Watch Out Assigning Assets in Divorce

by Robert W. Wood

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The tax treatment of litigation settlements and recoveries has long been an area of professional interest for me. Increasingly, lawyers and accountants, litigants and judges, are paying attention to the tax treatment of payments and recoveries before a dispute among private parties is finally put to rest. This is good. It is not good when the anticipated results do not come to fruition. It is not good when otherwise agreed-upon tax consequences go awry. It may be good for the government, but not for the private parties to the dispute. This is particularly so when the private parties will generally long ago have buried the proverbial hatchet by the time a matter comes up on audit.

Witchy Woman?

A recent case demonstrating this principle, and offering a good deal of learning about how to structure a settlement where assets are divided in a litigation context, is Jennifer L. Meisner v. United States, No. 97-1110 (8th Cir., Jan. 9, 1998), Doc 98-2273 (8 pages). In Meisner, the facts arose out of the 1981 divorce between Jennifer and Randy Meisner, the latter of whom was a member of the Eagles rock band. Most aging baby boomers fondly remember Eagles tunes, but the Meisner case involved an Eagles tune that decidedly went sour when it reached the U.S. Tax Court and then the Eighth Circuit Court of Appeals.

Takin’ It Easy

The reason it went sour was the 1981 divorce between a band member and his spouse. It involved a conveyance by Randy of all of his intellectual property interest in the band’s songs to the Eagles in exchange for a portion of the royalties. This conveyance of intellectual property for royalties occurred in 1978 when Randy left the Eagles. When Randy and his wife divorced in 1981, the couple entered into a property settlement agreement that gave Jennifer 40 percent of that royalty interest as her separate property. According to the agreement, Jennifer’s rights were to survive both her and Randy’s deaths. Her share of royalties was to be paid directly from the Eagles to her rather than through Randy.

For several years, things went along swimmingly, with the former Mrs. Meisner receiving her share of royalties and paying taxes on it. Then she had a bright idea, as ex-spouses sometimes do, about how her former spouse should be paying more in tax than he was. Her bright idea was to seek a refund of the taxes she had paid on the royalties, asserting that the royalties were taxable to Randy. Her theory, most tax advisers should be able to predict, was essentially an assignment of income notion.

During the trial of the case, she moved for judgment as a matter of law following the presentation of evidence (summary judgment). The IRS moved for summary judgment too, as it felt it was clearly right. The court denied both motions.

Question of Fact

This would indicate, of course, that the trial court was not willing to make a judgment for either side without getting into factual questions. On appeal to the Eighth Circuit, the circuit court agreed with the lower court that resolution of this matter depended on whether Randy Meisner had retained any power and control of the income after the transfer. See Commissioner v. Sunnen, 333 U.S. 591 (1948). Noting that Randy had reserved no reversionary interest for himself (nor for his estate) in the royalties, and that Randy had no power over Jennifer’s receipt of the royalty payments, the court of appeals concluded that there was evidence supporting the government’s position.

Thus, Jennifer would not be entitled to a refund of taxes paid, and was simply fully liable for the taxes herself. The court of appeals also rejected Jennifer’s challenge to a jury instruction, because the instruction of the language on the verdict form was taken from the Sunnen case cited above.

Assignment of Income Lore

Since assignment of income doctrine does not get discussed in the case law too much anymore, it is worth noting some of the discussion that the Eighth Circuit reviews in its Meisner opinion. The assignment of in-
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Income doctrine was, after all, at the crux of the decision that the court reached in this case. If the taxpayer is entitled to receive income but anticipatorily assigns it before receipt, the assignor will be taxed on it, just as though he had actually received it. See Harrison v. Schaffner, 312 U.S. 579 (1941). This is so even if the assignment is made before the actual accrual of the income. See Helvering v. Horst, 311 U.S. 112 (1940).

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However, when a taxpayer transfers earnings derived from an income-producing asset, the critical question is whether the asset itself has been transferred or if the mere income that is produced by the asset has been moved. Here, there was no evidence that Randy Meisner retained any control of the asset. He merely, and unconditionally, assigned Jennifer an undivided 40 percent interest in whatever royalties he might receive. He carved out no reversionary interest for either himself or his estate, and he retained no direct or indirect ability to affect the value of the rights he transferred.

He did not retain any power over Jennifer’s receipt of royalty payments. The checks went directly from the Eagles to Jennifer and did not pass through his hands. Thus, this did not appear to be an anticipatory assignment of income, but merely a division of an income-producing asset. See Commissioner v. Rees, 233 F.2d 30 (1st Cir. 1956).

What About Section 1041?

Almost as an afterthought, the Eighth Circuit confronted the question presented by a very broad and all-encompassing section 1041. The court said that it was “also” significant that the transfer of rights occurred pursuant to a divorce settlement. In the context of a divorce settlement (where gifts based on love and generosity are typically not found, noted the court), the transfers are normally more final and more businesslike.

Divorce transfers, said the court, are much more akin to a negotiated arm’s length transaction between adversaries. However, the court did not take the final step from this discussion to even refer to section 1041, which makes transfers between spouses in property settlements nontaxable to either spouse.

This is no surprise, since section 1041 was originally enacted in 1984 to reverse the decision in U.S. v. Davis, 370 U.S. 55 (1962). Meisner and his wife had divorced in 1981, before section 1041 was enacted. In Davis, the Supreme Court had held that the transferor of appreciated property in satisfaction of marital rights under a property settlement recognized gain on the transfer equal to the difference between the fair market value of the transferred assets and their adjusted tax basis. In effect, the property was considered sold by the transferor spouse to the former spouse, generating a tax liability.

Now that section 1041 exists and protects virtually all transfers between spouses, it is nevertheless appropriate to worry (at least occasionally) about the assignment of income doctrine. Interestingly, the assignment of income doctrine has come up before in the specific context of section 1041. For example, in Revenue Ruling 87-112, 1987-2 C.B. 207, the IRS ruled that transfers of assets such as Series E Savings Bonds will trigger income to the transferor, notwithstanding the context of divorce.

The theory of Revenue Ruling 87-112 was that section 1041 applies only to defer gain or loss on property that is transferred to a spouse or former spouse. There is much talk in the Revenue Ruling about the accrual of interest under section 454. It would seem that very little attention is now devoted to these assignment of income issues in the context of divorce. Instead, most of the case law in recent years has focused on whether section 1041 covers the transfer of business interests, covers corporate redemptions and whether constructive dividends may result. (For discussion of divorce and redemptions, see Raby, “Raby Revisits Stock Redemptions Incident to Divorce,” Tax Notes, Feb. 21, 1994, p. 1031; see also Raby, “Breaking Up May Be Taxing: Divorce Redemptions,” Tax Notes, July 18, 1994, p. 365.

Fortunately, since the enactment of section 1041, assignment of income issues would seem limited to Series E bonds, zero coupon bonds, and other instruments with respect to which one could truly say that income had been assigned. Presumably the Service would also take this position on a receivable from a personal service business that was assigned pursuant to divorce, although one might argue that the receivable would constitute property within the meaning of section 1041.

It may be surprising to continue to see cases decided under presection 1041 law. Most of the issues arising under the division of property have now been resolved by that section. Of course, don’t forget (and unfortunately many lawyers do forget) that while section 1041 eliminated most of the immediate tax consequences of a division of property, it did not solve the basis issues that may later unfairly burden one divorced spouse over the other.