Who Pays the Tax?: The Assignment of Income Doctrine, Code § 1041, and Dividing Non-Qualified Pensions

by Richard I. Zuber

There are some people who believe that lawyers ask the wrong questions just to receive the wrong answers.[1] A family law practitioner who contemplates agreeing to a property division dividing income derived from his or her client's labor or assets, or both, may unhappily discover that it is easy to ask the right questions and still obtain, from a tax perspective, the wrong answers. One reason for this enigma rests in the discord between a common law principle of taxation commonly referred to as the "assignment of income doctrine" and § 1041 of the Internal Revenue Code ("Code"). Another reason, endemic to the highly compensated spouse, is the adverse tax consequence that can result from the application of the assignment of income doctrine to the division of non-qualified deferred compensation plans.

This article attempts to unravel the enigma by exploring the potential tax consequences that may arise to a spouse or former spouse where there has been a failure to consider the applicability of the assignment of income doctrine to a property division. The article also considers whether Code § 1041 provides a tax-free safety net for "all" transfers of property between spouses or former spouses incident to a divorce. Finally, the article discusses tax commentators' perspectives on the inconsistent rulings addressing the tax consequences of interspousal transfers.

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Assignment of Income Doctrine

The assignment of income doctrine has been described by the U.S. Supreme Court as a first principle of taxation.[2] This doctrine stands for the proposition that "the one who earned the income is taxed on it regardless of who receives the proceeds."[3]

The doctrine first arose out of the 1930 U.S. Supreme Court case of *Lucas v. Earl*,[4] where a husband and wife mutually assigned to one another, in joint tenancy, all property that each had, or would thereafter acquire, including earnings from such things as salary and fees. Since the husband was the sole wage earner in 1920 and 1921, the IRS determined that he had underpaid his taxes for those two years by reporting only one-half of his income. The husband claimed that by reason of the prior assignment to his wife of one-half of his income, he should be taxed only on the remaining half. The Supreme Court held that while the contractual assignment of income by the husband to the wife was valid under state law, it was ineffective to shift income taxation to the wife. In an oft-quoted passage from the decision, Justice Holmes stated:

> There is no doubt that the [income tax] statute could tax salaries to those who earn them and provide that the tax could not be escaped by anticipatory arrangements and contracts however skillfully devised to prevent the salary when paid from vesting even for a second in the man who earned it. That seems to us the import of the statute before us and we think that no distinction can be taken according to the motives leading to the arrangement by which the fruits [income] are attributed to a different tree [person or income producing property] from that on which they grew.[5]

Ten years after its decision in *Lucas*, the U.S. Supreme Court held in the case of *Helvering v. Eubank* that anticipatory or future assignments of income also are taxable to the assignor.[6] In the companion case of *Helvering v. Horst*, the Supreme Court held that income assigned from income-producing property should be taxed to the owner of the income-producing property, on the theory that the power to dispose of income is the equivalent of ownership of the income.[7] Despite the apparent simplicity of the assignment of income doctrine, intriguing cases have arisen over the years that have made the applicability of the doctrine exceedingly complex. As one commentator points out, "The fruit of the tree doctrine is easier to state than apply."[8] Despite the difficulty where the doctrine is at issue, courts have generally focused on three key factors:[9] who earned the income;[10] what was transferred;[11] and whether the transfer was for adequate consideration.[12]

The reason the courts focus on the question of "what was transferred" rests with the fact that the assignment of income

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doctrine is not only applicable to those cases where the transferred income was earned by the labor of the taxpayer. As noted above, in situations where income was earned from income-producing property owned by the taxpayer, the underlying property, as well as the income derived therefrom, must be transferred before the assignment of income will be deemed effective to shift taxation. In deciding whether the underlying property has, in fact, been transferred, many cases have centered on whether the transferor relinquished control of all of the benefits and burdens of ownership and not simply title.[13]

Noteworthy on the relinquishment of control issue are those cases that hold that the assignment of future income as collateral is not sufficient to transfer the taxability of that income, based on the theory that the transfer was a loan and not a substantive sale.[14] Further illustrative of the applicability of the doctrine and the tax court's consideration of what was transferred are those cases addressing gifts of lottery and sweepstakes tickets. In the case of the assignment of a lottery ticket, there will be an effective transfer of income to the donee only if the transfer of the ticket is made prior to the selection of the winning ticket.[15] However, with an Irish sweepstakes ticket that is transferred after the horse is selected but before the race, the assignment of income doctrine can result in an allocation of income between the transferor and the transferee. This result can occur where the horse that is selected by the transferor causes the value of the ticket to appreciate in the hands of the transferor prior to the gift. In such a case, the transferor is taxable on the guaranteed value of the ticket at the time of transfer to the extent it is in excess of his or her basis, but not on the remaining proceeds eventually realized (by the transferee) on a winning ticket.[16]

The third relevant factor in determining the applicability of the assignment of income doctrine concerns the question of whether the transfer has been at arm's length for adequate consideration. In cases where there has been an arm's-length transaction involving an anticipatory assignment of income in return for consideration, the transferor is taxed only on the consideration received and the transferee is taxed on the amount collected in excess of his or her basis.[17] However, as is common, assignments of income frequently occur among family members, and as such are closely scrutinized by the courts to determine if there was, in reality, a gift for less than adequate consideration with the intent to avoid taxation.[18]

What Is Not Covered By Code § 1041

The law is clear that Code § 1041(a) provides a tax-free safety net for many transfers of property between spouses or former spouses incident to a divorce. Enacted in 1984 to alleviate the burden to taxpayers resulting from the *U.S. v. Davis*[19] decision and to provide a uniform federal standard, § 1041(a) provides:

> (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 or
> (2) A former spouse, but only if the transfer is incident to the divorce.

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While the non-recognition of gain or loss provisions of this Code section are mandatory[20] and are frequently looked on as a benefit by divorcing spouses, experienced family law practitioners should be aware that there can, nevertheless, still arise problematic tax consequences resulting from a transfer of property qualifying as a Code § 1041 transaction.[21] Further, while the provisions of § 1041(a) are broad enough to cover many transfers of property between spouses and former spouses (incident to a divorce) there exist Code and common law exceptions negating tax-free applicability of what could arguably qualify as § 1041(a) transfers.[22] For example, the Code exceptions include transfers of negative basis property into a trust;[23] transfers of installment obligations into a trust;[24] transfers to non-resident alien spouses;[25] premarital transfers;[26] and the interest component of installment obligations between spouses.[27] Not to be overlooked are the consequences that can occur from transfers of property between former spouses arising more than a year after the divorce, which are not related to the cessation of marriage.[28]

Further, since the 1984 enactment of Code § 1041, the IRS, the tax courts, and tax commentators have recognized in certain instances that the common law assignment of income doctrine qualifies as an exception to the tax treatment normally afforded a transfer of property between spouses or former spouses incident to a divorce.[29] Unfortunately, the nature and full extent of the doctrine's application to transfers between spouses and former spouses incident to a divorce remains unclear. One commentator suggests that the lack of clarity stems, in part, from the failure of Congress to statutorily define in § 1041 the tax treatment of (1) assignments of income that accompany transfers of the underlying asset or (2) a transfer of assets that represent a right to receive income.[30]

Acting to fill the statutory vacuum left by Congress and contributing further to the current uncertainty in the law, in 1987 the IRS published Revenue Ruling ("Rev. Rul.") 87-112. This Ruling concerned the issue of whether a transferor spouse who transferred individually owned U.S. savings bonds to a former spouse incident to a divorce was required to recognize as income in the year of transfer the deferred, accrued, and unpaid interest attributed to the bonds. The IRS concluded:

> Although § 1041(a) of the code shields from recognition *gain* that would ordinarily be recognized on a sale or exchange of property, it does not shield from recognition income that is ordinarily recognized upon the assignment of that income to another taxpayer. Because the income here is accrued but unrecognized interest rather than *gain*, § 1041(a) does not shield that income from recognition.[31]

One treatise indicates that Rev. Rul. 87-112 still represents the current view of the IRS that "transfers of accrued income such as accrued interest, dividends, or rent to a spouse or former spouse incident to a divorce remain taxable to the transferor spouse without regard to § 1041."[32] While the IRS continues to maintain that the assignment of income doctrine principles apply to what arguably could be considered Code § 1041(a) transfers, there remains uncertainty as to how the tax court views this issue.

In the 1992 Tax Court decision of *Balding v. Commissioner*,[33] a wife, incident to a divorce, relinquished her community property interest in the husband's military retirement pay in return for a cash settlement payable to her over three years. The IRS argued that the wife's relinquishment of her community property interest constituted an anticipatory assignment of income from the wife to the husband such that the consideration she received from the husband was immediately taxable to her. The Tax Court disagreed with the IRS argument and held that the transfer and/or release by the wife of her community property rights to the husband in return for compensation was incident to a divorce and thus was a non-taxable transfer under Code § 1041.

However, in note 8 of the *Balding* decision, the Tax Court left open the question of the potential future applicability of the assignment of income doctrine, so as to possibly require the wife to recognize income at such time that the retirement plan payments were in fact made to the husband.[34] This footnote, which has been subject to much discussion by commentators, provides, *inter alia*:

> We do not here deal with the tax consequences to Petitioner (Wife) of retirement payments made by the government on account of Balding's retirement. Accordingly, we have no occasion to consider whether the assignment of income doctrine would require Petitioner's share of those retirement payments to be taken into Petitioner's income as paid by the government to Balding, notwithstanding Petitioner's lack of entitlement to such payments.[35]

While it appears to some experts that the *Balding* court inferentially determined that Code § 1041 supersedes the assignment of income doctrine, tax commentators are of varying opinions. Some believe that, in light of note 8, such a conclusion is premature and the law is still developing in this area.[36] Others believe that the facts in *Balding* should be viewed as two separate and independent transactions for tax purposes. These latter commentators suggest that there is existing authority to support the application of the assignment of income doctrine so as to tax the wife on the husband's receipt of the wife's relinquished community property share of the retirement payments.[37]

It also is noteworthy in assessing the complexity in this area that the IRS, in arguing for the application of the assignment of income doctrine in *Balding*, relied on a state's community property law to charge the non-wage-earning spouse with having assigned income to the actual wage earner.

In 1994, two years after *Balding*, the IRS once again asserted, in the case of *Kochansky v. Commissioner*, the applicability of the assignment of income doctrine to a divorce-related transfer.[38] In *Kochansky*, the Tax Court upheld the IRS's conclusion and found that the entire income earned by the attorney/husband as a contingent fee in a malpractice case was includable in his gross income, despite the fact that the wife received a portion of the contingent fee incident to a divorce settlement. The Ninth Circuit, primarily relying on *Lucas* (discussed above), upheld the tax court's determination.[39] It is important to note that the Ninth Circuit decision did not discuss the possible applicability of Code § 1041 to the transaction.[40] Further, since the husband had not originally raised the issue in the Tax Court, the Ninth Circuit refused to consider the husband's plausible defense that there was no assignment of income because the wife already had a community property interest in the contingent fee that she was awarded incident to the divorce.[41]

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On February 8, 2000, the CBA Litigation Section and the Colorado Trial Lawyers Association ("CTLA") co-sponsor "Dialog With the Judiciary." Colorado Supreme Court Justice Gregory J. Hobbs, Jr. will be the presentor at this brown bag lunch, and the topic of his presentation will be "A Former Water Lawyer's View of Torts."

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Problematic Distributions

Since the enactment of the Employee Retirement Income Security Act of 1974 ("ERISA"), non-qualified deferred compensation plans have become an increasingly popular vehicle for employers to further compensate their executives and other highly compensated employees.[42] The plans have allowed employers to offer their highly paid employees retirement income approximating their pre-retirement pay by avoiding the dollar limit restrictions imposed on employer contributions and benefits provided under tax-qualified plans.[43]

While the non-qualified deferred retirement plans have been proven to be relatively free of regulating guidelines or restraint, they have not escaped the scrutiny of the IRS. In a request for a private letter ruling following the entry of a divorce decree, the IRS was asked, by the former wife of a baseball player, to address the question of which former spouse owed the tax resulting from a court-ordered distribution to the wife from the husband's non-qualified deferred compensation plan.[44] Since the wife was required, under the decree, to reimburse the husband for any taxes he incurred, at his rate, resulting from pension plan distributions to the wife, she requested a ruling that she be treated as the owner of the deferred compensation amounts awarded to her and thus be taxed at her rate.

The IRS found that, while Congress had provided a statutory framework for dividing "qualified" retirement plans between ex-spouses, so that each spouse would be taxed on the benefits he or she received, no such framework existed relative to the non-qualified deferred compensation plan under consideration. As a result, relying on the common law assignment of income doctrine and note 8 of the *Balding* decision, the IRS held that the baseball player, and not his former spouse, would be taxed on amounts distributed to the wife from the husband's income-producing asset. The IRS did not address the applicability of Code § 1041(a) in its letter ruling to the facts of this case.

Moreover, it is noteworthy that in arriving at its conclusion that the assignment of income doctrine was applicable, the IRS, as it had done in the *Balding* case, sought to determine the parties' ownership interest in the non-qualified deferred compensation plan under state law. In reviewing South Carolina law, the IRS concluded that, while some types of pensions had been held under state law to be marital property, and therefore subject to equitable distribution, there were no cases that addressed the status as property of a non-funded, unsecured, non-qualified compensation plan. The IRS also did not find any state cases that discussed the federal income tax consequences of a transfer of benefits under a non-qualified plan.

Conclusion

This article has attempted to make clear that the discord between the assignment of income doctrine and Code § 1041 is a tax trap for the unwary family law practitioner. Those tax scholars and practitioners who have considered the question are reported to be in almost unanimous agreement that, theoretically, the assignment of income doctrine should not override § 1041.[45] Their concerns appear to rest primarily with the assignment of income doctrine undermining the statutory purpose that led Congress to enact § 1041.[46] In addition, a Colorado commentator suggests that "if the assignment of income doctrine prevails over § 1041, spouses would have to determine their interests in the property under state law, thereby increasing the complexity of property transfers."[47]

Thus, until further clarity is forthcoming in the tax laws, family law practitioners would be well served to maintain a heightened sensitivity to the tax implications of property divisions, as well as using tax indemnification clauses in their agreements so as to better effect the intent of the parties.

NOTES

1. Mortimer, "Rumpole and the Confession of Guilt," in *Rumpole for the Defense* (New York: Penguin Books, 1982).

2. *Commissioner v. Culbertson*, 337 U.S. 733, 739-40 (1949).

3. 1 *Mertens Law of Federal Income Tax*, § 5.24 at 62 [*hereinafter*, "*Mertens*"].

4. 281 U.S. 111 (1930).

5. *Id*. Note: At the time the deficiency was assessed in *Lucas*, Congress had not provided for the filing of a joint return. It was not until 1948 that Congress provided for the filing of a joint return so that married couples in common law states were on an equal basis with married couples in community property states. Rose and Chommie, *Federal Income Taxation* (3d Ed.) (St. Paul, MN: Hornbook Services, West Pub. Co., 1988).

6. 311 U.S. 122 (1940) (life insurance agent assigns his present right to future renewal commissions).

7. 311 U.S. 112 (1940) (a father, with at or near maturity date of interest bond coupon payment, transfers to his son negotiable interest bond coupon while retaining ownership of bond).

8. *Mertens*, *supra*, note 3 at § 5.33, p. 81.

9. *Id*. at § 5.24, p. 62.

10. *Id*.

11. *Id*.

12. *Id.* at 62 and § 5.39, pp. 90-91.

13. *Id*. at § 5.24, p. 62 and § 5.33, p. 81-82, *citing Armston v. Commissioner*, 12 T.C. 539 (1949), *aff'd. sub nom. W. H. Armston Co., Inc. v. Commissioner*, 188 F.2d 531 (5th Cir. 1951). *See also Estate of Britt v. Commissioner*, 190 F.2d 946 (5th Cir. 1951) (husband's assignment of business assets to wife effective to shift taxation, even though husband was hired to manage the business for 50 percent of the net profits).

14. *Mertens*, *supra*, note 3 at § 5.24, p. 62 and § 5.34, p. 82-83, *citing Mapco, Inc. v. U.S.*, 556 F.2d 1107 (Ct. Cl. 1977).

15. *Mertens*, *supra*, note 3 at § 5.36, p. 85, *citing* Rev. Rul. 55-638, 1955-2 C.B. 35. The Ruling also cited favorably *Braunstein*, *Henry & Mae*, 1962 PH T.C. Memo 62-1247; reasoning followed: *Macri Corp.*, 1976 PH T.C. Memo 76-1193; and cited favorably in IRS Letter Ruling 8123015, 1981 PH 55, 096.

16. *Mertens*, *supra*, note 3 at § 5.36, *citing Braunstein v. Commissioner*, T.C. Memo 1962-210 (21 TCM 1132).

17. *Mertens*, *supra*, note 3 at § 5.39, p. 90, *citing Estate of Rhodes v. Commissioner*, 131 F.2d 50 (6th Cir. 1942), *aff'g* 43 B.T.A. 780; *Cotlow v. Commissioner*, 228 F.2d 186 (2d Cir. 1955).

18. *Mertens*, *supra*, note 3 at § 5.41, p. 93, *citing VanZandt v. Commissioner*, 40 T.C. 824 (1963), *aff'd*, 341 F.2d 440 (5th Cir. 1965).

19. 370 U.S. 65 (1962). *See also* Tax Management Portfolios (BNA); Wofford, 515 T.M. *Divorce and Separation* at A-14 (1995). (In *Davis*, the Supreme Court, looking at Delaware divorce law, held that a transfer of appreciated property titled in the husband's name to the wife pursuant to a settlement agreement was a taxable disposition of property by the husband in exchange for a release of marital rights. However, the Supreme Court acknowledged in *Davis* that different tax treatment could apply depending on a state's divorce laws. This resulted in a series of cases where lower courts were asked to determine the nature of the transferee spouse's interests in the transferred property under applicable state law.)

20. Wofford, *supra*, note 19 at A-15 ("Non-recognition treatment is mandatory if § 1041 applies. § 1041 lacks a provision corresponding to IRC 71(b)(1)(B), which permits taxpayers to elect non-alimony treatment for a payment, which otherwise qualifies as alimony.").

21. *Id.* at A-15 and A-16 (transferee spouse or former spouse acquires transferor's adjusted basis in property at time of transfer even if an arm's length transaction and regardless of whether transferee's cost to acquire property is in excess of transferor's adjusted basis; non-recognition provisions of § 1041 apply to *losses*

as well as gains; donor spouse cannot transfer to donee spouse unrealized depreciation occurring during donor spouse's holding period; transferee spouse subject to possible *depreciation recapture* for property depreciated by transferor; transferee spouse subject to possible *investment tax recapture* for credit previously claimed by transferor, should transferee change the character of the property to personal use; transferor spouse pursuant to IRC Reg. § 1.1041-1T(e) Q&A 14 is required to provide transferee spouse, at time of § 1041 transfers, records sufficient to determine basis and holding period of property at time of transfer.

22. *Id.* at A-21. The IRS and the courts continue to fine-tune the parameters of the nonrecognition rule of Code § 1041(a).

23. *Id.* at A-21. Code § 1041(e) requires a transferor to recognize gain to the extent that liabilities (assumed and to which property is subject) exceed the adjusted basis of property transferred in trust.

24. *Id.* at A-21. Code § 453B(g) requires the acceleration and recognition of gain by a transferor on a Code § 1041 transfer of an installment obligation into a trust. ("However, absent a trust and where there is a direct transfer between spouses or former spouses of an installment obligation, the tax treatment in the hands of the transferee spouse will be the same as it would have been in the hands of the transferor.")

25. *Id.* at A-21. Code § 1041(d) excludes from the scope of § 1041(a) transfers of property to non-resident alien spouses or former spouses.

26. *Id.* at A-21. Code § 1041(a) applies to spouses or former spouses, but not non-spouses.

27. *Id.*, Aug. 3, 1998, supplement to A-21. Large cash settlements at divorce are frequently payable in installments with interest over a period of time, and the tax treatment of interest addressed in the Tax Court decision of *Gibbs v. Commissioner*; T.C. Memo 1997-196, holding that Code § 1041 has no application to the interest portion of the payments that must be included in payee spouse's gross income.

28. Code § 1041(c) provides "... a transfer of property is incident to a 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." *See also* Wofford, *supra*, note 19 at A-17 and A-18. [A transfer is "related to the cessation of marriage" if transfer is pursuant to a divorce instrument and occurs not more than six years after date on which marriage ceases." *Citing* Temp. Reg. 1.1041-1T(a), Q&A 7.]

29. *Kochansky v. Commissioner*, 92 F.3d 957 (9th Cir. 1996); Rev. Rul. 87-112 (1987-2 C.B. 207); P.L.R. 9340032. *See also* Dods, "*Kochansky vs. Commissioner*, The Assignment of Income Doctrine, Community Property Law, and IRC § 1041," 72 *Washington Law Rev.* (July 1997).

30. Wofford, *supra*, note 19 at A-21 (*i.e.*, accrued and unpaid interest on transferred bonds and certificates of deposit, and failure to consider assets that themselves embody the right to receive income such as accounts receivable and retirement benefits).

31. 1987-2 C.B. 207.

32. Wofford, *supra*, note 19 at A-22.

33. 98 T.C. 368 (1992).

34. *Id.* at 373.

35. *Id.*; *see also* P.L.R. 9340032 (1993).

36. Wofford, *supra*, note 19 at A-22.

37. *Id.*, *citing* Asimov, "The Assault on Tax Free Divorce: Carryover Basis and Assignment of Income," 44 *Tax L.Rev.* 65, 84-112 (1988).

38. T.C. Memo 1994-160.

39. *Supra*, note 4.

40. *See* Dods, *supra*, note 29, for an extensive criticism of the *Kochansky* decision.

41. *Kochansky*, *supra*, note 29 at 959. It is important to note from the *Balding* and *Kochansky* cases that a state's property law may serve not only as a basis for the application of the assignment of income doctrine but also as a possible defense to its application. *See also Schulze v. Commissioner*, 46 T.C.M. (CCH) 14:3 (1983), and *Johnson v. Commissioner*, 135 F.2d 125 (9th Cir. 1943), where courts have refused to apply the assignment of income doctrine where the transferee spouse had, under state law, an interest in the property (community property) or the transaction was at arm's length for a non-tax purpose such as a property division.

42. Tauber, *Funding Alternatives for Non-Qualified Deferred Compensation Plans* (Research Institute of America, 1992).

43. *Id.* at 1. (ERISA initially limited contributions to tax qualified deferred contribution or individual account plans to $25,000 per year. ERISA also capped annual retirement benefits under tax qualified defined benefit pension plans at $75,000 joint and survivor annuity at age 65.)

44. P.L.R. 9340032 (1993).

45. Dods, *supra*, note 29 at 890, n.108.

46. *Id.*

47. Vogel, *University of Denver Divorce Tax Workshop Treatise 1997*, Ch. 13 at 13-15. ■

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