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I

INTRODUCTION

In 1971 approximately 750,000 divorces were granted in the United States, thus adding a million and a half citizens to the large—and growing—pool of the "formerly married." It is thus safe to estimate that there are, literally, tens of millions of Americans who are currently living under the guidance and economic confines of marital settlement agreements executed by them, or under decrees of court imposed upon them, articulating the dimensions of their legal rights and responsibilities as to support and care of the divorced spouse and progeny of the now-dissolved marriage.

Despite the very best which competent and capable counsel can do to devise marital settlement agreements which will serve the present and future needs of their clients, inevitably unforeseen personal, social and family changes will frequently occur which make such existing agreements less than desirable at best, and sometimes completely oppressive in their ongoing effect upon one or another of the parties. When such

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changes in circumstances arise, it often becomes patently advisable for the parties to formulate and agree upon necessary changes in the existing agreement which will adequately reflect the new and different family and personal problems presented. In doing so the parties and their counsel must be made aware that substantial changes or "novation" of an existing marital settlement are often accompanied by very important federal income tax consequences.

II

Basic Concept of Novation

The basic concept of "novation," in its most simplistic form, is that, just as parties are free to contract in the first instance, they are free thereafter to amend their existing agreement and make, yet again, a *new* contract.[1]

There are basic limitations upon a court's right to unilaterally impose or direct changes in a marital settlement agreement incorporated into a "consent decree" adopting an agreement of the parties with reference to either (1) a settlement of property rights, or (2) a lump sum settlement (frequently paid in instalments) of wife's *support* rights, such as a lump sum settlement in lieu of "alimony."[2] In such instances the court's jurisdiction is usually limited to

(a) enforcement of the terms of the incorporated agreement (irrespective of whether the court originally had jurisdiction to impose the terms of the consent decree); or

(b) modification of the *support* aspect where child support or straight alimony is involved, and then conditioned only upon a showing of "changes of circumstances" since entry of the decree warranting a revision as to support.

Thus the *reserved right* of the parties to agree upon post-decretal changes, and to have such changes endorsed by way of a modifying order of the court, is of paramount importance; parties to these agreements *need not* feel that they are "carved in stone," forever immutable in form and content.

III

Degree and Character of Change

There are basically three major configurations in terms of the time and character of changes in these agreements. These are:

1. Lindey, Separation Agreements 28 (Matthew Bender).
2. See 2A, Nelson on Divorce, 17.03 at 19-37.

(1) A *"nuc pro tunc"* amendment or reformation by the court which originally entered the decree, generally accomplished in close proximity to the date of actual entry of the decree;

(2) Renegotiation of limited aspects of an existing plan, leaving the original format of the agreement otherwise substantially intact, such as an agreed upon reduction in monthly payments on a lump sum settlement in lieu of alimony, or a property settlement; or

(3) A complete restructuring of the remaining obligation into an entirely different form and substantially revised basic content than originally agreed upon.

IV.

A "Nunc Pro Tunc" Reformation

Although the idea of a divorce decree amended *nunc pro tunc* seems to define a precise problem, the concept has within it two different and significant problems: A decree may be amended to reflect a retroactive change which facilitates a secondary agreement by the parties (such as specifying who is to have exemptions for the children where the original agreement is silent), or, it may be amended to correct an actual error in the original decree. Each of these kinds of changes brings with it totally different federal tax consequences.

When a decree is amended retroactively such that it attempts to provide retroactive benefits, benefits or money not originally entered, the reformation *cannot* affect the tax consequences of the payment already made thereunder.[3] The basic rule is hence quite clear: The determination of federal income tax consequences is not controlled by retroactive judgments of state courts.[4]

Thus a retroactive amendment to a decree *cannot* change the federal tax consequences already incurred under the decree as originally entered; the best that can be accomplished is some tax benefit *prospective* in character.

V.

Correction of Erroneous Decrees

The rendition of a *nunc pro tunc* order to correct some erroneous aspect of a decree *will* be controlling for federal tax purposes. A good

3. Diane v. Comm'r, 168 F.2d 449 (2d Cir. 1948).
4. Segal v. Comm'r, 36 TC 148 (1961); Turkoglus v. Comm'r, 36 TC 552 (1961); Van Vlaanderen v. Comm'r, 10 TC 706 (1948), *aff'd*, 175 F.2d 389 (3rd Cir. 1949). *See also* IT 4092, approving the results in the foregoing cases.

example of this doctrine is found in *Johnson v. Comm'r.*[5] In the *Johnson* case a decree of divorce provided for the payment of $75 per week unallocated alimony and child support although the *actual* intentions of the parties (and the court) was to provide $75 per week for *child support only.* The wife had proved that the trial judge's oral decision had clearly specified the $75 per week as "child support" only. The court here emphasized the distinction between the correction of an error in the statement of the court's actual order, and one in which there is a later attempt by the parties to correct some deficiency in the original decree, retroactively, which presumably was not an actual judicial error. In the former situation, a retroactive change *will* be effective to change the federal income tax consequences, even though the taxable year in question has passed and is thus closed, whereas, in the latter situation no retroactive change in the federal tax consequences will be permitted.[6]

Further expanding the Commissioner's position, in 1971 the Commissioner issued Revenue Ruling 71-416,[7] which provides that the retroactive correction of a mathematical error in a decree will be given full retroactive effect for federal income tax purposes. This ruling further modified the Commissioner's earlier rulings in this area[8] with respect to the tax effect of *nunc pro tunc* orders.

In summary, then, it now appears that a *nunc pro tunc* order issued to effect a secondary agreement by the parties will *not* be granted retroactive effect for federal income tax purposes. Conversely, a retroactive correction of an actual, provable, *error* in an existing decree *will* be granted retroactive treatment for federal income tax purposes.

VI.

Novation and Renegotiation of Existing Plans

Section 71(a)(1) of the Internal Revenue Code provides that a divorced spouse's reportable gross income must include the value of "periodic payments" received if certain qualifications are met. There is also a reciprocal right in the payor spouse under Section 215(a) to deduct such amounts which are includable under Section 71 in the payee-spouse's gross income. One such qualification for taxability and de-

5. 45 TC 530 (1966). (Compare, however, Saralee Lust v. Comm'r, 30 TCM 281 (1971).
6. Sklar v. Comm'r, 21 TC 349 (1953); Vargason v. Comm'r, 22 TC 100 (1954).
7. Rev. Rul. 71-416, 26 CFR 1.71-1 (1971).
8. IT 4108.

ductibility is that payments must be made "incident" to a divorce or separation. The question therefore immediately arises as to what effect a substantial modification or renegotiation of a marital settlement agreement will have on the taxability of payments made after a modification. Will the taxability of the payments made pursuant to the new plan be determined by the prior tax status or by the nature of the new payments? That is, will the tax treatment of the newly agreed upon payments be controlled by the prior payments' tax status or will they take on a new and different character? Additionally, is the new agreement, entered into many months or years following the actual decree itself, "incident to such divorce or separation" as required under § 71 (a)(1)?

Virtually all of the answers to these questions can be found in *Newton v. Pedrick*.[9] The court here determined that the words "incident to such divorce" referred to the *STATUS* of divorce and, *if a support obligation survives a decree of divorce (by decree of court or by agreement)*, a later adjustment of its financial terms (by decree of court or by subsequent agreement) will also be "incident" to the divorce in compliance with Section 71(a)(1) of the Code.[10]

The existence of some *support* obligation at the time of modification of the decree or agreement incorporated within the decree is of critical importance in meeting the "incident to" test. Without existence of some support obligation there *cannot* be newly instituted an obligation in the nature of "periodic payments." Ample verification of the foregoing general principle is found in Revenue Rulings 60-141 and 60-142.[11]

In Rev. Rul. 60-141, husband and wife entered into a separation agreement "whereby the husband agreed to pay his wife a specified sum monthly for her support and maintenance until her death or remarriage." The agreement was clearly obligation for the support of the wife, the agreement was not merged into nor adopted by the court (which recognized existence of the agreement and therefore made no support provisions for wife), and the payments thereunder clearly qualified as "periodic payments." Some years thereafter, the former wife having fallen on hard times and the husband's economic position

9. 212 F.2d 357 (2d Cir. 1954). *See also* Rev. Rul. 1960-1 CUM. BULL. 31, which affirmed and adopted the reasoning of the *Pedrick* case, and Hollander v. Comm'r, 248 F.2d 523 (9th Cir. 1957).

10. Hollander v. Comm'r, 248 F.2d 523 (9th Cir. 1957); Andrews v. Comm'r, 18 TCM 388 (1959); and Walsh v. Comm'r, 21 TC 1063 (1954).

11. Rev. Rel. 141, 142, 1960-1 CUM. BULL. 33, 34.

having improved since the divorce, husband agreed to *increase* the amount of support to his former wife. Since husband's *support* obligation still survived at the time of the agreed upon change, *notwithstanding* that the support obligation had been limited by the terms of the original separation agreement, the increased payments agreed upon by husband were "incident to" the divorce and hence the new payment schedule qualified as "periodic payments."

The foregoing result is in stark contrast to Revenue Ruling 60-142. Here husband and wife had entered into a *true property settlement* agreement which made absolutely no provision for wife's support and maintenance, and in fact (although not completely clear from the text), wife appears to have *waived* all rights to maintenance and alimony. The ensuing divorce decree adopted the property settlement agreement, although the agreement survived the decree, thus retaining its independent legal significance. Following the divorce, the *wife remarried* and she and her former husband amended their agreement, attempting thereby to achieve "periodic payment" treatment for subsequent amounts to be paid by the husband to his former wife. In clear terms, then, these parties seem to have attempted a transmutation of the husband's obligation to pay for wife's property interest, a non-deductible pay-out, into a tax deductible item—"periodic payments!" Quite apart from this consideration, however, Rev. Rul. 60-142 disallowed the claim to "periodic payments," holding as follows:

> In the instant case, no obligation to support survived the dissolution of the marriage. The agreement and decree made a final and permanent adjustment of the parties' rights and obligations.
>
> In light of the foregoing, it is held that payments made under the amendatory agreement do not constitute payments made because of the marital or family relationship in recognition of the general obligation to support. Therefore, such payments are not includable in the wife's gross income under section 71 of the Code and are not deductible by the husband under section 215 of the Code. . . .[12]

Inevitably the following question is bound to be raised by those who must test the outer limits of all rules: "Is the survival of a 'child support' obligation sufficient to sustain a post-decree amendment transmuting existing child support payments into a "periodic" form under *Lester v. Commr.*?"[13] Implicit in the question is that wife has waived her right to alimony and, following the decree, has only an existing

12. Rev. Rul. 142, 1960-1 CUM. BULL. 34, 35.
13. 366 U.S. 299 (1961).

right to receive non-taxable "child support" under Section 71(b). Unfortunately, no clear answer appears in the cited cases or Revenue Rulings, all of them being quite careful to emphasize the existence or non-existence of the legal obligation to support the wife, uncomplicated by the presence of a parallel legal and "family obligation" to support children. Thus what follows must be regarded as the author's informed judgment, unsupported to date by *clear* authority sustaining the analysis.

It is the author's opinion that, notwithstanding a waiver of alimony by a wife, where there still survives a legal obligation as to the support of minor children of the dissolved marriage, there *can* be *post-decretal* payments, or a post decretal amendment effected, which will qualify such payments as "periodic," hence taxable to wife and deductible by husband. In order to accomplish this result, however, either in the original proceedings or in a subsequent post-decretal amendment, it would be absolutely essential that the initial or amendatory support arrangement *not be* merged into a decree where the local state law prohibits the payment of "alimony" subsequent to a waiver or remarriage of wife.[14]

VII.

Discontinuance and Settlement of Alimony Payments

Frequently, after a marital agreement has been in effect for some years, the parties may mutually desire termination of the existing open-ended support plan in favor of a lump sum settlement in lieu of all future support payments. What are the tax consequences of the ensuing arrangement? If, for example, payment of support is being made which qualifies as "periodic," what would be the ensuing tax effect of a lump sum payment in lieu of all future support payments? Will the lump sum payment also receive treatment as "periodic payments" under the Code?

Section 71 of the Code sets forth the basic standards by which periodic payments must be measured, initially and at later times. In *Loverin v. Comm'r.*[15] the court reviewed a situation in which a taxpayer was obligated to pay his ex-wife $60 per week for her support. Several years subsequent to the divorce and effectiveness of the support agreement, the wife, wishing to remarry and thereby terminate her existing right to support payments, entered into a modified settlement agreement whereby wife agreed to accept a payment of $8,500 in lieu

14. *See* Brown v. Comm'r, 50 TC 865 (1968).
15. 10 TC 406 (1948).

of all future support payments. The Tax Court affirmed the Commissioner's determination that the $8,500 payment could not be accorded "periodic payment" treatment and was, therefore, not taxable to wife nor deductible by husband. In referring to the amendatory agreement the Tax Court found as follows:

> [I]t is obvious that the written instrument of January 2, 1942 contemplated neither periodic payments nor installment payments of a specified principle sum extending over a period of more than 10 years. It dealt only with a single, lump sum payment. The entire principal sum specified in the instrument was in fact paid at one time. The payment does not fall within the preview of Section 22 (K) [the 1939 Revenue Code counterpart of present § 71], and accordingly petitioner may not deduct any part of it under Section 23 (U) [the 1939 Revenue Code counterpart of present § 215].[16]

It is thus apparent that where a support obligation is terminated *in favor of a lump sum paid immediately* such amount will not be accorded "periodic payment" treatment for tax purposes. Conversely, where the support obligation is terminated in favor of a lump sum payable over a period of time, then the *same* tax rules apply which would otherwise have applied if the new agreement had been initially negotiated at the time of the divorce itself; for example, if the new series of payments meet the test of "periodicy" under the Code and the Regulations, then it is irrelevant that the payments are newly created and implemented in lieu of a different, pre-existing, support obligation. This doctrine is most clearly seen in Rev. Rul. 72-133, which provides as follows:

> WHERE husband and wife are divorced under a decree providing for child support and a settlement of property rights and annual alimony of $10,000 for wife, subject to termination upon her death or remarriage, such decree having been in effect for several years, and the parties agree to modify the open-ended alimony obligation as follows:
>
> $60,000 to wife, payable $20,000 *immediately* and 8 *quarterly* installments of $5,000 each, commencing 3 months from the date of the initial $20,000 payment, in *full satisfaction* of *all alimony and support* rights of wife,
>
> STILL SUBJECT to termination upon wife's death or remarriage,
>
> THEN the *entire* payout qualifies as "periodic" for tax purposes, includable in wife's income under § 71(a)(1) [citing

16. *Id.* at 409.

Reg. § 1.71-1(d)(3)], and are deductible to husband under § 215.[17]

Thus, husband *could* effectively pay wife *$35,000* in *one* taxable year, and have it *all* qualify as "periodic payments," the deal to be completely paid off within 2-1/4 years of initiation. Thus, why pay off with a non-qualifying lump sum when, presumably, an escrow could easily be utilized to guarantee full payment of the agreed-upon lump sum amount over an abbreviated period?

Also note that, unlike Revenue Ruling 60-142, we obviously have no question here of the parties attempting to conceal or transmute a payment into a payment for "support."

It must be noted, however, that just as the usual rules as to includability and deductibility are applied to "novated" payments as though the marital settlement were immediately "incident" to the divorce, and just as we have clearly determined that an executory agreement to pay for "property rights" cannot be transformed into "periodic" support by such an amendment, any attempt to discount existing arrearages of "periodic payments" into a lump sum amount, attempting to gain non-taxable treatment for the reduced payment in the recipient's hands, is destined to fail:

> EXAMPLE: Over a period of several years, due to adverse health, or business reasons, husband falls $10,000 behind in payment of "pure" alimony, or in payment of installments of a lump sum otherwise treatable as "periodic." He now has the money and wishes to pay off wife entirely, for $25,000 in cash, and wife is agreeable.

Tax Result: Since arrearages in payment of "periodic" support retain their essential tax character *whenever* paid,[18] $10,000 of the amount received by wife *must* be reported by her as "income" and husband, correspondingly, has a deduction for the same amount. The additional $15,000, since paid as a lump sum, not "periodic" in character, is tax free to wife and is non-deductible by husband.

Implementing The Plan:

> Wife hereby acknowledges receipt from husband of Ten Thousand Dollars ($10,000) as and for payment of alimony arrearages upon sums previously due her from husband [under said decree of divorce (or marital settlement agreement)]. She hereby further acknowledges receipt from husband of an additional payment of Fifteen Thousand Dollars ($15,000) as and for a complete waiver

17. Rev. Rul. 72-133.
18. Grant v. Comm'r, 209 F.2d 430 (2d Cir. 1953); Dalton v. Comm'r, 34 TC 879 (1960); Rev. Rul. 457, 1955-2 CUM. BULL. 527.

> by wife of any future right [under said decree or marital agreement, if any] she may have in and to alimony or support for herself from husband, and wife hereby does forever waive and release all past, present or future right she may have to receive alimony or support from husband under the laws of this or any other state or country.

Obviously, this plan should be endorsed by a court if there is otherwise in existence a decree obligating husband to continue making future payments exceeding those now agreed upon under the novated agreement.

CONCLUSION

It should now be abundantly evident that the creative and negotiating skills of the matrimonial lawyer are just as essential when planning and negotiating a post-decree amendment to an existing marital settlement plan as they were in the initial instance where the agreement was shortly followed by the divorce decree itself. In fact, it is often possible many months or years following actual achievement of the divorce, to negotiate a *more sensible* plan for the parties than was possible when great tensions and extreme emotions aurrounded achievement of the divorce itself.

The passage of time has a way of muting the pain, anger, and personal resentment which often becloud the judgment of the parties (and not infrequently their respective counsel) during the critical months and days preceding the divorce itself, such that the parties may later be better able to more objectively evaluate their own positions and needs than could have been expected under pre-existing circumstances. Adequate knowledge by counsel of the federal income tax ramifications of novation of marital settlement agreements is indispensable if counsel is to bring to bear the full measure of creative negotiating and drafting skills possessed by him.