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Community Property

For use in preparing

1997 Returns

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Contents

Introduction

This publication is for married taxpayers who are domiciled in one of the following community property states:

- Arizona,
- California,
- Idaho,
- Louisiana,
- Nevada,
- New Mexico,
- Texas,
- Washington, or
- Wisconsin.

You should understand how community property laws affect the way you figure your income on your federal income tax return. Your federal taxes are affected by community property laws **only** if you are married, live in a community property state, and are filing separate returns. In most cases, your tax will be less by filing a joint return if you are married. Sometimes, however, it may be to your advantage to file separate returns. If you and your spouse are filing separate returns, you have to determine your community income and your separate income.

Useful Items

You may want to see:

Publication

- ☐ **504** Divorced or Separated Individuals
- ☐ **505** Tax Withholding and Estimated Tax

See *How To Get More Information* near the end of this publication for information about getting these publications.

Domicile

You may have community property and community income or separate property and separate income depending on the state in which you are domiciled. If you are married and your domicile is different from that of your spouse, the laws of each domicile must be examined to determine whether you have community property or community income.

You have only one domicile even though you may have more than one home. Your domicile is a permanent legal home that you intend to use for an indefinite or unlimited period, and to which, when absent, you intend to return. The question of your domicile is mainly a matter of your intention as indicated by your actions. You must be able to show with facts that you intend a given place or state to be your permanent home. If you move into or out of a community property state during the year, you may or may not have community income.

The following are some of the factors considered in determining domicile:

- Where you pay state income tax,
- Where you vote,
- Location of property you own,
- Your citizenship,
- Length of residence, and
- Business and social ties to the community.

Amount of time spent. The amount of time spent in one place does not always explain the difference between home and domicile. A temporary home may continue for months or years while a domicile may be established the first moment you occupy the property. Your intent is the determining factor in proving where you actually have your domicile.

Community Property and Community Income

The laws of the state in which you are domiciled govern whether you have community property and community income.

Community property. Community property is all property acquired by a husband or wife, or both, during their marriage while they are domiciled in a community property state. Certain property acquired by gift or inheritance, by purchase with separate funds, or by exchange of separate property for other property is not community property. (See *Separate Property and Separate Income,* later). Community property also includes property that spouses have agreed to convert from separate property to community property.

According to state law, each spouse owns half the community property. Community property belongs as much to one spouse as it does to the other.

If property cannot be identified as separate property, it will be considered community property. For federal tax purposes, the property is classified according to the laws of the state in which you are domiciled.

Community income. Generally, community income is all income from community property. It includes salaries, wages, and other pay for the services of either or both a husband and wife during their marriage.

In Idaho, Louisiana, Texas, and Wisconsin, income from most separate property is treated as community income. You must identify community income in accordance with state law.

Income from real estate is community income if it is so treated under the laws of the state in which the real estate is located.

The classification of income as either community or separate is important if you and your spouse file separate federal tax returns. If you do, half the community income must be reported by you and the other half by your spouse.

Community property laws disregarded. Community property laws will not apply to an item of community income and you will be responsible for reporting it if:

1) You treat the item as if only you are entitled to the income, and
2) You do not notify your spouse of the nature and amount of the income by the due date for filing the return (including extensions).

Relief from separate return liability for community income. You are not responsible for reporting an item of community income if you meet **all** the following conditions.

1) You do not file a joint return for the tax year.
2) You do not include that item of community income in your gross income on your separate return.
3) You establish that you did not know of (and had no reason to know of) that community income.
4) Under all facts and circumstances, it would not be fair to include the item of community income in your gross income.

Spousal agreements. In some states a husband and wife can enter into an agreement that changes the status of certain property or income from community to separate or from separate to community. Any such agreement that complies with the requirements of state law is valid for federal income tax purposes.

Separate Property and Separate Income

The laws of the state in which you are domiciled govern whether you have separate property and separate income.

Separate property. Generally, separate property is all the property owned separately by you or your spouse before your marriage, as well as money earned while domiciled in a noncommunity property state. It is also property acquired separately after marriage by you or your spouse as a gift or inheritance. Separate property can be acquired during marriage by buying property with separate funds or by exchanging separate property for other property.

Separate income. Generally, under the community property system, income from separate property is income of the spouse who owns the property. However, in Idaho, Louisiana, Texas, and Wisconsin, income from most separate property is community income.

State law must be considered before federal tax laws are applied. If a husband and wife choose to file separate returns, the laws of the community property state where they are domiciled govern whether they have separate or community income.

Income from property acquired with both separate and community funds. Generally, if you acquire property during your marriage partly with community funds and partly with separate funds, the property is part community property and part separate property. Income from the part of the property bought with community funds is community income. Income from the part bought with separate funds is community income or separate income, depending on the laws of the state in which you are domiciled.

Deductions

If you file separate returns, your deductions generally depend on whether the expenses involve community or separate income.

Business and investment expenses. If you file separate returns, expenses incurred to earn or produce community business or investment income are generally divided equally between you and your spouse. Each of you is entitled to deduct one-half of the expenses on your separate returns. If you file separate returns, expenses incurred to earn or produce separate business or investment income are deductible by the spouse who owns the income. These expenses may be subject to other limits, such as those described in Publication 535, *Business Expenses,* and Publication 550, *Investment Income and Expenses.*

Personal expenses. Expenses that are paid out of separate funds, such as medical expenses, are deductible by the spouse who pays them. If these expenses are paid from community funds, the deduction is divided equally between you and your spouse.

Nonresident Alien Spouse

If you choose to treat your nonresident alien spouse as a U.S. resident for tax purposes and you are domiciled in a community property state or country, use the community property rules. You must file a joint return for the year you make the choice. You can file separate returns in later years. For details on making this choice, see Publication 519, *U.S. Tax Guide for Aliens.*

If you are a U.S. citizen or resident who is married to a nonresident alien and you do not choose to treat your nonresident alien spouse as a U.S. resident for tax purposes, treat your community income in the manner explained next under *Spouses living apart all year.* However, you do not have to meet the four conditions discussed there.

Spouses Living Apart

The following discussion gives the rules for separated spouses filing separate returns.

Spouses living apart all year. If you are married at any time during the calendar year, special rules apply for reporting certain community income. You must meet **all** the following conditions.

1) You and your spouse lived apart all year.

2) You and your spouse did not file a joint return for a tax year beginning or ending in the calendar year.

3) You and/or your spouse had earned income for the calendar year that is community income.

4) You and your spouse did not transfer, directly or indirectly, any of the earned income in (3) between yourselves before the end of the year. Do not take into account transfers of very small amounts or value. Also, do not take into account a payment or transfer to or for your dependent child, even though the payment or transfer satisfies an obligation of support imposed on your spouse.

If all these conditions are met, you and your spouse must report your community income as explained below. See also *Community property laws disregarded,* discussed earlier.

Earned income. You must treat earned income that is not trade or business or partnership income as the income of the spouse who performed the services. Earned income means wages, salaries, professional fees, and other pay for personal services. Earned income does **not** include any social security or social security equivalent of tier 1 railroad retirement benefits you receive during the year.

Trade or business income. You must treat income and related deductions from a trade or business that is not a partnership as those of the person carrying on the trade or business.

Partnership income or loss. You must treat income or loss from a trade or business carried on by a partnership as the income or loss of the spouse who is the partner.

Separate property income. You must treat investment income from the separate property of one spouse as the income of that spouse.

Social security benefits. You must treat social security benefits received during the year, including the social security equivalent portion of tier 1 railroad retirement benefits, as the separate income of the spouse who received them.

Other income. You must treat all other community income, such as dividends, interest, rents, royalties, or gains, according to the community property laws of your state.

Example. Daniel and Sharon were married throughout the year but did not live together at any time during the year. Both were domiciled in Texas, a community property state. They did not file a joint return or transfer any of their earned income between themselves. During the year their incomes were as follows:

	Daniel	Sharon
Wages	$20,000	$22,000
Consulting business fees	5,000	
Partnership income		10,000
Dividends from separate property	1,000	2,000
Interest from community property	500	500
Total	$26,500	$34,500

Under the community property laws of Texas, all of Daniel and Sharon's income is considered community income. Sharon did not take part in Daniel's consulting business.

Ordinarily, Daniel and Sharon would each report half the total community income, $30,500 ($26,500 + $34,500 ÷ 2), on their separate returns. But because they meet the four conditions discussed earlier, they must disregard community property law when reporting their income, except the interest from community property. They should report on their separate returns only their own earnings and other income and their share of the interest from community property. Daniel reports $26,500 and Sharon reports $34,500.

Other separated spouses. If you and your spouse are separated but do not meet the four conditions discussed earlier under *Spouses living apart all year,* you must treat your income according to the laws of your state. In some states, income earned after separation but before a decree of divorce continues to be community income. In other states, it is separate income.

End of the Marital Community

The marital community may end in several ways. When the marital community ends, the community assets (money and property) are divided between the spouses.

The division of community property in connection with a divorce or property settlement does not result in a gain or loss. For information on the tax consequences of the division of community property under a property settlement or divorce decree, see Publication 504.

Each spouse is taxed on half the community income for the part of the year before the community ends. However, see *Spouses living apart all year,* earlier. Any income received after the marital community ends is separate income. This separate income is taxable only to the spouse to whom it belongs.

An ***absolute decree of divorce or annulment*** ends the marital community in all community property states. A decree of annulment, even though it holds that no valid marriage ever existed, usually does not nullify community property rights arising during the so-called “marriage.” Check your state law.

A ***decree of legal separation or of separate maintenance*** may or may not end the marital community. The court in the state issuing the decree may terminate the marital community and divide the property between the spouses. Check your state law.

A ***separation agreement*** may divide the community property between you and your spouse. It may provide that this property along with future earnings and property acquired will be separate property. Such an agreement may end the community. In some states, the marital community ends when the husband and wife permanently separate, even if there is no formal agreement. Check your state law.

Basis of Property of a Surviving Spouse

In community property states, each spouse usually is considered to own half the estate (excluding separate property). If either spouse dies, the total value of the community property generally becomes the basis of the entire property, including the portion belonging to the surviving spouse. For this to apply, at least half the community interest must be includible in the decedent's gross estate, whether or not the estate must file a return.

For example, if at least half the fair market value of the community interest is includible in the decedent's estate and the fair market value of the total community interest is $100,000, the basis of the surviving spouse's half of the property is $50,000. The basis of the other half to the decedent's heirs is also $50,000.

For more information on the basis of assets, see Publication 551, *Basis of Assets.*

Preparing a Federal Income Tax Return

The following discussion does not apply to spouses meeting the conditions under *Spouses living apart all year.* Those spouses must report their community income as explained in that discussion.

Joint return versus separate returns. Ordinarily, filing a joint return will give you the greater tax advantage. But in some cases, your combined income tax on separate returns may be less than it would be on a joint return.

You can file separate returns if you and your spouse do not agree to file a joint return or if separate returns result in less tax. However, if you file separate returns:

1) Your spouse should itemize deductions if you itemize deductions because he or she cannot claim the standard deduction.

2) You cannot take the credit for child and dependent care expenses in most instances.

3) You cannot take the earned income credit.

4) You cannot exclude any interest income from Series EE U.S. Savings Bonds that you used for higher education expenses.

5) You cannot take the credit for the elderly or the disabled unless you lived apart from your spouse for all of 1997.

6) You may have to include in income more of the social security benefits (including any equivalent railroad retirement benefits) you received in 1997 than you would on a joint return.

7) You cannot take the credit for adoption expenses in most instances.

Figure your tax on both a joint return and separate returns under the community property laws of your state. Compare the tax figured under both methods and use the one that results in less tax.

If you file separate returns, you and your spouse must each report half your combined community income and deductions in addition to your separate income and deductions. List only your share of the income and deductions on the appropriate lines of your separate tax returns (wages, interest, dividends, etc.).

Attach a worksheet to your separate returns showing how you figured the income, deductions, and federal income tax withheld that each of you reported. An ***allocation worksheet,*** shown later, may be used for this purpose. If you do not attach a worksheet, each taxpayer should attach a photocopy of the other spouse's Form W-2 or 1099-R. Make a notation on the form showing the division of income and tax withheld.

If you and your spouse file separate returns, an extension of time for filing your return does not extend the time for filing the separate return of your spouse. If you and your spouse file a joint return, you cannot file separate returns after the due date for filing that return has passed.

Identifying Income and Deductions

To figure the best way to file your return — jointly or separately — you must identify your community and separate income and deductions according to the laws of your state.

Community income exempt from federal tax generally keeps its exempt status for both spouses. For example, under certain circumstances, income earned outside the United States is tax exempt. If you earned income and met the conditions that made it exempt, the income is also exempt for your spouse even though he or she may not have met the conditions.

Military retirement pay. State community property laws apply to military retirement pay. Generally, the pay is either separate or community income based on the marital status and domicile of the couple while the member of the Armed Forces was in active military service.

Pay earned while married and domiciled in a community property state is community income. This income is considered to be received half by the member of the Armed Forces and half by the spouse.

Civil service retirement. For income tax purposes, community property laws apply to annuities payable under the Civil Service Retirement Act (CSRS) or Federal Employee Retirement System (FERS).

Whether a civil service annuity is separate or community income depends on the marital status and domicile of the employee when the services for which the annuity is paid were performed. Even if you are now living in a noncommunity property state and you receive a civil service annuity, it may be community income if it is based on services you performed while married and domiciled in a community property state.

If a civil service annuity is a mixture of community income and separate income, it must be divided between the two kinds of income. The division is based on the employee's domicile and marital status in community and noncommunity property states during his or her periods of service.

Example. Henry Wright retired last year from civil service after 30 years of service. He and his wife were domiciled in a community property state during the last 15 years of that service.

Since half the service was performed while the Wrights were married and domiciled in a community property state, half the civil service retirement pay is considered to be community income. If Mr. Wright receives $1,000 a month in retirement pay, $500 is considered community income—half ($250) is his income and half ($250) is his wife's.

Lump-sum distributions. If you receive a lump-sum distribution from a qualified retirement plan, you may be able to choose optional methods of figuring the tax on the distribution. You may be able to use the 5-year or 10-year tax option. You must disregard community property laws for either tax option. For information, see Publication 575, *Pension and Annuity Income,* and Form 4972, *Tax on Lump-Sum Distributions.*

Gains and losses. Gains and losses are classified as separate or community depending on the character of the property. For example, a loss on separate property, such as stock held separately, is a separate loss. On the other hand, a loss on community property, such as a casualty loss to your home held as community property, is a community loss.

See Publication 544, *Sales and Other Dispositions of Assets,* for information on gains and losses. See Publication 547, *Casualties, Disasters, and Thefts (Business and Nonbusiness),* for information on losses due to a casualty or theft.

Individual retirement arrangements (IRAs). When you and your spouse file separate returns, your contributions to an IRA must be based on your own compensation. Your contributions are limited to the lesser of your compensation or $2,000. When filing jointly, the contributions of the spouse with less compensation can be based on the combined compensation of both spouses, reduced by the amount allowed as an IRA deduction to the higher income spouse. Assuming your combined compensation for the year is at least $4,000, both you and your spouse can contribute up to $2,000 to an IRA, for a maximum contribution of $4,000. For information on IRAs, see Publication 590, *Individual Retirement Arrangements (IRAs) (Including SEP-IRAs and SIMPLE IRAs).*

Personal exemptions and dependents. When you file separate returns, you must claim your own exemption ($2,650 in 1997).

You cannot divide the amount allowed as a deduction for a dependent between you and your spouse. When you have more than one dependent supported by community funds, you and your spouse may divide the number of dependents between you in any manner you choose.

Example. Ron White supports his wife and three dependent children with community funds. If he and his wife file separately, only he can claim his own exemption, and only his wife can claim her own exemption. By agreement, Ron may claim any or all three exemptions for his children and his wife may claim any remaining children, or his wife may claim any or all three exemptions for her children and Ron may claim any remaining children. They cannot divide the total deduction amount for their three children ($7,950) equally between them.

Self-employment tax. If any of the income from a trade or business other than a partnership is community income under state law, it is subject to self-employment tax as the income of the spouse carrying on the trade or business.

Partnership income. If you are a partner and your distributive share of any income or loss from a trade or business carried on by the partnership is community income, treat the share as your net earnings from self-employment. No part is treated as net earnings from self-employment by your spouse. If both you and your spouse are partners, each of you must claim your share when figuring net earnings from self-employment for self-employment tax purposes.

Earned income credit. For purposes of the earned income credit, compute your earned income without regard to community property laws. You cannot claim this credit if your filing status is married filing separately.

For more information about the credit, see Publication 596, *Earned Income Credit.*

Withholding tax. Report the credit for federal income tax withheld on community wages in the same manner as your wages. If you and your spouse file separate returns on which each of you reports half the community wages, each of you is entitled to half the income tax withheld on those wages.

Overpayments. Overpayments are allocated under the community property laws of the state in which you are domiciled.

- If community property is subject to premarital or other separate debts of either spouse, the full joint overpayment may be used to offset the obligation.
- If community property is not subject to premarital or other separate debts of either spouse, the portion of the joint overpayment allocated to the spouse liable for the obligation can be used to offset that liability. The portion allocated to the injured spouse can be refunded.

Estimated tax. In determining whether you must pay estimated tax, apply the estimated tax rules to your estimated income. These rules are explained more fully in Publication 505.

If you think you may owe estimated tax and want to pay the tax separately, determine whether you must pay it by taking into account:

1) Half the community income and deductions,

2) All of your separate income and deductions, and

3) Your own exemption and any exemptions for dependents that you may claim.

Whether you and your spouse pay estimated tax jointly or separately will not affect your choice of filing joint or separate income tax returns.

If you and your spouse paid estimated tax jointly but want to file separate income tax returns, either of you may claim all of the estimated tax paid, or you may divide it between you in any way that you agree upon.

If you cannot agree on a division, the estimated tax you can claim is equal to the total estimated tax paid times the tax shown on your separate return divided by the total tax shown on your return and your spouse's return.

Example

Walter and Mary Smith are married and domiciled in a community property state. Their two minor children and Mary's mother live with them and qualify as their dependents. Amounts paid for their support were paid out of community funds.

Walter received a salary of $38,160. Income tax withheld from his salary was $3,360. Walter received $94 in taxable interest from his savings account. He also received $155 in dividends from stock that he owned. His interest and dividend income is his separate income under the laws of his community property state.

Mary received $140 in dividends from stock that she owned. This is her separate income. In addition, she received $3,000 as a part-time dental technician. No income tax was withheld from her salary.

The Smiths paid a total of $3,850 in medical expenses. Medical insurance of $700 was paid out of community funds. Walter paid $3,150 out of his sepatate funds for an operation he had.

The Smiths had $6,842 in other itemized deductions, none of which were miscellaneous itemized deductions subject to the 2% adjusted gross income limit. The amounts spent for these deductions were paid out of community funds.

To see if it is to the Smiths' advantage to file a joint return or separate returns, a worksheet (shown next) is prepared to figure their federal income tax both ways. Walter and Mary must claim their own exemptions on their separate returns.

The summary at the bottom of the worksheet compares the tax figured on the Smiths' joint return to the tax figured on their separate returns. The result is that by filing separately under the community property laws of their state, the Smiths save $184 in income tax.

If the Smiths were domiciled in Idaho, Louisiana, Texas, or Wisconsin, the result would be slightly different because in those states income from separate property generally is treated as community income. If they lived in one of those states, the interest on Walter's savings account and the dividends from stock owned by each of them would be divided equally on their separate returns.

Table 1. **Worksheet—Walter and Mary Smith**

	Joint Return		Separate Returns: Walter's		Separate Returns: Mary's	
Income (Walter's):						
Salary	$ 38,160		$ 19,080		$ 19,080	
Interest and dividends ($155 dividends + $94 interest)	249		249		-0-	
Total		$ 38,409		$ 19,329		$ 19,080
Income (Mary's):						
Salary	$ 3,000		$ 1,500		$ 1,500	
Dividends	140		-0-		140	
Total		3,140		1,500		1,640
Adjusted gross income (AGI)		$ 41,549		$ 20,829		$ 20,720
Deductions (Community) Not subject to the 2% AGI limit		$ 6,842		$ 3,421		$ 3,421
Deductions (Medical):						
Premiums	$ 700		$ 350		$ 350	
Medical expenses (Walter's)	3,150		3,150		-0-	
Total	$ 3,850		$ 3,500		$ 350	
(Minus) 7.5% of AGI	(3,116)		(1,562)		(1,554)	
Medical expense deduction		$ 734		$ 1,938		$ -0-
Total deductions		$ 7,576		$ 5,359		$ 3,421
Subtract total deductions from AGI[1]		$ 33,973		$ 15,470		$ 17,299
(Minus) exemptions[2]		$ (13,250)		$ (5,300)		$ (7,950)
Taxable income		$ 20,723		$ 10,170		$ 9,349
Tax[3]		$ 3,109		$ 1,526		$ 1,399
(Minus) federal income tax withheld		(3,360)		(1,680)		(1,680)
Overpayment		$ (251)		$ (154)		$ (281)

[1] The itemized deductions are greater than the standard deduction of $6,900 for married filing jointly and $3,450 for married filing separately. **Note:** If one spouse itemizes, the other must itemize, even if one spouse's deductions are less than the standard deduction.

[2] An allowance of $2,650 for each exemption claimed is subtracted—5 on the joint return, 2 on Walter's separate return, and 3 on Mary's separate return.

[3] The tax on the joint return is from the column of the Tax Table for married filing jointly. The tax on Walter's and Mary's separate returns is from the column of the Tax Table for married filing separately.

Table 1. **Summary**

Tax on joint return		$3,109
Tax on Walter's separate return	$1,526	
Tax on Mary's separate return	1,399	
Total tax filing separate returns		2,925
Total savings by filing separate returns		$ 184

Table 2. **Allocation Worksheet**

	1 Total Income (Community/Separate)	2 Allocated to Husband	3 Allocated to Wife
1. Wages (each employer)			
2. Interest Income (each payer)			
3. Dividends (each payer)			
4. State Income Tax Refund			
5. Capital Gains and Losses			
6. Pension Income			
7. Rents, Royalties, Partnerships, Estates, Trusts			
8. Taxes Withheld			
9. Other items such as: Social Security Benefits, Business & Farm Income or Loss, Unemployment Compensation, Mortgage Interest Deduction, etc.			

NOTES

How To Get More Information

You can get help from the IRS in several ways.

Free publications and forms. To order free publications and forms, call 1–800–TAX-FORM (1–800–829–3676). You can also write to the IRS Forms Distribution Center nearest you. Check your income tax package for the address. Your local library or post office also may have the items you need.

For a list of free tax publications, order Publication 910, *Guide to Free Tax Services.* It also contains an index of tax topics and related publications and describes other free tax information services available from IRS, including tax education and assistance programs.

If you have access to a personal computer and modem, you also can get many forms and publications electronically. See *Quick and Easy Access to Tax Help and Forms* in your income tax package for details.

Tax questions. You can call the IRS with your tax questions. Check your income tax package or telephone book for the local number, or you can call 1–800–829–1040.

TTY/TDD equipment. If you have access to TTY/TDD equipment, you can call 1–800–829–4059 to ask tax questions or to order forms and publications. See your income tax package for the hours of operation.

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