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COMMENTARY

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INTRODUCTION

Prior to 1962, the federal courts reached conflicting conclusions on the issue whether a transfer of appreciated property from one divorcing spouse to the other, in partial or full release of marital rights, constituted a "taxable event" for the transferor.[1]

In 1962, the United States Supreme Court resolved this conflict in *United States v. Davis*[2] by holding that a transfer of appreciated property by one spouse to the other in connection with a marital settlement does indeed constitute a "taxable event." Consequently, capital gains taxes will be assessed upon the excess of the fair market value of the property transferred to the spouse over the original tax basis of the property in the transferor spouse's hands. The Court also held that the recipient spouse acquires the transferred property with a stepped-up tax basis equal to its fair market value at the time of transfer. A later Revenue Ruling amplified the *Davis* rule by determining that receipt by the transferee of the appreciated property will not be considered a receipt of "income" within the meaning of the Internal Revenue Code.[3] Instead, the transaction will be treated as a "purchase" of the property by the recipient spouse.

In the *Davis* opinion, the Court conceded that a different result would flow from a "division" of joint or community property, as distinguished from the "purchase" and "sale" situation found in the *Davis* case.[4] A "division" of property would most often occur in community property states where, under local state law, all property acquired during marriage is considered to be owned by both spouses equally, regardless of which of the parties to the marriage

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1. *See* Commissioner v. Halliwell, 131 F.2d 642 (2d Cir. 1942), *cert. denied*, 319 U.S. 741 (1943); Commissioner v. Mesta, 123 F.2d 986 (3d Cir. 1941), *cert. denied*, 316 U.S. 695 (1942).
2. 370 U.S. 65 (1962).
3. Rev. Rul. 67-221, 1967-2 C.B. 63.
4. 370 U.S. 65, 71 (1962).

actually earned the money utilized for purchase of the particular asset involved. In common law jurisdictions, a "division" of property would result only when property previously held in joint tenancy or tenancy by the entirety was equally allocated.

The net result of *Davis* then, is that the doctrine of "taxable event" does not apply where there is an equal division of community property in a community property jurisdiction. Likewise, in a common law jurisdiction, there is no "taxable event" in the limited situation where there is an equal division of property held in some form of joint tenancy between the divorcing spouses.

The Supreme Court recognized that its holding would cause considerable disparity of treatment between citizens of community and non-community property jurisdictions. Nevertheless, the Court stated that it was the sole province of Congress to rectify this problem through legislative action. Thus far, Congress has failed to act.

THE EFFECT OF *Davis* UPON MARITAL TRANSFERS IN COMMON LAW JURISDICTIONS

The different tax effects caused by the *Davis* holding stem from the substantive differences between the community and common law property systems regarding acquisition and "title" ownership of properties by married couples. Because of the minimal nature of the wife's rights in property "owned" by her husband in common law jurisdictions, the Court found that the wife owns no property, nor has any ownership interest in property registered solely in the husband's name. Furthermore, the character of the husband's obligation upon divorce consists primarily of a legal obligation to support the ex-wife out of his assets and income, thus resembling a debt which, when discharged by a transfer of property, could not be equated to a "division" of property as in community property jurisdictions. Hence, any transfer of husband's solely owned property in partial or complete discharge of his legal obligation to support his former wife and minor children of the marriage constitutes a "taxable event," and the husband must pay taxes on the recognized gain.

Having concluded that the transfer was a taxable event, the Court faced the additional problem of ascertaining the amount of gain realized by the husband. The *Davis* Court assumed, in the absence of evidence to the contrary, that the parties were dealing at arm's length and thereupon found the wife's released marital rights to be equal in value to the fair market value of property transferred by the husband. Recognizing the infirmities in this assumption, the Court nevertheless concluded that since "the transfer was a taxable event, it is more consistent with the general purpose and scheme of the taxing statutes to make a rough approximation of the gain realized thereby than to ignore altogether its tax consequences."[5]

Even though the transfer constitutes a taxable event for the husband, the Internal Revenue Service (IRS) does not treat the release of the wife's marital rights as a taxable event to her,[6] and has given no reason for treating the wife more favorably than the husband. In *Gould v. Gould*[7] the Court held, without formulating a convincing rationale, that the wife does not realize income when she receives money from her husband in satisfaction of the husband's obligation for support. This result applies unless the transfers or payments fall within Internal Revenue Code (IRC) Section 71, setting forth the concept of "periodic payments."[8]

The Marital Home as a Family Asset

The difficulties caused by *Davis* can best be understood by considering the common problem in divorce settlements: how to divide the marital house.

At present, almost two out of every three American families own their own homes,[9] a far higher proportion than in any other industrial nation. This is due in large part to various governmental policies that encourage and aid home ownership.[10] Thus, in most marriages, the most common joint asset is the marital home.

When a divorce occurs, the usual problem of who should get the house is exacerbated by the tax consequences stemming from application of the *Davis* rule. Especially today, due to the impact of inflation, a sale of the home and division of proceeds will produce substantial capital gains tax liability for both parties. While a deferral of tax on capital gains is possible by purchase of replacement residential property,[11] the usual experience is that the marital home is sold because its maintenance and upkeep is not economically feasible when the income of the family is necessarily divided upon divorce. Consequently, it is quite rare that either party has sufficient funds remaining after such division to purchase a replacement residence, thereby deferring capital gains taxes.

Because of inflation and other economic considerations, many

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5. *Id.* at 72-73.
6. Rev. Rul. 67-221, 1967-2 C.B. 63.
7. 245 U.S. 151 (1917).
8. *Id.*
9. TIME, September 12, 1977, at 50.
10. Section 163 of the Internal Revenue Code allows the deduction of interest paid or accrued during a taxable year on a mortgage of real estate. I.R.C. § 163. Also, § 164 provides that state and local real property taxes may be deducted. I.R.C. § 164(a)(1).
11. I.R.C. § 1034.

families find themselves "locked" into a marital home when it simply does not make good financial sense to sell the home upon a divorce. For example, a husband and wife with two infant children jointly purchase a marital home in 1967 at $35,000, negotiating a first mortgage loan of $25,000, at 6%, payable in monthly installments of $179.11 over 20 years. At the time of divorce in 1977, the home is valued at $80,000, and the mortgage balance is $16,132, thus projecting an equity of $63,868 which, if equally divided, would result in payment of $31,934 to each of them.

However, such a division might not be economically feasible. Mother and the children are living in a home with operating costs, considering deduction for approximately $1,000 per year in real estate taxes and another $850 for mortgage interest, approximating $290 per month. Even three bedroom rental apartments adequate to provide a reduced standard of living for mother and the children in the local area rent from a low of $325 per month to $400 per month, so nothing would be gained from a sale of the home.

In a typical divorce settlement, the husband releases his interest in the marital home to his wife, enabling her and the children to remain relatively undisturbed in the family home, thus muting the personal, emotional, and economic impact of the divorce upon the children.

However, under *Davis*, even this practice results in onerous tax consequences. The husband's generosity, as exemplified by the foregoing, has not only cost him his clear equity in the home, which often is not offset by a release of property of a comparable value to him, but he has "realized" a capital gain tax liability of $5,625 as well. This figure is arrived at by taking the fair market value of the home at the time of divorce ($80,000) less the tax basis ($35,000). The difference of $45,000 represents long term capital gain. Under *Davis*, the husband's release of one-half this amount constitutes a "sale" and a realization of $22,500 long term capital gain. When the twenty-five percent alternative capital gains tax rate is used, $5,625 in tax is payable. Thus either procedure creates substantial tax liability at a time when property settlements should be guided by other more important considerations.

THE SPECIAL EQUITIES DOCTRINE IN COMMON LAW JURISDICTIONS

The common law rule of separate properties for spouses is modified to allow for "special equity" claims in marital actions.[12] These

12. *See, e.g.*, Anderson v. Anderson, 380 Ill. 435, 44 N.E.2d 54 (1942); Pohren v. Pohren, 40 Ill. App. 3d 1083, 353 N.E.2d 6 (1976).

claims enable the non-title holding spouse to obtain a portion of the marital property upon divorce by proving equitable ownership. This general concept takes statutory form in many states.

In Illinois, for example, under section 18 of the Illinois Divorce Act,[13] the court is empowered to compel conveyance of property equitably belonging to one spouse, from the titleholding spouse, upon such terms as may be equitable.[14] If equitable merit is demonstrated, two avenues are open to the court. It may either order a conveyance of legal title, or it may restore the spouse's property interest by impressing a lien on the property in the amount of the equitable ownership. Fault of the requesting spouse for the demise of the marriage is irrelevant under section 18, and cannot foreclose his or her special equity claim, nor dilute its merit before the court.

The Uniform Marriage and Divorce Act[15] also adopts the philosophy behind the special equity doctrine by granting the housewife a share of the assets accumulated during the marriage, rather than limiting her to a mere stipend in the form of alimony.[16] Section 307 of the Act allows the court to equitably distribute the property acquired during marriage without reference to rigid common law principles of property title registration. Instead, equitable considerations govern, such as:

> the length of the marriage, any prior marriage of a party, the age, health, station, occupation, amount and sources of income, vocational skills, employability, estate, liabilities and needs of each of the parties, whether the property award is in lieu of or in addition to maintenance, and the opportunity of each for future acquisition of capital assets and income; the court shall also consider the contribution or dissipation of each in the acquisition, preservation, depreciation or appreciation in value of the respective estates, as well as the contribution of a spouse as a homemaker. It shall be presumed that each spouse made a substantial contribution to the acquisition of income and property while they were living together as husband and wife.[17]

However, the salutary effects of these statutes are greatly dimin-

13. ILL. REV. STAT. ch. 40, § 18 (1976) (repealed 1977).

14. *Id.* The effect which the new Illinois Marriage and Dissolution of Marriage Act will have on this remains to be seen. ILL. ANN. STAT. ch. 40, §§ 101 *et seq.* (1977) (Smith-Hurd). The new act states that the court may "divide the marital property . . . in just proportions considering all relevant factors." *Id.* § 503. One of these factors is the contribution of a spouse as a homemaker, or a contribution to the family unit generally. *Id.*

15. 9 U.L.A. § 101 *et seq.*

16. *Id.* § 307.

17. *Id.*

ished by the holding in *Davis*. That doctrine makes it virtually impossible for married couples in common law jurisdictions to agreeably recognize the wife's contribution to the accumulation of family wealth, without incurring adverse federal tax consequences. The IRS has continuously insisted upon detailed proof of the wife's direct legal right and title to property transferred to her by the husband before the presumption of a "taxable event" can be overcome.[18]

Indeed, the degree of proof required can almost never be ascertained before the fact, since only the highest state court's determination of the rights and duties of the parties will be respected for tax purposes. All other decrees of lower state courts are given only "proper regard."[19] This fact, plus the IRS's long-held position that it will not be bound by findings and characterizations of local courts as to various transactions, but may make its own independent investigation and verification of the underlying facts,[20] leaves divorce litigants in common law jurisdictions in a terrible quandary. Even if the spouse with title to property is prepared and willing to recognize the other spouse's equitable right to a share of the property upon divorce, *Davis* prevents the parties from merely agreeing to a division. Instead, the parties must definitively document each acquisition of wealth, and obtain at least a lower court's determination of "special equities" in order to avoid the *Davis* doctrine of "taxable event."

This problem is a difficult one for divorce litigants. For example, in *Robert B. Dunn,* the taxpayer was divorced after thirty-four years of marriage and raising three children to maturity. Mr. Dunn agreed with his wife to divide equally all of the property acquired during their years together. This property included a promissory note for $275,000 issued by their son as part of the purchase price for a closely held company which had been developed during the marriage. An equal division of all assets was accordingly accomplished. However, the Commissioner of Internal Revenue correctly applied the *Davis* doctrine and held that dividing the $275,000 with the wife constituted a "taxable event" and assessed Mr. Dunn $82,557 in back taxes and penalties. The Tax Court fully agreed with the Com-

18. *See* John Wattran, 19 T.C. 865 (1953). For further examples of the length to which the IRS will go in determining the actuating facts of a given transaction, *see* Houston v. Comm'r., 442 F.2d 40 (7th Cir. 1971); Van Orman v. Comm'r., 418 F.2d 170 (7th Cir. 1969); Enid P. Mirsky, 56 T.C. 664 (1971); Grant R. Bishop, 55 T.C. 720 (1971); Ernest H. Mills, 54 T.C. 608 (1970); Lewis B. Jackson, Jr., 54 T.C. 125 (1970); Robert B. Dunn, T.C.M. (P-H) ¶ 77,156 (1977).

19. Commissioner v. Estate of Borsch, 387 U.S. 456 (1967).

20. Hoffman v. Comm'r., 455 F.2d 1661 (7th Cir. 1972).

missioner[21] that, under state law, Mr. Dunn was "*the owner*" of the promissory note, as he had been of the business sold to his son, and that the wife had no interest therein. Therefore his agreement to divide his assets with her still constituted a taxable event.[22] The wife's contribution to the marriage was bluntly described by the court as "inconsequential."[23]

One state court's response to this dilemma was to introduce a hybrid form of property rights in divorce matters. In *Imel v. United States*,[24] the Colorado Supreme Court, upon certification from the federal district court,[25] held that a wife acquired a "vested" interest in her husband's property upon the filing of a divorce action.[26] Thus, the husband's transfer of appreciated property to her was in recognition and satisfaction of this vested property right and therefore constituted a "division" of property. The Tenth Circuit affirmed the district court's holding that, based on this interpretation of state property law, no *Davis* taxable event had occurred.[27]

Obviously, the Colorado Supreme Court decision was designed to gain a tax advantage for citizens and residents of Colorado. The Colorado Supreme Court, in effect, created a new specie of joint property never before known or recognized at common law—an *inchoate* right in the wife to a portion of her husband's property upon divorce. This inchoate right "vests" upon the filing of a divorce action. Thereafter, it is made specific by virtue of a court's judgment, or, as in *Imel*, by virtue of a marital settlement agreement between the parties specifying what the wife's rights shall encompass by way of a setoff of property to her.

Reduced to simplest terms, *Imel* recognized that "special equities" are present in all divorce situations. Furthermore, the *Imel* rationale is a judicial acceptance of the philosophy behind the rule for property division urged by the Uniform Marriage and Divorce Act.

By reason of the *Imel* decision, residents of Colorado may accomplish an end desired by residents of all other common law, title-holding jurisdictions, *i.e.*, the ability to pass substantially appreciated, individually owned, non-joint tenancy property to a spouse without incurring a "taxable event" under the *Davis* rule. *Imel* has

21. Robert B. Dunn, T.C.M. (P-H) ¶ 77,156 (1977).
22. *Id.* at 671.
23. *Id.* at 670.
24. 523 F.2d 853 (10th Cir. 1975).
25. Imel v. United States, 375 F. Supp. 1102 (D. Colo. 1974).
26. Imel v. United States, 523 F.2d 853, 855 (10th Cir. 1975).
27. *Id.* at 857.

achieved a *de facto* reversal of *Davis* in Colorado. As a result, the wife receives transferred property with a pass through of her husband's adjusted tax basis. A capital gains tax on the appreciation beyond the husband's basis is assessed only when she disposes of the property.

The foregoing tax result is highly desirable and should be available to citizens of all common law states. Criticisms of *Imel* arise solely because Colorado has been able to earmark a great tax advantage not shared with similarly situated citizens of other states.[28]

However, it cannot be maintained seriously that such new concepts of marital property, or the extension to local courts of the right to make equitable divisions of property upon divorce, elevates these transfers to the status of a "division" for federal tax purposes.[29] Nor is it realistic to assume that forty[30] or more common law states will revise their property systems to become community property states. Thus, in the immediate future, the prospect remains that great amounts of legal, legislative and judicial energy will be expended to achieve interpretations that distributions made under local law are, in fact, "divisions" instead of "sales" for federal tax purposes. The *Imel* case can reasonably be viewed as the tip of a veritable iceberg of discontent flowing from *Davis* problems.

THE EFFECT OF *Davis* ON COMMUNITY PROPERTY JURISDICTIONS

The tax consequences of property transfers pursuant to a divorce in community property jurisdictions vary according to the nature of the particular transaction. There are basically three kinds of property transfers upon divorce in community property jurisdictions.

Equal Division of Specific Assets

The clearest example of a property division, although the least common, is that in which the former spouses become tenants-in-common of all the former community property, or in which each

28. *See* Gallagher, *A New Look at the Income Tax Consequences of Property Divisions Incident to a Divorce*, 1 REV. OF TAX. OF INDIVIDUALS 9-26 (1972).

29. Pulliam v. Comm'r., 329 F.2d 97 (10th Cir. 1964); Robert E. Imel, 61 T.C. 318 (1973). Both of these cases were overruled by Imel v. United States, 523 F.2d 853 (10th Cir. 1975). *But see* Robert B. Dunn, T.C.M. (P-H) ¶ 77,156 (1977); Wiles v. Comm'r., 499 F.2d 255 (10th Cir. 1974) (Kansas divorce wherein an equal division of "marital property" was held to be a "taxable event," thus involving $110,000 in capital gains taxes).

30. There are presently 8 states which can be clearly characterized as community property states: Arizona, California, Idaho, Louisiana, Nevada, New Mexico, Texas and Washington. The status of Oklahoma, and states having a similar quasi-community property approach upon divorce, in view of the *Collins* cases, is in substantial doubt. *See* Schwartz, *Divorce and Taxes: New Aspects of the Davis Denouement*, 15 U.C.L.A. L. REV. 176 (1967).

spouse receives one-half of each specific asset. Such an arrangement is obviously a "division" among co-owners and is therefore not a taxable event.[31] After such a transfer, neither the husband nor the wife will recognize any income or gain, and each will carry over their pre-existing tax basis in one-half of the property thereafter owned by each of them separately. The same result would apply in a common law jurisdiction only if properties were jointly owned by the parties, both parties contributed to the acquisition of the joint accumulation, and the assets were equally divided[32]

Equal Divisions in Value

In situations where each spouse has received one-half of the value of the community property, with each piece of the community property allocated solely to one spouse or the other, the Tax Court has ruled several times that such an equal distribution, even though not made in kind, is not a taxable event.[33] In reaching this conclusion, the Tax Court has found that no gain or loss should result from the cross transfers of a mixed aggregate of assets. Implicit in this finding is that each spouse has a half interest in the total "fund" of the community rather than a half interest in each specific item of community property. Revenue Ruling 76-83[34] laid to rest many lingering doubts about the ultimate tax result flowing from numerous cross transfers and releases of community property interests between spouses. Essentially, that ruling holds that if there is a bottom line equality in value of the assets assigned to each of the parties, then no taxable event occurs from the multiple transfers. Each party takes as his/her tax basis the original community basis in the property assigned. If for any reason there is an unequal division of a given asset in order to equalize the total distribution, then each party takes a proportionate share of the community basis in the particular asset equal to the percentage of the entire asset received.[35]

Unequal Division of Assets

If one spouse receives more than one-half of the total value of the assets, courts have held that to be a sale of the community property

31. *See* Frances R. Walz, 32 B.T.A. 718 (1935).
32. Rev. Rul. 74-347, 1974-2 C.B. 26-27.
33. Frances R. Walz, 32 B.T.A. 718 (1935); Osceola Heard Davenport, 12 T.C.M (CCH) 856 (1953); Clifford H. Wren, 24 T.C.M. (CCH) 290 (1965).
34. Rev. Rul. 76-83, 1976-1 C.B. 213-14.
35. *Id.*

constituting a taxable event.[36] The courts have reasoned that an unequal division is essentially an equal division followed by a sale of some of the community property by one spouse.

Nevertheless, a finding of a taxable event in an unequal division of community property may be questionable in some situations. If the community property cannot be divided equally because compelling circumstances prevent such a division, then the same reasoning that allows an equal division in value also should apply to render the unequal division non-taxable. The California divorce statute allows the court to award a greater portion of the community property to the innocent spouse.[37] Under the prevailing general rule for unequal divisions, the divorcing taxpayers would always be forced to create a "taxable event."[38]

THE INEQUALITY OF THE CURRENT SYSTEM CONTRAVENES CONSTITUTIONAL AND PUBLIC POLICY

Since the time of the *Davis* case in 1962, divorce laws in the United States have been substantially modified to the point that forty-seven of the states have adopted some form of "no fault" divorce.[39] The number of citizens experiencing divorce is now one out of every three citizens over the age of eighteen.[40]

Every divorce involves an undeniable economic impact on the household. Added to the expenses of the divorce itself and the costs of maintaining separate households is the *Davis* tax burden imposed on property transfers. Furthermore, the development of the special equities doctrine, the adoption by a large number of states of the Uniform Marriage and Divorce Act, and the various characterizations of property allocations in community property jurisdictions tend to produce disparate tax results not only among jurisdictions, but among taxpayers as well. This uncertainty makes effective economic planning in divorce settlements extremely difficult.

All the foregoing factors compel the amendment of the tax laws to avoid *Davis* consequences. There are two major bases to justify change: (1) the unequal tax burden between taxpayers in common law and community property states violates the spirit of the Constitution, public policy, and the general congressional intent underly-

36. Rouse v. Comm'r., 159 F.2d 706 (5th Cir. 1947); Jean C. Carrieres, 64 T.C. 959 (1975); Gordon R. Edwards, 13 T.C.M. (CCH) 381 (1954).

37. CAL. CIV. CODE, § 146 (West).

38. *Id.*

39. Foster & Freed, *Family Law in the Fifty States: An Overview*, 3 FAM. L. REV. 4047 (1977).

40. The Encyclopedia Americana, Vol. IX, pp. 206-08.

ing the Internal Revenue Code; and (2) the unjustifiably harsh tax treatment contravenes the public policy for flexible and economically adequate divorce settlements.

Constitutional Infirmities of Davis

The Constitution of the United States establishes in Article I, Section 8, both the power to tax and restrictions on that power.

> (1) The Congress shall have the power To lay and collect Taxes, Duties, Imposts and Excises, to pay the Debts and provide for the common Defence and general Welfare of the United States; but all Duties, Imposts and Excises shall be uniform throughout the United States.[41]

Judicial interpretations of the uniformity requirement have limited it to territorial and geographic uniformity, not intrinsic uniformity.[42] This only requires that a tax operate with the same force and effect in every place where the subject of taxation is found.[43] Mere variations in application of a taxing statute are not considered to render them constitutionally invalid for lack of geographic uniformity.[44]

Notwithstanding the absence of a specific constitutional requirement for equality of tax burden, courts have held that equality is a basic principle of taxation.[45] In addition, the taxing power should always be exercised to produce, as nearly as possible, equal and uniform tax burdens.[46] The basic reasoning for this is obvious. Because the federal system is heavily dependent upon self-assessment, no individual or business should enjoy an advantage or tax preference not shared equally by others merely because of the accident of geography. Yet this is precisely the situation created by *Davis* for transfers of property in divorce settlements.

In keeping with this philosophy of taxation, a principal legislative purpose of most major revisions of the Internal Revenue Code has been to achieve a greater degree of equality and uniformity of treatment among taxpayers, wherever situated.[47] This legislative purpose is evident in the establishment of the joint return income tax rate

41. U.S. CONST., art. I, § 8, cl. 1.

42. Fernandez v. Wiener, 326 U.S. 340 (1945); Poe v. Seaborn, 282 U.S. 101 (1930).

43. Fernandez v. Wiener, 326 U.S. 340 (1945).

44. Fernandez v. Wiener, 326 U.S. 340 (1945); Philips v. Comm'r., 283 U.S. 589 (1931); Poe v. Seaborn, 282 U.S. 101 (1930); Gottlieb v. White, 69 F.2d 792 (1st Cir.), *cert. denied*, 292 U.S. 657 (1934).

45. Johnson v. Smith, 297 N.Y. 165, 77 N.E.2d 386, *cert. denied*, 335 U.S. 824 (1948).

46. Minnesota v. Federal Reserve Bank of Minneapolis, 25 F. Supp. 14 (D. Minn. 1938).

47. COMM. ON WAYS AND MEANS, INTERNAL REVENUE CODE OF 1954, H.R. REP. NO. 1337, 83d Cong., 2d Sess., *reprinted in* [1954] U.S. CODE CONG. & AD. NEWS 4025.

schedule for married taxpayers, and in the marital deduction for federal estate taxes. Both additions to the tax laws were adopted in order to equalize the tax treatment accorded taxpayers in community property states with those in common law states.[48] The same action should be taken for transfers of property upon divorce.

The economic realities surrounding the accumulation of wealth during marriage do not vary among communities. Yet, the accident of geography causes significant differences in tax consequences upon divorce. This inequality of tax burden violates the general principles of taxation outlined by the Constitution and congressional intent underlying the Internal Revenue Code.

Davis Contravenes Public Policy

It is well known that divorce, with attendant personal and economic hardship, has become increasingly common. Although there is little which can be done to ease the personal distress of the litigants, the economic hardship, already exacerbated by the high rate of inflation and cost of living, can be lessened.

Families forced to the remedy of divorce must set up two households on an economic capacity that often was stretched to support only one household. Obviously, imposition of a substantial burden of taxation, in addition to other personal, emotional and economic problems which inevitably accompany a divorce, is social engineering of the worst kind. Furthermore, the economic consequences of taxation in these matters often leave both parties, and the children of the dissolved marriages, in extremely tenuous economic circumstances.

Moreover, neither taxpayers in common law nor community property jurisdictions can be certain in advance of the precise tax treatment which will be accorded to their negotiated, or court-ordered, distribution of assets. In common law states this result is primarily due to the uncertain application of the special equities doctrine. In community property states the uncertainty is caused by the potential disallowance of the fund approach to a "division" of property, or the application of the cash-out doctrine.[50]

Another factor which often contributes to the economic harshness is the extremely difficult problem of valuation in property settlements. A common situation involves the husband's transfer to his

48. COMM. ON FINANCE, REVENUE ACT OF 1948, S. REP. NO. 1013, 80th Cong., 2d Sess., *reprinted in* [1948] U.S. CODE CONG. & AD. NEWS 1163, 1214-21.

49. *See* text accompanying notes 12-17 *supra*.

50. *See* text accompanying notes 30-38 *supra*.

wife of an interest in a closely held corporation. Ordinarily, the value of such interests can be determined by assuming the transaction is arm's length and the consideration given for such interest is equal to its value. In transfers pursuant to divorce, however, the consideration received is not cash or other measurable property, but the wife's release of inchoate marital rights. Under the *Davis* approach, these are measured by equating them to the value of the property given up by the husband. Hence, the valuation inquiry is circular. In this situation, the determination of the husband's gain and the wife's basis is extremely difficult, and the valuation conclusion may constitute unnecessarily and unjustifiably harsh treatment.

Another related issue which creates undue hardship generally arises with certain types of jointly held or community property; for example, a closely-held business where one spouse has the expertise at managing the firm and the other is a passive owner. It must be recognized that a "division" of this kind of property in the event of divorce is not always a rational or reasonable alternative available to the parties. In this case, the active manager logically should buy out the passive owner. The special nature of marital property or other circumstances which may make "division" thereof difficult include: (1) the marital home, which the parties agree should continue to be owned and occupied by the wife and children; (2) life insurance policies on the husband's life; (3) the value of accumulated, non-distributable pension and profit sharing rights; (4) various collections, *e.g.*, art work, coins or antiques; (5) the value of the husband's income producing potential; (6) where assets are of a character such that there is an extremely limited market and a sale cannot be made without a serious economic loss; and (7) where one of the spouses, by reason of poor physical or mental health, or by reasons of lack of business judgment, is truly incapable of managing any substantial property interests.

Under many circumstances, parties to divorce actions correctly perceive that the husband should retain the bulk of the marital assets and, in effect, "buy out" the wife's interest by installment payments over a substantial period of time. Under present tax law these payments are not accorded "periodic payment treatment," and are neither taxable to the wife, nor deductible by the husband.[51] The tremendous volume of tax litigation concerning this rule compels the conclusion that, with the exception of sophisticated tax counsel, (who rarely sojourn into the domestic relations area) it is

51. Treas. Reg. § 1.71-1(c)(4)(1977).

poorly understood. Indeed, there are many cases in which the parties obviously believed that payment for property interests in installments over a period exceeding ten years qualified the payments as "periodic" for tax purposes.[52] Thus it frequently happens that a husband will be required to pay current support for the wife and children, which may qualify for "periodic payment" treatment, in addition to non-deductible payments for property released to him by his wife, a total which often comprises an enormous tax and economic burden.

The existence of these problems seriously limits economic planning between the soon-to-be divorced couple and necessarily requires the devotion of substantial legal talent to the adequate and proper handling thereof.

Because of the prevalence of divorce in our society and its inherent economic impact on numerous families, public policy should be directed toward expanding the capacity of divorcing parties to make extremely flexible agreements related to support of the wife and offspring of dissolved marriages. It is, after all, the ultimate end of all concerned in these matters to assure that accumulated wealth of the marriage be devoted primarily to the discharge of the prime function of marriage itself: the care, comfort and support of the children who comprise the future wealth and resource of the nation.

Recommendations for Change

In response to the observable disparity of tax treatment raised by the *Davis* case, as well as for many of the same reasons set forth herein, the American Bar Association Committee on Domestic Relations Tax Problems in 1966 recommended that several measures be enacted that would modify the impact of the *Davis* case to achieve a more equitable and uniform result among all taxpayers in both common law and community property jurisdictions.[53]

Generally, the ABA 1966 proposal provides for the nonrecognition of gain or loss upon transfer of property in satisfaction of marital or support rights.[54] It also provides for a carryover of the

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52. Alfred J. Miville, 29 T.C.M. (CCH) 856 (1970); Edith M. Gerlach, 55 T.C. 156 (1970); Ernest L. Veverka, 29 T.C.M. (CCH) 1496 (1970).

53. *See* text accompanying notes 47-50 *supra*.

54. The Committee's recommendations were summarized as follows:

Recommendation #1966-7

The transfer of appreciated property incident to divorce results, under present law, in recognition by the transferor of taxable gain, with the transferee obtaining a new basis for the property equal to its then value. The transfer of property with a current value lower than the transferor's basis produces a new lower basis to the transferee and results in a loss to the transferor that may or may not be deductible depending transferor's initial tax basis in the transferred property. Consistent with current tax law, it also prohibits the value of property transferred by one spouse to another in settlement of marital rights from being treated as "income" to the transferee. This proposal should be incorporated into the Internal Revenue Code in order to alleviate the unfair disparity in present tax treatment accorded transfers of property pursuant to divorce.

CONCLUSION

There are undoubtedly many who will deny that these proposed changes are necessary or desirable, contending that tax policy should not be dictated by the needs of that segment of our society which chooses divorce as a solution to their personal and family problems. Additionally, difficulty in comprehension or administration of tax laws, if used as a standard for acceptability, would nullify much, if not all, of the Internal Revenue Code.[55]

However, these criticisms fail to reach the pertinent issues: (1) the fact that an unequal tax treatment depends primarily on the accident of geography; and (2) the imposition of a substantial tax burden at a time of emotional and economic disruption within the family structure is contrary to current public policy.

Divorce necessarily results in social and personal problems of a great magnitude for those involved. The sense of our national purpose should be to help alleviate at least one of the most predictable consequences of divorce—inadequate financial resources required to support the divorced family group, a consequence which is currently exacerbated by the federal tax system.

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on the applicability of Sec. 267. Presumably, the same results apply to transfers incident to separation, and at least in theory might apply to transfers incident to marriage or a contract to marry. Different rules, however, apply to equal division of community and certain other jointly owned property where neither gains nor losses are recognized, and the basis carries over. Even as to such property, there is some doubt as to the operation of the carry-over basis rule. The effect of divisions that are at all unequal is uncertain, and the IRS has, on occasion, raised doubts concerning the applicability of the non-recognition rule to equal divisions other than those effected solely in kind. This disparity in treatment is arbitrary and a clear rule is needed.

It is recommended that the present nonrecognition rule applicable to community property be made universally applicable to transfers by reason of the marital relation or its severance. This would eliminate the disparity in treatment between community and noncommunity property. It would also establish a clear-cut rule for determining basis.

19 ABA Taxation Section 63-66 (1966).

55. *Id.*

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