TAXATION OF PROPERTY DIVISIONS AT DISSOLUTION OF NONMARITAL RELATIONSHIPS

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Introduction: The IRS has ruled that partners in a Registered Domestic Partnership or a Civil Union will not be treated as spouses for purposes of federal tax law. Yet at dissolution of these relationships the partners are subject to the same property division and support obligation rules as spouses. The IRS will recognize the state property rights that are accorded these couples. See CCA 201021050 (IRS will recognize community property rights of California RDPs and tax each partner on 50% of community income). Unmarried and unregistered couples in all states may have some form of property rights in each other's property under the principles established in the *Marvin* case. Marvin v. Marvin, 18 Cal. 3d 660 (1976).

The Problem: There is absolutely no guidance from the IRS on how to treat property divisions following a court supervised dissolution of a registered partnership or civil union. Nor is there any guidance on how to tax property settlements in cases involving unmarried and unregistered partners. Family lawyers report that they often treat all payments from one partner to the other as either taxable income or taxable gifts. The reason they do this is that the Code Provisions that currently apply to property divisions and divorce apply only to spouses. See, e.g., IRC § 1041 (property transfers between spouses and ex-spouses are not taxable transfers). Many speakers on CLE programs around the country include statements in their outlines that say because §1041 is not available to non-spouses all transfers incident to dissolution of a non-marital relationship are taxable transfers. Speakers, as well as legal scholars, typically cite *United States v. Davis*, a 1962 Supreme Court decision, to support this conclusion. In *Davis*, the Supreme Court ruled that when a husband transferred appreciated stock to his wife incident to their divorce, the spouses were engaged in a bargained for transaction equivalent to a sale. Focusing solely on Mr. Davis, who was the only taxpayer before the court, the IRS had argued that he was transferring appreciated property in exchange for a release of his wife's marital rights. The fair market value of the "release" was presumed to be the same as the fair market value of the stock. As a result, Mr. Davis recognized a capital gain on the transfer in exactly the amount as if he had sold the stock for cash.

Finally, in 1984, Congress enacted §1041 which effectively reversed the decision in *Davis*. But, during the twenty-two years that elapsed between *Davis* and the enactment of Section 1041, case law established that spouses standing in the shoes of Mr. Davis would not always be taxed.
Even if registered partners (RPDs) or civil union partners (CUPs) cannot rely on Section 1041, they ought to be able to rely on the principles that were developed in the context of married

couples before the enactment of the statutory solution. The same may also be true for unmarried couples whose only claims arise under the *Marvin* principles.

This white paper will summarize those decisions and suggest that the reasoning in them may be applied to non-marital dissolutions.

1. Dissolution of RDPs in Community Property States.

Three states currently recognize RDPs and subject them to the state's community property regime, California, Nevada, and Washington (although only for RDPs aged 62 or older in Washington). That means the partners in these couples are equally vested owners in all community property. Equal divisions of jointly owned property are generally not taxable events. See Rev. Rul. 56-437 (severance of joint tenancy in stock followed by issuance of two separate stock certificates is not a realization event). This non-realization rule has been applied to equal divisions of community property, even before the decision in *Davis*. See *Walz v. Commissioner*, 32 B.T.A. 718 (1935). See also *Carrieres v. Commissioner*, 64 T.C. 959 (1975), *acq. in result*, 1976-2 C.B. 1, *aff'd per curiam*, 552 F. 2d 1350 (9th Cir. 1977)(nontaxable division of community property, but gain recognized to extent separate property was exchanged for community interest); Rev. Rul. 76-83, 1976-1 C.B. 213 (citing additional cases in accord). These decisions should apply to dissolution of registered partnerships in community property states (e.g., California, Washington, and Nevada).

2. Dissolutions of RDPs or CUPs in Non-Community Property States.

In common law property states, wives who were not on the deed were sometimes found to have a sufficient equitable interest in the marital property to apply the tax rules that were applicable to community property spouses. See *Imel v. United States*, 375 F. Supp. 1102 (D.C. Col. 1974)(split of marital property under equitable division rules is a nontaxable division of jointly owned property provided wife has sufficiently vested interest); *Collins v. Commissioner*, 412 F.2d 211 (10th Cir. 1969)(applying Oklahoma law and holding division of marital property non-taxable after U.S. Supreme Court remanded for decision in keeping with property rights announced by Oklahoma Supreme Court.)

Ultimately the Service agreed with the courts. See Rev. Rul. 81-292, 1981-2 C.B. 158 ("An approximately equal division of the total value of jointly owned property in a state that is not a community property state, under a divorce settlement agreement that provides for transferring some assets in their entirety to one spouse or the other, is a non-taxable division and does not result in the realization of gain or loss.") This ruling is still in effect. The legal argument is that there is **no realization** when two partners make an equal division of their jointly owned property. This argument can be used to support non-realization in property divisions between registered domestic partners or civil union partners, provided that the partners both have ownership interests (legal or equitable) under state law.

See also GCM 37716. This is an internal memorandum from the Chief Counsel, IRS, addressing the questions finally resolved in Rev. Rul. 81-292. The memo offers its rationale for treating married couples differently from unrelated individuals. Observation: Unmarried cohabitants at "divorce" are more similar to married couples than to unrelated individuals. See especially FN2 at the end of GCM 37716 (making the distinction between property divisions incident to the dissolution of a relationship and ad hoc property divisions between unrelated individuals).

Therefore, couples in equitable division states may be able to rely on pre-§1041 cases from common law states provided the partners can be characterized as co-owners. In some cases, even though legal title was held in the name of the husband, the wife's equitable interests were found to be sufficiently vested to avoid the *U.S. v. Davis* characterization. Cases include *Imel, supra* (Colorado law); *Collins, supra* (Oklahoma law); *McIntosh v. Commissioner*, 85 T.C. 31 (1985)(Montana law). But if the state's equitable division statutes give the judge too much discretion in dividing the property, the spouses will not be considered as co-owners. See *Wiles v. C. I. R.*, 499 F.2d 255 (10th Cir. 1974)(Kansas law). Note, however, that this is a case that applied principles of state law before the time that non-community property states had adopted modern marital property rules which give the non-titled spouse a stronger interest in the property at the time of divorce.

Given the current law in non-community property states which give both spouses (or here registered partners) a strong equitable claim to property acquired during the relationship, it should be possible to argue on the basis of cases like *Imel* and *Collins* that there is no realization event upon a substantially equal division of "marital property."

3. What about partners in a committed intimate relationships in the State of Washington?

Couples in the State of Washington who have cohabited but not registered as domestic partners may qualify under that state's "meretricious relationship" doctrine and thereby obtain quasi-community property rights. See *Gormley v. Robertson*, 120 Wash. App. 31, 83 P.3d 1042 (Div. 3 2004) (extending meretricious relationship doctrine to same-sex couple). Courts now refer to these relationships as committed intimate relationships. Quasi-community property rights are less vested than community property rights generally because the claim to half the property only arises at the time of dissolution of the relationship. Nonetheless this sort of claim to property, especially if the property division is ordered by a court, would seem to fall within the rationale of those pre-section 1041 cases that extended the no-realization principle to spouses in non-community property states, e.g., *Imel* and *Collins*.

4. What about unmarried cohabitants and *Marvin* claims?

In 1976, the California Supreme Court handed down a decision in *Marvin v. Marvin*, 18 Cal. 3d 660, which changed the law nationwide regarding claims by unmarried cohabitants who asserted ownership of property acquired during the relationship even if legal title was held by only one cohabitant. Before *Marvin*, most states adhered to a rule that proclaimed the non-titled cohabitant was out of luck because agreements related to non-marital cohabitation were against public policy and therefore not enforceable. *Marvin* changed that rule by proclaiming that such agreements were enforceable if they could be proved. Many commentators described the *Marvin* case as one that established the right to "palimony." But that characterization is a misdescription. "Palimony" suggests that a cohabitant has an obligation to support the other cohabitant. But that is not the law in any state. Instead, the *Marvin* case ruled more narrowly that a cohabitant who promised or impliedly promised to share property with the other cohabitant should be held to the terms of that contract. *Marvin* rights are not support rights. Instead they are rights to an equitable interest in any property acquired during the relationship. Most states have followed the *Marvin* decision and will recognize the equitable property rights claimed by the non-titled cohabitant in the right set of circumstances.

Only one tax case has analyzed how a payment in exchange for these rights will be taxed. That case is *Reynolds v. Commissioner*, TC-Memo 1999-62 (taxation of cash payments in settlement of cohabitant's claim to property acquired during the relationship). The IRS argued that the cash was payment for services rendered during the relationship. The taxpayer argued the cash was an excludable gift under Section 102. The Tax Court held that the payments were made to compensate the non-titled partner for her property rights in the property, rights that were acquired during the relationship. And, the court assumed that her basis in those rights was not lower than the amount she received and, therefore, she had no gain. Basically, the court held that the non-titled partner had an equitable interest in the property which she was exchanging for cash. Under this characterization of the transaction, had the partners merely divided the property equally, presumably the transaction would have been a non-taxable division of property. Instead, because she received cash payments, the transaction was treated as a sale. But there was no taxable gain in the absence of evidence that her basis was lower than the amount realized on the sale.

5. Other observations.

U.S. v. Davis focused only on the tax consequences to Mr. Davis. Some years later, the IRS issued a revenue ruling that covers spouses such as Mrs. Davis. Rev. Rul. 67-221 held that when a wife receives property at divorce in exchange for her dower rights, she has no income and takes a basis equal to fair market value. The ruling contains no rationale or justification for the conclusion it reaches, but it is commonly understood to be the right result under the "in lieu of" theory. That is, she should be viewed as receiving payments in exchange for her support and dower rights, both of which would have been excluded from income if she had received them, Similarly, if a domestic partner receives cash or property at "divorce" in exchange for marital rights like support and dower, the receipt of the cash or property should not be taxable income since it is "in lieu of" items she would have been entitled to enjoy tax free.

Conclusion:

(1) A substantially equal division of jointly owned property should not be taxable upon dissolution of a registered partnership or civil union because there is no "realization." This rule clearly applies to divisions of community property.

(2) This rule might also apply to registered partners or civil union partners in non-community property states because even non-titled partners have strong equitable claims to marital property.

(3) This rule may even apply to divisions of property by unregistered cohabitants if the rationale in *Reynolds* is applicable.

(4) Even if property is not jointly owned, under the likely rationale for Rev. Rul. 67-221, the transfer of property to the non-titled partner should not be treated as taxable income to the extent the property transfer is made in lieu of support rights (which registered partners and civil union partners can claim, but unmarried cohabitants cannot).

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