Michigan Law Review

Volume 61 | Issue 3

1963

Taxation-Federal Income Tax-Divocrce Property Settlement as a Taxable Event

Martin B. Dickinson Jr., S.Ed.
University of Michigan Law School

TAXATION—FEDERAL INCOME TAX—DIVORCE PROPERTY SETTLEMENT AS A TAXABLE EVENT—Respondent taxpayer transferred stock to his former wife pursuant to a voluntary property settlement agreement incorporated in their divorce decree. As consideration for the securities conveyed, his wife released her rights to alimony, dower, and intestate succession under Delaware law.[1] The Commissioner of Internal Revenue assessed as taxable gain the difference between the taxpayer's basis for the stock and its market value at the time of the transfer, but the Court of Claims ruled that the taxpayer realized no taxable gain from the transfer.[2] On certiorari, *held,* reversed.[3] The exchange was a taxable event in which the taxpayer received property equivalent in value to the market worth of the securities transferred. *United States v. Davis,* 370 U.S. 65 (1962).

The transfer of appreciated property pursuant to a divorce property settlement presents peculiar interpretative difficulties. Since the Internal Revenue Code of 1954 provides that appreciation in the value of property shall be taxed only upon its "sale or other disposition,"[4] the first question presented in the principal case was whether the transfer of property incident to a settlement agreement constitutes such a "sale or other disposition" and a consequent realization of economic gain or loss to the transferor

1 See DEL. CODE ANN. tit. 12, §§ 502, 901, 904, 905; tit. 13, § 1531 (1953); DEL. CODE ANN. tit. 12, § 512 (Supp. 1960).

2 Davis v. United States, 287 F.2d 168 (Ct. Cl. 1961).

3 The Court in the same opinion affirmed the holding of the Court of Claims that the taxpayer's payment of his wife's legal expenses in connection with the tax aspects of the divorce was not deductible under § 212(3) of the Internal Revenue Code of 1954. Principal case at 74.

4 INT. REV. CODE OF 1954, § 1001.

within the meaning of section 1001(a).[5] In such a property settlement the wife ordinarily releases her inchoate alimony, dower, and succession rights in return for an agreed consideration from the husband.[6] Assuming the consideration to have a fixed value as agreed upon by the parties, the husband receives the benefit of gain embodied in appreciated property, at least within the technical requirements of the Code, when he uses it to satisfy his settlement obligation, just as surely as if he sold that property and used the sale proceeds to satisfy the agreed obligation.[7] His wife, however, is concerned only with the total value of the property transferred to her; she derives no added benefit from the property she receives simply because its value at the time of the exchange exceeds its basis to her husband. While her marital rights constitute the basis of her bargaining position in the settlement negotiations and ordinarily bear an approximate relationship to the size of her husband's estate,[8] the specific property which she actually receives is designated in the agreement between husband and wife.[9] Assuming that the wife's bargaining position enables her to command a certain dollar amount in the settlement negotiations, it is of no concern to her whether she receives appreciated or depreciated property in satisfaction of her husband's obligation. It would be purely coincidental if the proportion of appreciation embodied in the property the wife in fact receives were equivalent to the proportionate growth in her settlement share by reason of capital accretions to her husband's estate. Such an analysis confirms the technical soundness of the established interpretation, followed by the principal case, that a transfer of appreciated property in a divorce settlement constitutes a realization of gain to the transferor and is therefore a taxable event to him.[10]

Measurement of the husband's taxable gain from the transfer presented a more difficult problem in the principal case. Section 1001(b) of the Internal Revenue Code of 1954 measures the amount realized from a "sale or other disposition" as "the sum of any money received plus the fair market value of the property (other than money) received." The

5 "The gain from the sale or other disposition of property shall be the excess of the amount realized therefrom over the adjusted basis provided in section 1011 for determining gain, and the loss shall be the excess of the adjusted basis provided in such section for determining loss over the amount realized."

6 See 1 NELSON, DIVORCE AND ANNULMENT § 13.07 (2d ed. 1945).

7 *Cf.* Helvering v. Horst, 311 U.S. 112 (1940); Kenan v. Commissioner, 114 F.2d 217 (2d Cir. 1940).

8 See 1 AMERICAN LAW OF PROPERTY § 5.18 (Casner ed. 1952); 2 NELSON, DIVORCE AND ANNULMENT § 14.42 (2d ed. 1961 rev.).

9 See Commissioner v. Halliwell, 131 F.2d 642 (2d Cir. 1942), *cert. denied,* 319 U.S. 741 (1943); 1 NELSON, *op. cit. supra* note 6, § 13.31.

10 Commissioner v. Halliwell, *supra* note 9; Commissioner v. Mesta, 123 F.2d 986 (3d Cir. 1941), *cert. denied,* 316 U.S. 695 (1942); E. Eugene King, 31 T.C. 108 (1958); Cristina de Bourbon Patino, 13 T.C. 816 (1949), *aff'd,* 186 F.2d 962 (4th Cir. 1950). *Accord,* Aleda N. Hall, 9 T.C. 53 (1947); Rev. Rul. 57-507, 1957-2 CUM. BULL. 511. *Contra,* Commissioner v. Marshman, 279 F.2d 27 (6th Cir.), *cert. denied,* 364 U.S. 918 (1960); Zimmers v. United States, 199 F. Supp. 903 (W.D. Ky. 1961). See also Rev. Rul. 59-47, 1959-1 CUM. BULL. 198; Rev. Rul. 57-506, 1957-2 CUM. BULL. 65.

Board of Tax Appeals, in early cases dealing with property settlements, found it impossible to determine the fair market value[11] of the property received by the husband, *i.e.*, the wife's released alimony, dower, and succession rights; it therefore declined to tax the husband.[12] The Courts of Appeals for the Second and Third Circuits reversed these decisions and assigned to the property received by the husband a value equivalent to that of the property transferred by him.[13] This view prevailed[14] until the original holding of the Board of Tax Appeals was revived by the Court of Appeals for the Sixth Circuit in *Commissioner v. Marshman*,[15] which was cited as controlling by the lower court in the principal case.[16] The *Marshman* decision returned to an outmoded view of section 1001(b) that prohibited taxation of capital gain at the time of the exchange if no fair market value could be assigned directly to the property received.[17] More recent cases, however, have presumed an equal exchange and have assigned to the property received a value equivalent to that of the property transferred where the latter has a readily ascertainable market value and an "arm's-length" transaction is involved.[18] Although most modern decisions have viewed a divorce property settlement as an arm's-length

11 "[F]air market value means the price at which a willing buyer and a willing seller would arrive, after negotiation for sale, where neither is acting under compulsion." *In re* Estate of Williams, 256 F.2d 217, 218 (9th Cir. 1958).

12 Walter S. Halliwell, 44 B.T.A. 740 (1941); L. W. Mesta, 42 B.T.A. 933 (1940).

13 Commissioner v. Halliwell, 131 F.2d 642 (2d Cir. 1942), *cert. denied*, 319 U.S. 741 (1943); Commisioner v. Mesta, 123 F.2d 986 (3d Cir. 1941), *cert. denied*, 316 U.S. 695 (1942).

14 E. Eugene King, 31 T.C. 108 (1958); Cristina de Bourbon Patino, 13 T.C. 816 (1949), *aff'd*, 186 F.2d 962 (4th Cir. 1950). *Accord*, Aleda N. Hall, 9 T.C. 53 (1947).

15 279 F.2d 27 (6th Cir.), *cert. denied*, 364 U.S. 918 (1960).

16 Davis v. United States, 287 F.2d 168, 174 (Ct. Cl. 1961). See Zimmers v. United States, 199 F. Supp. 903 (W.D. Ky. 1961).

17 See Champlin v. Commissioner, 71 F.2d 23 (10th Cir. 1934); O'Meara v. Commissioner, 34 F.2d 390 (10th Cir. 1929). Section 202(b) of the Revenue Act of 1919 encouraged reluctance to apply indirect valuation by providing that, in computing gain, the value of the thing received should "be treated as the equivalent of cash to the amount of its fair market value, *if any*." (Emphasis added.) Ch. 18, 40 Stat. 1060. An amendment in 1921 limited recognition of gain to instances where the property received had a "readily realizable market value." Revenue Act of 1921, ch. 136, § 202(c), 42 Stat. 230. In 1924 Congress formulated the realization of gain provision as it now stands in § 1001(b) of the Internal Revenue Code of 1954. Revenue Act of 1924, ch. 234, § 202(c), 43 Stat. 256. Courts now acknowledge that the congressional intent is to risk error in valuation rather than deny taxation entirely. See Helvering v. Safe Deposit & Trust Co., 316 U.S. 56 (1942); United States v. Ludey, 274 U.S. 295 (1927). Treas. Reg. § 1.1001-1(a) (1957), reinforces this policy by providing that "only in rare and extraordinary cases will property be considered to have no fair market value."

18 *E.g.*, United States v. General Shoe Corp., 282 F.2d 9 (6th Cir. 1960), *cert. denied*, 365 U.S. 843 (1961); International Freighting Corp. v. Commissioner, 135 F.2d 310 (2d Cir. 1943); Philadelphia Park Amusement Co. v. United States, 130 Ct. Cl. 166, 126 F. Supp. 184 (1954); E. Eugene King, 31 T.C. 108 (1958). The *Marshman* holding does not necessarily repudiate this principle, since there was serious doubt as to the true value of the property transferred by the husband. 279 F.2d at 33. Where subsequent events will make certain the value of the property received, the imposition of tax liability may be deferred. *E.g.*, Burnet v. Logan, 283 U.S. 404 (1931).

transaction unless the contrary is shown,[19] *Marshman* held that negotiations attended by the tensions that so often accompany marital discord could not be so described.[20] In the principal case the Court recognized that a divorce settlement should be described, for tax purposes, as an arm's-length transaction; the Court therefore repudiated *Marshman* and valued the property received by the taxpayer as equivalent to the market price of the securities transferred by him. This course was at least technically correct and should achieve certainty where previously there was substantial doubt.[21] Moreover, it seems clear that the discharge of a settlement obligation does provide an excellent opportunity for many husbands to realize the entire benefit of appreciation embodied in their property. It may, therefore, seem inequitable as a matter of policy to allow such a realization event to go entirely untaxed while granting no such privilege to persons utilizing appreciated property for more conventional purposes.

Nevertheless, because of other, undesirable consequences, congressional action altering the tax treatment of property settlements, as established by the principal case, should be seriously considered. The most objectionable aspect of the present law is that it produces a highly unfortunate disparity of tax treatment between common-law and community-property jurisdictions. While an equal division of community property goes untaxed,[22] an equal division of the husband's property in a common-law jurisdiction can produce a staggering tax liability. Congress has acted on numerous occasions to eliminate such inequalities of tax treatment arising from differences between the property law in common-law and community-property jurisdictions,[23] and should do so in this context.

Even within each property system the present Code produces unfortunate anomalies. The choice of husband and wife as to whether their property is to be owned jointly or severally is often a matter of whim or caprice; the accident of the form and incidents of their ownership may be little indication of the way the parties view their rights. Yet, when unexpected marital discord develops, the tax liability of the parties may depend in large measure on the accident of title. Although no cases have dealt with the point, most writers suggest that an equal division of property held by spouses in joint tenancy, like an equal division of community

19 See Commissioner v. Halliwell, 131 F.2d 642 (2d Cir. 1942), *cert. denied*, 319 U.S. 741 (1943); Commissioner v. Mesta, 123 F.2d 986 (3d Cir. 1941), *cert. denied*, 316 U.S. 695 (1942); E. Eugene King, *supra* note 18; Cristina de Bourbon Patino, 13 T.C. 816 (1949), *aff'd*, 186 F.2d 962 (4th Cir. 1950).

20 279 F.2d at 32.

21 The principal case has been cited as controlling by Robert K. Stephens, 38 T.C. 345 (1962).

22 *E.g.*, Swanson v. Wiseman, CCH 1961 STAND. FED. TAX REP. (61-1 U.S. Tax Cas.) ¶ 9264 (W.D. Okla. Feb. 23, 1961); Ann Y. Oliver, 18 P-H Tax Ct. Mem. 347 (1949); Frances R. Walz, 32 B.T.A. 718 (1935). Transfers other than equal divisions are taxed as in the principal case. *E.g.*, Long v. Commissioner, 173 F.2d 471 (5th Cir.), *cert. denied*, 338 U.S. 818 (1949); Johnson v. United States, 135 F.2d 125 (9th Cir. 1943); Jessie Lee Edwards, 22 T.C. 65 (1954). *Accord*, Rouse v. Commissioner, 159 F.2d 706 (5th Cir. 1947).

23 See, *e.g.*, INT. REV. CODE OF 1954, §§ 2(a), 2056(c), 2523(f).

property, would be treated as a non-taxable event.[24] In contrast, an equal division of property held in the husband's name alone could impose a huge liability on him. Indeed, the present treatment of property settlements can pose an insoluble dilemma for a husband whose assets, for instance, consist largely of greatly-appreciated stock in a close corporation. Transfer of such shares pursuant to a settlement agreement would give rise to a massive tax liability while the husband would receive nothing tangible—only the release of the wife's marital rights. Yet the husband might well wish to avoid sale of his remaining shares for fear of losing his voice in corporate matters. The harshness of the present law in this situation is compounded by the effect the impending tax liability may have on the settlement negotiations, for the husband's situation may be so desperate that the wife can extract inordinate concessions in return for any action by her that would allow the husband to retain the control represented by his stock.[25]

Finally, the present treatment of property settlements will inevitably present administrative difficulties. In two older cases dealing with the wife's basis for property received in a settlement the Tax Court accepted a figure set by the parties as the amount of the obligation discharged by the transfer of property, although the agreed figure was greater than the fair market value of the property actually transferred.[26] The converse of this approach would allow parties to a settlement to shift part of the husband's capital gain liability to the wife by setting the agreed obligation at a figure below the fair market value of the property used to discharge it. Since this result is fundamentally inconsistent with the rationale of the principal case and presents an extraordinary opportunity for manipulation of tax liability, it is doubtful the Internal Revenue Service would countenance it.[27] Nevertheless, the difficulty involved demonstrates that some aspects of the tax treatment of property settlements remain unsettled. The tax liability of the wife presents special problems, for it is not entirely clear, as a purely technical matter, why she should not be taxed on the gain in the value of her dower interest when she exchanges it for property from the husband in a divorce settlement. Taxation of the wife has been avoided in non-divorce settings only by prohibiting the husband who purchases release of his wife's dower interest from either adding the amount of the payment to the basis of his property or deducting it as an expense of defending or perfecting title.[28] Such difficulties demonstrate that the

24 See, *e.g.*, CCH 1962 STAND. FED. TAX REP. ¶ 4470.03; *cf.* Corfield v. Koehler, 207 F. Supp. 73 (D. Kan. 1962).

25 Just such a situation is described in Baer v. Commissioner, 196 F.2d 646 (8th Cir. 1952).

26 Cristina de Bourbon Patino, 13 T.C. 816 (1949), *non-acq.*, 1950-1 CUM. BULL. 7, *aff'd*, 186 F.2d 962 (4th Cir. 1950); Aleda N. Hall, 9 T.C. 53 (1947), *acq.*, 1947-2 CUM. BULL. 2.

27 The Commissioner's non-acquiescence in Cristina de Bourbon Patino, *supra* note 26, should be noted.

28 Illinois Nat'l Bank v. United States, 273 F.2d 231 (7th Cir. 1959), *cert. denied*,

present Code is simply not properly designed to deal with exchanges involving marital rights.

The magnitude of these problems suggests that a divorce property settlement is not an event appropriate for taxation of capital gain. The similarity of property settlements to other transactions which Congress has deemed inappropriate as taxable events reinforces this conclusion. As with an exchange in kind of property held for use in a trade or business or for investment,[29] or a sale and purchase of principal residences,[30] the transferor's gain in a settlement transfer does not take the form of property that could be used to make tax payments.[31] Likewise, divorce transfers often share the characteristics of the involuntary conversions which Congress has found inappropriate as taxable events.[32]

Congress could easily eliminate the harsh and inequitable effects of the present law, as applied in the principal case, by enacting a relatively simple nonrecognition provision.[33] Such an amendment would provide that the gain realized from the transfer of appreciated property pursuant to a divorce or separation property settlement agreement would not be recognized for tax purposes. A carryover provision would assign to the transferee the transferor's basis for the property.[34] An enactment of this sort would require no change in existing gift and estate tax law as applied to property settlements, for the operation of these chapters depends upon the nature and timing of the settlement agreement, and not upon the capital gain treatment of the property transferred.[35] It would of course be necessary to limit operation of the nonrecognition provision to settlement agreements entered into after the enactment of the new provision. Such a nonrecognition provision would merely postpone the payment of tax on the appreciation involved; because of the basis carryover provision

363 U.S. 803 (1960); O'Malley v. Yost, 186 F.2d 603, *petition for rehearing denied*, 189 F.2d 331 (8th Cir. 1951); George M. LeCroy, 15 T.C. 143 (1950); Frank J. Digan, 35 B.T.A. 256 (1937). *Contra*, Frank v. Commissioner, 51 F.2d 923 (3d Cir. 1931).

29 See INT. REV. CODE OF 1954, § 1031.

30 See INT. REV. CODE OF 1954, § 1034.

31 The Internal Revenue Service has followed the same course in declining to tax the donor of a charitable contribution on appreciation embodied in the property he contributes. Rev. Rul. 55-410, 1955-1 CUM. BULL. 297. *Accord*, Campbell v. Prothro, 209 F.2d 331 (5th Cir. 1954).

32 See INT. REV. CODE OF 1954, § 1033.

33 The American Law Institute, viewing property settlements as involuntary exchanges, has recommended such a provision. 1 ALI FED. INCOME TAX STAT. § X257 (Feb. 1954 Draft).

34 Since property acquired under a settlement agreement is ordinarily not considered a gift (see INT. REV. CODE OF 1954, § 2516), the basis carryover provisions of § 1015(a) would rarely apply, and a specific carryover provision would be necessary. Since the possibilities of avoidance are negligible, the transferor's basis should carry over regardless of whether it is greater or less than the fair market value at the time of the transfer. Section 362(a) applies a similar provision to corporate reorganizations.

35 See Willan, *Tax Aspects of Post-Death Marital Obligations*, N.Y.U. 17TH INST. ON FED. TAX 1211 (1959); Note, *Federal Tax Consequences in Divorce and Separation*, 7 UTAH L. REV. 385 (1961).

no forgiveness of tax liability would be involved. The principal case itself recognizes that the problem is not one of whether the gain will be taxed, but of when.

The principal benefit of such a nonrecognition provision would be equalization of treatment between common-law and community-property states. The relevant taxable event would be the same in both cases—the sale or disposition of the appreciated property to a party outside the former marriage relationship. Equality would also be achieved within each property system, for the location of title would have no tax significance at the time of divorce. The parties could therefore distribute the property involved in a more appropriate fashion, without regard to tax consequences which should properly be essentially extrinsic considerations.

The appropriateness of the taxable event would also be greatly enhanced by such a postponement of recognition. Gain would be taxed only on sale to an outsider, which in most cases would bring to the taxpayer liquid proceeds to defray the resulting tax liability. The inevitable result would be an amelioration of the weak bargaining position that the present law may impose on the husband. While the wife could demand more in the settlement negotiations because the tax liability would ultimately be imposed on her, the husband could satisfy that demand with an additional quantity of appreciated property; no tax would be due until further disposition of the property by the wife. Under the present law the tax must be paid immediately and in cash; the sale of appreciated securities to produce that cash only further multiplies the transferor's already sizable tax burden. In situations where corporate control is involved the husband could arrange for retention of voting rights of the stock transferred to his wife; under the present law some of that stock might have to be sold to outsiders to obtain cash with which to pay the tax.

Because divorce has become an extremely common phenomenon in the United States—with one divorce occurring for every five marriages[36]—Congress should seek to assure equality of treatment for all taxpayers in divorce circumstances. At the same time, however, Congress should insure against the dominance of arbitrary and artificial tax considerations in divorce negotiations. A nonrecognition provision eliminating the difficulties demonstrated by the principal case would go far toward attainment of both of these goals.

Martin B. Dickinson, Jr., S.Ed.

[36] Since 1950 the number of divorces in this country has averaged 375,000 yearly. U.S. DEP'T OF COMMERCE, STATISTICAL ABSTRACT OF THE UNITED STATES 52 (1962).