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THE recent enactment of community property law in Michigan and other states has created new problems for lawyers. Not the least of these is the question of the income tax consequences which flow from the existence of a community between the spouses. Nor is this the type of problem which can be shrugged off by reference to tax counsel. Local community property law and federal income tax law are too closely enmeshed to be intelligently divided. No authority is needed for the statement that recently enacted community property laws are a product of high surtaxes. At the same time, these laws of necessity have far-reaching effects upon the status of spouses and their property rights. Whenever there is a community property problem, there will probably be a federal tax problem. The basic legal propositions which underlie the impact of tax upon members of a community should be of interest to all lawyers.

As everyone knows, the community, as a potent factor under the income tax laws, derives its sanction from the case of *Poe v. Seaborn.*[1] The case has many unusual aspects. But its doctrine has been implicitly reaffirmed in *Commissioner v. Harmon*[2] and, presumably, *Poe v. Seaborn* will remain the law until such time as Congress makes a change by appropriate legislation.

The case itself arose under the community property laws of the state of Washington. The only issue was whether the taxpayer was required to include in his taxable income his wife's community share in his earnings from personal services and the yield on their community property. As in most other community property states, the Washington statute vested broad powers of management and control over these items in the husband. The court dealt with the question in surprisingly

* The federal estate and gift tax aspects of community property law are dealt with in Pedersen, "Application of Federal Income, Estate and Gift Tax Law to Community Property," 45 MICH. L. REV. 409 (1947).—*Ed.*

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[1] 282 U.S. 101, 51 S. Ct. 58 (1930).

[2] 323 U.S. 44, 65 S. Ct. 103 (1944).

simple terms. It was said that under Washington law the wife was the unqualified owner of one half of these items at the time of inception.[3] Since the revenue law[4] did not purport to tax *A* upon the income of *B*, the court concluded that the husband was not properly taxable upon his wife's share of any income item which, under local property law, was at all times vested in his wife. *Poe v. Seaborn* is a curious mutation in an environment which produced *Lucas v. Earl*,[5] *Helvering v. Horst*,[6] *Helvering v. Clifford*,[7] *Harrison v. Shaffner*[8] and other cases. The key to the decision is the concept of ownership employed by the court. It is a substantially different concept than that to which we are accustomed under the Internal Revenue Code.[9] It is familiar law that mere title, as established under local law, is not necessarily a categorical criterion of taxability. In the case of income derived from principal, the test has usually been, who owns the principal. But the answer to the question has generally involved a more sophisticated approach than recourse to local property law. For federal tax purposes, ownership is normally considered to be the aggregate of rights as respects use and enjoyment of the property.[10] This doctrine, adapted to compensation for personal services, becomes an inquiry into who earned the compensation. In *Poe v. Seaborn*, these approaches were considered and rejected by the court. Mr. Seaborn's broad powers of management and control over his wife's share of his earnings were said to have no legal significance for tax purposes. It is both interesting and puzzling to compare the quantum of rights vested in the taxpayer in *Poe v. Seaborn* and *Helvering v. Clifford*. In Washington the husband has the power to dispose of community property during marriage as if it were his own

[3] Marston v. Rue, 92 Wash. 129, 159 P. 111 (1916); Mabie v. Whittaker, 10 Wash. 656, 39 P. 172 (1895); Warburton v. White, 176 U.S. 484, 20 S. Ct. 404 (1900).

[4] In this case §§ 210(a) and 211(a) of the Revenue Act of 1926, 44 Stat. L. 9 at 21. Relevant current provisions are I.R.C., §§ 11 and 12.

[5] 281 U.S. 111, 50 S. Ct. 241 (1930). A husband's anticipatory assignment of compensation which under local law vests it in his wife without his intermediate ownership has no standing for income tax purposes.

[6] 311 U.S. 112, 61 S. Ct. 144 (1940). The assignment of accrued but unpaid interest by a taxpayer who owns the underlying principal obligation does not shift the tax burden to the assignee.

[7] 309 U.S. 331, 60 S. Ct. 554 (1940). As subsequently amplified by lower court decisions, the case stands for the proposition that the grantor of a trust may be taxable on its income notwithstanding that under local law the beneficiary is recognized as sole owner of the income.

[8] 312 U.S. 579, 61 S. Ct. 759 (1941). A life tenant may not escape tax on trust income by anticipatory assignment of a short-term interest therein.

[9] Helvering v. Clifford, 309 U.S. 331, 60 S. Ct. 554 (1940); Helvering v. Hallock, 309 U.S. 106, 60 S. Ct. 444 (1940); and see I.R.C., §§ 166 and 167.

[10] This concept, of course, is not confined to the federal income tax field.

property.[11] Mr. Clifford was the donor of a short-term trust and also its trustee. While his powers as respects the trust corpus were possibly as broad as Mr. Seaborn's rights over the community property, they were certainly no broader, and subsequent applications of the *Clifford* doctrine by the lower courts have demonstrated that it applies where the grantor's retained rights are only a diluted version of the husband's powers of management in the community property states.[12] The bemused observer must conclude that there is some element peculiar to community property law which otherwise has no counterpart in local property law. The facetious will say that there is and that *Poe v. Seaborn* supplied this element. Those more seriously inclined may be satisfied with the reference made in both *Poe v. Seaborn* and *Commissioner v. Harmon* to the antiquity of the community property system.

Since the test of taxability laid down in *Poe v. Seaborn* is ownership of the income item at inception under local community property law, it could be expected that the lower federal courts, in applying the test, would find themselves at the outset dealing with pure questions of community property law unembarrassed by the normal doctrine that title, ownership and kindred concepts frequently have a different meaning for federal tax purposes than for local property law purposes. And in the main, this has been so. Indeed, if the opinions are to be believed, this is always so. This approach is of considerable significance for more than one reason. The law of community property, originally unified in character, has acquired distinctive characteristics in the several states where it now prevails.[13] In some, it consists principally of what may be called, for want of a better term, the common law of community property.[14] In other states, there are more or less elaborate statutory statements of community property law.[15] The important point is that the taxable consequences of a given transaction may not be and frequently are not the same in all community property states. Hence, the federal cases in the field of income taxation are now precedent in Michigan

[11] Warburton v. White, 176 U.S. 484, 20 S. Ct. 404 (1900).

[12] Helvering v. Elias, (C.C.A. 2d, 1941) 122 F. (2d) 171. In discussing the application of the doctrine originally laid down in Helvering v. Clifford, 309 U.S. 331, 60 S. Ct. 554 (1940), the court observed that ". . . it is only when the term is longer than six or seven years . . . that the settlor's legal reservation of control becomes vital. . . ."

[13] See 2 DEFUNIAK, PRINCIPLES OF COMMUNITY PROPERTY 526 et seq. (1943) for the statutory provisions in the several community property states.

[14] By this is meant the case law filling in the interstices of a loosely knit statutory system or based solely on the historical concept of the community in states where it has been a factor in property law. See 1 DEFUNIAK, PRINCIPLES OF COMMUNITY PROPERTY 73, 74 (1943).

[15] E.g. Michigan. See Mich. Pub. Acts (1947) No. 317, effective July 1, 1947.

only to the extent that the Michigan community property law receives a construction parallel to the construction given the law in the state where the federal case arose. A simple example will suffice. In Texas, income derived during marriage from the separate property of the spouses is community income.[16] The rather elaborate tests to determine the extent to which distributable income from partnerships or sole proprietorships is allocable to the husband's separate capital investment as opposed to his personal efforts[17] have no significance in Texas. Conversely a ruling that dividends on securities purchased by the husband prior to marriage are taxable to the spouses half and half in Texas[18] has no significance in Michigan. In preparing this article it has been assumed that except as specifically modified by the Michigan statute, the so-called common law of community property now prevails in Michigan.[19]

It will be readily realized that *Poe v. Seaborn* modifies a large number of standard income tax concepts in a community property state. To facilitate discussion, it is advisable at the outset to recognize the distinction between a legal community and a consensual community as drawn in *Commissioner v. Harmon*[20] and divide the discussion into two broad categories. The first category consists of the income tax questions attendant upon the creation, the duration and the dissolution of a legal community. The second categary consists, essentially, of exploring the basic distinction between a legal community and a consensual community since communities of the latter type are treated, for all practical purposes under the income tax law, as though no community existed.[21]

I

THE LEGAL COMMUNITY; INCOME TAX PROBLEMS INCIDENT TO ITS CREATION

Normally the event creating a community is marriage. Acquisition of domicile in a community property state by the spouses also creates

[16] Frame v. Frame, 120 Tex. 61, 36 S.W. (2d) 152 (1931).

[17] See p. 6 et seq., infra.

[18] Mellie Esperson Stewart, 35 B.T.A. 406 (1937). See Anna Davis Terry, 26 B.T.A. 1418 (1932).

[19] Stated otherwise, where a given situation is not expressly covered by the Michigan statute, it is assumed that the Michigan courts will accept as controlling authority precedent in other states which have community property systems where such precedent has a "common law" character. See note 14, supra. This may be a rather generous assumption. See Schedule to the Michigan Constitution of 1835, § 2; Schedule to the Michigan Constitution of 1850, § 1; Schedule to the Michigan Constitution of 1908, § 1; Stout v. Keyes, 2 Doug. (Mich.) 183 at 188 (1845); May v. Rumney, 1 Mich. 1 at 4 (1847).

[20] 323 U.S. 44, 65 S. Ct. 103 (1944). And see p. 14 et seq., infra.

[21] Commissioner v. Harmon, 323 U.S. 44, 65 S. Ct. 103 (1944).

a community. In Michigan and other states, communities were created wholesale when new community property laws became effective. In general, the income tax problems which arise by reason of the creation of the community are common to all legal communities regardless of how created. Unfortunately, communities are not conveniently created on the first day of the taxable period. Hence, there arises the not unfamiliar problem of having part of the taxable year governed by one status and part of the taxable year governed by another.[22]

For present purposes, these problems will be dealt with in terms of the creation of a community in Michigan on July 1, 1947. The principles applicable will be equally applicable to the creation of a community as a result of marriage at any time during the taxable year.

The general rule is that items of income paid or accrued after July 1, 1947, which are community income under local law, are taxable half and half to the spouses.[23] There are exceptions to this rule. The cases seem to hold that whether the spouses elect to return income on the accrual basis or on the cash receipts and disbursements basis, the creation of the community puts both of them on a modified accrual basis.[24]

An example of this will be the December, 1947 bonus to the corporate executive. Plans for bonus compensation vary widely in character. Bonuses may be entirely at the discretion of the board of directors or may be the result of a contractual arrangement between the corporation and an employee. In either event, it seems that year-end bonuses in 1947 will, as a general rule, be apportioned as between community property and the separate property of the executive receiving the bonus.[25] This conclusion is based upon the theory that in almost all instances the husband receives his bonus for services rendered to the corporation throughout its current fiscal period.[26] In *Wrightsman v. Commissioner*[27] the taxpayer and his wife owned and dominated a corporation for which the taxpayer worked under a loose arrangement whereby he would be compensated by the directors at the end of the calendar year in the light of corporate profits for the year. The spouses resided in Oklahoma[28] but on December 24, they established

[22] It should be unnecessary to add that the creation of a community in the middle of a twelve-month taxable period does not result in a short taxable year for purposes of filing returns.

[23] I.T. 3782, INT. REV. BUL. 1946-4-12237.

[24] W. L. Honnold, 36 B.T.A. 1190 (1937); Sara R. Preston, 35 B.T.A. 312 (1937). The conclusion is said to be based upon community property law principles.

[25] Wrightsman v. Commissioner, (C.C.A. 5th, 1940) 111 F. (2d) 227.

[26] The corporation's bonus plan is normally integrated with its fiscal period which may or may not be co-extensive with the executive's taxable year.

[27] (C.C.A. 5th, 1940) 111 F. (2d) 227.

[28] The taxable year involved antedated enactment of a community property law valid for income tax purposes.

their domicile in Texas. In December 30 the directors voted to pay the taxpayer compensation of $50,000 for his services for the year. It was held that only 8/365ths of the taxpayer's compensation constituted community property. The rationale of the opinion seems to be that the taxpayer "acquired" his compensation as he earned it regardless of when received. The analogy made in the opinion to the acquisition of land by adverse possession is somewhat forced since it logically leads to the conclusion that the taxpayer's compensation was either all community property or all separate property.[29] The rule in the *Wrightsman* case should apply to a bonus based on a percentage of profits notwithstanding that at July 1, 1947 the corporation's operations for the first six months shows a deficit in earnings. The theory is that however late in the corporate accounting period the bonus becomes a matter of right to the executive, it is nevertheless paid in consideration of his services for the entire accounting period. Of course, where the corporation is on a fiscal period other than a calendar year the apportionment will be governed accordingly. There is an exception to this rule which is consistent with the theory underlying it. Where it can be demonstrated that the bonus is paid in consideration of services other than those rendered prior to the creation of the community, no part of the bonus is the separate property of the husband.[30] These basic rules apply to ordinary compensation in those cases where July 1, 1947 falls in the middle of the pay period, or whenever a spouse has earned but not received compensation for personal services at the time a community is created.[31] And it has been held that a wife may not escape tax on her half of her husband's compensation, earned but unreceived, by making an assignment thereof to her husband.[32] These problems do not exist in Michigan as respects yield on principal held by one spouse on July 1, 1947; the yield is separate property under local law.[33]

A problem which is perennial throughout the existence of the community, but which first occurs in the taxable period within which the community is created, is that of segregating separate income from community income in the case of partnerships or sole proprietorships existing prior to the creation of the community. The problem arises because the husband's income from principal owned by him at the creation of the community continues to be his separate income in many community

[29] 1 DEFUNIAK, PRINCIPLES OF COMMUNITY PROPERTY 154, 155 (1943).

[30] Fooshe v. Commissioner, (C.C.A. 9th, 1942) 132 F. (2d) 686.

[31] I.T. 3792, INT. REV. BUL. 1946-8-12289.

[32] Johnson v. United States, (C.C.A. 9th, 1943) 135 F. (2d) 125.

[33] Sections 1(a) and 2(a), Mich. Pub. Acts (1947) No. 317.

states, including Michigan.[34] There are many business enterprises, whether in the form of partnerships or sole proprietorships, where capital is a substantial income-producing factor. In such cases profits are in part earnings on capital invested and in part attributable to the personal efforts of the partner or proprietor. If the latter, they are community income; if the former, they are the separate income of the partner or proprietor. This problem must be distinguished from the status of unwithdrawn earnings of a partnership or a proprietorship existing at July 1, 1947. These constitute the separate property of the partner or proprietor whenever withdrawn, and, indeed, are his separate property whether withdrawn or not.[35] The cases and rulings are not entirely harmonious on the issue of allocation. The Treasury has developed an unusual formula for segregating income earned on capital invested and that attributable to personal efforts.[36] A reasonable rate of return is assumed on the capital. A reasonable rate of compensation is then assumed for the partner or proprietor. The aggregate of these two items is not necessarily, perhaps not even normally, equivalent to the net profits of the proprietorship or partnership for the taxable period. But the ratio of each hypothetical factor to the sum of the hypothetical factors is applied to net profit for the taxable period to determine proper segregation as between return on capital and compensation for personal efforts. This method has been sustained.[37] But other methods have been used. Where the partnership books reflect partners' salaries, this has been held the measure of return for personal services and the balance treated as return on capital.[38] In another case the going rate on investments was applied to invested capital to determine the separate income of the proprietor. The balance was said to be attributable to his personal efforts and, hence, community property.[39] It is difficult to justify the view stated in G.C.M. 9825[40] except in cases where it is impossible to determine the relative earning potential of capital and personal effort in an enterprise other than on an artificial basis. Perhaps

[34] Sections 1(a) and 2(a), Mich. Pub. Acts (1947) No. 317; Arizona Rev. Code (1939) § 63-302; Cal. Civ. Code (Deering, 1941) §§ 162, 163; 2 Nev. Comp. Laws (Hillyer, 1929) § 3355; New Mexico Ann. Stat. (1941) §§ 68-304, 68-303; Wash. Rev. Stat. (Remington, 1932) §§ 6890, 6891.

[35] Such earnings are clearly property owned by the partner-spouse at the date of the creation of the community. See § 1(a), Mich. Pub. Acts (1947) No. 317.

[36] G.C.M. 9825, 10 INT. REV. BUL. 146 (1931).

[37] J. Z. Todd, 3 T.C. 643 (1944).

[38] Julius and Rebecca B. Shafer, 2 B.T.A. 640 (1925); Roy F. Wilcox, T.C. Mem. Op., 5 C.C.H. TAX COURT MEM. DEC. 412, P-H T.C. MEM. DEC. ¶ 46,072 (1946).

[39] Lawrence Oliver, 4 T.C. 684 (1945).

[40] See note 36, supra.

the rulings and decisions may be harmonized by the time-honored dodge of resorting to the facts in each case. Where, under the circumstances, it appears impossible to demonstrate allocation by reasonably persuasive evidence, the artificial approach is justifiable, if only on the grounds that the commissioner's determinations are presumptively correct, and no satisfactory evidence is available to the taxpayer to rebut the presumption. Moreover, it is probably fair to say that where the partners inter se have placed a value on the personal services rendered by one or more of them, this is the best evidence of that value for the purposes.

There may be, of course, miscellaneous items of income received by one of the spouses during the last half of 1947 with respect to which there are doubts as to its status as separate or community income. Moreover, it may be that the solution as to status under local law is not finally determinative for income tax purposes. The Michigan act predicates status upon "acquisition" after creation of the community, and it is certainly an arguable question as to whether the term carries with it the inexorable application of the accrual concept. Domicile being what it is, there is a strong flavor of tax avoidance in cases like *Wrightsman v. Commissioner* and only those who are methodically ignorant of what everyone knows would deny that this factor influences decisions. If "acquisition" as used in the Michigan statute be construed to mean reducing the income item to possession and enjoyment, then *Poe v. Seaborn* prohibits application of *Wrightsman v. Commissioner* and similar cases in Michigan unless the doctrine of the latter case be justified as a proper exercise of the commissioner's power to put the taxpayer on an accounting system truly reflecting net income.

II

THE LEGAL COMMUNITY; INCOME TAX PROBLEMS INCIDENT TO ITS EXISTENCE

In general, items of gross income received during coverture are apt to fall within one of several broad classifications. They may be compensation for personal services, gain from the disposition of capital items which have appreciated in value since date of acquisition, yield in the form of interest, dividends and rent on capital items, or net profits of an individual proprietorship or corporation. The problem of allocating net profits of an enterprise as between a spouse's capital investment and his personal efforts remains a problem throughout the existence of the community and the enterprise.[41] Yield on capital items is taxed as community income or as separate income of one of the spouses in accordance

[41] See p. 6 et seq., supra.

with the status of the capital items as separate property or community property under the Community Property Act. Compensation for personal services is community property and taxed as such. The gain from the disposition of a capital item turns upon the status of the item as community property or separate property of one of the spouses. If the former status, the gain is taxable half and half to the spouses; if the latter, it is taxable to the spouse to whom the capital item belongs as separate property.

Section 8 of the Community Property Act empowers the spouses in broad, general terms to give or sell to one another existing community interests in property. Presumably this section will be frequently invoked. It is not uncommon to find that the husband, at the date of creation of the community, is engaged in a program of saving through the device of acquiring assets on a deferred or installment payment basis. An existing policy of whole life insurance is an example. The purchase of real property under an executory land contract is another. In the typical situation of this type, the husband must have recourse to his compensation for personal services to meet installment payments falling due after creation of the community. This may and frequently does lead to undesirable consequences under the community property law which are not within the scope of this article.[42] To foreclose these results, it is anticipated that many lawyers will advise the spouses to give single or cross-conveyances under section 8 of the act annually or oftener to maintain the separate character of items of this type. The conveyance by a wife to her husband of her community interest in assets purchased with her husband's compensation for services is a gift[43] but not taxable as such.[44] But income tax difficulties may arise in connection with cross-conveyances between the spouses. A transaction of this type may result in capital gain to one of the spouses.[45] It cannot, of course, result in capital loss to either spouse.[46] If the transaction be treated as an exchange between the spouses, one or the other will most certainly end up with gain unless the community interests transferred have equivalent fair market values.[47] It is theoretically possible to argue that

[42] E.g., where a husband carries life insurance naming his dependent mother as the beneficiary and pays premiums from community funds. Upon the death of the wife, her heirs would have an interest in the cash surrender value of the policy. In the event of the husband's prior death, the wife would have an interest in the proceeds of the policy.

[43] In the sense of a voluntary conveyance or transfer of property not founded on consideration. BOUVIER'S LAW DICTIONARY, Baldwin's 1934 ed., 467.

[44] I.R.C., § 1000(d); Pedersen, "Application of Federal Income, Estate and Gift Tax Laws to Community Property," 45 MICH. L. REV. 409 at 437 (1947).

[45] Johnson v. United States, (C.C.A. 9th, 1943) 135 F. (2d) 125.

[46] I.R.C., § 24(b).

[47] Unless, of course, the transaction falls within one of the nonrecognition provi-

the transaction is a transfer for inadequate consideration and, hence, a gift[48] to the extent of excess of value received by one spouse. In such event, no gift tax would be incurred if the excess of value was realized as a result of receipt of a community interest in property purchased with the recipient's compensation for personal services or separate property.[49] Whether this theory would insulate the gaining spouse from income tax is certainly questionable. Section 22 (b) (3), I.R.C. excludes gifts from gross income, but under the circumstances assumed the excess value is not a gift for gift tax purposes. And no gift of foresight is required to predict that the courts would be reluctant to find the transactions a gift within section 22 (b) (3) I.R.C. There would seem to be no question where the excess value is subjected to gift tax, e.g., where value passes from the spouse who purchased the property involved from his compensation.[50]

High surtaxes inspired many husband and wife partnerships that still exist. They present special problems under the Community Property Act. In the typical situation where the wife's partnership activities are those of a passive investor, her share of distributable earnings will continue to be her separate property. In the case of the husband who is both an investor and a manager, his distributable share of earnings are in part community property and in part separate property. There is nothing in the doctrine of *Commissioner v. Tower*[51] and *Lusthaus v. Commissioner*[52] which suggests that the tax benefits of community property will be denied the spouses with respect to that portion of the husband's distributive share which constitutes community property under local law. But is it a necessary corollary that distributions to the wife, heretofore taxable to the husband under *Commissioner v. Tower*, are now required to be taxed to the wife because of the enactment of the Community Property Act? The answer to this seems clear. The wife's ownership of her interest in the partnership and her title to her share of distributable earnings received by her as a partner are not affected in any real way by the Community Property Act. Since her distributable share was taxable to her husband prior to July 1, 1947 under *Commissioner v. Tower*, and since the status of these distributions has not been altered by the enactment of the community property law, it is fair to assume that distributions to her after July 1, 1947 will

sions of the code. See I.R.C., § 112(b)(1).

[48] See I.R.C., § 22(b)(3).

[49] Pedersen, "Application of Federal Income, Estate and Gift Tax Laws to Community Property," 45 MICH. L. REV. 409 at 437 (1947).

[50] Assuming, of course, that the transaction can be classified as a gift and not an exchange at arm's length.

[51] 327 U.S. 280, 66 S. Ct. 532 (1946).

[52] 327 U.S. 293, 66 S. Ct. 539 (1946).

likewise be taxable to her husband. Tenuous support can be found for a contrary view. It is perhaps arguable that the effect of Senate Enrolled Act 136 was to make her separate ownership "an incident of marriage by the inveterate policy of the State."[53]

What about husband and wife partnerships created after July 1, 1947? If the wife, as a passive investor, supplies capital from community funds resulting from her personal compensation, her share of the partnership earnings would be community property under the Michigan Act, and *Poe v. Seaborn* seems to require that it be taxed half to her and half to her husband. If we can accept the distinction between *Lucas v. Earl* and *Poe v. Seaborn* we should not gag over the distinction between the latter case and *Commissioner v. Tower*. Moreover, there is no out for the commissioner in allocating partnership earnings between capital contribution and compensation for the working husband since under the assumed facts both items would constitute community property under local law.

But suppose the husband endorses his salary check to his wife by way of gift and she invests these funds in a partnership between herself and her husband. Under the community property law the wife's share of distributable earnings from the partnership would be her separate property.[54] But here, it is believed, *Commissioner v. Tower* would require that her distributable share be taxed one half to her husband. While no cases can be cited for this conclusion, it is difficult to reach any other conclusion. As to one half of her capital investment, the wife acquired it by gift from her husband and she has rendered no vital additional services to the partnership. Hence as to her half of her distributable earnings, her situation necessarily falls categorically within the rule of *Commissioner v. Tower* and *Lusthaus v. Commissioner*. *Poe v. Seaborn* recognizes the other half of her capital investment to have been hers from inception; i.e., she did not acquire it by gift from her husband.

Here, as in connection with the creation of the community, there will be miscellaneous items of income received by one of the spouses with respect to which there are doubts as to its status under local law. In many instances, no precise precedent will be available in the tax field. But presumably ownership of these items at date of inception under local law will furnish a satisfactory standard to follow. Indeed, *Poe v. Seaborn* seems to require use of this standard except possibly where the spouses have attempted by anticipatory contract to alter the character of community property as established by local law.

[53] Commissioner v. Harmon, 323 U.S. 44 at 46, 65 S. Ct. 103 (1944).

[54] Section 2(a), Mich. Pub. Acts (1947) No. 317.

Deductions from gross income may also be a problem. Business and nontrade or nonbusiness expenses, interest, taxes and charitable gifts must be paid or incurred by the taxpayer.[55] If these items are paid during the taxable year by the husband from community funds and he is acting within the scope of the management powers conferred on him by the community property law, the wife is entitled to one half of the items as a deduction from her gross income. If the payment of the husband is outside the scope of his management powers, the same result would not seem to follow. For example, the Michigan act prohibits the husband from making gifts out of community funds without the consent of his wife.[56] In the absence of evidence of her consent, presumably the wife would not be entitled to any deduction on account of the gift since her position is roughly parallel to that of one whose funds have been misappropriated by another and then used to pay items normally deductible for income tax purposes. It is an interesting speculation as to whether under such circumstances the wife has sustained a deductible loss arising from "other casualty or from theft"[57] either at the time of misappropriation or later when it develops that the husband is financially unable to respond in an accounting between the spouses. The wife is entitled to a deduction for one half of community debts which became worthless during the year.[58] And she is entitled to one half of the depreciation allowance on community property used in the trade or business, or community property held for the production of income.[59] The same rule applies to depletion.[60] The deduction for alimoney under section 23 (u), I.R.C. is confined by its terms to a husband and, hence, regardless of whether the husband may, under the community property law, have recourse to community funds to meet his alimony obligations, his wife is not entitled to an alimony deduction.

III

THE LEGAL COMMUNITY; INCOME TAX INCIDENT TO ITS DISSOLUTION

The community may be dissolved in whole or in part. The death of either spouse or divorce affects a complete dissolution of the community. But the spouses may, under section 8 of the Michigan act, by

[55] I.R.C., § 23.

[56] Section 6(c)(1), Mich. Pub. Acts (1947) No. 317.

[57] See I.R.C., § 23(e).

[58] Poe v. Seaborn, 282 U.S. 101, 51 S. Ct. 58 (1930), combined with the statute [I.R.C., § 23(k)] requires this conclusion. The wife has a present vested interest in the credit.

[59] The wife sustains the depreciation loss since she has a vested ownership in the property subject to depreciation.

[60] See note 58, supra.

joint action, effectively dissolve the community as respects any specific item of property. Dissolution of the community by death of one of the spouses has no income tax significance except as questions of the cost basis of the community property in the hands of the surviving spouse and the heirs of the deceased spouse arise. The cost basis to the surviving spouse of her interest in the community property is the cost of that interest to the community at the time of acquisition prior to the death of the deceased spouse.[61] And this conclusion is unaffected by the fact that the surviving spouse's interest in the community property may have been subjected to estate tax as part of the deceased spouse's gross estate.[62] The cost basis of the deceased spouse's interest in community property in the hands of his heirs is fair market value at the date of the deceased spouse's death.[63]

Dissolution of the community in a specific piece of property by conveyances under section 8 of the act may result in taxable gain to one of the spouses.[64]

Dissolution of the community in its entirety by divorce may have income tax significance. Under section 12 of the act, the Michigan courts are given broad discretionary powers to divide community property between the spouses as they shall deem just, proper and equitable. Regardless of community property law, transfers by a husband to his wife of property as an incident of divorce and in exchange for a release by the wife of her marital rights, can result in taxable gain to the husband where the fair market value of the property transferred exceeds its cost to the husband.[65] It is obvious that if the divorce court exercises the powers conferred on it by section 12 and divides the community property between the spouses other than equally, one of the spouses will be the gainer. If there is injected into the situation a release by the wife of her marital rights, there is no apparent reason why the transaction should be treated any differently than other exchanges between the spouses.[66]

[61] "The basis of property shall be the cost of such property . . ." I.R.C., § 113(a). The surviving spouse's interest does not fall within any of the exceptions appearing in section 113(a), Internal Revenue Code. It is acquired by the surviving spouse although it may be acquired through the efforts or agency of the deceased spouse as manager of the community.

[62] Although subjected to estate tax, the surviving spouse's interest is not properly transmitted at death within the meaning of section 113(a)(5) Internal Revenue Code. The interest is taxed to the decedent's estate not because he owned it but because he controlled it.

[63] The situation falls categorically within I.R.C., § 113(a)(5).

[64] Johnson v. United States, (C.C.A. 9th, 1943) 135 F. (2d) 125.

[65] Commissioner v. Mesta, (C.C.A. 3d, 1941) 123 F. (2d) 986. Cf. Merrill v. Fahs, 324 U.S. 308, 65 S. Ct. 655 (1945); Commissioner v. Wemyss, 324 U.S. 303, 65 S. Ct. 652 (1945).

[66] This conclusion seems to be required by Johnson v. United States, (C.C.A. 9th,

IV

THE CONSENSUAL COMMUNITY AS DISTINGUISHED FROM THE LEGAL COMMUNITY

In *Commissioner v. Harmon* the Supreme Court observed:

> "Communities are of two sorts,—consensual and legal. A consensual community arises out of contract. It does not significantly differ in origin or nature from such a status as was in question in *Lucas v. Earl*. . . . In *Poe v. Seaborn* . . . the court was not dealing with a consensual community but one made an incident of marriage by the inveterate policy of the state."[67]

The courts of other community property states have held that the spouses may, by mutual declaration, convert future receipts which would otherwise be the separate property of either into community property as received and convert future receipts which would otherwise be community property into separate property as received.[68] There may be a question as to whether this view will prevail in Michigan,[69] but it is assumed, for present purposes, that it will. The use of the anticipatory arrangement is a vital ingredient in the planning of many taxpayers. In the not unusual case of a husband having large salary from personal services and a wife having income from investments of equivalent amount, the effect of the community property law is to increase the taxes of the family as a unit since the husband's salary becomes community in character, whereas the wife's investment income remains her separate property. The result is, that half of the husband's salary is added to the wife's investment income and taxed in high surtax brackets. Presumably, in a situation of this kind, lawyers may advise the execution of an anticipatory arrangement by which the spouses agree that the husband's future salary for personal services shall be his separate income. In some cases the parties may go even further in an effort to attain maximum income tax advantages, as, for example, contracting that the husband's salary for personal services from the *X* Corporation shall be his separate property, but that from the *Y* Corporation shall remain community property. If, as we have assumed, these agreements are good under the Michigan community property law, are they good for federal tax purposes? This involves a consideration of two questions:

1943) 135 F. (2d) 125.

[67] 323 U.S. 44 at 46, 65 S. Ct. 103 (1944).

[68] Wren v. Wren, 100 Cal. 276, 34 P. 775 (1893); Volz v. Zeng, 113 Wash. 378, 194 P. 409 (1920); cf. Frame v. Frame, 120 Tex. 61, 36 S.W. (2d) 152 (1931).

[69] There appears to be no express statutory sanction in the new act. Section 8 seems to refer to community interests in existing property.

1. Are the arrangements consensual in nature as respects the items of income to which they refer with the result that they will be disregarded entirely for income tax purposes? or

2. Are the arrangements consensual in character with respect to the items of income to which they pertain with the result that the community, generally speaking, is part consensual and part legal in character, and is not a legal community to any extent within the meaning of *Poe v. Seaborn*?

The Tax Court, circuit court and Treasury Rulings to date answer both questions in the negative.[70] But an examination of the Supreme Court cases suggests storm clouds on the horizon. Few will deny Justice Douglas' remark that *Lucas v. Earl* and *Poe v. Seaborn* represent "competing theories of income tax liability."[71] In the former case, Earl, a resident of California, entered into a contract with his wife whereby he assigned to her an interest in all of his future earnings from personal services. The issue submitted to the court was whether the agreement should stand for income tax purposes. The court held that it could not. A close reading of the opinion indicates that under California law the agreement between Earl and his wife may have been valid and that half of Earl's earnings may have vested in his wife without intermediate ownership in Earl, or, in the alternative, that the case would have been decided in the same way if this were the California law.[72] In *Commissioner v. Harmon*, which involved the status of the first Oklahoma Community Property Statute for income tax purposes, the court elected to follow *Lucas v. Earl* on the grounds that the Oklahoma Statute contained an elective feature as a condition precedent to its application. Stated otherwise, the Oklahoma law was not applicable unless the spouses agreed that it should be applicable. It was said that this created a consensual community and that *Lucas v. Earl* applied. The point made in the dissent was that the distinction between *Commissioner v. Harmon* and *Poe v. Seaborn* was a distinction without a difference inasmuch as the spouses in any community property state are free to contract their way out from under the law as they see fit. The dissent assumed that anticipatory arrangements in the

[70] Helvering v. Hickman, (C.C.A. 9th, 1934) 70 F. (2d) 985; Louis Gassner, 4 B.T.A. 1071 (1926); Harry S. Goldberg, 4 B.T.A. 1073 (1926); Cecil B. DeMille, 31 B.T.A. 1161 (1935); G.C.M. 18884, 16 INT. REV. BUL. (1937); G.C.M. 19248, 16 INT. REV. BUL. 59 (1937).

[71] Commissioner v. Harmon, 323 U.S. 44 at 56, 65 S. Ct. 103 (1944).

[72] "There is no doubt that the statute could tax salaries to those who earned them and provide that the tax could not be escaped by anticipatory arrangements and contracts however skillfully devised to prevent the salary when paid from vesting even for a second in the man who earned it. That seems to us the import of the statute. . . ." Lucas v. Earl, 281 U.S. 111 at 114, 115, 50 S. Ct. 241 (1930).

other community property states would not result in the creation of a consensual community, either in whole or in part, for purposes of federal income tax law. And there is substantial authority for this assumption.[73] But it is a significant fact that in the majority opinion appears the following passage:

> "We think it immaterial, for present purposes, that the community status may or may not be altered by contract between the parties, may or may not be avoided by antenuptial agreements, or that certain assets of a spouse may or may not be classed as 'separate property' excluded from the community."[74]

It is perfectly plain that the unexercised power of the spouses to remove themselves, in whole or in part, from the operation of the community property law does not alter their status as members of a legal community.[75] It is not at all clear whether the exercise of this power by the spouses converts the legal community into a consensual community, either in whole or in part. Unless the court answers this question in the affirmative, the distinction between *Commissioner v. Harmon* and *Poe v. Seaborn* is reminiscent of those "elusive and subtle casuistries"[76] which were forcefully consigned to oblivion in *Helvering v. Hallock*.[77] It is suggested that the court may ultimately hold that the exercise by the spouses of their anticipatory powers destroys the legal community and creates a consensual community governed by *Lucas v. Earl* and *Commissioner v. Harmon*. Opposed to this view is the fact that *Poe v. Seaborn* carried to its logical conclusion requires recognition of anticipatory agreements for tax purposes. The answer to this is that *Lucas v. Earl* and *Commissioner v. Harmon* carried to their logical conclusion require an opposite result. In practical effect, the court will be called upon to define with some precision the line of demarcation between *Poe v. Seaborn* on the one hand, and *Lucas v. Earl* and *Commissioner v. Harmon* on the other. In cases where the spouses' position, income-tax-wise, has been improved by the community property law, but could be further improved by anticipatory arrangements of a selective character, counsel should weigh the possible action of the Supreme Court before making any recommendation.

[73] See note 70, supra.

[74] Commissioner v. Harmon, 323 U.S. 44 at 48, 65 S. Ct. 103 (1944).

[75] Poe v. Seaborn, 282 U.S. 101, 51 S. Ct. 58 (1930).

[76] Helvering v. Hallock, 309 U.S. 106 at 118, 60 S. Ct. 444 (1940).

[77] See note 76, supra.