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NOTES

CAPITAL GAINS TAXATION ON THE "TRANSFER" OF APPRECIATED PROPERTY FROM HUSBAND TO WIFE PURSUANT TO A DIVORCE SETTLEMENT

UNITED STATES v. DAVIS:¹ THE SITUATION AND HISTORY

Pursuant to a voluntary property settlement, later incorporated into a divorce decree, the taxpayer transferred to his former wife five hundred shares of stock whose market value was then $82,250 but whose cost basis was $74,775.37.² The settlement was in satisfaction of all her rights against the taxpayer, including, but not limited to, dower.

The United States Court of Claims ruled against the Commissioner of Internal Revenue's determination of a taxable gain on the transfer of the stock.³ Since the decision of the court of claims was in conflict with prior determinations by both the Second and Third Circuit Courts of Appeals although in accord with a Sixth Circuit ruling,⁴ the Supreme Court granted certiorari. The Court found the Davis transaction to be an exchange of property and thus a recognized taxable event not other-

2. The adjusted basis would be determined by INT. REV. CODE OF 1954, §§ 1011, 1012, 1016. Here the adjusted basis would probably be the cost to the taxpayer plus brokerage fees. Capital gain is the amount "realized" on the sale or other disposition of capital assets minus the adjusted basis. Id., § 1001(a). The amount "realized" is the sum of any money received plus the fair market value of any property other than money received on the sale or other disposition of the capital asset. Id., § 1001(b). In a sale or exchange the amount of gain "realized" will usually be "recognized" for tax purposes and a capital gain tax levied on it. Id., § 1002.
4. The court of claims found there may have been economic gain but there was no taxable gain, because capital gain on transferred property is determined by the fair market value of the property received for it. The former wife's dower and alimony rights released to the husband in the court approved settlement agreement could not be valued with any satisfactory degree of accuracy. The court refused to use any value placed on the property which the husband transferred because that was the property which ultimately needed evaluation. INT. REV. CODE OF 1954, § 1001(b). This followed the reasoning of Commissioner v. Marshman, 279 F.2d 27 (6th Cir. 1960). Originally the Board of Tax Appeals in Mesta v. Commissioner, 42 B.T.A. 933 (1940), ruled that a similar transaction did not incur a capital gains tax because the settlement was in the nature of a property division and not a taxable event, and because the wife's rights could not be adequately valued. In Commissioner v. Mesta, 123 F.2d 986 (3d Cir. 1941), the Board was overruled and a taxable event was found. The value of Mrs. Mesta's rights was found to be the value of the property Mr. Mesta transferred to her. Commissioner v. Halliwell, 131 F.2d 642 (2d Cir. 1942), followed Mesta. The inconsistent Marshman case was the next to arise some eighteen years later.
wise excepted from taxation.\(^5\)

The Court reasoned that the taxpayer's wife released or transferred her rights of succession and alimony to her husband when the divorce settlement was approved by the court and in exchange she received the lump sum payment of appreciated stock. For capital gain purposes the value of the transferred stock is the value of the rights received therefor,\(^6\) but here the value of the rights received by the taxpayer was determined by the fair market value of the transferred stock itself.\(^7\) Dower and alimony rights are difficult to value in the abstract, but here they were held to be worth what was paid for them in a transaction that was found to be at arms-length.\(^8\) Consequently, if the \textit{Davis} transaction is a transfer which should properly be taxed, this circuitous method of valuation does provide a practical solution.

Even though the \textit{Davis} decision was unanimous it is still subject to question in several respects. The taxpayer contended there was a division of property rather than a transfer; a position which the Court recognized as not completely illogical. A division would require stock ownership by the wife prior to divorce, and though the Court recognized that the transaction was no ordinary transfer, still they viewed the wife's rights as "a burden on the husband's property rather than [making] . . . the wife a part owner thereof."\(^9\) Even though the husband was the sole legal owner of the property transferred, the economic consequences of the transaction so resemble those of a property division that the transfer could easily have been treated as such. This discussion will also consider whether (1) \textit{Davis} type transactions should be taxed as divisions of property in order to be consistent with other income taxation provisions, and to provide equality with community property states; (2) the transaction should be one of a group where capital gain is "realized" but not "recognized," and (3) because of the effect of taxation on domestic relations law, the parties and divorce negotiations, the \textit{Davis} situation should be exempt from capital gain taxation. The possibility of a gift was refuted and will not be treated.

\textbf{Character of a Wife's Rights}

\textit{Dower.} By Delaware law a wife has succession rights to at least

\(^5\) INT. REV. CODE of 1954, § 1002.
\(^7\) Ibid.
\(^8\) The process of valuation has been contested and upheld, and has been extensively reviewed in the following: 61 COLUM. L. REV. 101 (1961); 74 HARV. L. REV. 1226 (1961); 7 HOW. L. J. 64 (1961); 55 NW. U. L. REV. 773 (1961); 109 U. PA. L. REV. 438 (1961).
one-third of her deceased husband's personalty and one-third of the realty of which he was seized during marriage.\textsuperscript{10} Since she must succeed him, it is a contingent right. Unlike ownership, she has no control over the property of her living husband except to the extent that she may refuse to release her dower rights in realty he seeks to convey.\textsuperscript{11} But the retention of dower rights in conveyed property and the variable value of a wife's claim are unlike ordinary claims against property. Whereas a tortfeasor will have a maximum limit placed upon the reparations he must pay, and the person he has injured cannot affect that amount, a wife, by hard work or frugality, can substantially increase the final value of her succession rights. Her rights arise from the marital relationship and depend on a trust deeper than that on which most creditors would rely, for a husband can dissipate his assets and defeat his wife's expectations. A wife may actually have earned much of the property to which her husband holds title and she usually contributes to their joint welfare in many intangible ways. On a husband's death the law protects his wife by the legal transfer it found unnecessary during marriage. Her economic position at her husband's death is protected by her succession rights, though it often is hardly different than had she owned a share of his property during marriage. Indeed her rights against the deceased husband's personalty are subordinated to the rights of creditors.\textsuperscript{12}

\textbf{Alimony.} On divorce for the husband's aggression, Delaware restores his wife's property, either in gross sum or annual allowance.\textsuperscript{13} Since alimony is commonly considered a commutation of the husband's duty to support his wife, a man effectively has the duty to support his wife from the date of marriage until he dies or in some cases until she remarries.\textsuperscript{14} Unlike most claims which are for fixed amounts, the value of a wife's support rights during marriage varies continuously with her husband's fortunes. At divorce, when a wife's rights will become periodic payments or a gross sum alimony payment, her claim is still unlike ordinary claims. This is because courts commonly use one-third to one-half of a husband's property as a starting point for a gross sum alimony payment, and a wife may contribute substantially to her ali-

\textsuperscript{11} \textit{Del. Code Ann. tit. 12, § 901 (1953)}.
\textsuperscript{12} \textit{Del. Code Ann. tit. 12, §§ 512 (1953), as amended by § 512 (Supp. 1962)}.
\textsuperscript{13} \textit{Del. Code Ann. tit. 13, § 1531 (1953)}.
\textsuperscript{14} \textit{Fuchs, Materials for Course in Domestic Relations}, 179 (1959); 17 \textit{Am. Jur., Divorce and Separation}, § 653 (1957). A wife's remarriage constitutes strong grounds for terminating alimony or reducing its amount. See Annot., 112 A.L.R. 246, 253 (1938).
mony award by her industry and frugality during marriage.\textsuperscript{15} The whole process of awarding alimony largely on a percentage basis adjusted by other factors resembles a division of property between partners.\textsuperscript{16} Indiana specifically treats the allocation of alimony as a property division even though during marriage a wife has no legal title to a share of his property.\textsuperscript{17} Moreover the divorce award of property to a wife in Indiana cannot exceed a husband's ownership, and its purpose is to place a wife in as good a position as though she had just survived her husband.\textsuperscript{18} The community property system protects wives by recognizing joint legal ownership.\textsuperscript{19} In a community property state the Court would very likely reach a result contrary to Davis, and it could conceivably consider the transaction a division in a common law state such as Indiana.

While the economic results of divorce are similar to those which would result if there were a division of jointly owned property, it is true that a wife lacks the legal right to control which is a necessary attribute of ownership. However, marriage is effectively a joint enterprise with few reservations. The duty to support and to pay alimony regards the parties as completely independent individuals which they are not. The legal theory of transfer, which is used to secure to a wife a reasonable share when her husband will no longer voluntarily provide it, is only a means within the framework of the common law of recognizing, at a time when her best interests can no longer be entrusted to her husband, the equality of husband and wife and their effective joint ownership.

\textbf{COMMUNITY OF INTEREST IN OTHER AREAS}

It is recognized in several other areas that the marital relationship creates a community of interest economically similar to a partnership or joint venture. For example, it is recognized by the weight of authority that an innocent party to an invalid marriage is entitled to an equitable division of the property accumulated by the joint efforts of the parties

\textsuperscript{15} Lyon v. Lyon, 21 Conn. 184 (1851); Hull v. Hull, 274 Wis. 140, 79 N.W.2d 653 (1956); Madden, Persons and Domestic Relations, § 97-98 (1931); 17 Am. Jur., Divorce and Separation, § 685 (1957).

\textsuperscript{16} Factors affecting the amount of alimony decreed include necessities of the wife, husband's financial ability and capacity to earn, parties' social standing, their health and age, wife's earning capacity and ability to find employment, and their conduct. 17 Am. Jur., Divorce and Separation, § 688 (1957). "Probably the most important element . . . is the financial condition of the parties." A wife in good financial condition may be denied any alimony but her assistance in accumulation of the property is also a factor. 17 Am. Jur., Divorce and Separation, § 689 (1957).

\textsuperscript{17} Shula v. Shula, 235 Ind. 210, 132 N.E.2d 612 (1955); Ind. Ann. Stat. § 3-1218 (Burns Supp. 1962). This is an equivalent of the wife receiving at least her statutory forced share so that the husband does not benefit by his wrong doing.

\textsuperscript{18} Ibid.

\textsuperscript{19} Madden, Persons and Domestic Relations, §§ 97-98 (1931).
to the "marriage." The family expense doctrine and the family purpose doctrine both recognize the family as an economic unit. Moreover, in some jurisdictions one spouse may not receive a bequest from a third person when the other spouse was a witness to the will and is necessary for its probate.

The economic effect of marriage is for a wife to acquire for the life of her husband the benefit of a portion of all property that he acquires. A wife's equitable interests against her husband at divorce are not legal interests, but for the most part they are protected by the discretion of the court. Until death, or sometimes remarriage, the same two people continue to live on the same property or income after divorce as before, but they are burdened with the additional expenses of maintaining separate homes.

**CAPITAL GAINS THEORY AND TAX TREATMENT AT DIVORCE**

Capital gains tax is a single payment substitution for the ordinary annual income tax that would be levied on the property's appreciation in value. Taxes on "recognized" capital gains are paid when "realized" by sale or exchange, which occurs "when the last step is taken by which he [the taxpayer] obtains the fruition of the economic gain which has already accrued to him," and means that additional gain or loss will no longer affect the person to be taxed. This is a proper time for taxation because the taxpayer usually has money or new assets, which could

20. See cases listed at Annot., 31 A.L.R.2d 1255 (1953). Each party has an interest in the property and restoring the status quo requires a division. The Indiana alimony theory is more analogous to an annulment partition than states permitting alimony as a substitute for future support. Nevertheless the woman's equity is recognized at an annulment proceeding. Sclamberg v. Sclamberg, 220 Ind. 209, 41 N.E.2d 801 (1942).

21. The husband and wife are jointly and severally liable for all expenditures incurred for, on account of, and to be used in the family, and this embraces much more than mere common law necessaries. O'Haran v. Leiner, 306 Ill. App. 230, 28 N.E.2d 315 (1940); Smedley v. Felt, 41 Iowa 588, 590 (1875). Rent for family dwelling, Harrison v. Hill, 37 Ill. App. 30 (1890), and clothing, Ross v. Johnson, 125 Ill. App. 65 (1906), are family expense items.

22. The owner of an automobile who makes it available for his family's pleasure and convenience is liable for injuries caused by their negligence while operating it on a family purpose. The doctrine is designed to protect the public generally from insolvent minors who cause injuries while operating their parents' automobiles. Richardson v. True, 259 S.W.2d 70, 71 (Ky. 1953); McNamara v. Prather, 277 Ky. 754, 127 S.W.2d 160, 161 (1939).


24. MERTENS, LAW OF FEDERAL INCOME TAXATION, § 22.01 (1958).


be sold to pay the tax, and he can no longer benefit or lose from the property whose appreciation and transfer resulted in the imposition of a tax.

The transfer by trustees of securities which had appreciated in value while held by the trustees in partial satisfaction of a legacy has been held to result in a taxable capital gain. Similarly a transfer of appreciated capital assets in satisfaction of a taxpayer's tort liability would probably result in a taxable capital gain. Neither of these transfers generate any money in the transferor; however the recipient is an independent person with a fixed monetary claim which would not fluctuate in value as would a wife's claim before it is fixed by the divorce decree. Income is taxed to the person who earns it and receives, or causes another to receive, the economic benefits of it. The economic effects of taxation are significant in determining ownership of the income for tax purposes. Regardless of what alimony theory is applied, if income taxation reduces a wife's reasonable share, she is taxed as the owner of that amount. Although her reasonable share is transformed into a liquidated sum by judicial decree, basically her right is still to a share or percentage of her husband's property. If part of his property must be used to pay tax, it is only equitable that her lump sum be reduced. But such a reduction effectively places a capital gain tax on her as though she were the owner of a portion of his property, but at a time when she becomes the sole owner of that portion and is still affected by its value fluctuations.

Indefinite periodic alimony payments or those extending beyond ten years either directly or from a trust, are the taxable income of the wife and are not includible in the husband's gross income. A lump sum settlement payment is neither income to the wife nor a deduction for the husband. Thus periodic payments of alimony are treated as the wife's income and not as a debt of the husband which would require him to pay the income tax. Surely there is a satisfaction of her rights for each period just as a lump sum payment may satisfy those rights once and for all. The alimony is her income as are dividends on stock she owns. A lump sum payment is merely a liquidation of periodic alimony or the present value of future periodic earnings. A lump sum payable in less

27. Kenan v. Commissioner, 114 F.2d 217 (2d Cir. 1940).
29. INT. REV. CODE OF 1954, § 71 (a)-(d); Treas. Reg. §§ 1.71-1(c) (1) (iii), 1.71-1(c) (2) (1961). INT. REV. CODE OF 1955, § 215(a) provides for a deduction from husband's gross income where he has included in his gross any amount which the wife includes under § 71.
32. See 40 COLUM. L. REV. 677 (1940).
than ten years is given the character of capital rather than income to the wife, even though the same type of right is relinquished by her in return for either periodic or permanent alimony. To be consistent with the Internal Revenue Code of 1954, section 71, the lump sum should also be considered as her income rather than as a debt paid to her.

If, as the Court held, the rights of succession and a reasonable share partake more of a liability to the husband than a property interest of the wife, it seems only reasonable to tax the payment to the wife as her income. In selling or exchanging her succession and alimony rights, her monetary return could result in either ordinary income or capital gains. The lump sum payment is not compensation for loss or wrong or the periodic alimony payments would not be taxable as income of the former wife, at least so far as they are not punitive.

If a wife's rights are capital assets, her taxable gain is the money and property received in exchange for them that is in excess of her adjusted basis. The basis of her alimony rights is probably zero since they came into existence at divorce without cost. Neither can dower rights arising at marriage be given a basis other than zero. Thus the full value of the stock received would be capital gain.

If the wife's alimony rights derive from herself or her individual efforts, the payment received in sale or exchange would surely constitute income to her just as though she sold some of her hair or a musical composition. Since a wife is not taxed on the receipt of a lump sum alimony payment, it is apparent that her rights of succession and alimony result from the nature of marriage just as inheritance arises from our concepts of private property and life itself. Thus a wife's rights are compounded with her husband's property rather than independent of it. It would be more equitable to refuse to recognize a capital gain in a Davis situation than on an inheritance.

The fact that transfers pursuant to a divorce settlement of marital or property rights are considered full and adequate consideration for purposes of the gift tax does not control the event of taxing income. It is only an easy method of settling a tangled area because full and adequate consideration precludes a taxable gift.

33. INT. REV. CODE OF 1954, § 71.
34. INT. REV. CODE OF 1954, §§ 71(a), 104(a); Treas. Regs. § 1.61-14(a) (1962).
36. INT. REV. CODE OF 1954, § 1012.
37. INT. REV. CODE OF 1954, § 1302.
38. INT. REV. CODE OF 1954, § 2516.
The economic effects of gain and of ordinary income taxation further indicate ownership of the stock prior to divorce by the wife for the purposes of taxation. An oversimplified example is that of a retired couple whose only assets are the husband's ownership of $250,000 worth of stock which has appreciated from a basis of $100,000. They live on a five per cent return of $12,500 and each enjoys the $7,500 income which appreciation has brought. If divorced and the stock was divided equally, the wife would have $75,000 worth of stock more than if appreciation had not occurred. Each would have a $6,250 income instead of only $2,500 and the total income tax from both would remain the same.\footnote{40} The two people are treated as though each had earned the decreed percentage of their fortune, as in reality they may have. The divorce constituted a reorganization of their assets from the husband's singular control to separate control, not their disposition, and both will probably continue to live on the same total specie of property as before. Should the stock become worthless tomorrow, each would share the same misfortune as though still married. Both are economically damaged by the partition even without the incidence of capital gains tax. Had they sold one-half of the stock, they would of course have realized gain because its subsequent gain or loss could no longer affect them.\footnote{41}

This example leads to the conclusion that the capital gains tax levied in \textit{Davis} is a penalty imposed upon the divorcees for it has the effect of taxing both parties to the transaction. The effect created is a taxation of a division when only a sale or exchange are supposed to be taxed. But the conclusion that both must then be the owners is inconsistent with any tax at all. The Court has chosen "exchange" as its premise without a sufficient regard for consequences which indicate a different policy. Although the Commissioner is anxious to receive his revenue at the earliest possible moment, he need not necessarily lose revenue if the property's original basis to the marriage is preserved through the divorce partition. In the example above, without other income or deductions the husband would normally pay about $18,000 capital gains tax.\footnote{42} Since the settlement will usually be a percentage (fifty percent in the example), it is only fair that each share be reduced by about $9,000 to $116,000. This admits a division, but in no other transaction involving capital gains is the

\footnotesize\begin{itemize}
\item \footnote{40}{Because a married couple can file a joint return they are taxed as though one-half of the total income was earned by each spouse. This equals taxation in common law states with community property states. \textsc{Int. Rev. Code of 1954}, §§ 2, 6013.}
\item \footnote{41}{\textit{Helvering v. Horst}, 311 U.S. 112 (1940).}
\item \footnote{42}{\textsc{Int. Rev. Code of 1954}, §§ 1, 1201(b), 1202.}
\end{itemize}
person receiving the property also taxed. If the husband must bear the tax alone without his share being larger and he then sells his share of the stock, he will be held to have realized $150,000 gain and the former wife none, although each received $75,000 more than if the property had not appreciated.

The Davis Situation in a Community Property State

In a community property state incidence of taxation follows ownership of income.43 A true division of property in a divorce settlement is not susceptible of capital gains treatment because the parties only receive what they already legally own.44 There is some dispute over what constitutes a division of property based on whether the parties own shares in the whole (unit theory) or a share of each species of property.45 The choice has far reaching consequences; however the latter is highly theoretical, unrealistic and not accepted by the Internal Revenue Code of

44. Because of their theory of equal ownership, community property states raise this point. See Frances R. Walz, 32 B.T.A. 718 (1935). In this case the Commissioner argued for a division to prevent a capital loss being claimed. The transaction was personal and not for profit because a division, so no capital loss could be claimed. See INT. REV. CODE OF 1954, § 165 for losses confined to transactions for profit. It has been argued that since the husband had exited from ownership and could no longer realize gain or loss on the property after the partition that it must have been a transaction for profit and capital loss should therefore have been denied. Halpern, Income Tax Effect of Community Property Divisions Incident to Divorce, 23 CAL. ST. BAR J. 128, 135 (1948). Would this criteria include a gift? It would be better to look to the manner of disposal in view of the kind of transactions commonly entered for profit or to the transferor's actual profit motive. The court in Walz did this and found no profit seeking transaction in the division. The concept of transaction for profit is basic to capital gains treatment. In a type of transaction which normally would never bring a gain and which is not specifically entered to obtain a gain there is no justification for finding a gain. A transfer, the amount of which is determined as a percentage of the transferor's total wealth, does not appear to be one intrinsically or purposefully for profit. A legal division may transfer only actual control while an equitable division may transfer both actual control and the ability to prevent waste. Is this a significant difference in view of their equal economic results?
45. Frances R. Walz, 32 B.T.A. 718 (1935), held an equal division of the whole was a non-taxable division, even though the parties received entirely different kinds of property, or the husband gave his wife money for the property value he received over what she received. C. C. Rouse, 6 T.C. 908 (1946), aff'd 159 F.2d 706 (5th Cir. 1947) followed this general unity theory but found a capital gain existed because there was an unequal division, and the parties had actually settled their property rights by bargain and sale. The contrary theory that the community ownership is not in the whole but in each specie of property may be supported by Johnson v. United States, 135 F.2d 125 (1943), though it is not clear how perfectly equal the partition would have to be. The contention is that the wife may realize capital gain on her one-half of each piece of property which the husband obtains and vice versa. Halpern, Income Tax Effect of Community Property Divisions Incident to Divorce, 23 CAL. ST. BAR J. 128, 138 (1948). This would make divorce an event for recognizing all gain or loss accrued to date even though the property remained in ownership and use of the same two people. The effect would be the same as taxation at some point during marriage and could cause twice the gain recognized in Davis.
1954 for business partnerships.\(^{46}\)

Although the Supreme Court has not decided a *Davis* situation in a community property state, it could be expected to find a division of property and no capital gains treatment.\(^{47}\) Since the economic effect of a divorce settlement under either property system is substantially the same, a better policy, contrary to *Davis*, would be to heed equitable ownership and economic effect of taxation rather than that legal right to control the property that resides in the husband. Income taxation is directed toward the newly improved economic standing of the person who received or had the right to receive the wealth. A wife is not assigned part of the economic benefit accruing through stock appreciation but has it inherently and to a considerable extent as a right to support. She has also helped earn it by executing her duties in furtherance of their joint marital undertaking.

**Policies Favoring Equality Between Community Property and Common Law States**

The *Davis* decision deliberately creates different tax burdens between the residents of common law and community property states. This is not an area where the parties can always avoid transfers of appreciated property. For example, Indiana courts “may transfer property as between the parties . . .”\(^{48}\) and adjust property rights as in their discretion is just and proper.\(^{49}\) The *Davis* court relied on *Poe v. Seaborn*\(^{50}\) which resulted in the great disparity of treatment between residents of common law and community property states that finally resulted in the joint income tax return by husband and wife.\(^{61}\) Before Congress provided relief, several states had changed their theory of property law to obtain the lower tax rates that divided ownership of income produced for community property state residents.\(^{52}\) Congress has also extended its policy of equal taxation to the gift and estate tax areas by enacting provisions for the marital deduction,\(^{63}\) and for gifts by husband or wife to

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49. IND. ANN. STAT. § 3-1218 (Burns Supp. 1962).
52. GRISWOLD, FEDERAL TAXATION 246 (5th ed. 1960).
INT. REV. CODE OF 1954, § 2523. In a gift by a husband to his wife of other than community property, one-half of the value of the gift is allowed as a deduction in arriving at taxable gifts. Similarly, pursuant to § 2056 the value of a bequest devise or inheritance to a spouse is a deduction from gross estate in arriving at taxable estate for an amount up to fifty percent of adjusted gross estate.
a third party.\textsuperscript{54}

It is true that Congress need not adjust its tax laws to diverse state legislation so as to cause the tax to have equal effect in all states.\textsuperscript{55} The tax need not be intrinsically equal but only geographically equal so that its method operates throughout the United States.\textsuperscript{56} But in the area of income taxation Congress has shown a distinct policy of adjusting its tax laws to the two divergent property systems.\textsuperscript{57} This is undoubtedly an easier and more practical solution of the demand for equal taxation in fact and of the broader constitutional and congressional policy of equal taxation than revision of state property laws. It is more equitable than ignoring the existing but unnecessary inequality. Although the standards of tax equality need not be disturbed, the substantial congressional policy embodied in the joint tax return could have been persuasive in determining the nature of the transaction or its similarity to other gains “realized” but not “recognized.” Now the matter is placed directly before Congress.

\textbf{Non Taxable Transactions Analogous to Davis}

Besides the recognition of joint ownership in provisions for equalizing the tax effects between common law and community property states,\textsuperscript{58} there are several tax areas somewhat analogous to the divorce settlement situation but in which no capital gains taxation occurs. These transactions involve “sales or exchanges” which “realize” capital gains that are specifically not “recognized” for taxation.

\textit{Partnership or Joint Venture.} A partnership or joint venture is an unincorporated organization in which the partners actually carry on a business venture and divide the profits therefrom.\textsuperscript{59} The partner has a legal share of the production or profits which may be lost by his partner’s imprudence but which he nevertheless has a right to obtain by withdrawing from the partnership. Marriage, though not strictly a business, is surely a joint endeavor involving a division of labor that often overlaps the parties’ business and domestic duties. The effort expended for the acquisition of the parties’ wealth is more than mere investment. Although profits are not literally divided and wages are not paid, both husband and wife actually share part of the profits in their family ex-

\begin{itemize}
\item \textsuperscript{54} \textit{Int. Rev. Code} of 1954, § 2513. A gift made by one spouse to someone other than his spouse can be treated as though made one-half by each spouse.
\item \textsuperscript{55} Florida v. Mellon, 273 U.S. 12 (1927).
\item \textsuperscript{56} Billings v. United States, 232 U.S. 261 (1914); Knowlton v. Moore, 178 U.S. 41 (1899).
\item \textsuperscript{57} \textit{Int. Rev. Code} of 1954, §§ 2, 6013, 2523, 2513.
\item \textsuperscript{58} \textit{Int. Rev. Code} of 1954, §§ 2, 6013.
\item \textsuperscript{59} \textit{Int. Rev. Code} of 1954, § 761(a)-(b); Treas. Reg. § 1.761-1(a) (1961).
\end{itemize}
penditures, and to the extent of support, she has an enforceable right to profits. Moreover under defined circumstances a wife has a right to obtain a divorce and enforce her reasonable share or alimony at its current value. Although the value of such right may be diminished by her husband's, or even her own imprudence, such right makes a wife's expectancy share an actual property interest that she may lawfully secure as could a partner by withdrawing from the partnership.

The Income Tax Regulations provide that "no gain shall be recognized to a distributee partner with respect to a distribution of property (other than money) until he sells or otherwise disposes of such property except as otherwise provided by section 736... and section 751. . . ."

A partner's interest is in the unity of the partnership. In liquidating his share he can only realize taxable capital gain by obtaining more money than the basis of his share. Otherwise he would be taxed on a paper gain before it became income. Neither does the partnership (analogous to an ex-husband) which distributes property or money to a partner recognize any gain or loss. A business reorganization is thereby permitted without tax incidence. In contrast, the imposition of a tax upon the Davis situation, when considering marriage as a partnership, would be to tax the property on which two people, married or separated, must live before it leaves their economic community.

Stock Dividend. Eisner v. Macomber defined income as "gain derived from capital, from labor or from both combined . . . [or from] profit gained through a sale or conversion of capital assets." There, a stock dividend of common on common with only common outstanding was not taxable as income of the distributee under the sixteenth amendment because the corporation's property was not diminished and the shareholders' proportionate interests were not changed. Thus certain

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61. Where the partner receives his share of unreceived receivables and inventory items, his basis that remains after the deduction of any money received is first allocated to them. Int. Rev. Code of 1954, § 732. When the partner disposes of the unreceived receivables or inventory items, gain or less is generally treated as that from the sale of non-capital assets. Int. Rev. Code of 1954, § 735. Thus unreceived receivables will be taxed as income when finally disposed of and the capital assets will receive capital gains treatment when finally disposed of, but no capital gain tax will be levied in liquidation of the partnership interest unless realized in money. Where the partner receives property instead of his share of unreceived receivables, he is treated as though he sold them for the property and may realize ordinary income. Int. Rev. Code of 1954, § 751.


63. 252 U.S. 189 (1920).

64. Id. at 207. Koshland v. Helvering, 298 U.S. 441 (1936) defined income, for the purposes of stock dividends and the sixteenth amendment, as the receipt of "different rights or interests" or a change of the "proportionate interest in the net assets of the corporation." Thus taxing some stock transfers would be unconstitutional. Id. at 445.
stock dividends are protected by the Constitution as prior ownership of the distributee rather than income, and most are so treated by the Internal Revenue Code, which postpones the taxation until the distributee disposes of the stock. Since this change of control is permitted to be effectuated without the incidence of an income tax on the distributee, it is easy to understand why there is similarly no imposition of an income tax on a change of control at divorce where there is a lump sum settlement. The lump sum payment to a wife does not alter her economic status much more than do stock dividends, which may alter a shareholder's proportionate ownership of the corporation depending upon the type of stock distributed and on which stock it is distributed. It is not realistic to consider a wife as having earned her reasonable share by her labor (she has no capital invested). Even if her share is income, it is a right to a variable proportionate share of her husband's net worth on the day of liquidation.

The most reasonable interpretation is for her alimony right to be treated as prior ownership, just as stock dividends are, even though she did not previously have full legal ownership. This alternative prevents having to label her alimony rights a capital asset with a zero basis, or a right to income which will be taxed as such, or a right to be compensated for injury and paid with the very goods that defined the injury as though they were stolen. Prior ownership would mean that only a transfer of legal title occurred but for tax purposes a division of property actually took place.

Corporate Reorganization. Congress has provided elaborate procedures for corporate reorganization involving exchanges of stock and other assets but which need not incur any tax to either stockholders or corporations. This is to "permit business to go forward with the re-

65. Int. Rev. Code of 1954, § 305(a). Stock of the declaring corporation is not treated as property in § 317(a) and therefore not a part of dividends defined in § 316(a). Thus the value of the stock dividend is used to reduce the adjusted basis of the stock of the distributee and treated as a gain from sale or exchange of property only if its value exceeds the basis of the stock already possessed. Section 301(c)(2)-(3). When the distributee disposes of the stock it would then be treated as a capital gain or less unless it qualified as § 306 stock and was treated as ordinary income.

Helvering v. Griffiths, 318 U.S. 371 (1943) was concerned with the Eisner v. Macomber situation but refused to reconsider its constitutionality and held the existing statute did not attempt to impose an income tax on a stock dividend of common on common with only common outstanding. Nevertheless the language of the Court and dissent suggest that Eisner v. Macomber would have been overruled had the Court considered it.


adjustments required by existing conditions. The important relevant features of a tax free reorganization are a valid business purpose and a continuity of interest. Those who had a proprietary interest in the former corporation must receive for their assets a similar stock interest in the new corporation which interest represents a substantial portion of the value of the assets transferred.

The concept of corporate reorganization embodied in the tax law and required to prevent tax incidence on reorganization is an economic adjustment of affairs analogous to that made on the "entry" into and "exit" from marriage. If corporation A transfers some of its assets, along with the personal efforts that go with them, to corporation B, receiving in return stock of corporation B which is distributed to A's stockholders, a nontaxable reorganization is effected. The stock received by transferor A need not even be voting stock and can be redeemable at B's option, so long as a bona fide reorganization is taking place. Thus A has given up assets in return for stock that represents a direct economic interest in business B but lacks the control that full ownership enjoys.

Viewing individuals as economic units of self-preservation, when a woman marries she may "invest" some of her assets, and certainly her efforts, for an interest in the larger economic unit of marriage. Her interest is not full ownership or legal control but neither is that of the transferor who receives non-voting stock. The business of maintaining a livelihood continues throughout the reorganization. No gain by the woman is recognized in what may be a substantial monetary increase in her economic status, because each party is thought to have given full value. Her interest in the marriage will now fluctuate with its success or failure just as the interest of the non-voting stockholder. He may be able to turn his interest into cash or other property more readily than the wife, but once grounds for divorce exist she can obtain her percentage of the economic marital unit. The fact that she cannot convert her interest into cash as readily as the stockholder is for reasons promoting marital solidarity which certainly should not work to one's tax disadvantage. The Internal Revenue Code seeks to prevent penalizing an economic effort which merely changes its form and structure without altering the purpose of its organization or activity.

If marriage reorganizes the parties' economic activity under one
banner, divorce will also cause a reorganization. Where a textile corporation transferred to a new corporation the assets of its separate rental enterprise and distributed all of the new corporation's stock to a minority stockholder in return for part of her stock in the textile corporation, the transaction was held a reorganization and no gain was recognized by anyone.\textsuperscript{3} It was not necessary to distribute the new corporation's stock prorata. The result was that one stockholder received a specific piece of corporation property as a part of her interest in the corporation. The business she received was continued and the same people owned and were economically influenced by the same total property after the reorganization as before, but in different detail. This is much the same as the Davis situation except that the Court said the wife did not legally own a share of the marriage corporation, although she did deserve a "reasonable share" and had a power over it. Surely she is affected more as an owner than a creditor, because the total amount she will have a right to depends upon whether the transaction is taxed, while a creditor would have a continuous right to a certain sum regardless of taxation.

\textit{Miscellaneous.} No capital gain is realized upon the transfer of property as a gift or bequest, because the transferor has received nothing in \textit{sale or exchange} which is of greater value than his basis in the transferred property.\textsuperscript{74} It is conceivable that over a period of years a husband could give his wife over $60,000, tax free, from his total property of $120,000.\textsuperscript{75} Upon subsequent divorce, she might not ask for alimony and probably could not receive very much where her financial condition is a factor in determining alimony. The equivalent of a division of property on divorce would be accomplished and payment of capital gains tax would be postponed or possibly even avoided. Obviously she would legally own such a gift and could dispose of it, but the economic status of the marital community and its annual income tax liability would remain unchanged. He would accomplish the future support of his wife, and though her right to alimony remained, practically it would be worth much less with her well provided for.

There are several other areas of the Internal Revenue Code of 1954 where a gain is realized but not recognized.\textsuperscript{76} Usually this is because the

\begin{itemize}
\item 75. \textit{Int. Rev. Code of 1954}, § 2523 provides for a marital deduction of one-half of the gift value. Section 2521 provides for a $30,000 specific exemption and § 2503(b) gives an additional annual $3,000 exclusion.
\end{itemize}
transferor has nothing more or essentially different after the transaction than before.

**American Law Institute Recommendation and Domestic Relations Policy**

In 1954 the American Law Institute recommended that the decision of *Mesta v. Commissioner,* 7 which imposed a capital gains tax in a transaction similar to *Davis,* be abandoned and the transfer of capital assets not be subjected to capital gains tax. Their scheme was for all property to retain its original basis and they commented, "since marital settlements, in a sense, are involuntary exchanges it seems undesirable to impose a tax at that time." 8 This was an appeal to confine capital gains taxation to events where the transferor is, or normally would be, trying to realize a gain that had already accrued rather than taxing unavoidable transfers in pursuance of a valid public policy. Where one public policy requires a redistribution of wealth to prevent a former wife from becoming destitute, it seems inconsistent for another public policy to then tax that redistribution because of its form. Clearly domestic relations policy requiring a husband to support his wife after divorce and the policy in favor of final settlements are given little consideration and are even partially defeated by present taxation in this area. Possibly this stems from an excessive concentration upon the Internal Revenue Code and its interpretation unrelated to the effects which taxation has upon our society. The aftermath of *Poe v. Seaborn,* 9 is evidence of this. It is no answer to say that this taxation would be a deterrent to divorce or whether such a deterrent imposed for tax reasons would be beneficial. The states have machinery for solving marital problems, and it should not be encumbered by taxation without a study of its effects and whether those effects are desirable. Even then, one tax law could not serve all of the varied state attitudes on divorce. State domestic relations law is also of vital concern to the federal government. The *Davis* citation of *Poe v. Seaborn* 80 indicates that the Court believes Congress, if anyone, should make the change. Because of the reasons stated above and the additional difficulties imposed upon the divorce negotiations, Congress may yet be induced to act.

**Effect on Divorce Negotiations**

A divorce negotiation is inherently fraught with ill will, sentiment

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77. 123 F.2d 986 (3d Cir. 1941). See note 4 supra.
and haggling, and many have commented on its adversities. The Davis approach to appreciations in property value brings taxation immediately into the negotiations and may preclude what might be acceptable settlements because they involve the transfer of appreciated property. A husband must calculate capital gains tax on the property which his wife insists on receiving and must demand that a percentage of the tax be deducted from her share. Naturally this will be contested. Where appreciated capital assets must be transferred and the parties realize that both will lose, they may have to adopt a periodic payment plan which does not sever all ties and which neither prefers. At least they would have to consider that possibility. Under the existing tax law even a transfer of appreciated property in trust to make periodic payments to the ex-wife is subject to capital gains treatment.

If the basis of the property to the marriage would remain the same and the separation transfer not taxed, possible future capital gains taxation on the disposition of the property would still have to be considered. But its effects would not necessarily be immediate, and where neither party had to nor wished to dispose of the property inter vivos, the basis would be a minor consideration. It would be possible for the parties to disagree over what property to transfer because of an inequality in total basis of each person, but this need not prevent the particular property from being transferred. The difference in basis could be made up with other property.

The existing law presents opportunities to transfer property which has lost value rather than gained, thereby giving only the husband a deduction while in effect the wife also suffered the loss. If the husband's property should then rise in value he could offset his carry over capital loss against that gain and incur no tax on the sale of his share of the property when actually it was sold for more than its adjusted basis to him. Naturally the husband will wish to make the transfer when the market is down on his stock or at least transfer to the wife property that has lost value.

83. The unadjusted basis to the recipient of property acquired from a decedent is the fair market value of the property at the date of decedent's death. Int. Rev. Code of 1954, § 1014. However, the unadjusted basis to a donee of property received by gift may be the fair market value of the property when transferred on the donor's basis plus any gift tax paid, whichever is lower. Thus the sale of appreciated property by either party could cause them a heavy tax, a gift could cause the donee some tax when he disposed of the property, and on bequest the property might escape capital gains taxation altogether.
Assuming that Internal Revenue Code of 1954, section 1239 pertaining to related taxpayers would not apply to divorcees, an ex-husband could transfer to his ex-wife property depreciated below its fair market value (and be taxed on his gain), and she could then re-depreciate the property over the same value.\textsuperscript{85} If he also leased the property back from her, it would remain in the same community and be partially depreciated twice with only capital gains tax paid on that amount receiving double depreciation.

\textbf{Conclusion}

Whether a woman does or does not legally own a part of her husband's property, it has been shown that for several purposes they are treated as one economic community. She does have a substantial expectancy in dower and rights to support or its contingent substitute, alimony. A final division of assets may be made on divorce even in common law states, and the wife has more or less power to acquire her share depending on the available grounds for divorce. On annulment their joint venture is recognized. Certainly she is economically tied to the fortunes of her husband and can be of great aid to him. Consequently her equitable share is recognized on divorce. It should also be recognized by the Internal Revenue Code as the method of providing her legal control of a share of what she helped earn or deserves by way of marriage when, because of the separation, it becomes economically necessary for her to have legal control. It has been seen that the former wife feels the effects of taxing the transferred property just as though she was a co-owner. Also in some instances there may not even be an exchange.

The same type of tax inequality created by \textit{Poe v. Seaborn} is fostered by \textit{Davis}. It is now up to Congress to equate the two property systems in this more insignificant but equally deserving area. The glare of conflicting policies is not escapeable by statutory interpretation when the legislature has not weighed all of the competing demands. In \textit{Davis} the Court refused to follow congressional determination for the very similar areas of joint income tax returns, marital deductions and provision for a joint gift.

The Internal Revenue Code refuses to recognize capital gains in other areas such as partnership distribution and corporate reorganization. Even if the wife is not a legal owner, the effect upon her in a divorce settlement is more like a tax exempt owner than a creditor. Where economic conditions remain essentially the same, a formal change does not cause one to realize gain. The wife's situation is similar and probably

\textsuperscript{85} \textit{Int. Rev. Code of 1954, §§ 167(a), (f).}
even less desirable, and though the husband is said to be taxed, she feels it as if she were taxed.

Finally the Davis position complicates divorce negotiations and frustrates domestic relations purposes for what is probably an insufficient revenue return. In the interests of fairness and consistency Congress should overrule Davis.

INEQUITIES IN CORPORATE PAYMENTS TO WIDOWS

One of the present problem areas in income tax law is the taxability of voluntary payments by a corporate employer to a widow or other survivors of a deceased employee. This situation usually arises in closely held corporations or with executive employees. The Internal Revenue Code allows an exclusion of $5,000 to the beneficiaries or the estate of the employee if the payments are made by reason of the death of the employee. However, if the employee is entitled to receive the payments while living, the beneficiaries or the estate of the employee do not qualify for the exclusion. The problem area concerns whether the amount in excess of $5,000 is to be treated as income or a gift. If the payment can qualify as a gift, it is wholly excludable from the gross income of the recipient, and the corporation is able to treat the payment as an expense. Recent cases in the United States Courts of Appeals have held that amounts in excess of $5,000 are gifts, while other cases have held them to be taxable income. The cases that have classified the payments as

1. INT. REV. CODE OF 1954, § 101(b).
2. Treas. Reg. § 1.101-2 (1957), provides that the exclusion does not apply to amounts which constituted income payable to the employee during his life as compensation for services, such as bonuses, unused leave, or uncollected salary, plus other amounts to which the employee possessed a nonforfeitable right. A nonforfeitable right includes amounts to which the employee was entitled while living if he had made an election or demand, or upon termination of employment, such as under a pension or profit-sharing plan.