OFFICE OF
CHIEF COUNSEL

DEPARTMENT OF THE TREASURY
INTERNAL REVENUE SERVICE
WASHINGTON, D.C. 20224
June 23, 2000

Number: **200030022**
Release Date: 7/28/2000
CC:DOM:FS:IT&A
WTA-N-110406-00

UILC: 66.00-00

INTERNAL REVENUE SERVICE NATIONAL OFFICE SERVICE CENTER ADVICE

MEMORANDUM FOR SOUTHWEST ASSOCIATE DISTRICT COUNSEL
CC:WR:SWD:LV

FROM: Assistant Chief Counsel (Field Service)
CC:DOM:FS

SUBJECT: Treatment of Community Income

This responds to your request for advice dated May 19, 2000, in connection with the application of the burden of proof to I.R.C. § 66(b) cases.

ISSUES

1. Is a married filing separate return that reflects a community split of income presumptively correct?

2. Does the Service have to establish that section 66(b) applies?

3. Where section 66(b) is asserted, should it be clearly reflected in the notice of deficiency?

CONCLUSIONS

1. Taxpayers domiciled in community property states have an undivided one-half interest in the entire community so they ordinarily must either file jointly or file married filing separate tax returns that reflect one-half of the total community income and expenses. Therefore, a married filing separate return that reflects a community split of income is presumptively correct.

2. The Service must establish facts and admissible evidence to demonstrate that section 66(b) applies.

3. The government bears the burden of proof where the notice of deficiency fails to raise section 66(b) because new facts and evidence are needed to address this exception to normal community property rules. Therefore, where section 66(b) is asserted, it must be clearly reflected in the notice of deficiency.

FACTS

The Service has been disallowing married filing separate [hereinafter referred to as MFS] returns which report 50 percent of total community income and expenses [hereinafter referred to as a community split return] unless the taxpayer is able to establish an affirmative right to a community split. However, a MFS return reflecting a community split is presumptively correct and the burden is upon the government to establish otherwise.

Problems with MFS returns often arise in, but are not limited to, situations involving separations and pending divorces. In most community property states, community property laws still apply in these situations. One spouse, usually the one who has earned little income, will file a timely "single" or MFS return and report 100 percent of his/her wages, ignoring state community property laws. The other spouse, usually a high income earner, will file a MFS return reflecting a 50 percent split of total community income and expenses.

Sometimes, the spouses are still married, but one spouse has filed a MFS return reporting only 100 percent of his/her wages. The second spouse is a nonfiler who subsequently files an untimely MFS return reflecting a community split. Because the three year statute on assessment for the return filed by the first spouse has, or is about to, expire, this leaves the Service in a "whipsaw" situation. (We note that while the six year statute for assessment frequently applies in these situations, the Examination Division has not been asserting this.)

In the type of situations discussed above, the Examination Division has often disallowed the community split reflected on one spouse’s return unless the taxpayer can affirmatively establish a right to a community split. The taxpayer has frequently been required to prove that I.R.C. § 66(b), setting forth an exception to normal community property rules, is not applicable in his/her case.

A typical example of this is reflected in a letter issued by a service center that handles many of the community property states. A taxpayer who had filed a MFS return reflecting a community split of income earned prior to a divorce was informed that "in order to claim a community property split, you must provide verification that you informed your ex-spouse of the decision (to file a community split return) before the due date of the return. This can be in the form of a notarized letter from your ex-spouse, or a copy of the divorce decree with the stipulation of a community property filing for the tax year (at issue)".

LAW

Section 66(b) of the Code provides that the Secretary may disregard community property laws where the spouse is not notified of community income. It requires that the taxpayer act as if he/she was solely entitled to such income and further requires that the taxpayer fail to notify his/her spouse of such income 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.

DISCUSSION

Married taxpayers have two choices pertaining to their filing status on federal income tax returns. They can file their taxes jointly or they can file separate returns. With respect to married couples filing jointly, taxpayers in both common law states and in community property states are treated alike. The total income of the spouses is combined and both spouses are held jointly and severally liable for any tax liability arising from a jointly filed return. I.R.C. § 6013(d)(3).

Treatment of spouses electing to file separately varies depending on whether the couple lives in a common law property state or in a community property state. In a common law property state, spouses who elect to file separately are only responsible for reporting and paying the taxes on their individual income. In a community property state, where spouses file separately, the income of both spouses must be combined and split between the spouses for tax reporting and payment purposes.

The tax consequences flowing from state community property laws were not determined statutorily but were determined many decades ago by the Supreme Court of the United States, as well as the various Circuit Courts. Poe v. Seaborn, 282 U.S. 101 (1930) (Washington); Goodell v. Koch, 282 U.S. 118 (1930) (Arizona); Hopkins v. Bacon, 282 U.S. 122 (1930) (Texas); Bender v. Pfaff, 282 U.S. 127 (1930) (Louisiana); United States v. Malcolm, 282 U.S. 792 (1931) (California).

Based on the determination that married taxpayers domiciled in these community property states have an undivided one-half interest in the entire community, it has long been the law that such taxpayers must file either joint tax returns, or MFS tax returns which reflect one-half of total community income and expenses. United States v. Mitchell, 403 U.S. 190 (1971); Mischel v. Commissioner, T.C. Memo. 1997-350; Shea v. Commissioner, 112 T.C. 183 (1999). The Supreme Court stated that this is not only a right, but an obligation, regardless of which spouse earned the community income. United States v. Malcolm, 282 U.S. 792 (1931).

While there are situations in each state where normal community property laws do not apply, a strong presumption exists that all income earned during marriage is community income. Hardy v. Commissioner, 181 F.3d 1002 (9th Cir. 1999) (Nevada); Edwards v. Commissioner, 680 F.2d 1268 (9th Cir. 1982) (Arizona); Shea v. Commissioner, 112 T.C. 183 (1999) (community property states generally); Wilcox v. Commissioner, T.C. Memo. 1992-434, aff'd, 73 AFTR2d (RIA) 1508 (10th Cir. 1994) (New Mexico); Dooley v. Commissioner, T.C. Memo. 1992-39 (Louisiana); Schmidt v. Commissioner, T.C. Memo. 1981-38 (Texas); Forbush v. Commissioner, T.C. Memo. 1979-214 (Idaho); Webb v. Commissioner, T.C. Memo. 1996-550 (California).

The burden of proof is on the party attempting to rebut this presumption and establish that normal community property laws do not apply. Id. In a majority of community property states, evidence must be clear and convincing to rebut the community presumption. Hardy, supra; Kern v. United States, 491 F.2d 436 (9th Cir. 1974) (Washington); Edwards v. Commissioner, 680 F.2d 1268 (9th Cir. 1982) (Arizona).

In an effort to protect the non-earning spouse who must report the earner spouse's income on his or her income tax returns in community property states, Congress enacted section 66. Section 66 sets out three situations where state community property laws will be ignored when determining federal tax liability. The second situation, as set out in section 66(b), occurs where a taxpayer acted as if she/he was solely entitled to community income and failed to notify his/her spouse of the nature or amount of this income prior to the due date of the tax return.

The purpose of section 66(b)is to prevent unjust enrichment where a taxpayer fails to treat income as a community asset, (i.e., fails to share such income with spouse and children), but then attempts to claim the tax benefit connected with community income. Drummer v. Commissioner, T.C. Memo. 1994-214, aff'd without published opinion, 68 F.3d 472 (5th Cir. 1995). This provision "can be used only by (the government) in order to disallow the benefits of community property laws to a taxpayer under certain prescribed conditions." Hardy v. Commissioner, T.C. Memo. 1997-97, aff'd, 181 F.3d 1002 (9th Cir. 1999). When asserted, it is an exception to normal community property rules.

This statute does not impose an affirmative burden on taxpayers to establish that section 66(b) does not apply. Rather, the Service must develop facts and admissible evidence establishing that it does. Shea v. Commissioner, 112 T.C. 183 (1999); Mischel v. Commissioner, T.C. Memo. 1997-350; Sanders v. Commissioner, T.C. Memo. 1986-26, aff'd, 812 F.2d 715 (9th Cir. 1987). Additionally, the government bears the burden of proof where the notice of deficiency fails to raise section 66(b) because new facts and evidence are needed to address this exception to normal community property rules. Shea, supra; Layton v. Commissioner, T.C. Memo. 1999-218.

In Mischel, supra, the Service issued a notice of deficiency to an Arizona taxpayer which ignored the application of state community property laws. The Court noted and raised this omission on its own initiative. In holding that the taxpayer was liable for taxes only on his one-half community property interest, the Court stated that section 66(b) was not applicable because "at trial, (the Service) was unable to offer any persuasive reason why (it) was attempting to disregard the community property laws of the state of Arizona."

Similarly, in Shea v. Commissioner, 112 T.C. 183 (1999), a full Tax Court decision, the Service again issued a notice of deficiency which ignored California community property laws, and failed to reference section 66(b) as a basis for this treatment. The Court noted that "whether respondent may apply section 66(b) and disregard community property law in determining petitioner's income requires evidence of whether petitioner acted as if he were solely entitled to the income and whether he failed to notify his wife of the nature and amount of that income." The Court would not apply section 66(b) where the government's evidence established only that the taxpayer's wife had little involvement in his business and that such business income was underreported, holding that "there is no factual basis to justify (the government's) invocation of section 66(b)."

In summary, it is prudent and appropriate for the Examination Division to raise section 66(b), as well as section 66(a) and any applicable state law exceptions to community property rules, when a MFS return reflecting a community split is filed, particularly when a potential whipsaw situation exists. However, the Examination Division must be careful to apply the correct burden of proof.

The Examination Division has been placing the burden of proof upon the taxpayer to establish that section 66(b) does not apply. However, a community split return is presumptively correct. Thus, before the Service determines that section 66(b) applies, the Examination Division must develop evidence that supports this determination. In the absence of such facts, a community split return should be allowed, even where the return filed by the taxpayer's spouse does not reflect a community split. Where section 66(b) is asserted, it must be clearly reflected in the notice of deficiency.

Also, court proceedings arising in connection with examinations commencing after July 22, 1998, are subject to the change in the burden of proof rules enacted by the Restructuring and Reform Act of 1998 [hereinafter referred to as RRA 98]. RRA 98 provides that the Secretary has the burden of proof in any court proceeding with respect to a factual issue if the taxpayer produces credible evidence with respect to the factual issue relevant to ascertaining the taxpayer's specified tax liability. Section 7491; Staff of Joint Committee on Taxation, 105th Cong., General Explanation of Tax Legislation Enacted in 1998 (Comm. Print. 1998).

When a community split return is filed, we advise the Examination Division to pull the tax return of the related spouse and open two separate audits of both spouses. If the normal three year statute for assessment has expired against one spouse, the six year statute for assessment does not apply, and no basis for asserting civil fraud exists, the Service is without recourse against the spouse. However, this is inconsequential with regard to the validity of the community split return filed by the taxpayer.

In addition, as previously stated, other exceptions to the community property rules should be considered and asserted as applicable. For instance, section 66(a) is a special rule that generally allocates community income to the spouse who earned the income if certain statutory requirements are met. It applies where (1) two individuals are married to each other at any time during the calendar year; (2) the two individuals live apart at all times during the year and do not file a joint return for the year; (3) one or both of the individuals have earned income for the year which is community income; and (4) no portion of the earned income is transferred (directly or indirectly) between the spouses before the close of the year. If all of these criteria are met, then any community income of the individuals for the calendar year is treated according to the rules of section 879.

Under the rules of section 879, a separated couple's community income will be allocated between them for tax purposes as follows: (1) earned income (other than trade or business income and a partner's distributive share of partnership income) is treated as the income of the spouse who rendered the personal services; (2) trade or business income is allocated to the spouse exercising substantially all of the management and control of the trade or business; (3) a partner's distributive share of partnership income is allocated to the partner; (4) except for community income described in (1)-(3), community income which is derived from one spouse's separate property is treated as the income of that spouse; and (5) all other community income is treated as provided in the applicable community property law.

In response to the difficulty encountered in determining what Congress meant by "living apart," some states have adopted "separate and apart" statutes. For example, Washington and California have adopted separate and apart statutes that provide that the earnings and accumulations of a spouse living separate and apart may be treated as separate property. See Cal. Fam. Code § 771 (West 1994); Wash. Rev. Code Ann. § 26.16.140 (West 1004). Under these statutes, reliance on section 66(a) or 66(b) is unnecessary. Rather, income is attributed to the spouse who earned it when the spouses are living separate and apart.

Thus, in order to tax income to the spouse who earned it, the facts must be fully developed to ascertain the correct provisions to apply and to assert in the notice of deficiency, and the correct arguments to make in support of those assertions. State statutes, as well as section 66(a) and (b) should be considered.

DEBORAH A. BUTLER
Assistant Chief Counsel (Field Service)
By: RICHARD L. CARLISLE
Chief, Income Tax and Accounting Branch
CC:DOM:FS:IT&A