Harrah v. Commissioner, 70 T. C. 735 (1978)

In a divorce, a settlement agreement that divides assets as community property is treated as such for tax purposes, determining the recipient's basis in the assets.

Summary

Scherry Harrah received stocks from her ex-husband William Harrah as part of a divorce settlement agreement, which was incorporated into the divorce decree and characterized as a division of community property. The IRS challenged this characterization, arguing it was an exchange of William's separate property for Scherry's marital rights. The Tax Court held that the transaction was indeed a division of community property, thus Scherry's basis in the received stocks was their community basis. This decision reinforces the principle that courts will respect the parties' characterization of property in divorce settlements for tax purposes, unless proven otherwise.

Facts

William and Scherry Harrah, married twice, negotiated a property settlement agreement during their second divorce in 1969. The agreement, which was ratified by the Nevada divorce court, purported to divide their community property equally. Scherry received 2,000 shares of Harrah South Shore Corp. and 5,000 shares of Harrah Realty Co. as her share, while William received the remaining assets. The IRS later contested the tax basis Scherry used for these stocks, claiming they were William's separate property exchanged for Scherry's marital rights.

Procedural History

The IRS determined deficiencies in Scherry's income tax for the years 1969-1971 and 1974. Scherry challenged these deficiencies in the Tax Court, which consolidated the cases and severed the issue regarding the character of the stocks received from the other tax issues. The Tax Court ultimately decided that the stocks were received as part of a community property division, affirming the community basis for tax purposes.

Issue(s)

1. Whether the stocks Scherry Harrah received under the settlement agreement were part of a division of community property or an exchange of William Harrah's separate property for Scherry's marital rights?

Holding

1. Yes, because the settlement agreement and the subsequent divorce decree characterized the transaction as a division of community property, and Scherry failed to prove otherwise, thus her basis in the stocks is the community basis.

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Court’s Reasoning

The Tax Court’s decision was grounded in the legal principles governing community and separate property under Nevada law and the tax implications of property divisions in divorce. The court noted the arm’s-length nature of the negotiations and the parties’ belief that part of the increase in value of the Harrah corporations was community property due to their efforts during marriage. The court found that the agreement was not collusive and was a reasonable method to apportion the appreciated value of William’s assets between separate and community property. The court also cited the Nevada Supreme Court’s later decision in *Johnson v. Johnson* to support its view that the appreciation in value should be apportioned, reinforcing the fairness of the settlement. The court concluded that the agreement-decree was a valid division of community property, and Scherry’s attempt to characterize it as an exchange of separate property was not supported by evidence or consistent with her prior position.

Practical Implications

This case underscores the importance of how property is characterized in divorce settlements for tax purposes. It establishes that the IRS and courts will generally respect the characterization of property as community or separate in divorce decrees unless there is clear evidence to the contrary. Practitioners should ensure that settlement agreements accurately reflect the parties’ intentions regarding property division to avoid later tax disputes. The decision also illustrates the potential for tax consequences to be influenced by state property laws, particularly in community property jurisdictions. Subsequent cases may reference *Harrah v. Commissioner* when addressing the tax basis of assets received in divorce settlements and the validity of property characterizations in such agreements.

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