28 T.C. 1150 (1957)

In community property states, a property settlement agreement between spouses cannot shift the incidence of taxation on income earned during the marriage; each spouse remains liable for their share of the income, regardless of any agreement to the contrary.

Summary

Ione C. Hubner sought to avoid tax liability on her share of her former husband's partnership income. She argued a property settlement agreement, which she and her husband entered into, limited her tax obligations. The U.S. Tax Court held that the agreement could not alter her tax liability for income earned during the marriage. The court reasoned that, under established tax law principles, even if the income was assigned to one spouse as separate property, the tax liability for income earned while the community property regime existed could not be transferred. The court ruled against Hubner, determining she was liable for tax on her half of the increase in her ex-husband's partnership income, even though the settlement agreement appeared to limit her claim on the income.

Facts

Ione C. Hubner and E.J. Hubner were married in California, a community property state. E.J. Hubner was a partner in the Hubner Building Company. In 1950, Ione transferred her partnership interest to others. The partnership's fiscal year ended on February 28, 1951. In April 1951, the Hubners entered into a property settlement agreement that was later incorporated into an interlocutory decree of divorce. The agreement stated that Ione waived her interest in the partnership profits, with a stated exception. The IRS subsequently adjusted the partnership's income, increasing E.J. Hubner's distributable income. The Commissioner determined that Ione was liable for tax on one-half of the increased income. Ione contested this, arguing the agreement limited her liability.

Procedural History

The IRS determined a deficiency in Ione Hubner's income tax for 1951. Ione contested this determination in the U.S. Tax Court. The case was submitted on stipulated facts. The Tax Court ruled in favor of the Commissioner.

Issue(s)

1. Whether the property settlement agreement between Ione and E.J. Hubner limited her liability for income tax on her share of E.J. Hubner's partnership income, despite adjustments made to the income by the Commissioner.

Holding

1. No, because the property settlement agreement could not shift the incidence of tax liability for income earned during the marriage while the community property regime was in effect.

Court's Reasoning

The court acknowledged that under California law, spouses could enter into property agreements regarding their community property. However, the court distinguished between transferring ownership of property and shifting tax liability. The court cited cases such as *Johnson v. United States*, which established that the power to dispose of income is equivalent to ownership, and exercising that power to pay another is considered the realization of income for tax purposes. The court stated, "though income may be transferred, the incidence of tax may not be shifted from the transferor." The court reasoned that the Hubners each had a right to their share of the community income when the income was earned. Ione's act of waiving her rights under the agreement was a disposition of her income and not an act of ownership of separate property. The agreement, though valid for property transfer purposes, could not change the incidence of taxation. The court emphasized that the income was earned while the community property regime was in place, and thus, both parties were liable for the taxes on income earned during that time, irrespective of the property agreement.

Practical Implications

This case underscores the importance of understanding that property settlement agreements in community property states, while determining property ownership, do not automatically dictate tax liability. Attorneys must advise clients that attempting to shift the tax burden through such agreements, for income earned during marriage, will likely fail. The decision reinforces that tax liability is determined by the earning of income, not the subsequent transfer. This impacts how tax planning is conducted during divorce proceedings, emphasizing the necessity of considering tax consequences separately from property division. Later courts consistently cite *Hubner* to clarify that community property division does not alter federal income tax obligations. For example, in *United States v. Elam* (9th Cir. 981), the court referenced *Hubner* to state that the transfer of community property, including the income, does not change the tax liability.

