Tax Policy for Lovers and Cynics: How Divorce Settlement Became the Last Tax Shelter in America

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Last Christmas, Abie told Becky that he wanted a divorce in order to marry someone else. As Becky pondered the meaning of the past and Abie planned the present neither of them gave a thought to the future—the tax law! It is understandable that the Internal Revenue Code (“Code”) may not top Abie and Becky’s list of priorities during their divorce negotiations. The amendments to the Code made by the Deficit Reduction Act of 1984 (“1984 Act”) as modified by the Tax Reform Act of 1986 (“1986 Act”), however, will decide who bears the tax burden of the separation, the “unscrambling”*4 of their property, and the necessary provisions for the support of their dependents.

For taxpayers with competent counsel and the right kind of property/income profile, the Acts are a boon. In a well-structured settlement, tax saving is split between the parties, with the low income spouse receiving cash to offset increased liability. No one loses but the Treasury. In contrast, in a poorly structured settlement the tax burden can be shifted to the ill-advised taxpayer, presumably the nonearner, or low income spouse, without a compensating payment. In either case, the tax law rewards the pattern of divorce and remarriage for the high income taxpayer. As there are generally no tax consequences at the time of the divorce, the Code deceives the ill-advised taxpayer at the time when he or she has the most bargaining power. Thereafter, the latent tax burden will fall on the spouse who is in the most vulnerable economic position.5

In the context of a property settlement, the luckless taxpayer is likely to be the spouse receiving low basis property, or cash, and hence, the tax

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1 Internal Revenue Code of 1954 (“Code”), as amended, is cited by reference to section numbers only.


5 Generally, under equitable apportionment statutes, divorce courts favor husbands in a property settlement. See Rankin, Splitting the Assets Fairly in Divorce, N.Y. Times, Mar. 30, 1986, at F11, col. 1. Divorced mothers experience an economic decline of 73% in their standard of living, while non-custodial fathers achieve a 42% gain. Id. (citing L. WEITZMAN, THE DIVORCE REVOLUTION (1985)).
burden. The 1986 Act intensifies this result.\(^6\)

Even the good intentions of Abie and Becky will not overcome the design of the 1984 and 1986 Acts which fail to produce a fair division of the tax burden. The development of a fair scheme of taxing the property settlement is complicated by three factors: the statutory constraints of the tax accounting rules which dictate when a gain will be taxed on an exchange of property; the doctrine of assignment of income which prevents taxpayers from shifting gain or income to other parties in order to defeat the progressivity of the tax rates; and, the historic tax treatment of alimony and property division as independent transactions rather than as merely different aspects of the economic dissolution of a marital partnership.

In the overly simplified terms necessary to introduce the statutory mysteries that govern the lives of all the Abies and Beckys, the Code provides: (1) transfers of property do not create gain or loss for the transferee\(^7\) and (2) within statutory limits, cash payments between former spouses are income to the recipient\(^8\) and deductible by the payor.\(^9\)

The current federal law regulating the taxation of divorce was not designed to achieve a tax neutral result.\(^10\) Congress passed the legisla-
tion in response to the Supreme Court's concept of a fair scheme for the apportionment of tax in a property settlement. The Court, forced to apply the pre-1984 tax statute which did not distinguish divorce from other transfers, formulated a tax structure which treated the property division as a sale. Implicitly, the taxable transfer occurred in an unequal property division. Hence, the transferor of property was the spouse liable for tax due on the accumulation of the family wealth. In theory, this exacted the tax from the party who retained the bulk of the marital wealth. In practice, the individual resources of the transferor had no place in the determination of the tax liability. Congress overruled the Court by characterizing a property division as a gift rather than a sale. The treatment of a divorce related property division as a nontaxable transfer instead of a sale simply has shifted the tax liability from the group which suffered under prior law to their former spouses.

In the long run, the marital property settlement, including an economic disentanglement which may take years to complete, cannot be managed by a scheme in which gain or loss is taxed as a single property transfer, whether a gift or a sale, of a jumble of assets which the ordinary person would think of as owned jointly and needing only to be untangled and divided. Characterizing it as a sale taxes the transfer between spouses. Characterizing the property transfer as a gift defers recognition of gain or loss until a subsequent taxable transfer. Either way the spouse deemed to make the taxable transfer must account for all gain or loss. However equitable the division of property behind the transfer, the tax liability bears unfairly on one or the other spouse.

The dissolution of a marriage presents a myriad of related economic problems, not the least of which is the potential tax liability affecting the dollar amount each partner will recover from the marriage. At issue is the apportionment of a shared tax liability between former marital partners. Congress has failed to determine that issue directly.

This article examines the impact of the tax laws after the complex revisions of the Code in 1984 and 1986 on the domestic relations laws of


(12) See Davis, 370 U.S. at 69-70 (comparison of spousal property rights of Mrs. Davis and her counterpart in a community property state).

(13) See Carrières v. Commissioner, 64 T.C. 959 (1975), aff'd per curiam, 552 F.2d 1350 (9th Cir. 1977) (tax depended on pre-divorce ownership of transferred property).

(14) See I.R.C. § 1041.

In 1981, the Domestic Relations Tax Simplification Task Force of the A.B.A.'s Section on Taxation (“Task Force”) presented a legislative solution to the unpredictable tax consequences of divorce. See generally Preliminary Specification for Simplification, Technical Memorandum (May 17, 1981) (hereinafter cited as “Technical Memorandum”). Among other things, the Task Force proposed that the parties to a divorce may elect “correlative tax” results by written agreement. Id. at 2, 11-14 app. III. In the absence of a written agreement, the parties would be subject to uniform and mechanical federal rules governing the taxation of divorce transfers. Id. at 11. The mechanical rules also proposed that transfers of property in the course of marriage or divorce not be taxable; that the transfer of cash, including combined child and spousal support payments, be treated as alimony, deductible by the payor and income to the recipient; that the transfer of community property for cash be excluded from alimony treatment, while the satisfaction of marital rights in exchange for
many states. Part I traces the history of the taxation of property settlements. Part II provides an overview of property settlements under section 1041. Part III discusses how section 1041 can function as a tax shelter. Part IV examines the conversion of a cash property settlement into alimony. Part V evaluates the exceptions to the nonrecognition sections. Part VI examines the issues that are not resolved under the Code. Part VII suggests a legislative alternative to the present method of taxing divorce transfers.

The article concludes that the revisions of the tax code relevant to divorce diminish the property rights of the nonearner spouse under state law and create a tax preference for the transferor of property willing to structure his or her divorce settlement to take advantage of tax shelter opportunities. The taxation of property settlements incident to divorce is examined through a series of case studies based on the tax problems encountered by Abie and Becky, an allegorical husband and wife in the unhappy process of marital dissolution.

I. The Davis Legacy: Timing Decisions Lead to Assignment of Income

Congress passed section 1041 of the Code fixing the tax conse-
cash be treated as alimony. \textit{Id.} at 6-7 (rules define property to include community property but exclude marital rights).

The rules proposed by the Task Force were largely incorporated in H.R. 3475, a bill to achieve tax simplification, introduced in the House in June 1983. \textit{See} H.R. 3475, 98th Cong., 1st Sess. (1983). The resolution excluded both the transfer of marital rights and the transfer of community property for cash from alimony treatment. On October 4, 1983, the House Ways and Means Committee deleted this exclusion thereby making possible the treatment of transfers of both marital and community property rights as alimony. \textit{See} News Release, Committee on Ways and Means, U.S. House of Representatives 4 (October 5, 1983). The amendment also introduced the alimony recapture rules. \textit{Id.} The recapture was triggered if a property settlement exceeding $15,000 was paid in less than three years and did not meet certain statutory requirements. The House Ways and Means Committee, however, did not amend the proposal permitting combined spousal and child support payments to be treated as alimony. \textit{Id.}

The simplification provisions of H.R. 3475, including the divorce provisions, were incorporated into the more ambitious bill, H.R. 4170, which Congress eventually enacted as the Tax Reform Act of 1984. The full House passed H.R. 4170 on April 11, 1984 and the Senate approved the same provisions, now known as Title IV(B) of the Deficit Reduction Act of 1984, on May 17, 1984. Despite the approval of identical provisions by both the House and the Senate, the Conference Committee substituted entirely different provisions, including one denying alimony treatment for direct payment of combined spousal and child support payments and one increasing recapture to $10,000 and six years. The later amendments of the 1984 Act, drafted to achieve deficit reduction, all but eliminated the alimony deduction. \textit{Compare} I.R.C. § 71(c) (1982) (repealed by Pub. L. No. 98-369, 98 Stat. 369 (1984)) with H.R. 4170, 98th Cong., 2d Sess. Tit. IV, § 425. \textit{See} H.R. REP. No. 432, 98th Cong., 1st Sess. (1983); \textit{see also} TAX REFORM ACT (CCH) 995 n.8 (citing Commissioner v. Lester, 366 U.S. 299 (1961) (combined spousal and child support payment taxed as alimony)). The cash only alimony provision was originally drafted to achieve tax simplification. H.R. 3475 (Tax Simplification Act of 1983), 98th Cong., 1st Sess. (1983). The provision, unchanged by the Senate, was drastically amended by the Joint Finance Committee shortly before the dawn passage of the Act on June 23, 1984. N.Y. Times, June 23, 1984, at 8, col. 3; \textit{see} H.R. CONF. REP. No. 861, 98th Cong., 2d Sess. (1984); \textit{see also} TAX REFORM ACT (CCH) 997; J. EUSTICE, THE TAX REFORM ACT OF 1984 1-14 (1984) (hereinafter cited as EUSTICE). The full Congress approved the Conference version of H.R. 4170 on June 23, 1984 (H.R. CON. RES. 328, 98th Cong., 2d Sess. (1984)). The bill became law on July 18, 1984. Congress restored the liberal deduction rules for property settlements in a technical correction to the 1986 Act. H.R. 3938 Tit. XVIII, Sec. 1843, § 422(c) (amending I.R.C. § 71(f)). The 1986 Act cut the time required to avoid alimony recapture from six to three years, raised the exempt amount of payments from $10,000 to $15,000 per year and limited recapture to the third year only.
quences of property settlements with the express purpose of reversing United States v. Davis, under which the Supreme Court held that the transfer of appreciated property to satisfy spousal property rights in a divorce resulted in an immediate recognition of gain for the transferor. Under Davis, the timing of the recognition of gain or loss was fixed at divorce. However, the Court was not merely deciding when gain was properly recognized but also who would bear the entire tax burden of the division. Hence, by requiring the recognition of gain on divorce, the Court unequivocally assigned the tax burden to one party, the transferor.

To reach this result, the Court deemed that the inchoate marital rights satisfied by the property transfer were themselves property. It followed that the exchange of the husband’s stock for the release of his wife’s claim was treated as if the wife actually had transferred property, for example a new car, for her husband’s appreciated stock. The tax consequences determined under the Davis case result from two separate but simultaneous transactions. The first transaction is the husband’s sale of stock on which gain or loss is recognized. The second transaction is his purchase of the new property at fair market value. Thus, the husband was treated as if he sold the stock for cash and later exchanged the cash for the car. Because Mrs. Davis paid the full fair market value of the stock, her basis in the stock was also the fair market value. Upon her resale of the stock at the same market value, the Davis analysis normally precluded gain recognition to the wife. Hence, the appreciation in the property was taxed once, and it was taxed entirely to the transferor husband upon divorce.

The majority opinion clearly assigned the income tax burden on the appreciation of the property to the transferor husband. Deferring the recognition of gain until a sale by the recipient would have shifted the tax burden unfairly to the recipient wife. The shift is unfair because state
law values the wife's property rights, as well as the transferred property, at their fair market value at the time of the transfer, not at their cost basis to the transferor. For example, assume that the Davis property subject to division on divorce consisted of stock A worth $100, with a basis of $30, and stock B, worth $100, with a basis of $20, and $100 cash. If the property had been divided using basis, rather than fair market value, the marital assets would have been valued at $150. Assuming a one-third interest, the wife's share would have been worth $50, compared to her actual share of $100 worth of marital assets.\(^{28}\)

In contrast to the Davis transfer, equal divisions of community or jointly held property were treated as nontaxable partitions of property rather than as transfers.\(^{29}\) Because the spouse who was awarded the property in the divorce settlement was merely retaining his or her ownership (albeit in the form of individual rather than shared ownership), the original basis of the property was unchanged by the divorce settlement.\(^{30}\) Consequently, gain or loss was not recognized at divorce, but upon a subsequent sale by the recipient of the property involved.\(^{31}\) Taxation on the appreciation in the community or jointly owned property was deferred. Ultimately the appreciation was taxed to the recipient of the asset. Thus, under prior law, the marital domicile determined whether the transferor was taxed on a property division.\(^{32}\)

Whatever equities prompted the Davis holding, the Supreme Court clearly used the issue of when the gain would be reported to determine who would be taxed. Using the issue of timing to regulate the assignment of income between the divorced husband and wife generally results in an unequal allocation of tax liability between the husband and wife.\(^{33}\)

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\(^{28}\) In such case, one has no doubt that the wife's claim would be satisfied in cash. See id. at 67. In contrast to the Davis transfer, equal divisions of community or jointly held property were treated as nontaxable partitions of property rather than as transfers.\(^{29}\) Because the spouse who was awarded the property in the divorce settlement was merely retaining his or her ownership (albeit in the form of individual rather than shared ownership), the original basis of the property was unchanged by the divorce settlement.\(^{30}\) Consequently, gain or loss was not recognized at divorce, but upon a subsequent sale by the recipient of the property involved.\(^{31}\) Taxation on the appreciation in the community or jointly owned property was deferred. Ultimately the appreciation was taxed to the recipient of the asset. Thus, under prior law, the marital domicile determined whether the transferor was taxed on a property division.\(^{32}\)

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The unpredictable tax consequences meant that one former spouse could shift the tax burden of a divorce settlement causing an unanticipated liability for the other side and a windfall for the taxpayer sliding through the gap left by conflicting state divorce law and the federal tax law. As a result, the tax collector often was "whipsawed" between spouses claiming inconsistent tax positions.

II. Development of Section 1041

The traditional distinction between the non-deductible payment for property rights, commonly called the property settlement, and tax deductible support obligations imposed by law, called alimony, has been abandoned by the 1984 amendments to the Code. The essential requirements under prior law—that the payment be for the support of the recipient, and that it be paid pursuant to a legal obligation owed to a former spouse under state law—are no longer required under the current federal definition of alimony. This change in the definition of alimony means that a cash settlement of property rights under state law may be structured as alimony for federal income tax purposes, making the new Carrieres v. Commissioner, 64 T.C. 959 (1975), acq., 1976-2 C.B. 1, aff'd per curiam, 552 F.2d 1550 (9th Cir. 1977) (exchange of separate property—the proceeds of the loan—for the mortgaged community property was a taxable event); Siewert v. Commissioner, 72 T.C. 326 (1979). Compare Gerlach v. Commissioner, 55 T.C. 156 (1970) (separate cash exchange for community interest was taxable) with Davenport v. Commissioner, 12 T.C.M. (CCH) 856 (1953) (community cash exchanged for other community property was not taxable).

See Westbrook v. Commissioner, 74 T.C. 1357, 1368 (1980) (payment labeled "support" held property division).

See H.R. REP. No. 432, 98th Cong., 1st Sess. 191 (1983). If property had a basis of $10 and a fair market value of $100, the transferor did not report his or her gain of $90 and the recipient took a stepped up basis of $100 on the subsequent resale of the property received in a divorce settlement, likewise not reporting the gain of $90. Id. at 198. Under § 1041, geography no longer affects tax liability. See H.R. REP. Rep. No. 861, 98th Cong., 2d Sess. (1984); H.R. REP. No. 492, 98th Cong., 1st Sess. 192 (1983).


Section 71 of the Code defines alimony or separate maintenance payments as any payment in cash if

(A) such payment is received by (or on behalf of) a spouse under a divorce or separation instrument,

(B) the divorce or separation instrument does not designate such payment as a payment which is not includible in gross income under this section and not allowable as a deduction under section 215,

(C) in the case of an individual legally separated from his spouse under a decree of divorce or of separate maintenance, the payee spouse and the payor spouse are not members of the same household at the time such payment is made, and

(D) there is no liability to make any such payment for any period after the death of the payee spouse and there is no liability to make any payment (in cash or property) as a substitute for such payments after the death of the payee spouse.

I.R.C. § 71(b)(1) (1984) (amended by H.R. 3838 Tit XVIII, Sec. 1843, § 422(b) which deleted the parenthetical, "and the divorce or separation instrument states that there is no such liability," from the end of subsection D).

Compare H.R. REP. No. 432, 98th Cong., 1st Sess. 195 (1983) (recapture rule enacted to prevent property settlement disguised as alimony); Hayutin v. Commissioner, 508 F.2d 462 (10th Cir. 1974); Warnack v. Commissioner, 71 T.C. 541 (1979), acq. 1979-1 C.B. 1 with Riddell v. Guggenheim, 281 F.2d 836 (9th Cir. 1960) (payments for share of community property not alimony); Yoakum v. Commissioner, 82 T.C. 128 (1984) (alimony denied where payment attributable to property
law the antithesis of prior law.39

Under the alimony provisions of section 71, Congress has devised a substantial income shifting option available to the transferor spouse. Instead of the earner spouse recognizing a gain on the buyout of his or her spouse's marital rights, as under the pre-1984 rule,40 the transferor who pays cash has an above-the-line deduction.41 The recipient, in place of a tax-free receipt upon liquidation of the marriage,42 has gross income.43 However, the formal requirements for alimony treatment can be expensive in terms of liquidity.44 But even where liquidity is a problem, Congress has sweetened the tax result for the transferor spouse. Property transfers between spouses or former spouses in connection with divorce no longer result in a taxable event for the transferor.45 Under current law, tax liability for the recipient of a property transfer is not triggered by the divorce decree; the liability, however, lies dormant in the property, to arise, perhaps unexpectedly, sometime after the divorce.

The economic protection provided for the nonearner spouse by state community property or marital property laws,46 and formerly incorporated into the federal definitions of property settlement and alimony,47

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39 Under prior law, the Code defined alimony as payments made "in recognition of the general obligation to support." Treas. Reg. § 1.71-1(b)(4) (1960). Payments related to property division were excluded from alimony treatment because they were not for support. See H.R. Rep. No. 2383, 77th Cong., 2d Sess. 83-85 (1942); Beard v. Commissioner, 77 T.C. 1275 (1982) (under partnership dissolution theory periodic payments were return of capital—the quid pro quo of surrendered property rights is but one factor to consider). But see H.R. Rep. No. 432, 98th Cong., 1st Sess. 194-96 (1983) (recapture prevents deduction of one-time payment of property settlement).

A transfer made pursuant to a property division was neither income to the recipient nor deductible by the transferor. See Lambros v. Commissioner, 459 F.2d 69, 71 (6th Cir. 1972); Campbell v. Lake, 220 F.2d 941 (5th Cir. 1955); Smith's Estate v. Commissioner, 208 F.2d 351 (3d Cir. 1953); Mills v. Commissioner, 54 T.C. 608 (1970), aff'd, 442 F.2d 149 (10th Cir. 1971); Thompson v. Commissioner, 50 T.C. 522, 525 (1968); see also Schatz v. Commissioner, 42 T.C.M. (CCH) 292, 298 (1981); Bernatschke v. United States, 364 F.2d 400 (Ct. Cl. 1966); Ryker v. Commissioner, 33 T.C. 924, 929 (1960).


43 See I.R.C. § 71(a) (alimony is gross income to the recipient); I.R.C. § 71(f) (anti-front loading rules limit lump sum deductions to $15,000, subject to recapture, after December 31, 1986, and to $10,000 after January 31, 1984 but before January 1, 1987). See H.R. 3838 Tit. XVIII, Sec. 1843, § 422(c).

44 See supra note 77 (cash only required for alimony treatment).


47 White v. Commissioner, 770 F.2d 685 (7th Cir. 1985) (intent as to tax burden irrelevant); Wright v. Commissioner, 543 F.2d 593 (7th Cir. 1976) (payments made by husband on wife's life insurance policy not includable in gross income of wife); Westbrook v. Commissioner, 74 T.C. 1357 (1980) (payment labeled "support" held property division). See Beard v. Commissioner, 77 T.C. 1275, 1285 (1981) (both lump sum and installment payments held division of marital capital); Broida v. United States, 40 A.F.T.R.2d (P-II) 5675 (N.D. Ohio 1977); Weiner v. Commissioner, 61 T.C. 155 (1973); Jackson v. Commissioner, 54 T.C. 125, 129-30 (1970); Dorsey v. Commissioner,
has been diluted by the **sui generis** federal definition in the new law of property settlement and alimony.\(^4\) This variance between state and federal law makes divorce planning complex in itself.\(^4\)

The 1984 Act causes odd results, or some might say inevitable results, according to the taxpayer's bracket and family status. In comparison to the past law, the alimony deduction has now become less available to middle income taxpayers with children, but more available to wealthy taxpayers using alimony trusts.\(^5\) Such obscure provisions may have been avoided if the drafting process were not divorced from the political process. The two year legislative process, which did not include a single public hearing on divorce taxation, determined fundamental social issues, such as whether the transfer of community property for cash, or the cash payment of child support, should result in taxable income, as if they were neutral points of tax simplification.\(^5\) The economic impact on divorced taxpayers is hardly neutral.

**A. How Section 1041 Works**

The Code provides that gain or loss is not recognized on the transfer of property between spouses during marriage.\(^5\) Even after a marriage is dissolved, the gain or loss is not recognized if the transfer is made in connection with divorce.\(^5\) It follows from the nonrecognition rule that it

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\(^5\) Application of the revised Code provisions is also complex. See generally Eustice, supra note 15, at 1-7. See also supra note 10. For example, although most alimony payments qualify for the deduction, the Code contains stringent requirements governing the deduction of combined child support/alimony payments and direct alimony payments over $15,000 per year. See I.R.C. §§ 71(c)(2) & 71(f). In contrast, these latter provisions do not apply to alimony paid through trusts. See I.R.C. § 682. The final version of the tax provisions governing direct alimony payments do not match the alimony trust provisions. The first Technical Corrections Act did not alter the trust pattern. See H.R. Con. Res. 328, 98th Cong., 2d Sess. (1984). One surmises that the clash between the alimony trust and the direct alimony tax provisions was unplanned, and the legislators favoring an alimony deduction formed a natural constituency to protect the trust provision from the severe limitations applicable to direct alimony payments. The alimony trust provisions, originally a replica of the direct alimony provisions, were not amended by the 1984 Act. Compare I.R.C. § 682(a) (trust provisions) with H.R. 4170, 98th Cong., 2d Sess. 422 (1984) (alimony provisions).


\(^51\) Eustice, supra note 15 at 1-8. There were no hearings on the 1986 provisions affecting alimony.

\(^52\) Temp. Treas. Reg. § 1.1041-1T(a), A-2 (1984) (transfers between spouses including those whose divorce was never considered). But see id., ex. 3 (1984) (transfer between spouse and a corporation owned by other spouse taxable). A transaction between a spouse and a corporation controlled by the other spouse may be recharacterized by application of common law principles such as the step transaction theory. Id. For example, if Abie transferred property to a corporation owned by Becky and then the corporation distributed the property to Becky, the step transaction doctrine would recharacterize the transaction as one between Abie and Becky.

is impossible for a husband and wife to engage in a taxable exchange.\textsuperscript{54} The recipient of property is denied a step up in basis for the property acquired from his or her spouse. The form of ownership of property as jointly or separately owned under state marital regimes\textsuperscript{55} or contract law\textsuperscript{56} is irrelevant to the application of section 1041.\textsuperscript{57} Whether the property is exchanged in satisfaction of marital property rights,\textsuperscript{58} for other property,\textsuperscript{59} or for cash is equally irrelevant.\textsuperscript{60} Furthermore, unlike the old community property rule, section 1041 does not require the property division itself to be equal.\textsuperscript{61}

\textsuperscript{54} See Temp. Treas. Reg. § 1.1041-IT, A-1 (1984); but see Temp. Treas. Reg. § 1.1041-IT(a), A-2 ex. 3 (1984); id. at A-3 (corporation owned by spouse); id. (nonresident alien). See infra note 121 (transfer in trust of either an asset subject to liability in excess of basis or an installment obligation results in recognition of gain under H.R. 3838 Tit. XVIII, Sec. 1842, § 421) and infra notes 164-170 and accompanying text.

Section 1041 applies to transfers of property made after July 18, 1984, unless a transfer is pursuant to an agreement made on or before that date. Temp Treas. Reg. § 1.1041-1T(f), A-15 (1984). Pursuant to the transition rules, § 1041 may be elected by an agreement between spouses in two circumstances: transfers made after July 18, 1984 pursuant to an agreement predating the enactment, or any transfer made during 1984. Temp. Treas. Reg. § 1.1041-1T(f), A-16 (1984). Such an election is irrevocable and must cover all property transferred within the time period for the election. Temp. Treas. Reg. § 1.1041-1T(f), A-17 (1984). The election is made by attaching a statement signed by both spouses, or former spouses, to the tax return of the transferor for the year in which the first transfer is made. If later transfers are made, a copy of the statement must be attached to future tax returns. A later transfer must contain both parties' social security number, and a copy of the statement must be kept by each party. Temp. Treas. Reg. § 1.1041-1T(g), A-18 (1984) sets forth an example of an acceptable election form.

In addition to timing considerations, the applicability of § 1041 is also conditioned on the property being transferred pursuant to divorce. For example, Abie owns timberland in Southern Oregon with a basis of $144,000 and a fair market value of $1,000,000. Abie transfers the land to Becky in exchange for her promise to transfer land, unspecified at the time of the grant, to Abie worth $1,000,000 within five years from the date of the divorce. See Starker v. United States, 602 F.2d 1341 (9th Cir. 1979). Neither Abie nor Becky recognize gain. See I.R.C. § 1041(a). Here both properties are subject to the nonrecognition provision of section 1041 even though one parcel is acquired after the dissolution of the marriage. The transaction would be taxable. See I.R.C. § 1031(a)(3) (limits Starker: property identified 45 days and exchanged 180 days). The Code expressly provides that all transfers within one year after the divorce is final are conclusively presumed to be divorce related. I.R.C. § 1041(c)(1); Temp. Treas. Reg. § 1.1041-1T(b), A-6(1) (1984). Transfers made over a year after the divorce may be factually connected to the divorce, and hence, trigger § 1041. I.R.C. § 1041(c)(2); Temp. Treas. Reg. § 1.1041-1T(b), A-7 (1984). According to the temporary regulations, a transfer not required by the divorce instrument which occurs six years after divorce is final is presumed not incident to divorce. Id. The taxpayer can rebut the presumption, for instance, by showing that a problem in clearing title caused the delay. Id.


\textsuperscript{58} Temp. Treas. Reg. § 1.1041-1T(d), A-10 (1984) (transferor of property recognizes no gain or loss).

\textsuperscript{59} Id.

\textsuperscript{60} Id.

\textsuperscript{61} Id. I.R.C. § 1041 does not require an equal division. Prior law required a roughly equal division of community assets between the parties. See Harrah v. Commissioner, 45 T.C.M. (CCH) 187 (1982) (wife claiming community ownership of assets cannot claim stepped up basis); Carson v. Commissioner, 37 T.C.M. (CCH) 818 (1978) (mathematical certainty is not required in nontaxable divisions: 46.2:53.8 split of community property not taxable); Walz v. Commissioner, 32 B.T.A. 718
Section 1041 was designed to work in the simple case of the traditional marriage where the husband owns property and transfers a portion to his wife, or where both husband and wife own community property and the husband cashes out the wife’s vested interest with separate assets, typically the proceeds of a loan obtained by mortgaging the community property. For example, assume that Abie owns 200 shares of stock with a basis of $1 per share and a fair market value of $2 per share and Becky owns no property. In an equal division of assets under prior law, Abie’s transfer of 100 shares to Becky, whereby each receives $200 worth of stock, results in recognized gain for Abie of $100. Abie holds his remaining shares with a basis of $100 and a fair market value of $200. Unlike Abie, Becky receives stock worth $200 with a basis of $200.

Under section 1041, Abie and Becky end up in changed circumstances after the transfer. Gain or loss is not recognized on the transfer. By applying section 1041 to an identical transfer of 100 shares of stock from Abie to Becky, Abie does not recognize a gain. Each retains $200 worth of stock with a basis of $100 which is automatically derived from Abie’s basis before the transfer. If either sells the stock for $200, he or she recognizes a gain of $100.

Should Abie transfer depreciated property—stock with a fair market of $50 and a basis of $100—section 1041 does not allow recognition of the loss. Instead, the tax loss inherent in Abie’s basis crosses over to Becky. The basis rules of section 1041 do not impede the recognition of loss by the recipient spouse. Hence, on the sale of the stock for $50, Becky recognizes a loss of $50. Abie has identical treatment of the shares of stock he retains. In contrast, prior law obviated the issue of assignment of tax losses through the basis rules which provided that the recipient’s basis would be the fair market value of the property at the date of transfer. The transferor could not deduct the loss because section 267 did not allow losses between related parties. If the transfer occurred after divorce, the parties were no longer related and the loss could be

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See also Rev. Rul. 76-83, 1976-1 C.B. 213 ($516 of separate property exchanged in a $300,000 division held not taxable). I.R.C. § 1041(a) (overrules Davis).

I.R.C. § 1041(a) (overrules Siewert v. Commissioner, 72 T.C. 326 (1979) and Carrieres v. Commissioner, 64 T.C. 959 (1975), aff’d per curiam, 552 F.2d 1350 (9th Cir. 1977)).

See Davis, 370 U.S. at 66.

I.R.C. § 1012 (cost basis). Abie gets no step up in basis because there was no transfer of property.

Id.; Davis, 370 U.S. at 73 (Becky is treated as a purchaser for value).

I.R.C. § 1041(a).

I.R.C. § 1041(b). In the case of a transfer of appreciated property, Becky’s basis under § 1041 is comparable to the basis rules applicable to property acquired by gift. Compare I.R.C. § 1041(b) (spouse’s basis, no adjustment for gift tax) with I.R.C. § 1015(a) (donor’s basis adjusted for a portion of gift tax).

I.R.C. § 1041(a).

I.R.C. § 1041(b).

I.R.C. § 1041(b).


See Davis, 370 U.S. at 67.
The transfer of a tax loss under section 1041 differs from the result under the general rules governing the basis of property acquired by gift. Ordinarily under section 1015, regulating nonspousal gratuitous transfers, the donor cannot transfer a tax loss because the donee's basis is the lower of the donor's basis or the fair market value of the property at the date of the gift, $50 in the above example.

B. A Real Life Division Under Section 1041

Although it is unusual for the marital property to consist of highly liquid and fungible assets having an equal fair market value and equal bases, it is common for both spouses to own property. Section 1041 co-incidentally may produce an equal division of the tax burden, as in the ideal cases, or it may produce a variety of unequal divisions when the tax consequences of the property transfer are taken into account. A property settlement is normally difficult for the couple whose assets are not capable of division. In such circumstances, the parties could sell the assets to a third party and split the proceeds, divide the assets between themselves, or distribute all the assets to one spouse who would then buy out the other spouse's interest.

The first alternative results in a taxable transaction immediately. The division of the net proceeds of the sale will produce an equal division of both the property and tax burden. Under the second and third alternatives, tax is deferred. In the second alternative, although the market value of the assets is the same, their value after taxes may differ substantially. By transferring assets with a low or high basis, the transferor spouse can also transfer the bulk of the tax burden to his or her former spouse. The last alternative creates a tax liability for the spouse.

73 See I.R.C. §§ 165(c) & 262. Treas. Reg. § 1.165-9(a) (1964) (disallowing deduction for losses recognized on nonresidential non-business, non-income producing property). Generally in a taxable property division under prior law where the transfer occurred after the divorce, Abie would recognize the loss. However, if the transfer occurred before the divorce was final, the loss in property transferred between husband and wife was disallowed. See, e.g., McWilliams v. Commissioner, 331 U.S. 694, 699 (1947) (tax motive relevant); Merritt v. Commissioner, 400 F.2d 417, 421 (5th Cir. 1968) (lack of tax avoidance motive irrelevant). See also I.R.C. §§ 257(a), (b)(1) & (c)(4); H.R. 3858 Tit. XVIII, Sec. 1842, § 421(a) (adding I.R.C. § 267(g). Pursuant to Temp. Treas. Reg. § 1.1041(a)-IT(b), A-6 (1984), the timing of the transfer—before or after the divorce—was determined by state property law. See generally Deyoe v. Commissioner, 66 T.C. 904, 911 (1976) (title passed with benefits and burdens of ownership, not deed).

74 See I.R.C. § 1015(a). Compare I.R.C. § 1041(b) (recipient takes donor's basis) with I.R.C. § 1015(a) (lower of donor's basis or fair market value at transfer).

75 I.R.C. § 1001(a).

76 Example: Abie and Becky own appreciated property with a basis of $200 and fair market value of $400. On sale to a third party, the couple, or either of them, recognizes a gain of $200 which will be subject to tax. The remaining proceeds are divided equally.

77 The tax deferral possibility depends upon the recipient having income from other sources. For the recipient in need of cash immediately, the deferral is illusory.

78 Assume again that the fair market value of stocks A and B is $100 and their bases are $10 and $75, respectively. The transfer of stock A to Becky on divorce will not cause immediate recognition of gain. Under the 1986 Code, if one assumes capital gain treatment and a 50% tax rate, Becky bears a tax cost of $18 and nets $82 upon divorce. However, should Becky retain stock B, her potential gain is only $25. The tax cost is $5 and her net receipt is $95. Under the 1986 Act, assuming no capital gain preference and a 28% tax rate, Becky's cost rises to $26 for stock A or $7
acquiring the property, while allowing the other spouse tax free proceeds from the transfer.\textsuperscript{79} Hence, the carryover basis principle forces upon an apparently equal division of property a future and concealed tax result.\textsuperscript{80} Upon the sale of the asset this concealed tax liability will unbalance the planned financial distribution by altering the net value of the property.

The inequity of the new section 1041 parallels the inequity of the \textit{Davis} case. Marital assets are divided, but only one spouse carries the tax burden. All the gain once recognized by the transferor under \textit{Davis} is now recognized by the recipient under section 1041. Thus \textit{Davis} is simply turned on its head; the coin, however, remains the same.

Contrast the result under section 1041 with a system that would compensate either spouse for the receipt of property carrying a low basis or other undesirable tax attributes. Where two assets each worth $1,000 have respective bases of $100 and $900, in theory one can achieve an accurate division of property by simply aggregating the bases according to the fair market value of the property. In the above example, such division of both property and basis would cause each party in an equal division to receive property worth $1,000 with a basis of $500 and a potential gain of $500. One way to achieve such economic parity may be to permit the election of a substituted basis.\textsuperscript{81} The problem obviously is that such an option will require exquisite accounting. However, the difficulty is obviated by section 71. The expedience of a compensating nontaxable cash payment can be used to even the financial value of a property settlement. Thus, a property settlement with a respective potential tax burden of $900 for Becky and $100 for Abie, can be made into an equal division of net value of the property if Abie pays Becky $400.\textsuperscript{82}

The nonrecognition and carryover basis rules of section 1041 apply for stock B. Abie’s tax cost on a subsequent sale of the asset retained by him will be the mirror image of Becky’s. Hence, if Becky’s tax cost in 1986 is higher, here $18, his is lower, here $5.

\textsuperscript{79} Assume that Abie and Becky own the stock as community property and both assets are transferred to Abie. Under pre-1984 law, Becky realizes and recognizes a gain because co-owned property is not divided in kind, in particular the borrowed cash is Abie’s separate property. After divorce Abie’s property is subject to the mortgage. See Commissioner v. Siewert, 72 T.C. 326 (1979); Carrieres v. Commissioner, 64 T.C. 959 (1975), acq., 1976-2 C.B. 1, aff’d per curiam, 552 F.2d 1350 (9th Cir. 1977). Section 1041 changes that result. Becky does not recognize a gain and Abie’s basis is the community basis immediately before the transfer. Gain recognition awaits a subsequent sale. Then the gain will be recognized entirely by Abie. The recipient spouse will have credit for the holding period of the transferor. H.R. 3838 Tit. VI(C), Sec. 621(a) (amending I.R.C. § 382).

\textsuperscript{80} See I.R.C. § 1041(b).

\textsuperscript{81} See Simmons, \textit{Federal Income Taxation of Wealth Transfers on Divorce: A Policy Analysis and Proposal}, 37 Sw. L.J. 941 (1984). A distribution from a qualified pension plan divided before the effective date of the Pension Equity Act of 1984 is classified as a property settlement under I.R.C. § 1041(a). The transferor (employee) spouse and not the recipient is taxed on the income. See Ficchi v. Commissioner, T.C.M. (P-H) 1986-191; Ltr. Rul. 8531042. After the effective date of the Act, the pension is taxable to the recipient of the payments.

\textsuperscript{82} See I.R.C. § 71(b)(1)(B). Abie must avoid agreeing to pay Becky’s future tax. Such payment may produce income under I.R.C. § 61. See Old Colony Trust Co. v. Commissioner, 279 U.S. 716 (1929) (employer’s payment of tax on salaries is taxable income to employee); Rev. Rul. 71-498, 1971-2 C.B. 494 (replaced the complex algebraic formulas formerly used). See also Mahana v. United States, 88 F. Supp. 285 (Ct. Cl.) (payment of wife’s tax in guaranteed trust yield held alimony), cert. denied, 339 U.S. 978 (1950); Neeman v. Commissioner, 13 T.C. 397 (1949), aff’d, 200 F.2d 560 (2d Cir. 1952), cert. denied, 345 U.S. 956 (1953). The agreement may provide that the $400 is a transfer of cash based upon a hypothetical gain recognition to effect an equal distribution of the net value of the property. A statement containing a specific figure should not run afool of the \textit{Old Colony} case.
DIVORCE TAX SHELTERS

consistently to property transfers between spouses. The effect of the blanket application of section 1041 on a sale of property is startling. For example, Abie sells Becky his old samovar for its fair market value of $1,000. Abie bought the samovar at The Green Dragon market for $10. Under ordinary circumstances, Becky's basis in the samovar is $1,000 and Abie's gain in the transaction is $990. Section 1041 does not treat this as an ordinary arm's length transaction because Becky is married to Abie. Becky's inherits the transferor's basis of $10 even though the amount Becky paid in cash far exceeds the basis. Abie does not recognize a gain on this sale because section 1041 controls all property transfers between spouses.

On the other hand, a sale between Becky and a corporation wholly owned by Abie, will not trigger section 1041. In this case the sale is not literally between spouses, but between an individual and a corporation or between two corporations. These examples, or rather tax planning opportunities, based on the temporary regulations interpreting section 1041, suggest that the application of section 1041 may eventually become elective for taxpayers able to funnel their interspousal transfers through corporations. Hence, the tax treatment of divorced taxpayers will be inconsistent. Although the problem is relatively narrow, the mix of options available will seriously undermine the Congressional effort to make the taxation of property settlements consistent and predictable.

Assuming that nonrecognition should apply to business transfers, it is necessary to determine whether, and to what extent, the application of the nonrecognition provisions can be defeated through use of the simple device of a wholly owned or family owned corporation or other entity. If one spouse were permitted to transfer property in a taxable transaction to a corporation controlled by the other, the married couple could keep their property, and at the same time increase the basis of the property to gain depreciation allowances or other benefits between themselves.

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83 I.R.C. § 1012.
84 I.R.C. § 1001(a).
85 I.R.C. § 1041(a).
86 I.R.C. § 1041(b).
88 Temp. Treas. Reg. § 1.1041-1T(a), A-2 (1984). Section 1041 contains no exceptions for business transfers between spouses. Instead of the above example, suppose that Becky were an antique dealer, Abie an interior decorator, and the transfer occurred in the ordinary course of business. The result is the same. See id. at ex. 2. If the samovar were part of his inventory, Abie could deduct his cost ($10) from the cost of goods sold because title passed to Becky. See Treas. Reg. § 1.471-1 (1960). Because § 1041 applies, however, Abie would not count the $1,000 in cash as sales income. See Temp. Treas. Reg. §§ 1.1041-1T(a), A-2 & 1.1041-1T(d), A-11 (1984).
90 Id.
91 The determination of whether the sale was made by the individual spouse or his or her controlled corporation will raise difficult factual issues reminiscent of the Court Holding Company Doctrine. See Commissioner v. Court Holding Company, 324 U.S. 331 (1945) (corporate distribution of asset to shareholders after negotiation of sale by corporation, but prior to formal transfer, ineffective for tax purposes); but see United States v. Cumberland Public Service Company, 338 U.S. 451 (1950) (step-transaction doctrine not applied, sale held made by shareholders).
92 The 1986 Act reduced the amount of the tax benefits available under the 1984 Act. The value of the deduction, nevertheless, is directly related to the basis of the property. See H.R. 3838 Tit. II, Sec. 201 (modification of ACRS, I.R.C. § 168), Sec. 211 (repeal of investment tax credit, I.R.C. 1986)
Prior to the effective date of the 1986 Act, the gain recognition in the case of a wholly-owned or 80% owned corporation will bear a high cost. Section 1239 converts all gain to ordinary income on the transfer of an asset depreciable in the hands of the recipient which is transferred between related parties such as Becky and Abie's 80% owned corporation. If the asset is not depreciable under section 167, or if Abie only owns 79% of the corporation, section 1239 does not apply. Under the 1986 Act, there is little practical difference between capital gain income and ordinary income.

III. The Section 1041 Tax Shelter

A. The Tax Free Transfer of Assets With Undesirable Tax Characteristics

Pursuant to section 1041, the assignment of tax consequences between Abie and Becky occurs automatically because the recipient takes the transferor's basis and prior tax history in the property. If both spouses own property, marriage and divorce, and to a lesser extent marriage alone, may become the ultimate tax shelter. For example, assume Becky owns highly appreciated property, a prize Hampshire, basis $10 and fair market value of $100. Abie owns a Perigord worth $100 with a basis of $100. Upon divorce Abie and Becky trade pigs. Becky's potential gain of $90 is reduced to zero. She gets a $100 pig and freedom from taxes on the $90 profit she made on her $10 pig. Becky's basis and her potential gain of $90 attaches to the pig like a latent defect. Initially neither transfer is taxable under section 1041. But on a later sale, Abie will recognize a gain of $90 because Becky transferred her tax liability along with her pig.

Compare the foregoing tax results under section 1041 to other non-recognition transactions in which assignment of income is prevented because the transferor of the property keeps a relatively constant basis, and hence, an equally constant potential gain or loss throughout the chain of nonrecognition transactions. Assume in the above transaction

§ 46), Sec. 221 (reduction of general business credit, I.R.C. § 38(o)(1)(B)) & Sec. 241 (repeal of five year amortization of trade marks, I.R.C. § 177).


94 Id. The 1986 Act repealed the preference for long term capital gain income provided by I.R.C. § 1202. See HR 3838 Tit. III(A), Sec. 301.


96 See I.R.C. § 1041(a).

97 Compare I.R.C. § 1031 (carryover basis) with I.R.C. § 362 (substituted basis) and I.R.C. § 358 (carryover basis). In the latter case, for example, the transferor of Blackacre (basis $25) to a wholly owned corporation in exchange for corporate stock in a transaction qualifying for non-recognition treatment under I.R.C. § 351 takes a carryover basis in the stock equal to the transferor's basis in Blackacre ($25). The corporation takes a substituted basis in Blackacre equal to its transferor's former basis ($25). Although a corporation has a zero basis in its own stock, the substituted basis rule avoids the zero basis problem. See Rev. Rul. 74-503, 1974-2 C.B. 117. See also I.R.C. § 1032 (corporation recognizes no gain on exchange of its stock for property).

98 See, e.g., I.R.C. § 358(a)(1) (basis of property received in nonrecognition transfer to corporation); I.R.C. § 1031(d) (basis of nonrecognition property same as like-kind property exchanged). See also I.R.C. § 1033(b) (adjusted basis same as property converted).
the nonrecognition rules of section 1031 apply. However, Becky substitutes her historic $10 basis in the new pig. Thus, if Becky sells the pig for $100, she recognizes a gain of $90. Abie, likewise, keeps his original basis of $100, and on the subsequent sale of his new Hampshire for $100, does not recognize a gain or a loss.

The effect of the carryover basis rules is to shift the tax burden of appreciation inherent in the transferred asset from the transferor to the recipient. This is similar to the tax result which occurs in a gift transfer under section 1015. If the movement is all in one direction, that is only one spouse transfers property, the carryover basis principle of section 1041 is analogous to the gift tax basis. If each spouse transfers property to the other, however, the carryover basis is not appropriate. Transactions that are exchanges of property are more clearly analogous to a sale, not to a gift. Ordinary folks call it “bartering,” not “giving.” Further, since section 1041 applies to unequal property divisions, the statute permits an outright sale of tax consequences. The limit, of course, is that the parties to the transaction marry first.

B. Transfer of Property Subject to Liability in Excess of Basis

While overruling the Davis case, Congress dislodged a few other tax principles as well. For example, to effect an equal division of property in the divorce, Abie borrows $50 from National Bank, pledging the pig as collateral for the loan. Abie then transfers the pig to Becky subject to the $50 debt. The relief from the obligation to repay a loan is ordinarily treated as the equivalent of a cash receipt. Abie’s basis would thereby be reduced by the amount of the cost recovered in the exchange. Because the amount of the liability exceeded Abie’s basis,
one expects Abie to recognize gain.\textsuperscript{109} In the case of an ordinary gift, the gain is limited to the excess of the liability over Abie's basis.\textsuperscript{110} Thus $49 of Abie's potential $99 gain would be recognized.\textsuperscript{111} The donee of the gift would increase the basis to the amount of the liability, here $50.\textsuperscript{112} In divorce transfers, however, the recognition of Abie's gain for tax purposes is not only deferred, it is transferred to Becky.\textsuperscript{113} If the price of the pig fell below $50 and the bank foreclosed its lien, Becky will realize and recognize a gain of $49 for tax purposes.\textsuperscript{114} Notice that in this case she actually suffers a financial loss while Abie received the proceeds of the loan tax free.\textsuperscript{115} Hence, section 1041 enables the tax-free division of mortgaged property following divorce\textsuperscript{116} and coincidently allows the transferor to bail out cash and leave his or her spouse with both the liability to repay the loan and the tax bill.\textsuperscript{117}

Section 1041 is potentially useful to avoid gain recognition for the owner of a garden variety tax shelter, where the fair market value is less than the mortgage to which it is subject. Should the mortgagor foreclose, Becky would recognize gain equal to the difference between the liability, which is treated as her amount realized, and her basis.\textsuperscript{118} If Becky transfers the property to Abie prior to the foreclosure, Becky's inchoate gain will be recognized on the bank's foreclosure, with one important difference. Abie, not Becky, will realize and recognize the gain.\textsuperscript{119}

The nonrecognition section has the potential for tax abuse that is not balanced against the economic needs of a divorcing couple. In the case where the liability exceeds the basis of the property transferred, a limited deferral of the potential tax liability through the use of install-


\textsuperscript{110} Id.

\textsuperscript{111} Id.


\textsuperscript{113} Becky's basis is not increased by the liability she assumed. See id. at A-11. Under the 1986 Act, the recipient's ability to deduct interest is severely limited. For example, in the case of passive investment property, such as real estate, expenses are deductible up to the amount of income from the investment. Hence, if the property does not produce income, no expenses are deductible. See H.R. 3838 Tit. V, Sec. 501 (limits losses on passive activities) & Sec. 511 (limits non-business interest deductions, I.R.C. § 163(d)).


\textsuperscript{115} Id. at 309.


\textsuperscript{117} The 1984 Act did not distinguish outright transfers to a spouse from transfers to a trust for the benefit of a spouse. The 1986 Act makes I.R.C. § 1041 inapplicable to transfers of property in trust where the property is subject to liability in excess of basis and the transfer of installment obligations in trust. See H.R. 3838 Tit. XVIII, Sec. 1842, §§ 421(b) & (c) (adds I.R.C. § 1041(e)(1)). The 1986 Act permits a step up in basis equal to the gain recognized by the transferor, which may be of more benefit to the transferor than nonrecognition. Id. at § 421(b) (adding I.R.C. § 1041(b)(2)). See supra note 92.

\textsuperscript{118} Cf. Commissioner v. Tufts, 461 U.S. 300 (1983); Kirby Lumber Co. v. United States, 284 U.S. 1 (1931).

\textsuperscript{119} I.R.C. § 1041(b)(2).
ment reporting appears a more reasonable solution. The 1986 Act has slightly limited the abuse by exempting transfers of property subject to liability in excess of basis in trust. Direct transfers, however, are not affected.

Suppose again that Abie transfers an asset whose liability exceeds basis, but this time the transfer is in trust, income to Becky for life, remainder to a related third party. Under the 1986 Act, section 1041 is inapplicable to transfers in trust of installment obligations or assets, subject to a liability in excess of basis. The amendment causes the immediate recognition of gain upon the transfer of property in the course of a divorce, the very thing section 1041 was to prevent. Because sec-

121 The 1986 Act modified § 1041(a). See H.R. 3838 Tit. XVIII Sec. 1842, § 421(b) (adds §§ 1041(e) & 421(c) (adds I.R.C. § 453B(g)).
122 Transfer of property on behalf of one spouse to third parties will not escape taxation. For example, Abie agrees in writing to transfer his red Packard convertible, which is worth $40,000 and has a basis of $10,000, to Becky's attorney to cover Becky's legal fees. The property transfer to the attorney is treated as two transfers. Temp. Treas. Reg. § 1.1041-1T(c), A-9 (1984). One transfer is a gift from Abie to Becky and another simultaneous transfer is from Becky to her attorney. I.R.C. § 1041(a). Becky will recognize gain or loss pursuant to I.R.C. § 1001 with her basis derived from Abie. I.R.C. § 1041(b). Only the first transfer is made to a spouse and thus covered by § 1041. Temp. Treas. Reg. § 1.1041-1T(c), A-9 (1984) (third party transfers). Hence, Abie recognizes no gain or loss on the transfer, but Becky recognizes a gain of $30,000 on the transfer of appreciated property to satisfy a debt. See Davis, 370 U.S. at 66. Becky's payment is generally not deductible. See Fleishman v. Commissioner, 45 T.C. 439 (1966) (defending suit to set aside antenuptial agreement not deductible); United States v. Gilmore, 372 U.S. 39 (1963) (defending against wife's claim to community property not deductible); but see Ruth R. Wild, 42 T.C. 706 (1964) (fee to gain alimony is deductible). Suppose instead Abie transfers his red convertible to Becky's mother as a gift. Abie recognizes no gain or loss upon the transfer. Becky recognizes no gain or loss. I.R.C. § 1041(a). Becky is liable for gift tax, if any. For purposes of calculating gain, the basis of mother's new red convertible is Becky's basis, adjusted for the portion of gift tax attributed to the appreciation of the property, which is zero. I.R.C. § 1015(d). Here Becky's basis is Abie's basis immediately before transfer. I.R.C. § 1041(b)(2). Thus, the use of appreciated property rather than cash allowed Abie to fulfill his obligation to pay Becky's attorney and at the same time shifted the tax burden of the gain on property to Becky. A cash payment to Becky's attorney may qualify as alimony. I.R.C. § 71(b)(1)(A) (payment must be pursuant to written divorce instrument).

Even an asset with desirable tax consequences may cause unfair tax results for one spouse. Assume that Abie and Becky's major asset is their highly appreciated family home. If the house is sold to a third party, the Code provides relief from the inclusion of gain on such a sale. Rev. Rul. 74-250, 1974-1 C.B. 202 (nonrecognition applied separately where husband and wife separated on the sale of family home and each purchased replacement homes within statutory period). Suppose, however, that Becky moves out, they delay the sale, but continue to own the house for five years, at which time it will be sold to a third party and the proceeds evenly divided. In the latter case, each will recognize an equal amount of gain, but their potential tax liability might not be equal. Abie will be able to defer gain recognition by purchasing another residence within two years. See I.R.C. § 1034; see also I.R.C. § 121 (nonrecognition of $125,000 gain for taxpayers over 55). For Becky, however, tax relief is no longer available. At the time of the sale in the fifth year, the house is no longer Becky's residence and neither I.R.C. § 121 nor § 1034 apply. See Young v. Commissioner, 49 T.C.M. (CCH) 1002 (1985). But see Bolaris v. Commissioner, 776 F.2d 1428 (9th Cir. 1985) (I.R.C. § 1034 applied in the case of a temporary rental of an old residence until sold; depreciation deduction also allowed). The problem in a divorce case is that the spouse who moves out has abandoned residence. Payment of the mortgage or use of the house by the taxpayer's children does not meet the requirements of residence under Young.

123 See I.R.C. § 453B(g) (added by H.R. 3838 Tit. XVIII, Sec. 1842, § 421(c)).
124 See I.R.C. § 1041(e) (liability in excess of basis) added by H.R. 3838 Tit. XVIII, Sec. 1842, § 421(b).
125 The nonrecognition issue hinges on whether Davis applies to the transfer. For example, the transfer of community property or the retention of an interest by the grantor will invoke the pre-1984 nonrecognition rules. See infra note 167. The amendment to the 1986 Act was in response to a suggestion that such a transfer avoids taxing either spouse under the 1984 Act. See Ginsberg, State-
tion 1041 is not limited to divorce, this amendment permits the happily married taxpayer to gain a step up in basis without losing control of his or her property. Clearly, this is an unreasonable policy.

C. Recapture of Investment Credits and Accelerated Cost Recovery

Although under section 1041 the property settlement itself does not trigger tax liability for the transferor of property, the transfer of property eligible for the investment tax credit may carry immediate tax consequences for the recipient. Tacoma Slew, Abie’s famous breeding pig, qualifies for the investment tax credit when used in Abie’s business. Assume, Abie’s cost for Tacoma Slew was $10,000. Using the ACRS method, Abie depreciated the property in years one and two by $2,500 and $3,800, respectively, and in addition, claimed an investment credit of $400 in year one. In year three, when Abie transfers the pig to Becky, who keeps it as a family pet, it has an adjusted basis of $3,700 and a fair market value of $10,000. As a family pet, however, it no longer qualifies under the investment credit provisions. The amount Abie deducted two years ago as investment credit, $134, is recaptured. The change of use causes Becky, as the owner of the property at the time the property was no longer qualified, to increase her tax by an amount equal to Abie’s former tax credit. Had Becky’s use of Tacoma Slew qualified, the investment credit recapture would not apply.

Ordinarily, the seller of certain investment property or property used in business may recognize ordinary income in the form of depreciation Before the Senate Finance Committee on S. 814, June 5, 1985. In this example, according to Professor Martin D. Ginsberg’s interpretation of I.R.C. § 1041(a), when the bank forecloses on the pig, the gain is recognized as in the case of the direct transfer. It is the trust, however, the legal owner of the property, which recognizes the gain. Neither Abie, who is no longer the owner of the property, nor Becky, the income beneficiary, is liable for the payment of the tax. Since the pig is the trust’s only asset, the tax liability would be uncollectable. Professor Ginsberg noted that a similar shift of tax liability to a trust would occur in the case of a transfer of an installment obligation to a trust. Id.)

The nonrecognition provision of § 1041 specifically includes a transfer in trust where the spouse is a beneficiary and a third party is the remainder person of the trust. According to Professor Thomas R. White III, however, the application of § 1041 to a transfer in trust is unclear. Professor White argues that the nonrecognition afforded by § 1041 is limited to the recipient spouse’s portion of the transfer and should not extend to the remainder interest. See White, Memorandum to the Honorable Fred T. Goldberg, Jr., Chief Counsel, Internal Revenue Service, November 12, 1985. Under this interpretation and in view of I.R.C. § 1001(e) (zero basis allocated to income beneficiary), the 1986 Act would not change the effect of § 1041 on trusts.

The 1986 amendments do not clarify the scope of § 1041, which may allow the transfer of other tax attributes to third parties via § 1041 and a transfer in trust for the benefit of a spouse, remainder to third parties. The recapture provisions, however, are still applicable.

The investment tax credit was repealed by the 1986 Act. H.R. 3838 Tit. IIB, Sec. 211. The recapture provisions, however, are still applicable.

The investment tax credit was repealed by the 1986 Act. H.R. 3838 Tit. IIB, Sec. 211. The recapture provisions, however, are still applicable.

See I.R.C. § 47(e) (transfers between spouses of § 38 property under I.R.C. § 1041 do not trigger recapture) & § 48(a)(6) (livestock § 38 property).

I.R.C. § 38.

I.R.C. § 47.


tion recapture. This unattractive tax consequence can be avoided under section 1041. Abie can transfer property that has been depreciated under accelerated methods of cost recovery to Becky. Recapture of ordinary income will not occur on Abie’s transfer. Becky’s resale of the transferred property will trigger the recapture sections and Becky will recognize ordinary income. As in the case of the investment credit, the benefit of the depreciation deductions is enjoyed by the transferor of the property. Hence, Becky takes Tacoma Slew’s lower adjusted basis and the liability for the amount of gain subject to recapture of accelerated depreciation and the investment tax credit.

One may suppose that Abie’s lawyer won’t leave him holding Becky’s property and her tax liability. Even though the temporary regulations state Becky “must supply” Abie with “sufficient” documentation of her adjusted basis, holding period, and liability for the recapture of the investment credit, the glitch in the carryover basis rule is the absence of a procedure to enforce Becky’s record keeping obligation. The 1041 regulations state that the required information need not be supplied until the date of the transfer.

A procedure to permit either spouse to obtain records concerning the property to be transferred in a property division has not been devised. Thus, even if the records are volun-

133 I.R.C. § 1245 (depreciation recapture).
134 Whether the depreciation deduction was allowed solely to Abie on a separate return or to Abie and Becky on a joint return does not affect the application of I.R.C. § 1041(a) (nonrecognition of gain on transfer to former spouse).
136 See, e.g., I.R.C. §§ 291 (corporate preference items); 1245 (depreciable personal property); 1250 (depreciable real property); 1254(a) (deductible costs of oil, gas, and geothermal property). The 1986 Act does not alter significantly the recapture provisions. The Act does, however, limit losses from passive activities. See H.R. 3838 Tit. V., Sec. 501.
139 Id. The investment credit is also recaptured. See I.R.C. § 38; Temp. Treas. Reg. § 1.1041-1T(d), A-13 (1984).
140 The rule would also apply in the case where Abie acquired the property and elected the investment credit and an accelerated method of cost recovery prior to his marriage to Becky. I.R.C. § 453(i)(2) (installment recapture). Recapture will be a greater burden if Abie makes installment payments. After 1984, all recapture of ordinary income is recognized in the year of the transfer. The 1986 Act modifies this result. The Act makes § 1041 inapplicable to the transfer of installment obligations to a trust for the benefit of a spouse. H.R. 3838 Tit. XVIII, Sec. 1842, § 421(c) (adding I.R.C. § 453B(g)). See also supra note 138.
143 A good faith requirement in the determination of a property settlement has occasionally been imposed by the courts. See Schatten v. United States, 746 F.2d 319 (6th Cir. 1984); White v. United States, 550 F. Supp. 96, 100 (M.D. Ala. 1982); aff’d in part, rev’d in part, 740 F.2d 836 (11th Cir. 1984); Harrah v. Commissioner, 70 T.C. 735, 747 n.6 (1978) (spouses claiming one position in state divorce court not permitted to change theory in federal tax court). Cf. Meinhard v. Salmon, 249 N.Y. 458, 164 N.E. 545 (1929):
rily make available in time for Abie to prepare his tax return, the date of the transfer is too late for Abie to make a reasonable valuation of the proffered property.\textsuperscript{144}

IV. Property Settlement Taxed As Alimony

Under prior law, a cash payment in satisfaction of spousal property rights theoretically was not deductible as alimony by the payor.\textsuperscript{145} Property rights under state law, rather than the form of the payment,\textsuperscript{146} determined the tax result.\textsuperscript{147} A payment contingent on Becky’s survival was not deductible if the payment equalled the value of her interest in marital or community property.\textsuperscript{148} The test of alimony was not simply the distinction between cash and property,\textsuperscript{149} but the substance of the transfer.\textsuperscript{150} Only where the transfer was to satisfy the husband’s obligation of

\textsuperscript{144} The risk of latent tax liability originating through Becky’s fault or mistake is placed on Abie. Abie may receive some protection from a warranty by Becky of the tax history of the property transferred. Discovery through state rules of procedure will not fully inform the recipient of a latent liability. For example, if Becky owns depreciable property but failed to take the allowable depreciation deduction, the basis of the property is reduced by the allowable amount of depreciation, a minimum basis reduction based upon what could have been deducted by taxpayer even if the taxpayer literally could not benefit from the deduction. See I.R.C. § 1016(a).


\textsuperscript{146} See I.R.C. §§ 61(a)(3) (gain from sale of property included in gross income) & 1001(a) (recognition of gain).

\textsuperscript{147} But see Ryker v. Commissioner, 33 T.C. 924 (1960) (character of payment determined by surrounding facts and circumstances). See Wright v. Commissioner, 543 F.2d 593 (7th Cir. 1976); Bardwell v. Commissioner, 318 F.2d 786 (10th Cir. 1963); Schottenstein v. Commissioner, 75 T.C. 451 (1980), acq., 1981-2 C.B. 2 (periodic payments of "property settlement" taxed as alimony).


\textsuperscript{149} Prior to 1984, either cash or property qualified as alimony. See I.R.C. § 71(a) (1982); cf. I.R.C. § 61 & Treas. Reg. § 1.61-1(a) (1954) (gross income does not depend on form of receipt); Rice v. United States, 8 Cl. Ct. 792 (1985) (Davis applied to transfer of securities to satisfy alimony payments). But see Wright v. Commissioner, 543 F.2d 593, 599 (7th Cir. 1976) (form is a factor distinguishing property settlement from alimony payments).

\textsuperscript{150} See Oman v. Commissioner, 767 F.2d 290 (6th Cir. 1985) (lump sum alimony paid over nine years not taxed as alimony); Biddle v. Commissioner, 38 T.C.M. (CCH) 1361 (1979); Bolza v. Commissioner, 42 T.C.M. (CCH) 1138 (1981); Pierce v. Commissioner, 66 T.C. 840 (1977).
support under state law was the transfer treated as alimony.\textsuperscript{151} The revision of section 71 changes this result.\textsuperscript{152} The stated purpose of the revised definition of alimony is to make the application of alimony rules uniform and automatic,\textsuperscript{153} and not dependent on state matrimonial laws. The definition also prevents the deduction of large, one-time lump sum property settlements.\textsuperscript{154} Thus, large property settlements paid in installments or small property settlements paid in a lump sum are fully deductible.\textsuperscript{155}

Suppose in the property settlement Becky transferred depreciated property (adjusted basis $100,000, fair market value $15,000) in exchange for $15,000 cash from Abie. Becky cannot recognize a loss under section 1041.\textsuperscript{156} Her basis becomes Abie's basis.\textsuperscript{157} To add to Becky's

\textsuperscript{151} See Taylor v. Campbell, 335 F.2d 841, 845 (5th Cir. 1964). See also Widmer v. Commissioner, 75 T.C. 405 (1980); Newbury v. Commissioner, 46 T.C. 690 (1966). Cf. White v. Commissioner, 770 F.2d 685 (7th Cir. 1985), rev'd 82 T.C. 222 (1984) ("We cannot change the tax laws to allocate the tax burden as the parties may have contemplated."); Helvering v. F. & R. Lazarus & Co., 308 U.S. 252, 255 (1939) ("In the field of taxation, . . . written documents are not rigidly binding."). Courts have refused to determine tax issues on the mere form or labels given by the parties to the transaction at issue. See Westbrook v. Commissioner, 74 T.C. 1357, 1368 (1980) (payment labeled "support" held property division); Weiner v. Commissioner, 61 T.C. 155 (1973); Broida v. United States, 40 A.F.T.R.2d (P-H) No. 77-5189 (N.D. Ohio, 1977); Jackson v. Commissioner, 54 T.C. 125, 129-30 (1970).


\textsuperscript{154} See id.

\textsuperscript{155} See I.R.C. § 71(f). Under the 1986 Act, Abie can deduct a lump sum cash payment made pursuant to an alimony agreement, for example $200,000, in one year. Becky has $200,000 in ordinary alimony income. Assuming no further payments, neither one has income or a deduction in the second year. In the third year, Abie recaptures $185,000 of his excess alimony; Becky has a corresponding deduction. Since the rates for 1986 are considerably higher than those in 1988, Congress has given Abie yet another tax advantage. As under the 1984 Act, Abie can fully deduct the cash settlement if spread over the statutory minimum period for alimony. Here again Congress liberalized the deduction by cutting the period from six years, required in 1984, to three years after 1986. See H.R. 3838, 99th Cong., 2d Sess. (1986) (amending I.R.C. § 71(f) (three year time period is retroactive to the effective date of the 1984 Act).

The 1986 Act amends I.R.C. § 71(f) to make alimony treatment easier to obtain than under the 1984 Act. The alimony trust may increase Abie's tax benefit. Under current law, a property settlement paid through a trust is generally more advantageous to the transferor than the direct cash payment of a property settlement. The advantage stems from the revised trust provisions which permit the shifting of income between former spouses without meeting the requirements for alimony under I.R.C. § 71. Payments which decrease by more than $15,000 per year in the first three years of payment are subject to recapture by the payor. \textit{Id}. The penalties for front loading installment payments in § 71 do not affect § 682. The transfer of an income interest in trust to a former spouse is treated as a property settlement. The transferor spouse recognizes no gain or loss, and the recipient spouse is treated as the beneficiary of an ordinary trust. In effect, trust payments are taxed as if the settlement paid through a trust is generally more advantageous to the transferor than the direct cash payment of a property settlement. The advantage stems from the revised trust provisions which permit the shifting of income between former spouses without meeting the requirements for alimony under I.R.C. § 71(f). Under the Code prior to the 1984 Act the payments from trusts created to satisfy divorce settlements were taxed as alimony to the recipient (I.R.C. § 71(d) (1982), repealed by Pub. L. No. 98-369, 98 Stat. 795 (1984)).

\textsuperscript{156} I.R.C. § 1041(a). The 1986 Act modifies I.R.C. §§ 267(a), (b)(1), and (c)(4) to allow losses between spouses on transfers before the divorce is final. H.R. 3838 Tit. XVIII, Sec. 1842, § 421(a) (adds I.R.C. § 267(g)).

\textsuperscript{157} I.R.C. § 1041(b)(2) (property retains pre-divorce basis).
woe, under section 71 the $15,000 payment for the property can be structured as alimony. Section 1041 does not take precedence over section 71 and both sections are applicable to the transfer. Thus, if the agreement is drafted to comply with section 71, Abie has a double windfall. Assuming a constant $15,000 market value, Abie can recognize loss on his later disposition of the property and with proper drafting he can fully deduct his $15,000 cost as alimony under section 215.

V. Exceptions to Section 1041

A. Antenuptial Transfers

While generally denying gain recognition and a stepped up basis in marital transfers, Congress left a small hole. Transfers made prior to marriage pursuant to an antenuptial agreement are not within section 1041. Hence, if Abie transfers appreciated property to his future wife in exchange for her release of future marital rights, Abie recognizes gain and his future wife has a step up in basis. The higher basis will support increased depreciation deductions indirectly available to Abie if he and his future wife file a joint return. Because avoiding section 1041 can be accomplished through forethought and early planning, many Porsche owners seeking a significant relationship would not set foot in McGlade's Pub without a tax advisor in tow.

158 See generally Temp. Treas. Reg. § 1.71-1T(a), A-3 (1984). Payments need not be periodic. Id. Under current law alimony requirements are explicitly formal. However, similar results occurred under prior law. See Wright v. Commissioner, 543 F.2d 593 (7th Cir. 1976); Bardwell v. Commissioner, 318 F.2d 786 (10th Cir. 1963); Schottenstein v. Commissioner, 75 T.C. 451 (1980) (periodic payments of "property settlement" taxed as alimony), acq., 1981-2 C.B. 2

159 I.R.C. § 1041 regulates the transfer of property. I.R.C. § 71 determines whether the cash payment qualifies as alimony. The sections are not mutually exclusive.

160 See generally I.R.C. § 71(b).

161 See I.R.C. § 1041(b)(2).

162 See I.R.C. § 71.


164 See generally I.R.C. § 1041 (only property transferred during marriage or after divorce is within the scope of this section); Temp. Treas. Reg. § 1.1041-1T(a), A-5 (1984) (property acquired after divorce is § 1041 property). A division of property between unmarried cohabitants is not covered by I.R.C. § 1041. The incidence of gain recognition on the transfer of assets, including cash, is unclear. A transfer of separately owned property is either a gift (see Commissioner v. Duberstein, 365 U.S. 278 (1960)) and hence not normally subject to gain recognition or a payment of an obligation with appreciated property and hence subject to gain recognition. See supra note 73 (recognition of loss is not premitted in personal transactions). The transfer is not alimony for lack of a divorce or separation instrument.

The recipient's treatment is more uncertain. There will be no immediate tax consequences if the receipt is a gift. I.R.C. § 102. But see I.R.C. § 61; Commissioner v. Glenshaw Glass Co., 348 U.S. 426 (1955) (windfalls are taxable). In contrast, if the receipt is compensation for personal injury, the transfer is excluded under I.R.C. § 104. But see I.R.C. § 1012 (cost basis).


166 The transfer must be completed before the marriage to avoid the application of I.R.C. § 1041.

167 An equally significant exception to § 1041 which has limited application involves nonresident
B. Transfer Of An Income Interest In Trust

Where the subject of the property settlement is the right to receive all the income from the trust for the life of the grantor, Congress treats the transfer with a reversionary interest as alimony paid by a trust, and the transfer of the entire interest as a property settlement. For example, if Abie transfers his income interest to Becky for five years, the carryover basis rules of section 1041 do not apply. Becky has a zero basis in the term interest acquired by gift. Hence, on a taxable disposition of the term interest, Becky will be taxed on the entire amount received. On the other hand, if Abie transfers his entire term interest to Becky (the right to income for the life of the grantor), Becky succeeds to Abie’s basis in the trust. This distinction is in accord with the assignment of income principles applicable to nonmarital transfers.

C. The Rendering of Services

The temporary regulations state that property transferred in return to aliens. If the reader will erase Becky from the script for a moment and replace her with Katya, a resident and citizen of Sweden, Abie’s transfer of his separately owned jade chess set to Katya will trigger recognition of gain or loss for Abie under pre-1984 rules. I.R.C. § 1041(d); Temp. Treas. Reg. § 1.1041-1T(a), A-3 (1984). A nonresident alien normally is not taxed on property transfers. See, e.g., I.R.C. § 894; but see I.R.C. § 895. This exception to § 1041 is aimed at taxing the appreciation in the transferred property to Abie, the spouse who is subject to United States taxation. I.R.C. § 61(a)(5) (gains from dealing in property). Under pre-1984 rules, state law determines whether the property is separate or co-owned property. The division of co-owned property will not result in the recognition of gain by Abie and the property will retain its predivorce basis. See Serianni v. Commissioner, 765 F.2d 1051 (11th Cir. 1985); Imel v. United States, 375 F. Supp. 1102 (D. Colo. 1973), aff’d, 523 F.2d 853 (10th Cir. 1975); Collins v. Commissioner, 412 F.2d 211 (10th Cir. 1969); Walz v. Commissioner, 32 B.T.A. 718 (1935); Rev. Rul. 81-292, 1981-2 C.B. 158; Rev. Rul. 76-83, 1976-1 C.B. 213. The application of the nonrecognition principle is limited to in-kind divisions of property. See Carriers v. Commissioner, 64 T.C. 959, 964 (1975), acq., 1976-2 C.B. 1, aff’d per curiam, 552 F.2d 1350 (9th Cir. 1977). In such divisions, the recipient spouse has an interest prior to the divorce transfer. Compare Imel v. United States, 375 F. Supp. 1102 (D. Colo. 1973), aff’d, 523 F.2d 853 (10th Cir. 1975) (state’s highest court held recipient’s interest vested prior to divorce) with Wiles v. Commissioner, 499 F.2d 255 (10th Cir.), cert. denied, 419 U.S. 996 (1974) (no state decision on vesting, Davis followed). Here Abie will recognize gain on the transfer of separate property under the Davis principle. I.R.C. § 1239(b)(1) (1982) (repealed by Pub. L. No. 98-569, 98 Stat. 798 (1984)) (ordinary gain on transfer of depreciable property to spouse) (exception to § 1041 where recipient nonresident alien). Temp. Treas. Reg. § 1.1041-1T(a), A-3 (1984). See also Davis, 370 U.S. at 70 (satisfaction of an obligation with appreciated property is a taxable event). However, losses will be allowed only if the transfer occurs after the divorce. See I.R.C. § 267(a) (losses on the sale of depreciated property between spouses disallowed); I.R.C. §§ 267(b)(1) & (c)(4); see also I.R.C. § 267(d) (future gain by recipient reduced by loss disallowed to transferor); H.R. 3838 Tit. XVIII, Sec. 1842, § 421(a).

168 Cf. I.R.C. § 682(b) (receipt from alimony trust taxed under trust accounting rules); cf. H.R. 3838 Tit. XIV, Sec. 1402 (amending I.R.C. § 673) (provision repeals Clifford Trust exception from grantor trust rules).
169 Cf. I.R.C. § 1041(b) (recipient takes donor’s basis in property).
170 I.R.C. § 267(d).
171 I.R.C. § 1001(e)(1). “Term interest” is defined by the Code as “(A) a life interest in property, (B) an interest in property for a term of years, (C) or an income interest in a trust.” I.R.C. § 1001(e)(2).
172 I.R.C. § 1001(a) (Becky’s basis is zero).
173 I.R.C. §§ 1001(e)(3) (exception for transfer of entire interest) & 1041(b).
174 See Blair v. Commissioner, 300 U.S. 5 (1937) (assignment of entire beneficial interest in trust effectively to assignee); see also Helvering v. Horst, 311 U.S. 112 (1940) (transfer of annual interest coupon ineffective to shift donor’s income).
for services is not covered by section 1041.\textsuperscript{175} There is no doubt that Congress intended to enact a uniform nonrecognition rule for interspousal transfers.\textsuperscript{176} The 1984 legislation treats property transfers between spouses as transfers within an economic unit, and transfers between former spouses as the winding up of a marital partnership. The cash requirements of section 71 make it clear that the transfer of services does not qualify for alimony treatment.\textsuperscript{177} Even under prior law, which did not limit the form of alimony payment, the doctrine of imputed alimony was rejected.\textsuperscript{178} The temporary regulations relating to the transfer of services, should be clarified by the Service, in order to prevent parties from obtaining a step up in basis for the transfer between spouses of appreciated property in exchange for services.

VI. Issues Not Resolved by Section 1041

A. The Transfer of Property In Exchange For a Note

Although double taxation does not appear to have been intended by the reversal of the \textit{Davis} case, deferred payments have an uncertain status under section 1041, which may cause both Abie and Becky to be taxed on the same gain.

The application of the migratory basis rule\textsuperscript{179} becomes more curious where instead of cash, Abie gives Becky his note for $100,000 in exchange for her interest in their jointly owned property. Under prior law, Becky recognized a gain\textsuperscript{180} and Abie had a fair market value basis in the property that Becky transferred.\textsuperscript{181} The tax treatment was similar to her receipt of cash. Section 1041 now blocks recognition of gain on the transfer. Becky’s basis migrates over to Abie along with Becky’s property rights.

What is not obvious under section 1041 is how to determine Becky’s basis in the note. The Code says simply that the transferee’s (Becky’s) basis is the transferor’s (Abie’s) basis immediately before the transfer.\textsuperscript{182} Unfortunately, this language permits three plausible results.

First, the most reasonable result is to ignore the note for purposes of section 1041 and treat Becky as if she received cash. One may analyze the transfer as a simultaneous cash payment by Abie to Becky and loan from Becky to Abie. This result, however, does not follow from the literal application of section 1041. Abie is taxed on the entire appreciation

\textsuperscript{175} Temp. Treas. Reg. § 1.1041-1T(a), A-4 (1984). In its present form, the regulation casts some doubt whether the transfer of accounts receivable related to services by the transferor is “property” under I.R.C. § 1041(a). In view of the legislative history and the I.R.C. § 71 non-alimony election, property should include accounts receivable. \textit{Cf.} I.R.C. § 721 (accounts receivable are property for purposes of partnership contributions).


\textsuperscript{177} I.R.C. § 71(b)(1) (alimony must be paid in cash).

\textsuperscript{178} See, \textit{e.g.}, Pappenheimer v. Allen, 164 F.2d 428 (5th Cir. 1949) (rental value of residence not alimony).

\textsuperscript{179} I.R.C. § 1041(b).

\textsuperscript{180} See Sievert v. Commissioner, 72 T.C. 326 (1979).

\textsuperscript{181} See Gerlach v. Commissioner, 55 T.C. 156 (1970); \textit{see also} \textit{Davis}, 370 U.S. at 74.

\textsuperscript{182} I.R.C. § 1041(b)(2).
upon his disposition of the assets. The result then is similar to the *Davis* case.\textsuperscript{183}

The second possible tax result is that Abie, as maker of the note, has a basis of zero.\textsuperscript{184} This view, consistent with case law determining the basis of corporations and partnerships in their own paper, leads to a zero basis for Becky.\textsuperscript{185} Becky loses the value of her basis which traveled to Abie as the recipient of property under section 1041. Initially, it appears that Becky is taxed on the value of the property transferred, not merely her gain, and Abie is taxed on the entire appreciation of the property.\textsuperscript{186}

The third possible analysis, analogous to the result in a nonrecognition transfer of property between a stockholder and his or her corporation,\textsuperscript{187} sets Abie’s basis in the note equal to the basis of the property received. With this view, Becky’s basis boomerangs back to her. Here too, both Abie and Becky are taxed on the appreciation of the property, even though there is only one asset. The *Davis* Court solved the practical problem that flows from considering marital rights as property by determining that the basis of marital rights was equal to their fair market value at the date of disposition.\textsuperscript{188} Though theoretically there may have been a taxable transfer, the gain realized was zero.\textsuperscript{189}

The issue of Becky’s low basis may be obviated if the amount realized by collecting the face amount of the note is also a nontaxable transfer under section 1041.\textsuperscript{190} Whether there is a “transfer” is not apparent. There is no clear authority that Becky’s collection of Abie’s note is a “transfer” and therefore regulated by section 1041. On the contrary, the collection of a note under prior law did not constitute a sale or exchange for purposes of determining capital gain treatment.


\textsuperscript{184} *Davis*, 370 U.S. at 65.


\textsuperscript{186} See Bingham v. Commissioner, 105 F.2d 971, 972 (2d Cir. 1939); cf. Fairbanks v. United States, 306 U.S. 436 (1939) (redemption of bonds before maturity prior to enactment of I.R.C. § 1232).

\textsuperscript{187} Cf. I.R.C. § 362(a) (property acquired by corporation has basis equal to that of transferor, increased by amount of gain recognized to transferor on such transfer).

\textsuperscript{188} See Rev. Rul. 67-221, 1967-2 C.B. 63; *Davis*, 370 U.S. at 72, 75 n.7. Cf. I.R.C. § 1031 (carryover basis). In the case of the transfer of property to a corporation in exchange for corporate securities the transferor-stockholder takes a carryover basis in the property equal to the former basis in the property transferred, while the corporation takes a substituted basis in the property equal to its transferor’s former basis. I.R.C. § 362. Hence, if Becky transferred Blackacre with a basis of $10 to Abie Inc. in exchange for stock of Abie Inc. in a nonrecognition transaction, Becky’s basis in her Abie Inc. stock would be $10. Abie Inc.’s basis in Blackacre would be $10. Although a corporation has a zero basis in its own stock, the substituted basis rule avoids the zero basis problem. Cf. I.R.C. § 1032(a) (corporation recognizes no gain on exchange of its stock for property).

\textsuperscript{189} Rev. Rul. 67-221, 1967-2 C.B. 63 (Mrs. Davis’ tax result).

\textsuperscript{190} Query, if Becky holds the note to maturity, was there a transfer of property (the note) back to her former spouse (Abie) which is incident to divorce and hence protected by I.R.C. § 1041? Becky’s tax problems compound if Becky discounts the note to a third party. Here, the entire proceeds would recognized as gain to Becky. See Fairbanks v. United States, 306 U.S. 436 (1939); Galvin Hudson, 20 T.C. 734 (1953), aff'd sub nom., Ogilvie v. Commissioner, 216 F.2d 748 (6th Cir. 1954) (settlement of judgement debt not sale or exchange).
B. **Imputed Interest in Deferred Payments of Property Settlements**

Abie and Becky agree to a large property settlement. Becky exchanges her marital rights for $1,000,000 to be paid in five equal installments. The agreement states flatly the payments are not to be treated as alimony. From the details of the agreement, it is clear that Becky expects the payments to be tax-free to her. There are no cases deciding the issue of whether section 7872, which provides for imputed interest on interest free or below market interest loans, ought to apply to divorce agreements. Arguably, a portion of the installment payments made pursuant to a separation agreement constitutes imputed interest. However, the courts and the Service hold that sections 71 and 215 apply exclusively to divorce and take precedence over the imputed interest rules. Applying the Davis principle, the Tax Court and the Third Circuit held section 483 is not applicable to payments made pursuant to a property settlement agreement because the inclusion or deduction of such payments is exclusively determined by the sections of the Code concerning alimony. Hence, if a payment is not deductible as alimony, it is not deductible as interest. Although the Tax Court case related to the transfer of marital rights under section 483 of the Code, the Court did not distinguish payments according to whether they related to a support obligation, the satisfaction of marital rights, or the purchase of vested ownership rights. The Service followed the Tax Court holding that any deduction permitted in a divorce related transfer is governed exclusively by sections 71 and 215 of the Code.

Any other payment, including an imputed interest payment, ought to be treated as a gift under section 1041. Imputing interest in the case of certain transfers of vested property rights as opposed to equitable apportionment of other marital rights would make the application of sections 71 and 1041 uncertain as to taxation of divorce transfers. Even if one argues that interest is imputed under section 1041, the interest itself would be a gift.

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191 A transfer of property to a third party, even if incident to divorce, is not covered by I.R.C. § 1041; Temp. Treas. Reg. § 1.1041-1T(c), A-9 (1984) (third party transfer).


194 See Fox v. United States, 510 F.2d 1330 (3d Cir. 1975).

195 Id. Under the 1986 Act, non-business interest generally is not deductible. See H.R. 3838 Tit. V, Sec. 511.

196 See Gammill v. Commissioner, 73 T.C. 921 (1980) (marital rights not property under I.R.C. § 483), aff'd, 710 F.2d 607 (10th Cir. 1983) (property settlement is “property” under state law). See also Davis, 370 U.S. at 72 (marital rights treated as property equal to value to property received). But see Gerlach v. United States, 74-1 U.S.T.C. (CCH) 9425 (Ct. Cl. 1973) (distinguished vested rights such as joint ownership from marital property claim).

197 Rev. Rul 76-146, 1976-1 C.B. 144.

VII. A Proposal for New Legislation

In contrast to the 1984 and 1986 tax legislation, fairness would dictate that the tax liability follow the division of wealth. Thus, assuming a fifty-fifty split of assets between former spouses, the tax statute should also provide a fifty-fifty split of the amount of gain subject to taxation. The concept of tax neutrality underlies this legislative model. An amendment to the Code would greatly simplify the process of divorce taxation. The solution to many of the complications engendered by section 1041 is to require that the tax liability follow the division of marital property in a marriage or a divorce. Thus, the tax history, character, or other incidental attributes of property divided between spouses will have no individual tax significance. Property can be divided without regard to the tax burden. At the same time this would eliminate the tax planning opportunities described above, which, from a societal standpoint, are clearly undesirable.\(^{199}\) In addition, the current effect of the tax system on the uninformed taxpayer will diminish. For example, if a couple were to divide assets of equal value with bases of 10 and 36, each asset would take on a new mixed basis of 23. If property worth $100 were divided 60:40, the spouse receiving 60 percent of the property would recognize sixty percent of the gain. Assuming that the provisions permitting non-taxable cash payments between spouses continue, the real cost to the spouses can be divided as they wish. The difference under this proposal is that the Treasury does not underwrite the cost of a property settlement.

VIII. Conclusion

By focusing on tax relief for the transferor, Congress did not eliminate the root cause of the unfair apportionment of the amount of gain subject to taxation on property transferred in a property settlement. Congress changed the recognition principle which controls to whom the gain or loss will be taxed. Thus, the tax burden is shifted from the transferor to the recipient of property. The fairness of the tax consequences, however, depends upon whether the subsequent disposition of the property will produce gain or loss. The gain or loss is determined by the relative bases of the property which is to be divided by the couple. This in turn determines how the gain and the tax burden will be divided. The latter determination was not at issue in the Davis case. To simply reverse Davis by statute does not resolve the problem.

In order to apportion tax liability in proportion to the spouse's share of assets, one must determine the taxation of property settlement and alimony by a single standard. The shifting of tax liability to defeat the apportionment system must be prevented by limiting the recognition of gains and losses to the proportion of property received in the settlement. Additionally, the tax accounting rules should be modified to provide in-

\(^{199}\) This proposal would also address the extreme case where a person owning appreciated property seeks to avoid gain recognition by marrying and divorcing the prospective buyer. The transfer may, however, in any event, be vulnerable to attack as a sham transaction. See Boyter v. Commissioner, 668 F.2d 1382 (4th Cir. 1981). Cf. Shonfeld v. Shonfeld, 260 N.Y. 477, 184 N.E. 60 (1933).
stallment recognition of large gain or loss bunched in one taxable year. Such a system of tax apportionment is neutral because neither party is favored and because the property division will not produce unusual gain or loss for the divorced taxpayer.

By enacting section 1041, Congress simply moved the time when gain would be recognized from the date of the transfer of the property on divorce to the date of a later resale by the recipient spouse. On paper, the problem appears solved. But section 1041 is merely the reverse of Davis and does not address the essential problem of unfairness—that one party to a divorce may bear the tax burden and the other may not. The final tax result, determined not by section 1041 but by a number of variables comprising the prior tax history of the property, eludes the mechanical reckoning promised by a tax simplification act.