OFFICE OF
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DEPARTMENT OF THE TREASURY
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MEMORANDUM FOR TAXPAYER ADVOCATE SERVICE
ATTN: BRIAN JUSTER
Examination Technical Advisor
Area 7 - Oakland, California

FROM: Assistant Chief Counsel
Administrative Provisions and Judicial Practice
CC:PA:APJP

SUBJECT: Application of I.R.C. § 66(c) to Former Spouses

This Chief Counsel Advice responds to your memorandum of May 16, 2000, requesting advice as to whether the provisions of I.R.C. § 66(c) are available to provide relief from tax liability for community income in the situation described below. We have also considered two related issues. This document is not to be used or cited as precedent.

DISCLOSURE STATEMENT

Legend:

Taxpayer wife =
Taxpayer husband =
Date 1 =
Date 2 =
Date 3 =
Date 4 =
Date 5 =
Date 6 =
Date 7 =
Date 8 =
Year 1 =
Year 2 =
Year 3 =
Year 4 =
Year 5 =
a =
b =
c =
d =
e =
f =
g =
h =

ISSUES

1. Whether section 66(c) of the Code applies to relieve a former spouse (taxpayer wife) from liability for “community income” earned after the marriage is dissolved but before the final disposition of the income-producing community property (a partnership interest acquired while the parties were married).

2. Whether income from the partnership interest during the years at issue constitutes community property income under California community property law.

3. Whether the California divorce court order on Date 6 awarding the partnership interest to the taxpayer husband as his separate property is given retroactive effect for federal income tax purposes.

CONCLUSIONS

1. Assuming that the income from the partnership is community income during the years at issue, relief from that community income under section 66(c) is not available for a former spouse.

2. The income from the partnership interest is not community income for Years 2, 3, 4, and 5, because during these years the parties were no longer married and the community had ceased to exist. Section 66(c) is not applicable because the partnership income is not community income.

3. Under annual accounting principles, the California divorce court's retroactive award of the partnership interest to the taxpayer husband as his separate property cannot be given retroactive effect for federal income tax purposes. Thus, the Date 6 award is irrelevant in determining the tax treatment for Years 2, 3, 4, and 5.

FACTS

Taxpayer wife and taxpayer husband were married on Date 1. The couple resided in California throughout their marriage. The former spouses separated on Date 2. Taxpayer wife filed a petition for dissolution on Date 3 and the marriage was terminated by a judgment of dissolution on Date 4. Taxpayer husband remarried on Date 5. After the marriage was dissolved, the property settlement negotiations continued. The property settlement required a valuation and disposition of the parties' interest in a partnership.

In Year 1, during the marriage, the taxpayer husband formed a California limited partnership. At the same time, taxpayer husband also formed a corporation of which he was the principal shareholder. The corporation was the general partner of the limited partnership. Prior to the divorce, the partnership interest was community property. Pursuant to the partnership agreement, the partnership was required to distribute a percent of any income allocated to a general partner's account during a year as a "tax distribution" to cover the tax consequences.

The tax years at issue in this memorandum are Years 2, 3, 4 and 5. These are years subsequent to the year in which the marriage was dissolved. For Years 2 and 3, the partnership issued Forms K-1 to taxpayer husband reflecting his distributive share of various items of partnership income. The Year 2 Form K-1 reflected total income of $b including $c in guaranteed payments and cash distributions of $d. The Year 3 Form K-1 reflected total income of $e and cash distributions of $f. With respect to these years, the taxpayer husband reported only half of the reported amounts of partnership items (in addition to the guaranteed payment). In an attached disclosure statement, he indicated that his former wife was responsible for the other half of the partnership items. Taxpayer husband deposited the Year 2 and Year 3 cash distributions he received from the partnership into his bank accounts. Taxpayer wife reported no partnership income for Years 2 and 3.

For Years 4 and 5, the partnership issued K-1s to taxpayer husband reflecting his distributive share of partnership losses. Taxpayer husband reported all of the losses on his income tax returns. Taxpayer wife reported no part of the partnership losses on her returns for those years.

On Date 6, a date occurring in a year after Year 5, the California court determined that the community owned g percent of the aggregate ownership of the corporation and the partnership and that the value was $h. The judgment awarded the partnership interest to the taxpayer husband on a retroactive basis. This judgment was effective on Date 7, which was in a year prior to Year 2.

On Date 8, which is subsequent to the court's first order, the court vacated the prior judgment. The new judgment once again awarded the partnership interest to the taxpayer husband but the effective date was changed. The Date 8 judgment was effective on Date 8. Thus, the Date 8 judgment, unlike the Date 6 judgment, did not operate retroactively.

Although taxpayer wife was issued a statutory notice of deficiency for not reporting the partnership income, she did not petition the Tax Court. The time to petition the Tax Court has expired. Instead, taxpayer wife has sought relief from the Office of the Taxpayer Advocate. Taxpayer wife argues that she should be relieved of tax liability for the taxable years at issue with respect to any income from the partnership. She argues that she is entitled to the equitable relief provided under section 66(c) of the Code. As explained below, we conclude that section 66(c) relief is unavailable for a former spouse. Moreover, even if this relief were available to former spouses, it appears that taxpayer wife would not qualify for relief because she knew about the partnership income.[1]

[1]Relief is not available where the spouse knows about the source of the income even if she doesn't know about the full amount of the income. McGee v. Commissioner, 979F.2d 66 (5th Cir. 1992), aff'g T.C. Memo. 1991-510; and Thatcher v. Commissioner, T.C. Memo. 1988-537. See also section 4.03 of Rev. Proc. 2000-15, 2000-5 I.R.B. 447, which sets forth the factors to be considered for equitable relief under section 66(c).

DISCUSSION

Issue 1

We conclude that section 66(c) does not apply to former spouses. Before discussing this issue, it is helpful to explain the general rules pertaining to the taxation of community income.

Under community property laws, each spouse is generally regarded as owning one-half of the community income. Thus, if the spouse files a separate return, he or she generally must report half of the community income on his or her return regardless of which spouse earned the income. Poe v. Seaborn, 282 U.S. 101, 110-13 (1930); United States v. Malcolm, 282 U.S. 792, 794 (1930). Each spouse is liable even if he or she never receives the income. United States v. Mitchell, 403 U.S. 190 (1971). In Kimes v. Commissioner, 55 T.C. 774, 782 (1971) the Tax Court held prior to the entry of the divorce decree "a California wife is taxable on one-half of community income regardless of the fact that she neither received nor enjoyed the income in question."

Rev. Rul. 73-391, 1973-2 C.B. 12, explains the application of community property rules to income from a California partnership. Both spouses invested in the partnership. The wife's investment consisted solely of community property. The husband's investment consisted, in part, of community property and, in part, of his separate property. Rev. Rul. 73-391 holds that the wife's distributive share of partnership income consists of one-half of the income derived from the community property invested by her and her husband and one-half of the income from her husband's partnership salary. The husband's distributive share of partnership income consists of one-half of the income derived from the community property invested by him and his wife, one half of the income from his partnership salary, and all of the income derived from the separate property invested by him.

Under section 66, community property laws are disregarded for income tax purposes under specified circumstances. In considering the first issue, we assume that income from the partnership is community income for the years at issue. This raises the possibility that section 66(c) could apply to that income.

Section 66(c) was added to the Code by section 424(b) of the Deficit Reduction Act of 1984 (the 1984 Act), Pub. L. No. 98-369, (89th Cong., 2d Sess., July 18, 1984). As originally enacted, section 66(c) provided:

> 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 items of community income in such individual's gross income,
>
> then, for 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).

The legislative history associated with the enactment of section 66(c) explained the provision as follows:

> The bill provides a new rule relating to the treatment of certain community income. This provision applies in cases where a <u>spouse</u> fails to include in gross income an item of community income that would be treated as the income of the other <u>spouse</u> if the special allocation rules applicable under the community-income provision of present law had applied. This rule will apply only where the <u>spouse</u> seeking relief does not file a joint return for the taxable year, and establishes that, at the time the return was filed (if a return is filed), he or she had no knowledge of (or reason to know of) the item of community income. The bill also requires that a determination be made that it would be inequitable to include the unreported income in the gross income of the <u>spouse</u> seeking relief. This determination may take into account whether the <u>spouse</u> benefitted from the untaxed income and whether the defense was promptly raised so as to prevent the period of limitations from running on the other <u>spouse</u>.
>
> If all of the above requirements are met, then the unreported community income will be included in the gross income of the <u>spouse</u> to whom the income is attributable under the special rules of allocation.

H.R. Rep. No. 432, Pt. 2, 98th Cong., 2d Sess. 1503 (1984)(emphasis added). <u>See also</u> H.R. Conf. Rep. No. 861, 98th Cong., 2d Sess. 1119 (1984) and Staff of Joint Comm. On Taxation, 98th Cong., 2d Sess. 720-21, General Explanation of H.R. 4170 (Comm. Print 1984). Section 66(c) and its legislative history refer only to spouses, not former spouses. Thus, the statutory language on its face and its accompanying explanation do not include former spouses within its purview.

Moreover, section 7701(a)(17) of the Code further supports the conclusion that section 66(c) relief is unavailable for former spouses. Section 7701(a)(17) of the Code provides that if the husband and wife are divorced, wherever appropriate, the terms “husband” and “wife” should be read to include “former husband” and “former wife,” respectively. However, this rule only applies to the terms “husband” and “wife” as used in specified sections of the Code, namely, sections 152(b)(4), 682 and 2516 of the Code. Section 66(c) is not one of the specified Code sections in section 7701(a)(17), which indicates that section 66(c) does not apply to former spouses. Moreover, the 1984 Act made significant changes to the domestic relations provisions of the Code, including the rules pertaining to alimony (sections 71 and 215) and transfers between spouses or incident to divorce (section 1041). As part of this legislation, section 66(c) was enacted and section 7701(a)(17) was amended. We believe that if Congress had intended for section 66(c) to apply to former spouses as well as current spouses, it would have either added section 66(c) to the Code sections listed in section 7701(a)(17) or would have included within section 66(c) language similar to that in section 71(d) to the effect that the term “spouse” includes a former spouse (section 71(d) was enacted as part of the 1984 Act). Because Congress took neither of these actions in the domestic relations provisions of the 1984 Act, an inference arises that Congress did not intend for section 66(c) to apply to former spouses.

We recognize that under California law, the term “spouses” includes persons who are married to each other as well as persons who were previously married to each other. Cal. Fam. Code § 11. But, the California law definition of “spouse” is irrelevant because section 7701(a)(17) of the Code specifically defines the term for purposes of federal tax law. *Cf.* In re Miller, 167 B.R. 202, 209-10 (Bkrtcy.C.D.Cal. 1994) (the term ”spouse” is not a defined term in the Bankruptcy Code, so the court looked to state law definitions).

Congress recently amended section 66 and the provisions providing relief from joint and several liability. See section 3201 of the Internal Revenue Service Restructuring and Reform Act of 1998 (RRA 98), Pub. L. No. 105-206 (July 22, 1998). The changes generally expand the availability of relief. It should be noted that under RRA 98, relief is available for taxpayers who are no longer married, but the relief contemplated is applicable to years for which the affected taxpayers were married. See H.R. Conf. Rep. No. 599, 105th Cong., 2d Sess. (1998).

Section 3201(b) of RRA 98 amended section 66(c) of the Code with respect to the treatment of community income by adding at the end of the flush language, the following new sentence:

> Under procedures prescribed by the Secretary, if, taking into account all the facts and circumstances, it is inequitable to hold the individual liable for any unpaid tax or any deficiency (or any portion of either) attributable to any item for which relief is not available under the

> preceding sentence, the Secretary may relieve such individual of such liability.

Congress, in enacting section 6015(f) added similar equitable relief language for spouses who do not reside in community property states. See section 3201(a) of RRA 98.

The legislative history does not specifically address the change to section 66(c). It can be inferred, taking the legislative history as a whole, that the primary purpose of the RRA 98 change was to extend the existing relief for understatements to underpayments. Congress explained its reasoning for adding the equitable provision for the relief from joint and several liability for joint returns as follows:

> The conferees intend that the Secretary will consider using the grant of authority to provide equitable relief in appropriate situations to avoid the inequitable treatment of spouses in . . . situations [where tax was shown on a joint return, but not paid with the return]. For example, the conferees intend that equitable relief be available to a spouse that does not know, and had no reason to know, that funds intended for the payment of tax were instead taken by the other spouse for such other spouse's benefit.
>
> The conferees do not intend to limit the use of the Secretary's authority to provide equitable relief to situations where tax is shown on a return but not paid. The conferees intend that such authority be used where, taking into account all the facts and circumstances, it is inequitable to hold an individual liable for all or part of any unpaid tax or deficiency arising from a joint return. The conferees intend that relief be available where there is both an understatement and an underpayment of tax.

H.R. Conf. Rep. No. 599, 105th Cong., 2d Sess. 254-55 (1998).

Although the legislative history indicates that equitable relief need not be limited to underpayments, it does not suggest that equitable relief should be available for tax attributable to taxable years for which former spouses are no longer married in community property states. Also, Rev. Proc. 2000-15, 2000-5 I.R.B. 447, in discussing equitable relief under sections 66(c) and 6015(f), states "[s]ection 66(c) applies to married individuals with community property income . . . ." Emphasis added.

Case law provides additional support for the proposition that sections 66(b) and (c) do not apply to taxable years in which the parties are not married, although this issue has not been expressly addressed. In McPherson v. Commissioner, T.C. Memo. 1991-520, the taxpayer and his wife, Susan, were married and lived in

Idaho, a community property state, from 1976 to 1985. Taxpayer and Susan separated in November of 1984 and were divorced in June of 1985. At issue was the application of section 66(b) and (c) for the taxable years 1978 through 1986, "except 1986, when petitioner was no longer married." Significantly, the Service did not determine deficiencies under section 66(b) or (c) for 1986 because taxpayer husband was no longer married. An inference can be drawn from this case that sections 66(b) and (c) are applicable only to taxpayers who are married and in receipt of community income.

Arguably, a contrary inference can be drawn from Tseng v. Commissioner, T.C. Memo. 1994-126, aff'd in an unpublished opinion, 79 F.3d 1154 (9th Cir.), cert. denied, 519 U.S. 820 (1996). In this case, the Tax Court applied section 66 of the Code to the taxable year in which the parties divorced (1985). The income was earned for the taxpayer husband's services in 1983, a year in which the parties were married.[2] The parties separated in 1984 and were divorced on October 28, 1985. The income earned in 1983 was paid in 1985, but it is unclear whether the income was paid before or after the date of divorce. The taxpayer husband argued that income earned during the marriage, the payment of which was deferred until after the divorce, should be accorded community income treatment so that only 50 percent of the earnings would be taxable to him. The Service argued that the income did not constitute community income and that the entire amount received was taxable to the husband. Citing Winn v. Winn, 299 P.2d 721 (Cal. Ct. App. 1956) for the proposition that income earned during community years is community income, the court found that the income earned during the marriage in California was community property income. The court invoked section 66(b) to tax all of the income to taxpayer husband because (1) he treated the income as solely his, and (2) he did not notify his spouse of the nature or amount of income. The Tseng case is distinguishable from the present case in that its holding was specifically tied to income earned in a year in which the parties were married, but received in the year of the divorce. Here, the income at issue was both earned and received in taxable years after the year of the divorce.

Accordingly, we conclude that relief under section 66(c) of the Code is unavailable for the years at issue because the parties were no longer married in those years.

Issue 2

Community property is property owned by the marital community. Once the marriage is dissolved, the marital community no longer exists and, therefore, cannot

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[2] During 1983, taxpayer husband, rather than being paid for the quarter that he taught at a California university, "banked" the quarter and was supposed to take a paid quarter off in 1984. Instead, taxpayer husband taught in 1984 and the California university paid him for the banked quarter in 1985.

own property. The former community property is converted into property held by the former spouses as tenants in common. Estate of Layton v. Layton, 44 Cal.App.4th 1344, 52 Cal.Rptr. 251 (Cal.App. 6 Dist. 1996); Henn v. Henn, 26 Cal.3d 331, 161 Cal.Rptr. 502 (1980); In re Marriage of Brown, 15 Cal.3d 838, 544 P.2d 561 (1976), citing In re Marriage of Elkins, 28 Cal. App.3d 899, 903 (1972). See also Gorman v. Gorman, 90 Cal. App.3d 454, 153 Cal. Rptr. 479 (1979). *Accord* Bouterie v. Commissioner, 36 F.3d 1361 (5th Cir. 1994).

Statutes and court cases frequently refer to "community property" in describing certain property that was formerly community property. Such terminology may be convenient but is not entirely accurate. See 15A Am.Jur.2d *Community Property* § 101 (1999). It is imprecise to refer to property as "community property" after the marriage is dissolved. Estate of Layton, 52 Cal.Rptr. at 255. In Bouterie, the court awarded attorneys' fees to the taxpayer wife under section 7430 based on a determination that the Service had improperly relied on a Louisiana divorce court's imprecise use of the term "community property" in referring to property that was formerly community property.

The tax issue in Bouterie was the taxability to the wife of insurance commissions earned by the husband after divorce on renewal premiums paid on insurance policies that had been written before the divorce. As indicated above, the Louisiana divorce court characterized the commissions earned after the divorce as community property and, based on this characterization, the Service determined that the taxpayer wife was liable for tax on her share of the community income. The Fifth Circuit concluded that the Service was wrong to concede the issue as late as it did because the taxpayer wife had consistently explained that under long-settled Louisiana law, no community property interest can continue to exist after the marital community ceases. Further, she had consistently noted the state court's imprecise use of the community property terminology. The Fifth Circuit stated:

> [T]he term "community property" in this context is universally recognized shorthand, consistently used in Louisiana to distinguish assets of the former marital community from the assets of each former spouse's pre-existing separate estate. That is obviously the way that the Louisiana court used the term in this instance–and the fact that the Louisiana court here adopted this widely understood, customary parlance should have been readily apparent to a District Counsel's office located in New Orleans.

36 F.3d at 1372.

In the present case, the marriage was dissolved in a year prior to Years 2, 3, 4, and 5. Thus, for these years the partnership interest was not community property because the marital community no longer existed and the partnership income was not community income. Therefore, section 66(c) is not applicable. During these years, taxpayer husband and taxpayer wife owned the partnership interest as tenants in common. We express no opinion as to the manner in which partnership items for these years are treated under subchapter K of the Code. This issue may be the subject of additional advice.

Issue 3

This case is further complicated by the competing court orders disposing of the marital property and the effects of annualized tax reporting. The first court order, dated Date 6 (a date after the tax years at issue), determined that the partnership interest was awarded to the taxpayer husband as of Date 7 (a date prior to the tax years at issue). The second court order, dated Date 8 (a date subsequent to Date 6), determined that the partnership interest was awarded to the taxpayer husband as of the date of that second order.

Our tax system operates on an annual basis. I.R.C. §§ 441, 451, and 461; and Brent v. Commissioner, 630 F.2d 356, 359-60 (5th Cir. 1980), citing Burnet v. Sanford & Brooks Co., 282 U.S. 359, 365 (1931) and Security Flour Mills Co. v. Commissioner, 321 U.S. 281, 286 (1944). As explained above, we have concluded that after the martial dissolution, the taxpayer wife had an interest in the partnership that was not a community property interest. In accordance with the annual accounting principle, she was taxable on what she then owned, namely, her share of partnership income during Years 2, 3, 4, and 5, without regard to the first court order. See Brent v. Commissioner, 630 F.2d at 361 ("Although 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.")

As for the second court order, we do not regard it as a *nunc pro tunc* order and will not respect it for federal tax purposes. Where a *nunc pro tunc* order merely corrects a prior misstatement or clerical error, it is respected for federal tax purposes. Where a *nunc pro tunc* order affects the legal relationships between the parties, it is not accorded retroactive effect for federal income tax purposes. More specifically, a *nunc pro tunc* order does not have retroactive effect for federal income tax purposes if the effect is to change the rights of the parties or the legal status of payments. See Graham v. Commissioner, 79 T.C. 415 (1982); Gordon v. Commissioner, 70 T.C. 525 (1978); Segal v. Commissioner, 36 T.C. 148 (1961); Keheler v. Commissioner, 25 T.C. 1154 (1956); Rev. Rul. 74-393, 1974-2 C.B. 28. See also M.T. Straight Trust v. Commissioner, 24 T.C. 69 (1955), aff'd, 245 F.2d 327 (8th Cir. 1957); Daine v. Commissioner, 21 T.C. 349 (1947), aff'd, 168 F.2d 449 (2d Cir. 1948), Rev. Rul. 71-416, 1971-2 C.B. 83. Steen v. Commissioner, T.C. Memo. 1989-542. Here, the new order altered the rights of the parties because it did not merely correct an error: the new award of the property to the taxpayer husband did not take effect until after the tax years at issue whereas the earlier order had awarded the property to the taxpayer husband effective prior to the tax years at issue.

Should you have any further questions concerning the above advice, please contact us.

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Branch 2