

**Offsets under section 6402; Nevada, New Mexico, and Washington law.** This ruling provides guidance regarding the amount of an overpayment from a joint tax return that the IRS may offset against a spouse's separate tax liability for taxpayers domiciled in Nevada, New Mexico, and Washington. Nevada, New Mexico, and Washington are community property states and, under the respective state laws, each spouse has an undivided 50-percent interest in all community property. Rev. Ruls. 80-7 and 85-70 amplified and clarified.

## **Rev. Rul. 2004-73**

### ISSUE

What amount of an overpayment reported on a joint return may the Internal Revenue Service apply against one spouse's separate tax liability if the spouses are domiciled in Nevada, New Mexico, or Washington?

This ruling addresses how offsets apply for taxpayers filing joint returns and domiciled in Nevada, New Mexico, or Washington. Because these states have similar community property laws, Nevada, New Mexico, and Washington are addressed in one ruling. This ruling makes assumptions about the operation of state community property laws which are highly dependent on facts and circumstances. Therefore, taxpayers are cautioned to check current state law and apply it to their particular facts. Taxpayers domiciled in Arizona or Wisconsin should refer to Rev. Rul. 2004-71; taxpayers domiciled in California, Idaho, or Louisiana should refer to Rev. Rul. 2004-72; and taxpayers domiciled in Texas should refer to Rev. Rul. 2004-74.

## FACTS

*Situation 1, Nevada.* In Year 1, Liable Spouse, who is single, incurs a tax liability of \$20,000. Liable Spouse does not pay this tax liability. In Year 2, Liable Spouse and Non-Liable Spouse marry. In Year 4, Liable Spouse and Non-Liable Spouse file a joint return for Year 3, reporting an overpayment of \$1,000. The overpayment results from income taxes withheld from Liable Spouse's and Non-Liable Spouse's wages during Year 3. Liable Spouse and Non-Liable Spouse are domiciled in Nevada at all relevant times.

Nevada law presumes that property acquired during marriage by either husband, wife, or both, is community property, subject to limited exceptions. *See Nev. Rev. Stat. section 123.220 (2003)*. This presumption may be rebutted. *Forrest v. Forrest*, 668 P.2d 275, 277 (Nev. 1983). Further, during marriage, each spouse has a 50 percent interest in the community property. *See Nev. Rev. Stat. section 123.225 (2003)*. Generally, property owned by one spouse before marriage, or acquired during marriage by gift, bequest, devise, descent, or an award for personal damages, is separate property, and each spouse has a 100 percent interest in his or her separate property. *See Nev. Rev. Stat. section 123.130 (2003)*.

Nevada law provides that a creditor may reach all of a liable spouse's separate property and all of the community property to satisfy the liable spouse's debts that arose during the marriage. *See Hardy v. United States*, Civil No. CV-N-94-0824 (D. Nev. 1997); *Nelson v. United States*, Civil No. CV-N-89-659 (D. Nev. 1993), *aff'd*, 53 F.3d 339 (9<sup>th</sup> Cir. 1995); *United States v. ITT Consumer Financial Corp.*, 816 F.2d 487, n. 12 (9<sup>th</sup> Cir. 1987). However, a creditor may not reach any of the non-liable spouse's separate property to satisfy the liable spouse's debt that arose during the marriage. *See Hardy v. United States*, Civil No. CV-N-94-0824 (D. Nev. 1997). In addition, Nevada law provides that a creditor may not reach the non-liable spouse's separate property or the non-liable spouse's share of the community property to satisfy the liable spouse's separate debts incurred or contracted prior to marriage. *See Nev. Rev. Stat. section 123.050 (2003)*.

*Situation 2, New Mexico.* In Year 1, Liable Spouse, who is single, incurs a tax liability of \$20,000. Liable Spouse does not pay this tax liability. In Year 2, Liable Spouse and Non-Liable Spouse marry. In Year 4, Liable Spouse and Non-Liable Spouse file a joint return for Year 3, reporting an overpayment of \$1,000. The overpayment results from income taxes withheld from Liable Spouse's and Non-Liable Spouse's wages during Year 3. Liable Spouse and Non-Liable Spouse are domiciled in New Mexico at all relevant times, and Liable Spouse's tax liability is a separate debt as defined by New Mexico law.

New Mexico law provides that property acquired during marriage by the husband, wife, or both is presumed to be community property, and each spouse has a 50 percent interest in community property. *See N.M. Stat. Ann. section 40-3-12(A)(2002)*; *Central Adjustment Bureau, Inc. v. Thevenet*, 686 P.2d 954, 957-958 (N.M. 1984). This presumption may be rebutted. *C & L Lumber and Supply, Inc. v. Texas American Bank/Galeria*, 795 P.2d 502, 505 (N.M. 1990). Generally, property owned by a spouse before marriage is separate property, and each spouse has a 100 percent interest in all of his or her separate property. *See N.M. Stat. Ann. section 40-3-8 (2002)*.

New Mexico law provides that a creditor may reach all of the separate property of the spouse or spouses who contracted or incurred the debt, and all of the community property to satisfy a community debt. *See N.M. Stat. Ann. section 40-3-11(A) (2002)*. However, a creditor may not reach any of one spouse's separate property to satisfy a community debt incurred by the other spouse. *See Id.* New Mexico law provides that a creditor may reach all of the liable spouse's separate property and all of the liable spouse's share of community property to satisfy a separate debt. *See N.M. Stat. Ann. section 40-3-10(A) (2002)*. However, a creditor may not reach any of the non-liable spouse's separate property to satisfy the liable spouse's separate debt. *See Id.*

Under New Mexico law, a separate debt is defined as: (1) a debt contracted or incurred either before marriage or after entry of a decree of dissolution of marriage; (2) a debt contracted or incurred after a court has entered a decree pursuant

to N.M. Stat. Ann. section 40-4-3 (proceeding for division of property, disposition of children or alimony without dissolution of marriage); (3) a debt designated by a court as a separate debt; (4) a debt contracted by a spouse during marriage which, at the time of creation, is identified to the creditor in writing as the separate debt of the contracting spouse; (5) a debt that arises from a tort committed either before marriage or after entry of a decree of dissolution of marriage; or (6) a debt declared unreasonable pursuant to N.M. Stat. Ann. section 40-3-10.1 (certain debts that did not contribute to the benefit of both spouses or their dependents). *See N.M. Stat. Ann. section 40-3-9(A)(1) through (6) (2002)*. Community debt is defined as a debt, which is not a separate debt, contracted or incurred by one or both spouses during the marriage. *See N.M. Stat. Ann. section 40-3-9(B) (2002)*. New Mexico law presumes that a debt incurred during marriage is community debt. *See In re Fingado*, 113 B.R. 37, 42 (Bankr. D.N.M. 1990), *aff'd*, 995 F.2d 175 (10<sup>th</sup> Cir. 1993).

*Situation 3, Washington.* In Year 1, Liable Spouse, who is single, incurs a tax liability of \$20,000. Liable Spouse does not pay this tax liability. In Year 2, Liable Spouse and Non-Liable Spouse marry. In Year 4, Liable Spouse and Non-Liable Spouse file a joint return for Year 3, reporting an overpayment of \$1,000. The overpayment results from income taxes withheld from Liable Spouse's and Non-Liable Spouse's wages during Year 3. Liable Spouse and Non-Liable Spouse are domiciled in Washington state at all relevant times, and Liable Spouse's tax liability is a separate debt as defined by Washington state law.

Washington state law defines community property as any property acquired during marriage, by one or both spouses, that is not separate property. *See Wash. Rev. Code section 26.16.030 (2003)*. There is a rebuttable presumption under Washington state law that all property acquired during marriage is community property. *See Dean v. Lehman*, 18 P.3d 523, 528 (Wash. 2001)(en banc). Each spouse has an undivided 50-percent interest in all community property. *See In re Towey's Estate*, 155 P.2d 273, 275 (Wash. 1945). Washington state law defines separate property as property owned by a spouse before marriage and property acquired during mar-

riage by a spouse by gift, bequest, devise, or descent. See Wash. Rev. Code sections 26.16.010, 26.16.020 (2003). In addition, Washington state law defines as separate property any profits or income derived from separate property during marriage. See Wash. Rev. Code sections 26.16.010, 26.16.020 (2003).

Under Washington state law, a creditor may reach all of the community property, including the earnings of both spouses, to satisfy a community debt. See *Pacific Gamble Robinson Co. v. Lapp*, 622 P.2d 850, 854 (Wash. 1980). A creditor may reach all of a spouse's separate property to satisfy a community debt incurred by that spouse; however, a creditor of a community debt may not reach the other spouse's separate property. See Wash. Rev. Code sections 6.15.040, 26.16.010, 26.16.020 (2003). In general, under Washington state law, a creditor may not reach any of the community property to satisfy a separate debt. See Wash. Rev. Code section 26.16.200 (2003); *Pacific Gamble Robinson Co.*, 622 P.2d at 854. However,

under *United States v. Overman*, 424 F.2d 1142 (9<sup>th</sup> Cir. 1970), the Service may reach the liable spouse's 50-percent interest in the community property to satisfy a separate tax liability of the liable spouse. See also *Draper v. United States*, 243 F. Supp. 563 (W.D. Wash. 1965).

Under Washington state law, a debt incurred during marriage, for the benefit of the community, is a community debt. See *In re Marriage of Hurd*, 848 P.2d 185, 195–196 (Wash. App. 1993). Washington state law presumes that a debt is a community debt. See *Pacific Gamble Robinson Co.*, 622 P.2d at 854. If a debt is not a community debt, then it is a separate debt. See *Id.*

#### LAW

Section 6402(a) of the Internal Revenue Code provides that, in the case of any overpayment, the Service may credit the amount of the overpayment, including interest, against any internal revenue tax liability on the part of the person who made

the overpayment and shall refund the balance to the person.

Revenue Ruling 74–611, 1974–2 C.B. 399, holds that if a husband and wife file a joint return, each spouse has a separate interest in the jointly reported income and a separate interest in any overpayment. However, filing a joint return does not create a new property interest for the husband or the wife. *Id.*

Revenue Ruling 80–7, 1980–1 C.B. 296, holds that if a husband and wife file a joint return showing an overpayment, the Service may credit one spouse's interest in the overpayment against that spouse's separate tax liability. The amount of the spouse's interest in the overpayment is calculated by subtracting the spouse's share of the joint tax liability, determined under a separate tax formula, from the spouse's contribution towards the joint tax liability. Under the separate tax formula, a spouse's share of the joint tax liability is calculated as follows:

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<u>Spouse's Separate Tax</u>	$\times$	Joint Tax Liability Reported on Return
Total of Both Spouses' Separate Tax		

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Revenue Ruling 85–70, 1985–1 C.B. 361, provides a two-step process to determine the amount of a joint overpayment that the Service may offset against one spouse's separate tax liability if the spouses are domiciled in a community property state. First, if the joint overpayment is from wages that are community property income, then each spouse is considered to be the recipient of one-half of the aggregated wages regardless of whether the spouses may have earned different amounts of wages (the one-half rule). Accordingly, each spouse has a one-half interest in the overpayment, and the Service may offset the liable spouse's one-half interest in the overpayment against the liable spouse's separate federal tax liability regardless of whether state law provides that creditors may reach community property to satisfy the separate debts of a spouse. *Id.* Rev. Rul. 85–70 does not specifically address what portion of each spouse's actual wages is treated as having been offset as a result of applying the one-half rule. Under the facts of Rev.

Rul. 85–70, and specifically the assumed state laws, that analysis was not necessary. However, applying the second step of Rev. Rul. 85–70 in other cases may require a determination of the amount of each spouse's actual wages that were offset after applying the one-half rule. For that purpose, each spouse under the first step of Rev. Rul. 85–70 is treated as receiving one half of the wages from each community property source (or, collectively, one-half of the aggregated wages) and as such being entitled to receive one-half of the income tax withheld from each community property source.

Second, Rev. Rul. 85–70 provides that state law may enable the Service to offset an additional portion of the joint overpayment from community property sources to satisfy a spouse's separate federal tax liability. This additional right of offset is available if state law provides that creditors may reach community property to satisfy the separate debts of a spouse. (The amount potentially available to be offset under the second step of Rev. Rul.

85–70 is the amount remaining after application of the first step of that revenue ruling.) However, if state law provides that community property may not be reached to satisfy the premarital or other separate debts of either spouse, then the Service may not offset any portion of the non-liable spouse's share of the overpayment from community property sources against the liable spouse's separate tax liability. *Id.*

*Five-step process to determine amount of joint overpayment that the Service may offset against separate federal tax liability of one spouse.*

A five-step process is required to determine the amount of a joint overpayment that the Service may, pursuant to section 6402(a), offset against the separate federal tax liability of one spouse.

The first step is to identify the underlying source of the overpayment. The Service looks to the tax payments made by the spouses, including income tax withholding and estimated tax payments and other credits, such as the earned income tax

credit, that gave rise to the overpayment. If the earned income tax credit is a source of the overpayment, *see* Rev. Rul. 87-52, 1987-1 C.B. 347, for guidance.

The second step is to characterize the underlying source of the overpayment as either separate or community property. Because an overpayment will be charac-

terized in the same manner as the source of the overpayment, an overpayment will be characterized as community property, separate property, or as part community property and part separate property, depending on the character of the source of the overpayment. If the overpayment is part community property and part separate

property, the portion of the overpayment attributable to a separate property source must be subtracted from the remainder of the overpayment. The portion of the overpayment attributable to a separate property source is calculated as follows:

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Tax Payment From a Separate Property Source

x Overpayment

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Total Tax Payments

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The third step is to offset the liable spouse's share of the overpayment from a community property source against the liable spouse's separate tax liability. Under Rev. Rul. 85-70, the Service may offset the liable spouse's 50-percent interest in the overpayment from a community property source to satisfy the liable spouse's separate tax liability.

The fourth step is to determine whether, under state law, the Service may reach the non-liable spouse's share of the overpayment from a community property source. *See* Rev. Rul. 85-70.

The fifth step is to determine whether the Service may, under state law, reach a portion of the overpayment from a separate property source of the liable spouse or the non-liable spouse.

#### ANALYSIS

*Apply the five-step process to each situation.*

(1) *Step 1.*

In *Situation 1*, *Situation 2*, and *Situation 3*, the overpayment is from income taxes withheld in Year 3 from Liable Spouse's and Non-Liable Spouse's wages.

(2) *Step 2.*

Nevada, New Mexico, and Washington state law presume that all property acquired during marriage by either spouse or both spouses, including wages, is community property. In *Situation 1*, *Situation 2*, and *Situation 3*, the overpayment results from income tax withholding from Liable Spouse's and Non-Liable Spouse's wages. Because state law presumes that wages are community property, the entire overpayment in *Situation 1*, *Situation 2*, and *Situation 3* is assumed to be from a community property source.

(3) *Step 3.*

Under Nevada, New Mexico, and Washington state law, each spouse has a present and equal interest in all community property. In *Situation 1*, *Situation 2*, and *Situation 3*, the Service may offset Liable Spouse's \$500 share of the overpayment against Liable Spouse's separate tax liability.

(4) *Step 4.*

Under Nevada, New Mexico, and Washington state law, the amount of community property that a creditor may reach depends on the character of the debt. In *Situation 1*, Liable Spouse's tax liability arose before marriage. Nevada law distinguishes between debts that arose before or during the marriage. For debts that arose before marriage, a creditor may not reach either Non-Liable Spouse's portion of community property or Non-Liable Spouse's separate property. Accordingly, the Service may not offset any portion of Non-Liable Spouse's share of the overpayment against Liable Spouse's tax liability.

In *Situation 2*, Liable Spouse's tax liability is a separate debt under New Mexico law. In *Situation 3*, Liable Spouse's tax liability is a separate debt under Washington state law. New Mexico and Washington state law distinguish between community debts and separate debts. For a community debt (*e.g.*, a tax liability of one spouse that arose during the marriage by filing separate returns), a creditor may reach Liable Spouse's and Non-Liable Spouse's share of community property to satisfy the Liable Spouse's separate tax liability. However, if the debt is a separate debt (*e.g.*, a tax liability of one spouse that arose before marriage), a creditor may reach Liable Spouse's share of community property, but a creditor may not reach Non-Liable Spouse's share of community property. Because Liable Spouse's tax liability

is a separate debt in *Situation 2* and *Situation 3*, the Service may not offset any portion of Non-Liable Spouse's share of the overpayment against Liable Spouse's separate tax liability.

(5) *Step 5.*

Under Nevada, New Mexico, and Washington state law, a creditor may reach all of Liable Spouse's separate property to satisfy Liable Spouse's separate tax liability. A creditor may not, however, reach any of Non-Liable Spouse's separate property to satisfy Liable Spouse's separate tax liability. In *Situation 1*, *Situation 2*, and *Situation 3*, no part of the overpayment is from a separate property source. Accordingly, there is no separate property that the Service may offset against the Liable Spouse's separate tax liability.

#### HOLDING

*Situation 1.* The Service may offset \$500 of the overpayment against Liable Spouse's separate tax liability.

*Situation 2.* The Service may offset \$500 of the overpayment against Liable Spouse's separate tax liability.

*Situation 3.* The Service may offset \$500 of the overpayment against Liable Spouse's separate tax liability.

#### EFFECT ON OTHER REVENUE RULINGS

Revenue Ruling 80-7 and Rev. Rul. 85-70 are amplified and clarified.

#### DRAFTING INFORMATION

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