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Ellen S. Deutsch

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NEW APPROACH TO THE TRANSFER OF APPRECIATED PROPERTY PURSUANT TO DIVORCE

When appreciated property is transferred pursuant to a property settlement in a divorce or separation, the federal income tax consequences may vary considerably depending upon state law. The Internal Revenue Code requires that the entire amount of gain or loss from the sale or exchange of property be taxed,¹ and whether the transfer of appreciated property in contemplation of divorce is such a sale or exchange depends on the jurisdiction in which the settlement is negotiated. In community property states, the transfer of appreciated property pursuant to a divorce usually results in a nontaxable division of property between the co-owners.² Such a transfer may result in a taxable event, however, in common law states. When in a common law state the interest of the wife in property acquired during marriage is found to be less than that of a co-owner, the transfer of property

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1. Section 1001 of the Internal Revenue Code of 1954 provides in pertinent part:
 - (a) Computation of gain or loss.

The gain from the sale or other disposition of property shall be the excess of the amount realized therefrom over the adjusted basis provided in section 1011 of the Code for determining gain

- (b) Amount realized.

The amount realized from the sale or other disposition of property shall be the sum of any money received plus the fair market value of the property (other than money) received.

Section 1002 of the Code provides: "Except as otherwise provided . . . on the sale or exchange of property the entire amount of the gain or loss, determined under section 1001, shall be recognized."

2. "[Community property's] basic principle is that whatever is acquired during a marriage by the efforts of either spouse belongs, on acquisition, in equal halves to husband and wife." 4A R. POWELL, *THE LAW OF REAL PROPERTY* ¶ 625, at 714 (P. Rohan rev. ed. 1974).

When property is divided equally in a community property state pursuant to a property settlement, the division will not constitute a taxable event because of each person's vested interest in one-half of the property. Neither spouse will realize gain or loss on the transfer and the cost basis of the property will remain the same. However, when either the husband or the wife purchases the other's share for more than its basis, the gain will be taxable to the seller. Such a transaction is most likely when community property is made up almost entirely of one asset which cannot be divided, such as a business. If the parties do not want to sell the business, one party may buy out the other and the result will be a purchase and a sale. See Rudick, *Tax Consequences of Marriage and Its Termination*, American Law Institute and the American Bar Association's Joint Committee on Continuing Legal Education, 146-47 (1974).

will require the transferor to pay a tax on the difference between his basis and the appreciated value of the property at the time of the transfer.³

Recently, however, the Tenth Circuit held in *Imel v. United States*⁴ that the transfer of appreciated stock to the wife pursuant to a property settlement in a common law state was a division by co-owners of jointly owned property resulting in no capital gain taxable to the husband. The court found that under the law of Colorado, the wife had a "species" of common ownership which vested at the time of the filing of the divorce action.⁵ *Imel* is important because it enlarged prior case law by holding that a nontaxable property division may take place in common law states under a new concept of equitable interest in marital property. Thus, despite the absence of a community property statute, a wife can be found to be a co-owner based on the recognition of her contribution toward the acquisition of jointly acquired property. *Imel* also raises the question of whether a state court is competent to make a conclusive determination of what is a taxable event for federal income tax purposes.⁶ This article will examine the income tax consequences of a division of property pursuant to a divorce in the context of various types of property ownership, and whether, in light of *Imel*, the question of what degree of ownership must be found in order to create a nontaxable division has been resolved.

3. *United States v. Davis*, 370 U.S. 65 (1962). The tax consequences of such a transfer are illustrated by *Wiles v. Commissioner*, 499 F.2d 255 (10th Cir. 1974). In *Wiles*, the husband transferred stock to his wife pursuant to a property settlement. His basis in the stock was \$83,169.65. The fair market value was \$550,000. This resulted in a capital gains tax of \$109,650.54. The recipient of the property in such a transfer pays no tax until there is a disposition. Thus, the wife takes the property at fair market value (a stepped up basis). The wife's tax consequences were not in issue in *Davis*, but the Court observed that at that time it was the practice of the Internal Revenue Service not to treat such a transaction as a taxable event to the wife. 370 U.S. at 73 n.7. After the *Davis* decision, the Service issued Rev. Rul. 221, 1967-2 CUM. BULL. 63, which formally confirmed the prior practice of exempting the wife from taxation and allowing her to use the market value of the transferred property as her basis.

4. 523 F.2d 853 (10th Cir. 1975).

5. *Id.* at 857. The issue of whether the transfer is a sale or exchange within section 1002 of the Code arises when title to jointly acquired property is held in the name of one spouse. When property is held in joint tenancy or in tenancy by the entirety and is divided equally between the co-owners, there is no sale or exchange and no gain is assessed until there is a disposition. See Rev. Rul. 437, 1956-2 CUM. BULL. 507.

6. State law controls only when the federal law expressly or impliedly makes operation of the tax law dependent upon state law. See *Lyeth v. Hoey*, 305 U.S. 188, 194 (1938). When state law does control, federal courts must ascertain and apply state law. *Huddleston v. Dwyer*, 322 U.S. 232, 236 (1944). The field of domestic relations belongs exclusively to the laws of the states. *McCarty v. Hollis*, 120 F.2d 540, 542 (10th Cir. 1941). See also Cahn, *Local Law in Federal Taxation*, 52 YALE L.J. 799 (1943).

I. *Davis* AND ITS AFTERMATH

Before 1962, the courts in common law jurisdictions had been divided on the issue of whether a taxpayer must recognize gain as a result of a property transfer pursuant to a divorce.⁷ The Supreme Court resolved the dispute in *United States v. Davis*.⁸ Pursuant to a property settlement entered into prior to divorce, Mr. Davis had transferred 1,000 shares of stock held in his name to his wife for a release of any and all claims she might have against him. Mr. Davis contended that the transfer was a nontaxable division of property between co-owners. The government argued that the transfer was a "taxable transfer of property in exchange for the release of an independent legal obligation."⁹ The Court held that the transfer constituted a taxable event and that the husband must recognize gain on the transfer of the property to the extent that the fair market value of the property exceeded its basis.¹⁰

In order to determine whether the property transfer amounted to a division of property or a transfer for a release of a legal obligation, the Court looked to Delaware law.¹¹ It concluded that the inchoate rights granted a wife in her husband's property by Delaware law did not "even remotely reach the dignity of co-ownership."¹² The wife was found to have no control over the management or disposition of the property; her inchoate rights were not descendible; and upon dissolution of the marriage, she was eligible to receive only what the court determined was reasonable. While

7. See, e.g., *Commissioner v. Marshman*, 279 F.2d 27 (6th Cir.), cert. denied, 364 U.S. 918 (1960) (agreement that husband give up interest in option in consideration for release of wife's marital rights not a taxable event); *Commissioner v. Halliwell*, 131 F.2d 642 (2d Cir. 1942), cert. denied, 319 U.S. 741 (1943) (transfer of property for release of wife's marital rights taxable event for husband); *Commissioner v. Mesta*, 123 F.2d 986 (3d Cir. 1941), cert. denied, 316 U.S. 695 (1942) (transfer of property in complete satisfaction of wife's support claims taxable to husband).

8. 370 U.S. 65 (1962). See note 3 *supra*.

9. *Id.* at 69. "Marital rights" and independent legal obligations refer, in part, to one spouse's duty to support the other spouse during marriage, to dower, and to the right to an intestate share. See *Commissioner v. Maresi*, 156 F.2d 929, 930 (2d Cir. 1946).

10. 370 U.S. at 74.

11. In regard to property division pursuant to a divorce, the relevant Delaware statute provided:

When a divorce shall be decreed for the aggression of the husband, the complainant shall be restored to all her real estate, and allowed, out of her husband's real and personal estate, such share as the court thinks reasonable; but if the divorce be for the wife's aggression, the court may restore the whole or a part of her real estate, and also such share of her husband's personal property as seems reasonable.

24 Del. Laws, ch. 221 §§ 15, 16, as amended, 25 Del. Laws, ch. 213 § 4 (now DEL. CODE ANN. tit. 13, § 1527 (1974)).

12. 370 U.S. at 70.

conceding that there was some merit to Mr. Davis' position, the Court stated that "[r]egardless of the tags, Delaware seems only to place a burden on the husband's property rather than to make the wife a part owner thereof."¹³ The transfer was equated with the husband's legal obligations of support and alimony.¹⁴ The Court concluded that the transfer was in satisfaction of an independent legal obligation and was therefore a taxable event. The *Davis* Court further held that the relinquished marital rights were equal in value to the property transferred, and the taxable gain thus realized upon such a transaction would be measured as though the parties were dealing at arm's length.¹⁵

Although the Supreme Court based its decision in *Davis* on its interpretation of Delaware law, some observers have interpreted *Davis* as establishing that all transfers of appreciated property in property settlements are taxable events regardless of state law.¹⁶ Several subsequent court decisions have given state law only cursory examination by repeating the *Davis* Court's statement of Delaware law and applying it to the particular state involved.¹⁷ A careful reading of *Davis* shows, however, that under the laws

13. *Id.*

14. *Id.* at 70-71. The right to alimony is separate and distinct from the right to division of property jointly acquired by the parties during the marriage. The doctrine of alimony is based upon the common law obligation of the husband to support his wife. See 2c VERNIER, *AMERICAN FAMILY LAWS* 259 (1932). The income tax provisions governing the taxation of alimony provide that periodic payments made by the husband pursuant to a divorce decree are includible in the wife's gross income and deductible by the husband. INT. REV. CODE OF 1954, §§ 71(a)(1), 215. The payment of a lump sum discharging a part of an obligation is considered a property settlement and is neither includible in the wife's income nor deductible by the payor. *Id.* §§ 71(c)(1), 215.

Division of property, on the other hand, is based on the wife's right to a just and equitable share of that property which has been accumulated by the parties as a result of their joint efforts during their years of marriage. In this sense, the marital relationship is analogous to a partnership. Since in common law jurisdictions the property rights of the wife have generally not been found to arise until dissolution of the marriage, attempted divisions of property have been treated as property settlements for income tax purposes. See Graves, *Federal Taxation in Separation and Divorce*, 29 WASH. & LEE L. REV. 1 (1972); Note, *Federal Taxation: Tax Consequences of Divorce Property Settlements*, 1963 DUKE L.J. 365, 370; Note, *Property Transfer Pursuant to Divorce—Taxable Event?*, 17 STAN. L. REV. 478, 482 (1965).

15. 370 U.S. at 72.

16. See, e.g., Annot., 1 A.L.R.2d 1037 (1948); 6 MERTENS, *LAW OF FEDERAL TAXATION* § 37.48 (rev. ed. 1975); Comment, *Federal Tax Aspects of Divorce and Separation*, 44 MISS. L.J. 740, 755 (1973). This interpretation is probably based on the fact that no property statute in a common law state gives the wife the traditional ownership criteria cited in *Davis*, see p. 618-19 *supra*, as lacking in the Delaware statute.

17. See, e.g., *Pulliam v. Commissioner*, 329 F.2d 97 (10th Cir.), cert. denied, 379 U.S. 836 (1964) (*Davis* rule applied when no voluntary property settlement had been reached).

of other states, a property settlement pursuant to a divorce may constitute a division of marital property as opposed to a taxable exchange.¹⁸

The Tax Court and circuit courts have arrived at disparate results in interpreting state statutes. Efforts to have the courts interpret the laws of Florida, Iowa, Kentucky, New York, and Wisconsin in such a way that a non-taxable division of property would be possible have not met with success.¹⁹

A series of cases in the Tenth Circuit is illustrative. The cases required the court to analyze Oklahoma property law. In *Collins v. Commissioner*,²⁰ a taxpayer transferred securities with a basis of \$20,000 and an appreciated market value of \$532,000 to his wife in a divorce settlement. The husband had brought a small amount of stock in a corporation into the marriage and after the marriage had inherited a large block of stock in the same company.²¹ At the time of the divorce settlement, the husband transferred a substantial block of the stock to his wife but failed to report the transfer or the capital gains on the stock. The husband contended that because Oklahoma law conferred property ownership rights on his wife, the transfer was thus a nontaxable division of property.²² The Commissioner disagreed and assessed a deficiency.²³

The Tenth Circuit agreed that under *Davis* it was required to look to Oklahoma law to determine the exact nature of the disposition for tax

18. The Court explicitly recognized that such differing results were possible:

Although admittedly such a view may permit different tax treatment among the several States, this Court in the past has not ignored the differing effects on the federal taxing scheme of substantive differences between community property and common-law systems.

370 U.S. at 71.

19. See, e.g., *Wallace v. United States*, 439 F.2d 757 (8th Cir.), cert. denied, 404 U.S. 831 (1971) (Iowa — transferred securities were not included in settlement agreement but were ordered transferred by divorce court; transfer constituted taxable event); *Kraut v. United States*, 316 F. Supp. 740 (E.D. Wis. 1970) (court found taxable event but stated it would have looked at state law if state court had made a definitive ruling on the subject); *Matthews v. United States*, 425 F.2d 738 (Ct. Cl. 1970) (Florida and New York — husband gave up very limited rights under Florida law but wife's transfer of appreciated securities to husband resulted in \$1.25 million in capital gains); *Swaim v. Commissioner*, 50 T.C. 302 (1968), aff'd, 417 F.2d 353 (6th Cir. 1969) (Kentucky — tax court regarded *Davis* as providing federal criteria). J. CHOMMIE, *FEDERAL INCOME TAXATION* 344 n.76 (2d ed. 1973).

20. 388 F.2d 353 (10th Cir.), vacated per curiam, 393 U.S. 215 (1968).

21. *Id.* at 353. The wife brought into the marriage approximately \$10,000. The corporation in which the husband was a major stockholder had prospered greatly during the marriage.

22. Oklahoma is not a community property state. Nonetheless, Mr. Collins contended that Oklahoma had created by statute unique rights in the parties to the marriage that resembled those found in community property states. *Id.* at 355. See OKLA. STAT. tit. 12 § 1278 (1961), quoted note 25 *infra*.

23. 46 T.C. 461 (1966).

purposes.²⁴ Concluding that there had been no property division as Mr. Collins argued, the court interpreted the Oklahoma law as affording the wife no vested interest in her husband's property prior to the divorce decree.²⁵ The Court held that the transfer was a taxable event because Oklahoma law did not give the wife traditional ownership rights in property such as a descendible interest, the right to control and manage, and a right to disposition.²⁶

Shortly after Mr. Collins challenged in federal court his obligation to pay federal income tax on the transfer, he challenged in state court his obligation to pay a similar state income tax.²⁷ The Oklahoma Supreme Court found that the Tenth Circuit's interpretation of Oklahoma law had been incorrect and that the nature of the wife's interest under Oklahoma law was similar in concept to that of community property in community property states, concluding that the property was "held by a species of common ownership."²⁸ Although this interest was not descendible, the court distinguished the Oklahoma statute from the Delaware statute at issue in *Davis* on the ground that the Oklahoma statute placed a mandatory duty upon the court to divide

24. 388 F.2d at 355. "There is no dispute but that we must, as the Supreme Court did in the *Davis* case . . . look to the state law controlling the disposition of the property to determine the exact nature of that disposition for tax characteristic purposes." *Id.*

25. The Oklahoma statute provided in part:

As to such property, whether real or personal, as shall have been acquired by the parties jointly during their marriage, whether the title thereto be in either or both of said parties, the court shall make such division between the parties respectively as may appear just and reasonable, by a division of the property in kind, or by setting the same apart to one of the parties, and requiring the other thereof to pay such sum as may be just and proper to effect a fair and just division thereof.

OKLA. STAT. tit. 12 § 1278 (1951).

26. 388 F.2d at 357-58. The court stated that

[w]hatever the nature of the rights granted by Oklahoma law to spouses in jointly acquired property it is clear they do not include the traditional ownership rights in property. These rights such as descendible interest, right to control and disposition of property and vested interest are set out by the Supreme Court in *United States v. Davis* . . . as factors that distinguish a marital division in satisfaction of a legal obligation from a division between co-owners. Since these traditional elements of co-ownership are lacking, the fact that in making a decision the state courts speak as though they were dividing property between co-owners does not prevent the federal courts from saying that for tax purposes the division was in satisfaction of a marital obligation and thus taxable.

Id.

27. *Collins v. Oklahoma Tax Comm'n*, 446 P.2d 290 (Okla. 1968) (*Collins II*).

28. *Id.* at 295. The court indicated that "[t]he fact record title is in the husband by reason of conveyance or contract does not destroy such joint ownership, since the plain language of the statute precludes such requirement." *Id.*

the jointly acquired property in a "just and reasonable" manner.²⁹ As a result of this mandatory duty, the court held that the wife possessed a vested interest in jointly acquired property of the marital relationship. Thus the transfer was held to constitute a nontaxable division of property between co-owners for purposes of state income tax.

After the state court determination, Mr. Collins appealed the Tenth Circuit decision to the United States Supreme Court. The Supreme Court remanded³⁰ in light of the Oklahoma Supreme Court's interpretation of the statute. On remand, the Tenth Circuit,³¹ having the benefit of an authoritative interpretation of state law, concluded in *Collins IV* that "the stock transfer operated merely to finalize the extent of the wife's vested interest in property" and that therefore the transfer was nontaxable.³²

Significantly, the appeals court in *Collins IV* did not read *Davis* as having created federal criteria which were required to be met before the rights conferred by state law could be said to constitute co-ownership.³³ Under such a reading, state courts were free to find co-ownership under individual statutes regardless of whether the general ownership characteristics cited in *Davis* were present.

Subsequent to *Collins IV*, however, in *Wiles v. Commissioner*,³⁴ the Tax Court found the transfer of appreciated property to be a taxable event even when the state statute in question was indistinguishable from the Oklahoma law cited in *Collins*. The court read *Davis* to require a finding that the transfer constituted a nontaxable division only if the property interest a wife had in the divided property was as large as the interest of a wife in a community property state.³⁵ The relevant Kansas law, as the Tax Court interpreted it, did not elevate the wife's interest to one resembling co-ownership.³⁶ The Tax Court went on to note that the question of whether a

29. *Id.*

30. *Collins v. Commissioner*, 393 U.S. 215 (1968) (*Collins III*).

31. *Collins v. Commissioner*, 412 F.2d 211 (10th Cir. 1969) (*Collins IV*).

32. *Id.* at 212.

33. *Id.* The Tenth Circuit indicated that the *Davis* Court had "merely discussed certain general characteristics of co-ownership in an attempt to determine whether the wife possessed the rights of a co-owner under state law." *Id.*

34. 60 T.C. 56 (1973). A taxpayer and his wife had reached a voluntary agreement in which neither would claim alimony and their property would be equally divided. The value of the property in the taxpayer's name exceeded that in his wife's name. As a result, he agreed to transfer some property in his name to his wife.

35. *Id.* at 60. The difficulty with this view is that the Supreme Court must have been aware of the obvious differences between the wife's interest in Oklahoma and her interest in a community property state when it remanded *Collins III*.

36. This is rather surprising since Oklahoma law is derived from Kansas law and the court acknowledged this fact. *Id.* The statute provided in relevant part:

(b) The decree shall divide the real and personal property of the parties,

wife's interest in the marital property constituted an ownership interest was still unanswered in Kansas.³⁷ Although the Kansas statute, like that of Oklahoma, required upon divorce an equitable division of property of the marriage, regardless of legal title,³⁸ the court stated that without a Kansas decision flatly stating that a property settlement in Kansas was a division of property between co-owners, it was unwilling to so hold.³⁹

The Tenth Circuit affirmed the Tax Court decision and held the transfer in *Wiles* to be a taxable event.⁴⁰ The court stated that under Kansas law, the determination of the wife's interest was wholly within the discretion of the trial court. The trial court had a mandate to divide the property in a just and reasonable manner, and it could consider the contribution of each party, earning capacity, fault, and the needs of the parties in reaching a property settlement. The appeals court reasoned that the wife can have no vested co-ownership interest in property of the husband if the trial court possesses discretion in making a property division which denies her the property.⁴¹ Yet the trial court possessed the same discretionary power under the Oklahoma statute in *Collins*, in which the Tenth Circuit found the wife to have a species of common ownership.⁴²

II. THE SIGNIFICANCE OF *Imel*

*Imel v. United States*⁴³ involved the transfer of appreciated corporate stock pursuant to a court-approved property settlement. The Commissioner

whether owned by either spouse prior to marriage, acquired by either spouse in his or her own right after marriage, or acquired by their joint efforts, in a just and reasonable manner, either by a division of the property in kind, or by setting the same or a part thereof over to one of the spouses and requiring either to pay such sum as may be just and proper, or by ordering the sale of the same under such conditions as the court may prescribe and dividing the proceeds of such sale.

KAN. STAT. ANN. § 60-1610(b) (1964).

37. The Kansas Supreme Court, however, had analogized the marital relationship to a partnership. See *Garver v. Garver*, 184 Kan. 145, 334 P.2d 408 (1959); *Cummings v. Cummings*, 138 Kan. 359, 26 P.2d 440 (1933).

38. See note 36 *supra*.

39. 60 T.C. at 61-62. The dissenting opinion considered the application of the *Davis* and *Collins* decisions to the law of Kansas. The dissent felt the majority had erroneously interpreted *Davis* by restricting it to cases in which state property laws created the joint interest in property. The dissenters thought that domestic relations law could also create an interest in both spouses to jointly acquired property. *Id.* at 64-68.

40. *Wiles v. Commissioner*, 499 F.2d 255 (10th Cir. 1974), *cert. denied*, 419 U.S. 996 (1975).

41. "If a wife were a co-owner in Kansas, her interest in the property to be divided would be based on more than a right to a 'just and equitable share therein.'" *Id.* at 258.

42. 388 F.2d at 354.

43. 523 F.2d 853 (10th Cir. 1975).

held that the transfer was a taxable event and rendered a deficiency assessment. Imel paid the assessment and sought a refund in the United States District Court for the District of Colorado. The district court entered a judgment against the United States, holding that the transaction was a division of property between co-owners and not a sale or exchange resulting in a capital gain.⁴⁴

The district court in *Imel* found that under a new Colorado law it appeared that a wife had a species of common ownership similar to that which had been recognized by the Tenth Circuit in *Collins IV* under Oklahoma law.⁴⁵ However, rather than interpreting Colorado law itself, the court, pursuant to Colorado appellate rules,⁴⁶ certified the question to the Supreme Court of Colorado for a definitive statement of the applicable property law.⁴⁷ The Colorado Supreme Court answered that "at the time the divorce action was filed, there vested in the wife her interest in the property in the name of the husband,"⁴⁸ and that "under Colorado law, the transfer involved here was a recognition of a 'species of common ownership' of the marital estate by the wife resembling a division of property between co-owners."⁴⁹

44. *Imel v. United States*, 375 F. Supp. 1102 (D. Colo. 1973).

45. *Id.* at 1115-16. A prior case decided under an earlier Colorado statute had reached the opposite conclusion and found a taxable event upon the transfer. *Pulliam v. Commissioner*, 329 F.2d 97 (10th Cir.), *cert. denied*, 379 U.S. 836 (1964). The district court distinguished the cases on the basis that the statute in effect in *Pulliam* had provided that "the court may make such order and decree providing for payment of alimony and maintenance . . . as may be reasonable and just . . . or may decree a division of property." COLO. REV. STAT. ANN. § 46-1-5 (1953). The statute governing the *Imel* case, however, provided that "the court may make such orders, if any, as the circumstances of the case may warrant relative to the division of property, in such proportions as may be fair and equitable." COLO. REV. STAT. ANN. § 46-1-5 (1963), *as amended*, § 46-1-13 (Supp. 1971).

46. COLO. S. CT. APP. R. 21.1.

47. The question was phrased as follows:

When, under 1963 C.R.S. 46-1-5 [or under 1963 C.R.S. 46-1-13 as amended in 1971]

(a) a property settlement agreement is entered into providing for a transfer of property from husband to wife in acknowledgement of the wife's contribution to the accumulation of the marital estate, or

(b) a decree of the divorce court requires such transfer because of the wife's contributions to the accumulation of the family estate, and

(c) the transfer is not made in satisfaction of the husband's obligation for support,

is the transfer a taxable event for the purposes of federal income taxation?

In re Questions Submitted by the United States District Court for the District of Colorado, 517 P.2d 1331, 1331-32 (Colo. 1974).

48. *Id.* at 1331.

49. *Id.* at 1334.

A. State Court Controversy

After the Colorado Supreme Court's opinion, the government argued in federal district court that despite the previous determination, the transfer was taxable as a capital gain for purposes of federal income tax law. The district court disagreed, however, and concluded that the Colorado Supreme Court's decision was binding and that the transfer was a nontaxable division of property.⁵⁰

On appeal to the Tenth Circuit, the government argued that a state court could not determine what constitutes a taxable event under federal income tax laws. The appeals court concluded that while the occurrence of a taxable event depended upon whether the transaction was a nontaxable division of property by owners or whether it was a sale or exchange under sections 1001(c) and 1002 of the Internal Revenue Code, the nature of the property ownership was to be determined by the law of Colorado.⁵¹ The court stated: "Legal interests and rights are created by, and exist under, state law. Federal law determines what transactions involving interests or rights created by state law shall be taxed."⁵² Criticizing the district court's framing of the certified questions, the appeals court observed that the federal district court should not have asked the Colorado Supreme Court if the transaction was a taxable event; rather, it indicated that when a federal court certifies questions under permissive state procedures, the court should frame the question so that it only requires a determination of state law and that "[a] federal court may not impose on a state court the responsibility for determining a federal question."⁵³

50. 375 F. Supp. at 1118.

51. 523 F.2d at 855.

52. *Id.*, citing *Morgan v. Commissioner*, 309 U.S. 78 (1940). This issue is not as clear as the court asserts. The Court in *Morgan* stated that "If it is found in a given case that an interest or right created by local law was the object intended to be taxed, the federal law must prevail no matter what name is given to the interest or right by state law." *Id.* at 81.

In *Commissioner v. Bosch*, 387 U.S. 456 (1967), the issue was whether a federal court or agency in a federal estate tax controversy was conclusively bound by a state trial court adjudication of relevant property rights when the United States was not a party to the proceeding. The Supreme Court held that in actions arising under a federal statute, a determination of a question of state law by a state trial court is not binding on federal courts under the doctrine of *Erie R.R. Co. v. Tompkins*, 304 U.S. 64 (1938). The Supreme Court seemed to indicate that only the highest state court decisions would be deemed controlling in federal cases. 387 U.S. at 465.

In *United States v. Mitchell*, 403 U.S. 190 (1971), a case involving community property interests, the Court stated that "federal income tax liability follows ownership In the determination of ownership, state law controls." *Id.* at 197.

53. 523 F.2d at 857.

Although it concluded that the certified questions had been worded poorly, the appeals court held that the Colorado Supreme Court had conclusively defined the rights and interests of the parties under Colorado property law.⁵⁴ The property settlement was thus a nontaxable division of property between co-owners within the meaning of sections 1001 and 1002 of the Code.⁵⁵ The result of the decision in *Imel* is that when the highest court in a state makes a definitive determination of property law, that characterization of ownership rights conclusively controls the federal tax consequences.

B. Inconsistency in the Tenth Circuit

After the Colorado Supreme Court had defined rights and interests under the Colorado law, but before the Tenth Circuit's affirmance in *Imel*, the Tenth Circuit in another case, *Hayutin v. Commissioner*,⁵⁶ read the Colorado statute to create no ownership interest in the wife. In *Hayutin*, the court stated that the characterization by the Colorado Supreme Court of the wife's interest as a species of co-ownership which vested upon divorce was not controlling for tax purposes.⁵⁷ The *Hayutin* court characterized the Colorado law as placing a burden upon the husband's property rather than making the wife a co-owner, and found that "[a] husband's property in Colorado is basically free from any vested interest of the wife, except her inchoate rights"⁵⁸ The court went on to say that when the division of marital property is discretionary with the court it is not possible to also find co-ownership.⁵⁹

This is the same argument made in *Davis* and *Wiles* but rejected in *Collins IV* and *Imel*. The statutes in Delaware, Kansas, Oklahoma and Colorado all allow the trial court discretion to consider factors such as contribution,

54. *Id.*

55. *Id.*

56. 508 F.2d 462 (10th Cir. 1974). The *Hayutin* case involved a Colorado divorce in which there was a complicated property settlement under which the husband was required to make monthly payments of \$700 and had the unexercised right to prepay a sum of \$163,000. The issue was the tax liability of the wife under sections 71 and 215 of the 1954 Code, arising from the monthly payments by the husband. The wife unsuccessfully argued that the payments were a nontaxable division of property because of the prepayment option. The liability of the husband for capital gain under sections 1001 or 1002 of the Code was not in issue. The court of appeals therefore concluded that the questions of *Davis*, *Pulliam*, *Collins IV* and the certified questions decision of the Colorado Supreme Court were not determinative in *Hayutin*. 508 F.2d at 469.

57. *Id.* at 468.

58. *Id.* at 469.

59. *Id.*

need, and age in reaching a property settlement. Yet the Tenth Circuit found the wife to have an ownership interest in *Collins IV* and *Imel*, but reached a contrary result in *Hayutin*.⁶⁰

The *Hayutin* court appeared to be saying that the determination of the Colorado Supreme Court related specifically to the rights of the parties in the property covered by the *Imel* transfer. Therefore, since a cash settlement rather than appreciated property was involved in *Hayutin*, the characterization of the property interest was not binding.⁶¹ The distinction is obscure, particularly since the rationale for certifying questions to the state court is to obtain a definitive interpretation of the relevant property law. The appeals court in *Hayutin* could have found a taxable transaction under the applicable Code sections without resorting to the oft-cited *Davis* criteria for ownership. As a result of *Hayutin*, it is possible to conclude that the *Imel* holding was based more on a showing of substantial contribution than a reliance on the Colorado court's statutory interpretation. Whether the Tenth Circuit will follow *Imel* in a case in which there is no clear showing of contribution remains unclear.

In affirming the district court's decision in *Imel* and in holding that the transfer was a nontaxable division of co-owned property, the appeals court followed its reasoning in *Collins IV*. This represents a shift from the criteria used in *Davis* to determine ownership. In neither *Imel* nor *Collins IV* did the court find descendibility, power to control or manage, or a right of disposition. However, it is difficult to reconcile *Collins IV* and *Imel* with *Wiles*. It is necessary, therefore, to look beyond the holdings to find some factors which would explain the conflicting results.

III. AVOIDING THE *Davis* CONSEQUENCES

A. Joint Acquisition of Property

For several years after the *Davis* decision, it appeared settled that in common law jurisdictions the transfer of appreciated property pursuant to a divorce would result in taxable gain for the husband. Although the *Davis* Court stated that its "view may permit different tax treatment among the

60. The court of appeals in *Imel* attempted to distinguish *Hayutin* on its facts and on the basis that other sections of the Internal Revenue Code were involved in *Hayutin*. 523 F.2d at 856. While it is true the issues in *Hayutin* were different from those in *Imel*, the court's characterizations of the wife's interest under the same Colorado statute in *Hayutin* and *Imel* are irreconcilable. The *Hayutin* court characterized the wife's interest under Colorado law as identical to that of the wife in *Davis* as decided under Delaware law. 508 F.2d at 469. Yet in *Imel*, the court found the Colorado Supreme Court's determination of a species of co-ownership under Colorado law to be conclusive. 523 F.2d at 857.

61. 523 F.2d at 857.

several states,"⁶² few states looked beyond the general characteristics mentioned in *Davis* in interpreting the relevant property law.⁶³ Ownership interests have traditionally been created by property law. These interests, however, can also be said to have been created by divorce statutes,⁶⁴ as demonstrated in cases involving the concept of jointly acquired property.⁶⁵ Thus, a property right could be found in both spouses who have contributed to the enhancement in value of property brought about by the joint effort of husband and wife during their marriage. If property is found to be jointly acquired, it is immaterial in whose name any of the property is held at the time it is divided by the divorce court. A division of property may necessarily involve the transfer of title from one spouse to another and this is true even in the division of property in a community property state.⁶⁶ If this property is jointly acquired, however, the transfer of title would not be a sale or exchange within sections 1001 and 1002 of the Code because each spouse would be a co-owner.

Although the Oklahoma and Kansas statutes requiring mandatory division of property are unusual for common law jurisdictions, most states have provided for division of property based on equitable considerations.⁶⁷ This equity is based on the recognition of each spouse's contribution toward the acquisition of property after marriage, as well as age, need, style of living and length of the marriage. By recognition of property rights in jointly acquired property, a nontaxable division of property could be found. This result can be achieved through legislation or by the courts. However, as illustrated by *Wiles*, the Tax Court may still find a taxable event when a statute recognizes the concept of jointly acquired property. Thus, in order to be assured of a nontaxable division of property, it appears that it is necessary to have a decision by the highest court of a state characterizing the interest of the wife as a species of common ownership. Without an affirmative statement of this nature, a nontaxable division remains doubtful.

A 1974 revenue ruling acknowledges that a nontaxable division is possible in common law jurisdictions but fails to provide any mechanism for making

62. 370 U.S. at 71.

63. See cases cited note 19 *supra*.

64. See Richard E. Wiles, Jr., 60 T.C. 56, 64 (1973) (Goffe, J., dissenting).

65. See, e.g., *Zeller v. Zeller*, 195 Kan. 452, 407 P.2d 478 (1965); *Tobin v. Tobin*, 89 Okla. 12, 213 P. 884 (1923).

66. See de Funiak, *A Review in Brief of Principles of Community Property*, 32 KY. L.J. 63 (1943).

67. See, e.g., ALASKA STAT. § 09.55.200 (1974); ARK. STAT. ANN. § 34-1214 (1964); ILL. REV. STAT. ch. 40 § 18 (1972); IND. CODE § 31-1-12 to -17 (1973), TENN. CODE ANN. § 36-825 (1955).

such a determination prior to the writing of a settlement agreement.⁶⁸ The ruling states that “[p]roperty may be co-owned where (1) title to it is taken jointly under State property law, (2) the State is a community property law State, or (3) State property law is found to be similar to community property law.”⁶⁹ The inclusion of subsection three indicates that the Internal Revenue Service has recognized that certain states may have created a property interest in marital property similar to that which exists in a community property state. The questions unresolved by this ruling are when state law is deemed to be similar, and whether the issue must be addressed by the highest court in the state before the state determination is to be binding upon a federal court. The Tax Court and the Tenth Circuit specifically rejected the taxpayer’s case in *Wiles* because of the lack of a decision by the highest court in Kansas characterizing the ownership interests under Kansas law.⁷⁰

B. Lack of Federal Criteria

Prior to *Collins IV*, the courts had looked to the *Davis* decision as providing federal criteria, such as rights of management and control, disposition, and descendibility, that must be met before finding co-ownership. The courts found none of the above mentioned criteria in either *Collins IV* or *Imel*, yet a species of co-ownership was found which resulted in a nontaxable division of property.⁷¹ This represents a change from the criteria used in *Davis* to determine co-ownership in divorce settlements. Whether other courts will use the traditional criteria mentioned in *Davis* or, under a more expanded state law approach, use criteria similar to those in *Imel* or *Collins IV* is uncertain. It is possible that the *Davis* criteria would be invalid even in community property states, depending upon the wording of individual statutes.

Although the wife has a present vested interest in property acquired after marriage in community property jurisdictions, the husband may be deemed the manager of the property with the right to alienate it without the consent or permission of the wife.⁷² Hence, within a community property

68. Rev. Rul. 347, 1974-2 CUM. BULL. 26.

69. *Id.* at 27.

70. 60 T.C. at 61; 499 F.2d at 258.

71. 412 F.2d at 212; 523 F.2d at 857.

72. In discussing the Louisiana community property statute in *United States v. Mitchell*, 403 U.S. 190 (1971), the Supreme Court stated:

The husband is the head and master of the partnership or community of gains; he administers its effects, disposes of the revenues which they produce, and may alienate them by an onerous title, without the consent and permission of his wife.

Id. at 198, citing LA. CIV. CODE ANN. art. 2404 (1971).

state, a wife may not have rights of control, management or disposition. Yet the wife is unquestionably a co-owner.⁷³ Perhaps a better view of state property statutes would look to an equitable and just division of property based on contribution toward jointly acquired property rather than the previously cited criteria. This would allow a nontaxable division without meeting the traditional ownership criteria cited in *Davis*.

C. The Contribution Concept

One important factor in the *Imel* decision that received scant attention from the appeals court may provide a useful tool in reconciling prior decisions. The *Imel* court stated that "[u]nder the findings of both the state and federal courts the wife materially aided the accumulation of the family wealth and the settlement agreement was a fair division of the property."⁷⁴ In the district court, the court described in great length the "substantial contributions [made by Mrs. Imel] to the accumulation of the family estate."⁷⁵ Citing state case law authority,⁷⁶ the court observed that "under Colorado law an equitable award of money or property to the wife is dependent upon [the] extent of her contribution"⁷⁷

That a characterization of a wife's interest may turn on her respective contribution to the marital property is illustrated by the Eighth Circuit's decision in *Wallace v. United States*.⁷⁸ In *Wallace*, the district court had determined that Iowa law,⁷⁹ like that of Delaware, granted taxpayer Wallace's former spouse no interest, active or passive, in the taxpayer's personal property prior to the entry of the divorce. In holding that the transfer of property was properly taxable, the appeals court found the cases cited by the taxpayer which held that the wife was a co-owner of the property to be inapplicable

73. "The wife's half interest in the community property is not a mere expectancy during the marriage The title for half of the community property is vested in the wife the moment it is acquired by the community or by spouses jointly" 403 U.S. at 199, citing *Phillips v. Phillips*, 160 La. 813, 825-26, 107 So. 584, 588 (1926).

74. 523 F.2d at 857.

75. 375 F. Supp. at 1105.

76. Of particular interest is the case of *Kraus v. Kraus*, 159 Colo. 331, 411 P.2d 240 (1966), in which the issue was whether the court could make a cash property settlement in its discretion. The *Kraus* court stated:

Matters of property division and alimony rest within the sound discretion of the trial court Whether the wife has contributed to or in some manner aided in the accumulation or preservation of assets sought to be divided must be ascertained [by the court].

Id. at 333, 411 P.2d at 241-42.

77. 375 F. Supp. at 1111, citing *Shapiro v. Shapiro*, 115 Colo. 498, 175 P.2d 386 (1946).

78. 439 F.2d 757 (8th Cir.), cert. denied, 404 U.S. 831 (1971).

79. IOWA CODE ANN. § 598.14 (1950), as amended, § 598.21 (Supp. 1976).

because substantial evidence had been presented in each of those cases to show that the wife had contributed to the property in question either by her labor or her earnings. The Eighth Circuit stated that there was no evidence of contribution by the wife in *Wallace*.⁸⁰ The implication was that upon a showing of contribution by labor or earnings, the court might have found co-ownership in the property. While in many cases it is apparent that a wife has contributed substantially to acquisition of property through labor or earnings,⁸¹ it is unlikely that contribution would be found in the case of a wife who has remained a housewife.⁸² In order to find contribution under such circumstances, the court would have to view the marital estate as a joint economic unit.

A finding of substantial contribution through labor or earnings should suffice to characterize a wife as co-owner of jointly acquired property.⁸³ A nontaxable division of property would then be possible in those states which have discretionary property division statutes.⁸⁴

80. 439 F.2d at 761.

81. See, e.g., *Mills v. Commissioner*, 442 F.2d 1149 (10th Cir. 1971). In *Mills*, the court observed that the wife had acquired an interest in property accumulated during marriage through her efforts and skills. Her activities during the years of marriage were more extensive than those of an ordinary housewife. The payments in question were intended to be a property settlement—a division of the property in which the wife had acquired an interest by her contribution. *Id.* at 1151.

82. In *Pulliam v. Commissioner*, 329 F.2d 97 (10th Cir.), *cert. denied*, 379 U.S. 836 (1964), see note 17 *supra*, after finding a taxable event the court stated: "In this instance the wife performed the usual duties of a housewife, and performed no other tasks to specifically assist in the accumulation of property and brought no property into the marriage." *Id.* at 98.

The principle of contribution has long been recognized in the estate and gift tax provisions of the Internal Revenue Code. When there has been separate monetary contribution on the part of the wife, the entire value of the transfer is not taxable to the husband, and the wife's proportionate contribution to jointly held property is deducted from the husband's gross estate. INT. REV. CODE OF 1954, § 2040. The application of the contribution principle to property divisions under the income tax code would include recognition of contribution based on labor as well as earnings.

Under section 2516 of the gift tax code, when the husband and wife enter into a agreement relating to marital and property rights and a divorce occurs within two years, any transfers of property pursuant to the agreement are deemed to be made for full and adequate consideration and no gift tax is owed. INT. REV. CODE OF 1954, § 2515.

83. Thus, marital property in common law jurisdictions would be subject to the same tax consequences as community property and the wife would be given a statutory interest in recognition of her contribution to the property.

84. An example of the harsh result that can occur if there is a taxable rather than a nontaxable division of property is the situation in which the major or sole asset of the husband is ownership of a closely held business corporation. If the husband is forced to transfer an interest in the business to the wife he may be confronted with a large tax liability and no funds to satisfy the obligation.

IV. CONCLUSION

As a result of both *Collins IV* and *Imel*, it is now possible to have a nontaxable division of appreciated property and avoid the harsh consequences of *Davis* in a common law state.⁸⁵ It remains unclear, however, whether the Tax Court will allow the *Imel* result without a definitive ruling designating the property interests as a species of co-ownership by the highest court in the state.

Imel may result in more trial courts finding ownership in the wife created by substantial contribution toward the acquisition of property when state statutes are similar to those in Oklahoma or Colorado. Such a characterization may be given great weight by higher courts in light of the *Imel* result.

In *Imel*, neither the husband nor the wife was taxed on the division of the property. The transferee took the transferor's basis. Upon the sale of the property, the transferee will recognize capital gain on the difference between the adjusted basis and the sale price. The elevation of the wife to the status of co-owner or species of co-owner therefore results in a tax disadvantage to the wife, since her basis in the property will be lower and thus her capital gains greater upon its disposition. This disadvantage, however, could be lessened by a more equitable division of the property acquired after marriage. When jointly acquired property is distributed on the basis of contribution, each party would receive a just share and the tax burden would also be borne equally.

In a common law state in which the *Davis* result is expected, the transferor may be reluctant to transfer jointly acquired property since the tax consequences may be severe. Under the *Davis* rationale, the transferor may be left with a huge tax bill and no property or income as a result of the transfer. Ownership criteria cited in *Davis*, such as descendibility and the right to control and manage, do not have great relevance to the modern view of marriage as a joint economic unit in which both partners aid in the joint acquisition of property. For this reason state property and divorce statutes in common law states should be revised so that jointly acquired property can be justly divided.

Recognition of the concept of jointly acquired property through contribution would tend to obliterate the distinction between common law and community property states. Revisions of the tax code in the past have been

85. It should be noted that the Uniform Marriage and Divorce Act, a model code written by the National Conference of Commissioners on Unified State Laws, recommends that division of property be based on need and contribution. The Act also recognizes a spouse's contribution through care and maintenance of the home. UNIFORM MARRIAGE AND DIVORCE ACT § 307 (alternative A and B).

aimed at equalizing such differences.⁸⁶ Unless or until Congress amends the income tax code to exclude the possibility of finding a taxable event upon the transfer of appreciated property pursuant to a divorce, a nontaxable division in common law states can only be achieved through the courts with the help of the state legislatures. *Imel* illustrates how the courts can equalize the effect of the tax law without any amendment to the tax code. At the present time, however, without a ruling from the highest court in the state defining the property interest, the transfer of appreciated property in divorce or separation may be found to be a taxable event and the additional tax costs of such a transfer must be calculated in all property settlements in common law states.

Ellen S. Deutsch

86. See, e.g., Revenue Act of 1948, 62 Stat. 110. See also Brown, *Conflict of Laws Between Community Property and Common Law States in Division of Marital Property on Divorce*, 12 MERCER L.R. 287 (1961); Rudick, *Federal Tax Problems Relating to Property Owned in Joint Tenancy and Tenancy by the Entirety*, 4 TAX L.R. 3 (1948).