Tax Consequences of Community Income: Problems and Planning Opportunities During Divorce

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Tax Consequences of Community Income: Problems and Planning Opportunities During Divorce

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I. Introduction

Nine states—Arizona, California, Idaho, Louisiana, Nevada, New Mexico, Texas, Washington, and Wisconsin—have community property laws that determine the rights of spouses in property and income during marriage.[1] Although the community property laws vary among the states, each spouse domiciled in a community property state generally has an equal, undivided interest in community income.[2] Thus, community income which consists of salary, wages, and other pay for services is owned half by each spouse even though it may be the product of the labors of only one of the spouses.[3] This feature of community property law led to the ruling in *Poe v. Seaborn*.[4] Under *Seaborn*,

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1. *See* ARIZ. REV. STAT. ANN. §§ 25-211 to 217 (1991); 1992 CAL. STAT. ch. 162 (codified as amended in scattered sections of CAL. FAM. CODE); IDAHO CODE §§ 32-903 to 914 (1983); LA. CIV. CODE ANN. arts. 2334 to 2369 (West 1985 & Supp. 1995); NEV. REV. STAT. ANN. §§ 123.130 to .259 (Michie 1993); N.M. STAT. ANN. §§ 40-3-6 to 17 (Michie 1978 & Supp. 1994); TEX. FAM. CODE ANN. §§ 5.01 to .27 (West 1993); WASH. REV. CODE ANN. §§ 26.16.010 to .150 (1994); WIS. STAT. ANN. §§ 766.001 to .97 (West 1993 & Supp. 1994). For useful reference sources on community property law, see WILLIAM Q. DE FUNIAK & MICHAEL J. VAUGHN, PRINCIPLES OF COMMUNITY PROPERTY (2d ed. 1971); W. S. MCCLANAHAN, COMMUNITY PROPERTY LAW IN THE UNITED STATES (1982 & Supp. 1989); WILLIAM A. REPPY & CYNTHIA A. SAMUEL, COMMUNITY PROPERTY IN THE UNITED STATES (2d ed. 1982).

2. See *infra* notes 8-17 and accompanying text for a discussion of general principles of community property law pertinent to this article. Because community property laws vary from state to state, it is important to refer to individual states.

3. *See infra* notes 15-17 and accompanying text.

4. 282 U.S. 101 (1930).

community income is taxed half to each spouse without regard to which spouse generated the income, because each spouse owns one-half.[5] The *Seaborn* rule has no significance for married couples filing joint returns.[6] It has severe implications, however, for divorced spouses who were married for part of the year and for separated spouses who file separately.

Couples undergoing a divorce are often separated, living apart, and are not communicating. Nevertheless, until the marital community is dissolved, each spouse has federal tax reporting liability with respect to half of the post-separation or pre-divorce community income (''interim'' income) under the *Seaborn* rule. The rule's harshness for separated spouses becomes apparent when the spouse with lower income (''low income spouse'') has to report half of the other spouse's earnings. The low income spouse must report this income even though he or she has no knowledge of the amount or sources of the other spouse's income and the low-income spouse does not beneficially enjoy or control the other spouse's income. The complexities and inequities created by the *Seaborn* rule for separated spouses become even more apparent if a prolonged period of separation precedes a divorce.

This article discusses the current state of the law with respect to the taxation of post-separation income in community property states.[7] The article provides practical ways to avoid *Seaborn's* inequitable attribution of taxable income to separated spouses. Three methods to terminate the marital community requiring federal tax reporting of only separately earned income are considered. Particular attention is also given to congressional relief provided to spouses unable to successfully terminate the marital community. The article finally discusses planning opportunities in connection with final property divisions when spouses have been unable to avoid the trap set by *Seaborn*. Because community property

5. *Id.* at 111-18. *Seaborn* involved Washington's community property law. The Court's decision turned upon ownership of the income. Under Washington law, the wife became the co-owner of her husband's income the instant the income came into being.

6. Married couples who file joint returns take advantage of income splitting by treating the aggregate income of the couple as though each spouse earned one half. *See* I.R.C. §§ 1(a), 6013(a), (d) (1993). Thus, for the happily married couple, the *Seaborn* rule is unnecessary.

7. This article is an extension and update of an earlier article. John A. Miller, *Federal Income Taxation and Community Property Law: The Case for Divorce*, 44 Sw. L.J. 1087 (1990) (now SMU L. Rev.). For other treatments of certain aspects of this issue, see Susan Kalinka, *Federal Taxation of Community Income: A Simpler and More Equitable Approach*, 1990 Wis. L. Rev. 633; Fred F. Murray, *Problems of Taxation of the Income of Spouses in the Context of Divorce and Separation*, 14 Community Prop. J. 20 (1987); Jack M. Vaughn, *P.L. 96-605: Tax Relief for the Abandoned Spouse in a Community Property State?*, 8 Community Prop. J. 53 (1981).

laws vary among the states, this article begins with a standard discussion of the most salient points of community property pertinent to the present inquiry.

II. Basic Principles of Community Property Law

Generally, community property is all property, other than "separate property," that is acquired after marriage by spouses domiciled in a community property state.[8] Separate property is property acquired by a husband or wife prior to marriage, property received by gift or devise after marriage, and property acquired with the proceeds from either of the first two classes of separate property.[9] If separate property appreciates during marriage due to the uncompensated efforts, skills, or labor of one of the spouses, referred to as "active" appreciation, the appreciation in value of the separate property is considered community property.[10] "Passive" appreciation of separate property, however, is separate property.[11] Husbands and wives are equal managers of their community property.[12] Either spouse may act individually on behalf of the community with respect to dispositions of community property, but the spouses must act together with respect to dispositions of real property.[13]

Community income is all income derived from community property and all the earnings of either spouse during the marriage.[14] In some states, income from a spouse's separate property is also community

8. *See* MERTENS, LAW OF FEDERAL INCOME TAXATION § 19.04, at 23-24 (1988); MCCLANAHAN, *supra* note 1, §§ 6:1 to 6:4, at 329-35; REPPY & SAMUEL, *supra* note 1, at 2 (excerpting a portion of Michael J. Vaughn, *The Policy of Community Property and Inter-Spousal Transactions*, 19 BAYLOR L. REV. 20, 20-27 (1967)).

9. *See* MERTENS, *supra* note 8, § 19.05; MCCLANAHAN, *supra* note 1, §§ 6:1 to 6:4, at 329-35.

10. *See* MCCLANAHAN, *supra* note 1, § 6:18, at 357-59; June Miller Weisberger, *The Wisconsin Marital Property Act: Highlights of the Wisconsin Experience*, 13 COMMUNITY PROP. J. 1, 15 (1986), *reprinted from* 1 Wis. Women's L.J. 6 (1985).

11. *See* MCCLANAHAN, *supra* note 1, § 6:15, at 353; Weisberger, *supra* note 10, at 15.

12. *See* MCCLANAHAN, *supra* note 1, § 9:12, at 466-67.

13. *See id.*; Murray, *supra* note 7, at 26-27; REPPY & SAMUEL, *supra* note 1, at 205 n. 2. Texas has a distinct management scheme in which each spouse is the separate manager of the community property which would have been his or hers alone in a separate property state, such as earnings and income from separate property. TEX. FAM. CODE ANN. §§ 5.22(a), 5.24(a) (West 1975 & Supp. 1992). Louisiana and New Mexico grant sole management power over titled movables to the spouse in whose name they are titled even though the movables may be community property. MCCLANAHAN, *supra* note 1, § 9:14, at 474-75.

14. *See* DE FUNIAK & VAUGHN, *supra* note 1, at §§ 66 to 67; MCCLANAHAN, *supra* note 1, § 6:1, at 331; MERTENS, *supra* note 8, § 19.04.

income.[15] Separation of the spouses may serve to end the community with respect to income earned after the date of separation.[16] That income is then the separate property of the earner. Community income is simply a form of community property. Categorizing income as community property means the property is owned equally by each spouse.[17] Therefore, community income is owned equally by each spouse even though the income is the product of the labors of only one of the spouses.

State law determines whether income is community or separate, and thus, the federal tax attribution of income between spouses in community property states is often a direct consequence of state law. Because variation among community property states exists as to which sources produce community income, the federal tax consequences associated with various sources of income are also subject to some variation from state to state. For this reason, one must determine the source of income in order to characterize it.

III. Termination of the Community

If *Seaborn* establishes that community income is taxed half to each spouse, without regard to its source, then, by implication, separate income is taxed to the spouse who owns the separate income. This principle has broad implications and great practical significance. State law provides several ways in which the community may be partially or completely terminated with or without divorce. The marital commu-

15. *See* McCLANAHAN, *supra* note 1, § 6:11 to 6:12, at 344-46 (indicating that Idaho, Louisiana, Puerto Rico, and Texas fall into this category). According to Mertens, Wisconsin also falls into this category. MERTENS, *supra* note 8, § 19.04, at 24-25. Weisberger agrees. Weisberger, *supra* note 10, at 17-18. *See also* IDAHO CODE § 32-906 (1983 & Supp. 1990). Even in these states, however, gain from the sale of separate property would not ordinarily be community income. *But cf.* McCLANAHAN, *supra* note 1, §§ 6:15, 6:18 (discussing the impact of the use of community funds to enhance the value of separate property; the impact of enhancement in the value of separate property through the efforts of the non-earner spouse).

16. California and Washington utilize this rule. CAL. FAM. CODE § 771 (West 1994); WASH. REV. CODE ANN. § 26.16.140 (1994). *See* McCLANAHAN, *supra* note 1, § 6:19, at 360-62 (indicating Nevada may also fall into this category); William A. Reppy, Jr., *The Uniform Marital Property Act: Some Suggested Revisions for a Basically Sound Act*, 12 COMMUNITY PROP. J. 163, 168 n.63 (1985) (noting that a modified version of the living apart doctrine, embodied by statutes in Washington and California, has been erratically embraced by case law in Arizona). Idaho has a statute which purports to make the wife's post-separation earnings her separate property. The Idaho Supreme Court declared this statute unconstitutional. Suter v. Suter, 546 P.2d 1169, 1175 (1976). *See infra* text accompanying notes 18-30.

17. *See* DE FUNIAK & VAUGHN, *supra* note 1, § 67; McCLANAHAN, *supra* note 1, §§ 7:3 to :14; MERTENS, *supra* note 8, § 19.04, at 24. Each spouse has an equal, coexisting, and undivided interest in the community property. Murray, *supra* note 7, at 23.

nity can be terminated by statutory mandate, written agreement, or court decree.

A. Termination of the Community by Statute

In some states, separation of the spouses serves to end the community with respect to income earned after the date of separation. Washington State has an established principle that "when for all intents and purposes a marriage has been terminated and the spouses show by affirmative action their intent not to maintain the community status, then the community property laws will not be applied to the spouses."[18] Recognizing this principle of Washington law, the Internal Revenue Service (Service) has agreed that, in circumstances where Washington law regards the community as terminated, the earnings of each spouse are considered separate earned income for federal tax purposes even though the spouses are not yet divorced.[19] The rule also has application in California[20] and, perhaps, in Nevada[21] and Arizona.[22]

Ending the marital community after separation and taxing a spouse only on his or her own post-separation earnings is logical. Inherent in the idea of marital community is the belief that the spouses constitute a single economic unit.[23] However, that economic unity is destroyed when the spouses separate with the intent to permanently live apart. Once separation ends the economic union of the spouses, no basis exists for imputing ownership of half of the income of one spouse to the other non-earning or low-income spouse. The living apart statutes of Washington and California and the application of Revenue Ruling 68-66, which taxes post-separation earnings according to the spouse who earned the earnings, seemingly prevent the inequities created by the *Seaborn* rule. There are a number of limitations, however, imposed by Washington and California law which make the application of Revenue Ruling 68-66 uncertain.

Although Washington and California statutes provide that the earnings of the spouses are separate income while they are living separate and apart, mere physical separation by itself does not dissolve the

18. WASH. REV. CODE ANN. § 26.16.140 (1994).

19. Rev. Rul. 68-66, 1968-1 C.B. 33, 34.

20. CAL. FAM. CODE § 771 (West 1994).

21. *See* MCCLANAHAN, *supra* note 1, § 6:19, at 360 (indicating Nevada may also fall into the same category as Washington and California). *See supra* note 16.

22. *See* Reppy, *supra* note 16, at 168 n. 63: "Arizona apparently uses a nonstatutory version of the living-apart doctrine, though concededly a few cases flatly reject any form of it." *See supra* note 16.

23. *See* Richard W. Bartke, *Marital Sharing—Why Not Do It By Contract?*, 67 GEO. L.J. 1131 (1979).

community in either state. Both states require significant proof that the marriage has essentially ended. In Washington, the living apart statute "applies to those marriages which are for all practical purposes 'defunct'."[24] In California, the spouses must effect "a parting of the ways with no present intention of resuming marital relations."[25] Thus, whether interim earned income is community or separate is a question of fact to be resolved on a case-by-case basis even in those states with statutes causing such income to be separate income.[26] In circumstances where the parties have not acted with clear design, the application of Revenue Ruling 68-66 is uncertain. It is advised that the parties document compliance with state law requirements for termination of the community to assure that interim earnings will be treated as separate income for federal income tax purposes.

Although California and Washington treat separation as ending the community with respect to "earnings," post-separation income from community property remains community property under state law. Such post-separation income also remains community income for federal tax purposes,[27] with the income normally being taxed half to each spouse under the *Seaborn* rule. If a business is owned by the community and employs one of its members, a question may arise as to whether income derived from the family-owned business is earned income or income from community property.[28]

California and Washington have adopted statutes that terminate the marital community upon formal separation. However, both states treat only the earnings of spouses, and not other income, as separate income upon separation of the spouses.[29] In addition, both states require significant proof that the marriage has ended, a question of fact to be resolved

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24. Aetna Life Ins. Co. v. Bunt, 754 P.2d 993, 996 (1988). *Accord* Aetna Life Ins. Co. v. Boober, 784 P.2d 86 (1990).

25. *In re* Baragry, 140 Cal. Rptr. 779, 781 (1977) (quoting *In re* Imperato, 119 Cal. Rptr. 590, 592 (1975)).

26. *See* Feldman v. Nassi, 169 Cal. Rptr. 9 (1980); *In re* Baragry, 140 Cal. Rptr. 779 (1977).

27. This is because each spouse has a half interest in the property under state law. *See* McClanahan, *supra* note 1, § 12:5. In California and Washington, separation apparently does not affect the character of income other than earnings (*e.g.*, rents and royalties associated with community property). *See* Murray, *supra* note 7, at 48-50.

28. *See, e.g.*, Bass v. Commissioner, 45 T.C.M. (CCH) 1411 (1983). Applying California law, where separation causes earnings to be separate property, the Tax Court in *Bass* held that income from a community property company was comprised of both community income produced by the assets of the business and separate income produced by the efforts of the husband after separation, and ordered the wife to report one half of the community income for tax purposes. *Id.* at 1414-15. For another case of similar import involving a sole proprietorship under California law, see Thatcher v. Commissioner, 56 T.C.M. (CCH) 707, 709 (1988).

29. *See supra* note 27 and accompanying text.

on a case-by-case basis.[30] Even though termination of the community is provided by the law in these states, parties are encouraged to end the community without divorce by written agreement.

B. Termination of the Community by Marital Agreement

Divorcing spouses quite likely will have conflicting interests in whether their interim income is community income or separate income.[31] The potential dispute is best resolved in advance by a written separation agreement. All community property states provide for an ending of the community without divorce by written agreement.[32] If the spouses enter into a valid agreement terminating the community and declaring that their earnings will be the separate property of the earner, those earnings will be taxed accordingly.[33] This principle is acknowledged in Revenue Ruling 68-66, which states that if interim earned income is separate income under state law, then it is separate income for federal tax purposes.[34]

Most states do not give effect to oral divisions of community property.[35] Some states may if the oral agreements terminating the commu-

30. *See supra* notes 24-26 and accompanying text.

31. While the interim income is being received and spent, the higher income spouse has an interest in treating the interim income as separate income. When the time arrives to report the interim income for federal tax purposes, the higher income spouse has an incentive to consider the interim income community income. The reverse is true on both of these points for the lesser income spouse. Nontax considerations may alter the balance of these interests. For instance, if a spouse uses her interim income to purchase a capital asset, she may prefer to treat that interim income as separate income because otherwise the other spouse would own a half interest in the asset. Conversely, a spouse who spends all of his interim income on nondurable goods has less incentive to contend after the fact that the interim income is separate property.

32. ARIZ. REV. STAT. ANN. § 25-317 (1991); CAL. FAM. CODE §§ 1620, 3580 (West 1994); IDAHO CODE §§ 32-906, 916 (1983 & Supp. 1995); LA. CIV. CODE ANN. arts. 2328 to 2329 (West 1985); NEV. REV. STAT. ANN. § 123.190 (Michie 1993); N.M. STAT. ANN. § 40-2-8 (Michie 1978 & Supp. 1994); TEX. FAM. CODE ANN. § 5.53 (West 1993); WASH. REV. CODE ANN. § 26.16.120 (1994); WIS. STAT. ANN. § 766.58 (West 1993 & Supp. 1994). *See* MCCLANAHAN, *supra* note 1, §§ 8:2 to :18, at 408-30; MERTENS, *supra* note 8, § 19:13; REPPY & SAMUEL, *supra* note 1, at 23-25. Some states, such as Louisiana, require that a marital agreement obtain court approval. *See, e.g.*, LA. CIV. CODE ANN. art. 2329 (West 1985).

33. The reverse is true as well. Spouses can agree to convert separate property to community property, and the income from such property will be community income for tax purposes. *See* Rev. Rul. 77-359, 1977-2 C.B. 24.

34. Rev. Rul. 68-66, 1968-1 C.B. 33. The federal income tax ramifications flow from classification of income as separate property. *See supra* note 19 and accompanying text.

35. *See, e.g.*, Recio v. Recio, 666 S.W.2d 645 (Tex. Civ. App. 1984) (requiring that the agreement be in writing). For a discussion of a number of early cases on this and related issues, see Annotation, *What Contract, Understanding, Circumstances, Etc. Will Render a Wife's Personal Earnings Separate and Not Community Property*, 67 A.L.R.2d 708 (1959).

nity are coupled with performance.[36] Because of obvious proof problems, pre- or post-marital agreements should be in writing. Some lawyers recommend filing a copy of a marital agreement with the Internal Revenue Service district director's office, although usually it is not necessary to file an executed copy prior to review or audit of a return.[37]

There is an important limitation regarding the availability of marital agreements to classify income between the spouses. Such agreements are not entitled to retroactive effect for federal tax purposes even though they may have retroactive effect under state law.[38] Accordingly, community income received prior to execution of a separation agreement cannot be retroactively reclassified as separate income.

Caution should be exercised when the divorce lawyer drafts marital property agreements. A marital agreement that classifies any income received in the year the divorce is granted should be considered "separate income." Such an agreement is ineffective because it is a retroactive recharacterization based upon a future "triggering event."[39] Because of the retroactivity problem, planning during the early stages of separation or divorce is necessary to ensure that marital agreements will end the marital community and effectively recharacterize post-separation community income. Unfortunately, most spouses residing in community property states who separate do not plan ahead and are thus subject to the inequities of the *Seaborn* rule.

If a couple does not reside in California or Washington, where the marital community ends when a couple permanently separates,[40] and if a couple does not enter into a formal agreement because of the circumstances surrounding the separation,[41] termination of the martial community may still be possible by entry of a decree of separation.

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36. *See, e.g.*, Bowart v. Bowart, 625 P.2d 920 (Ariz. 1980) (holding oral agreement between spouses concerning division of profits on sale of real property not barred by statute of frauds); Schreiber v. Schreiber, 663 P.2d 1189 (Nev. 1983) (enforcing an oral agreement dividing community property as part of a divorce based on part performance and collateral estoppel principles); Callicoatte v. Callicoatte, 417 S.W.2d 618 (Tex. Civ. App. 1967) (upholding oral property division agreement). For a further discussion of oral transmutation, see Murray, *supra* note 7, at 44-47.

37. John Vitek, *Computing Community Income During the Divorce*, FAM. ADVOCATE, Fall 1992, at 26, 29. The Milwaukee District Office of the Internal Revenue Service also recommends serving a copy of the marital agreement with the Service at the time it is executed. WISCONSIN DEPARTMENT OF REVENUE, FEDERAL AND WISCONSIN INCOME TAX REPORTING UNDER THE MARITAL PROPERTY ACT (Pub. 113), Sept. 1989, at 10.

38. *See* Vitek, *supra* note 37, at 29 (citing Schmitz v. Commissioner, 46 T.C.M. (CCH) 1091 (1983)).

39. *Id.* at 29.

40. *See supra* notes 18-30 and accompanying text.

41. *See supra* notes 31-39 and accompanying text.

C. *Termination of Marital Community by Court Decree*

Some states permit ending the community by entry of a court decree of separation.[42] Such decree terminates the community as to earnings or income from property after the entry of the decree. As with marital agreements, decrees are not entitled to retroactive effect for federal tax purposes even though they may have retroactive effect under state law.[43]

In *United States v. Mitchell*,[44] a Louisiana wife formally renounced the community when she obtained a separation decree and decree of divorce in order to take advantage of a Louisiana statute which exonerated the wife from community debts following a renunciation of any interest in community assets. The Supreme Court held that the wife was liable for the federal tax on her half of the community income earned while she was married,[45] even though she was exempt under state law. The Court reasoned that the wife's renunciation had come too late because the federal tax liability had already attached under the *Seaborn* rule.[46]

In *Brent v. Commissioner*,[47] a Louisiana wife received a minimal amount of alimony during a three-year separation that ultimately ended in a divorce in 1971.[48] In Louisiana, when a divorce is granted, the post-separation earnings of the husband are retroactively converted into the husband's separate property[49] and the wife has no further claim on the earnings.[50] Despite this state statute, the Fifth Circuit in *Brent* held that the wife was liable for taxes owed on half of her doctor husband's earnings for the year 1970. Despite her argument that the divorce decree in 1971 prevented her from having any taxable interest in those earnings, the court determined that she must report those earnings as income in

42. *See* ARIZ. REV. STAT. ANN. § 25-313 (1991); CAL. FAM. CODE § 772 (West 1994); LA. CIV. CODE ANN. art. 2356 (West 1985 & Supp. 1995); N.M. STAT. ANN. § 40-4-3 (1978 & Supp. 1994); NEV. REV. STAT. § 123.259 (Michie Supp. 1993); WASH. REV. CODE ANN. § 26.09.030 (1994); WIS. STAT. ANN. § 767.07 (West 1993).

43. United States v. Mitchell, 403 U.S. 190 (1971); Brent v. Commissioner, 630 F.2d 356 (5th Cir. 1980); Rev. Rul. 74-393, 1974-2 C.B. 28. These authorities support the proposition that a state court decision which retroactively recharacterizes community income as separate income of one of the spouses will not alter the immediate federal tax consequences relating to the income.

44. 403 U.S. 190 (1971).

45. *Id.* at 204.

46. *Id.*

47. 630 F.2d 356 (5th Cir. 1980).

48. *Id.* at 357.

49. LA. CIV. CODE ANN. arts. 155A & 2356 (West 1985 & Supp. 1995).

50. *Id.* art. 155A. The statute does not prejudice the wife's rights to alimony or support during the separation. *Id.*

the year they were earned, since at that time the earnings still constituted community income.[51] The court said, "[a]lthough the decree is given retroactive effect, under the annual accounting principle effective in federal tax cases, it did not alter the federal tax treatment of income earned in a prior year."[52]

If the non-earning or low-income spouse cannot terminate the marital community, or if a marital agreement or decree characterizes income prospectively only, the spouse will be liable, under *Seaborn*, for federal tax on one-half of the post-separation, interim income. The liability to report one-half of the interim income exists even though the spouses are separated and living apart, the low-income spouse has received no benefit from the marital income, and the high-income spouse does not communicate to the low-income spouse his or her share of the community income. Recognizing the inequity[53] that may result from taxing interim income equally to separated but undivorced spouses, Congress enacted section 66 of the Code.[54]

Sections 66(a) and (c) provide relief from community property reporting if certain conditions are satisfied. Section 66(b) disallows the benefits of community property reporting to spouses in certain circumstances. Whereas, sections 66(a) and (c) are relief provisions designed to aid an innocent spouse (often the non-earning or low-income spouse), section 66(b) is directed against a culpable spouse (often the high-income earning spouse).

IV. Congressional Response to *Seaborn*

A. Section 66(a)

Section 66(a) provides relief to a spouse if: (1) the spouses live apart the entire calendar year; (2) the spouses do not file a joint return; and (3) with some exceptions,[55] no portion of the earned community

51. 630 F.2d at 359-61.

52. *Id.* at 361.

53. Reference here is only to the tax inequity involved. An inequity may remain in terms of the denial of beneficial enjoyment of a portion of the community income to the abandoned or deceived spouse.

54. Miscellaneous Revenue Act of 1980, Pub. L. No. 96-605, 101(a), 94 Stat. 3521 (1980). Section 66 was "intended to provide relief for abandoned spouses who are presently taxed on a portion of the income earned by the other spouse but have received no benefit from that income." S. Rep. No. 1036, 96th Cong., 2d Sess. 8 (1980), *reprinted in* 6 U.S.C.C.A.N. 7293, 7299 [hereafter S. Rep. No. 1036].

55. The most prominent exception would be *de minimis* transfers between spouses and transfers for support of minor children. S. Rep. No. 1036, *supra* note 54, at 8-9.

income is transferred between the two spouses during the calendar year.[56]

If these conditions are met, the community income is taxed to each spouse in accordance with the rules of section 879(a) of the Code. Section 879(a) provides that community income is taxed to each spouse as follows: (1) Earned income is allocated or taxed to the spouse who earned it;[57] (2) trade or business income, other than a partner's distributive share of partnership income, is allocated to the spouse who exercises substantially all of the management and control of such trade or business;[58] (3) a partner's distributive share of partnership income is

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56. SECTION 66. TREATMENT OF COMMUNITY INCOME

(a) Treatment of Community Income Where Spouses Live Apart.—If—

(1) 2 Individuals are married to each other at any time during a calendar year;

(2) such individuals—

(A) live apart at all times during the calendar year, and

(B) do not file a joint return under section 6013 with each other for a taxable year beginning or ending in the calendar year;

(3) one or both of such individuals have earned income for the calendar year which is community income; and

(4) no portion of such earned income is transferred (directly or indirectly) between such individuals before the close of the calendar year;

then for purposes of this title, any community income of such individuals for the calendar year shall be treated in accordance with the rules provided by section 879(a).

I.R.C. § 66(a) (1993).

Definitions of key terms employed in § 66(a) are found in § 66(d), which reads:

(d) Definitions.—For purposes of this section—

(1) Earned income.—The term "earned income" has the meaning given such term by section 911(b). [This appears to be an error. Reference should be to section 911(d)(2). Ed.]

(2) Community Income.—The term "community income" means income which, under the applicable community property laws, is treated as community income.

(3) Community Property Laws.—The term "community property laws" means the community property laws of a State, a foreign country, or a possession of the United States.

I.R.C. § 66(d) (1993).

Obviously, in order to apply § 66(a), the text of § 879(a) must also be examined. For the text of § 879(a), see *infra* text accompanying notes 57-61.

57. I.R.C. §§ 879(a)(1), 911(d)(2) (1993); Treas. Reg. § 1.879-1(a)(2) (1980).

58. I.R.C. §§ 879(a)(2), 1402(a)(5) (1993); Treas. Reg. § 1.879-1(a)(3) (1980). The statute actually allocates the trade or business income to the husband "unless the wife exercises substantially all of the management and control" of the business. In that instance, the trade or business income is allocated to the wife. Presumably this means that the managing spouse will be allocated the income. If spouses co-manage a business, then the business is probably a partnership, and each spouse would be allocated a portion of the income based on his or her distributive share.

allocated to the spouse who is the member of the partnership;[59] (4) community income derived from a spouse's separate property is allocated to the spouse who owns the property;[60] and (5) all other income is allocated in accordance with applicable community property laws.[61]

The mandatory separate income reporting prevents a low-income spouse from liability for federal income tax on the half of the community income that is earned by the other spouse, which is not received or enjoyed by the low-income spouse. Unfortunately, section 66(a) has a number of technical requirements that limit its usefulness. Many separated spouses have lived together part of the taxable year, in which case they will be outside the operation of section 66(a).[62] In addition, many others will have made some transfers of community income (maintenance and spousal support payments), and thus will also be excluded from the operation of section 66(a). For instance, one court denied relief under section 66(a), finding that transfers of community income had been made when the husband made mortgage payments on a residence in which the wife resided.[63]

We have found only one case where a spouse obtained relief under section 66(a). The issue in *Rutledge v. Commissioner*[64] was whether a transfer occurred as a result of funds deposited in a joint bank account. Although funds were deposited in a joint account, the court found no evidence that the spouse seeking relief had any involvement with the account nor made any withdrawals from the account. The spouses did not communicate, and a court order prevented the spouse from obtaining access to the joint account. Other than this one reported case, section

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59. I.R.C. §§ 879(a)(2), 1402(a)(5) (1993); Treas. Reg. § 1.879-1(a)(4) (1980).

60. I.R.C. § 879(a)(3) (1993); Treas. Reg. § 1.879-1(a)(5) (1980). This rule only applies to community income other than community income covered by the first three rules. *Id.*

61. I.R.C. § 879(a)(4) (1993); Treas. Reg. § 1.879-1(a)(6) (1980).

62. *See, e.g.*, Drummer v. Commissioner, 67 T.C.M. (CCH) 2963 (1994) (holding wife failed to prove that she lived apart from husband at all times), *aff'd*, 68 F.3d 472 (5th Cir. 1995); Trout v. Commissioner, 64 T.C.M. (CCH) 1474 (1992) (husband and wife did not live apart at all times during relevant year); Lucia v. Commissioner, 61 T.C.M. (CCH) 1982 (1991) (same), *aff'd.*, 962 F.2d 14 (9th Cir. 1992); Warner v. Commissioner, 53 T.C.M. (CCH) 703 (1987) (husband moved to separate residence in November of the tax year, and, therefore, did not qualify under § 66(a)). For a discussion of the limitations of § 66(a), see John Paul Parks, *Income Tax Relief for the Abandoned Spouse*, 12 COMMUNITY PROP. J. 119, 120 (1985); Stuart Salchow, *IRC Section 66: Relief for Abandoned Spouses?*, 10 COMMUNITY PROP. J. 121 (1983).

63. Swinger v. Commissioner, 63 T.C.M. (CCH) 2578 (1992). Note that *de minimis* transfers between spouses and transfers for support of minor children are to be ignored for purposes of determining whether any transfers of earned community income occurred during the year. *See supra* note 55.

64. 63 T.C.M. (CCH) 1926 (1992), *aff'd*, 4 F.3d 990 (5th Cir. 1993).

66(a) has provided little relief to separated spouses. In response to the limited utility of section 66(a), Congress enacted subsections (b) and (c) in 1984.[65]

B. Section 66(c)

Section 66(c) provides a spouse additional protection from community property reporting if the following requirements are met: (1) The spouse seeking relief was unaware of and had no reason to be aware of the community income; (2) the income would not be taxable to the spouse seeking relief if section 879(a) applied;[66] and all things considered, "it would be inequitable" to include the item in the gross income of the spouse seeking relief.[67]

As with section 66(a), section 66(c) contains technical requirements that limit its usefulness. The main limitation of section 66(c) is the requirement that a spouse lack knowledge or reason to know of the other spouse's income.[68] Knowledge of items of community property

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65. Deficit Reduction Act of 1984, Pub. L. No. 98-369, § 424(b)(1), 98 Stat. 494, 802-03 (1984). In that year, Congress engaged in a wide range overhaul of the tax laws relating to divorce. For discussion and analysis of that legislation, see Nancy J. Brown, Comment, *Domestic Relations Tax Reform*, 20 GONZ. L. REV. 251 (1984-85); Barb Mattei, Comment, *1984 Deficit Reduction Act: Divorce Taxation*, 1986 WIS. L. REV. 177 (1986). Neither comment discusses the amendments to § 66.

66. See *supra* notes 57-61 and accompanying text for the way in which § 879 allocates tax reporting responsibility between spouses.

67. Section 66(c) provides:

> (c) SPOUSE RELIEVED OF LIABILITY IN CERTAIN OTHER CASES—Under regulations prescribed by the Secretary, if—
> (1) an individual does not file a joint return for any taxable year;
> (2) such individual does not include in gross income for such taxable year an item of community income properly includible therein which, in accordance with the rules contained in section 879(a), would be treated as the income of the other spouse;
> (3) the individual establishes that he or she did not know of, and had no reason to know of, such item of community income; and
> (4) taking into account all facts and circumstances, it is inequitable to include such item of community income in such individual's gross income;
> then, for the purposes of this title, such item of community income shall be included in the gross income of the other spouse (and not in the gross income of the individual).

I.R.C. § 66(c) (1993).

See *supra* note 56 for the text of § 66(d) (containing definitions applicable to this provision); see *supra* notes 57-61 for the way in which § 879 allocates tax reporting responsibility between the spouses.

68. Courts may look to case law under § 6013(e) "because of the similarity of congressional intent underlying sections 66 and 6013(e) and because the same operative language is used in both sections to define the generalized objective and subjective tests." Berenbeim v. Commissioner, 63 T.C.M. (CCH) 2975 (1992). *See* Rutledge

is "determined with reference to knowledge of a particular income-producing activity and not with respect to knowledge of specific income items (expenditures)."[69] Courts apply a factual test in determining whether a spouse "has reason to know" of an item of community income, to wit, "what a reasonably prudent person would or should know under the circumstances, keeping in mind such person's level of intelligence, education, and experience."[70]

Courts have repeatedly denied relief under section 66(c) where a spouse was aware of the source of community income, but was unaware of the specific amount of the other spouse's community income.[71] In *Roberts v. Commissioner*,[72] the Fifth Circuit upheld the tax court's ruling that a spouse was liable to report one-half of a substantial, and possibly illegal, kickback received by her husband in a real estate deal. The trial court found that the spouse knew or should have known of the additional income even though she had no actual knowledge of the kickback itself.[73]

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v. Commissioner, 63 T.C.M. (CCH) 1926 (1992) (recognizing that § 66(c) does contain a "lack of knowledge" requirement similar to the one found in § 6013(e)), *aff'd*, 4 F.3d 990 (5th Cir. 1993).

69. McGee v. Commissioner, 62 T.C.M. (CCH) 976 (1991) (quoting Costa v. Commissioner, 60 T.C.M. (CCH) 1178, 1191 (1990)), *aff'd*, 979 F.2d 66 (5th Cir. 1992).

70. Swinger v. Commissioner, 63 T.C.M. (CCH) 2578 (1992) (citing Shea v. Commissioner, 780 F.2d 561, 566 (6th Cir. 1986), *aff'd*, 780 F.2d 561 (6th Cir. 1986)); Porter v. Commissioner, 62 T.C.M. (CCH) 1217 (1991) (noting that a spouse seeking relief under § 66(c) must "also prove that a reasonably prudent person with her knowledge of the surrounding circumstances would not and should not have known of the understatement, keeping in mind her level of intelligence, education, and experience").

71. Taylor v. Commissioner, 66 T.C.M. (CCH) 1320 (1993) (denying relief under § 66(c) where wife was aware of husband's business activities, but not aware of the amount of profit or income earned by husband's business), *aff'd*, 43 F.3d 1483 (10th Cir. 1994); Edelson v. Commissioner, 66 T.C.M. (CCH) 1210 (1993) (denying relief under § 66(c) where wife was aware of the source of community income, but not aware of the specific amount of the community income); Berenbeim v. Commissioner, 63 T.C.M. (CCH) 2975 (1992) (finding "wife did have reason to know of the items of community income with respect to gains from real estate"); Dooley v. Commissioner, 63 T.C.M. (CCH) 1858 (1992) (finding wife was aware that husband was receiving commission income, although she did not know exact amount); McPherson v. Commissioner, 62 T.C.M. (CCH) 1039 (1991) (finding even though wife may not have had control over the business' books nor access to its funds, she nevertheless knew that husband was receiving income from business); McGee v. Commissioner, 62 T.C.M. (CCH) 976 (1991) (holding wife knew or had reason to know of community income), *aff'd*, 979 F.2d 66 (5th Cir. 1992). For several older cases, *see* Roberts v. Commissioner, 54 T.C.M. (CCH) 94 (1987), *aff'd*, 860 F.2d 1235 (5th Cir. 1988); Baldwin v. Commissioner, 52 T.C.M. (CCH) 22 (1986); Bozek v. Commissioner, 51 T.C.M. (CCH) 350 (1986); Sanders v. Commissioner, 51 T.C.M. (CCH) 317 (1986).

72. 860 F.2d 1235 (5th Cir. 1988).

73. *Id.* at 1239.

According to the lower court, she had knowledge of the existence of the real estate deal which gave rise to the kickback and was generally familiar with the real estate business.[74] In addition, her husband deposited the kickback funds into an account to which she had access, and she knew that she and her husband were living beyond their means.[75] Other reported cases involving section 66(c) have reached the same result.[76]

The Fifth Circuit in *Roberts*, as well as other courts, has suggested practical guidance for increasing one's chance for obtaining relief under section 66(c). This includes the taxpayer seeking relief by establishing that he or she attempted to obtain information concerning the community income. The court in *Roberts* concluded that the "[t]axpayer should have made that inquiry which would have given her actual knowledge of the . . . kickback."[77] A second case denying relief to a separated spouse implied that the wife, who knew of her husband's business activity, should have attempted to obtain from him or his accountant information as to whether the business was producing income.[78] Yet another case denying relief found it determinative that the wife never questioned her husband regarding the specific amounts he earned from his business practice and made no effort to review tax documents presented to her for signing.[79] In these cases, the taxpayers were denied relief under section 66(c) on the basis that reasonable persons in their position would have taken further steps to determine their husbands' community income.

Taxpayers who have overcome the statutory hurdle requiring "lack of knowledge" have received relief under section 66(c). In *Porter v. Commissioner*,[80] the court addressed whether a wife should have known of unreported community income from her husband's business. The court concluded that a reasonably prudent person in her position would not and should not have known of the community income. Although she was a signatory on the business's bank account, the court emphasized that she had no formal education beyond high school and that she was unsophisticated with respect to financial or tax matters. The court noted that the wife was unfamiliar with the operations and financial

74. *Id.*

75. *Id.* at 1240.

76. Dooley v. Commissioner, 63 T.C.M. (CCH) 1858 (1992) (holding Louisiana wife was aware that husband was receiving commission income); Lucia v. Commissioner, 61 T.C.M. (CCH) 1982 (1991) (denying wife relief under § 66(c) where wife participated in certain business enterprises and was a joint signatory on certain bank accounts), *aff'd*, 962 F.2d 14 (9th Cir. 1992). *See supra* note 71.

77. 860 F.2d at 1240.

78. Swinger v. Commissioner, 63 T.C.M. (CCH) 2578 (1992).

79. McGee v. Commissioner, 62 T.C.M. (CCH) 976 (1991), *aff'd*, 979 F.2d 66 (5th Cir. 1992).

80. 62 T.C.M. (CCH) 1217 (1991).

aspects of the business and that her husband did not communicate these with her. Further, the court found no indication of "lavish or extravagant" expenditures that might have given the wife reason to know of the unreported community income.

In another case, *Trout v. Commissioner*,[81] the tax court determined that a California wife knew, or had reason to know, that her husband had an income of only $18,000 in a particular year. Considering the facts and circumstances concerning her standard of living, the court found it inequitable to include any amount of her husband's income greater than that of which the court determined she knew of or had reason to know of. The court's opinion was not clear on whether the wife knew of the "sources" of her husband's income (the husband operated radio broadcast stations, was an independent salesman, and received wages). As discussed earlier, courts generally deny relief if a spouse knew of the source of community income or had knowledge of a particular income-producing activity.[82] A spouse generally is not relieved of liability under section 66(c) "merely because she did not have specific knowledge of the precise amounts of community income earned" by the other spouse.[83]

C. *Section 66(b)*

Section 66(b) allows the Secretary to deny community property benefits (e.g., allocation of half of the couple's community income to the other spouse) where one spouse fails to notify the other spouse of community income. More specifically, section 66(b) prevents a spouse from avoiding tax on one-half of community income if (1) the taxpayer "acted as if" he alone owned the community income in his possession, and (2) the taxpayer failed to notify his spouse of the amount and nature of the income prior to the due date for their returns.[84]

Because of the vague "acted as if" language, spouses have had difficulty showing a lack of sharing of the funds in question. In one

81. 64 T.C.M. (CCH) 1474 (1992).

82. *See* cases cited *supra* note 71.

83. McGee v. Commissioner, 62 T.C.M. (CCH) 976 (1991), *aff'd*, 979 F.2d 66 (5th Cir. 1992).

84. Section 66(b) provides:

> (b) Secretary May Disregard Community Property Laws Where Spouse Not Notified Of Community Income.—The Secretary may disallow the benefits of any community property law to any taxpayer with respect to any income if such taxpayer acted as if solely entitled to such income and failed to notify the taxpayer's spouse before the due date (including extensions) for filing the return for the taxable year in which the income was derived of the nature and amount of such income.

I.R.C. § 66(b) (1993).

case, the court refused to re-allocate one-half of the community income to the husband (the possessory spouse), since the wife (the nonpossessory spouse) had signatory authority over and wrote checks from joint bank accounts.[85] The additional requirement that the possessory spouse must have failed to notify the nonpossessory spouse of his community income before the return due date limits the application of section 66(b). If the possessory spouse keeps the same job after separation, the nonpossessory spouse could be presumed to know the amount of community income earned.[86] These requirements, like those in sections 66(a) and (c), have prevented many taxpayers from receiving relief from the inequities caused by *Seaborn*.[87]

V. Planning Opportunities Under Section 66

Section 66 was intended as a relief provision when state community property law and federal tax law interact in ways which are unfair and oppressive. When it applies, each spouse must separately report all earned income, as well as community income generated by business interests under his or her control. Despite its intended purpose, however, section 66 provides little relief to separated spouses who receive less than half the aggregate community income. Section 66(a) provides relief only in situations of prolonged separation coupled with a lack of monetary transfers between spouses. Sections 66(b) and (c) both require significant lack of knowledge or notice on the part of the non-earning or low-income spouse, and both involve rather vague statutory language. These limitations prevent section 66 from having the wide-ranging significance Congress may have intended for it. To ensure entitlement to the benefits provided by section 66, one must plan for its later use.

A divorce lawyer practicing in a community property state should utilize section 66 in planning for the client. If a non-earning, low-income, or nonpossessory spouse does not benefit from the earnings

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85. Drummer v. Commissioner, 67 T.C.M. (CCH) 2963 (1994), *aff'd*, 68 F.3d 472 (5th Cir. 1995).

86. For a criticism and analysis of § 66(b), see Parks, *supra* note 62, at 121-22.

87. *See* Tseng v. Commissioner, 67 T.C.M. (CCH) 2501 (1994) (denying husband benefit of community property law under § 66(b) with respect to community income earned when married but later received by husband when divorced); McPherson v. Commissioner, 62 T.C.M. (CCH) 1039 (1991) (denying husband relief under § 66(b) requiring him to report all of his earnings without the benefit of Idaho's community property law). *See also* Drummer v. Commissioner, 67 T.C.M. (CCH) 2963 (1994) (finding § 66(b) did not reallocate wife's one-half of community income to husband, as wife had signatory authority over and wrote checks from five joint bank accounts), *aff'd*, 68 F.3d 472 (5th Cir. 1995).

of the other spouse or the other spouse's business, efforts to obtain income information should be documented. This might satisfy the spouse's apparent affirmative duty to ascertain such information, a duty which has been raised in several cases.[88] However, if spouses keep the same employment after separation, there is a risk that each spouse will be presumed to know the source and amount of community income earned by the other.

If a spouse is unsure whether he or she will qualify for relief (e.g., the possessory spouse will not provide income information to the other upon request or the spouse's whereabouts are unknown), precautionary steps should be taken to protect the taxpayer from Internal Revenue Service penalties related to the omission of the other spouse's community income. The Milwaukee District Office of the Internal Revenue Service recommends that the taxpayer ignore community property law principles and report his or her individual income on a common law basis.[89] It is recommended that "the return *clearly state* that income, deductions and tax payments are being reported on a common law basis even though the individual is responsible for tax reporting under community property principles."[90]

The taxpayer may avoid future contact with the Internal Revenue Service Center by declaring in bold letters at the top of the return "COMMUNITY INCOME REPORTING" and indicating at the bottom of the return that "income, deductions and tax payments are being reported on common law basis since it is impossible to determine community income share."[91] If the taxpayer is subsequently audited by the Internal Revenue Service and is determined to qualify for relief under section 66, then no adjustments would have to be made on the taxpayer's return. If the taxpayer does not qualify for relief, he or she should be relieved of any tax penalties. Relief from penalties would likely be granted only if the taxpayer could show that he or she requested income information from the other spouse or that he or she was unable to locate the spouse.[92] As discussed earlier, it is important that the taxpayer document such efforts.[93]

The advice from the Milwaukee District Office of the Internal Revenue Service concerns federal treatment under Wisconsin's community property law. Because it reflects the Service's position with respect to one community property jurisdiction, the divorce attorney is advised

88. *See supra* notes 77-79 and accompanying text.
89. WIS. DEP'T OF REV., *supra* note 37, at 6.
90. *Id.*
91. *Id.*
92. *Id.* at 7. *See supra* text accompanying notes 77-79.
93. *See supra* text accompanying notes 77-79, 88.

to discover the acceptable procedures, if any, used by the local district office in his or her community property state.

VI. Final Property Divisions

If a spouse is unable to terminate the marital community and is unsure whether he or she will qualify for relief under section 66, the spouse nevertheless will want to protect his or her community property interest in post-separation income pending the final division of the community property. In general, husbands and wives have equal management authority over their property,[94] with the corresponding ability to consume or expend community income without the consent of the other.[95] The nonspending spouse arguably has a claim for his or her share of the community property expended that should be satisfied in the final division of community property incident to the divorce. Nevertheless, the nonspender spouse should exercise diligence in protecting his or her community property interest in post-separation, interim income. The spouse may accomplish this by seeking a temporary support order pending the final division of the community property. A preferred alternative is for the spouse to obtain his or her share of the community income as it is earned or paid rather than wait to receive that share upon division of the community property.

A problem arises for the low-income spouse if community income is unequally divided in the final property division. For instance, the final division could allow each spouse to retain all of his or her interim earnings even though those earnings are community property in states other than California and Washington. If a disparity exists between the amounts earned by each spouse, there would be an unequal division of income which would still be taxed equally to each spouse following *Seaborn*. A spouse who is denied a half share in community income must pay taxes on income never received or that was received and then required to give up. Whenever a division unequally allocates previously earned or received community income between the spouses, the federal tax consequences will not coincide with beneficial enjoyment.[96]

94. McClanahan, *supra* note 1, § 9:12, at 466-67. *See supra* text accompanying notes 12-13.

95. Either spouse may act alone on behalf of the community with respect to dispositions of community personalty, but the spouses must act together with respect to dispositions of real property. *Id.*; Reppy & Samuel, *supra* note 1, at 205 n. 2; Murray, *supra* note 7, at 26-27.

96. The possibility for unequal division exists in all community property states. In the "equitable division" community property states, community property of the spouses need not be divided between them equally even in the aggregate. Several community property states permit "equitable division" of community property in divorce proceedings. McClanahan, *supra* note 1, §§ 12:5, 12:10 to :14.1 (listing Arizona, Idaho, Nevada, Texas, Washington, and Wisconsin in this category). In the

One remedy would be to give retroactive effect to the unequal division and circumvent the *Seaborn* rule. Unfortunately, retroactive unequal divisions of community income are not entitled to retroactive effect for federal income tax purposes.[97] This article discusses three ways in which the retroactivity problem may arise and offers possible solutions to each. Many of the remedies suggested have not been litigated and, therefore, uncertainty exists whether a court would allow relief under them.

A. Income Received in One Taxable Year and Then Unequally Divided in a Subsequent Taxable Year

The retroactivity problem may arise when community income is received in one taxable year and then unequally divided in a subsequent taxable year. *Brent v. Commissioner*, discussed earlier, involved a retroactive unequal division formalized in a year subsequent to that in which the income was realized. A Louisiana wife was required to report as income one-half of her husband's post-separation earnings for the year 1970, even though in 1971, the year of divorce, those earnings were retroactively converted into the husband's separate property under Louisiana law. The court stated, "Although the [divorce] decree is given retroactive effect, under the annual accounting principle effective in federal tax cases, it did not alter the federal tax treatment of income earned in a prior year."[98] At the close of the 1970 taxable year, the income belonged to the wife under a claim of right and had been constructively received by her.[99]

Relief may be available to the spouse who is in the same position as the wife in *Brent*. The *Brent* court recognized in dictum that the wife might be entitled to a compensating adjustment on her income tax return under section 1341 in the year the divorce became final.[100] If the requirements of section 1341 are satisfied, a taxpayer who reports income held under a claim of right in one year and is required to repay that income in a later year is permitted to take a deduction or claim a tax credit for the year that amount is repaid.[101] Because the court decree

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so-called "equal division" community property states, spouses do not have to divide equally each item as long as the division is equal in the aggregate. *Id.* §§ 12:10 to : 14.

97. Brent v. Commissioner, 630 F.2d 356 (5th Cir. 1980).

98. *Id.* at 361.

99. Receipt of the income by her husband constituted receipt by the community. *Id.* at 359, 361.

100. *Id.* at 359 n.8.

101. *See generally* BORIS I. BITTKER & MARTIN J. MCMAHON, JR., FEDERAL INCOME TAXATION OF INDIVIDUALS ¶ 4.3 (1988) (discussing scope, application, and effect of the claim of right doctrine). Under § 1341, the taxpayer deducts the amount of the repayment or claims a tax credit for tax paid on the amount included in the earlier year, whichever results in the least tax liability. I.R.C. § 1341(a)(4), (5) (1993).

divested the wife of any interest in the income, she in effect made a payment of the income to her husband in the year of the decree.

Although the potential adjustment under section 1341 is important, it is not entirely satisfactory. Section 1341 imposes a number of technical requirements. The adjustment is available only when: (1) the income was reported as gross income in one year because the taxpayer appeared to have an unrestricted right to the income; (2) a deduction is allowable for the current year because it was established that in fact the taxpayer's right to the income was not unrestricted; and (3) the amount of the deduction exceeds $3,000.[102] The second requirement of an allowable deduction may pose a problem unless the repayment is characterized as deductible alimony. The $3,000 *de minimis* rule may also be a problem. In addition to these technical requirements, the degree of sophistication required of a taxpayer in order to take advantage of it may prevent its use.

B. *Income Received and Then Unequally Divided in the Same Year*

Brent involved a scenario where income was received in one year and unequally divided in a later year. The retroactivity problem may also arise when community income is received, and then in the same taxable year, by agreement or decree, it is unequally divided between the spouses. For example, income may be realized throughout the taxable year. A decree is then entered in December which allocates all of the interim income to the husband. Does the wife, in such circumstances, have any obligation to report half of the community income? *Brent* provides no guidance as to how spouses should report the community income when the retroactive unequal division is formalized later in the same taxable year as that in which the income is realized. The Service apparently takes the position that unequal divisions are not entitled to retroactive effect within a single taxable year.[103] Thus, the wife would be obligated to report half of the post-separation community income even though she received none of it.

Relief may be available in the form of an alimony deduction if a wife is obligated to report half of the interim income even though all

102. I.R.C. § 1341(a)(1)-(3) (1993).

103. Lawrence M. Phillips & Robert P. Stellick, *Tax Reporting in the Year a Decree is Granted*, 6 WIS. J. FAM. L. 8-9 (1986); INTERNAL REVENUE SERVICE, U.S. DEP'T OF THE TREASURY, PUB. NO. 555, COMMUNITY PROPERTY AND THE FEDERAL INCOME TAX LAW 2 (1989). Though its facts involved the *Brent* scenario, Revenue Ruling 74-393 contains language which also tends to support this view. The Service said, "[S]tate court judgments cannot for Federal income tax purposes retroactively change the facts as they existed at the time of the original transactions." Rev. Rul. 74-393, 1974-2 C.B. 28, 29.

of it is allocated to the husband.[104] Permitting an alimony deduction under section 215 is consistent with permitting a compensating adjustment under Section 1341 in cases like *Brent*.[105] As with section 1341, however, the technical requirements of the alimony rules may prove troublesome. Generally, interim payments qualify as alimony only if they are made in cash pursuant to a written separation agreement or interim decree, and if they terminate upon the death of the recipient spouse.[106]

Although sections 1341 and 215 may provide relief to a separated spouse, several options are available to avoid the retroactivity dilemma involving unequal divisions after receipt. A separated spouse could seek the other spouse's agreement to turn over his or her share of the community income as it is received. Failing that, the separated spouse could seek a support order from the court at the time the petition for divorce is filed, requesting payments equal to one-half of the difference between the community income in his or her possession and the community income in the spouse's possession. These payments would cause each spouse to have possession of half of the aggregate community income. If the court denies the request or claim with respect to the community income, the client could argue that the retroactivity rule should not apply. The client may argue that the spouse held the entire community income item under claim of right and therefore the spouse should bear the entire tax liability with respect to it.[107]

C. Income Earned or Accrued, Unequally Divided, and Then Subsequently Received

The above two scenarios involve unequal divisions after receipt and raise pure retroactivity questions. A third scenario concerns unequal divisions after accrual, but before receipt. For instance, assume cash basis spouses have accrued but unpaid rental income potentially subject to attribution under the *Seaborn* rule when paid. If, as part of the division of the community property, the court awards the husband the rental property and the accrued rent, who is taxed on the resulting income when the rent is paid? The same question arises if the spouses

104. *See* I.R.C. § 215(a) (1993). The logical corollary would be an alimony inclusion for the husband. *See* I.R.C. §§ 61(a)(8), 71(a) (1993).

105. *See supra* notes 100-02 and accompanying text.

106. *See* I.R.C. §§ 71, 215 (1993).

107. The counterargument is that the failure of the court to enter a temporary support order does not foreclose the possibility of her receiving her share of the community income in the final property division. Thus, at the close of the taxable year, she may still be considered to have constructive possession of the income under claim of right and co-management principles.

have accrued but unpaid royalty income associated with property which the court allocates to the husband as part of the property division, or cash basis accounts receivable awarded to the husband. In each of these situations, if the item had been paid prior to the property division, the item would be considered community income reported equally by each spouse. Does the transfer of one spouse's interest in the accrued income item in advance of payment have any effect on this?

Arguably, the transfer does, based on the application of section 1041.[108] Under section 1041, property transfers between spouses or former spouses incident to a divorce result in no gain or loss recognition to the transferor spouse and in a carryover basis to the transferee spouse. In applying this provision to an agreement or court order, transferring one spouse's community interest in an item of accrued but unpaid income to the other spouse, one would simply say that the transferor spouse recognizes no gain and the transferee spouse takes the transferor spouse's zero basis in the item. When the item is paid, the transferee spouse would include the entire amount of the item in gross income.

There is one problem with applying section 1041 in this manner. The Service has taken the position that such an application of section 1041 improperly overrides the assignment of income doctrine set forth in *Lucas v. Earl*,[109] which held that earned income is taxed to the earner.[110] In Revenue Ruling 87-112,[111] the Service ruled that the transfer of U.S. savings bonds between spouses or former spouses incident to a divorce triggered recognition of accrued but unpaid interest income by the transferor.[112] The Service ruled that assignment of income principles rather than section 1041 applied in that context.[113]

That same year, the Service extended the rule enunciated in Revenue Ruling 87-112 into the difficult area of divorce property settlements involving division of deferred compensation benefits. In Private Letter Ruling 88-13-023,[114] former spouses agreed to three annual cash payments by the husband to the wife in exchange for the wife's relinquishment of her community property interest in the husband's military retirement plan. Relying on Revenue Ruling 87-112, the Service ruled that the receipt of such cash by the wife was

108. Section 1041 was enacted in the same act that created sections 66(b) and (c). Deficit Reduction Act of 1984, Pub. L. No. 98-369, § 421(a), 98 Stat. 494, 793 (1984). *See supra* note 65.

109. 281 U.S. 111 (1930).

110. *Id.* at 114-15.

111. 1987-2 C.B. 207.

112. *Id.* at 208.

113. *Id.*

114. Priv. Ltr. Rul. 88-13-023 (Dec. 29, 1987).

an assignment of future income that was immediately taxable to her outside of section 1041.

After petitioner received the private letter ruling from the Service, the Tax Court held in *Balding v. Commissioner*[115] that section 1041 applied, and that the wife had no income when she received the settlement payments in exchange for her release of her claim to a community property share of her ex-husband's military retirement benefits.[116] The court disregarded the Service's position that the wife's relinquishment of her community property interest in the retirement benefits constituted an anticipatory assignment of income.

In a footnote to the court's opinion, however, the court specifically left open the issue of whether the wife would have any tax consequences when the retirement payments were made by the government for the ex-husband's retirement. The court noted, "[W]e have no occasion to consider whether the assignment of income doctrine would require petitioner's share of those retirement payments to be taken into petitioner's income as paid by the Government to [husband], notwithstanding petitioner's lack of entitlement to such payments."[117] The court cited one commentator who had strongly criticized the Service's restrictive interpretation of section 1041.[118] Another commentator on the *Balding* court's decision suggested that the wife would not have income when the ex-husband actually received his military retirement pay.[119]

Controversy surrounds the proper relationship between the assignment of income doctrine and section 1041. In light of the policy behind section 1041 and the principles underlying the assignment of income doctrine, an argument can be made that the assignment doctrine should not be applied in the context of divorce settlements.[120] In cases like *Balding*, where separated spouses agree or a court has determined that

115. 98 T.C. 368 (1992), cited with favor in Gaughan v. Commissioner, 66 T.C.M. (CCH) 168 (1993).

116. *Id.* at 372-73.

117. *Id.* at 373 n.8.

118. *Id.* (citing Michael Asimow, *The Assault on Tax-Free Divorce: Carryover Basis and Assignment of Income*, 44 Tax L. Rev. 65, 84-112 (1988)).

119. Robert S. Mintz, *Not All Transfers of Marital Property in a Divorce are Tax Free*, 22 Tax'n for Laws 104 (1993).

120. According to Professor Asimow:

> The Service should announce that neither the strong nor the weak forms of assignment of income apply to bona fide transfers occurring in the course of divorce. . . . The Service seeks to undermine § 1041 through a wooden application of assignment of income principles that have no place in a world of tax-free divorce. Section 1041 provides a simple and practical approach to tax problems arising out of marital property division. The assaults on § 1041 should be repelled.

Asimow, *supra* note 118, at 112.

accrued but unpaid interim income will be the separate property of one of the spouses, application of the doctrine is not appropriate.

VII. Conclusion

Couples who are divorcing and reside in a community property state are faced with an uncertain state of law regarding the taxation of post-separation income. *Seaborn's* rule in the context of divorce is complex and holds the potential for unfairness. The rule's interaction with section 66 and section 1041 is uncertain. The difficulties with the present system can be mitigated by dissolving the marital community at an early stage of separation. The prudent practitioner is well-advised to have a client enter into a written marital agreement during the early stages of separation, because of the lack of retroactive effect accorded to them. If a retroactivity problem is inevitable, spouses could enter into an indemnity agreement to mitigate against any adverse tax consequences caused by *Seaborn*. This article suggests other ways to avoid *Seaborn's* inequitable attribution of taxable income to separated spouses. In this area, advance planning often will save much difficulty.