Memorandum 84-38

Subject: Study F-671 - Quasi-Community Property (Tax Implications)

When community property is divided at dissolution of marriage, the division is not a taxable event. Each spouse receives property in which the spouse had a pre-existing property interest. So long as the division is equal, neither spouse is deemed to have made a taxable gain or loss on division of an asset.

The situation in non-community property states is different. Under the rule of United States v. Davis, 370 U.S. 65 (1962), a husband's transfer of marital property to his wife at the time of divorce is treated for tax purposes as if the husband first sold the property for cash, then transferred cash to the wife. Consequently, the husband realizes gain or loss upon this transfer. A few states--Colorado, Oklahoma, and Oregon to be precise--have managed to avoid the rule of Davis by demonstrating that their systems of equitable division of marital assets are a "species of common ownership" akin to community property in which property rights "vest" upon filing of the divorce action; in these states division of marital assets is not a taxable event.

The Davis case has significance in California because at dissolution of marriage not only the community property is divided but also the quasi-community property of the spouses. Quasi-community property is property acquired by a married person during marriage that would have been community property if acquired while domiciled in California; however, because the married person was domiciled in a non-community property jurisdiction at the time of its acquisition, the property is characterized as separate under standard choice of law principles. The property is treated as separate in California for purposes of management and control during marriage, but is treated as community at termination of the marriage by dissolution or by death of the acquiring spouse. This hybird character gives rise to the name "quasi-community" property.

Does division of quasi-community property in California trigger Davis tax liability? It is separate property of one spouse that is being divided between both spouses at dissolution of marriage, just as

in non-community property jurisdictions. The law is not clear, and opinions of experts differ.

Professor Reppy has written to the staff, "Quasi-community property in California is, of course, separate property for Davis purposes every bit as much as was the separate property at issue in the Colorado, Oklahoma, and Oregon cases. Thus, relief is needed from Davis to cover awards of quasi-community property at divorce."

Mss. Angela and Chomsky are less dogmatic, stating that although Davis arose in a non-community property jurisdiction, "the decision is far-reaching and may be relevant to unequal divisions of community property and to divisions of quasi-community property." Angela & Chomsky, Property Divisions--Income Tax Aspects, in Tax Aspects of Marital Dissolutions: A Basic Guide for General Practitioners § 3.6 at 44 (Cal. Cont. Ed. Bar 1979).

Professor Asimow points out that quasi-community property has historically been treated for tax purposes as separate and not community property, and thus it may be argued that a division of quasi-community property triggers realization under the Davis rule. Nevertheless, he states that it seems reasonable to treat quasi-community property as if it were community property for this purpose. He argues that quasi-community property is much like Oklahoma and Colorado marital property that passes free of Davis tax liability, and in fact is even closer to community property because of the spouse's statutory right to one-half and because of the underlying presupposition of the spouse's contribution to ownership of the property. He concludes that "it is likely that quasi-community property can be divided between the spouses without a realization." Asimow, Property Divisions in Marital Dissolutions, 1983 Univ. So. Cal. Major Tax Planning Inst., ¶ 3.12 at 3-84.

Mr. Walzer, on the other hand, is noncommital on the recognition of taxable gain or loss on divisions of quasi-community property. He points out that the applicability of rules governing community property divisions "is made doubtful by the fact that division of quasi-community property, unlike division of community property, does not reflect equal vested property interests held during marriage." S. Walzer, California Marital Termination Settlements § 4.46 at 86 (Cal. Cont. Ed. Bar 1971). But he also notes that division of quasi-community property is distinguishable from the Davis situation in that the California statute re-

quires equal division; there may also be other distinctions arising from statutory restrictions on quasi-community property that were not present in Davis.

The tax problem is generally avoided under existing practice by the expedient of just not classifying quasi-community property at dissolution, but simply lumping it together with and treating it as community property. This may not be possible in every case, but it seems to be done with sufficient frequency that the tax issue is not a practical problem.

Would it be desirable to attempt to statutorily eliminate the possibility of Davis tax liability in those cases where characterization of quasi-community property is unavoidable? This could be done by adding to the quasi-community property definition language that has worked in Oklahoma and Colorado to the effect that quasi-community property is "a species of common ownership" that is deemed to "vest" upon commencement of the dissolution action.

The staff is somewhat concerned about the consequences of engrafting language like this onto the community property system, particularly the implications of the "vesting" language. Moreover, we fear that adding language to the statute may simply call attention to a problem that does not at present seem to be of practical concern, or may precipitate an adverse ruling where none now exists, with the end result that the law is worse than when we started. On balance, the staff's judgment is that it is best to leave this area of the law alone, pending further developments.

Respectfully submitted,

Nathaniel Sterling
Assistant Executive Secretary