

Offsets under section 6402; Texas 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 Texas. Texas is a community property state and, under the state law, each spouse has an undivided 50-percent interest in all community property. Rev. Ruls. 80-7 and 85-70 amplified and clarified.

Rev. Rul. 2004-74

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 Texas?

This ruling addresses how offsets apply for taxpayers filing joint returns and domiciled in Texas. This ruling makes assumptions about the operation of Texas 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 Nevada, New Mexico or Washington should refer to Rev. Rul. 2004-73.

FACTS

Situation 1. In Year 1, Liable Spouse, who is single, incurs a federal 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, claiming an overpayment of \$1,000. This 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 Texas at all relevant times.

Applying Rev. Rul. 80-7, 1980-1 C.B. 296, the Service determines that \$750 of the overpayment is attributable to community property subject to Liable Spouse's sole management, control, and disposition, and \$250 of the overpayment is attributable to community property subject to Non-Liable Spouse's sole management, control, and disposition.

Texas law defines separate property as property owned by a spouse before marriage; property acquired by spouse during marriage by gift, devise or descent; and any damages recovered by a spouse for personal injuries that do not represent loss of earning capacity during marriage. See Tex. Fam. Code Ann. section 3.001 (2002). Texas law defines community property as property, other than separate property, acquired by either spouse during marriage. See Tex. Fam. Code Ann. section 3.002 (2002). Each spouse has a 50-percent interest in community property. See *Broday v. United States*, 455 F.2d 1097 (5th Cir. 1972). There is a rebuttable presumption under Texas law that all property acquired during marriage is community property. See Tex. Fam. Code Ann. section 3.003 (2002).

Texas law distinguishes between community property subject to the joint management, control, and disposition of both spouses, and community property subject to one spouse's sole management, control, and disposition. See Tex. Fam. Code Ann. section 3.102 (2002). A spouse has sole management, control, and disposition over community property that spouse would have owned if that spouse were single. See Tex. Fam. Code Ann. section 3.102(a) (2002). This community property includes personal earnings; revenue from separate property; damages recovered from personal injuries; and the increase in value, mutations and revenue of all property subject to a spouse's sole management, control, and disposition. See Tex. Fam. Code Ann. section 3.102(a)(1) through (4) (2002). Texas law defines community property subject to joint management, control, and disposition as all community property that is not subject to a spouse's sole management, control, and disposition, and is not otherwise subject to an agreement of the spouses. See Tex. Fam. Code Ann. section 3.102(c) (2002).

Although each spouse has a 50 percent interest in the community property, Texas law limits the types of community property that a creditor may reach to satisfy a spouse's separate liability. See Tex. Fam. Code Ann. section 3.202 (2002). Texas law allows a creditor to reach all of the community property subject to the liable spouse's sole management, control, and disposition to satisfy the spouse's separate liability. See Tex. Fam. Code Ann. section 3.202(c) (2002). In addition, a creditor may reach all community property subject to the spouses' joint management, control, and disposition, and all of the liable spouse's separate property, whether the debt was incurred before or during marriage. See Tex. Fam. Code Ann. section 3.202(c) (2002). A creditor may not reach any portion of the community property subject to the non-liable spouse's sole management, control, and disposition, or the non-liable spouse's separate property. See Tex. Fam. Code Ann. section 3.202(c) (2002). However, under *Medaris v. United States*, 884 F.2d 832 (5th Cir. 1989), the Service may reach the liable spouse's 50-percent interest in the non-liable spouse's sole management community property to satisfy a separate federal tax liability of the liable spouse.

Situation 2. Same facts as *Situation 1*, except that \$250 of the overpayment is attributable to community property subject to Liable Spouse's sole management, control, and disposition, and \$750 of the overpayment is attributable to community property subject to Non-Liable Spouse's sole management, control, and disposition.

Situation 3. Same facts as *Situation 1*, except that the entire overpayment resulted solely from income tax withholding from Non-Liable Spouse's wages, and the entire overpayment is attributable to community property subject to Non-Liable Spouse's sole management, control, and disposition.

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:

$$\frac{\text{Spouse's Separate Tax}}{\text{Total of Both Spouses' Separate Tax}} \times \text{Joint Tax Liability Reported on Return}$$

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. 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 characterized 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:

$$\frac{\text{Tax Payment From a Separate Property Source}}{\text{Total Tax Payments}} \times \text{Overpayment}$$

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 any other portion 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 any 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 Year 3 joint overpayment is from income taxes withheld in Year 3 from Liable Spouse's and Non-Liable Spouse's wages.

(2) Step 2.

Texas law presumes 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 Texas 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 Texas law, each spouse has a present and equal interest in all community property. In *Situation 1*, the Service applies Rev. Rul. 80-7 and determines that \$750 of the overpayment is attributable to community property subject to Liable Spouse's sole management, control, and disposition, and \$250 of the overpayment is attributable to community property subject to Non-Liable Spouse's sole management, control, and disposition. Applying Rev. Rul. 85-70 and *Medaris v. United States*, 884 F.2d 832 (5th Cir. 1989), the Service may offset \$375 of the income tax withholding attributable to Liable Spouse's wages and \$125 of the income tax withholding attributable to Non-Liable Spouse's wages. Accordingly, in *Situation 1*, the Service may offset \$500 of the overpayment against Liable Spouse's Year 1 tax liability.

In *Situation 2*, the Service applies Rev. Rul. 80-7 and determines that \$250 of the overpayment is attributable to community property subject to Liable Spouse's sole management, control, and disposition, and \$750 of the overpayment is attributable to community property subject to Non-Liable Spouse's sole management, control, and disposition. Applying Rev. Rul. 85-70 and *Medaris*, the Service may offset

\$125 of the income tax withholding attributable to Liable Spouse's wages and \$375 of the income tax withholding attributable to Non-Liable Spouse's wages. Accordingly, in *Situation 2*, the Service may offset \$500 of the overpayment against Liable Spouse's Year 1 tax liability.

In *Situation 3*, the Service applies Rev. Rul. 80-7 and determines that none of the overpayment is attributable to community property subject to Liable Spouse's sole management, control, and disposition, and \$1,000 of the overpayment is attributable to community property subject to Non-Liable Spouse's sole management, control, and disposition. Applying Rev. Rul. 85-70 and *Medaris*, the Service may offset \$500 of the income tax withholding attributable to Non-Liable Spouse's wages. Accordingly, in *Situation 3*, the Service may offset \$500 of the overpayment against Liable Spouse's Year 1 tax liability.

(4) Step 4.

Under Texas law, the amount of community property that a creditor may reach depends on the nature of the property. In *Situation 1*, *Situation 2*, and *Situation 3*, under Texas law, the Service may reach all community property subject to Liable Spouse's sole management, control, and disposition, and all community property subject to Liable Spouse's and Non-Liable Spouse's joint management, control, and disposition.

In *Situation 1*, \$750 of the overpayment is attributable to community property subject to Liable Spouse's sole management, control, and disposition. Applying Texas law in Step 4, and in addition to the amount offset in Step 3, the Service may offset the remaining \$375 of the \$750 overpayment that is attributable to community property subject to Liable Spouse's sole management, control, and disposition.

Further, \$250 of the overpayment is attributable to community property subject to Non-Liable Spouse's sole management, control, and disposition. Applying Texas law in Step 4, in addition to the amount offset in Step 3, the Service may not offset the remaining portion of the overpayment from community property sources subject to Non-Liable Spouse's sole management, control, and disposition.

In *Situation 2*, \$250 of the overpayment is attributable to community property subject to Liable Spouse's sole management,

control, and disposition. Applying Texas law in Step 4, and in addition to the amount offset in Step 3, the Service may offset the remaining \$125 of the \$250 overpayment that is attributable to community property subject to Liable Spouse's sole management, control, and disposition.

Further, \$750 of the overpayment is attributable to community property subject to Non-Liable Spouse's sole management, control, and disposition. Applying Texas law in Step 4, in addition to the amount offset in Step 3, the Service may not offset the remaining portion of the overpayment from community property sources subject to Non-Liable Spouse's sole management, control, and disposition.

In *Situation 3*, none of the overpayment is attributable to community property subject to Liable Spouse's sole management, control, and disposition. Applying Texas law in Step 4, in addition to the amount offset in Step 3, the Service may not offset the remaining portion of the overpayment from community property sources.

(5) Step 5.

Under Texas state law, a creditor may reach 100 percent 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 \$875 of the overpayment against Liable Spouse's separate tax liability.

Situation 2. The Service may offset \$625 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

The principal author of this revenue ruling is Michael A. Skeen of the Office of

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