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Federal Income Taxations and Community Property Law: The Case for Divorce

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FEDERAL INCOME TAXATION AND COMMUNITY PROPERTY LAW: THE CASE FOR DIVORCE

*by John A. Miller**

I. INTRODUCTION

"Where are you between two thoughts?"[1]

A. The Set-up

IN *Poe v. Seaborn*[2] the United States 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 generated the income.[3] This rule arose in the same year as the Court's foundation assignment of income decision, *Lucas v. Earl*,[4] and thus became the most immediate and important exception to the principle that income is taxed to the person who earned it.[5] The income splitting opportunity which *Seaborn* created[6] led to the enactment in 1948 of a special rate structure for married

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1. J. CAMPBELL, THE FLIGHT OF THE WILD GANDER 224 (1969) (quoting S. K. MENON, ATMANIRVRITI 18 (1952)).

2. 282 U.S. 101 (1930).

3. *Id.* at 118. *Seaborn* involved the state of Washington's community property law. The Court reached the same decision in companion cases arising under the community property statutes of other states. *See* Goodell v. Koch, 282 U.S. 118 (1930) (Arizona community property statutes); Hopkins v. Bacon, 282 U.S. 122 (1930) (Texas community property statutes); and Bender v. Pfaff, 282 U.S. 127 (1930) (Louisiana community property statutes). Shortly thereafter, the Court reached the same conclusion with respect to the interaction between the federal income tax and California's community property law in United States v. Malcolm, 282 U.S. 792 (1931).

4. 281 U.S. 111 (1930).

5. Another exception exists for income earned by one acting as the agent of the recipient of the income. For a discussion of this exception see O'Neill, *Schuster v. Commissioner, An Appropriate Agency Test for Members of Religious Orders Working under Vows of Poverty?*, 1988 WIS. L. REV. 111 (1988). *See also* B. BITTKER & M. MCMAHON, FEDERAL INCOME TAXATION OF INDIVIDUALS, 31.2, ¶ 31-1 n.35 (1988) (discussing *Schuster* and similar cases).

6. In an income tax system employing a single progressive tax rate structure, two people filing separately with each reporting one half of their aggregate income pay less tax than one person with an equal amount of income. This occurs because the couple takes advantage of the lower tax rates twice and avoids some of the higher rates entirely. The present rather flat

couples who file joint returns that treated the aggregate income of the couple as though each spouse earned one half.[7] 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.[8] Because most married couples in stable marriages file joint returns,[9] the *Seaborn* rule now has its greatest significance for divorced spouses who were married for part of the year and for separated spouses choosing to file separately.

The purpose of this Article is critically to examine the legal principles which control federal income taxation of married persons in community property states. Particular attention is given to taxation of post-separation, pre-divorce income (hereinafter referred to as "interim income"). Ultimately this Article argues that the interaction between federal income tax law and community property law is complex, uncertain and potentially unfair, and that the marriage between these two bodies of law solemnized in *Seaborn* should end in divorce.

B. The Problems

Although traditionally viewed as a boon to married taxpayers, the income splitting which results from the *Seaborn* rule can create complexities and

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rate structure tends to reduce the value of income splitting by married couples. In addition, separate rate structures that now exist for single persons, married persons filing jointly, and married persons filing separately greatly complicate any discussion of income splitting. Many commentators have discussed the use of different rate structures based on filing status. *E.g.*, Beck, *The Innocent Spouse Problem: Joint and Several Income Tax Liability Should be Repealed*, 43 VAND. L. REV. 317, 371-72 (1990); Robinson & Wenig, *Marry in Haste, Repent at Tax Time: Marital Status as a Tax Determinant*, 8 VA. TAX REV. 773, 776-87 (1989); Coven, *The Decline and Fall of Taxable Income*, 79 MICH. L. REV. 1525, 1538-40 (1981).

7. Revenue Act of 1948, Pub. L. No. 471 §§ 103, 301, 303, 62 Stat. 110, 111, 114, 115-16. *See* I.R.C. § 1(a) (1988) (codified as amended at I.R.C. §§ 6012(b)(1) 6013(a),(d), 6014(b) (1988)). For enlightening discussions of the development and theoretical strengths and failings of the joint return rules, see Robinson & Wenig, *supra* note 6; Note, *A Feminist Justification for the Adoption of an Individual Filing System*, 62 S. CAL. L. REV. 197 (1988); McIntyre & Oldman, *Taxation of the Family in a Comprehensive and Simplified Income Tax*, 90 HARV. L. REV. 1573, 1581-92 (1977); and Bittker, *Federal Income Taxation and the Family*, 27 STAN. L. REV. 1389, 1408-63 (1975). For a criticism of the use of multiple rate schedules as the mechanism for different treatment of married and non-married persons, see Coven, *supra* note 6, at 1538-40. Not only do modern joint returns involve income-splitting but joint and several tax liability do as well. I.R.C. § 6013(d)(3) (1988). For a biting criticism of joint liability for spouses filing jointly see Beck, *supra* note 6 (arguing that the effect of joint liability is to burden wives with tax liabilities generated by their husbands and that innocent spouse rules are inadequate to address the problem). For a more moderate approach that also acknowledges the problem, see Borison, *Innocent Spouse Relief: A Call for Legislative and Judicial Liberalization*, 40 TAX LAW. 819 (1987). *See also* Minick, *The Innocent Spouse Doctrine: The Need for Reform and Planning Alternatives in Texas*, 15 COMMUNITY PROP. J. 13 (1988). The joint liability aspect of joint returns has historical antecedents separate and distinct from the income splitting aspect of modern joint returns. Beck, *supra* note 6, at 347.

8. The 1948 amendments may be characterized as a crude version of the *Seaborn* rule because 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; 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. *See infra* Part III.B.

9. Beck, *supra* note 6, at 319 *citing* I.R.S. statistics (asserting that 99% of all married persons file returns file jointly).

inequities when a prolonged period of separation precedes a divorce. This is because the tax reporting liability with respect to the income of the separated spouses may be unclear and may not coincide with the way that the income is beneficially enjoyed.[10] Moreover, any inequities are likely to operate disproportionately against wives rather than husbands[11] because women generally earn less than men.[12] When one considers the growing body of evidence that divorce already has disproportionately harsh economic consequences for women,[13] this outcome is particularly unjustified.

Inherent in the idea of marital community is the belief that the spouses constitute a single economic unit.[14] If the spouses are an economic unit, then arguably their income tax reporting obligations should not be affected by which spouse spends their combined income since both have benefitted from the expenditure. Separation with the intent to henceforth live apart, however, destroys that economic unity. The logic supporting taxation of married persons differently from unmarried persons has little application once separation ends the economic union of the spouses.[15] The separated spouses should be taxed in accordance with their beneficial enjoyment of their income, but the mechanics of the *Seaborn* rule can prevent such a result.

C. A Couple of Illustrations

The potential discrepancies between beneficial enjoyment of the income and the way the *Seaborn* rule attributes income for tax purposes may be

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10. For an illustration of the possible inequities, see Bagur v. Commissioner, 603 F.2d 491, 499 (5th Cir. 1979) (consolidated case holding wives liable for taxes on one half of income received by husbands). Other commentators have noted this problem. *See* Murray, *Problems of Taxation of the Income of Spouses in the Context of Divorce and Separation*, 14 COMMUNITY PROP. J. 20, 21-22 (1987); Vaughn, *P.L. 96-605: Tax Relief for the Abandoned Spouse in a Community Property State*, 8 COMMUNITY PROP. J. 53, 55-56 (1981) (quoting Representative Gibbons discussion purported benefits of amending I.R.C. § 66); Potgieter-Hoff, *Why Tax a Separated Spouse on Community Income She Does Not Receive?*, 7 COMMUNITY PROP. J. 61 (1980).

11. Potgieter-Hoff reached this same conclusion ten years ago. Potgieter-Hoff, *supra* note 10, at 61. Potgieter-Hoff thought that (then proposed) § 66 might offer a solution. As discussed in Part VII, it is doubtful that § 66 has had the impact its supporters hoped to see. Beck states that the joint liability rules also work to the detriment of women. Beck, *supra* note 6, at 320 n.4, 327. He bases his conclusion in part on an analysis of the cases involving the innocent spouse statute, § 6013(e). According to Beck, ninety per cent of all such cases involve I.R.S. actions to collect back taxes owed by the husband from the wife. *Id.* This seems to mirror the experience with § 66 discussed *infra* in Part VII.

12. Beck cites authority indicating that in 1986 women's wages averaged 65% of men's average wages. Beck, *supra* note 6, at 330 (citing Women Gain Ground in Wages, Study Shows, N.Y. Times, Feb. 9, 1989, at § C, at 11, col.3).

13. The most widely cited authority on this point is L. WEITZMAN, THE DIVORCE REVOLUTION (1985). *See also* Beck, *supra* note 6, at 329 nn.40-41 and the authorities cited therein; and Smith, *The Partnership Theory of Marriage: A Borrowed Solution Fails*, 68 TEX. L. REV. 689, 691 n.5 (1990).

14. *See* Bartke, *Marital Sharing—Why Not Do It By Contract*, 67 GEO. L.J. 1131 (1979). *Cf.* Smith, *supra* note 13 (details view of marriage in community property states as an economic partnership and criticizes the use of the partnership as a model for purposes of dissolution).

15. For a discussion of the competing theories of family taxation, regarding whether to tax as an aggregate or as individuals, see Bittker, *supra* note 7, at 1391-92.

illustrated with a couple of variations on a hypothetical case. In the first variation, suppose Alice and Bart, a married couple residing in a community property state, separate in February, but do not divorce until December. No written property division exists 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 $50,000 of earned income while Bart receives $100,000 of earned income. Because her income is adequate to supply her needs, Alice does not seek any support payments from Bart during the separation. The spouses, however, 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 the parties have nothing more to divide in December than in February. The property division divides their community assets between them equally.

Under the *Seaborn* rule, Alice and Bart are each obligated to report as income for federal tax purposes $75,000 of their aggregate earnings of $150,000 if those earnings are community property under state law. Only in California and Washington is it reasonably clear that these post-separation earnings are not community property (and even in those states some doubt remains).[16] Thus, in the other community property states, Alice may be obligated to report $75,000 of income even though she had the beneficial use of only $50,000.

In the second variation, assume the same facts except that each spouse has interim earnings of $50,000 and, in addition, assume that $50,000 of rental income from a community owned building accrues. The rental income accrued after the separation and before the court entered the divorce. Under these facts, the rental income is community property under state law in all community property states, and according to the Internal Revenue Service, (the "Service") the *Seaborn* rule requires each spouse to report and pay taxes on one half ($25,000) when it is paid to either spouse. This is true even though by acquiescence, agreement, court order or other circumstance the beneficial enjoyment of the income is allocated to Bart (as it might if the building were awarded to him as part of the property division). Alice is thus once again taxed on income she never received. Alice may use a number of avenues 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. The potential for inequitable attributions of income, however, is inherent in the *Seaborn* rule in the context of separation and divorce.

Not only does an inherent danger of inequity exist in applying the *Seaborn* rule to separated spouses, but inequities also may arise because the spouses' respective federal income tax reporting responsibilities for their interim income in community property states may be difficult to ascertain. Variables affecting the attribution of interim income between the spouses include the differences in the community property laws from state to state, the sources of the income, the length of time which passes between the separation and the

16. *See infra* Part VI.A.

divorce, the time of year when the separation occurs, a spouse's knowledge of the amount and sources of the other spouse's income, and, most importantly, whether the spouses entered into a written property agreement when they separated.

II. An Overview Of The Income Attribution Rules Which May Apply Under Current Law

There are two possible outcomes to the income attribution question posed with respect to each item of income of spouses residing in a community property state who file separate returns: (1) each spouse can report half of the income item under the *Seaborn* rule or, (2) the spouse who earned the income or who is most closely connected with the property which produced the income as measured by possession, management authority or ownership of the property can separately report the income item. Only one analytical approach leads to the first outcome, but at least four analytical approaches lead to the second.

A. *The Community Property Paradigm*

The first outcome, half and half reporting of the item, is required if the interim income is community income under state law, and if no federal rule overrides the *Seaborn* rule. In short, the income is community income for state purposes and community income for federal income tax purposes.[17] This is the paradigm case for federal taxation of community income.

B. *The Separate Reporting Exceptions*

The four analytical approaches leading to separate reporting have different antecedents and employ different routes to arrive at the same end.

1. *Section 879*

The first approach is established by section 879 of the Internal Revenue Code ("the Code").[18] This provision only applies to married couples residing in community property states when at least one of the spouses is a nonresident alien. In general, the statute provides that when such spouses file separate returns the community property laws will be disregarded with respect to their income. The statute then establishes rules for attribution of various types of income between the two spouses for reporting purposes. Obviously, this statute has limited immediate application. It is useful, however, to consider section 879 as a model for the taxation of married couples in contrast to the *Seaborn* rule.

2. *The Separate Income Principle*

Even in community property states a variety of circumstances exist in

17. *See infra* Part IV.
18. *See infra* Part V.

which income can be the separate property of one spouse. When this is the case, the income is taxed under federal law to that spouse alone. This principle is acknowledged in Revenue Ruling 68-66,[19] which applies the rule of law found in some community property states that separation of the spouses may end the community with respect to earned income even though no divorce has yet occurred. The revenue ruling states that if interim earned income is separate income under state law, then it is separate income for federal tax purposes.[20] Thus, each spouse reports only his or her own separate earnings. This approach plainly is correct because if the state considers the income to be separate income, there is no basis for treating it as community income at the federal level. The Revenue Ruling 68-66 approach has great practical significance even in those states where separation does not automatically cause the spouses' earnings to become separate property. This is because all community property states permit transmutation of community property and spousal earnings into separate property by written agreements between spouses.[21] Thus, separated spouses can agree in writing to allocate their interim income and, under Revenue Ruling 68-66, that is how they will be taxed. 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. In theory, however, the Service gives such agreements prospective effect only,[22] and consequently, the degree of cooperation and foresight exercised by the spouses and their attorneys should limit such agreements' utility in the divorce context.[23]

3. *Section 66*

Section 66 of the Code, however, contains a safety valve.[24] In effect, section 66 states that community income will be treated as separate income for federal tax purposes where 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, each spouse must separately report all of his earned income as well as community income generated by business interests under his control. These technical limitations appear to prevent section 66 from having the wide-ranging significance Congress may have intended for it.

4. *Section 1041*

The last approach is the most theoretically intriguing because of its potential for converting accrued but unpaid community income into the separate property of one spouse without triggering income recognition by the other

19. Rev. Rul. 68-66, 1968-1 C.B. 33. *See infra* Part VI.
20. *Id.*
21. *See* authorities cited *infra* note 51.
22. *See* Phillips, *Federal Tax Problems Under WUMPA*, 1 WIS. J. FAM. L. 27 (1986).
23. As a practical matter, the Service is unlikely to complain about the allocation of income reporting liability between the spouses as long as someone reports all of the aggregate income.
24. *See infra* Part VII.

spouse.[25] This approach derives from section 1041 of the Code. Under section 1041, property transfers between spouses or former spouses[26] 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. In short, the result would be the same as under the previous two approaches. 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.[27] Two important works involving the interaction of section 1041 and the assignment of income doctrine have recently been published,[28] and some of the principles discussed in those works will warrant consideration in their application to reporting community income.

Before proceeding further it is necessary to establish a general understanding of how community property laws operate and how they vary from state to state. The meaning and significance of the Court's decision in *Poe v. Seaborn* is also more fully considered.

III. COMMUNITY PROPERTY LAW ON THE HALF-SHELL

A. *The Community Property States*

Because community property law is state law, community property law exists in as many forms as there are community property states.[29] Currently, nine states have community property laws: Arizona;[30] California;[31]

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25. *See infra* Part VIII.

26. In the latter case, § 1041 only applies if the transfer is incident to the divorce of the former spouses. I.R.C. § 1041(a)(2) (1988).

27. Rev. Rul. 87-112, 1987-2 C.B. 61 (accrued interest on savings bond not shielded by 1041 because such income is not gain within the meaning of that section).

28. Reference here is made to the articles of Professor Michael Asimow and Professor Walter Nunnallee. Asimow, *The Assault on Tax-Free Divorce; Carryover Basis and the Assignment of Income*, 44 TAX L. REV. 65 (1989); 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).

29. For a brief history of community property in the United States and its historical antecedents, see Younger, *Community Property, Women and the Law School Curriculum*, 48 N.Y.U.L. REV. 211, 214-23 (1973). A few single volume works on community property law serve as very useful reference sources. *See* W. MCCLANAHAN, COMMUNITY PROPERTY LAW IN THE UNITED STATES (1982 & Supp. 1989); W. REPPY & C. SAMUEL, COMMUNITY PROPERTY IN THE UNITED STATES (2d ed. 1982); and W. DE FUNIAK & M. VAUGHN, PRINCIPLES OF COMMUNITY PROPERTY (2d ed. 1971).

30. ARIZ. REV. STAT. ANN. § 25-211-17 (1976).

31. ANN. CAL. CIV. CODE §§ 5102-32. (West 1983 & Supp. 1990). For a recent discussion of the complexities of marital property law in California, see Channick, *What's in a Name: A Critical Look at California's System of Characterizing Marital Property*, 26 CAL. W.L. REV. 1 (1990). *See also* Smith, *supra* note 13, at 703-06, 720-23.

Idaho;[32] Louisiana;[33] Nevada;[34] New Mexico;[35] Texas;[36] Washington;[37] and Wisconsin.[38]

The variety and complexity of community property concepts can be daunting to the uninitiated, partly because the premises of community property law are so fundamentally different from separate property law as to make comparisons between the two systems difficult and misleading. The courts sometimes compare the community to an equal partnership composed of husband and wife. A commentator has criticized this analogy in the context of divorce as being contradictory and inadequate, based on a false presumption of equality, exhortatory rather than reflecting reality, and inadequate to reflect the long-term economic consequences to the wife of a failed marriage.[39]

One way in which the community does resemble a partnership for income tax purposes is that neither the community nor a partnership are separate taxable entities.[40] Instead, both are merely conduits which direct the flow of income to their members.[41] Husbands and wives residing in community property states, however, are not specifically within the definition of a partnership for tax purposes[42] and do not file as partners. The analogy, there-

32. IDAHO CODE §§ 32-903-14 (1941). Two works on Idaho community property law are J. HENDERSON, COMMUNITY PROPERTY LAW OF IDAHO (1982); and W. BROCKELBANK, THE COMMUNITY PROPERTY LAW OF IDAHO (1962).

33. LA. CIV. CODE ANN. arts. 2334-2369 (1985). For a discussion of the unique historical antecedents of present day Louisiana community property law, see W. MCCLANAHAN, *supra* note 29, at §§ 3.7-11.

34. NEV. REV. STAT. § 123.130-.259 (1987).

35. N.M. STAT. ANN. §§ 40-3-6 to 40-3-17 (1978 & Supp. 1989).

36. TEX. FAM. CODE ANN. §§ 5.01-.27 (Vernon 1975 & Supp. 1990). For recent discussions of Texas community property law, see Smith, *supra* note 13, at 698-03, 707-20; *see also* Featherston & Springer, *Marital Property Law in Texas: The Past, Present and Future*, 39 BAYLOR L. REV. 861 (1987).

37. WASH. REV. CODE ANN. §§ 26.16.010-.150 (1986). A useful reference source on Washington community property law is G. SHIELDS, H. CROSS & J. HUSTON, WASHINGTON COMMUNITY PROPERTY DESKBOOK (2d ed. 1989). This book devotes a lengthy chapter to many of the federal tax aspects of community property law. *Id.* ch. 7.

38. WIS. STAT. ANN. §§ 766.001-.97 (Supp. 1989); *see* Rev. Rul. 87-13, 1987-1 C.B. 20 (ruling on how earned and investment income should be reported by married individuals domiciled in Wisconsin who file separate returns). For a detailed discussion of Wisconsin's community property law, see Weisberger, *The Wisconsin Marital Property Act: Highlights of the Wisconsin Experience*, 13 COMMUNITY PROP. J. 1 (1986) (reprinted from 1 WIS. WOMEN'S L.J. 6 (1985)). *See also* Comment, *1984 Deficit Reduction Act: Divorce Taxation*, 1986 WIS. L. REV. 177, 214-15 (1986).

39. Smith, *supra* note 13, at 730-39.

40. An early commentator suggested taxing the community as an association. Sebree, *Federal Taxation of Community Property*, 12 TEX. L. REV. 273, 301 (1934). I have found no evidence, however, indicating that the Department of Treasury or Congress ever gave serious consideration to such an idea. Of course, Sebree's proposal is not entirely dissimilar to the idea of taxing all of the community's income to the husband alone as favored by the Service in *Poe v. Seaborn*, discussed *infra* Part IV.

41. *See* I.R.C. § 701 (1988). The fact that the community is not taxed as an entity is one way in which the *Seaborn* rule differs from the income splitting provided by joint filing. In effect, joint filers have agreed to be taxed as single unit.

42. The Code defines a partnership as including "a syndicate, group, pool, joint venture, or other unincorporated organization, through or by means of which any business, financial operation, or venture is carried on . . . ." I.R.C. § 7701(a)(2) (1988). Congress intentionally defined this term broadly enough to encompass groups not commonly thought of as partner-

fore, shall not be carried further. Instead, at the considerable risk of oversimplifying, what follows is a rather standard discussion of the most salient points of community property law pertinent to the present inquiry.

B. Community Property, Separate Property and Equal Management

In general, community property is all property acquired by spouses domiciled in a community property state after marriage except property acquired by gift, devise or descent or by use of the proceeds of separate property.[43] Conversely, separate property is all property owned 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.[44] 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 community property.[45] "Passive" appreciation of separate property, however, is separate property.[46]

In general, husbands and wives are equal managers of their community property.[47] 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.[48] The ability of one spouse to consume or expend community income without the consent of the other is particularly troublesome in the context of separated spouses because once the money is gone, arguably, the other spouse has no claim against the

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ships. Treas. Reg. § 301.7701-1(c) (as amended in 1977). Nevertheless, the fact that married persons in community property states are not required to file partnership returns implies that the Service does not regard them as partners. Moreover, marriage itself does not ordinarily proceed from a business or profit motive that would seem requisite to the formation of a partnership. *Cf.* Treas. Reg. § 301.7701-2(a)(1) (as amended in 1983) ("[A]n objective to carry on business and divide the gains therefrom [is] generally common to . . . partnerships . . . .") *id.* § (2); UNIFORM PARTNERSHIP ACT § 6(1), UNIFORM LAWS ANN. (1969).

43. W. MCCLANAHAN, *supra* note 29, §§ 6:1-6:4, at 329-35; W. REPPY & C. SAMUEL, *supra* note 29, at 2 (excerpting a portion of Vaughn, *The Policy of Community Property and Inter-spousal Transaction*, 19 BAYLOR L. REV. 20, 20-27 (1967); M. MERTENS, LAW OF FEDERAL INCOME TAXATION § 19.04, at 24 (1988). *See* IDAHO CODE §§ 32-903, 32-906 (defining community property).

44. *Id*; W. REPPY & C. SAMUEL, *supra* note 29, at 60-61.

45. *See* Weisberger, *supra* note 38, at 15; W. MCCLANAHAN *supra* note 29, § 6.18, at 357-59. There is some variation in the application of this rule. The Uniform Marital Property Act, for instance, treats the appreciation as community property only if the appreciation was due to the uncompensated efforts of the non-owner spouse. Weisberger, *supra* note 38, at 16. According to Weisberger this limitation is unknown in any of the community property states. *Id.* *Cf.* Wolford v. Wolford, 117 Idaho 61, 785 P.2d 625 (1990).

46. Weisberger, *supra* note 38, at 15; *see* W. MCCLANAHAN, *supra* note 29, § 6.15, at 353. Contributions or improvements by the community to separate property may create a lien on the property or a right of reimbursement in the community. *Id.*

47. W. MCCLANAHAN, *supra* note 29, § 9:12, at 466-67.

48. *Id.*; W. REPPY & C. SAMUEL, *supra* note 29, at 205 n.2; Murray, *supra* note 10, at 26-27. Texas has a distinct management scheme in which each spouse is the separate manager of the community property which would have been his alone in a separate property state, such as earnings and income from separate property. TEX. FAM. CODE ANN. §§ 5.22(a), 5.24(a). Louisiana and New Mexico grant sole management power over titled moveables to the spouse in whose name they are titled even though the moveables may be community property. W. MCCLANAHAN, *supra* note 29, § 9:14, at 474-75.

spender spouse even though she may have a tax liability on the income spent. The counterargument states that the non-spender spouse has a claim for her share of the community property expended that should be satisfied in the final division of community property incident to the divorce. The latter view is preferable since the spouses are no longer functioning as a single economic unit. At least some courts require an accounting for all post-separation community income as part of the property division so that the court may take all community receipts into account when determining the parties' shares of the remaining community assets.[49] Nevertheless, the existence of equal management authority in each spouse makes it prudent for the spouse who does not have possession or control of the community income to exercise diligence in protecting her community property interest in post-separation income by seeking a temporary support order pending the final division of the community property. The spouse will likely be better off if she obtains her share of the community income as it is earned or paid rather than wait to receive her share upon division of the community property.[50]

C. *Transmutation of Property and Termination of the Community*

All community property states permit the spouses to transmute separate property into community property or community property into separate property by written agreement.[51] This effectively permits the spouses to terminate the community by agreement in most cases.[52] Otherwise, the community continues until divorce or death of one of the spouses[53] unless state law permits entry of a decree of separation.[54] When community and separate property are commingled so that tracing is impossible, the property is presumed to be community property.[55]

Other characterization questions and rules that have no special relevance for the current topic, such as those raised by moves from community property states to separate property states and vice versa, will not be addressed

49. *See, e.g.*, Suter v. Suter, 97 Idaho 461, 546 P.2d 1169, 1174 (1976) (requiring accounting); McMichael v. McMichael, 205 So.2d 433, 439 (La. 1968) (requiring accounting).

50. *See infra* Part VI.C.

51. W. REPPY & C. SAMUEL, *supra* note 29, at 23-25; W. MCCLANAHAN, *supra* note 29, §§ 8:2-8:18, at 408-30; M. MERTENS, *supra* note 43, § 19.13; Murray, *supra* note 10, at 44. *See* ARIZ. REV. STAT. ANN. § 25-317 (1976 & Supp. 1989); CAL. CIV. CODE § 4802 (West 1970); IDAHO CODE §§ 32-906, 916 (1983 & Supp. 1990); LA. CIV. CODE ANN. arts. 2328-2329 (West 1985 & Supp. 1990); NEV. REV. STAT. § 123.190 (1987); N.M. STAT. ANN. § 40-2-8 (1978); TEX. FAM. CODE ANN. § 5.53 (Vernon Supp. 1990); WASH. REV. CODE ANN. § 26.16.120 (1986 & Supp. 1990); WIS. STAT. ANN. § 766.58 (West Supp. 1989).

52. Or, in the case of the antenuptial agreement, the agreement can prevent the community from ever coming into existence.

53. *See* W. REPPY & C. SAMUEL, *supra* note 29, at 297, 314; W. MCCLANAHAN, *supra* note 29, §§ 11:5, at 511; 12:4-12.14, at 528-46.

54. *See* ARIZ. REV. STAT. ANN. § 25-313 (Supp. 1989); CAL. CIV. CODE § 5119 (West 1983 & Supp. 1990); LA. CIV. CODE ANN. art. 2356 (West 1985 & Supp. 1990); N.M. STAT. ANN. § 40-4-3 (1978 & Supp. 1990); NEV. REV. STAT. § 123.259 (1987); WASH. REV. CODE ANN. § 26.09.030 (1986); WIS. STAT. ANN. § 767.07 (West 1981 & Supp. 1989).

55. W. MCCLANAHAN, *supra* note 29, § 6:8, at 339; W. DE FUNIAK & M. VAUGHN, *supra* note 29, § 60. *See also* Martsch v. Martsch, 103 Idaho 142, 645 P.2d 882, 886 (1982).

here.[56] The reader should be alerted, however, that this cursory summary of a complex body of law is no substitute for detailed study in any given case.

D. *Community Income and Separate Income*

Community income is all income derived from community property and all pay for services to either spouse during the marriage.[57] In some states, income from a spouse's separate property is also community income.[58] In some states separation of the spouses may serve to end the community with respect to income earned after the date of separation.[59] Such income then becomes the separate property of the earner.

Community income is simply a form of community property. Categorizing property as community property means the property is owned half by each spouse.[60] Thus, community income is owned half by each spouse even though the income may be the product of the labors of only one of the spouses. This feature of community property law led to the result in *Poe v. Seaborn*. Under *Seaborn*, community income is taxed half to each spouse because that is how the spouses own it. A corollary principle is that separate income is taxed entirely to the spouse who owns it. 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. Since, as discussed above, 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 the income, in order to characterize it as community or separate under state and federal law. As established above,

56. For a discussion of some of these issues see Randall, *Of Visigoths, Community Property, Death, and Income Tax Basis*, 25 GONZ. L. REV. 237 (1989-90). *See also* W. MCCLANAHAN, *supra* note 29, ch. 13, at 565-605; W. REPPY & C. SAMUEL, *supra* note 29, ch. 22, at 353-74; and G. SHIELDS, H. CROSS & J. HUSTON, *supra* note 37, at ch. 8.

57. W. DE FUNIAK & M. VAUGHN, *supra* note 29, at §§ 66-67; W. MCCLANAHAN, *supra* note 29, § 6:1, at 331; M. MERTENS, *supra* note 43, § 19.04.

58. *See* W. MCCLANAHAN, *supra* note 29, § 6:11-6:12, at 344-46 (indicating that Idaho, Louisiana, Puerto Rico and Texas fall into this category). According to Mertens, Wisconsin also falls into this category. M. MERTENS, *supra* note 43, § 19.04, at 24-25. Weisberger agrees. *See* Weisberger, *supra* note 38, 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.* W. MCCLANAHAN, *supra* note 29, §§ 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).

59. *See infra* Part VI.A. California and Washington utilize this rule. *See* CAL. CIV. CODE § 5118 (West 1983 & Supp. 1990) and WASH. REV. CODE ANN. § 26.16.140 (1986 & Supp. 1990). *See also* W. MCCLANAHAN, *supra* note 29, § 6:19, at 360-62 (indicating that Nevada may also fall into this category). Idaho has a statute which purports to make the wife's post-separation earnings her separate property. The Idaho Supreme Court, however, declared this statute unconstitutional. Suter v. Suter, 97 Idaho 461, 546 P.2d 1169, 1175 (1976).

60. W. MCCLANAHAN, *supra* note 29, §§ 7:3-:14; W. DE FUNIAK & M. VAUGHN, *supra* note 29, § 67; M. MERTENS, *supra* note 43, § 19.04, at 24. Each spouse has an equal, coexisting, and undivided interest in the community property. Murray, *supra* note 10, at 23.

the categories of income which most often produce different tax consequences from state to state are earned income, income from community property and income from separate property. The possibility that an asset may produce income from more than one of these categories complicates the categorization.[61]

IV. The Meaning And Legacy Of *Poe v. Seaborn*

A. Poe v. Seaborn

The Seaborns were Washington residents who held all their property as community property. Apparently, only Mr. Seaborn was employed as a wage earner.[62] On the theory that each spouse owned half the community income, the Seaborns each separately reported one half of their community income and each took one half of their deductions.[63] In an income tax system with a progressive rate structure the Seaborns, thus, were able to take advantage of the lower rates twice and possibly avoid some of the higher marginal rates entirely. The Commissioner challenged this approach on the theory that the husband had such effective control of the community property and income that he should be viewed as the owner for tax purposes.[64] After analyzing the community property law of the state of Washington, the Supreme Court rejected this argument.[65] The Court reasoned that despite the broad control the husband could exercise under Washington law with respect to the community property, he still acted merely as agent for the community, and this did not negate "the wife's present interest as a co-owner."[66] In the Court's view, the decision turned upon ownership of the income; under Washington law, the wife became the co-owner of the income the instant the income came into being.[67]

B. Lucas v. Earl

The *Seaborn* decision does not square with the Court's holding in *Lucas v.*

61. An example of this is the case where a business is owned by the community and employs one of its members. *See, e.g.*, Bass v. Commissioner, 45 T.C.M. (CCH) 1411, 1414-15 (1983) (Applying California law where separation causes earnings to be separate property, 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. The court ordered the wife to report one half of the community income for tax purposes.). 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).

62. Poe V. Seaborn, 282 U.S. 101, 109 (1930).

63. *Id.*

64. *Id.* at 111-12. In retrospect the Commissioner might have been better advised to attack the matter more directly from the assignment of income perspective. But, of course, such an approach would only have applied to the earned income. In any event, the Commissioner may have been misled of the Court's intentions by its decision in United States v. Robbins, 269 U.S. 315 (1926). In *Robbins*, the Court denied a California husband and wife the right to split their income because under state law the husband exerted such broad and complete powers of management and control over the community property as to render the property essentially identical to his separate property. *Id.* at 326.

65. 282 U.S. at 113.

66. *Id.*

67. *Id.* at 111, 113, 117.

Earl,[68] issued only eight months earlier. *Earl* involved a husband and wife residing in a separate property state who had contracted to own and share equally as joint tenants all of their respective property and earnings. Like the Seaborns, the Earls each reported one half of their combined income, the bulk of which derived from Mr. Earl's salary and attorney's fees.[69] The Commissioner asserted that Mr. Earl must report all the income. The Court held for the Commissioner on the theory that, under the statute, income from the rendering of services is taxed to the one who earns it.[70] Although the Court discussed the argument offered by the Earls that joint ownership in the funds vested in Mrs. Earl "on the very first instant on which they were received," the Court declined to decide the case on such "attenuated subtleties."[71] Instead the Court wrote,

> There is no doubt the statute could tax salaries to those who earned them and provide that the tax could not be escaped by anticipatory arrangements and contracts however skillfully devised to prevent the salary when paid from vesting even for a second in the man who earned it. *That seems to us the import of the statute before us* and we think that no distinction can be taken according to the motives leading to the arrangement by which the fruits are attributed to a different tree from that on which they grew.[72]

Perhaps because of its poetic quality, commentators and teachers often focus on the fruit and tree metaphor.[73] The Court's conclusion that the "import" of the statute is to tax "salaries to those who earned them,"[74] however, is a more precise statement of the holding in *Earl*. In any event, the fruit and tree metaphor is a reasonably apt way of saying the same thing.[75]

C. The Inconsistency of Seaborn *and* Earl

If *Earl* holds that earned income is taxed to the earner, how is the *Seaborn* result consistent with *Earl*? The answer must be that it is not. Nonetheless, the *Seaborn* Court did not overrule *Earl*; the court simply reinterpreted it in a fashion having no solid basis in the language employed in *Earl*.[76] The

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68. 281 U.S. 111, 114-15 (1930).
69. *Id.* at 113-14.
70. *Id.* at 114-15.
71. *Id.* at 114.
72. *Id.* at 114-15 (emphasis supplied).
73. *See* Lyon & Eustice, *Assignment of Income: Fruit and Tree as Irrigated by the P.G. Lake Case*, 17 TAX L. REV. 293, 297, 389 (1962).
74. 281 U.S. at 115.
75. Lyon and Eustice point out that many legal commentators warn against reliance upon metaphors yet state "[d]oubtless one should heed these commentators. On the other hand, analogy is central to the judicial process and if analogy and metaphor are not the same thing, they are surely peas from the same pod." Lyon & Eustice, *supra* note 73, at 295 n.2.
76. Justice Douglas recognized this inconsistence in his dissent in Commissioner v. Harmon, 323 U.S. 44, 56 (1944) (Douglas, J., dissenting). Douglas contended *Earl* and *Seaborn* "state competing theories of income tax liability." *Id.* He disagreed with the result in *Seaborn* but believed that, unless the Court expressly overruled it, *Seaborn* should apply to all community property systems, whether elective or non-elective. Douglas believed the distinction between elective and non-elective community property systems "cannot be consistently maintained for federal income tax purposes." *Id.* at 53. The *Harmon* majority ruled that *Earl* rather than *Seaborn* governed the elective community property system in Oklahoma. *Id.* at

Court said of *Earl*:

> We held that, assuming the validity of the contract under local law, it still remained true that the husband's professional fees . . . were his individual income. . . . The very assignment in that case bottomed on the fact that the earnings would be the husband's property, else there would have been nothing on which it could operate. That case presents quite a different question from this [*Seaborn*], because here, by law, the earnings are never the property of the husband, but that of the community.[77]

Thus, the *Seaborn* court interpreted *Earl* to stand for the proposition that a voluntary assignment of income could not divest the earner of ownership for tax purposes, and that ownership (not earnership) was the key to establishing who was responsible for reporting the income.[78] The court reasoned that because the non-earner spouse in a community property state owns half the earnings ab initio, the non-earner spouse must report half of the earnings.[79] In *Seaborn* no assignment was made because the earner spouse never owned the non-earner spouse's half of the earnings, and thus, had nothing to assign to the non-earner spouse. Perhaps just as importantly in terms of the underlying judicial attitude, even if an assignment of income could be found, it was an involuntary assignment beyond the earner spouse's control. The Court later saw this lack of voluntariness as a significant difference between the results in *Earl* and in *Seaborn*.[80] This distinction lacks substance in the context of community property law, however, because all community property states permit the spouses to opt out of the community property system by written agreement.[81] Thus, although the result in *Earl* is mandatory, the result in *Seaborn* is prospectively elective.[82] If the spouses fail to elect out of the community property system, however, the half and half reporting of

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45-46. For a discussion of the majority opinion see *infra* note 80. For further discussions of Douglas's *Harmon* dissent see Gann, *Abandoning Marital Status as a Factor in Allocating Income Tax Burdens*, 59 TEX. L. REV. 1, 16-18, 59-60 (1980) and Wolfman, *Silver & Silver, The Behavior of Justice Douglas in Federal Tax Cases*, 122 U. PA. L. REV. 235, 254-59 (1973).

77. 282 U.S. at 117.

78. *Id.*

79. *Id.*

80. *See* Lyon & Eustice, *supra* note 73, at 393. *See also Harmon*, 323 U.S. at 51, and Kenfield v. U.S, 783 F.2d 966, 970 (10th Cir. 1986). In *Harmon* the Court held that *Earl* rather than *Seaborn* governed an election by a husband and wife to employ an optional community property law enacted in Oklahoma because of the element of voluntariness inherent in the ability to elect community property treatment. 323 U.S. at 47-48. The Court said:

> Communities are of two sorts,—consensual and legal. A consensual community arises out of contract. It does not significantly differ in origin or nature from such a status as was in question in *Lucas v Earl* . . . In *Poe v. Seaborn* . . . the court was not dealing with a consensual community but one made an incident of marriage by the inveterate policy of the State.

Id. at 46. The Court went on to say, "the important fact is that the community system of Oklahoma is not a system, dictated by State policy, as an incident of matrimony." *Id.* at 48. For a discussion of Douglas' dissent in *Harmon*, see *supra* note 76. All community property systems in the United States are basicly consensual. Thus, the majority founded its decision on a distinction without substance.

81. *See supra* note 51.

82. *See infra* Part VI.

their community income under *Seaborn* is mandatory.[83] This mandatory reporting must occur even if the spouse to whom the income is attributed received no benefit from the income,[84] unless one of the exceptions discussed later applies.

Recognizing that the rationales underlying the results in *Earl* and *Seaborn* are irreconcilable does not in itself establish that the Court incorrectly decided *Seaborn*. This recognition does, however, tend to establish that one or the other of those rationales is faulty.[85] At this point in time, the holdings of both cases are so deeply embedded in the law that a return to their roots seems almost a journey into the hoary mists of antiquity.[86] A simplistic justification for the *Seaborn* rule is that the owner of the income is better able to pay the tax on that income than the earner. Such a justification tends to overlook the co-management authority of community property spouses as well as the practical control which the earner spouse has over his own earned income. A justification of the *Earl* rule is that, in the non-marital context at least, it protects the integrity of the principle of progressive taxation.[87] In the case of married couples, of course, the joint return rules now allow income splitting despite the rule in *Earl*. The enactment of the marital income splitting provisions tended to obviate the other major criticism of the *Seaborn* rule, that it unfairly favored married couples in community property states over married couples in separate property states.[88]

As discussed above,[89] the difference in the two holdings depends upon whether one settles on who owns the income or upon who earned it as the decisive criteria for allocating reporting responsibility. This, in turn, suggests that only with respect to earned income must the two cases be viewed as irreconcilable. Indeed the branch of the assignment of income doctrine relating to income from property essentially follows the *Seaborn* rule.[90] One

83. United States v. Mitchell, 403 U.S. 190, 196 (1971). *See* Rev. Rul. 87-13, 1987-1 C.B. 20. *See* Part VI.C. for a discussion of these authorities.

84. Kimes v. Commissioner, 55 Tax Ct. Rep. (CCH) 2315, 2320 (30,655) (Feb. 21, 1971).

85. It is even possible that both cases utilized the wrong criteria. Perhaps the court should have looked at who benefitted from the income. *See* McIntyre & Oldman, *supra* note 7.

86. For an interesting discussion of the state of the law in this area prior to the decisions in *Earl* and *Seaborn* see Maggs, *Community Property and the Federal Income Tax*, 14 CALIF. L. REV. 351 (1926). A particularly good discussion of the state of the law in the immediate aftermath of *Seaborn* is Bruton, *The Taxation of Family Income*, 41 YALE L.J. 1172 (1932). Bruton criticized the *Seaborn* decision because it created geographical disparity of income tax burdens between community property and separate property states. *Id.* at 1178. Bruton favored an approach that would have taxed earned income to the earner and income from property to the husband based on his (then) largely exclusive management authority over the property. *Id.* at 1178 n.27. Murray provides a bibliography of sorts of early commentaries on the interaction of community property law and the federal income tax. *See* Murray, *supra* note 10, at 81 n.247.

87. Professor Bittker asserts that this view of *Earl* exaggerates its role as a "guardian of progression." Bittker, *supra* note 7, at 1402-03.

88. One commentator estimated that in 1928 married couples in community property states paid 30% to 32% less tax than they would have paid had they resided in a separate property state. Bruton, *supra* note 86, at 1179.

89. *See* Parts IV.A & B *supra*.

90. The seminal cases in this area are Blair v. Commisioner, 300 U.S. 5, 12 (1937), Helvering v. Horst, 311 U.S. 112, 120 (1940), and Helvering v. Clifford, 309 U.S. 331, 334 (1940). These cases support the principle that the owner of property is taxed on the income

exception to this glittering generality must be noted with respect to income from a spouse's separate property. In a few states such income is community income[91] and is taxed half and half to the spouses under the *Seaborn* rule[92] despite the assignment of income principles that tax such income entirely to the owner of the property that produced it.

For present purposes, one must understand that the *Seaborn* Court's effort to distinguish *Earl* rests upon a distorted reading of *Earl*. The *Earl* opinion's emphasis on taxation of the earner is completely lost in *Seaborn*. The distortion created by *Seaborn* has significance for the later discussion concerning the potential conflict between the assignment of income doctrine and section 1041.

D. *The Effect of* Seaborn *on Alimony*

One consequence of the *Seaborn* rule is its effect on interspousal support payments pending divorce. Such interim support can be treated as alimony for federal income tax purposes in separate property states if the various requirements of Code section 71 are satisfied.[93] If the payments are alimony, they are deductible from income by the payor spouse and includable in the income of the payee spouse.[94] The *Seaborn* rule forces a different analysis in community property states. To the extent that the payments do not exceed the payee spouse's share of the community income under the payor spouse's control, there is no inclusion under section 71 and no deduction under section 215 because that income is already includable in the gross income of the recipient spouse and excludable from the gross income of the payor spouse under the *Seaborn* rule.[95] The alimony rules apply only to the extent that the payments exceed the payee's community interest in the funds used to make the payments.[96] Generally, the result to the parties should be the same

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produced by the property. Indeed, the *Blair* decision, which served as a basis for the Court's rulings in the other two cases, specifically relies on *Seaborn*. *Blair*, 300 U.S. at 12. Many other significant cases reaffirm the *ownership* principle. See Lyons & Eustice, *supra* note 73, at 297. The present day rules concerning the taxation of income from trusts also may be seen to embody that principle. *See* I.R.C. §§ 671-82 (1986).

91. *See supra* note 58.

92. *See* I.R.S. Pub. No. 555 (June 12, 1989).

93. *See* I.R.C. § 71(b) (1988). In general, interim payments qualify as alimony 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. *Id.*

94. I.R.C. §§ 71(a), 215(a) (1988).

95. *See* Furgatch v. Commissioner, 74 Tax Ct. Rep. (CCH) 3958 (37,211) (Sept. 5, 1980). The Service accepted this analysis following an earlier tax court decision. *See* Rev. Rul. 62-115, 1962-2 C.B. 23 (relying upon Hunt v. Commissioner, 22 Tax Ct. Rep. (CCH) 2609 (20,316) (April 30, 1954)).

96. Rev. Rul. 62-115, 1962-2 C.B. 23. A nice question arises if the payor spouse has both community and separate income in his possession and claims to make the support payments out of his separate funds. In such a case, he could then argue that he should deduct the full amount paid and the payee should report the payments while at the same time arguing that each of the spouses should report half of the community income in his possession. This allows the payor spouse the best of both worlds, an alimony deduction under § 215 and an income exclusion under the *Seaborn* rule. Obviously the payee spouse suffers under such an approach by having income under § 71 and under the *Seaborn* rule. State law might well foreclose the payor's ability to make such an argument by providing that the payments will be deemed made

as in a separate property state as long as the payments are at least equal to the payee's community property share of the payor's income. If the payments are less than the payee's share, the payee will have to include the rest of her share in gross income under *Seaborn* even though she did not receive possession of the excess. Though this appears unfair, one must remember that she may be able to obtain additional payments for her share of the community income in the property division.[97]

V. THE SPECIAL CASE OF THE NON-RESIDENT ALIEN SPOUSE, SECTION 879

A. Overriding Seaborn

The Tax Reform Act of 1976 brought sections 6013(g) and 879 into the Internal Revenue Code.[98] Congress enacted these provisions as part of an integrated effort to deal with some nagging problems relating to the tax treatment of non-resident aliens married to United States citizens.[99] The main thrust of the changes permits non-resident aliens married to U.S. citizens to file joint returns with their spouses in exchange for their agreement to be taxed on their worldwide income in the same manner as a resident.[100] Thus, the spouses are able to split income by agreeing to sacrifice the non-resident alien spouse's ability to shield his or her foreign source income from U.S. taxation.[101] Section 879 delineates the outcome where the spouses do *not* make the election to file jointly and the couple reside in a community property state.

Section 879 overrides state community property laws by blocking the attribution for tax purposes of income from the citizen spouse to the alien spouse.[102] This prevents the alien spouse's half of the citizen spouse's for-

out of community property to the extent thereof. *See* IDAHO CODE § 32-708 (1983); Rev. Rul. 62-115, *supra* note 95, at 26.

97. For a discussion of the risks to the lesser income spouse in relying on the property division to resolve the inequity, see *supra* Part III.B and *infra* Parts VI.C and VII.D.

98. Tax Reform Act of 1976, Pub. L. No. 94-455, § 1012(a)(1)-(b)(1), 90 Stat. 1520, 1612-14.

99. H. R. REP. No. 658, 94th Cong., 2d Sess. 203, *reprinted in* 1976 U.S. CODE CONG. & ADMIN. NEWS 2897, 3098; S. REP. No. 938, 94th Cong., 2d Sess., pt. 1, at 212 (1976), *reprinted in* 1976 U.S. CODE CONG. & ADMIN. NEWS 3469, 3642.

100. *Id. See* I.R.C. § 6013(g)-(h) (1988).

101. According to Robinson & Wenig, non-resident aliens generally are not subject to U.S. taxation on their foreign source income. Robinson & Wenig, *supra* note 6, at 817.

102. Section 879 provides:

> TAX TREATMENT OF CERTAIN COMMUNITY INCOME IN THE CASE OF NON-RESIDENT ALIEN INDIVIDUALS.
>
> (a) GENERAL RULE.—In the case of a married couple 1 or both of whom are nonresident alien individuals and who have community income for the taxable year, such community income shall be treated as follows:
>
> (1) Earned income (within the meaning of section 911(d)(2)), other than trade or business income and a partner's distributive share of partnership income, shall be treated as the income of the spouse who rendered the personal services,
>
> (2) Trade or business income, and a partner's distributive share of partnership income, shall be treated as provided in section 1402(a)(5),
>
> (3) Community income not described in paragraph (1) or (2) which is

eign source community income from escaping United States taxation.[103] In 1984, Congress further amended section 879 to prevent a married couple,

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derived from the separate property (as determined under the applicable community property law) of one spouse shall be treated as the income of such spouse, and

(4) All other such community income shall be treated as provided in the applicable community property law.

(b) EXCEPTION WHERE ELECTION UNDER SECTION 6013(g) IS IN EFFECT.—Subsection (a) shall not apply for any taxable year for which an election under subsection (g) or (h) of section 6013 (relating to election to treat non-resident alien individual as resident of the United States) is in effect.

(c) DEFINITIONS AND SPECIAL RULES.—For purposes of this section—

(1) COMMUNITY INCOME.—The term "community income" means income which, under the applicable community property laws, is treated as community income.

(2) 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.

(3) DETERMINATION OF MARITAL STATUS.—The determination of marital status shall be made under section 7703(a).

I.R.C. § 879 (1988).

Since section 879(a) adopts the definition of "earned income" set out in § 911(d)(2), it is also necessary to refer to that provision. Section 911(d)(2) states:

(2) EARNED INCOME.—

(A) IN GENERAL.—The term "earned income" means wages, salaries, or professional fees, and other amounts received as compensation for personal services actually rendered, but does not include that part of the compensation derived by the taxpayer for personal services rendered by him to a corporation which represents a distribution of earnings and profits rather than a reasonable allowance as compensation for personal services actually rendered.

(B) TAXPAYER ENGAGED IN A TRADE OR BUSINESS—In the case of a taxpayer engaged in a trade or business in which both personal services and capital are material income-producing factors, under regulations prescribed by the Secretary, a reasonable allowance as compensation for the personal services rendered by the taxpayer, not in excess of 30 percent of his share of the net profits of such trade or business, shall be considered as earned income.

I.R.C. § 911(a)(2) (1988).

(Section 1402(a)(5) provides:

(5) [I]f—

(A) any of the income derived from a trade or business (other than a trade or business carried on by a partnership) is community income under community property laws applicable to such income, all of the gross income and deductions attributable to such trade or business shall be treated as the gross income and deductions of the husband unless the wife exercises substantially all of the management and control of such trade or business, in which case all of the gross income and deductions shall be treated as the gross income and deductions of the wife; and

(B) any portion of a partner's distributive share of the ordinary income or loss from a trade or business carried on by a partnership is community income or loss under the community property laws applicable to such share, all such distributive share shall be included in computing the net earnings from self-employment of such partner, and no part of such share shall be taken into account in computing the net earnings from self-employment of the spouse of such partner; . . . .

I.R.C. § 1402(a)(5) (1988).

103. S. REP. NO. 938, *supra* note 99, at 213. Normally, non-resident aliens are not taxable on their income derived outside the United States. *See* Treas. Reg. § 1.871-1(a) (1980).

both of whom were non-resident aliens, from using foreign community property laws to split the U.S. income of one spouse for U.S. tax purposes.[104]

Obviously, the statute assumes that Congress need not respect community property laws for federal income tax purposes. The lack of any language in *Seaborn* indicating a constitutional basis for the ruling tends to corroborate this assumption. The disregard for community property laws displayed in section 879 is mirrored in a patchwork of other tax provisions sufficient in number to suggest that the *Seaborn* rule has led to complexities that extend far beyond those addressed in this Article.[105] The many exceptions to the *Seaborn* rule carved out by Congress and its apparent lack of constitutional implication[106] have significance for the later discussion of the desirability of overruling *Poe v. Seaborn.*[107]

B. Income Attribution Under Section 879

Aside from its specific application, section 879 provides a model for how Congress might choose to attribute community income if it overruled the *Seaborn* rule on a broader basis.[108] The statute allocates tax reporting responsibility between the spouses based on five rules: (1) earned income is

104. Deficit Reduction Act of 1984, Pub. L. No. 369, § 139, 98 Stat. 494, 677. *See* H. REP. NO. 432, 98th Cong., 2d Sess. pt. 2, at 1531 (1984), *reprinted in* 1984 U.S. CODE CONG. & ADMIN. NEWS 697, 1170; H. R. CONF. REP. No. 861, 98th Cong., 2d Sess. 968, *reprinted in* 1984 U.S. CODE CONG. & ADMIN. NEWS 1445, 1656. For an illustration of the income splitting opportunity afforded to non-resident aliens under prior law see Westerdahl v. Commissioner, 82 Tax Ct. Rep. (CCH) 82 TC 83 (1984).

105. *See, e.g.*, I.R.C. §§ 32(c)(2)(B)(i) (1988) (disregarding community property laws with respect to earned income for purposes of the earned income credit); 66 (discussed *infra* Part VII); 219(f)(2) (disregarding community property laws for purposes of computing the maximum deduction for retirement account savings); 402(e)(4)(G) (disregarding community property laws for purposes of the tax on lump sum distributions); 403(b)(2)(D)(ii) (disregarding community property laws for purposes of computing adjusted gross income under the alternative exclusion allowance for annuities offered by tax exempt entities to their employees); 408(g) (disregarding community property laws for purposes of individual retirement accounts); 448(d)(4)(A) (disregarding community property laws for purposes of the definition of a qualified personal service corporation); 457(e)(8) (disregarding community property laws for purposes of determining the amount of includable compensation with respect to deferred compensation plans of state and local governments and tax-exempt organizations); 911(b)(2)(C) (disregarding community property laws for purposes of determining an individual's excludable foreign earned income); 932(d) (disregarding community property laws for purposes of determining which spouse has greater adjusted gross income in the case of a U.S. citizen having income derived from sources in the Virgin Islands); 1402(a)(5)(A) (disregarding community property laws for purposes of computing the self-employment tax); 2032A(e)(10) (disregarding community property laws for purposes of estate tax qualified property valuation); 2039(d)(2) (disregarding certain annuity interests for estate tax purposes which arise solely by operation of community property law); 4980A(d)(4)(A) (disregarding community property laws for purposes of computing excess retirement accumulations subject to the excise tax on such distributions); and 6013(e)(5) (disregarding community property laws for purposes of innocent spouse relief from joint liability in cases of substantial understatement of tax liability on joint returns).

106. A notable discussion of the question of whether the *Seaborn* rule has a constitutional basis is found in Gann, *supra* note 76, at 55. For discussion see *infra* note 259.

107. *See infra* Part X.A.

108. *See* discussion of § 66 *infra* Part VII. As will be seen later, Congress already employs this model in the context of abandoned spouses residing in community property states.

allocated to the spouse who earned it;[109] (2) trade or business income other than a partner's distributive share of partnership income is allocated to the spouse who manages the trade or business;[110] (3) a partner's distributive share of partnership income is allocated to the spouse who is the member of the partnership;[111] (4) community income from a spouse's separate property is allocated to the spouse who owns the property;[112] and (5) community income from community property other than that described above is allocated in accordance with "the applicable community property law."[113] Thus, only in the case of community income from community property other than business interests, does the statute provide for income splitting between the spouses based on ownership of the income.[114] Otherwise, the income is allocated in full to the spouse most closely connected with the income by either earning activities or by ownership of the property which produced the income.

VI. THE SEPARATE INCOME PRINCIPLE

If *Seaborn* establishes that community income is taxed half to each spouse no matter what its source, then by implication separate income is taxed to the spouse who owns the separate income. In other words, income that is separate property for state law purposes is separate income for federal tax purposes. This simple principle has broad implications. Indeed, the separate income principle is probably of greater practical significance than any of the Code provisions discussed later because state law provides several ways in which the community may be partially or completely terminated with or without divorce. Such terminations can result from statutory mandate, written agreement or court decree. The chief limitation on the operation of the separate income principle is that agreements or decrees which unequally divide previously paid or earned community income are not given retroactive effect for federal tax purposes even though they may be retroactive under state property law.

A. *Termination as to Earnings by Operation of Law*

In the context of earned income, Revenue Ruling 68-66[115] embraces the

109. I.R.C. §§ 879(a)(1) (1988), 911(d)(2) (1988); Treas. Reg. § 1.879-1(a)(2) (1980).

110. I.R.C. § 1402(a)(5)(A) (1988); Treas. Reg. § 1.879-1(a)(3) (1980). The statute actually allocates the trade or business income to the husband "unless the wife exercises subtantially all of the management and control" of the business; in such a case, the trade or business income is allocated to the wife. *Id.* Presumably this means that the managing spouse will be allocated the income. If the spouses co-manage the 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.

111. I.R.C. §§ 879(a)(2) (1988), 1402(a)(5) (1988); Treas. Reg. § 1.879-1(a)(4) (1980).

112. I.R.C. § 879(a)(3) (1988); Treas. Reg. § 1.879-1(a)(5) (1980). This rule only applies to community income other community income covered by the first two rules. *Id.*

113. I.R.C. § 879(a)(4) (1988); Treas. Reg. § 1.879-1(a)(6) (1980).

114. Normally, such income will be split half and half. *See* Treas. Reg. § 1.879-1(a)(7) example 3.

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

separate income principle. The ruling involved the question whether separated (but still married) spouses residing in the state of Washington must report half of their aggregate interim earned income, or whether each spouse should simply report his or her own earnings.[116] The ruling initially notes the well-established principle under Washington law 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."[117] Recognizing this principle of Washington law, the Service readily agreed that, in circumstances where Washington law regards the community as ended, the earnings of each spouse are regarded as her or his separate income for federal tax purposes even though the spouses are not yet divorced.[118] This rule also has application in California,[119] and, perhaps, in Arizona.[120] As discussed below, the principle can come into play in all community property states when the spouses enter into a valid agreement terminating the community as to their earnings.

The separate income principle plainly is correct. The result in *Seaborn* rested on the assumption that state law characterized the income in question as community income.[121] If the income is not community income, no basis exists for imputing ownership of half of the income to the non-earner spouse. Following the logic of *Seaborn*, if that spouse has no ownership interest in the property, then no income tax reporting liability exists. Instead, *Earl* would control and the income would be taxed to the spouse who earned it.

The application of Revenue Ruling 68-66 can present important difficulties because physical separation by itself does not dissolve the community under Washington or California law. Both of those states require significant proof that as a practical matter the marriage has ended.[122] Thus, whether

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116. *Id.*

117. *Id.* For more on Washington law see *supra* Part III.

118. Rev. Rul. 68-66, 1968-1 C.B. at 34.

119. *See supra* note 59.

120. *See* Reppy, *The Uniform Marital Property Act: Some Suggested Revisions for a Basically Sound Act*, 12 COMMUNITY PROP. J. 163, 168 (1985). Reppy argues that a modified version of the living apart doctrine embodied by statutes in Washington and California, and erratically embraced by case law in Arizona, should be incorporated into the Uniform Marital Property Act. *Id.* at 169-70. Under his approach, the community terminates one year after separation. *Id.*

121. Section 66 also looks to state law for its definitions of community income and community property. *See* I.R.C. § 66(d)(2)-(3) (1988).

122. Although a Washington statute provides that the earnings of the spouses are separate income while they are living separate and apart, mere physical separation is not sufficient to come within the statute. Aetna Life Ins. Co. v. Bunt, 110 Wash. 2d 368, 373, 754 P.2d 993, 996 (1988). Instead, the "statute applies to those marriages which are for all practical purposes 'defunct'." *Id. Accord* Aetna Life Ins. Co. v. Boober, 56 Wash. App. 56, 784 P.2d 186 (1990). The earnings of a spouse while living apart are the separate property of the spouse in California. CAL. CIV. CODE § 5118 (West 1971). California also requires more than a mere physical separation. The spouses must effect "a parting of the ways with no present intention of resuming marital relations." *In Re* Baragry, 73 Cal. App. 3d 444, 448, 140 Cal. Rptr. 779, 781 (1977) (quoting *In Re* Imperato, 45 Cal. App. 3d 432, 436, 119 Cal. Rptr. 590, 592 (1975)). For more discussion of post-separation earnings, see W. REPPY & C. SAMUEL, *supra* note 29, ch. 18.

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.[123] In addition, a question may remain in some cases whether income derived from a family-owned business is earned income or income from property.[124]

In circumstances where the parties have not acted with clear design, the application of the separate income principle embraced in Revenue Ruling 68-66 is uncertain. Only well documented compliance with state law requirements for dissolution of the community will assure the parties that their interim earnings will be treated as separate income for federal income tax purposes. By the same token, well documented compliance with state law requirements for maintaining the community may be necessary to assure that interim earnings are community income. Since for tax purposes the divorcing spouses will quite likely have conflicting interests in whether their interim income is community income or separate income, the potential dispute is best resolved in advance of the actual event.[125] As discussed below, spouses may accomplish this resolution by an understanding embodied in a written separation or settlement agreement[126] or, where state law so provides, by a judicial decree of separation.[127]

B. *Termination of the Community by Agreement or Decree*

In all community property states, even those that treat separation as end-

123. *See* Feldman v. Nassi, 111 Cal. App. 3d 881, 169 Cal. Rptr. 9 (1980); *In Re* Baragry, 73 Cal. App. 3d 444, 140 Cal. Rptr. 779 (1977). *See also* Bruch, *The Legal Import of Informal Marital Separations: A Survey of California Law and a Call for Change*, 65 CALIF. L. REV. 1015, 1022-26 (1977) (calling for the repeal of the California statute which provides that post-separation earnings of the spouses are separate property). *See* CAL. CIV. CODE § 5118 (West 1971). Louisiana has a statute providing that "separation of bed and board" terminates the community. LA. CIV. CODE ANN. art. 2356 (West 1980). The community is not dissolved, however, until a judgment of separation is entered. *See* McMichael v. McMichael, 251 La. 654, 205 So.2d 433 (1968). That judgment has retroactive effect for state law purposes but apparently not for federal tax purposes. *See* Brent v. Commissioner, 630 F.2d 356, 361 (5th Cir. 1980); Rev. Rul. 74-393, 1974-2 C.B. 28, 29 (discussed *infra* Part VI.C.).

124. *See supra* note 61.

125. 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. Non-tax 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 non-durable goods has less incentive to contend after the fact that the interim income is separate property.

126. All community property states give effect to written agreements between separated spouses that their earnings will be separate property. *See* ARIZ. REV. STAT. ANN. § 25-317 (1973); CAL. CIV. CODE § 4802 (West 1970); IDAHO CODE §§ 32-906, 32-916 (1980), LA. CIV. CODE ANN arts. 2328-29 (West 1980); NEV. REV. STAT. ANN. § 123.190 (1973); N.M. STAT. ANN. § 40-2-8 (1978); TEX. FAMILY CODE ANN. § 5.53 (Vernon 1987); WASH. REV. CODE ANN. § 26.16.120 (1881); WIS. STAT. ANN. § 766.58 (West 1987). *See also supra* note 59.

127. *See* ARIZ. REV. STAT. ANN. § 25-313 (1977); CAL. CIV. CODE § 5119 (West 1970); LA. CIV. CODE ANN. § 2356 (1980); NEV. REV. STAT. ANN. § 123.259 (Michie 1989); N. M. STAT. ANN. § 40-4-3 (1973); WASH. REV. CODE ANN. § 26.09.030 (1970); WIS. STAT. ANN. § 767.07 (West 1987).

ing the community with respect to earnings, post-separation income from community property remains community property under state law. Consequently, such post-separation income also remains community income for federal tax purposes,[128] and the income normally will be taxed half to each spouse under the *Seaborn* rule. As noted earlier, some states also treat the income from separate property as community property.[129] In those states, such income will also normally be taxed half to each spouse under *Seaborn* after separation. In some cases the problem of distinguishing between community and separate property[130] adds an element of uncertainty to this analysis. In addition, most community property states treat the interim earnings of both spouses as community income.

All of the community property states provide for ending the community without divorce by written agreement, and some permit ending the community by entry of a court decree of separation.[131] Though some states may give effect to oral agreements terminating the community when coupled with performance,[132] most states appear to give no effect to oral divisions of community property. Moreover, oral agreements have obvious proof problems.

In any event, where a valid agreement or decree under local law terminates the community, the separate income principle plays a major role in the federal taxation of interim income. If the spouses enter into a valid agreement declaring that their earnings will be the separate property of the earner, those earnings will be taxed accordingly.[133] If they agree to divide

128. This is because each spouse has a half interest in the property under state law. *See* W. McClanahan, *supra* note 29, at § 12.5. In California and Washington, separation apparently does not affect the character of income other than earnings. *See* Murray, *supra* note 10, at 48-50. In Louisiana, a court judgment dissolving the community is retroactive to the date the petition was filed, but the Service takes the position that the judgment has no retroactive effect on the community income for federal tax purposes. Rev. Rul. 74-393, 1974-2 C.B. 28, 29-30. *See infra* Part VI.C.

129. *See supra* note 58.

130. Many knotty characterization problems can arise concerning initially separate property. For instance, consider a spouse's closely held corporate stock which appreciates during the marriage due to the efforts of the community or to retention of income which if distributed would have been community property. *See* Bass, *An Update on Marital Property Planning in Texas After Jensen I and II*, 11 Community Prop. J. 51 (1984); *Jensen III*, 11 Community Prop. J. 55 (1984). *See also* Reppy, *supra* note 120, at 170-76; Gales, *Expenditure of Community Labor and Assets on Separate Property in Washington*, 12 Community Prop. J. 269 (1985). *See also supra* note 61 and accompanying text.

131. *See supra* Part III.C.

132. *See, e.g.*, Bowart v. Bowart, 128 Ariz. 331, 625 P.2d 920 (1980) (oral agreement between spouses concerning division of profits on sale of real property not barred by statute of frauds); Schreiber v. Schreiber, 99 Nev. 453, 663 P.2d 1189 (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.—Waco 1967, writ ref'd n.r.e.) (upholding oral property division agreement); *but cf.* Recio v. Recio, 666 S.W.2d 645 (Tex. App.—Corpus Christi 1984, no writ) (requiring that the agreement be in writing). For a further discussion of oral transmutation see Murray, *supra* note 10, at 44-47. 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).

133. 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.

their community assets, the income subsequently produced by those assets will be taxed to the owner spouse. The same will be true for income earned after entry of decrees of separation that are effective under state law to terminate the community as to earnings or income from property.

C. *The Question of Retroactive Characterization*

The Service and, apparently, the courts limit the availability of these mechanisms to attribute income between the spouses. They hold that such agreements and decrees are not entitled to retroactive effect for federal tax purposes even though they may have retroactive effect under state law.[134] This prohibition against retroactivity has significance for final property divisions, as well as for separation agreements and decrees, because such divisions may also unequally allocate previously earned or received community income between the spouses. If no retroactive effect is given the division, the federal tax liability with respect to that income continues to be controlled by *Seaborn*. For instance, the final division could explicitly or implicitly 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.[135] If a disparity exists between the amounts earned by each spouse, the effect would be an unequal division of income which is still taxed half to each spouse under *Seaborn*.

Five of the community property states permit "equitable division" of the community property in divorce proceedings.[136] Thus, the community property of the spouses need not be divided between them equally even in the aggregate.[137] Even the so-called "equal division" states do not require spouses to equally divide each item as long as the division is equal in the aggregate.[138] Thus, in an equal division state, a particular item of community income may still be unequally divided between the spouses. Whenever

134. U.S. v. Mitchell, 403 U.S. 190 (1971). *See also* Brent v. Commissioner, 630 F.2d 356 (5th Cir. 1980); Rev. Rul. 74-393, 1974-2 C.B. 28. These authorities, as discussed later in this subpart, 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.

135. This would not be at all implausible in Idaho, for instance. *See* Suter v. Suter, 97 Idaho 461, 546 P.2d 1169 (1976). In *Suter* the court declared unconstitutional a statute which provided that post-separation, pre-divorce earnings of the wife were her separate property. The court determined that, since under another statute the post-separation earnings of the husband remained community property, the statute making the wife's earnings separate property violated the equal protection clause. *Id.* at 1175. The court made it clear that, in the absence of a written agreement to the contrary, all post-separation earnings of both spouses are community income in Idaho. *Id.* But the court also noted that under Idaho law the trial court in a divorce action has discretion to make an unequal division of the community property, and "[t]he inclusion of all post-separation earnings of both spouses as community property, therefore, neither prohibits nor requires that they be assigned to the spouse who earned them." *Id.* For further discussion of *Suter*, see Cassity, *The Living Separate and Apart Doctrine Revisited*, 17 IDAHO L. REV. 111 (1980) (arguing for adoption of a constitutionally sound statute treating post-separation earnings as separate property).

136. W. MCCLANAHAN, *supra* note 29, § 12.5. McClanahan lists Arizona, Idaho, Nevada, Texas, and Washington in this category. *Id.*

137. *Id.* §§ 12.10-14.

138. *Id.* §§ 12.6-9.

community income is unequally divided, the federal tax consequences with respect to that income will not coincide with beneficial enjoyment unless some mechanism for circumventing *Seaborn* can be found.

For married couples using the cash method of accounting, the retroactivity problem may arise in three ways: (1) the community income may be received, and then later, in the same taxable year, by agreement or decree it may be unequally divided between the spouses; (2) the income may be received in one taxable year and then unequally divided in a subsequent taxable year; or (3) the income may be earned or accrued, unequally divided by agreement or decree, and then subsequently received in the same taxable year or in a later taxable year. Each of these scenarios raise different analytical questions. The first two scenarios involve unequal divisions after receipt, and thus raise pure retroactivity questions which will be addressed here. The third scenario concerns unequal divisions after accrual but before receipt, and thus involves the potential for applying section 1041. This scenario will be addressed in Part VIII where that provision is considered.

Any analysis of the retroactivity issue must begin with the case of *United States v. Mitchell*.[139] *Mitchell* involved two Louisiana cases granted certiorari in a single petition.[140] The first case, that of Mrs. Mitchell, concerned several taxable years for which neither spouse had filed returns.[141] All of their income in those years was community income. In a subsequent year, Mrs. Mitchell obtained a separation decree followed by a decree of divorce. In that same year she formally renounced the community in order to take advantage of a Louisiana statute which exonerates the renouncing spouse from all community debts. Three years later she received an inheritance from her mother which the Service sought to attach in order to collect the taxes on her half of the community income.

The second of the two cases involved a woman, Mrs. Angello,[142] who, like Mrs. Mitchell, filed no returns for the years in question, even though she and her husband had community income during that time. Several years later the Service sought to collect the back taxes by levying upon a life insurance policy on the life of her husband. Mrs. Angello was the named beneficiary of the policy. Her husband died the year following the levy, and a court battle ensued between the Service and Mrs. Angello on the question of entitlement to the insurance proceeds. Apparently, Mrs. Angello argued that she had impliedly renounced the community under the same statute which Mrs. Mitchell had utilized to escape she and her former husband's community debts.[143]

The Supreme Court began its analysis by recognizing the precedent estab-

139. 403 U.S. 190 (1971).

140. *Id.* at 190-94.

141. *Id.* Mr. Mitchell controlled the couple's financial affairs and told Mrs. Mitchell that he was filing timely returns for them. She assumed that he had signed them for her.

142. At the time of the Supreme Court case she was Mrs. Frances Angello. The taxes in question arose during years she was married to Jack Sparacio and bore the name Frances Sparacio. *Id.*

143. *Id.* at 193.

lished in *Seaborn* and related cases that each spouse owns half the community income under state law and thus must report such income for federal tax purposes.[144] The Court specifically declared that the *Seaborn* rule established that "the wife had the obligation, not merely the right, to report half the community income,"[145] reasoning that "federal income tax liability follows ownership."[146] The Court then pointedly added, "[i]n the determination of ownership, state law controls. 'The state law creates legal interests but the federal statute determines when and how they shall be taxed.' "[147] Based on these principles the Court offered a preliminary judgment that "[t]his would appear to foreclose the issue for the present cases."[148]

Nonetheless, the Court felt compelled to engage in a lengthy survey of Louisiana law in order to establish that a wife indeed co-owned the community's property in such a manner as would cause the *Seaborn* rule to apply.[149] The Court then arrived at the crux of the case; the effect of the Louisiana statute exonerating the wife from the community's debts (following her renunciation of any interest in the community's assets) upon her federal tax liability on her half of the community's income. On this point the Court took its cue from the tax court opinion in the *Mitchell* case stating, in effect, that Mrs. Mitchell's renunciation had come too late because the tax liability had already attached.[150] Though the women might have exempt status under state law, once the federal liability attached only federal exemptions from taxation were relevant. The Court reasoned that no such exemption applied in the present cases.[151] Though recognizing "that these are 'hard' cases and exceedingly unfortunate for the two women taxpayers," the Court concluded that the Service must prevail; Mrs. Mitchell must forgo her inheritance, and Mrs. Angello must forgo her beneficiary interest in the proceeds from the insurance on her husband's life.[152]

The issue raised by unequal divisions of already realized community income is somewhat different from the question in Mitchell. Arguably both Mrs. Mitchell and Mrs. Angello at least had the benefit of the income on which they were obliged to pay the taxes. In an unequal division, on the other hand, the spouse who is denied a half share in the community income must pay taxes on income she never received or received and then was required to give up. When faced with just such an unequal division in *Brent v. Commissioner*,[153] however, the Fifth Circuit concluded that, based on *Mitchell*, the lack of beneficial enjoyment did not alter the operation of the

144. *Id.* at 194-96.

145. *Id.* at 196 (relying on United States v. Malcolm, 282 U.S. 792, 794 (1931), a case involving California law and extending the *Seaborn* rule to that state).

146. *Id.* at 197 (citing Blair v. Commissioner, 300 U.S. 5, 11-14 (1937)). *Blair*, in turn, cites *Seaborn* on this point. 300 U.S. at 10.

147. 403 U.S. at 197 (quoting Burnet v. Harmel, 287 U.S. 103, 110 (1932) and several later cases).

148. *Id.*

149. *Id.* at 195-203.

150. *Id.* at 204.

151. *Id.*

152. *Id.* at 205-06.

153. 630 F.2d 356 (5th Cir. 1980).

Seaborn rule.[154]

Brent presented the court with another peculiarity of Louisiana law involving retroactivity. In Louisiana, post-separation earnings of the husband are community property. If a divorce is granted,[155] however, those earnings are retroactively converted into the husband's separate property.[156] Thus, though the statute does not prejudice her rights to alimony or support during the separation, the wife has no further claim on the earnings once the decree of divorce is entered.[157] In *Brent* the wife received a minimal amount of alimony during a lengthy separation[158] that ultimately ended in divorce in 1971. In a year subsequent to the divorce, the Service sought to collect from Mrs. Brent the taxes owed on half of her doctor husband's earnings for the year 1970 even though she never had possession of those earnings.[159] She resisted on the grounds 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 the year they were earned, however, since at that time the earnings still constituted community income.[160] 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."[161] At the close of the taxable year the income belonged to Mrs. Brent under claim of right and had been constructively received by her.[162] Thus, she must report the earned income. In short, the court determined that retroactive unequal divisions of community income were not entitled to retroactive effect for federal tax purposes.

There was a bright spot in the *Brent* court's decision from Mrs. Brent's perspective, however, because the court recognized that she might be entitled to a compensating adjustment on her income tax return under section 1341 in the year the divorce became final.[163] Section 1341 permits a taxpayer who reports income held under a claim of right in one year and who becomes obliged to refund that income in a later year to take a deduction or

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154. *Id.* at 359-61.

155. Note, however, that Louisiana law provides for an interlocutory decree of "separation from bed and board" which is a predicate for a final decree of divorce or which can stand alone to dissolve the community even though the spouses never obtain a divorce. The judgment of separation of bed and board is retroactive to the date the petition was filed. 1 LA. CIV. CODE ANN. arts. 155A & 2356 (West 1985 & Supp. 1990).

156. *Id.* art. 155A.

157. *Id.*

158. The spouses were separated for over three years. *Brent*, 630 F.2d at 357.

159. *Id.* The court held her lack of possession to be irrelevant because, under community property principles, receipt of the income by her husband constituted constructive receipt by her.

160. *Id.* at 359-60, 361. The court referred to North Am. Oil Consol. v. Burnet, 286 U.S. 417, 424 (1932) and Burnet v. Sanford & Brooks Co., 282 U.S. 359, 363-64 (1931). *Brent*, 630 F.2d at 359 n.7.

161. *Brent*, 630 F.2d at 361.

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

163. *Id.* at 359-60 n.8.

claim a credit in that later year.[164] Since the court decree divested her of any interest in the income, she in effect made a payment of the income to her husband in the year of the decree. The potential adjustment under section 1341 is important, but not entirely satisfactory because of both the technical requirements of section 1341[165] and the degree of sophistication required of a taxpayer in order to take advantage of it.

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.[166] For instance, suppose the income is realized throughout the taxable year and then a decree is 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? The Service apparently takes the position that state court judgments unequally dividing the community income cannot be given retroactive effect even in the tax year in which they are entered.[167] Thus, the wife would be obligated to report half of the interim community income even though she received none of it. Because the sanctity of the annual reporting principle established in *Burnet v. Sanford & Brooks Co.*[168] is not at stake, the Service may be applying realization principles too stringently. Though this result may have some theoretical basis, it is inherently unfair.

Even if one accepts that unequal divisions are not entitled to retroactive effect within a single taxable year, an equitable outcome may be achievable through the alimony rules. If the wife is obliged to report half of the community income even though all of it is allocated to the husband, allowing her an alimony deduction of equal amount would be logical.[169] This approach is consistent with the application of section 1341 in cases like *Brent*. As with section 1341, however, the technical requirements of the alimony rules may

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164. *See generally*, B. BITTKER & M. MCMAHON, *supra* note 5, at ¶ 4.3 (discussing scope, application and effect of the claim of right doctrine).

165. The § 1341 adjustment is available when: (1) the income was reported in 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. I.R.C. §§ 1341(a)(1)-(3) (1988). The second requirement of an allowable deduction may pose a problem unless the repayment is characterized as alimony deductible under I.R.C. § 215 (1988). The $3,000 de minimus rule may also be a problem.

166. This scenario is the first of the three described above. *Brent* involved the second scenario where the income is received in one year and unequally divided in a later year.

167. *See* Phillips, *Federal Tax Problems Under WUMPA*, 6 WIS. J. FAM. L. 27 (1986); Phillips & Stellick, *Tax Reporting in the Year a Decree is Granted*, 6 WIS. J. FAM. L. 8-9 (1986); and 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.

168. 282 U.S. 359, 365-66 (1931).

169. *See* I.R.C. § 215(a) (1988). The logical corollary would be an alimony inclusion for the husband. *See* I.R.C. § 61(a)(8) (West Supp. 1990).

prove troublesome.[170]

The well advised separated spouse who wishes to avoid the *Brent* dilemma has several options available to her. First, she can seek her spouse's agreement to turn over her share of the community income to her as he receives it. Failing that, she could seek a support order from the court at the time the petition for divorce is filed. She should request support payments equal to one half of the difference between the community income in her possession and the community income in her spouse's possession. These payments would cause each spouse to have possession of half their aggregate community income. If the court denies her request or awards less than she asks, she would be in a position to argue that the *Brent* rule should not apply to her since the court denied her claim with respect to the community income.[171] A less appealing alternative would be to seek an agreement converting the community income into her spouse's separate property. The obvious shortcoming of this approach is that she forgoes any chance of beneficial enjoyment with respect to the income.

As *Brent* illustrates, the intricacies of federal taxation of post-separation income in community property states lend themselves to inequitable outcomes. Recognition of this potential for unfairness led to the enactment of section 66. As will be discussed in the next part, however, the salutary effects of this provision are limited.

VII. THE ABANDONED OR DECEIVED SPOUSE; SECTION 66

A. *Section 66(a)*

Congress enacted section 66 in 1980[172] to relieve the inequity[173] that may result from taxing interim income equally to separated but undivorced spouses where one spouse abandons the other.[174] Section 66(a) provides that community income[175] will be attributed under the rules applicable to nonresident aliens discussed earlier[176] if:

(1) the spouses live apart the entire calendar year;
(2) the spouses do not file a joint return; and,

170. *See* I.R.C. §§ 71(b) & (f) (1988).

171. The Brent analysis rests on the claim of right doctrine. 630 F.2d 356, 359-60 & nn.7 & 8. If the court denies her request, she may possibly argue that her spouse held the entire community income item under claim of right and, consequently, he should bear the entire tax liability with respect to it. The counterargument, however, 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 might still be considered to have constructive possession of the income under claim of right and co-management principles.

172. Miscellaneous Revenue Act of 1980, Pub. L. No. 96-605, § 101(a) (1980) (codified as amended at I.R.C. § 66 (West Supp. 1990)).

173. Reference here is only to the tax inequity involved. Of course, an inequity may remain in terms of the denial of beneficial enjoyment of a portion of the community income to the abandoned spouse.

174. S. REP. No. 1036, 96th Cong., 2d Sess. 8 (1980).

175. Community income is defined in § 66(d)(2) as "income which, under applicable community property laws, is treated as community income." *See infra* note 178.

176. *See supra* Part V.B.

(3) with some exceptions,[177] no portion of the earned community income is transferred between the two spouses during the calendar year.[178]

Many separated spouses will have lived together part of the taxable year. In this case they will be outside the operation of section 66(a).[179] Similarly, many others will have made some transfers of community income between the spouses, and thus will also be excluded from the operation of section 66(a).[180] Congress became aware of the limited utility of section 66(a)[181] and in 1984 added two new subsections to section 66 in the same Act which produced section 1041.[182] These additions are vague in their terms, how-

177. The most prominent exception would be for child support. S. REP. NO. 1036, 96th Cong., 2d Sess. 8-9 (1980).

178. I.R.C. 66(a) provides:

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 calender year;

(2) such individuals—

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

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

(3) one or both of such individuals have earned income for the calender 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 calender year,

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

I.R.C. § 66(a) (1988).

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

(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) (1988).

Obviously, in order to apply § 66(a), the text of § 879(a) must also be examined. For the text of § 879(a) and related statutes see *supra* note 102.

179. *E.g.*, Warner v. Commissioner., 53 T.C.M. 703, 704 (1987) (husband moved to separate residence in November of the tax year, and therefore, did not qualify under I.R.C. § 66(a)). For a discussion of the limitations of § 66(a), see Parks, *Income Tax Relief for the Abandoned Spouse*, 12 COMMUNITY PROP. J. 119, 120 (1985); Salchow, I.R.C. *Section 66: Relief for Abandoned Spouses?*, 10 COMMUNITY PROP. J. 121 (1983).

180. 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. S. REP. No. 1036, 96th Cong., 2d Sess. 8-9, *reprinted in* 1980 U.S. CODE CONG. & ADMIN. NEWS 7293, 7299.

181. See H. R. REP. NO. 432, 98th Cong., 2d Sess. pt. 2, 1502, *reprinted in* 1984 U.S. CODE CONG. & ADMIN. NEWS 697, 1143. The problems with § 66 were diagnosed at the outset. *See* Vaughn, *supra* notes 10, 36, at 57-58.

182. 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 wideranging overhaul of the tax laws relating to divorce. For discussion and analysis of that legislation see Comment, *Domestic Relations Tax*

ever, and thus far have been narrowly interpreted.[183]

B. Section 66(b)

Section 66(b) authorizes the Secretary to disallow the benefits of community property law to any taxpayer if the taxpayer "acted as if" he alone owned the community income in his possession and failed to notify his spouse of the amount and nature of the income prior to the due date for their returns.[184] The main benefit of this provision over section 66(a) lies in the absence of any express requirement that the spouses live apart the entire year. But the "acted as if" language is vague. As a practical matter, a non-possessory spouse who lives with a possessory spouse may experience difficulty showing a lack of sharing of the funds in question. In addition, the requirement that the possessory spouse must have failed to notify the non-possessory spouse of his community income before the return due date limits the application of section 66(b). This restriction could also place a difficult burden of proof on the non-possessory spouse. Moreover, in cases such as that of our hypothetical Alice and Bart, each spouse could be presumed to know the amount of community income earned by the other if each keeps the same employment after their separation. The requirement that the spouse not know the income of the other spouse also creates an opening for the spouse who has possession of the community income to consume it before giving notice to the non-possessory spouse. The giving of notice would prevent the application of Section 66(b) even though as a practical matter the non-possessory spouse never benefitted from the community income.[185]

C. Section 66(c)

Section 66(c) authorizes the Secretary, under as yet unpromulgated regulations, to provide for full inclusion of an item of community income in a

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Reform, 20 GONZ. L. REV. 251 (1984-85), and Comment, *1984 Deficit Reduction Act: Divorce Taxation*, 1986 WIS. L. REV. 177 (1986). Neither comment, however, discusses the amendments to § 66.

183. *See infra* note 196.

184. 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.

185. For a criticism and analysis of § 66(b) see Parks, *supra* note 179, at 121-22. Parks argues that § 66 is inadequate and concludes that both spouses should be jointly and severally liable for all community income. *Id.* at 125-26. He would combine such a rule with a provision excusing a spouse from liability when "it would be inequitable to enforce such liability against him or her." *Id.* at 126. This seems a rather cumbersome and unrefined approach. While a liberalization of the relief provisions is in order, the creation of joint and several liability on all of the community income poses significant hazards. *See* Beck, *supra* note 6, at 323-32. Other approaches hold more promise for fairness. *See infra* Part X.

spouse's gross income.[186] Section 66(c) applies if: (1) the other spouse was unaware of and had no reason to be aware of the community income; (2) the income would not be taxable to the other spouse if section 879(a) applied[187] and (3) all things considered, "it would be inequitable" to include the item in the gross income of the other spouse.[188]

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. *Roberts v. Commissioner*[189] illustrates the apparent scope of this limitation. In *Roberts* 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 then husband in a real estate deal. The trial court had found as a matter of fact that the taxpayer either knew or should have known of the additional income even though she had no actual knowledge of the kickback itself.[190] The lower court based its finding on the taxpayer's knowledge of the existence of the real estate deal which gave rise to the kickback and on her general familiarity with the real estate business.[191] In addition, her husband deposited the kickback funds into an account to which the taxpayer had access, and the taxpayer knew that she and her husband were living beyond their means.[192] The Fifth Circuit Court of Appeals upheld the decision on the grounds that the tax court's finding that the taxpayer either knew or should have known of the community income was not clearly erroneous.[193] In doing so, the court concluded that the "[t]axpayer should have made that inquiry which would have given her actual knowledge of the Singing Hills kickback."[194] Thus, the court denied the taxpayer relief under section 66(c).[195] Other reported cases involving section 66(c) reach the same re-

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186. I.R.C. § 66(c) (West Supp. 1990).
187. *See supra* Part V.B for a description of those attribution rules and the text of § 879(a).
188. 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) (West Supp. 1990).

See *supra* note 178 for the text of § 66(d) (containing definitions applicable to this provision). See *supra* note 102 for the text of § 879(a) and other related provisions.

189. 860 F.2d 1235 (5th Cir. 1988).
190. *Id.* at 1239.
191. *Id.*
192. *Id.* at 1240.
193. *Id.*
194. *Id.*
195. *Id.*

sult.[196] Indeed, as of this writing there are no reported cases where a wife[197] has successfully raised section 66(c) as a defense to a tax assessment.[198] One gains the impression that a spouse who is merely naive will obtain little protection under section 66(c). The idea is implicit in the *Roberts* holding that the possessory spouse must have actively concealed the community income from the non-possessory spouse before the non-possessory spouse will be absolved from reporting a share of the community income.

D. *Commentary on Section 66*

The technical requirements of section 66 prevent it from providing relief to some separated spouses who receive less than half the aggregate community income.[199] Of course this inequity does not by itself establish that Congress should amend the provision. Some inequities may be an inevitable side effect of the effort to draw clear lines. But as has been demonstrated, section

196. *See* Thatcher v. Comm'r, 56 T.C.M. (C.C.H.) 707, 710 (1988) (Separated wife in California had knowledge that her husband's dental appliance sole proprietorship was producing income derived in part from the use of community property, and thus, should have known that some of that income constituted community property reportable by her. Consequently, she did not satisfy the lack of knowledge requirement of § 66(c)(3) even though she did not know the amount of community income.); Nelson v. Commissioner, 53 T.C.M. (C.C.H.) 1448 (1987) (California wife could not claim § 66(c) protection where she was directly involved in the theatre business managed by her husband. Thus, the court found sufficient evidence to support findings of tax fraud by both spouses.); Baldwin v. Commissioner, 52 T.C.M. (C.C.H.) 22 (1986) (Texas non-resident alien wife deemed to have knowledge of her husband's salary and, thus, could not satisfy the lack of knowledge requirement of § 66(c)(3). In addition, since she shared in the benefits of the community income, it was not inequitable to include half of the husband's salary in the wife's gross income. The court held her lack of knowledge of Texas community property laws and of U.S. income tax laws to be reasonable cause for her failure to file returns for two of the years in question for purposes of permitting her to avoid negligence penalties for those years.); Bözek v. Commissioner, 51 T.C.M. (C.C.H.) 350 (1986) (Wife could not raise § 66(c) as a defense because she had knowledge of the real estate commissions earned by her husband. The fact that the husband deposited the commissions into an account he held with his mother was irrelevant. The court found no inequity in holding the wife responsible for the taxes on half the commissions because the husband applied some of the commissions to community expenses.); Sanders v. Commissioner, 51 T.C.M. (C.C.H.) 317 (1986), *aff'd*, 812 F.2d 715 (9th Cir. 1987), *cert. denied*, 484 U.S. 830 (1987) (Arizona wife of a tax protestor could not raise § 66(c) as a defense when she knew her husband was employed. The wife had disclosed on her return that she was unable to report her share of her husband's earnings because she did not know the amount. The court also held that the wife had failed to prove the existence of an agreement transmuting the spouse's earnings into separate property. The court recognized the inequity of holding the wife liable, but noted that the law concerning taxation of community income is well established and provides no relief "even where the result seems inequitable." *Id.* at 318 (citing United States v. Mitchell, 403 U.S. 190 (1971))); and Rimple v. Commissioner, 49 T.C.M. (C.C.H.) 1533 (1985) (Texas wife who acted as a bookkeeper for two of three businesses operated by her husband and who knew of the existence of the third could not satisfy the lack of knowledge requirement of § 66(c)(3). Thus, the court held her liable for half of the unreported community income apparently derived from all three businesses.).

197. There are no reported cases where a husband has attempted to rely on § 66(c).

198. James Lewis, however, reports a case where the Service relieved a wife of liability. Because of the combination of an antenuptial agreement and a secretive and abusive spouse, the Service indicated that she had no reason to to know of her spouse's community income. Lewis, *Innocent Spouse Cases: Comments Inspired by Professor Borison's Article*, 40 TAX LAW. 865, 865-69 (1987).

199. I.R.C. § 66 (West Supp. 1990).

66 fails to draw clear lines. Its language is vague, and its application is dependent on the resolution of difficult factual questions.

The significance of section 66(a) is limited to situations of prolonged separation coupled with a lack of monetary transfers between spouses. Sections 66(b) and (c) both require a significant lack of knowledge or notice on the part of the non-earner spouse, and both involve rather vague statutory language. Although case law has yet to develop fully the scope of these two sections, early results indicate that only the profoundly innocent will receive much protection.[200] These factors limit the utility of section 66 as a planning tool. Indeed, Section 66 is clearly intended primarily as a relief provision when state community property law and federal tax law would otherwise interact in ways which are extremely unfair and oppressive to a spouse who had no ability to control the course of events. The non-possessory spouse who is merely ignorant of the law, poorly represented by counsel, or poorly served by a court may obtain no help from section 66.

This leads to another shortcoming of the statute. Section 66 does not take into account the fact that the *Seaborn* rule may trap the unwary. In this era of joint return filing, the usual tax reporting process does not inform the average taxpaying spouse, whether male or female, of the *Seaborn* rule. Only when separation or divorce compels the filing of separate returns does the typical taxpayer need to know of the rule. Without any prior reminder or notice of its existence, however, the taxpayer may be utterly ignorant of the rule. Indeed neither spouse may understand basic community property principles, much less the federal tax consequences of those principles. Thus, a wife who does not understand that she is accruing a tax liability on her spouse's income is less likely to take appropriate action to protect her property interest in that income. This statement is particularly true in the modern era when most women are more accustomed to supporting themselves and their families,[201] though for less wages than men. Even if she has sought a lawyer's assistance in the divorce process, certainly a possibility exists, perhaps a strong one, that her lawyer does not know of the rule in *Poe v. Seaborn*. In such circumstances, the *Seaborn* rule presents a danger for the unknowledgable wife and a potential source for a malpractice claim against the wife's lawyer.[202]

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200. *See supra* notes, 189-198 and accompanying text (discussing limitations of section 66(c)).

201. Since the early seventies lifelong wage earning has become the norm for most women in this country. *See* S. EVANS & B. NELSON, WAGE JUSTICE, COMPARABLE WORTH AND THE PARADOX OF TECHNOCRATIC REFORM, 29-30 (1989); Robins, *Economic Implications of Dependant Care Alternatives*, 46 TAX NOTES 343, 344 (1990).

202. Whether a divorce lawyer practicing in a community property state is obliged to understand the *Seaborn* rule as a minimal level of competence may be a matter for debate. It seems indisputable, however, that a lawyer handling divorces should have a firm understanding of the principles of community property law and at least a general grasp of the tax consequences of those principles.

One might also question whether the courts appreciate the problem since, typically at least, the courts focus on need in determining whether to order payments (other than for child support) from one spouse to another during separation. At least this appears to be true with respect to court ordered alimony. *See* Kay, *Equality and Difference: A Perspective on No-Fault*

Since nearly all married couples file joint returns, the rules of income attribution under the *Seaborn* rule are largely irrelevant except in the context of separate returns resulting from separation and divorce. Yet separation and divorce is the context in which *Seaborn* is least likely to reflect the actual circumstances of the parties. Spouses need an approach to income attribution on those separate returns that mirrors the economic realities of separation and divorce.[203] Section 66 does not do enough to accomplish this goal.

VIII. TRANSFERS OF ACCRUED BUT UNPAID INCOME ITEMS: SECTION 1041 AND THE ASSIGNMENT OF INCOME DOCTRINE

The final possible approach under current law for allocating tax reporting

Divorce and its Aftermath, 56 U. CIN. L. REV. 1, 11 (1987); Malman, *Unfinished Reform: The Tax Consequences of Divorce*, 61 N.Y.U.L. REV. 363, 376-78 (1986); Weitzman, *supra* note 13, at 149 (1985); Weitzman & Dixon, *The Alimony Myth: Does No Fault Divorce Make a Difference?*, 14 FAM. L.Q. 141, 147-50 (1980). *But cf.* Weitzman, *supra* note 13, at 180 (husband's income level and duration of marriage most important in determining alimony). But, in those cases where interim income is community property, why should the lesser income spouse be required to show need in order to obtain what belongs to her, that is, one half of the difference between her interim income and her spouse's interim income? One might further ask why shouldn't her share of the interim income under his control be paid out to her as it is received? Some might argue that she will receive her share in the property division. Those who take a strict constructionist view of community property principles might even argue that although the income is community property, the possessory spouse is entitled to consume it without ever reimbursing the non-possessory spouse. The basis for this view would be that as adminstrator of the community he is entitled to spend the community's earnings. *See* W. MCCLANAHAN, *supra* note 29, §§ 9:9-14. *See also* Younger, *supra* note 29, at 227-33 (recognizing and criticizing the separated wife's lack of access to the other spouse's community income). The normal community property rules, however, should not apply here since the wife has no immediate access to the funds. At the bare minimum, the funds should be accounted for in the property settlement. *See* Suter v. Suter, 97 Idaho 461, 546 P.2d 1169 (1976). Even if a court decree purports to include the interim income in the property division, the wife may still be at risk if she resides in one of the states permitting an unequal division of community property. The court could include the funds and still award her less than half of them. *See* W. MCCLANAHAN, *supra* note 29, §§ 12:10-14. *See also* Reynolds, *The Relationship of Property Division and Alimony: The Division of Property to Address Need*, 56 FORDHAM L. REV. 827, 833, 837 (1988). Moreover, waiting until the final property division to divide the community income positions the non-possessory spouse to suffer the consequences if the possessory spouse consumes the income, and other property available is insufficient to satisfy her claim. As a result she would be in the position of owing tax on income she never received, and § 66 would be of no help to her if her predicament is not the product of any concealment of the income by her husband. Even if the court awards the entire tax liability to the husband, the wife may still face difficulties because she would remain liable primarily for the tax from the government's perspective. From the foregoing, one could gather that even if the non-possessory spouse is well informed concerning her legal rights, she might prefer to enter into a written agreement terminating the community even when the agreement allows her less than her full half share of the spouses' aggregate interim income. She might prefer this rather than run the risk that she will face an income tax liability on, what to her may be, phantom income.

As discussed in the text at *supra* note 51, all community property states permit written agreements which prospectively terminate the community as to earned income and income from property. By entering such an agreement, the wife gives up some income but also avoids a potential tax liability on that income. She probably gives up more than she gets, but she gains a certainty of outcome that is lacking otherwise. *See* Mnookin & Kornhauser, *Bargaining in the Shadow of the Law: The Case of Divorce*, 88 YALE L.J. 950, 969-71 (1979) where the authors point out that, in the uncertain world of court ordered property and custody awards, a risk-averse spouse may prefer to accept a worse than expected result in order to avoid the risk of a much worse than expected result.

203. *See infra* Part X.

liability between spouses with respect to some items of income is to view section 1041 as the controlling provision. Prior to the enactment of section 1041 in 1984,[204] married couples in community property states enjoyed another advantage over their separate property state counterparts besides the income splitting advantage largely obviated by the 1948 amendments to the joint return rules. In separate property states transfers of separately owned, appreciated property between spouses incident to a divorce resulted in gain recognition to the transferor and a stepped up basis to the transferee.[205] On the other hand, in community property states, an equal division of the community assets did not trigger gain recognition.[206] In part, Congress enacted Section 1041 to extend this non-recognition advantage to separate property states.[207]

A. *The Questions Presented*

As mentioned previously, under section 1041 all transfers of "property" between spouses and former spouses incident to a divorce result in a no "gain or loss" recognition to the transferor and in a carryover basis to the transferee.[208] Typically, section 1041 applies where one spouse transfers the family home or some piece of business or investment property to the other spouse incident to a divorce. For present purposes, however, this Article focuses on its potential application where an accrued but unpaid income item is unequally divided between the spouses as part of their final property division in divorce.[209]

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204. Deficit Reduction Act of 1984, Pub. L. No. 98-369, § 421(a), 98 Stat. 494, 793 (1984).

205. *See* Davis v. Commissioner, 370 U.S. 65, 73 (1962).

206. *Id.* at 71. *See* Asimow, *supra* note 28, at 66-67. An unequal division of community assets may result in gain recognition. *Id.*

207. *See* H. R. REP. NO. 432, 98th Cong., 2d Sess., pt. 2, at 1491, *reprinted in* 1984 U.S. CODE CONG. & ADMIN. NEWS, 697, 1134.

208. Subsections (a) and (b) of § 1041 provide:

> Sec. 1041. Transfers Of Property Between Spouses Or Incident To Divorce.
> (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 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.

I.R.C. § 1041(a), (b).

The Regulations take the position that transfers between spouses are within § 1041 without regard to whether the transfers are incident to a divorce. *See* Temp. Treas. Reg. § 1.1041-1T (1984) (Question and Answer 2).

209. We will assume that the spouses are cash basis taxpayers. In this framework the income is not reported until received by one of the spouses. Since receipt by either spouse equals receipt by the community, a spouse is deemed to have constructive receipt of an item of community income when actually received by the other spouse.

Section 1041 is less likely to apply where there has been an ineffective oral termination of the community which is later ratified. Yet another variation on the hypothetical concerning Alice and Bart may illustrate this situation. Assume that the $50,000 of income in Alice's possession and the $100,000 of income in Bart's possession are the interim earnings of each. Alice and

To illustrate this scenario, recall the second variation on the hypothetical

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Bart have orally agreed that income will belong exclusively to the earner even though under state law the earnings belong half to each. (One might wonder why Alice would agree to this since under community property law $25,000 of Bart's earnings belong to her. One may speculate that she may not understand her rights under community property law. She and her lawyer (and perhaps even the courts?) may see her rights with respect to Bart's interim income in terms of the law as it relates to alimony and may believe she is not entitled to an alimony award. Moreover, because being part of the labor force is now normative conduct for women, she may simply choose to maintain a state of independence). *See* S. EVANS & B. NELSON, *supra* note 201, at 29-30; Robins, *supra* note 201, at 344).

Applying § 1041 to this scenario one would simply say that the non-earner spouse has transferred his or her half of the earner spouse's earned income to the earner spouse. The earnings would be viewed as property with a zero basis transferred from the non-earner spouse to the earner spouse. As a result, Bart would include in gross income the entire amount of his earned interim income when it is received and would exclude from gross income any part of Alice's earned interim income; Alice would do the same. In short, the result would be the same as in a separate property state.

This analysis, however, may be faulted on several counts. If under state law the oral agreement dissolves the community as to their earnings, then the earnings are the separate property of the earner spouse who would be liable for federal income tax purposes to report only his or her own earned income. Section 1041 would never come into play because there has been no transfer.

On the other hand, if the lack of a writing prevents the agreement from having legal effect under state law, it is difficult to see how § 1041 can reasonably apply here either. Since state law considers the oral agreement ineffective to terminate the community, no transfer has occurred for § 1041 purposes. State law creates the spouses respective rights and interests in the income which the federal law then acts upon. *See* Morgan v. Commissioner, 309 U.S. 78, 80-81 (1940). Since each spouse technically owned one half of the income when it was received, under *Seaborn* each was obliged to report half the income for tax purposes, assuming that § 66 will not apply to override the community property law. Under this scenario § 66 likely will not apply because of the calender year rule in § 66(a) and the lack of notice requirement in §§ 66(b) & (c).

If the subsequent property division divides the interim community earnings equally between the spouses, one might conclude no harm has been done. However, if the subsequent division of assets acquiesces in the orally agreed allocation of earnings without making any offsetting allocation of property to the lesser earning spouse or simply disregards the earnings because they have already been consumed on transitory needs and pleasures, the lesser earning spouse is taxed on income she never received or even indirectly benefitted from. In effect this subsequent course of events ratified the oral agreement. (Indeed, state community property law might ultimately consider the earnings separate property, but the earnings would be community property at the moment they are earned. The earnings could become separate property as a result of the deemed gift by each spouse of his or her interest in the earnings of the other. *See* W. MCCLANAHAN, *supra* note 29, § 4:19 at 210. *See also* IDAHO CODE §§ 32-903 & 32-906 (1990). But even if this ratification is seen as a § 1041 transfer, a transfer subsequent to the fixing of tax reporting liability with respect to the income encounters the problem with retroactivity set out in Part VI.C.

Even if we could somehow escape this analytical dead end, other barriers to the application of § 1041 also exist. Since § 66 deals more specifically than § 1041, with respect to interim income, it might be regarded as controlling to the extent the two provisions produce contradictory results. When there is a conflict between taxing statutes, the specific statute controls over the general statute. D. SANDS, SUTHERLAND STATUTORY CONSTRUCTION § 66.03 (4th ed. 1972). A contrary view might be asserted that, to the extent § 66 does not require interim income to be treated as separate income, § 1041 may come into play. The argument in support of this view might go something like this: § 66 is most directly concerned with unilateral actions by the earner spouse that deny the non-earner spouse the fruits of the earner's labor. The provision, then, does *tax justice* by causing the earner spouse to bear the tax liability associated with the earnings. Section 1041, on the other hand, represents a broad policy judgment by Congress that the tax system should not tax voluntary or court ordered transfers between spouses. *See* H. R. REP. NO. 432, *supra* note 207, at 1491. There is nothing inherently contradictory in the goals forwarded by the two statutes. Thus, if the spouses choose to case of Bart and Alice set out in the introduction to this Article. The hypothetical assumed that each spouse had earnings of $50,000 during the period of their separation prior to divorce. Additionally, the spouses had another $50,000 of accrued but unpaid rental income potentially subject to attribution under the *Seaborn* rule when paid. If, as part of the division of their community property, the court awards Bart 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 $50,000 is made up of cash basis accounts receivable awarded to Bart or if the $50,000 is accrued but unpaid royalty income associated with property which the court allocates to Bart as part of the property division. In all these situations we assume that if the item had been paid prior to the property division, the item would have constituted community income reportable half and half by Alice and Bart. Does the transfer of Alice's interest in the income item to Bart in advance of payment have any effect on this?

Arguably, the transfer does, based on the application of section 1041, but only if the income item is "property" laden with "gain" within the meaning of that section. Moreover, even if the item is gain property, the question remains whether the assignment of income doctrine will override the application of section 1041. This question presents a certain irony because the income splitting feature of the *Seaborn* rule is itself an exception to the assignment of income doctrine in the context of earned income.[210] Thus, in some contexts, if the assignment of income doctrine overrides section 1041, the doctrine will effectively preserve an exception to its application which otherwise would be overcome. Perhaps this absurd outcome provides sufficient basis for concluding that the doctrine should not override the application of section 1041 to transfers of service accounts receivable. In other contexts, however, the Service has taken the position that the assignment of income doctrine does apply despite section 1041. Thus, the matter requires further discussion.[211]

treat the interim income as the separate property of the earner spouse, this choice should be respected from a tax perspective even if § 66 would not force this result. How much credence one gives this argument probably depends upon the degree of conviction one has that the policies underlying § 1041 would be subverted by failing to apply it here. Some of those policies are the subject of the text discussion in Part VIII.C.

Beyond the retroactivity and preemption issues discussed above, additional questions exist concerning: whether the assignment of income doctrine prevents § 1041 from applying to a transfer of income, and whether a transfer of earnings is a transfer of property within the meaning of § 1041. Discussion of these questions is more appropriately addressed as part of the examination of § 1041's application to transfers of accrued but unpaid interim income items.

210. *See* discussion of *Seaborn, supra* Part IV.

211. It should be stated that the interaction between § 1041 and the assignment of income doctrine is a topic extending well beyond the scope of this Article and is worthy of an article unto itself. Fortunately, a couple of good ones have already been written on this topic and will serve as guides in the analysis which follows. *See* Asimow, *supra* note 28, and Nunnallee, *supra* note 28. In particular, Professor Michael Asimow's article is recommended to the reader with community property concerns.

B. *The Service's Position*

In its rulings the Service has taken the position that transfers of "sensitive assets"[212] between spouses trigger income to the transferor despite the message of section 1041. Sensitive assets are items which, because of the assignment of income doctrine, do not shift income to a recipient.[213] This definition is necessarily vague because of the wide variety of contexts in which the assignment doctrine can apply.[214] In Revenue Ruling 87-112,[215] 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.[216] Asserting that assignment of income principles rather than section 1041 applies in this context, the Service reasoned that section 1041(a) applies to "gain" but not to accrued interest "income."[217] The Service offered this narrow construction of section 1041 without any policy justification for its formalistic stance.

Private Letter Ruling 88-13-023[218] extends the rule enunciated in Revenue Ruling 87-112 into the difficult area of divorce property settlements involving division of deferred compensation benefits. The ruling involved a division of community property and thus is particularly relevant to this Article. In that ruling, former spouses A and B agreed to three annual cash payments by B to A in exchange for A's relinquishment of her community property interest in B's military retirement plan. The Service ruling reasoned that since her share of the retirement benefit payments would have been ordinary income to A had she received them, the substitute payments of cash from B should also constitute ordinary income.[219] The ruling then concludes that since the cash payments "represent payments for a right to future income rather than gain . . . [they] are outside the application of section 1041."[220]

The interim income question posed by the hypothetical of Alice and Bart is difficult to distinguish from the situation presented by Private Letter Ruling 88-13-023. First, the transfer of the interim income item, whether in the form of an account receivable, accrued rent or an accrued royalty payment, would normally fall prey to the assignment of income doctrine. Second, all of these items are "income" rather than "gain" if one accepts the meanings ascribed to those terms by the ruling. If the Service adheres to the course it has followed thus far,[221] it will likely find that section 1041 does not apply to

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212. Asimow coined this term. *See* Asimow, *supra* note 28, at 85.
213. *Id.* Sensitive assets encompass items of accrued but unpaid income.
214. *See supra* note 73 and accompanying text.
215. 1987-2 C.B. 207.
216. *Id.* at 208.
217. *Id.*
218. Priv. Ltr. Rul. 88-13-023 (Dec. 29, 1987).
219. *Id.* This position is consistent with other cases involving an anticipatory assignment for value. E.g., Estate of Stranahan v. Commissioner, 472 F.2d 867 (6th Cir. 1973) (proceeds from sale of right to future cash dividends treated as substitute for the dividends for federal tax purposes.)
220. *Id.*
221. In another ruling, Priv. Ltr. Rul. 88-20-086 (Feb. 25, 1988), the Service continued to

transfers of accrued interim income between separated spouses. Consequently, the assignment of income doctrine does apply.

One can understand this position from a purely technical standpoint. Section 1041 prevents recognition of "gain or loss on a transfer of property."[222] The terms "income" and "gain" are not always synonymous. Some might contend that all gain is income,[223] but not all income is gain. In particular, earned income arising from labor rather than ownership of property may fall outside the scope of the term "gain." Thus, transfers of interim earned income between spouses could never come within the terms of section 1041. On the other hand, an income stream is sometimes seen as a form of property, for example, an income interest in a trust. The right to income from an employment contract may create a beneficial interest in property in the same manner as the right to income from a trust. If an earned income stream is a form of property,[224] then, logically, the transfer of that income stream could produce "gain."[225] Normally, however, the assignment of income doctrine applies to a transfer of the earned income stream, but perhaps not to a transfer of the trust income stream.[226]

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narrowly apply § 1041, but for different reasons than those set out in the other rulings. Ruling 88-20-086 addressed the issue whether a transfer from one spouse's Individual Retirement Account (IRA) to the other spouse's constituted a non-recognition event under § 1041. The Service ruled that § 1041 had no application because § 408(d) specifically deals with the tax treatment of distributions from IRAs. The Service then ruled that, since § 408(d)(6) granted non-recognition on interspousal IRA transfers only when such transfers occurred incident to a divorce, it is implicit that a transfer between the IRAs of a happily married couple is a taxable event. When confronted with the application of § 1041 to interim income transfers between spouses, the service might argue that § 1041 does not apply since § 66 deals more specifically with the taxation of interim income. But in the interim income setting, the Service also has available the argument utilized in Revenue Ruling 87-112 and Private Letter Ruling 88-13-0-23 that the exchange involves future income rather than "gain". Thus, § 1041 has no application.

222. I.R.C. § 1041(a) (1990).

223. "Gross" income, at least, includes "[g]ains derived from dealings in property." I.R.C. § 61(a)(3) (1990). "Compensation for services" is treated as a separate category of gross income. I.R.C. § 61(a)(1) (1990).

224. In Hempt Bros., Inc. v. United States, 490 F.2d 1172 (3rd Cir. 1974), *cert. denied*, 419 U.S. 826 (1974), discussed *infra* note 226, the court considered accounts receivable property for tax purposes. One commentator recently argued that a cash basis taxpayer's right to future income should be considered property with a zero basis for § 1041 purposes. *See* Nunnallee, *supra* note 28, at 639.

225. Gain from a property disposition is the excess of the amount realized over adjusted basis. I.R.C. § 1001(a) (1990). Both "amount realized" and "adjusted basis" are defined terms. *See* I.R.C. §§ 1001(b) & 1011(a) (1990). Here the adjusted basis would be zero and, thus, the entire amount realized would be gain.

226. *Compare* Lucas v. Earl, 281 U.S. 111 (1930) (holding income is taxed to the person who earned it) *with* Blair v. Commissioner, 300 U.S. 5 (1937) (holding that a gratuitous transfer of an undivided interest in a trust income interest caused the donee to be taxed on his share of the trust's income). *But cf.* Hempt Bros., Inc. v. United States, 490 F.2d 1172 (3rd Cir. 1974), *cert. denied*, 419 U.S. 826 (1974) (section 351 granting tax free status to corporate formation overrides assignment of income doctrine). In *Blair* transfer of an income interest in a trust successfully passed the tax reporting liability associated with that income interest. The Court viewed the income stream as an equitable interest in the trust corpus, a separate and assignable property interest. 300 U.S. at 12. In *Hempt Bros.* the court held that the assignment of income doctrine does not prevent the tax-free transfer into a corporation of cash basis accounts receivables. 490 F.2d at 1178. Normally the assignment of income doctrine prevents the transfer of the receivables without either (1) income recognition by the transferor at the

This concern with the semantical debate over the degree of overlap between the terms "income" and "gain" could be viewed as an exercise in hypertechnicality. Some might contend that time is more "gainfully employed" by treating the question as one of tax policy rather than taking a cookbook approach to statutory construction. The Service has forced this analysis, however, because of its use of semantics as a means for avoiding the central issue: the conflict between section 1041 and the assignment of income doctrine.

One can see why the Service's kneejerk reaction would be against broadly interpreting section 1041. After all, section 1041 applies to all transfers of property between spouses, whether or not a divorce looms in the offing. To say that section 1041 completely overrides the assignment of income rules in the interspousal transfer context may create some tax avoidance opportunities for married couples. These tax avoidance opportunities, however, are of minor consequence.[227]

By focusing on definitional problems associated with sensitive assets, the Service has applied the assignment doctrine to those items without specifically asserting that the doctrine overrides section 1041. Why the Service failed directly to address the question of the relationship between Section 1041 and the assignment doctrine is a matter for conjecture. The Service probably hoped to avoid, temporarily at least, the controversy that often swirls around the proper relationship between the doctrine and non-recognition provisions in the Code.[228] This beating around the bush, however, does not satisfy those commentators who would prefer another result.

C. *The Critic's View*

Professor Michael Asimow has strongly criticized the Service's restrictive interpretation of section 1041 from a policy perspective.[229] In Asimow's

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time of transfer, or (2) income recognition by the transferor at the time the transferee collects the receivables. But the *Hempt Bros.* court determined that the policies supporting the enactment of § 351 which grants non-recognition to certain corporate formations, overrode the application of the assignment of income doctrine. *Id.* For a more detailed discussion of *Hempt Brothers* see Asimow, *supra* note 28, at 88-89.

227. In effect this interpretation of § 1041 would overrule the specific holding of *Lucas v. Earl*. Both the *Earl* and *Seaborn* rules would become default positions because they would only apply if the married couple had no agreement to the contrary. Married couples could then agree to share their tax reporting obligation on their aggregate gross income in any manner they see fit. The Tax Reform Act of 1986, however, has significantly reduced the potential benefits of assigning income between spouses by flattening the tax rates. Moreover, in nearly all cases spouses will file jointly if they are able since the tax costs for marrieds filing separately are higher. *See* I.R.C. § 1(a) & (d) (1990). Both Asimow and Nunnallee assert that the tax avoidance opportunities under § 1041 are minimal even if it overrides the assignment doctrine. *See* Asimow, *supra* note 28, at 106-07; Nunnallee, *supra* note 28, at 640-42.

228. *See* Nunnallee, *supra* note 28, at 629-36. In particular, the Service would doubtless prefer not to confront the precedent established by the *Hempt Brothers* case discussed *infra* note 226. *But cf.* Hillsboro Nat'l Bank v. Commissioner, 460 U.S. 370 (1983) (tax benefit rule applies notwithstanding the apparent applicability of § 336 which at that time prevented a corporation from recognizing gain upon liquidation).

229. Asimow, *supra* note 28, at 97-109. Professor Walter Nunnallee also has attacked the Service's position on policy grounds. *See* Nunnallee, *supra* note, 28 at 616.

view, the assignment doctrine should not be applied in the divorce setting because to do so would frustrate both the legislative purposes of section 1041[230] and the purposes of other divorce related tax statutes.[231] Asimow further contends that applying assignment principles in the divorce setting does not forward the policies underlying the assignment of income doctrine.[232] This Article will not attempt to conduct an exhaustive recapitulation of Asimow's analysis. Some of his points concerning the purposes of the assignment doctrine, however, particularly bear on the taxation of interim income and thus deserve discussion.

Asimow notes that the assignment of income doctrine arose as an effort to maintain the progressivity of the income tax.[233] He asserts that, in the context of divorce, application of the doctrine may often have the opposite effect.[234] This anti-progressive effect of applying the assignment of income doctrine is evident in the case of interim income in the community property setting. Consider again, for instance, the second variation of the hypothetical of Alice and Bart. Recall that Alice had \$50,000 of interim income and Bart had \$100,000 of interim income (if one includes the sensitive asset). Applying the assignment of income doctrine to defeat the application of section 1041 to the award of the sensitive asset to Bart results in each reporting \$75,000 of gross income (one-half their aggregate interim income) under the *Seaborn* rule. This result is anti-progressive. Applying section 1041 to the award causes Alice to report \$50,000 of gross income (Alice's earnings) and Bart to report \$100,000 (Bart's earnings and the entire amount of the sensitive asset), a progressive result. Thus, at least in the context of interim income, section 1041 advances the goal that is the ostensible basis for the existence of the assignment of income doctrine. Application of the doctrine, on the other hand, defeats that goal.

Asimow also points out that the donative assignment of income rules were founded on the assumption that the transferor had really given up little or nothing because of the closeness of the relationship between the transferor

230. Asimow, *supra* note 28, at 97-100. Asimow identifies six legislative purposes of § 1041: "the law relating to property settlements should be (1) simple, (2) foolproof, (3) not harsh, (4) difficult to plan around, (5) whip-saw-proof, and (6) unintrusive." *Id.* at 97.

231. *Id.* at 100-04. Asimow contends that application of assignment of income principles would undercut the policy expressed in (1) the alimony trust rules in § 682, (2) the rule in § 453B(g) that a § 1041 transfer of an installment obligation will not trigger gain recognition even though a gift of an installment obligation normally does trigger gain recognition, (3) the regulations excepting § 1041 transfers from the imputed interest rules applicable to below market loans, and (4) the Retirement Equity Act provisions preventing the application of the assignment of income doctrine to qualified plan divisions incident to a divorce. *Id.*

232. *Id.* at 104-09. Asimow divides the assignment of income doctrine into two branches, the donative assignment rules and the capital gains assignment rules. The purpose of the donative branch identified by Asimow is shoring up progressivity against deliberate manipulation. *Id.* at 104. The purpose of the capital gains branch is prevention of transmutation of ordinary income into capital gains. *Id.* at 109.

233. *Id.* at 104. *See supra* note 232. This, of course, takes us back to Lucas v. Earl discussed in Part IV. The assignment doctrine also plays a key role in preventing conversion of ordinary income into capital gains. *See* Asimow, *supra* note 28, at 86. That branch of the assignment doctrine is not of special concern in the context of interim income, however, since here the goal simply is to determine who will be taxed on the income.

234. *Id.* at 105.

and the transferee.[235] Obviously this assumption is not true in the context of interim income since the spouses are no longer acting as a single economic unit. Thus, if one assumes Alice transferred her interest in the sensitive asset without receiving anything in exchange,[236] she had the benefit of only $50,000 of the aggregate interim income and Bart had the benefit of $100,000. The fairness of treating each spouse's interim income as separate income seems incontrovertible. Even if Bart passed on some portion of his income to Alice in the form of alimony, no inequity results from separate income treatment because the alimony rules would grant Bart a deduction[237] and cause Alice to have income[238] in an amount equal to the alimony payments.

If Alice gives up her interest in the sensitive asset in exchange for another community asset of equal value, the case for applying the assignment doctrine is stronger. Even here, however, the danger of unfairness exists. Suppose Alice receives corporate stock worth $50,000 in which the community had a basis of $25,000 in exchange for her interest in the sensitive asset. Obviously, the stock transfer will be within the terms of section 1041. Bart will recognize no gain, and Alice will take a carryover basis of $25,000 in the stock. If the assignment doctrine applies to the transfer of Alice's interest in the sensitive asset, the opposite result will attend that part of the exchange. Alice will recognize $25,000 of gain[239] immediately upon the transfer of the sensitive asset to Bart,[240] and will be saddled with another $25,000 of inherent gain when she sells the stock. Bart, on the other hand, will recognize no gain currently and his basis in the sensitive asset will step up from zero to $25,000 as a result of Alice's gain recognition.[241] The parties can properly account for the unequal tax burden only by adjusting the values of other properties transferred between them. To some degree, such calculations are an integral part of the operations of section 1041, but selective application of the provision makes those calculations more complex and more prone to trap the unwary.

Whether the assignment of income doctrine should circumscribe the role of section 1041 presents a difficult question. It need not, and perhaps should not, require a blanket answer. The doctrine is a branch of the common law, and its growth and pruning is the proper province of the courts. Asimow makes a strong case for limiting its role in the context of divorce settlements and does not appear to countenance its application in the context of func-

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235. *Id.* at 108 (quoting Helvering v. Clifford, 309 U.S. 331, 335-36 (1940)).

236. Ordinarily one would expect this not to be the case in a division of community property. But if Alice receives less than half of the value of the community assets, how is one to know?

237. I.R.C. § 215(a) (1988).

238. *Id.* at § 71(a).

239. The Service would classify this as income not gain. *See id.*

240. Or she might be permitted to wait until Bart receives the item before being attributed with the income.

241. For an interesting discussion of the relationship between gain recognition and basis see Potts, *Did Your Law Professor Tell You Basis Means Cost? The Gain Recognition Theory of Basis*, 22 VAL. U.L. REV. 233 (1988).

tioning marriages.[242] The legislative history of section 1041 gives no clue what Congress intended unless one assumes that failure to mention the question provides an answer.[243] In deciding whether Section 1041 applies in a particular context, as Asimow argued, one must consider whether the doctrine's application forwards the underlying policy objectives supporting its creation. Where separated spouses agree or a court has determined that accrued but unpaid interim income will be the separate property of one of the spouses, the application of the doctrine is not sound policy. Unfortunately, the Service does not seem inclined to agree. Its position is sufficiently vulnerable to invite challenge, and the courts will likely have the last word.

IX. A COMMENT ON THE PRESENT STATE OF THE LAW

The current state of the law with respect to the taxation of post-separation income in community property states is burdened by complexity, uncertainty, and the potential for unfairness. As witnessed by the controversy concerning section 1041, these problems are not solely a function of the *Seaborn* rule. With respect to earned income, however, *Seaborn* presents a troublesome paradigm for attribution of taxable income to separated spouses because it is not calculated to comport with economic reality.[244] When significant disparity exists between the income levels of separated spouses, the spouse with the lower income (usually the wife) may be seriously disadvantaged by treating the post-separation income as community income for tax purposes. Though the disadvantage may be avoided with proper planning

242. Asimow, *supra* note 28, at 84-112.

> 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 28, at 112. Thus, Asimow does not entirely close the door to applying the doctrine in the non-divorce setting. But he does not seem to favor its application even where the transfer between spouses is unrelated to divorce, perhaps because to apply the doctrine in the latter context would threaten its application in the former. Professor Asimow has indicated that he would favor allowing § 1041 to override the assignment of income doctrine even in a functioning marriage. Letter from Micheal Asimow to John A. Miller (April 5, 1990) (on file with Miller).

243. The House Report states:

> The bill provides that the transfer of property to a spouse . . . will be treated . . . as a gift. Gain (including recapture income) 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.

H.R. REP. NO. 432, *supra* note 104, at 1492.

The report does not mention the assignment of income doctrine, nor does the discussion ever reach the treatment of income items which have traditionally brought the doctrine into play.

244. *See* the authorities cited *supra* note 13. This is not to say that the community property principle underlying the *Seaborn* rule should not represent economic reality. Strong evidence exists, however, suggesting that it does not.

and counseling, cases involving section 66 demonstrate that some wives do not escape the trap set by *Seaborn*.

Still one must recognize that the difficulties of the present system are mitigated by the availability of two courses of action that may simplify the tax concerns of separated spouses. First, if the parties are still married at the end of the year, they can file a joint return[245] and then pay the resulting tax liability in any fashion agreeable to both.[246] Though they may agree to file a joint return, the spouses must still apply the legal principles discussed in this Article if they are accurately to calculate their respective shares of their aggregate tax liability. Second, the parties can determine their respective tax liabilities by entering into a written agreement terminating the community as to their earnings and income producing property. Both of these mitigation approaches require cooperation and a degree of sophistication. Because of the spectre of joint liability, the joint return approach also involves some element of trust.[247] The written agreement approach requires foresight because of the lack of retroactive effect accorded to those agreements.[248] When the spouses' determination to divorce evolves over time, the prudence of an early agreed termination of the community may be apparent only with the benefit of hindsight.

In light of these avenues of escape from the burdens of *Seaborn*, is the current state of the law acceptable? This question is interrelated with the larger question: "whether natural persons should be taxed as isolated individuals, or as social beings whose family ties to other taxpayers affect their taxpaying capacity."[249] However, one need not fully answer that larger question in answering the question concerning *Seaborn*'s usefulness.[250] This

245. Determining when a joint return may be filed is not always a simple matter. Generally if the spouses are married on the last day of the year they can file a joint return unless legally separated under a decree of separate maintenance. I.R.C. §§ 6013(d), 7703(a)(2) (1988). For a discussion of the problems associated with determining marital and filing status see Robinson & Wenig, *supra* note 6, at 788-853.

246. I.R.C. §§ 6013(a), (d) (1988). If a decree of divorce or of separate maintenance has been entered before the end of the year, the parties will not be permitted to file a joint return. *Id.* at 6013(d). Joint filing is cost effective since the rates on married persons filing jointly are lower than on married persons filing separately. See *id.* § 1(a), (d).

247. *Id.* § 6013(d)(3). Of course § 6013(e) may provide relief from joint liability to an innocent spouse in some circumstances. Commentators have criticized this provision, however, as inadequate and unfair in its application. *See* Beck, *supra* note 6, at 348-69.

248. In saying this we must recognize that the Service will not likely pursue an action against either spouse if between the two of them all of their aggregate income is reported and if the resulting tax liabilities are paid. Where one spouse or the other fails to report the income under the terms of the written agreement or fails to pay his or her share of tax, however, the Service would feel free to disregard the agreement to the extent it purports to have retroactive effect.

249. Bittker, *supra* note 7, at 1391.

250. Others have sought to answer this question. *See, e.g.*, Chapman, *Marriage Neutrality: An Old Idea Comes of Age*, 87 W. VA. L. REV. 335 (1985) (promoting a mandatory system that requires married couples to file individual tax returns); Gann, *supra* note 76 (concluding that equity required an income tax system that is marriage neutral); McIntyre & Oldman, *supra* note 7 (attributing income to the individual utilizing or benefitting from the income, and thus, requiring changes in familial tax system); Note, *supra* note 7 (advocating elimination of the second wage earner distinction, and elimination of the joint filing system for married individuals).

is fortunate because the answer to that larger question is controversial, complex, full of imponderables, and ultimately uncertain.[251] Even if such matters as the propriety of income splitting between spouses through the use of joint returns[252] are beyond the scope of the present inquiry one may still reasonably conclude that the present state of affairs with respect to community property taxation should be changed. Since the advent of the joint return, the *Seaborn* rule's most important role is determining the income attribution of separated and divorced spouses. In this context, the rule bears its most tenuous relationship with economic reality. The fact that the primary options for resolving post-separation tax questions involve either embracing joint liability or dissolving the community at an early, and perhaps premature, stage of the separation suggests the need for a better central paradigm. The fact that the law already contains many exceptions to the *Seaborn* rule[253] tends to corroborate this assessment. The main question then becomes whether superior alternatives are available. This author believes there are.

X. ALTERNATIVE APPROACHES

A. *Overrule* Poe v. Seaborn

Federal legislation overruling *Poe v. Seaborn*[254] without necessarily elimi-

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251. Professor Bittker's discussion of the issues surrounding the question is excellent. He concluded:

> If my extended essay has a unifying theme, it is that theoreticians, whatever their backgrounds, cannot "solve" the problem of taxing family income. They can identify the issues that must be resolved, point out conflicts among the objectives to be served, propose alternative approaches, and predict the outcome of picking one route rather than another. Having performed these functions, the expert must give way to the citizen, whose judgments in the end can rest on nothing more precise or permanent than collective social preferences. Once the citizenry casts the die, however, the expert is entitled to offer a postscript, namely, that the chosen solution will itself turn out, sooner or later, to be a problem.

Bittker, *supra* note 7, at 1463.

252. Professor Bittker explains that "given a progressive rate schedule, a marriage-neutral tax system cannot be reconciled with a regime of equal taxes for equal-income married couples." *Id.* at 1395. We are forced to choose between taxing equal income couples equally or equal income individuals equally. We cannot do both simultaneously as long as we also maintain a progressive rate structure. For a demonstration of the mathematics involved, see *id.* at 1395-96. *See also* McIntyre & Oldman, *supra* note 7, at 1590-92 (illustrating the incompatibility of marriage-neutral tax and equal-income couple's tax burden).

253. *See supra* note 105.

254. Murray offered this idea. *See* Murray, supra note 10, at 64-65. Just prior to printing of the present article, Beck again suggested it (though without crediting Murray). *See* Beck, *Joint Return Liability and Poe v. Seaborn Should Both Be Repealed*, 49 TAX NOTES 457, 465 (Oct. 1990). The Beck piece was published too late for more than this passing reference in the present article. This idea is not a new one, though the reasons offered by others differ from those offered here. *E.g.*, Bittker, *supra* note 7, at 1438-39. Chapman, *supra* note 250, at 354-58; Note, *supra* note 7, at 238-52; Gann, *supra* note 76, at 32-52. All these articles discuss the desirability of a marriage neutral income tax system which would provide no opportunity for income splitting between spouses and which would tax all earnings to the spouse who earned them. The idea discussed in this Article represents a more modest proposal since it does not involve the elimination of income splitting by married couples who file joint returns.

nating the joint return rules[255] would solve the main problems associated with the income taxation of married persons filing separately in community property states. This proposal contains a certain irony since *Seaborn* induced Congress to enact the income splitting aspect of the joint return rules.

Overruling *Seaborn* would establish the *Earl* rule with respect to earned income and avoid many of the interpretive and fact based problems associated with section 66. Even so, overruling *Seaborn* would not be without complexities because it would generate stubborn attribution questions concerning income from property.[256] One commentator suggested that these attribution problems should be addressed by adopting rules similar to those established by section 879 for non-resident aliens.[257] Recall that with respect to most forms of income, section 879 attributes the income to the spouse who generated the income or who is otherwise most closely connected to the income.[258]

With respect to earned income, partnership income, sole proprietorship income, and income from separate property, section 879 may be an adequate template for attributing income reporting liability between the spouses.[259]

255. Beck offers a broader proposal for eliminating joint liability without the elimination of joint returns. Beck, *supra* note 6, at 393. He suggests the adoption of a proportional liability system which determines each spouse's separate tax liability based on the allocation formula currently in use for calculating each spouse's separate share of a refund from a joint return. *Id.* at 393-95 (citing Rev. Rul. 80-6, 1980-1 C.B. 296 (applying the separate tax method of allocation); Rev. Rul. 80-7, 1980-1 C.B. 296 (same); Rev. Rul 80-8, 1980-1 C.B. 298 (same)). This involves two steps. First, one determines the separate tax liability of each spouse as if each spouse filed separately. Then under Beck's proposal this hypothetical liability is used as a basis for allocating the spouses' joint return liability between them in the proportion each spouse's separate tax liability bears to their combined separate tax liabilities. Beck, *supra* note 6, at 393-95. The proposal set out in the text only involves the first step because of the underlying assumption that the spouses are filing separate returns.

256. *See* Gann, *supra* note 76, at 52-59.

257. *See* Murray, *supra* note 10, at 64-65. For a discussion of the § 879 rules, see *supra* Part V.

258. *See supra* Part V.B.

259. The constitutionality of overruling Poe v. Seaborn and attributing income to the spouses on some basis other than ownership may be questioned. A spouse attributed with income belonging to the other spouse could argue that such attribution violates the due process and equal protection clauses of the fifth amendment of the United States Constitution. Professor Gann raises this question and discusses it in some detail. As she explains, this argument draws support from the case of Hoeper v. Tax Commissioner, 284 U.S. 206 (1931). Gann, *supra* note 76, at 55-58. In *Hoeper*, the Court held a Wisconsin taxing scheme violated the due process clause when it sought to tax the husband on the aggregate family income, including the wife's earnings, at a time when Wisconsin was a common law state. 284 U.S. at 215. The majority believed that one's income tax liability could not be measured by reference to the income belonging to another. *Id.* Gann contends that *Hoeper* is no longer trustworthy precedent because of the Court's subsequent decision in Fernandez v. Wiener, 326 U.S. 340 (1945). Gann, *supra* note 76, at 57. In this Louisiana case the Court upheld the constitutionality of federal estate tax provisions which sought to tax the entire community in the gross estate of the first dying spouse except the part directly traceable to the earnings of the surviving spouse. 326 U.S. at 344-45, 362. If the first decedent spouse had been the sole breadwinner in the family, in all likelihood the entire community, including the half owned by the surviving spouse, would have been subject to estate taxation through inclusion in the decedent's gross estate. The Court upheld the tax in the face of a due process challenge without mentioning *Hoeper*. *Id.* at 357-58. The Court upheld the Louisiana tax in part at least, because spouses in Lousiana had various management and other interests in the other's share of their community property which expired upon the death of the other. *Id.* at 355-57. Thus, an interest in the surviving

Section 879, however, does not adequately address the concerns that would arise upon repeal of *Seaborn* with respect to income from non-business community property, such as corporate stock or investment real estate. Such income could be attributed based on ownership, title, or possession and enjoyment. The ownership approach simply would allocate half of the income from community property to each spouse.[260] The title approach would allocate the income to the record title holder.[261] For property titled in the names of both spouses, half and half reporting again would be the rule just as in the case of jointly owned property in separate property states.[262] The possession and enjoyment approach involves tracing the income to the spouse who possesses or expends the income. Each approach has strengths and weaknesses.

The ownership approach has a superficial appearance of fairness and, of course, comports with our existing understanding of community property law. The ownership approach, however, may not accord with the beneficial enjoyment of the income. For instance, if a cash dividend is declared on stock owned by the community but listed in the name of only one of the spouses, the dividend may be paid to and expended by that spouse alone. Unless an offsetting allocation of community property is made to the other spouse in the property division, the non-recipient spouse will be taxed on income she never possessed or enjoyed. The title approach has the same problem in reverse circumstances. If the spouse in whose name the stock is listed is taxed on the entire amount of the dividend even though he splits the cash dividend with the non-listed spouse, he will be taxed on income which he did not beneficially enjoy.

If both of the earlier approaches may be criticized because they fail in some cases to mirror beneficial enjoyment, one might presume the beneficial enjoyment approach to be a solution. The beneficial enjoyment approach has its own failing, however, in the form of administrative complexity and uncertainty.[263] In a sense, the beneficial enjoyment approach may be noth-

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spouse's share of the community property could pass to the surviving spouse by reason of the other's death. *Id.* at 358.

Extending *Fernandez* to the context of an income tax, one could argue that the spouses' comanagement powers make one spouse as likely a candidate for taxation on the community's income as the other. Moreover, as long as the attribution rules adopted with respect to community income rely on rational connections between the income and the attributed spouse (as § 879 does, for instance), it is difficult to conceive that the Court would challenge congressional authority in this area.

260. *See* Beck, *supra* note 6, at 397; Gann, *supra* note 76, at 55; McIntyre & Oldman, *supra* note 7, at 1582. The ownership approach, of course, amounts to a continuation of the *Seaborn* rule.

261. The title approach is the general rule for taxing income from property with the notable exceptions of income from community property titled in one spouse's name and income from property held in grantor trusts. *See* McIntyre & Oldman, *supra* note 7, at 1582-83.

262. *Id. See also*, Gann, *supra* note 76 at 54-55 (example of half and half reporting for tenants in common).

263. McIntyre & Oldman, *supra* note 7, explicitly embrace a comprehensive income tax system that attempts to rely on benefical enjoyment as the basis for income attribution. Yet for purposes of attributing income to married persons, McIntyre & Oldman believe the tracing problems warrant a strict 50-50 allocation of aggregate income to each spouse. *Id.* at 1596.

ing more than a statement of principle rather than an attribution rule since it requires attribution rules of its own for its application to a given circumstance. For instance, if a spouse uses the income from a community asset to pay the college tuition of a grown child of the marriage, should he be viewed as the beneficiary of the income for tax purposes or should both spouses be viewed as having benefitted equally?[264] The tracing of funds presents problems even greater than those of attribution.

Among these three approaches to attribute income from investment community property, the author prefers the title approach. Five factors support such a preference. First, the titleholder of the property is in the best legal position to insure that he will receive some benefit from the income it generates and, conversely, the non-titleholding spouse is disadvantaged in the contest to benefit from the income. Second, the approach is simple to apply. Third, the title approach comports with the rules already applicable in separate property states. Fourth, the approach offers some incentive for the titleholding spouse, perhaps more typically the husband, to agree to title the holdings of the community in the names of both spouses. Finally, if in fact the spouses split the income from the property, their tax reporting obligations can be altered appropriately via the alimony rules, but only if those rules are modified.

This reliance on alimony as a more appropriate vehicle for adjusting the relative tax burdens of the parties would involve some revision of the alimony rule discussed earlier in connection with the analysis of the legacy of *Poe v. Seaborn*.[265] Recall that the payor spouse may deduct payments of community income from one spouse to another as alimony and the payee spouse may include the payments as alimony only to the extent that the payments exceed the payee's ownership interest in the payments under community property law. This prevents a double inclusion of the income by the payee spouse who is already obliged to report her share of the community income under section 61 and the *Seaborn* rule even if she receives no payment. Under the title approach, the payee spouse would no longer be obliged to report her share of the community income from investment property titled in the payor spouse's name. Therefore, the payor spouse should be entitled to a section 215 deduction for payments of community income derived from his separately titled community property and the payee would have a section 71 inclusion for those payments.[266] In other words, community income (under state law) taxed exclusively to one spouse under the title approach would not only be excluded from the definition of community income for federal tax purposes in computing the non-titleholder's gross income, but also in computing alimony deductions and inclusions.

The terminable interest requirement of the present alimony rules also must be modified in order to qualify the payments of community income

264. I will not address the question whether the child rather than the spouses should be taxed on the income.

265. *See supra* Part IV.D.

266. Murray seems to agree with this conclusion. *See* Murray, *supra* note 10, at 65.

(under state law) as alimony. Under present law if the payee spouse's estate is entitled to additional payments of the income from the investment property after she dies, none of the income payments qualify as alimony for federal tax purposes.[267] In other words, alimony payments are required to terminate upon the death of the payee. Since, in the scenario under consideration here, the payments derive from the payee's interest as an owner of the property generating the payments, one would expect that the payments would not be terminable upon her death. Hence, the payments could not qualify as alimony under present federal law. In order to make the payments deductible by the payor and includable by the payee, an exception to the terminable interest requirement would be necessary. A narrowly drawn exception would involve the administrative irritation of tracing the source of the payment.

To illustrate with the example of Alice and Bart, suppose again that they each have $50,000 of earned income. In addition, Bart receives $50,000 of investment income from community property titled in Bart's name only.[268] Under the *Seaborn* rule each would report $75,000 in gross income without regard to whether Bart makes any payments to Alice as long as those payments do not exceed $25,000.[269] Under the title approach Alice would report only $50,000 of earnings and Bart would report the remaining $100,000 of income ($50,000 earnings plus $50,000 investment income). If he pays $15,000 of the investment income to Alice, he would receive a $15,000 alimony deduction, and she would take the $15,000 into income as alimony. Some potential for unfairness remains since in a subsequent tax year Alice might obtain another $10,000 tax free (representing the balance of her ownership interest in the income) as part of the property division. Even that subsequent payment could be designated as alimony, however, if it comports with the alimony rules.

Attribution of income from property is inherently problematic in community property states because community property law disregards the outward forms of ownership such as formal title and possession. When a spouse has neither formal title nor possession of property, however, she is disadvantaged in the effort to beneficially enjoy the income produced by property. The tax law should recognize this reality rather than blindly follow state law ownership principles.

B. Adopt the Rule Already in Effect in California and Washington

On balance, the rules of section 879 and either the title approach or the ownership approach are more likely to lead to a tax reporting result which reflects the economic realities of separation than a blind adherence to the

267. I.R.C. § 71(b)(1)(D) (1988).

268. The fact that the property is titled in Bart's name alone has no effect on its status as community property. If the money used to acquire the asset was community property, then the asset acquired is community property.

269. Bart could deduct payments in excess of $25,000 as alimony if the requirements of § 71 are otherwise met.

Seaborn rule. A less extreme approach, however, would probably solve most of the common problems associated with separation. This more modest proposal is that Congress amend Section 66 to provide that, for federal income tax purposes, separation of spouses terminates the community with respect to earned income. In effect, this amendment would adopt the community property laws of California and Washington for federal tax purposes only.[270] If Congress will not take such action, the seven community property states who do not employ this post-separation earnings rule could adopt it by state legislative action. Such action in the state legislative context, however, would involve non-tax consequences which must be weighed against the possible tax benefits.

As previously posited, the *Seaborn* rule is incompatible with the rule first set out in *Lucas v. Earl* requiring that income be taxed to the person who earned it. The law now permits all married taxpayers to take advantage of the income splitting aspect of the *Seaborn* rule simply by filing a joint return. Nearly all married taxpayers do so.[271] Thus, for the happily married couple, the *Seaborn* rule is unnecessary. For separated spouses unwilling or unable to file a joint return, the *Seaborn* rule is a double-edged sword that may cut well or badly depending on the circumstances. Its interaction with the rules embraced by Revenue Ruling 68-66, section 66 and section 1041 is also complex and uncertain. By redefining the paradigm in community property states for earned income from the *Seaborn* rule to the *Earl* rule, the initial tax reporting allocation of the income would more likely approximate the economic realities of separation. If income passes to the lesser earning spouse from the higher earning spouse, the tax liability can be adjusted by the mechanism of the alimony rules granting the transferor spouse a deduction and causing the transferee spouse to have income.[272] In short, each spouse is only taxed on the earned income over which the spouse has the power of consumption.

CONCLUSION

The enactment in 1948 of the income-splitting aspect of the present joint return rules and the more recent enactment of section 1041 have largely deprived married couples domiciled in community property states of any special federal income tax advantages over their counterparts in common law states.[273] The remaining interplay between the federal income tax and community property law largely involves separate return filing brought

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270. *See supra* note 59 and accompanying text. As suggested, such an approach is not without complexities because mere physical separation does not establish the sort of separation that dissolves the community with respect to earned income.

271. *See* Beck, *supra* note 6, at 319.

272. As described, the Service would have to amend Revenue Ruling 62-115 to treat the earned income as separate income for federal tax purposes. The terminable interest aspect of the present rules, however, would not pose a problem with respect to payments out of the payor's earnings because the payee's estate would normally have no claim under state law on those earnings after the death of the payee.

273. The remaining advantage of greatest consequences is the basis step-up received by a surviving spouse under I.R.C. § 1014(B)(6).

about by separation and divorce. Unfortunately, the *Seaborn* rule is least appropriate in that setting. Although the community may continue to exist in a technical sense after separation, the economic unity of the spouses is largely at an end. In addition, unlike the usually simple, foolproof and unintrusive operation of section 1041, the *Seaborn* rule's operation in the context of divorce is inordinately complex and holds potential for unfairness. Though the degree of complexity and potential unfairness varies depending on the circumstances of the parties and the community property laws of any particular state, change is needed. Congress should enact a rationally based set of income attribution rules that more accurately reflect the economic realities of divorce.

Unless and until such changes are enacted, advance planning often will save much difficulty. Typically, this involves a written agreement between the separated spouses entered into soon after they separate.[274] Moreover, no matter how their aggregate interim income is beneficially enjoyed, it will usually be cost effective in the aggregate for the spouses to agree to file a joint return if the law permits them to do so and if neither of them fears the joint liability attendant to joint filing. This requires a degree of sophistication, trust and cooperation which may be absent in many cases. Fortunately, failure to make advance plans or to file jointly does not render a fair allocation of the spouses' respective tax liabilities impossible. The intricate and, in some respects, embryonic state of the law in this area, however, leaves much uncertainty.

274. One suggestion which this Article does not make is that a lawyer representing one of the spouses should seek to hurry up the divorce process so as to avoid complications with respect to post-separation income. Though such an approach may serve as a practical resolution, it should not be regarded as proper routine practice. Lawyers should not encourage hasty decisions, especially in matters of such profound importance as marriage and divorce. *See* Scott, *Rational Decisionmaking About Marriage and Divorce*, 76 VA. L. REV. 9 (1990). Professor Scott persuasively argues for the development of legal restraints on the availability of divorce which will serve to make the individual decision whether or not to obtain a divorce a more rational and careful one. One of her suggestions is the requirement of waiting periods before divorce. *Id.* at 76-78. Whatever one may think of that suggestion, encouraging hasty divorces simply for tax reasons is obviously undesirable from a policy perspective.