Chapter 3: Marriage Planning Issues

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Corrections were made to this workbook through January of 2011. No subsequent modifications were made.

When a couple takes marriage vows, they often use the words "for better or worse" and "for richer or poorer," but rarely, if ever, are the words "tax benefits" included in the vows. Marriage affects the amount of income tax people pay. It sometimes causes married couples to pay more tax than they would pay as single individuals and sometimes it results in them paying less tax. This is because the Code looks at the household as the taxpaying unit. The household can be the married couple or the single individual.

A tax structure with the goals of progressive tax rates, equal treatment of married couples, and marriage neutrality results in conflict within the Code. Congress has yet to find a way to build marriage neutrality into the Code.

The balance between the three goals shifts over time. This is partly due to complaints of unfair treatment and partly in reaction to changing demographic patterns. Factors that create imbalance include:

1. A growing number of single taxpayers,
2. A greater likelihood that husband and wife both work,
3. Increased parity in earnings between working husbands and working wives, and
4. Changes in tax brackets.

Depending on the specific situation, the marriage penalty can be substantial. It can lead to one spouse deciding to work fewer hours or not work at all. The size of the marriage penalty or benefit depends on the number of components of the Code used in the calculation. Typically, using more components results in more couples incurring a tax penalty and fewer couples receiving a tax benefit.

In 1996, it was estimated that 42% of couples incurred marriage penalties, 51% received benefits, and 6% paid taxes unaffected by their marital status. The percentages change when looking at various income levels. At lower income levels, fewer couples incur a penalty and more couples receive a benefit. As a percentage of income, low-income families typically had higher marriage benefits and lower penalties than high-income taxpayers.[1]

This chapter discusses many of these benefits and penalties. The purpose of the chapter is to inform the reader rather than to advocate for or against marriage.

1. Congressional Budget Office Report, *For Better or For Worse: Marriage and the Federal Income Tax*, 97ARD 133-5 (June 1997).

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DEFINITION OF MARRIAGE

The Merriam-Webster Online Dictionary defines marriage as "the state of being united to a person of the opposite sex as husband and wife in a consensual and contractual relationship recognized by law."[2] Whether a marriage is recognized for federal income tax purposes depends on state law.

COMMON-LAW MARRIAGES

If taxpayers are married in compliance with the laws of the state in which they are married, the marriage is recognized for tax purposes, even if the couple later resides in another state.[3] If applicable state law recognizes common-law marriages and the state recognizes the couple as husband and wife, federal income tax rules and regulations also recognize the couple as husband and wife.

Black's Law Dictionary defines common-law marriage as: "Generally a nonceremonial relationship that requires a positive mutual agreement, permanent and exclusive of all others, to enter into a marriage relationship, cohabitation sufficient to warrant a fulfillment of necessary relationship of man and wife, and an assumption of marital duties and obligations."[4] Common-law marriages are only recognized in a few states. These include the following:

Alabama	South Carolina
Colorado	Texas
District of Columbia	Utah
Iowa	Georgia (if created before 1/1/97)
Kansas	Idaho (if created before 1/1/96)
Montana	New Hampshire (for inheritance purposes only)
Oklahoma	Ohio (if created before 10/10/91)
Rhode Island	Pennsylvania (if created before 1/1/05)

The following general elements are used to determine whether a common-law marriage exists:

- Cohabitation
- Holding out

"Holding out" means telling people that the couple are husband and wife through their conduct, such as using the same surname, filing a joint federal tax return, or other means of implying they are married. Therefore, mere cohabitation can never, by itself, rise to the level of constituting a marriage.

The U.S. Constitution requires every state to accord "Full Faith and Credit" to the laws of its sister states. Therefore, a common-law marriage that is validly contracted in a state where such marriages are legal is valid even in states where such marriages cannot be contracted and may be contrary to public policy.

While some states recognize common-law marriages, there is no such thing as a "common-law divorce." Consequently, a couple that is married under common law and files a married filing jointly (MFJ) return, must obtain a legal divorce if they separate and choose to file as single individuals. Otherwise, they must file using the status of married filing separately (MFS).

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2. [www.merriam-webster.com/dictionary/marriage] Accessed on July 22, 2010.

3. Rev. Rul. 58-66.

4. *Black's Law Dictionary,* 277 (6th ed., 1990).

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SAME-SEX MARRIAGES

Rev. Rul. 58-66 is somewhat out of date since some states have recently recognized same-sex marriages. However, these marriages are **not** recognized by the IRS. Under the Defense of Marriage Act (DOMA)[5] signed by President Clinton on September 21, 1996, the federal definition of marriage was established. According to the federal definition, (1) "marriage" is only a legal union between one man and one woman as husband and wife; and (2) a "spouse" is only a person of the opposite sex who is a husband or wife. Consequently, while same-sex marriage is recognized in some states, these couples are not entitled to use the MFJ or MFS federal tax filing statuses.

The Respect for Marriage Act[6] was introduced into the U.S. House of Representatives on September 15, 2009, and is cosponsored by nearly 100 House members. The bill also has the support of the Obama Administration. If passed, it would repeal DOMA. It would put same-sex marriages on par with traditional marriages for federal tax law.

> **Note.** In July 2010, a judge in the District Court of Massachusetts ruled DOMA unconstitutional.[7] Judge Joseph Tauro wrote that DOMA interfered with states' rights guaranteed in the 10th Amendment and it violated the Constitution's equal protection law. This ruling may influence further legislative action.

MARRIAGE: A TAX BENEFIT OR PENALTY?

A financial analysis of individuals anticipating marriage consists of many factors. Not all of these are income tax related. For example, programs such as welfare assistance, food stamps, and Medicare benefits can be reduced when an individual finds a good paying job or marries an individual with a moderate income. This analysis only covers the tax benefits or penalties that can result when a couple gets married.

At one time, there was a substantial difference in the amount of income taxes a married couple paid compared to what they would have paid as two single individuals. This was referred to as the marriage tax penalty. The Jobs and Growth Tax Relief Reconciliation Act of 2003 (JGTRRA)[8] reduced the impact of the marriage penalty on married couples who choose to file MFJ on their income tax returns. Depending on how Congress handles tax relief, the marriage penalty could be reinstated in future years.

HISTORY

The marriage penalty aspect of the federal tax code was associated with the federal tax tables. Higher taxes were computed for a married couple than two single individuals with the same income. This was true whether the married couple filed jointly or separately.

Prior to 1948, there was only one tax rate schedule and it applied to all taxpayers. It did not matter whether taxpayers filed jointly, separately, or as singles. Consequently, spouses could choose to file separate returns and pay the same tax as if they were single. This tax structure normally resulted in no marriage penalties or bonuses. In some cases, income could be shifted between spouses, resulting in a marriage benefit.

This caused Congress to create a separate rate structure for joint filers with rate brackets that were double the width of the rate brackets for single filers. This had the effect of attributing half of the combined income of the couple to each spouse and taxing half at the single rates. The total tax for a couple filing jointly was two times the tax for a single filer with half the couple's combined income. This structure eliminated marriage penalties, but there were marriage benefits. This was because a couple would often pay less tax filing jointly than spouses would pay if they each filed a separate return.

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5. P.L. 104-199.
6. H.R. 3567.
7. *Nancy Gill et al. v. Office of Personnel Management et al.,* No. 1:09-cv-10309 (Dist. of Mass. Jul. 8, 2010).
8. P.L. 108-27.

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Congress became concerned that some single individuals could have the same family obligations as a couple but could have higher tax liabilities. Therefore, they addressed this concern with the Revenue Act of 1951. The act included a new filing status for heads of household (HoH) with rate brackets larger than the single bracket but lower than the joint bracket. The new HoH bracket had no effect on joint filers, but it imposed a marriage penalty on some couples with children and decreased marriage benefits on others. This occurred because some couples with children would pay less if each spouse filed MFS, with at least one spouse using HoH status.

In 1969, Congress broadened the single-rate brackets to reduce the disparity between the tax imposed on some single taxpayers and a joint or HoH filer with the same income. The change reduced the disparity to 20% or less. This change did not affect joint filers but imposed marriage penalties on some couples and decreased marriage benefits for others. While childless couples were unaffected by the 1951 legislation, they now faced penalties.

Prior to 2003, if both spouses earned about the same amount of money, they ended up in a higher tax bracket and were penalized for being married. The smaller the difference between what they each earned, the higher the marriage penalty. However, if one spouse earned a high salary and the other did not, they were not penalized. The marriage penalty can affect couples in all income brackets, though. For example, couples who marry can lose earned income tax credits that they would have received as singles.

2003 TAX LAW CHANGES

JGTRRA reduced the impact of the marriage penalty on married couples who choose to file MFJ on their income taxes. This was done by doubling the amount of the standard deduction for married couples as compared to singles. The width of the 15% tax bracket was increased to twice the width for single taxpayers. However, the marriage penalty still exists for some couples depending on their tax bracket.

The reality is that marriage has plenty of legal and financial benefits, including tax benefits. Even before Congress changed the laws in 2003 to deal with the so-called marriage penalty, more married couples got a tax **benefit** from being married than paid a tax penalty.

MARRIAGE BENEFIT AND PENALTY

The marriage benefit typically occurs when one spouse has little or no income. If incomes become more equal, the marriage benefit becomes a marriage penalty.

In the following examples:

- A marriage benefit is represented by ☺, and
- A marriage penalty is represented by ☹.

SALE OF PRINCIPAL RESIDENCE

Taxpayers that meet the qualifications of the IRC §121 ownership and use tests may exclude up to $250,000, or $500,000 (MFJ), of gain on the sale of a principal residence. However, this exclusion may be used only once every two years. The "one home in two years" rule is the same for both single and married taxpayers. Therefore, if a taxpayer and a prospective spouse both own homes before marriage and plan to purchase a new home after they are married, they should consider selling both current homes before getting married. If they wait, they will lose one of the §121 exclusion amounts.

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Example 1. Sam is single and owns a principal residence which he purchased in 2000 for $300,000. Sarah also owns her principal residence that she purchased in 1995 for $200,000. Sam and Sarah are married in June 2010 and move into Sarah's house. Sam sells his house in August 2010 for $400,000 and uses §121 to exclude the tax on the $100,000 ($400,000 – $300,000) gain. In March 2011, Sam and Sarah buy another house and sell Sarah's old house for $450,000.

Even though Sarah meets the two-out-of-five-year residency qualification for §121, she is not allowed to utilize the exemption because Sam used a §121 exclusion in August 2010, thereby preventing Sarah from using the exclusion until after August 2012.

Had Sam and Sarah each sold their respective homes prior to getting married, each one could have utilized the §121 exclusion and excluded gain on both sales. However, if either one of them has utilized §121 in the last two years, then neither one can use it now.

In this example, an additional $250,000 ($450,000 – $200,000) of §121 gain could have been excluded on Sarah's home if she had sold it prior to her marriage.

For some taxpayers, selling the home after marriage could be more beneficial. Consider the following example.

Example 2. Jack owns a principal residence and he will realize a gain of $500,000 on its sale. Jack is engaged to Jill who has never owned a home. Jack and Jill plan to purchase a new home once they are married. If Jack sells the home before marriage, he must recognize $250,000 of gain because a single taxpayer is limited to a $250,000 §121 exclusion. However, if he sells the home after the marriage, he can exclude the entire $500,000 gain. This is a substantial marriage benefit for Jack. Using a 15% capital gains rate, Jack saves $37,500 (250,000 × 15%).

Note. Example 2 assumes that Jill has lived in the house for two years, even though she did not have an ownership interest in it. Under §121, both spouses must have used the home as a principal residence in at least two of the previous five years in order to qualify for the exclusion.

FIRST-TIME HOMEBUYER CREDIT

The first-time homebuyer credit was a part of the American Recovery and Reinvestment Act of 2009 (ARRA).[9] It was available to qualified homebuyers purchasing a principal residence between January 1, 2009, and December 1, 2009. The credit was later extended for homes purchased or contracted by April 30, 2010, by the Worker, Homeownership, and Business Assistance Act of 2009.[10]

Note. This credit was covered extensively in the 2009 *University of Illinois Federal Tax Workbook* beginning on page 421 (found on companion CD). Many different scenarios are given which explain that marriage may prevent certain taxpayers from receiving the credit.

This credit is also covered in Chapter 4, Tax Aspects of Home Ownership.

9. P.L. 111-92.

10. H.R. 3548.

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TAXABLE SOCIAL SECURITY BENEFITS

The amount of taxable social security benefits is affected by the taxpayer's marital status and total income. Generally, if social security benefits are the only source of income, the benefits are not taxable. Income from other sources causes social security benefits to become taxable if the taxpayer's modified adjusted gross income (MAGI) is more than the base amount for their filing status. The MAGI is the sum of the AGI plus any tax-exempt income. In no case are more than 85% of the benefits taxable. A base income level is used to compute the taxable benefits. The base level is:

- $25,000 if the taxpayer is filing as single, HoH, or qualified widow(er);
- $25,000 if the taxpayer is MFS and lived apart from the spouse for the entire year;
- $32,000 if the taxpayer files MFJ; or
- $0 if the taxpayer is MFS and lived with the spouse at any time during the year.

This different treatment of base income for different filing statuses can create a marriage benefit or penalty. This is shown in the following examples.

Example 3. Tom and Exlee met in 2009 on a senior-citizen bus trip and fell in love. Both are receiving social security payments of $18,000 per year. In addition, each has $17,500 of interest income. They were upset because the bus trips cost more for two single travelers with separate rooms than a married couple sharing a room. Consequently, they married prior to their 2010 trip. Their tax analysis follows:

	Tom	Exlee	Tom and Exlee
Social security benefit	$18,000	$18,000	$36,000
Nontaxable portion	(17,250)	(17,250)	(22,350)
Taxable portion	$ 750	$ 750	$13,650
Interest income	17,500	17,500	35,000
Total income	$18,250	$18,250	$48,650
Standard deduction	(7,100)	(7,100)	(13,600)
Exemption	(3,650)	(3,650)	(7,300)
Taxable income	$ 7,500	$ 7,500	$27,750
Income tax	$ 750	$ 750	$ 3,325

If Tom and Exlee did not get married, their total tax liability would have been $1,500 ($750 + $750). Therefore, their marriage penalty is $1,825 ($3,325 – $1,500).

As if the marriage penalty were not bad enough when they filed MFJ, they decided they wanted to file MFS in order to keep their finances separate.

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Example 4. Use the same facts as **Example 3,** except Tom and Exlee file using the MFS status. The results are as follows:

	Tom	Exlee	Tom and Exlee
Social security benefit	$18,000	$18,000	$36,000
Nontaxable portion	(2,700)	(2,700)	(22,350)
Taxable portion	$15,300	$15,300	$13,650
Interest income	17,500	17,500	35,000
Total income	$32,800	$32,800	$48,650
Standard deduction	(6,800)	(6,800)	(13,600)
Exemption	(3,650)	(3,650)	(7,300)
Taxable income	$22,350	$22,350	$27,750
Income tax	$ 2,934	$ 2,934	$ 3,325

Choosing to file MFS cost Tom and Exlee an additional $2,543 ($2,934 + $2,934 – $3,325) compared to filing MFJ. It cost them an additional $4,368 ($2,934 + $2,934 – $750 – $750) compared to what it would have cost if they had not married and cohabitated. However, the good news is — they saved $260 on the bus trip.

Social security recipients could have a marriage benefit in some cases as shown in the following example.

Example 5. Tom's friend Randy is also a retiree receiving social security benefits. Unlike Tom, Randy found the love of his life at his favorite watering hole. Randy receives $25,000 of social security benefits in 2010 and has $80,000 of interest income. His 30-year-old new bride, Gypsy Rose, has $7,500 of wages and no other income. Their tax analysis is as follows:

	Randy	Gypsy Rose	Randy and Gypsy Rose
Social security benefit	$ 25,000	$ 0	$ 25,000
Nontaxable portion	(3,750)	0	(3,750)
Taxable portion	$ 21,250	$ 0	$ 21,250
Wages	0	7,500	7,500
Interest income	80,000	0	80,000
Total income	$101,250	$7,500	$108,750
Standard deduction	(7,100)	(5,700)	(12,500)
Exemption	(3,650)	(3,650)	(7,300)
Taxable income	$ 90,500	($1,850)	$ 88,950
Income tax	$ 19,049	$ 0	$ 16,575 [a]

[a] This assumes that the AMT patch is not extended by Congress.

Randy saved $2,474 ($19,049 – $16,575) by marrying Gypsy Rose before the end of 2010.

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EARNED INCOME CREDIT

Congress enacted the earned income credit (EIC) in 1975.[11] It was originally intended to provide money to low-income taxpayers. Over the years, the EIC has been enhanced until it has become one of the principal anti-poverty programs. In 2010, it is possible for a family with three qualifying children to receive an EIC of $5,666.

The EIC is limited based on the taxpayer's earned income and AGI. The amount of credit increases until a certain income range is reached. After that range, the credit is phased out completely at the amounts shown in the table below.

2010 Earned Income Credit

Number of Children	Maximum EIC [a]	Completely Phased Out
0	$ 457	$13,460 ($18,470 if MFJ)
1	3,050	35,535 (40,545 if MFJ)
2	5,036	40,363 (45,373 if MFJ)
3 or more	5,666	43,352 (48,362 if MFJ)

[a] Taxpayers with more than $3,100 of investment income are not eligible for the credit.

Note. A graph showing the relationship between number of children and the maximum EIC is found in Chapter 9, Income Tax Credits.

Depending on the facts, marriage can severely affect the amount of EIC that taxpayers receive.

Example 6. Ed and Susan are planning to marry in 2010. They want to know whether there is a marriage benefit or marriage penalty if they marry before the end of the year. Ed has wages of $13,000 and one qualifying child. He is eligible to use the HoH filing status. Susan also has wages of $13,000 and has two qualifying children. She is also eligible to file as HoH. If they marry before the end of the year, they will file MFJ reporting $26,000 of wages and three qualifying children. Neither Ed nor Susan has any other income. The analysis shows the following.

	Ed	Susan	Ed and Susan
AGI	$13,000	$13,000	$26,000
Earned income	13,000	13,000	26,000
Adjusted earned income	13,000	13,000	26,000
Earned income credit	3,050	5,036	4,704

By getting married in 2010, Ed and Susan will lose $3,382 ($3,050 + $5,036 – $4,704) of EIC.

Example 7. Use the same facts as **Example 6,** except Susan has three qualifying children. Ed has $7,000 of wages and has no children. The analysis shows the following.

	Ed	Susan	Ed and Susan
AGI	$7,000	$13,000	$20,000
Earned income	7,000	13,000	20,000
Adjusted earned income	7,000	13,000	20,000
Earned income credit	457	5,666	5,666

By getting married in 2010 Ed and Susan will **only** lose $457 ($457 + $5,666 – $5,666) of EIC.

[11] P.L. 94-12.

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CHILD TAX CREDIT

A taxpayer must be able to claim a child as a dependent in order to claim the child tax credit. The credit has both a refundable and a nonrefundable component.

To qualify as a qualifying child for purposes of the child tax credit, the child must:

1. Be the taxpayer's son, daughter, stepchild, foster child, brother, sister, stepbrother, stepsister, or a descendant of any of them (e.g., the taxpayer's grandchild, niece, or nephew);
2. Be under age 17 at the end of the year;
3. Not provide over half of their own support for the year;
4. Have lived with the taxpayer more than half of the year;
5. Be claimed as a dependent on the taxpayer's return; and
6. Be a U.S. citizen, a U.S. national, or a U.S. resident alien.

The credit is reduced if the taxpayer's income exceeds a certain level for the taxpayer's filing status. For 2010, these levels are as follows.

Filing Status	Taxable Income
Married filing jointly (MFJ)	$110,000
Single, head of household, or qualifying widow(er)	75,000
Married filing separately (MFS)	55,000

Once the income limit is exceeded, the credit is reduced by $50 for each $1,000 of excess income.

The ARRA extended the years for which the refundable additional child tax credit for low income taxpayers is available. For 2009 and 2010, the earned income must exceed $3,000 rather than $8,500. Taxpayers with three or more children calculate the refundable portion of the child tax credit as the greater of:

- 15% of earned income in excess of $3,000, or
- The excess of the social security taxes over the taxpayer's EIC.

The effect marriage has on the child tax credit is shown in the following examples.

Example 8. Ty and Yolanda are engaged and are trying to decide on a December 2010 wedding or a January 2011 wedding. Each of them currently files as HoH, has earnings of $75,000, and has three children. A December 2010 wedding will produce the following child tax credit.

	Ty and Yolanda (Joint Return)	Ty (Head of Household)	Yolanda (Head of Household)
Wages	$150,000	$75,000	$75,000
Credit threshold	(110,000)	(75,000)	(75,000)
Excess income	$ 40,000	$ 0	$ 0
Credit before reduction	$ 6,000	$ 3,000	$ 3,000
Credit reduction	(2,000)	(0)	(0)
Credit after reduction	$ 4,000	$ 3,000	$ 3,000

By postponing the wedding until January 2011, Ty and Yolanda would preserve $2,000 ($3,000 + $3,000 – $4,000) of child tax credit.

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Example 9. Use the same facts as **Example 8** regarding the timing of the wedding. However, in this example, Ty has wages of $50,000 and no children, and Yolanda has six children, no earned income, and $20,000 of interest income. The result is the following.

	Ty and Yolanda (Joint Return)	Ty (Single)	Yolanda (Head of Household)
Wages	$ 50,000	$50,000	$ 0
Interest income	20,000	0	20,000
Credit threshold	(110,000)	(75,000)	(75,000)
Excess income	$ 0	$ 0	$ 0
Credit before reduction	$ 6,000	$ 0	$ 0
Credit reduction	(0)	(0)	(0)
Credit after reduction	$ 6,000	$ 0	$ 0

If she were not married, Yolanda would be entitled to no child tax credit since she has no earned income or income tax liability. Ty would not have any credit since he has no children. When they file a joint return, the combined income is below the joint return threshold and they are entitled to the entire $6,000 credit. Therefore, a December wedding will save them $6,000.

CHILD AND DEPENDENT CARE CREDIT

The cost of child and dependent care is a major expense for many taxpayers. Consequently, Congress allows taxpayers a nonrefundable credit if they are gainfully employed and their AGI is under a certain level. If the taxpayer is married, both the taxpayer and the spouse must be gainfully employed. The credit is available only if the child and dependent care expense is incurred to allow the taxpayer(s) to be employed.

The care must be for one of the following qualified individuals:

- A qualifying child of the taxpayer that is under the age of 13
- A taxpayer's dependent of any age that is physically or mentally incapable of caring for himself and resides with the taxpayer for more than half of the year (The dependency is determined without regard to whether the qualifying individual may be claimed as a dependent by another taxpayer, files a joint return with his spouse, or has income in excess of $3,650 in 2010)
- The taxpayer's spouse, if the spouse is physically or mentally incapable of caring for himself and resides with the taxpayer more than half of the year

The credit is determined by the AGI of the taxpayer(s). Whether the taxpayer is married or single does not change the calculations, but married taxpayers must have earned income for both spouses.

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The credit is based on a maximum of $3,000 of qualified expense for one individual or $6,000 for two or more qualifying individuals. The maximum credit is shown in the following table.

AGI	Applicable Percentage	One Qualifying Individual	Two or More Qualifying Individuals
$15,000 or less	35%	$1,050	$2,100
15,001–17,000	34%	1,020	2,040
17,001–19,000	33%	990	1,980
19,001–21,000	32%	960	1,920
...	...	...	...
39,001–41,000	22%	660	1,320
41,001–43,000	21%	630	1,260
43,001 and over	20%	600	1,200

3

Because the child and dependent care credit is nonrefundable, it is also limited by the difference between any tentative minimum tax and the regular tax owed by the taxpayer.

Note. In past years, the child and dependent care credit was used to pay the alternative minimum tax. This provision expired at the end of 2009 but could be extended through 2010.

Example 10. Tanner and Michelle are two single parents, each having two children. Each of them has wages of $40,000 and no other income. Therefore, each will receive a credit of $1,320 if they do not marry in 2010. However, if they marry, they will only be entitled to a child and dependent care credit of $1,200. The marriage costs the taxpayers $1,440 of credit ($1,320 + $1,320 – $1,200). This assumes Congress will extend the AMT exclusion to 2009 amounts.

Example 11. Use the same facts as **Example 10,** except Congress does **not** extend the AMT exemption. Each taxpayer now has a tentative minimum tax of $1,625 and regular tax of $2,500. Therefore, the credit is limited to $875 ($2,500 – $1,625). If they wed and file a joint return, the tentative minimum tax is $9,100 and the regular tax is $6,168. Therefore, the married couple is not entitled to any credit. Marriage cost the taxpayers $1,750 ($875 + $875) of child and dependent care credit.

PHASEOUT OF ITEMIZED DEDUCTIONS

If a taxpayer's AGI exceeded $166,800 in 2009, a percentage of his itemized deductions was lost. This amount is the same whether the taxpayer filed as single or MFJ.

For 2008 and 2009, the reduction to itemized deductions was the lesser of one-third of:

- 3% of the amount of the taxpayer's AGI in excess of $166,800, or
- 80% of the itemized deductions that would have been allowable for the year.

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The following example uses the 2009 phaseout amounts as an illustration of the way the phaseout works.

Example 12. Mitch and Grace have an AGI of $300,000 ($150,000 for each) and itemized deductions consisting of the following.

Mortgage interest		$15,000
Charitable contribution		5,000
Property tax		8,000
State income tax		7,500
Miscellaneous itemized deductions		30,000
Less: 2% AGI		(6,000)
Total itemized deductions		$59,500
3% AGI phaseout (3% × ($300,000 − $166,800))	$3,996	
	× 1/3	
	$1,332	(1,332)
Total itemized deductions		$58,168

Mitch and Grace are in the 35% marginal federal tax bracket. Therefore, they have suffered a $466 marriage penalty ($1,332 × 35%).

Because the phaseout amount begins at the same level for both married and single taxpayers, Mitch and Grace would not have lost any itemized deductions if they remained unmarried. The phaseout of itemized deductions never creates a marriage benefit.

Note. At the time this book was written, Congress had not renewed the phaseout of itemized deductions for high-income taxpayers. Consequently, unless Congress changes the law, there will be no itemized deduction phaseout in 2010.

PHASEOUT OF PERSONAL EXEMPTIONS

For tax years beginning after December 31, 2005, a taxpayer's personal exemption was reduced if his AGI exceeded a certain level. In 2006 and 2007, the reduction was two-thirds of the excess. In 2008 and 2009, the reduction was one-third of the excess. The reduction ended for tax years beginning after December 31, 2009. Currently, Congress has not established a phaseout of exemptions for 2010 tax returns. The following table shows the phaseout ranges for personal exemptions for 2009.

Filing Status	Phaseout Beginning	Phaseout Ending
Single	$166,800	$289,300
Head of household	208,500	331,000
Married filing jointly	250,200	372,700
Married filing separately	125,100	186,350

For 2008 and 2009, the phaseout amount is one-third of 2% of each multiple of $2,500 (or part of $2,500) of income above the beginning phaseout amount.

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The following example illustrates the phaseout of personal exemptions on a 2009 income tax return.

Example 13. Gordon is single and has an AGI of $200,000 in 2009. His personal exemption is computed as follows.

Personal exemption before reduction		$3,650	$3,650
AGI	$200,000		
Beginning of phaseout	(166,800)		
Excess AGI	$ 33,200		
	÷ 2,500		
Number of multiples of $2,500	14		
2% phaseout per multiple	× .02		
Reduction percentage	.28	× .28	
		$1,022	
		× ⅓	
Personal exemption reduction		341	(341)
Gordon's 2009 exemption			$3,309

Gordon's high income reduced his personal exemption by $341.

If Gordon were married, the exemption phaseout would not begin until AGI reached $250,200. However, this is not double the single amount of $166,800, so this could be considered a marriage penalty.

STUDENT LOAN INTEREST

The deduction for student loan interest is another tax deduction that is phased out based upon the taxpayers' MAGI. This deduction is scheduled to change for tax years beginning after 2010. The maximum deduction is $2,500 and is not adjusted for inflation or marital status. Therefore, two single taxpayers who each have student loan interest of $2,500 or more lose one of the $2,500 deductions if they marry.

Example 14. Timothy and Susan are both graduates of the University of Illinois and have substantial student loan balances. In 2010, Timothy pays student loan interest of $5,000 and Susan pays $4,000. If they postpone their wedding until 2011, each taxpayer can deduct $2,500 if they are not liable for the high-income phaseout. If they marry in 2010, they can only deduct $2,500 on their joint return.

The deduction begins to phase out when the MAGI exceeds $60,000, or $120,000 for joint returns. It is completely phased out when the MAGI reaches $75,000, or $150,000 for joint returns. The phaseout thresholds are adjusted for inflation.

The MAGI is computed after:

- The exclusion of qualified contributions to IRAs,
- The exclusion of U.S. savings bond interest used for higher education,
- The exclusion of qualified social security benefits,
- The exclusion of payments from adoption assistance programs, and
- The disallowance of passive activity losses.

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Next, the MAGI is increased by adding back:

- Excludable foreign earned income and housing costs;
- Excludable income from sources within Guam, American Samoa, the Northern Marianna Islands, and Puerto Rico;
- The domestic production activities deduction;
- Otherwise deductible student loan interest; and
- Otherwise deductible qualifying tuition and related expenses.

☺ **Example 15.** Use the same facts as **Example 14.** Timothy has a MAGI of $80,000 and Susan has a MAGI of $20,000. Susan does not have any student loan interest. If the taxpayers did not marry in 2010 and file as single taxpayers, Timothy would not be able to deduct any student loan interest since his MAGI exceeds $75,000. However, if Timothy and Susan wed in 2010, they can deduct the maximum of $2,500 in student loan interest since their combined MAGI of $100,000 does not exceed $120,000.

MAKING WORK PAY CREDIT

The ARRA added the making work pay credit (MWPC), which provides a maximum $400 refundable credit to taxpayers reporting earned income. The credit effectively eliminates the employee's share of FICA on the first $6,450 of a single worker's wages. The credit is a maximum of $800 for married couples filing joint returns.

The MWPC also has a phaseout provision. The credit is reduced by 2% of the taxpayer's MAGI that exceeds $75,000 (or $150,000 on a joint return). The MWPC is completely phased out at a MAGI of $95,000 (or $190,000 on a joint return).

☹ **Example 16.** Use the same facts as **Example 15,** except Susan's $20,000 of income is from interest income rather than wages. Therefore, she is not entitled to a MWPC since she has no earned income. Timothy is only entitled to a reduced MWPC since his wages exceed $75,000. The phaseout is illustrated in the following table.

Maximum MWPC		$400
MAGI	$80,000	
Beginning phaseout	(75,000)	
Excess MAGI	$ 5,000	
Multiplied by 2%	× .02	
Phaseout amount	$ 100	(100)
Timothy's MWPC		$300

☺ **Example 17.** If Timothy and Susan in **Example 16** marry in 2010, they will be entitled to an $800 MWPC. There will be no phaseout because the beginning phaseout amount on a joint return is $150,000. Because Timothy has earned income, the couple is entitled to an $800 MWPC.

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MORTGAGE INTEREST DEDUCTION

For many taxpayers, the amount of their mortgage interest allows them to itemize their personal deductions. This deduction has limits. **For both single and joint filers, the qualified residence interest is limited to the interest on $1 million of acquisition indebtedness and interest on up to $100,000 of home equity indebtedness.** The home equity indebtedness must be secured by the taxpayer's primary or secondary residence.

For years prior to 2010 and after 2010, a high-income taxpayer's itemized deductions are limited by a 3% AGI phaseout. The limitation does not apply to 2010 returns (as of the date this is written.) Taxpayers with large principal residence mortgages are often subject to the itemized deduction phaseout.

Example 18. Jonathon Litigator and Samantha Barrister are successful young attorneys working in New York City. They met while working for Dewey, Billum, and Howe and are planning to wed in either December 2010 or January 2011. Each owns a condo that cost $750,000 and is paying annual interest of $41,250. Each earns a salary of $250,000 per year. After they are wed, they plan to sell their condos and purchase a larger condo costing $1.5 million. They anticipate having a mortgage of $1.3 million. They have asked their tax preparer for a tax analysis for each year.

☺ As single taxpayers in 2010, their mortgage interest deduction is limited only by their earnings. Because each condo's mortgage is less than $1 million, there is no limitation on their mortgage interest deduction.

☹ However, if they wed in 2010, sell their individual condos, acquire a condo costing $1.5 million, and have a mortgage of $1.3 million, they will not be able to deduct the interest on the mortgage in excess of $1 million. Based on the interest rate they anticipate, this could be a lost deduction of $16,500.

☹ If they wed in 2011, their itemized deductions will be subject to a 3% AGI phaseout of $9,987.

Itemized deduction	$ 82,500
Multiply by 80%	× .80
	$ 66,000
AGI	$500,000
Minus phaseout base	(167,100)
	$332,900
Multiply by 3% phaseout rate	× .03
AGI phaseout	$ 9,987

SAVINGS BOND INTEREST EXCLUSION

The interest income received from U.S. savings bonds is generally included in taxable income. However, if the bond is a series EE bond issued after 1989 or a series I bond, part of the income may be excluded if it is used to pay qualified education expenses. The education expenses must be for the taxpayer, spouse, or a dependent that can be claimed as an exemption on the taxpayer's return. There is a phaseout range for the excluded interest based on MAGI.

For 2010, the phaseout ranges are as follows:

- $105,100 to $135,100 if the taxpayer is MFJ or is a qualifying widow(er)
- $70,100 to $85,100 for all other filing statuses

The bond must be issued in either the name of the taxpayer or in the name of the taxpayer and spouse (as co-owners). The bond owner must be at least 24 years old before the bond's issue date.

The tax-free interest is computed by multiplying the interest portion of the total proceeds by a fraction. The numerator of the fraction is the adjusted qualified education expenses (AQEE) paid during the year and the denominator is the total proceeds received during the year.

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Because the phaseout range differs for various filing statuses, marriage can either result in a tax benefit or penalty depending on the amount of interest income.

Example 19. Mark and Joan Washington, a married couple, cashed a qualified series EE U.S. savings bond in February 2010. They received proceeds of $9,000, representing principal of $6,000 and interest of $3,000. In 2010, they paid $7,650 of their daughter's college tuition. They are not claiming any American opportunity, Hope, or lifetime learning credit for these expenses, and their daughter does not have any tax-free educational assistance. Mark's and Joan's Form W-2 wages total $110,000 and they have no other income besides the EE bond interest.

$3,000 interest × ($7,650 AQEE ÷ $9,000 proceeds) = $2,550 tax-free interest

$2,550 × (($110,000 – $105,000) ÷ $30,000) = $416

The Washingtons can exclude $2,134 ($2,550 – $416) of interest in 2010. If they were not married and Mark had $60,000 of W-2 wages plus the EE bond interest and Joan had $50,000 of W-2 wages, the deductible interest would be $2,550. There would be no reduction because of AGI limitations.

INDIVIDUAL RETIREMENT ARRANGEMENT (IRA) DEDUCTION

The IRA deduction is another deduction affected by the taxpayer's AGI. If the taxpayer is covered by a retirement plan at work, the deductible amount of any IRA contribution is phased out when his AGI is between $56,000 and $66,000. If he is married, the phaseout range is between $89,000 and $109,000.

The phaseout range is different if only one spouse is covered by an employer's retirement plan. In this case, the phaseout range is between $167,000 and $177,000. Consequently, if a taxpayer not covered by an employer plan marries a taxpayer with such a plan, it is possible the taxpayer without a plan will no longer be able to deduct a traditional IRA contribution.

Example 20. Tom and Kathleen are two successful pharmacists. In 2010, Tom earns $130,000 and participates in his employer's retirement plan. Therefore, Tom is ineligible to deduct a traditional IRA. Kathleen earns $55,000, is not covered by an employer's retirement plan, and deducts a $5,000 contribution to her traditional IRA.

When Tom and Kathleen wed, they will have joint income of $185,000. Consequently, Kathleen will no longer be able to deduct her contribution to a traditional IRA since the couple's joint income exceeds the top phaseout amount of $177,000.

PATIENT PROTECTION AND AFFORDABLE CARE ACT

The Patient Protection and Affordable Care Act (PPACA) added two more marriage penalties.[12]

1. There is an additional hospital insurance tax on high-income taxpayers. An additional 0.9% tax is assessed on wages in excess of $200,000 for single taxpayers and combined wages of $250,000 for taxpayers filing a joint return.
2. The new 3.8% tax on net investment income is assessed on the lesser of:
   a. Net investment income, or
   b. MAGI in excess of $200,000 for single taxpayers, $250,000 for married filing joint taxpayers, or $125,000 for married filing separate taxpayers.

Note. Detailed information about the provisions of PPACA is included in Chapter 12, New Legislation.

12. P.L. 111-148.

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HIGH-INCOME TAXPAYERS

The enactment of the Economic Growth and Tax Relief Reconciliation Act of 2001 (EGTRRA)[13] reduced the income tax for higher-income taxpayers by phasing in a reduction of the tax bracket percentages as shown in the following table:

Tax Bracket Percentages

2000	28%	31%	36%	39.6%
2001	27.5%	30.5%	35.5%	39.1%
2002 and 2003	27%	30%	35%	38.6%
2004 and 2005	26%	29%	34%	37.6%
2006 and thereafter	25%	28%	33%	35%

In 2003, the Jobs and Growth Tax Relief Reconciliation Act (JGTRRA)[14] was enacted. The act accelerated the rate reductions of EGTRRA such that the rates applying to 2006 and later years began in 2003. However, JGTRRA did not repeal the sunset provisions of EGTRRA. Consequently, the pre-2001 rates will become effective in 2011 unless Congress enacts additional legislation.

The marriage penalty is built into the tax rate tables as well as in various deductions and credits. Prior to enactment of EGTRRA, even the lowest tax brackets favored single taxpayers. EGTRRA brought parity to joint filers that were in the 15% tax bracket by making the bracket range double that of the single filer. The change in brackets was phased in between 2005 and 2008. Unfortunately for married taxpayers, the EGTRRA change sunsets for tax years beginning after December 31, 2010. It is not anticipated that the current administration will extend this portion of the EGTRRA provisions. It is much more likely that the top rates will be expanded, creating more of a marriage penalty.

EGTRRA did not provide any marriage penalty tax bracket relief for higher-income taxpayers as shown in the following tables:

Tax Rate Schedule
Single Taxpayers
For Tax Years Beginning in 2010

If Taxable Income Is			
Over	But Not Over	The Tax Is	Of the Amount Over
$ 0	$ 8,375	10.0%	$ 0
8,375	34,000	837.50 + 15.0%	8,375
34,000	82,400	4,681.50 + 25.0%	34,000
82,400	171,850	16,781.25 + 28.0%	82,400
171,850	373,650	41,827.25 + 33.0%	171,850
373,650		108,421.25 + 35.0%	373,650

13. P.L. 107-16.

14. P.L. 108-27.

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Tax Rate Schedule
Married Individuals Filing Joint Returns and Surviving Spouses
For Tax Years Beginning in 2010

If Taxable Income Is			
Over	**But Not Over**	**The Tax Is**	**Of the Amount Over**
$ 0	$ 16,750	10.0%	$ 0
16,750	68,000	1,675.00 + 15.0%	16,750
68,000	137,300	9,362.50 + 25.0%	68,000
137,300	209,250	26,687.50 + 28.0%	137,300
209,250	373,650	46,833.50 + 33.0%	209,250
373,650		101,085.50 + 35.0%	373,650

The following example uses facts from a high-income taxpayer to illustrate the change in income tax liability with the sunset of EGTRRA. The example also shows the difference in taxes if the IRS does not extend the AMT exemption amount for 2010.

Example 21. Troy and LeAnn are two successful investment bankers. They earn a total of $300,000 per year. They have no children or other dependents and have the following income and deductions.

Wages	$300,000
Interest income	5,000
Dividends (all qualifying)	10,000
Medical expense	6,000
Qualified mortgage interest	44,000
Real estate taxes	12,000
Charitable contributions	55,000
Investment expense	3,000
State income taxes	28,000
Tax preparation fee	800
Student loan interest	6,000
Education expense (PhD tuition)	4,000

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	2010		2011	
	Without AMT Exemption Extended	With AMT Exemption Extended	With EGTRRA Sunset	Difference
Wages	$300,000	$300,000	$300,000	
Interest and dividends	15,000	15,000	15,000	
Total income	$315,000	$315,000	$315,000	
Adjustments	0	0	0	
Adjusted gross income	$315,000	$315,000	$315,000	
Personal exemptions	(7,300)	(7,300)	(3,504)	Personal exemptions are completely phased out after 2010 for joint filers with AGI in excess of $372,700.
Itemized deductions	(139,000)	(139,000)	(134,563)	A portion of the itemized deductions are phased out due to the 3% floor.
Taxable income	$168,700	$168,700	$176,933	
Regular tax	35,480	35,480	43,346	
Capital gains tax	34,180	34,180	0	$9,166 due to losing 15% capital gain rate and increase in regular tax rates.
Appropriate regular tax	34,180	34,180	43,346	
Net AMT	13,520	5,683	5,654	$520 due to reduction in AMT exclusion amount.
Total federal taxes	$ 47,700	$ 39,863	$ 49,000	

Calculation 1: Personal Exemption Phaseout for 2011

Personal exemption before reduction		$7,300	$7,300
AGI	$315,000		
Beginning of phaseout	(250,200)		
Excess AGI	$ 64,800		
	÷ 2,500		
Number of multiples of $2,500 (rounded)	26		
2% phaseout per multiple	× .02		
Reduction percentage	.52	× .52	
Personal exemption reduction		$3,796	(3,796)
Personal exemption			$3,504

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Calculation 2: Itemized Deduction Phaseout for 2011

Medical expense		$ 6,000	
AGI	$315,000		
Multiply by 7.5% of AGI	× .075		
Medical expense reduction	$ 23,625	(23,625)	
Net deductible medical expense		$ 0	$ 0
Charitable contributions			55,000
Real estate taxes	12,000		
State income taxes	28,000		
Total deductible taxes	$ 40,000		40,000
Qualified residential interest			44,000
Investment expenses	3,000		
Income tax preparation	800		
Total miscellaneous itemized deductions	$ 3,800		
2% AGI limitation	(6,300)		
Net miscellaneous itemized deductions	$ 0		0
Total itemized deductions pre-floor			$139,000
AGI	$315,000		
Phaseout threshold	(167,100)		
Excess AGI	$147,900		
Multiply by 3%	× .03		
3% AGI floor post-1990	$ 4,437		(4,437)
Net itemized deduction			$134,563

Deductions lost:	
Medical	$ 6,000
Miscellaneous	3,800
3% limit	4,437
Total lost itemized deductions	$14,237

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Calculation 3: Alternative Minimum Tax

	2010		2011
	Without AMT Exemption Extended	With AMT Exemption Extended	With EGTRRA Sunset
Taxable income	$168,700	$168,700	$176,933
Personal exemptions	7,300	7,300	3,504
Deductible taxes	40,000	40,000	40,000
Itemized deduction floor	0	0	(4,437)
AMTI	$216,000	$216,000	$216,000
AMT exemption before phaseout	45,000	74,950	45,000
Taxable AMTI	187,500	157,550	187,500
Tentative minimum tax from Schedule	49,000	40,963	49,000
Tentative minimum alternative capital gains tax	47,700	39,863	N/A
Tentative minimum tax	47,700	39,863	49,000
Regular tax	34,180	34,180	43,346
AMT	13,520	5,683	5,654
Total federal taxes	$ 47,700	$ 39,863	$ 49,000

In addition, the taxpayers lose any benefit from their student loan interest and lifetime learning credit.

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RESPONSIBILITY FOR A NEW SPOUSE'S TAX LIABILITIES

Encountering a marriage benefit or penalty is not the only tax-related matter that the couple should consider when contemplating marriage. If one of the taxpayers has certain unpaid obligations, the IRS may offset any tax refund due against these obligations. Consequently, when a taxpayer marries and files a joint income tax return with a new spouse, the IRS offsets the entire refund due against the outstanding obligation even though a portion of the refund is not attributable to the debtor.

In order to avoid the offset for the new spouse, a Form 8379, *Injured Spouse Allocation*, should be filed with Form 1040. The form provides information allowing the IRS to compute the amount of refund due the injured spouse.

The Department of Treasury's Financial Management Service (FMS), which issues IRS tax refunds, is authorized by Congress to conduct the Treasury Offset Program. Through this program, a taxpayer's refund or overpayment may be reduced by FMS and offset to pay any past-due child support, federal agency nontax debt, state income tax obligations, or certain unemployment compensation debts owed a state (namely debts for fraudulently-received unemployment compensation or for unpaid contributions due to the state fund).

Taxpayers can contact the agency to whom they owe a debt to determine whether their debt was submitted for a tax offset. They may also call the FMS at 800-304-3107. If the debt was submitted for offset, FMS will take as much of the refund as is needed to repay the debt and send it to the agency. Any portion of the refund remaining after the offset is refunded to the taxpayer.

The FMS will send a notice to the taxpayer if an offset occurs. The notice will reflect the original refund amount, the offset amount, the agency receiving the payment, and the address and telephone number of the agency. The FMS will notify the IRS of the amount taken from the refund. The taxpayer should contact the agency shown on the notice if he believes he does not owe the debt or is disputing the amount taken from the refund.

If a taxpayer filed a joint return and is not responsible for the debt but is entitled to a portion of the refund, he may request his portion of the refund by filing Form 8379 (see sample that follows). The form is attached to the original Form 1040 or it can be filed by itself after the taxpayer is notified of an offset. If Form 8379 is filed with the original return, the taxpayer should write "INJURED SPOUSE" at the top left corner of the Form 1040. The IRS will process the allocation request before an offset occurs. If Form 8379 is filed with the original return, processing may take up to 11 weeks if the return was filed electronically, or up to 14 weeks for paper returns.

If Form 8379 is filed by itself, it must show both spouses' social security numbers in the same order as they appear on the income tax return. The "injured" spouse must sign the form. The form instructions should be followed carefully and required forms should be attached to avoid delays. The IRS will compute the injured spouse's share of the joint return. If the taxpayer lives in a community-property state during the tax year, the IRS will divide the joint refund based upon state law.

Example 22. Tammy and Brandon were married in 2009 and filed a joint income tax return. They were anticipating an $8,000 tax refund that they were going to use to pay on the loan for their wedding. Instead, they received a notice from the IRS that the refund was applied to Brandon's unpaid child support from a prior marriage. Tammy files the following Form 8379.

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For Example 22

Form **8379** (Rev. January 2009) Department of the Treasury Internal Revenue Service

Injured Spouse Allocation

▶ See instructions.

OMB No. 1545-0074

Attachment Sequence No. **104**

Part I **Should you file this form?** You must complete this part.

1 Enter the tax year for which you are filing this form. ▶ 2009 Answer the following questions for that year.

2 Did you (or will you) file a joint return?
☑ **Yes.** Go to line 3.
☐ **No. Stop here.** Do not file this form. You are not an injured spouse.

3 Did (or will) the IRS use the joint overpayment to pay any of the following legally enforceable past-due debt(s) owed only by your spouse? (see instructions)
● Federal tax ● State income tax ● Child support ● Spousal support ● Federal nontax debt (such as a student loan)
☑ **Yes.** Go to line 4.
☐ **No. Stop here.** Do not file this form. You are not an injured spouse.
Note. If the past-due amount is for a joint federal tax, you may qualify for innocent spouse relief for the year to which the overpayment was applied. See *Innocent Spouse Relief,* on page 2 for more information.

4 Are you legally obligated to pay this past-due amount?
☐ **Yes. Stop here.** Do not file this form. You are not an injured spouse.
Note. If the past-due amount is for a joint federal tax, you may qualify for innocent spouse relief for the year to which the overpayment was applied. See *Innocent Spouse Relief,* on page 2 for more information.
☑ **No.** Go to line 5.

5 Were you a resident of a community property state (Arizona, California, Idaho, Louisiana, Nevada, New Mexico, Texas, Washington, or Wisconsin) at any time during the tax year entered on line 1? (see instructions)
☐ **Yes.** Enter name(s) of community property state(s) ______________________ .
Skip lines 6 through 9 and **go to Part II** and complete the rest of this form.
☑ **No.** Go to line 6.

6 Did you make and report payments, such as federal income tax withholding or estimated tax payments?
☑ **Yes.** Skip lines 7 through 9 and **go to Part II** and complete the rest of this form.
☐ **No.** Go to line 7.

7 Did you have earned income, such as wages, salaries, or self-employment income?
☐ **Yes.** Go to line 8.
☐ **No.** Skip line 8 and go to line 9.

8 Did (or will) you claim the earned income credit or additional child tax credit?
☐ **Yes.** Skip line 9 and **go to Part II** and complete the rest of this form.
☐ **No.** Go to line 9.

9 Did (or will) you claim a refundable tax credit, such as the health coverage tax credit or refundable credit for prior year minimum tax?
☐ **Yes. Go to Part II** and complete the rest of this form.
☐ **No. Stop here.** Do not file this form. You are not an injured spouse.

Part II **Information About the Joint Tax Return for Which This Form Is Filed**

10 Enter the following information exactly as it is shown on the tax return for which you are filing this form. The spouse's name and social security number shown first on that tax return must also be shown first below.

First name, initial, and last name shown first on the return	Social security number shown first	If Injured Spouse, check here ▶
BRANDON T GOODFELLOW	111 11 1111	☐
First name, initial, and last name shown second on the return	**Social security number shown second**	**If Injured Spouse, check here ▶**
TAMMY P GOODFELLOW	222 22 2222	☑

11 Check this box only if you are divorced or legally separated from the spouse with whom you filed the joint return and you want your refund issued in your name only . . . . ☐

12 Do you want any injured spouse refund mailed to an address different from the one on your joint return? ☐ **Yes** ☑ **No**
If "Yes," enter the address. ______________________
Number and street City, town, or post office, state, and ZIP code

For Privacy Act and Paperwork Reduction Act Notice, see page 4. Cat. No. 62474Q Form **8379** (Rev. 1-2009)

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For Example 22

Form 8379 (Rev. 1-2009) Page **2**

Part III **Allocation Between Spouses of Items on the Joint Tax Return** (see instructions)

	Allocated Items	(a) Amount shown on joint return	(b) Allocated to injured spouse	(c) Allocated to other spouse
13	Income: a. Wages	78,000	28,000	50,000
	b. All other income	10,000	5,000	5,000
14	Adjustments to income			
15	Standard deduction or Itemized deductions	11,400	5,700	5,700
16	Number of exemptions	2	1	1
17	Credits (**do not** include any earned income credit)			
18	Other taxes			
19	Federal income tax withheld	14,000	4,000	10,000
20	Payments			

Part IV **Signature.** Complete this part only if you are filing Form 8379 by itself and not with your tax return.

Under penalties of perjury, I declare that I have examined this form and any accompanying schedules or statements and to the best of my knowledge and belief, they are true, correct, and complete. Declaration of preparer (other than taxpayer) is based on all information of which preparer has any knowledge.

Keep a copy of this form for your records	Injured spouse's signature		Date	Phone number (optional) ( )
Paid Preparer's Use Only	Preparer's signature	Date	Check if self-employed ☐	Preparer's SSN or PTIN
	Firm's name (or yours if self-employed), address, and ZIP code			EIN Phone no. ( )

FEDERAL ESTATE TAXES

While marriage can cause additional income tax because of the marriage penalty, marriage can save substantial federal estate taxes. The following discussion assumes Congress does not eliminate the estate tax and the step up in basis that is a part of the 2009 law.

The estate tax is a tax on a taxpayer's right to transfer property at death. It consists of an accounting of everything the taxpayer owns or has an interest in at his death. Each item's FMV is used, rather than the amount the taxpayer paid for the items or the value of the item when acquired. The total of all these items is the "gross estate." The includable property may consist of cash and securities, real estate, insurance, trusts, annuities, business interests, and other assets.

Once the gross estate is determined, certain deductions and reductions to value are allowed in arriving at the "taxable estate." The deductions may include mortgages and other debts, estate administration expenses, and property that passes to surviving spouses and qualified charities. The value of some operating business interests or farms may be reduced for qualifying estates.

After the net amount is computed, the value of lifetime taxable gifts (beginning with gifts made in 1977) is added to this number and the tax is computed. The tax is then reduced by the available unified credit. Presently, the amount of the credit reduces the computed tax so that only total taxable estates and lifetime gifts that exceed $1 million are subject to tax.

Most relatively simple estates (cash, publicly-traded securities, small amounts of other easily valued assets, no special deductions or elections or joint legal property) do not require the filing of an estate tax return.

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UNLIMITED MARITAL DEDUCTION

If the taxpayer has a taxable federal estate, current law does not impose the estate tax if the entire estate passes to the taxpayer's spouse. However, these assets are included with the spouse's assets and are taxed upon the spouse's death. The unlimited marital deduction allows the spouse time to gift or otherwise transfer assets so they are not included in the estate at death.

A taxpayer with a large estate can establish a trust that shelters assets from federal estate taxes. The most common is the credit shelter trust (also called a bypass trust or an A/B trust). The trust can be created under a living trust or a testamentary trust. The provisions do not take effect until after the taxpayer's death.

The trust is structured so the maximum amount of assets sheltered by the unified credit is transferred to the trust. The remaining assets are transferred to the surviving spouse. Consequently, there are no federal estate taxes due. While the trust assets are not available to the spouse, all of the trust income can go to the spouse. The surviving spouse cannot be given the right to demand principal from the trust. However, the trustee can have the discretion to distribute principal in certain situations.

GIFTING

The gift tax is a tax on the transfer of property by one individual to another while receiving nothing, or less than full value, in return. The tax applies whether the donor intends the transfer to be a gift or not.

The gift tax applies to the transfer by gift of any property. A taxpayer makes a gift if he gives property (including money), or the use of or income from property, without expecting to receive something of at least equal value in return. If the taxpayer sells something at less than its full value or makes an interest-free or reduced-interest loan, he may be making a gift.

Any gift tax liability is paid by the donor. However, no tax is due unless the total value of the taxable gifts exceeds $1 million during the taxpayer's lifetime. Gifts that exceed the annual exclusion reduce the taxpayer's unified credit amount.

In 2010, the annual exclusion amount is $13,000 per donee. There is no limit to the number of donees in any year. Consequently, a taxpayer can substantially reduce the size of his taxable estate by making annual gifts.

> **Example 23.** Thomas, a widower, has six children, 30 grandchildren, and 14 great grandchildren. Thomas has a $5 million federal estate. In order to reduce the size of the estate, he makes a $13,000 gift to each of these individuals. Therefore, he has reduced his estate by $650,000 (50 × $13,000). If the children and grandchildren are married, he can also make gifts to their spouses. This amounts to an additional $468,000 (36 × $13,000) for a total of $1,118,000 ($650,000 + $468,000).

There is no limit to the amount of gifts a taxpayer can make to a spouse.

Gift Splitting

A husband and wife can each make a $13,000 gift to an individual. Consequently, a child could receive a total of $26,000 per year with no gift tax consequences. In many second marriages, a taxpayer wishes to reduce his estate by gifting to his children. The law allows a spouse to join in the gift with the donor. This allows the taxpayer to make a $26,000 gift to an individual with half of the gift deemed to be by the spouse. The spouse need not have any ownership of the gifted property. By joining in the gift, the spouse is promising not to make a gift of his own property to the same individual.

> **Example 24.** Use the same facts as **Example 23,** except Thomas has recently remarried. If his new bride joins in the gift, he can now reduce the size of his estate by $2,236,000 ($1,118,000 × 2) in 2010. This can occur without the new bride gifting any of her personally-owned property.

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DIVORCE

Note. Divorce issues were covered in detail in the 2006 *University of Illinois Federal Tax Workbook.* This can be found on the accompanying CD.

The first part of this chapter dealt with the marriage benefit and marriage penalty. Unfortunately, not all marriages work out and many result in divorce. This creates an entirely different set of income tax problems as well as possible cash-flow and net-worth problems.

INNOCENT SPOUSE

Unlike an "injured spouse," an "innocent spouse" is a former spouse who learns of an income tax liability of which he was not aware. Typically, this happens after the divorce and may be the result of an audit.

The spouse may have signed a joint tax return without knowing the estranged spouse omitted income or claimed erroneous deductions or credits. If this happens, the unknowing spouse may elect to seek relief from joint and several liability under the innocent spouse provisions.[15] An individual is relieved of liability for tax (including penalty, interest, and other amounts) for a tax year to the extent the liability is attributable to an understatement of income due to erroneous items of the other spouse.[16]

This election is made on Form 8857, *Request for Innocent Spouse Relief*, if all the following conditions are present:

1. A joint return was filed for the tax year.
2. There is an understatement of tax on the return that is attributable to erroneous items of the other spouse.
3. The innocent spouse establishes that, in signing the return, he did not know and had no reason to know of the understatement.
4. Taking into account all the facts and circumstances, it would be inequitable to hold the innocent spouse liable for the deficiency.
5. The innocent spouse elects the relief in the format that the IRS prescribes no later than two years after the IRS begins collection activities with respect to that spouse. This 2-year period does not expire earlier than two years after the date of the first collection activity.

Example 25. Marsha divorced Donald in 2008. In 2009, Marsha received an IRS notice that the 2007 tax return she filed with Donald failed to report $150,000 of gambling earnings. Marsha had no idea that Donald went to the casinos. When she investigated, she found Donald was giving his winnings to his numerous girlfriends. By the time the IRS notified Marsha of the deficiency, Donald had filed bankruptcy and was unable to work because of a terminal illness.

Marsha does not have the money to pay the tax liability, but after discussing the problem with her accountant, Marsha learns she qualifies for innocent spouse treatment. She files the following Form 8857.

15. IRC §6015(a)(1).

16. IRC §6015(b)(1).

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For Example 25

Form **8857** (Rev. June 2007) Department of the Treasury Internal Revenue Service (99)

Request for Innocent Spouse Relief

▶ Do not file with your tax return. ▶ See separate instructions.

OMB No. 1545-1596

3

Important things you should know

- Answer all the questions on this form that apply, attach any necessary documentation, and sign on page 4. Do not delay filing this form because of missing documentation. See instructions.
- By law, the IRS must contact the person who was your spouse for the years you want relief. There are no exceptions, even for victims of spousal abuse or domestic violence. Your personal information (such as your current name, address, and employer) will be protected. However, if you petition the Tax Court, your personal information may be released. See instructions for details.
- If you need help, see *How To Get Help* in the instructions.

Part I **Should you file this form?** You **must** complete this part for each tax year.

			Tax Year 1		Tax Year 2		Tax Year 3*	
1	**Enter each tax year you want relief.** It is important to enter the correct year. For example, if the IRS used your 2006 income tax refund to pay a 2004 tax amount you jointly owed, enter tax year 2004, not tax year 2006 ▶ **Caution.** The IRS generally cannot collect the amount you owe until your request for each year is resolved. However, the time the IRS has to collect is extended. See *Collection Statute of Limitations* on page 3 of the instructions.	1	2007					
2	**Check the box for each year you would like a refund if you qualify for relief.** You may be required to provide proof of payment. See instructions ▶	2	☑		☐		☐	
			Yes	No	Yes	No	Yes	No
3	**Did the IRS use your share of the joint refund to pay any of the following past-due debts of your spouse: federal tax, state income tax, child support, spousal support, or federal non-tax debt such as a student loan?** • If "Yes," **stop here;** do not file this form for that tax year. Instead, file Form 8379. See instructions. • If "No," go to line 4	3	☐	☑	☐	☐	☐	☐
4	**Did you file a joint return for the tax year listed on line 1?** • If "Yes," skip line 5 and go to line 6. • If "No," go to line 5	4	☑	☐	☐	☐	☐	☐
5	**If you did not file a joint return for that tax year, were you a resident of Arizona, California, Idaho, Louisiana, Nevada, New Mexico, Texas, Washington, or Wisconsin?** • If "Yes," see *Community Property Laws* on page 2 of the instructions. • If "No" on both lines 4 and 5, **stop here.** Do not file this form for that tax year	5	☐	☐	☐	☐	☐	☐

*If you want relief for more than 3 years, fill out an additional form.

Part II **Tell us about yourself**

6	Your current name (see instructions) MARSHA PUTTER		**Your social security number** 111 : 11 : 1111
	Your current home address (number and street). If a P.O. box, see instructions. 210 AZALEA DRIVE	Apt. no.	**County** GULF
	City, town or post office, state, and ZIP code. If a foreign address, see instructions. AUGUSTA, GA 55555		Best daytime phone number (555) 555-5555

Part III **Tell us about you and your spouse for the tax years you want relief**

7 **Who was your spouse for the tax years you want relief?** File a separate Form 8857 for tax years involving different spouses or former spouses.

That person's current name DONALD PUTTER	**Social security number** (if known) 222 : 22 : 2222
Current home address (number and street) (if known). If a P.O. box, see instructions. 21 OCEANSIDE DRIVE	Apt. no.
City, town or post office, state, and ZIP code. If a foreign address, see instructions. PHOENIX, AZ 66666	Best daytime phone number (555) 555-5556

For Privacy Act and Paperwork Reduction Act Notice, see instructions. Cat. No. 24647V Form **8857** (Rev. 6-2007)

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For Example 25

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Note. If you need more room to write your answer for any question, attach more pages. Be sure to write your name and social security number on the top of all pages you attach.

Part III *(Continued)*

8 What is the current marital status between you and the person on line 7?

- ☐ Married and still living together
- ☐ Married and living apart since ___ / ___ / ___ (MM DD YYYY)
- ☐ Widowed since ___ / ___ / ___ (MM DD YYYY) Attach a photocopy of the death certificate and will (if one exists).
- ☐ Legally separated since ___ / ___ / ___ (MM DD YYYY) Attach a photocopy of your entire separation agreement.
- ☑ Divorced since 06 / 30 / 2008 (MM DD YYYY) Attach a photocopy of your entire divorce decree.

Note. A divorce decree stating that your former spouse must pay all taxes does not necessarily mean you qualify for relief.

9 What was the highest level of education you had completed when the return(s) were filed? If the answers are **not** the same for all tax years, explain.

- ☑ High school diploma, equivalent, or less
- ☐ Some college
- ☐ College degree or higher. List any degrees you have ▶

List any college-level business or tax-related courses you completed ▶

Explain ▶

10 Were you a victim of spousal abuse or domestic violence during any of the tax years you want relief? If the answers are **not** the same for all tax years, explain.

- ☐ Yes. **Attach a statement** to explain the situation and **when** it started. Provide photocopies of any documentation, such as police reports, a restraining order, a doctor's report or letter, or a notarized statement from someone who was aware of the situation.
- ☑ No.

11 Did you sign the return(s)? If the answers are **not** the same for all tax years, explain.

- ☑ Yes. If you were forced to sign under duress (threat of harm or other form of coercion), check here ▶ ☐. See instructions.
- ☐ No. Your signature was forged. See instructions.

12 When any of the returns were signed, did you have a mental or physical health problem or do you have a mental or physical health problem now? If the answers are **not** the same for all tax years, explain.

- ☐ Yes. **Attach a statement** to explain the problem and **when** it started. Provide photocopies of any documentation, such as medical bills or a doctor's report or letter.
- ☑ No.

Part IV Tell us how you were involved with finances and preparing returns for those tax years

13 How were you involved with preparing the returns? Check all that apply and explain, if necessary. If the answers are **not** the same for all tax years, explain.

- ☐ You filled out or helped fill out the returns.
- ☐ You gathered receipts and cancelled checks.
- ☐ You gave tax documents (such as Forms W-2, 1099, etc.) to the person who prepared the returns.
- ☐ You reviewed the returns before they were signed.
- ☑ You did not review the returns before they were signed. Explain below.
- ☑ You were not involved in preparing the returns.
- ☐ Other ▶

Explain how you were involved ▶ I WAS GIVEN THE RETURN BY DONALD'S BUSINESS MANAGER AND TOLD TO SIGN.

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For Example 25

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Note. If you need more room to write your answer for any question, attach more pages. Be sure to write your name and social security number on the top of all pages you attach.

Part IV *(Continued)*

14 When the returns were signed, were you concerned that any of the returns were incorrect or missing information? Check all that apply and explain, if necessary. If the answers are **not** the same for all tax years, explain.

☐ You knew something was incorrect or missing, but you said nothing.
☐ You knew something was incorrect or missing and asked about it.
☑ You did not know anything was incorrect or missing.
Explain ▶

15 When any of the returns were signed, what did you know about the income of the person on line 7? If the answers are **not** the same for all tax years, explain.

☑ You knew that person had income.

List each type of income on a separate line. (Examples are wages, social security, gambling winnings, or self-employment business income.) Enter each tax year and the amount of income for each type you listed. If you do not know any details, enter "I don't know."

Type of income	Who paid it to that person	Tax Year 1	Tax Year 2	Tax Year 3
WINNINGS	GOLF TOUR	$ 4,000,000	$	$
ENDORSEMENTS	SPONSORS	$ 5,000,000	$	$
		$	$	$

☐ You knew that person was self-employed and you helped with the books and records.
☑ You knew that person was self-employed and you did not help with the books and records.
☐ You knew that person had no income.
☐ You did not know if that person had income.
Explain ▶

16 When the returns were signed, did you know any amount was owed to the IRS for those tax years? If the answers are **not** the same for all tax years, explain.

☐ Yes. Explain when and how you thought the amount of tax reported on the return would be paid ▶

☑ No.
Explain ▶ THE BUSINESS MANAGER PUT THE RETURN IN FRONT OF ME AND TOLD ME TO SIGN.

17 When any of the returns were signed, were you having financial problems (for example, bankruptcy or bills you could not pay)? If the answers are **not** the same for all tax years, explain.

☐ Yes. Explain ▶

☑ No.
☐ Did not know.
Explain ▶

18 For the years you want relief, how were you involved in the household finances? Check all that apply. If the answers are **not** the same for all tax years, explain.

☐ You knew the person on line 7 had separate accounts.
☐ You had joint accounts but you had limited use of them or did not use them. Explain below.
☐ You used joint accounts. You made deposits, paid bills, balanced the checkbook, or reviewed the monthly bank statements.
☐ You made decisions about how money was spent. For example, you paid bills or made decisions about household purchases.
☑ You were not involved in handling money for the household.
☑ Other ▶ I WAS GIVEN AN ALLOWANCE FOR MY OWN USE.
Explain anything else you want to tell us about your household finances ▶

19 Has the person on line 7 ever transferred assets (money or property) to you? (Property includes real estate, stocks, bonds, or other property to which you have title.) See instructions.

☐ Yes. List the assets and the dates they were transferred. Explain why the assets were transferred ▶

☑ No.

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For Example 25

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Part V Tell us about your current financial situation

20 Tell us the number of people currently in your household. Adults 1 Children 2

21 Tell us your current average monthly income and expenses for your entire household. If family or friends are helping to support you, include the amount of support as gifts under **Monthly income.** Under **Monthly expenses,** enter all expenses, including expenses paid with income from gifts.

Monthly income	Amount	Monthly expenses	Amount
Gifts		Federal, state, and local taxes deducted from your paycheck	
Wages (Gross pay)		Rent or mortgage	15,000
Pensions		Utilities	1,000
Unemployment		Telephone	800
Social security			
Government assistance, such as housing, food stamps, grants		Food	1,000
		Car expenses, payments, insurance, etc.	10,000
Alimony	30,000	Medical expenses, including medical insurance	
Child support	10,000	Life insurance	
Self-employment business income		Clothing	10,000
Rental income		Child care	
Interest and dividends		Public transportation	
Other income, such as disability payments, gambling winnings, etc. List the type below:		Other expenses, such as real estate taxes, child support, etc. List the type below:	
Type		Type	
Type		Type	
Type		Type	
Total ▶	40,000	**Total** ▶	37,800

22 Please provide any other information you want us to consider in determining whether it would be unfair to hold you liable for the tax. If you need more room, attach more pages. Be sure to write your name and social security number on the top of all pages you attach.

Caution

By signing this form, you understand that, by law, we must contact the person on line 7. See instructions for details.

Sign Here

Under penalties of perjury, I declare that I have examined this form and any accompanying schedules and statements, and to the best of my knowledge and belief, they are true, correct, and complete. Declaration of preparer (other than taxpayer) is based on all information of which preparer has any knowledge.

Keep a copy for your records. ▶ Your signature | Date

Paid Preparer's Use Only

Preparer's signature ▶ | Date | Check if self-employed ☐ | Preparer's SSN or PTIN

Firm's name (or yours if self-employed), address, and ZIP code ▶ | EIN | Phone no. ( )

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Attachment to Form 8857

Marsha Putter

111-11-1111

The purpose of the Form 8857 is to elect innocent-spouse treatment regarding the additional income tax assessed on the 2007 income tax I jointly filed with Donald Putter (222-22-2222).

The tax resulted from an unreported Form 1099-G received from Midnight Casino. The Form 1099-G reported $150,000 of gambling winnings.

I had no reason to know about the gambling winnings. I did not know Donald went to the casino while he was touring the world. He never mentioned he gambled or that he had any winnings and I never saw any of the winnings. I recently found Donald spent his winnings on his many girlfriends, who were unknown to me.

Any tax liability should be paid by Donald. I do not have enough income to pay this liability and if a lien is placed on my meager alimony, I will not be able to support myself.

I would appreciate your honoring this Form 8857 request.

An otherwise innocent spouse may be relieved of liability for the portion of tax attributable to the understatement that he did not know or have reason to know about. However, if he fails to establish that he did not know or have reason to know of the understatement, he must establish that he did not know or have reason to know of its extent.[17]

The innocent spouse may also petition the Tax Court to review the case. The petition must be filed at any time after the earlier of the IRS's mailing of a notice of final determination or six months after the Form 8857 is filed with the IRS.

Equitable Relief Rules. If relief is not available to a jointly-filing taxpayer under the innocent-spouse rules, the IRS may relieve the taxpayer of the liability for unpaid taxes under the equitable-relief rules. This relief may be given if it would be inequitable to hold the taxpayer liable, taking into account all facts and circumstances. Equitable relief applies only to the tax liability shown on the return before any adjustment to the return and is only available to the extent the unpaid tax is attributable to the spouse not requesting relief.

Note. Equitable relief is available even when there is no unreported income. It may be available when the proper amount of tax was shown on the return but all the tax was not paid.

PROPERTY SETTLEMENTS

A divorce usually ends with a division of the couple's assets. This is called a property settlement. **Property settlements are neither taxable to the recipient nor deductible by the payor.[18]** This is true even if the spouse receiving the property had no interest in the property prior to the divorce. The transfer of property between spouses incident to divorce is treated the same as if they received the property by gift. The recipient spouse receives the payor spouse's basis in the property.[19] Even if the property is transferred in a bona fide sale between spouses at its FMV, which is higher than the property's basis, the transfer has no tax consequences. If transfer fees are paid, they do **not** add to the basis of the property.[20]

17. IRC §6015(b)(2).

18. IRC §1041(a)(2).

19. IRC §1041(b)(2).

20. *Michael J. Godlewski v. Comm'r,* 90 TC 200 (Feb. 9, 1988).

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Transfers of property between spouses are not considered a gift, and no gift return is required if **all** of the following apply:

- The couple has a written property settlement agreement.
- The agreement is entered into two years prior to the divorce or one year after the divorce.
- The property is transferred as specified in the written agreement.

The term **property** means all property including real, personal, intangible, tangible, community, or separate.

A transfer is considered related to the marital termination in **either** of the following situations:

- The transfer occurs within one year after the divorce or legal separation is final.
- The transfer is required by a divorce or separation instrument and the transfer occurs within six years after the divorce or legal separation is final.

BASIS ISSUES

As discussed above, basis becomes an important consideration when deciding how to split property. While the FMV of the assets each couple receives may be the same, the tax consequences on a subsequent sale can vary considerably.

Example 26. Tom and Nicole decide to end their 10-year marriage. They agree that the assets should be shared equally. The attorneys asked them to list their assets, the FMV of the assets, and who would receive each.

The year following the divorce, Tom went to his CPA to have his tax return prepared. His CPA advised him that he could no longer represent Tom because he was representing Nicole and it would be a conflict of interest. Tom found a new preparer. The new preparer asked for a copy of the divorce settlement.

After reviewing the settlement, the new accountant asked for basis information, which Tom provided. The basis information follows.

	FMV			Basis	
	Total	Tom	Nicole	Tom	Nicole
Cash in bank	$ 34,850	$ 32,875	$ 1,975	$ 32,875	$ 1,975
Fidelity mutual fund	126,800	126,800		35,000	
Universal Pictures stock	375,000	375,000		50,000	
Merrill Lynch account	25,343,800	25,343,800		13,500,000	
Tom's 401(k) account	1,753,000	1,753,000		0	
Nicole's 401(k) account	1,500,000		1,500,000		0
Nicole's IRA	253,000		253,000		0
Nicole's 1998 Chevy Caprice Classic wagon	6,500		6,500		6,500
Nicole's 2007 Jaguar XK8	79,000		79,000		79,000
Tom's 2006 Ferrari F60 Enzo	1,290,000	1,290,000		1,100,000	0
Household goods	25,000	12,500	12,500	12,500	12,500
Residence in Beverly Hills	43,000,000		43,000,000		39,000,000
Vacation house in Nice	16,000,000	16,000,000		7,000,000	
Credit card debt	(82,000)	(81,500)	(500)		
Net assets	$89,704,950	$44,852,475	$44,852,475	$21,730,375	$39,099,975

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The accountant explained to Tom that he did not receive an equal settlement. If Tom sells all his assets, he will report a $23,122,100 ($44,852,475 – $21,730,375) gain while Nicole will report a gain of $5,752,500 ($44,852,475 – $39,099,975) if she sells all her assets. In addition, because the Beverly Hills residence is Nicole's personal residence, she can utilize IRC §121 to exclude part of the gain.

Observation. If a taxpayer incurs debt in order to purchase the spouse's interest in the personal residence, the interest on the debt qualifies as interest on debt to acquire a personal residence.[21]

Note. Tax practitioners should encourage clients to discuss potential tax consequences of divorce settlements early in the settlement process.

TIMING ISSUES

Transfers of property occurring more than six years after the cessation of marriage, but **not** included in the divorce or separation agreement, are presumed **not** related to the divorce. The presumption can be challenged if the couple can show the transfer was made to divide property owned by them when the marriage ended. If the transfer was delayed because of legal or business reasons or valuation issues, the transfer may relate to the divorce even if made outside of the 6-year period. However, these transfers should occur immediately after the impediment is removed.[22]

Example 27. George specializes in personal injury lawsuits. While in the middle of a large medical malpractice case, he and his wife Gotcha filed for divorce. A part of the property settlement called for George to give Gotcha one half of the contingency fee he will receive if he is successful in the malpractice case. The lawsuit was finalized; George was successful and received a $1 million contingency fee. However, he did not receive the fee until eight years after his divorce became final. George immediately paid his former wife her $500,000 share. This amount is neither deductible to George nor taxable to Gotcha.

Note. What George did not realize when agreeing to the property settlement was that he must include the entire $1 million fee in his income in the year received. Income is taxable to the person who earns it. This is based on a long-standing precedent.[23]

OTHER TAX ATTRIBUTES

Capital Loss Carryforward

Capital loss carryforwards must be allocated based on the separate capital gains and losses of each spouse.[24] Gains and losses on jointly-owned or community property are generally divided equally between the spouses.

Charitable Contribution Carryforward

Charitable contribution carryforwards must be apportioned between spouses in proportion to what separate carryforwards would be if the spouses filed separate returns for the year(s) the excess contribution arose.[25]

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21. IRC §163(h)(3)(A).
22. Temp. Treas. Reg. §1.1041-1T(b) Q&A 7.
23. *Lucas v. Earl*, 2 USTC ¶496, 282 U.S. 111,50 S.Ct. 241 (Mar. 17, 1930).
24. Treas. Reg. §1.1212-1(c)(1)(iv).
25. Treas. Reg. §1.170A-10(d)(4).

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Net Operating Loss Carryforward

Net operating loss (NOL) carryforwards are required to be allocated between spouses in proportion to what separate NOL carryforwards would be with each spouse separately computing income and deductions.[26]

An interesting situation occurs when a taxpayer files an individual return in a year subsequent to a divorce, incurs an NOL, and carries the loss back to a year in which he was married. The loss can only be applied to the taxpayer's separate income. After the NOL is deducted against the taxpayer's separate income, the joint tax rates apply to the remaining taxable income.

If the taxpayer was not married in the NOL year (or was married to a different spouse), and in the carryback year he was married and filed a joint return, his refund for the overpaid joint tax may be limited. He can claim a refund for the difference between his share of the refigured tax and his contribution toward the tax paid on the joint return. The refund cannot be more than the joint overpayment. The taxpayer must attach a statement showing how he computed the refund.

There are five steps for calculating a taxpayer's share of the refigured joint tax liability:

1. Figure the individual's total tax as though he had filed as MFS.
2. Figure the spouse's total tax as though the spouse had also filed as MFS.
3. Add the amounts in **(1)** and **(2)**.
4. Divide the amount in **(1)** by the amount in **(3)**.
5. Multiply the refigured tax on the joint return by the percentage figured in **(4)**. This is the taxpayer's share of the joint tax liability.

Unless there is an agreement or clear evidence of each spouse's contributions toward the payment of the joint tax liability, the taxpayer's contribution is calculated by adding the tax withheld on his wages and his share of joint estimated tax payments or tax paid with the return. If the original return for the carryback year resulted in an overpayment, the taxpayer's contribution is reduced by his share of the tax refund. The taxpayer's share of a joint payment or refund is calculated by the same method used in figuring his share of the joint tax liability. The taxable income as originally reported on the joint return is used in steps **(1)** and **(2)** above; substitute the joint payment or refund for the refigured joint tax in step **(5)**.[27]

Note. For a comprehensive example, see Chapter 7, Net Operating Losses, Example 10, in the 2009 *University of Illinois Federal Tax Workbook.* This can be found on the accompanying CD.

S Corporation Suspended Loss

Losses from an S corporation that are limited as a result of the shareholder's basis stay with the shareholder that held the stock at the time the loss was incurred. If the stock is transferred to a spouse incident to a divorce, then the suspended losses are treated as incurred by the corporation in the next taxable year for the transferee.[28]

For transfers made prior to January 1, 2005, if the stock held by one spouse was transferred to the other spouse, the transferee spouse takes the basis of the transferor spouse. A suspended loss, limited to the basis of the stock, is not deductible by the transferee spouse.[29]

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26. Treas. Reg. §1.172-1(D).
27. IRS Pub. 563, *Net Operating Losses (NOLs) for Individuals, Estates and Trusts.*
28. IRC §1366(d)(2).
29. Ltr. Rul. 9552001 (Aug. 3, 1995).

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General Business Credits Carryforward

General business and investment credit carryforwards can only be used by the taxpayer who owns the property after the divorce.[30]

ESTIMATED TAX PAYMENTS

If taxpayers pay their estimated tax based on a jointly-filed return but subsequently decide to file separately, they may split the estimated payments in any manner they choose. For example, one taxpayer could take credit for the entire estimated payment or any part thereof.

Unfortunately, at the time of a divorce, the taxpayers may not be able to agree on the split. In this case, they must split the payments based on each person's individual tax liability reported on their separately-filed return.[31] This division can result in inequitable results as shown in the following example.

Example 28. Mark and Karen were married eight years. Karen is an executive for an advertising agency and Mark is self-employed. Karen typically has enough withholding tax to cover her share of the tax liability. Mark, on the other hand, makes quarterly estimated payments, which total $3,000 in 2009. When it is time to file their 2009 income tax return, they are in the middle of a bitter divorce. Karen refuses to file a joint return with Mark. While the estimated payments were made from the farm checking account, Karen believes she is entitled to a share of the payments applied toward her tax liability. Because they cannot agree, the IRS prorates the payments according to each person's income tax as shown here.

	Mark		Karen	
Wages	$ 0		$140,000	
Taxable interest	750		750	
Ordinary dividends	188		187	
SE income	20,000		0	
Total income	$20,938		$140,937	
50% of SE tax	(1,413)		0	
Federal AGI	$19,525		$140,937	
Standard deduction	(5,700)		(5,700)	
Exemption	(3,650)		(3,334)	
Taxable income	$10,175		$131,903	
Tax	$ 1,079	$1,079	$ 32,405	$32,405
Total tax	÷ 33,484		÷ 33,484	
Percentage of total tax	3.22%		96.78%	
Estimated payment	× 3,000		× 3,000	
Estimated payment allocation	$ 97	(97)	$ 2,903	(2,903)
Withholding		0		(31,500)
Balance of taxes due		$ 982		($ 1,998)

Observation. If Mark and Karen filed a joint return, they would reduce their tax liability by $10,315.

Note. SE tax was not included in the computation of Mark's total tax. Including his SE tax liability would increase his estimated payment allocation from $97 to $323. Karen's estimated payment allocation would be reduced from $2,903 to $2,677.

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30. Temp. Treas. Reg. §1.1041-1T(d).

31. Treas. Reg. §1.6654-2(e)(5)(ii)(B).

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If any of the joint payments are claimed on the separate tax return, the former spouse's SSN must be entered in the space provided on the front of Form 1040 or Form 1040A. If the person claiming the estimated payment divorces and remarries during the year, the current spouse's SSN is entered in the space on the front, and the former spouse's SSN, followed by "DIV," is written to the left of line 62 of Form 1040, or line 39 of Form 1040A as shown here.

	Line	Description	Line	Amount
Payments	61	Federal income tax withheld from Forms W-2 and 1099	61	
	62	2009 estimated tax payments and amount applied from 2008 return 123-45-6789DIV	62	1,000
	63	Making work pay and government retiree credits. Attach Schedule M	63	

ESTIMATED TAX PENALTIES

If the taxpayers file separate returns, any estimated tax penalties are based on the return filed. If a joint return is filed and an estimated tax penalty is assessed after the divorce, both taxpayers have joint and several liability for any balance due.

TAX REFUNDS

If a joint return is filed, each spouse has a separate interest in any refund.[32]

> **Example 29.** Patricia and Tim were married in 2008 and filed a joint tax return. The entire tax on the joint return was paid from withholdings from Pat's W-2 wages. In addition, the return reported an overpayment of $7,000. Prior to the marriage, Tim filed as single in 2006 and 2007. He has an unpaid federal tax liability of $8,500 in those two years. The IRS cannot apply the $7,000 refund received in 2009 against Tim's unpaid taxes.

32. Rev. Rul. 74-611 (Jan. 1, 1974).

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SEPARATE RETURN ITEMIZED DEDUCTIONS

If the taxpayers are filing separate tax returns and one decides to itemize his personal deductions, both must itemize. The itemized deductions consist of those the taxpayer paid separately and a portion of those paid jointly. The following table from IRS Pub. 504, *Divorced or Separated Individuals,* shows how the deductions are split.

Table 1. **Itemized Deductions on Separate Returns** *Keep for Your Records*

This table shows itemized deductions you can claim on your married filing separate return whether you paid the expenses separately with your own funds or jointly with your spouse. ***Caution:*** *If you live in a community property state, these rules do not apply. See* Community Property.

IF you paid ...	AND you ...	THEN you can deduct on your separate federal return...
medical expenses	paid with funds deposited in a joint checking account in which you and your spouse have an equal interest	half of the total medical expenses, subject to certain limits, unless you can show that you alone paid the expenses.
state income tax	file a separate state income tax return	the state income tax you alone paid during the year.
	file a joint state income tax return and you and your spouse are jointly and individually liable for the full amount of the state income tax	the state income tax you alone paid during the year.
	file a joint state income tax return and you are liable for only your own share of state income tax	the smaller of: • the state income tax you alone paid during the year, or • the total state income tax you and your spouse paid during the year multiplied by the following fraction. The numerator is your gross income and the denominator is your combined gross income.
property tax	paid the tax on property held as tenants by the entirety	the property tax you alone paid.
mortgage interest	paid the interest on a qualified home[1] held as tenants by the entirety	the mortgage interest you alone paid.
casualty loss	have a casualty loss on a home you own as tenants by the entirety	half of the loss, subject to the deduction limits. Neither spouse may report the total casualty loss.

[1] For more information on a qualified home and deductible mortgage interest, see Publication 936, Home Mortgage Interest Deduction.

The following rules also apply if filing MFS:

1. Tax rates increase at income levels that are lower than those for a joint return filer.
2. The exemption amount for figuring the alternative minimum tax is half of that allowed a joint return filer.
3. The separate filer loses the credit for child and dependent care expenses in most cases.
4. The separate filer loses the earned income credit.
5. The separate filer loses the exclusion or credit for adoption expenses in most instances.
6. The separate filer loses the credit for higher-education expenses (Hope and lifetime learning credits), the deduction for student loan interest, or the deduction for tuition and fees.
7. The separate filer excludes the interest from qualified savings bonds that are used for higher-education expenses.

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8. If the taxpayer lived with his spouse at any time during the tax year:
   - He cannot claim the credit for the elderly or the disabled,
   - He must include in income up to 85% of any social security or equivalent railroad retirement benefits received, and
   - He cannot roll over amounts from a traditional IRA into a Roth IRA.
9. MFS imposes more strict income limits that reduce the child tax credit, retirement-savings contributions credit, itemized deductions, and amounts claimed for exemptions. These limits are half of those allowed a joint return filer.
10. The separate filer's capital loss deduction limit is $1,500 (instead of $3,000 on a joint return).
11. The basic standard deduction, if allowable, is half of that allowed a joint return filer.

PAYMENT OF KIDDIE TAX

Divorce can create problems when there are children under the age of 24. The child's parents may disagree about who pays the "kiddie tax." This can occur either during the divorce process or after the divorce is final. This is important since the kiddie tax (on the child's investment income in excess of $1,900 in 2010) is based on the parent's marginal tax rate. Form 8615, *Tax for Certain Children Who Have Investment Income of More Than $1,900,* must be completed and attached to the child's return.

If the parents are divorced, filing separately, or lived apart the last six months of the year, the income of the custodial parent is used in the calculation. If the custodial parent remarries and files a joint return with a new spouse, the top tax rate on the joint return is used. If the divorce is not final, the tax rate of the parent with the highest income is used. If the parent files an amended return later reporting a higher income, the kiddie tax must be recalculated. The responsibility of filing the child's return falls upon the custodial parent.

If the parent or sibling information needed to complete Form 8615 cannot be obtained before the due date of the child's tax return, the parental or sibling information may be estimated. "Estimate" must be written next to the applicable lines. When correct information is obtained, the child's return should be amended.[33]

SIGNING A JOINT RETURN

Although a high-income taxpayer may want the spouse to sign a joint tax return, there is no requirement to do so. The spouse cannot even be forced to sign by court order. However, there are court cases which address this situation. One Tax Court case suggests that if the nonsigning spouse has no income and has always signed a joint return and there is no reason to believe the return is fraudulent, then the filing spouse may still file a joint return. The joint return does not include the other spouse's signature.[34]

If the nonsigning spouse has already filed as MFS, nothing can be done.[35]

The IRS ruled that it accepts a claim for refund or credit filed by a divorced taxpayer on a Form 1040X for a joint return if the Form 1040X is signed by only one of the spouses.[36] The IRS issues a refund check in the name of the taxpayer who filed the Form 1040X. However, the amount of the individual taxpayer's refund is determined by recomputing the taxpayer's share of the joint liability and subtracting that amount from the taxpayer's contribution toward the joint liability. This is done using the IRS allocation method based on separate return liability amounts. The amount of the refund is limited to the amount of the joint overpayment.

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33. IRS Ann. 88-70 (Apr. 13, 1988).

34. *Vincent Riportella v. Comm'r,* TC Memo 1981-463 (Aug. 26, 1981).

35. *J. Michael Springmann v. Comm'r,* TC Memo 1987-44 (Sep. 21, 1987).

36. Rev. Rul. 80-8, 1980-1 CB 298 (Jan. 1, 1980).

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