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In response to the "sham divorce" tactic, the IRS recently issued Revenue Ruling 76-255. The author, professor of law at Boston University School of Law, although sympathetic with the IRS's position in the Ruling, points out situations where the divorce-remarriage may possibly be considered valid because of the existence of nontax effects.

IN REVENUE RULING 76-255[1] the Internal Revenue Service blocked taxpayer self-help against the so-called tax on marriage. The Service's ruling casts a cloud over tax-motivated divorces. The proper dimensions of the cloud, however, remain to be delineated.

Background

In 1969 Congress addressed itself to an apparent tax discrimination against single individual taxpayers. As the tax law had stood since 1948, a single individual taxpayer could reduce his federal income tax bill substantially by marrying a spouse with no income, filing a joint return and enjoying the benefits of the statutory income-splitting thereby conferred. The tax saving resulted from halving the progressivity of the income tax. In the late 1960s, this result was decried as discriminating against single individuals with the same income. The 1969 amendments[2] provided a separate and lower rate schedule for single individuals. Married persons continued to use the older and higher rates, even when filing separately. The result was to reduce the benefits of joint return filing if a taxpayer married a non-income-earning spouse and, thereby, reduce the injustice to single taxpayers.

Unfortunately, this change created a new and different kind of inequity. Under the earlier law, if two single taxpayers earning approximately the same amount of income got married, their combined tax bill would have remained about the same. But under the new provisions, their tax bill could increase substantially, primarily because

[1] I. R. B. 1976-28, 7. Also issued as News Release IR-1632, July 1, 1976, 769 CCH—STANDARD FEDERAL TAX REPORTS ¶ 6728.
[2] Tax Reform Act of 1969, Sec. 803.

of the higher-than-single rate schedule now being applied. For example, if two single lawyers, each making $32,000 taxable income, were to get married, their combined federal income tax bill now would increase by $3,840 from $20,580 to $24,420. In addition, part of the total standard deduction previously available might disappear: the maximum standard deduction for a married couple was less than twice the maximum for a single individual.[3] For tax purposes, it was manifestly more blessed to be single than married where both parties earned substantial income.[4]

Some married taxpayers who were aware of this disparity also noticed that the Internal Revenue Code generally determines marital status as of the end of the year.[5] A few of these taxpayers acted on this observation. They obtained a divorce at the end of December, so as to be unmarried as of the end of the year, intending to remarry early in January of the following year, which they did. The cost of a trip to a receptive Caribbean jurisdiction in order to obtain the divorce was far less than the tax savings involved.[6]

Revenue Ruling 76-255

Regrettably for the practitioners of this tactic, tax-inspired divorce is an engaging theme that has received publication in the media. Publicity doubtless has produced some embarrassment. In response, the Service has issued Revenue Ruling 76-255. Situation two, described in the Revenue Ruling, concerns a married couple who obtain a divorce on December 30 in a foreign jurisdiction. The divorce is assumed by the Ruling to be valid. However, at the time of the divorce, they intend to remarry and do so in January of the following year. The Ruling states that neither Section 143 nor Section 6013 contemplates a sham transaction designed to manipulate marital status as of the close of the year. Naturally, *Gregory v. Helvering*[7] is cited in support of this unobjectionable statement. The Ruling goes on to hold that therefore the divorce described in situation two is of no tax effect and the parties are deemed to be married for the earlier year.

As one law professor was wont to say, "I understand everything but the 'therefore.'" The question of whether the divorce is a sham can hardly be determined solely by the tax reduction intention of the parties. *Gregory* is also frequently cited for the proposition that a taxpayer may take appropriate steps to reduce his tax bill. To sink to the level of a sham, the trans-

[3] For 1975 the maximum percentage standard deduction for a single individual was $2300 and for a married couple was $2600.

[4] At the same time, where the incomes of the two individuals were disparate, marriage continued to confer a tax break, although of reduced magnitude.

[5] Sec. 6013(d)(1)(A) makes this the rule for joint return filing and Sec. 143(a) does so for standard deduction purposes. The tax rate tables incorporate the definitions of Sec. 143.

[6] It is believed that no taxpayer has sought to deduct the cost of the divorce trip as an expense in connection with determining a tax, Sec. 212(3).

[7] 35-1 USTC ¶ 9043, 293 U. S. 465. In *Gregory*, the taxpayer's corporation (United) owned stock in a second corporation (Monitor) which the taxpayer wanted to sell. Had United distributed the Monitor stock it would have been a dividend. Instead, United formed a new corporation, Averill, transferred the Monitor stock to it and distributed the new Averill shares to the taxpayer, all apparently in compliance with provisions for no gain or loss. Taxpayer then liquidated Averill at a claimed capital gain, instead of a dividend. The Second Circuit and the Supreme Court held there was a dividend nevertheless.

It is testimony to the peculiar strength of our legal logic that a classic case concerning the tax effects of a corporate division is the sole authority offered to characterize a marital division.

action must approach an illusion, that is, it must be little more than play acting for the tax collector without substantial impact elsewhere. The Tax Court recently has synthesized these aspects of sham-ness in a hands-on metaphor: "The building may not be constructed entirely from the tax advantage, but, if the foundation and bricks have economic substance, the economic or financial inducement of the tax advantage can provide the mortar." [8]

On this view, the divorce and remarriage should be treated as a sham and disregarded if the only effect of the transactions was to reduce the taxes of the parties. To the extent that the marriage and divorce have nontax effects, it should be substantially more difficult to describe the transaction as a sham. Thus, if a married couple decided to take a long New Year's weekend trip to Haiti, getting a divorce on the Thursday they arrive and remarrying on the following Monday before they leave, and return to the United States with these two pieces of paper, the easiest case for sham treatment could be put. On the other hand, if they return unmarried and some interval passes in which there may be nontax effects attaching to their single state, the result becomes more problematical.[9] Indeed, if the nontax consequences are substantial, the divorce should be respected though the interval be short.

Nontax Effects

A number of nontax effects are possible. For example, if one of the parties died in the interim period, would the survivor be a surviving spouse for state intestacy purposes,[10] for purposes of passing property under the decedent's will,[11] or even for purposes of the federal estate tax marital deduction? [12] Would coverage under disability, medical or other insurance policies lapse, at least temporarily? Would termination of the marriage convert property held in a tenancy by the entireties into a tenancy in common unless this result expressly is negated? [13] In a community property state, would the divorce sever community property and would it remain separate property upon the remarriage? [14] Would the divorce revoke will provisions in favor of a surviving spouse which the remarriage would not reinstate? [15] To the extent that such nonincome tax consequences followed from the divorce and from the subsequent marriage, the divorce was not a sham as that word was usually understood and should not be ignored for tax purposes. More affirmatively, the divorce is real for tax purposes to the extent it is meaningful outside the closed world of income taxes. Of course, the desirability of

[8] *W. Lee McLane, Jr.*, CCH Dec. 27,933, 46 TC 140, 145 (1966), aff'd per curiam 67-2 USTC ¶ 9491, 377 F. 2d 557 (CA-9).

[9] The validity of the divorce for state law purposes is assumed in the Ruling. While invalidity of the divorce would obviate any tax effect, the reverse does not follow.

[10] The same question would apply as to the "widow's mite," homestead allowance or statutory forced share. See, e. g., Uniform Probate Code Secs. 2-201, 2-402 and 2-401.

[11] Under the Uniform Probate Code Sec. 2-508, divorce revokes will provisions favoring the former spouse but reinstates them on remarriage.

[12] The Service recently litigated a number of marital deduction cases to determine which of two possible survivors is the surviving spouse. In those cases the decedent or the claimed survivor had a prior marriage which was dissolved by a divorce whose validity is upheld in some jurisdictions and attacked in others. *Est. of Spalding v. Commissioner*, 76-2 USTC ¶ 13,144 (CA-2); *Est. of Goldwater v. Commissioner*, 76-2 USTC ¶ 13,146 (CA-7); and *Est. of Steffke*, 76-2 USTC ¶ 13,145 (CA-7).

[13] See *Bernatavicius v. Bernatavicius*, 259 Mass. 486 (1927); but see *Finn v. Finn*, 348 Mass. 443 (1965).

[14] *Coffer v. Lightford*, 129 Cal. App. 2d 191, 276 P. 2d 618 (1954).

[15] *In re Est of Guess*, 213 S. 2d 638 (Fla. App. 1968); but see Uniform Probate Code Sec. 2-508.

such a divorce in order to save income taxes diminishes as these effects multiply.

One can appreciate the Service's dilemma. If a couple is married most of the time it seems fair to treat them as married for tax purposes. Yet, for convenience, the Code prescribes that marital status is determined not by the experience during the majority of the tax year but by marital status on the last day of the tax year. Understandably, efforts by taxpayers to alter their marital status only on that day are of concern, lest they distort the intended tax scheme. But there are other areas where tax effects turn on characterizing something at a single moment in time. For example, when a taxpayer sells stock at year-end to recognize gain or loss, the fact that he intends to reinvest early next year in the same stock arguably might prevent recognition, by requiring that we ignore the sale. In fact, except for the statutory wash sale or sale to related parties restrictions,[16] it is quite difficult to set aside a sale and purchase as of no effect, if the taxpayer suffered some investment risk. But where the sale has no economic substance apart from taxes, such action is justified.[17] If the divorce-remarriage is analogous, we should be chary of disturbing a valid divorce which occasioned real-world effects.

The theory of the Revenue Ruling must be that a divorce, otherwise valid, will not be given tax effect where the parties intend to undo the effects of the divorce shortly thereafter and do so. This approach is troublesome on two grounds. First, it raises the problems of deciding tax consequences by the subjective state of mind of the parties.[18] In the easiest case, where the effects of the divorce are limited to a short interim period, we might feel relatively confident in drawing conclusions as to intent. A reasonable couple might divorce and remarry for tax savings and run the risk of death during the short "single" period. As the interval between divorce and remarriage enlarges, and other effects multiply, however, doubts quickly emerge as to the primacy of the tax avoidance motive as compared with other motives. Our hypothetical reasonable couple is far less likely to dismiss the consequences of being unmarried for a longer period. A conclusion that the parties never intended to be divorced must rely on an exploration of what they said and did.

A second cause for doubt as to the Service's conclusion is the purpose of the rule which measures married status as of the end of the year. The *Gregory* case would seem to direct us to the purpose of the relevant tax provisions. Whatever else that Delphic opinion did, it compared the transactions before it with the legislative intent, and it concluded that Congress did not mean to include the transaction before it in the favored treatment. A weekend divorce-remarriage on which nothing else turns should receive a similar negative assessment: Congress probably did not intend to treat as single a husband and wife who pass through a Caribbean revolving door. As the interval of the unmarried period enlarges and real-world risks and effects attach to the divorce, this result becomes more dubious. One could argue that part of the convenience Congress sought to obtain by designating a single day to measure marital status was the avoid-

[16] Code Secs. 1091(a) and 267(a)(1).

[17] See *E. Keith Owens,* CCH Dec. 33,127, 64 TC 1 (1975).

[18] For a more elaborate statement of the effects of states of mind on tax results see Blum, "Motive, Intent and Purpose in Federal Income Taxation," 34 *University of Chicago Law Review,* 485 (1967); Paul, *Motive and Intent in Federal Tax Law Studies in Federal Taxation,* 255 (2d ed. 1938).

ance of controversy concerning the subjective elements which tend to establish marital relationships.

Conclusion

Congress could of course alter this statutory arrangement as it wished. It could change the present rule determining marital status on the last day of the year for all individual taxpayers. It could create an exception to that rule nullifying for tax purposes divorce and remarriage between the same individuals. It could even reexamine its 1969 amendments to eliminate the income tax pressures which underlie tax-motivated divorces. Meanwhile, the miasma emitted by the Revenue Ruling ought sufficiently to befog the end-of-year divorce ploy to discourage its use. For taxpayers willing to test the ruling in a courtroom challenge involving a divorce-remarriage with some substance, however, the temporarily single state may have its tax rewards. **[The End]**

TAX MEETINGS

Independent Accountants Association of Illinois.—The 27th Annual Tax Seminar will take place December 2-4, 1976, at the Ramada O'Hare Inn, in Des Plaines, Illinois. Commissioner Donald Alexander will be a featured luncheon speaker.

Registration fees are $70 for IAAI members; $55 for employees of IAAI members; and $125 for nonmembers. Further information may be obtained from Patricia W. Scott, Executive Secretary, Independent Accountants Association of Illinois, 726 South College Street, Springfield, Illinois 62704.

Florida Accountants Association.—The Annual Tax Institute is scheduled for Novembeer 28-December 1, 1976, at the Dutch Inn, in Orlando. This year's presentations will place special emphasis on the Tax Reform Act of 1976.

The registration fee is $85 for members and $125 for nonmembers. Further details may be obtained from Gordon M. Wiggin, Executive Director, Florida Accountants Association, 2120 S. W. 23rd Avenue, Ft. Lauderdale, Florida 33312.

Kentucky Society of CPAs.—The 19th Annual Institute on Federal Taxation will take place December 9-10, 1976, at the Gault House Hotel, in Louisville.

Further details may be obtained from Marvin L. Fishman, 19th Annual Kentucky Institute on Federal Taxation, c/o Arthur Young & Company, 2707 Citizens Plaza, Louisville, Kentucky 40202.

Wisconsin Institute of CPAs.—The 40th Annual Clinic will take place November 12, 1976, at the Pfister Hotel in Milwaukee. Topics to be covered include Recent Developments and Current Legislation, Current Techniques in Executive Compensation; Problems and Planning for Related Business Entities; Estate Planning for Executives in Closely Held Corporations; Tax Ramifications of Securities Transactions; and Tax Shelters—Escape.

Further details may be otbained from David A. Hart, Publicity Chairman, 40th Annual Tax Clinic of the Wisconsin Institute of CPAs, c/o Broesch, Jannsen & Hart, S. C., 1001 Madison Avenue, South Milwaukee, Wisconsin 53172.

Canadian Tax Foundation.—The 28th Annual Conference will take place November 22-23, 1976, at the Hotel Vancouver, Vancouver.

Further details may be obtained from the Secretary, Canadian Tax Foundation, 100 University Avenue, Toronto, Ontario M5J 1V6.