THE STORY OF DAVIS: TRANSFERS OF PROPERTY PURSUANT TO DIVORCE

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The United States Supreme Court's decision in *U.S. v. Davis* held that a transferor of property to a former spouse realized gain or loss as if he sold the property in an arm's length transaction for fair market value. It further held that the spouse who received the property in exchange for relinquishment of marital property rights took the property with an adjusted basis equal to its fair market value, assuring that the recipient would pay no tax on built-in appreciation. The decision created a furor in tax circles for several reasons. First, it worked a hardship on the transferor of property by adding to the complication of divorce settlements the additional cost of a tax on any built-in appreciation. Second, it created an inequity in treatment of divorcing couples. Those residing in community property jurisdictions were able to escape a tax on built-in appreciation because state law treated the husband and wife as co-owners in marital property. Transfers pursuant to divorce for these couples had no consequence because the transactions were viewed as nontaxable divisions of property by co-owners. Those couples, like the Davises, residing in a common law jurisdiction, owed a tax on the gain resulting from the deemed sale.

Despite the inequitable treatment of marital couples, the Supreme Court concluded that the integrity of the federal income tax base required inclusion of gains on the transfer of the separate property of the former spouse. Transfer of the asset in exchange for release from marital obligation marked an appropriation of gain by the transferor which justified imposition of a tax.

The Court called upon Congress, if it so chose, to correct the disparity created by different legal regimes.

Having concluded that Mr. Davis' transfer of property was a taxable event, the Supreme Court viewed it as an arm's length transaction in which the two properties exchanged – the separate property owned by Mr. Davis and the marital rights relinquished by Mrs. Davis – were presumed to be of equal value. By adopting this view, the Court rejected Mr. Davis' argument that no taxable event could arise from the divorce transfer because the property which he received had no ascertainable fair market value.

The *Davis* decision did not have a salutary effect on the development of federal tax law. It imposed a tax burden during a time when a couple's finances were unsettled and cash necessary to pay the tax was in short supply. In addition, the different tax consequences for a divorced spouse in common law and community property jurisdictions for substantially similar transactions led some common law jurisdictions to adopt complex state law changes designed to achieve nontaxation of property settlements incident to divorce. Even when one could discern state law rights to marital property, the complexity of the tax law consequences was daunting to all but the most sophisticated tax attorneys. For example, the result of a transfer could differ depending upon whether the wife exchanged her dower rights for her husband's separate property (nontaxable to her) or whether she exchanged her interest in jointly owned property for her husband's separate property (taxable to her).

Moreover, the complexity led to unintended failure to report property settlements. As a result, gain from transactions was not reported while the transferees were claiming a fair market value basis in the property received (thereby eliminating imposition of any tax on the gain). A final problem was the failure of the *Davis* decision to reflect the modern view of marriage as an economic partnership. State marital dissolution laws were increasingly based upon equitable distribution principles, which involved disposition of property on the basis of each spouse's contributions to the marital enterprise rather than on the basis of fault. Settlement of marital property according to equitable contribution principles would result in nontaxation of transfers because each spouse would be viewed as receiving property which was previously owned.

In response to the complexity and confusion arising out of property transfers incident to divorce, Congress enacted §1041 in 1984, which effectively repealed *Davis*. That section created a regime in which no gain or loss is recognized on any transfer of property between spouses and former spouses when the transfer is incident to divorce. The property is treated as having been acquired by gift, an amount which is excluded from gross income. The transferee spouse takes a basis in the property received equal to the transferor's adjusted basis, which shifts taxation of any built-in gain (or deduction of any deductible built-in loss) to the recipient.

Despite enactment of §1041, Davis retains vitality in four areas. It is authority for the proposition that properties exchanged in an arm's length transaction are presumed to have equivalent fair market values. This means that gain will be recognized on an exchange of property with a known fair market value for property of unknown fair market value. It also continues to support the rule that an exchange of property for any valuable right in a non-marital situation is a taxable event.

In addition, the *Davis* rule of taxation of exchanges continues to apply in the case of transfers between persons who are not married. Finally, *Davis* applies in the limited situation in which a property transfer to a former spouse is treated as not incident to a divorce because the transfer occurs long after the divorce proceedings have ended.

Although §1041 supersedes the *Davis* result in all cases except the four outlined above, the certainty which it provides is not an unqualified gain. The statute shifts the tax of gain on appreciated assets to transferees of property. A feminist critique of §1041 may conclude that this imposes an unacceptable burden upon divorced women with diminished resources, typically the bulk of marital property transferees, which may impede post-divorce financial rehabilitation.