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Community Income, Federal Income Taxation and Divorce

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TAX THOUGHTS

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This month's column again has two parts. The general interest item is an excellent discussion of community income, federal income taxation and divorce. This discussion is authored by John A. Miller, the tax professor at University of Idaho College of Law. He attended law school at the University of Kentucky and received his LL.M. in Taxation from the University of Florida. Prior to receiving his LL.M., Jack worked as the chief tax counsel for the Kentucky Revenue Cabinet.

This discussion of community income, federal income taxation and divorce is followed by a Tax Forum which is an exchange of ideas of particular interest to Idaho attorneys practicing in the tax area.

Community Income, Federal Income Taxation And Divorce

In *Poe v. Seaborn* the Supreme Court established that for federal income tax purposes in community property states half of the aggregate community income of a married couple must be included in the gross income of each spouse without regard to which spouse may have generated the income.[1] This rule arose in the same year as the Court's foundation assignment of income decision, *Lucas v. Earl*,[2] and, thus, became the most immediate and important exception to the principle that income is taxed to the person who earned it. The income splitting opportunity which *Seaborn* created led to the enactment in 1948 of a special rate structure for married couples who file joint returns which treats the aggregate income of the couple as though half was earned by each spouse.[3] In a broad sense, then, the 1948 amendments extended a crude form of the *Seaborn* rule to all married persons who file jointly irrespective of the state in which they are domiciled.[4] Because nearly all married couples in stable marriages file joint returns, the *Seaborn* rule now has its greatest significance for divorced spouses who were married for part of the year and for separated spouses who choose to file separately.

The income splitting which results from the *Seaborn* rule can create complexities and inequities when a prolonged period of separation precedes a divorce. This is because the tax reporting liability with respect to the income of separated spouses residing in a community property state may be unclear and may not coincide with the way in which the income is beneficially enjoyed.[5] Moreover, any inequities are likely to operate disproportionately against wives rather than husbands because women generally earn less than men. When one considers the growing body of evidence that divorce already has disproportionately harsh economic consequences for women,[6] this outcome is particularly unjustified.

The potential discrepancies between beneficial enjoyment of the income and the way the *Seaborn* rule attributes income for tax purposes may be illustrated with a simple hypothetical case. Suppose Alice and Bart, a married couple residing in a community property state, such as Idaho, separate in February but do not divorce until December. There is no written property division between them until the divorce is final. During the period of separation both continue to work in the same jobs they held before the separation, and Alice receives $20,000 of earned income while Bart receives $40,000 of earned income. Because her income is adequate to supply her needs, Alice does not seek any support payments from Bart during the separation, but the spouses have no express agreement in which Alice waives her property interest in Bart's earnings. Each spouse consumes his or her earnings so that in the property division there is nothing more to divide in December than there was in January. The property division divides their then existing community assets between them equally.[7]

Under the *Seaborn* rule, Alice and Bart are each obligated to report as income for federal tax purposes $30,000 of their aggregate post-separation earnings of $60,000 if those earnings are community property under state law. Only in California and Washington is it reasonably clear that post-separation earnings are not community property (and even in those states there may be some doubt).[8] In Idaho, post-separation earnings are generally considered community property.[9] Thus, Alice may be obligated to report $30,000 of income even though she had the beneficial use of only $20,000.

There are a number of avenues which Alice may use to escape the trap set for her by the requirement that she report half of the community income without regard to whether she actually received it. First, she may seek to equally enjoy the community income by seeking Bart's agreement or a court order specifying that she will receive $10,000 from Bart (one half of the difference between her earnings and his earnings, i.e., 40,000 – 20,000 = 20,000 × ½ = 10,000). This could be done by periodic payments or as part of the final property division. Normally this will represent the most desirable course to follow from Alice's perspective, and, presumably, an attorney representing her in her divorce action would seek such an arrangement at the inception of the action.

Another approach, less advantageous to Alice but which at least prevents her from being taxed on income she did not receive, is to enter into a written agreement with Bart at the time of separation that the earnings of each spouse will be his or her separate property. Under this approach Alice will report her post-separation earnings ($20,000) and Bart will report his post-separation earnings ($40,000). All community property states permit transmutation of community property and spousal earnings into separate property by written agreements between spouses.[10] Thus, separated spouses can agree in writing to an allocation of their post-separation income and that is how they will be taxed.[11] Similarly, the spouses can agree to divide their community property as they choose and then each spouse is liable to report only the income generated by his or her separate property. However, in theory the Service gives such agreements prospective effect only,[12] and, consequently, in the divorce context their utility should be limited by the degree of cooperation and foresight exercised by the spouses and their attorneys.[13]

Then there is the Section 66 safety valve.[14] This provision says, in effect, there are times when community income will be treated as separate income for federal tax purposes because the spouse who has possession of the income has abandoned the other spouse or otherwise acted as though it is his separate income. A number of technical requirements limit the application of Section 66, but where it applies it requires that each spouse separately report all of his earned income as well as community income generated by business interests under his control. The technical limitations of Section 66 appear to prevent it from having the wide-ranging significance Congress may have intended for it. In the hypothetical case of Alice and Bart it probably would not apply.

The last approach would also have no application to our hypothetical concerning post-separation earnings but would apply to divisions of already accrued but unpaid community income such as pensions or cash basis accounts receivable. This approach derives from Section 1041.[15] Under Section 1041 property transfers between spouses or former spouses[16] 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. Later, when the item is paid, the transferee spouse would include the entire amount of the item in gross income. One difficulty with applying Section 1041 in this manner is that such an application could be seen as improperly overriding the assignment of income doctrine. The Service has embraced this view.[17] This means, for instance, that the Service believes that a transfer of a community property interest in a pension is a taxable event to the transferor spouse.[18] It is likely that the Service's position on this matter will be tested in the courts.

This brief survey can only hint at the federal income tax complexities which may arise from separation and divorce in community property states. More detailed treatments of the topic are available.[19] But one conclusion that can be drawn from even so brief a discussion as this one is that the lawyer advising a divorce client needs to consider the interaction between these two bodies of law. Failure to do so may result in an unhappy client around tax time. ☐

ENDNOTES

[1]*Poe v. Seaborn*, 282 U.S.101 (1930).

[2]*Lucas v. Earl*, 281 U.S. 111 (1930).

[3]Revenue Act of 1948, Pub. L. No. 471, 62 Stat. 110. See I.R.C. § 1(a).

[4]The reason this may be characterized as a crude version of the *Seaborn* rule is that a joint return also carries joint liability for the entire amount of the tax owed by both spouses. In addition, spouses in community property states do not always have equal income because most community property states treat some income (such as income from property owned by a spouse before the marriage) as the separate property of a spouse. In Idaho income from a spouse's separate property is community property. Id. Code § 32-906. However, natural appreciation in the value of separate property is not community property. See *Martsch v. Martsch*, 645 P.2d 882 (1982).

[5]For an illustration of the possible inequities see *Bagur v. Comm'r*, 603 F.2d 491 (5th Cir. 1979). This problem has been noted by others. See Murray, Problems of Taxation of the Income of Spouses in the Context of Divorce and Separation, 14 *Com. Prop. J.* 20, 21-22 (1987); Vaughn, P.L. 96-605; Tax Relief for the Abandoned Spouse in a Community Property State, 8 *Com. Prop. J.* 53, 55-56 (1981) (Quoting Representative Gibbon); Potgieter-Hoff, Why Tax a Separated Spouse on Community Income She Does Not Receive?, 7 *Com. Prop. J.* 61 (1980).

[6]The most widely cited authority on this point is Weitzman, *The Divorce Revolution* (1985). See also Beck, The Innocent Spouse Problem: Joint and Several Liability Should Be Repealed, 43 *Vand. L. Rev.* 317, 329 (1990) and the authorities cited therein; and Smith, The Partnership Theory of Marriage: A Borrowed Solution Fails, 68 *Tex. L. Rev.* 689, 691 n. 5.

[7]Arguably this is not truly an equal division since it does not take into account the spouses' unequal enjoyment of the post-separation community income. See, e.g., *Suter v. Suter*, 546 P.2nd 1169, 1174 (Idaho S. Ct. 1976). However, Idaho law permits unequal divisions of community property in divorce. See Id. Code § 32-712.

[8]See Ann. Cal. Codes, Civ. Code § 5118 (1971) and Rev. Code Wash. Ann. § 26.16.140 (1972).

[9]Idaho has a statute which purports to make the wife's post-separation earnings her separate property. However, this statute has been declared unconstitutional. *Suter v. Suter*, note 7 supra, 1174-75. For a discussion of *Suter* see Cassity, The Living Separate and Apart Doctrine Revisited, 17 *Idaho L. Rev.* 111 (1980).

[10]See Ariz. Rev. Stat. Ann. § 25-317 (1973); Ann. Cal. Codes, Civil Code § 4802 (1970); Id. Code §§ 32-906, 32-916 (1980); Lou. Stat. Ann., Civil Code Arts. 2328-29 (1980); Nev. Rev. Stat. Ann. § 123.190 (1973); New Mex. Stat. Ann. § 40-2-8 (1978); Tex. Codes Ann., Family Code § 5.53 (1987); Rev. Code Wash. Ann. § 26.16.120 (1881); Wis. Stat. Ann. § 766.58 (1987).

[11]This principle is acknowledged in Revenue Ruling 68-66, 1968-2 C.B. 33.

[12]See Phillips, Federal Tax Problems Under WUMPA, 1 Wis. J. Fam. L. 27 (1986).

[13]As a practical matter the Service is unlikely to complain about the allocation of income reporting liability between the spouses as long as all of the aggregate income is reported by someone.

[14]I.R.C. § 66.

[15]I.R.C. § 1041.

[16]In the latter case section 1041 only applies if the transfer is incident to the divorce of the former spouses. § 1041(a)(2).

[17]Rev. Rul. 87-112, 1987-2 C.B. 207 (1987). This position has been strongly criticized. See Asimow, The Assault on Tax-Free Divorce; Carryover Basis and the Assignment of Income, 44 *Tax. L. Rev.* 65 (1989) and Nunnallee, The Assignment of Income Doctrine as Applied to Section 1041 Divorce Transfers: How the Service Got it Wrong, 68 Ore. L. Rev. 615 (1989).

[18]Private Letter Ruling 8813023. Under this approach the transferee spouse would take a basis in the pension equal to the income recognized by the transferor spouse in the transaction.

[19]See Murray, note 5 supra; Miller, Federal Income Taxation and Community Property Law: The Case for Divorce, 43 *Sw. L.J.* No 3 (Winter 1990-91).

Tax Forum

Payment of Death Taxes on the Death of the Second Spouse When QTIP Election Made on the Death of the First Spouse

Consider the following situation. Husband has one child, Harry, by a prior marriage. Wife has one daughter, Wendy, also by a prior marriage. Husband dies. His will leaves his estate to a QTIP eligible trust (i.e., all income to Wife, no invasion rights, and then to his child Harry on Wife's death).

The QTIP eligible trust is funded with $1.5 million and the QTIP election is timely made. Wife then dies owning property worth $1 million. Her will leaves everything to her daughter, Wendy. Further, her will provides that all death taxes will be paid from the residue of her estate. The QTIP election on Husband's death results in the value of the QTIP trust being included in Wife's estate on her death. Thus, her taxable estate will be approximately $2.5 million, on which the death taxes will total about $833,000.

Because Wife's will provides that all death taxes are to be paid out of the residue of her estate, her daughter arguably receives only $167,000 while Husband's son receives $1.5 million from the QTIP eligible trust. More specifically, Section 2207A of the Internal Revenue Code generally provides that, absent other direction in the Wife's will, any tax attributable to the inclusion of the QTIP trust corpus in the Wife's estate is recoverable by her estate from the person receiving the QTIP trust (i.e., from Husband's son). Thus, the provision in the will of Wife stating that all death taxes should be paid out of the residue arguably overrides the general rule of Section 2207A, with the result that all death taxes are paid by Wife's estate and none by the QTIP trust.

There is a question as to how specific the language must be in the will of the surviving spouse to override the general rule of Section 2207A. For example, a general provision in the surviving spouse's will that all death taxes are to be paid out of the residue of the estate may or may not be specific enough. In any event, the interpretation issue can be resolved by the addition of language similar to the following: "except that the amount, if any, by which the estate and inheritance taxes shall be increased as a result of the inclusion of property in my gross estate (for federal estate tax purposes) in which I may have a qualifying income interest for life." This language would be added to the provision stating that all death taxes should be paid out of the residue. You may have improvements on this language. If so, please contact John McGown, Jr. at Hawley Troxell Ennis & Hawley, P.O. Box 1617, Boise, Idaho 83701, or call me at 344-6000. ☐