

Family Law Tax Update

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Registered domestic partners income reporting

1. Registered domestic partners in California do not split their income pursuant to *Poe v. Seaborn*¹.
2. The IRS reasoned as follows:
 - a. Case law relating to income-splitting in community property states has always arisen solely in the context of “spouses” (defined as “husband” and “wife”).
 - b. The relationship between domestic partners is not marriage under California law.
 - c. The registered domestic partner status is more akin to states that allow spouses to contractually enter into community property rights.
 1. In *Commissioner v. Harmon*², the Supreme Court ruled that *Poe v. Seaborn* did not apply to contractual community property rights.
3. While perhaps not a surprise, this does not bode well for future rulings regarding domestic partners.

Ordlock v. Commissioner (126 T.C. 4 – 1/19/06):

Innocent spouse claim and community property

1. Wife granted innocent spouse relief for 1982, 1983 & 1984 under IRC §6015(b).
2. However, Wife is not entitled to a refund for her “share” of the community property payments already applied to the liability.
3. Wife argued that the statement under §6015(a) stating “any determination under this section shall be made without regard to community property laws” applied to the refund provisions of §6015(g).
4. Tax Court ruled against Wife’s argument and disallowed any refund of the community property payments applied.
 - a. §6015 does not change the characterization of the payments as community under state law.
 - b. “The nature of a marital community in California is to generally allow the individual debts of the spouses to be collected out of community assets”
 - c. Congress did not intend for §6015(a) to supplant community property law.
 - d. Accepting Wife’s argument would require the IRS to trace and allocate all payments made in innocent spouse cases between the spouses (20 years’ worth, in this case).

¹ 282 US 101, 51 S.Ct. 58, 75 L.Ed. 239

² (32 AFTR 1411, 65 S.Ct. 103 – 11/20/44)

- e. Accepting Wife's argument could create an opportunity for married couples to defraud the government.
5. It should be noted that Rev. Rul. 2004-72 determined that under California community property laws, the IRS may confiscate both parties' share of the community property refund to apply to the separate debt of one of the spouses.
6. It should also be noted that the parties were still married at the time of this ruling.
7. The dissenting opinion by Judge Vasquez, however, points out that not allocating the payments between the spouses creates an inequity between community and common law states.
8. This is a long and rather painful case to read that goes into the definition of "determination", congressional intent, etc.

Johnson v. Commissioner (97 AFTR 2d 2006-1716 – 3/28/06):

Lump-sum alimony payment

1. Husband and ex-Wife entered into a divorce agreement in 1976 providing for, among other things, periodic alimony payments.
2. The 1976 divorce agreement was subsequently modified a number of times as to the amount of alimony.
3. In 1997, the parties entered into a settlement agreement providing that Husband would pay ex-wife \$400k lump-sum alimony in full settlement of all claims after both filed motions to modify the 1976 divorce agreement.
4. IRS disallowed Husband's \$400k deduction since it did not satisfy the "periodic payment" requirement of the pre-1984 alimony (§71) rules.
5. Husband argued that the current §71 rules applied since the 1997 agreement is a separate stand-alone agreement.
6. The Tax Court ruled that the 1997 agreement was a modification of the 1976 agreement and thus, the pre-1984 rules apply.
7. The Appellate Court affirmed.
8. Two interesting items:
 - a. Had the 1997 agreement stated that the post-1985 alimony rules were to apply, Husband would have received the deduction under Reg. 1.71-1T(e) Q&A 26 and §422(e)(2).
 - b. Reg. 1.71-1T(e) Q&A 26 is rather confusing as to what constitutes a new agreement and what constitutes a modification of the original agreement.

Rev Rul 2006-16 (3/31/06):

Innocent spouse claim after Chapter 7 bankruptcy

1. Husband and Wife were assessed additional tax due to Wife's underreported income.
2. The parties jointly filed for bankruptcy.
3. The IRS filed a proof of claim for the taxes which was not objected to by the parties.
4. The Bankruptcy Court did not make a determination of the tax liability.

5. The taxes were not discharged in the bankruptcy since the liability was less than 3 years old.
6. The parties separated after the bankruptcy case closed.
7. Husband is not precluded from requesting innocent spouse relief.

Commissioner v. Ewing (97 AFTR 2d 2006-1224 – 2/28/06):

Tax Court jurisdiction – innocent spouse claim

1. Reverses Ewing v. Commissioner (2002) and Ewing v. Commissioner (2004)³ concluding that the Tax Court had jurisdiction to review Wife’s petition for relief under IRC §6015(f) even though no deficiency had been assessed.
2. §6015(e) was amended in 2000 to provide that a taxpayer against whom a deficiency has been assessed may petition the Tax Court for review.
3. The case involved taxes reported, but not paid with the original return.
4. The original 2002 case involved a sharply divided Tax Court (Judge Laro dissented).
5. The Appellate Court ruled that the plain language of §6015(e), as amended, prevented the Tax Court from reviewing the matter in the first place, thus, its decision to grant relief to Wife must be vacated.

Ferguson Jr. v. Commissioner (T.C. Memo 2006-32 – 2/27/06):

Divorce-related theft and bad debt losses

Aka “thank heavens this isn’t my client”

1. Husband deducted the following on his 2000 return:
 - a. Theft loss for ex-Wife’s alleged misappropriation of a diamond ring.
 - b. Bad debt deduction for paying loans originally secured by property granted to ex-Wife.
 - c. Bad debt / theft loss for additional tax paid due to ex-Wife’s alleged incorrect preparation of an earlier separate return.
2. Diamond ring:
 - a. Purchased by wholly-owned S corporation, but granted to ex-Wife in the MSA.
 - b. Husband argued that the corporation wasn’t a party to the divorce so granting ex-wife the ring in the MSA was invalid.
 - c. Husband was barred from recovering the ring from ex-Wife by a 1989 agreement which prevented either party from re-opening the divorce agreement.
 - d. The Tax Court ruled that Husband ratified the agreement on behalf of the corporation.
 - e. So, no theft.
3. Bad debt for loan payments:
 - a. Husband borrowed funds secured by the Southampton property just prior to its transfer to ex-Wife.
 - b. MSA stated that each party would assume the loans on the properties received.

³ Ewing v. Commssioner – 118 T.C. 494, 495 (2002) and Ewing v. Commssioner – 122 T.C. 32 (2004).

- c. However, the bank released the liens on the Southampton property since they violated the automatic restraining order.
 - d. Husband was unable to recover from ex-Wife because of the 1989 agreement barring the reopening of the divorce.
 - e. The Tax Court ruled there's no debt that became worthless, business or otherwise, so no bad debt expense.
4. Bad debt or theft loss regarding taxes:
 - a. Husband and ex-Wife were ordered to file separate returns for 1986 following IRC §66.
 - b. Husband alleges that ex-Wife incorrectly prepared her return, thus he was audited and was required to pay \$118k of "her" taxes.
 - c. Again, Husband was unable to recover from ex-Wife because of the 1989 agreement barring the reopening of the divorce.
 - d. However, MSA provided that Husband would indemnify ex-Wife for all taxes prior to 1987.
 - e. Thus, the Tax Court ruled no theft and no bad debt.
 5. This case has some entertainment value.

In re: Drake (97 AFTR 2d 2006-697 – 1/11/06):

Innocent spouse claim and bankruptcy

1. Wife's appeal against the IRS regarding innocent spouse relief was pending when she filed for bankruptcy in September 2003.
2. IRS sent a letter of determination denying Wife's appeal in January 2004.
3. Wife's debts were discharged in 2004, however, the unpaid taxes and a pension plan survived the bankruptcy.
4. IRS issuing the letter of determination in January 2004 violated the automatic stay as it continued the collection activity.
5. Thus, Wife's appeal was still pending.