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Unresolved Issues Regarding Passthrough Entities, Community Property, and Federal Tax Law Create Headaches for Spouses in Louisiana

Susan Kalinka[*]

Disregarded entities, partnerships, S corporations, and LLCs that are taxed as disregarded entities, partnerships, or S corporations are sometimes referred to as passthrough entities. The term "passthrough entity" describes the federal and state tax treatment of the entity's income and transactions between the owner and the entity. A disregarded entity is an entity owned by one person whose separate existence from its owner is disregarded for tax purposes.[1] Thus, the income of a disregarded entity "passes through" to the owner of the entity, and the owner is liable for the tax on the disregarded entity's income.[2] Because a disregarded entity is disregarded as a separate entity from its owner, transactions between the disregarded entity and its owner are not taken into account and have no tax consequences. Thus, distributions from a disregarded entity to its owner are not subject to income tax. In general, a disregarded entity is an unincorporated entity, like an LLC, organized under federal law or the laws of one of the states and is classified as a disregarded entity for federal tax purposes, if the entity has not made an election to be classified as a corporation.[3]

Under federal tax law, the income of a partnership or S corporation, like the income of a disregarded entity, "passes through" the entity and is taxed to the partners or shareholders. The partners and shareholder must report their shares of the entity's income in the year the income is earned, regardless of whether that income is distributed to them.[4] Later, when the previously taxed

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1. Treas. Reg. §§ 301.7701-1(a)(4), 301.7701-2(a), 301.7701-3(a) (2008).
2. *See id.* § 301.7701-2(a) (activities of a disregarded entity are treated as the activities of a sole proprietor, branch, or division of the owner for federal tax purposes).
3. *Id.* § 301.7701-3(a), (b)(1).
4. I.R.C. § 701 (2002 & Supp. 2008) (partnership does not pay tax on its income); *id.* § 702 (each partner is taxed on the partner's distributive share of partnership income); *id.* § 1363(a) (S corporation generally does not pay tax on its income); *id.* § 1366(a) (S corporation shareholder is taxed on the shareholder's pro rata share of the S corporation's income).

income of the passthrough entity is distributed to the owner(s), the distribution is tax free to the distributee.[5] For convenience, this Article often will focus on the treatment of the income of disregarded entities, partnerships, and S corporations under both federal income tax and community property law, with the reader's understanding that the treatment of an LLC's income is likely to be the same if the LLC is taxed as a disregarded entity, partnership, or S corporation. This Article will also sometimes refer collectively to disregarded entities, partnerships, S corporations, and LLCs taxed as such entities as "passthrough entities."

To the extent that a disregarded entity, partnership, or S corporation generally does not pay tax on its own income, the entity is treated as an aggregate of its owners. Louisiana business organization law, however, treats LLCs, partnerships, C corporations, and S corporations as entities separate from their owners.[6] It is uncertain whether Louisiana community property law treats a passthrough entity as an entity separate from its owners. The courts all agree that distributions of income earned by a passthrough entity during the existence of the community are community property, even if the interest is the separate property of one of the spouses, unless that spouse has reserved distributions as separate property in accordance with the procedures prescribed by Louisiana community property law.[7]

The Louisiana First Circuit Court of Appeal has held that the undistributed income of a partnership or S corporation is separate property if the partnership interest or stock in the S corporation is the separate property of a spouse.[8] Similarly, Louisiana courts have held that, as a general rule, the undistributed income of a

5. I.R.C. § 705(a) (2002) (adjusted basis of partner's interest in the partnership increased to reflect the partner's distributive share of the partnership's net income, reduced by distributions); *id.* § 731(a) (distributions from a partnership tax free to a partner to the extent of the partner's adjusted basis in the partner's interest in the partnership); *id.* § 1367(a) (2002 & Supp. 2008) (basis of S corporation shareholder's stock increased to reflect the shareholder's pro rata share of the S corporation's net income, reduced by distributions from the corporation to the shareholder); *id.* § 1368 (distributions from an S corporation to a shareholder are generally tax free to the extent of the shareholder's adjusted basis in his or her stock).

6. LA. CIV. CODE art 2801 (2009) (partnerships); LA. REV. STAT. ANN. § 12:41 (1994 & Supp. 2009) (corporations); *id.* § 12:1329 (LLCs).

7. Denegre v. Denegre, 30 La. Ann. 275 (La. 1878). *See also* LA. CIV. CODE art. 2339 (2009) (fruits of separate property are treated as community property unless the spouse who owns the property has reserved its fruits as separate property in writing).

8. McKneely v. McKneely, 764 So. 2d 1157 (La. App. 1st Cir. 2000) (S corporation); Ogden v. Ogden, 331 So. 2d 592 (La. App. 1st Cir.), *writ denied*, 337 So. 2d 523 (La. 1976) (partnership).

partnership is not community property if the interest is the separate property of one of the spouses.[9] Nevertheless, the Louisiana Third Circuit Court of Appeal has held that a spouse's share of a partnership's undistributed income is community property even though the spouse owns the partnership interest as separate property, if and to the extent that the spouse may withdraw it at any time and for any purpose.[10] The third circuit's distinction between undistributed income of a partnership in general and partnership income that is available to a partner makes sense. Nevertheless, the rule may result in inequity when the community terminates.

On termination and partition of the community, each spouse is entitled to receive one-half of the community property.[11] If the undistributed income of a partnership is treated as community property even though a spouse owns the interest in the partnership as separate property, the undistributed income is likely to be treated as having been distributed and then reinvested in the partnership.[12] In that case, the non-owning spouse may receive reimbursement for one-half of the income that is treated as reinvested in the partnership. On termination of the community, a spouse is entitled to reimbursement of the amount or value of one-half of the amount or value of community property used for the acquisition, use, improvement, or benefit of the separate property of the other spouse.[13] Thus, the spouse who does not own an interest in a partnership would be entitled to the same income twice: first when it is treated as distributed and therefore, community property, and second when the same income is treated as reinvested in the partnership. As of this writing, the Louisiana Supreme Court has not decided whether the undistributed income of a passthrough entity is community or separate property. Thus, it is uncertain how the undistributed income of a passthrough entity that is owned as separate property is classified under Louisiana community property law.

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9. *See, e.g.*, *Ogden*, 331 So. 2d 592; Dubuisson v. Moseley, 232 So. 2d 870 (La. App. 3d Cir. 1970).

10. Downs v. Downs, 410 So. 2d 793 (La. App. 3d Cir.), *writ denied*, 414 So. 2d 375 (La. 1982); Guilott v. Guilott, 361 So. 2d 1271 (La. App. 3d Cir.), *writ denied*, 361 So. 2d 1271 (La. 1978).

11. LA. CIV. CODE art. 807 (the right of a co-owner to partition property); *id.* art. 2341.1 (each spouse owns an undivided one-half interest in community property); *id.* art. 2369.1 (on termination of the community, provisions governing co-ownership generally apply to former community property).

12. *See, e.g.*, *Downs*, 410 So. 2d 793.

13. LA. CIV. CODE art. 2366.

Regardless of whether the undistributed income of a passthrough entity is treated as community or separate property, the spouse who does not own an interest in the entity will be liable for the tax on that income if the couple files a joint income tax return. As explained above, the owner of an interest in a passthrough entity is liable for the tax on the owner's share of the entity's undistributed income. If the spouses file a joint federal or state income tax return, the income attributable to a spouse's share of a passthrough entity's undistributed income must be reported on the return. Each spouse's liability for the tax required to be reported on a joint income tax return is joint and several, in the case of a federal joint tax return, or joint and *in solido* in the case of a state joint income tax return.[14] Because each spouse is liable for the entire amount of the tax due on the couple's aggregate income for the year in which the return is filed, the tax liability on the undistributed income of a passthrough entity is a community obligation.[15] If community property is used to pay the tax on the entity's undistributed income, the spouse who does not own an interest in the entity should not be entitled to reimbursement of any of the community property used to pay the tax. Thus, on partition of the community, the non-owning spouse should not receive any portion of the undistributed income or the amount of community property used to satisfy the tax liability on that income if the couple filed a joint return for the year in which the entity earned the income.[16]

Nevertheless, on partition of the community, a spouse is entitled to receive one-half of the amount by which a separately owned interest in a partnership, S corporation, or LLC increased in value to the extent that the increase in the value of the interest is attributable to the uncompensated or undercompensated labor of

14. I.R.C. § 6013(d) (2002 & Supp. 2008) (joint and several liability in the case of a joint federal income tax return); LA. REV. STAT. ANN. § 47:101(B)(1) (2001) (joint and *in solido* liability in the case of a joint state income tax return).

15. Louisiana Civil Code article 2360 provides that an obligation incurred by a spouse during the existence of a community property regime for the common interest of the spouses or for the interest of the other spouse is a community obligation. LA. CIV. CODE art. 2360. Because the spouse who does not own an interest in a passthrough entity that constitutes the separate property of the other spouse is liable for the tax on the entity's undistributed income, the tax liability is a community obligation. The payment of the tax is in the interest of the non-owning spouse.

16. *But see* McKneely v. McKneely, 764 So. 2d 1157, 1160 n.1 (La. App. 1st Cir. 2000) (observing, in dicta, that the trial court properly calculated a reimbursement to the non-owning spouse for her share of community funds used to pay taxes on an S corporation's undistributed income where the S corporation stock was the other spouse's separate property).

either or both of the spouses.[17] It may be difficult, however, for the non-owning spouse to prove that the increase in value of an interest in an entity that constitutes the separate property of the other spouse is attributable to the uncompensated or undercompensated labor of one or both spouses, especially if the spouse or spouses have been compensated for services provided to the entity. If the assets of the entity consist of income-producing property, the increase in value of a spouse's interest in that entity is likely to be attributable to the increase in value of the underlying assets, and not attributable to any effort or labor of either spouse.

Inequities may result if any of a spouse's share of the undistributed income of a passthrough entity is omitted from the joint return and the interest in the entity is the separate property of that spouse. In such a case, the IRS may seize the non-owning spouse's share of community property or the non-owning spouse's separate property in satisfaction of the tax deficiency, interest, and/or penalties attributable to the unreported or under-reported income unless the non-owning spouse qualifies as an "innocent spouse" under section 6015 of the Internal Revenue Code or section 47:101(B)(7) of the Louisiana Revised Statutes. However, it is not always easy for a spouse to qualify for innocent spouse status.

If the spouses file separate income tax returns, it is not certain whether a spouse is liable for the tax on one-half of a passthrough entity's undistributed income allocated to the other spouse whose interest in the entity is separate property. A spouse who resides in a community property state and files a separate income tax return is personally liable for the tax on one-half of the community income.[18] Regardless of whether the undistributed income of a passthrough entity is separate income under Louisiana jurisprudence, it is not certain that federal courts will accept the treatment of that income as separate property for federal income tax purposes. If a spouse domiciled in Louisiana who files a separate income tax return is liable for tax on one-half of the undistributed income of a passthrough entity allocated to the other spouse, whose interest in the entity is separate property, then the non-owning spouse may qualify for relief from liability for that income if he or she meets the innocent spouse requirements of section 66 of the Internal Revenue Code. Like innocent spouse status under section 6015, innocent spouse status under section 66 is not always easy to attain. This Article discusses some of the

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17. LA. CIV. CODE art. 2368.

18. Poe v. Seaborn, 282 U.S. 101 (1930). *See also* Bender v. Pfaff, 282 U.S. 127 (1930) (applying the principles of *Poe* to spouses domiciled in Louisiana).

problems that may arise for spouses in Louisiana where one of the spouses owns an interest in a passthrough entity as separate property and argues that such income should be treated as the separate property of the spouse who owns the interest in the entity both for purposes of community property law and for purposes of income tax law.

A discussion of the innocent spouse rules under sections 66 and 6015 of the Internal Revenue Code is beyond the scope of this Article. Other commentators have discussed the rules in detail.[19]

I. CLASSIFICATION OF INTERESTS IN AND INCOME OF A DISREGARDED ENTITY, PARTNERSHIP, S CORPORATION, OR LLC AS COMMUNITY PROPERTY OR SEPARATE PROPERTY AND THE FEDERAL TAX TREATMENT OF SUCH INCOME

An interest in a disregarded entity, partnership, S corporation, or LLC is separate property if it was acquired by a spouse before the marriage, before the establishment of a community property regime, or as a result of a partition of community property.[20] If an interest in a disregarded entity, partnership, S corporation, or LLC is acquired by one of the spouses during the existence of the community property regime by gift or inheritance, that interest also is considered separate property.[21] An interest in a disregarded entity, partnership, S corporation, or LLC also may be a spouse's separate property if the spouse acquires the interest with separate property or with separate and community property and the value of community property is inconsequential in comparison with the value of the separate property used to acquire the interest.[22]

In *Moise v. Moise*,[23] the Louisiana Fifth Circuit Court of Appeal held that an interest in an LLC was the husband's separate property even though the wife had provided valuable services on behalf of the LLC during the existence of the community. In 1993, Mr. Moise purchased real estate in Tangipahoa Parish for $24,000. Mr. and Mrs. Moise were married in 1995. On December 31, 2002, the Moise Family, L.L.C., was formed. In partial consideration of his 100% interest in the LLC, Mr. Moise transferred a partial interest in the Tangipahoa property. In 2003, the LLC entered into a lease agreement with Verizon Wireless for the parcel of the

19. *See, e.g.*, 3, 4A BORIS I. BITTKER & LAWRENCE LOKKEN, FEDERAL TAXATION OF INCOME, ESTATES, AND GIFTS §§ 76.4, 111.3.2 (3d ed. 2003).
20. LA. CIV. CODE art. 2341.
21. *Id.*
22. *Id.*
23. 956 So. 2d 9 (La. App. 5th Cir. 2007).

Tangipahoa property that Mr. Moise had transferred to the LLC. The lease agreement required Verizon to pay the LLC $12,000 per year.

Mrs. Moise argued that the LLC was community property and also that she owned a 50% interest in the LLC. To support her claim, Mrs. Moise produced the LLC's initial report naming her as one of "the first managers, or the members," the LLC's 2003 tax return listing Mr. and Mrs. Moise as 50% partners for purposes of profit sharing, and the Verizon lease identifying her as a member of the LLC. Mrs. Moise also testified that she contributed services to the LLC, including cutting grass on the Tangipahoa property, payment of the LLC's fees (including one-half of the fees paid to the LLC's accountant), meeting with Verizon's representatives in pursuant of the lease agreement, and opening the LLC's bank account.

The court held that Mrs. Moise was not a member of the LLC. The court determined that none of the documents Mrs. Moise presented supported her argument. The initial report was ambiguous as to Mrs. Moise's status. It listed her as either a manager or a member. A manager of a Louisiana LLC does not have to be a member.[24] The fifth circuit agreed with the trial court that the duties Mrs. Moise performed for the LLC were those of a manager. The court also concluded that the designation of Mrs. Moise as a member under the lease agreement did not change her status in fact.

Finally, the court concluded that the 2003 tax return was not relevant because Mrs. Moise was liable for the tax on one-half of the rents paid under the terms of the Verizon lease agreement. The United States Supreme Court has held that a spouse who resides in a community property state is personally liable for the tax on one-half of the community income.[25] Under Louisiana community property law, income from separate property is community property unless the spouse who owns the property makes a designation by authentic act that the income is separate property.[26] Thus, Mrs. Moise was the owner of one-half of the rents derived

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24. Subparts (12) and (13) of Louisiana Revised Statutes section 12:1301(A) provide different definitions of the terms "manager" and "member." Thus, managers are not the same as members. *See* LA. REV. STAT. ANN. § 12:1301 (1994 & Supp. 2009). Under Louisiana Revised Statutes section 12:1301(A)(12), the term "manager" is defined as a person or persons designated by the LLC members to manage the LLC as provided in the articles of organization. *Id.*

25. Poe v. Seaborn, 282 U.S. 101 (1930); Bender v. Pfaff, 282 U.S. 190 (1930).

26. LA. CIV. CODE art. 2339.

from the lease, regardless of whether she was designated as a member of the LLC on the couple's federal income tax return.

In finding that the LLC was Mr. Moise's separate property, the trial court and the fifth circuit relied on the fact that Mr. Moise had transferred separate property to the LLC in exchange for a 100% interest in the LLC. The Louisiana Civil Code provides that separate property includes property acquired by a spouse "with separate things or with separate and community things when the value of community things is inconsequential in comparison with the value of separate things used."[27] Under *Moise*, an LLC interest is separate property if it is acquired with separate property.

Mrs. Moise had paid some of the fees incurred by the LLC. The *Moise* court did not indicate whether the fees were paid with community property or Mrs. Moise's separate property. If the fees were paid with community property, then Mrs. Moise would have been entitled to reimbursement of one-half of the fees upon termination of the community. The fees owed by the LLC were the separate obligations of Mr. Moise because they were not incurred for the common interest of the spouses or for the interest of Mrs. Moise.[28] If community property is used to satisfy the separate obligation of a spouse, the other spouse is entitled to reimbursement upon termination of the community of one-half of the amount or the value of the community property at the time it was used.[29]

Similarly, a spouse is entitled to reimbursement of one-half of any community property that was used to benefit the separate property of the other spouse.[30] The payment of the fees in *Moise* either satisfied Mr. Moise's separate obligation to pay the fees (if he was personally liable for the payment) or else benefitted Mr. Moise's separate property (if the LLC was liable for the payment). Thus, Mrs. Moise would be entitled to reimbursement of one-half of the fees if she paid the fees with community property. On the other hand, if Mrs. Moise had paid the fees with her separate property, she should have been entitled to reimbursement of the entire amount she had paid.

It appears that the rents under the Verizon lease were paid directly to Mr. and Mrs. Moise. If the LLC had collected the rental income and not distributed it, it is not certain whether the court

27. *Id.* art. 2341.

28. *See id.* art. 2363 (defining the term "separate obligation" as an obligation incurred by a spouse prior to the establishment of the community or one incurred during the existence of the community but not for the common interest of the spouses or for the interest of the other spouse).

29. *Id.* art. 2364.

30. *Id.* art. 2365.

would have held that the undistributed income of the LLC was separate property.[31]

The LLC in *Moise* filed tax returns as a partnership for federal tax purposes. If, in fact, the LLC had only one owner, it should have been treated as a disregarded entity under the United States Treasury Department's entity classification regulations.[32] A disregarded entity is an unincorporated entity with only one owner that is not classified as a corporation for federal tax purposes. An LLC that is not classified as a corporation for federal tax purposes is classified as a partnership if it has more than one member, but as a disregarded entity if it has only one member.[33] The activities of a disregarded entity are treated as the activities of a sole proprietorship if the owner of the interest in the entity is an individual, or as a branch or division if the owner of the interest in the entity is a corporation or other entity.[34] Thus, the income of a disregarded entity is treated as the income of its owner. Accordingly, Mr. Moise would have been subject to tax on the LLC's rental income regardless of whether he actually received the rental payments made on the Verizon lease.

As of this writing, no case could be found in which a Louisiana court has ruled on the issue of whether the undistributed income of an LLC that is classified as a partnership or disregarded entity is community property when the interest in the LLC is the separate property of one of the spouses. Nevertheless, Louisiana courts of appeal have considered the issue of whether the undistributed income of a partnership or an S corporation is community property in cases where the partnership interest or S corporation stock is separate property and the owner of the interest in the entity did not

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31. *See, e.g.*, McKneely v. McKneely, 764 So. 2d 1157 (La. App. 1st Cir. 2000) (undistributed income of an S corporation constituted the separate property of the spouse whose interest in the S corporation was separate property); Ogden v. Ogden, 331 So. 2d 592 (La. App. 1st Cir.), *writ denied*, 337 So. 2d 523 (La. 1976) (undistributed income of a partnership did not constitute community income until it was used to purchase property titled in the name of the partner). *But cf.* Downs v. Downs, 410 So. 2d 793 (La. App. 3d Cir.), *writ denied*, 414 So. 2d 375 (La. 1982) (undistributed income of a partnership constitutes community income if the partner has control over whether and when the income will be distributed to him or her); Guilott v. Guilott, 361 So. 2d 1271 (La. App. 3d Cir.), *writ denied*, 363 So. 2d 68 (La. 1978) (partnership income deposited in partner's drawing account constituted community income even though the amount in the drawing account was not distributed to the partner whose interest in the partnership was her separate property).

32. Treas. Reg. §§ 301.7701-1–301.7701-3 (2008).

33. *Id.* § 301.7701-3(a).

34. *Id.* § 301.7701-2(a).

reserve the fruits of the partnership interest as separate property.[35] The courts seem to be split on the issue of whether the undistributed income of a partnership or S corporation that constitutes the separate property of a spouse should be treated as community property or separate property. The partnership cases are discussed first, followed by the S corporation case.

A. Undistributed Income of a Partnership

The partnership cases seem to distinguish between a partner's ability to access income transferred to the partner's drawing account and a partner's lack of control over the timing and amount of partnership distributions. The Louisiana Third Circuit Court of Appeal has held that the undistributed income of partnership income is community property if and to the extent that the partner may draw upon it at any time.[36] If a partner does not have control over distributions, then the undistributed income is not community property.[37] On the other hand, the Louisiana First Circuit Court of Appeal has indicated that partnership income included in the partner's capital account is separate property of the partner-spouse until the income has been distributed to the partner.[38]

In *Guilott v. Guilott*,[39] the Louisiana Third Circuit Court of Appeal held that certain stock purchased by a partnership in commendam for an in commendam partner constituted a distribution of the stock to the partner and was therefore community property. In *Guilott*, Mrs. Guilott had received an in commendam, or limited, partnership interest as a gift from her father. Thus, the partnership interest was separate property.[40] Each partner had a capital account and a drawing account. The capital account was referred to as a "net worth account" and was owned by each partner in proportion to the partner's respective interest in the partnership. Each year, the partnership placed each partner's share of partnership earnings in that partner's drawing account. A partner could require the partnership to distribute the earnings

35. *See, e.g.*, *McKneely*, 764 So. 2d at 1162–63; *Downs*, 410 So. 2d 793; *Guilott*, 361 So. 2d 1271; *Ogden*, 331 So. 2d 592.

36. *See, e.g.*, *Downs*, 410 So. 2d 793; *Guilott*, 361 So. 2d 1271; *Ogden*, 331 So. 2d 592.

37. *See, e.g.*, Dubuisson v. Moseley, 232 So. 2d 870 (La. App. 3d Cir. 1970).

38. *See, e.g.*, *Downs*, 410 So. 2d 793; *Guilott*, 361 So. 2d 1271; *Ogden*, 331 So. 2d 592.

39. 361 So. 2d 1271.

40. *See* LA. CIV. CODE art. 2341 (2009) (defining the term "separate property" to include property acquired by the spouse by donation to him individually).

credited to the partner's drawing account at any time and without the approval of the partnership or any of the other partners. The *Guilott* court held that all partnership earnings placed in Mrs. Guilott's drawing account during the existence of the community were fruits of her interest in the partnership and, therefore, constituted community property.[41]

While the *Guilott* court held that the partnership income in Mrs. Guilott's drawing account was community property, the court also held that the distributed and undistributed amounts in her capital account were her separate property.[42] According to the third circuit, the amount the partnership placed in Mrs. Guilott's drawing account should be treated as having been distributed to her because she could draw amounts from that account at will. It was as if the partnership had placed her share of the partnership's earnings in a checking account for her benefit.

During the existence of the community, the partnership formed a corporation with cash assets debited to the drawing account of each of the partners. Mrs. Guilott received fifty shares of capital stock in the corporation in return for $5,000 debited to her partnership drawing account. The partnership also acquired 1,500 shares of stock in the corporation in exchange for certain equipment owned by the partnership. The 1,500 shares were later distributed to each of the partners on the basis of three shares for every share of stock already owned by the partner. Thus, Mrs. Guilott received an additional 150 shares from that distribution. In a later year, Mrs. Guilott received another 300 shares of stock with a book value of $7,500. Mrs. Guilott's drawing account was debited $7,500 to pay for the 300 shares. Thus, Mrs. Guilott owned a total of 500 shares of stock, 350 of which had been acquired with funds debited from her drawing account, and 150 of which had been acquired with the equipment the partnership had transferred to the corporation.

The court held that the 350 shares acquired with funds from Mrs. Guilott's drawing account were community property because they were acquired with community income.[43] In contrast, however, the court held that the 150 shares that were acquired with partnership property were Mrs. Guilott's separate property. As explained earlier, the Louisiana Civil Code provides that property acquired with separate property is separate property.[44] The court reasoned that the 150 shares represented a mere change in form of

41. *Guilott*, 361 So. 2d at 1275.
42. *Id.* at 1278.
43. *Id.* at 1276.
44. LA. CIV. CODE art. 2341.

Mrs. Guilott's separate property. In acquiring the 150 shares of stock with its capital assets, the partnership changed the form of a portion of Mrs. Guilott's partnership capital account to stock. Thus, when Mrs. Guilott's stock was redeemed, the money she received in exchange for the 150 shares of stock continued to be her separate property.

When the partnership liquidated, it distributed four municipal bonds valued at $69,064 and cash of $39,500. Mr. Guilott conceded that $50,000 representing Mrs. Guilott's interest in the partnership capital account was her separate property. As in the case of the stock purchased on behalf of Mrs. Guilott and debited to her drawing account, the court held that the portion of the value of the municipal bonds representing funds due to her from her drawing account was community property. Similarly, the court held that checks drawn on the partnership's checking account and debited from Mrs. Guilott's drawing account were community property.

It seems that the partnership in *Guilott* established two accounts for each of its partners: (1) a capital account and (2) a drawing account. Mrs. Guilott's capital account seems to have included her share of the original capital that had been contributed to the partnership or income attributable to the partnership interest that the partnership earned before Mrs. Guilott acquired the partnership interest. In contrast, the partnership contributed all of its current income to the partners' drawing accounts in proportion to their interests in the partnership. It is not certain whether the partnership retained any of its current earnings in the partners' capital accounts.

In *Downs v. Downs*,[45] the third circuit clarified its position concerning the characterization of a partnership's undistributed income. In *Downs*, Mr. Downs owned an interest in a partnership as separate property. The partners did not have drawing accounts. Under the terms of the partnership agreement, however, Mr. Downs could draw from his capital account at any time. The court held that the amount of partnership income allocated to Mr. Downs's capital account was not community property.[46] The court described the nature of a partner's capital account as follows:

> The evidence shows that a partner's capital account is nothing more than a reflection of the net capital invested by that partner in the business, together with his share of the partnership's profits reinvested by him. The accounts are

45. 410 So. 2d 793 (La. App. 3d Cir.), *writ denied*, 414 So. 2d 375 (La. 1982).
46. *Id.*

> not separate and distinct entities that can be characterized as "property". [sic] They exist only on paper as a means of showing the value of each partner's interest in the partnership. We find no merit in defendant's contention that plaintiff's capital account is community property.[47]

Nevertheless the court held that Mrs. Downs was entitled to one-half of the increase in value of Mr. Down's capital account. At the time that *Downs* was decided, the Louisiana Civil Code provided that on termination of the community, a spouse was entitled to reimbursement of one-half of the increase in the value of the other spouse's separate property to the extent that the increased value was attributable to improvements made with community funds or the labor of either or both spouses.[48] For purposes of allowing Mrs. Downs one-half of the partnership's income that had been credited to Mr. Downs's capital account, the court concluded that "when a husband's share of partnership profits is made available to him in such a manner that he may withdraw them from the partnership at any time and for any purpose, then those profits represent income to him which is community property during the existence of the community."[49] In addition, the court noted that Mr. Downs had devoted a great deal of time and effort to the partnership's business. Accordingly, the court awarded Mrs. Downs one-half of the amount by which Mr. Downs's share of the partnership's capital and profits had increased during the existence of the community.[50]

The holding in *Downs* is difficult to understand. On the one hand, the court declined to treat a partner's capital account as *per se* community property. However, to the extent that the partner's capital account was enhanced by the partner's share of partnership profits made available to him in such a manner that he could draw them from the partnership at any time, the partnership profits were community property. If Mr. Downs's share of the partnership's undistributed income was community property when it was earned, that income would have been counted twice in determining Mrs. Downs's share of the community property, once when the income was earned, and a second time when the income was reinvested in the partnership. The Louisiana Civil Code provides both that each spouse owns an undivided one-half interest in community property and its fruits and products,[51] and that on termination and partition

47. *Id.* at 796.
48. LA. CIV. CODE art. 2408 (1870), *repealed by* 1979 La. Acts No. 709, § 1.
49. *Downs*, 410 So. 2d at 799.
50. *Id.* at 801.
51. LA. CIV. CODE art. 2369.2 (2009).

of the community, each spouse is entitled to receive one-half of the former community property and its fruits or products, including any income from community property.[52] In addition, the Louisiana Civil Code provides that if community property is used to benefit separate property, the spouse who does not own an interest in the separate property is entitled to one-half of the amount or value of such property so used upon termination of the community.[53] The *Downs* court avoided awarding Mrs. Downs both one-half of Mr. Downs's share of the partnership's undistributed income and one-half of that income treated as reinvested in the partnership. While the court reached an equitable result, it offered no rationale for avoiding the double counting of the same income on partition of the community. Under *Downs*, a spouse who does not own an interest in a partnership should be entitled to receive one-half of the other spouse's share of that income, one-half of the income when it is treated as community property, and the other half of the income when it is treated as reinvested in the partnership.

In *Dubuisson v. Moseley*,[54] the third circuit held that a partner's share of income that had been placed in the partnership's checking account was not community property where the partner's interest in the partnership was separate property. The court explained:

> The partnership checking account was not a community checking account. The community only had an interest in the partnership, and the partnership checking account did not become identifiable community funds until withdrawn for the personal benefit of one of the partners. This is not a case where separate and community funds are deposited and withdrawn in an account. Here, only partnership funds were deposited in the partnership account, and the only interest the community had in those funds was by virtue of its interest in the partnership.[55]

While the quoted language indicates that the community had an interest in the partnership, that interest was only an interest in the enhanced value of Mr. Dubuisson's partnership interest attributable to Mr. Dubuisson's undercompensated services provided to the partnership. Earlier in the opinion, the *Dubuisson* court, like the

52. *Id.* art. 807 (allowing a co-owner to demand partition of co-owned property); *id.* art. 2369.1 (applying the co-ownership provisions to former community property after termination of the community).

53. *Id.* art. 2367.

54. 232 So. 2d 870 (La. App. 3d Cir. 1970).

55. *Id.* at 872.

Downs court, referred to Mr. Dubuisson's partnership interest as separate property.[56]

The third circuit's opinions in *Guillot*, *Downs*, and *Dubuisson* seem to treat a partner's share of the partnership's income as separate property where the interest in the partnership is the separate property of one of the spouses, unless the spouse who owns the interest in the partnership has the right to withdraw that income at any time and for any purpose. The third circuit's partnership opinions are consistent with *Ogden v. Ogden.*[57] In *Ogden*, the Louisiana First Circuit Court of Appeal held that partnership income did not constitute community property until that income was distributed to the spouse who held the partnership interest as separate property.[58] In *Ogden*, John Ogden had inherited from his father a one-sixth interest in a partnership that operated a motion picture theater. Thus, the partnership interest was separate property.[59] Nevertheless, the court held that Mrs. Ogden was entitled to one-half of the amount by which the partnership interest increased in value during the existence of the community.[60] Under former article 2408 of the Civil Code, as in effect when the community in *Ogden* terminated, a spouse was entitled to the increase in value of an interest in an entity owned as separate property of the other spouse to the extent that the increase in value was attributable to the common labor, expenses, or industry of one or both spouses.

After Mr. and Mrs. Ogden were divorced, Mrs. Ogden filed suit for a determination of her share of the community property. Mrs. Ogden argued that she was entitled to one-half of $10,461.09, the value of Mr. Ogden's one-sixth interest in the net worth of the partnership's business, much of which was held in the partnership's bank account. Mrs. Ogden maintained that because the partnership income was commingled with cash on deposit at the time of their marriage, the commingling caused Mr. Ogden's interest in the account to be considered community property. The court disagreed for the following reasons:

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56. *Id.* at 871.

57. 331 So. 2d 592 (La. App. 1st Cir. 1976). *See* Guilott v. Guilott, 361 So. 2d 1271 (La. App. 3d Cir.), *writ denied*, 363 So. 2d 68 (La. 1978) (citing *Ogden*, 331 So. 2d 592).

58. The court noted that partnership income did not belong to the partner until it was actually paid to him. *Ogden*, 331 So. 2d at 596–97.

59. LA. CIV. CODE art. 2341 (2009) (separate property includes property acquired by a spouse by inheritance to him individually).

60. *Ogden*, 331 So. 2d at 595 (citing LA. CIV. CODE art. 2408 (1870), *repealed by* 1979 La. Acts No. 709, § 1).

> The Gordon Theatre business was a partnership, and as such it is a separate legal entity. The defendant, Mr. Ogden, owns only an undivided interest in the partnership. He has no interest in the assets of the partnership other than his interest. All of the income deposited in the partnership account belonged to the partnership, and not to the partners in undivided interests.
>
> The only claim that the community can have against this partnership is for the enhanced value of the interest, owned by the defendant since he married.[61]

That issue, and the facts in *Ogden*, were the same as the issue and facts in *Dubuisson*, and the first and third circuits reached the same conclusion as to the characterization of the income. Unlike the partnerships in *Guilott* and *Downs*, the partnership in *Ogden* either did not allow partners to withdraw funds from their drawing accounts at will or did not place its income in the partners' drawing accounts as that income was earned. The *Ogden* court held that the partnership's income did not belong to any of the partners until it was actually distributed to them. Accordingly, the court held that none of the partnership's undistributed income constituted community property.

Nevertheless, when the partnership used its undistributed income for the benefit of Mr. Ogden, the court treated that portion of the partnership's income as community property. The partnership had paid $400 with a check drawn on the partnership's checking account to purchase forty shares of stock in a family owned corporation. The $400 purchase price of the stock was drawn from Mr. Ogden's partnership drawing account and issued in Mr. Ogden's name. While the first circuit held that none of the partnership income belonged to Mr. Ogden until it actually was paid to him, the court held that the stock was community property. The court stated:

> Of course, the defendant [Mr. Ogden] argues that the $400.00 was not income to him from the partnership, but merely a transfer of money in his partnership capital account to Broadmoor Theatres, Inc. for stock. This argument might hold true if the stock had been placed in the name of the partnership, for then it would simply be nothing more than another asset of the partnership; however, the stock in Broadmoor Theatres, Inc. was issued in the name of the defendant. Whether the check from the partnership was issued to the defendant in his name,

61. *Id.*

> deposited by him, and a new check issued to Broadmoor Theatres, Inc. for the purchase of the stock, or whether the check was issued in the defendant's name and endorsed by him to Broadmoor Theatres, Inc., or written directly to Broadmoor Theatres, Inc. on his behalf is of no moment, because under any of these circumstances the defendant was receiving income from the partnership, either directly or indirectly. Since the money that was used to purchase the stock is community, the stock is community.[62]

Ogden is consistent with *Downs* and *Guilott* because the partner in *Ogden* owned only a one-sixth partnership interest in a general partnership. Under Louisiana partnership law, a majority of the partners in a general partnership must make all decisions affecting the management of the partnership (including whether or not to authorize partnership distributions) unless the partners stipulate otherwise.[63] Thus, Mr. Ogden had no control over the partnership's distribution policies. The partnership agreement in *Ogden* did not provide that a partner could withdraw any amount in his or her capital account. In contrast, the partnership income that was allocated to Mrs. Guilott's drawing account and Mr. Downs's capital account was available for their use at any time. Accordingly, the *Guillot* and *Downs* courts treated that income as fruits of separate property and, therefore, community property.

The treatment of a partner's share of a partnership's undistributed income and distributions from a partnership under *Ogden* and *Dubuisson* is inconsistent with the treatment of that income under federal tax law. As explained earlier, a partnership is not subject to tax on the income it earns.[64] Instead, each partner pays tax on that partner's distributive share of partnership income.[65] Thus, a partner is treated as if the partner actually earned the partner's distributive share of partnership income. If Mr. Ogden or Mr. Dubuisson had earned the partnership's income directly, rather than through a partnership, the income would have been community property.[66]

The treatment of distributions from a partnership under community property law is also inconsistent with the manner in which partnership distributions are treated under federal tax law.

62. *Id.* at 597.

63. LA. CIV. CODE art. 2807.

64. I.R.C. § 701 (2002 & Supp. 2008).

65. *Id.* § 702(a).

66. *See* LA. CIV. CODE art. 2338 (defining the term "community property" to include property acquired during the existence of the community through the effort, skill, or industry of either spouse).

Distributions from a partnership to a partner generally are tax free to the extent that the amount of money distributed to the partner does not exceed the adjusted basis of the partner's interest in the partnership.[67] The adjusted basis of a partner's interest in a partnership generally includes the amount of money and the adjusted basis of property the partner has contributed to the partnership[68] and the partner's distributive share of items of partnership income and gain (including tax-exempt income).[69] The adjusted basis of a partner's interest in the partnership generally is reduced (but not below zero) by the amount of money and the adjusted basis of property distributed by the partnership to the partner and the items of deduction and loss (including expenses that are not deductible and not properly chargeable to a capital account).[70] Thus, to the extent that the money distributed to a partner does not exceed the amount of net income allocated to the partner, a distribution from the partnership to the partner is treated as a mere return of capital and not income to the distributee partner. In contrast, the Louisiana courts have held that partnership distributions of income are treated as community property.

B. Undistributed Income of an S Corporation

A Louisiana LLC also may be taxed as an S corporation.[71] It is likely that a Louisiana court will apply case law concerning the status of undistributed income of an S corporation under Louisiana community property law in determining whether the undistributed income of an LLC taxed as an S corporation is the separate

67. I.R.C. § 731(a) (2002).
68. *Id.* § 722 (2002 & Supp. 2008).
69. *Id.* § 705(a)(1) (2002).
70. *Id.* § 705(a)(2).
71. A Louisiana LLC is an unincorporated association. LA. REV. STAT. ANN. § 12:1301(A)(10) (1994 & Supp. 2009). Under the check-the-box regulations, an unincorporated business entity that is organized under the laws of any state government is eligible to make an election to be classified as a partnership if it has two or more members, a disregarded entity if it has one member, or an association taxable as a corporation if the LLC is not a joint-stock company, an insurance company, a business conducting banking activities, or a business entity that is taxable as a corporation under a provision of the Internal Revenue Code other than section 7701(a)(3). Treas. Reg. §§ 301.7701-2(b), 301.7701-3(b)(1) (2008). A Louisiana LLC that is eligible to be classified as a partnership or disregarded entity is classified as a partnership if it has two or more members or a disregarded entity if it has one member unless the LLC makes an election to be classified as a corporation. *Id.* § 301.7701-3(b)(1). If an LLC is classified as a corporation, it will be taxed under subchapter C of the Internal Revenue Code unless the LLC is eligible to elect and makes an election under section 1362(a) to be an S corporation.

property of the spouse whose interest in the LLC is separate property. Only one case could be found in which a Louisiana court decided that issue, and it is not certain whether the court was correct. In *McKneely v. McKneely*,[72] the Louisiana First Circuit Court of Appeal held that the undistributed income of an S corporation whose stock is the separate property of a spouse does not constitute community property unless and until that income actually is distributed to the spouse-shareholder.[73]

Like the Louisiana cases concerning the characterization of the undistributed income of a partnership as community or separate property, *McKneely*'s treatment of the S corporation's income under community property law is inconsistent with the treatment of that income under federal income tax law. The income of an S corporation is generally computed in the same manner as the income of an individual.[74]

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72. 764 So. 2d 1157 (La. App. 1st Cir. 2000).

73. *Id.*

74. I.R.C. § 1363(b) (2002 & Supp. 2008). An S corporation may be required to pay a corporate-level tax on its net recognized built-in gains and excess passive income. *Id.* §§ 1374, 1375. The built-in gains tax applies to an S corporation's net recognized built-in gain at a rate equal to the highest rate of tax that applies to corporate income under Code section 11. *Id.* § 1374(a), (b)(1) (2002). The built-in gains tax applies only in certain limited situations. First, the built-in gains tax applies only to gain recognized by an S corporation on the sale or exchange of property the S corporation acquired in a year in which the S corporation was a C corporation or property acquired from a C corporation if the adjusted basis of the property in the hands of the S corporation was determined in whole or in part by reference to the adjusted basis of the property in the hands of the C corporation at the time it was acquired. *Id.* § 1374(c)(1), (d)(3), (5)–(6). The built-in gains tax also does not apply if the property that is sold has been held by the S corporation for more than ten years after the corporation's subchapter S election became effective, or, in the case of property acquired from a C corporation with an adjusted basis determined in whole or in part to the C corporation's basis in the property, if the S corporation holds the property for more than ten years after the later of the date that the S corporation acquired the property or the date the corporation's subchapter S election became effective. *Id.* § 1374(d)(3), (6)–(7). The amount of gain subject to the built-in gains tax is limited to the built-in gain recognized on the sale or exchange of property potentially subject to the tax, reduced by the built-in loss recognized on the sale or exchange of property acquired before the first day of the taxable year in which the corporation's subchapter S election became effective or, in the case of property acquired from a C corporation, on the date that the S corporation acquired the property. *Id.* § 1374(a), (d)(4). For this purpose, the term "built-in gain" means the amount by which the fair market value of the property at the beginning of the taxable year in which the corporation became an S corporation exceeded the adjusted basis of the property at that time, or in the case of property acquired from a C corporation with an adjusted basis determined in whole or in part by reference to the basis of the property in the hands of the C corporation, on the date the S corporation acquired the property. *Id.* §

1374(d)(3)(B), (8). The term "built-in loss" means the amount by which the adjusted basis of property acquired by an S corporation before the first taxable year in which the corporation's subchapter S election became effective exceeds the fair market value of the property at that time or, in the case of property acquired from a C corporation with an adjusted basis determined in whole or in part by reference to the C corporation's adjusted basis in the property, at the beginning of the taxable year in which the property was acquired. *Id.* § 1374(d)(4). Furthermore, the amount of gain subject to the built-in gains tax is limited to the amount by which the unrealized built-in gain with respect to all of the S corporation's property potentially subject to the built-in gains tax exceeds the net recognized built-in gain for prior taxable years beginning in the year in which the corporation's subchapter S election became effective or, in the case of property acquired from a C corporation with an adjusted basis determined in whole or in part by reference to the C corporation's adjusted basis, at the time the property was acquired. *Id.* § 1374(c)(2), (d)(8). The net unrealized built-in gain is the amount by which the fair market value of all the property acquired as of the first day of the taxable year in which the corporation's subchapter S election became effective or, in the case of property acquired from a C corporation with an adjusted basis determined in whole or in part by reference to the C corporation's adjusted basis, at the time the property was acquired, exceeds the aggregate adjusted bases of such assets. *Id.* § 1374(d)(1), (8). The amount of gain subject to the built-in gains tax for any taxable year also is limited to the lesser of: (1) the amount that would be taxable income of the S corporation for the taxable year if only built-in gains and built-in losses were taken into account; or (2) the corporation's taxable income for the taxable year determined without regard to any net operating losses and without regard to the dividends received deduction. *Id.* §§ 172, 241–249, 1374(d)(2), 1375(b)(1)(B) (2002 & Supp. 2008). The net unrealized built-in gain is also reduced by net operating loss carry forwards from years in which the corporation was a C corporation. *Id.* § 1374(d)(5)(B) (2002). The built-in gains tax is reduced by certain business credit carryovers from years in which the corporation was a C corporation. *Id.* § 1374(b)(3)(B). Even if an S corporation is subject to the built-in gains tax on the sale or exchange of its property, the S corporation's shareholders also include in income their pro rata shares of all the gain recognized on the sale of the property in question. *Id.* § 1366(a)(1)(A) (2002 & Supp. 2008).

The tax on the net excess passive income of an S corporation only applies in a year in which the S corporation has either earnings and profits from years in which the corporation was a C corporation or earnings and profits that it acquired from a C corporation as a result of a corporate reorganization in which less than all of the gain on the transfer of the C corporations' assets to the S corporation and more than 25% of the S corporation's gross receipts are passive income. *Id.* § 1375(a). The tax is imposed at a rate equal to the highest rate of tax that applies to a C corporation under section 11 on the S corporation's excess net passive income. *Id.* The amount of an S corporation's excess net passive income is computed by multiplying the S corporation's net passive income for the taxable year times a fraction, the numerator of which is the amount by which the corporation's passive investment income for the taxable year exceeds 25% of its gross receipts for the taxable year, and the denominator of which is the corporation's passive investment income for the year. *Id.* § 1375(b)(1). For this purpose, the term "passive investment income" generally includes gross receipts

Nevertheless, an S corporation is generally not subject to the federal income tax on the income it earns.[75] Instead, each shareholder of an S corporation computes his or her income tax liability by including the shareholder's pro rata share of the S corporation's items of income, gain, loss, deduction, and credit.[76] In requiring an S corporation shareholder to report his or her share of the corporation's income on the shareholder's income tax return, subchapter S treats a shareholder's pro rata share of an S corporation's income as if the income were earned by the shareholder, not by the corporation.

Subchapter S also treats an S corporation shareholder as if the shareholder contributed the shareholder's share of the S corporation's net undistributed income back to the corporation as a contribution to capital. Subchapter S accomplishes this result by increasing the adjusted basis of the shareholder's stock by the amount of the corporation's undistributed income allocated to that shareholder.[77] Under federal tax law, a contribution of money by a shareholder to a corporation increases the adjusted basis of the shareholder's stock.[78]

An S corporation that was a C corporation in any prior year may have accumulated earnings and profits from the years in which it was a C corporation. The existence of earnings and profits may affect the tax treatment of distributions from an S corporation. In general, a distribution from an S corporation to a shareholder is not taxable to the extent that the distribution does not exceed the

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derived from royalties, rents, dividends, interest, annuities, and sales or exchanges of stock or securities (where gross receipts of such sales or exchanges are taken into account only to the extent of the gains therefrom). *Id.* §§ 1362(d)(3)(C), 1375(b)(3). Net passive income is passive investment income, reduced by the allowable deductions that are clearly related to the production of passive investment income, other than net operating losses and the dividends received deduction. *Id.* §§ 172, 241–249, 1375(b)(2). Gain that is subject to the built-in gains tax is not taken into account in determining an S corporation's net passive investment income. *Id.* § 1375(b)(3).

75. *Id.* § 1363(a).

76. *Id.* § 1366(a) (determination of S corporations shareholder's income tax liability).

77. *Compare id.* § 1367(a) (adjusted basis of an S corporation shareholder's stock increased in an amount equal to the shareholder's pro rata share of the S corporation's items of income and gain and reduced (but not below zero) by the amount of distributions from the S corporation to the shareholder and the shareholder's pro rata share of the S corporation's items of deduction and loss) *with id.* § 358(a) (basis of shareholder's stock increased by the amount of money the shareholder contributes to the corporation (applicable to S corporations under section 1371(a) (2002)).

78. *Id.* § 358(a).

adjusted basis of the shareholder's stock in the corporation.[79] The adjusted basis of an S corporation shareholder's stock generally includes the amount of money and the adjusted basis of the property contributed by the shareholder to the corporation and the shareholder's pro rata share of the S corporation's net income that was included in the shareholder's income each year and was not distributed to the shareholder in any year.[80] Thus, distributions from an S corporation to a shareholder are generally tax free to the extent that the shareholder has included the corporation's net income in the shareholder's income for the current or prior years and has not already received a distribution of that income.

If an S corporation has accumulated earnings and profits, the S corporation must keep track of its net income that was not distributed to shareholders in prior years. The term used by the Internal Revenue Code to describe the bookkeeping device that keeps track of a corporation's undistributed net income earned during the years in which the corporation is an S corporation is the "accumulated adjustments account" (sometimes referred to as "AAA").[81] In general, distributions to a shareholder from an S corporation with earnings and profits are tax free to the extent that the amount distributed does not exceed the adjusted basis of the shareholder's stock in the corporation and to the extent that the amount distributed does not exceed the AAA.[82] When an S corporation has only one shareholder, the AAA is computed in a manner that is similar to the manner in which the basis of the shareholder's stock is adjusted.[83] Thus, a distribution from an S corporation to its sole shareholder is generally included in the

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79. *Id.* § 1368(b).

80. *Id.* § 358(a) (adjusted basis of stock in an S corporation includes the amount of money and the adjusted basis of property contributed by the shareholder to the corporation, decreased by the amount of money, the fair market value of property distributed to the shareholder, and the amount of liabilities assumed by the corporation in connection with the transfer of property in exchange for the stock); *id.* § 1367(a) (adjusted basis of an S corporation shareholder's stock increased by the shareholder's pro rata share of the S corporation's items of income and gain and reduced (but not below zero) by tax-free distributions from the corporation to the shareholder and the shareholder's pro rata share of the S corporation's items of deduction and loss).

81. *Id.* § 1368(e)(1).

82. *Id.* § 1368(b), (c)(1).

83. There are two important differences between the computation of the AAA and the adjustments that are made to the adjusted basis of an S corporation's stock. Unlike the basis of the shareholder's stock, the AAA is not adjusted for income that is exempt from tax or the expenses related to tax-exempt income of the S corporation, and the amount in the AAA may fall below zero. *Compare id.* § 1367(a) (adjustments to the basis of shareholder's stock) *with id.* § 1368(e)(1)(A) (adjustments to the AAA).

shareholder's income only to the extent that the amount of the distribution exceeds the S corporation's AAA.

In *McKneely*, the Louisiana First Circuit Court of Appeal held that amounts distributed to a shareholder from an S corporation's AAA were community property. The *McKneely* court acknowledged that its treatment of the undistributed income of an S corporation under community property law is inconsistent with the treatment of that income under federal income tax law.

The holding in *McKneely* also is inconsistent with the holding in *Downs* and *Guilott*. In *McKneely*, Mr. McKneely was entitled to draw his one-half share of the S corporation's undistributed income at any time. When Mr. McKneely's brother was asked why he did not notify the police when he discovered that Mr. McKneely had withdrawn $110,000 from the S corporation's checking and savings accounts, the brother replied, "Well once the check cleared the bank, I noted that he was entitled to it—he was entitled to half of the funds that were there and so I thought he was entitled to it."[84] Indeed, the brothers had a history of drawing money from the corporate accounts whenever they needed it.[85] Unlike the *Downs* court, the *McKneely* court disregarded the fact that Mr. McKneely had control over whether and when he would receive distributions of the S corporation's income. In this respect, the *McKneely* court treated the undistributed income of an S corporation in the same manner as the undistributed income of a C corporation when the stock in the corporation constitutes the separate property of one of the spouses.

When stock in a C corporation is the separate property of a spouse, the income of the C corporation is not community property unless and until that income is distributed as a dividend to the shareholder-spouse.[86] In the case of a C corporation, it is not relevant whether the shareholder-spouse has control over dividend policy. As long as dividends are not actually distributed by the C corporation to the shareholder-spouse, the undistributed income of the corporation is not community property.

For example, in *Pellerin v. Pellerin*,[87] James Pellerin acquired 25% of the common stock in a C corporation, Pellerin Laundry Machinery Sales Co., Inc. (PLMSCO),[88] as a gift from his father

84. Transcript of Record at 30, McKneely v. McKneely, 764 So. 2d 1157 (La. App. 1st Cir. 2000) (No. 9601002).

85. *Id.* at 22–25.

86. *See, e.g.*, Pellerin v. Pellerin, 550 So. 2d 1250 (La. App. 4th Cir. 1989).

87. *Id.*

88. The *Pellerin* court did not specify that PLMSCO was a C corporation. However, PLMSCO must have been a C corporation because the court stated that its income was subject to a double tax. *Id.* at 1254. Moreover, when

and grandfather before he was married to Mrs. Pellerin on July 19, 1975. Thus, James's 25% interest in PLMCSO was separate property. The remaining 75% of the stock in PLMSCO was owned by each of James's three siblings in equal shares. In other words, James's father and grandfather gave 25% of the stock in the corporation to each of the four siblings. After Mr. and Mrs. Pellerin were married, the general manager of PLMSCO resigned, and James's father convinced James to manage the corporation in lieu of attending graduate business school. At the same time, PLMSCO's sales manager received 8% of PLMSCO's stock, reducing each of the siblings' stock in the corporation to 23%.

James became the president of PLMSCO in May 1976, at which time the corporation was recapitalized. James's siblings each exchanged their common stock in PLMSCO for preferred stock, and James acquired a controlling interest in the voting common stock of the corporation. The documents concerning the plan of recapitalization recited that James's siblings agreed to give James a controlling interest in the voting common stock of the corporation and an increased share in the future appreciation and growth of the corporation in appreciation of his services in managing the corporation and as an incentive for James to manage the company in such a way as to assure a substantial annual income from their continued interest in the corporation.

Pellerin involved several issues concerning the partition of community property as a result of the Pellerins' divorce. Mrs. Pellerin argued that James's increased ownership interest in the future growth of the corporation was a form of compensation granted to James in return for making his services available and, therefore, constituted community property. As explained earlier, community property includes property acquired during the existence of the community through the effort, skill, or industry of either spouse.[89] James argued that he did not receive any additional shares of stock as a result of the recapitalization and that the controlling interest of stock ownership cannot exist apart from the stock itself. James also noted that no value could be assigned to his controlling interest. James maintained that PLMSCO's success was

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PLMSCO was recapitalized, a new class of preferred stock was issued. *Id.* at 1252. An S corporation may not have more than one class of stock. I.R.C. § 1361(b)(1)(D) (2002 & Supp. 2008); Treas. Reg. § 1.1361-1(l)(1) (2008). Thus, PLMSCO was not an S corporation. PLMSCO also was not a real estate investment trust ("REIT") because it did not meet the requirements to be a REIT under Code section 861(a)(1). Thus, PLMSCO must have been a C corporation.

89. LA. CIV. CODE art. 2338 (2009).

dependent on another corporation whose products PLMSCO sold. Moreover, James contended that his controlling interest was only temporary because his siblings had the right to exchange their preferred stock for common stock if they became active in the business.

The Louisiana Fourth Circuit Court of Appeal held that the increase in James's controlling interest in PLMSCO was not an asset itself, but was tied as an integral part of the position of president of the corporation and served as an incentive for James to serve as president of PLMSCO.[90] Thus, James's common stock retained its characterization as separate property, and Mrs. Pellerin was entitled to the increase in value, if any, in James's PLMSCO stock during the existence of the community to the extent that the increase in value was attributable to James's uncompensated labor or industry.[91] As explained earlier, the party claiming reimbursement for the enhancement in value of separate property upon dissolution of the marriage has the burden of proving that the increase in value is attributable to the uncompensated common labor and industry of the spouses.[92] The court held that Mrs. Pellerin had failed to meet her burden of proof because, in its opinion, James was adequately compensated for his labor and industry by virtue of his salary and bonus.[93]

Mrs. Pellerin also claimed that PLMSCO unreasonably withheld dividends on its common stock, which would have been community property if they had been distributed. The court did not consider the fact that Mr. Pellerin could have required PLMSCO to distribute dividends at any time. Instead, the court accepted the testimony of expert witnesses that distributions from the corporation would be subject to a double tax at a high rate. If PLMSCO had distributed dividends to James during the Pellerins' marriage, the distributions would have been subject to tax at the rate of 50%. For every $100 in dividends James received, $50 would have had to be paid in taxes. Another CPA described the double tax problem. A C corporation is subject to tax on its own income.[94] The income of a C corporation is subject to tax a second time, at the shareholder level, if and when it is distributed as a dividend to that shareholder.[95] Moreover, an accountant testified that it was typical of small family corporations not to pay

90. *Pellerin*, 550 So. 2d at 1253.
91. LA. CIV. CODE art. 2368.
92. Guarisco v. Guarisco, 526 So. 2d 1126, 1127 (La. App. 1st Cir. 1988), *writ denied*, 523 So. 2d 1337 (La. 1989).
93. *Pellerin*, 550 So. 2d at 1253.
94. I.R.C. § 11(a) (2002).
95. *Id.* §§ 61(a)(7), 301(a), (c)(1), 316(a) (2002 & Supp. 2008).

dividends on common shares. There was additional testimony that PLMSCO retained its earnings for exposure to at least two law suits. Accordingly, the court held that Mrs. Pellerin failed to prove that the refusal to pay dividends was capricious or that the corporation's earnings were retained to deprive the community.[96]

It is not certain whether the holding in *McKneely* will be followed by other courts. The *Pellerin* court justified a C corporation's retention of earnings, in part, because of the tax burden that would result if the corporation's income had been distributed. In contrast, the corporation in *McKneely* was an S corporation. As explained earlier, distributions of an S corporation are generally tax free to the shareholders to the extent that the amount distributed already has been subject to tax. It would seem that the partnership cases are more like the *McKneely* case.

C. Undistributed Income of a Disregarded Entity

As of this writing, no cases could be found in which a Louisiana court addressed the treatment of the undistributed income of a disregarded entity where the interest in the entity is the separate property of the entity's owner. Where the owner of the interest in a disregarded entity is an individual, it is likely that the disregarded entity will be organized as an LLC.[97] In *Moise v. Moise*, the court did not indicate whether the income received on the Verizon lease was distributed to Mr. Moise. It is not certain whether Louisiana courts will treat an LLC like a partnership or a corporation for purposes of determining whether the undistributed income of an LLC is community property in cases where the interest in the LLC is separate property.

Like a partnership or S corporation, a disregarded entity generally is not subject to tax on its own income. Instead, the entity

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96. *Pellerin*, 50 So. 2d at 1254.

97. As explained earlier, a Louisiana LLC with only one owner will be taxed as a disregarded entity unless the LLC makes an election under the check-the-box regulations to be taxed as a corporation. Treas. Reg. § 301.7701-3(a) (2008). There are two other entities that may be classified as disregarded entities, a qualified real estate investment trust subsidiary ("qualified REIT subsidiary") or a qualified subchapter S subsidiary ("QSub"). I.R.C. §§ 856(i)(1)(A) (qualified REIT subsidiary), 1361(b)(3)(B) (QSub). The stock in a qualified REIT subsidiary or a QSub, however, may not be owned by an individual. *See id.* § 856(i)(2) (defining the term "qualified REIT subsidiary" as a corporation if 100% of the stock of the corporation is held by a REIT if the corporation is not a taxable REIT subsidiary); *id.* § 1361(b)(3)(B) (defining the term "QSub" as a domestic corporation that is not an ineligible corporation if 100% of the stock in the corporation is held by an S corporation and the S corporation elects to treat the corporation as a QSub).

is disregarded as a separate entity from its owner, and the disregarded entity's items of income, gain, loss, deduction, and credit are included on the owner's income tax return for the year in which the items are earned or incurred.[98] For tax purposes, the owner of an interest in a disregarded entity does not have a basis in the interest. Instead, a sale of all or a part of an interest in an LLC that is classified as a disregarded entity is treated as a sale of a proportionate interest in each of the LLC's assets.[99] Distributions of a disregarded entity's income are not subject to tax because transactions between a disregarded entity and its owner are not included for income tax purposes.

As the sole owner of an interest in an LLC that is classified as a disregarded entity, the owner of the interest has absolute control over whether and when the LLC will distribute its income. If a court treats the undistributed income of an LLC classified as a disregarded entity like the undistributed income of a partnership, the undistributed income will constitute community property even if the LLC is the separate property of one of the spouses. On the other hand, if a court treats an LLC like an S corporation, then under *McKneely*, the LLC's undistributed income will be separate property if the interest in the LLC is separate property. As explained earlier, the Louisiana Supreme Court has not decided whether the undistributed income of a passthrough entity allocable to an interest in the entity is community property or separate property if the interest in the entity is separate property. It is hoped that the supreme court will hold that a spouse's share of the undistributed income of all passthrough entities is separate property if the interest in the entity is separate property.

D. Should the Undistributed Income of a Passthrough Entity Be Treated as Separate Property or Community Property?

In general, the undistributed income of a passthrough entity should not be treated as community property if the interest in the entity is separate property. In *McKneely*, the Louisiana First Circuit Court of Appeal reached the right result but did not provide the best rationale for distinguishing an S corporation's undistributed income from the undistributed income of a partnership. As explained earlier, the *McKneely* court held that the third circuit's opinion in *Guilott* was not relevant in determining the character of an S corporation's undistributed income because the undistributed income in *Guilott* had been placed in Mrs.

98. Treas. Reg. § 301.7701-2(a).
99. Rev. Rul. 99-5, 1999-1 C.B. 434.

Guilott's drawing account. In contrast, Mr. McKneely's share of the S corporation's undistributed income had been placed in the corporation's accumulated adjustments account. The *McKneely* court's distinction between the AAA and a partner's drawing account is similar to the third circuit's treatment of a partner's capital account in *Downs*, in which the court held that a partner's capital account is not community property where the partner's interest in the partnership is separate property. The third circuit concluded that a partner's capital account exists "only on paper as a means of showing the value of each partner's interest in the partnership."[100]

The Texas Court of Appeals provided a much more satisfying distinction between an S corporation and a partnership in *Thomas v. Thomas*.[101] Like the *McKneely* court, the *Thomas* court held that the undistributed income of an S corporation is not community property where the interest in the corporation is the separate property of one of the spouses. In *Thomas*, Mr. Thomas owned 16% of the stock in a family owned S corporation as separate property. Mrs. Thomas argued that because an S corporation is taxed as a partnership and community property had been used to pay the tax on the S corporation's undistributed income, that income should be treated as community property. The court disagreed.

The *Thomas* court observed that federal tax law recognizes that a corporation's election to be taxed under subchapter S does not convert a corporation into a partnership.[102] Moreover, the court determined that the community benefits from the subchapter S election reduces the community's income tax liability. Distributions from an S corporation are tax-free to the community and deductions, losses, and tax credits attributable to the S corporation may be claimed by the spouses on their joint income tax return.[103] Furthermore, the court noted:

> Upholding the trial court's order in this case [treating Mr. Thomas's share of the S corporation's undistributed income as community property] could lead to undesirable and unpredictable results. It would tend to engraft upon our

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100. Downs v. Downs, 410 So. 2d 793, 796 (La. App. 3d Cir.), *writ denied*, 414 So. 2d 375 (La. 1982).

101. 738 S.W.2d 342 (Tex. Ct. App. 1987).

102. *Id.* at 344 (citing United States v. Richardson, 469 F.2d 349 (10th Cir. 1972)); United States v. Silverman, 359 F. Supp. 1113 (N.D. Ill. 1973); Neal v. United States, 313 F. Supp. 393 (C.D. Cal. 1970); Wilhelm v. United States, 257 F. Supp. 16 (D. Wyo. 1966).

103. *Thomas*, 738 S.W.2d at 344–45.

> community property system the manifest complexities of federal tax law. If, by paying taxes, the community acquired an interest in a Subchapter S corporation's retained earnings, it presumably would also acquire an interest in property purchased with the reinvestment of those earnings. The bright line dividing the corporate estate from the marital estate would be dimmed. Such a result would not bode well for the future of this highly desirable corporate form.[104]

The rationale in *Thomas* also should apply in determining whether the undistributed income of a partnership or LLC is separate or community property. Nevertheless, the third circuit's treatment of a partnership's undistributed income as community property seems reasonable in cases where the spouse who owns the interest in the entity as separate property has the ability to withdraw his or her share of partnership profits at any time. Where a passthrough entity has placed some or all of its undistributed income aside for a person who owns an interest in the entity to draw upon that income at any time, the entity has no need for the income and there is no need to treat that income as if it had not already been distributed to the owner.

It is not reasonable, however, to treat the undistributed income of a partnership or other passthrough entity as community property merely because the spouse who owns the interest in the entity as separate property has a controlling interest in the entity and therefore has the power to require the entity to distribute its income. Partnerships, like corporations and LLCs, are separate entities from their owners. A partner, like a shareholder or LLC member, does not own any interest in partnership property.[105] The retained earnings of a partnership, corporation, or LLC belong to the entity, not to the persons who own interests in the entity.[106] Thus, the undistributed income of a passthrough entity organized under state law as a partnership, S corporation, or LLC is not the property of a person who owns the interest in the entity. While the owner may be taxed on a passthrough entity's undistributed

104. *Id.* at 345.

105. *Compare* LA. CIV. CODE art. 2801 (2009) (defining a partnership as a juridical person distinct from its owners) *with* LA. REV. STAT. ANN. § 12:41 (1994 & Supp. 2009) (corporation has powers to sue and be sued in its own name and to own and dispose of its own property) *and id.* § 12:1329 (member has no interest in LLC's property).

106. *See, e.g.*, McClanahan v. McClanahan, 868 So. 2d 844, 848–49 (La. App. 5th Cir. 2004); Taylor v. Taylor, 772 So. 2d 891, 893 (La. App. 2d Cir. 2000).

income, the tax consequences do not change the nature of that income for purposes of determining the ownership of the income as either separate or community property.

Treating a passthrough entity's undistributed income as community property merely because a person owns a controlling interest in the entity as separate property might require the entity to distribute one-half of its income to satisfy the claims of the spouse who does not own the interest in the entity. Where a member, partner, or shareholder owns a controlling interest in the entity, a required distribution could drain the entity of significant resources. Such a distribution could cause significant harm to the entity and its business, the other owners, employees, and creditors of the entity. If a business organization is required to distribute a significant amount of its retained earnings, the entity may not have sufficient working capital to pay for its day-to-day business operations. If an entity has invested its retained earnings in property, the entity may be required to sell assets at an inopportune time to satisfy the claims of a spouse. Moreover, some distributions are unlawful. A Louisiana corporation may not pay a dividend when the corporation is insolvent or would be made insolvent if it paid the dividend.[107] A Louisiana LLC may not make a distribution if, after giving effect to the distribution, the LLC would not be able to pay its debts as they become due or the LLC's assets would be less than its liabilities.[108] Similarly, a partner in commendam may not receive distributions of partnership capital or profits if the distribution would render the partnership insolvent.[109]

There are many reasons for an entity to retain its earnings. In *Pellerin*, the court justified the retention of the corporation's earnings, in part, as insurance for payment of potential claims in connection with law suits. An entity may also retain earnings to expand the business and enhance the future earnings that will inure to the benefit of the entity's owners, suppliers, customers, and employees. If such retained earnings are treated as community property and required to be distributed to a spouse on termination of the community, the distribution could jeopardize the entity's

107. LA. REV. STAT. ANN. § 12:63(A) (1994). The Louisiana LLC law also prohibits the LLC from making distributions if, after accounting for the distribution and the liabilities to the to the LLC's creditors, the LLC would not have sufficient assets to satisfy preferential rights to distributions payable to other members on dissolution of the LLC that are superior to the rights of the member receiving the distribution unless the LLC's articles of organization or a written operating agreement provides otherwise. *Id.*

108. LA. REV. STAT. ANN. § 12:1327(A) (1994 & Supp. 2009).

109. LA. CIV. CODE art. 2842.

business opportunities to the detriment of the other owners, employees, and suppliers of the business.

The foregoing concerns are not relevant, however, if and to the extent that the entity has placed all or a portion the owner's share of its undistributed profits at the disposal of the owner. In that case, the entity essentially has declared that it does not need or plan to use that portion of the undistributed income. Of course, any amount of a passthrough entity's undistributed or distributed income that represents the separate property of a spouse because it was earned before the commencement of the community is that spouse's separate property.[110]

Nevertheless, treating the undistributed income of a passthrough entity as community property in cases where the interest in the entity is the separate property of a spouse could require the spouse who owns the interest to have to transfer 100% of that income to the other spouse on termination of the community. If the undistributed income of an entity is treated as community property, then the same undistributed income should be treated as having been contributed back to the entity. In that case, the same undistributed income will be treated as community property twice, once because the spouse to whom the income was allocated had control over whether the income would be distributed, and a second time when it is transferred back to the entity. Article 2366 of the Louisiana Civil Code provides that on termination of the community, a spouse is entitled to one-half of the amount or value of community property that has been used for the acquisition, use, improvement, or benefit of separate property of the other spouse. In *Downs v. Downs*,[111] the Louisiana Third Circuit Court of Appeal held that Mr. Downs's share of the undistributed income of a partnership constituted community property, even though Mr. Downs's interest in the partnership was separate property, because the partnership agreement gave him the ability to withdraw the funds at any time and for any purpose. At the same time, the court held that Mr. Downs was required to reimburse Mrs. Downs for one-half of the increase in value of Mr. Downs's share of the capital and undivided profits of the partnership during the time of their marriage.

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110. *See, e.g.*, Denegre v. Denegre, 30 La. Ann. 275 (La. 1878) (on dissolution of a partnership, amounts representing a spouse's share of partnership capital were the separate property of the spouse who owned the interest as separate property).

111. 410 So. 2d 793 (La. App. 3d Cir.), *writ denied*, 414 So. 2d 375 (La. 1982).

A spouse should not be entitled to include the same undistributed income of a passthrough entity twice in the inventory of community property when the community terminates. If so, on partition of the community, the spouse who does not own the interest in an entity holding undistributed income would be entitled to receive 100% of the undistributed earnings. Thus, for every $100 of undistributed income of a passthrough entity allocable to a spouse whose interest in the entity is separate property, $100 would be payable to the other spouse on termination of the community. A spouse living under a community property regime in Louisiana has an undivided one-half ownership interest in community property,[112] not a 100% interest in community property.

On the other hand, excluding the undistributed income of an entity from community property would deprive the spouse who does not own an interest in the entity of any of the undistributed income even though the non-owning spouse may be liable for the tax on one-half of that income.[113] Mrs. McKneely argued that the undistributed income of the S corporation should be treated as community property because she was liable for the tax on one-half of that income. Nevertheless, the amount of the liability for tax on one-half of the undistributed income is smaller than 100% of the undistributed income. As of this writing, the maximum rate of federal income tax that applies to the taxable income of an individual is 35%.[114] The maximum rate of state tax that applies to the Louisiana tax table income of an individual is 6%.[115] Thus, the combined federal and state income tax rate that applies to the income of an individual is 41% (35% federal tax rate + 6% state income tax rate). Accordingly, for every $100 of a passthrough entity's undistributed income allocable to a spouse whose interest in the entity is the separate property of one spouse, the other spouse may be liable for, at most, $20.50 (41% of $50, (one-half of the $100 of undistributed income)). The economic equities lie in favor of treating a passthrough entity's undistributed income as the separate property of the spouse whose interest in the entity is separate property.

In *Downs*, the court counted Mr. Downs's share of the partnership's undistributed income only once in determining the amount that Mrs. Downs was entitled to receive on termination of

112. LA. CIV. CODE art. 2336.
113. *See infra* notes 117–202 and accompanying text.
114. I.R.C. § 1(a)–(e) (2002 & Supp. 2008).
115. LA. REV. STAT. ANN. § 47:296(C) (2001), *repealed by* 2002 La. Acts. No. 51 § 2.

the community. The *Downs* court, however, did not provide a reason for counting Mr. Downs's share of the partnership's undistributed income as community property only once.[116] It is hoped that Louisiana courts will not treat a passthrough entity's undistributed income twice. As explained earlier, the undistributed income of a passthrough entity could be treated as community property a second time, when the income is distributed.

II. RIGHT TO REIMBURSEMENT FOR TAXES PAID ON UNDISTRIBUTED INCOME OF A PASSTHROUGH ENTITY

As of this writing, no cases could be found in which a Louisiana court has determined whether a spouse is entitled to receive a reimbursement from the community for the taxes paid on one-half of the undistributed income of a passthrough entity allocated to the interest in the entity owned by the other spouse as separate property. The determination is likely to turn on whether the liability for the tax is a community or separate obligation. If the spouses file a joint income tax return, the liability for the tax on the undistributed income of a passthrough entity is a community obligation. To the extent that the tax is paid with community property, the spouse who does not own the interest in the entity should not be entitled to reimbursement of any of the taxes paid on the entity's undistributed income. On the other hand, there may be a question as to whether a spouse is entitled to reimbursement of

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116. *Downs* was decided under former article 2408 of the Louisiana Civil Code, which was repealed by the 1980 revisions to the Louisiana community property law. 1979 La. Acts No. 709, § 1. Former article 2408 provided:

> Art. 2408. Division of increase or improvements of separate property: When the separate property of either the husband or the wife has been increased or improved during the marriage, the other spouse, or his or her heirs, shall be entitled to the reward of one half of the value of the increase or ameliorations, if it be proved that the increase or ameliorations be the result of the common labor, expenses, or industry; but there shall be no reward due, if it be proved that the increase is due only to the ordinary course of things, to the rise in value of property, or to the changes of trade.

LA. CIV. CODE art. 2408 (1870), *repealed by* 1979 La. Acts No. 709, § 1. Before the 1980 revisions, there was no provision like current article 2366, which allows a spouse to receive one-half of the amount or value of community property used for the benefit of separate property. Nevertheless, the pre-1980 Louisiana community property regime, like current Louisiana Civil Code article 2339, provided that the fruits of separate property were community property unless the spouse who owned the separate property reserved such fruits as separate property by a declaration made in an authentic act or under private signature duly acknowledged. LA. CIV. CODE art. 2402 (1870), *repealed by* 1979 La. Acts No. 709, § 1.

community property used to pay the tax on that spouse's share of one-half of the entity's undistributed income if the spouse files a separate income tax return. When the spouses file separate income tax returns, it is likely that the determination of whether the non-owning spouse is entitled to reimbursement for any of the tax paid will depend on whether the non-owning spouse is personally liable under federal and state income tax law for the tax on one-half of the undistributed income. This Part discusses the right to reimbursement of community property used to pay the taxes and the right to reimbursement of separate property used to pay the taxes in cases where the spouses file either a joint or separate income tax returns.

A. Joint Income Tax Returns, Community Property Used to Pay the Tax

When a joint federal income tax return is filed, each spouse is jointly and severally liable for the aggregate tax liability reported on the joint return.[117] The liability of each spouse is joint and solidary when a joint Louisiana income tax return is filed.[118] If the tax liability on the undistributed income of a passthrough entity is not paid and the couple has filed a joint return, the IRS or the Louisiana Department of Revenue generally may recover the entire amount of the unpaid tax from either spouse, even if the undistributed income in question is separate property, by seizing either community property or the spouse's separate property to satisfy the tax deficiency.[119]

An obligation incurred by a spouse during the existence of a community property regime for the common interest of the spouses or for the interest of the other spouse is a community obligation.[120] Because each spouse is personally liable for the entire income tax attributable to a joint return, the tax liability is a community obligation. Under Louisiana community property law, a spouse is

117. I.R.C. § 6013(d)(3) (2002 & Supp. 2008). *But see id.* § 6015 (relieving an "innocent spouse" from joint and several liability for an understatement of tax on a joint return that is attributable to the other spouse).

118. LA. REV. STAT. ANN. § 47:101(B)(1) (2001). *But see id.* § 47:101(B)(7) (relieving an innocent spouse from joint and solidary liability for an understatement of tax on a joint Louisiana state income tax return).

119. *But see* I.R.C. § 6015 (relieving a spouse of liability for an understatement or underpayment of tax on a joint return if the spouse meets the requirements for innocent spouse status or is eligible for liability only with respect to tax attributable to that spouse's items of income). A discussion of section 6015 is beyond the scope of this Article.

120. LA. CIV. CODE art. 2360 (2009).

not entitled to reimbursement of any community property that is used to satisfy a community obligation.[121] Thus, on termination of the community, the spouse who did not own any interest in a passthrough entity should not be entitled to a reimbursement of any of the community property used to pay the tax on the entity's undistributed income.

When separate property of a spouse has been used to satisfy a community obligation, that spouse is entitled, on termination of the community, to reimbursement for one-half of the amount or value that the separate property had at the time it was used.[122] Thus, where there is an understatement or underpayment of tax with respect to a joint return and the spouse who does not own an interest in a passthrough entity uses separate property to pay a tax deficiency, interest, or penalties attributable to the entity's undistributed income, the spouse will have a claim for reimbursement from the other spouse (or former spouse) for one-half of the amount paid to the taxing authority or authorities. Reimbursement may not be forthcoming, however, if the other spouse or former spouse has no community property with which to reimburse the spouse who paid the tax. The liability of a spouse who owes reimbursement in a case where separate property has been used to satisfy a community obligation is limited to the value of the obligor-spouse's share in the community after deduction for all community obligations.[123]

At first blush, it does not seem fair that a spouse who is not entitled to receive one-half of the undistributed income of a passthrough entity that constitutes the separate property of the other spouse also is not entitled to receive reimbursement for one-half of the community property used to pay the taxes on that income when the community terminates. This inequitable result, however, is not limited to the undistributed income from a passthrough entity or the tax on that income where the interest in the entity is the separate property of a spouse. In a case where a spouse has reserved the fruits of separate property as separate property, the other spouse still is jointly and severally liable for the

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121. On termination of the community, a spouse is entitled to reimbursement for one-half of the amount or value of community property used to satisfy the other spouse's separate obligation. LA. CIV. CODE art. 2364. A spouse also is entitled to a reimbursement of one-half of the amount or value of separate property used to satisfy a community obligation. LA. CIV. CODE art. 2365. Nevertheless, the community is responsible for its own obligations. Thus, there should be no reimbursement to either spouse for community property used to satisfy community obligations.

122. LA. CIV. CODE art. 2365.

123. *Id.*

tax on that income if the spouses file a joint return. Thus, for example, if a spouse owns rental property as separate property and reserves the rental income from that property as separate property, the other spouse will not be entitled to one-half of the rental income or one-half of the taxes paid on that rental income on termination of the community if the spouses filed a joint income tax return. Moreover, spouses who reside in non-community property states are jointly and severally liable for the tax on the spouses' aggregate income, regardless of which spouse's labor or property generates that income, if they file a joint return. Unlike a spouse in a community property state, a spouse in a non-community property state has no interest in the property of the other spouse, regardless of whether that property was acquired during the marriage.

On the other hand, inequities could result if a spouse were entitled to receive one-half of the undistributed income of a passthrough entity owned as separate property of the other spouse on termination of the community. A member of a Louisiana LLC, partnership, or S corporation does not own an interest in any of the entity's undistributed property.[124] The value of the spouse's interest in an LLC, partnership, or S corporation is likely to be less than the spouse's share of the entity's undistributed income. Even if the spouse owns a sufficient interest in the entity to require the entity to distribute one-half of the spouse's interest in the entity's undistributed income, requiring such a distribution could compromise the entity's business, to the detriment of other members, partners, shareholders, or employees.

Some of the inequity to the spouse who does not own any interest in a passthrough entity may be reduced if the value of the interest in the entity has been increased by the uncompensated or undercompensated labor of either or both of the spouses. On termination of the community, a spouse is entitled to reimbursement for one-half of the increase in value of separate property of the other spouse where that increase is attributable to

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124. LA. REV. STAT. ANN. § 12:1329 (1994 & Supp. 2009) (LLC member); LA. CIV. CODE art. 2801 (defining the term "partnership" as a juridical person, distinct from its partners); LA. REV. STAT. ANN. § 12:41 (powers of a corporation, including the right to sue and be sued in its own name and in any manner to acquire, hold, use, and alienate or encumber property of any kind, subject to special provisions and limitations prescribed by law or the articles of incorporation). *See also* Taylor v. Taylor, 772 So. 2d 891 (La. App. 2d Cir. 2000) (mineral leases negotiated by an LLC during the existence of the community were not community property where the interest in the LLC was the separate property of one of the spouses).

the uncompensated or undercompensated labor or industry of either or both of the spouses.[125]

Nevertheless, entitlement to reimbursement for one-half of the increase in value of an interest in a passthrough entity attributable to uncompensated labor of either spouse may be of little value to the spouse who does not own an interest in the entity. No reimbursement is allowed to the extent that a spouse has been fairly compensated of his or her labor.[126] The spouse seeking reimbursement must first prove that the increase in value of the separate property was attributable to the labor that one or both spouses expended on the separate property.[127]

If the increase in value of an interest in a passthrough entity is attributable to the labor of an employee other than one of the spouses, no reimbursement is due.[128] Louisiana courts also have held that compensation for labor provided on behalf of a corporation includes not only the spouse's salary, but also amounts distributed as dividends.[129] Similarly, compensation for a spouse's labor should include distributions from a partnership or LLC.[130] Thus, to the extent that an entity has paid for a spouse's services or distributed amounts commensurate with the value of the services provided to the entity by the spouse, no reimbursement will be required on termination of the community if the interest in the entity is the separate property of the other spouse. Moreover, no

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125. Louisiana Civil Code article 2368 provides, "If the separate property of a spouse has increased in value as a result of the uncompensated labor or industry of the spouses, the other spouse is entitled to be reimbursed from the spouse whose property has increased in value one-half of the increase attributed to the common labor." LA. CIV. CODE art. 2368. The phrase, "common labor" implies that a spouse is not entitled to reimbursement unless the value of the property has increased as a result of the labor of both spouses. The comment to Louisiana Civil Code article 2368, however, clarifies that reimbursement is permitted for one-half of the increase in value attributable to the uncompensated common labor of either spouse. LA. CIV. CODE art. 2368 cmt. For cases discussing the issue of whether an increase in the value of the separate property of a spouse is attributable to the uncompensated or undercompensated labor of one or both of the spouses, see KATHERINE S. SPAHT & RICHARD D. MORENO, MATRIMONIAL REGIMES § 7.18, *in* 16 LOUISIANA CIVIL LAW TREATISE 608–23 (3d ed. 2007).

126. LA. CIV. CODE art. 2368 cmt.

127. SPAHT & MORENO, *supra* note 125, § 7.18, at 610.

128. *See, e.g.*, Brehm v. Brehm, 762 So. 2d 1259 (La. App. 5th Cir.), *writ denied*, 772 So. 2d 657 (La. 2000); Phillips v. Wagner, 470 So. 2d 262 (La. App. 5th Cir.), *writ denied*, 474 So. 2d 948 (La. 1985).

129. *See, e.g.*, Beals v. Fontenot, 111 F.2d 956 (5th Cir. 1940).

130. *Cf.* Abraham v. Abraham, 87 So. 2d 735, 738 (La. 1956) (applying similar principles in determining that the value of an interest in a partnership had been increased by the wife's management of the partnership).

reimbursement is available if the increase in the value of an interest in an entity constituting the separate property of the other spouse is attributable to factors other than the services provided by a spouse, such as the vagaries of the economy or the type of business in which the entity is engaged.[131]

If a spouse has proven that the value of separate property of the other spouse has been increased in whole or in part as a result of the uncompensated or undercompensated labor of one or both of the spouses, however, the spouse is entitled to reimbursement of one-half of the enhanced value attributable to that labor.[132] The Louisiana Supreme Court has held that a spouse seeking reimbursement for one-half of the enhanced value of separate property must prove: (1) the property is separate; (2) the property increased in value; and (3) the increase in value was attributable to the uncompensated or undercompensated labor of the other spouse.[133] Once the spouse has satisfied that burden of proof, the burden of proof shifts to the other spouse to prove that the increase in value was due to factors other than the uncompensated or undercompensated labor.[134] While the spouse seeking reimbursement does not have to prove a negative, i.e., that the value of separate property was not due to the ordinary course of things, the initial burden may nevertheless be high, especially if the spouse whose interest in the entity constitutes separate property either has not provided services on behalf of the entity or has received sufficient compensation for services provided to the entity.

B. Joint Return, Payment of the Tax with Separate Property

Another problem may arise, however, if the tax liability on the joint return is paid with the separate property of the spouse who owns the interest in the passthrough entity. As explained earlier, the tax required to be paid in connection with a joint return of a couple living under a community property regime is a community obligation. If separate property is used to satisfy a community

131. *See, e.g.*, Gill v. Gill, 895 So. 2d 807, 816 (La. App. 2d Cir. 2005) (husband who worked on wife's separate property not entitled to reimbursement of one-half of the increase in value of the property due to the general appreciation in the real estate market); Guarisco v. Guarisco, 526 So. 2d 1126, 1131 (La. App. 1st Cir.), *writ denied*, 523 So. 2d 1337 (La. 1988) (wife denied reimbursement for increase in value of stock owned as separate property primarily attributable to the vagaries of the oil industry during the period in question).

132. SPAHT & MORENO, *supra* note 125, § 7.18, at 619.

133. Salley v. Salley, 661 So. 2d 437, 438–39 (La. 1995).

134. *Id.*

obligation, the spouse whose property was so used is entitled to reimbursement of one-half of the value of the amount or value of the property on termination of the community.[135] Thus, if a spouse whose interest in a passthrough entity is separate property uses separate property to pay the tax on the spouse's share of the entity's undistributed income, and the couple files a joint income tax return, the spouse who paid the tax will be entitled to one-half of the tax payment on termination of the community.

While it may seem unlikely that a spouse would pay the tax reported on a joint return with separate property, questions may arise if a passthrough entity pays the tax on its undistributed income. Partnerships and S corporations that do not make frequent distributions often pay income tax on behalf of the partners and shareholders. If the passthrough entity actually distributes the amount of tax due on a spouse's share of the entity's income, the distribution will be community property. As explained earlier, Louisiana courts have consistently held that distributions from a partnership or S corporation are community property even if the interest in the entity is the separate property of one of the spouses unless the spouse-partner or spouse-shareholder has reserved income from the passthrough entity as his or her separate property.

Sometimes, however, an LLC, partnership, or S corporation will pay the tax liability of its members, partners, or shareholders directly to the taxing authorities.[136] If such a payment is made on behalf of a spouse whose interest in the entity is separate property, there may be a question as to whether the tax payment constitutes community property or separate property. For income tax purposes, the payment will be treated as a constructive distribution. If community property law adopts the federal tax treatment of the tax payment as a constructive distribution, then the payment is community property. As explained earlier, actual distributions of the income of an LLC, partnership, or S corporation constitute

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135. LA. CIV. CODE art. 2365 (2009).

136. *See, e.g.*, Treas. Reg. § 1.1361-1(l)(2)(ii) (2008) (concerning the issue of whether tax withheld by an S corporation and paid to a state on behalf of its shareholders will result in the S corporation having more than one class of stock and thereby terminating the corporation's subchapter S election). *See also* LA. REV. STAT. ANN. § 47:201.1 (2001 & Supp. 2009) (requiring partnerships to withhold and pay Louisiana income tax on behalf of nonresident partners unless the partners agree to submit to the state's jurisdiction to collect the tax directly from the partners); *id.* § 47:287.732 (requiring an S corporation to pay income tax on its own income unless each of the shareholders includes on his or her income tax return the shareholder's pro rata share of the S corporation's income). *Cf., e.g.*, Old Colony Trust Co. v. Comm'r, 279 U.S. 716 (1929) (corporation paid taxes owed by some of its officers directly to the Treasury Department).

community property even if the interest in the distributing entity is the separate property of one of the spouses. Because the tax liability is a community obligation when a joint return is filed, the spouse whose interest in the entity is separate property will not be entitled to reimbursement of any portion of the tax payment if the constructive distribution used to pay the tax is community property. A payment of a community obligation with community property does not give rise to a claim for reimbursement by either spouse.

On the other hand, if Louisiana courts do not treat the tax payment as a constructive distribution from the entity, then the amount of the tax payment is separate property. As explained earlier, Louisiana courts have held that the undistributed income of a partnership or S corporation (and presumably, of an LLC taxed as a partnership or S corporation) is not community property where the interest in the entity is the separate property of a spouse. If the tax payment is treated as having been paid with the entity's undistributed income, the payment should be treated as having been made with separate property. When separate property is used to pay a community obligation, the spouse whose separate property is so used is entitled to reimbursement on termination of the community of one-half of the amount or value of the property used to pay the obligation.[137] It is not certain whether Louisiana courts will treat the payment of the tax by an LLC, partnership, or S corporation on its undistributed income as a distribution for purposes of community property law.

Federal courts have defined the term "constructive distribution" as a specific economic benefit provided by a corporation to a shareholder for which the shareholder does not pay the equivalent value.[138] For example, if a corporation pays an obligation of a shareholder without any reimbursement by the shareholder to the corporation, the payment is a constructive distribution to the shareholder.[139] When a corporation sells property to a shareholder at a discount, the discount may be treated as a constructive distribution. For example, if a corporation sells an item to a shareholder for $60, but the item is worth $100, the

137. LA. CIV. CODE art. 2365.

138. *See* United States v. Smith, 418 F.2d 589, 593 (5th Cir. 1969) (defining the term "constructive dividend" as an economic benefit provided by the corporation to the shareholder "without expectation of repayment").

139. *See* BORIS I. BITTKER & JAMES S. EUSTICE, FEDERAL INCOME TAXATION OF CORPORATIONS AND SHAREHOLDERS § 8.05[8] n.222 (7th ed. 2000 & 2008 Supp.).

shareholder is treated as receiving a distribution from the corporation of $40, the amount of the discount.[140]

A transfer from a corporation to a relative of a shareholder may be treated as a constructive distribution to the shareholder followed by a gift from the shareholder to the relative.[141] Courts also have treated as constructive distributions money or property transferred by a corporation to a person other than the shareholder if the payment provides an economic benefit for the shareholder. For example, the transfer of money from one corporation to another corporation for no consideration has been treated (for tax purposes) as a distribution from the corporation to the shareholder in cases where the shareholder owned a controlling interest in both corporations.[142]

For purposes of federal income tax law, an entity other than a corporation also may make constructive distributions to its owners. In the case of passthrough entities like partnerships and S corporations, however, the classification of the entity's income as a constructive distribution often does not make a difference in the tax results to the owner. Unlike the income of a C corporation, the income of a passthrough entity is included in the owners' income when the entity earns the income and then is tax-free, regardless of whether that income is actually or constructively distributed to the owner.[143]

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140. *See* Treas. Reg. § 1.301-1(j) (property transferred by a corporation to a non-corporate shareholder is treated as a distribution in an amount equal to the difference between the amount paid for the property and its fair market value). If the discount is granted to a shareholder who also is an employee of the corporation, the amount of the discount may be treated as salary. I.R.C. § 83(a).

141. *See, e.g.*, Hagaman v. Comm'r, 958 F.2d 684 (6th Cir. 1992); Green v. United States, 460 F.2d 412 (5th Cir. 1972); Epstein v. Comm'r, 53 T.C. 459 (1970).

142. *See, e.g.*, P.R. Farms, Inc. v. Comm'r, 820 F.2d 1084 (9th Cir. 1987); Gulf Oil Corp. v. Comm'r, 87 T.C. 548 (1986).

143. The treatment of a payment by a partnership or S corporation to another person as a constructive distribution to a partner or shareholder, however, does have an impact under federal tax law. A constructive distribution from a partnership on behalf of a partner will reduce the partner's capital account and may reduce the adjusted basis of the partner's interest in the partnership (but not below zero). I.R.C. §§ 705(a)(2), 733 (2002) (adjusted basis of a partner's interest in a partnership reduced (but not below zero) by the amount of money and the adjusted basis of property distributed to the partner); Treas. Reg. § 1.704-1(b)(2)(iv)(b) (capital account reduced by the amount of money and the fair market value of property distributed to the partner). To the extent that a constructive distribution of money to a partner exceeds the adjusted basis of the partner's interest in the partnership, the partner will recognize gain. I.R.C. § 731(a)(1). A constructive distribution from an S corporation to a shareholder will reduce (but not below zero) the accumulated adjustments account (if the S corporation has an AAA) and the adjusted basis of the shareholder's stock.

A transfer from a corporation does not need to be treated as a distribution under state law to be treated as such for federal income tax purposes.[144] Thus, a transfer treated as a constructive distribution under federal income tax law will not necessarily be treated as such under state law. The Louisiana Civil Code does not necessarily treat all corporate distributions as "fruits" to be treated as community property. Article 551 of the Civil Code defines the term "fruits" as things produced by or derived from another thing without diminution of its substance.[145] Article 551 provides, in part, "Civil fruits are revenues derived from a thing by operation of law or by reason of a juridical act, such as rentals, interest, and *certain* corporate distributions."[146] The word "certain" indicates that not all corporate distributions are fruits of the corporation's stock. Article 551 and the comments thereto do not specify what types of corporate distributions constitute fruits.

For purposes of community property law, however, Louisiana courts sometimes have declined to treat as distributions transfers from corporations that are constructive distributions under federal income tax law. For example, in *McClanahan v. McClanahan*,[147] the Louisiana Fifth Circuit Court of Appeal held that transfers from one entity owned by Mr. McClanahan to another entity owned by Mr. McClanahan did not constitute community property where both entities were his separate property. Under federal income tax law, some of the transfers in *McClanahan* could have been treated as constructive distributions to Mr. McClanahan, followed by a contribution by Mr. McClanahan to the other entities.

Mr. and Mrs. McClanahan were married on January 23, 1988, and lived under a community property regime until the community terminated on March 25, 1998. During their marriage, Mr. McClanahan engaged in numerous complicated business

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I.R.C. § 1367(a)(2)(A) (2002 & Supp. 2008) (adjusted basis of an S corporation shareholder's stock reduced (but not below zero) by the amount of distributions from the corporation that were not includible in the shareholder's income under Code section 1368); *id.* § 1368(e)(1)(A) (adjustments to an S corporation's accumulated adjustments account generally made in the same manner as the adjustments to the basis of the shareholders' stock under Code section 1367).

144. *See, e.g.*, Jacques v. Comm'r, 935 F.2d 104 (6th Cir. 1991) (possible prohibition of a dividend by state law did not preclude finding of a constructive dividend); Estate of Chism v. Comm'r, 322 F.2d 956 (9th Cir. 1963) (adjudication by state court not controlling).

145. LA. CIV. CODE art. 551 (2009).

146. *Id.* (emphasis added).

147. 868 So. 2d 844 (La. App. 5th Cir. 2004).

transactions, many of which were the subject of Mrs. McClanahan's claims for distributions on termination of the community.

Mr. McClanahan conducted business through several affiliated LLCs, partnerships, and corporations, some of which existed before he married Mrs. McClanahan, and some of which came into existence during their marriage. Mrs. McClanahan sought a distribution on termination of the community of some of the assets resulting from business transactions between and among the entities.

One of the entities was McClanahan Contractors, a corporation formed before the existence of the community. Mr. McClanahan owned 85% of the stock in McClanahan Contractors. McClanahan Contractors acquired a 50% interest in Sterling Investments, LLC in exchange for $50,000 at a time when Mr. and Mrs. McClanahan were married. Mr. McClanahan testified that the $50,000 capital contribution came from funds received on the sale of other separate property owned by McClanahan Contractors. The remaining 50% interest in Sterling Investments was owned by Kelly O'Rourke, Mr. McClanahan's daughter. Sterling Investments obtained a bank loan for $169,000, which was personally guaranteed by Mr. McClanahan and Ms. O'Rourke. On May 15, 1996, Sterling Investments purchased for $211,000 a piece of residential real estate in which Ms. O'Rourke intended to reside. In September of 1997, Ms. O'Rourke assigned an oil and gas lease to Sterling Investments, valued at $25,000, as a capital contribution. Later, Sterling Investments borrowed money from another one of Mr. McClanahan's corporations and obtained a bank loan. In 1999, McClanahan Contractors contributed another $4,000 to the capital of Sterling Investments, and Sterling Investments purchased another piece of residential property for $465,000.

Mr. McClanahan testified that the purpose of Sterling Investments was to help his daughter purchase a house. Because the property was owned by the LLC, and not Ms. O'Rourke, she would not have title to the property unless she paid for it. A federal court could have held that McClanahan Contractors' $50,000 contribution to the capital of Sterling investments was a constructive distribution to Mr. McClanahan, followed by a transfer of that amount to Sterling Investments or a gift to his daughter, Ms. O'Rourke. In 1996, the only property held by Sterling Investments was a piece of residential property acquired for the benefit of Ms. O'Rourke. There did not seem to be any benefit to McClanahan Contractors in acquiring an interest in an LLC formed to acquire residential property for the daughter of its majority shareholder. While McClanahan Contractors actually held a 50% interest in Sterling Investments, it seems that the only

purpose for which Sterling Investments was formed in 1995 was to benefit Ms. O'Rourke. The facts do not indicate that Ms. O'Rourke would pay a commission or premium to the LLC for acquiring the property on her behalf.

Sometime after Sterling Investments was formed, Ms. O'Rourke drew $29,700 from the LLC and made some repairs on the property valued at $93,000. There is no indication, however of the amount that Ms. O'Rourke paid for the repairs. If she paid $93,000 for the repairs, the $63,300 net amount ($93,000 – $29,700 draw) could have been treated as a contribution to the capital of Sterling Investments. The contribution, however, would not have benefitted McClanahan Contractors unless Ms. O'Rourke was required to pay Sterling Investments the fair market value of the residential property she intended to use as her personal residence. There is no indication that she would be required to pay Sterling Investments any more than the $211,000 Sterling Investments had paid to acquire the property. If the foregoing interpretation of the facts in *McClanahan* is correct, then the $50,000 capital contribution to Sterling Investments by McClanahan Contractors served no business or investment purpose or opportunity for the corporation. In that case, the contribution could have been treated as a constructive distribution to Mr. McClanahan. Federal courts have held that payments by a corporation for the benefit of a shareholder's child constituted constructive distributions to the shareholder.[148]

It is likely that the $4,000 McClanahan Contractors contributed to Sterling Investments in 1999 would not have been treated as a constructive distribution to Mr. McClanahan because that amount was used to acquire a second residential property by the LLC. If the LLC had acquired the second property as an investment or to hold for rent, McClanahan Contractors, as a 50% member of the LLC, would have benefitted from its $4,000 contribution. On the other hand, if Sterling Investments had purchased the second residential property for the benefit of Mr. McClanahan or one of his relatives, then that contribution also could have been treated as a constructive distribution to Mr. McClanahan. The 1999 contribution, however, should not have been an issue in *McClanahan* because it was made after the termination of the community in 1998.

In *McClanahan*, the fifth circuit declined to treat the $50,000 capital contribution by McClanahan Contractors to Sterling

148. *Cf.* Nicholls N. Buse Co. v. Comm'r, 56 T.C. 1225 (1971) (dominant shareholder received constructive distribution from personal use of a corporate yacht by the shareholder's son).

Investments as a distribution to Mr. McClanahan under community property law. Mrs. McClanahan argued that because Sterling Investments was created during the existence of the community, the LLC was community property. The court held that Mr. McClanahan had no direct interest in Sterling Investments. The interests in the LLC were owned, 50% by McClanahan Contractors, a separate and distinct entity, and 50% by Ms. O'Rourke. The court noted:

> Ms. McClanahan has not argued, nor would it be supported by the record, grounds to pierce the corporate veil and we find no reason to do so. Further, no intent on the part of Mr. McClanahan to reduce the community interest has been shown. Mr. McClanahan testified that he was trying to assist his daughter's acquisition of a $211,000 house, a thing that a father with a 50 million dollar separate estate has the right to do. Thus, respecting the legal status of McClanahan Contractors as a separate and distinct legal entity, and the fact that it is not disputed that McClanahan Contractors is the separate property of Mr. McClanahan, the asset [i.e., McClanahan Contractors' interest in Sterling Investments] cannot be community property.[149]

The *McClanahan* court effectively treated the transfer of $54,000 by McClanahan Contractors to Sterling Investments as a conversion of separate property to another asset constituting separate property. Louisiana courts generally treat a capital contribution of separate property to an entity as a mere change in the form, so that the interest in the entity constitutes separate property of the transferring spouse.[150]

149. *McClanahan*, 868 So. 2d at 850.

150. *See, e.g.*, Moise v. Moise, 956 So. 2d 9 (La. App. 5th Cir. 2007) (when spouse transferred separate property to an LLC in exchange for a 100% interest in the LLC, the LLC was the separate property of the transferring spouse); Reeves v. Reeves, 607 So. 2d 626, 629–30 (La. App. 2d Cir.), *writ denied*, 608 So. 2d 1010 (La. 1992) (one-half interest in real estate acquired during the existence of the community constituted separate property of the husband where husband transferred his interest in other real estate valued at $38,340, plus $21,667 (of which only $7,030 was community property); held, entire one-half interest in the real estate constituted separate property because the value of community property transferred in the exchange was inconsequential in relation to the value of separate property transferred in the exchange); Succession of Sonnier, 208 So. 2d 562, 566 (La. App. 3d Cir. 1968) (real estate received by a spouse in exchange for real estate owned by that spouse as separate property constituted the separate property of the transferring spouse). *See also* LA. CIV. CODE art. 2341 (2009) (separate property includes property acquired by a spouse with separate things or with separate and community things when the value of

In *McKneely v. McKneely*,[151] the Louisiana First Circuit Court of Appeal also declined to treat a withdrawal from an S corporation as a distribution under community property law to the spouse whose stock in the corporation constituted his separate property. In *McKneely*, Mr. McKneely had withdrawn an aggregate amount of $110,000 from the S corporation's savings and checking accounts. Mr. McKneely effected the $110,000 withdrawal by drafting three checks. First, Mr. McKneely withdrew $50,000 from the S corporation's savings account and purchased a cashier's check payable to the S corporation. He drafted a second check from the S corporation's business checking account and endorsed it to a bank in exchange for a cashier's check payable to the order of himself. Both cashier's checks were held in the safe of Mr. McKneely's accountant. The third check, for $10,000, was drafted from the S corporation's business checking account. Mr. McKneely cashed the $10,000 check. He later returned the entire $110,000 to the S corporation.

The trial court found that all three checks were written as a protective measure for Mr. McKneely's benefit during a period of dispute between Mr. McKneely and his brother, each of whom owned one-half of the S corporation's stock. By drafting the checks and purchasing cashier's checks, Mr. McKneely kept the amounts drawn from the S corporation's savings and checking accounts under his own control and out of the hands of his brother. The trial court held that the entire $110,000 did not become community property and therefore, Mrs. McKneely was not entitled to reimbursement of one-half of the $110,000 on termination of the community.

Reversing in part, the first circuit held that the $50,000 check drawn to the order of Mr. McKneely was community property because the funds were physically withdrawn from the account of the S corporation and placed in Mr. McKneely's separate personal account before the termination of the community. Mr. McKneely had cashed both $50,000 checks by endorsing and exchanging them for cashier's checks. The $10,000 check, however, was drafted and cashed after the termination of the community. Thus, the court held that the $10,000 check was not community property. Even though the $50,000 cashier's check drafted to the order of the S corporation was issued before the termination of the community, the *McKneely* court held that the second $50,000 check was not

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community things is inconsequential in comparison with the value of the separate things used).

151. 764 So. 2d 1157 (La. App. 1st Cir. 2000).

community property because it was not distributed to Mr. McKneely personally.[152]

Mr. McKneely had exercised control over the $50,000 cashier's check drafted to the order of the S corporation by having the check placed in the accountant's safe to keep $50,000 of the corporation's income from his brother. It is likely that a federal court would have treated the check as a constructive distribution. Nevertheless, the court held that the $50,000 withdrawal was not community income because the cashier's check was not drafted to the order of Mr. McKneely.

Under *McKneely*, a check from an account of an S corporation must be drawn to the order of the shareholder in order to be treated as a distribution to the shareholder. The *McKneely* court determined that its conclusion was not inconsistent with the third circuit's conclusion in *Guilott*. Unlike the partnership in *Guilott*, which had placed its undistributed income into the partners' drawing accounts, the S corporation in *McKneely* had placed its undistributed income into the corporation's accumulated adjustments account over which the corporation had control until that income was distributed to the shareholder. The court noted that unlike a partner's drawing account, an S corporation's accumulated adjustments account is not a physically separate account for the benefit of one of the owners, but instead is an "accounting established on paper for bookkeeping purposes."[153] Accordingly, the court concluded that an S corporation shareholder's pro rata share of the corporation's undistributed income reflected in the accumulated adjustments account differs so significantly from a partner's drawing account that amounts reflected in the AAA are not community property.

Just as the *McKneely* court disregarded the characterization of the retained earnings of an S corporation under federal income tax law, the *McKneely* court also declined to treat a payment from an S corporation to a person other than a shareholder as a constructive distribution from the S corporation even if that payment might have constituted a constructive distribution under federal income tax law. As explained earlier, a constructive dividend under federal tax law generally is an economic benefit conferred on a shareholder by a corporation if the shareholder does not pay fair consideration in exchange for the benefit. Thus, the payment by a passthrough entity of tax on behalf of an owner is a constructive dividend to the owner for federal tax purposes.

152. *Id.* at 1160.
153. *Id.*

McClanahan and *McKneely*, however, indicate that the payment of income tax by a passthrough entity on its own income will not be treated as a constructive distribution and should therefore constitute a payment of the tax with separate property if the interest in the entity is separate property. In that case, on termination of the community, the spouse who does not own the interest in the entity may be required to reimburse the spouse who owns the interest in the entity one-half of the tax paid by the entity on the income reported on the spouses' joint tax return.

As explained earlier, the liability for tax on separate income is a community obligation if the spouses file a joint return. On termination of the community, a spouse who uses separate property to satisfy a community obligation is entitled to reimbursement of one-half of the amount or value of the community property used to satisfy the obligation.[154] If undistributed income of a passthrough entity is separate property and is used to pay the tax with respect to a joint income tax return, then the Louisiana community property law may require the non-owning spouse to reimburse the other spouse in an amount equal to one-half of the tax paid by the entity. It is hoped that a Louisiana court will find a way to avoid requiring reimbursement of any of the tax in such a case.

C. Separate Income Tax Returns

No cases could be found in which a court determined whether the liability for the tax on one-half of the undistributed income of a passthrough entity is a community obligation if the spouses file separate income tax returns. If a spouse who files a separate income tax return is not liable for tax on the undistributed income of a passthrough entity under federal tax law, the spouse is also exempt from liability for state tax on that income. An individual who is a Louisiana resident must include in his or her Louisiana income the individual's federal adjusted gross income.[155] An individual's federal adjusted gross income includes the individual's pro rata share of the gross income earned by a

154. LA. CIV. CODE art. 2365.

155. LA. REV. STAT. ANN. § 47:290(A) (2001) (individual income tax law intended to comport with the United States Internal Revenue Code, except as otherwise expressly provided); *id.* § 47:293(1) (2001 & Supp. 2009) (defining the term "adjusted gross income" to mean the adjusted gross income that is reportable on the individual's federal income tax return); *id.* § 47:293(9)(a) (defining the term "tax table income" for Louisiana residents as adjusted gross income increased by certain amounts and reduced by other amounts that are not relevant to the discussion in this report); *id.* § 47:295(C) (imposing the Louisiana individual income tax on an individual's Louisiana tax table income).

partnership, S corporation, or LLC that is taxed as a disregarded entity, partnership, or S corporation regardless of whether that income is distributed to him or her.[156] If the undistributed income of a passthrough entity is treated as community property for federal tax purposes, the spouse who does not own an interest in the entity is required to include one-half of that income in his or her federal adjusted gross income. For convenience, this Article will discuss only the federal income tax precedent concerning the liability of a spouse for the tax on one-half of the income earned by the other spouse during and after the existence of the community, with the reader's understanding that the Louisiana income tax treatment of that income is the same as the manner in which the income is treated for federal tax purposes.

The United States Supreme Court has held that a spouse who is a domiciliary of a community property state is personally liable for the tax on one-half of the community income even if the spouses file separate income tax returns.[157] Similarly, Louisiana courts have held that liability for tax on income earned by one of the spouses during the existence of the community is a community obligation.[158] In all of the Louisiana cases treating the tax on one of the spouse's income as a community obligation, the income on which the tax was due was community income. In contrast, federal courts sometimes have held that a spouse in a community property state is liable for tax on one-half of the other spouse's separate income.

The Supreme Court's primary rationale for requiring a non-earning spouse in a community property state to pay tax on one-half of the income earned by the other spouse is that the non-earning spouse has a present, vested, one-half ownership interest in that income under community property law.[159] As soon as community income is earned, one-half of the income belongs to the non-earning spouse. It would seem that a spouse who files a separate income tax return should not be liable for tax on one-half of the undistributed income of a passthrough entity if that income is not community property. Nevertheless, in *United States v.*

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156. I.R.C. §§ 61(a), 62(a)(1), 702(a), 1366(a) (2002 & Supp. 2008); Treas. Reg. § 301.7701-2(a) (2008).

157. *See, e.g.*, United States v. Mitchell, 403 U.S. 190 (1971); Poe v. Seaborn, 282 U.S. 101 (1930); Bender v. Pfaff, 282 U.S. 127 (1930).

158. *See, e.g.*, Messersmith v. Messersmith, 86 So. 2d 169 (La. 1956); Maginnis v. Maginnis, 580 So. 2d 709 (La. App. 1st Cir.), *cert. denied*, 588 So. 2d 111 (La. 1991); Franz v. Franz, 729 So. 2d 724 (La. App. 1st Cir. 1999); Freeman v. Freeman, 552 So. 2d 636 (La. App. 2d Cir. 1989).

159. *See, e.g.*, *Poe*, 282 U.S. 101.

Mitchell,[160] the United States Supreme Court held that a spouse domiciled in Louisiana was liable for the tax on one-half of her husband's income even though she was not entitled to and did not have an ownership interest in any of the income under Louisiana community property law.

In *Mitchell*, Mr. and Mrs. Mitchell were married and living under a community property regime in Louisiana. During their marriage, Mr. Mitchell was in charge of the couple's financial affairs and seldom consulted Mrs. Mitchell about them. She had so little knowledge of her husband's finances that she often did not know the balance in the family bank account. Even though Mr. Mitchell assured Mrs. Mitchell that he had filed their joint income tax return every year, no income tax returns had been filed for 1955 through 1959.

The Mitchells began to live separately and apart in July 1960, and they were divorced in October 1962. Mrs. Mitchell renounced the community on September 18, 1961. Under Louisiana community property law in effect at that time, a wife who renounced the community was not entitled to any distribution of community property or a property settlement upon dissolution of the marriage.[161] The effect of renunciation, however, was to exonerate the wife of "debts contracted during the marriage."[162]

When the IRS sought to collect the tax on one-half of the income earned by Mr. Mitchell from 1955 through 1959, Mrs. Mitchell argued that she was not personally liable for community obligations because she had renounced the community. The tax liability in question was a community obligation because it had been incurred during the existence of the community on income attributable to Mr. Mitchell's effort, skill, and industry during the existence of the community.[163] The United States Supreme Court disregarded the exoneration of Mrs. Mitchell under Louisiana community property law as to the liability to pay federal income tax. Accordingly, Mrs. Mitchell was liable for tax on one-half of the income Mr. Mitchell earned during the existence of the community even though she had not received any of the

160. 403 U.S. 190.

161. Former Louisiana Civil Code article 2410 provided, "Both the wife and her heirs or assigns have the privilege of being able to exonerate themselves from the debts contracted during the marriage by renouncing the community of acquets and gains." LA. CIV. CODE art. 2410 (1870), *repealed by* 1979 La. Acts No. 709, § 1.

162. *Id.*

163. *See* LA. CIV. CODE art. 2338 (2009) (defining the term "community property" to include property acquired during the existence of the legal regime through the effort, skill, or industry of either spouse).

community property remaining after the divorce and did not have an ownership interest in any of the community income Mr. Mitchell earned while she was married to him.

Similarly, in *Brent v. Commissioner*,[164] the United States Fifth Circuit Court of Appeals disregarded Louisiana community property law to hold a wife liable for the tax on one-half of the income her husband earned between the date that she filed for divorce and the date the divorce was final. Mrs. Brent had filed a petition for divorce on March 26, 1970. The divorce became final on December 9, 1971. Under Louisiana community property law, a judgment for divorce terminates the community property regime retroactively to the date that the petition was filed.[165] Thus, if a judgment of divorce is granted, the income of each spouse earned after the petition for divorce was filed and during the pendency of the suit is the separate property of the spouse who earned the income. The *Brent* court held that Mrs. Brent was liable for the tax on one-half of the income earned by Mr. Brent during the pendency of the divorce in 1970 even though that income was Mr. Brent's separate property.[166]

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164. 630 F.2d 356 (5th Cir. 1980).

165. LA. CIV. CODE art. 150 (1870), *repealed by* 1990 La. Acts No. 1009, § 9. During the year in issue in *Brent*, former Louisiana Civil Code article 155 also provided for retroactive termination of the community upon the date the divorce was final. *Id.*

166. In dicta, the *Brent* court opined that Mrs. Brent might have been entitled to relief under Internal Revenue Code section 1341 for the tax she paid on one-half of the amount of income her husband earned after the termination of the community. 630 F.2d at 359–60 n.8. Under the theory suggested by the *Brent* court, section 1341 would allow the non-earning spouse to claim a credit against tax for the year in which the divorce was final in an amount equal to the tax paid on her husband's income earned after the retroactive termination of the community. I.R.C. § 1341(a)(5) (2002). Alternatively, section 1341 would allow Mrs. Brent to deduct the amount of the tax she paid on that income in the year in which the divorce was final if the deduction, rather than the tax credit, would produce better tax results to Mrs. Brent. *Id.* § 1341(a)(4). Relief is available under section 1341 if: (1) an item was included in income in a prior year because it appeared that the taxpayer had an unrestricted right to the item; (2) a deduction is allowable for the taxable year because it was established after the close of such prior year that the taxpayer did not have an unrestricted right to the item or to a portion of the item; and (3) the amount of the deduction exceeds $3,000. *Id.* § 1341(a)(1)(3). No cases could be found in which a court allowed a spouse to claim relief under section 1341 for tax paid on amounts of community income on which the spouse paid tax in an earlier year. It is not certain that the IRS would allow a spouse like Mrs. Brent to claim section 1341 relief for the tax she paid on one-half of the income her husband earned after the petition for divorce was filed and before the year in which the divorce was final. The IRS has been reluctant to allow taxpayers to claim relief under section 1341 where events happening in a year following the year in which the tax was paid

Both *Mitchell* and *Brent*, however, can be distinguished from a case in which the income in question is the separate property of one of the spouses. In *Mitchell* and *Brent*, the income in question was community property at the time it was earned. In contrast, courts have held that the undistributed income of a passthrough entity is not community income if one of the spouses owns an interest in the entity as separate property. In determining whether a spouse is liable for the tax on one-half of the undistributed income of a passthrough entity, when the interest in the entity is the separate property of the other spouse, a court should consider the fact that the undistributed income was not community income at the time it was earned. In *Mitchell*, the Supreme Court found it significant that Mrs. Mitchell's power to renounce the community was exercised long after her ownership in the community income had been fixed under state law.[167] While Mrs. Mitchell had the right to renounce the community income, that income was hers to renounce or accept.

In *Brent*, the Fifth Circuit justified its imposition of the tax by relying on the annual accounting principle of income tax law. Under the annual accounting principle, a taxpayer must report income using the facts that are available in which the income is earned even though it might be determined that the taxpayer is required to return that income in a later year.[168] At the time a petition for divorce is filed in Louisiana, there is no certainty that the divorce will be finalized. Couples may reconcile before the case is decided or settled. If an action for divorce fails for any reason, the community does not terminate.[169] The Fifth Circuit provided the following rationale for imposing liability on Mrs. Brent for the tax on income that was not hers:

> There is no practical way for the tax collector to know that a married person who files a tax return is party to a

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establish that the taxpayer is not entitled to the item of income. *See, e.g.*, Rev. Rul. 68-153, 1968-1 C.B. 371.

167. United States v. Mitchell, 403 U.S. 190, 204 (1971).

168. N. Am. Oil Consol. v. Burnet, 286 U.S. 417 (1932).

169. Indeed, the second sentence of Louisiana Civil Code article 159 provides, "The retroactive termination of the community shall be without prejudice to rights of third parties validly acquired in the interim between the filing of the petition and the recordation of the judgment." LA. CIV. CODE art. 159 (2009). Presumably, the government's claim for the tax liability incurred on one-half of the community income is a right of a third party "validly acquired" during the pendency of the suit for divorce. The second sentence of article 159 was not enacted until after 1970, the year in issue in *Brent*. Nevertheless, the *Brent* court imposed liability for the tax on other grounds.

> separation or divorce proceeding. Even if that fact were known, the levy of an assessment against the husband would be improper if the suit were dismissed or terminated without a decree favorable to the plaintiff.[170]

Mitchell and *Brent* could be treated as cases creating rules of administrative convenience for purposes of determining whether a spouse in a community property state is liable for the tax on one-half of the other spouse's income even if that income is not community property. In *Mitchell*, the court refused to treat community income as separate property for a year in which it will not be known whether the spouse who was otherwise liable for the tax on one-half of the community would later renounce the community. Similarly, the Fifth Circuit refused to impose upon the tax collector the burden of determining whether a married spouse was a party to a separation or divorce proceeding and whether the divorce decree became final in a later year.

As explained earlier, the Louisiana Supreme Court has not ruled on the issue of whether the undistributed income of a passthrough entity is community property where the interest in the entity is the separate property of one of the spouses. The Louisiana Courts of Appeal have reached different conclusions in different cases. It is not certain whether a federal court would impose on the IRS the burden of analyzing different Louisiana appellate court opinions to determine whether the undistributed income of a passthrough entity the interest in separate property or community property in a case where the interest in the entity is the separate property of one of the spouses.

Nevertheless, the Fifth Circuit has interpreted *Mitchell* to mean that federal courts may disregard community property law to hold a spouse liable for the tax on one-half of the other spouse's income. In *Bagur v. Commissioner*,[171] the Fifth Circuit disregarded Louisiana community property law in holding two wives liable for the tax on one-half of their husbands' income, even though the wives had no access to the income and, in the case of Mrs. Bagur, had no idea how much her husband had earned. The old head-and-master laws under former Louisiana community property law were in effect during the years in issue in *Bagur*. Under the then-effective community property law, the husband was the head and master of the partnership or community of gains.[172] As such, the husband administered the community, disposed of its revenues

170. *Brent*, 630 F.2d at 360.
171. 603 F.2d 491 (5th Cir. 1979).
172. LA. CIV. CODE art. 2404 (1870), *repealed by* 1979 La. Acts No. 709, § 1.

produced by the community property, and was entitled to alienate community property or the revenue therefrom without the consent of the wife.[173] Under Louisiana community property law at the time, the husband was responsible for community debts; the wife was not personally liable for community obligations out of her separate property.[174] Indeed, a wife was not even a proper party defendant in an action to collect a community obligation.[175]

The tax liabilities in *Bagur* were community obligations, incurred by the taxpayers' husbands in connection with administering the community. The Fifth Circuit observed that if the debts in *Bagur* were owed to a state creditor, rather than to the United States, the taxpayers would have prevailed.[176] Nevertheless, the *Bagur* court held the wives personally liable from their separate property for the tax on one-half of their husbands' earnings citing *Mitchell* as authority for disregarding community property law.[177] Thus, it is not certain whether a federal court will follow community property law in determining whether a spouse in a community property state is liable for the tax on the separate income of the other spouse.

As explained earlier, the Louisiana Civil Code provides that the fruits of separate property are community property unless the spouse reserves the fruits from that property as separate property in writing.[178] The Louisiana appellate courts seem to agree that the income of a passthrough entity is separate property if the interest in the entity is separate property unless the share of the entity's income is made available to a spouse who owns the interest in the entity so that the spouse may withdraw the income at any time and for any purpose. While the IRS should treat such income in accordance with the decided cases, a federal court might hold that it would impose too heavy a burden on the IRS to determine whether, in fact, the undistributed income of such a passthrough entity is separate property under Louisiana community property law. During the existence of the community, the spouse who owns an interest in a passthrough entity as separate property is required to include the spouse's share of the entity's undistributed income on that spouse's income tax return. As in *Brent*, a federal court could decide that the IRS is not required to determine whether and

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173. *Id.*

174. *Bagur*, 603 F.2d at 500 (citing Poindexter v. La. & Ark. Ry. Co., 128 So. 297 (La. 1930)); Smith v. Viser, 117 So. 2d 673 (La. App. 2d Cir. 1960); Rouchon v. Rocambra, 84 So. 2d 873 (La. App. Orl. 1956).

175. LA. CODE CIV. PROC. arts. 2410, 2411 (repealed).

176. *Bagur*, 603 F.2d at 500.

177. *Id.*

178. LA. CIV. CODE art. 2339 (2009).

to what extent the undistributed income of a passthrough entity allocated to a married taxpayer, who resides in a community property state, is separate or community income, especially where community property law provides that income from separate property is community property.

Moreover, the Louisiana Supreme Court has not decided whether the undistributed income of a passthrough entity is community property if the interest in the entity is separate property. Admittedly, the Louisiana Supreme Court held in *Reynolds v. Reynolds*[179] that the undistributed income of a trust is not community property where the beneficiary held the interest in the trust as separate property, but that the income distributed from the trust was community property. Unlike the undistributed income of a passthrough entity, however, the undistributed income of the trust in *Reynolds*, like the undistributed income of a C corporation, was not includible in the beneficiary's income for tax purposes.[180] Under federal tax law, the current income of a trust, like the trust in *Reynolds*, is generally included in the beneficiary's income when it is distributed to that beneficiary.[181]

The treatment of the undistributed income in *Reynolds* was consistent with federal income tax law. Thus, the IRS did not have to determine whether the trust's undistributed income was community or separate income. When the trust's income actually was distributed to the beneficiary in *Reynolds*, the distributed income constituted community property. Thus, each spouse was personally liable for the tax on one-half of the income distributed to the beneficiary. The treatment of the trust income in *Reynolds* does not impose any administrative burden on the IRS. In contrast, treating the undistributed income of a passthrough entity as separate property for federal tax purposes would require the IRS to utilize significant resources in determining whether the interest in a passthrough entity is separate property, whether the spouse who owns the interest in the entity had reserved the fruits as separate

179. 388 So. 2d 1135 (La. 1980).

180. The income in the trust in *Reynolds* could be accumulated or distributed to the beneficiary at the discretion of the trustee. Such income, when not distributed, is included in the income of the trust, and not the beneficiary. I.R.C. § 641(a)(4), (b) (2002 & Supp. 2008).

181. Like S corporations, trusts are treated as passthrough entities because the income of a trust generally is subject to tax only once. A trust generally pays tax on its own income. *Id.* § 641. However, the trust may deduct that income if it makes certain distributions to the beneficiary. *Id.* §§ 651, 661. The beneficiary then includes the distributed income on the beneficiary's income tax return for the year in which the income is distributed to him or her. *Id.* §§ 652, 662.

property, and whether and to what extent the entity's income had been distributed to the spouse.

Furthermore, it is not certain whether a federal court will pay strict attention to a decision of a state court for purposes of determining whether a spouse in a community property state is liable for the tax on the income of the other spouse. In *Bagur*,[182] the Fifth Circuit indicated that statutory law is more important than case law in determining whether income earned by one spouse is community or separate property. In *Bagur*, the court disregarded the Louisiana Supreme Court's characterization of a wife's interest in community property as "imperfect ownership" for purposes of determining whether the taxpayer-wife had a sufficient ownership interest in her husband's income to require her to use her separate property to pay the tax on one-half of his income.[183]

The United States Supreme Court's rationale for requiring a spouse who files a separate return to pay tax on one-half of the income earned by the other spouse during the existence of the community is that the spouse has a present, vested income in that community income.[184] If a spouse's ownership in income earned during the existence of the community is not a perfect ownership interest, the spouse should not be liable for tax on one-half of that income.

The taxpayers in *Bagur* argued that they should not be liable for the tax on any income earned by their husbands during the existence of the community because the Louisiana Supreme Court recently had held that a wife's interest in community property was an "imperfect interest."[185] *Bagur* was decided under the old head-and-master provisions of the Louisiana Civil Code, which allowed the husband to control the disposition of community property without the consent of the wife.[186] Because the wife lacked control over the disposition of community assets, the Louisiana Supreme Court concluded in *Creech v. Capitol Mack, Inc.*[187] that the wife lacked perfect ownership of community property.

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182. 603 F.2d 491.

183. *Id.* at 497–99.

184. *See, e.g.*, United States v. Mitchell, 403 U.S. 1763 (1971); Bender v. Pfaff, 282 U.S. 127 (1930).

185. *Bagur*, 603 F.2d at 497 (relying on Creech v. Capitol Mack, Inc., 287 So. 2d 497 (La. 1973)), *appeal after remand*, 276 So. 2d 387 (La. App. 1st Cir.), *writ denied*, 299 So. 2d 802 (La. 1974).

186. LA. CIV. CODE art. 2404 (1870), *repealed by* 1979 La. Acts No. 709, § 1 (as head and master of the community, husband is permitted to alienate community property by onerous title or gratuitous title, without the consent of the wife).

187. 287 So. 2d at 509.

In *Bender v. Pfaff*,[188] the United States Supreme Court had held that a wife in Louisiana was liable for the tax on one-half of the community income earned by her husband because the wife had a present, vested one-half ownership interest in that income. In reaching its conclusion, the Supreme Court relied on *Phillips v. Phillips*,[189] in which the Louisiana Supreme Court held that the wife owns one-half of the community property as soon as the property is acquired and that the wife's interest in community property is not that of an expectant heir.[190]

The taxpayers in *Bagur* argued that *Creech*, decided almost fifty years after *Phillips*, had changed the Louisiana law with respect to the wife's rights under Louisiana community property law. While the *Creech* court held that the wife's interest in community property was greater than a mere expectancy or a mere right to inherit, the court nevertheless indicated that her interest was somewhat less vested than the *Phillips* court had indicated.[191]

In cases that did not concern the ownership of community income, the United States Supreme Court consistently has held that the person who earns income and has the power to dispose of that income is the person who is liable for the tax on that income.[192]

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188. 282 U.S. 127 (1930).

189. 107 So. 2d 584 (1926).

190. *Id.* at 588.

191. *Creech*, 287 So. 2d at 508.

192. *See, e.g.*, Helvering v. Clifford, 309 U.S. 331 (1940) (income from property transferred to a trust is taxable to the transferor where the trust corpus reverts back to the transferor on termination of the trust and the transferor retains the power to determine whether and when the beneficiary will receive distributions of that income, to vote the shares of stock transferred to the trust, to dispose of trust income, to invest trust income, and to hold trust property in the names of persons other than the income beneficiary of the trust, including in his own name); Lucas v. Earl, 281 U.S. 111 (1930) (compensation for personal services included in the income of the person who performed the services); Corliss v. Bowers, 281 U.S. 376 (1930) (income from property transferred to a trust taxable to the transferor where the transferor retained the power to revoke the trust and reacquire the trust corpus and income for himself). In *Helvering*, the United States Supreme Court stated:

> The dominant purpose of the revenue laws is the taxation of income to those who earn or otherwise create the right to receive it and enjoy the benefit of it when paid . . . . The tax laid by the 1934 Revenue Act upon income "derived from . . . wages, or compensation for personal service, of whatever kind and in whatever form paid . . .; also from interest . . ." therefore cannot fairly be interpreted as not applying to income derived from interest or compensation when he who is entitled to receive it makes use of his power to dispose of it in procuring satisfactions which he would otherwise procure only by use of the money when received.

Under those opinions, the wife's ownership of community income in Louisiana should have been sufficiently imperfect to absolve her of liability for tax on any of the community income earned by the husband.

In holding that the taxpayers were personally liable for the tax, the *Bagur* court disregarded the *Creech* opinion. In *Bagur*, the Fifth Circuit indicated that statutory law was more significant than case law in determining the nature of the wife's interest in community property.

During the years in issue in *Bagur*, the Louisiana Civil Code recited that a marriage in Louisiana "superinduces a partnership or community" of gains.[193] The Fifth Circuit concluded that the wife's ownership interest was established because the Civil Code provided that a husband and wife may dispose of his or her one-half of the community by will and each was powerless to affect the other's half.[194] Furthermore, the Fifth Circuit relied on the provisions of the Louisiana Civil Code concerning the wife's right to one-half of the community assets upon the dissolution of the community[195] and the her liability for her one-half share of the debts contracted during the marriage.[196]

The Louisiana Civil Code is silent as to whether the undistributed income of a passthrough entity, the interest in which is the separate property of one of the spouses, constitutes community property where the spouse has not made a special declaration that the fruits of separate property are separate property. As explained earlier, the Louisiana Civil Code treats the fruits of separate property (which may or may not include income created by the efforts of one of the spouses) as community property. Because the undistributed income of a passthrough entity is subject to tax, a federal court could treat such income as "fruits" and therefore community income, regardless of whether the interest in the entity is community or separate property.

In *United States v. Mitchell*, the United States Supreme Court seemed to have applied partnership income tax principles in holding a spouse personally liable for tax on her share of the community income. Former provisions of the Louisiana Civil Code

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311 U.S. at 119 (1940). Subparts (1) and (4) to section 61(a) impose a tax on the same income described in the quoted passage. I.R.C. § 61 (2002 & Supp. 2008). Thus, *Horst* continues to serve as controlling precedent.

193. LA. CIV. CODE art. 2399 (1870), *repealed by* 1979 La. Acts No. 709, § 1.

194. LA. CIV. CODE arts. 915, 916 (1870), *repealed by* 1981 La. Acts No. 919, § 1.

195. LA. CIV. CODE art. 2406 (1870), *repealed by* 1979 La. Acts No. 709, § 1.

196. LA. CIV. CODE art. 2408 (1870), *repealed by* 1979 La. Acts No. 709, § 1.

referred to the community as a "partnership" or a "partnership of gains."[197] Even though the community was not considered a commercial partnership at that time, the Supreme Court relied heavily on the view that the wife was treated like a limited partner under Louisiana community property law.[198] Similarly, a court could hold that each spouse in a community property state is taxed like a partner on all of the aggregate income of both spouses.

Like a wife under the old head-and-master provisions of community property law, a limited partner may not participate in the management of the business.[199] As explained earlier, a partner is taxed on his or her share of partnership income when the income is earned, regardless of whether the income is distributed to the partner.[200] Similarly, a federal court might apply federal tax law, rather than community property law, in determining that each spouse is personally liable for the tax on one-half the undistributed income of a passthrough entity, regardless of whether the interest in the entity is community or separate property.

In Revenue Ruling 73-391,[201] however, the IRS ruled that the undistributed income of a partnership consisted in part of community property and in part of separate property for purposes of federal income taxation. In the revenue ruling, a husband and wife residing in California became members of a partnership in that state. The husband contributed both community and separate property to the partnership in exchange for his partnership interest. The wife contributed only community property to the partnership. The husband received adequate compensation from the partnership for services he provided to the partnership. The spouses had no agreement in effect to change any of the community property they had contributed to the partnership to separate property or to change any of the separate property the husband had contributed to community property.

Under California community property law in effect when Revenue Ruling 73-391 was issued, community property consisted

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197. LA. CIV. CODE arts. 2399, 2402–2404, 2406, 2409–2410, 2415, 2418–2419, 2423, 2430 (1870), *repealed by* 1979 La. Acts No. 709, § 1 (referring to the community as a "partnership," a "partnership of gains," or a "community of acquets or gains). The current provisions of the Louisiana Civil Code do not refer to the community as a partnership.

198. United States v. Mitchell, 403 U.S. 190, 201 (1971) (citing Succession of Wiener, 14 So. 2d 475, 481–82 (La. 1943)).

199. A limited partner who participates in the control of the partnership's business may be liable as a general partner for partnership debts and obligations. LA. CIV. CODE art. 2844(A) (2009).

200. I.R.C. § 702(a) (2002 & Supp. 2008).

201. 1973-2 C.B. 12.

of property acquired by the husband and wife, when not acquired as the separate property of either.[202] The IRS ruled that the partnership profits attributable to the community property contributed to the partnership, and amounts paid for the husband's services constituted community property. Accordingly, the IRS also ruled that the wife's distributive share of partnership income consisted of one-half of the partnership income derived from the community property she and her husband invested in the partnership and one-half of the amount paid by the partnership for her husband's services. The IRS also concluded that the husband's distributive share of the partnership's income consisted of one-half of the income attributable to the community property he and his wife had invested in the partnership, one-half of the compensation he received for his services to the partnership, and all of the partnership income attributable to the separate property he had contributed to the partnership.

Revenue Ruling 73-391 offers no guidance for taxpayers in Louisiana. Unlike Louisiana community property law, it seems that income from separate property was treated as separate property under California law when the revenue ruling was issued. The IRS did not have to determine whether the partnership income in Revenue Ruling 73-391 had been distributed. If the partnership income in Revenue Ruling 73-391 had been distributed, the portion of the distribution still would have been separate property. In contrast, the Louisiana courts have been consistent in holding that distributions to a spouse from a partnership or corporation are community property under Louisiana law, even if the interest in the partnership or corporation is separate property.

Revenue Ruling 73-391, however, indicates that it might not be too heavy a burden for the IRS to determine whether a passthrough entity's income is separate or community property. In the revenue ruling, the IRS carefully considered the facts and the law in determining what portion of the partnership's income constituted community property and what portion of that income constituted separate property. Nevertheless, the Louisiana Civil Code is silent as to the characterization of a passthrough entity's undistributed income as separate or community property when an interest in the entity is the separate property of one of the spouses, and the Louisiana Supreme Court has not decided the issue. Moreover, no cases could be found outside the Louisiana First and Third Circuit Courts of Appeal in which appellate courts have decided the issue. Thus, it is not certain whether the IRS or a court will follow the

202. CAL. CIV. CODE § 687 (West 2007) (cited in Rev. Rul. 73-391, 1973-2 C.B. 12).

first and third circuit's opinions in characterizing such income as community or separate property.

D. Should Federal Courts Treat the Undistributed Income of a Passthrough Entity Owned as Separate Property of a Spouse in Louisiana as Community Property or Separate Property?

Because of the disparate treatment of the undistributed income of a passthrough entity under Louisiana community property law and federal income tax law, the IRS and the Louisiana Department of Revenue have no real guidance for determining whether such an entity's undistributed income should be treated as community property for tax purposes. The Louisiana Supreme Court has not decided the issue. On the termination of the community, a spouse is entitled to receive one-half of the community property.[203] Thus, on termination of the community, the spouse who has no ownership interest in the undistributed income of a passthrough entity nevertheless may be liable for the tax on one-half of that income under federal income tax law. If the tax liability on the undistributed income of a passthrough entity is a community obligation, the non-owning spouse will not be entitled to receive any reimbursement for taxes paid with community property on that income. When spouses who are domiciled in Louisiana file a joint income tax return, the tax liability on the spouses' aggregate income is a community obligation because each spouse's liability for the tax is joint and several or joint and *in solido*.[204] If there is an understatement or underpayment of the tax with respect to the joint return, the IRS or the Louisiana Department of Revenue may seize community property held by either spouse to satisfy the deficiency, interest, or penalties incurred in connection with the joint return.[205] Thus, it is not necessary to determine the character of a

203. Upon the termination of the community, the spouses own community property as co-owners. LA. CIV. CODE art. 2369.1 (2009). Nevertheless, either spouse may request a partition of the community property at any time after the community terminates. LA. CIV. CODE art. 807.

204. LA. CIV. CODE art. 2360 (defining the term "community obligation" as an obligation incurred by a spouse during the existence of the community property regime for the common interest of the spouses).

205. *Cf.* Ordlock v. Comm'r, 126 T.C. 47, 59–60 (2006), *aff'd*, 533 F.3d 1136 (9th Cir. 2008) (spouse domiciled in a community property state who qualified for innocent spouse relief from joint and several liability for the tax in connection with a joint return was not entitled to refund of tax authorized by the statute because the tax on the community income was a community obligation paid with community property; IRS should not be placed at a disadvantage compared to any other creditor concerning community obligations).

passthrough entity's undistributed income when the spouses file a joint return.

The liability for the tax on a joint return applies both to community income and to separate income, regardless of the source of the income. Indeed, each spouse who is domiciled in a non-community property state and files a joint return is jointly and severally liable for the tax on the joint return, regardless of the fact that the income may be entirely attributable to the other spouse. Any inequity in imposing liability on a spouse for the tax attributable to income of the other spouse is not caused by state property law, but instead is the result of federal and state tax law.

The issue concerning the characterization of a passthrough entity's income as community or separate property is relevant, however, when the spouses file separate income tax returns. In such cases, the disparate treatment of the income of and distributions from partnerships and S corporations (and presumably, LLCs taxed as partnerships, S corporations, or disregarded entities) under community property law and federal income tax law can create confusion and inequity.

The income tax liability of a taxpayer is generally determined by reference to the state law property rights to that income. The undistributed income of a passthrough entity is subject to tax when it is earned. If the income was separate property when it was earned, the same income will become community property when it is distributed. Nevertheless, when the undistributed income of a passthrough entity is distributed, the distribution is tax free. The annual accounting principle would require federal courts to treat the undistributed income of a passthrough entity as separate or community property in accordance with the way the income is classified under state community property law at the time the income is earned.

Louisiana appellate courts have consistently held that the undistributed income of a partnership or S corporation is generally the separate property of the spouse who owns the interest in the entity as separate property, except where that income has been made available to the spouse so that he or she may withdraw it at any time and for any purpose. The IRS should treat such income in the same manner in which the appellate courts treat it unless and until the Louisiana Supreme Court decides otherwise. The Louisiana courts of appeal have treated a spouse's share of the undistributed income of a partnership or S corporation consistently with the statutory law. As explained earlier, such treatment seems appropriate in determining whether the income of any passthrough entity is separate or community property, except in cases where a passthrough entity's undistributed income may be counted twice in

determining the amount of community property to be distributed to a spouse or the spouse's heirs on termination of the community.

The Louisiana Civil Code treats the natural and civil fruits of separate property as community property unless the spouse who owns the separate property reserves such fruits as separate property in a written document and provides the document to the other spouse before it is filed.[206] For this purpose, article 551 of the Louisiana Civil Code defines the term "civil fruits" as revenues derived from a thing by operation of law or by reason of a juridical act, such as rentals, interest, and certain corporate distributions. Income that is earned, but not distributed, by a C corporation is not a fruit of the corporate stock for purposes of community property law. Because Louisiana partnerships and LLCs, like corporations, are separate entities from their owners the undistributed income of a Louisiana partnership, S corporation, or LLC generally should not be treated as community property.

Moreover, the IRS and the Department of Revenue should be familiar with the manner in which the third circuit has treated income allocated to a partner's drawing account or made available to the partner for withdrawal at any time. Treating such income as constructively distributed to the partner is similar to the constructive receipt doctrine under federal tax law. In general, gains, profits, and income are included in a taxpayer's income in the taxable year in which that income is actually or constructively received by the taxpayer.[207] Income is constructively received when it is credited to the taxpayer's account, set apart for the taxpayer, or otherwise made available so that the taxpayer may draw on it at any time.[208] Likewise, the Louisiana Third Circuit Court of Appeal has held that a partner's share of partnership income is treated as having been constructively distributed to the partner and, therefore, constitutes community property where the partner's interest in the partnership is separate property if the partner may withdraw it at any time. The third circuit's rule should also apply to undistributed income of an S corporation or LLC. The IRS and the Louisiana Department of Revenue should not have difficulty determining whether a passthrough entity's income has been constructively distributed to the owner and therefore constitutes community property.

Because the Louisiana Supreme Court has not decided whether a spouse's share of the undistributed income of a passthrough entity owned as separate property is community or separate

206. LA. CIV. CODE. art. 2339 (2009).
207. Treas. Reg. § 1.451-1(a) (2008).
208. *Id.* § 1.451-2(a).

property, there is no way to treat such income as either community or separate property for tax purposes without creating inequity to one of the spouses. On the one hand, it would be unfair to the spouse who owned an interest in a passthrough entity as separate property to treat the spouse's share of the undistributed income as separate property for federal tax purposes even though the Louisiana Supreme Court might decide later that the undistributed income is community property. On the other hand, it also would be unfair to the spouse who does not own an interest in the entity to treat the entity's undistributed income as community property even though the Louisiana Supreme Court might later hold that the income is the separate property of the other spouse. Because one of the spouses will lose, regardless of whether the Louisiana Supreme Court treats the income as separate or community property, the courts should follow the treatment of that income as decided by the Louisiana appellate courts.

Of course, Congress could alleviate any potential problem, as well as numerous other problems attributable to the manner in which community income is taxed, by disregarding community property law for purposes of determining the tax liability of each of the spouses who are domiciled in a community property state. A discussion of other problems that may arise because Congress imposes liability on each spouse in a community property state for the tax on one-half of the community income is beyond the scope of this Article. Those problems have been discussed elsewhere.[209] In the meantime, spouses in Louisiana will have to wait until further guidance is offered concerning the treatment of the undistributed income of a passthrough entity as community property or separate property for both community property law purposes and income tax purposes.

III. CONCLUSION

The Louisiana courts that have decided the issue have held that the undistributed income of a passthrough entity owned as separate property by a spouse domiciled in Louisiana is separate property unless that income is made available to the spouse so that he or she may withdraw it at any time and for any purpose. While the Louisiana Supreme Court has not yet ruled on the characterization of such income as community or separate property, tax courts

209. *See, e.g.*, Susan Kalinka, *Federal Taxation of Community Income: A Simpler and More Equitable Approach*, 1990 WIS. L. REV. 633 (1990); John A. Miller, *Federal Income Taxation and Community Property Law: The Case for Divorce*, 44 SW. L.J. 1087 (1990).

should treat that income in the same manner in which the appellate courts treat the income. Treating a passthrough entity's income as separate property, except in cases where the income has been set aside for the spouse to withdraw at any time, would cause less aggregate harm to the spouses and to the other owners of the interests in, as well as the employees of, the passthrough entity on termination of the community.

Of course, if the Louisiana Supreme Court decides that the undistributed income of a passthrough entity owned as separate property is separate property, the IRS and the Louisiana Department of Revenue would follow the court's opinion.[210] It is hoped that the Louisiana Supreme Court will grant a writ to decide the issue.

On the other hand, the Louisiana Legislature could amend the Civil Code to provide that all income from separate property is separate property. The IRS follows state property law in determining whether a spouse in a community property state is liable for the tax on income from property that constitutes the separate property of the other spouse.[211] Of the nine community property states, five treat income from separate property as separate property.[212] The other four community property states, including Louisiana, treat income from separate property as community property.[213] Indeed, the Louisiana Legislature has indicated that it does not have any policy reason for treating income from separate property as community property. Article 2339 of the Louisiana Civil Code allows a spouse who owns separate property to elect to treat the income from separate property as separate property.[214] Nevertheless, commentators disagree as to whether income from separate property should be separate under community property law.[215] A discussion

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210. *See, e.g.*, Comm'r v. Gray, 159 F.2d 834 (5th Cir. 1947) (setting forth a careful analysis of Louisiana Supreme Court cases to determine whether royalties received on a mineral lease were community or separate income where the mineral rights were the separate property of one of the spouses).

211. Rev. Rul. 73-391, 1973-2 C.B. 12.

212. *See, e.g.*, ARIZ. REV. STAT. ANN. § 25-213 (2007 & Supp. 2008); CAL. CIV. CODE § 770 (West 2007) (repealed); NEV. REV. STAT. § 123.130 (2007); N.M. STAT. ANN. § 40-3-8 (West 2003 & Supp. 2008); WASH. REV. CODE § 26.16.010 (2005 & Supp. 2009).

213. IDAHO CODE ANN. § 32-906 (2006 & Supp. 2008); LA. CIV. CODE art. 2339 (2009); TEX. FAM. CODE ANN. §§ 3.001, 3.002 (Vernon 2006 & Supp. 2008); WIS. STAT. ANN. § 766.31 (West 2001 & Supp. 2008).

214. *See also* WIS. STAT. ANN. § 766.59.

215. *See, e.g.*, Thomas R. Andrews, *Income from Separate Property: Towards a Theoretical Foundation*, 56 LAW & CONTEMP. PROBS. 171 (1993) (arguing that income from separate property should be treated as community

concerning the propriety of treating income from separate property as separate or community under state law is beyond the scope of this Article.

The best solution to the problem, however, resides in the hands of Congress. Section 1 of the Internal Revenue Code imposes a tax on the taxable income of individuals. The United States Supreme Court has interpreted this language to mean that each spouse in a community property state is liable for the tax on one-half of the community income because each spouse has an undivided, present, vested interest in one-half of that income.[216] While the Supreme Court could change its mind, the Court has indicated that it has no intention to do so.[217]

Congress could, however, amend section 1 of the Internal Revenue Code to provide that in determining the income of an individual, community property law shall not be taken into account. Such a provision would not be unprecedented. The Internal Revenue Code contains several provisions stating that the statute applies without regard to community property law.[218] If Congress amended section 1 to disregard community property law, it would significantly reduce compliance costs and administrative burdens incurred as taxpayers and the IRS determine the portion of the aggregate income of a married couple that constitutes the separate property of each of the spouses who are domiciled in a community property state.

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property); Leslie Joan Harris, *"Just and Proper Division": Property Distributions at Divorce in Oregon*, 78 OR. L. REV. 735, 761 (1999) (income from separate property represents the investment decisions of the owner and should be treated as separate property under marital property law); Margaret Berger Strickland, Comment, *What's Mine is Mine: Reserving the Fruits of Separate Property Without Notice to the Unsuspecting Spouse*, 51 LOY. L. REV 989, 1008 (2005) (indicating a preference for treating income from separate property as community property).

216. Poe v. Seaborn, 282 U.S. 101 (1930).
217. *See, e.g.*, United States v. Mitchell, 403 U.S. 190 (1971).
218. *See, e.g.*, I.R.C. §§ 1402(a)(5)(A)–(B), 6015(a) (2002 & Supp. 2008).