Internal Revenue Service

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Person To Contact:
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Legend

X =
Y =
Z =
$A =
Year 1 =
Date 2 =
Date 3 =
Year 4 =

Dear :

This letter is in response to a request for a letter ruling on the proper treatment of a payment received by X. Specifically, X has requested a ruling that, under the community property laws of State Z, only 50 percent of the payment is includible in X's gross income.

FACTS

X and Y were married individuals residing in State Z, a community property state. X and Y divorced on Date 2. At the time of the divorce, X and Y were, and continue to be, cash basis taxpayers. On Date 3, a Stipulated Judgment on Reserved Issues was rendered completing X and Y's property settlement. There were no other agreements, prenuptial or otherwise, regarding community and separate property in effect at that time, or at any time during X and Y's marriage.

X practiced law for many years. While in practice, X was a shareholder and employee of a closely-held corporation (Firm 1), which reported income on the cash basis. X's stock in Firm 1 was a community asset. Firm 1 often referred large contingency fee, personal injury cases to another law firm (Firm 2). Per the agreement with Firm 2, Firm 1 was entitled to a portion of the contingency fee if the suit was successful. Once referred, neither X nor Firm 1 was required to engage in any further functions relating to the law suits.

In Year 1, when X and Y were married and living together, Firm 1 referred a number of law suits to Firm 2. In Year 4, the cases settled with a significant contingency fee, of which $A was payable to X through Firm 1.

Subsequent to the law suits being filed and before any settlements on the cases had been reached, X and Y were divorced. The Stipulated Judgment on Reserved Issues dictates that any settlement from these cases should be split evenly between X and Y using one of two methods: 1) X reports all of the income and then splits the remainder with Y after all taxes are paid, or 2) X and Y each report one half of the income on their respective returns and each pay tax on one half of the income.

LAW AND ANALYSIS

Section 61 of the Internal Revenue Code provides that, except as otherwise provided by law, gross income means all income from whatever source derived.

Under *Lucas v. Earl*, 281 U.S. 111 (1930), income is ordinarily taxed to the person who earned it, and tax liability may not be shifted by an anticipatory assignment of income. In that case, Mr. Earl tried to avoid tax liability by executing a contract whereby half of his earnings were to become the property of his wife. The court held that income is taxable to the person who earns it, and thus, despite the contract, all of Mr. Earl's earnings were taxable to him.

In *United States v. Mitchell*, 403 U.S. 190, 197 (1971), the issue of compensation for the exchange of services in a community property state was addressed. Mitchell, the taxpayer, was assessed a tax deficiency for the years 1955-1959, during which she was married and community income was earned by both spouses. Mitchell was not involved in the family finances as her spouse handled everything, and for the years in question no tax returns were filed. Pursuant to her divorce in 1962, Mitchell renounced the community to relieve herself of the community's debts, and thus did not receive a property distribution or a property settlement. Despite the lack of control over finances and the renunciation of the community property altogether, the court held that Mitchell had "an immediately vested ownership interest in half the community property income and was personally responsible for the tax on her share," which was not affected by her renunciation. *Id*. at 192. The court reasoned that, "with respect to community income, as with respect to other income, federal income tax liability follows ownership. … In the determination of ownership, state law controls." *Id*. at 197. *See also Poe v. Seaborn*, 282 U.S. 101 (1930), which provides that where compensation rights are earned through the performance of services by one spouse in a community property state, the portion of the compensation treated as owned by the non-earning spouse under state law is treated as the gross income of the non-earning spouse for federal income tax purposes.

Community property laws in State Z provide that each spouse should include in gross income half of the community income attributable to services rendered by either spouse. Whether compensation for past earnings is separate property or community property depends on when the income was earned. If the absolute right to receive the income is fixed while the community is intact, the earnings are community property and each spouse has an undivided interest in half of that income even if the income is not received before dissolution of the marriage. See *Foosh v. Commissioner*, 132 F2d. 686 (9th Cir. 1942); *Doty v. Commissioner*, 81 T.C. 652 (1983).

As noted above in *Mitchell*, state ownership laws determine federal tax liability. Since State Z is a community property state, X and Y each have immediately vested ownership interests in an undivided half of all community assets that were acquired during the marriage. In this case, X had earned the absolute right to the contingency fee prior to the divorce. X was no longer involved in producing the income after the divorce. Thus, under community property laws of State Z, this contingency fee is considered a community asset. Additionally, per the stipulated judgment on reserved issues, both X and Y recognized that this was a community asset capable of being divided. Therefore, prior to dissolution of the marriage, X and Y each had an undivided one-half interest in the contingency fee. Furthermore, because it is a community asset, X's transfer of half of the contingency fee to Y prior to paying tax on it is not an assignment of income as was the case in *Lucas v. Earl*, *supra*.

CONCLUSION

Based strictly on the information submitted, we conclude that X must include in gross income 50 percent of the $A contingency fees.

CAVEATS

The rulings contained in this letter are based upon information and representations submitted by the taxpayer and accompanied by a penalty of perjury statement executed by an appropriate party. While this office has not verified any of the material submitted in support of the request for rulings, it is subject to verification on examination.

This ruling is directed only to the taxpayer requesting it. Section 6110(k)(3) of the Code provides that it may not be used or cited as precedent.

In accordance the Power of Attorney and Declaration of Representative on file in this office, a copy of this letter is being sent to your representative.

A copy of this letter should be attached to any tax return to which it is relevant. We enclose a copy of the letter for this purpose. Also enclosed is a copy of the letter showing the deletions proposed to be made when it is disclosed under § 6110.

Sincerely,

Michael J. Montemurro
Acting Branch Chief
Office of Chief Counsel
(Income Tax & Accounting)

Enclosures (2)