

INJURED SPOUSE ALLOCATION

HOW TO PROTECT YOUR TAX REFUND FROM YOUR SPOUSE'S TAX DEBT

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Filing a joint income tax return can be a costly mistake. On the other hand, given that the combined tax on a joint return is often less than the combined tax that would have been owed had each spouse filed separately, there exists a strong incentive to file jointly with a spouse. And not all pitfalls from a joint filing stem from the fact that each spouse is jointly and severally liable for the tax due. Another pitfall—and the subject of this article—is what happens when a joint return is filed showing an overpayment, and where, but for the tax debt owed by one of the spouses, the other spouse would have received a refund. In other words, when one spouse owes money to the IRS, can the couple continue to file jointly without causing the other spouse, the injured spouse,¹ to lose the tax refund to which he or she would have been entitled? In the absence of a remedy, the entire overpayment would simply be snatched by the IRS and applied to the back debt. Before we can answer this question, it is first helpful to look at how to file and amend a joint income tax return.

I. Married Filing Jointly

A. Benefits of a Joint Return

The Internal Revenue Code (Code)² provides that a husband and wife³ may file a joint income tax return.⁴ If a married couple files jointly, their separate incomes are aggregated and the tax is computed on the total.⁵ A married couple is not required to file

¹ Throughout this article, the term “injured spouse” refers to that spouse whose tax overpayment is being applied to satisfy the other spouse’s tax debt. Such term is not to be confused with an “innocent spouse”, the usage of which indicates a separate form of relief.

² All Code references are to the Internal Revenue Code of 1986, as amended.

³ The Code expressly uses the term “husband and wife”, and as a result of the 1996 Defense of Marriage Act (DOMA), couples that have entered into a Civil Union under New Jersey law are still prohibited from filing joint federal income tax returns (though they may file joint returns in New Jersey).

⁴ IRC § 6013.

⁵ Regs. § 1.6013-4(b).

a joint return, but in most instances the joint filing produces an overall tax that is lower than the combined tax that would have been owed had each spouse filed separately.

The reason for this is that the Married Filing Separately (MFS) status does not allow the electing taxpayer to claim certain tax benefits. For example, an MFS taxpayer cannot claim a (a) credit for child and dependent care, (b) student loan interest rate deduction, (c) tax-free exclusion of US bond interest used for higher education expenses, (d) tax-free exclusion of Social Security Benefits, (e) credit for the elderly or disabled, (f) tuition and fees deduction, (g) earned income credit, or (h) Hope or Lifetime Learning Educational credits. Also, MFS taxpayers have a lower income phase-out for IRA deductions, and the IRS essentially requires that if one MFS taxpayer utilizes the standard deduction, that the other filer must do so as well. The standard deduction for any MFS taxpayer whose spouse itemized deductions is \$0.⁶

B. Amending Separate Filed Returns

In the case where an individual files a separate return for a taxable year for which a joint return could have been made, and where the time for filing that return has expired, such individual may nevertheless make a joint return with her spouse for that taxable year.⁷ However, the joint return may not be made if more than three (3) years has expired from the date the return would have been due (without regard to any extension).⁸ Furthermore, once a joint return is filed, the taxpayers—except in the case of a decedent—cannot later file separate returns after the due date of the return.⁹

Example 1: H & W (calendar year taxpayers) file separate income tax returns for 2008. H filed his return on March 6, 2009. W filed for an extension and later filed her return on October 15, 2009. The last day H & W may file a joint income tax return for 2008 is April 17, 2012 (because April 15 is a Sunday and April 16, 2012 is a recognized holiday).¹⁰ This date is three (3) years from the date their joint return would have been due—April 15, 2009—without extensions.

However, the date by which a joint return may be filed to amend prior separate filings is often not the date the return is *deemed* to have been filed for various purposes. For example, for purposes of determining IRS assessment and collection activities under § 6501 and penalties under § 6651, a joint return is *deemed* to have been filed as follows:

⁶ IRS Publication 501 (2011).

⁷ IRC § 6013(b)(1) – Note however that this special rule does not work in reverse. Where a joint return has been filed, and where the time for amending that return has expired, the option of filing separate returns is lost.

⁸ IRC § 6013(b)(2)(A); See also IRC § 6013 generally for other limitations on filing joint returns.

⁹ IRS Publication 501 (2011).

¹⁰ IRC § 7503.

1. **Where both spouses filed separate returns.** In the case where both spouses filed separate returns, the joint return is deemed filed on the date the last separate return was filed (but not earlier than the date prescribed by law).¹¹

Example 2: For example, in *Example 1* above, the joint return filed on or before April 17, 2012 would be deemed to have been filed on October 15, 2009 for purposes of assessment and collection activities. This means that the three (3) year period for assessment¹² expires after October 15, 2012, which is beyond the standard three (3) year period from the date the return was deemed filed.¹³

2. **Where one spouse filed separately and where the other spouse was not obligated to file.** In the case where one spouse filed separately and where the other spouse was not obligated to file, the joint return is deemed filed on the date the separate return was filed (but not earlier than the date prescribed by law).¹⁴

Example 3: For example, if we modify the facts of *Example 1* above to say that W did not file having had no filing obligation, the joint return would be deemed to have been filed on April 15, 2009, despite H filing before this deadline.

3. **Where both spouses were obligated to file but only one spouse did file.** In the case where both spouses were obligated to file but only one spouse did file, the joint return is deemed filed on the date the joint return is actually filed.¹⁵

Example 4: For example, if we modify the facts of *Example 1* above to say that W did not file though she was obligated to do so, the statute of limitations on assessment and collection would not begin to run until the filing of the joint return. Note that such an amended return would essentially restart the statute of limitations on the spouse who did file timely.

For purposes of filing for any credit or refund due under § 6511, the joint return is deemed to have been filed on the last date prescribed by law for filing the return (without regard to extensions).¹⁶

Example 5: For example, in *Example 1* above, the joint return would be deemed filed on April 15, 2009—the last date prescribed by law for the filing of the return. This means that any claim for a refund must be brought within three

¹¹ IRC § 6013(b)(3)(A)(i).

¹² IRC § 6501(a).

¹³ See also IRC § 6501(c)(7) providing a 60-day rule when the amended return shows an additional tax owed.

¹⁴ IRC § 6013(b)(3)(A)(ii).

¹⁵ IRC § 6013(b)(3)(A)(iii).

¹⁶ IRC § 6513(b)(3)(B).

(3) years of that date, or by April 17, 2012, or two (2) years from the time the tax was paid, whichever is later.¹⁷ However, if the claim is not filed within the 3-year period, the amount of the credit or refund cannot exceed the portion of the tax paid during the two (2) years immediately preceding the filing of the claim.¹⁸

C. Joint & Several Liability

In the case of a joint return, each spouse is jointly and severally liable for the entire amount of tax that is owed.¹⁹ This means that both spouses are personally liable not only for the tax they report on the return, but for the entire tax liability, including interest and penalties.²⁰ This risk of an additional assessment and the imposition of interest and penalties should be given careful consideration by the practitioner before advising the client to file jointly.

Example 6: H & W file jointly for 2008. On audit, IRS assesses an additional tax and penalty for unreported income by H. W is personally liable for the additional tax, interest and penalties assessed on H's income. Unless W qualifies for relief from joint and several liability,²¹ the IRS may bring a collection action against W.

D. Separate Interest in Joint Income

In the case of a joint return, despite the aggregation of income, the IRS has repeatedly held that each spouse has a separate interest in the jointly reported income and a separate interest in any overpayment.²² Rooted in this concept of separate interests is the relief available to an injured spouse, and calculating that separate interest, the first step towards obtaining relief, is the subject of Revenue Ruling 80-7, discussed below.

II. Revenue Ruling 80-7

A. Issue Presented

If a taxpayer and spouse file a joint return in which an overpayment is reported, what is the proper method of determining the amount that may be credited to a spouse's separate liability?

¹⁷ IRC § 6511(a).

¹⁸ IRC § 6511(b)(2)(B).

¹⁹ IRC § 6013(d)(3).

²⁰ Regs. § 1.6013-2(e).

²¹ IRC § 6015.

²² Rev. Rul. 74-611; Rev. Rul. 80-7.

B. Facts

A and B are married and filed a joint 1977 Federal income tax return showing a liability of \$13,004. A reported \$20,000 of wages, from which \$6,000 was withheld, and \$10,000 of other income. B reported \$10,000 of wages, from which \$2,000 was withheld, and \$5,000 of other income. A and B filed a joint estimated tax declaration and paid \$8,000 in estimated tax payments. A has an unpaid separate liability of \$5,000 from a prior year. Had A and B filed separately, A's liability would have been \$10,302 and B's would have been \$3,334. (See also Exhibit A attached).

C. Analysis

The IRS noted that when a decedent's final return is a joint return, the regulations provide a formula for determining what part of that joint income should be attributable to the deceased spouse and therefore allowable as a deduction.²³ The formula for calculating the decedent's share of joint tax is as follows:

$$\text{(Decedent's Separate Tax / (Sum of both Separate Taxes)) x Joint Tax Shown on Return} = \text{Decedent's Share of Joint Tax}$$

Example 7: For example, if the Joint Tax equaled \$15,542 and the Decedent's separate tax—the tax that would have been reported had Decedent filed MFS—equaled \$11,587, and the Surviving Spouse's separate tax equaled \$4,489, the Decedent's share of the joint tax would equal \$11,202 as follows (See also Exhibit B attached):

$$(11,587 / (11,587 + 4,489)) \times 15,542 = 11,202$$

The IRS applied this rationale to the situation of how to allocate joint tax, estimated payments, and credits among joint filers. The IRS reasoned that by making this allocation, an injured taxpayer could protect her share of any refund allocated to her. To determine that portion of an estimated tax payment attributable to a joint filer, the following formula is used:

$$\text{(Separate Tax Liability / (Sum of both Separate Tax Liabilities)) x Estimated Tax Payment} = \text{Spouse's Share of Estimated Tax Payment}$$

Example 8: For example, applying this formula to the facts contained in the Revenue Ruling, A's share of the \$8,000 estimated tax payment would equal \$6,044 as follows (See also Exhibit A attached):

$$(10,302 / (10,302 + 3,334)) \times 8,000 = 6,044$$

²³ Regs. 20.2053-6(f).

Conversely, B's share of the estimated tax would equal \$1,956.

$$(3,334 / (10,302 + 3,334)) \times 8,000 = 1,956$$

D. Application to Facts

The taxpayers in the Revenue Ruling had a combined overpayment of \$2,996 determined as follows: \$6,000 [A's Tax Withholding] + \$2,000 [B's Tax Withholding] + \$8,000 [Joint Estimated Payments Made] – \$13,004 [A & B's Joint Tax Liability].

Given that A owes the IRS \$5,000 in back debt, if nothing is done, the entire overpayment would be used to offset that prior debt. To prevent this from happening and to protect B's share of that overpayment, the first step is to calculate how much of the overpayment is attributable to B.

Step 1: Determine A and B's share of the joint tax liability. Using the above formula we find that A's share equals \$9,825 and B's share equals \$3,179 as follows:

$$\text{A's Share: } (10,302 / (10,302 + 3,334)) \times 13,004 = 9,825$$

$$\text{B's Share: } (3,334 / (10,302 + 3,334)) \times 13,004 = 3,179$$

Step 2: Determine A and B's deemed portion of any estimated tax payment. In *Example 8* above, we calculated A's share of the \$8,000 estimated tax payment at \$6,044 and B's share at \$1,956.

Step 3: Add the deemed portion from *step 2* to any individual tax withholding. Here, A's tax withholding was \$6,000 and B's was \$2,000. Adding these numbers to the deemed portion gives us the deemed total tax contribution:

$$\text{A's Deemed Total Tax Contribution: } 6,000 + 6,044 = 12,044$$

$$\text{B's Deemed Total Tax Contribution: } 2,000 + 1,956 = 3,956$$

Step 4: Finally, determine the individual share of any overpayment (or underpayment) by subtracting the deemed total tax contribution (*Step 3*) from the share of the joint tax liability (*Step 1*):

$$\text{A's Individual Share of the Overpayment: } 12,044 - 9,825 = 2,219$$

$$\text{B's Individual Share of the Overpayment: } 3,956 - 3,179 = 777$$

Note that the total of the individual shares should equal the total amount of any overpayment (or underpayment). Here, \$2,219 [A's share] + \$777 [B's share] equals the combined overpayment of \$2,996. Therefore, of the \$2,996 overpayment, \$777 is attributable to B and can be protected for B if the proper steps are followed.

Note also that on different facts, one spouse might be owed a refund whereas the other might owe additional tax. (See Exhibit C attached.) In this case, even with an Injured Spouse Allocation, the injured spouse would still be jointly and severally liable for the joint tax. The allocation would only serve to protect an amount of refund, if any, over any tax debt for that year.

E. Holding

Therefore, in the ruling the IRS held that when a joint return is filed showing an overpayment, that the amount credited to one spouse's separate tax liability is not to exceed such spouse's share of the overpayment.

III. How to Obtain Relief

A. Making an Injured Spouse Allocation

Revenue Ruling 80-7 sets out the formula for determining how to calculate each spouse's share of a joint tax liability. Taking advantage of this ruling requires the injured spouse to actually make an "Injured Spouse Allocation" by filing **Form 8379** (copy attached). The instructions (also attached) provide that the form can either be submitted along with the joint return (or amended joint return) by entering "Injured Spouse" in the upper left corner of page 1 of the joint return. If the form is submitted separately, a copy of all W-2s for both spouses, and any 1099s showing tax withholding should be attached to the form.

B. Amending a Previously Filed Return

If an amended joint return (Form 1040X) is being filed, **Form 8379** will need to be submitted regardless of whether one was submitted when the initial return was filed. Also, as discussed above, the filing of separate tax returns may be amended with the filing of a joint tax return so long as the conditions for doing so are met. In certain cases it may be appealing to amend previously filed separate returns with a joint return while using an Injured Spouse Allocation to protect the injured spouse. However, it is important to note that an Injured Spouse Allocation will not protect a spouse from being jointly and severally liable for the combined tax, interest and penalties stemming from the tax year for which that joint return is filed. The allocation will only protect an individual's overpayment from being used to offset a spouse's prior tax debt.

Example 9: H & W (calendar year taxpayers) were married in 2005. They filed a joint return for 2005, 2006 and 2007. Then, for tax year 2008, H did not file a return despite having taxable income; W filed a separate return. This pattern continued for 2009 and 2010. Given that the time for amending a 2008 return is April 17, 2012, the taxpayers may want to file a joint return for 2008. However, doing so would subject W to the tax, interest and penalties imposed on H for that year. An “Injured Spouse Allocation” in this instance would not serve to protect A from being jointly and severally liable for B’s tax debt.

IV. Interaction with New Jersey Law

Under New Jersey tax law, there is no analogous form or concept to federal law. It is the state’s position that in the instance of a SOIL (Set Off of Individual Liability) hold by another state agency, that it is up to the agency that placed the hold to release any monies deemed appropriate to the taxpayer, or injured spouse. There is no affirmative allocation for relief that can be made.

V. Different From Innocent Spouse Relief

As illustrated in *Example 9* above, W would be jointly and severally liable for her husband’s tax debt in any year she chooses to file a joint return with him. Relief from joint and several liability can be granted in certain cases.²⁴ This relief, commonly known as “Innocent Spouse Relief”, can be requested on **Form 8857**. To summarize the differences:

Innocent Spouse Relief: Protects a taxpayer from joint and several liability for the tax debt of a spouse in any year in which relief is granted.

Injured Spouse Allocation: Protects a taxpayer’s overpayment from being used to satisfy a spouse’s prior tax debt.

VI. Conclusion

An Injured Spouse Allocation is an effective tool when bringing taxpayers into compliance with the IRS. In many instances it is important for taxpayers to be current with their filings despite one spouse’s tax debt from prior years.

Take the example of a couple where one spouse was filing separate returns while the other was not filing returns at all. One of the first steps in any attempt to reduce the

²⁴ IRC § 6015.

noncompliant spouse's debt is to file all tax returns. While it makes sense in most cases to keep the filings separate for all years in which interest and penalties have accumulated, for the current tax year, a joint filing may make sense. If the joint filing has the effect of producing an overall lower tax, and thereby a larger tax refund, an allocation to apportion that refund between the taxpayers should provide an immediate tax savings.

An "Injured Spouse Allocation" must be affirmatively made by the injured spouse and failure to make the allocation would foreclose relief. This relief is rooted in the premise that even when it comes to joint tax returns, joint filers still have a separate interest in the joint income and credits reported. By making this allocation, taxpayers may continue to file joint returns and enjoy, in most instances, an overall lower tax burden without exposing their share of any overpayment to the separate tax liability of a spouse. By making this allocation, a taxpayer can protect his or her tax refund without the need to file a separate tax return.

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