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INCOME TAX CONSEQUENCES OF DIVIDING MARITAL PROPERTY IN A MARRIAGE DISSOLUTION

Richard A. Munson*

I. INTRODUCTION

The Montana Legislature adopted a modified version of the Uniform Marriage and Divorce Act (UMDA) in the 1975 legislative session, effective for all dissolutions of marriage occurring after January 1, 1976.[1] Professor Herma Hill Kay, co-reporter of the commission that formulated the UMDA, summarized the intended thrust of the Act as an elimination of fault from the dissolution, maintenance and property disposition aspects of a dissolution of marriage; to substitute a "non-judgmental" process for the prior assignment of fault process under earlier law.[2]

The implementation of a "non-judgmental" disposition of property has been the subject of many decisions by the Montana Supreme Court since the enactment of the UMDA in Montana. Accordingly, the guidelines to be used by the district courts in settling a division of marital property are becoming fixed. Little judicial attention, however, has been given to the income tax consequences that result from a division of property in Montana. Contrary to the intent of all concerned, including the courts, a seemingly "non-judgmental" property settlement may result in unexpected economic hardship when income tax liability for the year of settlement is determined.

The central purpose of this article is to assist practitioners in determining and minimizing the adverse income tax consequences of a division of property. The complex rules in this area of income taxation are mainly concerned with the title to the property, whether the property is separately or jointly owned. While these rules seem, at times, to stray far afield, the basic premise, as developed in this article, remains the same: all transfers of separately owned property are taxable; divisions of "jointly owned" property in accordance with the property interests of each spouse are nontaxable.

After discussing the tax consequences of transferring sepa-

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1. MONT. CODE ANN. §§ 40-4-101 through -225 (1981).
2. *Uniform Marriage and Divorce Act Seminar*, 1975 Proc. Mont. B. 2.

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rately owned and jointly owned property, the article arrives at the suggestion that Montana law on property settlements encourages taxpayers, for Federal income tax purposes, to divide jointly owned property at the transfer or division of the marital property. To fully comprehend the effect of this suggestion, it is necessary to investigate all tax aspects of the division of jointly owned property, including the rules that have developed concerning joint ownership in community property states. Finally, the article concludes with a discussion of the role that district court judges must play in determining tax consequences of a property settlement ordered or approved by the court.

II. Division of Separately Owned Property

A summary of the tax rules that apply to a property settlement involving the transfer of separately owned property in a non-community property law state is shown by the following example:

> Husband[3] owns a parcel of real property which he bought in 1965 for $10,000 for investment purposes. In 1970 husband and wife are married and the property is worth $15,000. In 1982 the parties are divorced and husband transfers the property to wife pursuant to an amicable property settlement in return for wife releasing her marital rights in other property being retained by the husband, title to which is also in husband. At the execution of the deed conveying the real property, the parcel is worth $50,000, and the aggregate value of the property retained by husband is $50,000.

The division seems equitable, but an examination of the tax consequences reveals the tax and hence economic inequity created by the division:

> (1) Husband has realized a gain of $40,000, the character of which will be capital gain due to the investment nature of the asset. Because the capital asset has been held for more than one year, the gain is long term capital gain (LTCG). This gain is fully taxable to husband in the year the property is transferred. Although long term capital gain is taxed at very advantageous rates, $16,000 is taxed as additional income to husband in 1982.[4]
> (2) The Internal Revenue Service (Service) takes the position[5]

3. References to "husband" are intended to apply equally to the situation in which the transferor is the wife. *See* I.R.C. § 7701(a)(17) (1982).

4. The $16,000 amount is arrived at by reducing the gross amount of long term capital gain by I.R.C. § 1202 (1982) "Capital Gains Deduction" which is equal to 60% of the gross figure and assumes that husband has no capital losses in the year of transfer.

5. Rev. Rul. 67-221, 2 C.B. 63.

Munson: Tax Consequences

that wife has *no gain* upon the release of her marital rights in consideration for the conveyance of the land.

(3) Wife takes as her basis in the property received the fair market value of the property on the date of transfer.[6] Thus, in the example, the wife's basis for determining gain or loss on future disposition of the property is $50,000. If wife holds the property for investment, making it a capital asset to her, and further, if she holds it for the requisite one year period, any amount she realizes from a sale of the property in excess of her basis of $50,000, will be taxed at the favorable long term capital gain rates. Obviously, wife can sell the property for $50,000 or less, and have no tax liability.

A. United States v. Davis: *The Source of the Rules*

These consequences are dictated by the United States Supreme Court decision in *United States v. Davis.*[7] *Davis* arose in Delaware, a noncommunity property law state as is Montana. The case involved a transfer by the husband of some individually owned, and appreciated, property incident to a dissolution of marriage. The Service taxed the transfer, treating it as a sale of the property at its fair market value. The initial question presented to the Court was whether the transfer was taxable. The Court examined several basic concepts of the income tax codified in certain sections of the Internal Revenue Code (Code). Section 61(a)(3) provides that gross income includes all income, regardless of its source, including gains derived from dealing in property. Under section 1001(a), gain from the sale or other disposition of property is the excess of the amount realized over the adjusted basis as determined under section 1011. Section 1001(b) defines the "amount realized" as the sum of any money received plus the fair market value of other property received. The entire amount of the gain realized under section 1001, must be "recognized" under section 1001(c) unless provided otherwise in the Code.[8]

Finding that these general rules of taxation applied to the transfer, the Court held that the husband's transfer of appreciated shares of stock in full satisfaction of all claims and rights that the wife might have against the husband resulted in taxable gain to

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6. *Id.*
7. 370 U.S. 64 (1962).
8. If gain is "recognized," it is subjected to taxation in the tax year it is realized. A common "nonrecognition" provision is I.R.C. § 1033 (1982) commonly known as a "like-kind" exchange. Under nonrecognition, the gain is deferred and subjected to taxation in some later tax year.

the husband. In reversing the Court of Claims, the Supreme Court found that Congress, through section 61(a)(3), intended to tax any and all appreciation of property.[9]

Under the Court's analysis, the only issue presented was when the appreciation should be taxed. Two options were available to the Court: (1) impose the tax on the transfer to the wife; or (2) impose the tax when the wife sells or disposes of the property received in the settlement. In holding that the former option was the proper consequence in this case, the Court rejected the husband's argument that the transfer was merely a nontaxable division of property between co-owners. The Court analyzed the rights granted to the wife under Delaware law and found that the wife's rights were not those of a co-owner of property, but rather were a "personal liability" of the husband.[10]

The Court found that the husband received "property" in exchange for his transfer in the form of the release of wife's inchoate marital rights.[11] The Court established the value of these rights by relying on a Court of Claims case which held that if there is an arms length dealing between two individuals, the values of the two properties exchanged are either equal in fact or are presumed to be equal.[12] The Court admitted that there were problems with viewing the property settlement as an arms length transaction due to the emotions and tensions involved along with practical necessities dictated by the divorce and property settlement,[13] but the Court concluded that it was inconsistent with the purpose and scheme of taxation to ignore the tax consequences of the transfer.[14]

The Court, in a footnote, recognized the Service's view that no gain is realized by the wife in these situations.[15] The Court also states in *Davis* that the wife's basis in the shares of stock she received is equal to the fair market value of the property released by her,[16] which of course is equal to the fair market value of the stock received from the husband.

B. *Application of the Rules*

The message from the United States Supreme Court in *Davis*

9. United States v. Davis, 370 U.S. 64, 68 (1962).
10. *Id.* at 70.
11. *Id.* at 72.
12. *Id.* The Court relied on Philadelphia Park Amusement Co. v. United States, 126 F. Supp. 184, 189 (Ct. Cl. 1954).
13. *Id.*
14. *Id.* at 72, 73.
15. *Id.* at 73, n. 8.
16. *Id.* at 73.

is clear: a transfer by the husband to the wife of separately owned appreciated property will result in taxable gain to the husband. The following example shows the disaster that may result from a transfer of separately owned property:

> Husband, a single man, buys 10,000 acres of grassland from his widowed mother at $10 per acre in 1945. In 1952, husband and wife are married and from that date forward wife works with husband on the ranch. Cattle are purchased and sold by husband and wife as joint owners. The title to the grassland however remains in husband alone.
>
> In 1982, husband and wife are divorced. Proceeds in the bank accounts are divided equally and, in recognition of wife's twenty-nine years of labor and contribution, the district court orders an equal division of the 10,000 acres of unencumbered grassland.
>
> Without much thought as to tax consequences, husband executes a deed to wife conveying 5000 acres to wife on the 15th of September, 1982, the date of the divorce decree. Upon audit of the husband's 1982 tax return, the Service assesses a tax deficiency based on the transfer. It is determined that in 1982 a neighbor made a bona fide offer to purchase the grassland from husband at $125 per acre. No other evidence being available, $125 per acre is determined to be the fair market value of the land.

What appeared to be "an equal division" of property is now transformed into a tax trap:

> Husband has a taxable gain of $115 per acre or a total gain of $575,000 computed as follows: Amount realized ($625,000) less husband's adjusted basis ($50,000) equals gain realized of $575,000, which will be "recognized". This gain will qualify for long term capital gain treatment under Section 1231(b) and 1222(3) of the Code, and assuming that husband has no other capital transactions in 1982, $230,000 of that gain will be taxable at husband's marginal rate which will be 50%.[17] Thus, without considering other income or deductions of husband, some $115,000 will be due the Internal Revenue Service.[18]

The probable result of the tax assessment is a sale of all or a portion of the husband's retained grassland to pay the taxes. This sale will also result in tax liability, but this liability will be borne by husband in the year of actual sale subsequent to 1982.

Conversely, the wife can sell her 5000 acres of the land at $125

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17. The $230,000 amount is calculated by reducing the gross amount of long term capital gain by the I.R.C. § 1201 (1982) "Capital Gains Deduction" which is equal to 60% of the gross figure and assumes that husband has no capital losses in the year of transfer.

18. This tax "bill" does not consider the possible effects of income averaging under I.R.C. § 1301-1305 (1982) or the Alternative Minimum Tax under I.R.C. § 55 (1982).

per acre (the fair market value at the date of transfer from husband) and will have no taxable gain: amount realized ($575,000) less the adjusted basis ($575,000) equals no realized gain.

Husband's advisors should suggest alternatives to a conveyance of the land. Some possible alternatives are:

(1) Husband can borrow a sum of money, using the land as security, equal to one-half the fair market value of the land and pay wife in cash:
(a) the borrowing of the money and mortgage of the property is not a taxable event;[19] and
(b) transfer of cash in exchange for release of the marital rights does not result in taxable gain to either husband or wife under the *Davis* rules.
(2) As a second alternative, husband's attorney can present to the court a tax analysis of the proposed settlement, considering tax consequences. For example: if husband were to transfer 4500 acres to wife, the gain realized by husband would be $517,500 of which $207,000 would be taxed.[20] Husband's marginal rate will be 50%, thus there will be a tax of approximately $103,500. If we look at the value of the 5500 acres retained by husband as being $687,500 (5500 acres x $125 per acre) less the $103,500 tax, husband is left with a value of $584,000 and wife's property has a value of $562,500. Thus, by merely reducing the amount of property transferred by 500 acres we have reached a much more equitable division of the property.

In summary, the rules of *Davis* should be considered in all proposed property divisions incident to a dissolution under the UMDA, and the possible tax results should be presented to the client for his consideration. *Davis* cannot be ignored if there is a transfer of separately owned appreciated property.

III. Division of Jointly Owned Property

Most married couples in Montana own a large portion of their marital estate as joint tenants with right of survivorship or as tenants in common. A property settlement in these instances consists of severing the joint ownership, and if needed to provide an equitable division, a cross-transfer of separately owned property. *Davis* applies to these property settlements to the extent the division varies from the interest of each spouse in the jointly owned property.

19. Woodsom & Associates, Inc. v. Comm'r., 198 F.2d 357 (2d Cir. 1952).
20. The same computations are made here as at *supra* note 17.

A. *Revenue Ruling 74-347: The Service's Position*

Revenue Ruling 74-347[21] applied the *Davis* rules to a property settlement involving jointly owned property. Neither spouse owned much property at the time of marriage. The salaries of each spouse were commingled during marriage and tracing of individual assets to individual earnings were impossible. The jurisdiction involved was a noncommunity property law state which provided an inchoate right in each spouse's separately owned property similar to dower and courtesy. The jurisdiction also made provisions for an equitable distribution of property on divorce.

The total fair market value of all property owned at the date of divorce was $110,000, of which $70,000 was jointly owned and $40,000 was in the husband's name alone. The divorce decree divided the property equally: the wife got $55,000 worth of property and the husband got a like amount. By the terms of the decree, the husband was allowed to retain his $40,000 of separate property, receiving $15,000 of the jointly owned property. The adjusted basis of the jointly held property given to the wife was $27,500.

The Ruling concluded that the husband had made a taxable transfer under the *Davis* rule even though all the property was divided equally on the basis of ending value.[22] The Service found that there was *an unequal division of the jointly owned property* and that the law of the jurisdiction did not give the wife an interest in husband's separate property which amounted to co-ownership. The Service, therefore, held that the husband recognized a gain of $10,000:

(1) Amount Realized: Property received by wife of $55,000 less one-half the jointly owned property ($35,000) equals $20,000 which is husband's amount realized;

(2) Adjusted Basis: To determine the adjusted basis of the excess jointly held property transferred to the wife, the Service used this formula: adjusted basis =

$$\frac{\text{net fair market value of excess jointly owned property received}}{\text{fair market value of all jointly owned property received}} \times \text{adjusted basis of jointly owned property received}$$

Applying this formula to the facts of the ruling:

21. Rev. Rul. 74-347, 1974-2 C.B. 26.
22. *Id.*

$$A/B = \frac{\$20,000}{\$55,000} \times \$27,500$$

$$A/B = \$10,000$$

(3) Gain Realized: The amount realized of $20,000 less the adjusted basis of $10,000 equals a $10,000 gain that is recognized.

As unfair as this result may seem, the Service is not taking an unsupported position in Revenue Ruling 74-347. It seems accepted that an unequal division of community property is taxable. Further, in *Robert K. Stevens*[23] the Tax Court held that a taxable transfer occurred when the husband, pursuant to court order, transferred to the wife his interest in some jointly owned real estate; his gain realized was the amount by which the fair market value of his interest exceeded the adjusted basis.

B. *The Rationale for the Taxable Event*

The taxable event occurs because of the unequal division of jointly owned property resulting from the *Davis* rationale: the husband conveyed *appreciated* property in consideration of wife's release of any claims she might have to the property retained by husband; the wife's release is deemed to be an item of property equal in value to the property she received. This theory can lead to some very odd results:

> Husband and wife own $100,000 of jointly owned property with an adjusted basis of $10,000. Husband, anxious for a dissolution of the marriage, agrees to convey all his right, title and interest in the property to wife if wife will agree to a speedy dissolution. The bargain is consummated and a dissolution is obtained.

Husband takes nothing from the marriage—except a tax bill. Under the *Davis* rationale, the wife's claim is presumed to have a value equal to the value of the property received: the husband's $50,000 worth of jointly owned property.[24] Thus, the difference between the $50,000 amount realized and husband's one-half of the $10,000 adjusted basis is husband's realized and recognized gain.

Revenue Ruling 74-347 sets forth this rule: in any situation where one spouse receives more than his interest (presumably one-half) in jointly owned appreciated property and where local law does not accord that spouse an interest in the other spouse's individually owned assets which rises to the status of co-ownership, *the spouse receiving less than a one-half interest in the jointly owned*

23. 38 T.C. 345 (1962).
24. *Philadelphia Park Amusement Co.*, 126 F. Supp. 184 (Ct. Cl. 1954).

property will realize a taxable gain.

C. *Achieving an Equal Division*

How is an equal division of property implemented? As Revenue Ruling 74-347 implies, the Service has held that an equal division or partition of jointly owned property does not result in recognition of gain.[25] The Service concluded that a division based on approximately equal "ending values" is nontaxable.[26] Therefore, receipt of various assets owned jointly but of equivalent value will be treated as nontaxable, thereby deferring the tax recognition until the property is sold by the recipient.[27]

D. *The Optimum Settlement*

The Service and the courts have shown the practitioner the way to minimize taxation when the marital property consists solely or largely of jointly owned property. The tax consequences attendant to a dissolution dictate an equal division of jointly owned property with each spouse retaining his separate property. For example, in *Zell v. Zell*,[28] the Montana Supreme Court upheld the district court's division of property giving each spouse one-half of the joint tenancy property, and leaving the property owned by each spouse individually with that spouse. No adverse tax consequences would be caused by the property division ordered by the district court.[29]

IV. A Species of Common Ownership

A property settlement by division of jointly owned property rather than transfer of separately owned property is preferable for tax purposes. Accordingly, it is necessary to determine if property is jointly owned *for tax purposes*. The Service stated that property may be co-owned where:

(1) Title is to be 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.[30]

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25. Rev. Rul. 56-437, 1956-2 C.B. 507.
26. Rev. Rul. 81-292, 1981-2 C.B. 158.
27. Practitioners must still be careful in analyzing the fairness of the disposition by analyzing the inherent gain caused by the carryover of basis in each asset to the spouse receiving it.
28. 174 Mont. 216, 570 P.2d 33 (1977).
29. *See supra* notes 25 and 26.
30. Rev. Rul. 74-347, 1974-2 C.B. 26-27.

The following discussion examines the third category of joint ownership by reviewing three cases decided by the supreme courts in the noncommunity property law states of Oklahoma, Colorado and Kansas. These cases all hold that the applicable dissolution laws create a "species of common ownership" in marital property similar to community property. Thus, in these states, property settlements which appear to be based on transfers of separately owned property are transformed into divisions of jointly owned property, achieving substantial income tax advantage. There are important similarities between these cases and current Montana law which raise the possibility of applying this doctrine to property settlements under the UMDA with the attendant tax consequences.

A. Collins v. Oklahoma Tax Commissioner

Collins began in the Tax Court,[31] which held that a transfer of appreciated property by the husband incident to a divorce in Oklahoma was taxable under the rule of *Davis*. The husband appealed, but the Tenth Circuit Court of Appeals upheld the ruling of the Commissioner.[32]

The Oklahoma taxing authority also asserted a tax liability, but the Oklahoma Supreme Court found that the property division did not subject the husband to any state tax liability because:

> (1) the property divided was acquired during marriage (marital property);
> (2) applicable state law *required* the district court to divide marital property "as may appear just and reasonable" upon divorce;
> (3) under Oklahoma law, "the nature of the wife's interest is similar in conception to community property of community property states, and is regarded as held by a species of common ownership."[33]

The settlement, therefore, amounted to a nontaxable division of jointly owned property.

During the pendency of the state action, husband had appealed the decision of the Tenth Circuit Court of Appeals to the United States Supreme Court. The Supreme Court remanded the Tenth Circuit Court of Appeals' decision for consideration in light

31. 46 T.C. 461 (1966) *acq.* 1970-2 C.B. XIX, *aff'd.*, 388 F.2d 353 (10th Cir. 1968), *vacated and remanded*, 393 U.S. 215 (1968), *rev'd. and remanded*, 412 F.2d 211 (10th Cir. 1969).

32. 388 F.2d 353 (10th Cir. 1968).

33. Collins v. Okla. Tax Comm'n., 446 P.2d 290, 295 (Okla. 1968).

of the Oklahoma Supreme Court holding.[34] On remand, the state decision was followed, and the Commissioner's determination of a tax deficiency was reversed.[35]

Collins was the first state supreme court case in a noncommunity property state to find that the applicable state divorce laws "create" a species of common ownership in marital property. In analyzing the Oklahoma statute providing for the division of property, the Oklahoma court emphasized that the divorce court was *required* to make a division of property that was "just and reasonable."[36] The applicable Oklahoma statute read in part as follows:

> As to such property, whether real or personal, as shall have been acquired by the parties jointly during their marriage, whether the title hereto 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.[37]

The court in *Collins* found that the record title of marital property was irrelevant[38] and that "although one spouse brings separate property to the marriage, enhanced value resulting from joint efforts, skills or funds of both working together constitutes jointly acquired property subject to division."[39] The Oklahoma Supreme Court also compared the Oklahoma statute to the Delaware statute considered in *Davis* and found a "complete dissimilarity": the wife's rights under Oklahoma law were those of ownership, not merely a personal liability of husband.[40]

Collins was narrowed in its scope by the Oklahoma Supreme Court's holding in *Sanditen v. Sanditen*[41] that the wife's ownership interest in property acquired during marriage "depends upon occurrence of a statutorily enacted contingency such as divorce, separation, inability to support, homestead and death, all of which emanate from the marriage relationship. A wife then has no vested interest in property acquired during coverture but a contingent interest which the law protects."[42] The "vesting" of this contingent

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34. 393 U.S. 215 (1968).
35. 412 F.2d 211 (10th Cir. 1969).
36. *Collins*, 446 P.2d at 295.
37. *Id.* at 295. OKLA. STAT. Tit. 12 § 1278 (1961).
38. *Collins*, 446 P.2d at 295.
39. *Id.*
40. *Id.* at 296.
41. 496 P.2d 365 (Okla. 1972).
42. *Id.* at 367.

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interest takes place, under the reasoning of the Oklahoma Supreme Court, by reason of divorce and not by reason of the marriage relationship itself.[43] *Sanditen* involved a claim by a wife alleging that her husband made gratuitous transfers to defendants over a period of time of property acquired by the joint efforts of wife and her husband during marriage and that those transfers were made with the intent to defraud her of her marital and vested rights. The Oklahoma Supreme Court rejected the wife's argument that she had a vested interest in jointly acquired property. The Oklahoma Supreme Court distinguished and limited the holding in *Collins* by finding that the property interest of the wife vested only "by reason of the divorce pendency under our statute and not by reason of the marriage relationship."[44]

The similarities between Oklahoma law, as described in *Collins*, and present Montana law are:

> (1) The property division made upon a dissolution is statutorily directed to be made on an "equitable" just and reasonable basis;[45]
> (2) The status of the title of the property is largely irrelevant in determining the equitable division;[46]
> (3) The wife's "contribution" must be considered by the court in making the equitable division.[47]

B. *Questions re* Imel v. United States

The holding in *Collins*, as interpreted and limited by *Sanditen*, was adopted by the Colorado Supreme Court in *Questions re Imel v. United States*.[48] The taxpayer and his wife were married for thirty-five years. In 1964, a divorce was granted by a Colorado district court. The taxpayer and his wife negotiated a property settlement, assigning the wife one-half of the marital

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43. *Id.*

44. *Id.*

45. MONT. CODE ANN. § 40-4-202 (1981). *See also* Hebel v. Hebel, 176 Mont. 339, 578 P.2d 305 (1978) (district judge's discretion allowed him to dispose of any or all property, however acquired or held).

46. MONT. CODE ANN. § 40-4-202 (1981). *See also* Biegalke v. Biegalke, 172 Mont. 311, 564 P.2d 987 (1977) ("The title to or possession of property (except as to property not acquired by the joint efforts of the parties) cannot defeat the power of the Court to make such an adjustment").

47. MONT. CODE ANN. § 40-4-202 (1981). In determining "contribution," the court may consider cash contributions; work or effort directly furthering the acquisition or increase in value of marital assets; the performance of the ordinary duties of the wife or husband and any extraordinary services performed by the wife or husband; and other matters in the individual case which the court reasonably feels constitutes a "contribution, 'direct or indirect' to such acquisition." Biegalke v. Biegalke, 172 Mont. 311, 564 P.2d 987 (1977).

48. 184 Colo. 1, 517 P.2d 1331 (1974).

property (which at the date of divorce was in the name of the husband alone) in recognition of the wife's active contribution to the appreciation of the marital property. The Service assessed a tax deficiency against the husband of approximately $92,000 plus interest of almost $18,000.

The taxpayer paid the deficiency and claimed a refund. The United States district judge certified a question to the Colorado Supreme Court with regard to the wife's interest in the marital property.[49] The Colorado Supreme Court stated that the issue to be resolved was whether a transfer of property from the husband to the wife to acknowledge the wife's contribution to marital property was a recognition of a "species of common ownership" and thus a division of property or whether the transfer was a conveyance by the husband for the release of an "independent obligation owed by him to his wife."[50]

The Colorado Supreme Court found that the wife's interest in the marital property amounted to a species of common ownership, citing with approval the holding of *Collins* as explained and limited by *Sanditen*.[51] The Colorado Supreme Court found that upon the filing of a dissolution petition, the wife's interest in marital property "vested".[52] The source of the vested interest was the Colorado statute which directs the district court to divide marital property "in such proportions as may be fair and equitable."[53] The Colorado Supreme Court held, as did the Oklahoma Supreme Court in *Sanditen*, that the interest of the wife was merely an inchoate right during marriage because the property to be transferred to her had not yet been determined.[54] The court stated that "except for those rights which vest upon the filing of the divorce action, we in no way change the Colorado law that a husband's property is free from any vested interest of the wife and, with a possible exception of two, he can sell it or give it away."[55]

C. Cady v. Cady

Kansas became the latest state to find "a species of common ownership" existing under state divorce law. In *Cady v. Cady*, de-

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49. Imel v. United States, 375 F. Supp. 1102 (D. Colo. 1974), *aff'd.*, 523 F.2d 853 (10th Cir. 1975).

50. *Imel*, 184 Colo. at 3, 517 P.2d at 1332.

51. *Id.* at 6-7, 517 P.2d at 1333-34.

52. *Id.*

53. *Id. See* COLO. REV. STAT. § 46-1-13 (1963).

54. *Id.* at 9-10, 517 P.2d at 1335.

55. *Id.* at 8, 517 P.2d at 1334-35.

cided in 1978, the Kansas Supreme Court stated:

> We hold that a filing of a Petition for divorce or separate maintenance creates a species of common or co-ownership in one spouse in the jointly acquired property held by the other, the extent of which is determined by the trial court pursuant to K.S.A. 1972 Supp. 60-1610(b). Except for those rights which vest by virtue of the filing of the divorce action, we in no way change the interest of one spouse in the property held by the other or in the ability of the other spouse to convey, sell or give away such property. Our decision is in accord with the cases decided by the Oklahoma and Colorado Supreme Courts.[56]

In *Cady*, the husband and wife were married in 1956, and were divorced in 1973. The decree incorporated a property settlement which provided for alimony and a division of property. The husband agreed to assign to the wife 50,000 shares of stock held in his name, while retaining other stock. All the stock had been acquired during marriage. The Service issued a deficiency against the husband on the basis of *Davis*.

The husband sought a declaratory judgment in the Kansas state courts to determine the nature of the wife's interest. On the basis of the Kansas statute,[57] prior Kansas case law, and the decisions of *Collins* and *Imel*, the Kansas Supreme Court held that the division of property at issue was a division of jointly owned property and not a transfer of separate property. The Kansas legislature later codified the holding by amending the definition of marital property to provide that "each spouse has a common ownership in marital property which vests at the time of commencement of such action [for dissolution]."[58]

D. *Establishing the Species of Common Ownership Doctrine*

Both *Imel* and *Cady* distinguished federal court decisions which had previously determined that neither Colorado nor Kansas law gave the wife vested ownership rights in property acquired during marriage and held in the husband's name.[59] The *Davis* doctrine is still viable in noncommunity property law states. A federal

56. 224 Kan. 339, 581 P.2d 358, 363 (1978).

57. KAN. STAT. ANN. § 60-1060(b) (1972).

58. KAN. STAT. ANN. § 23-201(b) (1981).

59. The Colorado Supreme Court in *Imel* distinguished an earlier tenth circuit case, David R. Pulliam, 39 T.C. 883 (1963), *aff'd.* 329 F.2d 97 (10th Cir. 1964), *cert. denied*, 379 U.S. 836 (1964). In *Cady* the Kansas Supreme Court distinguished the case of Richard E. Wiles, 60 T.C. 56 (1973), *aff'd* 449 F.2d 255 (10th Cir. 1974), *cert. denied*, 419 U.S. 996 (1974).

district court in Iowa rejected the *Collins* rationale.[60] The Tax Court held in *Dunn v. Commissioner*, that under Tennessee law wife has no vested interest in property acquired in husband's name during marriage and therefore, a transfer of that property in a property settlement is a taxable transaction.[61] Accordingly, absent statutory provisions implementing the doctrine,[62] it appears that a holding by a state supreme court is necessary before residents of that state may successfully urge the "species of common ownership" doctrine.

E. *Montana and the Species of Common Ownership Doctrine*

To determine the existence and effect of the "species of common ownership" doctrine in Montana, two questions must be answered: (1) whether the *Collins-Imel* rationale is consistent with Montana law; (2) whether the *Collins-Imel* holding would eliminate the tax problems identified in parts II and III of this article. Assuming that the Montana Supreme Court is presented with the first question,[63] a decision following the *Collins-Imel*[64] rationale could be rendered based on the present status of Montana law.

As the examination of the *Collins*, *Imel*, and *Cady* decisions shows, the basic concepts of Oklahoma, Colorado, and Kansas law relating to property divisions on dissolutions are very similar to those of Montana law.[65] On the basis of these similarities, Montana law also may be distinguished from the Delaware law applied in *Davis*.[66]

The change in tax consequences caused by finding a species of common ownership is generally favorable from the taxpayer's perspective. The concern is the extent of change or uncertainty in other areas of Montana law that would be caused by the *Collins-Imel* holding. The *Imel* court rejected the contention that a finding of a species of common ownership would make Colorado a community property state.[67] The Colorado Supreme Court stated that its holding in *Imel* caused no change in Colorado law other than the

60. Wallace v. U.S., 439 F.2d 757 (8th Cir. 1971).

61. T.C. Memo 1977-156, 36 T.C.M. 664.

62. *See, e.g.*, ILL. ANN. STAT. ch. 40, § 503(c) (Smith-Hurd 1981); MO. ANN. STAT. § 452.330 (Vernon 1982); N.C. GEN. STAT. § 50-20(k) (1981).

63. An initial consideration is in what context this issue will be presented to the Montana Supreme Court. It appears that the issue will not arise in any context other than a tax controversy.

64. *See supra* text accompanying note 51.

65. *See supra* text accompanying notes 44-46.

66. *See supra* text accompanying note 43.

67. 184 Colo. 1, 8, 517 P.2d 1331, 1335 (1974).

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vesting of an inchoate property right on the filing of a petition for dissolution of marriage.[68] Apparently, vesting would necessitate having both spouses join in the conveyance of property during the pendency of a dissolution proceeding. This does not appear to be a major change as most practitioners presently require the "non-titled" spouse to join in any conveyance for the purpose of releasing his potential claim under the Montana elective share statutes.[69] Other substantial or adverse changes are not apparent.

Does utilization of the *Collins-Imel* rationale eliminate all tax complications? It can be suggested that the only effect of finding a species of common ownership is to place the property division under the rules governing divisions of jointly owned property and that an unequal division of all marital property would have tax consequences similar to those of an unequal division of property owned as joint tenants or community property.[70] Alternatively, it might be suggested that finding a species of common ownership does in fact result in the property division being completely nontaxable in all cases decided in a jurisdiction adopting the species of common ownership approach. The Tenth Circuit Court of Appeals rendered decisions in both *Imel* and *Collins* and language can be found in both decisions supporting the argument that the state supreme court decision in each case rendered the property settlement nontaxable.[71]

Application of either suggestion will result in a general rule of no taxable gain because of the very unique property interest accorded the non-titled spouse in the *Collins-Imel* rationale. An accepted but unstated proposition in the decisions of both the *Collins* and *Imel* state courts is that while the marital property may not have been *equally* divided, each spouse got an amount of property proportionate to his property interest. The only transfer, therefore, is a division of property according to interest without any rearranging of ownership of rights. For example, if tenant in common Smith contributes one-third of the purchase price for a parcel of real estate, and tenant in common Jones contributes the other two-thirds, any subsequent division of the property on a basis other than the one-third/two-thirds ratio is a taxable transfer between the tenants in common. The same rule applies to marital property in which the non-titled spouse has a species of common ownership: the wife's equitable share of marital property corre-

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68. *Id.*
69. MONT. CODE ANN. §§ 72-2-701 through -707 (1971).
70. Rev. Rul. 74-347, 1974-2 C.B. 26. *See also* text accompanying notes 88-106.
71. *See, e.g., Imel*, 523 F.2d at 857.

sponds to her proportional interest in the marital property. It follows that there can never be a division of marital property (assuming one that is equitable and just) in a species of common ownership jurisdiction that does not correspond to each spouse's property interest. Community property is somewhat different in that once property becomes in fact an asset of the marital community, each spouse has equal ownership rights, and therefore, anything varying from an equal division is taxable.

Finally, then, utilization of the *Collins-Imel* rationale will eliminate tax complications of a property settlement involving distribution of marital property in kind to each spouse. Nonetheless, divisions or settlements involving, for example, transfers of nonmarital cash or issuance of a promissory note to equalize divisions will be taxable. This proposition is based on the development of the "bargain and sale" doctrine in income taxation of property settlements in community property states. As indicated, this doctrine applies when, for example, the husband gives the wife his promissory note in exchange for the wife's interest in the family business. The Tax Court has deemed this to be a "sale" by the wife through a "bargain" with the husband similar to a sale by one tenant in common to another of his interest in property.[72] This doctrine could have application to a species of common ownership state because once the wife's interest in the marital property vests upon filing of the petition for divorce, any subsequent disposition of that interest, to the husband or any third party, will be a taxable event.

Accordingly, it is necessary to review the taxation of divisions of community property to complete the tax analysis of the species of common ownership rationale.

V. Community Property

The Tax Court has recently stated the general rule governing the tax consequences of a property settlement in one of the eight community property states:

> Where divorcing spouses in community property states make an approximately equal division of the entire community property, the partition is nontaxable, and the basis of the property set aside to each spouse is its basis to the community prior to the division.[73]

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72. Carrieres v. Comm'r, 64 T.C. 959 (1975), *aff'd per curium*, 552 F.2d 1350 (9th Cir. 1977).

73. Courtney L. Siewart, 72 T.C. 326 (1979). The eight community property states are: Arizona, California, Idaho, Louisiana, Nevada, New Mexico, Texas, and Washington.

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For example, a husband and wife own $30,000 in cash and $30,000 in stock, with the stock having been acquired in 1976 for $10,000 with the title in the husband's name alone. Upon divorce the wife takes the stock and the husband retains the cash. In California, for example, there would be no gain to either husband or wife, and the wife would take a $10,000 basis in the stock.[74] An approximately equal division according to ending value is nontaxable in a community property state.[75]

A. *Taxable Divisions of Community Property*

Not every division of community property is nontaxable. In *Courtney L. Siewert*, decided in 1979, the Tax Court cites two situations where a division of community property is taxable: (1) where one spouse received property having an aggregate value equal to substantially more than half the value of the entire community property; and (2) where one spouse gave his note or other separate property for a substantial portion of the other spouse's community property set aside to him.

The first taxable situation is the same as an unequal division of jointly owned property in a noncommunity property law state.[76] The second taxable situation is exemplified by *Carrieres v. Commissioner*,[77] in which the husband was awarded all of the wife's community property share of stock in the family's closely held corporation. In exchange, the husband was required to give up his share of other community property, and to equalize the division, he also had to come up with some "separate property" (cash). The Tax Court held that to the extent the husband used his separate property to pay for the wife's interest in the stock, the wife made a sale to the husband and had to recognize gain accordingly.[78]

To the extent husband, however, used his interest in other community property to acquire the stock, no gain was realized.[79] To illustrate this point, assume that a husband and wife own the following property:

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74. A *Collins-Imel* state would reach the same result. *See supra* text accompanying notes 34-43.

75. Frances R. Walz, 32 B.T.A. 718 (1935), and Rev. Rul. 81-292, 1981-2 C.B. 158, would presumably lead to the same result in a *Collins-Imel* state.

76. *See supra* text accompanying note 21. This first taxable situation should not occur in a *Collins-Imel* jurisdiction because property interests are not solely 50/50 but vary with the equitable division.

77. 64 T.C. 959 (1975), *aff'd. per curium*, 552 F.2d 1350 (9th Cir. 1977).

78. *Id.*

79. *Id.*

PROPERTY	ADJUSTED BASIS	FAIR MARKET VALUE
Cash	$ 20,000	$ 20,000
Real Estate	10,000	60,000
Family Business	0	200,000

The realty and business are in the husband's name alone, but in order to make the division in line with community property rules, the court orders the following division:

PROPERTY	HUSBAND	WIFE
Cash	$ 10,000	$ 10,000
Real Estate	30,000	30,000
Family Business	200,000	—
Note given by husband to wife to equalize value	(100,000)	100,000
TOTAL	$140,000	$140,000

Under *Carrieres*, the wife is treated as having sold her community property interest in the business for the husband's note, a "bargain and sale." Thus, the wife has gain of $100,000, the character of which is probably long term capital gain.[80] The wife's basis in the note is $100,000 if she should be able to sell (discount) the note. The wife will take a carryover basis in the other property. For example, she will have a $5000 basis in her share of the real property.[81]

If we put the parties in a *Collins-Imel* type of separate property state and assume the wife's interest in the marital property entitles her to one-half of such property, the results should follow the community property rules. Thus, a holding that follows the *Collins-Imel* rationale results in the "tax" of dissolution being transferred from husband to wife just as in the bargain and sale situation. The reason for the tax bears repeating: the wife's rights have risen to the status of ownership rather than a claim on her

80. The Service could treat the transaction as being a sale of an interest in each asset of the business and allocate the $100,000 accordingly. However, the wife can argue that the asset sold was her property interest, a capital asset. The analysis of the "bargain and sale" doctrine becomes very complex if, unlike *Carrieres*, more than one marital asset is left with the husband thereby requiring determination of which asset has been sold. For an excellent analysis of this problem, see Biblin, *Divorce, Taxes and Community Property: Some Current Cases, Problems and Concerns*, U.S.C. TAX. INST. 571 (1978).

81. In a nontaxable division (or assets that are not deemed sold) there is a carryover basis. *See supra* text accompanying note 85. Under the bargain and sale theory, the adjusted basis of the "buying" spouse is equal to one-half of the original adjusted basis in the property plus the amount of consideration paid to the selling spouse. Rouse v. Comm'r., 6 T.C. 908 (1946), *aff'd* 159 F.2d 706 (5th Cir. 1947).

husband's assets, and thus the transaction is a disposition of the wife's ownership rights rather than a satisfaction of the husband's personal obligation.

VI. Summary of Parts II-V

To recapitulate, in an analysis of possible tax consequences of a proposed property settlement in Montana, the following must be addressed:

How does title to the property stand?

(a) If the property is owned solely by one of the spouses, subject only to an equitable claim of the other spouse on dissolution, *Davis* rules will apply as detailed in part II of this article.

(b) If the property is jointly owned in joint tenancy, community property, or the "*Collins-Imel*" species of common ownership, it must be determined whether:

(1) there is a nontaxable division of the property according to property interests;

(2) there is a taxable division of the property differing from the property interests as discussed in part III of this article; or

(3) there is a taxable "bargain and sale" involved as discussed in part V of this article.

The questions to be asked are relatively simple. The issues raised, however, by the *Collins-Imel* holding recognizing a species of common ownership and the application of the bargain and sale theory pose difficulties.

VII. The Role of the District Courts

This article began with the suggestion that any proposed property settlement should be analyzed as to income tax consequences. While the best time for this analysis to occur is at or before final negotiation of the settlement, a Montana district court has the duty to inquire into the "concrete" tax consequences of a court ordered division of property.

The Montana Supreme Court has held that a district court must consider "any concrete and immediate adverse tax impact that a division of marital property might have on the parties."[82] Conversely, the court has also held that a district court "does not abuse its discretion by refusing to consider theoretical tax consequences when the court ordered property division does not con-

82. Beck v. Beck, ____ Mont. ____, 631 P.2d 282, 285 (1981).

template any taxable event which triggers present tax liability."[83]

To make the distinction between "concrete" and "theoretical," a district court must inquire into the tax consequences of every property settlement. While the Montana Supreme Court decisions could be read to require an analysis of tax consequences only in those situations where the district court is making the division, it seems equally important for the district court to determine whether or not the parties to a negotiated settlement have considered the tax consequences before the court can approve the settlement as being equitable. Further, it is prudent for practitioners to make representations to the court in every case as to the tax analysis undertaken in structuring the property settlement. The central problem with considering every settlement is the expense in those cases involving minimal property. It may be possible for the parties to waive the analysis in a negotiated settlement, but the court should be apprised of and approve such a waiver.[84]

VIII. CONCLUSION

Montana law now requires a consideration of "concrete" tax consequences of a division of marital property. Once an analysis has begun, which set of rules apply? While present Montana law places Montana taxpayers in a position to argue that the *Collins-Imel* rule applies, until the Montana Supreme Court so rules or the legislature acts, the *Davis* rule will continue to govern in Montana with its largely negative results from the taxpayer perspective.

The intrusion of potentially disastrous tax consequences into the already emotional process of dissolving a marriage is unfortunate, but adoption of the *Collins-Imel* rationale will substantially lessen that intrusion.

83. *Id.* (citing Gilbert v. Gilbert, ___ Mont. ___, 628 P.2d 1088 (1981)). For a discussion of these two cases and the distinction between "concrete" and "theoretical" see Note, *Montana Supreme Court Survey—Family Law,* 43 MONT. L. REV. 317, 319 (1982). The most common example of a "concrete" consequence would be the sale of the family residence. *See In re* Marriage of Epstein, 24 Cal. 3d 76, 592 P.2d 1165, 154 Cal. Rptr. 413 (1979). "Theoretical" consequences would include tax consequences of a withdrawal of husband from a partnership at some future unspecified time. *See In re* Marriage of Fonstein, 17 Cal. 3d 738, 552 P.2d 1169, 13 Cal. Rptr. 873 (1976). It is suggested that "immediate" versus "speculative" would be more descriptive of the distinction the Montana Supreme Court was making in *Beck* and *Gilbert.*

84. The waiver issue has not been considered by the Montana Supreme Court and practitioners should consider the waiver suggestion as being made without express judicial authority.