ACKNOWLEDGED SIGNIFICANT ADVICE, MAY BE DISSEMINATED

Office of Chief Counsel **RELEASED 6/18/98**
Internal Revenue Service **SCA 1998-018**

memorandum

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date: FEB 11 1998

to: District Counsel, South Texas District, Austin

from: Assistant Chief Counsel (Income Tax and Accounting)
CC:DOM:IT&A

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subject: Significant Service Center Advice

This responds to your request for Significant Advice dated November 3, 1997, in connection with questions posed by the Austin Service Center.

Disclosure Statement

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ISSUES

1. How much of a joint overpayment is an injured spouse entitled to receive when all of the income and withholding is the separate management and control community property of the injured spouse?

2. How much of the joint overpayment is the injured spouse entitled to receive when all of the income and withholding is the separate management and control community property of the liable spouse?

3. Are the computations in 1 and 2 any different depending on whether the offset is being made under § 6402(a), 6402(c), or 6402(d)?

4. How is self-employment tax allocated in computing injured spouse claims?

5. How is the earned income credit allocated in computing injured spouse claims?

a. Is it allocated according to who earned the income or allocated to who is the parent of the child?

b. Is the earned income credit joint or separate management and control community property?

c. Since married taxpayers filing separately cannot claim the earned income credit and the earned income credit is a negative tax and not a payment of tax, how should their respective tax liabilities be computed?

6. In computing each taxpayer's share of the tax liability, should separate management and control community property be allocated fifty percent to each spouse or allocated to who earned it? How should withholding credits be allocated? Bathrick v. I.R.S., 1 BR 428, 430 (Bankr. S.D. Tex. 1979).

7. Is the computation in paragraph 6 any different depending on whether the offset is being made under §§ 6402(a), 6402(c), or 6402(d)?

8. Does the Internal Revenue Service have the same offset rights with respect to § 6402(c) as it has with respect to § 6402(a)?

9. Does the Service have the same offset rights with respect to § 6402(d) as it has with respect to § 6402(a)?

CONCLUSIONS

Based on the facts submitted we conclude:

1. The injured spouse is entitled to one half of the joint overpayment in all situations in which the overpayment results from income and withholding that is subject to the sole management and control of the injured spouse.

2. The injured spouse is not entitled to any portion of a joint overpayment if the overpayment results from income and withholding that is subject to the sole management and control of a spouse who is liable for a separate tax liability in those community property states where the property (as opposed to the person) can be reached to pay the separate debts of the liable spouse.

3. Conclusion 1 is the same regardless of whether the

overpayment is offset pursuant to § 6402(a), 6402(c), or 6402(d).

Conclusion 2 is different for debts subject to offset pursuant to § 6402(c) or 6402(d). In the case of an offset pursuant to § 6402(c) or 6402(d), the injured spouse is entitled to one half of the joint overpayment even if the overpayment results from income and withholding that is subject to the sole management and control of a spouse who is liable for the debt.

4. The self-employment tax is allocated to the spouse who is subject to the tax.

5. The earned income credit is allocated according to the formula set forth in Rev. Rul. 87-52 irrespective of whether community property laws apply.

6. Each spouse owns a one-half interest in the wages and withholding. Each spouse has a one-half interest in the refund in the case of an overpayment resulting from wages and withholding of tax thereon. If the wages and withholding are those of one spouse, the entire refund is subject to the sole management and control of the spouse who earned the wages.

7. The computation of each spouse's respective interest in the refund and the determination of what portion of the refund is subject to the sole management and control of one spouse is the same regardless of whether the Internal Revenue Service is making an offset pursuant to § 6402(a), 6402(c), or 6402(d).

8. The Service does not have the same offset rights under § 6402(c) as it does under § 6402(a). With respect to an offset under § 6402(a) the Service, as creditor, may offset the entire amount of the refund in community property states in which the property is subject to offset to satisfy the separate debts of a spouse.

9. The Service does not have the same offset rights under § 6402(d) as it does under § 6402(a). With respect to an offset under § 6402(a) the Service, as creditor, may offset the entire amount of the refund in community property states in which the property is subject to offset to satisfy the separate debts of a spouse.

DISCUSSION

I. Application of joint overpayments to separate unpaid tax liabilities.

A. General.

Section 6402(a) provides that in the case of any overpayment, the Secretary, within the applicable period of limitations, may credit the amount of such overpayment, including

any interest allowed thereon, against any liability in respect of an internal revenue tax on the part of the person who made the overpayment and shall, subject to subsections (c), (d), and (e), refund any balance to such person.

Rev. Rul. 80-7, 1980-1 C.B. 296, amplified by Rev. Rul. 85-70, 1985-1 C.B. 361, clarified by Rev. Rul 87-52, 1987-1 C.B. 347, describes the proper method for computing the amount of an overpayment shown on a joint return that can be credited to one spouse's unpaid separate tax liability from a prior year for purposes of § 6402(a). In general, the liable spouse's share of the joint overpayment is determined by subtracting the liable spouse's share of the joint liability, determined by a separate tax formula set forth in the ruling, from the liable spouse's contribution toward the joint liability.

B. Community Property Rules.

Rev. Rul. 85-70, 1985-1 C.B. 361, amplified by Rev. Rul. 87-52, provides a two-part process for determining the amount of a joint overpayment that the Service may offset against the separate tax liability of one of the spouses. In a community property state, each spouse is considered to be the recipient of one-half of the aggregate wages. Each spouse is also entitled to a credit for one-half of the taxes that are withheld from such wages. Pursuant to Rev. Rul. 85-70, in a community property state each spouse has a one-half interest in the overpayment.

In response to Issue 6, each spouse owns a one-half interest in the community property. In the case of an overpayment resulting from wages and withholding of tax thereon, each spouse has a one-half interest in the refund. If the wages and withholding are those of one spouse, the entire refund is subject to the sole management and control of the spouse who earned the wages. With respect to Issue 7, the computation of each spouse's respective interest in the refund and the determination of what portion of the refund is subject to the sole management and control of one spouse is the same regardless of whether the Internal Revenue Service is making an offset pursuant to § 6402(a), 6402(c), or 6402(d).

In the second step described in Rev. Rul. 85-70, the rights of creditors under state law are considered. If permitted by State law, the Service may exercise a common law right of offset against the amount of the overpayment otherwise payable to the nonliable spouse. In a state in which all community property is subject to the premarital or separate debts of either spouse but is exempt from tax claims, the state law exemption is invalid against the United States.

State law governs in determining the extent of a taxpayer's

interest in a joint refund. See Aquilino v. United States, 363 U.S. 509 (1960). Once a taxpayer's interest has been defined by state law, federal law determines the consequences for federal tax collection purposes. United States v. Bess, 357 U.S. 51 (1958).

Under Texas law, "community property" is defined as any property other than separate property acquired by either spouse during marriage. Tex. Fam. Code Ann. § 5.01(b) (West 1993). Personal earnings are generally classified as community property subject to the earning spouse's "sole management, control, and disposition." Tex. Fam. Code Ann. § 5.22(a)(1) (West 1993). Therefore, each spouse would have a one-half property interest in an overpayment shown on a joint return that shows wages and withholding irrespective of which spouse earned the wages and paid the withholding. The overpayment would be subject to the sole management, control, and disposition of the spouse that earned the wages and paid the withholding. See Bathrick v. Internal Revenue Service, 1 BR 428 (Bankr. S.D. Tex. 1979). Texas law is an example of community property law according to which the property subject to one spouse's sole management, control, and disposition is not subject to any liabilities incurred by the other spouse before marriage. Tex. Fam. Code Ann. § 5.61(b)(1) (West 1993).

Applying Rev. Rul. 85-70 to cases involving Texas community property law or laws similar to Texas law, under § 6402(a) the Service can offset 50% of a joint refund if the injured spouse was the sole wage earner and the refund was entirely the injured spouse's sole management community property. Each spouse has a 50% community property interest in the refund. The Service is entitled to take the liable spouse's 50% property interest in the refund to pay that spouse's debts. This leaves the injured spouse only entitled to 50% of the refund. The injured spouse cannot claim to also be entitled to the liable spouse's 50% interest (i.e., 100% of the refund) on the grounds that state law exempts the injured spouse's sole management property from being used to pay the other spouse's debts incurred before marriage. The state law exemption does not apply to the Service. See Medaris v. United States, 884 F. 2d 832, 833-34 (5th Cir. 1989), in which the court concluded that in Texas the Service could levy on 100% of a liable spouse's income and on 50% of a nonliable spouse's income. Although the injured spouse cannot use the exemption under state law to request 100% of the refund, the Service is still only entitled to the liable spouse's 50% community property interest in the refund and must return the injured spouse's 50% interest.

The Service can take 100% of a joint refund if the liable spouse was the sole wage earner and the refund was entirely the liable spouse's sole management community property. Each spouse

has a 50% community property interest in the refund. However, the Service can offset 100% of the refund because it is the liable spouse's sole management property (wages and wage withholding) and under Texas community property law all of the liable spouse's sole management property is available to pay that spouse's debts.

In response to Issue 1, the liable spouse has a one-half interest in the joint overpayment. Therefore, the Service is only required to return the injured spouse's one-half interest. The injured spouse is entitled to one half of the joint overpayment in all situations in which the overpayment results from income and withholding that is subject to the sole management and control of the injured spouse. This conclusion is the same regardless of whether the overpayment is offset pursuant to § 6402(a), 6402(c), or 6402(d).

With respect to Issue 2, when the income and withholding are the separate management and control property of the liable spouse, the Service is not required to return any portion of the refund to the injured spouse. The injured spouse is not entitled to any portion of a joint overpayment if the overpayment results from income and withholding that is subject to the sole management and control of a spouse who is liable for a separate tax liability in those community property states where the property (as opposed to the person) can be reached to pay the separate debts of the liable spouse. In this case the Service can exercise the right of offset described in Rev. Rul. 85-70.

II. Application of joint overpayments to separate unpaid nontax liabilities.

Section 6402(c) provides that the amount of any overpayment to be refunded to the person making the overpayment shall be reduced by the amount of any past-due support (as defined in § 464(c) of the Social Security Act) owed by that person of which the Secretary has been notified by a State in accordance with § 464 of the Social Security Act.

Section 6402(d) provides that upon receiving notice from any federal agency that a named person owes a past-due legally enforceable debt (other than past-due support subject to § 6402(c)), the Secretary shall reduce the amount of any overpayment payable to such person by the amount of such debt, pay the amount by which the overpayment is reduced to the agency, and notify the person making the overpayment that the overpayment has been reduced by an amount necessary to satisfy the debt.

In Bosarge v. United States Dept. of Education, 5 F.3d 1414 (11th Cir. 1993), cert. denied, 114 S. Ct. 2720 (1994), the court held that state law exemptions did not prevent the interception

of a tax refund pursuant to § 6402(d). However, in Emily Oatman v. Department of Treasury, 34 F.3d 787 (9th Cir. 1994), the court concluded that the Treasury must return to a joint filing spouse her share of the refund if she claims it by proper and timely application. 42 U.S.C. § 664(a)(3)(C) provides that if the other person filing a joint return with the individual owing the past-due support takes the appropriate action to secure his or her proper share of the refund from which a withholding was made, the Secretary of the Treasury shall pay such share to the other person. The Court of Appeals concluded that the rule applicable in some states whereby one spouse's share of community property can be reached for payment of the other spouse's separate debts relates only to creditors' rights. In the case of past-due child support, only the state agency, as creditor, may proceed against the nondebtor's community property if permitted by state law.

Section 6402(d)(3)(B)(ii), in the case of OASDI overpayments, and § 301.6402-6(i) of the Procedure and Administration Regulations, in the case of past-due, legally enforceable federal debts, provide that if the other person filing a joint return with the person liable for the debt takes appropriate action to secure his or her proper share of the refund subject to reduction under § 6402(d), the Secretary shall pay such share to such other person.

Under both §§ 6402(c) and 6402(d), if a person filing a joint return with the person liable for the debt takes appropriate action to secure his or her proper share of a refund from which an offset was made, the Service is required to pay the person (the "injured spouse") his or her share of the refund and shall deduct that amount from amounts payable to the creditor agency.

With respect to Issue 3, in situations involving §§ 6402(c) and 6402(d), the Service is required to repay the injured spouse his or her share of the joint refund irrespective of whether the overpayment is the sole management and control property of the liable spouse. With respect to an offset under § 6402(a) the Service, as creditor, may offset the entire amount of the refund in community property states in which the property is subject to offset to satisfy the separate debts of a spouse. Therefore, with respect to Issues 8 and 9, the Service does not have the same offset rights under §§ 6402(c) and 6402(d) as it does under § 6402(a).

III. Self-Employment Tax.

Section 1401(a) provides that in addition to other taxes, there shall be imposed for each taxable year beginning after December 31, 1989, on the self-employment income of every individual, a tax equal to 12.40 percent of the self-employment

income for the taxable year. In addition to the tax imposed by § 1401(a), § 1402(b) imposes a tax of 2.90 percent.

Section 1402(a) defines net earnings from self-employment, in general, as the gross income derived by any individual from any trade or business carried on by such individual, less the deductions allowable which are attributable to such trade or business, plus the individual's distributive share (whether or not distributed) of income or loss from any trade or business carried on by a partnership of which the individual is a member.

Section 1402(a)(5)(A) provides that if any of the income derived from a trade or business (other than a trade or business carried on as a partnership) is community income under the community property laws applicable to such income, all of the gross income and deductions attributable to such trade or business shall be treated as the gross income and deductions of the husband unless the wife exercises substantially all of the management and control of such trade or business, in which case all of such gross income and deductions shall be treated as the gross income and deductions of the wife.

Section 1402(a)(5)(B) provides that if any portion of a partner's distributive share of the ordinary income and loss from a trade or business carried on by a partnership is community income or loss under the community property laws applicable to such share, all of such distributive share shall be included in computing the net earnings from self-employment of such partner, and no part of such share shall be taken into account in computing the net earnings from self-employment of the spouse of the partner.

In community property states, the income from a trade or business is treated as the self-employment income of the spouse who carries on the business. In the case of income from partnership interests, the self-employment income is that of the spouse who has the interest in the partnership.

The self-employment tax is imposed at a flat rate on the self-employment income of each spouse. If both spouses have self-employment income then each spouse is subject to the tax and each spouse must complete a Schedule SE to be attached to the income tax return. Therefore, in response to Issue 4, the self-employment tax should be allocated on a dollar-for-dollar basis to the spouse whose self-employment income is subject to the tax. The self-employment tax shown on the Schedule SE of each spouse can be used in making an allocation of a joint overpayment rather than using the formula set forth in Rev. Rul. 80-7.

IV. Earned Income Credit.

Rev. Rul. 87-52, 1987-1 C.B. 347, describes the proper method for allocating the earned income credit shown on a joint return in determining the amount of an overpayment shown on a joint return that can be applied against the separate unpaid tax liability of one spouse pursuant to § 6402(a). Because of the phaseout of the credit, for a couple filing a joint return, the amount of the allowable credit may be less than the aggregate credits that would be allowable if each spouse's earned income credit were to be considered separately (and assuming that the credit was available for taxpayers filing separate returns). Therefore, the credit cannot be allocated on a dollar-for-dollar basis merely by recomputing the credit on the basis of taxpayers filing separately.

Rev. Rul. 87-52 determines each spouse's contribution to the actual credit by multiplying the joint earned income credit by the ratio of each spouse's hypothetical separate earned income credit to the sum of hypothetical separate earned income credits for both spouses. The separate credit is hypothetical because the earned income credit is not available on separate returns of a married couple. The Earned Income Credit Tables are used to determine each spouse's hypothetical separate earned income credit if the spouse had filed a separate return (and if the earned income credit was available on a separate return). The ruling states that this formula applies to taxpayers in both community property states and noncommunity property states because the earned income is computed without regard to community property laws.

Under current law, the phaseout of the credit depends on the number of qualifying children. For example, assume a married couple file a joint return for 1997 with the husband reporting $8,500 in wages and the wife reporting $4,000 in wages. Assuming the couple have two qualifying children, the joint credit from the 1997 Earned Income Credit Tables is $3,531. The husband's hypothetical separate credit based on his separate wages and two qualifying children is $3,410. The wife's separate hypothetical credit based on her separate wages and two qualifying children is $1,610. The formula in Rev. Rul. 87-52 results in the husband contributing $2,398.55 toward the actual joint credit ($3,531 X $3,410/$3,410+$1,610) and the wife contributing $1,132.45 ($3,531 X $1,610/$3,410+$1,610).

The purpose of the allocation formula of Rev. Rul. 87-52 is to avoid the effect that the phaseout amounts have when the hypothetical credit is determined using each spouse's separate income. Rev. Rul. 87-52 does not take into account the effect that the number of qualifying children have on the phaseout amounts under the current earned income provisions. Therefore, the question not addressed by Rev. Rul. 87-52 is whether the spouses should be allowed to allocate the number of qualifying

children for purposes of calculating the hypothetical separate credit. Using the same wage amounts as in the example in the preceding paragraph, the husband would be entitled to a hypothetical separate credit of $3,410 if two qualifying children were used in his separate computation, and the wife would be entitled to a hypothetical separate credit of $308 if no qualifying children were used in her separate computation. Using the formula in Rev. Rul. 87-52, the husband's contribution to the joint credit would be $3,238.49 and the wife's contribution would be $292.51. On the other hand, the husband would be entitled to a hypothetical separate credit of $95 if he claimed no qualifying children and the wife would be entitled to a hypothetical separate credit of $1,610 if she claimed two qualifying children. This approach would result in the husband's contribution toward the actual credit of $196.74 and the wife's contribution of $3,334.26. Allowing the spouses to allocate the qualifying children for purposes of determining each spouse's contribution toward the joint credit can result in an allocation of the actual credit that is not in proportion to the actual earned income of each spouse. Therefore, in order to allocate the actual joint credit in a way that maintains a ratio that approximates that of the actual income of each spouse, each spouse should use the same number of qualifying children for purposes of determining the hypothetical separate credit as were used to determine the actual joint credit.

With respect to Issue 5, the earned income credit is allocated according to the formula set forth in Rev. Rul. 87-52. Rev. Rul. 87-52 recognizes that the earned income credit is not available to married couples filing separately. Therefore, the ruling allocates the credit on a hypothetical separate basis using each spouse's separate income. Since the earned income credit is computed without regard to community property laws, the credit cannot be characterized as joint or separate management and control property. However, an overpayment based on the separate wages and withholding of one spouse (taking into account the allocable credit) would be subject to the sole management and control of the spouse that earned the wages.

If you have any questions regarding this memorandum, please contact John McGreevy at 622-7506.

JODY J. BREWSTER

By: /s/
JOHN M. COULTER, Jr
Senior Technician Reviewer