Baker v. Commissioner, 17 T.C. 1610 (1951)

Payments to a divorced spouse based on a percentage of the payer's income, without a specified principal sum, are considered periodic payments taxable to the recipient, not installment payments taxable to the payer.

Summary

The Tax Court addressed whether payments made by a husband to his divorced wife, based on a percentage of his net income, qualified as "periodic payments" under Section 22(k) of the Internal Revenue Code (1939), thus deductible by the husband. The agreement, incident to their divorce, required payments to be made over five years, calculated as a percentage of his income. The court held that these payments were indeed periodic because no principal sum was specified, and the amount was uncertain due to its dependence on the husband's fluctuating income.

Facts

A husband and wife entered into a separation agreement, incident to their divorce, where the husband agreed to pay his wife a certain percentage of his net income for a period of five years. The payments were made subsequent to the divorce decree. The husband sought to deduct these payments from his income, arguing they were periodic payments under Section 23(u) of the Internal Revenue Code, includible in the wife's gross income under Section 22(k).

Procedural History

The Commissioner of Internal Revenue disallowed the husband's deduction, arguing that the payments were installment payments, not periodic. The case was brought before the Tax Court to determine the proper classification of the payments and the corresponding tax treatment.

Issue(s)

Whether payments made by a husband to his divorced wife, based on a percentage of his net income for a fixed period, constitute "periodic payments" or "installment payments" within the meaning of Section 22(k) of the Internal Revenue Code.

Holding

Yes, because the agreement fixed no principal sum, and it was impossible to know in advance how much the petitioner would have to pay his wife due to the fluctuating nature of his income. These payments are considered periodic and thus taxable to the wife, not the husband.

Court's Reasoning

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The court reasoned that Section 22(k) distinguishes between "periodic payments" and "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." The Commissioner argued that a lump sum is specified whenever the total amount to be paid can be calculated by a formula, even if the formula involves uncertainty (like mortality tables). The court rejected this argument, stating that while the agreement specified a percentage of income for five years, it did not fix a principal sum because the husband's income was variable. The court stated, "The agreement of the parties in this case fixed no principal sum and it was impossible to know in advance how much the petitioner would have to pay his wife. She was not content to receive a lump sum, but wanted to share in his earnings." Because no principal sum was specified, the payments were considered periodic and taxable to the wife.

Practical Implications

This case clarifies the distinction between periodic and installment payments in divorce settlements for tax purposes. It establishes that payments contingent on the payer's income, without a fixed principal amount, are generally considered periodic. Attorneys structuring divorce settlements should be aware of this distinction, as it affects which party is taxed on the payments. Agreements should clearly define whether a specific principal sum is intended. Later cases have cited *Baker* to support the principle that uncertainty in the total amount to be paid weighs in favor of classifying payments as periodic. This ruling impacts how alimony and spousal support agreements are drafted and interpreted, emphasizing the importance of clear language regarding the existence of a specified principal sum.

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