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Form, Substance, and Section 1041

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FORM, SUBSTANCE, AND SECTION 1041

by Deborah A. Geier

Deborah A. Geier is assistant professor of law, Cleveland-Marshall College of Law, Cleveland State University. This article grew out of research and remarks prepared in connection with a "mini-program" entitled "Selected Issues in Taxation of the Family" presented by the Teaching Taxation Committee at the May meeting of the ABA Section of Taxation. The views expressed here are her own, however, and do not necessarily reflect the views of the committee.

The article reviews recent cases and rulings dealing with the interplay of section 1041 with both (1) the assignment of income doctrine in the deferred compensation context and (2) the substance over form doctrine in the context of redemptions of closely held stock. The author argues that such doctrines, which attempt to avoid improper shifting of income between taxpayers, are inappropriate in the context of section 1041 transfers in light of the history and goals of that section. She believes that final regulations adopted under section 1041 should ensure that the form of transfers or redemptions negotiated by the parties dictates the resulting tax consequences.

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I. Introduction

Internal Revenue Service attorney Edward Schwartz,[1] speaking at the May meeting of the Domestic Relations Committee of the ABA Section of Taxation, stated that the proposed 1993 IRS business plan included the finalization of regulations under section 1041 of the Internal Revenue Code. As reported in this publication, he disclosed that "[t]he Service may engage in a 'wholesale reconsideration' of regulations covering section[] 1041, rather than finalize the current proposed regulations. . . ."[2] This brief article advocates that, in revisiting those regulations, the Service ought not to forget the underlying purpose animating the enactment of section 1041.

The usual temptation in tax to elevate substance over form — not necessarily an evil temptation in other contexts — ought not to infect the regulations under section 1041, where form, indeed, should govern. The parties' plenary power to decide who between themselves will shoulder the tax consequences attaching to property should be confirmed in order to implement the "private ordering" implicit in section 1041[3] and to advance the certainty and simplicity behind section 1041. In this context, neither the fisc nor sound tax theory demand otherwise.

Specifically, the article argues that (1) the regulations ought to make clear that the Service no longer will invoke the common law assignment of income doctrine as a trump over the nonrecognition and exclusion rules of section 1041, and (2) Temporary Regulation section 1.1041-1T(c), Q&A 9, pertaining to "transfers on behalf of a spouse," ought to be either dropped or rewritten. The parties must be given the tools to ensure that the form of stock redemptions in

[1] Branch 6, Office of Assistant Chief Counsel (Income Tax & Accounting).

[2] "Domestic Relations Regulations Not Final Yet," *Tax Notes*, May 17, 1993, p. 881.

[3] "In the divorce context, private ordering simply means that the spouses should be free to determine the tax consequences and costs of their divorce arrangement and to allocate those costs inter se by private agreement." Leon Gabinet, "Section 1041: The High Price of Quick Fix Reform in Taxation of Interspousal Transfers," 5 *Am. J. Tax Pol'y* 13, 31-32 (1986).

closely held corporations, negotiated by them no doubt with the tax consequences in mind, will be respected for tax purposes, and the regulation may thwart that certainty. As a preface to those discussions, the article briefly reviews the evolution leading to section 1041 because that history informs the analysis of these issues.

II. The Enactment of Section 1041

Congress enacted section 1041 as part of the Deficit Reduction Act of 1984[4] expressly to overrule the result in *United States v. Davis.*[5] In 1955 and pursuant to a divorce decree, H transferred to his former spouse, W, shares of E.I. du Pont de Nemours & Co. that had a cost basis in H's hands of approximately $75,000 and a fair market value at the time of the transfer of approximately $82,250. In return, W released H from all claims, including dower and any rights under the laws of testacy and intestacy. Concluding that "the inchoate rights granted a wife in her husband's property by the Delaware law do not even remotely reach the dignity of co-ownership,"[6] the Supreme Court applied the marketplace rule that the transfer of property owned by one taxpayer to another taxpayer in exchange for the release of an independent legal obligation is a realization event.[7] Assuming that the value of the release of the inchoate marital rights equalled the value of the stock, the Court concluded that H realized a gain of approximately $7,250 on the transfer and that W took a cost basis of $82,250 in the stock.[8] The Court noted in a footnote the "administrative practice" of not taxing W on the release of marital rights.[9]

Congress enacted section 1041 expressly to overrule the result in United States v. Davis.

Had W possessed some sort of ownership interest in the stock at the time of the divorce, as in a community property state, the outcome might have been different. The transaction might have been viewed instead as a division of jointly owned property, which was not considered a realization event. The Court acknowledged, but apparently was not overly troubled by, the disparities its decision would create between community property states, in which no transfer might be deemed to occur on the division of marital property, and common law states.

The post-*Davis* era was one of confusion and uncertainty and certainly one full of traps for the unwary. It was also an era that witnessed state legislation that had as its goal the frustration of a federal tax case, the *Davis* case, while maintaining a common law property regime in other respects.

The Service conceded that approximately equal divisions of community property[10] or property in states where the law is "similar to community property law"[11] were not taxable; the transferee took a carryover basis and tacked holding period in the property. Similarly, the Service ruled that approximately equal divisions of property owned in joint tenancy or property held as tenants in common were nontaxable divisions of property, even though ownership wasn't partitioned but, rather, some assets went in their entirety to one spouse and some went in their entirety to the other.[12] Not all transfers in community property states were tax-free events, however. An exchange of separate (nonmarital) property for community property or an unequal division of community property resulted in taxation.[13] Similarly, unequal divisions of jointly owned property in noncommunity property states resulted in taxation.[14]

Davis required an examination of state law in order to determine whether the transferee of property had an existing property interest in the property received at the time of the transfer, notwithstanding that the transferor was the titleholder to the property. If the transferee in a common law state possessed an interest "similar to community property," the transferor might not realize gain on the transfer and the transferee would take a carryover basis, even though the property was not in fact community property or jointly held. This examination of state law enabled states to enact "anti-*Davis*" legislation, exemplified by Oregon's statute: "Subsequent to the filing of a petition for annulment or dissolution of marriage or separation, the rights of the parties in the marital assets shall be con-

[4]Deficit Reduction Act of 1984, Pub. L. No. 98-369, section 421(a), 98 Stat. 793 (1984). Amendments occurred in 1986 as part of the Tax Reform Act of 1986, Pub. L. No. 99-514, section 1842(b), 100 Stat. 2085 (1986) (dealing with transfers in trust of installment obligations or of property with liabilities in excess of basis), and in 1988 as part of the Technical and Miscellaneous Revenue Act of 1988. Pub. L. No. 100-647, section 1018(L)(3), 102 Stat. 3342 (1988) (dealing with transfers to nonresident aliens).

[5]370 U.S. 65 (1962).

[6]*Id.* at 70.

[7]*Id.* at 68-70. *Cf. International Freighting Corp. v. Commissioner*, 135 F.2d 310 (2d Cir. 1943) (transfer of appreciated property to employee in payment for services rendered is a realization event for transferor).

[8]370 U.S. at 71-74. *See Philadelphia Park Amusement Co. v. United States*, 126 F. Supp. 184 (Ct. Cl. 1954) (basis of property received in taxable exchange is fair market value of property received).

[9]370 U.S. at 73, n.7.

[10]Rev. Rul. 76-83, 1976-1 C.B. 213.

[11]Rev. Rul. 74-347, 1974-2 C.B. 26.

[12]Rev. Rul. 81-292, 1981-2 C.B. 158.

[13]*See, e.g., Siewart v. Commissioner*, 72 T.C. 326 (1979) (receipt by W of noncommunity cash and a personal note of H for transfer of her one-half interest in community property constituted a sale, not a division of community property); *Carrieres v. Commissioner*, 64 T.C. 959 (1975), *aff'd*, 552 F.2d 1350 (9th Cir. 1977) (*per curiam*) (taxable sale to W to the extent H used his separate property to pay for W's community interest in stock but no taxable sale with respect to the portion of such stock exchanged for H's interest in other community property).

[14]Rev. Rul. 74-347, 1974-2 C.B. 26.

sidered a species of co-ownership and a transfer of marital assets . . . shall be considered a partition of jointly owned property."[15] The equitable distribution statutes of other states often were interpreted to vest a property interest in the transferee in the case of a "special equity" determination. These eleventh-hour vestings of property rights during the course of divorces in non-community-property states most often were upheld by the courts as effectively eviscerating *Davis*.[16]

The reasons Congress cited in 1984 for the change in law were (1) the confusion and litigation under *Davis* and the resulting variance of results depending on state law, (2) the inappropriateness and intrusiveness of the marketplace realization rule in the context of marriage, (3) the whipsaw often experienced by the government, with the transferor spouse claiming a tax-free division of property and the transferee spouse claiming a stepped-up basis under *Davis* on later disposition, and (4) the reality that the uncertain rules often created a trap for the unwary.[17]

In general,[18] gain or loss technically realized under *Davis* and section 1001 on the transfer of appreciated or depreciated property is not recognized today by the transferor by reason of section 1041(a) if the transfer is between spouses or between former spouses if incident to divorce. Under sections 1041(b)(1) and 102, the transferee excludes as a gift the value of the cash or other property transferred even if adequate consideration is paid for property[19] and, under section 1041(b)(2), takes a carryover basis for purposes of computing both gain and loss on later disposition.[20] The transferee also takes a tacked holding period under section 1223(2).[21]

III. Interplay With Assignment of Income Doctrine

There is one sense in which broad assignment of income principles arise in the divorce context that is unexceptional. That is the case in which cash is transferred from one spouse to another and — as a factual matter — it is perhaps unclear (1) whether the spouse receiving the cash is merely receiving the cash equivalent value of his or her prior interest in marital property retained by the transferor spouse, which cash should be excludable under section 1041(b)(1), or (2) whether the recipient receiving the cash actually was the recipient of a prior property interest with respect to which the cash then was simply earned income, includable under section 61. If, as a factual matter, the recipient spouse actually received a prior property interest that then accrued income, the principle applied is that the owner of property is taxable on the income earned on that property. That is, such a transfer of a property interest earning subsequent income is an example of a successful assignment of income, and section 1041 is not going to shield the recipient spouse from including in income subsequent cash earned with respect to the prior property interest received. That, as said, is unexceptional.

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[15]ORS 107.105(1)(f) (discussed in *Laird v. United States*, 16 Cl. Ct. 441 (1989)).

[16]*See, e.g.*, *Collins v. Commissioner*, 421 F.2d 211 (10th Cir. 1969); *Imel v. United States*, 523 F.2d 853 (10th Cir. 1975); *Cook v. Commissioner*, 80 T.C. 512 (1983), *aff'd*, 742 F.2d 1431 (2d Cir. 1984); *Boucher v. Commissioner*, 710 F.2d 507 (9th Cir. 1983); *Bosch v. United States*, 590 F.2d 165 (5th Cir. 1979), *cert. denied*, 444 U.S. 1044 (1980); *McIntosh v. Commissioner*, 58 T.C. 4 (1986) (applying pre-1984 law); *Laird v. United States*, 61 Cl. Ct. 441 (1989) (applying pre-1984 law).

[17]*See* H.R. Rep. No. 432, 98th Cong., 2d Sess. 1491 (1984).

[18]Section 1041 currently reads as follows:

> (a) General Rule. — No gain or loss shall be recognized on a transfer of property from an individual to (or in trust for the benefit of) —
>
> (1) a spouse,
>
> (2) a former spouse, but only if the transfer is incident to the divorce.
>
> (b) Transfer Treated as Gift; Transferee Has Transferor's Basis. — In the case of any transfer of property described in subsection (a) —
>
> (1) for purposes of this subtitle, the property shall be treated as acquired by the transferee by gift, and
>
> (2) the basis of the transferee in the property shall be the adjusted basis of the transferor.
>
> (c) Incident to Divorce. — For purposes of subsection (a)(2), a transfer of property is incident to the divorce if such transfer —
>
> (1) occurs within one year after the date on which the marriage ceases, or
>
> (2) is related to the cessation of the marriage.

(Footnote continued in next column.)

(Footnote 18 continued.)

> (d) Special Rule Where Spouse is Nonresident Alien. — Subsection (a) shall not apply if the spouse (or former spouse) of the individual making the transfer is a nonresident alien.
>
> (e) Transfers in Trust Where Liability Exceeds Basis. — Subsection (a) shall not apply to the transfer of property in trust to the extent that —
>
> (1) the sum of the amount of the liabilities assumed, plus the amount of the liabilities to which the property is subject, exceeds
>
> (2) the total of the adjusted basis of the property transferred.
>
> Proper adjustment shall be made under subsection (b) in the basis of the transferee in such property to take into account gain recognized by reason of the preceding sentence.

[19]*See* section 1.1041-1T(d), Q&A 10, 11.

[20]The lower-of-fmv-or-carryover-basis rule of section 1015 for purposes of computing losses on property received as an *inter vivos* gift does not apply. *See* section 1015(e).

[21]*See generally* PLR 8719007 (Feb. 2, 1987) (illustrating operation of rules in typical case in which H transferred to W his one-half business interest in franchises previously owned one-half by W and one-half by H in exchange for cash payment of $1.2 million within the year of the divorce: (1) nonrecognition of gain or loss by H; (2) no income included by W on receipt of the one-half interest and no income included by H on receipt of the cash; (3) no depreciation or investment credit recapture; (4) W takes carryover basis in the one-half interest received, notwithstanding payment of $1.2 million; and (5) W takes a tacked holding period in the one-half interest received under section 1223(2)).

For example, H and W in PLR 9123053[22] resided in a community property state. One of the marital assets was H's "benefits," which were undescribed, in business N. No agreement regarding W's community property interest in the benefits was made at the time of their divorce. In a later year, however, H and W executed an instrument that provided for 60 monthly installment payments from H to W, which was considered the actuarial value of one-half of the benefits. The ruling reasoned that whether the payments constituted an excludable property settlement depended on the nature of what was transferred to W.

> The instrument executed in year B did not give Wife title to one-half of the Husband's Benefits in Business [N]. Rather, in consideration for Wife's community property interest, the instrument required Husband to pay Wife the cash equivalent of one-half of the Benefits. Accordingly, the payments are transfers of property between an individual and a former spouse, incident to divorce, and are nontaxable under section 1041 of the Code.[23]

Had the agreement confirmed title of one-half of the benefits in W, the ruling implies that W would have been taxable on the money received as owner of the property generating the income.

Such an example can be found in *Kenfield v. United States.*[24] H was a 50-percent partner in a partnership engaged in land sales, and the divorce decree provided that W was entitled to one-half of H's partnership interest (i.e., a 25-percent interest in the partnership). Because valuation was difficult, the court awarded the wife 50 percent of all "future net proceeds received" by H with respect to his original partnership interest. H duly paid over the amounts every year. The issue was whether H must include the full 50 percent of the partnership's income on his own return or whether H need include only 25 percent, with W including the remaining 25 percent, because of the court order vesting one-half of H's partnership interest in W.

The Tenth Circuit concluded that the transfer gave W ownership of one-half of H's partnership interest, and thus W must include in her gross income the income attributable to that property. "After the settlement, Kenfield did not own the asset that produced his ex-wife's share of the 1977 post-divorce income, i.e., his ex-wife's half of the partnership income. Kenfield thus also is not taxable on the partnership income earned by that asset."[25] If the court had concluded as a factual matter that W did not really receive an interest in the partnership, but rather was merely compensated for her marital interest in the partnership, then the results would have been different. H would have had to include the full 50-percent share of the partnership's profits on his own return, and the installment payments received by W to compensate her for her marital interest in H's partnership interest would be excludable today under section 1041(b)(1).[26]

But there is another context in which the Service's invocation of assignment of income principles is much more controversial. Recently, the Service has begun to invoke the assignment of income doctrine in the section 1041 context in order to trump the nonrecognition and exclusion rules in section 1041(a) and (b)(1), a practice

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[22](March 13, 1991).

[23]PLR 9123053 (March 13, 1991). Note that if these undescribed "benefits" constituted accrued deferred compensation in which W had a prior marital interest under community property law, the Service did not invoke the assignment of income doctrine to argue that W could not exclude the payments under section 1041(b)(1), as it has in other rulings. *Compare* PLR 8813023 (Dec. 29, 1987) (concluding that payments received by W that represented her marital interest in H's pension could not be excluded under section 1041(b)(1) under the assignment of income doctrine). *See infra* notes 36-40 and accompanying text (discussing ruling and subsequent litigation stemming from it).

[24]783 F.2d 966 (10th Cir. 1986).

[25]*Id.* at 968.

[26]Another ruling examining this issue was PLR 9143050 (July 26, 1991). H was the sole titleholder to patents on many inventions he had made. In 1977, H filed numerous lawsuits, later consolidated and still pending at the time of his divorce, against defendants, alleging patent infringement. W was not a party to the suit. In 1986, H filed for divorce. The revised order issued by the court granting the divorce required the spouses to divide any proceeds obtained by H from "various currently pending patent lawsuits in which he is the party plaintiff" by distributing to W x percent of any net proceeds received by H or for H's benefit. In 1990, H entered into a settlement agreement with one of the defendants for $Y. Out of his settlement, H paid W the requisite x percent. Because the payment to W of her x percent of any settlement or judgment relating to the patent lawsuit would not cease on her death, the amount was not alimony. *See* section 71(b)(1)(D).

Citing the assignment of income case of *Helvering v. Horst,* 311 U.S. 112 (1940), the ruling stated: "Income from property generally is taxable to the owner of the property." It continued:

> [T]he focus in this case is whether, pursuant to the Court's Revised Order, the Taxpayer became the owner of an interest in the income-producing property. If considered the owner of the income-producing property (that is, the Patents underlying the Patent Lawsuit), the taxpayer should be taxed under section 61 of the Code on any litigation proceeds received. However, if the taxpayer is merely entitled to payments from H measured by the cash equivalent of an x percent interest in the income-producing property, the payments received pursuant to the Revised Order would be nontaxable property transfers under section 1041(a).

Thus, while the ruling did not cite *Kenfield, supra* notes 24-25 and accompanying text, the analysis mirrored the analysis in that case. Unlike the result in *Kenfield,* however, the ruling concluded that the court did not transfer an ownership interest in the patents to W, because the laws of the state precluded the court from transferring ownership of personal or real property from one spouse to the other absent the transferor spouse's consent. The court could order only a monetary payment from H to W as an adjustment of the equities and rights of the parties arising out of the marriage. Because the payments to W represented part of the monetary award ordered by the court, and not a return on her ownership of the patents, the amounts were nontaxable under section 1041(b)(1).

excoriated by Professor Michael Asimow in his definitive article on the topic.[27]

> ***The Service has begun to invoke the assignment of income doctrine to trump the nonrecognition and exclusion rules in section 1041(a) and (b)(1).***

One must be concerned with the specter of the assignment of income doctrine whenever "sensitive assets," in Professor Asimow's nomenclature, are transferred between spouses or former spouses. "Sensitive assets" are those that, if given away, do not shift income to the donee and do not give rise to capital gain if sold. They include accounts receivable of an unincorporated, cash-basis, service business; an interest in a partnership that holds unrealized receivables or contracts to render personal services in the future; rights to royalties; investment assets with accrued but not-yet-recognized income; and, what I would like to focus on here as the most important example for most couples, deferred compensation, i.e., retirement benefits.[28]

First, a caveat. There is no question about who gets taxed on pension benefits that are covered by a statutory mechanism created in the Retirement Equity Act of 1984[29] called a "qualified domestic relations order," or QDRO, under section 414(p). Prior to creation of the QDRO, it was possible to split pension assets in a divorce, but the court order was directed at the spouse with the pension, rather than at the pension plan itself. For example, H might have been ordered by the court to pay one-half of his monthly pension payments to W when he begins to receive them — perhaps 20 years in the future. If H died before retirement, W received nothing. Under section 414(p), the pension plan administrator is the subject of the court order, and W receives vested rights. The administrator is ordered to treat W in our scenario just as if she were a plan participant. The "alternate payee" under a QDRO, W in our scenario, is taxed on the payments when ultimately paid by the pension, not H, as exemplified in PLR 8837013.[30]

QDROs can apply only to defined benefit and defined contribution plans such as 401(k) and profit-sharing plans. They cannot apply to individual retirement accounts or other deferred compensation arrangements. It is with respect to these other arrangements that the Service has argued, albeit inconsistently, that transfers of title of (or surrenders of community property interests in) rights to receive income cannot shift the burden of including the income that has already accrued. That is, in our situation in which H transfers to W rights to future payments that represent H's accrued interest in deferred compensation (considered owned solely by him in a common law state), the Service might argue that even though W receives the cash, H is taxed — either at the time of the transfer of title (how much?) or when W receives the cash years down the road. Similarly, if H and W live in a community property state and W receives a payment of cash to compensate her for a surrender of her marital interest in deferred compensation nominally owned by H, the Service might argue that the payment of cash nonetheless is taxable to W, notwithstanding section 1041(b)(1).

In exploring that scenario, I'd like to focus on three rulings,[31] one of which ended up as a case in the Tax Court. Taken together, they seem to be irreconcilable and give no coherent guidance regarding when the Service is going to invoke the assignment of income doctrine in this context and when it will not. They also thus demonstrate not only how unworkable the doctrine is in this context, but also how it undermines section 1041 by frustrating the results of the parties' negotiations.

The first is more of a pure statutory interpretation case. In PLR 8820086,[32] H proposed to transfer an undivided one-half interest in an IRA to the IRA of his spouse, W. The proposed transfer was not in contemplation of divorce. No mention was made regarding whether the state in which H and W reside is a community property state, a point to note in connection with the next two rulings. H requested a ruling that the transfer would not be considered a taxable distribution from his IRA subject to inclusion in H's gross income under section 408(d)(1).

Section 408(d)(6) provides that the transfer of an individual's interest in an IRA to a spouse or former spouse under a divorce or separation instrument is not to be considered a taxable transfer, notwithstanding any other provision, and that the transferred interest is to be considered owned by the transferee. Section 408(d)(6) originally was introduced as part of ERISA in 1974, a time when *Davis* made many such transfers taxable. The section was not repealed when section 1041 was introduced in 1984; in fact, a technical correction was made to it in the same act to delete a reference to the obsolete "qualified retirement bonds" repealed by the 1984 act.

The Service interpreted section 408(d)(6) as limiting nonrecognition to the divorce context and not the interspousal context by citing the rule of statutory construction that a specific rule (408(d)(1)) controls over a general one (1041(a)) and by citing the decision by Congress to retain section 408(d)(6) when it enacted

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[27] Michael Asimow, "The Assault on Tax-Free Divorce: Carryover Basis and Assignment of Income," 44 *Tax Law Rev.* 65 (1988).

[28] *Id.* at 93-94.

[29] Pub. L. No. 98-397, section 204, 98 Stat. 1445 (1984).

[30] (June 7, 1988). For a concise article on avoiding pitfalls in drafting effective QDROs, *see* Mary Rowland, "Splitting Up a Pension in a Divorce," *N.Y. Times* (National Edition), April 4, 1993, at 17.

[31] Other rulings to consult include Rev. Rul. 87-112, 1987-2 C.B. 207, and PLR 8707069 (Nov. 19, 1986).

[32] (Feb. 25, 1988).

section 1041(a) as evidence that Congress intended that section 408(d)(6) nonrecognition be limited to the divorce context. Thus, the Service ruled against H.[33]

Compare that result with the one in PLR 8929046[34] issued about a year later. That ruling also considered the tax consequences of an interspousal exchange, not incident to divorce, of interests in two IRAs, this time in order to transmute community property into separate property. The couple, who lived in a community property state, owned two IRAs: one for the sole benefit of H and one for the sole benefit of W. They executed a written agreement that transmuted the IRAs from community property to separate property, under which W transmuted her community property interest in H's IRA to the separate property of H, and H transmuted his community property interest in W's IRA, as well as some additional assets, to the separate property of W. Contrary to the prior ruling, the Service concluded that section 1041 applied and prevented the recognition of any gain. The ruling quoted the legislative history underlying section 1041 that emphasized that section 1041 extends literally to all transfers between spouses.

Query: How can these two rulings be reconciled? There are several possibilities: (1) The Service changed its position between the earlier and later rulings regarding the view that nonrecognition can apply to IRA transfers only in the divorce context; (2) the authors of the two rulings did not communicate;[35] and (3) the Service believes that the two situations are substantively different because one involved the transfer of record title while the other involved only the surrender of a community property interest to the record titleholder. That last view is the most troubling, as it either reintroduces the distinction between community property states and states with laws "similar to community property" on one hand, and other states on the other hand — a distinction that Congress clearly intended to obliterate with the enactment of section 1041 — or it lends an inordinate distinction to whether there is a transfer of record title instead of merely a surrender of an interest in community property. That position, if indeed it is one, also is not pursued consistently, as exemplified in the next ruling, which ended up in the Tax Court.

In PLR 8813023,[36] W's marriage was dissolved in a community property state in December 1981. At that time, the Supreme Court's ruling in *McCarty v. McCarty*[37] was in effect, which held that a military spouse's retirement benefit was that spouse's separate property in community property states and thus not subject to division as part of the community property. Pursuant to the *McCarty* decision, the divorce decree stated that H's military retirement plan was the separate property of H. The *McCarty* decision subsequently was overruled by statute in the Uniform Services Former Spouses' Protection Act. W moved to modify the divorce decree to recognize her interest in H's military retirement plan and then agreed to relinquish her claims in exchange for three payments by H: $15,000 in 1986, $14,000 in 1987, and $13,000 in 1988. W requested a ruling that the payments were nontaxable transfers under section 1041(b)(1).

The ruling concluded that, because the interest surrendered by W was a right to future income already earned under the community property laws, the surrender constituted an assignment of income. The payments from H to W thus were includable in her gross income in the year received, notwithstanding section 1041. "[W] cannot escape the taxation of ordinary income by recharacterizing her assignment of the income as a nontaxable transfer of property under section 1041(a) of the Code."

The taxpayer went to the Tax Court, which ruled in her favor in *Balding v. Commissioner*.[38] The Tax Court concluded that the cash payments to W were "property" within the meaning of section 1041, and thus excludable,[39] notwithstanding the argument made by the government that the assignment of income doctrine required taxation of the three payments. In a footnote, the Tax Court expressly declined to rule whether the assignment of income doctrine might apply in future years when actual payments were made under the plan to H, but it cited Professor Asimow's article "[f]or an argument that petitioner is not required, under the Assignment of Income Doctrine, to take into income any portion of the retirement benefits. . . ."[40]

Query: How can the Service's position in *Balding* be reconciled with its position in the 1989 ruling concerning the tax-free exchanges of community property interests in IRAs as well as some additional property to the separate property of the spouse who had record title? In each instance, a community property interest in a retirement plan was surrendered to the record titleholder. In the IRA ruling, the Service ruled that the surrender of the interest was not taxable under section 1041, making no mention of the assignment of income doctrine, while in the *Balding* ruling and subsequent case, the Service argued, essentially, that one could never surrender the tax consequences of a community property interest in deferred compensation. The Service argued that whatever one received in exchange for the interest was taxable at that time. (One of the

[33]The amendment to section 408(d)(6) might have been purely ministerial in nature, a reflexive amendment as part of a search to delete all references to the obsolete "qualified retirement bonds." Thus construed, the amendment would not reflect a considered decision by Congress to limit nonrecognition to the divorce context.

[34](April 25, 1989).

[35]The author of the 1988 ruling was Allen Katz, chief, Employee Plans, Ruling Branch, while the author of the 1989 ruling was William A. Galanko, assistant chief counsel (Income Tax & Accounting), acting chief, Branch 6.

[36](Dec. 29, 1987).

[37]453 U.S. 210 (1981).

[38]98 T.C. 368 (1992).

[39]For an argument that these issues remain alive today because of the lack of a definition of "property" in section 1041, *see* Gabinet, *supra* note 3, at 15-31.

[40]98 T.C. at 373 n.8.

spouses in the IRA ruling received not only confirmed separate title to her own IRA but also to other property.)

How can the Service's position in Balding be reconciled with the 1989 ruling concerning the tax-free exchanges of community property interests in IRAs?

In his article, Professor Asimow attacks the invocation of the assignment of income doctrine in the marital context, stating: "In my opinion, application of assignment of income principles in the divorce context creates perverse results, dramatically undercuts section 1041, and produces little if any revenue for the Treasury (indeed, it may lose revenue)."[41] His argument is buttressed by the fact that Congress demonstrated an intent that section 1041 nonrecognition have a depth thought inappropriate in other nonrecognition contexts. For example, the 1984 House report stated that Congress intended that section 1041 nonrecognition apply to transfers of property even in the situation thought abusive in other nonrecognition contexts, as exemplified by section 357(c): that in which the transferor mortgages out appreciated property on the eve of transfer and then transfers the property subject to the mortgage.[42] This intent shows the depth of this nonrecognition provision as compared to other nonrecognition provisions, i.e., the extent to which Congress intended that no tax consequences should arise in the marital context — period — even in situations thought abusive in other nonrecognition contexts.

The rulings demonstrate that even if the Service is determined to invoke the assignment of income doctrine in this context, it has not done so consistently, leaving taxpayers with very confusing guidance with respect to deferred compensation not covered by a QDRO.

IV. Interplay With Redemptions of Closely Held Stock

When the family business is incorporated in a closely held corporation, a divorce often involves a redemption of stock held by one spouse. The Service's ruling as well as its litigating position in this context is that form governs the tax consequences. The Ninth Circuit's position, and arguably that adopted in the temporary regulations, is that substance governs and can trump the form chosen by the taxpayers.

In PLR 9046004,[43] H owned 90 percent of Famil Corp; the remaining 10 percent was owned by H' brother and son. The corporation's bylaws and article of incorporation required shareholders to offer to se stock to the corporation and fellow shareholders befor a sale of stock to a third party. Pursuant to a divorc decree, H transferred stock amounting to 39 percent o the outstanding stock of Family Corp to W withou first offering it to the corporation or the other share holders. The stock then was immediately redeemec under the terms of the divorce decree, i.e., W held i only momentarily. Family Corp issued a promissory note to W in payment for the stock, guaranteed by H. Immediately after the redemption, H owned 83.6 percent of the outstanding stock directly and 90 percent of the outstanding stock constructively.

Though the ruling does not describe the potential tax consequences of the redemption depending on whose stock (H's or W's) is considered redeemed, they are radically different. If the form of the transaction is respected and W is considered the owner of the redeemed stock, she probably could obtain "exchange" treatment under section 302(a) and (b)(3) so long as the redemption occurred after she no longer was married to H, i.e., she would realize as capital gain or loss the difference between the amount of the distribution and her carryover basis in the stock. If H is considered the owner of the redeemed stock, who then transferred the redemption proceeds to W (excludable under section 1041(b)(1)), H would be taxed on the entire amount of the distribution as ordinary income under section 302(d) and the "other" *Davis* tax case,[44] so long as there were sufficient earnings and profits in the corporation.

The Service reasoned that, absent section 1041(a), this transaction would be viewed as a redemption of stock owned by H, followed by a transfer of the note from H to W, in light of the mandated redemption in the divorce decree. W would be considered a mere conduit. The Service concluded, however, that section 1041(a) changes this result because Congress intended to allow taxpayers to determine who will pay the tax on built-in gain. "The spouses are thus free to negotiate between themselves whether the 'owner' spouse will first sell the asset, recognize the gain or loss, and then transfer to the transferee spouse the proceeds from that sale, or whether the owner spouse will first transfer the asset to the transferee spouse who will then recognize gain or loss upon its subsequent sale."[45] (As described above, however, much more was at stake here than merely who would recognize the built-in gain or loss. Both the amount taken into account and the character of that amount were implicated.)

That argument is persuasive. The parties agreed that W should be the one between the two of them to dispose of the stock outside the marital unit, and they

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[41] Asimow, *supra* note 27, at 84.

[42] *See* H.R. Rep. No. 432, 98th Cong., 2d Sess. 1492 (1984) ("This nonrecognition rule applies whether the transfer is for the relinquishment of marital rights, for cash or other property, for the assumption of liabilities in excess of basis, or for other consideration and is intended to apply to any indebtedness which is discharged."). The temporary regulations and a PLR give effect to this broad intent. *See* regulation section 1.1041-1T(d), Q&A 12; PLR 9250031 (Sept. 14, 1992).

[43] (July 20, 1990) *See also* PLR 8842072 (July 29, 1988).

[44] *United States v. Davis*, 397 U.S. 301 (1970) (redemption of stock of sole owner not in complete termination of interest is always considered a distribution "essentially equivalent to a dividend" within the meaning of section 302(b)(1)).

[45] PLR 9046004 (July 20, 1990).

structured the transaction accordingly. To have the negotiated arrangement disrupted with a "substance over form" argument undermines one of the animating purposes behind section 1041 — that the parties be given the power to decide between themselves who should carry the tax consequences regarding property dispositions — and radically changes, after the fact, the nature of the "deal" made by the parties.

> ***To have the negotiated arrangement disrupted with a 'substance over form' argument undermines one of the animating purposes behind section 1041.***

The Service also cited and relied on regulation section 1.1041-1T(c), Q&A 9, though that regulation seems to cut against the Service's position. In its entirety, the regulation provides:

> Q-9. May transfers of property to third parties on behalf of a spouse (or former spouse) qualify under section 1041?
>
> A-9. Yes. There are three situations in which a transfer of property to a third party on behalf of a spouse (or former spouse) will qualify under section 1041, provided all other requirements of the section are satisfied. The first situation is where the transfer to the third party is required by a divorce or separation instrument. The second situation is where the transfer to the third party is pursuant to the written request of the other spouse (or former spouse). The third situation is where the transferor receives from the other spouse (or former spouse) a written consent or ratification of the transfer to the third party. Such consent or ratification must state that the parties intend the transfer to be treated as a transfer to the nontransferring spouse (or former spouse) subject to the rules of section 1041 and must be received by the transferor prior to the date of filing the transferor's first return of tax for the taxable year in which the transfer was made. In the three situations described above, the transfer of property will be treated as made directly to the nontransferring spouse (or former spouse) and the nontransferring spouse will be treated as immediately transferring the property to the third party. The deemed transfer from the nontransferring spouse (or former spouse) to the third party is not a transaction that qualifies for nonrecognition under section 1041.

Thus, a transfer to a third party "on behalf of" a nontransferring spouse, including transfers made under the terms of a divorce decree, will shift the tax consequences of the disposition outside the marital couple from the spouse who actually makes the transfer to the nontransferring spouse. Substance governs over form. The transferred property is viewed as first going to the nontransferring spouse (with a carryover basis) and then to the third party, triggering the tax consequences at that point.

The regulation likely has an ameliorative purpose and likely was intended to further the ability of the parties to negotiate who should bear the tax consequences of property dispositions outside the marital unit. Without the regulation, the only way to ensure that spouse 1 is burdened with the tax consequences of a disposition of property to a third party is to ensure that spouse 1 is the sole titleholder before the transfer and thus actually makes the transfer in form. If spouse 2 were the sole titleholder, spouse 2 would have to transfer the title to spouse 1 before the disposition to the third party. That transfer might trigger the imposition of unwanted state transfer taxes. The regulation allows the tax consequences to be shifted to spouse 1 without an actual prior transfer of title from spouse 2 to spouse 1. In that sense, the regulation is ameliorative and furthers the private ordering implicit in section 1041. As demonstrated in *Arnes*, discussed below,[46] it might not work out that way in practice, however, and thus might create more damage than it is worth.

In the facts of the ruling, for example, it seems to me that this regulation, applied literally, means that the actual transfer from one of the spouses (W here) to a third party (Family Corp here) should be considered as being made "on behalf of" the nontransferring spouse (H here) because it is made pursuant to the divorce decree. That is, the transfer of the stock by W to the third party (Family Corp) as mandated by the divorce decree should be considered as a transfer on behalf of H, the nontransferring spouse, shifting to H the tax consequences of the transfer to the third party. The only way to rule otherwise by citing Q&A 9 would be to ignore the actual transfer from H to W before the transfer to the third party, which the ruling expressly declined to do; it made it clear that the transfer to W was given effect. In a confusing passage using the word "transferee" spouse instead of "transferring" or "nontransferring" spouse, the ruling concluded:

> Q&A 9 is based on the premise that the transferee spouse, by directing that the property be transferred to a third party, has exercised sufficient ownership over the property to be considered a transferee for purposes of section 1041 of the Code. In the present case, Ex-Wife agreed to immediately transfer the stock to the corporation. Thus, by agreeing to immediately redeem the stock, the wife exercised a form of "ownership" and under Q&A 9, became the party responsible for the tax consequences of the transfer to the corporation.[47]

While that quotation makes no sense, the Service's position was clear that form will govern because of the "private ordering" intent behind section 1041. The parties could see that W owned the stock, if only for a moment, and so apparently bargained for the tax consequences to fall on her.

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[46] *See infra* notes 48-49 and accompanying text.

[47] PLR 9046004 (July 20, 1990).

In *Arnes v. United States*,[48] Joann and John Arnes each owned one-half of the stock of Moriah, a corporation formed to operate a McDonald's franchise. The couple agreed to divorce in 1987, and the settlement agreement required that Joann's stock be redeemed for $450,000. The payment would consist of forgiveness of a $110,000 debt Joann owed the corporation, two payments of $25,000 during 1988, and monthly installments of the remaining $290,000 over 10 years. Joann surrendered her 2,500 shares to the corporation, and the corporation shortly thereafter issued an additional 2,500 shares to John.

Joann viewed the transaction as a nontaxable transfer of her stock to John under section 1041 followed by a redemption of the stock by the corporation, the tax consequences of which would then fall on John. At the time of the redemption, John would be the sole shareholder of Moriah, so the redemption would be taxable under section 302(d) and *Davis*.[49] The entire distribution, not simply the amount in excess of basis, would be includable in full by John as ordinary income so long as Moriah had sufficient earnings and profits.

The Service argued that the form of the transaction should be respected in the divorce context, resulting in the tax consequences of the redemption falling on Joann. She would be entitled to exchange treatment under section 302(a) and (b)(3), meaning she would realize and recognize capital gain or loss on the difference between the amount of the distribution and her basis in the shares.

The only difference between the facts of this case and the facts of the prior ruling was that here Joann owned the stock that was redeemed under the divorce decree long before the divorce proceedings were instituted. In the ruling, H transferred to W the stock as part of the divorce decree, and the stock then was immediately redeemed as part of the same decree. If anything, the factual difference weighs even more heavily in *Arnes* for respecting the form of the transaction and analyzing the redemption as a redemption of W's shares. The court, however, citing and relying on section 1.1041- 1T(c), Q&A 9, which the Service garbled in its ruling, concluded that the transfer of the stock to the corporation was made "on behalf of" John, the nontransferring spouse, and thus the tax consequences of the disposition outside the marital unit were shifted to John. The Ninth Circuit thus would certainly view the outcome of the ruling considered above as incorrect.

Query: Why is the Service so willing to respect the form of a transaction that it explicitly states it would not respect outside the divorce context in the case of a redemption of closely held stock by arguing that section 1041 was intended to allow the parties to plan who should get taxed on the redemption (which often deals not with section 1001 "gain" but a distribution treated as a dividend) when it rejects that very argument in the assignment of income context? The approaches seem fundamentally inconsistent to me.

V. Conclusion

Three of the most common assets divided or transferred during marriage or divorce are the marital home, the rights to deferred compensation, and closely held stock in a family business. While the tax consequences arising on the transfer of the first are fairly straightforward under sections 1041, 121, and 1034,[50] the tax consequences arising on the transfers of the last two interests have, unfortunately, become mired in uncertainty, and an unnecessary uncertainty at that.

The two common law doctrines explicitly or implicitly invoked to challenge the form of the transactions discussed here are the assignment of income doctrine and the substance over form doctrine. In this context, both attempt to avoid improper shifting of income between taxpayers. But, by definition, there can be no "improper" shifting of income under section 1041. Indeed, what is considered "improper" in other contexts is not improper under section 1041; section 1041 contemplates just the kind of planning regarding the shifting of income thought to be a mortal sin elsewhere in the tax realm. The parties themselves were intended to be given the explicit power to negotiate who between the two should carry the tax burden regarding income and appreciation attaching to property interests and accruing during the marriage. Because of the special context in which it arises, the nonrecognition in section 1041 is of a breadth and depth not seen in connection with other nonrecognition sections of the code.

What is considered 'improper' in other contexts is not improper under section 1041.

Certainty should attach to the form the parties negotiate between themselves, a form that they understandably believe will dictate the tax consequences. The final regulations under section 1041 ought to confirm that.

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[48] 981 F.2d 456 (9th Cir. 1992).

[49] *See supra* note 44 and accompanying text.

[50] *See* Deborah A. Geier, "Section 1041: Transfers of Property Between Spouses or Incident to Divorce," in ABA Section of Taxation, 1993 *May Meeting Material*.