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INTERNAL REVENUE SERVICE NATIONAL OFFICE FIELD SERVICE ADVICE

MEMORANDUM FOR DISTRICT COUNSEL
NORTHERN CALIFORNIA DISTRICT, SAN FRANCISCO
ATTN: PAUL KRUG, CC:WR:NCA:SF

FROM: Assistant Chief Counsel (Administrative Provisions and Judicial Practice) CC:PA:APJP

SUBJECT:

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<u>LEGEND</u>

Petitioner =
Former wife =

Date 1	=
Date 2	=
Date 3	=
Date 4	=
Date 5	=
Date 6	=
Date 7	=
Date 8	=
Date 9	=
Year 1	=
Year 2	=
Year 3	=
Year 4	=
Year 5	=
a	=
b	=
c	=
d	=
e	=
f	=
g	=
h	=

ISSUES

(1) Whether, upon a California court's entry of a judgment of dissolution of marriage which reserves jurisdiction over property issues, community property retains its character as such until division of the property.

(2) Whether I.R.C. § 66(b) is applicable to the distributive share of partnership income for years subsequent to the dissolution of the marriage until division of the marital property.

(3) Whether the California divorce court order on Date 6 awarding the partnership interest to the petitioner as his separate property is given retroactive effect for federal income tax purposes.

(4) Whether petitioner's loss deductions are limited to half of the distributive share of partnership losses attributable to the partnership interest held in his name.

(5) Whether petitioner is required to pay tax on half of the partnership distributions he received. Whether petitioner can increase his capital account by amounts that were not allocated to him as partnership income.

(6) Whether petitioner can be held liable as a transferee for his Former wife's taxes.

(7) Whether petitioner can be held liable under a fraudulent conveyance theory for partnership distributions made to him that he did not share with his Former wife.

(8) Whether the government can argue that petitioner is liable for 100 percent of the distributive share of partnership income because he is judicially estopped from denying that treatment.

(9) Whether the government can argue that petitioner is liable for 50 percent of the partnership distributions based on the theory that he misappropriated his Former wife's share of those distributions.

CONCLUSIONS

(1) Under California law, once the parties are no longer married, the community ceases to exist. The former community property is converted into property held by the former spouses as tenants in common.

(2) Section 66(b) does not apply for two reasons. First, section 66(b) does not apply to former spouses. Second, section 66(b) does not apply because there is no community income.

(3) Under annual accounting principles, the California divorce court's retroactive award of the partnership interest to the petitioner as his separate property cannot be given retroactive effect for federal income tax purposes. Thus, the Date 6 award is irrelevant in determining the tax treatment for Years 2, 3, 4, and 5.

(4) Petitioner's loss deductions are limited to half of the distributive share of partnership losses attributable to the partnership interest held in his name.

(5) Petitioner is required to pay tax on his share of partnership distributions that exceed his adjusted basis of his partnership interest immediately before the distribution. Considering our litigating position that upon dissolution of the marriage, the character of the partnership interest was a tenancy in common, petitioner's share of the partnership distributions is one-half of the partnership distributions made to the partnership interest held in his name. Petitioner cannot increase his capital account for amounts that were not allocated to him as partnership income.

(6) Petitioner cannot be held liable as a transferee for his Former wife's taxes.

(7) Petitioner cannot be held liable under a fraudulent conveyance theory for partnership distributions made to him that he did not share with his Former wife.

(8) The government should not argue that petitioner is liable for 100 percent of the distributive share of partnership income because he is judicially estopped from denying that treatment.

(9) Petitioner is taxable on Former wife's half of the partnership distributions that he did not share with her.

FACTS

Former wife and petitioner were married on Date 1. The couple resided in California throughout their marriage. The former spouses separated on Date 2. Former wife filed a petition for dissolution on Date 3 and the marriage was terminated by a judgment of dissolution on Date 4. Petitioner remarried on Date 5. After the marriage was dissolved, the property settlement negotiations continued. The property settlement required a valuation and disposition of the parties' interest in a partnership.

In Year 1, during the marriage, the petitioner formed a California limited partnership. At the same time, petitioner also formed a corporation of which he was the principal shareholder. The corporation was the general partner of the limited partnership. Prior to the divorce, the partnership interest was community property. Pursuant to the partnership agreement, the partnership was required to distribute a percent of any income allocated to a general partner's account during a year as a "tax distribution" to cover the tax consequences.

The tax years at issue are Years 2, 3, 4 and 5. These are years subsequent to the year in which the marriage was dissolved. For Years 2 and 3, the partnership issued Forms K-1 to petitioner reflecting his distributive share of various items of partnership income. The Year 2 Form K-1 reflected total income of $b including $c in guaranteed payments and cash distributions of $d. The Year 3 Form K-1 reflected total income of $e and cash distributions of $f. With respect to these years, the petitioner reported only half of the reported amounts of partnership items (in addition to the guaranteed payment). In an attached disclosure statement, he indicated that Former wife was responsible for the other half of the partnership items. Petitioner deposited the Year 2 and Year 3 cash distributions he received from the partnership into his bank accounts. Former wife reported no partnership income for Years 2 and 3.

For Years 4 and 5, the partnership issued K-1s to petitioner reflecting his distributive share of partnership losses. Petitioner reported all of the losses on his income tax returns. Former wife reported no part of the partnership losses on her returns for those years.

On Date 6, a date occurring in a year after Year 5, the California court determined that the community owned g percent of the aggregate ownership of the corporation and the partnership and that the value was $h. The judgment awarded the partnership interest to the petitioner on a retroactive basis. This judgment was effective on Date 7, which was in a year prior to Year 2.

On Date 8, which is subsequent to the court's first order, the court vacated the prior judgment. The new judgment once again awarded the partnership interest to the petitioner but the effective date was changed. The Date 8 judgment was effective on Date 8. Thus, the Date 8 judgment, unlike the Date 6 judgment, did not operate retroactively.

On Date 9, respondent issued a notice of deficiency and petitioner timely filed a petition with the Tax Court. [redacted] Among other issues raised that are not a part of this field service advice, the Service determined that petitioner was required to report and pay tax on the full amount of his distributive share of partnership income for Year 2 and Year 3, but was only entitled to half of the losses for Year 4 and Year 5. The Service also determined that section 66(b) applied.

LAW AND ANALYSIS

Issue 1

Under community property laws, each spouse is generally regarded as owning one-half of the community income. Thus, if the spouse files a separate return, he or she generally must report half of the community income on his or her return regardless of which spouse earned the income. Poe v. Seaborn, 282 U.S. 101, 110-13 (1930); United States v. Malcolm, 282 U.S. 792, 794 (1930). Each spouse is liable even if he or she never receives the income. United States v. Mitchell, 403 U.S. 190 (1971). In Kimes v. Commissioner, 55 T.C. 774, 782 (1971) the Tax Court held prior to the entry of the divorce decree "a California wife is taxable on one-half of community income regardless of the fact that she neither received nor enjoyed the income in question."

Rev. Rul. 73-391, 1973-2 C.B. 12, explains the application of community property rules to income from a California partnership. Both spouses invested in the partnership. The wife's investment consisted solely of community property. The husband's investment consisted, in part, of community property and, in part, of his separate property. Rev. Rul. 73-391 holds that the wife's distributive share of partnership income consists of one-half of the income derived from the community property invested by her and her husband and one-half of the income from her husband's partnership salary. The husband's distributive share of partnership income consists of one-half of the income derived from the community property invested by him and his wife, one half of the income from his partnership salary, and all of the income derived from the separate property invested by him.

Community property is property owned by the marital community. Once the marriage is dissolved, the marital community no longer exists and, therefore, cannot own property. The former community property is converted into property held by the former spouses as tenants in common. Estate of Layton v. Layton, 44 Cal.App.4th 1344, 52 Cal.Rptr. 251 (Cal.App. 6 Dist. 1996); Henn v. Henn, 26 Cal.3d 331, 161 Cal.Rptr. 502 (1980); In re Marriage of Brown, 15 Cal.3d 838, 544 P.2d 561 (1976), citing In re Marriage of Elkins, 28 Cal. App.3d 899, 903 (1972). See also Gorman v. Gorman, 90 Cal. App.3d 454, 153 Cal. Rptr. 479 (1979). Accord Bouterie v. Commissioner, 36 F.3d 1361 (5th Cir. 1994).

Statutes and court cases frequently refer to “community property” in describing certain property that was formerly community property. Such terminology may be convenient but is not entirely accurate. See 15A Am.Jur.2d *Community Property* § 101 (1999). It is imprecise to refer to property as “community property” after the marriage is dissolved. Estate of Layton, 52 Cal.Rptr. at 255. In Bouterie, the court awarded attorneys’ fees to the wife under section 7430 based on a determination that the Service had improperly relied on a Louisiana divorce court’s imprecise use of the term “community property” in referring to property that was formerly community property.

The tax issue in Bouterie was the taxability to the wife of insurance commissions earned by the husband after divorce on renewal premiums paid on insurance policies that had been written before the divorce. As indicated above, the Louisiana divorce court characterized the commissions earned after the divorce as community property and, based on this characterization, the Service determined that the wife was liable for tax on her share of the community income. The Fifth Circuit concluded that the Service was wrong to concede the issue as late as it did because the wife had consistently explained that under long-settled Louisiana law, no community property interest can continue to exist after the marital community ceases. Further, she had consistently noted the state court’s imprecise use of the community property terminology. The Fifth Circuit stated:

> [T]he term “community property” in this context is universally recognized shorthand, consistently used in Louisiana to distinguish assets of the former marital community from the assets of each former spouse’s pre-existing separate estate. That is obviously the way that the Louisiana court used the term in this instance–and the fact that the Louisiana court here adopted this widely understood, customary parlance should have been readily apparent to a District Counsel’s office located in New Orleans.

36 F.3d at 1372.

In the present case, the marriage was dissolved in a year prior to the years at issue. Thus, for these years the partnership interest was not community property because the marital community no longer existed and the partnership income was not community income. During these years, petitioner and his Former wife owned the partnership interest as tenants in common.

Issue 2

Under I.R.C. § 66, community property laws are disregarded for income tax purposes under specified circumstances. Section 66(b) authorizes respondent to “disallow the benefit of any community property law to any taxpayer with respect to any income if such taxpayer acted as if solely entitled to such income and failed to notify the taxpayer’s spouse before the due date (including extensions) for filing the return for the taxable year in which the income was derived of the nature and amount of such income.”

Section 66(b) was added to the Code by section 424(b) of the Deficit Reduction Act of 1984 (the 1984 Act), Pub. L. No. 98-369, (89th Cong., 2d Sess., July 18, 1984). Section 66(b) and its legislative history refer only to spouses, not former spouses. See H.R. Conf. Rep. No. 861, 98th Cong., 2d Sess. 1119 (1984) and Staff of Joint Comm. On Taxation, 98th Cong., 2d Sess. 720-21, General Explanation of H.R. 4170 (Comm. Print 1984). Thus, the statutory language on its face and its accompanying explanation do not include former spouses within its purview.

Section 7701(a)(17) of the Code supports the conclusion that section 66(b) is unavailable to tax former spouses. Section 7701(a)(17) of the Code provides that if the husband and wife are divorced, wherever appropriate, the terms “husband” and “wife” should be read to include “former husband” and “former wife,” respectively. However, this rule only applies to the terms “husband” and “wife” as used in specified sections of the Code, namely, sections 152(b)(4), 682 and 2516 of the Code. Section 66(b) is not one of the specified Code sections in section 7701(a)(17), which indicates that section 66(b) does not apply to former spouses. The 1984 Act made significant changes to the domestic relations provisions of the Code, including the rules pertaining to alimony (sections 71 and 215) and transfers between spouses or incident to divorce (section 1041). As part of this legislation, section 66(b) was enacted and section 7701(a)(17) was amended. We believe that if Congress had intended for section 66(b) to apply to former spouses as well as current spouses, it would have either added section 66(b) to the Code sections listed in section 7701(a)(17) or would have included within section 66(b) language similar to that in section 71(d) to the effect that the term “spouse” includes a former spouse (section 71(d) was enacted as part of the 1984 Act). Because Congress took neither of these actions in the domestic relations provisions of the 1984 Act, an inference arises that Congress did not intend for section 66(b) to apply to former spouses.

We recognize that under California law, the term “spouses” includes persons who are married to each other as well as persons who were previously married to each other. Cal. Fam. Code § 11. But, the California law definition of “spouse” is irrelevant because section 7701(a)(17) of the Code specifically defines the term for purposes of federal tax law. *Cf.* In re Miller, 167 B.R. 202, 209-10 (Bkrtcy.C.D.Cal. 1994) (the term "spouse" is not a defined term in the Bankruptcy Code, so the court looked to state law definitions).

Case law provides some support for the proposition that section 66(b) does not apply to taxable years in which the parties are not married, although this issue has not been expressly addressed. In McPherson v. Commissioner, T.C. Memo. 1991-520, the taxpayer and his wife, Susan, were married and lived in Idaho, a community property state, from 1976 to 1985. Taxpayer and Susan separated in November of 1984 and were divorced in June of 1985. At issue was the application of section 66(b) and (c) for the taxable years 1978 through 1986, "except 1986, when petitioner was no longer married." Significantly, the Service did not determine deficiencies under section 66(b) or (c) for 1986 because taxpayer husband was no longer married. An inference can be drawn from this case that section 66(b) and (c) are applicable only to taxpayers who are married and in receipt of community income. A similar inference may be drawn from Rutledge v. Commissioner, T.C. Memo. 1992-52, which drew a careful distinction between oil company royalty checks paid before, and after, the date of divorce.

Arguably, a contrary inference can be drawn from Tseng v. Commissioner, T.C. Memo. 1994-126, aff'd in an unpublished opinion, 79 F.3d 1154 (9th Cir.), cert. denied, 519 U.S. 820 (1996). In this case, the Tax Court applied section 66 of the Code to the taxable year in which the parties divorced (1985). The income was earned for the taxpayer husband's services in 1983, a year in which the parties were married.[1] The parties separated in 1984 and were divorced on October 28, 1985. The income earned in 1983 was paid in 1985, but it is unclear whether the income was paid before or after the date of divorce. The taxpayer husband argued that income earned during the marriage, the payment of which was deferred until after the divorce, should be accorded community income treatment so that only 50 percent of the earnings would be taxable to him. The Service argued that the income did not constitute community income and that the entire amount received was taxable to the husband. Citing Winn v. Winn, 299 P.2d 721 (Cal. Ct. App. 1956) for the proposition that income earned during community years is community income, the court found that the income earned during the marriage in California was community property income. The court invoked section 66(b) to tax all of the income to taxpayer husband because (1) he treated the income as solely his, and (2) he did not notify his spouse of the nature or amount of income. As indicated above, it is unclear from the opinion whether the income was paid before or after the divorce. Nevertheless, Tseng is distinguishable from the present case in that its holding was specifically tied to income earned in a year in which the parties were

[1] During 1983, taxpayer husband, rather than being paid for the quarter that he taught at a California university, "banked" the quarter and was supposed to take a paid quarter off in 1984. Instead, taxpayer husband taught in 1984 and the California university paid him for the banked quarter in 1985.

married, but received in the year of divorce. Here, the income at issue was both earned and received in taxable years after the year of the divorce.

Accordingly, we conclude that section 66(b) of the Code is unavailable to tax petitioner for the years at issue because the parties were no longer married in those years. Moreover, section 66(b) only applies to community income. And as previously discussed, the partnership interest ceased to be community property upon dissolution of petitioner's and Former wife's marriage.

Issue 3

This case is further complicated by the competing court orders disposing of the marital property and the effects of annualized tax reporting. The first court order, dated Date 6 (a date after the tax years at issue), determined that the partnership interest was awarded to petitioner as of Date 7 (a date prior to the tax years at issue). The second court order, dated Date 8 (a date subsequent to Date 6), determined that the partnership interest was awarded to petitioner as of the date of that second order.

Our tax system operates on an annual basis. I.R.C. §§ 441, 451, and 461; and Brent v. Commissioner, 630 F.2d 356, 359-60 (5th Cir. 1980), citing Burnet v. Sanford & Brooks Co., 282 U.S. 359, 365 (1931) and Security Flour Mills Co. v. Commissioner, 321 U.S. 281, 286 (1944). As explained above, we have concluded that after the martial dissolution, Former wife had an interest in the partnership that was not a community property interest. In accordance with the annual accounting principle, she was taxable on what she then owned, namely, her share of partnership income during Years 2, 3, 4, and 5, without regard to the first court order. See Brent v. Commissioner, 630 F.2d at 361 ("Although the decree is given retroactive effect, under the annual accounting principle effective in federal tax cases, it did not alter the federal tax treatment of income earned in a prior year.")

As for the second court order, we do not regard it as a *nunc pro tunc* order and will not respect it for federal tax purposes. Where a *nunc pro tunc* order merely corrects a prior misstatement or clerical error, it is respected for federal tax purposes. Where a *nunc pro tunc* order affects the legal relationships between the parties, it is not accorded retroactive effect for federal income tax purposes. More specifically, a *nunc pro tunc* order does not have retroactive effect for federal income tax purposes if the effect is to change the rights of the parties or the legal status of payments. See Graham v. Commissioner, 79 T.C. 415 (1982); Gordon v. Commissioner, 70 T.C. 525 (1978); Segal v. Commissioner, 36 T.C. 148 (1961); Keheler v. Commissioner, 25 T.C. 1154 (1956); Rev. Rul. 74-393, 1974-2 C.B. 28. See also M.T. Straight Trust v. Commissioner, 24 T.C. 69 (1955), aff'd, 245 F.2d 327 (8th Cir. 1957); Daine v. Commissioner, 21 T.C. 349 (1947), aff'd, 168 F.2d 449 (2d Cir. 1948), Rev. Rul. 71-416, 1971-2 C.B. 83. Steen v. Commissioner, T.C. Memo. 1989-542. Here, the new order altered the rights of the parties: the new award of the property to petitioner did not take effect until after the tax years at issue whereas the earlier order had awarded the property to petitioner effective prior to the tax years at issue.

Issue 4

Section 701 provides that a partnership as such shall not be subject to the income tax imposed by chapter 1. Persons carrying on as partners shall be liable for income tax only in their separate or individual capacities.

Our litigation position in this case is that for the years at issue, petitioner and Former wife held their interests in the partnership as tenants in common. Thus, each is deemed to own one-half of the interest. Accordingly, we conclude that petitioner is entitled to only half of the distributive share of partnership losses (and income) attributable to the partnership interest held in his name for the years at issue.

In particular, petitioner argues that he properly took 100 percent of the distributive share of partnership losses in Year 4 and Year 5 into account on his individual income tax return. He argues that under the terms of the partnership agreement, Former wife was not able to take her share of losses and they therefore became allocable to petitioner.

This argument fails. A section of the partnership agreement provides:

> Allocation of Losses in Excess of Capital Account. The amount of any Net Losses in excess of any then positive balance in the capital account of a Limited Partner, which would be allocable to a Limited Partner but for this Section [ ], shall be allocated to the General Partners as a group.

Petitioner appears to be arguing that the divorce effectively converted Former wife's interest in the general partnership interest to a limited partnership interest. However, this section does not apply to Former wife as she is not a partner under the terms of the partnership agreement. The agreement specifically lists each general and limited partner, and defines the term "Limited Partner." A "Limited Partner" means "any person, including a Substituted Limited Partner, who is a limited partner of the Partnership at the time of reference thereto, in such person's capacity as a limited partner of the Partnership." A "Substituted Limited Partner" is defined as "a person admitted to all of the rights of the Limited Partner who has transferred or assigned his Partnership Interest to such person."

To be a limited partner under the terms of the partnership agreement, Former wife must either be listed as a limited partner, which she is not, or she must have been assigned a partnership interest from a limited partner. Nothing has been transferred or assigned to Former wife. Petitioner was (and still is) a general partner in the partnership, and during the marriage his general partnership interest constituted community property. Upon divorce, the community interest in the partnership ceased, and the former spouses continued their co-ownership of the general partnership interest in the partnership, holding it as tenants in common. The divorce did not result in a transfer of the partnership interest.

While we may treat Former wife as a partner in the partnership for federal tax purposes, the partnership agreement is governed by state law, not federal tax law. Accordingly, for purposes of the partnership agreement, Former wife is not a partner in the partnership. The partnership allocated losses to petitioner according to his jointly-held general partnership interest, and the former spouses are each entitled to their half of those losses.

Issue 5

Section 722 of the Code provides that the basis of an interest in a partnership acquired by a contribution of property, including money, to the partnership shall be the amount of such money and the adjusted basis of such property to the contributing partner at the time of the contribution increased by the amount (if any) of gain recognized under section 721(b) to the contributing partner at such time.

Upon dissolution of the marriage, the partnership interest did not remain community property, the former spouses became tenants in common until division of the property. Consequently, the basis of the partnership interest was divided in half, one-half of the basis attributable to each spouse.

Adjustments to petitioner's basis in his partnership interest in the ensuing years should be made in accordance with sections 705 and 752(a) and (b). A partner's adjusted basis in the partnership interest is increased under section 705(a)(1) by the partner's share of the taxable and tax-exempt income of the partnership, and is decreased under section 705(a)(2) by any distributions made to the partner by the partnership, the partner's share of any net operating loss, and the partner's share of any expenditures of the partnership not deductible in computing its taxable income and not properly chargeable to capital account.

Section 752(a) provides that an increase in a partner's share of partnership liabilities is treated as a contribution of cash by that partner. In combination with section 722, section 752(a) has the effect of increasing the partner's adjusted basis in a partnership interest by the amount of the increase in liabilities. Conversely, section 752(b) provides that a reduction in partnership liabilities is treated as a distribution of money to the partner by the partnership. In combination with section 705, section 752(b) has the effect of decreasing the partner's adjusted basis in a partnership interest by the amount of the reduction in liabilities.

The regulations under section 752 set forth rules for determining a partner's share of partnership liabilities. The analysis used depends upon whether the liability is recourse or nonrecourse. The facts indicate that the partnership is a limited partnership. It is unknown whether the liability that he guaranteed was recourse or nonrecourse to the partnership.

Treas. Reg. § 1.752-2 provides that a partner's share of recourse partnership liability equals the portion of that liability, if any, for which the partner of related person bears the economic risk of loss. The determination of the extent to which a partner bears the economic risk of loss for a partnership liability is made under the rules in paragraphs (b) through (c) of section 1.752-2.

Section 1.752-2(b)(1) provides that except as otherwise provided in this section, a partner bears the economic risk of loss for a partnership liability to the extent that, if the partnership constructively liquidated, the partner or related person would be obligated to make a payment to any person (or a contribution to the partnership) because that liability become due and payable and the partner or related person would not be entitled to reimbursement from another partner or person that is a related person to another partner.

Section 1.752-2(f), example 3, provides a useful illustration of the effect a guarantee by a limited partner where the general partner is deemed to satisfy the obligation. In example 3, E and F form a limited partnership. E, the general partner, contributes $2,000 and F, the limited partner, contributes $8,000 in cash to the partnership. The partnership agreement allocates losses 20% to E and 80% to F until F's capital account is reduced to zero, after which all losses are allocated to E. The partnership purchases depreciable property for $25,000 using its $10,000 cash and a $15,000 recourse loan from a bank. F guarantees payment of the $15,000 loan to the extent the loan remains unpaid after the bank has exhausted its remedies against the partnership. In a constructive liquidation, the $15,000 liability becomes due and payable. All of the partnership's assets, including the depreciable property, are deemed to be worthless. The depreciable property is deemed sold for a value of zero. Capital accounts are adjusted to reflect the loss on the hypothetical disposition as follows:

	E	F
Initial contribution	$2,000	$8,000
loss on hypothetical sale	(17,000)	(8,000)
	(15,000)	- 0 -

E, as a general partner would be obligated by operation of law to make a net contribution to the partnership of $15,000. Because E is assumed to satisfy the obligation, it is also assumed that F would not have to satisfy F's guarantee. The $15,000 is treated as a recourse liability because one or more partners bear the economic risk of loss. E's share of the liability is $15,000, and F's share is zero. This would be so even if E's net worth at the time of the determination is less than $15,000, unless the facts and circumstances indicate a plan to circumvent or avoid E's obligation to contribute to the partnership.

Section 1.752-3 provides a three-tiered system for determining a partner's share of nonrecourse liabilities of a partnership. The three tiers are applied sequentially. First, a partner is allocated an amount of the liability equal to that partner's share of partnership minimum gain under section 704(b). Under the second tier, to the extent the entire liability has not been allocated under the first tier, a partner will be allocated an amount of liability equal to the gain that partner would be allocated under section 704(c) if the partnership disposed of all partnership property subject to one or more nonrecourse liabilities in full satisfaction of the liabilities. Under the third tier, a partner is allocated any excess nonrecourse liabilities in accordance with the partner's share of partnership profits, which may be determined under one of several methods that the partnership may choose.

After analyzing petitioner's guarantee of additional partnership indebtedness under the section 752 regulations, his basis in the partnership interest in this case should be adjusted upward and downward in accordance with the rules under sections 705 and 752 for the period he held the interest in the partnership. Whether a basis increase allowed petitioner to absorb the partnership losses in Years 4 and 5 should be determined in accordance with the above.

Generally, partnership distributions are not taxable events. Section 731 provides gain will not be recognized by a partner upon receipt of a partnership, except to the extent that any money distributed exceeds the adjusted basis of such partner's interest in the partnership immediately before the distribution.

We conclude that petitioner is required to pay tax on his share of partnership distributions that exceed his adjusted basis of his partnership interest immediately before the distribution. Considering that the character of the partnership interest was a tenancy in common, petitioner's share of the partnership distributions is one-half of the distributions made with respect to the partnership interest held in his name, and his adjusted basis in the partnership interest is one-half of the total adjusted basis in the partnership interest.

Section 1.704-1(b)(2)(iv)(B) provides the general rules for capital account maintenance. These rules require that a partner's capital account be increased by (1) the amount of money contributed by him to the partnership, (2) the fair market value of property contributed by him to the partnership (net of liabilities secured by such contributed property that the partnership is considered to assume or take subject to under section 752), and (3) allocations to him of partnership income and gain.

Because the increase in petitioner's capital account relates to corrections of accounting errors that should have been included in income but were not, we conclude that petitioner cannot increase his capital account for amounts that were not allocated to him as partnership income.

Issues 6 and 7

The request for Field Service Advice raises the issue as to whether the effective date of the division of the marital property was the date specified in the first judgment, the date of entry of the first judgment, or the date of entry of the second judgment. A fundamental principal is that transferee liability may not be asserted if the transferor is not liable for the tax both at the time of the transfer and at the time the Service asserts transferee liability. Commissioner v. Henry Hess Co., 210 F.2d 553 (9th Cir. 1954). Also, to hold petitioner liable under a fraudulent conveyance theory, the transferor must be liable for the tax. We assume for purposes of this advice that Former wife was liable for taxes, at the relevant times, on the partnership distributions. This assumption, by necessity, also means that the partnership distributions were not awarded to petitioner in the property division.

Section 6901 provides the Service with a method of collecting the unpaid tax liability "at law or in equity" of a transferee of property. In order to impose transferee liability under section 6901, there must be a transfer of the taxpayer's property to a third party. Copeland v. Commissioner, 33 T.C.M. 246 (1974). The transfer may be direct or indirect, actual or constructive. Since Former wife did not transfer her marital share of the partnership distributions to petitioner, we would have to show that there was an indirect or constructive transfer. In that regard, we could make a good argument that the payment of the total partnership distribution from the partnership to petitioner was an indirect or constructive transfer of Former wife's marital share of the partnership distribution. Alternatively, we could argue that petitioner's failure to share any of the partnership distributions with Former wife was a constructive transfer of Former wife's marital share of the partnership distributions. In Hatch v. Morosco Holding Co., 50 F.2d 138 (2nd Cir. 1931), the court stated:

> The inquiry, therefore, should not be whether there was a technical transfer of title, but whether property of the taxpayer was so dealt with as to make the [transferee] liable at law or in equity to the Government as a creditor of the taxpayer.

Accordingly, since petitioner treated Former wife's share of the partnership distributions as his own, and the partnership transferred all partnership distributions to petitioner, we could argue that there was a constructive transfer of Former wife's marital share of the partnership distributions to petitioner.

Transferee liability at law is based on the transferee's express contractual agreement to pay the income tax liability of the transferor, or based on a state or federal statute that imposes liability on the transferee. We have been given no information indicating that there was a contract between petitioner and his Former wife whereby petitioner agreed to pay his Former wife's income tax liabilities arising from the partnership distributions. Moreover, since we are assuming, for purposes of this advice, that Former wife's marital share of the partnership distributions were not part of the property division, it is doubtful that petitioner can be held liable under a California statutory provision.

Transferee liability in equity is based upon state law. California has adopted the Uniform Fraudulent Transfer Act, Cal. Civ. Code § 3439, et. seq. Under California law, the transferee can be held liable where there is “actual” fraud (3439.04(a)), where a transfer is made without receiving a reasonably equivalent value (3439.04(b)), or where a transfer results in the debtor’s insolvency (3439.05). Under either theory, the Service would have to show that the actions of Former wife, the liable party, were fraudulent as to the Service. If the Service could show that Former wife knowingly, or in a conspiracy with petitioner allowed Former wife’s community share of the partnership distributions to be distributed to petitioner, we could argue that such actions on her part amounted to a constructive transfer, and petitioner could be held liable as a transferee under a fraudulent conveyance theory. However, we have not been given any information from which we would conclude that the Service can make such a showing. Furthermore, in addition to showing that there was a constructive transfer of assets by Former wife, the Service would still have to show that the other elements of the applicable California statutory provisions are met.

Under section 3439.04(a), the transfer must be made with actual intent to hinder, delay, or defraud the Service. Under section 3439.04(b), the transfer must be made without receiving a reasonably equivalent value in exchange for the transfer, and the debtor: (1) was engaged or was about to engage in a business or a transaction for which the remaining assets of the debtor were unreasonably small in relation to the business or transaction; or (2) intended to incur, or believed or reasonably should have believed that he or she would incur, debts beyond his or her ability to pay as they become due. Under section 3439.05, the transfer must be made after the creditor’s claim arises, without the debtor receiving a reasonably equivalent value, and the debtor must be insolvent at the time of the transfer or become insolvent as a result of the transfer. We have not been given any information from which we would conclude that the Service can satisfy any of these statutory provisions.

Accordingly, we conclude that there is insufficient evidence to assert liability against petitioner either as a transferee at law on a fraudulent conveyance theory.

Issue 8

Judicial estoppel precludes a party from taking inconsistent positions. Yanez v. United States, 989 F.2d 323, 326 (9^{th} Cir. 1993). Our case is appealable to the Ninth Circuit. The Ninth Circuit has adopted the majority rule where judicial estoppel applies only if a court has relied on the party's previously inconsistent statement. Interstate Fire & Casualty Company v. Underwriters at Lloyd's, London, 139 F.3d 1234, 1239 (9^{th} Cir. Or. 1998); Masayesva v. Hale, 118 F.3d 1371, 1382 (9^{th} Cir. 1997). Thus, we would have to show petitioner’s prior inconsistent position and that the State court relied on that position. We do not know what position petitioner actually took. Additionally, the State court vacated the original court order for which we would claim reliance and an agreed order was entered which is contrary to the original order. Thus, under the facts presented we could not invoke the doctrine.

Issue 9

There is case law on a spouse's "misappropriation" of "community income." In Bagur v. Commissioner, 603 F.2d 491, 502 (5th Cir. 1979), the Fifth Circuit held that an intent to deprive a wife permanently of her share of the community income may be inferred from a husband's wanton appropriation of community assets in pursuit of his own pleasure or needs. The Fifth Circuit remanded the consolidated cases to the Tax Court for development of the facts to determine in each instance whether the husband appropriated his earnings in such a way as to be the equivalent of a theft of the wife's ownership of one-half of the earnings, a loss deductible under section 165(c)(3), the amount of any deduction and the year or years in which each taxpayer is entitled to claim a loss. Id. at 503. There is no report of either of the consolidated cases on remand. See Susan Kalinka, The Repeal of Provisions for Separation From Bed and Board Increases the Federal Tax Burden of Separated Spouses in Lousiana, 53 La. L. Rev. 597, 608 (1993). In Connor v. Commissioner, T.C. Memo. 1982-302, the Tax Court opined that Mr. Connor's use of his pay for his lavish living style was not a "wanton appropriation" of the community income and would not rise to the level of theft under state law. In Rutledge v. Commissioner, T.C. Memo. 1992-52, the taxpayer husband argued that temporary orders and the divorce decree restricted his rights to certain royalty checks and that even though he received them, he held them in trust for the benefit of his wife. The Tax Court determined that the taxpayer husband did not hold the checks issued subsequent to his divorce in trust for his former wife. The Tax Court recognized that the oil property was awarded to the wife and that the husband should have turned the checks over to her but he kept the checks and retained the proceeds. As such, the checks represented income to him even if he did misappropriate them.

Petitioner did not share the cash distributions received from the partnership with his former wife. He exercised dominion and control over the funds distributed and did not transfer to his former wife any portion of the amount distributed to which she was entitled as a co-owner of the partnership interest. On this basis, he is taxable on partnership distributions that she was entitled to receive, but which he retained. See Rutledge v. Commissioner, supra. It is not necessary to establish, as in Bagur v. Commissioner, that his appropriation of funds to which his former spouse was entitled is the equivalent of theft.

CASE DEVELOPMENT, HAZARDS AND OTHER CONSIDERATIONS

[redacted]

[redacted]

Please call if you have any further questions.

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Branch 2