Divorcing the Husband and Wife Business: An Analysis and Critique of I.R.C. § 761(f)

Adam S. Winger
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INTRODUCTION

Congress extended a unique benefit to husband-and-wife businesses in its 2007 modification of I.R.C. § 761(f). The subsection now allows a spousal venture to elect out of federal partnership status in favor of a newly created hybrid entity, the “qualified joint venture.” By splitting the existing partnership into two distinct sole proprietorships, the qualified joint venture relieves couples of complex compliance burdens associated with partnership taxation. Additionally, I.R.C. § 761(f) calls for a proportionate division of income between the spouses, thus each will be correctly awarded Social Security and Medicare credit for their efforts. Although the subsection’s benefits are clear, Congress’ failure to resolve several related issues may unfortunately limit the legislature’s benevolent intent.

This article provides an analysis of I.R.C. § 761(f), highlighting some of its benefits and shortcomings and also provides a few recommendations for improvement. Part I investigates several benefits I.R.C. § 761(f) seeks to extend. Part II offers both an

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2. I.R.C. § 761(f) (West 2007).
5. See discussion infra Part I.
6. See discussion infra Parts I-III.
7. See discussion infra Part II.
analysis and critique of the subsection’s provisions. 8 Finally, Part III provides functional recommendations for improvement.9

I. I.R.C. § 761(f) BENEFITS

I.R.C. § 761(f) achieves three core objectives, and does so without detrimentally impacting national revenue:10 First, it relieves husband-and-wife businesses of unnecessary compliance burdens; second, it ensures the integrity of the Internal Revenue Service (IRS); third, it corrects an existing problem with family Social Security and Medicare crediting.11

A. Reduces the Compliance Burden

Whether they know it or not, a couple working together is most likely operating a partnership for federal tax purposes.12 As a result, the spouses are expected to understand and comply with Subchapter K of the Internal Revenue Code.13 Subchapter K’s provisions, however, are “distressingly complex and confusing” and present immense challenges even to “one who is sophisticated in tax matters with many years of experience in the tax field.”14 By enabling a couple to elect out of partnership status, I.R.C. § 761(f) relieves couples of the majority of these hardships.15

To illustrate the compliance burdens, the following is an example of the potential annual filing requirements. The partnership is recognized as an entity apart from its owners.16 Consequently, the

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8. See discussion infra Part III.
9. See discussion infra Part IV.
11. Id.
couple must file a Form 1065 on the entity’s behalf reporting all income, deductions, gains, and losses from operations.\textsuperscript{17} Next, two Schedule K-1s must be completed that reflect each spouse’s allocable share of the income or loss.\textsuperscript{18} The couple must then transcribe the Schedule K-1 information onto individual Schedule Es, reporting the partnership income as their own.\textsuperscript{19} Next, because partners are not considered employees for federal tax purposes, both must complete Schedule SEs, characterizing their distributive share of income as earned from self-employment.\textsuperscript{20} Finally, all personal schedules merge onto the couple’s joint Form 1040, which ultimately determines the net tax liability on partnership earnings.\textsuperscript{21} The IRS estimates the partnership forms alone—Form 1065 and Schedule K-1s—take approximately 165–200 hours to prepare and file.\textsuperscript{22} Translated into economic terms, a family business has the option to either sacrifice more than a month of productive labor or pay lofty fees to a tax practitioner just to comply with Subchapter K.\textsuperscript{23}

By allowing married couples qualified joint venture status, Congress removes nearly all federal compliance burdens.\textsuperscript{24} In contrast to the partnership, the qualified joint venture’s two sole proprietorships are not separate legal entities for federal income tax purposes.\textsuperscript{25} Consequently, no entity-level filings are required.\textsuperscript{26} Instead, the spouses simply divide net income in accordance with their respective ownership interests and report this information on


\textsuperscript{18} I.R.S. Report, supra note 3, at 175.


\textsuperscript{20} See id. at SE-2.

\textsuperscript{21} See generally id.

\textsuperscript{22} I.R.S. Report, supra note 3, at 172.

\textsuperscript{23} See generally CHARLES RANGEL, TAXPAYER PROTECTION ACT OF 2007, H.R. REP. No. 110-84, at 8 (2007) (indicating husband-and-wife business owners “may be subject to unnecessary complexity under present law”) (hereinafter RANGEL ACT).

\textsuperscript{24} Andrew R. Biebl, Tax Bill du Jour, TOP PRODUCER, Summer 2007, at 34.


\textsuperscript{26} Id.
two Schedule Cs. Unlike the partnership, "[t]he IRS estimates that it takes the average taxpayer about [eleven] hours to complete a Schedule C." Although each spouse will remain responsible for reporting self-employment income, the qualified joint venture relieves couples of the most oppressive burdens associated with Subchapter K.

B. Assisting in Maintaining the Integrity of the IRS

Due to either a lack of awareness or the substantial cost of compliance, family businesses have traditionally shirked the responsibilities connected to their partnership status. This continuing neglect triggered the IRS's issuance of Revenue Procedure 81-11. Instead of punishing the couples, however, the procedure exacerbated the problem by waiving penalties for small businesses that "historically had not filed partnership returns." Interestingly, the waiver did not "eliminate the filing requirement for partnerships . . . ; it merely provide[d] that a penalty for failure to file will not be assessed." The National Tax Advocate took issue with this leniency, stating:

Respect for the integrity of the tax system suffers when rules are imposed that place an unnecessarily heavy compliance burden on taxpayers, that many taxpayers ignore . . . , that the IRS . . . does not enforce, and that have no impact on tax liability. It is

27. Id. § II-B, -A-4 n.28; see 1040 INSTRUCTIONS, supra note 17, at C-2. The Schedule C is used to report "Profit and Loss from Business" operations. Note also that Schedule F is used for similar items in farming contexts.


29. Id. at 181. Note also that in Chief Counsel Advice 200816030, guidance was issued to confirm that rental real estate income, which would otherwise be exempt from Self Employment tax, will retain its exempt status in the hands of a qualified joint venture. Qualified Joint Ventures and Rental Business Income, I.R.S. Chief Counsel Advisory 200816030 (Apr. 18. 2008).


31. Id.


confusing and pointless for the Internal Revenue Code to require all partnerships to file a partnership tax return, while the IRS... 

Congress effectively mitigated the risk of compromising its integrity via modification of I.R.C. § 761(f). By splitting the husband-and-wife business into two sole proprietorships, thereby taking them out of partnership status, the legislature eliminated the need to prosecute for couples' noncompliance with Subchapter K.

C. Curing Issues with Social Security and Medicare Crediting

The new law also resolves a complication arising from improper Social Security and Medicare crediting. Where both spouses actively participate in a business, each is entitled a portion of the "distributive share... of income or loss." This income is correctly reportable as "net earnings from self-employment." The government then imposes a tax for Social Security and Medicare. In return, each spouse becomes eligible to receive future health and retirement benefits.

Frequently, however, one spouse will lose credit for their earned income due to incorrect return filing. In Royer v. Apfel, for instance, a husband and wife jointly operated a farm for more than twenty-five years. Not knowing a partnership had been formed, the husband recognized all earnings under his name as sole-proprietorship

35. See id. (encouraging Congress to "simply change the law to reflect the desired policy" as was done in adopting I.R.C. § 761(f)).
36. Id. at 179–80.
39. Id.
42. Id.
income.\textsuperscript{44} When the couple divorced, the wife learned that the mistake deprived her of all governmental benefits.\textsuperscript{45} The court corrected the error by reallocating the benefits and ordered the husband to reimburse the government for the value of benefits he had unjustly received.\textsuperscript{46} Although the court was able to resolve the issue, the filing mistake needlessly cost both parties time and considerable legal fees on top of those already expended for their divorce.\textsuperscript{47}

The qualified joint venture seeks to eliminate this potential of improper employment tax reporting.\textsuperscript{48} Because I.R.C. § 761(f) demands that the new entity’s income be divided in accordance with each spouse’s interest in the venture, both spouses must recognize their distributive share as proceeds from their own self-employment.\textsuperscript{49} Though this may increase the venture’s immediate tax burden, it will ensure the proper crediting of Social Security and Medicare and remove the potential of a costly, \textit{Royer}-like reallocation upon divorce.\textsuperscript{50}

\textit{D. Negligible Impact on National Tax Revenue}

I.R.C. § 761(f) achieves all the aforementioned benefits while simultaneously avoiding any negative impact to the national budget.\textsuperscript{51} Just as all income, deductions, gains, and losses flow from a partnership down to its partners, all net earnings pass through to the owner of a sole proprietorship.\textsuperscript{52} As a result, “[r]egardless of how the net earnings from the business are reported—either as a flow-through item from the partnership return or as net earnings from Schedule

\begin{itemize}
  \item \textsuperscript{44} \textit{Id.} at *3 (acknowledging the husband made the mistake unintentionally).
  \item \textsuperscript{45} \textit{Id.}
  \item \textsuperscript{46} \textit{Id.} at *6.
  \item \textsuperscript{47} \textit{See generally id.}
  \item \textsuperscript{48} \textit{See I.R.C. § 761(f)} (West 2007); \textit{see also RANGEL ACT, supra note 23, at 183.}
  \item \textsuperscript{49} 1040 INSTRUCTIONS, supra note 17, at C-2 (instructing that “[e]ach . . . [spouse] must also file a separate Schedule SE to pay self-employment tax, as applicable”).
  \item \textsuperscript{50} I.R.S. Report, supra note 3, at 181.
  \item \textsuperscript{51} \textit{Id.}
  \item \textsuperscript{52} \textit{See U.S. Income Portfolios 700, supra note 25, § II-B.}
\end{itemize}
C—the income tax liability of the husband and wife generally will be the same."53

II. I.R.C. § 761(f): ANALYSIS & CRITIQUE

Although I.R.C. § 761(f) offers helpful benefits to married co-owners, its qualification prerequisites may frustrate Congress’s benevolent intent.54 I.R.C. § 761(f) has four eligibility requirements, all of which risk excluding qualifying couples from qualified joint venture status: (1) the only members of such joint venture are a husband and wife; (2) both spouses materially participate in the trade or business; (3) both spouses elect for the subsection to apply, and; (4) the couple files jointly.55

A. Introduction to Entity Formation and Classification

As stated, both spouses must make an affirmative election before Congress extends the benefits of the qualified joint venture.56 Unfortunately, many married taxpayers may never know to make such an election.57 In Royer, the court acknowledged the husband had no intent to mislead the IRS in misclassifying the family business as a sole proprietorship.58 Instead, like many others, he was simply unaware of his family’s partnership status.59 If he never knew he was subject to Subchapter K, it is impossible that he would know to elect

53. I.R.S. Report, supra note 3, at 181. For additional qualified joint venture benefits, see discussion on income shifting and divorce settlements, id. at 177–78.
54. See generally I.R.C. § 761(f) (West 2007).
55. Id. at § 761(f)(2)(A)-(C).
56. Id. at § 761(f)(2)(C).
59. See S.S.R. 84-11, at 42 (1984) (indicating “it is quite possible that a couple may have actually operated their business as a partnership without recognizing that fact”); see also Ardolina v. Comm’r, 186 F.2d 176 (3d Cir. 1951); Garrison v. Garrison, 726 So. 2d 723 (Ala. Civ. App. 1999).
out of it. Although the willful avoidance of partnership status may make up some of the government's family compliance problem, Royer represents another faction: those unaware of their operation's partnership designation.

History has shown that determining whether a relationship constitutes a partnership is less than self-evident. I.R.C. § 761(a) offers the only statutory guidance, stating a partnership may take the form of a "syndicate, group, pool, joint venture, or other unincorporated organization . . . ." The subsection does not, however, answer the question of what level of activity is required to establish a syndicate, group, pool, joint venture, or other unincorporated organization.

The IRS has offered limited guidance—clarifying that relationships such as employer-employee, debtor-creditor, purchaser-seller, and co-owners are all by themselves insufficient to create a partnership. Problems arise, however, when more complex factual scenarios are considered. For instance, while mere co-ownership of rental property does not constitute a partnership, if the owners "provide services to the occupants," the relationship will likely be transformed. Consequently, the taxpayer is left to make a thorny legal conclusion of whether their activities constitute "services," and

60. Sloan Interview, supra note 57. Note that Sloan believes this conclusion may have been reached by another practitioner and does not take credit for the concept.
61. See generally id. (suggesting the families who do not know they are subject to Subchapter K likely will not know to make the necessary election).
63. I.R.C. § 761(a) (West 2007).
64. See generally Eric Sloan, Opening Pandora's Box: Who Is (or Should Be) a Partner?, in 746 TAX PLANNING FOR DOMESTIC & FOREIGN PARTNERSHIPS, LLCs, JOINT VENTURES & OTHER STRATEGIC ALLIANCES 291, at § II (Louis S. Freeman & Clifford M. Warren eds., Practising Law Institute 2007) [hereinafter Pandora's Box] (turning to the "Culbertson trilogy" for clarification).
65. U.S. Income Portfolios 710, supra note 14, § II-B.
66. See generally Rev. Rul. 75-374, 1975-2 C.B. 261 (stating the "furnishing of additional service will render a co-ownership a partnership").
67. Id.; see also 26 C.F.R. § 301.7701-1(a), (a)(2) (2006) (stating "a separate entity exists for federal tax purposes if co-owners of an apartment building lease space and in addition provide services to the occupants either directly or through an agent") (emphasis added).
neither option is without consequences.68 On one hand, the couple can file as a sole proprietor risking subsequent interest, penalties, and Royer-like legal fees in the event the IRS finds a partnership.69 On the other, they can recognize the partnership and face the complex compliance burdens associated with a sea of technical tax law.70 Not surprisingly, taxpayers have chosen the former and frequently found themselves before the court arguing over the existence of a partnership.71

I. Classification Litigation: The Culbertson Trilogy

Partnership disputes of this nature spurred the creation of a multi-factored test which was fleshed out in three foundational decisions commonly referred to as the "Culbertson trilogy."72 In Commissioner v. Tower, decided first, the Supreme Court held the parties' intent to be the primary partnership indicia.73 Justice Black, writing for the majority, stated that "whether the partners really and truly intended to join together for the purpose of carrying on business and sharing in the profits or losses" will determine the existence of a partnership.74 Following Tower came Commissioner v. Culbertson and Commissioner v. Luna, instructing courts to consider the following factors in addition to the intent element:

1) the agreement of the parties; 2) the conduct of the parties in execution of the provisions of the agreement; 3) the statements of the parties; 4) testimony of disinterested persons; 5) the relationship of the parties; 6) their respective abilities and capital

68. See generally Rev. Rul. 75-374, 1975-2 C.B. 261 (providing additional factors to be used to make a conclusive partnership decision). It is uncertain whether the lenient treatment of Rev. Proc. 81-11 will continue to apply to couples eligible for qualified joint venture treatment.
70. See Foxman v. Comm'r, 41 T.C. 535, 551 n.9 (1964).
71. See generally Hobbs, supra note 62.
72. See, e.g., Comm'r v Culbertson, 337 U.S. 733, 742 (1949); see also Pandora's Box, supra note 64, at 299; Comm'r v. Tower, 327 U.S. 280 (1946); Comm'r v. Luna, 42 T.C. 1067 (1964).
73. Tower, 327 U.S. at 287.
74. Id.
For years, these Culbertson-trilogy factors served to conclusively identify the existence of a partnership.\footnote{\textit{Compare} Treas. Reg. § 301.7701-1 to -3 (1997) (effective 1997), with Culbertson, 337 U.S. at 742 (decided in 1949).}

2. The New Classification Challenge: The Hybrid Entity

A new set of classification issues arose, however, with the inception of the "hybrid form of business entity."\footnote{\textit{Id. at} 510. Following the initial authoring of this Note, the I.R.S. released its position that "only businesses that are owned and operated by spouses as co-owners, and not in the name of a state law entity (including a general or limited partnership or limited liability company)" are to be eligible for qualified joint venture treatment. \textit{See} I.R.S., \url{http://www.irs.gov/businesses/small/article/0,,id=177376,00.html} (heading entitled "Definition of a qualified joint venture") (last visited Mar. 21, 2009). Although this contention is beyond the scope of this Note, it is arguable whether this limitation will persist.} A hybrid entity is one containing characteristics of two or more business structures.\footnote{\textit{See generally} Kandi v. United States, No. C05-0840C, 2006 WL 83463 (W.D. Wash. Jan. 11, 2006).}

The limited liability company (LLC), for instance, extends the limited liability of a corporation while retaining the flow-through tax advantages of a partnership.\footnote{\citeauthor{Fleischer}, \textit{If It Looks Like a Duck}: \textit{Corporate Resemblance and Check-The-Box Elective Tax Classification}, 96 \textit{COLUM. L. REV.} 518, 553 (1996) (identifying the need for a more predictable entity classification system).} Because the entity is a creation of state law, the originating state determines the entity's legal rights and obligations.\footnote{\textit{E.g.}, Gulley v. Comm'r, 79 T.C.M. (CCH) 2171, at *5 (2000) (stating federal law, not state, controls to determine whether a partnership was terminated for federal tax purposes).} For purposes of federal taxation, however, it is federal law that controls, not state law.\footnote{\textit{Id. at} 510.}

This legal disparity resulted in varying and unexpected judicial results.\footnote{\textit{Id. at} 510.} In \textit{Evans v. Commissioner}, for example, a taxpayer transferred his partnership interest to a closely-held corporation in exchange for corporate stock.\footnote{\textit{Evans v. Comm'n}, 447 F.2d 547, 548 (7th Cir. 1971).} The taxpayer was under the...
impression that because he remained a partner for state law purposes, he would remain so under the federal tax code as well. The court held otherwise, stating "after the assignment [the taxpayer] could no longer be regarded as a partner for federal income tax purposes, even though he remained one for state purposes." In 1997, the Treasury Department responded to this confusion with the "Check-the-Box" Regulations.

3. Check-the-Box Regulations Simplify the Classification Struggle

Where the Culbertson trilogy aided in determining whether a partnership was formed, the check-the-box regulations attempt to clarify whether an unincorporated entity should be taxed as a corporation or partnership. The regulations created an elective regime, where the taxpayer, not the government, decides the entity's tax classification. Under the regulations, "[a] business entity with two or more members is classified for federal tax purposes as either a corporation or a partnership." Alternatively, "[a] business entity with only one owner is classified as a corporation or is disregarded." Finally, if no election is made, the regulations provide for the partnership or the disregarded entity to serve as default classifications. Therefore, under the check-the-box regulations, so long as the relationship constitutes a "business entity," the entity classification issue appears settled.

84. Id. at 549.
85. Id. at 552.
86. Treas. Reg. § 301.7701-1 to -3 (1997). Before the Check-the-Box regulations were issued, courts relied on the Kintner Regulations. For a discussion of the Kintner Regulations and the history of the classification issue, see Hobbs, supra note 62.
87. See generally Treas. Reg. § 301.7701-1 to -3 (1997).
88. See Treas. Reg. § 301.7701-2(a) (1997) (making entity status entirely elective and creating the partnership as the default entity for businesses with two or more owners).
91. Id. § 301.7701-3(b).
92. See id.
Absent from the regulations, however, is guidance indicating when exactly a “business entity” is formed.\(^93\) For instance, suppose a husband and wife co-own real property and file as an LLC with their state.\(^94\) Although the formality of a state filing may suffice to create a “business entity” under state law, as stated previously, “mere coownership [sic] of property . . . does not constitute a partnership” for purposes of federal taxation.\(^95\) Instinctively, a taxpayer may revert to the “Culbertson trilogy” for clarification, but reputable commentators argue those concepts no longer apply in a check-the-box world.\(^96\) Thus, the taxpayer is again thrown back in the predicament of making an extremely subjective legal conclusion as to whether his or her operation constitutes a business entity, and therefore a partnership.\(^97\)

4. The Impossible Challenge of Exclusion Without Knowledge of Inclusion

In sum, couples may justifiably be unaware they are subject to Subchapter K for two reasons, and consequently, will not know to make the necessary I.R.C. § 761(f) election.\(^98\) First, because many family businesses ignore their tax status, the couple may not know (or care) that they are operating a partnership.\(^99\) Second, couples operating in the grey area of the “business entity” requirement, such as real estate owners, may not know that their relationship has risen

\(^93\) U.S. Income Portfolios 710, supra note 14, § II-B.


\(^96\) WILLIAM S. MCKEE, WILLIAM F. NELSON, & ROBERT L. WHITMIRE, FEDERAL TAXATION OF PARTNERSHIPS AND PARTNERS, ¶ 3.01.2 (stating “the analysis in Tower and Culbertson should become irrelevant to determining partnership tax classification”); see also I.R.S. Priv. Ltr. Rul. 199911033 (Mar. 19, 1999) (applying the Culbertson analysis after the check-the-box regulations to determine the partnership formation issue). But see Pandora’s Box, supra note 64, at 304 (arguing this “view . . . has little merit”).

\(^97\) See generally U.S. Income Portfolios 710, supra note 14, § II-B (indicating no real guidance exists on the business entity element).

\(^98\) See discussion supra Part II(A)(1)–(3).

to the level of a partnership. Unfortunately, I.R.C. § 761(f) addresses neither, and as a result, many qualifying families may be without the knowledge to elect out of partnership status.

B. A Closer Look into the Material Participation Requirement—I.R.C. § 469(h)

The provision in I.R.C. § 761(f)(2)(B), requiring the material participation of both spouses, may also conflict with the subsection’s general intent. I.R.C. § 496(h) defines “material participation” as “regular, continuous, and substantial” involvement in the operations of the activity. The IRS augmented this definition issuing Treasury Regulation § 1.469-5T in 1998.

Even with this addition, however, “[t]he rules for determining what constitutes material participation are complex.” In fact, it has been noted that the restrictions in I.R.C. § 469 “comprise one of the more complicated areas of the tax law.” Consequently, by making material participation a condition of qualification, Congress requires a group historically troubled by the complexities of the tax law to understand and comply with one of the law’s most intricate provisions. This result does nothing to simplify family taxation as suggested in the section’s title: “Family Business Tax Simplification.” Instead, it complicates things by adding a complex

100. See Sloan Interview, supra note 57; see also U.S. Income Portfolios 710, supra note 14, § II-B (indicating no real guidance exists on the business entity element).
102. Sloan Interview, supra note 57.
104. I.R.C. § 469(h)(1)(A)–(C) (2006); see also id. at (h)(2) (excluding all limited partners from material participation status).
analytical layer, thereby risking frustration of I.R.C. § 761(f)'s intent.\footnote{110 See generally Bankman, supra note 106; H.R. REP. NO. 110-84, supra note 109.}

1. The Material Participation Issue for Limited Partnerships

Another unintended conflict related to the participation requirement arises when a husband-and-wife business currently operates as a limited partnership with one spouse serving as a limited partner.\footnote{111 See generally I.R.C. § 469(h)(2) (2006).} I.R.C. § 469(h) categorically prohibits a limited partner from satisfying the material participation requirement.\footnote{112 Id. But cf. I.R.C. § 469(i)(6) (allowing some exceptions for material participation in rental activities).} Consequently, even if both spouses meet the baseline participation requirement, because one is a limited partner, they will be precluded from qualified joint venture treatment.\footnote{113 See generally I.R.C. § 469(h)(2) (stating limited partnership interests shall not be treated as material participation and also referring to exceptions in Treas. Reg. § 1.469-5T(e)).} This result seems to conflict with the subsection's intent.\footnote{114 See I.R.S. Report, supra note 3, at 183 (noting the goal of removing the partnership compliance burdens).} According to the National Tax Advocate, a primary purpose in amending I.R.C. § 761(f) was to alleviate partnership compliance burdens.\footnote{115 Id. at 181.} Couples operating limited or family limited partnerships are subject to these burdens, but cannot avail themselves of the beneficial treatment due to their current status.\footnote{116 See I.R.C. § 761(f) (2007); I.R.C. § 469(h)(2).} Thus, the very taxpayers I.R.C. § 761(f) seeks to assist are those categorically restricted from enjoying its benefits.\footnote{117 Id.}

C. Interaction of § 761(f) with Revenue Procedure 2002-69

explained in the subsections below, this disparity has the potential to undermine the requirements of I.R.C. § 761(f).120

1. An Overview of Revenue Proc. 2002-69

The IRS issued Rev. Proc. 2002-69 to provide guidance on the classification of husband-and-wife entities in community property states.121 The distinction became necessary when community property law intersected with the check-the-box regulations.122 The basic tenant of community property gives both spouses equal ownership in all marital assets.123 These joint ownership characteristics arise whether both spouses generate or manage the assets or not.124 For instance, it was noted in Yokochi v. Yoshimoto that although company stock was held in the husband’s name and controlled entirely by the husband, these factors in no way diminished the wife’s equal ownership rights in the stock.125 The shared ownership aspects of community property raised questions about a spouse’s ability to serve as an entity’s sole owner, and this distinction became crucial when the taxpayer attempted to exchange like-kind property pursuant to I.R.C. § 1031.126

2. Introduction to I.R.C. § 1031 Exchanges

Section 1031 provides for the deferral of gain or loss recognition on exchanges of like-kind business properties.127 Traditionally, taxpayers will rely on lender financing to fund their new investment.
in the replacement property. 128 After sustaining massive losses in the 1980s, however, commercial lenders began taking precautionary measures before extending such credit. 129 Financial institutions now typically demand replacement property to be held in a "bankruptcy remote entity." 130 For instance, instead of the individual taxpayer holding the asset directly, leaving the property exposed to creditors, the lender may insist that the asset be held in a bankruptcy remote LLC. 131 This requirement, however, found married real estate owners in community property states at risk of violating I.R.C. § 1031's "exchange element." 132

The implicit "exchange element" of I.R.C. § 1031 requires the same taxpayer both to relinquish the existing property and receive the replacement property. 133 The potential violation occurs when the husband and wife's dual-ownership in the LLC is treated as the operation of a partnership under the check-the-box regulations. 134 Although owning the LLC should equate to "mere co-ownership," 135 as stated previously, it is uncertain whether the formation of a state entity automatically satisfies the check-the-box "business entity" requirement. 136 If it does, because the husband and wife would then co-own a "business entity," not just property, the entity must be classified as either a corporation or tax partnership. 137 Therefore,

128. See generally Cuff, supra note 94, at 230. ("Most attorneys who deal with real property transactions have observed the growth of single member LLCs as special purpose entities to hold real property in connection with securitized financing."). See also Bradford Updike, Exploring the Frontier of Non-Traditional Real Estate Investments: A Closer Look at 1031 Tenancy-In-Common Arrangements, 40 CREIGHTON L. REV. 271, 274 (2007) (defining replacement property as "the real estate the taxpayer ultimately ends up with once the exchange is completed").

129. See Howard J. Levine & David A. Weintraub, Two-Member LLC Can be Disregarded in 1031 Exchange Where One Member Has No Economic Interest, 90 J. TAX'N, 138 (Mar. 1999).

130. For a discussion of the bankruptcy remote entity, see Updike, supra note 128, at 274 n.167.


132. Levine & Weintraub, supra note 129.


134. See Cuff, supra note 94.


136. See generally Cuff, supra note 94 (recognizing uncertainty in husband-and-wife like-kind exchanges).

although the couple is considered the taxpayer relinquishing the property, the LLC, recognized as a separate taxable entity, may be found to have received the replacement property.\textsuperscript{138} This result violates the exchange requirement, thereby destroying any deferral allowed under I.R.C. § 1031.\textsuperscript{139}

Had this situation arisen in a non-community property state, both the original ownership and the LLC interest would be disregarded for federal tax purposes.\textsuperscript{140} The assets and obligations of a disregarded entity "are treated as owned directly by the owner of the entity."\textsuperscript{141} As a result, the replacement property, although housed in an LLC, would be treated as owned directly by one of the spouses, thereby preserving the exchange element.\textsuperscript{142} Community property taxpayers grew frustrated with this disparity, and turned to the IRS for clarification.\textsuperscript{143}

The IRS responded with Rev. Proc. 2002-69, which allows a husband-and-wife in a community property state to choose whether their entity is taxable as a disregarded entity or partnership for federal tax purposes.\textsuperscript{144} As a result, even if the family operation did in fact constitute a federal tax partnership, it could elect out of Subchapter K in favor of disregarded entity status.\textsuperscript{145} This clarification removed the barrier obstructing the successful effectuation of tax-deferred, like-kind exchanges, but as indicated below, it now runs counter to I.R.C. § 761(f) in a number of ways.\textsuperscript{146}

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\footnotesize
\textsuperscript{138} See Cuff, supra note 94.
\textsuperscript{139} See id.
\textsuperscript{140} See generally I.R.S. Priv. Ltr. Rul. 97-51-012 (Sept. 15, 1997) ("The acquisition of the replacement property by each nonelecting LLC, wholly-owned by Taxpayer, will be deemed an acquisition by Taxpayer.").
\textsuperscript{142} See Cuff, supra note 94, at 233.
\textsuperscript{143} Id.
\textsuperscript{144} Rev. Proc. 2002-69, 2002-45 I.R.B. 831; see also Cuff, supra note 94.
\textsuperscript{145} See Cuff, supra note 94, at 236-37.
\textsuperscript{146} See id.
\end{flushright}

Rev. Proc. 2002-69 conflicts and undermines I.R.C. § 761(f) by affording the same disregarded treatment to families without imposing the most stringent of the qualified joint venture requirements.\(^{147}\) To qualify as a qualified joint venture under I.R.C. § 761(f), a couple must (1) file jointly; (2) be the only members of the joint venture; (3) materially participate; and (4) both spouses must make the necessary election.\(^{148}\) In contrast, to be eligible for functionally identical treatment under Rev. Proc. 2002-69, a couple in a community property state must only prove to be the sole owners of the business.\(^{149}\) Consequently, community property couples are afforded equally beneficial tax treatment even though it is possible that neither spouse materially participates in the entity's operations.\(^{150}\) In this situation, so long as one of the spouses owns the company outright, community property laws will attribute ownership to the other. By imposing this requirement on couples in separate property states, but not those in community property states, the IRS renders the subsection's provisions meaningless in community property states.\(^{151}\)

D. A New Employment Tax Liability for Couples

By separating the partnership into two disregarded entities, both spouses may potentially become personally liable for unpaid employment taxes.\(^{152}\) This result creates a significant disincentive for couples to make the I.R.C. § 761(f) election if they currently enjoy the protection of an LLC.\(^{153}\) For instance, because an LLC taxed as a


\(^{149}\) See Rev. Proc. 2002-69, 2002-45 I.R.B. 831 § 3 (defining requirements of a "Qualified Entity").

\(^{150}\) Id.

\(^{151}\) See generally I.R.C. § 761(f); see also Rev. Proc. 2002-69, 2002-45 I.R.B. 831.

\(^{152}\) See Steam & Co., LLC v. United States, 499 F. Supp. 2d. 899, 902 (2007) (holding the sole owner of LLC liable because the entity was disregarded (citing Littriello v. United States, 484 F.3d 372, 378 (6th Cir. 2007))).

\(^{153}\) E-mail from Cassady V. Brewer, Tax Partner, Morris, Manning & Martin, LLP (Nov. 6, 2007, 11:47 EST) (on file with author) [hereinafter Cassady E-mail]. As noted supra, note 79, the I.R.S.
partnership is recognized as an entity separate from its owners for federal tax purposes, the LLC, not its members, is considered the employer and thus liable for employment taxes. Should the couple split, however, both entities would become disregarded for tax purposes. If state law mirrors this treatment, two single-member LLCs would then exist, and courts consistently hold the owner of a single member LLC liable for unpaid employment taxes.

In Treasury Decision 9356, issued August of 2007, the IRS parted ways with this common holding finding that a single-member LLC should be treated “as [a] separate entit[y] for purposes of employment tax[es].” Therefore, going forward, the LLC, not the individual, will be considered the employer responsible for the employment tax burden regardless of its number of owners. These regulations, however, were not applicable until January 1, 2009. Before that date, the sole owner remains personally liable for all employment taxes, consistent with existing case law. Consequently, couples may be encouraged to postpone making an I.R.C. § 761(f) election until after 2009 in order to avoid shedding their employment tax liability shield.

Even if the couple chooses to wait, however, additional uncertainty leaves the couple facing continued exposure. Treasury Decision 9356 provides for entity-level protection only for “single-owner eligible

currently considers “only businesses that are owned and operated by spouses as co-owners, and not in the name of a state law entity (including a general or limited partnership or limited liability company)” to be eligible for qualified joint venture treatment. Although the author disagrees with the legitimacy of this position, a full discussion of the issue is beyond the scope of this Note.

156. Treas. Reg. § 301.7701-2(a); see generally 1040 INSTRUCTIONS, supra note 17, at C-2 (requiring both spouses to file separate Schedule Cs).
160. See id.
161. Id.
162. Id.
163. See generally Cassady E-mail, supra note 153.
entities that currently are disregarded as entities separate from their owners." 164 It is currently uncertain how the spouses will be treated should they split for tax purposes. 165 Above, it was assumed that state law would automatically mimic the tax-law division, thereby creating two single-member LLCs. 166 Without the proper documentation filed, however, this result seems unlikely. 167 Instead, the couple’s state law designation will probably remain unchanged. 168 Consequently, although the spouses are separated for tax purposes, they will remain one, dual-member LLC under state law. 169 Under this scenario, it may be found that they represent two sole proprietorships for tax purposes. Should this be the case, because a sole proprietorship is not an "entity separate from its owner," 170 both would face personal liability for any unpaid employment taxes. 171 This risk creates yet another disadvantage to electing treatment as a qualified joint venture under I.R.C. § 761(f).

III. RECOMMENDATIONS

Many of the difficulties associated with I.R.C. § 761(f) stem from the various requirements the subsection imposes. 172 For instance, to elect out of partnership status, the couple must first know that they are subject to Subchapter K. 173 Also, the taxpayers must be able to conclude that both spouses meet the complex requirements of material participation. 174 Unless these burdens are removed,

165. See generally I.R.C. § 761(f) (West 2007) (failing to clarify what entity status the separated couple would take for employment tax purposes.)
166. See supra text accompanying note 159.
167. See, e.g., O.C.G.A. § 14-11-203 (2003) (requiring the delivery of “articles of organization to the Secretary of State” in order to create an LLC).
169. Id.
170. See U.S. Income Portfolios 700, supra note 25, § II-B.
172. See discussion supra Part II.
173. See discussion supra Part II.
qualifying taxpayers may not receive the beneficial treatment Congress intended.\footnote{175}

\textit{A. Eliminate the Material Participation Requirement}

The material participation requirement should be eliminated from I.R.C. § 761(f).\footnote{176} Although it is arguable that doing so leaves a potential for awarding Social Security and Medicare credits to inactive spouses,\footnote{177} this result is already checked statutorily by § 162(a)(1) as well as by the government’s ability to reallocate credits.\footnote{178}

Individuals are awarded Social Security and Medicare benefits in return for taxes paid on net income from self-employment.\footnote{179} The business paying the compensation is awarded a corresponding deduction under I.R.C. § 162(a)(1).\footnote{180} I.R.C. § 162(a)(1) provides for an income tax deduction “for salaries or other compensation for personal \textit{services actually rendered}.”\footnote{181} Therefore, any amounts taken against income for services not “actually rendered” are disallowed.\footnote{182} Because, by improperly obtaining the Social Security and Medicare crediting, the family also violates I.R.C. § 162(a)(1), the IRS also has the authority to monitor and identify the fraudulent activity.\footnote{183} Should a mechanism be put in place to report such abuses to the Social Security Administration, the IRS can effectively serve as the first line of defense against improper crediting.

In addition to the IRS’s ability to reject crediting for unearned income, the government also has the authority to reallocate credit,
which provides a further check on fraudulent income shifting. The Commissioner of the Social Security Administration is expressly authorized "to correct errors made in the allocation . . . of wages or self-employment income" in 42 U.S.C. § 405(c)(5)(G). Thus, even if the IRS fails to identify the error, the Social Security Administration has another effective tool to take corrective action. These two combined capabilities render the participation requirement unnecessary.

B. Make Qualified Joint Venture the Default Status

In addition to removing the participation requirement, Congress should eliminate the requirement that a formal election be made. Instead, the qualified joint venture should serve as the default entity choice for couples jointly operating a business. This will achieve both the desired result of sidestepping Subchapter K while also eliminating the need for Rev. Proc. 2002-69. As a result, the Rev. Proc. should also be retracted, to remove the current conflict between it and I.R.C. § 761(f).

1. Retract Revenue Procedure 2002-69

Rev. Proc. 2002-69 allows taxpayers in community property states to remove themselves from Subchapter K without meeting any of the I.R.C. § 761(f) requirements. Although it provides for the successful completion of an I.R.C. § 1031 exchange, the result undermines I.R.C. § 761(f) by affording preferential treatment.

185. Id.
186. Id.
188. See generally Sloan Interview, supra note 57.
189. See generally id.
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without addressing the Social Security and Medicare issues. Because I.R.C. § 761(f) and Private Letter Ruling (PLR) 199911033 offer equally effective solutions to the I.R.C. § 1031 problem, Rev. Proc. 2002-69 is no longer needed and should therefore be retracted.

a. A Cure for Social Security and Medicare Crediting

In requiring both spouses to participate materially in the venture, Congress forces couples to recognize the economic realities of their operation. Because both spouses are actively involved in the business, both should receive income and earn eligibility for governmental benefits via self employment taxes. By allowing disregarded entity status without such participation, Rev. Proc. 2002-69 frustrates this legitimate purpose.

b. § 761(f) Facilitates Like-Kind Exchange Tax Deferrals

Use of the qualified joint venture in an I.R.C. § 1031 exchange will effectively facilitate the sought after tax deferral. Community property taxpayers were concerned that the check-the-box regulations would mechanically transform their newly created entity into a tax partnership, thereby violating the implicit exchange requirement. With I.R.C. § 761(f), however, the same entity and the qualified joint venture will both relinquish and receive the like-kind property. Therefore, regardless of how the IRS decides the “business entity” issue, I.R.C. § 761(f) removes any concerns of an exchange violation.

199. See discussion supra Part II.
201. See id.
Should the revenue procedure be retracted and the material participation requirement not be removed, however, the community property issue will reemerge. For instance, if only one spouse participates in the real estate venture, the non-participating spouse’s lack of material participation will disqualify the couple for I.R.C. § 761(f) treatment. Consequently, the couple will again need clarification as to the automatic conversion of their new bankruptcy remote entity. Fortunately, however, PLR 199911033 sufficiently addresses this issue and leaves no justification for Rev. Proc. 2002-69’s continued existence.

c. No Purely Mechanical Entity Classification System

PLR 199911033 dispelled the notions that the check-the-box regulations produced a strict and mechanical entity classification system. There, similar to the situation addressed in Rev. Proc. 2002-69, taxpayers were concerned that a newly created, two-member LLC would, by definition, violate I.R.C. § 1031’s exchange requirement. In the PLR, the lender required that the replacement property be held in a bankruptcy remote entity and that the lender obtain a membership role in the entity to disallow a voluntary bankruptcy filing. The effect of this arrangement, however, left the newly-created LLC with two members, the taxpayer and the lender. In deciding whether the LLC would violate the exchange requirement, the IRS surprisingly ventured beyond the regulations and analyzed the relationship under the Culbertson principles. Eventually, the IRS found the two had no intent to “come together to

202. See id.
204. See discussion supra Part II.
206. Id.
207. Id.
208. Id.
209. Id.
210. Id.
form a partnership," and therefore denied the existence of the entity.211

This ruling confirms the IRS’s willingness to look beyond the regulations’ rigid constructs to make a correct, fact-based finding.212 In doing so, the IRS breathed life back into the Culbertson trilogy, demanding that at the very least, parties intend to join together to create a partnership.213 Accordingly, no partnership should be found if co-ownership, which is merely a product of community property law, is not coupled with a corresponding intent to form a partnership.214 Therefore, even if the participation requirement remains, PLR 199911033 provides adequate assurances that an automatic conversion will not affect community property couples performing like-kind exchanges.215 Because the PLR, coupled with I.R.C. § 761(f), achieve the same results as Rev. Proc. 2002-69, the Rev. Proc. should be retracted, thus removing the current I.R.C. § 761(f) conflict.216

CONCLUSION

I.R.C. § 761(f) extends benefits to married taxpayers unnecessarily burdened by the complexities of federal partnership law.217 However, before the spouses can appreciate these benefits, the subsection insists that a number of requirements be met.218 Unfortunately, history has shown these requirements will likely interfere with and deny the beneficial treatment to many deserving couples.219 As a result, Congress should remove those obstacles making the qualified

212. See generally id.
213. Id. (stating that “[t]he primary inquiry is whether the parties had the intent to join together to operate a business and share in its profits and losses”).
214. Id.
219. See discussion supra Part II.
joint venture the default entity choice for businesses run exclusively by husband and wives.220 Doing so achieves all I.R.C. § 761(f) benefits and also removes any further need for the conflicting Rev. Proc. 2002-69.221

220. See discussion supra Part III.
221. See discussion supra Part III.