STATE OF NEW YORK

DIVISION OF TAX APPEALS

In the Matter of the Petitions	:	
of	:	
MITCHELL M. GITIN AND SUZANNE STRONG	:	DETERMINATION DTA NOS. 817223
for Redetermination of Deficiencies or for Refund of New York State and New York City Personal Income Tax under Article 22 of the Tax Law and the Administrative Code of the City of New York for the Years 1992, 1993 and 1994.	:	AND 817224

Petitioners, Mitchell M. Gitin and Suzanne Strong, c/o Peter Gold, CPA, 280 Central Avenue, Hartsdale, New York 10530, filed petitions for redetermination of deficiencies or for refund of New York State and New York City personal income tax under Article 22 of the Tax Law and the Administrative Code of the City of New York for the years 1992, 1993 and 1994.

On May 10, 2000 and May 17, 2000, respectively, petitioner, by Arnold Y. Kapiloff, Esq., and the Division of Taxation, by Barbara G. Billet, Esq. (Jennifer L. Hink, Esq., of counsel), waived a hearing and agreed to submit this matter for a determination based on documents and briefs submitted by September 5, 2000, which date began the six-month period for the issuance of this determination. After review of the evidence and arguments presented, Timothy J. Alston, Administrative Law Judge, renders the following determination.

ISSUE

Whether payments made by petitioner Mitchell M. Gitin to his former spouse, consisting of a percentage of his share of partnership income, incident to a divorce and pursuant to a marital agreement, constitute New York taxable income to petitioners.

FINDINGS OF FACT

The facts in this matter are not in dispute. The following Findings of Fact include those contained in a Stipulation of Facts submitted by the parties and other relevant facts in the record.

1. Petitioner, Mitchell M. Gitin,[1] and Rena Gitin were married on April 7, 1968 in Kings County, New York.

2. Petitioner and Rena Gitin were divorced pursuant to an *in rem* Australian divorce decree, dated September 6, 1991, obtained by petitioner.

3. Thereafter, Rena Gitin commenced an action in New York Supreme Court, seeking, among other things, equitable distribution, maintenance and a determination of her financial rights.

4. By an agreement signed by Rena Gitin on August 26, 1992 and by petitioner on September 4, 1992 ("the Agreement"), the parties to the marital action resolved their respective disputes.

5. By Order of the Supreme Court dated November 17, 1992, the marital action was discontinued and the Agreement incorporated into the Court's Order.

6. Prior to the settlement of the marital litigation, petitioner had withdrawn as a partner from the law firm of Skadden, Arps, Slate, Meagher & Flom ("Skadden Arps"). As a result of his withdrawal, petitioner was entitled to receive, among other things, payments from Skadden Arps for his interests in the partnership capital account and the partnership income account (also called a "run-off" account). The run-off income account was payable in 16 equal quarter-annual

[1] Petitioner Suzanne Strong is a party to these proceedings solely because she filed a joint New York State income tax return for the year 1994 with petitioner Mitchell M. Gitin. Accordingly, unless otherwise indicated, all references to petitioner herein shall refer to Mitchell M. Gitin.

payments, the first of which was paid to petitioner in July 1992, before the execution of the Agreement.

7. Pursuant to Paragraph 3B of the Agreement, Rena Gitin was to receive "the sum of $713,333.00" of the $1,760,920.00 due to petitioner as his partnership share of the run-off account income of Skadden Arps. The amount paid to Rena Gitin represented 40.5 percent of the total due petitioner from the run-off account and was payable in 16 equal quarter-annual payments. More specifically, the Agreement provided that Rena Gitin was to receive "$44,573.29 of each quarter-annual payment [payable to petitioner], except that [Rena Gitin] shall receive the sum of $63,381.08 from the next quarter-annual payment to adjust for payment previously received by [petitioner]." The amount owed to petitioner accrued during the time he was a partner.

8. Because of adjustments created by the subsequent payment of partnership expenses properly chargeable against the amount owed petitioner, Rena Gitin was paid the sum of $150,856.00 for 1992, $131,099.00 for 1993 and $127,279.00 for 1994. These amounts represented 40.5 percent of the total amounts paid by Skadden Arps to petitioner for his interest in the run-off account in each of those years. The Agreement at Paragraph 3D provided that Rena Gitin was to include the aforesaid payments that she received as income for personal income tax purposes.

9. Pursuant to the Agreement, petitioner directed Skadden Arps to make all payments of his run-off account to an escrow agent. The escrow agent then paid over to Rena Gitin the amount due her under the Agreement and thereafter remitted to petitioner the amount due him under the Agreement.

10. On February 17, 1998, the Division of Taxation ("Division") issued to petitioner Mitchell M. Gitin a Notice of Deficiency which asserted $12,711.62 in additional New York State and City personal income tax due, plus interest, for the year 1992.

11. Also on February 17, 1998 the Division issued to petitioners, Mitchell M. Gitin and Suzanne Strong, a Notice of Deficiency which asserted $10,592.99 in additional New York State and City personal income tax due, plus interest, for the years 1993 and 1994.

12. Petitioner Gitin filed a New York State Nonresident and Part-Year Resident return (Form IT-203) for the year 1992. Petitioners Gitin and Strong jointly filed an IT-203 for both 1993 and 1994.

13. A portion of the additional tax due for the year 1992 results from a disallowance by the Division of a foreign housing deduction and a foreign income exclusion. Petitioner does not take issue with this portion of the deficiency. The balance of the 1992 deficiency and the entire 1993 and 1994 deficiencies result from the Division's assertion that the amounts paid by petitioner to Rena Gitin from petitioner's run-off account are properly taxable to petitioner.

SUMMARY OF THE PARTIES' POSITIONS

14. Petitioner concedes that, outside of the marital context, the amounts he transferred to Rena Gitin from his share of the partnership run-off account would be properly taxable to him under the assignment of income doctrine. Petitioner contends, however, that section 1041 of the Internal Revenue Code ("IRC") is applicable under the instant circumstances, and that the application of that section "trumps" the assignment of income doctrine. Petitioner characterizes the transfer to Rena Gitin as the transfer of a right to receive income. He contends that the term "property" as used in section 1041 should be broadly construed and that this term includes a right to receive income. Petitioner describes the transfer to Rena Gitin in terms of section 1041 as

follows: Petitioner had a zero basis in his right to receive income from the run-off account. He transferred that right to Rena Gitin pursuant to the Agreement. Under section 1041, Rena acquired petitioner's zero basis in the income right. When the income was paid to Rena, she effectively disposed of her right to receive the income and the incidence of taxation occurred. Petitioner thus asserts that the payments from the run-off account to Rena Gitin are taxable to Rena and not to petitioner.

15. The Division contends that petitioner is properly subject to tax on the run-off account income transferred to Rena Gitin pursuant to the assignment of income doctrine. The Division argues that IRC § 1041 applies only with respect to transfers of "property" and that the instant matter involves a transfer of "income," which is not "property" for purposes of section 1041. The Division thus asserts that section 1041 does not apply under the instant circumstances. The Division further asserts that subjecting Rena Gitin to taxation on the subject income as petitioner proposes runs contrary to the intent of section 1041.

CONCLUSIONS OF LAW

A. The starting point for determining New York adjusted gross income for petitioner, a nonresident, is Federal adjusted gross income (***see***, Tax Law § 631). Federal adjusted gross income is defined as all income from whatever source derived, minus any pertinent deductions (***see***, IRC § 61[a]; § 62[a]).

B. Before examining the issue of whether petitioner is taxable on the amounts paid to Rena Gitin from petitioner's share of the partnership run-off account, it is necessary to examine and to make clear the substance of the transactions present in this matter. "It is a central tenet of tax law that tax liability depends upon the substance and not the form of a transaction" (***Greene***

v. United States, 13 F3d 577, 581). In order to determine its substance, a transaction must be viewed as a whole (***see***, ***Commr. v. Court Holding Co.***, 324 US 331, 334).

There are, in fact, two transactions (or sets of transactions) relevant to the instant matter. The first set consists of the payments made by Skadden Arps in respect of petitioner's interest in the run-off account. As noted, the amount owed to petitioner accrued during the time he was a partner. Pursuant to petitioner's direction and in accordance with the Agreement, these payments were made to an escrow agent, who then paid Rena Gitin under the Agreement. These transactions were, in form and substance, payments to petitioner of his share of partnership income.

The second set of transactions present in this matter are the payments to Rena Gitin from the escrow account pursuant to the Agreement. This set of transactions consists, in substance, of an exchange of a percentage of the run-off account payments made to petitioner by Skadden Arps for Rena Gitin's marital rights. In viewing this set of transactions as a whole, it is clear that these transfers amount to an exchange of money for marital rights. Contrary to petitioner's assertion, Rena Gitin did not acquire an "income right" separate and apart from the payments themselves. The Agreement states that Rena was to receive from petitioner "the sum of $713,333.00" from his total of $1,760,920.00 payable in 16 quarter-annual installments. The Agreement makes no reference to any rights regarding the run-off account separate from the payments themselves. It merely provides Rena with a right to be paid a certain sum of money in accordance with a certain schedule.

C. With respect to the first set of transactions noted above, pursuant to the assignment of income doctrine, petitioner is subject to income tax on the full amount paid to him by the partnership for his interest in the run-off account. "It is a principle of Federal income tax law

that income is to be taxed to the person who has earned it. If that person assigns this income to another, it nevertheless is the income of the assignor and is taxable to him" (***REP Sales v. United States***, 86-1 US Tax Cas ¶ 9387, at 83,850 [SD WVa], ***citing Lucas v. Earl***, 281 US 111; ***Helvering v. Horst***, 311 US 112). This is "one of the primary principles of our system of income taxation" (***Vercio v. Commr.***, 73 TC 1246, 1253). "The choice of the proper taxpayer revolves around the question of which person . . . in fact controls the earning of the income rather than the question of who ultimately receives the income." (***Id***. at 1253.) Accordingly, tax may not be escaped by the earner through the use of "anticipatory arrangements and contracts however skillfully devised" to prevent income when paid from vesting in him (***Lucas v. Earl***, ***supra***, at 115).

In the instant matter, there is no doubt that petitioner controlled the earning of the run-off account income. The assignment of income doctrine thus requires that such income be taxed in its entirety to petitioner, notwithstanding the payments to Rena Gitin under the Agreement.

D. While petitioner concedes that, outside of the marital context, the income from the run-off account is properly taxable to him under the assignment of income doctrine, he asserts that such analysis is inapplicable to the instant matter by operation of Internal Revenue Code § 1041, which provides in relevant part:

> (a) General Rule.- No gain or loss shall be recognized on a transfer of property from an individual to (or in trust for the benefit of) -
>
> (1) a spouse, or
>
> (2) a former spouse, but only if the transfer is incident to the divorce.
>
> (b) Transfer Treated As Gift; Transferee Has Transferor's Basis. - In the case of any transfer of property described in subsection (a) -

> (1) for the purposes of this subtitle, the property shall be treated as acquired by the transferee by gift, and
>
> (2) the basis of the transferee in the property shall be the adjusted basis of the transferor.
>
> (c) Incident to Divorce. - For purposes of subsection (a)(2), a transfer of property is incident to the divorce if such transfer -
>
> (1) occurs within 1 year after the date on which the marriage ceases, or
>
> (2) is related to the cessation of the marriage.

Before the enactment of section 1041, the tax treatment of the division of property between spouses incident to a divorce depended on the manner in which each spouse's rights and obligations were viewed for state law purposes. The Supreme Court had ruled that a transfer of appreciated property to a spouse or a former spouse in exchange for the release of marital rights resulted in the recognition of gain to the transferor (***United States v. Davis***, 370 US 65 [1962]). Under ***Davis***, the spouse receiving the property received a basis in the asset equal to its fair market value. The ***Davis*** rule did not apply in the case of an approximately equal division of community property on divorce (***see***, ***Carrieres v. Commr***., 64 TC 959, 964, ***affd per curiam*** 552 F2d 1350). Nor, according to the Internal Revenue Service, did the rule apply to the partition of jointly held property (***see***, Rev Rul 74-347). Additionally, the tax treatment of divisions of property between spouses involving other types of ownership under different state laws was often unclear and resulted in much litigation (***see***, HR Rept 98-432 [II], at 907). Furthermore, several states amended their laws in an effort to avoid the result in the ***Davis*** case (***see***, ***id.***, at 1492).

It was in this context, then, that Congress enacted IRC § 1041. The House of Representatives Ways and Means Committee noted reasons for the change, in part, as follows:

> The Committee believes that, in general, it is inappropriate to tax transfers between spouses. . . . The current rules governing transfers of property between

> spouses or former spouses incident to divorce have not worked well and have led to much controversy and litigation. Often the rules have proved a trap for the unwary as, for example, where the parties view property acquired during marriage (even though held in one spouse's name) as jointly owned, only to find that the equal division of property upon divorce triggers recognition of gain. . . . The Committee believes that to correct these problems and to make the tax laws as unintrusive as possible with respect to relations between spouses, the tax laws governing transfers between spouses and former spouses should be changed. (HR Rept 98-432[II] at 907, 908.)

The Ways and Means Committee explained the provision in part as follows:

> The bill provides that the transfer of property to a spouse incident to a divorce will be treated, for income tax purposes, in the same manner as a gift. Gain . . . or loss will not be recognized to the transferor, and the transferee will receive the property at the transferor's basis . . . . This nonrecognition rule applies whether the transfer is for the relinquishment of marital rights, for cash or other property, for the assumption of liabilities, in excess of basis, or for other consideration and is intended to apply to any indebtedness which is discharged. Thus, uniform federal income tax consequences will apply to these transfers notwithstanding that the property may be subject to differing state property laws. In addition, this nonrecognition rule applies in the case of transfers of property between spouses during marriage. (HR Rept 98-432[II] at 908.)

E. Petitioner correctly notes that IRC § 1041 is applicable to his transfer of 40.5 percent of the run-off account income to Rena Gitin in settlement of the marital action. "Transfers of property, or releases of marital rights, incident to divorce, . . . are subject to a special set of rules found in section 1041." (***Balding v. Commr.***, 98 TC 368, 370.) As discussed previously, the transfer between petitioner and Rena Gitin is an exchange of cash for marital rights. The Tax Court has held that such an exchange is subject to section 1041 (***see***, ***id***.). Petitioner is incorrect, however, with respect to the income tax consequences flowing from the application of section 1041.

Petitioner correctly asserts that the run-off account income transferred to Rena Gitin may not result in taxable gain to him pursuant to section 1041(a). The operation of section 1041 does not, however, negate or prevent the taxation of the run-off account income paid to petitioner by

the partnership. Section 1041 applies to transfers between spouses or former spouses. The transfers that result in income tax liability to petitioner, however, are the run-off account payments from the partnership to petitioner. Section 1041 does not apply to these transfers. As discussed previously, under the assignment of income doctrine, such payments are deemed realized by petitioner and are taxable to him, notwithstanding petitioner's direction that the partnership make these payments to an escrow agent and notwithstanding petitioner's obligation to transfer 40.5 percent of these payments to Rena Gitin. Accordingly, while petitioner is correct in that the transfers to Rena do not result in a taxable gain to petitioner as transferor, petitioner is nonetheless subject to tax on the income paid to him by the partnership. The taxable event, however, is not the transfer from petitioner to Rena, but the payments from the partnership to the escrow account, deemed to be payments to petitioner through the assignment of income doctrine. Section1041 thus does not allow petitioner to escape taxation on the portion of the run-off account income paid to Rena Gitin.

Petitioner erroneously asserts that Rena Gitin is properly subject to income tax on the run-off account payments made to her.[2] To the contrary, section 1041 provides that Rena Gitin is not subject to tax on the run-off account payments from petitioner to her. Specifically, section 1041 provides that "the property shall be treated as if acquired by gift" and thereby indicates that receipt of the transferred property is nontaxable. Furthermore, the regulations state that "the transferee of property under section 1041 recognizes no gain or loss upon receipt of the

[2] Petitioner's assertion that Rena Gitin is properly subject to tax on the run-off account payments from petitioner to Rena rests upon a mischaracterization of these transfers. As noted herein, petitioner asserts that he transferred an income right to Rena under the Agreement. This characterization allows petitioner to fit the transfer, however awkwardly, within the language of section 1041 (***see***, paragraph "14"). As discussed previously, however, the transfer from petitioner to Rena, viewed as a whole, was one of cash payments for marital rights. Petitioner's characterization artificially separates this transfer into a right to income and the subsequent conversion of that right into income. Petitioner's characterization does not reflect the substance of the transaction and has therefore been rejected.

transferred property" (Temp Treas Reg § 1.1041-1T[d]). Additionally, the House of Representatives Ways and Means Committee's report clearly expresses a desire not to tax transfers between spouses (***see***, Conclusion of Law "D"). (***See also***, ***Balding v. Commr***. ***supra***.)

F. The conclusion herein is supported by the companion cases of ***Smith v. Internal Revenue Service***, (94-2 US Tax Cas ¶ 50,503 [SD NY]), and ***United States v. Smith***, (94-2 US Tax Cas ¶ 50,504 [SD NY]), wherein the United States District Court for the Southern District of New York found that a taxpayer-husband was taxable on the full amount of his lottery winnings notwithstanding that he transferred 50 percent of such winnings to his former spouse pursuant to court-ordered equitable distribution in a New York divorce action. Similar to the instant matter, such lottery winnings were payable to the taxpayer in installments. The court found that the taxpayer's payment of his lottery winnings to his ex-wife did not "reduce the taxes to be paid by plaintiff or create an opportunity to impose a new tax on the plaintiff's ex-wife" (***Smith v. Internal Revenue Service***, ***supra***) and that "a distribution of marital property incident to a divorce is not a taxable event and does not give rise to income or deduction for either spouse" (***United States v. Smith***, ***supra***). Similarly, petitioner is properly subject to tax on the full amount of the run-off account payments from the partnership to him despite his transfer of 40.5 percent of such payments to his former spouse in settlement of a marital action. Petitioner is taxed on the payment of income to him by the partnership; the subsequent transfer to Rena Gitin is not a taxable event and does not reduce petitioner's taxable income or give rise to income to Rena.

G. The petitions of Mitchell M. Gitin and Suzanne Strong are denied and the notices of deficiency dated February 17, 1998 are sustained.

DATED: Troy, New York

February 15, 2001

/s/ Timothy J. Alston
ADMINISTRATIVE LAW JUDGE