

IRS Collection Issues: The Consequences of California Community Property

By Dennis N. Brager

Dennis Brager examines issues that arise in spite of Code Sec. 6015's remedies available to insulate "innocent spouses" from joint and several liability as a direct consequence of California community property law.



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It can be difficult representing clients who owe the IRS large sums of money, but those difficulties are compounded in community property states because spouses who generally think of themselves as "innocent spouses" can still bear the economic brunt of bad decisions made by their husband or wife. It is of course a foregone conclusion that parties who file a tax return, and elect to do so jointly in order to take advantage of the lower joint rates sign up for joint and several liability should something go wrong. Code Sec. 6015 provides a variety of remedies which are available to insulate "innocent spouses" from joint and several liability, if they can run the gauntlet of that section. The rules of Code Sec. 6015 are, however, outside the scope of this article. This article deals with the very real consequences that arise in spite of Code Sec. 6015 as a direct consequence of California community property law.

Community Property: Will You Know it When You See it?

The character of property as "separate" or "community" is determined by the marital status of a couple when the property was acquired. All property that a person acquires while married in California is presumed to be community property.¹ Note, however, that Social Security income is not community property.² The parties' respective interests in community property are "present, existing, and equal."³ This means that the spouses hold equal (or 50/50) interests in the

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whole of the community property rather than 50-percent ownership interests in the community estate to the exclusion of each other.⁴

On the other hand, the earnings and accumulations of spouses who live “separate and apart” are the separate property of the spouse who earns or accumulates property.⁵ In California, all property owned by marriage partners is either (1) community property, (2) separate property of the husband (HSP) or (3) separate property of the wife (WSP).

Sometimes the phrase “community debt” or “community liability” is used to describe who is responsible for a debt. However, this is an imprecise formulation. There are no community property debts *per se*. There are simply debts, and the question is what property a creditor can reach to satisfy those debts.

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California is considered to a creditor friendly state. According to the California Supreme Court ... “[T]he policy of protecting the ... creditors [of a spouse] outweighs the policy of protecting family income ...”⁶ This creditor friendliness spills over to the IRS since as a general rule the IRS looks to state property law to determine to what extent a tax delinquent has property or property rights to which its federal tax liens, or levies attach to.⁷

Thus, the separate tax liabilities of the husband may be satisfied by HSP and the separate tax liability of the wife may be satisfied by WSP.⁸ The separate property of a nondelinquent spouse may *not* be reached to satisfy the separate liability of the delinquent spouse.⁹ However, all community property may be reached administratively or judicially to satisfy the separate tax liabilities of either spouse which arose “before or during marriage.”¹⁰

In *M. Babb v. Schmidt*, the Ninth Circuit faced the question of whether a California wife’s one-half interest in community bank accounts was subject to the federal tax lien for the husband’s premarital tax liability. In holding

that the lien could reach her one-half interest, the Court reasoned that since California law made the nondebtor wife’s share of the community property available to creditors of the debtor husband, “California law has by the same rule implicitly given the husband rights in that property sufficient to meet the requirements of 26 U.S.C. § 6321.”¹¹

On the other hand, California Family Code §910(b) carves out an exception to the liability of community property for debts incurred by spouses while they live “separate and apart.” Section 910(b) provides that, for purposes of Section 910, the phrase “during marriage” does not include “the period during which the spouses are living separate and apart before a judgment of dissolution of marriage or legal separation of the parties.” Thus, the community property of a spouse is *not* liable for the debts incurred by the other spouse during the period that the spouses live “separate and apart.”¹²

Joint Tenancy Property Is NOT Community Property

Joint tenancy property is treated as a different species of property than community property. One of the more important aspects of joint tenancy is that upon the death of one of the joint tenants the decedent’s one-half joint interest passes to the remaining joint tenant without going through probate. On the other hand, each spouse’s community interest is subject to disposition under the decedent’s will.

Joint tenancy property is treated differently for tax debt purposes as well. The nonliable spouse’s 1/2 interest in joint tenancy property cannot be used to satisfy the taxpayer’s debt. However, the IRS may administratively levy the taxpayer’s interest in the property and sell that interest; the IRS cannot administratively seize and sell the nonliable co-tenant’s interest in the property.¹³ However, Code Sec. 7403 empowers a federal District Court to order the sale of a delinquent taxpayer’s entire property owned jointly with a third party who does not owe any of the tax indebtedness, and not merely the sale of the delinquent taxpayer’s interest in that property.¹⁴ Once the property is sold the IRS will receive half the proceeds, and the nonliable spouse will receive the remaining half of the proceeds.

The Court in *Rodgers* interpreted Code Sec. 7403 “to contemplate, not merely the sale of the delinquent taxpayer’s own interest, but the sale of the entire property (as long as the United States has any ‘claim or interest’ in it).”¹⁵ It noted, however, that the District Court, in individual cases, may exercise equitable discretion and consider both the Government’s interest in prompt and certain collection

of delinquent taxes and the possibility that innocent third parties will be harmed in that effort.¹⁶ Thus, the permissive language of Code Sec. 7403(c), *i.e.*, “may decree,” indicates that courts have discretion to refuse foreclosure.¹⁷

Protections for Joint Tenancy Property

The Supreme Court in *Rodgers* delineated the following four factors which courts should consider in determining whether to allow foreclosure of property jointly-owned by the taxpayer and a nonliable third party:

- (1) “the extent to which the Government’s financial interests would be prejudiced if it were relegated to a forced sale of the partial interest actually liable for the delinquent taxes”;
- (2) “whether the third party with a nonliable separate interest in the property would, in the normal course of events (leaving aside § 7403 and eminent domain proceedings, of course), have a legally recognized expectation that that separate property would not be subject to forced sale by the delinquent taxpayer or his or her creditors”;
- (3) “the likely prejudice to the third party, both in personal dislocation costs and in ... practical undercompensation”;
- (4) “the relative character and value of the nonliable and liable interests held in the property.”¹⁸

As to the third factor, the Supreme Court pointed out with a dry understatement that judges seem to be uniquely capable of that, even though the nonliable spouse would be entitled to her rightful share of the sales proceeds, “financial compensation may not always be a completely adequate substitute for a roof over one’s head.”¹⁹

Notwithstanding the above formulation, the Court in *Rodgers* emphasized that the four factors are nonexclusive and should not be applied mechanically.²⁰ “Ultimately the district court’s decision should rest on ‘common sense’ and the ‘special circumstances’ of the individual case.”²¹

Many courts have denied tax lien foreclosure of the nonliable spouse’s interest in a residence, especially where that spouse is fairly advanced in years, is on a fixed-income, has limited education and would be unduly prejudiced by losing the roof over her head, in that it would be extremely costly for her to obtain a suitable replacement residence for the rest of her life and the sale of her property would result in significant undercompensation of her interest in the property.²²

Other examples include: *Johnson, Jones* and *Sellner*.²³

The district courts also have been creative in structuring

equitable remedies to protect a nondelinquent spouse’s interest in the family home while simultaneously expropriating the delinquent spouse’s interest and providing a cash recovery to the Government.²⁴

Community Property and Installment Agreements

In analyzing a taxpayer’s financial condition, the IRS follows State community property law.²⁵ The IRS may request financial information pertaining to the taxpayer’s nonliable spouse in a community property state.²⁶ Calculating the amount of an installment agreement for married taxpayers where only one spouse is liable is not for the faint hearted. The IRS describes the process as follows:

Clients who have significant tax liabilities, and are about to get married, should strongly consider entering into a pre-nuptial agreement with their intended spouse.

Shared Expenses. If a taxpayer lives with a nonliable person,²⁷ and especially if expenses are paid from comingled funds, then the IRS may seek to review other income in the household, and any expenses shared with the nonliable person.²⁸

1. A taxpayer is only allowed to reduce income by expenses that she is “required to be pay”
2. First calculate Total Household income and expenses
3. Determine the taxpayer’s percentage of income. Taxpayer’s income/total household income
4. Calculate total allowable expenses
5. Determine which expenses are shared, and which are the taxpayer’s sole responsibility:
 - a) Sole responsibility type expenses include child support, union dues and educational loans.
6. Apply the income percentage to the total amount of allowable shared expenses
7. Add 100 percent of the allowable sole responsibility type expenses

Example. Taxpayer income equals \$50,000. Nonliable person’s income equals \$25,000. Taxpayer has medical expenses of \$1,000. Household housing and utilities for the four-person household are \$2,256

which is under the allowable standard in Los Angeles County of \$2,961. National Standard expenses are \$1,509 for four people. The taxpayer's income is two-third of household income. The taxpayer will be allowed to deduct two-third of the shared National Standard expenses, and the housing expenses, or \$1,006 + \$1,504, plus 100 percent of the medical expenses, for total allowable expenses of \$3,510.

Offers in Compromise and Community Property

The income and assets of a nonliable spouse are not considered in determining the amount of an adequate offer.²⁹ However, if state community property law permits collection from the nonliable spouse's assets, then the income and assets will be considered.³⁰ Thus, if one spouse is able to obtain innocent spouse treatment that generally will not be helpful in California, unless the nonliable spouse has significant separate property which as discussed above the IRS cannot proceed against to satisfy the liable spouse's debt. Care must be taken, however, to ensure that separate property is not comingled with community property so as to cause the separate property to lose its character.

If the taxpayer demonstrates that the collection of such assets or income would have a material and adverse impact on the standard of living of the taxpayer, the nonliable spouse or their dependents, then the community assets, or income will NOT be taken into account in determining the amount of an adequate offer.³¹ It is hard to imagine a situation where collection from the nonliable spouse would not materially and adversely affect the taxpayer, the nonliable spouse or their dependents. Nevertheless, in the author's experience, one should expect a good deal of push-back from the IRS on this issue.

ENDNOTES

¹ Cal. Fam. Code §760 (West 1994); *In re Marriage of Haines*, 39 Cal. Rptr. 2d 673, 681 (1995).

² *In re Marriage of Hillerman*, 109 Cal. App. 3d 334 (1980); *In re Marriage of Peterson*, 243 Cal. App. 4th 923, 930 (2016).

³ Cal. Fam. Code §751.

⁴ *In re McIntyre*, CA-9, 2000-2 USTC ¶150,613, 222 F3d 655, 658 (2000) (applying California law and finding that wife's community property interest in husband's pension benefits were subject to an IRS levy to satisfy husband's separate tax liability).

⁵ Cal. Fam. Code §771.

⁶ *Weinberg v. Weinberg*, 67 Cal2d 557, 63 Cal. Rptr. 13, 432 P2d 709, 711 (Cal. 1967).

⁷ *See Aquilino*, SCT, 60-2 USTC ¶9538, SCT-60, 363 US 509 (1960).

⁸ *See* Cal. Fam. Code §§913 and 914.

⁹ *See* Cal. Fam. Code §913.

¹⁰ Cal. Fam. Code §910(a); *See M. Babb v. Schmidt*, CA-9, 74-1 USTC ¶9476, 496 F2d 957, 960; *B.C. Kingsbury, Jr.*, CtCls, 77-2 USTC ¶9699, 563 F2d 1019, 1025, 215 CtCls 136 ("The wife's interest in community property in California is subject to the tax debts of her husband").

¹¹ *M. Babb v. Schmidt*, 496 F2d at 960.

¹² *See In re McCoy*, 111 BR at 281 (retroactively applying Cal. Civ. Code §5120.110, a predecessor statute to Cal. Civ. Code §910(b), and holding that "Mrs. McCoy's community property was not liable for the debts incurred by Mr. McCoy while the two lived separate and apart, prior to the dissolution of their marriage"); *In re Glad*,

Possible Counter Measures

Clients who have significant tax liabilities, and are about to get married, should strongly consider entering into a pre-nuptial agreement with their intended spouse. The prenuptial agreement will document any separate property that the nonliable spouse owns. In addition, the parties to a prenuptial agreement can agree that future earnings that would normally be community property will be treated as each person's separate property. This will insulate it from enforced collection by the IRS. Care should be taken, however, not to comingle separate property as doing so may cause the IRS to take the position that it is not truly separate property.

Even if the parties are already married, they may wish to enter into a postnuptial agreement for the same reasons they might enter into a prenuptial agreement. However, a California Appeals Court has held that a taxpayer's attempt to transmute community property earnings to her separate property constituted a fraudulent transfer pursuant to Cal. Civ. Code § 3439.04.³²

The parties may consider obtaining a divorce, and splitting up their property thereby ending its community property status. This strategy is, however, doomed to failure if the IRS has already made its tax assessment which gives rise to the secret federal tax lien.³³ Taxpayers also need to consider the impact of the *Woo* case in using this strategy, especially if they plan on living together after the divorce.

Conclusion

While practitioners in other states frequently represent California residents in IRS collection matters if the taxpayer is married, it is critical that he or she be represented by a practitioner who is thoroughly familiar with the vagaries of California community property law.

CA-9, 66 BR 115, 121 (BAP 1986) (only husband's one-half interest in community property could be reached to enforce collection of post-separation, pre-dissolution tax liabilities for which husband alone was personally liable); *see also In re Porter*, 1993 U.S. Dist. LEXIS 13513, **10-20, 72 AFTR2d 6197, 93-2 USTC ¶ 50,543 (N.D. Cal. Apr. 7, 1993) (IRS entitled to reach only taxpayer-husband's one-half community interest in sales proceeds of marital residence not divided by divorce court, in satisfaction of his post-separation, post-dissolution tax liability); *In re Marriage of Schenck*, 228 Cal. App. 3d 1474, 1481, 279 Cal. Rptr. 651, 655 (Cal. App. 3d Dist. 1991) (noting that legislative history of Cal. Civ. Code §5120.110, statutory predecessor of Cal. Fam.

Code §910(b), “reveals that the section was not meant to prevent execution on undivided community assets pending their division, but simply was intended to ensure that post-separation debts are satisfied exclusively from the debtor spouse’s interest in the property”).

¹³ See *L.M. Rodgers*, S.Ct., 83-1 USTC ¶9374, 461 US 677, 103 S.Ct. 2132.

¹⁴ *Rodgers*, *Id.*

¹⁵ 461 US at 694.

¹⁶ *Id.*, at 709.

¹⁷ *Id.*, at 708–709 (noting that “[a] § 7403 proceeding is by its nature a proceeding in equity, and judicial sales in general have traditionally been accompanied by at least a limited degree of judicial discretion”); see also *Young*, 1992 U.S. Dist. LEXIS 7908 *11 (N.D. Cal. Apr. 8, 1992) (“The court finds that discretion should be exercised under IRC Section 7403(c) and that a forced sale of the property ... should not be ordered without first allowing defendant the opportunity to satisfy the obligation by some less draconian means”), *rev’d* in part on other grounds, 1993 U.S. App. LEXIS 29044 (9th Cir. Nov. 1, 1993).

¹⁸ *Rodgers*, 461 US at 710–711.

¹⁹ *Rodgers*, 461 US at 704.

²⁰ *Id.*, at 711.

²¹ *D. Jensen*, DC-UT, 92-1 USTC ¶15,078, 785 F.Supp 922, 924 (Government could not immediately foreclose its lien against taxpayer’s tenancy-in-common interest in house held by him and his wife, who was innocent third party, had lived in house for more than 20 years and was in frail health due to advanced cancer, and possibility of undue harm to wife substantially outweighed any prejudice to Government in delaying sale of property).

²² See *J.C. Eaves*, CA-10, 74-2 USTC ¶9526, 499 F.2d 869, 870–871 (trial court had discretion to refuse to order outright sale of husband’s and wife’s residence for payment of husband’s tax liability and to order instead that sale be limited to husband’s undivided one-half interest); *Winsper*, 2010 U.S. Dist. LEXIS 118680, 106 AFTR 2d 6945 (Nov. 4, 2010) (refusing to allow foreclosure of Federal tax liens against property that taxpayer-husband and wife jointly owned

because forced sale would only satisfy small portion of his tax debt and wife’s portion would not permit her to relocate to other reasonable housing); *Persaud*, DC-FL, 420 F.Supp2d 1263, 1269–1270 (2006) (denying foreclosure sale as to one of five parcels, which nonliable spouse had owned and occupied as her residence for over 22 years, since she had paid to improve property and homeowner’s expenses, three daughters resided with her, and she would be significantly undercompensated if evicted from her home); *Johns*, 2006 U.S. Dist. LEXIS 78393 **17–21, 2007-1 USTC ¶ 50,316, 98 AFTR2d 7592 (N.D. Fla. Oct. 27, 2006) (denying foreclosure as to nonliable spouse who had lived by herself in trailer on property for 16 years, she had recently received cancer treatment, she was unemployed and her sole source of income was disability payments and she would sustain substantial prejudice in being forced out of her home to enable government to satisfy 14-year old tax debt for which her husband alone was liable).

²³ *R.H. Johnson*, DC-KS, 96-2 USTC ¶15,654, 943 F.Supp 1331, 1335 (nonliable spouse was 68 years old, had lived in home for 38 years, lived on fixed income, had limited education and would be unduly harmed by foreclosure sale of entire property because it is unlikely that her share of sales proceeds would be sufficient to enable her to purchase life estate in an equivalent home); *H.C. Jones*, DC-NJ, 95-1 USTC ¶15,190, 877 F.Supp 907, 918–919 (declining to sell family residence, finding that it would be “grossly unfair” for court to dispossess nonliable spouse of her interest in residence in which she had lived for over 17 years to satisfy separate tax liabilities of her husband, where she had not worked outside of home since her marriage in 1969, had no source of income and took care of minor son); *Sellner*, 1990 U.S. Dist. LEXIS 10564 **20–22, 1990 WL 132710, 90-2 USTC ¶ 50,452 (D.Mont. Aug. 1, 1990) (limiting foreclosure sale to taxpayer’s one-half interest in jointly-owned property, where nonliable spouse had not been employed outside of home for 23 years, three children lived there, including child with a severe mental handicap, which required full-time care, and couples’ only

asset was small parcel of land on which family resided).

²⁴ See *Jones*, 877 F.Supp at 916–921 (declining to enter foreclosure order but nonetheless entering judgment against taxpayer and order allowing levy on taxpayer’s interest in property and requiring nonliable spouse to pay fair rental value for occupying government’s one-half of the estate, *i.e.*, \$375 per month); *Tanchak*, 2009 U.S. Dist. LEXIS 8895, 103 AFTR2d 779 (D.N.J. Feb. 5, 2009), *aff’d*, 351 Fed. Appx. 729 (3rd Cir. 2009) (declining to foreclose on entire property, since nonliable spouse had expectation that property would not be susceptible to forced sale and requiring taxpayer to instead pay government one-half of rental value of property every month until tax debt was paid in full); see also *Young*, 1992 U.S. Dist. LEXIS 7908 **10–12 (delaying foreclosure sale of residence for six months to allow nonliable wife to satisfy tax liens or substitute other property to satisfy tax obligation); *Brynes*, 848 F.Supp at 1100 (deferring foreclosure sale by five-and-a-half months to enable nonliable wife to either obtain refinancing to pay off husband’s tax lien on property or to arrange for private sale on more favorable terms).

²⁵ IRM, pt. 5.15.1.4.2 (Nov. 17, 2014).

²⁶ *M. Ranuio*, 100 TCM 123, Dec. 58,301(M), TC Memo. 2010-178. See Reg. §301.7122-1(c)(2)(ii)(A). (The IRS also may request information regarding the assets and income of the nonliable spouse for the purpose of verifying the amount of and responsibility for expenses claimed by the taxpayer).

²⁷ These guidelines apply not just to married taxpayers, but also are supposed to be applied anytime a taxpayer lives together with, and shares expenses with a nonliable person.

²⁸ IRM, pt. 5.15.1.4.2 (Nov. 17, 2014).

²⁹ Reg. §301.7122-1(c)(2)(ii)(A).

³⁰ Reg. §301.7122-1(c)(2)(ii)(B).

³¹ *Id.* See also IRM, pt. 25.18.4.13.1 (Mar. 4, 2011).

³² *State Bd. of Equalization v. Woo*, 82 Cal. App. 4th 481 (Ct. App. 2000).

³³ See Code Sec. 6321.

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