***Carrieres v. Commissioner, 70 T. C. 237 (1978)***

In a divorce, the exchange of community property for separate property results in taxable gain to the extent of the separate property received.


## Summary

In Carrieres v. Commissioner, the Tax Court addressed the tax consequences of dividing community property during a divorce. The court held that when part of the community property (Sono-Ceil Co. stock) was exchanged for separate property (cash), the transaction was partially taxable. Petitioner transferred her interest in the stock to her ex-husband, receiving both community and separate property in return. The court ruled that the exchange was taxable only to the extent of the separate property received, establishing a proportionate recognition of gain based on the ratio of separate to total property received.


## Facts

George and the petitioner, married and residing in California, were unable to agree on the division of their community property during their divorce proceedings. The Superior Court awarded George the 4,615 shares of Sono-Ceil Co. stock, valued at $241,000, and required him to pay the petitioner $89,620. 01 to equalize the division. George paid this sum in a lump sum, using $65,000 borrowed from Sono-Ceil Co. , $13,111. 66 from his community half of cash in bank accounts, and $11,508. 35 from his separate property. The petitioner transferred her interest in the stock to George in exchange for the payment.

## Procedural History

The petitioner filed her 1968 income tax return claiming no taxable gain from the property division. The IRS determined a deficiency of $26,921. 29, which the petitioner contested. The Tax Court reviewed the case and issued a decision in 1978.

## Issue(s)

1. Whether the division of community property in a divorce is taxable when part of the division involves the exchange of community property for separate property?
2. If taxable, to what extent must the gain be recognized?

## Holding

1. Yes, because the exchange of community property for separate property constitutes a taxable event under the Internal Revenue Code.
2. The gain must be recognized proportionally to the extent of the separate property received, because the court found that the nonstatutory nonrecognition principle applies only to the community property portion of the exchange.

 

## Court’s Reasoning

The court applied the general rule that gain from the sale or exchange of property is recognized unless a nonrecognition rule applies. It noted the well-established judge-made nonrecognition rule for equal divisions of community property in divorce, as seen in cases like Commissioner v. Mills. However, the court distinguished this case because the petitioner received separate property in exchange for her community interest in the stock. The court reasoned that this created a sale to the extent of the separate property, necessitating recognition of gain. The court used the ratio of separate property received to the total property received to determine the taxable portion of the gain, reflecting the intent of the parties and avoiding a “cliff effect” that would render the entire transaction taxable if any separate property were involved. The court also clarified that the Superior Court’s order did not change the tax consequences of the transaction, as it merely replaced an agreement the parties could not reach themselves.

## Practical Implications

This decision impacts how attorneys and divorcing couples should approach the division of community property to minimize tax consequences. When structuring property settlements, parties should be aware that using separate property to equalize an unequal division of community property can trigger taxable gains. Practitioners should calculate the potential tax liability and advise clients on structuring the division to minimize tax exposure, possibly by maximizing the use of community property in the exchange. This case has been cited in later decisions, such as in Conner and Showalter, where the courts continued to apply the principle of proportionate recognition of gain when separate property is involved in the division of community assets.

 