7 T.C. 413 (1946)

When a separation agreement, incorporated into a divorce decree, designates a specific amount of periodic payments as child support, that amount is not deductible by the payor spouse for income tax purposes.

Summary

Robert Budd sought to deduct alimony payments made to his former wife. The IRS disallowed a portion of the deduction, arguing that the separation agreement, incorporated into the divorce decree, specifically allocated $200 per month for child support. The Tax Court agreed with the IRS, holding that when construing the separation agreement as a whole, $2,400 per year was explicitly designated for the support of Budd's minor child and was therefore not deductible under Section 23(u) of the Internal Revenue Code.

Facts

Robert Budd and his wife, Dorothy, entered into a separation agreement in anticipation of their divorce. The agreement stipulated that Robert would pay Dorothy $500 per month for her support and the support of their minor son, Robert Ralph, until he entered college. If Dorothy remarried, the payment for Robert Ralph's maintenance would be $200 per month until he entered college. The agreement was incorporated into the divorce decree. Robert paid Dorothy $6,000 in both 1942 and 1943 and deducted these amounts as alimony. Dorothy did not remarry during these years.

Procedural History

The Commissioner of Internal Revenue determined a deficiency in Budd's income tax liability. Budd petitioned the Tax Court, contesting the Commissioner's determination that $2,400 of the $6,000 deduction claimed as alimony was not allowable. The Tax Court reviewed the separation agreement and the divorce decree.

Issue(s)

Whether $2,400 of the $6,000 paid to Budd's former wife constituted "a sum which is payable for the support of minor children" under Section 22(k) of the Internal Revenue Code, thus not deductible by Budd.

Holding

Yes, because when the separation agreement is construed as a whole, $2,400 per year (or $200 per month) was explicitly designated for the support of Robert Ralph Budd, the minor child.

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Court’s Reasoning

The Tax Court emphasized that the separation agreement must be read as a whole. While paragraph (3) of the agreement might suggest that the entire $500 monthly payment was for alimony and support, other paragraphs, specifically paragraph (4), clearly indicated that $200 per month was allocated for the child’s support in the event of the wife’s remarriage. The court stated, “When the separation agreement which is here before us for consideration is so read, it seems to us apparent that, of the $6,000 paid by petitioner to a former wife during the taxable years pursuant to that agreement, the sum of $2,400 represented an amount fixed by the terms of the agreement, in the terms of an amount of $200 per month, as a sum payable for the support of petitioner’s minor child, and we have so found.” The court relied on Section 22(k) of the Internal Revenue Code, which excludes from the wife’s gross income (and therefore from the husband’s deduction under Section 23(u)) any portion of periodic payments “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.”

Practical Implications

This case illustrates the importance of clearly and unambiguously drafting separation agreements and divorce decrees, particularly regarding the allocation of payments for alimony versus child support. If parties intend for the entire payment to be treated as alimony for tax purposes, the agreement must avoid explicitly designating any portion as child support. The ruling emphasizes that courts will interpret these agreements holistically. The Budd case serves as a reminder that seemingly minor clauses can have significant tax implications, affecting the deductibility of payments for the payor and the inclusion of income for the recipient. Later cases cite Budd for the principle that the entire agreement must be examined to determine the true intent of the parties regarding child support allocations within alimony payments.

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