Community Property Marital Settlements: The Problem and a Proposal

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Property settlements pursuant to marriage dissolutions may involve a multitude of tax consequences not readily apparent to the affected parties. Ever since the decision in United States v. Davis, it has been clear that if one former spouse transfers appreciated separate property to the other former spouse pursuant to a divorce or dissolution settlement.

1. In most dissolutions the property involved may be of minor significance, and lawyers will be more concerned with the tax consequence of post-dissolution payments made to support one spouse or minor children. Post-dissolution payments can create problems not only under INT. REV. CODE of 1954, §§ 71 & 215 [hereinafter cited as I.R.C.] (periodic payments by husband to wife for support are deductible by the husband and income to the wife unless they are specifically designated as child support), but under id. § 141 (husband cannot claim standard deduction if he deducts periodic payments); id. § 152(e) (husband gets dependency exemption for children if he pays at least $600 per year child support per child and agreement or decree awards the exemption to him); id. § 214 (wife cannot take deduction for child care payments if exemptions for children are awarded to the husband under I.R.C. § 152(e)); and numerous other sections. This article is concerned only with property settlements made pursuant to the dissolution of a marriage. Very few statutory provisions are directed specifically to the problem.


3. As used in sections 71, 152 (b) (4), 215 and 682, if the husband and the wife therein referred to are divorced, wherever appropriate to the meaning of such sections, the term "wife" shall be read "former wife" and the term "husband" shall be read "former husband"; and, if the payments described in such sections are made by or on behalf of the wife or former wife to the husband or former husband instead of vice versa, wherever appropriate to the meaning of such sections, the term "husband" shall be read "wife" and the term "wife" shall be read "husband."

I.R.C. § 7701(a)(17).

This article makes similar assumptions. Thus, husband and wife are referred to as spouses even if a marriage has been, or is in the process of being, dissolved. Moreover, the article assumes that if a division is unequal, the wife will receive the larger
ment, and in order to discharge marital obligations of the transferor, the transferor spouse will recognize a gain equal to the excess of the market value of the property over its adjusted basis. The transferee spouse generally will recognize no income and the basis in the property transferred will be its fair market value on the date of transfer.

It is generally assumed, however, that these rules do not apply to the "division" of property held by spouses as co-owners. Equal divisions of community property are said to be nontaxable events in which the adjusted basis of the marital community in a given asset carries over to the person to whom the asset is awarded. As a result.

4. The Davis rule has been applied in Pulliam v. Commissioner, 329 F.2d 97 (10th Cir. 1964) (husband taxed even though wife did not release her marital rights); Matthews v. United States, 425 F.2d 738 (Cl. Cl. 1970) (tax imposed on transfer by wife to husband even though she had no financial responsibilities to him); Swaim v. Commissioner, 417 F.2d 353 (6th Cir. 1969) (husband taxable on installment note transferred to wife as alimony). For general discussions, see Kleinbard, Matrimonial Law—Impact on Federal Taxes, N.Y.U. 31st Inst. on Fed. Tax. 1679 (1973); Schwartz, Divorce and Taxes: New Aspects of the Davis Denouement, 15 U.C.L.A. Rev. 176 (1967); Barton, Current Tax Problems of Marriage and Divorce, U. So. Cal. 1967 Tax Inst. 609.


6. In Davis, the Court carefully noted that the wife's claims to property transferred to her by her husband "do not even remotely reach the dignity of co-ownership." United States v. Davis, 370 U.S. 65, 70 (1962). The Court, therefore, did not disturb a line of cases, beginning with Frances R. Walz, 32 B.T.A. 718 (1935), holding divisions to be nontaxable even if they are not partitions. Although the Court did not endorse those decisions, such endorsement is implicit in Collins v. Commissioner, 393 U.S. 215 (1968). In Collins, the Tenth Circuit had rejected the husband-transferee's contention that the wife had a vested property right prior to the divorce decree and that a transfer of property to her was a nontaxable division. 388 F.2d 353 (10th Cir. 1968). While the case was pending before the Supreme Court, the Oklahoma Supreme Court in Collins v. Oklahoma Tax Comm'n, 446 P.2d 290 (Okla. 1968), ruled that under Oklahoma law a wife did have vested property rights prior to divorce for Oklahoma tax purposes. The United States Supreme Court remanded for reconsideration in light of the state tax decision. On remand, the Tenth Circuit reversed its prior holding since the wife's interest was a "species of common ownership." 412 F.2d 211 (10th Cir. 1969). The Internal Revenue Service also concedes that divisions of co-owned property are not taxable to the extent that the divisions are "equal." Rev. Rul. 74–347, 1974 Int. Rev. Bull. No. 29, at 6.


8. Beth W. Corp. v. United States, 350 F. Supp. 1190 (S.D. Fla. 1972) (division of property held by former spouses as tenants by the entirety). See also John H. Schacht, 47 T.C. 552 (1967) in which the Commissioner conceded that a partition of stock was not a taxable event. The court held that the basis of the transferee spouse in assets transferred severally is the "basis or cost to the community." Id. at 557. The court added that "the Davis case is not applicable here. It concerned rights under Delaware law, not community property rights." Id. at 558. The property in Schacht was California community property.
an equal property division in terms of market value can be unequal in terms of adjusted basis. Community property settlements can nevertheless be taxable if they are unequal, or to the extent that they involve the sale of a community property interest by one spouse for the separate cash property or obligation of the other spouse. And, whether community property divisions are taxable or nontaxable, they may present assignment of income problems that are often avoided in noncommunity property states.

It has been forcefully argued that federal tax consequences of property settlements should not depend upon whether the property involved is separate or community property; as a matter of policy, the tax treatment applied to community property divisions is preferable for both types of property to the rules set forth in United States v. Davis. The rules set forth in the Davis case may, and probably

9. No cases have been found dealing with "unequal" divisions in which one spouse did not purchase part or all of the interest of the other. Cases finding divisions to be nontaxable have always involved divisions that were substantially equal. See, e.g., Osceola Heard Davenport, 12 CCH Tax Ct. Mem. 856 (1953); Ann Y. Oliver, 8 CCH Tax Ct. Mem. 403 (1949), Rev. Rul. 74-347, 1974 INT. REV. BULL. No. 29, at 6, holds that an unequal division is taxable under Davis principles only to the extent that one spouse transfers more than one-half of co-owned property to the other spouse. In Rouse v. Commissioner, 159 F.2d 706 (5th Cir. 1947), the wife was taxed not only because she sold her interest in property to her husband but also because he paid less than the property was worth; because payment was less than value, the division was unequal.


11. Jessie Lee Edwards, 22 CCH Tax Ct. Mem. 65 (1954) (sale by wife of about one-half of her interest in return for note of husband held to be a taxable sale); Murine DeWolfe Brown, 12 CCH Tax Ct. Mem. 948 (1953) (transfer of interest in ranch to husband for his agreement to pay $150,000 held to be a taxable sale).

12. Each spouse in a community property state realizes one-half of total income realized by the marital community. Poe v. Seaborn, 282 U.S. 101 (1930). If such income is recognized after the termination of the marital community and collected by only one spouse, it can be argued that the non-collecting spouse has assigned the income to the other spouse and should therefore report one-half the income. See United States v. Mitchell, 403 U.S. 190 (1971) (widow taxed on her share of income earned by deceased husband even though she had renounced her claim to such income): [T]he wife's transfer of her interest to the husband [in a nontaxable division] could be treated as an anticipatory assignment of the income to be realized from services rendered by the community. In this event, the income so assigned would be taxed to her as collected by the husband. Victor, Divorce and Deferred Compensation Arrangements, U. So. CAL. 1972 TAX INST. 469, 482–83.

The "innocent spouse" rule of I.R.C. § 6013(e) may alter this rule for years in which a joint return was filed, but the statute does not apply if a joint return was not filed. Mary Lou Galliher, 62 T.C. 760 (1974).

13. See, e.g., Barton, Tax Aspects of Divorce and Property Settlement Agreements—The Davis, Gilmore and Patrick Cases, U. So. CAL. 1964 TAX INST. 421. The American Bar Association Section on Taxation has recommended that the result in Davis be
should be, modified to reflect changes in the marital relationship and in the underlying rights of the parties to a marriage. *Davis* assumes a marital relationship that was typical decades ago in noncommunity property states; *i.e.*, the husband accumulated property by working outside the home; the wife accumulated only "inchoate marital rights" by working inside the home.¹⁴

Recent cases have recognized that property is often acquired from the combined earnings of husband and wife.¹⁵ When this occurs, the wife's interest in property might achieve the "dignity of co-ownership" lacking in *Davis*. It would be reasonable to go further and provide that even if one spouse works only at home, such contribution to the family wealth is substantial enough to support a family property interest which achieves the dignity of co-ownership for federal income tax purposes. One court appears to have gone nearly that far. In *Imel v. United States*,¹⁶ the *Davis* case was held inapplicable to a transfer of separate property by husband to wife, on the basis of a Colorado Supreme Court certification that:¹⁷

at the time the divorce action was filed there vested in the wife her interest in the property in the name of the husband . . . [The] transfer involved here was a recognition of a 'species of common ownership' of the marital estate resembling a division of property between co-owners. . . . [The transfer does not] more closely resemble a con-

overruled by legislation. As a result, the transferor would recognize no gain and the transferee would inherit the transferor's basis and holding period. *Bull. Section of Taxation A.B.A.*, July 1966, at 63–66. One object of the proposal is to extend the rule that no gain or loss is recognized on an equal division of community property "to unequal divisions as well, including those frequent situations where the husband gets more than half of the property presently in being in return for a note or other promise to pay future moneys." *Id.* at 65. By another amendment, such payments would be income to the wife (and deductible by the husband) if they are made over a period of more than 10 years and are not specifically identified in the decree or written instrument as being "for the purchase of property rights owned by the wife before the divorce." *Id.* at 62.

Treasury Department proposals in 1969 also recommended that the transfer of appreciated property pursuant to a divorce settlement not be a taxable event and that the transferee assume the transferor's basis. The proposal says nothing about community property. *U.S. Treasury Department, 91st Cong., 1st Sess., Tax Reform Studies and Proposals*, 343 n.6 (Comm. Print 1969).

15. *See, e.g.*, Elbert G. Sharp, 31 CCH Tax Ct. Mem. 795 (1972) (where both spouses were employed, payments by husband on behalf of wife held to be payments for a property interest rather than periodic payments subject to rules of I.R.C. §§ 71 & 215).
17. *Id.*
veyance by the husband for the release of an independent obligation owed by him to the wife . . . .

Although *Imel* does not inspire confidence,\(^{18}\) one may nevertheless expect that property settlements in noncommunity property states will eventually be governed by the rules that apply to divisions of community property. Regrettably, however, the "rules" governing community property divisions do not comprise a coherent body of law. Some of these difficulties, which will be discussed in this article, include: (1) It is not clear why a spouse who receives assets in a nontaxable division should, as the general rule requires, take as an adjusted basis in each asset the adjusted basis held by the marital community. It would seem more logical and practical to award to each spouse one-half of the aggregate community basis and allocate that basis among assets received in proportion to their values.\(^{19}\) (2) What may appear to be an equal division of community property may in fact be a taxable sale, as where the community owns one asset which is awarded to one spouse who gives the other a promissory note in an amount equal to one-half the value of the asset.\(^{20}\) (3) It is not clear how "equal" a division must be in order to be nontaxable. Divisions that are taxable because they are unequal raise difficult questions concerning the amount of gain to be recognized and the resultant adjusted basis of property received.\(^{21}\) (4) A division involving an assignment of a right to income may not be taxable in the year of division, but may lead to post-division tax consequences that are intolerable.\(^{22}\) The cases do not indicate the extent to which traditional assignment of income principles should be applied to accounts receivable, installment obligations, pensions, and so forth. These problems have developed chiefly as a result of the failure of courts to deal with isolated problems as part of a larger whole. In short, courts have generally been required to answer only one question in each case involving community property divisions and

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18. The court's opinion leaves open the possibility that the filing of a divorce action may be deemed a taxable event. The decision would have rested on firmer ground if the Colorado Supreme Court had instead certified that the property held in the husband's name was a "species of co-ownership" even before the divorce action was filed.
19. See text accompanying notes 123–27 infra.
21. See text accompanying notes 81–86 infra.
22. See Parts V–A,–B &–C infra.
have not shown an exceptional awareness of the implications of each decision.

This article is an attempt to deal with the "larger whole" of community property divisions. It concludes with a proposal that, inasmuch as marriages in community property states are similar to partnerships, the dissolution of marriages should be treated for tax purposes in a manner similar to the dissolution of partnerships.

I. A PRELIMINARY CONSIDERATION OF BASIC PRINCIPLES

*United States v. Davis* has been the subject of intensive analysis, comment and criticism.\(^2\) It is reviewed here only to show that community property settlements often result in tax consequences that are precisely the opposite of those in settlements involving transfers of noncommunity property.

At one time, a typical family in a noncommunity property state might have included a wife who worked only in the home and a husband who earned income outside the home. All income was that of the husband, notwithstanding the domestic labors of the wife, and all property accumulated during marriage became the property of the husband.\(^4\) The wife had no property. She was entitled, however, to support during the marriage and to a portion of her husband's estate if she survived him.\(^5\) The wife had a claim against the husband for these inchoate marital rights lost by reason of dissolution of the marriage. The husband might satisfy these claims by making periodic payments (alimony), by means of a property settlement, or by some combination of alimony and property settlement. In *Gould v. Gould*,\(^6\) the United States Supreme Court held, on the basis of

\(^2\) See notes 4 & 13 *supra.*

\(^4\) It has been said that the early common law "embodied the basic concept that in marriage the husband and wife were merged into one and, in effect, the husband was that 'one.'" *W. DEFUNIAK & M. VAUGHN, PRINCIPLES OF COMMUNITY PROPERTY* § 2, at 4 (2d ed. 1971). The husband became the owner of the wife's movable property and of her earnings. The same authors note that, as a result of various married women's property acts, spouses in common law states are regarded as separate persons. *Id.* at 5.

\(^5\) See generally Commissioner v. Halliwell, 131 F.2d 642 (2d Cir. 1942); Commissioner v. Mesta, 123 F.2d 986 (3d Cir. 1941).

\(^6\) 245 U.S. 151 (1947).
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the statute then applicable, that periodic payments were neither deductible by the husband nor income to the wife. As a result, the tax burden for the payments made to a wife pursuant to a divorce fell exclusively on the husband.

In 1942, Congress responded to Gould by establishing a framework under which the tax burden for interspousal payments could be transferred from the former husband to the former wife. These provisions, now codified as Sections 71 and 215 of the Internal Revenue Code of 1954 (the Code), provide that "periodic payments" made by the husband to the wife pursuant to a written separation agreement or a decree of dissolution or separate maintenance, are deductible by the husband as an itemized personal deduction and are income to the wife. These rules do not apply, however, to lump sum property settlements or to installment payments of an ascertainable lump sum unless the installment payments are to be made over a period of more than 10 years from the date of the decree.

If one assumes that Gould still applies, except to the extent it has been modified by Sections 71 and 215, then it is clear that the tax burden on a transfer by husband to wife should fall on the husband where these two sections do not apply. For example, the payment of a

28. Periodic payments are not deductible by the husband and are not income of the wife, however, if they are specifically designated as being "for the support of minor children of the husband." I.R.C. § 71(b). The designation must be specific and cannot be inferred. A payment of $200 per month, reducible to $100 per month when a child becomes 21, is not a payment for child support. See Commissioner v. Lester, 366 U.S. 299 (1961); Betty Lou Nelson, 32 CCH Tax Ct. Mem. 356 (1973) (applying Lester, payment of $475 per month, reduced by $137.50 per month when each of two minor children became emancipated and by another $200 per month when the wife remarries, held not to be child support).
29. Alimony "in gross" is not deductible. See, e.g., Rev. Rul. 73-392, 1973 INT. REV. BULL. NO. 39, AT 8; GORDON D. OXFORD, 32 CCH TAX CT. MEM. 1321 (1973) (payment of $4,000 in lump sum not deductible by husband even though it was not paid for property interest of wife); WILLIAM M. HARDY, 59 T.C. 857 (1973) (husband who agreed to pay alimony until former wife's remarriage, and to then pay her a lump sum of $5,000, could not deduct lump sum payment).
30. I.R.C. § 71(c). Installment payments made over a period of less than 10 years can be deducted by the husband (and reported as income by the wife) if they are subject to some contingency, as where they terminate on the death of either spouse or upon the remarriage of the wife. Rev. Rul. 72–133, 1972–1 CUM. BULL. 25. Compare George B. Kent, 61 T.C. 133 (1973) (payments of $600 per month for 59 months held nondeductible where not subject to contingencies in agreement or decree or under Arizona law).
lump sum of cash by husband to wife is not a "periodic" payment, and, in a noncommunity property state,\textsuperscript{31} is neither income to the wife nor deductible by the husband. It follows that if the husband sells appreciated property and transfers the proceeds to the wife, the husband is taxed on the gain and the wife receives the proceeds tax-free. It is only logical to conclude, as did the Court in \textit{Davis}, that if the husband transfers appreciated property to the wife, he should be similarly taxed on the gain. The wife has no income and her basis in the property is its fair market value on the date of transfer.\textsuperscript{32} In short, the transfer results in a taxable gain, and the tax burden falls upon the transferor.

\textit{Davis} can be interpreted to require that all tax burdens in a non-community property state be borne by the spouse who earns the income (if the item involved is a right to income such as an account receivable)\textsuperscript{33} or by the spouse who owned the property prior to its interspousal transfer (if the item involved is property or a right to collect proceeds from the sale of the property).\textsuperscript{34} If any of these items is transferred from one spouse to the other pursuant to a marriage dissolution, it passes to the transferee free of any tax burden unless a statute specifically provides otherwise. Thus, payments to a wife are taxable to her only if they are alimony; the transfer of appreciated (or depreciated) property to the wife is treated as a taxable event in which the husband must recognize gain (or loss)\textsuperscript{35} and the wife takes a basis equal to the market value on the transfer date. "Income items" transferred to the wife, such as accounts receivable and installment obligations, will likewise be taxed to the husband.

In a community property state these same principles can be applied

\begin{footnotes}
\item[31] In a community property state, the transfer of a lump sum of cash could cause the wife to recognize a taxable gain if the cash payment is deemed to represent a transfer of her community property interest. The husband takes no deduction but the payment may affect his basis in property. See text accompanying notes 62–64 infra.
\item[33] This conclusion follows ineluctably from the decision in Lucas v. Earl, 281 U.S. 111 (1930). The earner would be taxed at the time of collection even if the transfer were not a taxable event. Helvering v. Eubank, 311 U.S. 122 (1940).
\item[34] This conclusion follows only if the transfer itself is considered a taxable event, as it was in \textit{Davis}. If the transfer were considered to be a gift, the wife would take the property with the husband's adjusted basis and would, therefore, take it subject to any tax burden attributable to unrealized appreciation. See I.R.C. § 1015; Taft v. Bowers, 278 U.S. 470 (1929).
\item[35] This assumes the loss is otherwise deductible under I.R.C. § 165.
\end{footnotes}
to achieve what may appear to be contrary results. Income is still
taxed to the person who earns it, but in a community property state
each spouse is deemed to earn half the income, and the wife will be
taxed on one-half the income from accounts receivable even if they are
awarded to the husband—and vice versa. Similarly, gain from
community property sold during marriage on the installment basis
should be taxed equally to each spouse, regardless of who collects the
payments, because gains are taxed to the owner of property and each
spouse owned half the property when it was sold. Equal divisions of
community property upon dissolution are not taxable events because
the transfer does not necessarily permit one spouse to obtain property
free of a “tax burden.” It is necessary that the transferor husband rec-
ognize gain in a noncommunity property state because the transferee
wife recognizes no income and obtains a stepped-up basis. She obtains
no stepped-up basis in a community property state and assumes a po-
tential tax burden; the tax can, therefore, be postponed but not
avoided.

II. NONTAXABLE PROPERTY SETTLEMENTS
NOT INVOLVING SPECIAL ITEMS

Long before the United States Supreme Court decided Davis, the
Board of Tax Appeals had held that equal divisions of community
property are not taxable events even though each spouse exchanges an

37. Johnson v. United States, 135 F.2d 125 (9th Cir. 1943).
38. The court in Ann Y. Oliver, 8 CCH Tax Ct. Mem. 403, 428–31 (1949),
reaches a contrary result (gain from accounts receivable awarded to husband taxed to
him), but does not discuss the issue raised in the text.
39. These special items include unequal divisions, settlements that involve sales,
assignments of rights to income, and assumptions of indebtedness.
undivided one-half interest in all assets for a complete interest in only part of the assets.\footnote{40} Even though \textit{Davis} did not apply to community property divisions, it raised serious doubts about the precedential value of prior decisions dealing with community property divisions.\footnote{41} It was clear, however, that even after \textit{Davis}, if the marital community was divided such that each spouse received one-half of each community asset, the division would not be taxable.\footnote{42}

In a true partition of one asset or of fungibles, each co-owner begins as the owner of an undivided partial interest in the whole, and ends up with the complete ownership of only a part of that same asset or those same fungibles—as where tenants in common of a parcel of land divide the land into two parcels of equal size and value. Precise partitions are rare, however, in property settlements accompanying dissolution. A typical marital community owns a wide variety of assets. Each spouse may begin with an undivided half interest in each asset, but will end (after the dissolution) with the complete ownership of some assets and no interest in others. One could therefore, argue, after \textit{Davis}, that even in equal divisions, each spouse “exchanges” his or her interest in assets awarded to the other spouse in return for the other spouse’s interest in assets awarded to him or her. One could further argue that absent a nonrecognition provision, all gains realized on these exchanges would be taxable.\footnote{43} This argument has never been adopted; it has not even been formally advanced.

\footnote{40} Francesco R. Walz. 32 B.T.A. 718 (1935). In \textit{Walz}, community property was valued at $92,000; the wife received property (worth $10,650) and her husband’s note for $35,350, thus rendering the division “equal” ($46,000 each). Today the transaction might well be considered a sale by the wife. \textit{See}, e.g., Jean L. May. 33 CCH Tax Ct. Mem. 256 (1974).

\footnote{41} The American Bar Association at one time was concerned that “the division of community property incident to a divorce or legal separation is thrown into chaos by the apparent determination of the Internal Revenue Service to reexamine rules thought settled, all because of Davis.” \textit{Bull. Section of Taxation A.B.A.}, July 1966, at 65. If there has been any re-examination, the Service has been remarkably quiet about any results.

\footnote{42} John H. Schacht. 47 T.C. 552 (1967). “This partition, as respondent concedes, was not taxable. The basis to Elizabeth [the wife] of the 97.18 shares assigned to her was the basis or cost to the community of $100 per share.” \textit{Id.} at 557 (citation omitted).

\footnote{43} In an “item theory” community property state this approach would be theoretically correct. Before dissolution each spouse has an undivided one-half interest in each asset owned by the community. This undivided interest in all assets is exchanged for a complete interest in some assets. Thus, there is a “sale or exchange” to which no nonrecognition section of the Code applies. \textit{See} I.R.C. § 1002. It is doubtful, however, whether any community property state adheres strictly to the “item theory.” In the divorce context, the item theory seems to be limited to the rule that items of
A second possible result, plausible before and after Davis, is that community property owned by husband and wife is partnership property. Under this argument, one-half of the aggregate adjusted basis of community property would be allocated to each spouse. Cash would be included in community property adjusted basis at its face value. On division, an ex-spouse would recognize no loss and would recognize gain only to the extent that cash (or its equivalent) is received by that ex-spouse. Under this argument, few divisions would be taxable, but basis adjustment would be necessary in most.\(^4\) This second possibility is the result advocated in Section VI of this article. It has not been advanced by the Internal Revenue Service or accepted by the courts.

A third possible result, again plausible before and after Davis, is that a division of community property is not taxable if it is “equal.” Each spouse takes as his or her basis in property awarded to him or her the adjusted basis of the marital community in that property.\(^4\) This solution has been adopted by the tax court in “equal divisions” of community property.\(^4\) The Supreme Court and the Internal Revenue Service have also implied that equal divisions of community property are not taxable events, even if each spouse exchanges a one-half interest in all assets for a complete interest in half the assets.\(^4\) Where divisions are not taxable, lawyers need not be concerned with nonrecognition provisions\(^4\) that might otherwise apply, or with the fact that

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\(^4\) No support for this proposal has been found in the case law, even though it would necessarily follow from treating a marital community like a partnership. See I.R.C. §§ 731–32; Part VI infra.


\(^4\) See, e.g., John H. Schact, 47 T.C. 552 (1967); Clifford H. Wren, 24 CCH Tax Ct. Mem. 290 (1965). If, however, divisions are unequal, the Commissioner takes the position that the division is taxable to the extent of the inequality. See Part III–A infra.


\(^4\) See, e.g., I.R.C. § 1031 (nonrecognition of gain on “like kind” exchanges). Interestingly, application of the basis carryover provisions applicable to § 1031 would lead to a division of aggregate basis rather than a carryover of community basis in each asset. Thus, if two assets, each worth $100, but with respective bases of zero and $100, are divided so that the husband receives the zero basis asset and the wife the $100 basis asset, each spouse would, if § 1031 applied, end up with a basis of $50. See § 1031(d).
divisions might give rise to gain on appreciated assets but to nondeductible losses on depreciated assets held for personal use.49 Neither precedent nor policy indicates that “equal divisions” should be taxable, unless special items50 are involved or unless one spouse in effect “cashes out.”51

If, in fact, the rule is that equal divisions of community property can never be taxable events, it necessarily follows that the basis of a spouse in each asset awarded to him or her will be the same as the adjusted basis of the community in that asset, and will not be one-half the aggregate community basis. Tax avoidance would otherwise be possible because a spouse could obtain an increase in basis in certain assets without recognizing any gain. This conclusion is best illustrated by an example.

Assume that husband and wife own as community property cash of $100,000 and assets with a basis of zero but a market value of $100,000. Wife receives the cash and husband the assets in a property division. The basis of the wife in the cash cannot be less than $100,000. In order to prevent tax avoidance, it is necessary to rule either: (1)(a) The aggregate community basis is $100,000; (b) the wife’s share of that basis is $50,000; (c) she, therefore, realizes a gain of $50,000 on the division; and (d) the husband’s basis in the assets awarded to him is $50,000 (one-half the aggregate community basis); or, (2)(a) The division is tax-free; (b) the husband’s basis in the assets is zero; and (c) the wife’s basis is $100,000. While there appear to be no cases which consider the problem of basis when one spouse receives nothing but community cash,52 some courts have held that the second

49. The courts have apparently not addressed the question of whether a transfer of depreciated property, for which a loss deduction would be allowed but for the provisions of I.R.C. § 267, is deductible. The question is moot in a division that is not a taxable event. In the author’s opinion, the Internal Revenue Service should rule that a taxable sale or exchange pursuant to the dissolution of a marriage is not subject to I.R.C. § 267 if the parties are in fact divorced by the end of the year. See I.R.C. § 153. Application of I.R.C. § 267 to such situations serves only to trap the unwary and cause prudent spouses to make transfers after, rather than before, dissolution of the marriage.
50. See note 39 supra.
51. One spouse “cashes out” when he or she receives cash from the other spouse for whatever interest the former has in the community assets.
52. Dictum in Maurine De Wolfe Brown, 12 CCH Tax Ct. Mem. 948 (1953), suggests, however, that a division of property in which one spouse receives all the community cash is not taxable. In that case, the husband’s purchase of his wife’s interest in a community property ranch was held a taxable sale. The court stated:

We do not have a mere division of community interests in the ranch . . . . Nor was this a case in which the community property consisted of the ranch and a
alternative applies when each spouse receives property. Those cases suggest that the division described above would be nontaxable; it was not a transfer in satisfaction of a wife's marital rights, but an equal division. If the husband's basis is to be zero, he assumes a tax burden which is simply postponed. Thus, it would be unfair to tax the wife.

These rules are simple to apply and allow a division to be nontaxable even if one spouse "cashes out" so long as the cash itself is community property. But they create several problems. First, the rules can work an inequity on uninformed taxpayers. Spouses who receive properties of equal value may, unknowingly, receive properties with disparate tax burdens. Second, the rules may encourage unequal divisions. An informed taxpayer who receives low basis property may demand and receive somewhat more than half the community property in order to compensate for the disparate tax burden. A recent Revenue Ruling indicates that such a division is taxable to the extent of its inequality. Third, the rules create potential for tax avoidance. A "sale" by one spouse of his or her interest for the separate cash or separate obligation of the other spouse is a taxable event even though the division may appear to the uninformed to be equal. Thus, if the only asset is property worth $100,000, but with a basis of zero, a sale by the wife of her interest to the husband for his separate obligation (incurring a debt) of $50,000, will cause the wife (as transferor) to recognize a gain of $50,000 and the husband (as transferee) to increase his basis in the asset by that amount. Such taxation is avoided, however, if the debt is incurred before, rather than as part of, the dissolution. Assume in the example above that community assets consist of property worth $100,000 (basis of zero), subject to a

large amount of cash and in which it was agreed that the total property would be severed in such manner that the husband would keep the ranch and the wife would keep the cash.

Id. at 952.


54. If one spouse receives only cash and the other nothing but a low basis asset pursuant to a division, the tax on the sale of that asset will be borne entirely by the latter.

55. Rev. Rul. 74–347, 1974 INT. REV. BULL. No. 29, at 6; see, e.g., Rouse v. Commissioner, 159 F.2d 706, 707 (5th Cir. 1947) (division taxable not only because it was a sale, but also because wife "parted with an interest in that community that in quantity and estate was equal to that of her husband but for less than one-half its value and less than she would have been entitled to had the property merely been divided . . . .")

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community debt of $50,000, and cash of $50,000. If the wife receives
the community cash and the husband the property subject to the debt,
a simple application of existing basis rules would indicate that the di-
vision is nontaxable. Thus, the existing rules encourage spouses to
borrow money in anticipation of a dissolution so as to avoid taxation.
Finally, the rules concerning basis carryover are inconsistent with the
principle that each spouse bears one-half the tax burden that accrues
to the community property.\textsuperscript{57}

To avoid these difficulties each spouse should be awarded one-half
of the aggregate community basis in a nontaxable property settlement.
Under this approach, a division would be taxable only to the extent
that the cash received by one spouse exceeds his or her share of aggre-
gate community basis. For this purpose, the assumption by one spouse
of a community debt should be treated as a distribution of cash to the
other spouse in an amount equal to one-half the debt.\textsuperscript{58}

III. TAXABLE PROPERTY SETTLEMENTS—SALES

A. Sale or Unequal Division?

A community property settlement is taxable to the extent that it is a
sale\textsuperscript{59} or, as a recent Revenue Ruling indicates,\textsuperscript{60} to the extent that a

\textsuperscript{56} The most recent case supporting the conclusion that the wife is taxed on this
kind of "sale" is Jean L. May, 33 CCH Tax Ct. Mem. 256 (1974). A pre-\textit{Davis} case
to the same effect is Jessie Lee Edwards, 22 T.C. 65 (1954). Cases of this sort are
numerous. They may reflect the fact that many lawyers who handle dissolution
proceedings are not tax experts. These lawyers are aware of the general rule that
equal divisions of community property are not taxable and often incorrectly assume
that a division is equal if one spouse receives all the assets and agrees to pay the other
spouse an amount equal to one-half the value.

For authority that the husband can increase his basis by the gain recognizable by
the wife, see \textit{Long v. Commissioner}, 173 F.2d 471 (5th Cir. 1949).

\textsuperscript{57} Under existing law, if all community property were sold one day before the
divorce, each spouse would be taxable on half the total gain, even if a joint return
were not filed. \textit{Poe v. Seaborn}, 282 U.S. 101 (1930). It remains unexplained why the
result should be different if the property is sold one day after the marriage has been
dissolved. For example, if the community assets consist of $10,000 cash and zero
basis property worth $10,000, a sale \textit{before} dissolution causes each spouse to recognize
a $5,000 gain. \textit{Id}. However, if the husband receives the property in a nontaxable
division pursuant to dissolution, and the wife receives the cash, the entire gain on the
later sale of the property will be taxed to the husband. \textit{Beth W. Corp. v. United States},

\textsuperscript{58} See \textit{Part VI-D infra}.

\textsuperscript{59} See note 56 and accompanying text \textit{supra}.

\textsuperscript{60} See note 55 and accompanying text \textit{supra}.
property division is "unequal." Early cases seem to use the two terms interchangeably, but the concepts are distinct and should be distinguished. In an unequal division of property, there is a taxable event because property is transferred in discharge of a marital obligation. The property transferred is the amount by which the total amount awarded to the wife exceeds one-half of the total community property. This "excess" is presumably transferred to discharge a marital claim of the wife. In contrast, when a sale is involved, the community property settlement is taxable, not because property is transferred to discharge a marital obligation, but rather because the wife has sold her own property for cash.

B. Sales that Result in Equal Divisions

Early cases appear to have held sales not to be taxable if they had the result of creating an "equal division." In *Francis R. Walz*, community property was valued at about $92,000. The wife received community property worth $10,650 plus the husband's promissory note in the amount of $35,350, thus receiving $46,000 in total value, or one-half the value of the community property. The husband received all other community property (presumably worth $81,350, subject to the wife's claim). The Tax Court held that the transaction was not taxable because the division was "equal." Subsequent cases indicate, however, that even these "equal" divisions are taxable if one spouse sells some or all of his or her community property to the other.

For example, in *Jean L. May*, the principal item of community property was a residence valued at $400,000. The husband (an architect who used the residence as a showplace) was awarded the house and agreed to pay the wife $200,000, which he borrowed. The division was thus "equal" in the sense that the wife received $200,000 and the husband received property worth $400,000 subject to debts of $200,000, but the wife was nevertheless taxed on the sale. Presumably,

61. See, e.g., Frances R. Walz, 32 B.T.A. 718 (1935).
62. Id.
63. Id. at 719. See also Osceola Heard Davenport, 12 CCH Tax Ct. Mem. 856 (1953) (wife received over $500,000 in cash in return for her interest in community property—not clear where cash came from; division held nontaxable).
64. 33 CCH Tax Ct. Mem. 256 (1974). See also Rouse v. Commissioner, 159 F.2d 706 (5th Cir. 1947) (husband's basis after a taxable purchase from wife reflected the purchase price).
the husband's basis in the house was stepped-up to reflect the purchase price arrived at for settlement purposes. Although Mrs. May "cashed out," the transaction would have been just as much a sale, and a taxable event, if she had instead transferred her interest in the house to the husband for his separate promise to pay.

The May case does not indicate whether the assumption of a community debt by one spouse is a "sale" or is rather part of a "division." We have seen that a division in which one spouse receives all the community cash and the other receives assets can be nontaxable.\(^\text{65}\) Conversely, a "division" in which one spouse retains all the property and agrees to pay the other one-half the value thereof is a taxable sale.\(^\text{66}\) The assumption of a community debt by one spouse seems to fall between these two factual situations. Clearly, the assumption by one spouse of a debt incurred in contemplation of dissolution should be treated as a taxable sale by the other spouse. Indeed, one might argue that any assumption of a community debt by one spouse is a sale by the other spouse even if the debt is not incurred in contemplation of dissolution. If the husband "buys" the wife's property by giving her his separate promise to pay, he would also appear to "buy" property when he gives the community creditor his separate promise to pay the entire community obligation.

But taxation is a practical matter, and, in practical terms, it would be disastrous to say that one spouse "sells" to the other in any division involving the assumption by one spouse separately of a former community debt, because so many marital communities own property subject to debts. In most settlements involving such property, one spouse receives the property and assumes or takes subject to the mortgage. These divisions are probably not taxable.\(^\text{67}\) Thus, if the debt was not incurred in contemplation of the marriage dissolution, the spouse whose debt is forgiven should be treated as having received community cash in an amount equal to one-half the debt.\(^\text{68}\)

\[^{65}\text{See text accompanying notes } 51-53 \text{ supra.}\]
\[^{66}\text{Maurine De Wolfe Brown, } 12 \text{ CCH Tax Ct. Mem. } 948 \text{ (1953). See also Ben C. Land, } 61 \text{ T.C. } 675 \text{ (1974).}\]
\[^{67}\text{No case has been discovered which discusses this issue.}\]
\[^{68}\text{These same rules should apply even if the parties only agree, as between themselves, that one spouse shall pay the debts or if one spouse takes property subject to a former community debt. The creditor might, in such a case, be able to hold both spouses liable on the debt, but it should be presumed that the obligor will pay. For corporate tax analogies, see I.R.C. } \S\S \text{ 311(c) } \& \text{ 358.}\]
We have thus far assumed that a settlement is either a taxable "sale" in its entirety or a completely nontaxable division. Dissolution settlements, however, are seldom so tidy. In many community property settlements some assets may be divided and others sold, as where there are three assets of equal value, with one awarded to the husband, the other awarded to the wife and the third awarded to one spouse who agrees to pay the other spouse an amount equal to half the value of the asset. Despite a commentator's statement that in 1967 the Commissioner adopted the administrative practice of "treating a division as taxable in full to both parties when any element of purchase and sale is present," there is little evidence of such a practice. In fact, several recent cases suggest that a settlement will be a taxable event only to the extent that items are purchased and sold. If so, taxpayers may be able to reduce taxes by specifying precisely which assets are divided and which are sold. To illustrate, assume that a husband and wife own, as community property, the following assets:

<table>
<thead>
<tr>
<th>Asset</th>
<th>Adjusted Basis</th>
<th>Value</th>
</tr>
</thead>
<tbody>
<tr>
<td>House</td>
<td>$ 40,000</td>
<td>$ 60,000</td>
</tr>
<tr>
<td>Yacht</td>
<td>50,000</td>
<td>60,000</td>
</tr>
<tr>
<td>Business</td>
<td>20,000</td>
<td>60,000</td>
</tr>
<tr>
<td>Total</td>
<td>$110,000</td>
<td>$180,000</td>
</tr>
</tbody>
</table>

If the wife receives the house and $30,000 of cash borrowed by her husband, and the husband receives the yacht and the business, there are probably two events for tax purposes: a nontaxable division of two assets (the house and the business) and a sale by the wife to the husband of her interest in the third asset (the yacht). If the house and the business are "divided equally" (i.e., house to wife and business to husband) and the wife sells her interest in the yacht to the husband as

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70. These cases involve the issue of whether the husband's payments are deductible "periodic payments" (I.R.C. §§ 71 & 215) or are installment payments reflecting the purchase by the husband of a property interest of the wife. See, e.g., Ben C. Land, 61 T.C. 675 (1974); Edith M. Gerlach, 55 T.C. 156 (1970). These cases do not decide the issue discussed in the text; no case directly in point has been discovered. However, Clifford H. Wren, 24 CCH Tax Ct. Mem. 290 (1965) seems to support a dual treatment. Wren involved a division in which the Commissioner attempted to treat a sale of stock as a taxable event. Also involved in the decision was a house awarded to the wife. In ignoring the award of the house, the Commissioner seems to have assumed that a settlement can be part taxable sale and part nontaxable division.
suggested, her gain will be considerably less ($25,000) than if the house and the yacht (instead of the business) are divided and the wife's interest in the business (instead of the yacht) is sold for $30,000 ($20,000 gain).\footnote{This results because the adjusted basis in the yacht is higher than that in the business. In the first instance (sale of the yacht), the wife sells her interest of $25,000 (one-half the community adjusted basis) for $30,000, realizing a gain of $5,000. In the second instance (sale of the business instead of the yacht), the wife sells her interest of $10,000 (one-half the community adjusted basis) for $30,000 and realizes a gain of $20,000.} If the parties wish to reduce immediate gain, the separation contract can probably effect such a reduction by providing that the yacht, rather than the business, is being sold. Such provisions may be repugnant to the notion that tax consequences should not depend on form rather than substance, but it is difficult to prescribe more satisfactory results under existing rules.

Results can be even more untidy when one asset is partially divided and partially sold, as commonly occurs when there are several community assets with one worth more than all the rest combined. Assume, for example, that husband and wife own as community property the following assets:

<table>
<thead>
<tr>
<th></th>
<th>Adjusted Basis</th>
<th>Value</th>
</tr>
</thead>
<tbody>
<tr>
<td>Miscellaneous</td>
<td>$20,000</td>
<td>$40,000</td>
</tr>
<tr>
<td>Business</td>
<td>50,000</td>
<td>100,000</td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td><strong>$70,000</strong></td>
<td><strong>$140,000</strong></td>
</tr>
</tbody>
</table>

Assume further that the wife is awarded the miscellaneous property and $30,000 of cash borrowed by her husband. At least four mutually exclusive results are possible: (1) Considered in its entirety, the settlement is more in the nature of a nontaxable division than a taxable sale or exchange; or, (2) Considered in its entirety, the settlement is taxable, so that the wife exchanges her interest (adjusted basis of $35,000) in the community for cash and property equaling $70,000 and, therefore, recognizes a gain of $35,000; or, (3) The wife has sold her interest in the business (adjusted basis of $25,000) for $50,000 ($30,000 in cash and $20,000 in kind) and, therefore, recognizes a gain of $25,000; or, (4) The wife has exchanged $20,000 (40 percent) of her interest in the business for her husband's interest in the miscellaneous property in a nontaxable division. She has also sold the re-
main 60 percent of her interest in the business (basis of $15,000) to her husband for cash of $30,000 and, therefore, recognizes a gain of $15,000. It would appear that the first two possible results would not be adopted because the courts are reluctant to adopt an “all or nothing” approach. The third result is a “clean” one which a court might well adopt. The fourth result is not as clean but just as feasible; a court would probably rely on the language of the agreement or decree to determine whether the wife has sold all or only a part of her interest in the business. The separation contract could state explicitly that the wife is to receive the house and that the husband is to receive 40 percent of the business by way of “equal division,” and that the wife is to sell her half of the remaining 60 percent of the business to the husband for $30,000. Although a provision of this type might not be binding on the Government, it seems likely that, in the present state of confusion, it would be accepted.

C. Taxable Sales and Periodic Payments

Sections 71 and 215 of the Code provide a mechanism by which the tax burden attributable to current payments pursuant to a dissolution can be shifted from the husband to the wife. Compliance with these provisions permits the husband to deduct the payments and requires the wife to report them as ordinary income. Such payments do not effect either spouse’s basis in community property. A taxable sale by the wife of her interest in community property has quite different results: The income of the wife is limited to actual or imputed interest plus other gain (capital or ordinary); the husband can deduct only actual or imputed interest, increasing his basis in property by the amount of gain realized by the wife. The parties to such a tax-

72. Cf. note 58 supra. The possibilities are mentioned, however, because they are possibilities. There appears to be no decision which discusses the issues presented by the illustration.
73. Under I.R.C. §§ 71 & 215, periodic payments by the husband to the wife for support are deductible by the husband and income to the wife unless such payments are specifically designated as child support.
74. See Gerlach v. United States, 74-1 U.S. Tax Cas. ¶ 9425 (Ct. Cl. 1973) (husband entitled to deduction for imputed interest under I.R.C. § 483 on payments for wife’s interest in property). The imputed interest rules of I.R.C. § 483 do not apply, however, if payments are not for property and are not deductible by the husband because they are installments of a lump sum payable over a period less than 10 years. Fox v. United States, 74-1 U.S. Tax Cas. ¶ 9358 (E.D. Pa. 1974).
75. Rouse v. Commissioner, 159 F.2d 706, 707 (5th Cir. 1947).
able sale might well prefer to come within the ambit of Sections 71 and 215, thereby giving the husband a current deduction rather than an increase in basis. It is clear, however, that Sections 71 and 215 do not apply to periodic payments made to purchase a wife's interest in community property, even if the literal requirements of those sections are met. Sections 71 and 215 apply only to payments made for the wife's support; they do not apply to payments made for her property and may not even apply to payments made for marital rights other than support. Taxpayers cannot alter tax consequences by labelling payments for property "alimony," when they are not such, in fact.

Whether a given payment is a payment for support rights or a payment for property rights can, however, present difficult factual issues. Some taxpayers attempt to exploit these difficulties. A blatant example of exploitation is a dissolution agreement or decree reciting that the value of the community property is zero, but requiring the husband to make periodic payments, when the value of the community property is in fact substantial and the periodic payments are in fact designed to compensate the wife for her interest in that property. It is not difficult to imagine more sophisticated schemes, such as where the wife actually receives some property but where the property awarded to her is overvalued (or the property awarded to her husband is undervalued) in such a manner that she appears to receive one-half the total community property (but does not in fact), and she receives additional payments for "support" that in fact compensate her in part for a prop-

78. The Regulations state that installment payments are deductible only if they "are in the nature of alimony or support." Treas. Reg. § 1.71-1 (d)(3)(i)(b)(1957). Bernatschke v. United States, 364 F.2d 400 (Ct. Cl. 1966) and Soltermann v. United States, 272 F.2d 387 (9th Cir. 1959), indicate that even if payments would otherwise qualify as installment payments payable over a period of more than 10 years, and even if they are not payments for a property interest of the wife, they are not deductible under I.R.C. § 215 unless they are in the nature of alimony or support. The requirement that payments be in the nature of "alimony or support" should, in the author's opinion, be interpreted to mean any payments other than payments for a property interest of the wife.
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property interest. Less sophisticated, but more difficult to unravel, are arrangements by which a wife receives payments that are designed both to compensate her for a property interest and to pay her additional support, as, for example, where the value of her interest in community property is $5,000 and she receives periodic payments of $15,000, but no property.

A claimed deduction for current payments should be disallowed to the extent the payments are made for the wife's interest in community property. The primary issue in cases involving such claims, and assumed in the schemes noted above, is the respective values of the items awarded to each spouse.79

Both ethics and good judgment require that the parties make an honest evaluation of each item of property and that payments made for the wife's property be specifically designated as installment purchase payments.80

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79. Although the Internal Revenue Service will seldom challenge a deduction claimed under § 215 unless the wife fails to report the income under § 71, there is little reason why the wife should report income under § 71 if the payments received by her are not alimony in fact. If she reports no periodic payments as income under § 71, the Service is bound to challenge the wife and the husband.

The difficulty of valuing such items was illustrated in A. J. Roberts, 33 CCH Tax Ct. Mem. 750 (1974). The wife in Roberts received the family home and miscellaneous other property, and the husband received the family business. A property settlement agreement provided that the wife should also receive "Two Hundred Dollars ($200.00) per month for a period of ten years and two months, which payments shall be property division and not support or alimony ...." The agreement also provided for the payment of alimony ($100 per month) and child support ($100 per month). The husband nevertheless attempted to deduct the monthly payments stated to be by way of "property division" and was successful. The Tax Court found that the wife had received one-half the value of the community property in assets other than the installment payments.

80. Marion R. Hesse, 60 T.C. 685 (1973), also indicates the necessity of accurately stating whether payments are or are not for property. In Hesse, the husband stated that he would "give one-half million dollars to be rid" of his wife. She took him at his word and negotiated a settlement in which she received that amount over a period in excess of 10 years. The payments were held to be taxable to her as alimony even though the amount was fixed and not subject to termination on her remarriage or the death of either spouse.

IV. TAXABLE PROPERTY SETTLEMENTS—UNEQUAL DIVISIONS

It has been stated that "the concept of equal division will be applied in the absence of an absolutely equal division." If the inequality is nominal or if it arises because of an honest mistake in valuing property, it will probably be ignored. A deliberate misrepresentation of values in a separation contract, however, so as to give the appearance of equality when inequality is known to exist, could subject the parties to criminal penalties as well as to tax liability; e.g., the husband may retain property known to be worth $25,000 and the wife retain property known to be worth $75,000, when the assets awarded to each are valued at $50,000 in the separation agreement. The false statements in the separation agreement may amount to a willful attempt to defeat or evade a tax and result in criminal penalties. Such a division would probably be taxable even in absence of fraud, as where one spouse, in order to obtain the divorce, consents to the misstatement of values without intending to avoid tax.

The problem can, of course, be even more refined. Few items of property have an exact market value. If the assets awarded to one spouse are valued at the high end of a permissible scale, and the assets awarded to the other are valued at the low end of a permissible scale, with each spouse receiving one-half the assets so valued, the division is probably not taxable. Where the division does not purport to be equal, but where the inequality is the result of the larger tax burdens assumed by one spouse, as where the recipient of low-basis property

81. Barton, supra note 69, at 623 (emphasis added).
82. See I.R.C. § 7201; Legatos v. United States, 222 F.2d 678 (9th Cir. 1955).
83. In finding a settlement to be a sale, Judge Raum of the Tax Court noted in Maurine De Wolfe Brown, 12 CCH Tax Ct. Mem. 948, 952 (1953), that "the so-called property agreement . . . represented merely the best bargain that [the wife] could drive in the circumstances." In unequal division cases the spouse who will often pay the tax will be the one in the weaker bargaining position. The results may seem harsh, but the fact is that one who accepts less than half the community property in a community property state generally does so for a reason; such a spouse is willing to pay in order to obtain a divorce. Spouses who pay cash are taxed on that cash as it is earned and it is difficult to see why those who pay with property should fare better.
84. Apparently, however, some courts are willing to become parties to valuation battles. See e.g., A. J. Roberts, 33 CCH Tax Ct. Mem. 750 (1974).
receives more than half the community property, the division should not be taxable.  

These considerations demonstrate that the threshold question of whether the division is "equal" is not easily answered. The paucity of litigation may simply mean that unless the disparity is obvious, taxpayers generally treat the "division" as nontaxable and the Internal Revenue Services does not intervene. Some of the problems presented by unequal divisions are treated in a recent Revenue Ruling which represents the Tax Commissioner's first attempt to set forth rules in this difficult area. Thus, it merits close examination.

In Rev. Rul. 74–347, a husband and wife had, by their combined efforts (both had been employed), acquired jointly-owned property worth $70,000; the husband acquired separate property worth $40,000. The marriage was dissolved in 1973 and the wife was awarded assets worth $55,000, all of which had been jointly-owned property. The Commissioner found that the wife had a property interest only in the jointly-owned property ($70,000) and that her interest therein was worth $35,000. The excess joint property awarded to her (worth $20,000) was a taxable transfer in which the husband exchanged his interest in jointly-owned property in order to free himself of his wife's claim against his separate property.

In sum, the Commissioner treated the joint property as if it were first equally divided ($35,000 to each spouse) and then $20,000 of the husband's interest in such property was transferred to the wife in discharge of a marital obligation. The amount realized by the husband as a result of this transfer was $20,000. The husband's basis in the property transferred was determined by a complex formula which may be distilled as follows: (1) Ascertain the total adjusted basis of assets awarded to the wife by totaling the basis of each item awarded to the wife; (2) Subtract from the result in (1) the amount by which the adjusted basis of assets for which losses are not deductible exceed the value of such assets to determine the "modified adjusted basis" in assets received by the wife; and (3) Multiply the "modified adjusted basis" in assets received by the wife by the fraction representing the wife's interest in the jointly-owned property.

85. To treat such divisions as taxable would raise administrative difficulties not justified by any substantial increase in revenue. In essence, a de minimis rule should be applied.

86. 1974 INT. REV. BULL. No. 29, at 6.
basis" by a fraction, the numerator of which is the net value of “excess” property awarded to the wife and the denominator of which is the net value of all property awarded to the wife.

In Rev. Rul. 74-347 the adjusted basis of property awarded to the wife was $29,500, but this included personal furniture with a basis of $4,000 and a value of $2,000. “Modified adjusted basis” of assets awarded to the wife was therefore $27,500. Because the value of “excess” joint property awarded to the wife was $20,000 and the value of all joint property awarded to her was $55,000, the basis of the husband in the “excess” property transferred was ($20,000 ÷ $55,000) x $27,500, or $10,000. The husband therefore recognized a taxable gain of $10,000.

Rev. Rul. 74-347 apparently does not permit the parties to designate which assets go into the “excess” portion transferred to the wife. If such designation were possible, the parties might first divide the assets equally, then specify which assets awarded to the husband are to be transferred to the wife in payment of marital obligations. Thus, taxpayers could reduce taxes by designating high basis assets as the assets transferred in payment of marital obligations. In such a case the wife’s basis in the assets transferred in payment of marital obligations would be the market value of those assets at the time of transfer. To illustrate, assume that husband and wife own jointly the following assets:

<table>
<thead>
<tr>
<th>Asset</th>
<th>Adjusted Basis</th>
<th>Value</th>
</tr>
</thead>
<tbody>
<tr>
<td>A</td>
<td>$ 10,000</td>
<td>$ 50,000</td>
</tr>
<tr>
<td>B</td>
<td>20,000</td>
<td>50,000</td>
</tr>
<tr>
<td>C</td>
<td>30,000</td>
<td>50,000</td>
</tr>
<tr>
<td>D</td>
<td>40,000</td>
<td>50,000</td>
</tr>
<tr>
<td>Total</td>
<td>$100,000</td>
<td>$200,000</td>
</tr>
</tbody>
</table>

Assume further that the wife is to receive three assets worth a total of $150,000. Before Rev. Rul. 74-347, the parties might first have awarded to the wife Assets A and B and to the husband Assets C and D. The husband might then have transferred Asset D to the wife in payment of a marital obligation, giving the husband a taxable gain of $10,000 and giving to the wife a basis of $50,000 in Asset D. Rev. Rul. 74-347 seems to assume this cannot be done. In the example given, the total adjusted basis (before modification) of property received by the wife is $70,000 (assets A, B and D), the value of “ex-
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"excess" property received by the wife is $50,000 and the value of all property she receives is $150,000. Under Rev. Rul. 74–347, the husband's basis in "excess" property transferred to the wife is presumed to be one-third of $70,000, or $23,333. His recognized gain is therefore $26,667, and the wife's basis in her assets should be correspondingly increased. The Ruling, however, does not indicate how the increased basis is to be allocated to the respective properties received by the wife.

It is submitted that the Ruling is incorrect with respect to calculation of the husband's gain and the wife's adjusted basis in the property transferred. Under the Ruling, the Commissioner has adopted an "item-by-item" approach in determining the wife's basis in assets before the adjustment and a kind of "aggregate" approach in determining the amount of the husband's gain. Under a pure "item-by-item" approach, the parties could designate which assets are the "excess" assets transferred to the wife and basis adjustments would be made only on those assets. Under a pure "aggregate" approach, the aggregate basis would be allocated in accordance with value. The basis in "excess" property transferred could then be determined in accordance with the following formula: basis in excess property transferred bears the same ratio to total basis as the value of excess property transferred bears to total value. After the husband's gain is computed, it is added to each asset received by the wife in proportion to the value such asset bears to total value of assets received.87 Either a pure item-by-item approach or a pure aggregate approach is preferable to that taken in Rev. Rul. 74–347 because either approach, applied con-

87. Thus, in the preceding example, each of the four assets would have a basis equal to one-half its value, or $25,000, since the aggregate basis ($100,000) is equal to one-half the aggregate value ($200,000). Under the formula suggested:

\[
\frac{\text{basis of excess property (X)}}{\text{aggregate basis}} = \frac{\text{value of excess property}}{\text{aggregate value}}
\]

\[
\frac{X}{100,000} = \frac{50,000}{200,000}
\]

\[
X = 25,000
\]

Husband's gain now equals $25,000 ($50,000 (value) less $25,000 (adjusted basis of excess property)). Total value of assets (A, B & D) received by the wife equals $150,000. The value of each asset ($50,000) accounts for 1/3 of the total value received by the wife. Thus, her basis in each asset is increased by $8,333 (1/3 of $25,000) to $33,333 ($25,000 + $8,333).
sistantly, clearly allocates the increased basis to the respective properties received by the wife.

Rev. Rul. 74-347 makes it clear that the Internal Revenue Service now acquiesces in the proposition that an "equal division" of co-owned property pursuant to a dissolution of marriage is not a taxable event. By referring to "net fair market values," the Ruling also suggests that property subject to indebtedness can be divided on a tax-free basis. Moreover, the Ruling assumes that the basis of assets awarded to each spouse in a nontaxable division is the same as the pre-dissolution basis in that property, thus implying that ostensibly "equal" property divisions in which one spouse receives cash only (so long as the cash was the joint or community property of the spouses prior to dissolution) can be nontaxable.

In Rev. Rul. 74-347 the husband surrendered an interest in jointly held property in order to free his separate property from his wife's marital obligation claims.88 One might therefore argue that the Ruling does not apply to an unequal division of community property unless there is also some separate property involved in the settlement. If there is no separate property, a husband who receives less than half the community property could claim that he receives nothing for the excess property transferred by him, because he has no separate property subject to his wife's claims. However, there is little merit to such an argument. The husband could receive something of value in an unequal community property division, such as a release or reduction of his wife's claims to his post-dissolution earnings and property. Certainly there is no indication that Mr. Davis (in United States v. Davis) could have avoided tax by transferring everything he had to his wife.89

V. ASSIGNMENT OF INCOME PROBLEMS IN TAXABLE AND NONTAXABLE PROPERTY SETTLEMENTS

A. General

Although the preceding discussion is concerned primarily with community property, it also applies to marital settlements in which any

88. See text accompanying note 86 supra.
89. The Court in Davis assumed that the husband had received value for the transfer of property to his wife equivalent to the value of that property. See text accompanying note 2 supra.
joint or common property interests are divided or sold. Assignment of income problems, however, are almost unique to community property jurisdictions. In a noncommunity property state, if the spouse who has earned a right to receive income retains that right, the other spouse will not be taxed when the earner collects the income. The earner is also taxed even though he transfers the right of collection to the other spouse. In neither event is the spouse who did not earn the income taxed.

Results in community property states are different because each spouse is entitled to share equally in the income earned and gains derived by the community. It follows that if one spouse is awarded a right to receive earned income in a nontaxable property settlement, the other spouse will nevertheless be treated as having earned one-half the income and will be taxed on that one-half when it is collected by the other spouse. This assignment of income principle can arise in many contexts. Some obvious instances include: (1) Accounts receivable earned by cash basis taxpayers during the existence of the marital community but not collected until after the community is terminated; (2) Vested and contingent rights under qualified pension plans earned during the existence of the marital community but not collected until the post-dissolution retirement or death of the employee; (3) Amounts receivable under installment contracts, the gain on which is reported as amounts are paid by the debtor under Section 453 of the

90. Albert Hurwitz, 23 CCH Tax Ct. Mem. 2011 (1964) (earner of noncommunity property taxed in the year of transfer, where he assigned rights to personal service income to his wife pursuant to the dissolution of their marriage).

91. See, e.g., United States v. Mitchell, 403 U.S. 190 (1971), where the Supreme Court held a Louisiana widow liable for tax on one-half the income earned by her deceased husband even though she had renounced any claim to such income. See also Mary Lou Galliher, 62 T.C. 760 (1974).

92. This assumes, of course, that the income was earned during coverture. When a marital community terminates may be difficult to determine because something less than divorce or dissolution can terminate it in some jurisdictions. See Knodle v. Warren, 67-1 U.S. Tax Cas. ¶ 9261 (W.D. Wash. 1966)(community terminated when spouses separate and by agreement or otherwise manifest an intent to dissolve the community). Although a community can terminate before dissolution, the parties may file a joint income tax return if they are not in fact divorced at the end of the tax year. For general discussion, see Internal Revenue Service, Dep't. of the Treasury, Community Property and the Income Tax, Pub. 555 (1973).

93. For discussion of such pension plans, see Note, Disposition of Military Retired Pay Upon Dissolution of Marriage, 50 Wash. L. Rev. 505 (1975).
If these assets are partitioned, with one-half ultimately payable to each spouse, the partition is not taxable and each spouse will report his or her proportional share as collected. But in most cases the income items will go to one spouse in return for property awarded to the other. The questions raised are whether the division is itself taxable and, if it is not, who should bear the tax burden when the income is eventually collected.

B. Accounts Receivable of Cash Basis Taxpayers

If a wife “sells” her interest in community property accounts receivable for the separate property or separate obligation of the husband, she will be taxed on her half of the income at the time of sale. In such a sale, the wife’s basis in the consideration received (if other than

94. See I.R.C. §§ 47, 1245, 1250 & 1251. These recapture items are discussed in Part VI infra. As to investment credit recapture, the court, in Frank R. Hammerstrom, 60 T.C. 167 (1973), held that a conversion of community property into property held by former spouses as tenants in common does not trigger investment credit recapture. The decision implies, however, that a wife who transfers her interest in “section 38 property” (certain depreciable property for which an investment tax credit is granted) in exchange for her husband’s interest in other property is subject to the recapture rules of I.R.C. § 47. See also Rev. Rul. 390, 1970-2 CUM. BULL. 2 (although surviving spouse receives stepped-up basis in her share of community property under I.R.C. § 1014(c)(6), she is still subject to investment credit recapture rules if the property is sold even though the interest of the decedent is not subject to these rules).

95. See, e.g., Royce L. Showalter, 33 CCH Tax Ct. Mem. 192 (1974), in which a wife received some assets and cash in a “division” of community property. In addition, she received her husband’s separate note of $10,000 “in payment for” accounts receivable of the husband (community property under Texas law) in the amount of $10,910.40. The wife was held to have realized $5,455 in the year of “sale” to her husband. Presumably, the husband had to account for only $5,455.

Showalter is unfortunately typical in the questions it leaves unanswered. Thus, if the wife received a note of $10,000, why is her income limited to one-half the accounts receivable? If the note is for something other than her interest in accounts receivable, one wonders why no gain or loss on the sale of the other item is not considered. Perhaps the excess payment is really a lump sum payment for the wife’s support, not includable in her income and not deductible by the husband.

Perhaps rough justice is all that can be expected in these cases, but even rough justice should be articulated. The Internal Revenue Service seems to take the position
Community Property Marital Settlements

cash) will be the amount reported as income on the sale plus her share of community basis, if any, in the accounts. But the mere fact that a division involves accounts receivable does not render it taxable. The Ninth Circuit Court of Appeals indicated in Johnson v. United States that a division in which one spouse receives all accounts receivable and the other spouse receives other community assets in return is non-taxable. In such a nontaxable division, each spouse will, of course, nevertheless report one-half the income from the accounts receivable as it is collected, regardless of who collects it. To illustrate, if the only assets are (1) accounts receivable with an adjusted basis of zero and a value of $20,000 and (2) a house with a basis of $10,000 and a value of $20,000, an award of the accounts to the husband and the house to the wife would be nontaxable. The wife, however, will recognize $10,000 of income when the accounts are collected by her husband.

Because existing rules have no sound logical base, the collateral tax consequences of the wife's recognition of income are impossible to predict with confidence. For example, in the illustration just discussed, the husband reports $10,000 income from the accounts receivable. The wife reports $10,000 income also but should be able to increase her basis in the house from $10,000 to $20,000. Such a basis step-up, however, could result in a loss of tax revenue because $20,000 of income is taxable in any event and would not, absent divorce, lead to a step-up in basis. One could argue alternatively that the husband that tax will not be imposed in the year of sale (but rather when payment is made) if hardship would otherwise result. See Rev. Rul. 471, 1969-2 Cum. Bull. 10. But cf. Realty Loan Corp., 54 T.C. 1083 (1970); Charles Sorensen, 22 T.C. 321 (1954) (wife does not qualify for installment sale provisions on sale of pension rights because such rights are not "property" for tax purposes).

96. Royce L. Showalter, 33 CCH Tax Ct. Mem. 192 (1974) illustrates difficulties that can arise in this area. The Tax Court assumes that the taxpayer's adjusted basis in the accounts receivable was their face value, rather than the amount reported by her as income. If the excess of face value over adjusted basis represented only a payment in discharge of marital obligations (rather than a purchase of other property), the conclusion is correct.

97. 135 F.2d 125 (9th Cir. 1943).

98. See Helvering v. Eubank, 311 U.S. 122 (1940). See also United States v. Mitchell, 403 U.S. 190 (1971). In Lucas v. Earl, 281 U.S. 111 (1930), the Supreme Court held that income is taxed to the person who earns it. The earner cannot shift the tax to someone else by assigning the right to receive that income to someone else. In Poe v. Seaborn, 282 U.S. 101 (1930), the Court elaborated on Lucas in holding that in a community property state, the husband and the wife each "earn" one-half the income earned by the other. Accordingly, a wife who relinquishes her right to collect income earned during the existence of the marital community (and therefore earned by her) will be taxed on it.

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should recognize a capital gain of $10,000 when he transfers the house to the wife, but in such a case he would bear the entire tax burden attributable to the appreciation of the house.

To amplify, the illustration shows $10,000 potential capital gain in the house awarded to the wife and $20,000 potential ordinary income in the accounts awarded to the husband. United States v. Mitchell indicates that each spouse should eventually recognize $10,000 of ordinary income and $5,000 of capital gain. Thus, the wife should recognize $10,000 of ordinary income upon collection of the notes and have an adjusted basis of $15,000 in the house. The husband should recognize a capital gain of $5,000 when the house is transferred to the wife (he has sold his interest in the house) and should recognize ordinary income of $10,000 when the notes are collected. This result would be inconsistent, however, with the rule that an equal division is not taxable even if accounts receivable are awarded to one spouse. Thus, none of these results are entirely acceptable and there is apparently no case or revenue ruling which adequately considers the dilemma.

In any event, separation contracts should be drafted in such a manner that accounts receivable are either partitioned or sold by one spouse to the other in a taxable sale. To allocate the accounts to one party in a nontaxable division will almost certainly impose hardship on the spouse who surrenders his or her rights in those accounts.

C. Retirement Benefits

Retirement benefits, whether in the form of interests in qualified pension and profit sharing plans, or in nonqualified plans, may often be the single most valuable asset of a marital community. A preliminary question that should be asked in these cases is whether nonvested pension rights should be considered community property for federal income tax purposes. Lucas v. Earl holds that income is

99. 403 U.S. 190 (1971), discussed at note 91 supra.
100. It is possible, but not certain, that this result was adopted in Johnson by the Court of Appeals for the Ninth Circuit. The court's opinion does indicate that the husband would recognize some gain in this example but does not indicate the effect on the wife's basis in property.
102. 281 U.S. 111 (1930).
taxed to the person who earns it, even if the right to collect the income is transferred to someone else. The court held in *Poe v. Seaborn*[^103] that one-half the income earned by a husband in a community property state is in fact "earned" by the wife and should be taxed to her. It seems to follow that a husband's retirement benefits, if awarded to him in a nontaxable exchange, will be at least partially taxable to the ex-wife when the ex-husband collects those benefits. But if the retirement benefits are subject to a substantial risk of forfeiture until after the marriage is dissolved, e.g., the rights are forfeited if the employee resigns without cause,[^104] it can be argued that none of the benefits are in fact earned until the marriage has been dissolved and that no benefits should be taxed to the nonemployee spouse. Although the question remains unresolved, it would seem proper to hold that retirement benefits which are subject to a substantial risk of forfeiture are not community property for federal income tax purposes.[^105] If so, many divisions considered to be equal under state law may not be equal for federal tax purposes.[^106]

It seems clear, however, that if a wife *sells* her interest in vested retirement rights to her husband for his cash or separate property, the sale is a taxable event. At least one court has also held that a wife, who withdraws her one-half community interest in a qualified profit-sharing fund maintained by her husband's employer, recognizes ordinary income to the extent of the withdrawal.[^107] But one commentator has


[^104]: For treatment of some of these plans, see I.R.C. § 83. Even qualified plans may remain unvested for a period of time. *See* Employee Retirement Income Security Act of 1974, 8A U.S. CODE CONG. & AD. NEWS 1 (Sept. 2, 1974).


[^106]: To illustrate, if a husband and wife own property with a basis of $10,000 and a value of $20,000, and if that property is awarded to the wife in return for her release of claims against the husband's forfeitable retirement benefits (which he considers to be worth $20,000), the division, which the parties consider to be equal, may be unequal because the husband has received "no property" for federal tax purposes and, therefore, must recognize a gain of $5,000. The husband surrenders (sells) his one-half interest in the property (basis $5,000 and value $10,000) in return for the wife's release of her claims against the retirement benefits and, therefore, must recognize the $5,000 gain. Rev. Rul. 74-347, 1974 INT. REV. BULL. No. 29, at 6.

[^107]: Bussey v. United States, 71-1 U.S. TAX CAS. ¶ 9314 (W.D. Tex. 1970). The taxpayer in *Bussey* apparently failed to argue that the transaction should be treated as a nontaxable division of community cash. Instead, she argued only that the proceeds should have been taxed to her as long term capital gains. The Service has ruled that there is no "disposition" when stock purchased by the husband with community property funds through the exercise of a qualified stock option is divided equally be-
suggested that equal divisions involving the transfer of an interest in vested pension rights are nontaxable.\(^\text{108}\) In such nontaxable divisions, the wife is presumably taxed on part of the pension when it is collected. The commentator provides, as an example of a nontaxable property division involving vested retirement rights, a marital community owning a pension right with a basis of zero and value of $100,000, cash of $50,000, and stock with a basis of $10,000 and value of $50,000. Pursuant to divorce, the husband received the pension and the wife received the cash and stock. The commentator concludes that the wife would have no income upon the division but that she would report half the pension as income as it is collected by the husband.\(^\text{109}\)

These presumed tax consequences of nontaxable divisions of pension rights are, however, unrealistic and unreasonable. An ex-wife is not likely to report any part of her ex-husband's pension after he retires. Retirement might occur 10 to 30 years after divorce. It is extremely unlikely that she would know how much to report even if she were aware of the law and wanted to report the proper amount of income. Finally, if she predeceases the husband, the tax she might be liable to pay cannot be paid by anyone. Her obligation to pay a tax in the future is not, after all, income in respect of a decedent.\(^\text{110}\)

Divisions involving transfers of vested retirement benefits should be taxed in the year in which the division takes place or, if not taxed, should by legislation be treated as the separate property of the employee spouse for federal income tax purposes.\(^\text{111}\)
Community Property Marital Settlements

D. Rights Under Installment Contracts

Property divisions involving transfers of community property interests in accounts receivable and in vested pension (and similar) rights create special problems because these items are not "property" for federal tax purposes. They represent rights to income earned by the marital community properly taxable one-half to each spouse. Gains from installment contracts representing income realized by the community, but not reported until after dissolution, are similar to accounts receivable and pension rights in these respects and present similar problems. One might, therefore, expect installment contracts to be treated like accounts receivable. In Ann Y. Oliver, however, the court treated an installment contract like any other community "property." In Oliver the husband received the right to collect on an installment contract in a nontaxable division. The tax court ruled that the husband assumed the basis of the community in the contract. Thus, he was taxed on all the installment income even though it was "realized" while he was married to his former spouse. The court apparently did not consider whether the former wife should have been taxed on one-half the income. Oliver is the only case in this area and is of dubious precedential value.

E. A Caveat

The preceding discussion assumes that nontaxable property divisions involving transfers of rights to earned income cannot operate to

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sury could lose substantial revenue when and if employee spouses report only a fraction of their pension income on the theory that the remainder should be taxed to an ex-spouse.

112. One might argue that any disposition of an installment obligation is a taxable event, even in an equal division pursuant to dissolution, because I.R.C. § 453(d) indicates that any disposition of an installment obligation is taxable unless the disposition is specifically exempted from taxation by that section. No cases which consider this question have been discovered.

113. 8 CCH Tax Ct. Mem. 403, 428–31 (1949). In Oliver, a husband and wife sold Texas community property on the installment basis for $1,500,000. The community basis in the property sold was slightly over $40,000 and the sale occurred in 1941. Divorce occurred in 1942, the husband was awarded all rights in the contract in a division assumed to be "nontaxable." The Commissioner wanted to reduce the husband's basis in the property by one-half, but the court ruled that the husband received the entire community basis in property awarded to him in a nontaxable division. The court thus assumed two doubtful propositions without discussion: (1) that there was no taxable disposition; and (2) that the wife should not be taxed on half the income.
shift the tax on the earned income from one spouse to the other. However, as we have seen, assignment of income principles are not applied to divisions involving transfers of rights under installment contracts, and their application to divisions involving transfers of pension rights would lead to intolerable and unrealistic results. Parties to a dissolution settlement should be aware that it is entirely possible that a court in the future will refuse to apply these principles to divisions by which rights in accounts receivable are transferred. It would be more equitable and practical to tax the income from accounts receivable to the person who collects that income, regardless of who earned it, unless a division involving accounts receivable is taxable to the extent such accounts are transferred, as suggested below.

VI. A PROPOSAL

A. General

Statements to the effect that equal divisions of community property are not taxable events are incomplete at best: they do not address the ancillary tax consequences (e.g., post-division adjusted basis in individual assets) of nontaxable property divisions; they do not define what is meant by “equal division”; they do not distinguish “divisions” from “sales”; and they do not consider the unique problems presented by divisions involving rights to earned income and other items. The development of decisional law in this area has been understandably haphazard; a court in a given case is seldom called upon to decide more than one issue.\textsuperscript{114} Thus, as we have seen, community property divisions present many issues not yet faced by any court. The resulting lack of coherence and predictability is understandable but regrettable. Comprehensive guidelines should be promulgated.\textsuperscript{115} Although courts

\textsuperscript{114} If the issue is whether one or both spouses should pay a tax because of the division, a court is not necessarily required to decide what the adjusted basis of each spouse in property should be after the division; if the issue is whether accounts receivable awarded to one spouse should be taxed in part to the other spouse, a court may not be required to decide what effects its decision will have on the adjusted basis of other property awarded to each spouse. Moreover, a decision involving a nontaxable division of property other than cash may be of little relevance to an equal division in which one spouse receives his or her entire interest in cash.

\textsuperscript{115} Nonetheless, the Internal Revenue Service apparently has abandoned its attempts to promulgate comprehensive guidelines dealing with community property marital settlements. Instead, protection is to “be achieved by the spouses entering
would not be required to follow such guidelines, guidelines would make a court more aware of the implications of its decision on issues not immediately before it and would contribute to a more orderly development of the law.

As a general proposition, the tax consequences of property settlements made pursuant to the dissolution of marriages should be based upon the nature of the marital relationship. Although a marital relationship in a community property state may not qualify as a partnership under state law or the Uniform Partnership Act, it is more closely akin to a partnership than any other entity or quasi-entity recognized by the Code. Moreover, the Code already contains detailed rules governing the dissolution of partnerships and the sale of partnership interests.

For instance, it is a general rule that a partner must recognize gain on the dissolution of a partnership only to the extent that cash received exceeds his adjusted basis in the partnership. His adjusted basis in assets received on dissolution is determined by reference to his basis in the partnership, reduced by any cash received pursuant to the

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Footnotes:

116. And there is no escape from the fact, however much some may cavil at it, that it [the community system] was viewed there [in Spain] as being in the nature of a partnership between the spouses... It is difficult to see how it can be considered in any other light, for it represents the right to share equally in the acquests and gains of the spouses during the marriage as well as liability for the obligations incurred on behalf of the community, usual attributes of a partnership.

W. deFUNIAK & M. VAUGHN, PRINCIPLES OF COMMUNITY PROPERTY § 95, at 236-37. (2d ed. 1971). Professor Cross has stated that the “community property system may be regarded as a type of partnership,” adding that though such spouses “are not possessed of the rights and liabilities of ordinary business partners,” each spouse is regarded as contributing equally to and sharing equally in the economic well-being of the marital enterprise. Cross, The Community Property Law in Washington, 49 WASH. L. REV. 729, 733-34 (1974).


dissolution. There are also special rules which apply to sales of partnership interests and to dissolutions and sales involving unrealized receivables and appreciated inventory. These rules, with appropriate modifications recognizing unique problems presented by marital partnerships, may be profitably applied to property settlements made pursuant to marriage dissolutions in community property states.

B. Ascertain the Adjusted Basis in the Marital Community

A member of a formal partnership knows that his or her adjusted basis in the partnership is not necessarily the sum of his or her proportionate share of the partnership’s basis in each asset it owns; it is rather the algebraic sum of a given partner’s adjusted basis in property he or she contributed to the partnership, plus partnership income taxed to that partner, plus his or her share of partnership indebtedness, less prior tax deductions claimed, and less prior distributions. The adjusted basis of a spouse in a marital community cannot usually be ascertained in such a formal manner for obvious reasons. However, a very close approximation can be made by ascertaining the sum of the community’s basis in each asset it owns (including cash) and dividing the result by two. The result is each spouse’s adjusted basis in the marital community. To illustrate, if a husband and wife own (1) a house with an adjusted basis of $30,000 and a value of $50,000, and (2) cash of $50,000, total adjusted basis is $80,000 and the adjusted basis of each spouse in the marital community is $40,000. If the husband receives the cash and the wife the house in an equal division pursuant to dissolution of the marriage, the husband recognizes a capital gain of $10,000 since he has in effect “cashed out” his interest in the partnership. The wife has no gain and her adjusted basis in the

119. I.R.C. § 732(b).
120. I.R.C. § 741.
121. I.R.C. §§ 735 & 751.
122. The detailed rules relating to partnership dissolutions and sales are readily available elsewhere and are not discussed in this proposal. For a discussion of partnership taxation, see, e.g., A. Willis, Handbook of Partnership Taxation (1957).
123. I.R.C. § 722.
124. I.R.C. § 705. The assumption of liabilities is considered to be a contribution of money to the partnership. I.R.C. § 752.
house is increased from $30,000 to $40,000 to correspond to her basis in the prior partnership. If the second asset in the above example were, instead of cash, a security with a basis of $40,000 and a value of $50,000, the division would be nontaxable and each spouse's adjusted basis in property awarded to him or her would be $35,000.125

If this formulation is accepted, it would require several modifications, the first of which would account for unique problems presented by property the sale of which gives rise to a nondeductible loss. Such property may be referred to as "nondeductible property."

C. Basis Modifications for "Nondeductible Property"

Most marital communities own some assets not held for sale to customers, for investment or for use in a trade or business. Many of these assets will be worth less than their adjusted bases because, although they depreciate in fact, basis is not adjusted since depreciation deductions are not allowed.126 Common examples of assets usually worth less than adjusted basis are automobiles, furniture and boats. Other items of nondeductible property, such as homes, might or might not be worth less than their adjusted basis. Application of the formula set forth above, without modification, would be improper because unrealized nondeductible losses might be used to increase the adjusted basis of appreciated items.

The proposed solution to problems of nondeductible property may be illustrated by a simplified example of a marital community owning only two assets—a house worth more than its adjusted basis and a boat worth less:

<table>
<thead>
<tr>
<th>Asset</th>
<th>Adjusted Basis</th>
<th>Value</th>
</tr>
</thead>
<tbody>
<tr>
<td>House</td>
<td>$20,000</td>
<td>$30,000</td>
</tr>
<tr>
<td>Boat</td>
<td>40,000</td>
<td>30,000</td>
</tr>
<tr>
<td>Total</td>
<td>$60,000</td>
<td>$60,000</td>
</tr>
</tbody>
</table>

125. This proposed formula differs from results in recent trial court cases. See, e.g., Beth W. Corp v. United States, 350 F. Supp. 1190 (S.D. Fla. 1972), in which the basis of the community in a given property carried over to the spouse to whom the property was awarded.

126. I.R.C. § 167 grants a depreciation deduction only for "property used in the trade or business" or "property held for the production of income." See also I.R.C. § 183.
If the marital community were to sell both assets, the community would recognize a $10,000 taxable gain and a $10,000 nondeductible loss. That result should not be changed merely because the property is divided pursuant to a dissolution of the marriage. If partnership rules are applied without modification, aggregate basis of $60,000 would be divided between husband and wife. Thus, if the wife received the house and the husband the boat, and if each sold his or her asset at division-date value, neither would recognize a gain because each would have a basis in the marital community of $30,000. If one assumes that the value of the nondeductible loss property will never rise above division-date value, the modification would be simple: Provide that the adjusted basis of each nondeductible property asset, in computing basis in the marital community, shall be the lesser of division-date value or adjusted basis.127 Thus, the basis of the boat would be reduced to $30,000 in computing an aggregate marital community basis of $50,000. The wife's basis in the house would be $25,000 and the husband's basis in the boat would be $25,000. If each asset were sold at division-date value, total income recognized would be the same as if both assets had been sold prior to dissolution.

This modification admittedly results in the loss of capital which might be recoverable if the loss item appreciated after the division date, but in most cases the problem will not exist. Where the problem does exist, it can be solved by not recognizing the gain on the sale of nondeductible items 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. Specifically, if the boat in the above example were subsequently sold by the husband for $30,000, he would recognize a $5,000 gain; if it were sold for $40,000, he would still recognize only a $5,000 gain; but if it were sold for $45,000, he would recognize a $10,000 gain.

D. Problems Presented by Community Debts

Under the proposal here advanced, the assumption by one spouse of community debts, or the award of property to one spouse subject to

127. This is a variation of the approach adopted in Rev. Rul. 74-347, 1974 INT. REV. BULL. No. 29, at 6, which involved a taxable "unequal" division of joint property. See Part IV supra.

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what was formerly a community debt, should ordinarily be treated as a distribution to the other spouse of cash equal to one-half the amount of the community debt.\textsuperscript{128} At the very least, exoneration from debts should be treated in the same manner as the receipt of cash if the debt is reflected by a lien on specific property awarded to the spouse who agrees to pay the debt. Consider a marital community owning the following assets:

<table>
<thead>
<tr>
<th>Asset</th>
<th>Adjusted Basis</th>
<th>Gross Value</th>
<th>Lien</th>
<th>Net Value</th>
</tr>
</thead>
<tbody>
<tr>
<td>House</td>
<td>$40,000</td>
<td>$60,000</td>
<td>$20,000</td>
<td>$40,000</td>
</tr>
<tr>
<td>Securities</td>
<td>30,000</td>
<td>40,000</td>
<td>0</td>
<td>40,000</td>
</tr>
<tr>
<td>Total</td>
<td>$70,000</td>
<td>$100,000</td>
<td>$20,000</td>
<td>$80,000</td>
</tr>
</tbody>
</table>

Assume further that the husband receives the house, subject to the lien, and that the wife receives the securities, in an equal division of property pursuant to the dissolution of the marriage. It would be inappropriate simply to state that the wife's adjusted basis in the securities is $35,000 (one-half of total adjusted basis). The wife, in such event, would receive $10,000 of capital for which she pays nothing. Therefore, the wife's adjusted basis in the securities should be reduced from $35,000 to $25,000 and the husband's adjusted basis in the house increased from $35,000 to $45,000. The propriety of this result is supported by comparing the tax consequences of sales with and without dissolution at division-date value. Absent dissolution, the total gain on the sale of all assets would be $30,000. Each spouse would be taxable on half of such gain—$15,000 per spouse. Under the formula set forth in this paragraph, the husband and wife would each recognize a gain of $15,000 on the sale at division-date value of the house and securities, if the house were awarded to the husband and the securities were awarded to the wife pursuant to a dissolution of the marriage. In sum, where debts are assumed by one spouse under these circumstances, one-half the debt should be treated as a distribution to the "exonerated" spouse and as a capital investment by the other spouse.

These same rules should also apply to general unsecured debts of the community. For example, if the community owns assets with a

basis of $5,000 and a value of $10,000, and if the community has
general unsecured indebtedness of $10,000, the wife should realize a
gain of $2,500 if she "walks away" in a division awarding all assets to
the husband, subject to all community debts.\footnote{129} The same result
would follow if the division were treated as unequal (wife transferring
her half of the assets to the husband in discharge of a marital obliga-
tion) and if the debt assumption by the husband were disregarded.

E. Unrealized Receivables and Appreciated Inventory

The dissolution of a partnership is not normally considered to be a
sale or exchange. Cash distributed pursuant to a partnership dissolu-
tion, therefore, first reduces a partner's basis in a partnership and is
taxable only to the extent that the amount distributed exceeds a part-
ner's basis in the partnership.\footnote{130} Other items distributed are not con-
sidered to be sold or exchanged except to the extent that an interest in
an ordinary income type asset is exchanged for an interest in a capital
gain type asset. Thus, a partner whose basis in a partnership is
$10,000, and who receives cash of $8,000 and property worth
$10,000, will not be taxed on the distribution and will have an ad-
justed basis of $2,000 in the property received\footnote{131}—unless the dissolution
involves an exchange of, for example, accounts receivable for
capital assets. To the extent of the exchange, the dissolution is tax-
able.\footnote{132}

To illustrate in a marriage dissolution, assume that a husband and
wife own the following assets as partners:

<table>
<thead>
<tr>
<th>Asset</th>
<th>Adjusted Basis</th>
<th>Value</th>
</tr>
</thead>
<tbody>
<tr>
<td>House</td>
<td>$30,000</td>
<td>$50,000</td>
</tr>
<tr>
<td>Accounts Receivable</td>
<td>0</td>
<td>50,000</td>
</tr>
<tr>
<td>Total</td>
<td>$30,000</td>
<td>$100,000</td>
</tr>
</tbody>
</table>

\footnote{129} If the assets had been sold at value prior to division and the proceeds used
to pay the community debt, total gain would be $5,000; each spouse's share of the
gain would be $2,500 and neither spouse would end up with anything of value because
all the cash must be used to pay the community debt.

In the textual example, results are essentially the same. The wife is left with
nothing. The husband owns assets worth $10,000 but they are subject to an equal
amount of indebtedness.

\footnote{130} I.R.C. § 731.
\footnote{131} I.R.C. § 732(b).
\footnote{132} I.R.C. §§ 731 & 751; Treas. Reg. § 1.751-1(b) (1956). The Regulations do
not refer to partnerships having two partners only, but presumably include such
partnerships.
If the house were sold and the accounts were collected before dissolution of the partnership, each partner would recognize capital gain of $10,000 and ordinary income of $25,000. These results would not be changed merely because the partnership is dissolved; likewise, they should not be changed merely because the marriage relationship terminates.

In the dissolution of a partnership, Section 751 and related sections of the Code indicate that in the example just given, each spouse shall be treated as having "sold" his or her interest in the partnership to the extent that his or her share of "income" items is exchanged for the interest of other partners in "property" items—and vice versa. Thus, if in the example given, there is a division by which the wife receives the house, and the husband the accounts receivable, the wife is deemed to have sold her interest in accounts receivable (basis of zero and value of $25,000), in return for her husband's interest in the house, recognizing $25,000 of ordinary income. Her basis in the house becomes $40,000; the distribution of the house to her is not a taxable event. The husband is deemed to have sold his interest in the house (basis $15,000 and value $25,000), recognizing a capital gain of $10,000 and obtaining a basis of $25,000 in the accounts receivable. Assuming no change in values, the husband will recognize $25,000 of ordinary income when the accounts are collected; the wife will realize a capital gain of $10,000 when the house is sold. Thus, tax consequences are the same as if the marriage had not been dissolved. Only the timing is different.

In some cases, of course, the rules proposed above will accelerate the recognition of income and may impose hardship. Some hardships, however, can be avoided by a division which provides for an equal partition of income items. Such divisions need not be taxable events because they do not involve the exchange of "property items," e.g., cash or house, in return for "income items," i.e., items listed as "unrealized receivables" and "substantially appreciated inventory" in the Code.133

The suggested formula may also be resisted by taxpayers because it renders a division a taxable event to the extent that an interest in ordi-

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133. Section 751 does not apply to any distribution to a partner of his or her ratable share of appreciated inventory or unrealized receivables. Treas. Reg. § 1.751-1(b)(1)(ii).
nary income type assets is exchanged for an interest in capital gain type assets (and vice versa). The author doubts, however, whether existing uncertainty is preferable to the solutions proposed. Moreover, the propriety of taxing all "income items" to the person who collects those items is questionable. Such a rule would be inconsistent with our present notions of community property law and would permit tax avoidance by allocating "income items" to the spouse in the lower tax bracket.

The formula suggested herein is also a necessary corollary to the proposal that aggregate community basis be divided equally between spouses. If that proposal is accepted, consistency requires that partnership-type treatment also be applied to divisions of income items.

F. More Assignment of Income Problems—Retirement Benefits

The rules relating to partnership taxation and dissolution are readily applicable to assignment of income problems inherent in the division of retirement benefits upon dissolution. It is likely that most retirement benefits accounted for in a community property division are "income items" which have not previously been taxed. Application of the formula proposed above would cause one-half the division-date value of those benefits to be taxed to the nonemployee spouse in the year of division if she receives other property in return for her interest in those benefits. The employee spouse would recognize a capital gain to the extent that he surrenders an interest in appreciated capital assets for his wife's interest in the retirement benefits. The suggested formula creates a substantial acceleration in the realization of income and creates an awkward "basis" in the employee’s retirement benefits.

Retirement benefits present problems that are soluble only by legislation. While it is assumed that divisions involving retirement benefits can be tax-free, it is also further assumed, unrealistically, that the nonemployee spouse will be taxed when benefits are received by the employee spouse.134 To eliminate unacceptable acceleration in realization of income under the formula, legislation should permit partners to remove vested retirement benefits and other property of equal value from the partnership equation. Thus, if vested pension rights have a

present basis of zero and a present value of $50,000, other property of equal value could be awarded to the nonemployee spouse in return for his or her interest in the pension. The nonemployee spouse would then take the other property at the marital community’s adjusted basis. Only the employee spouse would recognize income as the retirement benefits are collected. This solution would cause a disproportionate share of the tax burden to fall upon the employee spouse, but it would prevent premature realization of income and problems incidental to such realization. A similar solution could, of course, be applied to all income items, but its application to items such as accounts receivable would lead to tax avoidance for the reasons already discussed.135

G. Unequal Divisions and Sales

Under the partnership rules, an unequal division, or a sale, should be treated as a transaction involving two separate and distinct steps: (1) an equal division subject to the rules proposed in Parts VI-A through F, supra, followed by (2) a sale of designated items by one spouse to the other for the separate cash or property of the other, or a transfer of property in discharge of a marital obligation.136 Under such a rule, the separation contract or dissolution decree should specify the assets to be received by each spouse in the equal division as well as the items transferred or sold after such a division.

The simplicity and equity of such a solution may be illustrated by an example. Assume that a husband and wife own as community property the following:

<table>
<thead>
<tr>
<th>Asset</th>
<th>Adjusted Basis</th>
<th>Fair Market Value</th>
</tr>
</thead>
<tbody>
<tr>
<td>House</td>
<td>$30,000</td>
<td>$75,000</td>
</tr>
<tr>
<td>Securities</td>
<td>20,000</td>
<td>25,000</td>
</tr>
<tr>
<td>Total</td>
<td>$50,000</td>
<td>$100,000</td>
</tr>
</tbody>
</table>

Regardless of whether the dissolution involves a “sale” or an “unequal” division, the first step should treat the dissolution as an equal

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135. See text accompanying notes 52–57 supra.
136. See Part III-B supra.
division, with the agreement or decree specifying the property to be awarded to each spouse. If the husband is to receive the securities and the wife is to receive the house, the husband, in the first step, should receive one-third ($25,000 worth) of the house and all the securities. The basis of each spouse in assets received by him or her would be half of the aggregate community basis, allocated among assets in accordance with market values. Results, in tabular form, can be expressed as follows:

<table>
<thead>
<tr>
<th>Asset</th>
<th>Adjusted Basis</th>
<th>Fair Market Value</th>
</tr>
</thead>
<tbody>
<tr>
<td>Securities (husband)</td>
<td>$12,500</td>
<td>$25,000</td>
</tr>
<tr>
<td>One-third house (husband)</td>
<td>12,500</td>
<td>25,000</td>
</tr>
<tr>
<td>Two-thirds house (wife)</td>
<td>25,000</td>
<td>50,000</td>
</tr>
</tbody>
</table>

Once these determinations are made, further tax consequences following from “inequality” of division or from categorization of the division as a “sale” are easily ascertained. Thus, because the division is unequal in fact, the husband realizes a capital gain of $12,500 under accepted principles since he is deemed to have transferred his share of the house in satisfaction of his marital obligations. The wife would have no income and would increase her basis in the house from $25,000 to $50,000. Precisely the same results would follow if the husband were to receive a (separate property) note from his wife in the amount of $25,000 in order to “equalize the division.” In the first instance the division was “unequal.” In the second instance the husband “sold” his interest in the house to the wife.  

VII. CONCLUSION

It is clearly not enough simply to say that “equal divisions” of community “property” are not taxable events. We have seen that what may appear to be an equal division may in fact be a taxable “sale.” It is obvious that not all “divisions” are “equal” and that “property” for state law purposes may not be “property” for federal income tax purposes. Thus, many property settlements are taxable in whole or in part even if the settlements involve only community property. This article

137. Although no cases discuss the issue, it appears that nonvested retirement benefits are not deemed property for federal tax purposes and, therefore, are not in the “equation” anyway.
has considered the ancillary tax problems created by nontaxable divi-
dsions and the tax consequences of settlements taxable in whole or in
part. We have seen that many questions remain unanswered and al-
though other questions have been answered on a piecemeal basis, the
development of the law has not been a model of rationality or cohe-
siveness.

It is sensible to consider a marriage in a community property state
to be a de facto partnership for tax purposes. Once this proposition is
accepted, the tax consequences of a property settlement pursuant to
the dissolution of such a marriage are easily predictable and one need
pay special attention only to modifications or adjustments required by
the unique character of property owned by marital communities, such
as nondeductible property and pension rights.

Taxpayers are entitled to certainty in negotiating property settle-
ments. No such certainty exists at present. The occasional hardship
that may result from application of partnership rules to marital rela-
tionships, e.g., acceleration of income, would be more than offset by
the fact that husbands, wives and their counsel could arrange dissolu-
tion settlements with confidence as to the resulting federal tax conse-
quences.