9 T.C. 61 (1947)

Transfers of property pursuant to a separation agreement incident to a divorce are not subject to gift tax if made in the ordinary course of business, at arm's length, and free from donative intent; however, subsequent transfers not explicitly part of that agreement may be considered taxable gifts absent adequate consideration.

Summary

The Tax Court addressed whether two $50,000 transfers made by Josephine Barnard to her husband, Henry, incident to their divorce were subject to gift tax. The first transfer was part of a written separation agreement. The second, made after the divorce, was to a pre-existing trust for Henry's benefit, pursuant to a separate oral agreement. The court held that the first transfer was not a taxable gift because it was made at arm's length without donative intent. However, the second transfer to the trust was deemed a taxable gift because it lacked adequate consideration and was not part of the ratified separation agreement.

Facts

Josephine and Henry Barnard separated in July 1943 due to marital differences. On August 12, 1943, they executed a written separation agreement where Josephine paid Henry $50,000. This agreement settled property rights and child custody. Simultaneously, they made an oral agreement that, if Josephine obtained a divorce, she would pay an additional $50,000 to a pre-existing trust she had created for Henry in 1941. The trust paid income to Henry for life, with the remainder to their children. Josephine was independently wealthy, with assets exceeding $600,000 and a substantial annual income from a separate trust. Josephine obtained a divorce in Nevada on October 20, 1943. The divorce decree ratified the written separation agreement. On October 25, 1943, Josephine transferred $50,000 to the trust for Henry.

Procedural History

The Commissioner of Internal Revenue determined a gift tax deficiency against Josephine for 1943, arguing both $50,000 transfers were taxable gifts. Josephine contested this determination in the Tax Court. After Josephine's death, her estate, City Bank Farmers Trust Company, was substituted as the petitioner.

Issue(s)

1. Whether the $50,000 transfer made pursuant to the written separation agreement was a taxable gift?

2. Whether the subsequent $50,000 transfer to the pre-existing trust for Henry's benefit was a taxable gift?

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Holding

1. No, because the transfer was made without donative intent in an arm's length transaction for adequate consideration.

2. Yes, because the petitioner failed to demonstrate that the transfer to the trust was supported by adequate consideration in money or money's worth.

Court's Reasoning

Regarding the first transfer, the court relied on precedent like *Lasker v. Commissioner* and *Herbert Jones*, emphasizing that transactions made at arm's length where each party seeks to profit are not considered gifts. Quoting *Commissioner v. Mesta*, the court noted, "We think that we may make the practical assumption that a man who spends money and gives property of a fixed value for an unliquidated claim is getting his money's worth." The court found Josephine paid the $50,000 to free her property from Henry's claims, thus receiving adequate consideration.

As for the second transfer, the court distinguished it from the first because it was based on a separate oral agreement and not explicitly part of the ratified separation agreement. The court found no evidence that the Nevada divorce court was aware of this oral agreement, nor that Josephine received any consideration for this transfer beyond what was agreed to in the written separation agreement. The court emphasized the petitioner's burden to prove that the transfer was made for adequate consideration under section 1002 of the Internal Revenue Code, which they failed to do. Therefore, the transfer was deemed a taxable gift.

Practical Implications

This case clarifies the importance of documenting all aspects of a divorce settlement in a written agreement, especially concerning property transfers, to avoid unintended gift tax consequences. Transfers not explicitly incorporated into a ratified divorce decree are more likely to be scrutinized as potential gifts. It highlights that even transfers between divorcing spouses must be supported by adequate consideration to avoid gift tax, and that "ordinary course of business" transactions are not considered gifts. Subsequent cases might distinguish *Barnard* by demonstrating a clear, integrated plan encompassing all transfers, even if some are made after the formal separation agreement.

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