of the stock of a corporation worth $50,000.

While the sale of appreciated stock held by nondealers normally triggers capital gain (after the tax-free recovery of basis), Congress enacted I.R.C. § 302 in order to ensure that this treatment will apply when shareholders sell their stock back to the corporation itself *only* if the sale sufficiently resembles a sale to a third party and is not a ruse to extract earnings from the corporation without dividend treatment. If a redemption results in little or no diminution in the redeemed shareholder's interest in the corporation, then the transaction will not be respected as a sale but rather will be treated as the distribution of a cash dividend—ordinary income to the recipient with no tax-free basis recovery.[303]

Since Ann is completely redeemed in our hypothetical, she has clearly reduced her interest in the corporation, and thus her sale will be respected as a true sale rather than a disguised dividend distribution.[304] She thus will realize a $40,000 capital gain ($50,000 amount realized less her $10,000 stock basis).

John might also realize tax consequences on Ann's redemption. Even though the value of his economic interest in the corporation remains unchanged before and after the redemption, he would nevertheless be treated as realizing a dividend of $50,000 if John had actually had the "primary and unconditional obligation" to purchase Ann's stock upon her retirement, and the corporation satisfied that obligation in John's stead.[305] The transaction would be treated, in that case, as if John had received a $50,000 cash distribution (a dividend[306] to him), which he then used to purchase Ann's stock interest (resulting in $40,000 of capital gain for her, as before). If

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[303] *See* I.R.C. § 302(d).

[304] *See* I.R.C. § 302(b)(3), (a). While I.R.C. § 302(c) provides that the attribution rules of I.R.C. § 318 apply in determining the extent to which a shareholder's interest has actually decreased, the family attribution rules do not operate to attribute John's stock to Ann. *See* I.R.C. § 318(a)(1) (failing to mention sibling attribution).

[305] *See, e.g.*, Rev. Rul. 69-608, 1969-2 C.B. 43.

[306] I am assuming, of course, that the corporation has sufficient earnings and profits so that the entire cash distribution qualifies as a dividend. *See* I.R.C. §§ 301(a) & (c), 316.

John did *not* have the primary and unconditional obligation to purchase Ann's interest, then he would realize no tax consequences on Ann's stock redemption. Notice that Ann's treatment is not affected by John's tax treatment. She realizes $40,000 of capital gain, whether she is deemed to transfer the stock to the corporation or to John.

John's tax treatment, revolving around whether he had the "primary and unconditional obligation" to purchase Ann's stock at the time of the redemption, was developed in a series of litigated cases[307] that resulted in the issuance of Revenue Ruling 69-608, which summarized them and provided guidance regarding the tax consequences of common buyback agreements among shareholders when a closely held corporation redeems stock. The ruling makes clear that form will govern in this context. If, for example, John and Ann had entered into an agreement under which either would purchase the stock of the other upon the other's death or retirement, and that agreement remained outstanding at the time of Ann's retirement and redemption of her stock by the corporation, then John would realize a dividend.[308] If, in contrast, John and Ann had amended such an agreement prior to her retirement to provide that the corporation would assume the obligation to redeem her stock upon her retirement, then John would avoid dividend treatment, so long as the amendment did, indeed, occur prior to Ann's retirement (when John's obligation would have ripened).[309] If the buyback agreement between John and Ann had provided that the corporation would have the primary obligation to redeem the stock interest of each upon death or retirement, with a secondary obligation imposed on the remaining shareholder to purchase the stock if the corporation is unable to fulfill its obligation, then John would avoid dividend treatment, since his obligation would not be "primary" but only "secondary."[310] Because form controls in this context, the parties are given absolute power to determine what the tax consequences will be through their choice of form.

It's not my purpose to analyze whether this form-sensitive approach makes sense as the general background rule. Rather, my job is to note that it has been well accepted for more than three decades and then to consider how it ought to affect the tax treatment of redemptions in divorce.

Now assume the same facts as above, except that Ann and John are married, and Ann's 50% stock interest in the corporation is required to be redeemed for $50,000 in their divorce agreement. Suppose instead that the divorce decree actually required *John*, not the corporation, to purchase Ann's stock, but the corporation nevertheless redeems the stock. How should Ann and John be treated for tax purposes in these situations?

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[307] *See, e.g.*, Sullivan v. U.S., 363 F.2d 724 (8th Cir. 1966); Holsey v. Comm'r, 258 F.2d 865 (3d Cir. 1958); Wall v. U.S., 164 F.2d 462 (4th Cir. 1947); S.K. Ames, Inc. v. Comm'r, 46 B.T.A. 1020 (1942), *acq.*, 1942-1 C.B. 1; Kobacker v. Comm'r, 37 T.C. 882 (1962), *acq.*, 1964-2 C.B. 6.

[308] *See* Rev. Rul. 69-608, *supra* note 305, Situations 1 & 2.

[309] *See id.*, Situations 6 & 7.

[310] *See id.*, Situation 5.

There are two possibilities. Ann's stock transfer could be respected as a direct transfer to the corporation. Under this view, Ann would realize a $40,000 capital gain when she receives the $50,000 cash, and John would have no tax consequences. In the second situation, in particular, however, John may be considered to have had the "primary and unconditional obligation" to purchase Ann's stock but instead caused the corporation to redeem it. Should we deem the $50,000 cash to have gone first to John (dividend to John), which John used to purchase Ann's stock, as we do outside the divorce context? Or, to put the steps in a different order (though it makes no difference in end result), should we deem Ann to have transferred to John her stock since he was, in fact, required to purchase it, which was then redeemed (dividend to John[311]), followed by the payment by John to Ann of the redemption proceeds? Ann's deemed transfer to John in that case would be nontaxable under I.R.C. § 1041. This would be the one big difference in tax consequences, as compared to the same transaction occurring outside the divorce context, where Ann would realize capital gain in any event (either on the transfer to the corporation or on the transfer to her fellow shareholder), since no nonrecognition provision would be available for the redeemed shareholder outside the divorce context.[312]

Is that the proper approach? Would it make sense to deviate from the current practice outside the divorce context (*i.e.*, essentially allowing the parties to designate to whom the corporate distribution should be taxed by their choice of form) if the redemption happens to occur pursuant to divorce? Might not the divorce context actually provide the more persuasive context for maximum flexibility for the parties to decide to whom the distribution should be taxed? Before addressing these questions, consider another possibility.

Another common fact pattern in divorce is that only one spouse, say John, actually owns 100% of the couple's interest in the corporation, but Ann is entitled to a $50,000 cash payment representing her marital property interest in the stock. In the simplest case, John can pay Ann cash directly from other resources, and the tax consequences of that cash payment would be analyzed under I.R.C. § 71, described in Part II. But suppose John has his wholly owned corporation redeem one-half of his stock for $50,000, which he then transfers to Ann? Because the redemption would not reduce his percentage interest in the corporation (since John would own 100% both before and after the redemption), John would be treated as receiving a $50,000 dividend.[313] The cash transfer to Ann would again be analyzed under I.R.C. § 71.

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[311] *See* U.S. v. Davis, 397 U.S. 301 (1970) (holding that when one person owns 100% of the stock of a corporation, actually or constructively, any redemption distribution is taxable as dividend unless the transaction qualifies as a partial liquidation under I.R.C. § 302(e)).

[312] Ann's receipt of the cash, which would then be deemed to come from John instead of the corporation, would be tax-free to her as well as "not alimony" (under current law, at least), except in the extremely unlikely event that her estate's right to receive the cash would disappear if Ann died prior to receipt. Under the proposals advanced in Part II, John and Ann could decide whether the cash transfer from John to Ann would be includable/deductible or excludable/nondeductible.

[313] *See Davis*, *supra* note 311.

Finally, suppose that John actually transfers 50% of his stock (with a $10,000 basis) to Ann under the divorce decree, which then requires that the corporation redeem Ann's 50% interest for $50,000. If the form of the transaction were respected, *i.e.*, if Ann's perhaps momentary ownership of the shares were respected, then John's transfer of stock would be a nonrecognition event under I.R.C. § 1041(a). Ann would exclude the value of the stock under I.R.C. § 1041(b)(1), take John's basis in the stock under I.R.C. § 1041(b)(2), and realize and recognize $40,000 of capital gain on the redemption.

The government's ruling as well as litigating position in these contexts is that form governs the tax consequences. The government argues that actual transfers of stock between the spouses should succeed in shifting the tax consequences when the stock is transferred to the third party (the corporation), even if the stock so transferred is held for only a moment before redemption.[314] Moreover, it argues that a direct redemption of stock without an actual transfer between the spouses should also be respected as a direct redemption, with no implicit transfer between spouses prior to the redemption, absent facts ensuring that the nonredeemed spouse knew of and directed such a deemed stock transfer prior to the redemption.[315] This approach not only happens to accord with the law that applies outside the divorce context in the case of such stock redemptions but is also clearly consistent with I.R.C. § 1041 itself.

For example, in one private ruling,[316] H owned 90% of the stock in a family corporation. (The remaining stock was owned by H's brother and son.) The corporation's bylaws and articles of incorporation required shareholders to offer to sell stock to the corporation and fellow shareholders before a sale of stock to a third party. Pursuant to a divorce decree, H made an actual transfer of stock (amounting to 39% of the outstanding stock of the corporation) to W without first offering it to the corporation or other shareholders. The stock was then immediately redeemed under the terms of the divorce decree, *i.e.*, W held it only momentarily. The corporation issued a promissory note to W in payment for the stock, guaranteed by H. The ruling reasoned that, *absent* I.R.C. § 1041(a), this transaction would be viewed as a redemption of stock owned by H, followed by a transfer of the note from H to W, who would be considered a mere conduit. The ruling concluded, however, that the transfer to W should be respected for tax purposes, shifting the tax burden of the redemption to W, because I.R.C. § 1041 was intended by Congress to allow the parties to decide who between themselves should be taxed on the built-in gain in property, including stock, when it is transferred outside the marital unit.

The spouses are thus free to negotiate between themselves whether the "owner" spouse will first sell the asset, recognize the gain or loss, and then transfer to the transferee spouse the

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[314] *See, e.g.*, Priv. Ltr. Rul. 9046004 (July 20, 1990); Priv. Ltr. Rul. 8842072 (July 29, 1988).

[315] *See infra* notes 321-22 and accompanying text (describing the government's litigating position in *Arnes*).

[316] *See* Priv. Ltr. Rul. 9046004 (July 20, 1990).

proceeds from that sale, or whether the owner spouse will first transfer the asset to the transferee spouse who will then recognize gain or loss upon its subsequent sale.[317]

That argument is persuasive. In light of the actual stock transfer from H to W, the parties agreed that W should be the one between the two of them to dispose of the stock outside of the marital unit, with the tax consequences of that disposal falling on her, and they structured the transaction, accordingly. We should assume that the amount of stock transferred, as well as other terms of the divorce decree, took into account that the tax liability accompanying the built-in gain should be W's responsibility, and to rule otherwise would upset the economic terms of their settlement. To have the negotiated arrangement disrupted with a "substance-over-form" argument undermines one of the animating purposes behind I.R.C. § 1041—that the parties be given the power to decide between themselves who should carry the tax consequences regarding property dispositions—and radically changes, after the fact, the nature of the "deal" made by the parties.

But the government's position as reflected in Temporary Regulations is arguably more ambiguous and has resulted in some courts, when implored to do so by one of the divorcing spouses, deciding that form will *not* be respected, undermining both the government's litigating position and the certainty of the law for divorcing taxpayers. In its entirety, Treasury Regulations § 1.1041-1T(c), Q&A 9, provides:

> (c) *Transfers on behalf of a spouse.*
>
> Q-9. May transfers of property to third parties on behalf of a spouse (or former spouse) qualify under section 1041?
>
> A-9. Yes. There are three situations in which a transfer of property to a third party on behalf of a spouse (or former spouse) will qualify under section 1041, provided all other requirements of the section are satisfied. The first situation is where the transfer to the third party is required by a divorce or separation instrument. The second situation is where the transfer to the third party is pursuant to the written request of the other spouse (or former spouse). The third situation is where the transferor receives from the other spouse (or former spouse) a written consent or ratification of the transfer to the third party. Such consent or ratification must state that the parties intend the transfer to be treated as a transfer to the nontransferring spouse (or former spouse) subject to the rules of section 1041 and must be received by the transferor prior to the date of filing of the transferor's first return of tax for the taxable year in which the transfer was made. In the three situations described above, the transferor of property will be treated as made directly to the nontransferring spouse (or former spouse) and the nontransferring spouse will be treated as immediately transferring the property to third party. The deemed transfer from the nontransferring spouse (or former spouse) to the third party is not a transaction that qualifies for nonrecognition of gain under section 1041.

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[317] *Id.*

Focus for a moment on the "third situation" described above, which refers to a consent or ratification explicitly mentioning I.R.C. § 1041 and explicitly stating that the property transferred directly from one spouse to a third party outside the marital unit should be considered first as going to the nontransferring spouse (before going to the third party). This rule has a built-in safeguard to ensure that the parties understand the consequences of their agreement. An example of situation three would be one in which John transfers property directly to Bill only after receiving a consent signed by Ann that explicitly says that she should be considered as having received the property first under I.R.C. § 1041 and then transferring the property to Bill directly. In light of their explicit agreement, Ann should have little cause to complain when any built-in gain in the property that is realized on the transfer to Bill is held to be her tax responsibility. This portion of the regulation has prompted no litigation—for good reason, I think. The parties have necessarily had a meeting of the minds regarding whom should be taxed, and thus there is no room for each to point at the other party later and claim that the other is responsible for the tax liability arising on the transfer to the third party. I believe that this is a good rule that should be continued in any revamped version of this regulation, though I would add that this meeting of the minds could be evidenced by a provision in the divorce agreement itself that the property should be considered transferred by John, rather than Mary, to the third party.

Why doesn't John simply go ahead and transfer the property to Ann first, to ensure that there can be no misunderstanding, as in the ruling described earlier?[318] One reason might be cost. Transferring title for state law purposes, even if it involves no more than drawing up an agreement, costs time and usually at least some money. It might actually cost quite a bit of money if the property at issue is real estate and the state in which John and Ann live imposes a real estate transfer tax. Transferring title twice (once from John to Ann and then again from Ann to Bill) can be much more expensive than a single transfer from John to Bill (on behalf of Ann). This portion of the regulation therefore can be seen as consistent with the overall goal of allowing the parties to decide for themselves who should be responsible for the tax consequences of built-in gain (as well as built-in loss) when property leaves the marital unit (Ann, in this case), while at the same time allowing the parties to reduce the costs that might attend an explicit transfer to Ann that would ensure that result. Situation three, in other words, explicitly provides the parties with the flexibility to *knowingly* shift the tax responsibility to Ann without having to incur the burden of, say, two real estate transfer taxes.

But now focus on the regulation language describing the "first situation." It seems to provide that *any* transfer of property from one of the spouses to a third party outside the marital unit should be considered instead to a be a transfer first to the other spouse, and then a transfer from that spouse to the third party, so long as "the transfer to the third party is required by a divorce or separation instrument." Notice that it does not provide that the divorce decree stipulate that the transfer should be considered as made first to the other spouse under I.R.C. § 1041 before leaving the marital unit. It says only that the transfer outside the marital unit *itself* must be required in the divorce decree. That potentially includes every single property transfer

[318] *See supra* notes 316-17 and accompanying text.

(including, but not limited to, stock redemptions[319]) required to be made to a third party outside the marital unit by a divorce decree. In other words, it appears to say that every time a divorce decree requires a transfer of property to someone outside the marital unit, such as with a stock redemption, the property should be considered as going to the other spouse first as a matter of course, shifting the tax consequences of the disposition to the other spouse in every case, regardless of the intention of the parties. Unlike in situation three, where the parties must clearly indicate their intent that a transfer between the spouses be deemed to occur, this rigid reading of the language describing situation one implies that property (and its attendant tax liabilities) should be deemed to have been shifted between spouses prior to the taxable transfer outside the marital unit when the spouses themselves did not knowingly intend that result. If this is the right way to read that language, it is a *huge* trap for the unwary. (It also, it seems to me, makes situations two and three entirely redundant. If *every single transfer* made to an outside party under a divorce instrument is deemed to be first transferred to the other spouse, it seems to me that there could be no situation where the consent of the other party would be necessary to shift the tax liability.)

Such a reading is inconsistent with the government's litigating and ruling position that I.R.C. § 1041 allows the parties to decide for themselves who, between them, should be responsible for the built-in gain or loss with respect to property transferred outside the marital unit. It also is inconsistent with the overall flavor of Q&A 9 itself, taken as a whole, which seems intended primarily to provide some flexibility to the parties to have a direct transfer outside the marital unit be considered as first going to the other spouse and then outside the marital unit without incurring the associated costs attending an actual transfer to the other spouse. As stated by the government in a private ruling, "Q&A 9 is based on the premise that the transferee spouse [Ann, in our John-directly-to-Bill transfer posed above], *by directing that the property be transferred to a third party*, has exercised sufficient ownership over the property to be considered a transferee for purposes of section 1041 of the Code."[320] Ann's direction is assumed to be present. Such an assumption is not warranted, however, simply because the transfer is required to be made by the divorce decree, with no showing that the transfer is *actually* made on Ann's behalf, as would occur with the documentation described in situation three.

In other words, the overall flavor of Q&A 9 is pro-taxpayer, to provide the divorcing parties with the flexibility to achieve their desired ends through more efficient means. Situation three clearly assumes that the deemed transfer will be a *knowing* one, *i.e.*, that the spouse who is deemed to have received the property from the other spouse (and thereafter transferred it outside the marital unit) *directed* the transfer to the third party on her behalf. A rigid reading of the language describing situation one, to the effect that *any* transfer to a third party under a divorce decree first involves a deemed transfer to the other spouse, lifts those words out of context and imbues them with a meaning that does not sit well within the larger framework. But that reading

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[319] *See, e.g.*, Berger v. Comm'r, 71 T.C.M. (CCH) 2160 (1996) (discussing these issues within the context of a transfer of an unincorporated cemetery business directly from one spouse to a third party outside the marital unit, as required by a divorce decree).

[320] Priv. Ltr. Rul. 9046004 (July 20, 1990).

has nevertheless essentially been seized upon by some courts. At the least, the language has caused confusion.

In *Arnes v. United States*,[321] for example, Joann and John Arnes each owned one-half of the stock of Moriah, a corporation formed to operate a McDonald's franchise. The couple agreed to divorce in 1987, and the settlement agreement required that Joann's stock be redeemed for $450,000, since McDonald's informed John Arnes that it required 100% ownership of the equity and profits to be owned by the owner/operator and that their joint ownership must terminate on the divorce. Joann surrendered her 2,500 shares to the corporation in exchange for cash and other consideration, and the corporation shortly thereafter issued an additional 2,500 shares to John.

The divorce settlement agreement did not state that Joann's stock, which she transferred directly to the corporation, should first be viewed as going to John under I.R.C. § 1041. The decree required only that the redemption take place, period, so that Joann would no longer be involved with the corporation, pursuant to McDonald's franchise requirements. Joann nevertheless took the position, first at the District Court level and then before the Ninth Circuit, that she should be considered to have first transferred the stock to John, which was then redeemed by the corporation, because she argued that the redemption was made "on behalf of" John within the meaning of Treasury Regulations § 1.1041-1T(c), Q&A 9.

In other words, Joann seized upon the inartful language in the regulation to argue that John should shoulder the tax consequences of the redemption (even though Joann received the cash)—*regardless* of whether there was a meeting of the minds that Joann should be deemed to have transferred the stock to John before the redemption occurred. Joann, in short, used the regulation offensively as a tool, as though the regulation were intended to encapsulate a normative decision that John ought to be taxed in these situations (regardless of what the parties intended) rather than merely to provide flexibility to parties to agree between themselves to shift the tax burden of the transfer to the other spouse without having to undertake an actual property transfer to the other spouse first.

Under this approach, Joann's deemed stock transfer to John would be considered a tax-free transfer to Joann under I.R.C. § 1041. Joann's actual receipt of the cash that is then deemed to have come from John would also be tax-free, since her right to these receipts would presumably not terminate on her death. The cash payments would thus be tax-neutral payments outside the inclusion/deduction system of I.R.C. §§ 71 and 215. Under this view, Joann implicitly argued that John (who was not a party to the litigation) should be deemed to have transferred the stock to Moriah, producing a constructive dividend for John.

The government disagreed, arguing that the form of the transaction as a redemption of Joann's stock directly by the corporation should be respected in the divorce context, resulting in the tax consequences of the redemption falling on Joann, not John. She would be entitled to exchange treatment under I.R.C. §§ 302(a) and (b)(3), meaning that the difference between the

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[321] 981 F.2d 456 (9th Cir. 1992).

consideration that Joann received and her basis in the surrendered stock would produce capital gain or loss for her.

The Ninth Circuit agreed with Joann, interpreting Treasury Regulations § 1.1041-1T(c), Q&A 9, to mean that the transfer made directly by Joann to the corporation should be deemed to have been made to John instead, since the transfer outside the marital unit was required by their settlement agreement. The court reasoned that the transfer by Joann to Moriah was made "on behalf of" John because the redemption was mandated by an agreement that was executed in settlement of any community property claims that Joann might otherwise have been able to assert against John. Since virtually any property transfer mandated by a divorce decree or settlement is part of an agreement that, by its nature, settles all claims between the parties that each can otherwise possibly assert against the other under state law, such an approach essentially means that *any* transfer of property that the divorce decree or agreement requires to be made to a third party outside the marital unit (for any reason, including franchise contract requirements) should first be deemed made to the other spouse before leaving the marital unit, regardless of whether the parties are aware of or intend such a deemed transfer at the time.

The bizarre uncertainty and unintended tax surprises that such an approach creates for divorcing parties was made clear when Mr. Arnes, in a separate Tax Court case brought by the government against him after it lost the case against Joann, argued that the form of the transaction should be upheld, with the tax consequences of the redemption falling on Joann. The Tax Court agreed—a position that I think to be correct—with the result that *neither* party was held responsible for the tax consequences of the redemption.[322]

The Tax Court also originally held that the law outside the divorce context that can impose a constructive dividend on the nonredeemed spouse[323] should inform when transfers are made "on behalf of" the other spouse within the meaning of Treasury Regulations § 1.1041-1(c), Q&A 9. In *Hayes v. Commissioner*,[324] for example, H was required to purchase W's stock under the terms of their divorce settlement. Instead, however, the corporation redeemed W's stock. Because H had the "primary and unconditional obligation" to purchase the stock under the divorce settlement at the time of the redemption, the Tax Court concluded that H should, as in the non-divorce context, be deemed to have received a constructive dividend under the cases summarized in Revenue Ruling 69-608. In other words, W was deemed to have transferred her stock to H, since H had a legal obligation to purchase it, before it was redeemed by the corporation. W's transfer would be a nonrecognition event under I.R.C. § 1041, H's deemed redemption would trigger a constructive dividend for him, and the deemed transfer of the redemption proceeds from H to W would likely not fall within the inclusion/deduction scheme of I.R.C. §§ 71 and 215.

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[322] *See* Arnes v. Comm'r, 102 T.C. 522 (1994); *see also* Blatt v. Comm'r, 102 T.C. 77 (1994) (also respecting the form of a transaction and taxing W on a direct redemption of her stock).

[323] *See supra* notes 302-10 and accompanying text.

[324] 101 T.C. 593 (1993).

I think that *Hayes* was rightly decided. I can't see that H should have been surprised by the conclusion that he was responsible for the tax consequences of the stock disposition outside the marital unit, since the divorce agreement actually required *him* to purchase the stock from W. The tax results should have come as no surprise in view of the form chosen by the parties, unlike in *Arnes*, where H did not have a legal obligation to purchase W's stock and yet was held (by the Ninth Circuit, at least) to have been the object of a deemed transfer of the stock from W, which was then redeemed, with the redemption proceeds then deemed transferred from H to W. (Lots of deemed transfers!)

In February of 2000, the full Tax Court, in a lengthy reviewed decision, with one concurring and four dissenting opinions, revisited its approach in this respect in *Read v. Commissioner*[325] and essentially abandoned the approach in *Hayes* that looked for guidance regarding the meaning of the terms "on behalf of" by looking to the law outside divorce. Carol Read owned about 48% and William Read owned about 52% of all of the stock of Mulberry Motor Parts, Inc., when they decided to divorce. Under the terms of their divorce agreement, William Read was required *either* to purchase Carol's stock *or* to cause Mulberry Motor Parts to redeem the stock. If he chose the latter, which he did, he would guarantee the payment, which would make him secondarily liable for payment under state law. Carol Read did not include any capital gain regarding the stock redemption, and William Read also did not include any constructive dividend equal to the consideration received by Carol. The issue, of course, was whether the direct redemption should be respected for tax purposes or whether Ms. Read should be considered as having transferred the stock to the corporation "on behalf of" Mr. Read, thus shifting the tax consequences of the redemption to him. To protect its interest as stakeholder, the government issued notices of deficiency to both parties. The opinion relates: "[The government's] role here is that of a stakeholder. Nonetheless, [the government] has indicated that 'Ms. Read has the better argument that she should not recognize any gain from the sale of her stock pursuant to I.R.C. § 1041.'"[326]

It's fairly clear that William did not have a "primary and unconditional obligation" to purchase Carol's stock at the time of the redemption, since the divorce settlement required that *either* William *or* the corporation purchase Carol's stock. This is similar, though not precisely on point, to Situation 5 in Revenue Ruling 69-608, where the ruling concludes that the nonredeemed shareholder did *not* realize a dividend when he was only secondarily obligated to purchase the shares if the corporation failed to redeem them.[327]

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[325] 114 T.C. 14 (2000).

[326] *Id.*

[327] *See supra* note 310 and accompanying text. The ruling cites S.K. Ames, Inc v. Comm'r, 46 B.T.A. 1020 (1942). In that case the nonredeemed shareholder entered into a contract that provided that he had the obligation "to purchase or cause to be purchased" the shares of the redeemed shareholder. Under this language, the nonredeemed shareholder was held not to have had the "primary and unconditional obligation" to purchase the shares that were instead redeemed.

But all of that is irrelevant under the Tax Court's decision, because the Tax Court majority concluded that the standard developed outside the divorce context for measuring when a nonredeemed shareholder should be considered to have received a constructive dividend—*i.e.*, the "primary and unconditional obligation" standard—should not be considered commensurate with the standard determining whether a property transfer is made "on behalf of" the nontransferring spouse within the meaning of Treasury Regulations § 1.1041-1T(c), Q&A 9. A quick reading of the case might first imply that the case stands for the proposition that satisfaction of the primary-and-unconditional-obligation test is but one means by which a transfer will be considered "on behalf of" the other spouse but that the latter language can go much further as well. But the court explicitly disclaimed any relevance at *all* of the primary-and-unconditional-obligation standard to stock redemptions in divorce.

We hold that the primary-and-unconditional-obligation standard is not an appropriate standard to apply in the instant cases in order to determine whether Ms. Read's transfer of her ... stock to [the corporation] was a transfer of property by the transferring spouse (Ms. Read) to a third party ([the corporation]) on behalf of the nontransferring spouse (Mr. Read) within the meaning of Q&A-9. We further hold that the primary-and-unconditional-obligation standard is not an appropriate standard to apply in any case involving a corporate redemption in a divorce setting in order to determine whether the transfer of property by the transferring spouse to a third party is on behalf of the nontransferring spouse within the meaning of Q&A-9.[328] In short, the meaning of "on behalf of" in Q&A 9 should be determined afresh, without regard to the primary-and-unconditional-obligation test that is applied outside of the divorce context.

The Tax Court concluded that, although the stock redemption did not satisfy a legal obligation of Mr. Read, the stock transfer was nevertheless made "on behalf of" him under the "common, ordinary meaning"[329] of those words. Parsing the language "on behalf of" as though it appeared in the statute itself, rather than a regulation that apparently attempted simply to provide some planning flexibility to the parties, the Tax Court majority quoted Webster's Ninth New Collegiate Dictionary (1990) in concluding that "on behalf of" meant "in the interest of" or "as a representative of."[330] Applying those standards, the Tax Court concluded:

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[328] *Read*, 114 T.C. at 14.

[329] *Id.*

[330] The terms "on behalf of" are not in the statute, though the court parses that language as though they were. They are in a regulation that attempts to further the purpose of the statute by giving effect to the parties' agreement that a deemed transfer between the spouses prior to the transfer outside the marital unit should be respected when the parties' intent that such a deemed transfer occur is made clear. The court's approach, by excising those words and analyzing them independently of the entire context of Q&A 9 as well as I.R.C. § 1041 as a whole, can apparently result in a holding that a deemed transfer occurred, *even if neither of the parties intended or bargained for such a transfer*, if the court believes that the transfer by one spouse was nevertheless made "as a representative of" the other.

> Ms. Read was acting as Mr. Read's representative in transferring her ... stock to [the corporation], and Ms. Read was acting in the interest of Mr. Read in making that transfer to [the corporation], in that she was following and implementing Mr. Read's direction as reflected in his election under the divorce judgement that she transfer her ... stock to [the corporation].[331]

The Tax Court further concluded that the transfer came within "situation one" of the Q&A 9 regulation, since the transfer was made pursuant to the divorce decree.

The most recent case was *Craven v. United States*,[332] decided in June of 2000 by the Eleventh Circuit, a case which confirms that *any* transfer made directly to a third party pursuant to a divorce decree should be deemed to be made "on behalf of" the other spouse, regardless of whether the parties knowingly intend that result. Billy Joe and Linda Craven started and subsequently incorporated a pottery business, with 51% of the stock owned by Billy Joe, 47% owned by Linda, and the remaining 2% owned by their two children, 1% each. Under the terms of their 1991 divorce agreement, Linda was obligated to sell her stock to the corporation for a promissory note of $4.8 million, guaranteed by Billy Joe, who acknowledged that the terms of the arrangement were of "direct interest, benefit and advantage" to him. Linda argued that the redemption should be considered to have been made "on behalf of" Billy Joe under Treasury Regulation § 1.1041-1T(c), Q&A 9, thus shifting the tax consequences to him, solely because it was required by the divorce decree, consistent with the broadest possible reading of "situation one" of that regulation. "She argues that the transfer of stock to the corporation was done pursuant to her divorce agreement and therefore was on behalf of her former spouse within the language and purposes of the temporary regulations."[333] The government argued that the form of the transaction should be respected, with Linda taxed on the redemption.

Both the District Court and the Eleventh Circuit held in favor of Linda, in opinions that confirmed the scope of the Q&A 9 language to include virtually *all* transfers of property outside the marital unit to third parties, without regard to the parties' apparent or actual intent, so long as the transfers are required by the divorce decree. The District Court held that the transfers were made "on behalf of" Billy Joe "because the redemption came as a result of Billy Joe's obligation under Georgia law to equitably divide all marital assets." You can't get any broader than that. Virtually all such transfers are made as part of the parties' property settlement. The Eleventh Circuit recounted with approval the Tax Court majority's opinion in *Read*, including its reading of the terms "on behalf of" to mean "in the interest of" or "as a representative of." The Eleventh Circuit then cited three factors as supporting Linda's position: (1) that the redemption was mandated by the divorce decree, (2) that Billy Joe guaranteed the redemption note issued by the corporation, and (3) that he acknowledged that the terms were of "direct interest, benefit and advantage to him." But—and this is critical—the court made it clear that, *even if the second and*

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[331] *Read*, 114 T.C. at 14.

[332] 2000-2 U.S.T.C. (CCH) ¶ 50,541 (11th Cir. 2000).

[333] *Id.*

third factors were entirely absent, Linda would win simply because the redemption was mandated by the divorce decree. "The first fact enumerated above [that the redemption was required by the divorce decree] would be enough on its own to qualify Linda's transfer to the corporation for nonrecognition under § 1041. The other two factors simply add strength to this conclusion."[334]

This myopic reading of the "first situation" in Q&A 9 (that *any* transfer to a third party required by a divorce decree should be considered as made by the other spouse), lifted from its surrounding context, is just the sort of reading that not merely drains the pro-taxpayer regulation of the very ability to specify who should be responsible for the tax consequences of a third-party transfer that I believe was its purpose but actually mandates a "one-size-fits-all" approach that can require precisely the opposite result that the parties intended. There is no reason to believe that simply because a divorce decree requires one of the spouses to transfer property outside the marital unit that the parties will understand that to mean that the transferring spouse should first be deemed to have transferred it to the other spouse, shifting the tax responsibility to her. Indeed, if a divorce decree explicitly requires John to transfer property that he owns to someone outside the marital unit, the natural assumption on the part of the divorcing couple would quite likely be just the opposite—that John is responsible for that gain—since he owned the property, and the decree could have just as easily required John to transfer it to Mary first but did not.

I think that it should be fairly obvious that the primary-and-unconditional-obligation test could not provide the outer reaches of the standard regarding when a transfer is made "on behalf of" a spouse, if for no other reason than that the Q&A 9 regulation applies to transfers of all kinds of property to all kinds of third parties—not simply stock transfers to corporations. Nevertheless, I also think that it should be clear that whenever H is required by a divorce settlement to purchase W's stock, but instead the corporation redeems W's stock, W should be considered as transferring the stock to H first. This would result in the tax consequences of the redemption falling on H, consistent with the parties' apparent agreement that H should take ownership of the stock, so that when it's transferred to the corporation, he should be deemed to have made that transfer. This tax treatment also happens to be the same tax treatment that would arise outside the divorce context under the primary-and-unconditional-obligation test. In other words, I think it should be clear that satisfaction of the primary-and-unconditional-obligation test should also satisfy the standards of the on-behalf-of test in the stock-redemption context, since the on-behalf-of test under I.R.C. § 1041 ultimately turns on the parties' intent, and when the nonredeemed spouse is legally obligated to purchase stock that is instead redeemed, the parties intent that he should take title before the stock leaves the marital unit is sufficiently clear.

But if W and H state in their divorce settlement that Blackacre is required to be transferred by W directly to a third party, and further state that it should be considered first as going to H, thus shifting the tax liability to H (even though the transfer was made directly to the third party for the sake of expediency), that agreement should be respected—*even if* H did not have any scintilla of legal obligation to purchase Blackacre from W at the time she made the transfer, let alone a "primary and unconditional obligation."

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[334] *Id.*

In short, the overarching consideration that should inform interpretation of I.R.C. § 1041 is that the parties' bargain should be respected, *i.e.*, their agreement regarding who should bear the burden of taxation on a transfer of property outside the marital unit should be respected. This value should be respected even if the nontransferring spouse does not have a legal obligation to purchase property from the other spouse but nevertheless agrees that the tax obligation attending the transfer of the property outside the marital unit should be his. This allows the parties to bargain for a fair and equitable division of marital property by taking into account the tax consequences that will attend disposition of property outside the marital unit. Protecting the "deal" made by the parties is a value in the divorce context that should be paramount.

The agreements in *Read* and *Craven* were not, unfortunately, crystal clear, and it is on *this* issue where the discussion should center regarding how the regulations should be amended to fix these ambiguities. How clearly should the regulations require the parties' intent to be stated regarding deemed transfers between the spouses prior to a transfer outside the marital unit before that intent is given effect? The agreement in *Read* did not—as it ideally should, in my opinion—explicitly provide that the stock should be considered as being transferred to Mr. Read first, even though that formal step was omitted in the interest of expediency, with a direct transfer from Ms. Read to the corporation, instead. Should we nevertheless try to extract the parties' intent as best we can in such ambiguous circumstances? Or should we require a higher degree of proof before we consider deemed transfers to occur, since, after all, the parties could have gone to the bother of actually transferring the property to the other spouse first? If they want the luxury of dispensing with that intermediate step, but nevertheless have it deemed to have occurred, perhaps they should have the burden of making that intent sufficiently clear. The regulation was apparently intended to provide pro-taxpayer flexibility, not a straightjacket, but the regulation should not provide standards that are so vague that it will continue to require courts to struggle in gleaning the parties' unclear intent.

This is all the more true because of one more important point that needs to be made. The lack of clarity in the current regulations is in dire need of a fix, not only to provide clear guidance to divorcing couples, but also to eliminate the good chance of whipsaw that the Federal Treasury can experience. As was the case in the confusion under *Davis* before I.R.C. § 1041 was enacted,[335] each party can take advantage of this ambiguity by taking reporting positions that *the other* is responsible for the tax consequences of the transfer outside the marital unit. Moreover, unlike under I.R.C. §§ 71 and 215, there is no information-reporting requirement under I.R.C. § 1041 that can decrease the chance of such a whipsaw that goes unnoticed by the government.

This concern for whipsaw, as well as a desire to decrease the chances for litigation, leads me to recommend completely rewriting Treasury Regulations § 1.1041-1T(c), Q&A 9, in such a way as to both create bright-line, understandable rules that should accord with common presuppositions of divorcing parties and reinforce the notion that was likely intended by that regulation, *i.e.*, that the parties can explicitly agree to shift the tax responsibility attending property owned by one spouse to the other spouse—without having to actually transfer the property to that other spouse prior to the transfer outside the marital unit—so long as the parties make their intention sufficiently clear that an implicit transfer should be deemed to occur (in

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[335] *See supra* notes 60-72 and accompanying text.

order to shift the tax responsibility) prior to the transfer to the third party. The bottom line is that there should be as little chance for surprises and uncertainty as possible, while at the same time there should be the maximum flexibility possible for the parties to decide who, between them, will be responsible for the built-in gain or loss with respect to property transferred outside the marital unit. With that in mind, I would advocate that any doubt from the face of the divorce documents about whether the parties intended a deemed transfer between the spouses to precede the transfer outside the marital unit should be resolved in favor of *not* deeming such a transfer to have occurred—which is precisely opposite to the presumption that we have under the *Read* and *Craven* courts' interpretation of "situation one" of the temporary regulations—since the parties usually have the freedom to arrange an actual transfer between them prior to the transfer to the third party if they so desire.

The regulation might look something like this:

§ 1.1041-x. **Transfers to Third Parties.**—(a) *In General.* Transfers of property by one or both spouses to a third party outside the marital unit are not entitled to nonrecognition treatment under section 1041, regardless of whether the transfer is incident to divorce. If, for example, H transfers property with a basis of $10,000 to a third party for $50,000, as required under a divorce decree, H's $40,000 realized gain is not entitled to nonrecognition under section 1041, absent application of one of the exceptions noted below. If H makes an actual transfer of the property to W, who then transfers the property to a third party for $50,000, H's $40,000 realized gain is not recognized under section 1041(a), W excludes the $50,000 value of the property under section 1041(b)(1), W takes H's $10,000 basis in the property under section 1041(b)(2), and W realizes and recognizes the $40,000 gain on the subsequent transfer to the third party for $50,000, even if the transfer to the third party is contemplated at the time of the transfer to W. In the three limited circumstances described below, property transferred directly by one spouse to a third party will be deemed to have first been first transferred to the other spouse, thus shifting the tax consequences of the transfer outside the marital unit to the other spouse, without an actual prior transfer to that other spouse. Such an implicit transfer between the spouses preceding the transfer to the third party will be deemed to occur only if: (1) the parties explicitly agree in the divorce or separation instrument or in a later separate agreement that such a transfer to the other spouse should be deemed to occur under section 1041, (2) the other spouse had a primary and unconditional obligation to purchase the property that was instead directly transferred to the third party, or (3) the transfer directly to the third party satisfied a debt or other obligation owed by the other spouse to the third party.

(b) *Examples.* The following examples illustrate this paragraph.

Example 1. H owns Blackacre, with a basis of $10,000 and fair market value of $50,000. The divorce settlement between H and W requires H to sell Blackacre and divide the proceeds equally between H and W. In order to equitably divide the value in all the marital property, after taking into account the tax consequences of the disposition, H and W agree that W should be responsible for

recognizing the $40,000 gain with respect to Blackacre for tax purposes. The divorce settlement therefore also provides that the property transferred directly from H to the third party should be considered first as having been transferred from H to W. H transfers the property directly to the third party for $50,000 and transfers $25,000 to W. Even though H transfers the property directly to the third party, he will be considered for tax purposes as having first transferred the property to W, and W will be considered as having transferred the property to the third party and subsequently transferring one-half of the sales proceeds to H. H's $40,000 realized gain is not recognized under section 1041(a), W excludes the $50,000 value of the property under section 1041(b)(1), W takes H's $10,000 basis in the property under section 1041(b)(2), and W realizes and recognizes the $40,000 gain on the transfer to the third party for $50,000. W's deemed $25,000 cash payment to H is analyzed under sections 71 and 215.

Example 2. H owes $50,000 to a third party. Pursuant to the terms of their divorce decree, W transfers Blackacre, which has a basis of $10,000 and a fair market value of $50,000, directly to the third party in satisfaction of H's debt. The property transferred directly to the third party will be deemed to have been first transferred to H. W's $40,000 realized gain is not recognized under section 1041(a), H excludes the $50,000 value of the property under section 1041(b)(1), H takes W's $10,000 basis in the property under section 1041(b)(2), and H realizes and recognizes the $40,000 gain on the transfer of the property to the third party in satisfaction of his debt.

Example 3. H and W each own 50% of the stock in the corporation through which they operate the family business. The terms of their divorce settlement require W to transfer her stock, which has a basis of $10,000 and a fair market value of $50,000, to the corporation in exchange for $50,000. The corporation redeems W's stock in exchange for $50,000. W's $40,000 realized gain is not entitled to nonrecognition under section 1041, and W's tax consequences on the redemption will be governed by section 302. H realizes no tax consequences on the redemption.

Example 4. H and W each own 50% of the stock in the corporation through which they operate the family business. The terms of their divorce settlement require H to purchase W's stock, which has a basis of $10,000 and a fair market value of $50,000. H does not purchase W's stock, but the stock is instead redeemed for $50,000 by the corporation. Because H had the primary and unconditional obligation to purchase W's stock, the stock transferred directly to the corporation will be deemed to have been first transferred to H. W's $40,000 realized gain is not recognized under section 1041(a), H excludes the $50,000 value of the stock under section 1041(b)(1), H takes W's $10,000 basis in the stock under section 1041(b)(2), and H's tax consequences on the redemption will be governed by section 302.

Example 5. H and W each own 50% of the stock in the corporation through which they operate the family business. The terms of their divorce settlement require H to purchase W's stock or, at H's election, to have W's stock redeemed by the corporation. W's stock has a basis of $10,000 and a fair market value of $50,000. H does not purchase W's stock, but the stock is instead redeemed for $50,000 by the corporation. Because H did not have the primary and unconditional obligation to purchase W's stock, the stock transferred directly to the corporation will not be deemed to have been first transferred to H. W's $40,000 realized gain is not entitled to nonrecognition under section 1041, and W's tax consequences on the redemption will be governed by section 302. H realizes no tax consequences on the redemption.

Conclusion

I am of the opinion that the law pertaining to transfers of cash and property incident to divorce was substantially improved in 1984, particularly with respect to the enactment of I.R.C. § 1041 to overturn the *Davis* result involving in-kind property transfers. But problems remain, and *much* too much litigation continues to plague this area, an area that ensnares ordinary citizens in all walks of life and income levels. These transactions are not multinational corporate reorganizations involving sophisticated counsel and planning. Divorce is a common, personal transaction, not engaged in for tax reasons, and which results in significant non-tax events, such as the parties separating their households. In most respects, the problems arise not as the necessary and right consequences of a coherent theory but because of history and political compromise or the blind application of doctrines that grew up in other contexts that are not appropriate or well suited to the unique context of divorce. Moreover, though enactment of I.R.C. § 1041 should be applauded, it has raised new issues that need particular redress now.

The current mechanisms that must be applied to determine which party will be taxed on a cash receipt or on a stock redemption are not only ambiguous in many respects but also resolve the question in ways that often make no sense (*e.g.*, characterizing as "property settlements" the payment of attorneys' fees, medical expenses, or unallocated support payments). The resolution also often requires Federal tax adjudicators to delve into murky state law in order to determine the answers to these ambiguities, a practice that was heavily criticized before 1984 and was supposed to end with the 1984 legislation.

As I have argued throughout this article, not much revenue is at stake in our system of how to tax cash transfers incident to divorce. Similarly, the answers to whether transfers of accrued income rights ought to be taxed to the transferee or transferor, and whether stock redemptions incident to divorce ought to be taxed to the shareholder whose stock is redeemed or the other spouse, pose little revenue concerns. In each and every possible scenario posed, one of the spouses will be taxed; the only question is which spouse's marginal rate bracket will apply. The government is a mere stakeholder. Unlike other areas of tax, the question is not merely whether a deduction will be allowed or whether a receipt should escape taxation, issues that can pose real revenue concerns. In the context of divorce, every deduction is necessarily accompanied by a corresponding income inclusion, so that the only revenue at stake is measured by the difference in rate brackets (if any) between the payor and payee. Similarly, there is no question that assigned income rights and stock redemptions are taxable, even though incident to divorce. The only question is which spouse will realize those tax consequences.

As I have argued throughout this article, the parties' agreement regarding who, between them, should be taxed on income items, whether income accrued prior to the divorce but paid after, or income earned after, should be respected. With no significant revenue streams at stake, there is no compelling reason why the law ought to be otherwise. The parties reach agreement on how to equitably divide their assets and income streams by (if well advised) taking the resulting tax consequences into account. When the government steps in and upsets these expectations after the fact, it upsets the bargain reached between the parties, often for no net revenue gain—and often at substantial litigation expense for both the government and the divorced couple.

In many respects, I.R.C. §§ 71, 215, and 1041 already recognize and intentionally implement this bedrock value. The time has come to finally abandon the remaining remnants of our futile attempt to differentiate "alimony" from "child support" from cash "property settlements," distinctions increasingly abandoned under state law in this era in which an equitable and fair apportionment of all undifferentiated income and property rights is the goal. The parties should be permitted to designate whether *any* cash payment should be includable by the recipient and deductible by the payor, on the one hand, or excludable and nondeductible, on the other, with the default rule (in the case of silence) being that such payments are includable by the recipient and deducible by the payor, unless the payment is to a third party on behalf of a child. Treasury should also make it clear by issuing a new regulation (perhaps pursuant to a new Congressional directive in I.R.S. § 1041, though I don't believe that statutory amendment is absolutely necessary) that the assignment-of-income doctrine, which is fundamentally inconsistent with the premises underlying I.R.C. § 1041, does not trump the nonrecognition rule of I.R.C. § 1041 in the context of divorce. Finally, Treasury ought to issue a new regulation to replace Treasury Regulation § 1.1041-1T(c), Q&A 9, to specify clearly, in the manner described, when property transferred directly from one spouse to a third party outside the marital unit will be considered as having been transferred first to the other spouse before the transfer outside the marital unit, thus shifting the tax consequences to that other spouse.

C. Private Benefit, Public Benefit and Exemption

Prepared for the Joint Committee on Taxation Simplification Study

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1. Introduction: Public Benefit and Private Benefit

Exemption is reserved for organizations that operate for the exempt purposes set forth in the Internal Revenue Code (the "Code") and which provide benefits to appropriate recipients defined in relation to an organization's exempt purpose. These exempt purposes define the public benefits of an exempt organization. The public benefit is the benefit arising from the exempt activities. Those who share in an organization's public benefit will be beneficiaries defined by the organization's exempt purpose. Section 501(c)(3) public charities operate for the benefit of a charitable class defined in relation to the various organizations' particular exempt purposes. A section 501(c)(3) organization does not have to serve the interests of the entire public but will be treated as providing a public benefit to every member of the public interested in the organization's particular mission, whether preventing cruelty to animals or presenting opera or fostering interest in stamps or any of the other hundreds, if not thousands, of interests that fall under the exempt purposes enumerated in section 501(c)(3).[1] Other exempt organizations also provide public benefits, benefit resulting from their various exempt purposes, even though these organizations have a less encompassing scope than do section 501(c)(3) organizations. For example, the members of a labor union and those non-union workers who benefit from a collectively bargained contract will be the appropriate public beneficiaries of the operation of a labor union.[2] Members of a trade association are business entities in a particular line of business and the public benefit is a benefit to that line of business, not benefits to the individuals firms of a type that give them a relative advantage over other firms operating in the same line of business.[3] Social and fraternal organizations operate for the benefit of their members.[4]

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[1] Section 501(c)(3) lists the following exempt purposes: "religious, charitable, scientific, testing for public safety, literary, or educational purposes, or to foster national or international amateur sports competition (but only if no part of its activities involve the provision of athletic facilities or equipment), or for the prevention of cruelty to children or animals."

[2] Labor organizations are described in section 501(c)(5).

[3] Trade associations are described in section 501(c)(6).

[4] Social and fraternal organizations are section 501(c)(7) social clubs, section 501(c)(8) fraternal benefit societies, and section 501(c)(10) fraternal societies.

A private benefit, in contrast, is a benefit arising from a relationship with the exempt organization not defined by the public or exempt purpose.[5] Private benefits are inconsistent with exempt status. Ordinary employment contracts or ordinary contracts for the provision of goods needed by the exempt organization are not the kinds of relationships that provide private benefits that jeopardize the organization's exempt status since these are cost incurred in connection with conduction the organization's exempt activities. Private benefits are benefits that are not related to the achievement of the organization's exempt purpose.

This paper is based on the premise that any coherent rationale for exemption from taxation is necessarily based on the provision of a public benefit. It further argues that much of the incoherence and complexity of the current law of tax exemption arises from the attempt to ground exemption in the absence of private benefit rather than on the provision of a public benefit.

The absence of private benefit is not the same as the presence of public benefit. Consider the following hypothetical. A section 501(c)(3) organization is established for the purpose of educating the public on the issue of loss of habitat for endangered species. The organization hires one employee at a modest salary and that employee devotes her time to the study of the loss of habitat for endangered species. She reviews all the relevant literature, travels to areas of receding habitat, and consults all of the leading authorities throughout the world. None of the expenses were unreasonable. Indeed, the board remarked each year on how economically the employee conducted her work. During this time, the employee wrote no papers, issued no reports, spoke at no conferences. The organization made no information available on the loss of habitat for endangered species. After five years, the organization terminated its operations and distributed its remaining assets to another section 501(c)(3) organization. There was no private benefit in the sense of excessive payments to an employee or to some other person. Yet, there was no public benefit, and the organization should not be treated as exempt.

Reliance on the absence of a private benefit as the core rationale for exemption has created a conceptual trap for exempt organizations. One side of this trap is the difficulty inherent in grounding exemption primarily on the absence of private benefit. This difficulty becomes acute when an exempt organization engages in exactly the same activities as a taxable entity and both are charging the same fees for their services. There is a process of convergence between exempt and taxable entities.[6] Why is one hospital that provides a peppercorn of charity care

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[5] For example, a section 501(c)(5) labor organization or a section 501(c)(6) trade association that provides football tickets to its members would be providing a private benefit because neither organization is created to provide this kind of benefit. In contrast, a section 501(c)(3) organization that provided children from economically disadvantaged backgrounds tickets to a football game would in most cases be treated as engaging in an exempt activity and not providing a private benefit. At the same time, a section 501(c)(3) organization that provided football tickets to its contributors might be treated as providing a private benefit or as inurement (if the contributor were an "insider") or as an excess benefit transaction (if the contributor had substantial influence over the operation of the organization).

[6] Convergence between taxable and exempt entities has become an increasingly prominent theme in three books studying the market activities of exempt organizations by

taxable and another hospital that provides a peppercorn of charity care exempt? Why should one university be taxable while another university providing the same types of degrees in the same subjects is exempt? Why should a university be exempt with respect to its tuition for on-campus "bricks and mortar" classes while the same university chooses to be taxable with respect to the revenue from its cyberclasses in the same subjects leading to the same degrees? Is exemption purely voluntary? Is there in practice a check-the-box regime for exemption? The absence of any coherent rationale for exemption in an era of convergence is likely to become a prominent feature of future disputes over tax exemption.

The second side of the trap for exempt organizations is that they have become subject to increasingly stringent private benefit requirements. Private benefit, inurement, and excess benefit transactions now all apply in ways that cannot be predicted. Yet, these private benefit doctrines are necessarily limited by the operational needs of the organizations. Excessively stringent private benefit doctrines can impede achievement of an exempt organization's exempt purposes. The protracted conflicts over compensation, including incentive based compensation, illustrate the difficulty. If doctors cannot be compensated at a market rate defined by taxable entities, then exempt hospitals cannot provide the same quality of care. The same considerations apply to at least some segments of universities. If the football coach at a school that treats football as a source of self-definition and a source of revenue cannot receive a compensation package comparable to that offered by the taxable teams in the professional leagues, then the school will not be able to compete for players and assistant coaches. The same considerations apply, although usually with less press interest, in other departments of universities.[7] Efforts to implement restrictions on transactions that may appear to provide a private benefit can seem gratuitous and unrelated to the operational requisites of efficient operation. Private benefit doctrines alone cannot provide a rationale for exemption at the very time that convergence makes such a rationale a more pressing practical necessity. Without a public benefit rationale, exemption will seem simultaneously overinclusive and underinclusive.

A public benefit rationale is more complete than a private benefit rationale, even if one could be developed, because exempt organizations engage in activities that may not result in private benefit but which, at the same time, are not related to providing a public benefit. The result is that both the technical requirements for exemption and the conceptual rationales for exemption ignore much of the activity of contemporary exempt organizations. A public benefit rationale would address both the distribution of resources to persons other than the intended beneficiaries of the organization's exempt activities and the diversion of resources from exempt activities to nonexempt activities within the organization. While private benefit doctrines direct attention to distribution of organizational resources outside the organization, they do not address

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Professor Burton Weisbrod and his colleagues. *See* BURTON A. WEISBROD, THE VOLUNTARY NONPROFIT SECTOR: AN ECONOMIC ANALYSIS (1977); THE NONPROFIT ECONOMY0 (1988); TO PROFIT OR NOT TO PROFIT: THE COMMERCIAL TRANSFORMATION OF THE NONPROFIT SECTOR (1998).

[7] University compensation structures generally reflect a hierarchy based on the presence of a market alternative to teaching, so that medical school faculty make more than law school faculty who make more than most professors in the humanities or social sciences, there being a very limited private market in anthropologists or philosophers.

the diversion of resources within the organization to activities that are not related to the organization's public benefit purpose. Academic theories have focused on the external distribution issues addressed by private benefit doctrines.[8] There has been no academic attention to internal diversion and its implications for exemption. This paper and the companion paper on the unrelated business income tax begin to address the contours of such a nondiversion constraint.

This paper does not resolve the conceptual and practical issues arising from the failure to define the rationale for exemption in terms of public benefit. It focuses on the elements of complexity arising from the three private benefit doctrines. The paper identifies four elements of complexity characterize private benefit concepts under current law: (1) the concurrent existence of three concepts of private benefit—private benefit, inurement, and excess benefit transactions—each of which presents unresolved issues and definitional complexities; (2) different meanings of private benefit and inurement as these apply to different types of exempt organizations; (3) the absence of guidance relating to the scope of private benefit, inurement or excess benefit that jeopardizes exempt status; and (4) overlapping application of two or three of the elements of private benefit to particular types of exempt organizations.

This paper discusses the three types of private benefit doctrines as they apply to various types of exempt organizations and the intersections among the three doctrines.[9] It then offers proposals for addressing the ambiguities of each of the three doctrines and the intersections among them and considers alternative approaches that might follow from basing exemption on an affirmative public benefit requirement.

2. Two Contemporary Cases: A Template and a Conceptual Collapse

The tensions and paradoxes discussed above are the central feature of a case that has become a template for much of the contemporary thinking on private benefit, the doctrines through which it is currently expressed, and its relationship to exempt status. The *United Cancer Council* ("UCC") case seemed poised to become the STET of our era until it was settled, due largely to the exhaustion of the parties.[10] Despite the settlement, the case reverberates through

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[8] The concept of a nondistribution constraint was developed in a series of articles by Henry Hansmann, who found this concept only an attenuated rationale for exemption from taxation. *See,* Henry B. Hansmann, *The Role of Nonprofit Enterprise,* 89 YALE L. J.(1980); *The Rationale for Exempting Nonprofit Organizations from the Corporate Income Tax,* 91 YALE L. J. (1981); *The Evolving Law of Nonprofit Organizations: Do Current Trends Make Good Policy?* 39 CASE WN. RES. L. REV. 807 (1988-89).

[9] This paper does not attempt to present a complete consideration of all aspects of these three doctrines. For a more complete analysis, *see* FRANCES R. HILL AND DOUGLAS M. MANCION, TAXATION OF EXEMPT ORGANIZATIONS (Warren, Gorham & Lamont, forthcoming 2001).

[10] United Cancer Council v. Commissioner, 109 T.C. 326 (1997), rev'd and remanded, 165 F. 3d 1173 (7th Cir. 1999). The closing agreement between the Service and the UCC, which was dated April 7, 2000, is available at 2000 TNT 75-12.

contemporary efforts to craft a private benefit doctrine that can carry the burden of providing the rationale for exemption.

The UCC, an organization formed for the exempt purpose of educating the public with respect to approaches to treating cancer, encountered severed financial difficulties when several of its affiliates left to join a competing cancer organization, thereby depriving the UCC of dues on which it relied. In the face of this financial crisis, the board decided to engage the services of a professional fundraiser. A committee of the board investigated fundraising options and recommended that the organization engage a firm specializing in direct mail fundraising. A separate committee of the board negotiated a contract with the direct mail fundraiser Watson and Hughey ("W & H").

The contract provided that W & H would advance the initial money required for the fundraising as well as money for continued operation of the UCC. Both of these provisions were critically important to the UCC, which was insolvent when it entered into the contract. W & H became the UCC's exclusive fundraiser for a five-year period. The contract gave W & H the exclusive right to unrestricted use of the mailing list generated under the contract even after the contract terminated. The UCC, which paid W & H for all the costs of generating the mailing list, would never have the right to sell, lease, or exchange the mailing list, even after its contract with W & H terminated. Gross receipts from the mailings were placed in an escrow account, and W & H was paid before any money went to the UCC. Over the term of the contract, the direct mail solicitations produced $28.8 million in gross receipts. UCC received $2.3 million, and W & H received the remaining $26.5 million. The Tax Court was never able determine during its protracted consideration of this case how much of this amount was profit for W & H.[11]

The Service revoked the UCC's exemption in 1990.[12] Thus began a saga that is important not so much for its length as for the way it highlighted the overlapping application of private benefit and inurement, the uncertainty in the interpretation of each doctrine, and the possibility that neither private benefit nor inurement is the true issue in the case. Above all, the UCC case illustrates the difficulty of examining the absence of a public benefit by attempting to show the presence of private benefit or inurement.

The Service revoked the UCC's exemption on grounds that it was operated primarily for a commercial purpose, not an exempt purpose, and that the fundraising contract was so favorable to W & H that it resulted in a more than insubstantial private benefit to the fundraising firm. The Service presented this public benefit argument in terms of a "commensurate in scope"

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[11] United Cancer Council, Inc. v. Commissioner, 109 T.C. 326 (1997). The Tax Court expressed its frustration with the parties' failure to provide all of the information that the court considered relevant.

[12] Final Notice Revocation (Nov. 2, 1990, retroactive to June 11, 1984). The Tech. Adv. Mem. in which Service presented its reasoning is available at 91 TNT 144-5.

claim.[13] The service rejected any fixed percentage of an organization's assets which must be used for exempt purposes, but it took the position:

> The "commensurate test" requires that organizations have a charitable program that is both real and, taking the organization's circumstances and financial resources into account, substantial. Therefore, an organization that raises funds for charitable purposes but consistently uses virtually all of its income for administrative and promotional expenses with little or no direct charitable accomplishments cannot reasonably argue that its charitable program is commensurate with its financial resources and capabilities.[14] The Service did not add the inurement claim only in its second amended filing in the Tax Court and it treated this claim only perfunctorily in its reply brief in the Tax Court.

After it had considered the case for four years, the Tax Court held that the Service had properly revoked the UCC's exemption, but it based its decision solely on the inurement claim.[15] This claim was widely regarded among the private bar as the most innovative and the most dangerous element of the UCC case.[16] The idea that a contract negotiated between unrelated parties negotiating at arms length could make a party to the contract an insider for inurement purposes threatened to disrupt the joint ventures and royalty agreements that were becoming increasingly important to a growing number of exempt organizations. Neither the parties nor the amici nor the Tax Court considered the Service's claim that the UCC was not operating for an exempt purpose, that it was not providing a public benefit. The Service itself failed to develop this claim in the Tax Court, even though it had been one of the grounds for revoking the UCC's exempt status.[17]

The Seventh Circuit, in an opinion by Chief Judge Richard Posner, reversed the Tax Court on inurement.[18] Judge Posner found that anyone could be an insider with the requisite control over the organization even if the person had no formal role in the organization, but he did

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[13] See the Tech. Adv. Mem. At 91 TNT 144-5.

[14] Id. both amicus brief presented vigorous arguments opposing this approach.

[15] United Cancer Council, Inc. v. Commissioner, 109 T.C. 326 (1997).

[16] Amended brief for American Heart Association, American Lung Association, American Cancer Society, and Independent Secter as Amici Curiae (Jan. 5, 1994) (9400 TNT 18-37). (arguing that the fundraising contract provided an impermissible private benefit to W&H but rejecting the Service's public benefit test as an abridgement of First Amendment freedom of speech). But see, brief Amicus Curiae of Non-Profit Mailers Federation (Jan. 5, 1994) (94 TNT 9-58) (arguing that the fundraising contract furthered the UCC's exempt purposes.

[17] See, Brief for Respondent in United Cancer Council Case (Nov. 1, 1993) (93 TNT 240-30).

[18] United Cancer Council v. Commissioner, 165 F. 3d 1173 (7th Cir. 1999).

not find the requisite control in this case. A one-side contract does not in itself establish control over the party that agreed to a bad bargain.

The Seventh Circuit remanded the case to the Tax Court on the private benefit issue and on the issue of whether the UCC was operating for an exempt purpose by providing a public benefit. The apparently disproportionate share of the gross revenues received by the fundraising firm was, in the court's view, relevant to this analysis. The issue was whether the UCC had made the equivalent of a gift to the fundraiser by paying it an excessive amount. If the UCC had failed to preserve its assets for its exempt purpose, it was not operating for an exempt purpose and was not providing a public benefit.

The *UCC* case thus addressed both private benefit and inurement and did so from two different perspectives.[19] The Tax Court opinion was a conventional doctrinal analysis that, despite its prodigious length, did not provide an adequate factual basis for fully considering the issues. The Seventh Circuit opinion, while noting the lacunae in the record below, applied a market analysis that focused on the UCC's limited choices for contracting with a fundraiser when it was already insolvent. Judge Posner looked at the fundraising contract as a standard risk allocation between parties with asymmetrical bargaining power and seemed to express impatience with the more regulatory analytical framework presented by the Tax Court.

The *UCC* case did not involve section 4958 excess benefit transaction issues because that provision had not been enacted during the years at issue. Yet, the case had a significant impact on the regulations issued under section 4958. The proposed regulations followed the Tax Court opinion,[20] and the temporary regulations took account of the Seventh Circuit opinion.[21]

Gainsharing is terms for an incentive compensation strategy that the Service was prepared to rule was consistent with exempt status until the Department of Health and Human Services ("HHS") ruled that it violated the Medicare laws. The differences between the two agencies illustrate the limits on the Service's approach of defining a public benefit as the absence of a private benefit.

Gainsharing based compensation on net profits of the exempt organization, not on gross revenues generated by the particular employee. The concept arose in the health care industry, but it could have been applied in universities or other fee for service organizations. The particular gainsharing arrangement on which the Service was prepared to rule favorably arose in a teaching hospital.[22] The physicians in a particular practice group contracted with the hospital

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[19] *See*, Frances R. Hill, *Deregulating the Exempt Sector? CA-7 Reverses Tax Court in United Cancer Council*, J. TAX'N.303 (1999).

[20] The proposed regulations were issued in 1998. See 63 Fed. Reg. 41486 (Aug. 4, 1998).

[21] The temporary regulations were issued in 2001.

[22] The following discussion is based on the text of a private letter ruling that was never released. This unreleased ruling is available at 1999 TNT 128-39.

to maintain or improve patient service while reducing the cost of the services they provide. Once the group as a whole met a threshold level of patient satisfaction, then the group would be awarded points based on their success in meeting cost management targets. The physician group would be required to show that no member of the group based decisions on admissions to the hospital on the patient's race, creed, color, religion, sex, sexual preference, national origin, health status, age, handicap, income level, or ability to pay, and that coverage or lack of coverage under any government health care program, or any financial incentives under the contract with the hospital.[23] The incentive compensation was limited to a fair market value equivalent as determined by an independent committee relying on market comparables. The ruling also recounted that the arrangement was negotiated between the hospital and the physicians group at arms length.

There was no discussion of what factors establish an arms length negotiation at a teaching hospital. For example, it is not clear whether the teaching hospital was a part of a university and whether some or all of the members of the physicians group were members of the university faculty. It is not clear how the incentive compensation arrangement related to any other relationships the physicians had with the hospital and / or the university. The Service seemed to lack a certain curiosity in its presentation of the facts.[24]

> The Service also seemed to lack curiosity about what cost containment meant in the context of a teaching hospital and what element of cost could be controlled by physicians' decisions. Presumably, the costs of supplies and the choice of suppliers of all of the materials and equipment required by a teaching hospital, as well as the cost of employees, were the responsibility of the hospital management. It would appear that only element of hospital costs which the physicians control is hospital admissions and the nature and extent of the care provided to various types of patients. The critical question is whether gainsharing means rationing care in ways based in some part on the ability to pay.

The Service ruled that the program was not inconsistent with the hospital's exempt status. As the Service saw it, the issue was whether the gainsharing program resulted in compensation that was reasonable in amount. There was no analysis at all of the exempt purpose of the teaching hospital and the relation of the gainsharing arrangement to the exempt purpose.

It was left to HHS to point out that rationing patient care was inconsistent with federal funding programs because gainsharing involved rationing of health care.[25] HHS took the

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[23] The draft ruling described the review process but gave no information on the criteria for excluding a physician from the program, an action that would render the entire group of physicians ineligible for participation in the incentive compensation program.

[24] Much of the language of the factual narrative was marked by conclusory language that seemed like a barrier to understanding the facts.

[25] Department of Health and Human Services, Office of Inspector General, Special Advisory Bulletin on Gainsharing Arrangements and Civil Money Penalties for Hospital Payments to Physicians to Reduce or Limit Services to Beneficiaries, 64 Fed. Reg. 37598 (July 14, 1999).

position that the method used to determine cost savings permitted limiting the amount and quality of care available to patients. This method thus, in the view of HHS, violated the Social Security Act. In effect, HHS reminded the Service and the Treasury that exempt organizations have a duty to operate for a public benefit. Gainsharing has come to stand for the idea that exemption does not depend on providing a public benefit but on avoiding the technical definitions of private benefit.

Proponents of gainsharing arrangements made a creative effort to establish the view that exemption means the absence of a private benefit during the comment period for the proposed regulations under section 4958. The claim was that gainsharing arrangements are not revenue-based compensation arrangements because they are based on lower costs, not on revenue earned. Treasury and the Service refused to adopt this approach, pointing to the HHS position on gainsharing and announced that no private letter rulings would be issued with respect to gainsharing arrangements.[26]

The gainsharing case illustrates the conceptual bankruptcy of separating private benefit from public benefit. The implicit premise that the absence of private benefit establishes the presence of public benefit was rejected by HHS and, in less dramatic fashion, was questioned by Judge Posner in the *UCC* case. These two cases have shaped the Service's position on private benefit, inurement and excess benefit transactions. The conceptual gap at the heart of these two cases have become increasingly central to the three private benefit doctrines discussed below.

3. Private Benefit

Private benefit has been developed and applied as a separate doctrine primarily in the case of section 501(c)(3) organizations. In the case of most other exempt organizations, the concept of inurement includes at least certain instances of private benefit. Inurement, in turn, is a general anti-abuse provision that does not always lead to revocation of exemption.

Private benefit is most important as a separate element in the case of section 501(c)(3) organizations. These public charities are exempt only if they are organized and operated "exclusively" for an exempt purpose.[27] An organization will be treated as organized for an exclusively for an exempt purpose based on the statements of purpose in its organizing documents. An organization will be treated as "'operated exclusively' for one or more exempt purposes only if it engages primarily in activities which accomplish one or more such exempt purposes."[28] By engaging in activities that accomplish one or more exempt purposes, an organization "serves a public rather than a private interest."[29] A section 501(c)(3) organization will not be treated as operating exclusively for an exempt purpose "if more than an insubstantial

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[26] T.D. 8920, 66 Fed. Reg. 2144, 2155-56 (Jan. 10, 2001).

[27] Section 501(c)(3). For this purpose, "exclusively" is defined as "primarily." Treas. Reg. § 1.501(c)(3)-1(c)(1).

[28] Treas. Reg. § 1.501(c)(3)-1(c)(1).

[29] Treas. Reg. § 1.501(c)(3)-1(d)(1)(ii).

part of its activities is not in furtherance of an exempt purpose."[30] The Supreme Court has held that even one "substantial" nonexempt purpose will support revocation of exemption even for an organization that operates for one or more exempt purposes.[31]

In practice, these concepts are difficult to apply because there has been no guidance on how to determine whether activities are "insubstantial." The Tax Court had held that activities constituted less than ten percent of an organization's total activities were properly treated as insubstantial.[32] The Tax Court based its determination on all the facts and circumstances and did not suggest factors to consider or methods for making such determinations.

The Service has defined insubstantial as "incidental" in both qualitative and quantitative senses. An activity will be incidental in the qualitative sense if it is a "necessary concomitant of the activity which benefits the public at large" in the sense that "the benefit to the public cannot be achieved without necessarily benefiting certain private individuals."[33] The Service has ruled, for example, that a section 501(c)(3) organization that maintained a law library for the use of members of a local bar association, judges, and certain other persons but not the general public, provided benefits to the public and did not provide a private benefit to those permitted to use it.[34]

A benefit will be incidental in the quantitative sense if it is insubstantial when compared with the public benefit provided by the organization.[35] The quantitative standard is thus not a bright line percentage test but is instead a facts and circumstances test balancing public and private benefits.[36] The Service ruled that an art gallery that displayed and sold the work of artists from a particular area provided more than an insubstantial private benefit because any artist whose work was sold received 90 percent of the sale proceeds and the organization received the remaining ten percent.[37] The Tax Court applied the balancing test in the case of a hospital

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[30] Treas. Reg. § 1.501(c)(3)-1(c)(1).

[31] Better Business Bureau of Washington, D.C. v. United States, 326 U.S. 279 (1945).

[32] World Family Corp. v. Commissioner, 81 T.C. 958 (1983), acq. in part and nonacq. in part, 1984-2 C.B.

[33] Gen. Couns. Mem. 37789 (Dec. 18, 1978). The concept is similar to the concept of a trade or business that is not subject to the unrelated business income tax because it is "substantially related" to the organization's exempt purpose.

[34] Rev. Rul. 75-196, 1975-1 C.B. 155. The Service reasoned: "The fact that attorneys who use the library may derive personal benefit in the practice of their profession from the information garnered thereby is incidental to this purpose and is, in most instances, a logical by-product of an educational process."

[35] Gen. Couns. Mem. 37789 (Dec. 18, 1978).

[36] Gen. Couns. Mem. 35701 (Mar. 4, 1974); Gen. Couns. Mem. 39862 (Nov. 22, 1991).

[37] Rev. Rul. 76-152, 1976-1 C.B. 151.

founded by a group of doctors.[38] The court balanced the limited amount of charity care against the benefits received by the founding doctors and held that the hospital did not qualify for exemption under section 501(c)(3) because the benefit received by the doctors was not insubstantial.[39]

The private benefit test has been extended to situations that involve important but intangible benefits that are more difficult to measure or even to identify. Perhaps the most important extension of this kind is the application of private benefit to the political activities of section 501(c)(3) organizations. This trend began with the Tax Court's decision in *American Campaign Academy*, a case involving a training program for campaign professionals.[40] The organization's activities were educational, and thus the organization was organized and operated for an exempt purpose. The issue was whether it was operated exclusively for an exempt purpose or whether it was operated to provide a private benefit that was more than insubstantial and that was not merely incidental to its exempt purpose. In this case the Tax Court held that the Republican Party received a private benefit in the form of a cadre of trained campaign workers and that this private benefit was more than insubstantial. Even though the court found that the benefits to the Republican Party were "secondary benefits" compared to the "primary benefits" received by the students who attended the campaign school, it held that "[s]econdary benefits which advance a substantial purpose cannot be construed as incidental to the organization's educational purpose."[41]

A section 501(c)(4) organization has a different exempt purpose and a different concept of private benefit. While section 501(c)(3) organizations are based on the assumption that contributors and beneficiaries are different persons, section 501(c)(4) organizations are based on the assumption that contributors and beneficiaries will be the same persons.[42] The difference is the difference between charity and self-help. Because section 501(c)(4) organizations are based on self-help, they will necessarily provide a benefit to the persons who supported the benefit through their contributions of labor and money. The benefits of section 501(c)(4) organizations are classic public goods in the sense that they tend to be nonexcludable and nondivisible. If a

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[38] Sonora Community Hospital v. commissioner, 46 T.C. 519 (1966), aff'd 397 F. 2d 814 (9th cir. 1968).

[39] Id. This case would under current law be decided on inurement and excess benefit transaction grounds.

[40] American Campaign Academy v. Commissioner, 92 T.C. 1053 (1989).

[41] Id. at 1078.

[42] The distinction between section 501(c)(3) and section 501(c)(4) organizations is far from clear in practice. For example, in Rev. Rul. 68-14, 1968-1 C.B. 243, the Service ruled that an organization formed to beautify an entire city served a charitable purpose and was properly exempt under section 501(c)(3), while it ruled in Rev. Rul. 75-286, 1975-2 C.B. 210 an organization formed to beautify one city block did not qualify for exemption as an organization described in section 501(c)(3). *See also* Gen. Couns. Mem. 36157 (Feb. 10, 1975).

section 501(c)(4) organization provides a lake for a community, all members of the community will benefit even if they did not participate in the effort to provide the lake. Enjoyment of the lake is not a private benefit because providing such enjoyment was the exempt purpose of the section 501(c)(4) organization. This is the clear case of a section 501(c)(4) social welfare organization. However, section 501(c)(4) has become a very diffuse category used by the Service to resolve difficult issues under other subsections of section 501(c), particularly section 501(c)(3

Section 501(c)(4) organizations may or may not be membership organizations. Private benefit may be sufficient to preclude exemption if an organization has a restricted membership and provides benefits only to its members. For example, an organization that provide a large television antenna and permitted only its members to access the antenna did not qualify for exemption as a section 501(c)(4) organization[43], while an organization that provided a television antenna available to the entire community did qualify as a section 501(c)(4) organization.[44] The Service issued two very similar rulings reaching the same result with respect to bus service.[45] This is not to say that a section 501(c)(4) organization must provide benefits to the entire community. However, confining benefits to a narrow membership will generally not support exemption as a section 501(c)(4) organization. It is far from clear whether these results arise from excess private benefit or from the absence of an exempt purpose and of a public benefit, and the authorities do not generally make this distinction.

The relationship between private benefit and exemption remains difficult conceptually and in practice in part because it is unclear whether reasonableness is a defense against treatment as a private benefit. The best approach is to conclude that reasonableness is a defense in some circumstances but not in others. For example, an amount paid for office supplies will not be a private benefit to the supplier if the price is consistent with market standards but it will be a private benefit if the price paid by the organization significantly exceeds the usual market price.[46] In this case, the reasonableness of the price is a defense against a claim that the organization was operating for the private benefit of the supplier.

Consider, in contrast, a case in which an exempt organization provides a benefit to a private person that is reasonable in amount for the benefit provided but that benefit is not related to the organization's exempt purpose. In this case, the reasonableness of the price of the benefit

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[43] Rev. Rul. 62-167, 1962-2 C.B. 142.

[44] Rev. Rul. 54-394, 1954-2 C.B. 131.

[45] Rev. Rul. 78-69, 1978-1 C.B. 156 (exempt section 501(c)(4) organization provided free his service to any member of the community during rush hour); Rev. Rul. 55-311, 1955-1 C.B. 72 (organizations providing his service only to its members did not qualify for exemption).

[46] This example does not mean that the private benefit concept has been used to make finely calibrated judgments about organizational operations.

is not a defense against private benefit in the view of the Service and some courts.[47] The confusion arises because the issue in this case is not private benefit alone but is also the issue of the absence of a public benefit. This is the issue which was remanded to the Tax Court in the *UCC* case by the Seventh Circuit. The confusion over whether reasonableness is a defense to a private benefit claim is more usefully analyzed as a balancing of public and private benefits. This is the element of exempt organization law that has been eroded to the point of conceptual insignificance under current interpretations.

Most other exempt organizations also lack a distinct private benefit limitation. Instead, they have inurement prohibitions that appear to encompass what would be treated as a private benefit in the context of a section 501(c)(3) organization.

4. Inurement

a. Overview of Inurement

To say that inurement applies to a broad range of exempt organizations may be simultaneous formally correct but misleading. Inurement might be described in summary form as private benefit to persons who exercise control over an organization. While private benefit can arise from a distribution to any person without regard to that person's relationship to the organization, inurement arises from the misuse of control over the organization. It is this misuse of control that accounts for the general concept that inurement triggers revocation of exemption without regard to the extent of the benefit arising from the exploitation of control.

This overview of inurement is incomplete and potentially misleading because it suggests that there is only one inurement doctrine that applies across all forms of exempt organizations. In fact, there are two forms of inurement, which are labeled in this article "leadership inurement" and "membership inurement." Leadership inurement involves distributions to persons who exercise control over an organization, persons like members of the board and senior staff. Membership inurement applies to a wide variety of distributions to members if those distributions are in some way disproportionate. The high profile inurement cases have involved persons in leadership positions who appear to have misused their positions for personal benefit. It is far from clear whether this "leadership inurement" is more prevalent than "membership inurement" in the actual operation of exempt organizations. While leadership inurement can

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[47] *See, e.g.,* est of Hawaii v. Commissioner, 71 T.C. 1067 (1979); Church by Mail v. Commissioner, 765 F. 2d 1387 (9th cir. 1985, aff'g TCM 1984-349 (1984). The Service attempted to devise a structural approach to private benefit that in fact turned on the absence of public benefit and perhaps implicitly rested on concerns that the organizations were not treated as separate entities. In this effort, the Service took the position, "finding private benefit does not require that payments for goods or services be unreasonable or exceed fair market value." *See,* Anrew Megosh, Lary Scollick, Mary Jo Salins and Cheryl Chasin, *Private Benefit under IRC 501(c)(3),* Internal Revenue Service Continuing Professional Education Text for Fiscal 2001 (2000). This effort suffers from the failure to discuss public benefit as an affirmative requirement for exemption. By failing to discuss public benefit, this approach has added substantial confusion to the analysis of private benefit.

occur in any type of exempt organization, membership inurement is limited, obviously, to organizations with members. It is unclear what constitutes a member for this purpose. Because most section 501(c)(3) organizations do not have members, these organizations have become the setting for understanding of inurement solely in terms of leadership inurement.

In the abstract, inurement supports revocation of exemption, at least for section 501(c)(3) and section 501(c)(4) organizations. Whether inurement triggers revocation for other types of exempt organizations is far from clear. Even for section 501(c)(3) organizations the consequences of inurement have become more complex since the enactment of section 4958 in 1996. Inurement in the case of section 501(c)(3) or section 501(c)(4) organizations may trigger revocation but it may only trigger the excise taxes applicable in the case of an excess benefit transaction within the meaning of section 4958 or it may trigger both.

b. Leadership Inurement

In practice, inurement has served as an anti-abuse provision for cases involving benefits to persons in a position to exercise substantial influence over the operation of the organization. These general propositions take on slightly more particularized meaning in the context of particular exempt organizations, but, even in these cases, inurement remains more of an anti-abuse provision with the aura of equity than a matter of law with defined requirements.

In the case of section 501(c)(3) organizations, the Code states simply that an organization described in section 501(c)(3) is one "no part of the net earnings of which inures to the benefit of any private shareholder or individual." The regulations do not clarify this concept but simply state that "[a]n organization is not operated exclusively for one or more exempt purposes if its net earnings inure in whole or in part to the benefit of private shareholders or individuals."[48]

This reference to shareholders has supported analysis of inurement in terms of dividend equivalents. The distribution of an organization's assets or earnings to private persons would constitute inurement by analogy to dividends. The question that emerged was whether analogies to constructive dividends provided an analytical template for understanding inurement. Questions of excessive compensation, for example, are classic constructive dividends for corporate tax purposes and also constitute inurement if the person receiving the excess compensation falls within the category of "any private shareholder or individual." This term is defined as "persons having a personal and private interest in the activities of the organization."[49] In nonprecedential guidance the Service has described private shareholder or individual as "persons who, because of their particular relationship with an organization, have an opportunity to control or influence its activities."[50] This concept is expressed in shorthand by referring to "insiders."

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[48] Treas. Reg. § 1.501(c)(3)-1(c)(2).

[49] Treas. Reg. § 1.501(a)-1(c).

[50] Gen Couns. Mem. 39862 (Nov. 22, 1991).

For most of its history, inurement has been applied in cases in which organization resources were diverted to a person who unquestionably exercised control over the organization. The fact patterns involved excess compensation paid to the or excessively favorable terms under a contract controlled by an insider, often the founder who was functioning as the executive director of the organizations.[51] A more contemporary case involved the sale of an exempt hospital's assets to a taxable corporation controlled by the chair of the hospital's board of directors on terms well below fair market value.[52]

An inurement was prohibition was added to the language of section 501(c)(4) in 1996.[53] The inurement prohibition is applied with some differences arising from the purposes of section 501(c)(4) organizations. As was discussed above, section 501(c)(4) organizations were defined as a separate type of organization because the members of the organization provide benefits to themselves, in contrast to section 501(c)(3) organizations, which provide benefits to persons other than the members or contributors. Section 501(c)(4) organizations are structures that permit people to help themselves and their communities by providing such civic betterments as parks or other improved public spaces. The concern was that this type of activity could be construed as violating the private benefit limitation applicable to section 501(c)(3) organizations. The same concerns might arise with respect to the inurement prohibition since officers and directors and substantial contributors will benefit from the activities of section 501(c)(4) organizations. Such benefits will not constitute prohibited inurement if insiders benefit in the same way and to the same extent as other members of the public. The public quality of the benefit arises from the nature of the benefit as classic public goods that are indivisible and non-excludable. Thus, for example, a park will be open to all members of the community whether or not they participated in the work and expense of providing the park.[54] If, however, a section 501(c)(4) organization provided such benefits as replacing curbs or sidewalks and confined its

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[51] See, for example, Birmingham Business College v. Commissioner, 276 F. 2d 476 (5th Cir. 1960); Texas Trade School v. Commissioner, 30 T.C. 642 (1958), aff'd, 272 F. 2d 168 (5th Cir. 1959); Western Catholic Church v. Commissioner, 73 T.C. 196 (1979), aff'd , 631 F. 2d 736 (7th cir. 1980, cert. Denied, 450 U.S. 981 (1981).

[52] Anclote Psychiatric Center, Inc. v. Commissioner, T.C.Mem. 1998-273, aff'd, 190 F. 3d 541 (11th Cir. 1999).

[53] Sec. 1311(b) of HR 2337, the Taxpayer Bill of Rights 2, added new section 501(c)(4)(B), which states that an organization will not qualify for exemption "unless no part of the net earnings of such entity inures to the benefit of any private shareholder or individual."

[54] This is the classic freerider issue. In a sense, there can be no freerider problem in a section 501(c)(4) organization since the purpose of the organization is to provide benefits to the community and the tax exemption is, in part, compensation for the provision of such benefits. It is interesting to consider whether, to what extent, and under what circumstances a person who is an intended beneficiary could be considered a freerider.

activities to the curbs or sidewalks adjoining the property of the organization's insiders, then there would be inurement.[55]

Other exempt organizations will also lose their exempt status if they engage in these kinds of transactions with an insider. For example, regulations applicable to section 501(c)(9) voluntary employee benefit societies state that "[g]enerally, the payment of unreasonable compensation to the trustees or employees of the association, or the purchase of insurance or services for amounts in excess of their fair market value from a company in which one or more of the association's trustees, officers or fiduciaries has an interest, will constitute prohibited inurement."[56]

Inurement became far more controversial when the Service attempted to use it in closer cases. The first such attempt was the Service's attempt to treat staff physicians as insiders so that revenue-based compensation arrangements would jeopardize the hospital's exempt status.[57] While the broad definition of an insider was the most obviously controversial element of this position, the effort to make rather fine distinctions among compensation levels was also controversial.

The *UCC* case also became a very controversial inurement case. The issue was whether a contract could make a third party an insider. As discussed above, the Seventh Circuit refused to find inurement in this case.[58] Judge Posner did not reject the idea that an outside could become an insider, but he refused to find that the fundraising firm in this case had become an insider. Judge Posner also ruled that an unfavorable contract does not necessarily establish that the compensation received pursuant to such a contract was necessarily excessive. Both of these factors became important in section 4958 and the regulations thereunder.

c. Membership Inurement

Membership inurement arises from the provision of differential benefits to various classes of members or the provision of benefits to members at the expense of nonmembers. This concept is treated as inurement because of prohibitions on inurement in the statutory language describing various types of exempt organizations. These references appear in those exempt organizations that are commonly regarded as membership organizations.

Section 501(c)(5) simply lists "[l]abor, agricultural, or horticultural organizations" and contains no specific requirements. The regulations provide that these organizations will qualify for exemption only if they "[h]ave no net earnings inuring to the benefit of any member."[59]

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[55] There would be room for discussion if, for example, the only curbs or sidewalks that needed repair were on or adjoining the property of the organization's insiders.

[56] Treas. Reg. § 1.501(c)(9)-4(a).

[57] GCM 39498 (Jan. 28, 1986); GCM 39670 (June 17, 1987).

[58] *See supra* Part II.

[59] Treas. Reg. § 1.501(c)(5)-1(a)(1).

However, inurement is applied differently in the case of each of the section 501(c)(5) organizations. The Service has explained the difference in the following terms:

> The prohibition against inurement of earnings applies to many organization described in IRC 501(c), but what constitutes inurement under one paragraph many not be inurement under another paragraph....the promotion of the economic self-interest of members of a labor organization is inherent in the purposes of such an organization. However, because the exempt purposes of an agricultural organization are to better the conditions of those engaged in agricultural pursuits generally rather than to specifically benefit the individual members...the provision of such organizations of financial aid and welfare assistance to their members, such as death, sick, accident, and similar benefits, would constitute inurement.[60]

The Service amplified its explanation of the mutual benefit aspects of labor unions and the implications for inurement:

> Labor organizations are exempt from income tax because, among other reasons, they operate in part as mutual benefit organizations, providing benefits to their members or their members' families in the event of strike, lockout, death, sickness, accident, etc. Accordingly, payment of such benefits by a labor organization to its members or their families from funds contributed by its members, if made under a plan which has as its object the betterment of the conditions of its members, does not constitute inurement and does not preclude exemption for the organization under IRC 501(c)(3).[61]

There is little other guidance available on inurement in the context of section 501(c)(5) organizations.[62] As in the case of section 501(c)(3) or section 501(c)(4) organizations, section 501(c)(5) organizations that pay unreasonable compensation to persons with substantial influence over the organization will jeopardize their exempt status based on inurement.[63] Because section 501(c)(5) organizations are generally membership organizations in which members have voting rights not only to select the board but also to vote on policy issues, there is some question of whether members are insiders for inurement purposes. There is no direct guidance on this issue.

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[60] IRM 7751 (VII)(533).

[61] IRM 7751(VII)(525).

[62] The Service refers inurement issues to the National office "because of the lack of precedent." IRM 7751 (524).

[63] The Service has cited examples of an expense allowance that does not require itemized accounting or the payment of a labor organization official's legal expenses may attract special scrutiny on inurement grounds. IRM 7(10)69(VII)(521.6).

Similar principles apply in determining whether there is inurement in a section 501(c)(6) business league. The inurement prohibition states that a business league is an organization "no part of the earnings of which inures to the benefit of any private shareholder or individual." For example, a trade association of wholesale grocers that owned a copyright on certain food labels jeopardized its exempt status when it distributed the royalties earned from the copyright to its members.[64] A pro rata refund of dues to members will not constitute inurement unless the amount refunded exceeds the amount of dues paid.[65]

The inurement prohibition is absolute and the Service has applied it to revoke exempt status in a case involving a fairly limited amount.[66] Inurement does not apply simply to the provision of benefits to members but to the provision of differential benefits to members. Inurement also applies to the provision of benefits not related to the organization's exempt purpose to some or all members. Transactions that do not involve direct distributions of the organization's earnings or differential benefits to classes of members may be treated as inurement or as the provision of particular services to members, which is not an exempt activity but not one which jeopardizes exemption unless it becomes the organization's primary activity.

The provision of differential benefits constitutes inurement because it involves a subsidy of some members by other members and the organization becomes the mechanism for both extracting value from one group of members and transferring this value to another set of members. This general principle becomes quite complex and even counterintuitive when it is applied to particular fact patterns. For example, the Service found that there was no inurement when two trade associations, each with a complex membership structure, transferred funds between themselves to deal with collective bargaining and other labor activities in a particular industry.[67]

The provision of benefits not related to the business league's exempt purpose will be treated as inurement even if the distribution does not differentiate among members or rely on a subsidy from nonmembers. By the same token, provision of benefits that are related to the organization's exempt purpose will not be treated as inurement. The distinctions in particular cases are often conceptually elusive. For example, a business league's provision of a loan fund to members experiencing financial difficulties during a strike was a benefit to individual members, only some of whom availed themselves of the benefit, but it did not constitute inurement because it was available on the same terms to all members and because it promoted the common business goal of the particular business league.[68] However, a trade association of chiropractors that compensated members for their expenses in defending malpractice suits and in

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[64] Wholesale Grocers Exchange v. Commissioner, 3 T.C.M. 699 (1944).

[65] King County Ins. Ass'n. v. Commissioner, 37 B.T.A. 288 (1938), acq. 1938-1 C.B. 17. *See also* Rev. Rul. 81-60, 1981-1 C.B. 335.

[66] Rev. Rul. 67-251, 1967-2 C.B. 196.

[67] Priv. Ltr. Rul. 9448036.

[68] Gen. Couns. Mem. 38559 (Nov. 7, 1980).

paying damages awarded plaintiffs in such suits lost its exempt status on grounds of inurement.[69] Similarly, the Service has ruled that a business league did not qualify for continued exemption on inurement grounds because it provided financial assistance and welfare benefits to its members.[70]

Section 501(c)(6) business leagues may distribute their assets or the proceeds from the sale of their assets to their members in liquidating distributions upon dissolution without have the distribution treated as inurement.[71] There is no direct authority on the question of redemption of a membership interest in a trade association.

Section 501(c)(7) social clubs are also subject to an inurement prohibition.[72] For purposes of the inurement prohibition, each member is treated as an insider by virtue of being a "shareholder" with rights to share in any distribution upon dissolution of the organization.[73] Payment of dividends from club earnings constitutes inurement. The most common inurement patterns in social clubs arise from the differential treatment of different classes of members. Inurement does not arise from having different classes of members entitled to different levels of benefits but rather from the provision of benefits to one or more classes of members that are disproportionate to the dues paid by those classes of members. For example, if two classes of members pay the same dues but receive different levels of benefits, inurement will arise with respect to the class of members receiving the greater level of benefits. By the same token, charging different levels of dues to members receiving the same benefits will result in inurement with respect to those members who pay the lower dues. In Rev. Rul. 70-48, the Service ruled that charging higher dues to nonvoting members who enjoyed the same level of club benefits as voting members resulted in inurement.[74] In this case the Service found the inurement in what it described as the subsidy of the voting members by the nonvoting members. Inurement can also arise when income from nonmembers is found to subsidize the benefits enjoyed by members. It is not clear that simply earning a net profit on the provision of services to nonmembers is sufficient in itself. However, a deliberate policy of providing nonmember services at a sufficient profit to support member services that could not be provided from dues alone would constitute inurement.

While distributions from current earnings can constitute inurement, earnings arising from the appreciation of the property of a social club will not constitute inurement if distributed to all

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[69] National Chiropractic Ass'n. v. Birmingham, 96 F. Supp. 874 (1951).

[70] Rev. Rul. 67-251, 1967-2 C.B. 196.

[71] Crooks v. Kansas City Hay Dealers Ass'n., 37 F. 2d 83 (8th Cir. 1929); Washington State Apples, Inc. v. Commissioner, 46 B.T.A. 64, 70 (1942), acq. 1942-1 C.B. 17.

[72] Section 501(c)(7) describes an exempt social club as a social club "no part of the net earnings of which inures to the benefit of any private shareholder."

[73] West Side Tennis Club v. commissioner, 111 F. 2d 6 (2d Cir. 1940), aff'g 39 BTA 149 (1939), cert. Denied, 311 US 674 (1940).

[74] Rev. Rul. 70-48, 1970-1 C.B. 133.

of the members upon dissolution or if distributed to some subset of members in redemption distributions.[75] The Service has ruled that liquidating distributions to the members upon the dissolution of the social club and the sale of its assets did not constitute inurement.[76] Redemption of one member's stock at book value at the time of redemption did not constitute inurement even though book value at the time of the redemption exceeded the purchase price.[77]

Many of the same issues arise with respect to inurement in the context of section 501(c)(8) fraternal benefit societies. Differential benefits to members that are disproportionate to the dues paid by various categories of members constitute inurement. In most cases, a social club will not jeopardize its exempt status on inurement grounds if it has a class of members that receives no benefits. However, the Tax Court has held that a fraternal benefit society organized in a way that results in 90 percent of the members' receiving no benefits did violate the inurement prohibition and thus was not exempt.[78] The principle is that the dues paid by members who do not receive benefits may not be used to fund benefits for other members.[79]

Cemetery associations described in section 501(c)(13) are also subject to an inurement prohibition.[80] Excess payments of whatever form to organizational insiders will be treated as prohibited inurement, but it is not clear whether every instance of such inurement will trigger revocation. In addition, cemetery associations are generally organized as stock corporations. Issuance of dividend with respect to common stock constitutes prohibited inurement. A cemetery association may not issue preferred sock, but there are transition rules relating to the retirement of outstanding preferred stock.[81]

Various revenue-sharing arrangements are treated as inurement in the context of section 501(c)(13) cemetery associations. The most common are so-called equity sales arrangements in which sales of property are made to a cemetery for a percentage of the association's net

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[75] These distributions of assets to members of section 501(c)(3) organizations would violate the dissolution clause.

[76] Rev. Rul. 58-501, 1958-2 C.B. 262. Gen. Couns. Mem. 39658 (Aug. 27, 1987) takes the position that liquidating distributions of the net proceeds from the sale of a social club's assets used in the performance of the club's exempt function does not jeopardize the club's exempt status, but the social club its taxable on the sale.

[77] Rev. Rul. 68-639, 1968-2 C.B. 220.

[78] Polish Army Veterans Post 147 v. commissioner, 24 T.C. 891 (1951), remanded, 236 F. 2d 509 (3rd Cir. 1956).

[79] Rev. Rul. 64-194, 1964-2 C.B. 149.

[80] Sec. 501(c)(13) expresses its inurement prohibition in the familiar language stating that "no part of the net earnings of which inures to the benefit of any private shareholder or individual."

[81] Treas. Reg. § 1.501(c)(13)-1(c).

earnings.[82] In addition, any debt obligation that provides for an interest payment in whole or in part defined as a percentage of net earnings will be treated as inurement.[83]

Voluntary Employee Beneficiary Associations ("VEBAs") are also subject to an inurement prohibition. Under section 501(c)(9) VEBAs exempt purpose is to pay "life, sick, accident, or other benefits to the members" or the members' dependents or designated beneficiaries. The VEBA will be exempt "if no part of the net earnings of such association inures (other than through such payments) to the benefit of any private shareholder or individual." The regulations define inurement as "[t]he disposition of property to, or the performance of services for less than the greater of fair market value or cost (including indirect costs) to the association."[84] Whether any transaction constitutes inurement depends on the facts and circumstances of each case.[85] As in the case of other mutual benefit associations, inurement in the context of a section 501(c)(9) VEBA includes both excessive compensation to insiders and disproportionate benefits among members.

Payment of disproportionate benefits to the members constitutes inurement in the context of a section 501(c)(9) VEBA.[86] The regulations provide that "the payment to any member of disproportionate benefits, where such payment is not pursuant to objective and nondiscriminatory standards, will not be considered a benefit..."[87] As an example of this principle, the regulations provide that "payment to highly compensated personnel of benefits that are disproportionate in relation to benefits received by other members of the association will constitute prohibited inurement."[88] A second type of disproportionate benefits involves distinctions among benefits to members who are not otherwise distinguishable. The regulations state that "payment of similarly situated employees of benefits that differ in kind or amount will constitute prohibited inurement unless the difference can be justified on the basis of standards adopted pursuant to the terms of a collective bargaining agreement."[89] The concept of disproportionate benefits turns largely on the concepts sets forth in the provisions relating to discrimination in favor of highly compensated employees.[90] The regulations state that "[i]n

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[82] Treas. Reg. § 1.501(c)(13)-1(d).

[83] Id.

[84] Treas. Reg. § 1.501(c)(9)-4(a).

[85] Id., which states that the regulations provide "guidelines" that "are not an exhaustive list of the activities that may constitute prohibited inurement, or the persons to whom the association's earnings could impermissibly inure."

[86] Treas. Reg. § 1.501(c)(9)-4(b).

[87] Id.

[88] Id.

[89] Id.

[90] Id.

general, benefits paid pursuant to standards or subject to conditions that do not provide for disproportionate benefits to officers, shareholders, or highly compensated employees will not be considered disproportionate."[91]

As is the case for most membership mutual benefit associations, including social clubs, a VEBA may make liquidating distributions to its members upon dissolution of the organization without having such distributions treated as inurement.[92] The limitations are that such distributions must be made "pursuant to criteria that do not provide for disproportionate benefits to officer, shareholders, or highly compensated employees of the employer."[93] The regulations further provide that "a distribution to members upon dissolution of the association will not constitute prohibited inurement if the amount distributed to members are determined pursuant to the terms of a collective bargaining agreement or on the basis of objective and reasonable standards which do not result in either unequal payments to similarly situated members or in disproportionate payments to officers, shareholders, or highly compensated employees of an employer contribution to or otherwise funding the employees' association."[94]

5. Excess Benefit Transactions

a. Background and Overview

In 1996 Congress added section 4958 to the Code.[95] Section 4958 defines a new concept described as an excess benefit transaction and levies sanctions on "disqualified persons"[96] and "organization managers"[97] who engage in such transactions. The sanctions levied on the disqualified persons and organization managers are excise taxes on the amount of the excess benefit.[98] The exempt organization itself is not subject to these excise tax sanctions under section 4958.

Section 4958 was the end product of a call for an "intermediate sanction" in the case of inurement. The original concept was that some sanction other than revocation of exempt status

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[91] Id., which cross-references Treas. Reg. § 1.501(c)(9)-2(a)(2) and (3) on this point.

[92] Treas. Reg. § 1.501(c)(9)-4(d).

[93] Id., which cross-references Treas. Reg. § 1.501(c)(9)-2(a)(2) for definition of highly compensated employees of the employer.

[94] Id.

[95] The excess benefit transactions provisions were part of the Taxpayer Bill of Rights 2, Pub. L. 104-168, 110 Stat. 1452 (1996).

[96] Sec. 4958(f)(1).

[97] Sec. 4958(f)(2).

[98] Sec. 4958(a) and (b).

was required because revocation could be either inappropriately harsh or unacceptably inconsequential. It may appear counterintuitive to suggest that revocation can be too harsh or too inconsequential, but that result is the heart of the problem of relying solely on revocation. Revocation is an inappropriately harsh sanction when it applies to an organization with established programs of exempt and the amount involved in the inurement transaction is very small compared with the scope of the public benefit being provided. In these cases, revocation disrupts relationships with the contributors and deprives the public of the benefits of the organization's activities consistent with its exempt purposes.

Revocation is unacceptably inconsequential, amounting to no more than temporary inconvenience, in the case of organizations that serve nonspecific beneficiaries, such as "the public" in a very general sense, and have one or two funders who regard the organization as the equivalent of an alter ego. Revocation does not disrupt the relationship with the funding sources since they will simply establish a new organization to conduct the same activities. Revoking the exempt status of an organization that no longer operates and no longer has resources is meaningless with respect to the organization. The process is meaningful only if the Service is prepared to deny the charitable contribution deduction in cases where these organizations operated as section 501(c)(3) organizations.

Monetary sanctions, so-called intermediate sanctions, addressed both of these cases. In cases where revocation is inappropriately harsh, monetary sanctions can be levied on those who benefited from the inurement without imposing sanctions on the beneficiaries of the organization's programs. In cases where revocation is unacceptably inconsequential, sanctions can be levied on those who manipulated exemption for their own benefit.

Section 4958 attempts to clarify the two unresolved issues that arise under inurement—the identity of the insiders and the nature of the transactions that trigger sanctions. In addressing these issues, section 4958 draws on elements of the private foundation self-dealing provisions[99] as well as on elements of the inurement concept applicable to public charities. The self-dealing provisions prohibit persons with certain relationships to the organization from engaging in certain identified transactions. Inurement is a facts and circumstances determination in which the reasonableness of the compensation is taken into account. Section 4958 seeks to identify disqualified persons and transactions requiring special scrutiny but unlike the private foundation self-dealing provisions, it is based on facts and circumstances determinations in which reasonableness of the end result is one of the factors considered.

Section 4958 applies only to section 501(c)(3) and section 501(c)(4) organizations or to any organization that was such an organization during the five-year period ending on the date of

[99] Sec. 4941.

the excess benefit transaction.[100] Section 4958 does not apply to a foreign organization that receives "substantially all of its support from sources outside the United States."[101]

Disqualified Persons and Organization Managers

The parties to an excess benefit transaction are disqualified persons and organization managers. Both concepts have been derived from the self-dealing provisions applicable to private foundations. The organization manager concept is also based in part on the definition of an organization manager for purposes of the section 4955 excise tax on excess campaign activity by a section 501(c)(3) organization. A transaction entered into by an organization manager with a person who is not a disqualified person does not trigger the excise taxes of section 4958. It is rather less straightforward to claim that a transaction between a disqualified person and the organization entered into by a person who is not an organization manager would not trigger section 4958. The answer in this second case depends on whether an organization manager is defined by position or whether the actual ability to bind the organization means, in effect, that any transaction entered into by an employee can be an excess benefit transaction if the organization in fact performs pursuant to the agreement entered into by the employee, even if the agreement was beyond the scope of the employee's normal authority.

b. Disqualified Persons

A disqualified person is any person "in a position to exercise substantial influence over the affairs of the organization" at any time during the five-year period ending on the date of such transaction[102] and the members of such person's family.[103] Family is defined for this purpose as the disqualified person's spouse, siblings and their spouses, ancestors, and descendants through great grandchildren and their spouses.[104] An entity in which one or more disqualified persons holds at least 35 percent control is also a disqualified person.[105] Control is defined for this purpose as "combined voting power" in a corporation, a profits interest in a partnership and a beneficial interest in the case of a trust or an estate.[106] The regulations set forth two tests for determining whether a person is in a position to exercise substantial influence over the affairs of

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[100] Sec. 4958(e).

[101] Temp. Treas. Reg. § 53.4958-2T(a)(2) applies this exception to section 501(c)(3) organizations and Temp. Treas. Reg. § 53.4958-2T(a)(3) applies this exception to section 501(c)(4) organizations.

[102] Sec. 4958(f)(1)(A).

[103] Sec. 4958(f)(1)(B) and Prop. Treas. Reg. § 53.4958-3(b)(1).

[104] Temp. Treas. Reg. § 53.4958-3T(b)(1).

[105] Sec. 4958(f)(1)(C) and Temp. Treas. Reg. § 53.4958-3T(b)(2).

[106] Temp. Treas. Reg. § 53.4958-3T(b)(2). Constructive ownership rules apply so that control is based on both direct and indirect ownership. Temp. Treas. Reg. §53.4958-3T(b)(2)(iii).

an organization. One is a per se test based on the person's role in the organization and the second is a facts and circumstances test.

The per se test treats the following persons as disqualified persons: (1) voting members of the governing body;[107] (2) the president, chief executive officer or chief operating officer who "has or shares ultimate responsibility for implementing decisions of the governing body or supervising the management, administration, or operation of the applicable organization";[108] (3) treasurer or chief financial officer or any other individual who "has or shares ultimate responsibility for managing the organization's financial assets and has or shares authority to sign drafts or direct the signing of drafts, or authorizes electronic transfers of funds, from organization bank accounts";[109] and (4) "[p]ersons with a material financial interest in a provider-sponsored organization."[110] Persons in these roles are per se disqualified persons, as are the members of their family and entities in which they (individually or as a group) hold 35 percent control. Nevertheless, a transaction between an applicable tax exempt organization and a disqualified person is not an excess benefit transaction unless there is excess value for the disqualified person. It is important to understand that the first three categories are also organization managers and that they can be subject to two levels of excise tax if the transaction is an excess benefit transaction, one level of tax is that levied on disqualified persons and the other is the tax levied on organization managers.

A facts and circumstances test may result in treatment of certain other persons as disqualified persons based.[111] Under the proposed regulations, factors "tending to show that a person has substantial influence over the affairs of the organization, include, but are not limited to" the following:

(1) the person founded the organization;

(2) the person is a substantial contributor;

(3) the person received primarily revenue-based compensation;

(4) the person controls or determines a significant portion of the organization's capital expenditures, operating budget, or employee compensation;

(5) the person has managerial authority or serves as a "key adviser" to such a person;

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[107] Temp. Treas. Reg. § 53.4958-3T(c)(1).

[108] Temp. Treas. Reg. § 53.4958-3T(c)(2).

[109] Temp. Treas. Reg. § 53.4958-3T(c)(3).

[110] Temp. Treas. Reg. § 53.4958-3T(c)(4).

[111] Temp. Treas. Reg. § 53.4958-3T(e).

(6) the person owns a controlling interest in an entity that is a disqualified person.

(7) the person is a nonstock organization controlled, directly or indirectly, by one or more disqualified persons.[112]

These factors can be established by a contractual relationship with the organization. The Temporary Regulations provide an example of a taxable entity that contracted with an applicable tax exempt organization to manage its bingo games.[113] The contract gave the taxable entity authority to make all the decisions relating to the bingo operation, which provided over half of the exempt organization's annual total revenue. The same company "manages a discrete activity of [the exempt organization} that represents a substantial portion of [the exempt organization's] income compared to the organization as a whole"[114] The management company is a disqualified person with respect to the exempt organization.

The temporary regulations provide an exception to the disqualified person rules for the period of the initial contract between the exempt organization and the person.[115] This initial contract exception applies only to "fixed payments" which includes certain revenue-based compensation.

This "first bite rule" means that Treasury now explicitly invokes the inurement and private benefit principles as a safeguard against abuse in this area.[116] This alone means simplification by repealing the leadership inurement provisions is no longer feasible.

c. Excess Benefit Transactions

Section 4958(c) defines two types of excess benefit transactions. The first and more general definition defines an excess benefit transaction is a transaction between an applicable tax exempt organization and a disqualified person "if the value of the economic benefit provided exceeds the value of the consideration (including the performance of services) received for providing it."[117] The second definition relates to revenue sharing transactions that result in inurement.[118] It is not clear why the second definition is stated separately or what relationship is intended between inurement and the excess benefit transaction provisions. Each of these provisions is discussed below.

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[112] Prop. Treas. Reg. § 53.4958-3(e)(2)(I)-(vi).

[113] Prop. Treas. Reg. § 53.4958-3T(a), Example 5.

[114] Id.

[115] Temp. Treas. Reg. §53.4958-4T(a)(3)

[116] Temp. Treas. Reg. § 53.4958-8T(a).

[117] Sec. 4958(c)(1).

[118] Sec. 4958(c)(2).

1. Excess Value Transactions

The excess value transactions described in section 4958 is the core of section 4958. Without an element of excess value, section 4958 does not apply to a transaction even if one of the parties to the transaction is a disqualified person. This is the essential difference between the section 4958 excess benefit transaction provisions and the section 4941self-dealing rules applicable to private foundation. The private foundation self-dealing rules prohibit transactions to which disqualified persons are parties even if those transactions are priced at fair market value and are beneficial to the organization. For example, a substantial contributor's lease of property to an exempt organization at a rent below the prevailing market rate violates the self-dealing rules simply because the substantial contributor is a disqualified persons who is a party to the transaction. If the same transaction were conducted by a section 501(c)(3) public charity or a section 501(c)(4) organization, section 4958 would not apply because the transaction produced no excess value for the disqualified person. In this sense, section 4958 is consistent with the prevailing concept of inurement, which also requires some evidence of an excess value, whether monetary or intangible.

The temporary regulations applicable to excess value transactions provide guidance on determining when a transaction involves an excess benefit.[119] The key inquiry is whether the contract amount is reasonable based on comparable transactions, including comparable based on transactions involving taxable entities.[120]

Determination of the reasonableness of a contract for the purchase or use of property is based on the standard defined by a transaction between "a willing buyer and a willing seller, neither being under any compulsion to buy, sell or transfer property or the right to use property, and both having reasonable knowledge of relevant facts."[121] The temporary regulations do not elaborate, but they clearly establish the need for an excess value as a precondition for the application of section 4958.

Determination of the excess value of compensation for services is also based on reasonableness as determined by comparisons with amounts that "would ordinarily be paid for like services by like enterprises under like circumstances."[122] The temporary regulations provide a list of items to be considered in determining whether compensation is reasonable.[123]

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[119] Temp. Treas. Reg. § 53.4958-4T.

[120] Id.

[121] Temp. Treas. Reg. §53.4958-4T(b)(1)(i).

[122] Temp. Treas. Reg. §53.4958-4T(b)(1)(ii)(A).

[123] Temp. Treas. Reg. §53.4958-4T(b)(1)(ii)(B).

2. Revenue Sharing and Inurement Transactions

Section 4958(c)(2) refers to revenue sharing transactions that result in inurement. There has been much confusion over the intended purpose of this provision and its relation to the general excess value definition of an excess benefit transaction. The possibility exists that this is simply a drafting mistake added late in the drafting process to ensure that revenue sharing transactions would not be prohibited per se under the general excess value standard. In practice, this statutory provision has raised questions about revenue sharing transactions and about whether the reasonableness standard applies to them. In sum, it may have a result directly contrary to the intent of the drafters.

This second definition of an excess benefit transaction should logically be part of the first definition.[124] Whether the excess benefit is defined as a share of an organization's revenue or as a fixed sum or by some other measure should all be variants of the general principle that an excess benefit arises where all the value received by a disqualified person exceeds the consideration that the disqualified person provided.

In the Proposed Regulations, the Treasury treated the second definition of an excess benefit transaction as a definition of structural inurement in which the disqualified person benefits at the expense of the exempt organization.[125] The logic for this position is that in revenue sharing each party receives a share of a fixed amount, so that as the amount received by the disqualified person increases, the amount received by the exempt organization necessarily decreases. The same is true, however, of any payment for goods or services. The Proposed Regulations then treat the entire amount received by the disqualified person, not simply the excess benefit, as subject to the excise tax sanctions. This position is based on the definition of the excess benefit in terms of the inurement. Section 4958(c)(2) states that in this case "the excess benefit shall be the amount of the inurement not so permitted." The Treasury's position would mean that inurement is defined in terms of the entire amount received and not as the excess over any reasonable amount for the goods or services provided. Section 4958(c)(2) states that it applies "to the extent provided in regulations." The consequence of this position is that inurement is defined without any reasonableness component. The history of inurement as a general antiabuse provision that supports revocation of exemption means that questions of extent of inurement have not been addressed. It does appear, however, that inurement turned not on control but on an excess over a reasonable amount.

The issue that Treasury highlighted in its Proposed Regulations on structural excess benefit transactions is one that does not fit within either inurement as currently understood or

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[124] One reasonable reading of Sec. 4958(c)(2) is that is serves to highlight revenue sharing transactions as one type of excess benefit transaction because it states that "the term 'excess benefit transaction' *includes*" revenue sharing transactions that constitute inurement. (Emphasis added) Under this reading, the reasonableness limitation that is part of the definition of an excess benefit transaction in Sec. 4958(c)(1)(A) would be read into Sec. 4958(c)(2).

[125] Prop. Treas. Reg. § 53.4958-5.

section 4958 as currently drafted.[126] The reference to inurement in section 4958(c)(2) simply compounds the confusion and complexity. The problem with the regulations is that they represent an effort to translate the issue of the absence of a public benefit into the presence of an excess benefit transaction.

Treasury did not issue these proposed regulations in temporary form.[127] Whether Treasury and the Service now offer guidance on the relationship between excess benefit transactions and public benefit remains to be determined. This paper suggests that the proposed regulations provide a beginning for such an analysis.

6. Approaches to Simplification

Three private benefit doctrines apply to at least some exempt organizations. Might it be possible to remove one or two of these doctrines from the Code, at least in the case of section 501(c)(3) and section 501(c)(4) organizations? The answer appears to be no. The most likely simplification would be to repeal inurement and rely solely on section 4958. However, the new temporary regulations issued in January 2001 created situations where the regulations explicitly rely on inurement as an anti-abuse provision.[128]

There is one change to section 4958 that would constitute both simplification and clarification. This is the recommended repeal of section 4958(c)(2), which includes in the definition of an excess benefit transaction a revenue-sharing transaction that constitutes inurement. This is the only time that section 4958 refers explicitly to inurement. It is not clear why there is a special rule for revenue sharing transactions. It would appear that the intent of section 4958(c)(2) is to provide that revenue sharing transactions are treated like any other transaction. The proposed regulations, however, used section 4958(c)(2) as the statutory authority for a special rule for revenue sharing transactions that had a very different result.[129] Whatever one thinks of the proposed regulation, any statutory provision capable of such misinterpretation should be repealed. The most reasonable explanation of this provision is that it was a drafting error. Assuming the original intent was to treat revenue sharing transactions under the general rules, no special rule is needed.[130]

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[126] Prop. Treas. Reg. § 53.4958-5.

[127] Temp. Treas. Reg. § 53.4958-5T simply notes that it is "reserved". The preamble to the temporary regulations states that the general excess benefit transaction standards will apply unless or until regulations applying specifically to revenue sharing transactions are issued. 66 Fed. Reg. 2144, 2153 (Jan. 10, 2001).

[128] Temp. Treas. Reg. § 53.4958-8T(a).

[129] STET. Treas. Reg. § 53.4958-5. Prop. Treas. Reg.

[130] The temporary regulations apply the general excess benefit transaction provisions to revenue sharing transactions. *See* Temp. Treas. Reg. §53.4958-4T.

Most of the complexity relating to exemption from taxation arises from the structural issue of what constitutes an exempt organization. How much exempt activity must an organization conduct to qualify for exemption? How does one determine what amount or what proportion of its activities constitutes exempt activities? This paper does not answer this question. It has analyzed private benefit issues in their own terms and not directly in terms of the consequences for exempt status.

At the same time, this paper has placed its discussion of the three private benefit doctrines in the larger framework provided by a public benefit perspective. This paper began with a discussion of the consequences for exemption and for the private benefit doctrines of relying on evidence of the absence of private benefit to establish the basis for exemption. In light of this approach, the paper notes that recommendations relating to simplification of the private benefit provisions could attempt to build a public benefit requirement or could attempt to refine and clarify the current approach of establishing the absence of a private benefit.

A reasonable case could be made that the simplest approach to exemption would be to craft a public benefit standard providing that an organization is exempt if it devotes some defined proportion of its income to exempt purposes. The use of the remaining percentage would then have no consequences for exemption, but the organization would be taxed on any amounts not used for exempt purposes. The percentage required to be devoted to exempt activities would logically be a very high percentage to avoid the misuse of exemption for commercial or political purposes. For example, one approach would be to say that an organization is exempt if it devotes 95 percent of its annual budget to activities directly connected with its exempt purpose and directly beneficial to the intended beneficiaries of its exempt activities. The remaining percentage of the annual expenditures could be used for any purpose without tax and without jeopardizing the organization's exempt status. Questions of the distinctions among private benefit and inurement and excess benefit transactions would not arise or would not arise with the same import because all activities that do not satisfy the public benefit test would be treated alike.

The alternative approach is to attempt to simplify and clarify the three private benefit doctrines and to do so in a way that links them to a public benefit requirement. Exemption would be based on the absence of excess private benefit. This approach might be consistent with the development of clearer guidelines, but it is far from clear that such an approach would provide a coherent and practical balance among stringent rules, operational necessities and a persuasive rationale for treating certain organizations as exempt from taxation. The contours of a possible approach are sketched out below. These discussions are not recommendations for legislative action but are instead illustrations of the difficulties.

The private benefit concept applies most clearly in the case of section 501(c)(3) public charities. Private benefit has become a diffuse doctrine applied broadly to avoid the complexities of other elements of the exemption provisions. The following points summarize the elements of an effort to clarify the private benefit doctrine.

(1) Private benefit should be defined as any benefit provided to any person other than a benefit that is directly related to the organization's exempt purposes.

(2) All private benefit levels should be computed as a percentage of revenue actually spent on exempt activities.

(3) Private benefit would be subject to sanctions at all levels except a de minimis level of 5 percent or less of the organization's program budget.

(4) If private benefit expenditures are between 6 and 49 percent of program expenditures, excise taxes would be levied on both the organization and the organization managers.

(5) If private benefit expenditures are 50 percent or more of an organization's program expenditures, the organization's exempt status may be revoked and/or excise taxes will be levied on the organization and on its managers.

(6) If an exempt organization uses its treasury funds to engage in campaign-related advocacy, however such advocacy is characterized for election law purposes, the expenditure will be treated as a private benefit to any candidate or group of candidates or any political party that is referenced positively by name or by the use of a picture or an identifying logo or symbol the same excise tax would apply to the beneficiaries of the negative ads. The beneficiary will be subject to an excise tax of 100 percent of the expenditure. If the candidate or group of candidates or political party does not take affirmative efforts to cause the exempt organization to stop making the private benefit expenditure, the candidate will be subject to an excise tax equal to 200 percent of the private benefit expenditure.

These elements do not necessarily achieve their intended purpose. They impose monetary penalties where none may be appropriate. But, they do illustrate the potential consequences of continued reliance on the absence of private benefit as the hallmark of exemption.

Because section 4958 now addresses the kinds of excess benefits that arise during more routine operations, there is a reasonable case for leaving the leadership inurement provisions in their current form as broad anti-abuse provisions. Inurement would apply only in those instances where the excess benefit transaction provision did not apply or where the excess benefit was either such a large part of the organization's budget or such a recurrent part of the organization's operations that one could conclude the organization was not operating to provide a public benefit.

Section 4958 does not apply, or does not appear to apply, to member inurement. Disproportionate benefits to classes or categories of members or to members compared with nonmembers who are permitted to avail themselves of certain services provided by the organization are treated as inurement in the case of certain types of exempt organizations. This paper recommends that the consequences of disproportionate benefits be addressed directly so that this area of the law becomes clear for organizations and their members of all classes and so that the Service has guidance in enforcing these provisions. Elements of such an approach might include:

(1) Members who receive disproportionate benefits will include the fair market value of the benefit in gross income.

(2) Organizations that provide disproportionate benefits will pay an excise tax equal to 100 percent of the disproportionate benefit. If the payment of disproportionate benefits is not corrected, the organization will be subject to excise taxes equal to 200 percent of the fair market value of the disproportionate benefit.

(3) If organizations become subject to excise taxes on disproportionate benefits, organization managers will also become subject to excise taxes.

(4) If an organization provides disproportionate benefits, it will be potentially subject to revocation of exemption in addition to or as an alternative to payment of an excise tax.

These possible clarifications of the private benefit doctrines do not make a persuasive case for exemption. They are themselves complex and may well interfere with the legitimate activities of exempt organizations.

The paper concludes that it is time to consider developing an affirmative public benefit test for exemption. This paper is a very small initial step in this effort

D. Exemption and Commercial Activities: Approaches to Rationalizing the Unrelated Business Income Tax

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I. Introduction

The unrelated business income tax ("UBIT") provisions of current law[1] rest on three structural elements[2] which are subject to twenty-two modifications and exceptions.[3] Identifying absurd results under these provisions is not particularly difficult, although views will differ on specific choices. In some sense the very scope of the UBIT provisions presents issues of complexity. In another sense, however, the particular exceptions and modifications are so targeted that each provision taken alone may not be particularly complex. The central issue relating to UBIT is the relation of the UBIT provisions to the question of exemption. This paper suggests that the relationship between UBIT and exemption remains largely unexplored fifty years after UBIT was enacted. Part of the problem is the absence of any consensus on a rationale for exemption and thus on the criteria that define an exempt organization. Part of the problem arises from the UBIT provisions themselves. In some sense, one might take the position that Congress enacted UBIT to solve the problem of feeder organizations and not to address issues arising from the conduct of commercial activities by an exempt organization directly. This would explain the absence of any legislative guidance on how UBIT relates to exempt status. The legislative history discussed below offers some support for this proposition.

While no one would argue that the UBIT provisions have been derived from coherent principles, few are currently calling for change, whether fundamental or incremental. Each of the exceptions and modifications has beneficiaries, and thus defenders. The three structural elements permit such planning flexibility that they facilitate the current developments accounting for the convergence of the exempt and taxable sectors. Taxable entities are entering fields previously thought to be the preserve of exempt organizations, and exempt organizations are becoming increasingly involved with activities previously thought to be the preserve of exempt entities.

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[1] I.R.C. secs. 511-14. All references are, unless otherwise stated, to the Internal Revenue Code of 1986, as amended.

[2] Unrelated business income is defined as income from a trade or business that is regularly carried on and is not substantially related to an organization's exempt purpose. The three elements are: (1) trade or business; (2) regularly carried on; and (3) not substantially related to the organization's exempt purpose. The contested issues with respect to each of these are discussed *infra* at Part .

[3] These exceptions and modifications are discussed *infra* at Part IV.

If current trends toward convergence continue, the current UBIT provisions will again become controversial. For some, the remaining UBIT provisions will be impediments to the efficient operation of exempt organizations. Persons holding this view will call for the return of the destination of income test of prior law[4] or for the elimination of any taxation of commercial activities or perhaps for some structure for taxation but no limitation on the scope of an exempt organization's commercial activities. Others will use the sectoral convergence as evidence of the failure of the UBIT provisions to define exempt entities in ways that distinguish them from taxable commercial entities. Persons holding this view will call for more restrictive provisions that impose tax on a broader range of market activities of exempt organizations.

None of these approaches is likely to clarify the UBIT provisions without at the same time considering the relation between UBIT and exemption. Neither the legislative history nor the administrative regulations nor academic analyses have addressed the issues encompassed in exploring this relationship as a structural question intended to provide policy guidance. This paper examines the origins of UBIT to see how this fundamental structural question could have remained unaddressed and what assumptions were made explicitly or implicitly that bear on this question. The paper examines the judicial decisions that created the destination of income test, which the Service never accepted and against which it continued to litigate, and Congressional efforts to craft a statutory alternative. It then analyzes how the questions left unaddressed and the assumptions made in drafting the UBIT provisions have shaped its operation. The paper then briefly considers the adoption of the various modifications and exceptions to the basic structure and explores the rationale for these provisions. The paper concludes with consideration of structural changes in the UBIT provisions as well as of incremental changes within the structure of current law.

II. Analytical Overview

The unrelated business income tax ("UBIT") is complex and uncertain in its application in part because it has no coherent rationale and because its place in the structure of the exemption provisions is undefined. It is not clear that the UBIT provisions are in fact related to the question of whether and under what circumstances an organization should continue to qualify for exemption. One view is that UBIT simply levies a tax on unrelated business income and the scope of the unrelated business activity has no consequences for exemption. Another view is that unrelated business activity cannot be an exempt organization's primary activity because of the requirement that an exempt organization operate exclusively, which is defined in the regulations as primarily, for an exempt purpose. Under this view income subject to UBIT has been determined to be unrelated to the organization's exempt purpose and thus "excess" unrelated business activity would jeopardize exemption. By the same reasoning, business activities that are not subject to UBIT because they are substantially related to the organization's exempt purpose would not jeopardize the organization's exemption. If this is correct, what consequences flow from activities that are not substantially related but are not subject to UBIT because they fall within one of the twenty-two modifications or exceptions? Are the exceptions and modifications simply exclusions from the tax or are they also ways of saying that the activities do not jeopardize exemption? There is no answer. Indeed, questions of scope only

[4] The destination of income test is discussed *infra* at Part V.

become more difficult. Assume that an organization engages in lobbying, which is a permissible but not an exempt activity for a section 501(c)(3) organization, as well as investment activities excluded from UBIT under section 512(b)(1) as well as sales of goods that are subject to UBIT. How does one determine the aggregate activities that are not primarily for an exempt purpose? These questions are outside the scope of this paper but they illustrate the difficulty of applying the primary purpose test to an exempt organization with multiple types of permissible activities.

The characterization issue is the question of whether a commercial transaction necessarily should be subject to tax. Stated abstractly, the problem is that a commercial transaction in form might well provide or be otherwise consistent with an exempt activity.[5] Or, should either the purpose of the commercial transaction or the consequences of the commercial transaction control the characterization? Current law adopts multiple approaches simultaneously. Some activities which take the form of a commercial exchange, notably tuition payments for education and fees for health care, are treated as exempt because the service provided in exchange for the payment are treated as exempt activities. Others are not subject to UBIT not because they are exempt activities but because they are "substantially related" to exempt activities. These include the sale of goods in museum shops. The twenty-two modifications and exceptions to the general UBIT principles are means of defining particular rules for recurrent situations where the general principles do not provide a clear basis for characterization or point to restrictive rules. The general question is whether the conduct of commercial activities is an independent factor in characterizing activities as exempt activities. The conceptual problem is that all commercial transactions are in essentialist terms the same, but that commercial transactions differ when analyzed in consequentialist terms. In other words, viewed simply as transactions, there are no grounds for distinguishing among commercial transactions based on the tax status or the purposes of the seller. Or, a sale is a sale. At the same time, it is possible to argue that the consequences to the buyer do differ depending on the purposes of the seller. This is the claim that supports the "substantially related" test of current law. The argument is that the transaction is a commercial transaction in form but the seller's purpose is to achieve a certain exempt purpose measured in terms of the transaction's consequences to the buyer and that the commercial quality of the transaction either does not impede the achievement that that exempt purpose or is in other ways appropriate as a means of achieving the exempt purpose.

No persuasive or even particularly coherent theory has been developed to support either view. Why, then, are commercial transactions singled out for special treatment? This question has no persuasive answer. One argument might be that commercial transactions taint the exempt activities in some way. This is difficult to sustain in light of the fee for service entities, the hospitals and educational organizations, that account for well over half of the revenue of the entire exempt sector. If the fee for service arrangements are treated as exempt activities, then a theory is required to determine when a transaction that appears commercial in form is exempt in substance. Another argument might be that permitting exempt organizations to engage in commercial transactions permits unfair competition with taxable entities engaged in the same activities. The unfair competition might provide a criterion for distinguishing among

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[5] This is the logic of the substantially related test of current law. The problems arising under the substantially related test are discussed *infra* at Part III.C.

commercial transactions. However, it carries with it questions of what competition is unfair. Is unfair competition simply a question of sectoral allocation? If so, the dynamic process of convergence between the exempt and taxable sectors makes any distinctions necessarily transitory.[6] For example, if exempt educational organizations were charging a fees for providing education, an exempt activity, when the law was first enacted, does that mean that they would be reclassified as competing unfairly as for-profit taxable entities enter the market for education? Similarly, as exempt entities engage in travel tours, thereby competing with taxable travel agents, are they necessarily competing unfairly simply because of their exemption from taxation? In sum, would subsequent entry by taxable entities reclassify the activities of exempt organizations and would efforts at subsequent entry by exempt organizations be forestalled by per se unfair competition? Obviously, these consequences have not followed from convergence because unfair competition has never become an operative rationale for the UBIT provisions.

UBIT is explained more by historical factors than by any rationale basis for the distinctions that were made in 1950 when the present provisions were enacted. The UBIT provisions were a series of legislative compromises designed to address particular practices that were generating adverse press commentary at the time and which members of Congress decided to address. The effort in 1950 was to limit certain targeted transactions, not to address the questions of the distinction between exempt and commercial transactions.

In crafting these legislative compromises, Congress aimed not a completeness but at reassuring the exempt organizations, particularly the universities, that their customary activities would not be disturbed. Only with these assurances would any legislation have been possible. The question for current reconsideration of the UBIT provisions is not whether Congress was right or wrong in 1950 but whether the particular issues that drove the crafting of the UBIT provisions meant that particular issues never arose or were necessarily resolved in particular ways. The history of how the law came to be what it is today is the history of such choices.

In making these choices, Congress appeared to assume that the revenue earned by exempt organizations from commercial activities would be used to support the organization's exempt activities. This is an empirical assumption that has not been tested with empirical data. No one knows what exempt organizations do with any particular type of revenue or with their overall revenue. The assumption has had the result (but probably not the intention) of deflecting attention from the question of whether an exempt organization is operating exclusively for an exempt purpose. As a result, questions of the amount of related or unrelated business activity that might be consistent with exempt status have also been obscured.

III. Current Law: The Structural Elements

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[6] Convergence occurs as exempt entities take on more activities associated with taxable entities and taxable entities engage in activities prviously associated primarily with exempt entities. For three collections of studies that have followed the accelerating pace of convergence, see Burton A. Weisbrod, The Voluntary Nonprofit Sector (Lexington Books 1977); Burton A. Weisbrod, The Nonprofit Economy (Harvard University Press 1988); and Burton A. Weisbrod, To Profit or Not To Profit (Harvard University Press, 1998).

Current law defines unrelated business income in terms of three structural elements--a trade or business, that is regularly carried on, and that is not substantially related to the organization's exempt purpose. Each of these three structural elements contains its own internal complexity, but more importantly, each also contributes to the complexity of the relationship between UBIT and the structural elements of the exemption. The three elements together do not present any coherent rationale for UBIT or for exemption. Consequently, determinations of whether particular transactions result in UBI are often difficult to reconcile with similar cases. Current law has become so porous that few transactions will result in UBI. This is due in part to the unresolved issues embedded in the three structural elements and in part to the twenty-two modifications and exceptions. In addition, practical application of the cost allocation rules mean that exempt expenses are allocated to UBI to reduce the UBIT payable.

A. Trade or Business

Unrelated business income is income earned from the conduct of a trade or business.[7] The regulations define trade or business by reference to section 162(a) and state that a trade or business "generally includes any activity carried on for the production of income from the sale of goods or performance of services."[8] The problem in determining whether activities that take the form of a commercial transaction constitute a trade or business for purposes of the UBIT provisions is that presuming that such transactions are undertaken with a profit motive of the kind that makes them a trade or business is overinclusive under current law. The problem arises with respect to the fee for service transactions of universities and other schools that charge tuition and of hospitals, which charge for patient care. Yet, neither of these two cases is treated as a trade or business for UBIT purposes. In other words, neither hospitals nor universities avoids UBIT on its fee income through an analysis that treats the exchange of education for a fee or health care for a fee as a trade or business but one that is substantially related to its exempt purpose. The analysis is that the provision of education is the university's or the school's exempt purpose and that the charging of a fee is incidental to this exempt purpose.

The importance of the profit motive in determining whether particular activities constitute a trade or business rests on the Supreme Court opinion in *American Bar Endowment*, in which the Supreme Court held that the American Bar Endowment's insurance activities were a trade or business within the meaning of section 513(a).[9] The Endowment's sole argument was that the insurance activities did not constitute a trade or business. The Endowment argued that it did not receive fees from the insurance companies for providing services to the companies, and that the absence of such fees distinguished it from several section 501(c)(6) trade associations that, like the Endowment, served as a group policyholder. The Endowment won in the Claims

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[7] Sec. 512(a); Sec. 513(a); Treas. Reg. §1.513-1(a).

[8] Treas. Reg. § 1.513-1(b). The cross reference to section 162 provides little direct assistance since neither that Code section nor the regulations thereunder provide a definition of trade or business. The main effect of the cross-reference is to make the cases construing section 162 applicable in the UBIT context.

[9] American Bar Endowment v. United States, 477 U.S. 105 (1986).

Court, which looked less at the profit motive than at the manner in which the Endowment conducted its insurance activities and the absence of competition with commercial enterprises.[10] The Federal Circuit upheld the Claims Court, emphasizing the absence of fees from the insurance companies.[11] The Federal Circuit held that the Claims Court had applied the appropriate legal test of a trade or business when it looked to the manner in which the activities were conducted and competition with commercial enterprises.[12]

The Supreme Court reversed and held that the experience dividends that the members permitted the Endowment to retain constituted UBI and that the insurance activities constituted a trade or business within the meaning of section 513(a).[13] The Court appeared to regard the profit motive test as so well established that it referred to the cases under section 162 and UBIT cases based on a profit motive only in a footnote in which it observed that the existence of a profit motive is "[t]he standard test for the existence of a trade or business for purposes of § 162."[14] The Court also held that the Endowment competed unfairly with commercial enterprises.[15] In so holding, the Court did not rely on specific findings of competition with commercial enterprises but appeared to find that the very fact of the exemption made any competition unfair due to the differential tax treatment.[16]

The affinity credit card cases involved litigation over whether the transactions constituted trade or business activities.[17] The Tax Court did not even cite *American Bar Endowment* in its analysis of whether the Alumni Association's activities constituted a trade or business and held

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[10] American Bar Endowment v. United States, 4 Cl.Ct. 404 (1984).

[11] American Bar Endowment v. United States, 761 F. 2d 1573, 1577 (Fed. Cir. 1985).

[12] Id. at 1578. The Federal Circuit stated: "Unlike what some other courts may do, this court does not find 'profits,' or the maximization of revenue, to be the controlling basis for a determination of whether the unrelated business income tax provisions apply. We consider not only the amount of money the charitable organization receives, but the source and character of those funds...."

[13] American Bar Endowment v. United States, 477 U.S. 105 (1986).

[14] Id. at 110, n.1.

[15] Id. at 114-15.

[16] Id. The Court held: "This case presents an example of precisely the sort of unfair competition that Congress intended to prevent. If ABE's members may deduct part of their premium payments as a charitable contribution, the effective cost of ABE's insurance will be lower than the cost of competing policies that do not offer tax benefits. Similarly, if ABE may escape taxes on its earnings, it need not be as profitable as its commercial counterparts in order to receive the same return on its investment. Should a commercial company attempt to displace ABE as the group policyholder, therefore, it would be at a decided disadvantage."

[17] Alumni Ass'n. of Univ. of Oregon v. Commissioner, 71 T.C.M. 2093 (1996).

that a profit motive does not serve as evidence that particular activities constitute a trade or business within the meaning of the UBIT provisions unless profit is "the primary purpose for engaging in the activity."[18] This formulation limits the scope of UBIT. Not only must the profit motive be "primary," but it must also be "the" primary purpose, which means that arguments setting forth other substantial purposes are likely to defeat claims that profit is "the primary" purpose.[19]

The Tax Court applied the same test and the same reasoning in a case involving a covenant not to compete, where the court stated that "the taxpayer's primary purpose for engaging in the activity must be for income or profit."[20]

Cases rarely turn solely on the question of whether particular activities constitute a trade or business. Most cases also raise questions of whether one of the exceptions or modifications applies to the particular transaction. These modifications and exceptions have had the result that the need to clarify what constitutes a trade or business for UBIT purposes.

B. Regularly Carried On

Income from a trade or business will not be UBI unless the trade or business is "regularly carried on."[21] The regulations provide that in determining whether a trade or business is regularly carried on "regard must be had to the frequency and continuity with which the activities productive of the income are conducted and the manner in which they are pursued."[22] These criteria are not to be applied mechanically but in light of all the relevant facts and circumstances in light of the purpose of UBIT "to place exempt organization business activities on the same tax basis as the nonexempt business endeavors with which they compete."[23] The regulations apply these general principles in a series of highly specific regulations dealing with recurring activities. To the extent that there is any common theme in these regulations, it is that limited amounts of income earned in limited periods of time are not UBI. This theme is in fact quite controversial. Nothing in the regulations relates in any way to the percentage of an organization's annual income earned through the trade or business activity. Regularly carried on is consistent with an organization that earns its entire annual budget at its sandwich stand at the fair. As long as a small organization earns what is in general a small amount of money during a

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[18] Id. at 2099 the Tax Court relied on Commissioner v. Groetzinger, 480 U.S. 23 (1987)(whether activities of a professional gambler constituted a trade or business).

[19] The Tax Court's formulation raises all the limitations that have circumscribed the application of section 269, which applies only in cases where a taxpayer acquires control of an entity for "the primary purpose" of evading or avoiding taxes.

[20] Ohio Farm Bureau Federation v. Commissioner, 106 T.C. 222 (1996).

[21] Sec. 512(a)(1).

[22] Treas. Reg. § 1.513-1(c)(1).

[23] Id.

limited period and then uses the money for exempt purposes, the regularly carried on element will shield the income from tax as UBI. In effect, the regularly carried on element is consistent with a destination of income concept of UBIT.

The *National Collegiate Athletic Association* case changed the understanding of the regularly carried on element of the UBIT definition.[24] The case turned on the proper tax treatment of income sale of advertising for the program of the men's basketball tournament, also know as "March Madness." The National Collegiate Athletic Association (NCAA) admitted that the sale of advertising was a trade or business and that it was unrelated to the organization's exempt educational purposes.[25] It argued, however, that the activity was not regularly carried on because it is an intermittent activity. As such, the regulations define intermittent activities as fundraising events "lasting only a short period of time...if they recur only occasionally or sporadically."[26] The manner in which these activities is carried on is irrelevant. The Service had generally limited this provision to fundraising events.[27]

The Tax Court held that the sale of advertising was regularly carried on because the NCAA hired a commercial company to sell advertising on its behalf during more than six months each year. The Tenth Circuit reversed on grounds that the period of at least six months was intermittent compared with the twelve months per year that a commercial enterprise could be expected to sell advertising.

The *NCAA* case has carried the regularly carried on element of the UBIT definition far beyond the sandwich stands at the county fair or the once a year fundraising event for the firefighters. The Tenth Circuit's opinion seems to open broad latitude for avoiding UBIT treatment. This case involved no showing that the advertising revenues were used for the NCAA's exempt purpose or that it was used for anything but funding further payments to the commercial company. This factor was not considered relevant by the two courts that heard this case. In effect, the courts did not require the NCAA to show that it satisfied the destination of income test.

C. Substantially Related to the Organization's Exempt Purpose

The planning opportunities of the other two elements of the UBI definition pale in comparison with those arising under the substantially related test. The legislative history gives little indication of the reason for including this element and little guidance on how it is to be interpreted. One reason appears to have been to have been to avoid taxing all transaction that

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[24] National Collegiate Athletic Association v. Commissioner, 914 F. 2d 1417 (10th Cir. 1990), rev'g 92 T.C. 456 (1989).

[25] The Service has ruled that collegiate athletics, whether intramural or intercollegiate, is exempt educational activity within the meaning of section 501(c)(3).

[26] Treas. Reg.. § 1.513-1(c)(2)(iii).

[27] See, for example, Suffolk County Patrolmen's Benevolent Association v. Commissioner, 77 T.C. 1314 (1981).

were in form the sale of goods or services and to look beyond the form to the relationship with the organization's exempt purpose.

There are two general categories of problems with the substantially related test. One is that the criteria for determining a relationship with exempt purposes have never been established. In some cases, operating in the same field seems adequate. In others, serving the same class of beneficiaries establishes the substantial relationship. The other category of problems is that any determination is largely subjective and thus open to controversy if not litigation. One example of this is the Service's "rock concert" ruling[28]. In this ruling, the Service held that offering a rock and roll concert at a university facility was not substantially related to the organization's exempt educational purpose. Any school that has a music department or an arts department or even a business school or an economics department would appear to satisfy the substantially related test when it presented a rock concert. The Service emphasized the manner in which the concert was promoted made it more akin to a commercial venture than an educational venture. Surely, this is an antiquated concept of the arts, particularly elements of popular culture for mass audiences. Such is the indeterminacy in this area that one wonders how the Service would rule on an appearance by the Three Tenors at the same university. Would the Service be more inclined to find the Three Tenors educational despite the media whirl, fan frenzy, and relentless promotion association with their appearances?

These two cases, one real and one hypothetical, illustrate the indeterminacy inherent in the substantially related concept. This indeterminacy can result in treating commercial activities as substantially related as well as treating substantially related activities as unrelated and subject to UBIT. One example of the low threshold for qualifying as substantially related to an organization's exempt purpose is the Service's revenue ruling treating the sale of personalized greeting cards as substantially related to a museum's exempt purpose[29]. The cards featured a reproduction of a work of art, although not necessarily one in the museum's collection, and the name, nationality, date of birth and date of death of the artist in small print on the back of the card. The Service ruled that the sale of such greeting cards as well as the amount charged for personalizing the cards and envelopes was substantially related to the museum's exempt purpose to educate the public about art. One might agree, albeit somewhat tentatively, with treating income from the sale of the cards as substantially related, but it is difficult to sustain the claim that the income from personalizing the cards and envelopes served an important educational purpose. The ruling did not address this issue.

IV. Modifications and Exceptions

There is no common theme that explains the modifications and exceptions.

Some of the modifications and exceptions appear to provide clear authority for results that would arise from the operation of the three structural elements. The exclusion of investment income from UBI is perhaps the clearest case of this type of modification.

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[28] TAM 9147008 (Nov. 22, 1991) and GCM 39863 (Nov. 26, 1991).

[29] Rev. Rul. 73-104, 1973-1 C.B. 263.

Some of the modifications and exceptions appear to underscore efforts to distinguish commercial modes of operation from non-commercial, or to distinguish activities that might arise from the operation of the exempt organization from activities that would ordinarily be engaged in for the purpose of earning a profit. The volunteer exception of section 513(a)(2), the contributed property exception of section 513(a)(3), and the low-cost items of section 513(h) might be examples of this type of modification.

Some of the modifications and exceptions appear to be based on a distinction between active and passive activities, perhaps on the theory that more passive activities do not divert attention from exempt activities in the same way that the active conduct of a trade or business might. The exception for income from royalties, annuities, securities lending transactions, and the sale of capital assets might be examples of this type of modification.

Other modifications and exceptions appear to represent negotiated resolutions of special cases. The corporate sponsorship provision of section 513(i) and the bingo exception of section 513(f) might be examples of such special cases.

This paper does not suggest that these analytical categories explain the process through which these provisions came to be included in the UBIT provisions. United States public policy is not commonly based on a Cartesian process driven by first principles, which may be part of the country's strength. The process resulting in enactment of the UBIT provisions was a Lockean process of opportunistic quasi-empiricism in which participants made whatever arguments they could devise to support what they took to be their self-interest. In the case of UBIT, exempt organizations of all varieties marshaled arguments, generally based on customary activities of charities, to exclude particular activities from UBIT. The purpose of looking for analytical categories in this paper is to suggest a framework for rationalizing UBIT.

Certain of the modifications and exceptions might be explained by claims that the activities in question on not "commercial" or are not sufficiently commercial to support UBIT characterization. Some of these activities might not involve all of the steps of an ordinary commercial transaction. Others might involve only limited amounts of money even if the transactions encompass all of the elements of an ordinary commercial transaction.

The volunteer exception in section 513(a)(1) illustrates the conceptual difficulties inherent in these provisions. Section 513(a)(1) provides that an activity will not be treated as an unrelated trade or business if "substantially all of the work in carrying on such trade or business is performed for the organization without compensation." The Service has ruled that a thrift shop selling items on consignment,[30] a volunteer fire department holding public dances each week,[31] and a retail store selling items to the public[32] all qualified under the volunteer exception.

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[30] Rev. Rul. 80-106, 1980-1 C.B. 113. In this case all the workers were volunteers and all the revenue received was transferred to Section 501(c)(3) organizations. See also Priv. Ltr. Rul. 9033056.

[31] Rev. Rul. 74-361, 1974-2 C.B. 159.

[32] Treas. Reg. § 1.513-1(e).

In each of these cases the work of the volunteers contributed materially to earning the income at issue. Where the volunteer labor is not a material factor in earning the income, the Service has refused to apply the volunteer exception.[33] In this ruling the Service found that the only labor involved was processing rental payments from a net lease of machinery. Even though all of the work was performed by a volunteer, the Service ruled that the volunteer exception did not apply because "the performance of services in this case is not a material income-producing factor in the business."[34] The Service has applied the volunteer exception even where the total amount of labor is minimal if that labor is a material factor in the production of the income.[35]

While the volunteer exception is well-established, the definition of a volunteer remains controversial in cases where the volunteers receive some value. The controversy centers on whether the value was received in exchange for the services or whether the value would have been received even if the person performing the services had not provided those services. The issue emerged in the case of a religious order that operated a large commercial agricultural enterprise.[36] The members of the order had taken a vow of poverty and there was no question of individual enrichment in this case. The members of the order operated the agricultural enterprise. The revenue went to the order, which provided food and shelter and paid the FICA contribution of each of the members of the order. The order argued that it should not be taxed on the revenue from its agricultural enterprises because the work was performed by volunteers, thereby satisfying the volunteer exception. The Service took the position that the members of the order had received compensation within the meaning of section 513(a). The Tax Court agreed that compensation could be paid in non-cash forms but held that the support provided by the order was not compensation because it would have been provided whether the individual worked or not. The Tax Court focused on the directness of the exchange and held that "a critical element of the concept is that there must be a 'but-for' connection between the payment and the services."[37] In this case, elderly or infirm members of the order or members who were attending school receive the same support as those whose labor produced the income. The Tax Court held that "[t]his is simply not a case where, but for the rendering of services, the payment would not have been made."[38]

The Service nonacquiesced to the portion of the *St. Joseph Farms* case which relied on the "but-for" test for compensation.[39] The Service revoked the exempt status of another organization on similar facts. The Shiloh Youth Revival Centers operated several businesses

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[33] Rev. Rul. 78-144, 1978-1 CB 168.

[34] Id.

[35] Tech. Adv. Mem. 8211002.

[36] St. Joseph Farms of Indiana v. Commissioner, 85 T.C. 9 (1985).

[37] Id. at 24.

[38] Id.

[39] 1986-1 C.B. 1-2.

operated by members who lived at the centers and who received room and board from the centers.[40] In this case, however, members received support only if they worked and the organization could afford to pay living expenses only if all of the members worked. The Tax Court held that the members received compensation and that the volunteer exception did not apply. The Service argued that volunteers should be defined as "individuals who not only work without expectation of payment, but who also receive their support from sources outside the exempt organization."[41] The Tax Court refused to adopt this definition for purposes of the volunteer exception of section 513(a).[42]

These two cases pose dilemmas in linking the exception to the exemption. Both enterprises were regularly carried on and neither was substantially related to the organization's exempt purpose. In neither case did the facts address the issue of whether the revenue received from the trade or business was used for the exempt activity on which the exemption was based, but the organizations did not make any such claims. What is troubling about the two cases considered solely as matters of tax law is that the far more economically powerful organization was able to support its reliance on the volunteer exception by virtue of its control of sufficient resources, whether generated by the commercial enterprise itself or by other activities, including exempt activities, to ensure that those members of the organization who did not work would be supported. The Shiloh Youth Revival Centers did not have sufficient resources to support non-workers. As a purely technical matter, it is not at all clear that the support offered non-workers should become a central criterion for defining compensation in the case of the workers. It is far from clear that either of these commercial enterprises is properly exempt from taxation or that the volunteer exception was ever intended to apply to either. Current law offers little if any basis for resolving this matter in terms that relate UBIT and the exceptions to UBIT to exemption.

V. The Destination of Income Test

The Bureau of the Revenue initially took the position that all income from commercial activities was subject to tax. This position was not as comprehensive as it initially appeared, since educational institutions were never taxed on their tuition revenues and hospitals were never taxed on their income from patient fees. In effect, the Service was applying its general rule with a more limited version of the "substantially related" exception.

The courts, however, rejected this limitation on exemption and crafted instead the "destination of income test," which treated all income used for exempt purposes as exempt from tax.

The early cases involved commercial activities conducted by an organization that also conducted substantial exempt activities. In the *Trinidad v. Sagrada Orden*, the commercial activities could be reasonably described as incidental but they were not substantially related

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[40] Shiloh Youth Revival Centers v. Commissioner, 98 T.C. 565 (1987).

[41] Id. at 580.

[42] Id.

within the meaning of current law.[43] The commercial activities included investments in stock, debt instruments, and corporate equities and sales of wine, chocolate, and certain other items used in the Order's churches, schools, missions, and other subordinate agencies. While wine sales were linked with the sacerdotal function of communion, no one suggested any sacerdotal function for the chocolate. The Service took the position that the Order was not operating "exclusively" for an exempt purpose.[44]

The Supreme Court held that the sales income was not subject to tax, for several reasons. It concluded that such sales "do no amount to engaging in trade in an proper sense of the word."[45] It based this conclusion on the absence of competition with taxable entities, a conclusion it apparently based on the fact that the items were for purely internal use by the Order.[46] This argument did not consider the possibility that the Order's internal market might be sufficiently important that a taxable entity might want to compete for the right to sell the items. There may have been no possibility of such competition in this particular case, but the idea that an internal market establishes the absence of competition is more difficult to maintain in the case of a large organization such as a university or a hospital.[47]

The Court also held that the trading activities were "purely incidental to the pursuit of those [exempt] purposes."[48] The Court did not explain what it meant by incidental. For example, incidental could mean limited in scope or it could mean related to the exempt activities. The Court also noted that the trading "is in no sense a distinct or external venture."[49] Again, the Court did not explain the meaning of what factors would make a venture either distinct or

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[43] Trinidad v. Sagrada Orden de Predicadores de la Provincia del Santisimo Rosario de Filipinas, 263 U.S. 578 (1923).

[44] Id. at 579. The 1913 Act provided an exception for taxation for corporations "organized and operated exclusively for religious, charitable, scientific, or educational purposes, no part of the net income of which inures to the benefit of any private stockholder or individual." G(a) and M of II of the Act of October 3, 1913, c.16, 38 Stat. 172, 180.

[45] Id. at 582.

[46] The Court stated: "It is not claimed that there is any selling to the public or in competition with others. The articles are merely bought and supplied for use within the plaintiff's own organization and agencies,--some of them for strictly religious use and the others for uses which are purely incidental to the work which the plaintiff is carrying on. That the transactions yield some profit is in the circumstances a negligible factor. Financial gain is not the end to which they are directed."

[47] The exclusive dealing contracts that commercial suppliers are entering with universities suggest the importance of the internal market of large exempt organizations.

[48] Id. at 581.

[49] Id.

external. This omission meant that it was unclear whether the conduct on trade or business activities in a subsidiary should be distinguished from the direct conduct of such activities.

The Court's reasoning centered on its assumption that the Order used its trading profits for its exempt purposes. The factual basis of this assumption was not explored because the Service had stipulated to this fact. Such a stipulation was, in retrospect, unfortunate for future cases although understandable in this particular case. Had there been no such stipulation, subsequent cases would have involved greater care in establishing the use of the revenue from the trade or business activities. In this case, the Order had substantial holdings in land and in corporate debt and equity instruments. While the trading activities were insignificant compared to the investment activities, there is still the question of whether the trading activities contributed, even in a small way, to the acquisition of the investment assets.

The Court linked the question of the use of the funds from the trading activities to the public benefit arising from the exempt activities. The Court reasoned:

> The plaintiff, being a corporation sole, has no stockholders. It is the legal representative of an ancient religious order the members of which have, among other vows, that of poverty. According to the Philippine law under which it is created, all of its properties are held for religious, charitable and educational purposes; and according to the facts stipulated it devotes and applies to those purposes all of the income—rents, dividends and interest—from such properties. In using the properties to produce the income, it therefore is adhering to and advancing those purposes, and not stepping aside from them or engaging in a business pursuit.[50]

The Court held that the statute "says nothing about the source of the income, but makes the destination the ultimate test of exemption."[51] This language served as the basis for the destination of income test. The rapid expansion of the destination of income test took no account of the facts of the case. If the holding in *Trinidad v. Sagrada Orden* were confined to the facts of the case, then only cases involving limited amounts of trade or business activity by organizations that clearly used all the net proceeds of the trade or business for their exempt purposes, that did not compete with commercial enterprises, and which limited their trade or business activities to a market within the organization would have come within the Court's reasoning. This was not the course of future developments.

The destination of income test became the rationale for two patterns of trade or business activity by exempt organizations. Under one pattern, an organization conducted a trade or business directly, whether or not the trade or business had a relationship with the nature of the organization's exempt purpose. Under the second pattern, the exempt organization owned the stock of a business enterprise and the business enterprise claimed that it was exempt from taxation because it distributed all of its net earnings to the exempt organization in the form of

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[50] Id. at 582.

[51] Id. at 581.

dividends. The first pattern fit the facts in *Trinidad v. Sagrada Orden*. The second pattern, that of indirect operation of a trade or business, became the more common practice. The exempt organization held all the stock of a business enterprise and received all of that business enterprises net income each year in the form of dividends, which were not taxable to the exempt shareholder. The business claims that it, too, should be exempt from taxation since all of its income was, under the destination of income test, used for exempt purposes.

The Service rejected these claims, but several courts, relying on *Trinidad v. Sagrada Orden*, tended to rule in favor of exempt status for the business entities. The leading case taking this position was *Roche's Beach*.[52] In this case, the owner of a bathing beach established a corporate entity to operate the beach after his death and a foundation to assist destitute women and children. The corporation rented beach houses, operated a restaurant, and rented towels and beach chairs. The beach was a substantial business enterprise, with up to 6,000 patrons on summer days. The corporate did in fact turn over all of its net proceeds to the foundation, which used the revenue for the designated exempt purpose.

The Service denied the corporation's application for recognition of exemption, and the Board of Tax Appeals ruled in favor of the Service.

The court refused to distinguish between an exempt organization that engaged in trade or business activities directly and a corporation that did not engage in any exempt activities itself but devoted its net income to the support of an exempt organization, concluding, that "[n]o reason is apparent to us why Congress should wish to deny exemption to a corporation organized and operated exclusively to feed a charitable purpose when it undoubtedly grants it is the corporation itself administers the charity."[53]

Judge Learned Hand, in his dissent, distinguished *Trinidad v. Sagrada Orden* from the facts in *Roche's Beach* on grounds that the business income in that case was "very trifling."[54] He explicitly rejected the majority's reliance on what is now section 501(c)(2) as the statutory basis for the majority holding.

The other leading case involved New York University Law School and its ownership of the stock of the C.F. Mueller Company, which made and still makes pasta products. This case became the metaphor for the problem of exempt organizations' business activities and it figured prominently in Congressional debates on the topic.

The focus on the business subsidiary pattern meant that the Congressional debate over the business activities of exempt organizations did not address the direct conduct pattern and did not appreciate the different issues that arise under each pattern. The direct conduct pattern raises the question of the relation between exemption and business activities in the form of a question about the permissible scope of the business activities. The subsidiary business model does not

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[52] Roche's Beach, Inc. v. Commissioner, 96 F2d 776 (2d Cir. 1938).

[53] Id. at 779.

[54] Id.

raise the scope question but instead raises the question of the distinction between the source of the funds and the use of the funds. This question, arising out of the second pattern, was the foundation of the substantially related concept of current law. When Congress shifted to current law, it enacted a system of the direct conduct of a business activity. But, in light of the intense concern with the business activities of universities, which generally operated on the subsidiary model, the shift to the direct conduct model ignored the scope issues arising under the direct conduct approach. This oversight arose from the focus on curing the problems associated with the subsidiary enterprises model and not considering the potential issues arising under the direct conduct model. In this sense, the unrelated business income issue has never been conceptually integrated with the exemption issue. UBIT is not prohibited in the same way that inurement and participation or intervention in a political campaign are prohibited. UBIT is more like legislative lobbying in that both are permissible activities but neither would support exemption for an organization described in section 501(c)(3). Lobbying does, of course, constitute an exempt activity for a section 501(c)(4) organization. The question for all exempt organizations with respect to UBIT is whether there is any limit on the amount of an organization's time or resources or both that may be devoted to trade or business activity.

The destination of income test has one potential element of at least potential conceptual coherence in the sense that it directs attention to the exempt purposes for which the business income is purportedly used. In this sense, the destination of income test has at least the potential of addressing the commensurate in scope issues that have faded from view under current law.

Congress and Treasury began to grapple with these issues during the early 1940s even while World War II continued. After the war, Congress examined the tax law changes enacted to finance the war. Issues relating to exempt organizations arose in the context of this larger effort.

VI. Legislative Disputes

The commercial activities of exempt organizations were becoming increasingly controversial and Treasury began to lay the groundwork for reform as early as 1942. In that year Randolph Paul testified before the House Ways and Means Committee on Treasury's view of the situation:

> Our revenue laws have been generous in exempting certain corporations from the income tax. Thus charitable or educational corporations are not subject to the corporate income tax. Many exempt corporations, however, have so far departed from the purpose of the exemption as to engage in trades and business completely unrelated to their exempt activities, and yet the income of such business activities remains exempt from tax. If a college operates a hotel, the activities remains [sic] from tax. If an orphans' home operates a waterworks and an electric power and gas company, the earnings of these utilities are exempt; if a charitable organization operates a bathing beach, the earnings of the beach are exempt. In this way sources of considerable tax revenue are withdrawn from the scope of the tax. At the same time privately owned businesses are forced to compete with other businesses not subject to an income tax.

> It is believed that the exemptions accorded to such organizations should not be so distorted. It is therefore suggested that such corporations be taxed on the income derived from a trade or business not necessarily incident to their exempt activities. Thus, it is not intended to tax an institute for the welfare of the blind on the proceeds from the sale of articles made by those aided by the institute. It might also be desirable to allow a flat exemption of $5,000 regardless of the nature of the business activity.[55]

Congress took no action on these observations during 1942. In a foretaste of future controversies, one individual and one exempt organization expressed opposition amounting to outrage at the very idea of taxation.[56] In 1942, however, Congress received many more adverse comments on the proposal to increase the excise tax on gasoline and lubricating oils.[57]

In 1943 Congress enacted the requirement that exempt organizations file information returns.[58] The legislative history made it clear that this filing requirement was intended to provide information on exempt organizations' business activities with a view to future legislative changes.[59] The committee reports emphasized the possibility under existing law for exempt organizations to compete with taxable businesses without jeopardizing their exempt status and asserted that such direct competition was unfair because the entities were taxed differently.[60]

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[55] HEARINGS ON THE REVENUE REVISION OF 1942 BEFORE THE COMMITTEE ON WAYS AND MEANS OF THE U.S. HOUSE OF REPRESENTATIVES, 77th Cong, 2d Sess. 89 (1942).

[56] Id. at 3491-97.

[57] Id. at 3501-43.

[58] Revenue Act of 1943, H.R. 3687, Pub.Law 78-235, sec. 117.

[59] REPORT ON THE REVENUE BILL OF 1943 BEFORE THE COMMITTEE ON WAYS AND MEANS OF THE UNITED STATES HOUSE OF REPRESENTATIVES, REPORT NO. 871, 78th Cong., 1st Sess. 24-25, 47 (1943). REPORT ON THE REVENUE BILL OF 1943 BEFORE THE COMMITTEE ON FINANCE OF THE UNITED STATES SENATE, Report No. 627, 78th Cong., 1st Sess. 21, 46-47 (1943). The Ways and Means Committee Report at 24-25 stated: "...it is the intent of your committee to make a thorough study of the information contained in such returns with the view to closing this existing loophole and requiring the payment of tax, and the protection of legitimate companies against this unfair competitive situation." The Senate Finance Committee Report at 21 stated that the provision was being enacted "in order to secure sufficient information to determine whether such corporations should be subject to taxation."

[60] The Ways and Means Committee Report at 24 stated: "It has come to the attention of your committee that many of these exempt corporations and organizations are directly competing with companies required to pay income taxes, and that this practice is becoming more widespread and affording a loophole for tax evasion and avoidance.

These organizations were originally given this tax exemption on the theory that they were not operated for profit, and that none of their proceeds inured to the benefit of shareholders.

The Ways and Means Committee held hearings on cooperatives and exempt organizations again in 1947.[61] These hearings dealt primarily with cooperatives, but some members of the committee and certain witnesses addressed exempt organizations' business activities. Chairman Harold Knudson, for example, read into the recorded the following list of activities that had been found on the information returns of exempt organizations:

> ...the Chair would like to insert, as part of the record, as list of activities engaged in by educational, charitable, and religious organizations....The types of business operations are operating a bathing beach, operating a radio station, manufacturing health foods, operating a petroleum sales business, manufacturing chocolate, manufacturing piston rings, manufacturing cough syrup, operating race tracks, manufacturing tools, manufacturing wire and cable, constructing boats, operating apartment houses, operating rooming houses, operating hotels, building and operating an entire community of homes, selling gas and oil, generating and selling electricity, operating a public greenhouse, operating a cotton gin, operating an amusement park, operating restaurants, restaurant chains, and cafeterias, operating farms, operating bowling alleys, operating bars, operating lumber companies, designing and manufacturing precision instruments, operating a travel bureau, publishing major newspapers and periodicals, publishing books in the field of scholarship and letters, publishing a cookbook, selling fire insurance to churches, operating barbershops, operating a dental clinic, publishing a magazine on amateur photography, operating jazz concerts for which admissions are charged, operating a publishing business, carrying on research and receiving patent royalties in the following fields: (*a*) Chemistry generally, (*b*) vitamin D concentrates, (*c*) smoke abatement, (*d*) paper and pulp industry.[62]

In a subsequent colloquy with George J. Schoeneman, Commissioner of the Internal Revenue, and S.L. Montgomery, Chief of the Exempt Organizations' Rulings Section, Income Tax Unit Bureau of Internal Revenue, Chairman Knudson raised the question of exempt organizations' use of revenue from their business activities by using a vivid hypothetical:

> THE CHAIRMAN. Take the case of a very large church in one of our very large cities that owns real estate that covers everything from bawdy houses to office buildings, do they pay any tax on their income?
>
> MR. SCHOENEMAN. No, sir.
>
> THE CHAIRMAN. Nothwithstanding that it may run into millions?

However, many of these organizations are not engaged in operation of apartment houses, office buildings, and other businesses which directly compete with individuals and corporations required to pay taxes on income derived from like operations."

[61] HEARINGS BEFORE THE COMMITTEE ON WAYS AND MEANS OF THE U.S. HOUSE OF REPRESENTATIVES, REVENUE REVISIONS, 1947-48, 80th Cong., 1st Sess. (1947).

[62] Id. at 1903.

MR. SCHOENEMAN. That is right.

THE CHAIRMAN. Is there any requirement as to how they should spend their income, or can they keep piling it up and putting up more bawdy houses and office buildings?

MR. MONTGOMERY. The general rule is that the income must be expended for the purpose for which the organization is formed. In the case of your religious organization, naturally it carries with it the proposition that is must be spend for carrying on its religious activity.

THE CHAIRMAN. Do you investigate to see that they do it?

MR. MONTGOMERY. To my knowledge no investigations have been made of any churches to determine what they do with their income.[63]

The exempt organizations, lead by the universities and the hospitals, continued to urge that the destination of income test be retained. The highlight of the 1947 hearings was indirect testimony of the Chancellor Harry Woodburn Chase of New York University, who sent a letter read by John Gerdes, the university's attorney and active alumnus of New York University.[64] Chancellor Chase stated that New York University was a tuition-dependent university that served students who worked while attending school.[65] Chancellor Chase called "tax-exemption privileges for institutions of higher education...one of the great bulwarks of democratic opportunity in this country," he told the Committee:

> Anything which removes or tend to diminish the tax-exemption privileges of institutions of higher education is a step away from democracy. It increases the burdens of those who wish to go to college and of their families. The only recourse of an institution like ours, should tax exemption be curtailed or abolished, is to make up the difference by large increases in student fees. These in turn would make it impossible for large numbers of our most worthy students to obtain a college education. I submit that the end of such a process is to make of higher education not a democratic opportunity but a class privilege. This is diametrically in opposition to the policies to which New York University is dedicated and in which I am convince the nation believes.[66]

The Committee was less interested in discussing democratic theory than in discussing taxation of business income. John Gerdes argued that there was no unfair competition because exempt organizations used all of their income for their exempt purposes.[67] Using an analogy to a

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[63] Id. at 1930-31.

[64] Id. at 3525-42.

[65] Id. at 3525-26, stating that 90 percent of the university's total income came from student fees.

[66] Id. at 3526.

[67] Id. at 3526-27.

taxable business, he argued that exempt organizations have no taxable profit on their business activities because they use the earnings for their exempt purposes. Consequently, according to John Gerdes, there was no basis for claims of unfair competition due to exemption:

> The competitive value of the power to retain in the business approximately 40 percent of the income which would otherwise be payable to the Government in the form of taxes, is illusory so far as educational institutions are concerned, since they have such heavy demands upon their income as to make it necessary for them to use currently all income which is available. The history of endowment funds of educational institutions clearly shows that endowments do not grow as a result of income produced by the investment of the funds but that their growth is due to the receipt of new gifts. It is reasonable to suppose, therefore, that not only the earning represented by tax savings but, in all probability, most of the earnings in excess of these sums will immediately be taken out of the business enterprise to meet current educational needs.[68]

Mr. Gerdes suggested that in those rare cases where exempt organizations did not use all of their income currently for their exempt purposes, the Code could be amended to require that, instead of paying tax, the exempt organization would be required to use an amount equal to the tax that would have been paid by a taxable entity for their exempt purpose.[69]

Chairman Knudson was not persuaded and suggested that exempt organization might "accumulate such large funds in the aggregate as to constitute almost a menace to our economy."[70] Mr. Gerdes responded that exempt organizations had not accumulated such wealth in the entire history of America.[71]

At the same time, taxable entities that competed with exempt organizations began to call for tax on their business activities.[72]

In 1950, President Truman called for a revision of the tax law.[73] This message contained a call for a broad-scale revision of the law to reconsider and revise several of the wartime

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[68] Id. 3527.

[69] Id.

[70] Id. at 3528.

[71] Id.

[72] One example was the testimony given on behalf of the American Council of Commercial Laboratories asking that information be gathered relating to the commercial research of universities. Id. at 2755-59.

[73] Message from the President of the United States Transmitting Request for a Revision of the Tax Laws (January 23, 1950), printed in COMMITTEE ON WAYS AND MEANS OF THE UNITED STATES HOUSE OF REPRESENTATIVES, D0c. No. 451, 81st Cong. 2d Sess. 1 (1950).

provisions as well as other issues. The President's message called for closing "loopholes" that had been "developed through the abuse of the tax exemption accorded educational and charitable organizations."[74]

Treasury identified the fundamental issues as (i) the conduct of commercial enterprises directly by exempt organizations, particularly universities, or by business corporations that themselves claimed exempt status because they distributed their net income to exempt parent and (ii) the use of borrowed funds to acquire property for leaseback transactions that supported tax deductions for taxable entities.[75] Secretary Snyder testified that "[s]ome colleges and other institutions are engaging in a wide variety of business undertakings, including the production of such items as automobile parts, chinaware, and food products, and the operation of theaters, oil wells, and cotton gins."[76] As to the leaseback transactions, Secretary Snyder found that the benefit to the exempt organizations was their ability to use a larger share of the rental income to repay the debt because they did not have to pay taxes and urged that "[t]he exemption should be limited to income received from ordinary investments which involves no abuse."[77]

Secretary Snyder called for "a solution which will eliminate the abuse but will not interfere with the basic activities of these organizations."[78] Treasury's recommended solution was that "the income derived by these institutions from the operations of businesses which are

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[74] Id. at 5. The President's message described the situation in the following terms: "Some tax loopholes have also been developed through the abuse of the tax exemption accorded educational and charitable organizations. It has properly been the policy of the Federal Government since the beginning of the income tax to encourage the development of these organizations. That policy should not be changed. But the few glaring abuses of the tax-exemption privilege should be stopped.

Responsible educational leaders share in the concern about the fact that an exemption intended to protect educational activities has been misused in a few instances to gain competitive advantage over private enterprise through the conduct of business and industrial ventures, and the funds intended for charitable purposes, buttressed by tax exemption, have been used to acquire or retain control over a wide variety of industrial enterprises.

These and other unintended advantages can and should be removed without jeopardizing the basic purposes of those organizations which should rightly be aided by tax exemption."

[75] HEARINGS ON REVENUE REVISION OF 1950 BEFORE THE COMMITTEE ON WAYS AND MEANS OF THE HOUSE OF REPRESENTATIVE, 81st Cong., 2d Sess. 18-19 (1950)(statement of Secretary of the Treasury John W. Snyder). Treasury estimated that 50-100 universities were involved in one or both of these activities.

[76] Id. at 19.

[77] Id.

[78] Id.

clearly unrelated to their primary functions be taxed at regular corporate income tax rates."[79] Vance Kirby, the Legislative Counsel of the Treasury Department, traced much of the problem to the judicial doctrine of destination of income and pointed out that Treasury had made a similar legislative proposal in 1942.[80] Kirby distinguished between commercial activities conducted directly by an exempt organization and commercial activities conducted by a feeder organization in the following terms:

> Under the recommendation, if such activities are conducted by the exempt organization itself, the exemption of the organization would not be disturbed, but such business income would be segregated and subjected to tax. If a separate organization conducts those activities for the exempt institution, the entire income of the separate organizations would be taxed.[81]

This formulation expresses some of the subsequent uncertainty with respect to the scope of permissible unrelated business activity. The distinction was aimed at the Roche's Beach and Mueller Macaroni cases, the latter of which was being litigated during the 1950 Hearings. The reasons for the distinction were not articulated during the Hearings. One reason might be that the feeder organization conducted too much UBIT, and another reason might be that the feeder organization conducted no exempt activities. These two lines of reasoning converge when the unrelated business activity is the organization's only activity, but they diverge when an organization conducts both exempt activities and unrelated business activities. Congressman Dingell captured the conceptual framework of the 1950 legislation when he told a witness representing universities:

You are not going to be taxed for producing fine students. That is a very fine product this is never taxed. Always it is tax exempt. When you go into the noodle business or when you go into the real-estate business, so far as I am concerned, you are going to pay a tax. That it exactly the way I am going to vote. That is my view.[82]

Vance Kirby embraced the idea that investment activities are "traditional" for exempt organizations and that investment income would not be taxed, assuring the universities and other exempt organizations that "[u]nder the proposal, the traditional sources of income of these institutions, consisting of interest, dividends, rents, royalties, or capital gains, would remain tax-exempt."[83] Similarly, "[d]ues, contributions, assessments, gifts, grants, and the like would also continue to be tax-exempt."[84]

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[79] Id.

[80] Id. at 165.

[81] Id.

[82] Id. at 582.

[83] Id. at 165.

[84] Id. at 165-66.

With respect to the leaseback transactions, Vance Kirby told the Committee that such a transaction "allows such organizations to trade on their tax exemption."[85] The absence of taxation meant that exempt organizations could borrow a greater share of the purchase price, and in many case the entire purchase price, and they use a greater share of the rental income to pay the mortgage. Treasury proposed that the rental income be taxed in the same proportion as the as the proportion of the purchase price that the organization had borrowed.[86]

Treasury assumed that exempt organizations used the revenue from their commercial activities for their exempt activities. Congressman Hale Boggs asked Thomas Lynch, the General Counsel of the Treasury Department, "How many instances do you have, if any, where the revenues derived from the operations of these commercial establishments are not devoted entirely and exclusively to the operation of the educational institution?"[87] Lynch responded that he had no information on the issue because "[w]e assume that the revenue is devoted to that purpose."[88]

One of the witnesses addressed the distinction between the direct conduct of a commercial enterprise by an exempt organization and the receipt of dividends from a controlled commercial entity.[89] While he stated that "any encroachment on the tax-exemption principle is dangerous," Killian also stated that "our colleges and universities have a responsibility not to engage in business or investment practices which might be reasonably judged to be border-line or outside the tax-exemption area."[90] He took the position that universities should be free to invest their funds and to engage in activities like dormitories and food services to their students. He did not, however, extend the same reasoning to commercial entities, stating:

> ... I believe that a different situation arises when a manufacturing or commercial business is carried on by a separate entity which would certainly not be entitled to tax exemption if all of its property and income were not dedicated to some university, when such manufacturing or commercial business has no connection with the educational or research work of the university, other than the attribute of producing income for the university.

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[85] Id. at 166.

[86] Id. at 167.

[87] Id. at 175.

Congressman Boggs was concerned that private universities would not be able to compete against state universities if they were taxed on their business income.

[88] Id.

[89] Id. at 500-03 (Statement of Dr. J.R. Killian, Jr. President, Massachusetts Institute of Technology, Representing the Association of American Universities).

[90] Id. at 501.

> I believe that it is sound policy for a university not to seek tax exemption for such a separate entity, and not to enter into a transaction involving such a separate entity, if the advantage of the transaction depends upon the separate entity being free of Federal income tax.[91]

Dr. Killian told the Committee that universities would be unlikely to operate such manufacturing or commercial enterprises directly because of concerns over liability and because attempting to do so would be ultra vires.[92]

The question of the direct conduct of a business by an exempt organization and the indirect conduct by a controlled entity received its fullest if not most illuminating airing in the "noodle debate" between Congressman Dingell (D-MI) and Philip C. Pendelton, the treasurer of the University of Pennsylvania who appeared on behalf of the American Council on Education.[93] Mr. Pendelton testified that businesses conducted in separate entities should not be tax exempt simply because they distributed their net income to an exempt shareholder.[94] He also testified that a university could not use its endowment funds to capitalize a separate entity because he assumed that such separate entities would be owned by alumni or friends, not by the university.[95]

Congressman Dingell rejected the distinction between businesses operated directly by an exempt organization and businesses operated through separate commercial entities, stating:

> As to this macaroni or noodle works that is owned by the New York University, it seems to me it does not make any difference whether the university holds it directly or whether it is held by a subsidiary corporations, the alumni, or by any other group or any other scheme or plan. The fact of the matter is that they are tax-exempt. From the purely competitive standpoint, especially at the present level of taxes, the advantage of a tax-exempt corporation, regardless of whether it is held by a university or whether it is controlled or owned by the alumni or any other groups or association, is so great that, if something is not done to level it off, the macaroni monopoly will be in the hands of the universities or their subsidiary companies. Eventually all the noodles produced in this country will be produced by corporations held or created by universities, by educational institutions, and there will be no revenue to the Federal Treasury from this industry. That is our concern. There is no question about the fact that the advance of tax-exempt

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[91] Id.

[92] Id. at 502.

[93] Id. at 571-80.

[94] Id. at 573.

[95] Id. at 579. Under current tax law, an exempt organization may use its contributions or any other revenue to capitalize a taxable subsidiary.

> institutions, such as the macaroni concern, is so great that eventually it is bound to put the privately owned noodle corporations out of business.[96]

Another member of the Ways and Means Committee observed that a macaroni factory in his district in the Middle West had been in operation for thirty-five years, but "[i]t is now being forced to the wall by the competition from this macaroni factory of the New York University that is gradually getting out into the Middle West with their product."[97]

When Mr. Pendelton stated that he agreed that businesses conducted in separate entities should be taxed, Mr. Dingell stated emphatically that this was an insufficient response and was unimpressed with Mr. Pendelton's assertions that universities would not consider operating business enterprises directly because of the fear of liabilities and of business losses.[98] Mr. Dingell rejected an such distinction, stating:

> To me it does not make any difference whether it is the university that acquires it, it does not make any difference whether they purchase it or whether they received it at the hands of some well-wisher who passed away, or whether it is a subsidiary corporation. As long as it enjoys that tax-exempt status because of the educational touch, then it makes it impossible for private enterprise to compete with it.[99]

Several witnesses from the taxable sector testified on the competition they faced from tax-exempt organizations that operated commercial enterprises. These witnesses were concerned only with seeing that the commercial enterprises operated by exempt organizations were taxed on the same terms and at the same rates as were their own enterprises. They were not concerned with questions of the exempt status of organizations that operated commercial enterprises in addition to their commercial activities.

The issues relating to the leasebacks were treated as a distinct issue. The question was the use of borrowed funds to leverage funds that had supported deductions to contributors and which were not taxed in the hands of the exempt organization. Here, too, the major concern was leaseback transactions by universities. The issue was not treated as another example of a business activity but as a question of an investment activity with borrowed funds. The universities argued vigorously that these transactions should not be taxed because they did not differ from any other investment activity and involved no tax abuse. Mr. Pendelton of the University of Pennsylvania, who appeared on behalf of the American Council on Education, wrote to the Committee to supplement his testimony on leasebacks:

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[96] Id. at 579-80.

[97] Id. at 580 (statement of Congressman Noah M. Mason (R-IL)).

[98] Id. at 581-82.

[99] Id. at 581.

> None of us can see how these really affect the tax revenues of the Government. If we pay more for the property than it is worth, then the seller makes a bigger gain and the Government gets more taxes. If we pay too low a rental, then the vendor-lessee can deduct less as a business expense and he will have a higher profit to be subjected to tax. If there is any evidence that the transaction is improper in any way, the Internal Revenue Bureau pounces on it when the vendor-lessee files its income tax.
>
> The real reason that these deals are profitable to both parties is that the vendee-lessor takes a long term nonliquid investment and the vendor-lessee get liquid capital to put into his business instead of having a large part of his assets tied up in real estate.[100]

Dr. Killian took the position that leaseback transactions were generally not abusive, at least in cases which did not give the taxable seller a repurchase option.[101] He urged Congress to ease the restrictions on charitable contributions so that universities would not feel the need to engage in transactions like leasebacks.[102] An attorney appearing on behalf of Oberlin College took the same position with respect to real estate transactions.[103]

Congress focused solely on the use of the borrowed money in these transactions not on the broader issue of real estate transactions, largely because the universities insisted that they had traditionally invested in real estate and extracted promises that this type of commercial activity would not be subject to whatever tax regime that Congress imposed on exempt organizations.

VII. Approaches and Recommendations

This paper has taken the position that the complexity of the UBIT provisions arises in part from successful lobbying to define an ever-increasing list of modifications and exceptions and in part from lack of clarity on the purpose of UBIT and its relation to exemption. The recommendations are presented in two sections. The first section deals with alternatives to the present UBIT provisions and the second considers various changes that could be made within the current structure.

A. Structural Reform

This paper has taken the position that the fundamental purpose of UBIT is to protect the integrity of the exemption by distinguishing taxable activities that are not related to an organization's exempt purpose from activities directly related to an organization's exempt purpose. The paper has suggested that the absence of any concept of how much commercial

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[100] Id. at 582.

[101] Id. at 502

[102] Id.

[103] Id. at 554-64 (Statement of King E. Fauver, Attorney, Oberlin College, Elyria, Ohio).

activity is consistent with exemption undermines the integrity of the exemption and raises fundamental questions about the usefulness of the current UBIT provisions. Two broad alternatives to the current structure would address the issue in different ways. The first is a structure that taxes any commercial activity. The second is a return to an explicit destination of income test. Each of these is discussed below.

1. Tax on Commercial Activity

The tax on commercial activity would resolve the characterization issues relating to commercial transactions by taxing all income from the sale of goods or services. The use of the income so derived would be irrelevant to the inclusion of these amounts in gross income. This approach would eliminate both the regularly carried on requirement and the substantially related requirement of current law.

This approach would eliminate much of the complexity of current law. Museum shops and university books stores would no longer operate under the fragmentation rule requiring that each item sold be analyzed in terms of its substantial relationship to the organization's exempt purpose. Corporate sponsorship would be treated as the sale of advertising. Bingo would simply be part of the gaming industry.

A commercial activity tax would not solve all characterization problems. For example, is a covenant not to compete, which has become a feature of certain joint venture and conversion transactions, a commercial activity? A more common question arises with respect to fee for service income, especially when the service provided is one of the traditional exempt activities of a public charity. Is paying tuition a commercial transaction or an exempt transaction? Now that commercial schools and universities are becoming more common and now that exempt universities are establishing for-profit subsidiaries to operate their distance learning enterprises, there is no inherently correct answer and tradition appears a less compelling argument for treating tuition income as exempt income. The same is true in the case of fees for health care. The case of a health care facility operated as a joint venture between an exempt entity and a taxable entity illustrates the issue. The same enterprise is, under current law, treated as producing two different types of income based solely on the tax status of the joint venture partner.

A tax on commercial does not address questions of the scope of permissible commercial activity. Would questions of scope become irrelevant under a commercial activity tax? Questions of scope would become irrelevant if the problem is thought to be unfair competition, but they would not become irrelevant if the problem is thought to be charitable inefficiency, the internal diversion of resources from exempt activity, whether conducted by the exempt organization itself or by a subsidiary, whether exempt or taxable, capitalized by the exempt organization.

These examples suggest that a commercial activity tax would be simple but controversial. Indeed, it would in all probability be unacceptable to virtually every exempt organization that engages in any commercial activity or any activity that might be characterized as commercial activity.

2. Destination of Income Approach

The second structural alternative is an explicit return to the destination of income test under which any exempt organization would be taxed only on revenue that is not used for activities directly related to the conduct of exempt activities. This approach would introduce substantial simplification while focusing directly on the exempt activities of exempt organizations. This approach would protect the integrity of exemption only if it were applied in conjunction with renewed attention to section 502 and clarification of the derivative exemption doctrine that has brought the *Mueller* and *Roche's Beach* model back into the law after they had supposedly been overturned. The exempt parent would not be taxable on the earnings distributed to it, provided that it used such income for its exempt purposes, but the taxable subsidiary would not itself qualify for exemption based on its distribution to the exempt parent. An exempt subsidiary would be able to claim the benefits of the destination of income approach only if it used the funds for its own exempt activities.

A destination of income approach limited to income earned directly by the exempt organization would have certain unanticipated consequences. For example, a university would be taxable on any tuition revenue used to capitalize taxable subsidiaries even if the taxable subsidiary distributed its earnings to the exempt parent. The earnings would be taxable to the exempt parent if they were not used for the parent's exempt purpose. The same principle would apply to partnership distributions to an exempt partner, whether in an investment partnership or an operating joint venture such as a whole hospital joint venture or a joint venture between a university and a taxable company to market the practical applications of research performed by the university.

A destination of income structure would not eliminate the complexity relating to the determination of what activities are exempt activities. Current law defines exempt purposes but offers no guidance on translating purposes into activities. For example, are intercollegiate athletics an exempt educational activity or a commercial activity? The Service had ruled that all college athletics, whether intramural or intercollegiate, are educational activities, as is the broadcast of games. If one disregards the tax status of the sponsoring entity, there is little compelling reason to treat intercollegiate athletics as educational activities? Addressing long-ignored questions of what exempt purpose properly support exemption and what activities are directly related to these purposes would, ultimately, simplify exempt organization taxation, but the process of addressing this issue would not be an effortless path to simplification and few would find it a welcome prospect.

The destination of income approach would raise questions of unfair competition and questions of charitable efficiency or internal diversion. Questions of unfair competition would become newly important because the scope of commercial activity would become irrelevant. In effect, the new destination of income approach would raise the questions of allegedly unfair competition that fueled the effort to enact current law. The new debate would, however, focus directly on commercial activities conducted by exempt organizations themselves and not on the commercial activities of feeder organizations. Questions of charitable efficiency, the diversion of time and resources from exempt activity, would also be important. What evidence would establish use of revenue from commercial activities for exempt activities? How would investment in the commercial activities be treated? Would investment in business expansion and

business efficiency be consistent with exemption? How would business losses be treated? Would exceptions from taxation be provided for a start-up period? Could an organization remain exempt without regard to the scope of its commercial activities even if the commercial activities never produced revenue used for any purpose other than maintaining or expanding the commercial activities themselves? Would commercial activities that never produced revenue for exempt activities be consistent with exempt status?

B. Simplification of the Current Structure

If the current system is retained, there are elements of simplification that would also prevent the kind of diversion of resources to non-exempt purposes that undermines the integrity of exemption. These simplification measures do not resolve the fundamental structural issue of the relationship between UBIT and exemption.

(1) *Repeal the "regularly carried on" element in the definition of an unrelated trade or business and replace it with a small organization exception*

The regularly carried on element is a proxy variable for commerciality. The examples in the regulations relate to limited amounts of unrelated business income earned by small scale organizations that would appear likely to use the UBI for exempt activities. None of these factors and implicit assumptions proved relevant in the *NCAA* opinion issued by the basketball fans on the Court of Appeals for the Tenth Circuit. Rather than a costly, uncertain, and time-consuming litigation strategy to deal with this ill-advised and baseless opinion, it would be simpler to clarify the law by addressing directly the apparent purpose by enacting a small organization exception.

(2) *Repeal section 514*

Section 514 has no apparent purpose other than to prevent the leveraging of exempt organizations' assets. However, the exclusion of qualified educational organizations suggests that the provision has only limited impact. In view of the many other forms of commercial activity that are currently regarded as consistent with exempt status and in view of the ability of exempt organizations to issue bonds in public bond markets, there is little reason to regard borrowing money using exempt organization property as collateral as inherently inconsistent with exempt status.

One approach that seems to be missing from this paper would be to simplify the modifications and exceptions by repealing some or all of them. This approach would not, however, result in either simplification or rationalization of the current structure even if it were politically possible. Reducing the total number of modifications and exceptions would be largely irrelevant to the operational simplification of UBIT as it affects particular organizations. The problem with the modification and exceptions is not that they are complex for individual organizations but that they reflect the conceptual incoherence of the relationship between UBIT and exemption.

By tracing the legislative history of the current UBIT provisions, this paper has taken the position that Congress did not adequately consider the relationship between UBIT and exemption

when it enacted the UBIT provisions. The time for considering the issue of the diversion of resources from exempt to commercial purposes within exempt organizations is long overdue.

E. Simplification of the EITC Through Structural Changes

Submission to the Joint Committee on Taxation for its Study of the Overall State of the Federal Tax System

By

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I. Introduction

The earned income tax credit (EITC) is one of the most complex provisions of the federal income tax law, yet its purpose is to provide a benefit to low-income taxpayers who should not be facing such complexity. While there have been various proposals over the past several years to simplify the EITC, few changes have been made and recent law changes, such as the enactment of the child credit, have made the EITC even more complex for many of the individuals who claim it. In addition to complexity, the EITC is also prone to fraud and additional provisions have been added to combat this.

At credit levels of 7.65%, 34% and 40% depending on the type of individual claiming the EITC, the credit results in a refund of all or some portion of the employee's share of FICA and Medicare taxes. In these situations, the EITC is basically a mechanism to refund a tax that perhaps just as easily could not have been withheld in the first place. Such a result could be achieved by using a system similar to the income tax withholding system that doesn't begin until a certain income level is reached. If further simplifications were made to conform definitions used for the EITC, such as "qualifying child," to other definitions used in computing federal taxable income, such as "dependent," the structural change would be more feasible and further simplification could be achieved.

The EITC could be restructured to be an immediate offset of payroll taxes in more than one way. For example, all employees could have an exemption from Social Security (FICA) and Medicare taxes (referred to in this paper as "payroll taxes") on a specified amount of wages. Of course, to offset the reduction in tax collections, the tax rates and maximum amount of earned income subject to payroll taxes would need to be adjusted. Another alternative would be to have payroll taxes computed on a graduated rate basis tied to the worker's wage base (similar to how federal income tax withholding is computed). Because the current EITC structure can result in refunds greater than the worker's payroll tax amount,[1] additional changes would be needed to maintain the current level of benefit provided by the EITC to taxpayers with one or more

[1] For example, in 2000 the maximum EITC for an individual with two or more qualifying children is $3,888 when earned income is between $9,720 and $12,690. The employee's share of payroll taxes on $12,690 of income is only $971 ($12,690 x 7.65%).

qualifying children. These changes might be achieved through increased dependency exemptions or child credits for individuals with specified amounts of earned income.

Beyond simplification, an additional potential benefit of an alternative structure and simplification of qualifying status requirements would be that it might make it easier to move to a return-free tax system. Structural changes as described above would also serve to provide the EITC benefit to low-income taxpayers in each paycheck without a need for individuals to apply to receive an advance EITC. In addition, these structural changes could be implemented in a manner so as to reduce the current high marginal tax rates that result from the phase-out provision of the EITC.

Format of the Paper

Section II of this paper provides a brief background to the EITC as relevant to appreciating and evaluating appropriate structural changes. Section II reviews the history and rationale of the EITC, issues surrounding it (many of which stem from the complexity of the EITC), and relevant data on the usage of the EITC to better understand who it applies to and its effects to low-income individuals. Section III examines the possible mechanics and feasibility of an alternative structure for the EITC that would simplify the operation of this program and provide an effective and low-cost benefit to low-income individuals.

Focus on Simplicity

The focus of the change proposed in this paper is simplification of the EITC. Thus, there is little discussion of making changes to modify the social and economic policies underlying the EITC. This is not to say that non-tax policy aspects of the EITC are not important, but to emphasize that this paper has been prepared for inclusion in a tax law simplification study.

However, the underlying policy cannot completely be ignored and the discussion of the advantages and disadvantages of the proposals outlined in this paper does note some of these issues. Broader discussions of EITC reform should include a review of the welfare function of the credit. Under today's EITC structure, the amount of the benefit received is dependent on a worker's marital status and number of children (with the benefit capped at two children). The EITC does not provide equivalent benefit to all low-income workers with respect to whether they earn above or below the poverty line for their family size. Also, while the EITC has been viewed by many as an effective tool in increasing employment of low-income workers,[2] perhaps more so than other welfare policies, the use of the tax law to provide welfare benefits beyond the level necessary to remove individuals with income below the poverty level from federal income and payroll taxes should be evaluated in any major EITC reform effort. The rationale for such evaluation includes the fact that the EITC has grown in complexity with its expansion over the years and the fact that it is a program administered by the Internal Revenue Service, rather than an agency with expertise in the administration of welfare programs. Also, the amount of the benefit provided has increased significantly since the EITC was first introduced in 1975, and the

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[2] See "Should EITC Benefits Be Enlarged For Families With Three or More Children?" prepared by the Center on Budget and Policy Priorities, July 10, 2000.

incidence of fraud and error in claiming the credit has increased. In addition, any major reform of the EITC system could also be judged in terms of how it would comport with any possible Social Security tax reform.

Reasons for Simplifying the EITC

Key reasons for simplifying the EITC include:

(a) To reduce the number of errors that occur in computing the credit.

(b) To better ensure that eligible individuals claim the credit.

(c) To make it more likely that individuals claiming the credit can be included in a return-free system that we may move to in the future.[3]

(d) To reduce the administrative and compliance costs associated with the current EITC.

(e) To reduce or eliminate the problems associated with the high marginal tax rates that result from the phase-out feature of the EITC.

II. Brief Background On The Earned Income Tax Credit (EITC)

Eligibility and Computation Basics

IRC §32 provides for an earned income tax credit (EITC). The EITC is a refundable credit available to individuals with specified amounts of earned income. The credit is intended to provide tax relief to certain low-income individuals. Thus, if the individual's earned income exceeds a specified threshold, the amount of the credit phases out. If an individual's earned income (or adjusted gross income, if higher) exceeds the phase-out limit, no credit is available. These dollar amounts are adjusted annually for the effect of inflation. The credit amounts and phase-out rates and amounts vary depending on whether the claimant has one qualifying child, two or more qualifying children, or no qualifying child. Definitions of earned income and qualifying child are provided for purposes of the credit.

Certain factors will disqualify a low-income individual who otherwise meets the income thresholds from claiming the credit. For example, married taxpayers must generally file a joint return in order to claim the credit. Also, individuals must provide the taxpayer identification numbers of the qualifying children. In addition, individuals with investment income in excess of $2,400 (for the year 2000) are not eligible for the EITC.

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[3] Today, individuals with a qualifying child claiming an EITC may not use Form 1040EZ. In addition, individuals may not use the simple Telefile system if they claim dependents or received advance earned income credit payments. The Internal Revenue Service Restructuring and Reform Act of 1998 (P.L. 105-206; July 22, 1998; Section 2004) requires the Service to study the feasibility of and to develop procedures for a return-free tax system for "appropriate" individuals for tax years beginning after 2007.

The credit percentage and phase-out percentages used to compute the EITC are shown in the following chart.

Eligible individual has ...	(a) Credit percentage	(b) Phase-out percentage
1 qualifying child	34	15.98
2 or more qualifying children	40	21.06
No qualifying child	7.65	7.65

For the year 2000, the following amounts apply in computing the EITC:[4]

Number of Qualifying Children	(c) Maximum EITC	(d) Earned Income Amount	(e) Phase-out Amount	(f) Completed Phase-out Amount (no EITC available if the greater of earned income or modified AGI exceeds these amounts)
1	$2,353	$6,920	$12,690	$27,413
2 or more	$3,888	$9,720	$12,690	$31,152
None	$ 353	$4,610	$5,770	$10,380

Formula: The EITC is calculated using the following formula using the letter references in the above two charts.

Step 1: If an otherwise eligible taxpayer's earned income (or modified AGI, if higher) exceeds the completed phase-out amount (f), the taxpayer is not eligible for the EITC.

Step 2: Determine the lower of the taxpayer's earned income or the earned income amount (d).

Step 3: Multiply the amount from Step 2 by the credit percentage (a). If the taxpayer's earned income (or modified AGI, if higher) does not exceed the phase-out amount (e), then the amount computed at Step 3 is the EITC amount. If the taxpayer's earned income (or modified AGI, if higher) equals or exceeds the phase-out amount (e), then Step 4 is needed because the taxpayer is in the EITC phase-out range.

Step 4: Compute [Earned income (or modified AGI, if higher)] – [Phase-out amount (e)] x Phase-out percentage (b)

Step 5: EITC = [Maximum EITC (c)] – [Step 4 amount]

Example 1: Mr. and Mrs. Smith have earned income of $10,000 in 2000 and no other income. Thus, their AGI is also $10,000. The Smiths have two qualifying children. The Smith's EITC is $3,888 computed as follows.

Step 1: The Smiths are eligible for the EITC because their earned income is less than $31,152.

Step 2: The lower amount is $9,720.

Step 3: $9,720 x 40% = $3,888. Because the Smith's earned income does not exceed $12.690, their EITC is $3,888 (which is the maximum EITC amount).

[4] Rev. Proc. 99-42, 1999-46 I.R.B. 568, 570.

Example 2: Same as Example 1 except that the earned income amount is $16,000. The Smith's EITC is $3,191 computed as follows.

Step 1: The Smiths are eligible for the EITC because their earned income is less than $31,152.

Step 2: The lower amount is $9,720.

Step 3: $9,720 x 40% = $3,888. Because the Smith's earned income equals or exceeds $12,690, the phase-out must be computed.

Step 4: [$16,000 - $12,690] x 21.06% = $697.

Step 5: $3,888 - $697 = EITC of $3,191.

Observations: The effect of the phase-out is to create a range of earned income that produces the maximum EITC. This range is from the earned income amount (d) to the phase-out amount (e). At earned income amounts below (d) and those above (e), the EITC gradually reduces in amount. The effect of this formula is to create an "ideal" income range between (d) and (e) where the maximum credit can be obtained. This feature has led to problems of some individuals reporting higher income than actually earned in order to reach the earned income amount (d) or to report lower earned income to reduce the effect of the phase-out when income exceeds the phase-out amount (e). The phase-out mechanics also causes an individual's marginal tax rate to increase once earned income exceeds the phase-out amount (e).[5]

Rationale for the EITC

The EITC was created to provide relief to families[6] with little or no income tax liability, but who were subject to payroll taxes on their earned income. The credit has been viewed as "an effective way of providing tax relief for low-income families, while at the same time providing work incentives for these individuals."[7] In 1990, the amount of the credit was increased to provide partial relief for the regressive effect of excise tax increases.

History[8]

The EITC was created by the Tax Reduction Act of 1975.[9] The EITC was part of a package of tax reductions intended to address the high unemployment rate and slow economy.

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[5] For a detailed explanation of the marginal tax rate effects of the EITC phase-out, see Joint Committee on Taxation, *Present Law and Analysis Relating to Individual Effective Marginal Tax Rates* (JCS-3-98), Feb. 3, 1998, pages 39-45.

[6] The credit was extended to low-income individuals with no qualifying children in 1993.

[7] General *Explanation of the Revenue Act of 1978*, prepared by the Staff of the Joint Committee on Taxation, March 12, 1979.

[8] For a more detailed history of the EITC, see Joint Committee on Taxation, *Present Law and Analysis Relating to Individual Effective Marginal Tax Rates* (JCS-3-98), Feb. 3, 1998, pages 37 – 39.

The EITC began as a one-time benefit to families with at least one dependent child to provide a refundable credit of 10% on the first $4,000 of earned income, for a maximum credit of $400. The EITC phased out as income rose from $4,000 to $8,000. Congress expected that the EITC would help stimulate the economy because most claimants would spend the credit they received. The credit was intended to provide relief to families with little or no income tax liability, but who were subject to Social Security tax on their earned income. In 1975, the Social Security tax rate was 5.85% on earnings up to $14,000, while self-employed individuals were subject to a rate of 7.9% on self-employment income up to $14,100. For 1975, the EITC was intended to be a simple calculation that merely involved adding up earned income and applying the credit percentage. Also, individuals below the income level requiring for filing a tax return were expected to have a simple form available to them for claiming the credit.[10]

The Revenue Adjustment Act of 1975 extended the EITC to the first six months of 1976.[11] The Tax Reform Act of 1976 extended the EITC through the end of 1977 and made slight modifications to the eligibility criteria.[12] The rationale for the extension was explained as follows:[13]

> [The EITC] provides needed tax relief to a hard-pressed group in the population – the lower income worker. It also provides a work incentive, since the credit is based on the amount of earned income. In effect, it offsets the social security payroll taxes payable with respect to those who are working but whose incomes are slightly, if any, above the levels of those on welfare. This is designed to improve the financial position of those who work relative to those remaining on welfare.

The Revenue Act of 1978 made the EITC a permanent provision and increased the credit to 10% of the first $5,000 of earned income for a maximum credit of $500. The income phase-out was changed to begin at $6,000. The eligibility criteria were simplified and a system was created to allow individuals to claim advance earned income tax payments throughout the year.[14]

Small increases to the EITC were made by the Deficit Reduction Act of 1984[15] and the Tax Reform Act of 1986.[16] More substantial increases were made to the EITC by the Omnibus

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[9] P.L. 94-12 (March 29, 1975).

[10] House of Representatives Report No. 94-19 (1st Sess), 1975-1 C.B. 569, 579; Senate Report No. 94-36 (1st Sess.), 1975-1 C.B. 590, 595.

[11] P.L. 94-164 (Dec. 23, 1975).

[12] P.L. 94-455 (Oct. 4, 1976).

[13] *General Explanation of the Tax Reform Act of 1976*, prepared by the Staff of the Joint Committee on Taxation, JCS-33-76, Dec. 29, 1976, pages 123-126.

[14] P.L. 95-600 (Nov. 6, 1978).

[15] P.L. 98-369 (July 18, 1984), §§423(c), 471(c) and 1042(a).

Budget Reconciliation Act of 1990.[17] In addition, the 1990 Act broadened the category of individuals eligible for the EITC, and added the supplemental young child credit and supplemental health insurance credit. With the EITC increase, the advance EITC was changed to be limited to the credit allowable to a taxpayer with only one qualifying child. In addition, Congress called for the Treasury Department to conduct a study on the effectiveness of the advance payment system and how complexity could be alleviated for small businesses. The rationale for the study was the fact that participation in the advance payment program was minimal. Treasury was also directed to create a taxpayer awareness program to inform the public of the EITC.

The Omnibus Budget Reconciliation Act of 1993[18] further raised the EITC rates and expanded eligibility. The 1993 changes allowed individuals without a qualifying child to also claim the credit, but at a much lower rate then for taxpayers with children. Taxpayers with no qualifying children must be at least age 25 and under age 65 to claim the EITC. The 1993 Act also repealed the supplemental young child and supplemental health insurance credits that had been added just three years earlier.

Tax legislation in 1994, 1995 and 1996 made certain individuals, such as prison inmates, ineligible for the EITC. Also, individuals with certain levels of "disqualifying income," such as certain investment income, were made ineligible for the EITC. Finally, the most recent changes of significance were compliance provisions added by the Taxpayer Relief Act of 1997.[19] These changes include a provision that denies the EITC for ten years for taxpayers who fraudulently claimed the EITC, as well as a provision that imposes due diligence requirements on paid preparers of returns on which the EITC is claimed.

Who Claims the EITC

In 1998, approximately 19.1 million taxpayers claimed the EITC on their tax returns. Of these taxpayers, 4.4 million (23%) were in the EITC phase-in range, while 11.7 million (61%) were in the EITC phase-out range. The income categories for the 19.1 million claimants was as follows:[20]

Income Category	Number of Taxpayers Claiming the EITC (millions)
Less than $10,000	4.8
$10,000 - $20,000	6.7

16 P.L. 99-514 (Oct. 22, 1986), §§104(b), 111 and 1272(d)(4).

17 P.L. 101-508 (Nov. 5, 1990), §§11101(d) and 11111 to 11116.

18 P.L. 103-66 (Aug. 10, 1993), §§909-910.

19 P.L. 105-34 (Aug. 5, 1997), §1085.

20 Joint Committee on Taxation, Present Law and Analysis Relating to Individual Effective Marginal Tax Rates (JCS-3-98), Feb. 3, 1998, page 42.

$20,000 - $30,000	5.3
$30,000 - $40,000	2.1
$40,000 - $50,000	0.2
$50,000 - $75,000	Under 50,000

Projections for 1997 indicated the following breakdown of the types of individuals claiming the EITC:[21]

Type of Household	Number of returns (000s)	EIC (millions)	Percentage of dollars
No qualifying children	3,639	635	2
One qualifying child	7,949	11,463	43
Two or more qualifying children	7,064	14,821	55
All households	18,652	26,919	100

Average EITC Benefits

In 1975, the average credit for families claiming the credit was $201. This amount gradually increased to reach $601 in 1990 and $1,567 in 1997. The projected benefit is $1,625 per family for 2000 and $1,701 for 2002.[22]

EITC Problem Areas

The EITC began in 1975 as a fairly simple calculation (10% of earned income, not to exceed a credit of $400, with a phase-out on earned income up to $8,000). Today, the maximum credit is much larger ($3,888 in 2000) and the definitions necessary to calculate the credit go beyond just "earned income" and the credit has been expanded to cover more low-income individuals. In addition, the number of individuals claiming the credit has grown in the past 25 years. In 1975, about 6.2 million taxpayers claimed the credit (totaling approximately $1.25 billion of credits), while 19.4 million claimed it in 1998 (about $30 billion of credits).[23] The expansion of the EITC, the large dollar amounts involved and the refundable nature of the credit have caused the EITC to be both error prone and fraud prone. In addition, the large phase-out range for the credit can create high marginal tax rates for certain individuals. Finally, the EITC

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21 Joint Committee on Taxation, Impact on Individuals and Families of Replacing the Federal Income Tax (JCS-8-97), April 14, 1997, page 40.

22 House Ways and Means Committee, 2000 Green Book, WMCP: 106-14, page 813; hereinafter 2000 Green Book.

23 Treasury Dept., Management Advisory Report: Administration of the Earned Income Credit, September 2000, No. 2000-40-160; available from Tax Analysts: 2000 TNT 217-17; hereinafter 2000 Treasury Report.

is not tied to providing similar relief in terms of the level above the poverty line at which individuals have federal income and payroll tax liabilities. These problems are further explained below for the purpose of indicating why changes are needed to the EITC.

Taxpayer Costs—Complexity:

- The 1999 IRS Publication 596, *Earned Income Credit (EIC)*, was 54 pages long.
- An IRS study has indicated that about 65% of taxpayers claiming the EITC in 1997 used a paid preparer, compared to 53% of all taxpayers who used a paid preparer.[24]
- Many reports, including ones from the IRS National Taxpayer Advocate, have commented on the complexity of the EITC.[25] The American Institute of Certified Public Accountants (AICPA) has described the EITC as the Number 1 Taxpayer Headache:

> "Childhood dreams turn into adult nightmares for low-income parents trying to figure out the earned income tax credit. The credit has been changed 13 times since 1976 and now requires taxpayers to wind their way through a maze of eligibility tests and worksheets. This credit is one of the most error prone, complex provisions of the individual income tax."[26]

The Joint Committee on Taxation notes that the sources of EITC complexity stem from two sources: 1) identifying whether a child is a "qualifying child," and 2) calculation of the credit and what constitutes earned income.[27]

Simplification proposals from the Service and tax practitioners have often called for conforming the definition of "qualifying child" to that of "dependent child," changing the definition of earned income to wages plus self-employment income, and providing tax relief for children through the dependency exemption rather than the EITC.[28]

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[24] *2000 Treasury Report, supra.*

[25] IRS, National Taxpayer Advocate's Annual Reports to Congress for FY 1999 and FY 1998. EITC complexity was also noted in the Annual Report from the Commissioner of the Internal Revenue Service on Tax Law Complexity, June 5, 2000.

[26] AICPA, "10 Big Taxpayer Headaches That Could Be Cured Through A Little Tax Simplification," 4/9/98, http://www.aicpa.org/members/div/tax/headache.htm.

[27] Joint Committee on Taxation, Overview of Present Law and Issues Relating to Individual Income Taxes (JCS-18-99), April 14, 1999, page 82.

[28] See AICPA, Individual Tax Simplification, 1997, http://www.aicpa.org/letters/pkgcvr7.htm; Treasury Dept., Treasury News Release LS-904, 9/22/00; and IRS, Annual Report from the Commissioner of the Internal Revenue Service on Tax Law Complexity, June 5, 2000, pages 17 - 18.

Taxpayer Costs—Tax Rate Anomolies:

- Above the phase-out point, a taxpayer's marginal tax rate can be quite high. Arguably, this effect also creates a disincentive to earn more.

Example: Married taxpayers with two qualifying children have earned income in 2000 of $12,690 which entitles them to the maximum EITC amount of $3,888. If the family earns an additional $1,000 of earned income, their EITC is reduced by $211 ($1,000 x 21.06%). The marginal tax on the $1,000 of earned income is 51% (15% income tax + 21.06% EITC phase-out + 15.3 payroll taxes). Other credits though, such as the child credit, would reduce this amount.

It is estimated that over 50% of EITC claimants are in the phase-out range, and thus, subject to the high marginal tax rate explained in the example.[29]

- The EITC can create a significant marriage penalty when both spouses work. This can be seen in the charts provided earlier on how to calculate the EITC. Assume two working individuals each have one qualifying child and earned income of $12,690, which would qualify each for the maximum EITC in 2000 of $2,353 (a total of $4,706). If these two individuals were instead married, their earned income amount would be in the phase-out percentage and their EITC would be less than the maximum of $3,888.[30]

Taxpayer Costs—Problems of Obtaining the Credit:

- The complexity problems noted above can prevent eligible taxpayers from claiming the credit.[31]
- At least one private study has estimated that as few as 65% of eligible taxpayers receive the EITC.[32] As reported by the Joint Committee on Taxation in 1995, other studies have reported higher participation rates, noting that EITC participation is likely higher than for other programs, such as food stamps and SSI. The report also noted that EITC was more prone to improper claims because it was not subject to the same verification process as food stamps and similar welfare programs.[33]

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29 Joint Economic Committee, The EITC and the Taxation of Lower-Income Working Families, March 2000, page 8; hereinafter, 2000 JEC Report.

30 The specifics of the EITC marriage penalty, as well as possible remedies, are explained in Congressional Budget Office, *For Better or Worse: Marriage and the Federal Income Tax*, June 1997.

31 The complexity of the EITC, along with the fact that it is refundable, has also caused individuals to overclaim the credit.

32 2000 Treasury Report, supra; see Executive Summary of Treasury Report, footnotes 6, 7, and 8.

33 Joint Committee on Taxation, Description of Present Law and Discussion of Issues Relating to the Earned Income Tax Credit, JCX-27-95, 6/14/95. See footnotes 12, 13 and 14 of

- One expert on low-income taxpayer problems believes that up to 25% of the EITC error rate that the Service may follow up on stems from individuals who are entitled to the credit but don't respond to IRS notices due to time constraints, inability to access a phone, or to take time off from work to obtain requested documentation.[34]
- While some EITC-eligible individuals may receive the EITC in their paychecks, doing so involves filing Form W-5 with the individual's employer every year. An individual may be disinclined to give an employer a W-5 for privacy reasons. Also, the instructions to Form W-5 and the limitations on who may claim the Advance EITC may discourage an eligible individual from applying (and instead waiting to receive the EITC when the Form 1040 is filed in the subsequent year).

IRS Costs and Problems:

• "The IRS uses a complex process to administer the approximately $30 billion in EIC claims received each year. The over 18 functions that process these claims have conflicting goals and different approaches for achieving full participation and compliance, both between and within functions. For example, one function's goal is to process paper tax returns and issue refunds within 45 days. Another function's goal is to identify fraudulent returns during processing of the returns and stop payment of the refunds."[35]

• The fraud and error rate for 1997 was about 25.6%, compared to 21% for 1994. This means that about $7.8 billion of credits were erroneously paid out.[36]

• The most common math error on tax forms is incorrectly calculating the EITC. "[EITC] errors accounting for the highest percentage (28 percent) of math errors related to categories of complexity."[37]

• The IRS spends over $140 million annually on EITC compliance.[38]

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the JCT report which primarily refer to John Karl Scholz, "The Earned Income Tax Credit: Participation, Compliance, and Antipoverty Effectiveness," National Tax Journal, 47, March 1994.

34 Comment from Nina Olson, Director of the Community Tax Law Project in Virginia, reported in Tax Analyst, "EITC Error Rates Up; Review Process Slows Down," 2000 TNT 191-3, 9/29/00.

35 2000 Treasury Report, supra.

36 Treasury Dept., Treasury News Release LS-904, 9/22/00. In response, Treasury announced new administrative initiatives, legislative proposals, and urged Congress to enact two simplification proposals included in the Administrations FY 2001 budget, including conforming definitions used for the EITC to those used in other parts of the income tax rules. Also see Tax Analysts, "IRS Proposes Solutions to Boost EITC Compliance," 2000 TNT 186-1, 9/22/00.

37 IRS, Annual Report from the Commissioner of the Internal Revenue Service on Tax Law Complexity, June 5, 2000, pages 12 and 50 - 51.

38 2000 JEC Report, supra, page 11.

EITC Benefits and Poverty Levels:

While the relationship between EITC benefits and poverty levels is not a simplification issue, the topic is briefly noted here. A structural change to deliver the EITC benefit via a payroll tax exemption (or similar mechanism) along with an increased dependency exemption or child credit amounts in order to maintain the dollar amount of the EITC, is likely to be more equitable in providing relief to low-income taxpayers in terms of providing similar tax relief for those at similar poverty levels than is the current mechanism. The issues with equity under the current EITC is that it is capped at two or more qualifying children and is much lower for individuals with no qualifying children. Thus, to illustrate that such improved equity should not discredit the proposal, a brief discussion of how the current EITC does not provide similar relief to similarly situated individuals relative to poverty levels is provided.

• The income and payroll taxes imposed at the poverty level as a percentage of the poverty level for selected years and family sizes is illustrated in the following chart.[39] The percentages vary among family sizes, not only due to the EITC, but also due to the bracket structure, standard and personal deductions, and the child credit.

Year	Family Size					
	1	**2**	**3**	**4**	**5**	**6**
1993	10.3	7.7	-4.8	-0.2	3.2	5.3
1999	9.1	5.6	-8.1	-9.4	-3.7	-0.2
2002	9.2	5.7	-7.9	-9.2	-3.5	0.0

• From 1993 to 2009 (projected), only individuals with a family size of one have an income tax liability when their income is below the poverty level.[40]

• In 1998, the poverty rate or children in families with three children was 22.4% and for was 33.8% for children in families with four children.[41]

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39 2000 Green Book, supra, pages 839 to 842.

40 2000 Green Book, supra, pages 841.

41 Center on Budget and Policy Priorities, Should EITC Benefits Be Enlarged For Families with Three or More Children?, July 10, 2000, page 3. The report suggests that allowing a larger EITC for families with three or more children would promote work and self-sufficiency. It also notes that approximately 15% of families claiming the EITC have three or more children and therefore, an expanded EITC would have a limited cost.

III. Proposal for an Alternative EITC Structure

Criteria: An alternative structure for delivering the benefits of the current EITC should satisfy the following criteria:

a. Employ a system that prevents taking money from individuals (payroll tax withholding) and returning all or part of that money later. The system must be more effective than the current advance EITC procedure that is not available to all EITC taxpayers and not required to be used.
b. Be able to provide the same dollar benefit as under the current EITC structure.
c. Be simpler for EITC-eligible taxpayers.
d. Be simpler for the IRS to administer.

The Proposed Alternative Structure: The premise of the alternative structure for the EITC that would satisfy the above criteria is to change the withholding system for payroll taxes. The specifics of this changed withholding structure are listed below.[42] Potential problem areas and potential solutions for them are also covered.

i. Withholding would not apply until a certain threshold of income is earned. To phase-out this benefit at increasing earned income levels, the new withholding system (rate structure) could be progressive with the tax rate increasing as income exceeds the threshold. Statutory changes would be needed to change the rate structure for these payroll taxes.
Observation 1: To be simple, this structure should apply to all individuals with earned income. There should be no exceptions based on age (as there is with today's EITC for individuals with no qualifying child). If the current structure of limiting the EITC benefits to a maximum of two qualifying children is to remain, the rate structure would have to consider the number of qualifying children the worker has (similar to our current withholding table for income taxes). Similarly, if a much lower EITC remains for individuals with no qualifying children, the withholding rate would need to incorporate this.

Observation 2: While the structure could instead just exempt people with an expected annual salary below a certain amount from payroll tax withholding, such a system would likely be more complicated for employers. To maintain revenue neutrality, the new progressive rate structure could be set to, in effect, cause higher income individuals to end up paying payroll taxes on the initial exempted amount (similar to the corporate surtax system that results in corporate taxpayers at certain high levels of income losing the benefit of having some of their initial income taxed at the lower bracket amounts).

Two potential problem areas of the exemption amount for all individuals with earned income is that for individuals beyond the EITC eligibility levels, they would see their paychecks get smaller as the year progresses. This is the opposite effect individuals with earnings above the Social Security base experience today. However, this issue could be resolved by incorporating a

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42 The proposed alternative structure for the EITC is similar to proposals made by others. See 2000 JEC Report, supra; Joint Committee on Taxation, Description of Present Law and Discussion of Issues Relating to the Earned Income Tax Credit, JCX-27-95, 6/14/95; and Yin, Scholz, Forman, and Mazur, "Improving The Delivery of Benefits To The Working Poor: Proposals To Reform The Earned Income Credit Program," 94 TNT 40-56, 3/3/94.

"leveling" mechanism into the withholding system whereby withholding would be performed on a more equal basis throughout the year (similar to the current withholding system for income taxes).

A similar problem is created for some EITC-eligible individuals in that they would receive the bulk of their EITC benefit in the first part of the year, rather than evenly throughout the year (although today, many receive the entire benefit after they file their Form 1040). This could also be addressed by incorporating a leveling mechanism into the withholding schedule. Under such a system, the gross earnings would be annualized to determine the payroll withholding rate to use. While this could be complicated for employers, payroll software systems used by many employers today could handle the necessary calculations (the payroll tax withholding structure would be similar to the current income tax withholding mechanism). This same leveling mechanism would also address the issue of non-EITC eligible workers having smaller paychecks later in the year.

ii. The employer share of payroll taxes could remain as they are today, or employer payroll taxes could match employee payroll taxes. This is an important issue to resolve both for revenue neutrality purposes and for purposes of determining how much self-employment taxes a self-employed individual should pay.

iii. Replace part of the current EITC benefit with increased dependent deduction and/or child credit. This mechanism will allow a larger EITC benefit tied to family size (although whether the EITC should be provided beyond two qualifying children is a political and social issue for lawmakers to resolve). An advantage of replacing some of the EITC benefit with the dependent deduction or child credit is that it could help alleviate the potential problem a worker having multiple jobs during the year may face. Such an individual may not have paid enough payroll taxes. To reduce or eliminate that person's liability to the U.S. Treasury, he will have a reduced dependent deduction or reduced child credit. In addition, employees could be allowed to indicate on Form W-4 that they want payroll tax withholding for the remainder of the year when they change jobs during the year. *Observation*: Today's EITC has both a phase-in and phase-out feature. The withholding system proposed here could be unduly complicated if the phase-in structure were added to it. Alternatively, if the phase-in structure were kept, it could be implemented via the dependency exemption, child credit and/or personal exemption amounts allowed at certain earned income levels.

iv. For further simplicity, the definitions used in the EITC should be changed to better match terms used elsewhere in the Internal Revenue Code. For example, the definition of "qualifying child" could match that of dependent child. This would allow employers to use W-4 information in determining the payroll tax withholding for employees.

Expected Benefits:

- Workers eligible for EITC benefits would be able to receive the benefits throughout the year without the need to file a W-5 with the employer.
- The calculation by individuals of the EITC would be simplified in that the "truing up" of the EITC amount could be done as part of the Form 1040 calculations, particularly if EITC definitions of earned income and "qualifying child" are conformed to other definitions already used in computing taxable income. For example, a person's adjusted gross income (AGI) and number of dependent children would indicate the

EITC amount and such amount should have already been provided to that taxpayer through the new payroll withholding system.

- The reduction in complexity should lower the fraud and error rate that currently exists for the EITC.
- Costs to taxpayers should be reduced in that they would need to perform fewer calculations and could, perhaps, avoid having to hire someone to prepare their return.
- The alternative structure should work better under a return-free filing system because the necessary filing information would be on an employee's W-4 and W-2 and the number of calculations required to compute the credit could be reduced.

IV. Conclusion

No one would likely disagree with the statement that the EITC is too complex. While it began as a fairly simple calculation in 1975, its expansion and increase in benefit amount and desire to place certain limitations on eligibility have made it overly complex. Complexity brings with it results that are counterproductive to the purpose of the benefit. That is, complexity leads some eligible individuals to not claim their full EITC benefit, causes some ineligible individuals to attempt to claim the credit, and increases costs for both taxpayers and the IRS.

The EITC is designed to provide relief to low-income taxpayers who, while exempted from income tax on the first several thousand dollars of their earned income, are still subject to payroll taxes. However, unlike the income tax relief they receive in each paycheck, the payroll tax relief provided through the EITC is really only effectively returned today after the end of the year when the worker files his tax return. A structural change (as well as some changes to simplify EITC definitions and provide some of the benefit through increased dependency deductions and child credits) can turn the EITC benefit into one that is provided through the payroll tax withholding system, just as is done under the income tax system.

While the alternative structure described in Part III above might not be the simplest item in the tax law, it should be simpler than the current overly complex EITC structure. In addition, it would enable eligible taxpayers to obtain the EITC benefit throughout the year, rather than waiting until after year-end when they file their Form 1040.

F. Reforming and Simplifying the Income Taxation of Private Business Enterprises

By

George K. Yin and David J. Shakow*
November 15, 2000

Under current law, many private firms, no matter what their organizational characteristics, are entitled to choose among subchapters C, K and S of the Internal Revenue Code for their applicable income tax rules. In this paper, we recommend that current law be reformed and simplified by treating generally all private business firms as conduits for income tax purposes. Conduit taxation disregards the existence of the firm for tax purposes as much as possible; the rules of subchapter K are the closest approximation of conduit taxation in this country. In addition, because conduit taxation, as manifested by existing subchapter K, can be extremely complicated, and because needed reforms may only make it more so, we propose that the recommendation be implemented through a "two-track" approach. A simplified set of conduit tax rules would be used by certain private firms unless they elect otherwise, and a regular set of conduit rules would be used by all others. In general, the simplified rules would be available only to firms that are owned exclusively by individuals and that have surrendered some flexibility in their economic arrangement. The simplified rules will resemble a liberalized version of current subchapter S, whereas the regular conduit rules will consist of the subchapter K rules as modified by selected, proposed reforms.

Rarely is there an opportunity to adopt a proposal that provides both meaningful reform *and* simplification of the tax laws. Too often, those objectives are in conflict with one another. While many details need to be carefully considered, we believe that the recommendations outlined in this paper have the potential for achieving that happy combination.

The paper is organized as follows. Part I briefly summarizes the defects of current law. Parts II and III address why private firms should generally be treated as conduits for tax purposes and why a two-track approach for carrying out that recommendation is appropriate. Part IV then provides the principal details regarding how the two-track approach would be implemented. Part V contains our conclusion.

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*George K. Yin is Howard W. Smith Professor of Law and Barron F. Black Research Professor, University of Virginia. David J. Shakow is Professor of Law Emeritus, University of Pennsylvania, and Director, KPMG, LLP. Copyright © 2000 by George K. Yin and David J. Shakow. This paper summarizes the principal recommendations of an American Law Institute Reporters' Study prepared by the authors on this topic. See AMERICAN LAW INSTITUTE, FEDERAL INCOME TAX PROJECT: TAXATION OF PRIVATE BUSINESS ENTERPRISES -- REPORTERS' STUDY BY GEORGE K. YIN & DAVID J. SHAKOW (1999), 496 pp. Interested readers should consult the Study for the complete set of proposals and a fuller discussion of the issues. Copies are available from the ALI (800-253-6397).

I. Defects of Current Law

At present, many private business enterprises, no matter what their organizational characteristics, are provided with an explicit choice regarding how the income of the firm is taxed. For firms engaged in general business activities, the choices under the "check-the-box" regulations of current law are generally the rules contained in subchapters C, K, and S of the Internal Revenue Code. Although incorporated firms are currently not provided with the same choice as unincorporated ones, an unincorporated business with *precisely* the same characteristics as an incorporated firm *is* given that choice. Hence, it seems only a matter of time before all private firms, incorporated and unincorporated, will be afforded the same explicit choice of taxation schemes.[1]

This state of affairs is inconsistent with the historical development and substantive rules of subchapters C, K, and S. Each set of rules -- most clearly in the case of subchapters C and K and less obviously in the case of subchapter S -- was designed to apply to a particular form of business organization with specific characteristics. Yet, adoption of the check-the-box regulations reflects a policy determination generally to disregard business organization form and characteristics for income tax purposes. Given that, it is difficult to understand why private firms are nevertheless allowed a choice regarding how they are taxed, and why they are given the particular choices that they are.

If the three sets of rules produced more or less the same tax consequences in most situations, the choice among them might not be especially significant. But that is not the case. In any given situation, subchapters C, K or S may provide an advantageous tax result for particular taxpayers. For example, under subchapter C, the firm (and not the owners) is taxed on the business income when it initially arises and the owners are taxed on the same income when it is distributed to them. The possibility of double taxation, and the inability to net business income and losses with other tax items of the owners, is ordinarily unattractive to taxpayers. On the other hand, for many private subchapter C firms, the business income is initially taxed at graduated rates unrelated to the ability to pay of the owners.[2] In addition, the second tax of such firms may be deferred or eliminated altogether, or may be levied at preferential rates. In combination with the graduated tax rate schedule, it is therefore possible for business income to be taxed more favorably under subchapter C than either subchapters K or S. Private firms may also select subchapter C because it allows the future conversion to public status to be without tax consequences, and entitles the firm to other special tax provisions.

In contrast, subchapters K and S each offers a form of conduit taxation under which the firm is not taxed; instead, business income and losses are passed through to the owners of the firm. Thus, double taxation is avoided and owners are permitted to net any business income and

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[1] Public firms are not provided the same choice by reason of section 7704 of the Code. See Treas. Reg. § 301.7701-2(b)(7). In this paper, we assume continuation of the general policy decision to treat public and private firms differently for tax purposes, and we offer no recommendation regarding how public firms should be taxed.

[2] See I.R.C. § 11(b).

losses with their other tax items. On the other hand, the owners must pay tax at their tax rates on the business income as it arises. Obviously, these features of conduit taxation may or may not be advantageous, depending upon the applicable tax rates and other factors. As between subchapters K and S, there are a number of significant tax differences. Under subchapter K but not subchapter S, (1) firms may specially allocate their tax items among their owners,[3] (2) entity-level debt may be included in the basis of the owners in their ownership interests,[4] and (3) the inside basis of a firm's assets may be adjusted upon the death of an owner, a transfer of ownership interests, or a distribution from the firm.[5] In addition, a contribution or distribution transaction between the owners and the firm more likely results in the nonrecognition of gain or loss under subchapter K than subchapter S.[6] On the other hand, only subchapter K firms are subject to a series of complicated rules designed to prevent tax advantages in selected situations.[7] Further, S corporations, like C corporations, can convert to public status without tax consequences and can participate in a tax-free reorganization with a C corporation.[8] Subchapter K firms cannot participate in reorganizations and, when they go public, the transaction may or may not be wholly tax-free. After taking into account all of the differences, subchapter S is usually less advantageous than subchapter K but in certain cases, it may be more advantageous.

The elective tax treatment undermines both equity and efficiency objectives for the income tax. Although in theory, similarly situated businesses have an equal opportunity to be treated in the same tax-advantageous manner under current law, the practical reality is probably to the contrary, due to disparities in the quality of advice the businesses receive. By permitting such disparate tax choices without any apparent underlying, conceptual foundation, current law simply provides a tax benefit for the well-advised and a trap for the ill-advised. There is no particular policy reason why the taxation of private business firms should result in the minimization of tax liabilities for only the well-advised. Moreover, current law violates vertical equity norms. By giving well-advised private business owners a range of tax liabilities to choose from, current law by definition cannot impose the "proper" level of tax on them based upon vertical equity principles.

The elective nature of current law fosters inefficiency in several ways. First, not all businesses are provided with the same tax benefit of being able to choose their tax liability within a range of options. Neither public firms nor sole proprietors, for example, are provided

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[3] Compare I.R.C. § 704(a) and (b) with §§ 1366(a)(1), 1377(a).

[4] See I.R.C. § 752.

[5] See I.R.C. § 754.

[6] Compare I.R.C. § 351 with § 721 and §§ 1368, 302, 331, 311, and 336 with §§ 731, 704(c)(1)(B), 737, 707(a)(2)(B), and 751(b).

[7] See, e.g., I.R.C. §§ 704(c), 707(a)(2) and (b), 724, 731(c), 732(c), 735, 737, and 751. Subchapter S firms are, however, subject to the collapsible corporation provisions of section 341. See I.R.C. § 1371(a).

[8] See I.R.C. § 1371(a).

with the same degree of flexibility in determining the amount of their income tax liabilities. Thus, current law may distort the economic decisions of firms near the boundary of those eligible for the tax choice, thereby potentially causing deadweight losses. Indeed, private firms were already generally taxed more favorably than either of the other two types of businesses prior to the check-the-box regulations; the new choice for private firms simply tilts the tax scales further in their favor.

Second, as previously noted, not all eligible firms may make the optimal tax choice due to a variety of factors. But if, for whatever reasons, firms differ in their access to the tax minimization techniques, then allocative distortions across firms may result.

Finally and most importantly, current law is unnecessarily complicated and costly. To minimize tax burdens, businesses must consider the consequences of three possible operating rule systems on their anticipated business activities and learn to comply with the rules selected. The IRS must administer and give oversight to the three different systems. Further, the planning, compliance, and administration costs are ongoing in that businesses may have the opportunity to change their choice of rule structure as their business activities evolve or as other aspects of the law change. Reducing the number of choices should simplify the law and improve its efficiency by decreasing transactions costs.

In conclusion, the current system of taxing the income of private business enterprises has evolved into one that is inconsistent with its historical roots and violates important tax policy objectives. With the link between taxes and organizational form broken, there is no longer any clear justification to maintain all three systems of taxation. The next part of this paper describes why all private firms should generally be treated as conduits for income tax purposes.

II. Taxation of Private Business Firms as Conduits

The two basic approaches to taxing the income of a firm are conduit and entity taxation. Under conduit taxation, the firm is not treated as a taxpayer separate and apart from its owners. Rather, the firm is transparent for tax purposes; its various tax items pass through to the owners of the firm, the real (and only) taxpayers in interest. Under current law, both the partnership tax rules of subchapter K and the subchapter S rules for certain closely held corporations implement a version of conduit taxation, with subchapter K being a closer approximation of the approach.

In contrast, under entity taxation, the firm is treated as a taxable entity in its own right. Current subchapter C, under which the firm is taxed on business income as it arises and then the owners are taxed again upon a distribution of profits to them, is an example of entity taxation. However, entity taxation need not result in double taxation. For example, in 1992, the Treasury Department recommended exploration of an approach, termed the Comprehensive Business Income Tax (CBIT), that would subject the income of all business entities (except for extremely small ones in terms of gross receipts), including sole proprietorships, partnerships, corporations, and firms organized in other business forms, to a single, comprehensive entity-level tax, with generally no further income tax consequences at the owner level. The Treasury estimated that

CBIT would produce greater welfare gains than any other form of corporate integration, including Treasury's version of partnership-style integration.[9]

Another example of an entity tax approach is the imputation credit system of integration recommended by the ALI Reporter's Study.[10] Under that approach, an entity-level tax on business income would be imposed pending a distribution, at which point there would be a reconciliation of the entity and owner-level taxes to prevent double taxation and to insure that the income is ultimately taxed at the owner's tax rate. Thus, undistributed income would be subject to an entity tax and distributed income would be temporarily subject to one. Business losses would not pass through to owners. Although the ALI Reporter's recommendation only addressed the taxation of corporations, the approach could in theory be made applicable to all business firms, no matter how they are organized.

The following sections compare the advantages and disadvantages of conduit and entity taxation. To provide a fair comparison, the discussion assumes that the entity tax system would be implemented without imposing double taxation. Although the choice is a very close one, we conclude that all private firms generally should be taxed in accordance with the principles of conduit taxation.

A. Equity and efficiency. -- Tax policy principles of equity and efficiency both seem to favor conduit over entity taxation of a firm. An equity argument begins with the proposition that people, and not entities, pay taxes, and that people should pay income taxes in accordance with their ability to pay. Two important objectives relating to the taxation of business income flow from this proposition. First, the owners of a firm should be entitled to net their income, deductions, and losses from other sources with their share of the firm's tax items in order to determine their overall ability to pay. Second, the resulting net tax items of the owners, including their share of the firm's tax items, should be taxed at rates consistent with their ability to pay. By disregarding the entity for tax purposes and taxing owners directly on their share of the entity's tax items, conduit taxation potentially accomplishes each of these two goals.

In contrast, entity taxation does not satisfy either goal. A single entity tax rate, by definition, cannot be made consistent with the ability to pay of the owners in any situation where the owners have differing abilities.[11] In addition, entity taxation limits the ability of owners to net their tax items with their share of the firm's tax items, thereby precluding a proper determination of their ability to pay. For example, owners would not be able to utilize any

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[9] U.S. DEP'T OF TREASURY, INTEGRATION OF THE INDIVIDUAL AND CORPORATE TAX SYSTEMS: TAXING BUSINESS INCOME ONCE (1992) [hereinafter TREASURY INTEGRATION REPORT].

[10] See AMERICAN LAW INSTITUTE, FEDERAL INCOME TAX PROJECT: INTEGRATION OF THE INDIVIDUAL AND CORPORATE INCOME TAXES -- REPORTER'S STUDY OF CORPORATE TAX INTEGRATION BY ALVIN C. WARREN (1993) [hereinafter ALI REPORTER'S INTEGRATION STUDY].

[11] This statement is true even under a system like the ALI Reporter's Study where the entity tax plays a withholding role. Pending a distribution, taxation of the business income is generally taxed at the wrong rate.

available deductions to reduce their share of the firm's income in calculating their taxable income. Similarly, owners could not use their share of a firm's losses to reduce their income from other sources. In short, entity taxation is not consistent with equity principles for the income tax.

An efficiency argument in favor of conduit taxation is that it conforms more closely than entity taxation to how proprietorships are taxed and therefore minimizes distortions in the choice of business form. This is because sole proprietors are taxed directly on their proprietorship income as it arises and are entitled to deduct currently any losses of the enterprise as they arise. The business itself is not subject to a separate federal income tax.

Of course, to conform to entity taxation, it would theoretically be possible to treat a proprietorship as a taxpayer separate from its proprietor. As noted, the 1992 Treasury report made exactly that recommendation. But such a system would be very problematic, depending upon the applicable tax rate structure.

For example, suppose all proprietorships were treated as taxpayers separate from their proprietors and made subject to a flat 30 percent income tax rate. In that case, proprietors in marginal tax brackets higher than 30 percent would be encouraged to redesign their economic arrangements to generate proprietorship income for themselves rather than wages or other income. Meanwhile, proprietors in marginal tax brackets less than 30 percent would be encouraged to employ the opposite strategy. For instance, they might increase the level of deductible salary payments paid by their proprietorship to themselves. Given the absence of arm's length dealing between a proprietor and proprietorship, it would presumably be extremely difficult for the IRS to monitor and prevent purely tax-motivated arrangements of this sort.

Taxing the proprietorship's income in a progressive manner would not improve matters because there still would not be any necessary correlation between the proprietorship's tax rate and the proprietor's ability to pay. The proprietor may well have income, deductions, or losses from other sources which would need to be taken into account, along with the proprietorship income, to determine the proprietor's ability to pay. It is for this same reason that the graduated tax rate structure under which many corporations are taxed today does not carry out any vertical equity objective.

Assuming, then, that proprietors are to continue to be taxed directly on their business income and losses, it follows that businesses with more than one owner should likewise be taxed as conduits. If the proprietorship is not treated as a separate taxpayer, it is difficult to see why, say, a two-person general partnership should be so treated. Further analogies then might suggest that *no* business firm should be separately taxed. As an economic matter, if proprietors are taxed directly on their proprietorship income but partnerships (and not the partners) are taxed on the partnership income, then the tax system will have created an undesirable barrier against or inducement in favor of the pooling of resources via a partnership.

True, the state law characteristics of a proprietorship may be different from those of many other business forms. Unlike a proprietorship, other forms of business organization are treated for a number of state law purposes as legal entities separate from their owners. But certain of these state law characteristics are only default positions, supplying a rule in the

absence of any contrary agreement by the parties. Thus, they do not provide a very solid basis for determining the manner in which a firm should be taxed. Moreover, the clear message of the check-the-box regulations is to ignore state law differences among private business entities in making that determination. At least for *tax* purposes, then, it would seem that proprietorships and other private business firms should be treated as similarly as possible. Conduit, and not entity, taxation of private firms accomplishes that goal.

In formulating its 1992 recommendation, the Treasury Department articulated a different efficiency consideration, one that it believed constituted a rationale for entity taxation:

> Assuring that corporate income is taxed once, but only once, does not require that corporate income be taxed at individual rates, however. Attaining a single level of tax -- with the most significant efficiency gains we project from any system of integration -- can be achieved with a schedular system in which all corporate income is taxed at a uniform rate at the corporate level without regard to the tax rate of the corporate shareholder....
>
> ... Economic efficiency suggests that all capital income should be taxed at the same rate. Accordingly, we place less emphasis than some advocates of integration on ... trying to tax corporate income at shareholder tax rates.[12]

But to the extent this rationale is based on the efficiency of taxing *all* income, whether from capital or labor, in a uniform manner, it may conflict with equity objectives of the income tax, which may dictate that all income should not be taxed at the same rate. If, on the other hand, the rationale is based on the more limited proposition that it is efficient to tax only *capital* income uniformly, the equity objection is still potentially present, although less severe. Moreover, an entity tax approach may not be a particularly effective way of accomplishing the more limited goal. The basic problem is that various income-shifting devices, especially available to the owners of private, closely held firms, easily permit taxpayers to muddy the distinction between capital and labor income. Some business income of a firm may in reality be income from the labor of the firm's owners, and some labor income may in reality include capital income from investment in a firm. Hence, taxing a firm's income at the same rate may not be an effective method of taxing all capital income, and *only* capital income, in a uniform manner.

In summary, equity considerations clearly favor conduit over entity taxation. Efficiency considerations are a little more mixed. Given how proprietorships almost surely must be taxed, conduit taxation minimizes distortions in the choice of business form. Entity taxation promotes greater uniformity in taxation, but only through a potential conflict with equity objectives of the income tax. And entity taxation may not be an effective way of taxing only capital income uniformly, if that is the efficiency objective.

B. Compliance and administration. -- Considerations of tax compliance and administration provide a preference for entity taxation over conduit taxation. One important

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[12] TREASURY INTEGRATION REPORT, supra note, at 12-13.

advantage of the former is that it potentially reduces the extent of taxpayer involvement in the taxation of business income. The firm, rather than the owners, would be the focal point for the Treasury's tax collection efforts in an entity tax system.

Entity taxation also potentially facilitates a simpler determination of tax liability by permitting the tax consequences of a transaction to follow its form. For example, suppose a business firm earns $300 in taxable profits in a given year. How is the income tax on that $300 to be determined? Under entity taxation, the answer is straightforward -- the $300 is taxed to the firm at some rate applicable to the firm. In contrast, under conduit taxation, the $300 must be included in the tax bases of the owners of the firm and taxed to such owners. But how much should be allocated to whose base? The difficulty in answering that question is the fundamental problem of any conduit tax system.

The source of the difficulty is the fact that income and other items realized by many business entities are treated under state law as belonging to the entity and not to the owners. The receipt by the owners of the entity's income, for example, may arise only upon a distribution from the entity. Yet consistent with basic income tax principles, tax reporting of the income cannot await a distribution. Someone must include it in that person's tax base when the income arises. Thus, under conduit taxation, if there is no distribution but the income is retained by the firm, there must nevertheless be a current allocation of the income among the owners to permit them to report currently their share of it. In short, entity taxation follows the form of the transaction by taxing the firm, the nominal earner of the profits. Conduit taxation, in contrast, requires a determination of substance -- which owner has really obtained the economic benefit of the profits? There must be identified an economic baseline against which the validity of the tax allocation can be tested.

Unfortunately, despite many complex requirements contained in the Treasury regulations implementing conduit taxation, the necessary economic baseline is indeterminable. We simply do not know how the owners would have shared undistributed income earned by a firm, for example, had there in fact been a distribution of that income in the year it was earned. Indeed, in many cases, the owners themselves do not know how they would have shared the income, because their "deal" extends far beyond the economic outcome of a particular year. But without that piece of information, it is not possible to fashion a workable rule that can ferret out purely tax-advantaged allocation arrangements under a conduit model of taxation. Conduit taxation rejects form and requires a determination of substance, yet there is no clear way of ascertaining what the substance is.

The discussion thus far would seem to have exposed major flaws in *both* conduit *and* entity taxation. Although the latter would tax the business income at the wrong rate and prevent netting of the owner's tax items, the former cannot provide assurance that the business tax base is taxed to the right owner. So which approach is preferable?

To help answer that question, it is worth considering in a little more detail some of the potential compliance and administration problems presented by an entity tax system. As previously noted, an entity tax approach offers the advantage of taxing a transaction in accordance with its form. An "inside" event, such as a firm's earning of profits, is generally taxed "inside" the firm (*i.e.*, the firm pays tax on the profits); the profits need not be allocated

and taxed "outside" the firm (*i.e.*, to the owners of the firm). Somewhat surprisingly, however, entity taxation raises some of the same difficult implementation issues as conduit taxation. In certain important situations, "inside" events have tax ramifications "outside" the firm (*i.e.*, to the owners), and "outside" events generate tax consequences "inside" the firm. Thus, mere form cannot always be followed; in an entity tax system, some determination of substance is also necessary.

To illustrate, consider a scheme in which business income is taxed once at the entity level with distributions of already taxed income then being tax-free to the owners of the firm. Consider just the single issue of how the gain or loss arising upon a transfer of the ownership interests of a firm should be taxed under such a system.

In theory, any gain or loss might reflect some combination of (1) income accumulated by the firm that has already been subject to the entity-level tax, (2) accumulated preference income that has escaped the entity-level tax, and (3) unrealized gains and losses of the firm (including the value of the firm's projected profits and losses).[13] Neither the fully taxed income nor the preference income should be taxed again upon the transfer of ownership interests, assuming there is a policy decision to pass through preferences. Presumably, however, there should be a tax on the gain or loss representing the unrealized entity-level gain or loss. How should the rules be designed to tax this last element while not taxing the portion of the gain or loss representing accumulated, previously taxed income or preference income?

One rough method of accomplishing that end, suggested by both the Treasury Department and the ALI Reporter in their integration proposals, is to provide outside basis adjustments equal to the fully taxed and preference income (assuming passthrough of preference income) not distributed by the firm.[14] Analytically, the procedure, termed a "dividend reinvestment plan" or "DRIP" by the Treasury, would allow firms to retain their earnings but to declare constructive distributions followed by constructive reinvestments of those amounts back to the firm. The distributions of previously taxed (or preference) income would be tax-free to the distributees, and the reinvestments would produce the desired increase in outside basis. At least in theory, if all retained earnings were made subject to a DRIP, then gain and loss upon transfer of ownership interests would reflect only unrealized gains and losses at the firm level.

A DRIP, however, is nothing more than an allocation of undistributed income among the owners of the firm, the core requirement of a conduit tax system. Although the ramifications of a DRIP under an entity-level tax would be less significant than in a conduit system because the income being allocated under the DRIP would already have been subject to tax, nevertheless the practical difficulties with the allocation would be the same. If a set of rules could be developed to specify the appropriate outside basis adjustments for private business firms with tiers of owners and preferential, contingent, and inchoate ownership interests, among other things, those same rules could be utilized to implement a conduit tax system. In short, implementing an entity

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[13] The possibility of inflationary gains is irrelevant to this discussion and is therefore ignored.

[14] TREASURY INTEGRATION REPORT, supra note, at 87-88; ALI REPORTER'S INTEGRATION STUDY, supra note , at 126-27 (proposal 5).

tax system introduces some of the same inside/outside coordination problems that plague a conduit tax system.

C. Summary and conclusion. -- The choice between conduit and entity taxation is a very close one. The conduit approach is clearly favored based on equity considerations. The question is a little closer if efficiency is taken into account and closer still after compliance and administration issues are considered. Perhaps the deciding factor is the greater transitional cost of an entity tax approach. A conduit approach is already in effect for those firms currently taxed under either subchapters K or S. In contrast, an entity tax approach imposing only a single level of taxation on business income would represent a new system for all firms. Accordingly, we recommend that as a general rule, a conduit tax approach be adopted for the income taxation of private business firms. The starting point should be the rules of subchapter K, the closest approximation to conduit taxation under current law.

III. The Case for an Alternative (and Simplified) Version of Conduit Taxation

In this part, we discuss why *two* versions of conduit taxation should be developed for private business firms -- a "regular" version (resembling a reformed subchapter K) and an alternative, "simpler" version (resembling a liberalized subchapter S). In the next part, we provide the principal details of how this two-track recommendation should be implemented, including a description of which firms would be eligible to use each set of rules. In this part, we explain the rationale for developing an alternative, simplified conduit version for a subset of private firms.

In the ideal, all private firms should be taxed in the same way. Indeed, the basic criticisms of current law described in Part I center around the inequity and inefficiency of maintaining multiple taxation schemes. Multiple systems also make the law more complicated, introduce coordination problems, and increase the number of transitional issues.

On the other hand, a single tax system that addresses the disparate tax issues of a diverse population of taxpayers may be too unwieldy for an important segment of that population. In that case, there may be advantage to identifying a somewhat less diverse subgroup of the population and designing a separate set of tax rules just for them. The tax system has followed this route many times in the past, such as in the development of the "simple" and "complex" trust rules,[15] the availability of the short and shorter forms of the basic individual income tax return, and the exempting of large categories of taxpayers from certain administratively onerous rules.[16]

Whether two or more tax systems should be developed for the taxation of business income depends upon the resolution of several difficult questions, including (1) whether a simplified tax system for a meaningful subgroup of the population can be devised; (2) whether

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[15] See I.R.C. §§ 651-652, 661-664; Treas. Reg. § 1.661(a)-1.

[16] See, e.g., I.R.C. §§ 55(e) (exempting certain small corporations from alternative minimum tax), 263A(b)(2)(B) (exempting certain property of certain small businesses from uniform capitalization rules), and 448(b)(3) (allowing certain small businesses to use the cash method of accounting for tax purposes).

use of the simplified system would reduce compliance costs and produce other gains for the subgroup for whom the rules are designed; and (3) whether such gains, if any, exceed the costs incurred in maintaining two systems rather than one. Obviously, none of these questions can be answered in the abstract. An alternative system must be offered before an analysis of any of these questions can even begin.

The question, therefore, is whether there is sufficient evidence to support an attempt at developing an alternative, simplified system for a subgroup of private business firms. Is the case so overwhelming against the need for such an option that its development would surely be futile? Although the evidence is not nearly as complete as desired, it appears to be sufficient to warrant at least initial consideration of such a system.

Consider first the central difficulty of any conduit tax system -- the allocation of the firm's tax items among the owners of the firm. Under subchapter K, an allocation must have "substantial economic effect" to be respected. The complex and burdensome manner in which the regulations interpret that term is already legendary, with the result that there may be a high degree of taxpayer noncompliance with them. For example, taxpayers might fail to establish and utilize mandated procedures, such as the maintenance of book capital accounts in a particular manner, or erroneously omit certain boilerplate provisions in their partnership agreements. Or, taxpayers might not actually follow through on provisions in their agreements mandated by the tax authorities, such as the requirement to make liquidating distributions in accordance with the capital account balances of the partners. Taxpayers may also flunk one or more of the subjective standards contained in the regulations.

To a handful of partnership tax experts, compliance with the allocation provisions of subchapter K may be largely second nature by now. But surely that is not the proper standard to use in evaluating the impact of the rules. Probably a more accurate assessment of current practice is reflected in the comment that:

> [g]arden-variety partnerships -- small businesses advised by ordinary lawyers and accountants -- will seldom make allocations that have "substantial economic effect" in the sense in which the regulations use that term.[17]

If this view is correct, the allocation rules of subchapter K risk being a mere facade, a nice theoretical way of imposing taxes on business income that is not matched by real world consequences to most taxpayers.

It is true that partnerships with very straightforward economic arrangements may have little to be concerned about even if they do not comply with the substantial economic effect requirements. In the event of noncompliance, such partnerships will have their tax items allocated in accordance with the "partner's interest in the partnership" ("PIP"), which should ordinarily mean the straightforward economic arrangement. But there are two problems with that response to the complexity of the allocation provisions. First, it does little to reduce the compliance burdens of taxpayers. They may continue to try to meet the substantial economic

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[17] See ALAN GUNN, PARTNERSHIP INCOME TAXATION 44 (2D ED. 1995).

effect requirements; the tax authorities may simply tell them, in effect, "never mind" upon discovering that they did not succeed. Second, reliance upon the PIP default is a risky proposition, the success of which depends upon how straightforward the economic arrangement really is. It would seem preferable to establish upfront the limits of a straightforward arrangement, and then to allow taxpayers who stay within those limits to avoid the burdensome allocation requirements altogether.

The difficulty of a conduit tax system epitomized by subchapter K is not limited to allocations. Many analysts have suggested that there may be widespread disregard of one or more other partnership tax rules because of the inability of firms and their advisors to apply them correctly and of the IRS to administer them. As Judge Raum complained over 30 years ago:

> The distressingly complex and confusing nature of the provisions of subchapter K present a formidable obstacle to the comprehension of these provisions without the expenditure of a disproportionate amount of time and effort even by one who is sophisticated in tax matters with many years of experience in the tax field.... Surely, a statute has not achieved "simplicity" when its complex provisions may confidently be dealt with by at most only a comparatively small number of specialists who have been initiated into its mysteries.[18]

Many, many others have voiced similar concerns.

Furthermore, the partnership tax rules were made even more difficult by the adoption of a general "anti-abuse" regulation in subchapter K.[19] Although there continues to be some disagreement as to the meaning and scope of the regulation, as well as its wisdom and validity, the adoption of the regulation is certainly not a positive indication of the general health of the subchapter K rules. Indeed, some of the commentary published in response to the proposed version of the regulation illustrates examples of transactions meeting the literal terms of the statute and/or regulations yet reaching seemingly nonsensical results.

It is evident that if one were writing on a clean slate, one would not adopt a set of operating rules like subchapter K that first touts their flexibility,[20] then proceeds to restrict that flexibility with a series of highly complex mechanical and sometimes subjective tests,[21] and then overlays on top of those tests a relatively amorphous supertest authorizing the disregard of the consequences of earlier tests despite plain compliance with them. Indeed, the general anti-abuse rule may apparently apply to negate a taxpayer's successful navigation of other anti-abuse rules adopted to monitor particular types of partnership-related transactions.[22] Something very

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[18] *Foxman v. Commissioner*, 41 T.C. 535, 551 n.9 (1964).

[19] Treas. Reg. § 1.701-2.

[20] H.R. REP. NO. 1337, 83RD CONG., 2D SESS. 65 (1954).

[21] See, e.g., Treas. Reg. § 1.704-1, -2, and -3.

[22] See Treas. Reg. § 1.701-2(d), ex. (8)(iii).

fundamental must be awry in the basic structure of the rules for the law to have evolved into this unhappy state.

Once again, it is sometimes argued that taxpayers with relatively simple business arrangements are not adversely affected by the many complications of subchapter K. Under this view, subchapter K is flexible enough to be all things to all people: a fairly simple set of tax rules for taxpayers with simple business deals, and a more complex set of tax rules for taxpayers with more elaborate undertakings. Thus, according to this position, there is no need to create a simplified version of conduit taxation.

It may well be true that many smaller firms already use a simplified version of subchapter K to calculate their income tax liabilities. But if true, that phenomenon may simply be a practical response to the burdensome nature of the partnership tax rules. It is not at all clear that the law actually *authorizes* such use.

For example, consider a three-person firm that decides to split up. A separation as simple as a cash buyout by the firm of the entire interest of one of the partners may have the counterintuitive results of some ordinary income consequences to the partner who is bought out and a change in the basis of some of the firm's remaining assets.[23] Indeed, according to the IRS, the same results may occur even *without* an actual distribution to anyone.[24] And if the buyout were complicated slightly by assuming a distribution of property other than cash to the partner being bought out, such as a distribution of a parcel of land to the distributee, the continuing partners as well as the distributee may have either capital or ordinary income or loss from the transaction. The distributee is treated as acquiring the portion of the distribution that is disproportionate to the distributee's pre-distribution share of such property from the other partners in exchange for other, undistributed property of a different character which the distributee disproportionately surrenders in the distribution.[25] Thus, at least in theory, the complications of subchapter K may well intrude into the common transactions of many simple business arrangements.

Moreover, even if it were true that taxpayers with simple deals and their advisors need not concern themselves with the more complicated portions of subchapter K, the law does not so advise them. Rather, like all private firms, they would at least initially face compliance with the entire panoply of subchapter K rules. In contrast, their task would be simplified if they were provided with an abbreviated set of tax rules with which they had to comply. The trust area is instructive: for the most part, the "simple" and "complex" trust rules in subchapter J do not produce different tax outcomes for simple trusts. Rather, two sets of rules are provided "to

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[23] See I.R.C. § 751(b)(1).

[24] See Rev. Rul. 84-102, 1984-2 C.B. 119.

[25] See I.R.C. § 751(b)(1); Treas. Reg. § 1.751-1(b).

prevent burdening ... simple trusts with the complicated rules that are needed only for the problems of the complex trusts."[26]

Finally, development of a simplified system for a subset of firms opens up the possibility of meaningful reform of the regular conduit system applicable to all other firms. Because such reform may make subchapter K even more complicated than it is today, it is effectively blocked so long as smaller taxpayers with less sophisticated advisors are subject to those rules. The end result is an unhappy combination: rules still too complicated for the less sophisticated and too imprecise and manipulable for the more sophisticated.

Accordingly, we recommend development of two different versions of conduit taxation. The starting point for each version would be the provisions of subchapter K and the goal of each version would be to produce as administrable a set of operating rules as possible. One version, however, would be developed for a subset of private firms whose organizational and operational structure is relatively simple and straightforward. Careful identification of the eligibility requirements for this version should allow for a much more workable set of conduit rules, perhaps with some concession to not always achieving the precisely correct tax outcome in all cases. The other version, to be applicable to all firms ineligible for, or electing out of, the first version, could then concentrate on "getting the rules right" to prevent inappropriate tax outcomes. The next part provides the principal details regarding how these two systems would be developed and coordinated.

IV. Implementing the "Two-Track" Approach

This part briefly addresses the three principal implementation issues presented by our proposals. We consider the eligibility conditions for firms entitled to use the simplified version and the general terms of the simplified and regular conduit tax systems.

A. What firms would be eligible to use the simplified system? -- The purpose of developing a simplified version of conduit taxation is to provide a mechanism to relieve many private business firms of the enormous complexity of the subchapter K rules. As noted, the rules impose significant compliance burdens on taxpayers, with many observers suggesting that there is widespread disregard of one or more of the subchapter's requirements. Although smaller economic firms may have the greatest difficulty dealing with the rules, compliance problems are certainly not limited to those firms.

Simplification of the rules begins with some understanding of why they have become so complicated. Over 40 years ago, the reporters and two consultants to the ALI project on partnership tax described the source of the difficulty in subchapter K in the following way:

> Most of the problems encountered in the partnership area are concerned with the distribution of the burden of taxation among the members of the group. Since the Treasury from the standpoint of tax policy is not greatly concerned about this

[26] See PAUL R. MCDANIEL, HUGH J. AULT, MARTIN J. MCMAHON, JR. & DANIEL L. SIMMONS, FEDERAL INCOME TAXATION: CASES AND MATERIALS 1246 (4TH ED. 1998).

allocation, the issues are essentially not between Treasury and taxpayer-partner but between partner and partner.[27]

The passage of time since publication of that statement has revealed that the authors were only partly correct. Certainly, one of the principal difficulties of partnership tax has been the distribution or allocation of the tax burden of the business firm among the owners of the business. But in contrast to the second sentence of the quoted statement, which lay the groundwork for the authors' proposal of what is now section 704(a), it would appear that the Treasury Department *is* greatly concerned with the manner of allocation. For example, the regulations under section 704 evidence Treasury's concern that the flexibility of the subchapter K rules will be used to shift tax items from one owner to another. This concern is not limited to the possibility that income will be shifted from high-taxed to low-taxed persons, while deductions flow from the low-taxed to the high-taxed. Also included are possible shifts of particular categories of income -- section 1231 gains and losses, foreign-source income and deductions, capital gains and losses, passive income and losses, and so forth. Moreover, the shift need not necessarily be within a particular time period. The shifting of income, deductions, losses, and other tax items recognized in different time periods may also be objectionable.

The theory of our recommendation is to identify the characteristics of firms for which the second sentence of the ALI reporters' statement would also be true, that is, firms whose tax issues would be essentially between owner and owner rather than between the Treasury and the taxpayer. If the characteristics of such firms offer only limited potential for the type of tax advantages that the Treasury is worried about, then the firm can be provided with an operating rule structure consisting of a stripped-down version of subchapter K, one that eliminates many of the burdensome compliance requirements of those provisions. To be sure, the eligibility conditions cannot be so precise as to preclude every possible instance of the firm being used to achieve an advantageous tax result. Nevertheless, the objective of our recommendation is to balance a concern of protecting the fisc with a desire to provide an administrable set of tax operating rules for as many firms as possible.

Consistent with that goal, we recommend that there be two basic eligibility conditions for firms entitled to use the simplified version of conduit taxation. First, the firm must generally be owned only by individuals who are not nonresident aliens. Thus, public firms taxed under subchapter C, foreign persons, and tax-exempt entities would all be excluded as potential owners of an eligible firm. Our examination of data published by the IRS suggests that many domestic, individual owners of current subchapter K or S firms are taxed in the 28 percent or higher marginal income tax bracket. Moreover, even where that is not the case, we believe there would be limited opportunity for such taxpayers to gain tax advantage from certain shifting strategies through ownership of a private firm. By contrast, many of the excluded owners are taxed at a low or zero (or negative) marginal income tax bracket and would afford ample opportunity for tax advantage if they were included as possible owners of eligible firms. Accordingly, their exclusion as owners should allow for simplification of the operating rule structure.

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[27] J. Paul Jackson, Mark H. Johnson, Stanley S. Surrey & William C. Warren, *A Proposed Revision of the Federal Income Tax Treatment of Partnerships and Partners -- American Law Institute Draft*, 9 TAX L. REV. 109, 112 (1954).

Although this ownership restriction is designed to insure that most owners have roughly the same tax profile and therefore cannot easily benefit from income and loss shifts between one another, it would not be effective at precluding strategic shifts of *categories* of income and loss and other tax items. For example, two high-bracket owners would not ordinarily benefit from shifting ordinary income from one to the other. But if one owner had unused capital losses and the other did not, the two owners might both benefit from a shift of capital gains to the owner with the capital losses. Thus, to preclude such possibilities, a second condition is necessary -- we would require all eligible firms to have only a single class of residual ownership interests. In effect, such a rule, similar to the "one class of stock" rule in subchapter S, would eliminate the possibility of item allocations. Every outstanding interest in the residual class would have to confer identical rights with respect to income, loss, distributions, and liquidation proceeds of the firm. Unlike subchapter S, we would permit multiple classes of a limited form of preferred ownership interests (analogous to debt) provided that a clear order of priority for the different preferred interests is established.

B. General description of the simplified version of conduit taxation. -- We recommend that the simplified operating rules consist of a liberalized version of subchapter S. We come to this proposal indirectly, for subchapter S was not our starting model for the rules of the simplified system. Indeed, subchapter S's entity tax features, a natural outgrowth of the subchapter's original application only to corporations and its close relationship with subchapter C, seemed to make it an unsound foundation on which to construct a simplified *conduit* version applicable to all forms of business organization.

Nevertheless, our analysis has led us to conclude that the operating rules of the simplified system should have a strong resemblance to subchapter S. In part, this result can be explained by the historical roots of that subchapter. Subchapter S was enacted in 1958 to reduce the impact of tax consequences on the choice of business form and to remove the double tax burden on, and permit the passthrough of losses by, small businesses. Although the creation of an administrable set of provisions was not stated as a specific objective, it is evident that Congress included consideration of that goal in crafting the rules. Whether Congress has achieved that goal is a matter of some disagreement, but most observers surely would agree that subchapter S is far simpler than subchapter K. Thus, in trying to develop a simple conduit approach to a particular tax issue, it was natural to consider the rule in subchapter S. Indeed, the basic structure of subchapter S serves as a remarkably coherent version of a simple conduit system.

Subchapter S provided another important advantage. One worry in trying to fashion a "simpler" set of rules is the possibility that they will not be adequately protective of the fisc. Elimination of complicated subchapter K provisions intended to prevent inappropriate tax outcomes might result in such outcomes being resurrected within the simplified conduit system. Subchapter S, however, offers an instructive 40-year track record of taxpayers and transactions subject to those rules. Thus, if a transaction with an inappropriate result has not arisen under that subchapter, it may be indicative of the experience one could expect under a new system modeled after one or more of its rules.

A difficulty with relying too heavily on subchapter S, however, is its somewhat perverse relationship to subchapter K. Assuming that use of the simplified conduit version is a matter of explicit or transactional election by the taxpayer, then the substantive tax outcomes under that

version must be coordinated with those under the regular conduit version, which we assumed would be a closer variant of subchapter K. Unless the results under the simplified version are roughly equivalent to (or indeed, more taxpayer-favorable than) the results under the regular system, use of the simplified version might well be discouraged. Yet current subchapters K and S do not have that relationship. Subchapter S is simpler than subchapter K but it also generally produces tax results less favorable to taxpayers. As a result, some commentators have predicted the demise of subchapter S and some have even urged its repeal.

For reasons previously described, we believe it is important to preserve a simplified version of conduit taxation for as many private business firms as possible. To accomplish that end, it is necessary to reconfigure somewhat the tax consequences under subchapters S and K. Far from being repealed, the former should generally be liberalized in the simplified system; in contrast, some of the vaunted flexibility of the latter should be curtailed in the regular version of conduit taxation. The challenge is achieving the right balance: liberalization of subchapter S should not result in any significant loss of simplicity, and modifying subchapter K should not cause it to produce incorrect results.

We propose that the simplified operating rules consist of subchapter S with the following principal modifications: (1) the firm would be allowed to have a limited form of preferred ownership interests; (2) contribution transactions would generally be taxed in accordance with the partnership tax rules; (3) indebtedness of the firm would be passed through and taken into account in the outside basis of the firm's owners; (4) the collapsible corporation rules would no longer be applicable, but certain provisions to prevent income character conversion following a contribution would be included; and (5) conversion of a firm from public to private status would generally be a taxable event. Most of these differences serve to liberalize the rules of subchapter S, and most make those rules more consistent with conduit tax principles.

C. General description of the regular version of conduit taxation. -- In general, private business firms ineligible for, or electing out of, the simplified operating rules would be taxed under the regular version of conduit taxation. We recommend that the regular conduit rules consist of subchapter K as modified by selected reforms. Unfortunately, in this brief paper, we cannot present fairly the nine specific reforms we include in our ALI Reporters' Study. Instead, we describe in this section the basic rationale for what is perhaps our most controversial recommendation -- our proposal to treat a distribution transaction under the regular conduit rules as a taxable event to the firm and to the distributee in the same general manner as under current subchapter S.

In general, the rules relating to property contributions and distributions between an owner and a private business firm should achieve the following tax policy objectives:

- Preservation and proper allocation of amount of gain and loss -- The transaction should not change either the amount or the allocation of gain or loss in existence immediately prior to the transaction;

- Preservation and proper allocation of character of income and loss -- The transaction should not change either the amount or the allocation of the character of income in existence immediately prior to the transaction;

- Minimization of basis shifts -- Even assuming that the amount and character of income is properly preserved and allocated, the transaction should minimize basis shifts from one property to another; and

- Nonrecognition -- To the extent compatible with the other objectives, the transaction should result in the nonrecognition of any gains or losses realized.

The original, 1954 subchapter K rules concerning property contributions and distributions reflect a strong desire by Congress to fulfill the last objective mentioned above -- nonrecognition. The 1954 Congress provided that contributions of property by a partner to a partnership should always be tax-free to both the partner and the partnership.[28] In addition, it approved broad nonrecognition rules in the case of partnership distributions, in the process rejecting a House Ways and Means Committee recommendation that would have taxed more of those transactions.[29]

Even in 1954, however, Congress recognized to some degree the paramount importance of the first two policy objectives: the need to preserve the amount and allocation of gain or loss prior to the transaction, and the amount and allocation of income character. This awareness is demonstrated by the adoption in 1954 of three deviations from a blanket nonrecognition rule on distributions. First, in deference to the first objective, Congress required a partner to recognize gain or loss on a cash distribution in circumstances where a nonrecognition result would not have been able to preserve the proper amount of gain or loss.[30] Further, in deference to the second policy objective, Congress required a partner to recognize loss on certain liquidating distributions where only money, unrealized receivables, and inventory items were distributed, in order to prevent the shifting of basis to those ordinary income assets.[31] Finally, Congress recharacterized certain distributions as taxable exchanges to both the partnership and the partner if, as a result of the distribution, there was a shift in the partners' shares of unrealized receivables and substantially appreciated inventory items of the partnership.[32]

Since 1954, Congress has adopted a series of amendments to the partnership contribution and distribution rules that provide additional evidence of the primacy of the first two tax policy objectives over a goal of nonrecognition. In general, Congress has approved provisions designed to maintain the proper allocation of gains and losses following a contribution,[33] and to preserve

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[28] See I.R.C. § 721(a), substantively unchanged since 1954.

[29] See I.R.C. § 731(a) and (b), substantively unchanged since 1954.

[30] See I.R.C. § 731(a)(1) and (2)(A), unchanged since 1954.

[31] See I.R.C. § 731(a)(2), substantively unchanged since 1954.

[32] See I.R.C. § 751(b), substantively unchanged since 1954.

[33] See, e.g., I.R.C. §§ 704(c)(1)(A), 704(c)(1)(B), and 737.

the amount and allocation of income character following both contributions and distributions,[34] often achieving those ends by further compromising the nonrecognition objective. In addition, in a few cases, Congress has reversed the nonrecognition result altogether where it considered that outcome to be inappropriate, even apart from concerns relating to the first two objectives.[35] Taken together, these changes have greatly increased the compliance costs and administrative burdens of partnership contributions and distributions to taxpayers and the IRS.

Despite these changes and the amount of time that has transpired since the original set of rules were adopted, the first two policy objectives for contributions and distributions remain elusive. Simply put, the rules do not always preserve immediately after the transaction either the proper amount of gains and losses in existence just prior to the transaction or the proper allocation of such amounts among the owners of the firm. Further, the rules do not always continue the appropriate amount and allocation of the character of the pre-transaction income and loss.

Although Congress has not yet seen fit in the partnership area to address the third policy objective noted -- the minimization of basis shifts apart from concerns regarding the preservation and allocation of income character -- it has done so with respect to another nonrecognition transaction, like-kind exchanges.[36] The basic concern is the shifting of basis between properties where one is more likely to be disposed of than the other. Unfortunately, current law provides ample opportunity in the partnership area to achieve this outcome. The amendment in the like-kind exchange area may evidence greater sensitivity on the part of Congress to this issue, and may foreshadow future amendments applicable to partnership transactions to forestall this practice.

All of these continuing problems, in combination with the burdensome nature of the existing rule structure, suggest that some significant changes in the taxation of contributions and distributions are in order. Accordingly, for the regular version of conduit taxation, we generally recommend adoption of the subchapter S rules for the tax treatment of distributions by firms. Thus, a firm would recognize gain on the distribution of property to an owner as if the firm sold the property to the owner for its fair market value. Loss would also be recognized by the firm if it completely liquidates. After the passthrough of any gain or loss recognized by the firm, the distributee would compare the amount distributed with the distributee's outside basis. A distributee would recognize gain in a distribution that does not completely liquidate the distributee's interest in the firm, and gain or loss in one that does. The distributee would obtain a fair market value basis in any property distributed.

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[34] See, e.g., I.R.C. §§ 724, 732(c), 735(c)(2), 751(b)(3), 751(c), and 751(d).

[35] See, e.g., I.R.C. §§ 707(a)(2), 721(b), 351(e)(1), and 731(c). The common theme of these provisions is the judgment that the transaction is more like a sale than a bona fide contribution or distribution between an owner and a passthrough entity.

[36] See I.R.C. § 1031(f).

Adoption of the corporate subchapter S rules might initially seem odd because of their anti-*General Utilities* origin and their purpose of preserving the corporate tax base. Obviously, as in the case of distributions by current S corporations with no prior history as a C corporation, such purpose has no applicability to distributions by firms taxed under the regular version of conduit taxation. Rather, the subchapter S rules are proposed because they constitute rules of recognition. We have concluded that it is simply not possible, or at least not possible without an inordinate cost in complexity, to provide widespread nonrecognition treatment of distributions while still achieving the other policy objectives for such transactions. As Congress first made clear in 1954 and has made even more clear since then, where these policy objectives are in conflict, the nonrecognition goal must yield. Indeed, in view of the changes enacted by Congress since 1954, many distributions are *not* nonrecognition events today. Thus, our recommendation is just one further step in this evolutionary process to treat a distribution as a recognition event. It is an important step, however, because it facilitates significant simplification of the law. It is not mere happenstance that subchapter S has managed to stay remarkably free of many of the complications now included in subchapter K. Our proposed change facilitates repeal of a host of provisions, including sections 751(b), 704(c)(1)(B), 731, 732, 735, and 737.

Another possible criticism of our proposal stems from the view that the S corporation treatment of a distribution is consistent with an entity theory of the firm whereas the current partnership rules favor the aggregate or conduit theory. Therefore, according to this argument, our recommendation runs counter to an objective of taxing private firms in accordance with *conduit* tax principles.

In fact, however, neither the S corporation nor the partnership rules are completely consistent with either an aggregate or an entity theory of the firm. An entity theory would suggest that property transfers between the owners and the firm are generally taxable ones. There might be some relaxation of that result in cases where the firm is an alter ego of the owner, and the transfer therefore effects a mere change in form in the owner's investment. But certainly, an "alter ego" exception would not support the general rules in the partnership area, which permit virtually any transfer of property between a partnership and partner potentially to be tax-free.

An aggregate theory of the firm would suggest that transfers between an owner and the firm constitute in substance transfers among the owners. Thus, if a contributor of property is the sole owner, or nearly so, of the firm, one might excuse the existence of a taxable event because the contributor is merely transferring the property to himself or herself. But, under an aggregate theory, one would certainly not extend tax-free treatment to the lengths provided by the partnership rules. Under the aggregate theory, a group of investors who join together to pool their respective capital have made a substantial change in their property rights as a result of the pooling and, under normal income tax principles, they ought to be taxed.

The cost in complexity of nonrecognition treatment of a distribution might be worth bearing if there were a compelling policy justification for that outcome. But neither valuation and liquidity problems, nor concerns about lock-in, provides any such justification. The starting point, under either an aggregate or an entity view of the firm, is that a distribution constitutes a taxable event. The current nonrecognition rule that trumps that outcome is one "of stunning

scope and flexibility,"[37] and permits deferral (and, potentially, income character conversions, misallocations, and basis shifts) in circumstances that go well beyond the normal instances where nonrecognition treatment of sales or exchanges is permitted, such as like-kind exchanges and corporate reorganizations.

A final reason for this recommendation is that it conforms to the general tax treatment of distributions. An identical rule is proposed for the simplified version of conduit taxation, and essentially the same rule exists in subchapter C, applicable to public firms. The only exception is for distributions by sole proprietorships, which continue to be nontaxable events but which also present tax issues different from distributions by firms. Consideration should be given to possible nonrecognition exceptions to our recommendation if they can be implemented without a significant loss of simplicity.[38]

More generally, it may be possible to allow tax-free treatment of pro rata distributions of property that leave all owners with the same direct interest in property that they had indirectly through their ownership in the distributing firm. Each owner would hold the property with the same basis as the owner's pro rata share of inside basis in the property just prior to the distribution. If this approach were followed, rules would be needed to deal with situations where the owner's outside basis is less than the pro rata share of inside basis in the property. One possible solution would be to require the owner to recognize gain equal to any such amount.

V. Conclusion

In this paper, we have argued that the income taxation of private business firms should be reformed and simplified. There is simply no policy justification for allowing such firms to continue to choose among subchapters C, K and S for their applicable income tax rules, and the existence of the choice unnecessarily complicates the law. We would instead generally treat all private firms as conduits for income tax purposes. Conduit taxation disregards the existence of the firm for tax purposes as much as possible. In addition, because conduit taxation can be extremely complicated, and because needed reforms may only make it more so, we propose that the recommendation be implemented through a "two-track" approach. A simplified set of conduit tax rules would be used by certain private firms unless they elect otherwise, and a regular set of conduit rules would be used by all others. In general, the simplified rules would be available only to firms that are owned exclusively by individuals and that have surrendered some flexibility in their economic arrangement. The simplified rules would resemble a liberalized

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[37] William D. Andrews, *Inside Basis Adjustments and Hot Asset Exchanges in Partnership Distributions*, 47 TAX L. REV. 3 (1991).

[38] Cf., e.g., I.R.C. §§ 704(c)(1)(B) (exception for distributions of property back to contributing owner), 731(c)(3)(B) (gain recognition generally limited to disproportionate portion of property distributed). It may also be appropriate not to apply the recommendation to a technical termination of the firm under section 708(b)(1)(B), assuming that that rule is continued. Cf. Treas. Reg. §§ 1.704-4(a)(4)(ii), -4(c)(3) (inapplicability of section 704(c)(1)(B) to technical terminations), 1.737-2(a) (inapplicability of section 737 to technical terminations).

version of current subchapter S, whereas the regular conduit rules would consist of the subchapter K rules as modified by selected, proposed reforms.

Rarely is there an opportunity to adopt a proposal that provides both meaningful reform *and* simplification of the tax laws. While many details need to be carefully thought through, we believe that the recommendations outlined in this paper offer the potential for achieving that happy combination, and we urge policymakers to give them serious consideration.