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[Need to Amend the Internal Revenue Code to Extend Innocent Spouse Rule to Community Property Situations]. GGD-77-56; B-137762. July 12, 1977. 2 pp. + enclosure (8 pp.).

Report to Rep. Al Ullman, Chairman, Joint Committee on Taxation; by Elmer B. Staats, Comptroller General.

Issue Area: Tax Administration (2700).
Contact: General Government Div.
Budget Function: General Government: Central Fiscal Operations (803).
Organization Concerned: Department of the Treasury; Internal Revenue Service.
Congressional Relevance: Joint Committee on Taxation.
Authority: (P.L. 91-679; 84 Stat. 2063); Internal Revenue Code, sec. 6013(e). Poe v. Seaborn, 282 U.S. 101 (1930). United States v. Mitchell, 403 U.S. 190 (1971).

Under current law, the Internal Revenue Code grants relief to an "innocent spouse" on a fraudulent joint return where he or she neither benefits from nor receives income received by the other spouse and not reported. The applicable section of the code does not apply if separate returns are filed by two married persons. Findings/Conclusions: Typically, the cases have concerned married individuals living apart but not legally separated or divorced, where the husband has appropriated the entire community income to his own use, and the wife, filing separately, receives no support or other financial assistance from the husband. The Internal Revenue Service (IRS) has proceeded against the wife directly as the person primarily liable for the Federal income tax on her one-half share, notwithstanding that the husband has appropriated the entire community income to his own use. It does not appear that IRS has ever proceeded against the husband to collect the wife's one-half share of the community tax liability in this situation. Recommendations: Section 6013 of the Internal Revenue Code should be amended so that, where certain conditions exist, the separated spouse who does not receive the one-half of community income to which he or she has a vested right under State law is relieved of tax liability to the extent that such liability is attributable to the omission from gross income of the one-half of community income not received. (SC)

COMPTROLLER GENERAL OF THE UNITED STATES
WASHINGTON, D.C. 20548

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The Honorable Al Ullman
Chairman, Joint Committee
on Taxation
Congress of the United States

Dear Mr. Chairman:

In reviewing the Government's administration of our tax laws, we have come across a problem that we believe can be corrected by legislation. The problem relates to a spouse in a community property situation who files a separate return from which is omitted the one-half of community income he or she owns but does not receive. Under current law, Section 6013(e) of the Internal Revenue Code grants relief to an "innocent spouse" on a fraudulent joint return where he or she neither benefits from nor receives income received by the other spouse and not reported. Section 6013(e) does not apply if separate returns are filed by two married persons.

Typically, the cases have concerned married individuals living apart but not legally separated or divorced where the husband has appropriated the entire community income to his own use and the wife, filing separately, receives no support or other financial assistance from the husband.

Under State community property rules the husband, as trustee of the community, is legally obligated to pay both his and his wife's one-half share of taxes due with respect to community property and income out of the proceeds of the community property under his management and control. The Internal Revenue Service (IRS), however, looking to the fact that the wife's interest in the community property, under the applicable State law, is a present, vested interest, has proceeded against her directly as the person primarily liable for the Federal income tax on her one-half share--notwithstanding that the husband has appropriated the entire community income to his own use, for other than family purposes or use. It does not appear that IRS ever has proceeded against the husband to collect the wife's one-half share of the community tax liability in this situation. The fact that the wife is primarily liable for the tax on her one-half share is not a legal impediment to IRS's proceeding against the husband as trustee of the community and as the one in possession of the wife's one-half share.

IRS officials informally advised us that they try to exhaust available administrative remedies before recommending costly litigation. They also noted that, to their knowledge, the Justice Department will not accept IRS recommendations for suit if administrative recourse is still available.

The Tax Court and the United States Supreme Court, when confronted with this tax problem, have expressed sympathy for the wife whose one-half share of the community has been misappropriated by the husband but have failed to sustain the wife's position in the face of what they have regarded as the impossible weight of the precedent established by Poe v. Seaborn, 282 U.S. 101 (1930). The United States Supreme Court in United States v. Mitchell, 403 U.S. 190 (1971) recommended that Section 6013 of the Internal Revenue Code be amended to correct this situation. Despite the Court's recommendation, the IRS has not sought legislative relief and has continued to assess tax, interest, and where applicable, additions to tax and penalties against the wife, who on a separate return, fails to include in gross income her one-half share in community income in the possession and control of the husband.

We recommend that Section 6013 of the Internal Revenue Code be amended so that, where certain conditions exist, the separated spouse who does not receive the one-half of community income to which he or she has a vested right under State law is relieved of tax liability to the extent that such liability is attributable to the omission from gross income of the one-half of community income not received. IRS officials informally agreed that legislation along the lines we recommend is the best solution to the problem. We explain the issue in detail in the enclosure to this letter.

We are also providing a copy of this report to the Vice Chairman of the Committee, the Secretary of the Treasury, the Assistant Secretary for Tax Policy, the Commissioner of Internal Revenue, and other interested parties. We would be pleased to discuss this matter further with you or your staff if you believe it would be appropriate.

Sincerely yours,

Comptroller General
of the United States

Enclosure

U.S. GENERAL ACCOUNTING OFFICE
NEED TO AMEND THE INTERNAL REVENUE CODE TO EXTEND INNOCENT SPOUSE RULE TO COMMUNITY PROPERTY SITUATIONS

I. INTRODUCTION

The proposed amendment extends the "innocent spouse" rule of section 6013(e) of the Internal Revenue Code to the spouse who files a separate return in a community property situation. Under current law, section 6013(e) grants relief to an innocent spouse on a fraudulent joint return where he or she does not benefit from the omitted income; it does not relieve an innocent spouse filing a separate return from liability for taxes on one-half of community income which he or she does not receive, either directly, or indirectly in the form of support. Typically, the cases have concerned married individuals living apart, but not legally separated or divorced, where the wife, filing separately, receives no support or other financial assistance from the husband and where the husband has appropriated his earnings and other community income to his own use, for other than family purposes or use. On the authority of Poe v. Seaborn 282 US 101 (1930) and companion cases, the Internal Revenue Service (IRS) requires the wife in this circumstance to include in her gross income, reported on a separate return, her one-half share of community income appropriated by the husband. This situation cannot arise in a common law state. Since the innocent spouse rule of section 6013(e) does not apply if a separate return is filed, legislation is required to extend the rule to cover a wife who does not report her one-half share of community income which she does not receive. Mary Lou Galliher 62 T.C. 760 (1974).1/

The proposed amendment provides that, where certain conditions exist, the separated spouse who does not receive the one-half of community income to which he or she has a present, vested right under state law, is relieved of tax liability to the extent that such liability is attributable to the omission from gross income of the one-half of community income not received.

1/ Tax writers have pointed out the inherent unfairness of this situation and urged legislative relief. See J. Chrys Dougherty, "Supreme Court holds wife liable in Mitchell: A too harsh adherence to precedent?" 35 Journal of Taxation 296 (1971); Frederick W. Bradley, "Community Property - Federal Income Tax Liability of Wife During Existence of Community," 46 Tulane Law Review 329 (1971); Annon.," 'Innocent Spouse' Statute Does Not Equate Separate Returns in a Community Property State with Joint Returns Filed There or Anywhere Else," 1 Community Property Journal 252 (1974); Mary Jane Boyd, James H. Boyd, "IRC Secs. 6013(e)

II. REASONS FOR THE PROPOSED AMENDMENT

The general rule in the community property states of Arizona, California, Idaho, Louisiana, Nevada, New Mexico, and Texas is that the community relationship continues notwithstanding the spouses are separated and living apart. This means that the husband continues as manager of the community and each spouse remains primarily liable for one-half of the total tax due on community income. This rule is uniformly applicable in the case of community income derived from earnings of the husband living separate from the wife.2/ There is some variation among states concerning the husband's ownership of, and hence liability for tax on, the one-half of community derived from the earnings of the wife living separate from the husband.3/

In the community property state of Washington, the community relationship can be dissolved by de facto separation prior to legal divorce. This means that, while living apart, each spouse is taxable upon the total amount of his (her) earned income and is not taxable on one-half of the total income earned by the other spouse. This rule applies only if the spouses "show by affirmative action their intent not to maintain the community status." Rev. Rul. 68-66, 1968-1 C.B. 33; Knodle v. Warren (D.C.W.D. Wash., 1967) reported in 67-1 U.S.T.C. para. 9261; See also, Dalton v. United States, (D.C.W.D. Wash., 1969) reported in 69-1 U.S.T.C. para. 9233.

Numerous cases have arisen in which a husband and wife, living apart, have filed separate returns of community income under the mistaken belief that their physical separation was effective to dissolve the community. In this circumstance, IRS has recomputed the tax liability of both spouses on the basis that each was taxable on one-half of the earnings of the other spouse, notwithstanding that neither spouse in fact received any part of the community income earned by the other or

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2/ See Jack M. Vaughan, "Community Property Divorce: "Preparing the Tax Returns," Community Property Journal 213 (1975).

3/ See references cited in William Q. de Funiak and Michael J. Vaughn, Principles of Community Property, 2d edition, 1971, sections 56, 114, 142.

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derived income from property over which the other had control.

IRS' position has been sustained in the Tax Court and on appeal to the United States Supreme Court. Christine K. Hill 32 T.C. 254 (1959); Carmen Ramos, T.C. Memo 1969-157; Charloette J. Kimes 55 T.C. 774 (1971); United States v. Mitchell 403 U.S. 190 (1971). The same rule applies even though the wife, after separation, moves to a common law state. Marjorie Hunt 22 T.C. 228 (1954).

In most cases this result has caused considerable financial hardship to the wife required to pay one-half of the much larger tax liability attributable to the higher income of her husband out of the much smaller earnings and separate property from which she supports herself. The fact was noted by J. Featherston in Ramos:

> "We are not unaware that this conclusion produces a harsh result: It seems unfair to impose liability on petitioner for a tax based on earnings from which she received not the slightest benefit. But, regardless of our sympathies, we have no discretion to relieve petitioner of the tax; our decision is dictated by the inexorable provisions of Texas community property law: . . ."

Indeed, if the wife does not work and owns no separate property, it is not clear how, as a practical matter, she can be forced to pay such personal statutory obligation. See Edward H. Mitchell, "Federal Taxation in Recent Contact with California Community Property," 14 So. Calif. Law. Rev. 390, 391 (1941).

IRS has not sought to collect the tax from the husband in such cases. Ample legal authority exists, both under state community property law, and under federal tax law rules, for IRS, as a creditor of the community, to proceed against the husband as agent or trustee of the community and to collect the full amount of the community tax liability out of the proceeds of the entire community in his possession

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and control. Depending upon the facts of the case, tax liability of the husband who has appropriated the entire community income to his own use can be based on misappropriation, on unjust enrichment, or on his position as a transferee.4/

IRS officials informally advised us that they do not consider it a feasible alternative to proceed in court against the husband on the basis that he is the trustee for the community property. They believe the Service should exhaust available administrative remedies before recommending costly litigation. They also noted that, to their knowledge, the Justice Department will not accept IRS recommendations for suit if administrative recourse is still available.

However, without discussing whether or not IRS should have, or could have, proceeded against the husband in Mitchell to collect the wife's personal tax liability out of her one-half share of the community income in his possession, the Supreme Court recommended a legislative solution to the problem:

> "The remedy is in legislation. An example is Pub. L. 91-679 of January 12, 1971, 84 Stat. 2063, adding to the Code subsection (e) of 6013 and the final sentence of 6653(b). These amendments afford relief to an innocent spouse, who was a party to a joint return, with respect to omitted income and fraudulent underpayment. Relief of that kind is the answer to the respondent's situation."

Despite the Supreme Court's recommendation in 1971 that the law be amended, the Internal Revenue Service has not sought legislative relief and has continued to assess tax, interest, and where applicable, additions to tax and penalties against the unsupported wife who, on a separate return fails to include in gross income her one-half share of

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4/ William Q. de Funiak 1 Principles of Community Property Law, 1st edition (1943), section 241 and authorities cited; Alvin E. Evans, "The Ownership of Community Property," 35 Harvard Law Review 47 (1921). The general rule is that the liability and accountability of the husband, in his capacity as administrator of his own earnings, and of personalty acquired out of such earnings, is identical to those of a common law agent or tenant in common. Where the wife's one-half share of the community is in the hands of the husband, she in fact satisfies her personal tax liability with respect to such income through the agency of her husband. Baca v. Village of Belen 240 P. 803, 807 (S.C. N. Mex., 1925) and authorities cited; de Funiak and Vaughn, op. cit., Sections 100, 102, 103, 113, 126, and authorities cited.

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community income which she does not receive. See, for example, Aimee D. Bagur 66 T.C. 317 (1976); Bettie Jayne Coffman, T.C. Memo 1974-308; Jesse R. Williams, T.C. Memo 1976-348; Mary Ellen Brent, T.C. Dkt. 7176-74; Audrey L. Hardin, T.C. Dkt. 4518-74. And the Tax Court has continued to decide for the government although recognizing that, in a real sense, the wife is an innocent victim of wrongdoing in this circumstance. Mary Lou Galliher, supra, at 764. Thus, Judge Tannenwald for the Tax Court in Marlene Quinn, T.C. Memo 1972-112 stated:

> "We sympathize fully with petitioner, but we are unfortunately unable to ameliorate the plight in which she finds herself. The Supreme Court of the United States has declared that, under the circumstances described herein, she must include one-half of her husband's earnings in her income, notwithstanding the fact that she at no time had any dominion or control over such income. United States v. Mitchell, 403 U.S. 190 (27 AFTR 2d 71-1457) (1971), reversing 430 F. 2d 1 (26 AFTR 2d 70-5127) (C.A. 5, 1970), which, in turn, reversed 51 T.C. 641 (1969). See also Christine K. Hill, 82 T.C. 254 (1959)."

The joint-return requirement of section 6013(e) is an absolute bar to relief under the "innocent spouse" rule of section 6013(e)

> "We realize that given the equal income interests vested in each spouse under the community property laws, certain inequitable situations that section 6013(e) was designed to eliminate may very well arise if the spouses elect to file separately in community property states. However, we have previously held that, regardless of the inequities that might result, the intent of Congress was clear that a joint return must be filed before an otherwise "innocent spouse" can be accorded the benefits of section 6013(e). Mary Lou Galliher, supra. Therefore, we find this section inapplicable in the instant case." (J. Forrester in Mildred L. Fehland, T.C. Memo 1975-300).

In view of the fact that the Mitchell decision may now preclude IRS from proceeding against the husband as administrator of the community income for payment of income taxes due with respect to the wife's one-half share, we recommend that relief be sought by amendment to section 6013 of the Code for those circumstances where the married individuals are living apart but not legally separated or divorced.

IRS officials informally agreed that legislation along the lines we recommend is the best solution to the problem.

III. GENERAL EXPLANATION

Our proposed amendment adds a new subsection (f) to section 6013. The amendment provides that when four conditions exist, a married individual is to be relieved of tax liability (including interest, penalties, and other amounts) to the extent that such liability is attributable to the omission from gross income of the one-half of community income attributable to the married individual under applicable state community property laws and not received by such individual.

The four conditions which must exist are:

(1) a separate return has been filed by an individual who is married; (2) there is omitted from gross income reported on the separate return community income derived from income earned by the other spouse or derived from community property; (3) the married individual filing the separate return lives separate and apart from the other spouse for the entire taxable year, whether or not such individual maintains a separate home or has as a principal place of abode the home of a third person; (4) the individual filing the separate return establishes that he or she has not received, directly or indirectly, the one-half of community income omitted from gross income.

The first requirement, that a separate return be filed by a person entitled to file a joint return, is intended to limit the relief provided in the bill to those cases where a married individual, living apart from a spouse resident in a community property state, files a separate return covering his or her own earnings or income from separate earnings. The second requirement, that there is omitted from gross income reported on the separate return the one-half of community income, is intended to grant relief in situations where the married individual has no realistic alternative to filing a separate return from which one-half of community income is omitted.

Typically, the litigated cases have involved an unsupported wife who does not know, and has no way of knowing, the financial status and affairs of the community or even the whereabouts of her husband. In many cases, no return has been filed or tax paid by the absent husband. In such situations the wife has no control over her statutory income tax liability and no means to compel her husband to divulge information for tax filing purpose concerning the community's assets, liabilities, or income. As a practical matter, the wife filing separately can neither prepare a return showing the community income nor pay the tax on such income. Further, she has no power to guarantee that the community will be sufficiently solvent to satisfy the tax liability with respect to the one-half community income out of her separate property. Despite the availability in most community property states of a suit for separation of property or a suit against the husband's heirs after the community is dissolved by death, the wife is, as a practical matter, helpless if the husband cannot be located for service of process.

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Further, while the wife may be relieved of obligations to contract creditors and of obligations created by state law under a state exemption statute if she renounces the community, such renunciation does not relieve her of liability for federal income taxes due on the one-half of community income attributed to her.

The third and fourth conditions require a factual determination (by the Internal Revenue Service or the courts) as to whether the individual filing separately (1) lived separate and apart from the other spouse for the entire taxable year (2) has not received, directly or indirectly, any benefit from the one-half of community income omitted from gross income. It is intended that such individual will have the usual burden of proof (preponderance of the evidence) on these two issues and not the higher burden required of the government in civil fraud cases.

With respect to the third and fourth conditions, factors to be taken into account include the fact of whether the individual in question is deserted or abandoned, receives alimony, separate maintenance or child support payments during the taxable year from the spouse. It is not necessary that the individual filing separately maintain a separate home which would qualify as a household under section 2(b) (relating to definition of head of household) but for the fact that such individual is considered as married under section 143(b) (relating to certain married individuals living apart). All that is required is that such individual not be a member of a household maintained by the other spouse. For purposes of determining whether the individual filing separately has received any amount of the community income, any amount received as alimony, separate maintenance, or child support payment from the spouse shall be regarded as an amount of community income received, and shall reduce dollar-for-dollar the amount of the one-half of community income with respect to which tax liability does not attach.

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IV. CHANGES IN EXISTING LAW

Section 6013 of the Internal Revenue Code of 1954

Section 6013 Joint Returns of Income Tax By Husband and Wife

(f) Separate Return after Filing Joint Return

(1) In General - Under regulations prescribed by the Secretary or his delegate, if

(A) a separate return has been made for a taxable year by an individual who is married and on such return there was omitted from gross income an amount includable therein under applicable community property laws,

(B) the spouse filing the separate return lives apart from the other spouse for the entire taxable year, and

(C) the spouse filing the separate return establishes that he (she) has not received directly or indirectly any amount of the community income omitted from gross income

then such spouse shall be relieved of liability for tax (including interest, penalties, and other amounts) for such taxable year to the extent that such liability is attributable to omission of the community income from gross income.