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# Merrill v. Fahs: Release of Marital Rights Is Insufficient Consideration for Transfer Tax Purposes

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# *Merrill v. Fahs*: Release of Marital Rights Is Insufficient Consideration for Transfer Tax Purposes

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The United States Supreme Court's 1945 decision in *Merrill v. Fahs*[1] stands for the proposition that the release of marital rights in exchange for the receipt of property is insufficient consideration to avoid a gift.[2] Therefore, when the husband in that case transferred property to his wife in accordance with the terms of a prenuptial agreement, and the wife released marital rights in exchange for the husband's transfer, the husband's transfer was properly classified as a taxable gift.[3] Even though *Merrill* remains good law, its impact is greatly reduced by legislative changes enacted in the years subsequent to the decision.

The taxpayer, Charles E. Merrill, entered into a prenuptial agreement the day before marrying his third wife, Kinta Desmare, on March 8, 1939. While Miss Desmare did not have any meaningful assets, the Court noted that Mr. Merrill was financially secure.[4] The prenuptial agreement required Mr. Merrill to create three separate trusts, and for Miss Desmare to relinquish "all rights that she might acquire as wife or widow in taxpayer's property, both real and personal, excepting the right to maintenance and support."[5] The inducements for entering into the agreement were (i) the contemplated marriage, (ii) a desire to make fair requital for the release of marital rights, (iii) freedom for the taxpayer to make appropriate provisions for his children and other dependents, and (iv) the uncertainty surrounding the taxpayer's financial and marital tranquility.[6]

The first trust that Mr. Merrill created was an irrevocable trust. It was formed within ninety days of the marriage, funded with $300,000, and included provisions conforming to Miss Desmare's wishes. The second and third trusts were to be created under Mr. Merrill's Will, and

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1 324 U.S. 308 (1945).

2 *Id.* at 312-13.

3 *Id.* at 313.

4 *Id.* at 309.

5 *Id.*

6 *Id.*

each to be funded with $300,000 upon his death. The second trust would also benefit Miss Desmare and contain the same provisions as within the irrevocable trust, whereas the third trust was to benefit any children of their marriage.

Mr. Merrill filed a 1939 gift tax return reporting the creation and funding of the irrevocable trust, but claimed that no tax was due. The I.R.S. disagreed and sought to collect a deficiency of $99,000 resulting from the transfer. Mr. Merrill paid the $99,000 tax, and then filed a claim for refund.[7] When the refund was denied, he filed suit in district court[8] where he was vindicated. The I.R.S. then appealed to the Fifth Circuit Court of Appeals, which reversed,[9] and the Court granted certiorari.[10]

The *Merrill* Court noted that the resolution of the case turned on the proper interpretation of section 503 of the Revenue Act of 1932 ("1932 Act"),[11] which provided,

> [W]here property is transferred for less than adequate and full consideration in money or money's worth, then the amount by which the value of the property exceeded the value of the consideration shall, for the purpose of the tax imposed by this title, be deemed a gift, and shall be included in computing the amount of gifts made during the calendar year.[12]

The *Merrill* Court then cited the *Estate of Sanford*[13] in finding that the

> gift tax was supplementary to the estate tax. The two are in pari materia and must be construed together. The phrase on the meaning of which decision must largely turn – that is, transfers for other than adequate and full consideration in money or money's worth – came into the gift tax by way of estate tax provisions. It first appeared in the Revenue Act of 1926.[14]

Although the 1932 Act did not reference the relinquishment of marital rights in the gift tax context, it did affirmatively state the relinquishment of marital rights does not constitute consideration in money or money's worth for estate tax purposes.[15] By virtue of its finding in

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7 *Id.* at 310.
8 Merrill v. Fahs, 51 F. Supp. 120, 123 (S.D. Fla. 1943).
9 Fahs v. Merrill, 142 F.2d 651, 652, 655 (5th Cir. 1944).
10 Merrill v. Fahs, 324 U.S. 308, 310 (1945).
11 Revenue Act of 1932, ch. 209, §503, 47 Stat. 169, 247 (1932).
12 *Merrill,* 324 U.S. at 310.
13 Estate of Sanford v. Comm'r, 308 U.S. 39, 44 (1939).
14 *Merrill*, 324 U.S. at 311.
15 *Id.* at 312.

*Estate of Sanford* that the estate and gift tax must be construed together, the *Merrill* Court believed that it must read the same interpretation into the gift tax setting. It stated,

> [T]o interpret the same phrases in the two taxes concerning the same subject matter in different ways where obvious reasons do not compel divergent treatment is to introduce another and needless complexity into this already irksome situation. Here, strong reasons urge identical construction. To hold otherwise would encourage tax avoidance.[16]

Justice Reed dissented. While he noted that taxability of gifts to a spouse in exchange for the release of marital rights had been in dispute before the enactment of the 1932 Act, he seemed particularly bothered by the Court's reading a clause into the gift tax setting that did not exist in the 1932 Act. He wrote that in section 804 of the 1932 Act, Congress "declared that a transfer of marital rights should not be consideration in money or money's worth under the estate tax provisions."[17] However, section 503 of the 1932 Act, which applied to gift tax, did not have a provision forbidding the valuation of marital rights. Justice Reed pointed out that "when Congress expressly provided that relinquishment of dower, curtesy or other statutory estate was not consideration for estate tax purposes and left the gift tax provision without such a limitation, it intended that these rights be accorded a different treatment under these sections."[18]

While *Merrill* remains good law, there have been legislative changes that have weakened its impact. These changes include the creation of a gift tax exemption and elimination of certain transfers from gift tax treatment. Notwithstanding its weakening, one piece of legislation actually strengthened the *Merrill* decision by eviscerating the impact of Justice Reed's dissent. In 1958, Treasury Regulation section 25.2512-8 was introduced. The Regulation brought the legal support that the *Merrill* Court imagined already existed when deciding the case. The Regulation provides as follows:

> [A] consideration not reducible to a value in money or money's worth, as love and affection, promise of marriage, etc., is to be wholly disregarded and the entire value of the property transferred constitutes the amount of the gift. Similarly, a relinquishment or promised relinquishment of dower or curtesy, or of a statutory estate created in lieu of dower or curtesy, or of other marital rights in the spouse's property or estate, shall

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16 *Id.* at 313.
17 *Id.* at 315 (Reed, J., dissenting).
18 *Id.* (Reed, J., dissenting).

> not be considered to any extent a consideration in money or money's worth.[19]

While his dissent is no longer applicable, Justice Reed had the stronger argument at the time *Merrill* was decided. With the introduction of Treasury Regulation section 25.2512-8, the *Merrill* Court had legal support for its conclusion. However, at the time of the decision, the Court created new law, as opposed to interpreting existing law.

Twenty years after *Merrill* was decided, the I.R.S. abandoned its view that the waiver of support rights could not serve as consideration under section 2043(b)(1).[20] In Revenue Ruling 68-379 the I.R.S. notes that

> the regulations make no reference to support rights. Consequently, since support rights are distinguishable from inheritance rights, a surrender of support rights is not a surrender of "other marital rights," as that phrase is used in the regulations. A release of support rights by a wife constitutes a consideration in money or money's worth.[21]

Today, *Merrill*, Treasury Regulation section 25.2512-8, and Revenue Ruling 68-379 provide a road map for practitioners who wish to draft a prenuptial agreement and avoid any resulting transfers classifying as a taxable gift. There is simply no reason for a prenuptial agreement to include language that has no impact on consideration, and could result in a gift being made by the wealthier spouse. Prohibited language includes statements by which a spouse is waiving his or her rights "of dower or curtesy, or of a statutory estate created in lieu of dower or curtesy, or of other marital rights in the spouse's property or estate."[22]

A further minimization to the *Merrill's* impact is the marital gift tax deduction, which was introduced in 1948 ("1948 Act"),[23] three years after *Merrill* was decided. When enacted, the deduction was limited to fifty percent of the gift, and only when the gift was made to a spouse. Thus, even if the transfer by Mr. Merrill would have qualified for the marital deduction in the 1948 Act, the outcome would not have changed, only the size of the gift. However, the Economic Recovery Tax Act of 1981 ("1981 Act")[24] brought the unlimited marital deduction.

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19 Treas. Reg. § 25.2512-8.

20 *See* Estate of Herrmann v. Comm'r, 85 F.3d 1032, 1037 (2d Cir. 1996) (citing Rev. Rul. 12367, 1946-2 C.B. 166, 166-69).

21 Rev. Rul. 68-379, 1968-2 C.B. 414.

22 Treas. Reg. § 25.2512-8.

23 Revenue Act of 1948, Pub. L. No. 80-471, 62 Stat. 110 (1948) (codified as amended at I.R.C. § 812).

24 Economic Recovery Tax Act of 1981, Pub. L. No. 97-35, 95 Stat. 176 (1981) (codified as amended at I.R.C. § 1).

As such, there is simply no longer a reason for a taxpayer to make a taxable gift when transferring assets to a spouse. The fact that Mr. Merrill's transfer was in trust would not impact the applicability of the unlimited marital gift tax exemption, as the 1981 Act extends the deduction for "qualified terminable interest property."[25]

So what is the current impact of *Merrill* on prenuptial agreements? According to LearnVest.com, "the most common purpose for a prenup is to determine who gets what in the event of a divorce."[26] If one accepts that a prenuptial agreement is prepared to allocate property upon the dissolution of the marriage, there is no reason for any resulting transfer to generate a taxable gift. Section 2516 of the Code was enacted as part of the 1954 Code. It was designed to provide guidance on avoiding gift tax treatment on transfers between spouses in connection with divorce. The committee report stated, "under present law property settlements between spouses are not regarded as taxable gifts if the property settlement is incorporated in the decree of divorce. However, the gift tax status under present law of settlements not incorporated in the decree of divorce is uncertain."[27]

To comply with section 2516, taxpayers must comply with the following requirements: (i) a written agreement regarding the marital and property rights of the spouses and (ii) a final decree of divorce.[28] The final decree of divorce must be received within one year prior to or two years after the execution of the agreement. The applicable Treasury Regulation provides as follows:

> Section 2516 provides that transfers of property or interest in property made under the terms of a written agreement between spouses in settlement of their marital or property rights are deemed to be for an adequate and full consideration in money or money's worth and, therefore, exempt from the gift tax (whether or not such agreement is approved by a divorce decree), if the spouses obtain a final decree of divorce from each other within two years after entering into the agreement.[29]

There clearly does not seem to be a reason to use a prenuptial agreement, as in *Merrill*, to reference either party will be releasing marital rights in exchange for property. Furthermore, if the wealthier spouse

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25 *See* I.R.C. § 2523(f)(2).

26 Alden Wicker, *9 Things You're Embarrassed to Ask About Prenups*, LEARNVEST (July 2, 2013), https://www.learnvest.com/2013/07/9-things-youre-embarrassed-to-ask-about-prenups (last visited Dec. 5, 2016).

27 S. REP. NO. 83-1622, at 128 (1954).

28 Treas. Reg. §25.2516-1(a).

29 *Id.*

desires to transfer assets to the other spouse after they are married, the transfer will qualify for the unlimited marital deduction. Finally, if the prenuptial agreement is prepared to provide for the transfer of assets subsequent to divorce, *Merrill* has no application, as section 2516 will exclude such transfer from gift tax.