Federal Income Tax Consequences of Dissolving the Marital Community Upon Divorce

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Repository Citation
In his quest to achieve an equitable division of community property for his client, a practitioner may overlook the immediate and long-term tax ramifications which redound upon a termination of the matrimonial regime. The result of not giving due regard to federal tax consequences frequently will be the transformation of what was originally perceived to be a highly favorable distribution of assets into an unpropitious assumption of significant tax liabilities. A working knowledge of the tax implications in the division of community property is thus essential for the general practitioner.

The existing tax law regarding property settlements confected pursuant to the dissolution of marriage has developed jurisprudentially in the virtual absence of statutory guidance and has been criticized as being deficient in both its theory and its application. Fortunately, on June 30, 1983, legislation was introduced in the United States Congress which would comprehensively address marital property settlements and greatly simplify the current law. This note surveys the applications and shortcomings of the body of common law which currently governs community property divisions and examines the proposed legislative solution, which adopts the tax deferral treatment of equal divisions of community property and extends that nonrecognition principle to all property settlements, regardless of the state property law or the compensatory nature of the division.

Background

The Board of Tax Appeals in *Walz v. Commissioner* first addressed the question of whether a division of community property incident to a divorce constitutes a taxable transaction. The board held that no gain or loss results from such a partition on the basis that the transaction was

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* The legislation discussed in this note was incorporated, without amendment, within the Tax Reform Act of 1984, Publ. L. No. 98-369, which was signed by the President on July 18, 1984. As finally adopted, the Act incorporates substantially all of the suggestions advocated by the author.


3. Since 1942 known as the Tax Court of the United States.

4. 32. B.T.A. 718 (1935). The only contested issue in *Walz* concerned 400 shares of stock which were awarded to the wife pursuant a partition agreement. The stock had cost the community $16,881 but had a fair market value of only $6,650. Petitioner-husband deducted the $10,231 difference, but the court ruled in favor of the IRS in disallowing the deduction by finding that petitioner had received other community assets of equivalent value.
not a sale or exchange but was merely a "division" of property and that
gain or loss on the partitioned property "would depend upon its subse-
quent disposal by the respective parties."

The only rationale given by the board for its position was that the
respective parties were "only receiving that which was [theirs] already."6
This conclusion was clearly erroneous and has been criticized by a number
of commentators,7 for the parties received something quite different from
that which they had before the division; after the division the parties had
full ownership of specific assets, rather than their previous undivided one-
half interests in all the community property.8 In Walz,9 the husband gave
his undivided one-half interest in community stock in exchange for his
wife's relinquishing her one-half interest in other community assets of
equivalent value.

The limited statutory authority pertinent to such a transaction seems
to support a determination that a division of community property assets
constitutes a taxable event. Section 61(a)10 of the Internal Revenue Code
provides that gross income includes "all income from whatever source

5. Id. at 720.
6. Id. at 719-20.
7. See Commerce Clearing House, His, Hers or Theirs?—Federal Income Taxation
of Divorce Property Settlements ¶ 301-02 (1983); Halpern, Income Tax Effects of Com-
munity Property Divisions, 23 Cal. St. B.J. 128 (1948); Kaney, Federal Income Taxation
of Exchanges in Partition of Community Owned Property: Realization vs. Realism, 8 Fla.
St. U.L. Rev. 629 (1980); Seago, The Income Tax Consequences of Community Property
Divisions at Divorce, 13 Tax Adviser 402 (1982).
spouse owns a present undivided one-half interest in the community property," and art.
2337 states that "[a] spouse may not alienate, encumber, or lease to a third person his
undivided interest in the community or in particular things of the community prior to the
termination of the regime." See also arts. 2347 and 2349 for other limitations imposed
upon a spouse with respect to community property. Such limitations are of course removed
upon the partition of the community property when each party usually receives exclusive
ownership of specific assets. See La. R.S. 9:2801 regarding judicial partitions of community
property.

It is interesting to note that the IRS does not consider the distribution of property
held by tenants in common as a mere "division" of assets and therefore nontaxable. In
Rev. Rul. 79-44, 1979-1 C.B. 265, 266, the Service held that "[t]he transfer of interests
in real property held by tenants in common that resulted in the conversion of two jointly
owned parcels into two individually owned parcels is an exchange under section 1001(a)
note 26.
10. I.R.C. § 61(a) (1983). Unless otherwise indicated, all references to sections are to
the Internal Revenue Act of 1954, as codified and amended in title 26 of the United States
Code.

The comparable provision to section 61(a) under the Revenue Act of 1928 (the statutory
authority at the time Walz was decided) was section 22 which provided: "'Gross income'
includes . . . gains or profits and income derived from any source whatever." 45 Stat.
791, 797 (1928).
"derived" unless specifically exempted by a provision in the Code. Sections 1001(a) and (c) further provide that gain or loss on the sale, exchange or other disposition of property shall be fully recognized (i.e., included in gross income and taxed) except as otherwise provided by the Code. At the time of this writing, the Code provides no such specific exception for the nonrecognition of gain or loss upon a division of community property incident to a divorce. Perhaps the most enlightened and candid explanation of the tax deferral treatment of an equal division of community property upon divorce is that of Judge Hall of the Tax Court in the 1976 decision of Carrieres v. Commissioner, who recognized it as a "well-settled," "judge-made," "nonstatutory" exception to the general recognition rule of Section 1001.

The Supreme Court tangentially addressed the question of whether a division of community or coowned property constitutes a taxable event in its 1962 decision of United States v. Davis. Davis involved a property settlement agreement entered into by a Delaware couple prior to their divorce and pursuant to which the taxpayer transferred to his former wife appreciated property (stock) "'in full settlement and satisfaction of any and all claims and rights'" which she might have had against him. Mr. Davis contended that the transaction was analogous to a "nontax-

11. I.R.C. § 1001(a) and (c) (1983). The comparable provisions to sections 1001(a) and (c) under the Revenue Act of 1928 were sections 111(a) and (c) which provided:

(a) Computation of gain or loss - Except as hereinafter provided in this section, the gain from the sale or other disposition of property shall be the excess of the amount realized therefrom over the basis provided in section 113, and the loss shall be the excess of such basis over the amount realized.

(c) Amount realized - The amount realized from the sale or other disposition of property shall be the sum of any money received plus the fair market value of the property (other than money) received.

12. Congress is currently considering legislation which would add section 1041 to the Code to provide specifically for the nonrecognition of gain or loss on the transfer of property between spouses or former spouses incident to a divorce. See discussion at notes 110 et. seq. and accompanying text, infra.

13. 64 T.C. 959 (1975), aff'd per curiam, 552 F.2d 1350 (9th Cir. 1977), acq. in result, 1976-2 C.B. 1.

14. Id. at 963.

15. I.R.C. § 1002 from 1954 through 1976


17. A non-community property state. The eight community property states are Arizona, California, Idaho, Louisiana, New Mexico, Nevada, Texas, and Washington.


19. The court noted that "[u]nder Delaware law all the property transferred was that of the taxpayer subject to certain marital rights of the wife including a right of intestate succession and a right upon divorce to a share of the husband's property." Id. at 66 (emphasis added). It was these marital rights which the wife agreed to relinquish in exchange for the stock.
able division of property between two co-owners,"²⁰ but the Court concluded that the wife's rights in her husband's property under Delaware law did "not even remotely reach the dignity of co-ownership,"²¹ and held that the transfer of stock for the relinquishment of his wife's inchoate marital rights was a taxable transaction.²² The court nonetheless, for purposes of argument, accepted the premise that a division of property between two co-owners was nontaxable. The Court admitted that such a view does permit different tax treatment between community property and non-community property jurisdictions but determined that it was up to Congress to alleviate this disparity.²³

Equal Divisions of Community Property

General Rule

In the fifty-year period which has ensued since Walz,²⁴ judicial decisions²⁵ and administrative rulings²⁶ have reaffirmed the Board of Tax

²⁰. Id. at 69.
²¹. Id. at 70.
²². In determining that Mr. Davis recognized a taxable gain on the appreciated value of the stock (i.e., its fair market value over its cost basis), the court reasoned that in the absence of evidence to the contrary, "[i]t must be assumed . . . that the parties acted at arm's length and that they judged the marital rights to be equal in value to the property for which they were exchanged." Id. at 72.
²³. It is interesting to note that Mrs. Davis realized no gain on the transaction and took as her tax basis in the stock the amount which the court presumed her former husband had realized on the transfer (i.e., its fair market value). The court remarked in footnote 7 of the opinion that it was "administrative practice" to regard the release of marital rights in exchange for property or other consideration as a "nontaxable event as to the wife." Id. at 73. See Rev. Rul. 79-312, 1979-2 CB 29 and Rev. Rul. 67-221, 1967-2 C.B. 63. See also Commissioner v. Mesta, 123 F.2d 986 (3d Cir. 1941) and Commerce Clearing House, His, Hers or Theirs?—Federal Income Taxation of Divorce Property Settlements ¶ 211-13 (1983).
²⁴. 32 B.T.A. 718 (1935).
²⁵. Carrieres v. Commissioner, 64 T.C. 959 (1975), aff'd per curiam, 552 F.2d 1350 (9th Cir. 1977); Beth W. Corp. v. Commissioner, 350 F. Supp. 1190 (S.D. Fla. 1972), aff'd per curiam, 481 F.2d 1401 (5th Cir. 1973); Mills v. Commissioner, 12 T.C. 468 (1949) aff'd 183 F.2d 32 (9th Cir. 1950); Carson v. Commissioner 37 T.C.M. (CCH) 818, (1978); Davenport v. Commissioner, 12 T.C.M. (CCH) 856 (1953); Oliver v. Commissioner, 8 T.C.M. (CCH) 403 (1949).
²⁶. Rev. Rul. 76-83, 1976-1 C.B. 213. The IRS also acknowledged the "well established exception" to the general rule of section 1001 (see discussion at note 10 and 11 and
Appeals' determination that an equal division of community property is nontaxable. The Tax Court in Carrieres v. Commissioner summarized its position by noting that a nontaxable equal division of community property may be accomplished in three ways: by having each spouse receive (1) an undivided one-half interest in each community asset, (2) an equal number of units of fungible community assets, or (3) community assets worth one-half the aggregate value of the community estate. Furthermore, since an equal or "approximately equal" division of the community is considered a nontaxable partition of property, each party's bases in the assets received will be that of the former community.

Application

In determining whether a division of community property is substantially equal to warrant tax deferral treatment, the courts and the Internal Revenue Service concern themselves only with the net fair market value of the community assets which each spouse receives in comparison with the aggregate net value of the community estate. It is therefore the practitioner's responsibility during the negotiation and litigation process to consider the respective bases of the various community assets to ensure accompanying text, supra) of equal divisions of community property pursuant to a divorce and extended the exemption to marital divisions of jointly owned property in noncommunity states. Rev. Rul. 81-292, 1981-2 C.B. 158.

27. 64 T.C. 959 (1973), aff'd per curiam, 552 F.2d 1350 (9th Cir. 1977), acq. in result, 1976-2 C.B. 1.

28. Such an allocation is clearly nontaxable, for the property continues to be held in indivision and because each of the parties would have been previously taxed on one-half of the income used to acquire these assets (see U.S. v. Mitchell, 403 U.S. 190 (1971) and Poe v. Seaborn, 282 U.S. 101 (1930)); therefore, they are truly receiving only "that which was [theirs] already." Commissioner v. Walz, 32 B.T.A. 718, 719-20 (1935).

29. E.g., cash or shares of stock. See Commissioner v. Mills, 183 F.2d 32 (9th Cir. 1950). See also Commerce Clearing House, His, Hers or Theirs?—Federal Income Taxation of Divorce Property Settlements ¶ 302. But see discussion of distribution of property held by tenants in common at note 8, supra.

30. See generally the cases cited in note 25 supra. Though Walz involved a situation which would not have been characterized as an equal division of community property under a Carrieres analysis (see infra notes 90-103 and accompanying text), the discussion was limited to the 400 shares of RCA stock which the wife received in exchange for her husband's receipt of other community assets of equivalent value.

31. For analysis and discussion, see infra notes 54-72 and accompanying text.


33. See infra notes 54-62 and accompanying text regarding the de minimis rule.

34. See generally the cases cited in note 25, supra.

35. See generally the revenue rulings cited in note 26 supra.
that an "equal division" is in fact equitable for his client. For example, consider a hypothetical community estate consisting of the following assets:

<table>
<thead>
<tr>
<th>HYPOTHETICAL A</th>
<th>COMMUNITY BASIS</th>
<th>FAIR MARKET VALUE</th>
</tr>
</thead>
<tbody>
<tr>
<td>CASH</td>
<td>$60,000</td>
<td>$60,000</td>
</tr>
<tr>
<td>RESIDENCE</td>
<td>30,000</td>
<td>100,000</td>
</tr>
<tr>
<td>INVESTMENT PROPERTY</td>
<td>80,000</td>
<td>100,000</td>
</tr>
<tr>
<td>STOCK A</td>
<td>70,000</td>
<td>10,000</td>
</tr>
<tr>
<td>STOCK B</td>
<td>10,000</td>
<td>70,000</td>
</tr>
<tr>
<td></td>
<td>$250,000</td>
<td>$340,000</td>
</tr>
</tbody>
</table>

Assume the following two nontaxable partitions:

**Partition 1:**

<table>
<thead>
<tr>
<th></th>
<th>H</th>
<th>W</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>BASIS</td>
<td>FMV</td>
</tr>
<tr>
<td>CASH</td>
<td>$30,000</td>
<td>$30,000</td>
</tr>
<tr>
<td>RESIDENCE *</td>
<td>15,000</td>
<td>50,000</td>
</tr>
<tr>
<td>INVESTMENT PROPERTY *</td>
<td>40,000</td>
<td>50,000</td>
</tr>
<tr>
<td>STOCK A</td>
<td>35,000</td>
<td>5,000</td>
</tr>
<tr>
<td>STOCK B</td>
<td>5,000</td>
<td>35,000</td>
</tr>
<tr>
<td>TOTAL</td>
<td>$125,000</td>
<td>$170,000</td>
</tr>
</tbody>
</table>

* Each party holding an undivided one-half interest in these assets with the expectation of a subsequent sale and division of the proceeds.

Such a division of the community property is truly equal, for not only does each party receive one-half of the aggregate value of the community property, but each also receives one-half of the aggregate community basis; thus, neither party receives a disproportionate potential gain or loss.

**Partition 2**

<table>
<thead>
<tr>
<th></th>
<th>H</th>
<th>W</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>BASIS</td>
<td>FMV</td>
</tr>
<tr>
<td>CASH</td>
<td>$60,000</td>
<td>$60,000</td>
</tr>
<tr>
<td>RESIDENCE</td>
<td></td>
<td></td>
</tr>
<tr>
<td>INVESTMENT PROPERTY</td>
<td>80,000</td>
<td>100,000</td>
</tr>
<tr>
<td>STOCK A</td>
<td>70,000</td>
<td>10,000</td>
</tr>
<tr>
<td>STOCK B</td>
<td></td>
<td></td>
</tr>
<tr>
<td>TOTAL</td>
<td>$210,000</td>
<td>$170,000</td>
</tr>
</tbody>
</table>
The great disparity between the aggregate basis of the assets which each spouse receives makes it quite evident that, though the above partition will be considered "equal" for tax deferral treatment, it is grossly inequitable from the point of the view of W, who will have to recognize a substantial capital gain on the subsequent disposition of her property. H, on the other hand, will realize a net tax benefit upon the subsequent disposition of his property.

**Other Tax Characteristics Retained**

Incident to the carryover of the community basis, it should logically follow that other tax attributes of the individual assets received by the parties will be retained upon equal division of the community estate. The Internal Revenue Service in Revenue Ruling 81-292 recognized the applicability of section 1223(2) in determining that the holding period of the assets which each spouse receives includes the period in which the property was held jointly. Any potential "recapture" should also be carried over with the particular asset and not realized until a subsequent disposition, since the recapture provisions apply to a disposition as opposed to a division of property. Additionally, as a result of the assumption that the partition is only a division of property in which each spouse merely receives that which was previously his, the "assignment of income" doctrine should not apply. Thus, pre-divorce earnings in the

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37. Based on the assumption that the values of the individual assets will remain relatively stable.
39. Id. at 159.
41. Id.
42. See supra note 4 and accompanying text.
43. Generally, the assignment of income doctrine provides that the taxpayer cannot shift tax liability to another by assigning the right to receive income, or to use the metaphor of Justice Holmes, the tax must be borne by the tree which bears the fruit. Lucas v. Earl, 281 U.S. 111, 115 (1930). See generally, Lyon & Eustice, Assignment of Income: Fruit and Tree as Irrigated by the P.G. Lake Case, 17 Tax L. Rev. 295 (1962); Eustice, Contract Rights, Capital Gain, and Assignment of Income—the Ferrer Case, 20 Tax L. Rev. 1 (1964). In community property states each spouse is taxed on one-half of the income earned by
form of receivables of a cash basis taxpayer may be retained by either party without any immediate tax consequences to the other.\textsuperscript{44}

To illustrate the practical significance of the undivided assets' retention of community characteristics after division, consider a hypothetical community estate with the following assets:

<table>
<thead>
<tr>
<th>HYPOTHETICAL B</th>
<th>COMMUNITY FMV</th>
</tr>
</thead>
<tbody>
<tr>
<td>RESIDENCE</td>
<td>$ 60,000 $ 90,000</td>
</tr>
<tr>
<td>SECTION 1245 PROPERTY*</td>
<td>30,000 60,000</td>
</tr>
<tr>
<td>SECTION 1250 PROPERTY**</td>
<td>25,000 30,000</td>
</tr>
<tr>
<td>ACCOUNTS RECEIVABLE (cash basis)</td>
<td>0 50,000</td>
</tr>
<tr>
<td>STOCK A (purchased 8/1/82)</td>
<td>50,000 40,000</td>
</tr>
<tr>
<td>STOCK B (purchased 1/1/80)</td>
<td>5,000 10,000</td>
</tr>
<tr>
<td>TOTAL</td>
<td>$ 170,000 $ 280,000</td>
</tr>
</tbody>
</table>

* Depreciable personal property with a recomputed basis of $50,000 (see section 1245(a)(2)) and subject to a potential investment tax credit Recapture (see section 47) of $2,000.

** Depreciable reality with recapturable depreciation of $5,000. Assume the community was divided on December 31, 1982, in the following manner:

Due to the uncertainty in this area, it is advisable, when one spouse receives a disproportionate share of community receivables pursuant to a property settlement agreement, to provide in the agreement for the liabilities of the parties in the event the assignment of income doctrine is held applicable.

Because each party receives assets with an aggregate fair market value equivalent to one-half the value of the community estate, the Internal Revenue Service and the courts will consider the partition to be equal and nontaxable. But assuming H and W (each in a 50 percent tax bracket) sold their respective assets on January 5, 1983, note the inequitable tax consequences which would result.

All three of W's assets are capital assets.\(^45\) The sale of the residence and Stock B will result in a long-term capital gain of $35,000.\(^44\) The sale of Stock A will result in a short-term capital loss of $10,000.\(^47\) Consequently, W will realize a net capital gain of $25,000\(^48\) on the disposition of her assets; she will thus have to pay an additional $5,000\(^49\) in income taxes in 1984.

The sale by H of the section 1245 property will result in the recognition of ordinary income in the amount of $20,000,\(^50\) long-term capital gain in the amount of $10,000,\(^51\) and an investment tax credit recapture

\[\text{Net capital gain} = \text{Amount realized} - \text{Recomputed basis} = 60,000 - 50,000 = 10,000\]

\[\text{Ordinary income, see § 1245(a)} = 20,000\]

\[\text{Total ordinary income to be recognized on the disposition} = 20,000 + 10,000 = 30,000\]

\[\text{Increased tax liability} = \text{Net taxable gain} \times \text{tax rate} = 10,000 \times 0.50 = 5,000\]

\[\text{Ordinary income} = 20,000\]

\[\text{Total capital gain to be recognized} = 10,000\]
of $20,000. The sale of the section 1250 property and the accounts receivable will cause H to recognize an additional $55,000\textsuperscript{2} of ordinary income. Upon the disposition of the above assets H will thus incur an additional income tax liability of $41,500\textsuperscript{3} for 1984. In effect, H received $36,500 less than his former wife as a result of the "equal" partition. Counsel should thus be well-informed of the nature of the assets which comprise the community estate and the potential tax consequences as to each to insure an equitable result for his client.

Unequal Divisions of Community Property

Approximately Equal Divisions—The De Minimis Rule

In what may have been a response to the Tax Court's concern about a potential "'cliff effect' under which the use of even $1 of separate property to remedy a disparity in the division of community property would render entirely inapplicable the protection of the nonstatutory nonrecognition principle, and . . . frustrate the beneficial policy underlying that principle,"\textsuperscript{4} the IRS in Revenue Ruling 76-83\textsuperscript{5} acknowledged the previous Tax Court position on the subject\textsuperscript{6} and maintained that when the aggregate value of the community property received by each spouse is approximately equal, no gain or loss will be recognized. Unfortunately, neither the Service nor the courts have established guidelines to facilitate the determination of what constitutes an approximately equal allocation.\textsuperscript{7}

\textsuperscript{52.} $50,000 on the receipt of payment on the account receivables plus $5,000 § 1250 recapture.
\textsuperscript{53.} Net capital gain (assuming no additional dispositions of capital assets for 1983)
  - Capital gain deduction $10,000
  - Net taxable gain $6,000
  - Add: Ordinary income recognized on the dispositions $4,000
  - Net taxable income $75,000
  - 50% tax rate 4,000
  - Tax liability before recapture of tax credits $39,500
  - Investment tax credit recapture 2,000
  - Increased tax liability $41,500

\textsuperscript{54.} Carrieres v. Commissioner, 64 T.C. 959, 965 (1975).
\textsuperscript{55.} 1976-1 C.B. 213. Advice was requested as to the tax consequences of the partitioning of a $300,000 community estate pursuant to which the husband would receive community property valued at $150,258 and the wife would receive the remainder plus her husband's note for $258 to equalize the division. The Service noted that "technically the husband's note could be viewed as a sale or exchange by one spouse to the other of property rights in some of the community estate" but ruled that it was not sufficient to preclude the division from being approximately equal and nontaxable.
\textsuperscript{56.} See Edwards v. Commissioner, 22 T.C. 65 (1954).
\textsuperscript{57.} The Internal Revenue Service in Revenue Ruling 78-83 did note the following factors in its decision: (1) the taxpayers intended to effect an equal division of their community property; (2) certain community assets could not feasibly be partitioned because their
A 1978 Tax Court memorandum opinion contains the most liberal application to date of the *de minimis* rule. In *Carson v. Commissioner*, the Tax Court sustained the Internal Revenue Service determination that a division of the community property was not "substantially disproportionate and therefore should be characterized as a nontaxable partition of community property" when the wife had received 53.8 percent of the community assets and the husband had received the remaining 46.2 percent of the community property. The partition in *Carson* was made pursuant to a court-ordered property settlement which expressed an intention "to achieve a substantially equal division of the community property"; such an expression of intent incident to arm's length negotiations appears to be a significant consideration of both the Service and the courts in their determination of whether a division is substantially equal to warrant application of the nonrecognition rule.

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58. 37 T.C.M. (CCH) 818 (1978).

59. Id. at 821. The facts of *Carson* are somewhat complicated. Pursuant to the property settlement, the wife received $94,350 worth of community assets, a $10,000 personal note from her husband in exchange for her one-half share of the goodwill in her husband's medical practice, and $1,488 of her husband's separate property purportedly to equalize the division. The husband received $80,925 in community assets, plus the $10,000 of goodwill he purchased from his wife, and $26,400 in accounts receivable which he asserted was community property but which the court determined to be his separate property under California law. Disregarding the $26,400 in accounts receivable and the wife's $10,000 share of goodwill which was deemed subject to a taxable sale or exchange, the wife effectively received $94,350 (53.8%) of the community assets and the husband received $80,925 (46.2%) of the community property. The petitioner contended that the award of his separate property caused the settlement to be substantially unequal and therefore a taxable transfer entitling him to recognize a capital loss, but the court held that based on the above allocation of the community property, the taxpayer had not met his burden of proving incorrect the respondent's determination that the division was not substantially disproportionate and therefore nontaxable.

60. Id. at 819.

61. See supra note 57.

62. In *Carson*, the community consisted of items other than those enumerated in note 59, supra, which were largely of a personal nature and to which no agreed monetary value was assigned; the Tax Court simply noted that these items were apparently divided equally. See also Harrah v. Commissioner, 70 T.C. 735 (1978), Davidson v. Commissioner, 43 T.C.M. (CCH) 854 (1982) and Davenport v. Commissioner, 12 T.C.M. (CCH) 856 (1953), which demonstrate the emphasis which the Internal Revenue Service and the courts place on the arm's length nature of a community property partition and the parties' expression that they consider the division to be equal, even in the absence of evidence as to the value of the assets. Such a reliance on the parties' expression of intent to allocate the community property equally between themselves is warranted because, even though no gain or loss will be recognized on the transaction, there will also be no adjustment in basis upon an equal division; thus, the potential gain on appreciated property is merely postponed until a subsequent disposition by the spouse acquiring such property.
Fully Taxable Divisions

Although both Revenue Ruling 76-83\(^\text{63}\) and Carson\(^\text{64}\) concluded that the respective divisions of community property were approximately equal and therefore properly characterized as nontaxable partitions, it is not at all clear that the the two opinions addressed the same issue.\(^\text{65}\) The Tax Court in Carriers\(^\text{66}\) had noted two categories of taxable divisions: one is a division in which a spouse receives property having an "aggregate value equal to more than half the value of the entire community property,"\(^\text{67}\) and the other is one in which "one spouse gives his note or separate property for all or substantially all of the other spouse's community property."\(^\text{68}\) Arguably, Carson\(^\text{69}\) contemplated only the former situation, while the Revenue Ruling\(^\text{70}\) addressed the latter. Such a conclusion is warranted in light of the court's determination that the division was taxable to the extent that Mrs. Carson received her former husband's $10,000 personal note in exchange for her one-half interest in the goodwill of the medical practice; thus, the court would likely have made a similar determination\(^\text{71}\) had the wife made an offsetting payment for the $6,713 disparity in the distribution of the community assets.\(^\text{72}\)

The first of the two taxable divisions enumerated above has given commentators and practitioners some concern,\(^\text{73}\) for it suggests that even

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\begin{itemize}
  \item 63. 1976-1 C.B. 213.
  \item 64. 37 T.C.M. (CCH) 818 (1978).
  \item 65. See supra text accompanying notes 58-60.
  \item 66. 64 T.C. 959 (1975), aff'd per curiam, 552 F.2d 1350 (9th Cir. 1977), acq. in result, 1976-2 C.B. 1.
  \item 67. Id. at 964.
  \item 68. Id.
  \item 69. See supra note 59.
  \item 70. One commentator views the ruling as "merely giving assurance that de minimis amounts of separate property will not necessitate complex gains and basis calculations." Seago, The Income Tax Consequences of Community Property Divisions at Divorce, 13 Tax Adviser 402, 408 n.59 (1982).
  \item 71. The opinion in Carriers provides: "To the extent . . . that one party receives separate cash or other separate property, rather than community assets, . . . he has sold or exchanged such portions and gain, if any, must be recognized thereon." 64 T.C. 959, 965-66 (1975). See Commissioner v. Showalter, 33 T.C.M. (CCH) 192 (1974), where a $10,000 offsetting payment was deemed to have been made in exchange for the wife's share of community accounts receivable.
  \item 72. See discussion of partially taxable divisions, infra at notes 90-103 and accompanying text. If it is contemplated that one party, without receiving any additional consideration, is to receive assets of slightly less value than the assets retained by the other, then it would be advisable that no value be placed on the former community assets and have the property settlement agreement provide: "It is the intention and agreement of the parties that the division of community property between them is and shall be equal in value . . . ." Harrah v. Commissioner, 70 T.C. 735, 742 (1978). Under such a situation if the parties can demonstrate a good faith attempt to achieve an equal division, Rouse v. Commissioner, 6 T.C. 908, 913 (1946), then it is highly unlikely that the Service will question the partition as not being an equal partition. See supra note 62.
  \item 73. See Parsons and Vaughan, Income Tax Considerations in Divorce Negotiations,
in the absence of additional consideration, a community property division may be deemed taxable simply because it results in a disproportionate distribution of community assets. The basis for this concern is the implication in the Supreme Court's Davis decision that, in the absence of strong evidence to the contrary, courts will presume that the party receiving less than his proportionate share of community property received consideration of equal value. This apprehension is exacerbated by Revenue Ruling 74-347, which determined that an unequal division of jointly-owned property incident to a divorce in a non-community state constituted a taxable exchange of a portion of the husband's jointly-owned property for the wife's marital rights in his separate property. Revenue Ruling 74-347 and the underlying rationale of Davis, however, are simply not applicable in community property states which do not recognize "inchoate marital rights." It is also comforting to note that in the ten-year history of Revenue Ruling 74-347, neither the Internal Revenue Service nor the courts have applied the ruling in any published opinion concerning a division of community property. Furthermore, the practitioner should find solace from a strict reading of the Carrieres dicta regarding the two types of taxable transactions by reviewing the three cases cited in support of the position; all three cases addressed situations in which one spouse exchanged his separate property for the other spouse's interest in community assets. Therefore, the Tax Court more accurately restated the jurisprudence pertinent to disproportionate divisions of community property in Carson, three years after its decision in Carrieres, when it stated that a substantially unequal division of community property is a taxable sale or exchange "if coupled with payment from one spouse's separate property," and then only "[t]o the extent the division is unequal." Consequently, when the parties agree to a disproportionate division of community property, it is unlikely that either the IRS or the courts will consider the division to be a taxable transaction in the absence of evidence that additional consideration (e.g., separate property or the release of marital rights) was received in exchange for the property settlement agreement.

74. 370 U.S. 65 (1962). See discussion supra at note 22 and accompanying text.
76. For discussion of Davis, see supra notes 16-22 and accompanying text.
77. Long v. Commissioner, 173 F.2d 471 (5th Cir. 1949), cert. denied, 338 U.S. 818 (1949); Rouse v. Commissioner, 159 F.2d 706 (5th Cir. 1947), and Johnson v. United States, 135 F.2d 125 (9th Cir. 1943).
78. The Tax Court in Rouse v. Commissioner, 6 T.C. 908, 913 (1946), aff'd, 159 F.2d 706 (5th Cir. 1946) noted that whether or not there is a mere partition or a sale depends on the facts of the particular situation; i.e., whether "it appears that the parties to the agreement chose to settle their property rights by bargain and sale rather than by partition or division." (emphasis added).
79. See, Commerce Clearing House, His, Hers or Theirs?—Federal Income Taxation of Divorce Property Settlements ¶ 501-518. See also, Note, Taxation of Divorce Settlements
The second of the two classifications of taxable divisions of community property recapitulated in Carrieres pertains to allegedly equal divisions of community property in which one spouse gives his separate property for "all or substantially all" of the other spouse's interest in the community property.80 When all of the community assets are set aside to one spouse in the taxable division, "the transferor spouse is deemed to have sold or exchanged his community interest in the asset[s] to the transferee spouse, and gain realized to such transferor equals one-half of any excess over the community's basis of the fair market value of the asset at the time of the transfer."81 To illustrate such a taxable transaction, consider the fact situation which confronted the Tax Court in Commissioner v. Brown.82 In that case the principal asset of the community was a ranch which could not be partitioned feasibly. Mrs. Brown eventually agreed to relinquish her one-half interest in the ranch for $150,000, which represented "the best bargain she could drive in the circumstances."83 Since the $150,000 was the separate property of her husband, she was deemed to have sold her one-half interest in the ranch for $150,000; thus, she had to report a capital gain in the amount by which the $150,000 exceeded one-half of the community basis in the ranch. Consequently, Mr. Brown's cost basis in the ranch after the above transaction would consist of one-half of the community basis in the ranch for his one-half interest, plus the amount of separate property ($150,000) expended to acquire his former wife's interest in the asset.84

80. 64 T.C. 959, 964 (1975).
81. Id. at 964-65.
82. 12 T.C.M. (CCH) 948 (1953).
83. Id. at 952.

In May, the principal asset of the community was the $400,000 residence that had been awarded to the husband incident to a divorce decree. To equalize the division, the decree directed the husband to pay the wife $200,000 from his separate funds. The Tax Court held that the conveyance of the wife's community interest in the residence to her husband was a taxable event, and the divorce decree "merely [took] the place of the agreement they were unable to reach without the court's aid." The court further commented: "The net
The courts\(^8\) have formulated no precise test for determining when a property settlement agreement amounts to a \("\text{virtual sale}\"\)\(^6\) of a spouse's interest in community assets; rather, they focus on such factors as the disparity in the community assets received by the parties,\(^7\) whether the result was \("\text{bargained}\"\)\(^8\) for, and the amount of separate property used to equalize the division.\(^9\)

**Partially Taxable Divisions—The Carrieres Case**

The Tax Court's decision in *Carrieres v. Commissioner*\(^6\) was the first to hold expressly that a division of community property may be partially taxable. The court found that \("[t]o the extent . . . that one party receives [pursuant to a divorce decree] separate cash or other separate property, rather than community assets, in exchange for portions of his community property, he has sold or exchanged such portions and gain, if any, must be recognized thereon.\")\(^8\)

The divorcing parties in *Carrieres*, unable to agree on a division of the community property, petitioned the divorce court to settle the matter. The wife (petitioner) had wanted to retain her community interest in the family business, Sono-Ceil Company. Her husband requested the court to give him a one-hundred percent interest in the business and allow him to make an equalization payment to compensate his wife for the disproportionate division that would result. The court decided in the husband's favor and divided the property as follows:


\(^7\) In *Edwards*, the husband had received the \("\text{great bulk}\"\) of the community property pursuant to the settlement agreement, while his wife received only two items of small value. Id at 69.

\(^8\) In *Edwards*, the Tax Court stressed that the petitioner (wife) was insistent on receiving cash for her share of the community because she \("\text{didn't know anything about business}\"\) and did not want the responsibility of having any interest in the two principle assets of the community, \(i.e.,\) her husband's business and real estate investments. See also note 83 supra and accompanying text. Id.

\(^9\) The Tax Court in *Showalter v. Commissioner*, 33 T.C.M. (CCH) 192, 195 (1974) stated: \("A note or cash given out of the separate property of one of the spouses to the other as part of the division of property is indicative that something more than a mere division of community property has occurred,"\) and cited *Edwards* in support of this proposition.

\(^90\) 64 T.C. 959 (1975), aff'd per curiam, 552 F.2d 1350 (9th Cir. 1977), acq. in result, 1976-2 C.B. 1.

\(^91\) Id. at 965-66. On petitioner's appeal, the Ninth Circuit concluded that the Tax Court's opinion was \("\text{sound}\"\) and \("\text{affirm[ed] on the grounds therein stated.}\"\)
To equalize the partition, the Superior Court ordered the husband
to make an offsetting payment of $89,620 to his wife. On July 31, 1968,
he did so with a lump sum payment, of which $13,112 was from his
share of the community cash. On the next day, his wife delivered to him
her interest in the 4,615 shares of Sono-Cell stock.

The Tax Court concluded that the above transaction was a hybird—
neither totally taxable as contended by the Government, nor entirely tax-
free as urged by the petitioner. The court found “no reason why the
use of separate cash to purchase part of the community should preclude
the application of the nonrecognition principle to the extent of the value
of the community property retained by the spouse.”

In determining which community assets were “sold,” i.e., delivered
for separate property, and which community assets were “divided,” i.e.,
subject to tax deferral treatment, the court established as a general rule
that the courts are to look first to the expressed intent of the parties. The court thus determined that the parties clearly intended a purchase

92. The difference between the petitioner’s one-half interest in the community property ($194,059) and the value of the community assets she received pursuant the property settlement ($104,439).
93. Petitioner was originally to receive her husband’s note for $89,620, but the parties subsequently revised the property settlement with the divorce court’s approval to provide that she would receive a lump sum payment instead.
94. The Government argued that the disposition of the wife’s interest in the Sono Cell Co. Stock was fully taxable to her thus requiring the recognition of gain to the extent that one-half of the fair marked value of the stock ($120,500) exceeded one-half of the community basis.
95. Petitioner argued that the division was a nontaxable partition of community rather than a sale due to the intent of the parties to divide the community equally.
96. 64 T.C. 959, 965 (1975).
97. Id. at 966.
and sale of the petitioner's interest in the Sono-Ceil stock to the extent that she received separate property from her husband. Consequently, of petitioner's $120,500 interest in the Sono-Ceil stock, she was deemed to have sold $76,508 (63.5 percent of $120,500) of her equity in the stock for her husband's separate property and divided the remainder ($43,992) in a nontaxable partition of community property. Her gain would be calculated as follows:

<table>
<thead>
<tr>
<th>PERCENTAGE ALLOCATION</th>
<th>PETITIONER'S INTEREST</th>
<th>PETITIONER'S BASIS*</th>
</tr>
</thead>
<tbody>
<tr>
<td>Sono-CEIL Co. STOCK</td>
<td>$120,000</td>
<td>50,000</td>
</tr>
<tr>
<td>PERCENTAGE DEEMED TAXABLE</td>
<td>x 63.5</td>
<td>x 63.5</td>
</tr>
<tr>
<td>AMOUNT RECOGNIZED</td>
<td>$76,508</td>
<td>$31,750</td>
</tr>
</tbody>
</table>

* The opinion failed to disclose the community basis in the Sono Ceil stock; for purposes of illustration, assume a total community basis in the stock of $100,000.

The husband's basis in the 4,615 shares of stock he received pursuant to the divorce decree would consist of (1) one-half of the community basis for his one-half interest in the stock, (2) that portion of the community basis in the stock which relates to the interest transferred by petitioner in exchange for his interest in other community assets, and (3) his cost.

---

98. The $89,620 offsetting payment less that portion of which was made from her husband's share in the community bank accounts ($13,112). See supra note 93 and accompanying text.

99. In essence the Tax Court perceived the property settlement as consisting of two transactions which occurred simultaneously, the first of which being an equal, nontaxable division of community property.

<table>
<thead>
<tr>
<th>CASH</th>
<th>PETITIONER</th>
<th>HUSBAND</th>
</tr>
</thead>
<tbody>
<tr>
<td>$ 28,291</td>
<td>$ 2,067</td>
<td></td>
</tr>
<tr>
<td>RENTAL PROPERTY</td>
<td>27,500</td>
<td>27,500</td>
</tr>
<tr>
<td>Sono-CEIL CO. STOCK</td>
<td>76,508</td>
<td>164,492</td>
</tr>
<tr>
<td>OTHER COMMUNITY ASSETS</td>
<td>61,760</td>
<td></td>
</tr>
<tr>
<td>TOTAL</td>
<td>$194,059</td>
<td>$194,059</td>
</tr>
</tbody>
</table>

* Remember, $13,112 of this amount consists of what was originally allocated to H, but was subsequently awarded the petitioner pursuant to the amended property settlement. See note 98, supra.

The second transaction was the sale of petitioner's share in the Sono-Cell Co. stock to her former husband.
in separate property for that portion of his wife's interest in the stock deemed to have been purchased in a taxable event. 100

_Carrieres_ is a highly significant decision for it affords the practitioner the opportunity to structure property settlements with a fair degree of certainty as to the tax ramifications of an unequal division of community property. If the community property is to be divided disproportionately between the spouses, then the property settlement should stipulate clearly the particular assets transferred by one spouse in exchange for separate consideration from the other; 101 otherwise, an unintended and undesired tax consequence may result. 102 To minimize the tax exposure in such a transfer, high basis capital assets usually should be designated for this purpose. 103

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100. Assuming a community basis of $100,000 in the 4,615 shares of Sono-Cell Co. stock, husbands' basis in the stock would consist of the following amounts:

(1) $ 50,000
(2) 18,250* (36.5% of $50,000)
(3) 76,508 (see note 98, supra, and accompanying text).

$144,758 Husband's total basis in the stock

* The interest transferred by petitioner in a nontaxable exchange for other community assets was $43,992 ($120,500 - $76,508) or 36.5% of her interest in the stock.

101. See supra note 97 and accompanying text.

102. In _Siewert_ v. Commissioner, 72 T.C. 326 (1979), petitioner (husband) received community property with a net value of approximately $2,000,000. His wife received the remaining community assets valued at approximately $700,000, and $200,000 of her husband's separate property ($100,000 cash and a $100,000 note). Petitioner contended that the above transaction was a mere division of community property and therefore nontaxable. In the alternative, he cited _Carrieres_ in support of the proposition that the transaction was a substantially equal division of the community property except for the ranch (valued at $900,000) and that only his wife's interest in it was purchased.

The court dismissed both contentions, and as to the latter, it stated: "We have carefully weighed the evidence presented in this respect and have concluded that it would not support a realistic finding to that effect." Id. at 337 n.5. Therefore, a clear delineation as to which assets are "divided" and which assets are "sold," should be made in property settlements which provide for an unequal distribution of the marital community.

The court in _Siewert_ held that since petitioner received substantially more than half of the community and agreed to pay large sums to his wife from his separate property or income, the transaction was one which required a "basis adjustment." Id. at 333. Petitioner's new basis in the assets acquired in the division was then calculated to consist of (1) one-half of the community basis in these assets, (2) the $200,000 in separate property and notes which he gave his wife, (3) the fair market value (approximately $357,000) of his one-half interest in the assets which his wife received, and (4) his wife's half interest of the community liabilities (approximately $80,000) which he assumed.

For a more extensive analysis of the _Siewert_ decision and the concerns it raises, see Asimow, _Property Divisions in Marital Dissolutions_, 35 Major Tax Plan. ¶ 300, at ¶¶ 310-11 (1983).

103. Assume a marital community consisting of the following assets:

<table>
<thead>
<tr>
<th>ASSET</th>
<th>BASIS</th>
<th>FMV</th>
</tr>
</thead>
<tbody>
<tr>
<td>A</td>
<td>$10,000</td>
<td>$10,000</td>
</tr>
<tr>
<td>B</td>
<td>5,000</td>
<td>10,000</td>
</tr>
<tr>
<td>C</td>
<td>5,000</td>
<td>10,000</td>
</tr>
</tbody>
</table>
Transfers between Husband and Wife - IRC Sections 267 and 1239

Once a transfer of community property is deemed a taxable event, sections 267 and 1239 will become operative unless the division occurs after the judgment of divorce or separate maintenance\(^4\) becomes final. Section 267 precludes the recognition of losses from sales or exchanges of property between spouses. The Tax Court\(^5\) has held that this provision applies to unequal divisions of community property which occur prior to or simultaneously with the execution of a final divorce decree. Therefore, if the parties desire to structure the property settlement to provide for a deductible loss, the agreement must state that it shall not become effective until after the divorce.

Section 1239 currently\(^6\) provides that gain recognized on the sale or exchange of depreciable property between husband and wife shall be treated as ordinary income rather than as a capital gain. The application of Section 1239 to divorce property settlements executed prior to a final decree\(^7\) of divorce has proven to be a trap for the unwary which may have disastrous consequences.

If pursuant a property settlement, W is to receive B and her husband’s personal note for $5,000, and H is to receive A and C, then the settlement agreement should stipulate that the $5,000 personal note was received in exchange for W relinquishing her interest in Asset A. By drafting the agreement in such a manner, the parties will avoid recognition of gain on the division.

104. I.R.C. § 143(a) (1982) provides: “An individual legally separated from his spouse under a decree of divorce or of separate maintenance shall not be considered as married.” See Garsaud v. Commissioner, 28 T.C. 1086 (1957), where it was held that a Louisiana couple were not married for income tax purposes after a judgment of separation from bed and board had been rendered.

105. In Siewert v. Commissioner, 72 T.C. 326 (1979), the property settlement agreement provided that its execution was contingent upon the granting of a divorce between the parties. The court held that the sale transaction effected pursuant to the agreement occurred simultaneously with the execution of the final judgment; thus, section 267 applied to the transaction.


107. Treas. Reg. § 1.1239-1(c) (1978) provides that if a taxpayer is “legally separated from his spouse under an interlocutory decree of divorce, the taxpayer and his spouse shall not be treated as husband and wife, provided the sale or exchange is made pursuant to the decree and the decree subsequently becomes final.” Though Louisiana law does not expressly provide for an “interlocutory decree” of divorce, Civil Code article 2375 provides: “A judgment decreeing separation of property terminates the regime of community property retroactively to the day of the filing of the petition, without prejudice to rights validly acquired in the interim between filing of the petition and rendition of judgment.” Therefore, a petition of divorce filed in Louisiana should be deemed equivalent to an interlocutory decree of divorce for purposes of § 1239 in light of Treas. Reg. § 1.1239-1(c) (1978). But see Brent v. Commissioner, 630 F.2d 356 (5th Cir. 1980) in which the court held that, due to the requirement of annualizing income for federal income tax purposes, a Louisiana spouse was subject to taxation on one-half of the income earned by her former husband but never received by her, despite the pendency of a suit for divorce which was eventually granted during the following year.
In *Deyoe v. Commissioner*, a separated California couple, who had filed for a divorce, entered into a property settlement which was effective upon execution and which provided that petitioner would quitclaim her entire community interest in the family ranch to her husband. The settlement was memorialized in a written agreement executed on June 18, 1969. A final decree of divorce was granted on August 6, 1969, and on August 27, the deed transferring petitioner's interest in the ranch was signed and acknowledged. The court held that, as a result of the transfer of the benefits and privileges of ownership, the sale was completed no later than the date of the execution of the written agreement (two months before the divorce). Therefore, Section 1239 applied to the conveyance and required the recognition of ordinary income rather than capital gain. To avoid such an unpleasant result, the property settlement agreement should state explicitly that it is only executory and will not take effect until after a final decree of divorce has been rendered.

**Proposed Legislative Reform**

The Supreme Court rendered its *Davis* decision in 1962. Four years later, the American Bar Association recommended to the Congress that it legislatively overrule *Davis* by amending the Internal Revenue Code to provide that "transfers of property . . . in pursuance of a divorce or property settlement agreement should not give rise to the recognition of income or gain or to a change in the basis of the transferred property." On June 30, 1983, legislation was introduced in Congress to do essentially just that.

The "Domestic Relations Tax Reform Act of 1983" would amend the Internal Revenue Code by adding a new Section 1041. Under this

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109. In *duPont v. Commissioner*, 37 T.C.M. (CCH) 115 (1978), a property settlement agreement was signed the day before the parties were divorced. The court concluded in light of the parties' intent and Montana law, and because the agreement, the deed, and the bill of sale were not delivered until after the divorce, the transfer of the property did not take place until after the divorce.
111. 19 Bulletin of the Section of Taxation of the American Bar Association No. 4, 62 (1966).
113. As reported out of the Committee on Ways and Means of the United States House of Representatives on October 20, 1983.
114. Amending Part III of subchapter O of chapter 1 (regarding nontaxable exchanges), reprinted below.

SEC. 1041 TRANSFERS OF PROPERTY BETWEEN SPOUSES OR INCIDENT TO DIVORCE.

(a) GENERAL RULE. - No gain or loss shall be recognized on a transfer of property from an individual (or in trust for the benefit of) -
section, no gain or loss would be recognized on the transfer of property between spouses "incident to a divorce" (defined as those transfers which are related to the divorce and occur within one year after the date on which the marriage ceases). The transfer would be treated for income tax purposes as a gift rather than as a taxable exchange, and the transferor's basis would be carried over to the receiving spouse even if the property had depreciated in value.

To dispel any doubt as to the applicability of the broad language of Section 1041 to divisions (unequal as well as equal) of community property incident to a divorce, the Committee on Ways and Means of the House of Representatives provided in its committee report:

This nonrecognition rule applies whether the transfer is for the relinquishment of marital rights, for cash or other property, for the assumption of liabilities in excess of basis, or for other consideration and is intended to apply to any indebtedness which is discharged. Thus, uniform Federal income tax consequences will apply to these transfers notwithstanding that the property may be subject to differing state property laws.

Application of Proposed Section 1041

By adopting the nonrecognition rule of equal divisions of community property and extending its application to all "transfers of property" between spouses incident to their divorce, section 1041 would effectively overrule the jurisprudence requiring the recognition of gain or loss on unequal divisions of community assets and would amplify the basis con-
Considerations of equal divisions of community property. For example, consider the facts of Hypothet B discussed earlier:

<table>
<thead>
<tr>
<th></th>
<th>COMMUNITY BASIS</th>
<th>FMV</th>
</tr>
</thead>
<tbody>
<tr>
<td>RESIDENCE</td>
<td>$ 60,000</td>
<td>$ 90,000</td>
</tr>
<tr>
<td>SECTION 1245 PROPERTY*</td>
<td>30,000</td>
<td>60,000</td>
</tr>
<tr>
<td>SECTION 1245 PROPERTY**</td>
<td>25,000</td>
<td>30,000</td>
</tr>
<tr>
<td>ACCOUNTS RECEIVABLE</td>
<td>0</td>
<td>50,000</td>
</tr>
<tr>
<td>(cash basis)</td>
<td></td>
<td></td>
</tr>
<tr>
<td>STOCK A</td>
<td></td>
<td></td>
</tr>
<tr>
<td>(purchased 8/1/84)</td>
<td>50,000</td>
<td>40,000</td>
</tr>
<tr>
<td>STOCK B</td>
<td></td>
<td></td>
</tr>
<tr>
<td>(purchased 1/1/80)</td>
<td>5,000</td>
<td>10,000</td>
</tr>
<tr>
<td></td>
<td>$170,000</td>
<td>$280,000</td>
</tr>
</tbody>
</table>

* Depreciable personal property with a recomputed basis of $50,000 (see section 1245 (a)(2)) and subject to a potential investment tax credit recapture (see section 47) of $2,000.

** Depreciable reality with recapturable depreciation of $5,000.

Assume the parties agree that the husband is to receive all the community assets in exchange for an equalization payment of $140,000 to his wife. Under present jurisprudence,117 such a division would constitute a taxable transaction; the wife (assuming a 50 percent tax bracket) would incur an additional $23,250118 tax liability, and the husband would realize a step-up in cost basis in the former community assets to the extent

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117. For discussion see id. notes 63-89 and accompanying text.

118. Under the present jurisprudence, the wife is deemed as having sold her one-half interest in the community assets:

<table>
<thead>
<tr>
<th></th>
<th>W'S BASIS</th>
<th>FMV</th>
<th>TAX TREATMENT</th>
</tr>
</thead>
<tbody>
<tr>
<td>RESIDENCE</td>
<td>$30,000</td>
<td>$45,000</td>
<td>$15,000 L.T.C.G.</td>
</tr>
<tr>
<td>SECTION 1245 PROPERTY</td>
<td>15,000</td>
<td>30,000</td>
<td>1,000 I.T.C. Recap.</td>
</tr>
<tr>
<td></td>
<td></td>
<td></td>
<td>10,000 § 1245 Recap.</td>
</tr>
<tr>
<td></td>
<td></td>
<td></td>
<td>5,000 L.T.C.G.</td>
</tr>
<tr>
<td>SECTION 1250 PROPERTY</td>
<td>12,500</td>
<td>15,000</td>
<td>2,500 § 1250 Recap.</td>
</tr>
<tr>
<td>ACCOUNTS RECEIVABLE</td>
<td>0</td>
<td>25,000</td>
<td>25,000 O.I.</td>
</tr>
<tr>
<td>STOCK A</td>
<td>25,000</td>
<td>20,000</td>
<td>5,000 S.T.C.L.</td>
</tr>
<tr>
<td>STOCK B</td>
<td>2,500</td>
<td>5,000</td>
<td>2,500 L.T.C.G.</td>
</tr>
<tr>
<td></td>
<td>$85,000</td>
<td>$40,000</td>
<td>$17,500 Net Cap. Gain</td>
</tr>
<tr>
<td></td>
<td></td>
<td></td>
<td>+ 37,500 O.I.</td>
</tr>
</tbody>
</table>

Taxable income (after capital gains deduction) $44,500
Tax rate 50%
Tax liability $22,250
Investment tax credit recapture 1,000
Increased tax liability $23,250
separate property was expended ($140,000). Under the proposed legislation, the above property settlement would not be considered a taxable event. The husband (assuming a 50 percent tax bracket) would thus absorb the $23,250 potential tax liability of his wife, for there would be no increase in the cost basis of the former community assets. Consequently, the husband would be ill-advised to make an "equalization" payment of $140,000. Counsel for the husband must factor in the potential tax consequences of the various community assets before pleading his client's case before the trial court. If the client anticipates an immediate disposition of the assets subsequent to the divorce, the attorney should advise him that an equalization payment of only $116,750 would be in order and should forcefully so argue before the court. If the client is uncertain as to when he might dispose of the assets, then an equalization payment of $121,250 should be acceptable.

Alternatives to Proposed Section 1041

Before H.R. 3475 was introduced in Congress, various commentators advocated a number of alternatives to the carryover of the community basis (as well as other tax characteristics) rule by making analogies to existing tax principles established in other provisions of the Internal Revenue Code. Their fundamental concern was the "unfortunate consequence" of disproportionate shifting of potential gains and losses and other tax attributes of community property which resulted from the retention theory implemented by the Internal Revenue Service and the

119. Since the division will be considered a nontaxable event, the husband may desire to transfer appreciated property to his wife to equalize the partition. Assume he owns separate property with a cost basis of $26,250 and a fair market value of $140,000. If he transfers this property to his wife, his wife would receive a potential tax liability of $22,750 ($113,750 gain less the 60% capital gain deduction multiplied by a 50% tax rate) which would counterbalance the potential tax liability of her interest in the community property.

120. $140,000 less the $23,250 tax liability which will be incurred at the end of the taxable year. An adjustment on the wife's behalf for the time value of money would also be appropriate.

121. $140,000 less the wife's share of the potential tax liability in those assets which would likely result in the timely recognition of ordinary income (i.e. the accounts receivable, plus the potential depreciation recapture on the section 1245 and 1250 property). The $4,500 additional potential tax liability of the wife's interest in the community property procured by the husband would be offset by his use of the money until the tax liability is actually incurred.

122. See note 112 supra.


courts. Two of these proposals were a "tax-free exchange approach"\textsuperscript{125} and a "partnership liquidation approach."\textsuperscript{126}

The tax-free exchange approach would draw inferences from Internal Revenue Code sections 358 and 1031 in allocating the total basis of the assets equally between the spouses. Under these rules, the basis in the property acquired in a tax-free exchange is the same as that of the property transferred. Therefore, no shifting of gain or loss would result. For example, consider a community estate consisting of the following two assets:

<table>
<thead>
<tr>
<th>ASSET</th>
<th>BASIS</th>
<th>FMV</th>
</tr>
</thead>
<tbody>
<tr>
<td>A</td>
<td>$60,000</td>
<td>$100,000</td>
</tr>
<tr>
<td>B</td>
<td>$80,000</td>
<td>$100,000</td>
</tr>
</tbody>
</table>

Pursuant to a property settlement, H is to receive asset A and W is to receive asset B. H's basis in asset A would be $70,000, consisting of the basis in his one-half interest in the asset, plus the basis in his one-half interest of asset B relinquished to acquire full title in A. Likewise, W's basis in asset B would be $70,000.\textsuperscript{127} Thus, the $60,000 potential capital gain would be borne equally by the two spouses.

The partnership liquidation approach would treat the community as a marial partnership and apply the relevant partnership provisions of the Internal Revenue Code upon its dissolution. In the case of a partnership distribution under section 731(a), no gain would be recognized by a partner except to the extent that money distributed exceeds the adjusted basis of the partner's interest in the partnership. The adjusted basis of a spouse's interest in the marital partnership is assumed to be one-half of the community basis.\textsuperscript{128} Under section 732(b), the basis of property received by a partner in a liquidating distribution would be his adjusted basis in the partnership reduced by any money received. Therefore, under the same property settlement discussed above and using the partnership liquidation model, H would have a $70,000 basis in asset A (one-half of his adjusted

\textsuperscript{125} The suggestion that the tax-free exchange approach may be preferable to the retention approach expounded by the judiciary is found in Commerce Clearing House, His, Hers or Theirs?—Federal Income Taxation of Divorce Property Settlements ¶¶ 304-404 (1983). Under this alternative "any property received in an equal division (cash and relief from liabilities aside) would be considered as qualifying (nonrecognition) property." Id. at § 308.

\textsuperscript{126} The proposal for the adoption of a partnership liquidation approach for taxing community property divisions is found in Hjorth, Community Property Marital Settlements: The Problem and a Proposal, 50 Wash. L. Rev. 231 (1975), and is discussed at length in Commerce Clearing House, His, Hers or Theirs?—Federal Income Taxation of Divorce Property Settlements ¶¶ 309-404 (1983).


\textsuperscript{128} Hjorth, Community Property Marital Settlements: The Problem and a Proposal, 50 Wash. L. Rev. 231, 266 (1975).
basis in the partnership) with no resulting gain; similarly, W's basis in asset B would be $70,000. Consequently, as under the tax-free exchange approach, neither party would receive a disproportionate potential gain upon the dissolution of the community.

These alternatives are not without significant shortcomings. An initial drawback to the two models is that the use of separate property would render the transaction either wholly or partially taxable. For example, consider the property settlement by Hypothetical B pursuant to which H received all the community assets in exchange for an offsetting payment of $140,000 to his wife. It is true that neither party would receive an inordinate potential gain or loss under either of the two alternatives, but to achieve this result W would be forced to recognize an immediate tax liability of $23,250. The tax deferral treatment of proposed section 1041 would thus be defeated as would be the underlying Congressional policy that it is "inappropriate to tax transfers between spouses."

A second shortcoming to the tax-free exchange and partnership liquidation approaches is that since the basis of domestic currency is always its face value, if one party receives only community cash and her spouse receives appreciated property, she must recognize taxable gain under either

130. Id. at ¶¶ 401-05.
131. As would result under the proposed legislation, see supra notes 118-19 and accompanying text.
132. As discussed supra note 118, before the dissolution of the community each spouse is subject to potential taxable income of $44,500 or a tax liability of $23,250, assuming a 50% tax bracket for each party. This potential tax liability will not be shifted from W to H as it would under proposed section 1041; rather, W would recognize her share of the potential tax liability in the current year and H would recognize a comparable increase in the cost basis in the former community assets.

Under the partnership liquidation approach as expounded by Professor Hjorth, "an unequal division, or a sale, should be treated as a transaction involving two separate and distinct steps: (1) an equal division . . . , followed by (2) a sale of designated items by one spouse to the other for the separate cash or property of the other. . . ." Hjorth, Community Property Marital Settlements: The Problem and a Proposal, 50 Wash. L. Rev. 231, 273 (1975). See also Commerce Clearing House, His, Hers or Theirs?—Federal Income Taxation of Divorce Property Settlements ¶¶ 401-04 (1983). In this case W transferred her entire interest in the community for her husband's separate cash; thus, the division was fully taxable to her, and H's basis would be adjusted accordingly.

The use of separate cash under the tax-free exchange approach would render the transaction taxable to the extent money or nonqualifying property was received. I.R.C. § 1031(b) (1982). See also Commerce Clearing House, His, Hers or Theirs?—Federal Income Taxation of Divorce Property Settlements § 308 (1983).
133. H.R. Rep. No. 432, 98th Cong., 1st Sess. 191 (1983). "This policy is already reflected in the Code rule that exempts marital gifts from the gift tax, and reflects the fact that a husband and wife are a single economic unit." Id.
of the two alternatives. For example, consider a hypothetical community estate consisting of the following assets:

**HYPOTHETICAL C**

<table>
<thead>
<tr>
<th>ASSET</th>
<th>BASIS</th>
<th>FMV</th>
</tr>
</thead>
<tbody>
<tr>
<td>A</td>
<td>$50,000</td>
<td>$100,000</td>
</tr>
<tr>
<td>CASH</td>
<td>100,000</td>
<td>100,000</td>
</tr>
<tr>
<td></td>
<td>$150,000</td>
<td>$200,000</td>
</tr>
</tbody>
</table>

If W received the community cash upon the termination of the marriage, she would recognize a taxable gain of $25,000. Her husband, on the other hand, would defer the recognition of any gain until the subsequent disposition of asset A.

A third concern is how to overcome the problem of unrealized nondeductible losses when allocating community basis between the two spouses. For example, consider a division of the following two assets:

<table>
<thead>
<tr>
<th>ASSET</th>
<th>BASIS</th>
<th>FMV</th>
</tr>
</thead>
<tbody>
<tr>
<td>A</td>
<td>$5,000</td>
<td>$10,000</td>
</tr>
<tr>
<td>AUTOMOBILE</td>
<td>15,000</td>
<td>10,000</td>
</tr>
<tr>
<td></td>
<td>$20,000</td>
<td>$20,000</td>
</tr>
</tbody>
</table>

The application of either of the two alternatives, without modification, would be improper because an unrealized nondeductible loss would be used to increase the adjusted basis of an appreciated item. Therefore, if H was to receive A and his wife was to receive the automobile, it would be improper to divide the $20,000 community basis equally between the two spouses because to do so would eliminate a $5,000 potential taxable gain.
gain; no provision in the Internal Revenue Code supports such a result even by analogy. 138

A fourth problem of the two alternative approaches of taxing community property divisions is the treatment of ordinary income items (e.g., receivables and recapture property). 139 If one spouse receives the other's interest in an income item in exchange for his interest in a non-income item, the transaction would be wholly taxable for both parties. For example, consider a division of the following community assets:

<table>
<thead>
<tr>
<th>ASSET</th>
<th>BASIS</th>
<th>FMV</th>
</tr>
</thead>
<tbody>
<tr>
<td>ACCOUNTS</td>
<td></td>
<td></td>
</tr>
<tr>
<td>RECEIVABLE</td>
<td>$0</td>
<td>$100,000</td>
</tr>
<tr>
<td>B</td>
<td>$50,000</td>
<td>100,000</td>
</tr>
<tr>
<td></td>
<td>$50,000</td>
<td>$200,000</td>
</tr>
</tbody>
</table>

Under both the partnership liquidation approach 141 and the tax-free

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138. The solution offered to address this dilemma is to draw an analogy to Treas. Reg. § 1.165-9 (1960), as amended by T.D. 6712, 29 Fed. Reg. 3652 (1964) (conversion of non-business property to business property), and reduce the basis of the nondeductible item to its fair market value and distribute the remaining community basis between the two spouses. In the illustration presented in the text, H's basis in asset A would be $7,500 and W's basis in the automobile would also be $7,500.

The proposed solution would prove to be unacceptable for at least two reasons. First, it is based on the assumption that both spouses would immediately dispose of their respective assets, in which case the realized gain would be shared equally by the two parties. But in all likelihood the noninvestment property (usually a boat, automobile, residence, or other large asset acquired for personal use) would continue to decrease in value, and one-half of the potential gain would thus never be realized. Secondly, to overcome the loss in capital the proposed solution would provide that "to the extent that the amount received on sale is greater than division-date value but not greater than adjusted basis just before the division" gain would not be recognized on nontaxable items. Id at 268. Such a solution would favor the spouse receiving the nondeductible items, for she in essence would have been allocated a disproportionate share of the community basis.

139. For the complexity of relatively simplistic two-asset community property divisions, see Commerce Clearing House, His, Hers or Theirs?—Federal Income Taxation of Divorce Property Settlements ¶ 310 (1983).

140. See id.

141. I.R.C. § 751(b) (1982) provides that, to the extent unrealized receivables of the partnership are distributed to a partner in exchange for all or a part of his interest in other partnership property (including money), the transaction shall be considered a sale. Therefore, H is considered to have sold his one-half interest in asset B (basis of $25,000 and a value of $50,000) in exchange for his wife's one-half interest in the receivables; thus, he must recognize a $25,000 capital gain. His basis for the $100,000 in receivables would be adjusted to $50,000 ($50,000 cost of the receivables acquired plus his zero basis in the $50,000 in receivables deemed distributed to him in liquidation) to reflect this income recognition.

W is considered to have sold her one-half interest in the partnership receivables (basis of zero and a value of $50,000); thus, she must recognize $50,000 in ordinary income. Her basis in asset B would be adjusted accordingly to $75,000 ($50,000 cost of her husband's interest plus the $25,000 basis in B deemed distributed to her in liquidation). See Hjorth,
approach,\textsuperscript{142} if H received W's interest in the accounts receivable, he would recognize a $25,000 capital gain on the exchange and a $50,000 step-up in cost basis in the accounts receivable. The wife upon receipt of full ownership of asset B would recognize $50,000 in ordinary income as a result of relinquishing her one-half interest in the accounts receivable, and her basis in asset B would be adjusted accordingly to $75,000. Again a disproportionate division of potential taxable gain is avoided,\textsuperscript{143} but only by inflicting on the parties the additional hardship of income recognition at a time when both are incurring considerable expenses and are not likely to have the available funds to meet this immediate tax burden.

A fifth shortcoming which overshadows the utility of the tax-free exchange and partnership liquidation approaches is that neither is a comprehensive federal tax solution to divorce property settlements. The two alternatives were formulated to address the problem of the carryover of basis of community or concurrently-owned property upon the termination of marriage. Their applicability to the distribution of assets and liabilities from one spouse to another incident to a divorce or separation decree executed under the various domestic laws of most non-community states is quite dubious. The foundation of these two tax principles is the concept of basis.\textsuperscript{144} To theorize that each spouse has a vested one-half interest in the community basis under a matrimonial regime in which each spouse is taxed on one-half of the community income\textsuperscript{145} and owns an undivided one-half interest in the community property\textsuperscript{146} is reasonable. But an analogy to these provisions of the Internal Revenue Code would

\textsuperscript{142} See I.R.C. \textsection\textsection 722, 1031 (1982).

\textsuperscript{143} Before the partition there was a potential capital gain to the community of $50,000 with respect to B and a potential for ordinary income of $100,000 with respect to the receivables. Under the two suggested alternatives, the potential tax liabilities would be distributed equally between the spouses. W would recognize $50,000 of ordinary income in the current year and defer the recognition of her share of the capital gain until a subsequent disposition of B. H would recognize his share of the potential community capital gain upon the dissolution of the community, and would defer recognition of his share of the ordinary income until the outstanding receivables were collected.


\textsuperscript{145} Id.
be inappropriate under the domestic laws of states which do not provide for a readily ascertainable means for determining the interest (and thus the basis) which each spouse has in the property acquired during the marriage. A society which has become increasingly migratory has a substantial need for uniformity and certainty in the federal tax laws which the two alternative approaches do not provide.

Finally, and "[m]ost importantly, to avoid the complexity that is introduced—in what today is a very common occurrence—by other approaches to the problem," the Congressional proposal of section 1041, rather than the proposed alternatives, should be adopted. As illustrated earlier, the application of the two alternatives would result in (1) significant basis adjustments in property received upon divorce, (2) the recognition of taxable gain at a time when funds are likely to be scarce, (3) the necessity of determining which assets were "sold" upon an unequal division of community property, (4) the need to ascertain the immediate as well as the long-term tax consequences upon the allocation of community assets with various tax attributes, and (5) the use of provisions of the Internal Revenue Code which were not intended to apply to marital property settlements and do not provide for the comprehensive framework necessary for simplicity and certainty. On the other hand, proposed section 1041 is founded on sound policy considerations and, if properly understood and applied, offers an equitable and operative solution to the controversy over the proper tax treatment of the transfer or the division of property incident to a divorce.

To overcome the problem of shifting potential tax burdens from one spouse to the other upon the dissolution of the marital community, counsel must be aware of the tax characteristics (including the basis) of the various


For example, in Mississippi no specific statute provides for an equitable division of marital property. See Miss. Code Ann. § 93-5-23 (Supp. 1983). The jurisprudence of Mississippi, though, does recognize that a spouse may receive a lump sum alimony award in addition to periodic alimony payments upon consideration of her rank and condition in life, the estate of her husband and her contribution to the accumulation of assets during the marriage. Jenkins v. Jenkins, 278 So. 2d 446 (Miss. 1973); Reeves v. Reeves, 410 So. 2d 1300 (Miss. 1982). The trial court is afforded great discretion in making a lump sum award in addition to periodic alimony payments.


149. See supra note 140 and accompanying text for discussion of unrealized nondeductible losses.

assets and liabilities of the community estate. Counsel must also be aware of the financial position of the parties (i.e., whether one or both are in need of liquid assets), their immediate and prospective tax brackets, and their general intention regarding the subsequent disposition of the assets received under the settlement. By being well-informed on these matters, counsel for the opposing parties should be able to structure a tax-wise settlement which would enhance the post-divorce economic position of both spouses and minimize the legal, accounting and other costs of the divorce.151

The Role of the Domestic Court

When the parties are unable to agree on a partition of community property or on the settlement of the claims arising from the matrimonial regime, it becomes the responsibility of the divorce court to ensure that an equitable division is made.152 Louisiana Revised Statutes 9:2801153 provides: "The court shall divide the community assets and liabilities so that each spouse receives property of an equal net value."154 It further provides that to achieve this result, "[t]he court shall consider the nature and source of the asset or liability, the economic condition of each spouse,155 and any other circumstances that the court deems relevant."156 A reasonable interpretation of the provision seems to oblige the court to consider the basis and other tax attributes of the various items which comprise the community estate to ensure that the partition is in fact equitable.157 Unfortunately, domestic courts have shown a reluctance to consider tax ramifications, perceived as "speculative,"158 in their adjudica-

152. It makes no difference from a tax perspective whether the partition of community property was pursuant to a judicial order or a settlement agreement. "The decree merely takes the place of the agreement they were unable to reach without the court's aid." May v. Commissioner, 33 T.C.M. (CCH) 256, 258 (1974).
154. Louisiana courts should resist the temptation to interpret the statute as requiring only that each spouse receive property with an aggregate fair market value equivalent to one-half of the value of the community estate. The underlying objective of the statute (i.e. to provide for a truly "equal" division of the marital property) can be realized only upon a careful consideration of the tax implications of the partition.
155. This language would permit the court to consider the different tax brackets of the parties in rendering an equitable and tax-wise division.
157. If separate property is used to equalize the partition pursuant to 9:2801(4)(c), then upon passage of proposed I.R.C. § 104(1) (1982), the tax characteristics of this property must likewise be considered, for the Federal legislation makes no distinction between separate and community property received pursuant to a property settlement.
158. The supreme courts of Arizona and California have held that the trial court need not consider the future tax consequences to the respective parties resulting from the partition of community assets. Goldstein v. Goldstein, 120 Ariz. 23, 583 P.2d 1343 (1978); Fonstein
tion of property settlements. Fortunately, 9:2801 permits the court to "appoint such experts . . . as it deems proper to assist the court in the settlement of the community and partition of community property." Therefore, the appointment of a qualified professional to testify as to the tax implications of a property settlement may become necessary for the court faithfully to discharge its judicial responsibility of dividing the community assets and liabilities equally and equitably. As one commentator succinctly explained:

Valuing this future tax consequence may not be easy and, often, may not be totally accurate. However, courts exist to make difficult decisions based on the facts and circumstances presented; hence, if one party takes property in a community partition with a built-in future tax liability, he should be compensated in the community division for taking such property.

Conclusion

The Committee on Ways and Means of the United States House of Representatives has recognized that:

The current rules governing transfers of property between spouses or former spouses incident to divorce have not worked well and have proved a trap for the unwary . . . .

. . . .

. . . [T]o correct these problems, and make the tax laws as unintrusive as possible with respect to relations between spouses, the tax law governing transfers between spouses and former spouses should be changed.

The proposal recommended by the Ways and Means Committee is a practical, equitable, and comprehensive solution to the concerns enumerated. Accordingly, it should be adopted into law before the expiration of the current legislative session.


Given this background, it is questionable whether a court of appeals will modify a judicial partition of the community property because the trial court failed to consider the future tax ramifications of the division to the parties. Therefore, counsel should make every effort to ensure that the trial judge is well-informed of the tax attributes of the various community assets at the early stages of the litigation process so as to minimize the need for appeal on this point.


The one potential drawback to the proposed legislation is that the retention of basis and other tax attributes of the transferred or divided property permits the shifting of future tax burdens from one spouse to the other upon the termination of the marriage. But such a result is warranted to achieve the laudable policy objective of the proposal (i.e., avoidance of taxing transfers between spouses) which is implemented by maximizing the tax deferral treatment of such transactions. Additionally, the adverse tax consequences of a disproportionate assumption of future tax liabilities by one of the spouses may be easily overcome if his counsel recognizes the potential problem during the negotiation and litigation process.

Warren Paul Kean