

**BEFORE THE TAX COMMISSION OF THE STATE OF IDAHO**

In the Matter of the Protest of	)	
	)	DOCKET NO. 15867
[Redacted],	)	
	)	DECISION
Petitioners.	)	
_____	)	

On August 6, 2001, the Tax Discovery Bureau (TDB) of the Idaho State Tax Commission (Commission) issued a Notice of Deficiency Determination (NOD) to [Redacted] (taxpayers), proposing income tax, penalty and interest for the years 1995 and 1996 in the total amount of \$6,176.

On August 29, 2001, a timely protest and petition for redetermination was filed by the taxpayers. An informal hearing has not been requested by the taxpayers. The Commission has reviewed the file, is advised of its contents, and hereby issues its decision modifying the NOD.

The taxpayers both had wages reported to the Idaho Department of Labor (DOL) for 1995. [Redacted] also had wages reported to DOL in 1996 and 1997.

[Redacted] had the following wages reported to the Idaho DOL in 1995:

<b>EMPLOYER</b>	<b>1<sup>ST</sup> QUARTER</b>	<b>2<sup>ND</sup> QUARTER</b>	<b>3<sup>RD</sup> QUARTER</b>	<b>4<sup>TH</sup> QUARTER</b>	<b>TOTAL</b>
[Redacted]	\$2,313.50		\$ 72.50	\$ 234.00	\$ 2,620.00
[Redacted]	\$3,052.00	\$5,232.00	\$5,430.60		\$13,714.60
[Redacted]			\$ 138.00		\$ 138.00
[Redacted]				\$2,054.03	\$ 2,054.03
<b>TOTAL</b>					\$18,526.63

In 1996 [Redacted] had wages of \$34,865 working for [Redacted].

[Redacted] was issued an Idaho driver's license on September 25, 1996 with an address of [Redacted] He also was issued an Idaho resident Fish & Game license on April 18, 1997.

The Tax Enforcement Specialist (specialist) from TDB sent the taxpayers a letter dated January 5, 2001. [Redacted] responded to the letter by calling the Commission on January 18, 2001. During that telephone call, [Redacted] said that [Redacted] moved to [Redacted] to work at the end of 1995 through 1996. [Redacted] said she stayed in Idaho and worked. The specialist explained split domicile to [Redacted] to which she did not agree. [Redacted] did say she and [Redacted] were separated at that time (1996 tax year). [Redacted] requested forms for the years in question, which were sent on January 19, 2001. No tax returns were received, so a NOD was issued for the years 1995 and 1996 on August 6, 2001. In the NOD the taxpayers were given a filing status of married filing joint based on their [Redacted] On September 6, 2001, the specialist received protest letters from the taxpayers, which stated:

For: Year of 1995

We wish to file a protest regarding your determination for the following reason(s):

We believe we do have a tax obligation for this year but would like to obtain our records and file a proper return as to compare what you show owing with our filing. Currently all of our tax records and W-2's are in storage in [Redacted]. We will be returning there on Oct 7, 2001. This return has been postponed several times but this seems like a definite date now. We will file a return immediately upon our arrival.

For: Year of 1996

We wish to file a protest regarding your determination for the following reason(s):

We are protesting this determination because we were separated all of the year of 1996. [Redacted] lived with his brother and then at [Redacted] lived in Idaho and had her own income, which she plans to file a return for as soon as she can obtain her records. Currently all of our tax records and W-2's are in storage in [Redacted]. We will be returning there on Oct 7, 2001. This return has been postponed several times but this seems like a

definite date now. She will file a return immediately upon her arrival.

The specialist secured the taxpayers' W-2s for 1995 but was unable to get a copy of [Redacted]W-2 for 1996.

In a letter to the taxpayers dated October 18, 2001, the specialist canceled the NOD for tax year 1995 only. Based upon information available to this office, the specialist informed the taxpayers they had Idaho source income in excess of Idaho's filing requirement and were required to file for the tax year 1995. The specialist prepared a return for 1995 and enclosed it with his letter to the taxpayers. Also in this letter, the specialist revised the NOD for the tax year 1996 because [Redacted] provided information that indicated [Redacted] lived and worked in [Redacted] state in 1996. A revised NOD was issued with half of [Redacted] income subtracted from their total adjusted gross income.

On November 8, 2001, the specialist received the taxpayers' signed return for 1995 which showed a tax due of \$9. The 1995 return filed by the taxpayers has been accepted by the Commission. As a result, the taxpayers' 1995 return will not be addressed any further in this decision. [Redacted] also included tax returns for 1996 and 1997 with a filing status of "married filing separate." [Redacted] included a payment of \$1,583.90 and a copy of her W-2 for 1996.

On November 8, 2001, the specialist sent a letter to the taxpayers which notified them that the Commission had received the above correspondence. In that letter, the specialist informed the taxpayers that the Commission could not accept [Redacted] 1996 income tax return as filed. Information received [Redacted] indicated that the taxpayers had filed their 1996 income tax return with a filing status of "Married filing joint". Idaho Code section 63-3031(c) states, in short, that if a husband and wife elect to file a joint return for federal purposes they must file a joint return with the state of Idaho.

The taxpayers' return for tax year 1997 was not addressed in the Commission's deficiency and will not be addressed in this decision. However, it appears that [Redacted] wished to apply the refund claimed on her 1997 return to her 1996 tax liability. Since [Redacted] 1997 return was received on November 8, 2001, the specialist informed the taxpayers that Idaho Code section 63-3035 clearly states in part, "No credit for refund will be made to an employee who fails to file his return, as required under this chapter, within three (3) years from the due date of the return."

TDB sent a letter to the taxpayers to inform them that their file was being transferred to the Commission's legal/policy division.

On January 25, 2002, the Commission's Tax Policy Specialist (policy specialist) sent a letter to the taxpayers who stated in pertinent part:

In your letter to [Redacted] received November 7, 2001, you stated that:

We were separated the entire year . . . We did not reconcile until 1998. . . .

Please explain the meaning of "separated" and "reconcile" as used in those two sentences. This information is necessary to resolve community property issues in your 1996 income tax filing.

The taxpayers responded to the policy specialist in a letter received April 1, 2002, which they stated:

To clarify my letter to [Redacted] received November 7, 2001, I will give a little more personal detail. My husband and I have had a difficult relationship for many years. In 1992 we were divorced. In 1995 I agreed to remarriage as I thought things had changed in that relationship. There really were not significant changes. In Dec of 1995 we separated with my husband returning to [Redacted]. And my grandson and I staying in Idaho. In July of 1997, I moved to [Redacted]. In Sept of 1997, I agreed to make a trip to [Redacted] where my husband had relocated so my grandson could visit him. My husband and I discussed our difficulties again and I agreed to try

living together again. We have been together since. I hope this is sufficient clarification.

A review of the taxpayer's revised NOD for 1996 showed that the taxpayer's standard deduction and personal exemptions were not prorated for a nonresident return as is required by Idaho Code section 63-3026A(4). These deductions have been adjusted in the Commission's final decision.

The Commission and taxpayers disagree whether the state of Idaho can impose its income tax on half of [Redacted] wages earned in the state of Washington when the taxpayers' filing status on their federal return was "married filing joint." The following is analysis of this issue.

What is the proper Idaho income tax treatment of earned income of a husband and wife who are living apart? Specifically, how does Idaho treat the earned income of spouses where one spouse is residing and working in Idaho and the other is residing and working in Washington?

Generally, when spouses are living apart, whether earned income is community or separate is based upon the laws of the state in which the individual is domiciled. For purposes of the following analysis, it is assumed that one spouse is domiciled in Idaho and the other spouse is domiciled in Washington. If both spouses were domiciled in either Idaho or Washington, the answer may be different depending upon the community property laws of the state in which both spouses are domiciled.

The short answer to the question posed above depends on whether the elements required under Internal Revenue Code (I.R.C.) section 66(a), or Revised Code of Washington (R.C.W.) section 26.16.140, are met. If the elements of I.R.C. section 66(a) are met, then the Idaho and Washington community property laws do not apply and the earned income of each spouse is

treated as that spouse's sole and separate income. If I.R.C. section 66(a) does not apply, but R.C.W. section 26.16.140 does apply, then the earned income of the spouse residing in Washington will be treated as that spouse's sole and separate income, while the earned income of the spouse residing in Idaho will be treated as community income. If neither of these code provisions is met, then the earned income of both spouses will be treated as community income.

Generally speaking, the federal income tax code does not establish whether income earned during the marriage is separate or community income. Instead, state law will determine the separate or community character of income earned during marriage. See generally Poe v. Seaborn, 282 U.S. 101, 51 S.Ct. 58 (1930) (Applying Washington's community property law, the U.S. Supreme Court held that husband and wife were entitled to file separate federal individual income tax returns, each treating one-half of the community income as his or her respective incomes.); United States v. Mitchell, 403 U.S. 190, 91 S.Ct. 1763 (1971) (Under Louisiana's community property law, each spouse "has a vested title in, and is the owner of, a half share of the community income" and is, therefore, subject to federal income tax on that half share.).

There is, however, an exception to this general rule where the married taxpayers are living separate and apart and meet the other requirements of I.R.C. section 66(a). I.R.C. section 66(a) provides in relevant part as follows:

(a) Treatment of community income where spouses live apart. —If—

(1) 2 individuals are married to each other at any time during a calendar year;

(2) such individuals—

(A) live apart at all times during the calendar year, and

(B) do not file a joint return under section 6013 with each other for a taxable year beginning or ending in the calendar year;

(3) one or both of such individuals have earned income for the calendar year which is community income; and

(4) no portion of such earned income is transferred (directly or indirectly) between such individuals before the close of the calendar year,

then . . . any community income of such individuals . . . shall be treated in accordance with the rules provided by I.R.C. section 879(a).

I.R.C. section 879(a) goes on to provide that:

(a) General Rule. In the case of a married couple . . . who have community income for the taxable year, such community income shall be treated as follows:

(1) Earned income . . . other than trade or business income and a partner's distributive share of partnership income, shall be treated as the income of the spouse who rendered the personal services .

..

The effect of I.R.C. sections 66(a) and 879(a) is to preempt state community property law and to treat the income generated by each spouse as his or her separate income. Thus, if I.R.C. section 66(a) applies, each spouse will treat his or her earned income as separate income. As a result, the spouse residing in Idaho will report all her earned income to Idaho as her sole and separate income, and the spouse residing in Washington will report none of his earned income to Idaho. Only income derived from community property will be treated as community income under I.R.C. section 66(a).

In order for I.R.C. section 66(a) to apply, all of the elements set out in the statute must be met. In addition, the burden of proof is on the party asserting that I.R.C. section 66(a) applies. Generally, it will be the taxpayers who are asserting that I.R.C. section 66(a) applies and that the community property laws of Idaho and of the other community property states are, therefore, preempted.

Under Idaho law, earnings of a spouse are presumed to be community property. Idaho Code section 32-906(1) (second sentence); Martsch v. Martsch, 103 Idaho 142, 645 P.2d 882 (1982). This is true even if the husband and wife are separated and living apart. Suter v. Suter, 97 Idaho 461, 546 P.2d 1169 (1976) (finding Idaho Code § 32-902 unconstitutional); Desfosses v. Desfosses, 120 Idaho 354, 815 P.2d 1094 (Ct. App. 1991). Thus, under Idaho law, only death or a legal divorce will disband the community.

Washington community property law also provides that income earned through the labor of a spouse is presumed to be community income. R.C.W. section 26.16.030; In re Marriage of Hurd, 848 P.2d 185 (Wa.Ct.App. 1993) (“Earnings arising from services performed during marriage are community property.”). However, the Washington community property laws provide an exception to this general principle where the husband and wife are living separate and apart even though they are not legally divorced. Specifically, R.C.W. section 26.16.140 provides that “[w]hen a husband and wife are living separate and apart, their respective earnings and accumulations shall be the separate property of each.” Thus, under Washington law, earnings of a spouse are community property except where the spouses are separated and living apart, in which case each spouse’s earnings are treated as his or her separate property.

Washington Courts have consistently held that in order for R.C.W. section 26.16.140 to apply, the married couple must be living separate and apart as a result of marital discord. The fact that the couple is living apart is not, by itself, sufficient to give rise to the separate property treatment set out in R.C.W. section 26.16.140. For example, in Aetan Life Ins. Co. v. Bunt, 754 P.2d 993 (Wash. 1988), the Washington Supreme Court held that for section 26.16.140 to apply, the marriage must be, for all practical purposes, “defunct.” Likewise, in Oil Heat Co. of Port Angeles, Inc. v. Sweeney, 613 P.2d 169 (Wash. Ct. App. 1980), the Washington Court of

Appeals held that the mere physical separation of the husband and wife does not establish that they are living “separate and apart” to the degree necessary to negate the existence of the community. Finally, in Seizer v. Sessions, 940 P.2d 261 (Wash. 1997), the Washington Supreme Court emphasized that the “separate and apart” requirement of R.C.W. section 26.16.140 “contemplates permanent separation of the parties – a defunct marriage.” Thus, the separate property treatment of R.C.W. section 26.16.140 should not be presumed simply because the couple are residing in different states. Instead, the party seeking to employ that code provision has the burden of proving that the marriage is, for all practical purposes, defunct.

In those cases where I.R.C. section 66(a) does not apply, but R.C.W. section 26.16.140 does apply, the Idaho resident spouse will treat her earned income as community income, while the Washington resident spouse will treat his earned income as separate income. The reason for this dissimilar treatment is that the community property laws of the state of Idaho are applied to the income earned by the Idaho resident spouse, and the community property laws of the state of Washington are applied to the Washington resident spouse. Since Idaho does not have a provision similar to R.C.W. section 26.16.140, the income earned by the Idaho resident spouse is treated as community income even though the marriage is “defunct” and the couple is living separate and apart.

Under the scenario described above (wife lives and works in Idaho, husband lives and works in Washington, and R.C.W. section 26.16.140 applies), the income earned by the spouse living in Idaho is attributed one-half to the wife and one-half to the husband. The income earned by the spouse residing in Washington is attributed solely to that spouse. Furthermore, under Idaho Code section 63-3026A and Income Tax Administrative Rule 270, compensation for services performed in Idaho is Idaho source income. As a result, the nonresident spouse (the

husband in our hypothetical) will be required to report his share of his wife's compensation to Idaho as Idaho source income received by a nonresident individual. The wife as a resident of the state of Idaho is also required to report her share of the community income to Idaho. In the aggregate, 100% of the earned income of the wife is reported to Idaho, while none of the earned income of the husband is reported to Idaho.

If neither I.R.C. section 66(a) or R.C.W. section 26.16.140 apply, then both the Idaho resident spouse and the Washington resident spouse will treat their earned income as community income. Under this scenario, the wife, residing in Idaho, will report one-half of her earned income plus one-half of her husband's earned income to Idaho, and the husband, residing in Washington, will report one-half of his wife's earned income to Idaho. This allocation is the result of the fact that the wife, as an Idaho resident, is required to report all her income (regardless of source) to Idaho, while the husband, as a nonresident, is required to report the Idaho source income attributable to him from his wife's employment services.

Since the taxpayers filed their 1996 federal income tax return with a filing status of married filing joint, the exception to state community property laws granted by I.R.C. section 66(a) would not apply.

The taxpayers must now employ R.C.W. section 26.16.140 in order to treat [Redacted] earned income in Washington as his separate property. The Commission finds that taxpayers may not claim this exception to Washington community property laws because they have not met the burden of proof that the marriage was, for all practical purposes, defunct. As a result, the income earned by [Redacted] will be treated as community income under Washington law. In this case, the wife earned \$27,592 from her Idaho employment, and the husband earned \$34,865 from his Washington employment. On their Idaho married filing joint return, the wife must

report \$31,228.50 (½ of her \$27,592 wages plus ½ of husband's \$34,865 wages); and the husband must report \$13,796 (½ of wife's \$27,592 wages). WHEREFORE, the Notice of Deficiency Determination dated August 6, 2001, as modified, is hereby APPROVED, AFFIRMED, and MADE FINAL.

IT IS ORDERED and THIS DOES ORDER that the taxpayer pay the following tax, penalty and interest:

<u>YEAR</u>	<u>TAX</u>	<u>PENALTY</u>	<u>INTEREST</u>	<u>TOTAL</u>
1996	\$2,426	\$607	\$907	\$ 3,940
			Payment	<u>(1,575)</u>
			<b>Total Due</b>	<b><u>\$2,365</u></b>

Interest is computed through February 5, 2003.

DEMAND for immediate payment of the foregoing amount is hereby made and given.

An explanation of the taxpayers' right to appeal this decision is enclosed with this decision.

DATED this \_\_\_ day of \_\_\_\_\_, 2002.

IDAHO STATE TAX COMMISSION

\_\_\_\_\_  
COMMISSIONER

**CERTIFICATE OF SERVICE**

I hereby certify that on this \_\_\_\_ day of \_\_\_\_\_, 2002, a copy of the within and foregoing DECISION was served by sending the same by United States mail, postage prepaid, in an envelope addressed to:

[Redacted]

[Redacted] \_\_\_\_\_