

# CHAPTER 10

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## 10. ASSIGNMENT OF INCOME DOCTRINE.

### 10.1 Overview.

The assignment of income doctrine is a theory of taxation whereby the party that earns an item of income is taxed on that income. Earnings can occur either through the direct efforts of the party or through the party's ownership of an asset that generates income. Many cases involving assignment of income in the divorce arena focus on the party that is given ownership of the income-producing asset; specifically, cases involve determining who must report the income, rather than whether the item should be included in gross income.

### 10.2 Background.

The assignment of income doctrine was developed and refined in the courts. As such, the many statutory changes over the years have dealt with items of income that can be excluded from taxation. In order to understand the doctrine fully, a review of the major court cases is necessary.

The seminal case in this area is *Lucas v. Earl*, 281 U.S. 111 (1930). In *Lucas*, the husband and the wife had entered into an agreement whereby each party would give to the other through a joint tenancy any property acquired by the other in the future. What makes this case interesting is that the agreement was executed in 1901, prior to enactment of the Federal Income Tax Law under the Sixteenth Amendment in 1913. Obviously, tax avoidance was not the parties' motive for entering into the agreement. The husband, an attorney, reported only half of his personal earnings; his wife reported the other half. In this landmark decision, the Supreme Court of the United States ruled:

There is no doubt that the statute could tax salaries to those who earned them and provide that the tax could not be escaped by anticipatory arrangements and contracts, however skillfully devised, to prevent the salary when paid from vesting even for a second in the man who earned it. That seems to us the import of the statute before us and we think that no distinction can be taken according to the motives leading to the arrangement by which *the fruits are attributed to a different tree from which they grew*. (Emphasis added)

The concept was enacted and continues to this day. Most of the early cases involved income-splitting among several taxpayers. Family members would split income into different tax brackets, thus lowering the overall tax due while maintaining control of the earnings. As time went on, the doctrine was applied to transactions involving closely-held corporations. The intent of the shareholders was to avoid income tax, double taxation or liquidations by moving income from one entity to another.

### 10.3 *Historical Case Summary.*

Over time, the courts have established two concepts to guide the assignment of income doctrine. The first concept, frequently referred to as donative assignment of income, deals with transfers between family members or controlled corporations. Such transfers could be for personal services or for future dividends, rents or profits.

The second concept, capital gains assignment of income, seeks to restrict transfers in order to produce preferential capital gains treatment. These transfers are typified by sales of contract rights where the seller seeks to treat the sale as property, thus qualifying for capital gain treatment. The two concepts are artfully summarized by Michael Asimow in a 1988 article for *Tax Law Review*.<sup>329</sup>

#### Donative Assignment of Income Doctrine:

1. Earnings from personal services are taxed to the person who earned them.
2. In a community property state, each spouse is taxed on one-half of community income.
3. The owner of property is taxed on the income earned by that property even though the income item is given away.
4. A transferor of property is taxed on accrued income that is later collected by the transferee.
5. A transferor of property who retains excessive control over that property is taxed on income from that property.

#### Capital Gains Assignment of Income Doctrine:

1. A contract right to render personal services or a right to payment from services already rendered is not a capital asset.
2. A right to income from an asset, when separated by the seller from the asset itself, is not a capital asset.
3. A right to accrued income is not a capital asset even when sold along with the asset itself.

### 10.4 *Internal Revenue Service Position.*

The IRS takes the position that the non-recognition provision of § 1041(a) deals with the transfer of property between spouses, not the transfer of income. The assignment of income doctrine is thus applicable to transfers between spouses. The IRS takes a very narrow interpretation of “property.” Was Congress’ intent to allow the transfer of property without capital gain or loss also applicable to items of income? The IRS’s argument is in part bolstered by Temp. Treas. Reg. § 1.1041-1T(a), A-4 which states: “Only transfers of property (whether real or personal, tangible or intangible) are governed by Section 1041. Transfer of services are not subject to the rules of Section 1041.” However, in all likelihood this question deals with services rendered between spouses.

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329 Michael Asimow, *The Assault on Tax-Free Divorce: Carryover Basis and Assignment of Income*, 44 *Tax. L. Rev.* 65 (1988).

## 10.5 COUNTER-ARGUMENTS TO IRS POSITION.

Congress sought to allow divorcing parties to divide their assets in a simple manner to enable them to continue their lives with as little federal taxation interference as possible. The effect of the assignment of income doctrine is to keep the parties linked together for future determination and allocation of income and expense items. Often, the party not receiving the cash generated by a transaction will be required to pay the tax on the transaction. Even prior to the enactment of § 1041, the courts repeatedly rejected the assignment of income doctrine in the division of marital property. A brief summary of these cases follows:

*Kenfield v. U.S.*, 783 F.2d 966, 86-1 USTC 9225 (10th Cir. 1986). In this case, the divorce court awarded the wife a 50% interest in the net proceeds received from the husband's partnership, and continuing access to the books and records of the business. The husband was given complete control over the operations of the company. The court ruled that the state court's underlying purpose was to give half of the partnership interest to the wife and, as such, the wife was the owner of the partnership for federal income tax purposes. She, not the husband, was required to pay income taxes on the annual net profits of the partnership. With regard to the issue of assignment, the court found that the transfer by the husband was involuntary and was, therefore, a division of property between co-owners, not an assignment. No evasion of tax was found and the assignment of income cases were inapposite.

*Schulze, Jr. v. Commissioner*, T.C.M. 1983-263 (August 4, 1983). In contrast to the IRS's ruling in Priv. Ltr. Rul. 9143050 (July 26, 1991), the Court found that the wife's interest in her husband's proceeds from a lawsuit against his former law partners was taxable to the wife. The husband and wife entered into a settlement agreement whereby the proceeds of the lawsuit would be divided between the parties in order to split the marital estate equally. All of the parties' assets were held for their joint benefit until the final division. The value of the lawsuit was not determinable at the time of the divorce. The commissioner argued that there had been an anticipatory assignment of income, and as such, the husband should pay the tax on the entire proceeds.

In ruling, the Court found that the interest in the lawsuit was contingent, was at arms-length, did not involve a gift or gratuity, occurred in a different year from when the claim was paid, and was for a legitimate business purpose. The assignment was, therefore, not an anticipatory assignment of income, and the proceeds were found to be taxable to the wife. The major significance of the ruling was that the husband could not assign income that was uncertain, and that the assignment was for a legitimate non-tax purpose.

The following is a summary of factors considered by the courts in determining whether an assignment of income has occurred.

### 10.5.1 INVOLUNTARY.

Transfers due to divorce are not voluntary. Neither party wants to give up any asset to the other. The typical wage-earner feels that he or she has caused the accumulation of assets and that the non-wage-earner should not be entitled to any of that accumulation.