TAXATION - INCOME TAX - TAXABILITY OF INCOME OF ALIMONY TRUST TO HUSBAND-SETTLOR-RULE OF DOUGLAS v. WILLCUTS

Benjamin W. Franklin
University of Michigan Law School

Follow this and additional works at: https://repository.law.umich.edu/mlr

Part of the Common Law Commons, Taxation-Federal Estate and Gift Commons, and the Tax Law Commons

Recommended Citation
Benjamin W. Franklin, TAXATION - INCOME TAX - TAXABILITY OF INCOME OF ALIMONY TRUST TO HUSBAND-SETTLOR-RULE OF DOUGLAS v. WILLCUTS, 38 MICH. L. REV. 1285 (1940).
Available at: https://repository.law.umich.edu/mlr/vol38/iss8/9
Taxation — Income Tax — Taxability of Income of Alimony Trust to Husband-Settlor — Rule of Douglas v. Willcuts — Three recent decisions of the Supreme Court of the United States, Helvering v. Fitch,1 Helvering v. Leonard,2 and Helvering v. Fuller,3 all involving an application of the rule of Douglas v. Willcuts,4

1 (U. S. 1940) 60 S. Ct. 427.
2 (U. S. 1940) 60 S. Ct. 780.
3 (U. S. 1940) 60 S. Ct. 784.
4 296 U. S. 1, 56 S. Ct. 59 (1935). The parties entered an agreement under which the husband was to create a trust for the benefit of the wife. She was to receive a stipulated amount of income yearly therefrom; the manner of making up deficiencies was prescribed; and any surplus was to be paid to the husband, who also had the reversionary interest. This was accepted in lieu of and in full settlement of alimony, dower, statutory claims and claims for support. The divorce decree ordered that the trust be set up according to the agreement. By statute, the divorce court had power to provide for the creation of the trust, was given full control over it and could later modify it by any order which would have been proper in the original decree. Holding that the husband was taxable on the income, the Court said that the decree merely imposed sanctions upon a “preexisting duty” of the husband; that the substance was the same as though he had received the income and paid it over to the wife under the decree. As to the statutory basis for the tax, the Court said: “We think that the definitions of gross income . . . are broad enough to cover income of that description.” 296 U. S. 1 at 9. The Court expressly rejected those sections dealing with the taxation of trusts and fiduciaries (p. 9) and those dealing with the situations in which the grantor remained taxable (p. 10). This case is discussed in 20 Minn. L. Rev. 538 (1936); 34 Mich. L. Rev. 443 (1936); 24 Cal. L. Rev. 474 (1936). Discussing the decision below, Willcuts v. Douglas, (C. C. A. 8th, 1934) 73 F. (2d) 130, cf. 48 Harv. L. Rev. 815 (1935); 33 Mich. L. Rev. 634 (1935); 83 Univ. Pa. L. Rev. 534 (1935).
raise the question of what that rule means in its practical application. Stated briefly, that rule is that the income from a so-called alimony trust is taxable to the husband-settlor whenever it discharges a continuing obligation for him.

I.

In the *Fitch* case, an alimony trust was included in a property settlement, confirmed by the divorce decree. The husband assumed no obligation other than to create the trust. He was held taxable on the income from the trust under *Douglas v. Willcuts* because he had failed to show "that in Iowa divorce law the court has lost all jurisdiction to alter or revise the amount of income payable to the wife from an enterprise which has been placed in trust," hence he had failed to show by "clear and convincing proof . . . that local law and the alimony trust have given . . . a full discharge and leave no continuing obligation however contingent."

In the *Leonard* case, the parties entered into a separation agreement while their divorce was pending. This agreement incorporated by reference a trust agreement, which in turn provided for an irrevocable trust of cash and certain securities, the husband undertaking to guarantee the payment of the principal and interest of certain bonds included. The separation agreement, which was affirmed and made a part of the divorce decree, made other property settlements, provided for the release of dower, etc., and also provided for an additional payment by the husband to the wife of $35,000 yearly. The Court held that the husband was properly taxable on the whole income of the trust. As to the bonds, a continuing obligation was found in the undertaking to guarantee the payment of the principal and interest when due. As to the balance of the trust, while the Court conceded that under New York law, a property settlement could not be modified under the statutory reserved power, even though incorporated in the decree, it was found that such settlements could be remade by the divorce court like any other settlement between husband and wife. Consequently, as defendant had not sustained the burden of proof imposed by the *Fitch* case, he was held to be taxable as to that income.

In the *Fuller* case, the parties entered an agreement in contempla-

---

5 The article of Randolph E. Paul, "Five Years with Douglas v. Willcuts," 53 Harv. L. Rev. 1 (1939), fully discusses the consequences of that case up to the fall of 1939. The present comment does not go beyond the questions raised by the recent cases; nor is the question of the propriety of the rule taxing trust income to the settlor where it discharges his legal obligation here considered. On the liability of settlors of irrevocable short term trusts, see 38 Mich. L. Rev. 885 (1940).

6 Helvering v. Fitch, (U. S. 1940) 60 S. Ct. 427 at 430.

7 Ibid., 60 S. Ct. 427 at 430.
tion of their divorce, which provided for the creation by the husband of an irrevocable trust of certain stock, the income to be applied to the support and maintenance of the wife for ten years, with the corpus over to her absolutely at the end of that time. The agreement provided for a waiver of all other claims growing out of the marital relation, and for the payment of an additional $40 per week by the husband for a specified time. The divorce decree approved the agreement. The Court found that under Nevada law the wife’s allowance was final unless the decree reserved power to modify it, or approved a settlement which provided for modification. It was held that, as no such power was reserved here, the duty of defendant was fully discharged and the income from the trust was not taxable to the husband under the rule of Douglas v. Willcuts.

2.

The rationale of Douglas v. Willcuts apparently was that as the divorce court could modify the decree and increase the obligation of the husband, he could not have been completely discharged, therefore the obligation continued to exist, and consequently the income from the trust thus used to discharge the settlor’s continuing obligation was properly taxable to him. There were three important factors present in that case which might have influenced that decision. (1) By statute, the divorce court had power to appoint a trustee to receive and invest property paid to the wife and turn the income over to her; (2) by Minnesota law, the court could modify its decree not only in regard to the alimony provisions, but also in regard to the trust provisions; (3) the husband had undertaken to make up deficiencies in the trust income. Under the Fitch case, it would seem that the power of the divorce court to modify its decree is the controlling factor. In its last analysis, that case seems to be one of judicial legislation, designed to plug what was considered to be a hole in the income tax law, whereby the income from such trusts would escape taxation. That feeling was based on the proposition that “amounts paid to a divorced wife under a decree for alimony are not regarded as income of the wife.”

8 “Apparently” is advisedly used in this case, for it would be presumptive to state authoritatively what that case really means.

9 “The reason given to support such a conclusion is that the liability of the settlor for taxes on trust income is based on the possibility that the settlor may be called upon for additional sums in the future. If the obligation continues, the tax liability continues. If the obligation is ended, the tax liability is ended.” Justice Reed, dissenting, Helvering v. Fuller, (U. S. 1940) 60 S. Ct. 784 at 788.


11 Douglas v. Willcuts, 296 U. S. 1 at 8, 57 S. Ct. 59 (1935).
proposition, the Court cited Gould v. Gould\(^{12}\) and Audubon v. Shufeldt.\(^{18}\) Unless Douglas v. Willcuts itself decided that proposition, it is without foundation, for neither of the cases cited so hold.\(^{14}\) Even assuming the validity of that proposition, there seems to be no good reason for extending it so as to hold that the amounts received by the wife from a so-called alimony trust are not taxable income. If that proposition is baseless, it is hard to see why such income is not taxable under section 161(a)(2).\(^{15}\)

Assuming now that the Court was correct in its proposition that alimony is not taxable income and that there was a loophole in the income tax law, the results of Douglas v. Willcuts are still undesirable, for as a matter of practical administration, the rule of this case leaves too many variables to be determined and too many questions unanswered. In its requirement that the taxpayer show by “clear and convincing” proof that under local law his obligation is fully discharged, it imposes an unreasonable, if not impossible burden. For example, in the Fitch case, defendant failed to establish his case because, as the Court conceded, “on this state of the Iowa authorities we can only speculate as to the power of the Iowa court to modify...”\(^{16}\) If the local law is thus unsettled, how can the taxpayer ever sustain his burden? What does this burden involve? If the basis of the decision is that an obligation of the husband is being paid by the trust income, thereby making him the real beneficiary, then logically the inquiry should go further than merely to ask whether the divorce court may have power to modify the trust decree.

\(^{12}\) 245 U. S. 151, 38 S. Ct. 53 (1917).
\(^{13}\) 181 U. S. 575, 21 S. Ct. 735 (1901).
\(^{14}\) Gould v. Gould, 245 U. S. 151, 38 S. Ct. 53 (1917), held only that, under the rule that tax statutes should be construed in a manner most favorable for the taxpayer, alimony was not income as defined by the Revenue Act of 1913. Although not patent in the decision, the Court seemed to feel that as such payments were not deductible from the husband’s income and as he was already taxable on those amounts they should not be taxed a second time as income of the wife. If it meant to go further and hold that in no event was alimony income of the wife, then it was an unwarranted extension of the authority there cited. It too relied upon Audubon v. Shufeldt, 181 U. S. 575, 21 S. Ct. 735 (1901), which held merely that under the definitions of “debt” in the Bankruptcy Act of 1898, accrued alimony was not a provable debt so as to be discharged by an adjudication.

\(^{15}\) Prior provisions are re-enacted by the Internal Revenue Code of 1939, 53 Stat. L. 66, § 161 (a): “The taxes imposed by this chapter upon individuals shall apply to the income of estates or of any kind of property held in trust, including ... (2) Income which is to be distributed currently by the fiduciary to the beneficiaries...”

\(^{16}\) Helvering v. Fitch, (U. S. 1940) 60 S. Ct. 427 at 430.
3.

It is not entirely clear just what the husband's obligation is.\(^{17}\) As a general proposition, the common-law duty to support is terminated by a divorce; alimony is a statutory substitute imposed by the divorce court. On the face of the matter, it would seem that necessarily it is the latter obligation that is meant.\(^{18}\) If this is so, then it would seem that the only duties imposed by the decree are the ones which that decree itself requires. Assuming that the court may, at some later time, modify the decree and impose a greater obligation upon the husband, if the original decree requires the creation of a trust, why is not the duty imposed by that decree as fully discharged by the creation of that trust until such time as the court sees fit to increase that obligation as it is when there is no such reserved power? This distinction is difficult to discern.

In this connection, it should also be asked by whom the divorce was sought and on what grounds, for under local law (and, "an inquiry into state law seems inescapable"\(^{19}\)), those factors often affect the wife's right to demand alimony and the court's power to grant it. If the trust is created in a situation where the wife could not demand it and the court could not have ordered it, where, or what, is the obligation of the husband? or are we to say that the trust agreement itself created the obligation?\(^{20}\) It should also be asked in this connection

\(^{17}\) In Helvering v. Leonard, (U. S. 1940) 60 S. Ct. 780, two different obligations were found, wholly apart from the fact whether the court had power to modify the decree. The first was the guarantee by the husband of the payment of the bonds. It is difficult to see how this fits into the Douglas v. Willcuts picture. If this argument is carried to its logical conclusion, then whenever a principal debtor pays off his obligations, it may be considered as income of his surety. The other "obligation" was found in the fact that the court could overhaul a contract made between husband and wife where it was unfair, inequitable, unjust or where there was overreaching. If this is sufficient to make the obligation a continuing one, then it would seem as though the obligations incurred by a husband in any antenuptial or postnuptial agreement, even though he had presently performed all the covenants, would be continuing, and therefore the income received by the wife thereunder taxable to him. It is submitted that both of these "obligations" are very dissimilar from those upon which the Court based its result in Douglas v. Willcuts. If the Leonard case is an application of that doctrine, as it purports to be, it is an unwarranted and extreme extension of the position taken in the Douglas case.

\(^{18}\) Yet the Court speaks of the divorce decree imposing certain sanctions upon a "preexisting duty of the husband" in the Douglas case, 296 U. S. 1 at 8, and again in the Fitch case, 60 S. Ct. 427 at 430. If by this language the Court meant that the common-law duty was continued, it created further difficulties in the application of the rule, as will be seen from the questions raised later in this note.

\(^{19}\) Helvering v. Fuller, (U. S. 1940) 60 S. Ct. 784 at 787.

\(^{20}\) That position was taken in Glendinning v. Commissioner, (C. C. A. 3d, 1938) 97 F. (2d) 51.
whether the agreement was a property settlement or an alimony settlement, and whether it was in lieu of alimony, dower, or other property claims, for this may be important in determining whether or not the court is bound by the agreement of the parties. For instance, if it is a property settlement the court may be bound. In most cases, the trust is accepted in lieu of alimony, dower and all other property claims, so this point is left obscure. If the court is not bound, but may approve and confirm the agreement as its own, to what extent can the court modify its decree when it does confirm or approve such a settlement? It is not infrequent that the local law permits a modification in regard to alimony agreements, but refuses it as to property settlement. In such a case, is the income from the trust to be allocated, part to the property settlement and part to the alimony settlement? Or would the assumption that the whole was intended as alimony be justified? 21 And what of the case where the trust is accepted in lieu of dower claims as well? The income from a trust in lieu of dower has been held to be taxable to the wife. 22 Is there any logical reason for distinguishing between this and a trust in lieu of alimony? And is the income to be apportioned in this case? Or is that part which might be said to be paid in lieu of dower to be taxable to the husband? 23 Again it may be asked whether an assumption that the entire trust income is paid in lieu of alimony can be justified.

Having found that the court does have power to modify and that this is the type of a decree that can be modified, it is necessary to consider by whom the decree may be reopened. Can the court modify on its own motion, or only on application by one of the parties? Or must both parties apply? And what showing must be made on application to secure a modification? 24 If the continuity of the obligation turns on the possibility that an increased burden might later be imposed, then these last questions would seem to be fully as important as the mere question of the power of the court. But assuming that a continuing obligation may be found, what is the extent thereof and by what is it measured?

In general, the common-law obligation to support a wife is determined by the husband's station in life, his income and standard of living. Is it sound to assume, as the cases apparently do, that the entire trust in-

21 That assumption seems to have been made in both the Fuller case and the Leonard case. In both, there were provisions for additional payments by the husband which might well have been intended to be the only alimony provisions, the balance being intended as a property settlement.


23 This seems to have been done in all four of these cases, although in Douglas v. Willcuts the Court distinguished Helvering v. Butterworth.

24 In this regard, it might be noted that in the Douglas case, the divorce court had power to modify any provision, on application of either party.
come is necessary for the proper support of the wife? The imposition of the tax is rationalized on the theory that the effect is the same as though the income had been paid to the husband, who in turn paid it over to the wife, so that he is the true beneficiary. But quaere, is he benefited beyond the extent of his obligation as measured by his common-law duty?

It will now be seen that, turning as it does on the possibility of the court's imposing an increased obligation on the husband in the future, the inquiry cannot stop merely with asking whether or not the divorce court, as a general proposition, does have the power subsequently to modify alimony provisions but must be extended to include these other questions, for each has an important bearing on that issue. If this be so, then it would seem that in practical application, this doctrine involves too many questions and too many fine points of law, often not settled under local law, for either the taxpayer or the commissioner to apply with any degree of certainty. It leaves the taxpayer's liability entirely too much to speculation and would require, before it could be definitely determined, a resort to the Supreme Court in every disputed case. And in view of the uncertainty in the rule, such disputes seem inevitable.

A final objection to the doctrine of Douglas v. Willcuts relates to the questions that may arise in attempts to collect such a tax in the event the husband becomes uncollectible or bankrupt. Would the income in the hands of the wife be sufficiently that of the husband's as to be subject to a tax-lien, or subject to distraint because of his non-payment? It would seem that the same arguments that exempted it from taxation in the first instance would preclude its being subject to tax liability in such case. Or will the corpus, irrevocably placed beyond the control of the husband, be subjected to the satisfaction of the tax claim? These questions remain to be answered.27

This comment makes no attempt to answer the many questions it raises. When the Court itself has failed to make clear the real meaning

25 An embarrassing question could be asked in this regard concerning the exemption allowed to a married man. Internal Revenue Code, 53 Stat. L. 18 (1939), § 25 (b) (1).

26 Query at this point, is he to be considered sufficiently the beneficiary of the trust income that the corpus will be taxed to his estate upon his death under the estate tax, Internal Revenue Code, 53 Stat. L. 121 (1939), § 811 (c) (1)? That section provided for the inclusion in the gross estate of property which was transferred by trust, in which the grantor retained for life "the possession or enjoyment of, or the right to the income from, the property."

27 It would be no answer to say that in such case the husband could petition the court for a modification of the decree, for, as both the income and the corpus are irrevocably beyond his control, a mere modification would be of little help to him.
of *Douglas v. Willcuts*, it would be extremely difficult, if not impossible, to try to predict what the answers might be. They were raised for the purpose of showing that, far from being a solution to the problem of how to tax the income from a trust under these circumstances, the rule of *Douglas v. Willcuts* has created more problems than it has solved. Conceding that "The evident general purpose of the statute was to tax in some way the whole income of all trust estates," and that alimony is not taxable income, so that in this case some of the trust income would escape taxation, it would seem more desirable to have awaited Congressional action, rather than to have imposed an artificial rule by means of judicial legislation which results in such arbitrary and unpredictable tax liability. Federal taxation should be based on sound federal law and not on nice distinctions in the local law. As was pointed out by Justice Reed,

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

_Benjamin W. Franklin_

---

28 The majority of the law review notes discussing *Douglas v. Willcuts*, cited in note 4, supra, approve of the result.
30 It would have been still better to hold that such income is taxable under § 161 (a) (2), quoted in note 15, supra.