PRESENT LAW AND BACKGROUND RELATING TO TAX TREATMENT OF "INNOCENT SPOUSES"

Scheduled for a Public Hearing

Before the

SENATE COMMITTEE ON FINANCE

on February 11, 1998

Prepared by the Staff

of the

JOINT COMMITTEE ON TAXATION

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INTRODUCTION

The Senate Committee on Finance has scheduled a public hearing on February 11, 1998, on the tax treatment of "innocent spouses" under the Internal Revenue Code (the "Code").

The document,[1] prepared by the staff of the Joint Committee on Taxation, provides a description of present-law rules and the legislative background relating to innocent spouses, joint returns, and joint and several liability under the Code, regulations, and court interpretations, and also describes certain proposals.

Part I of the document is an overview. Part II is a description of present law and background. Part III is a description of two proposals: Section 321 of H.R. 2676 (the "Internal Revenue Service Restructuring and Reform Act of 1997"), as passed by the House of Representatives on November 5, 1997, and the proposal by the American Bar Association.

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[1] This document may be cited as follows: Joint Committee on Taxation, Present Law and Background Relating to Tax Treatment of "Innocent Spouses" (JCX-6-98), February 9, 1998.

I. OVERVIEW

Present law

Spouses who file a joint tax return are each individually responsible for the accuracy of the return and for the full tax liability. This is true even though only one spouse may have earned the wages or income which is shown on the return. This is "joint and several" liability. A spouse who wishes to avoid joint liability may file as a "married person filing separately." However, married filing separate status will generally result in a higher total tax liability for the couple.

Relief from liability for tax, interest and penalties is available for "innocent spouses" in certain limited circumstances. To qualify for such relief, the innocent spouse must establish: (1) that a joint return was made; (2) that an understatement of tax, which exceeds the greater of $500 or a specified percentage of the innocent spouse's adjusted gross income for the preadjustment (most recent) year, is attributable to a grossly erroneous item of the other spouse; (3) that in signing the return, the innocent spouse did not know, and had no reason to know, that there was an understatement of tax; and (4) that taking into account all the facts and circumstances, it is inequitable to hold the innocent spouse liable for the deficiency in tax. The specified percentage of adjusted gross income is 10 percent if adjusted gross income is $20,000 or less. Otherwise, the specified percentage is 25 percent.

H.R. 2676[2]

The House bill generally makes innocent spouse status easier to obtain by eliminating all of the understatement thresholds. The bill provides for flexible innocent spouse relief on an apportioned basis. That is, the spouse may be relieved of liability as an innocent spouse to the extent the liability is attributable to the portion of an understatement of tax which such spouse did not know of and had no reason to know of. The bill specifically grants jurisdiction to the Tax Court to review any denial (or failure to rule) by the Secretary regarding an application for innocent spouse relief. The Tax Court may order refunds as appropriate where it determines the spouse qualifies for relief and an overpayment exists as a result of the innocent spouse qualifying for such relief. The bill also requires the Secretary of the Treasury to develop, within 180 days from the date of enactment, a separate form with instructions for taxpayers to use in applying for innocent spouse relief. An innocent spouse seeking relief under this provision must claim innocent spouse status with regard to any assessment not later than two years after the date of such assessment.

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[2] Section 321 of H.R. 2676 (the "Internal Revenue Service Restructuring and Reform Act of 1997"), as passed by the House of Representatives on November 5, 1997.

American Bar Association[3] proposal

Rather than reform the innocent spouse provision of present law, the American Bar Association (ABA) proposes its replacement with a system based on separate liability. The separate liability system envisioned by the ABA allocates liability between spouses in proportion to their relative liabilities had each filed a separate return reporting his or her allocable share of any item of income, expense or credit. The separate liability system is proposed to be used only to determine which spouse is ultimately responsible for the payment of taxes due. It would not change the combined liability of the married couple, nor can it be used to increase or initiate a refund of taxes already paid.

[3] The American Bar Association proposal is contained in its Legislative Recommendation LEG-9206-012, adopted by its House of Delegates in February, 1995.

II. PRESENT LAW AND LEGISLATIVE HISTORY

Summary

Code section 6013(d)(3) provides that spouses who file a joint tax return are each individually responsible for the accuracy of the return and for the full tax liability. This is true even though only one spouse may have earned the wages or income which is shown on the return. This is "joint and several" liability. If one spouse has concealed income and failed to report it on the joint return, it may be unfair to collect the resulting tax liability from the other spouse, if the other spouse did not know of or benefit from the income. Code section 6013(e) provides relief from liability for tax, interest and penalties for "innocent spouses" in certain limited circumstances.

Filing a joint return is optional. A spouse who wishes to avoid joint liability may file as a "married person filing separately." However, the decision to file separately will generally result in a higher combined tax liability. In addition, in community property States, each spouse is liable for the tax on one-half of the other spouse's earned income, even when they file separately.[4] Code section 66(c) provides limited relief for innocent spouses filing separate returns in States with community property laws.

Historical background on the joint return and joint and several liability

Before 1918, each spouse was required to file a separate return. In 1918, Congress first permitted married couples to file a single, joint return.[5] In 1921, Congress clarified that a husband and wife may either file returns individually, or include "[t]he income of each . . . in a single joint return, in which case the tax shall be computed on the aggregate income."[6] The 1921 Act did not address the allocation of tax liability for taxes reported on a joint return. In 1923, the Bureau of the Internal Revenue ("IRS") began asserting the joint and several liability of each spouse for the entire tax due on the return. The IRS used a unitary approach to tax liability, stating that the husband and wife are each individually liable for the full amount, because "a single joint return is one return of a taxable unit, not two returns of two units on one sheet of paper."[7]

Courts considering the issue of joint and several liability of spouses disagreed with the IRS. The Ninth Circuit Court of Appeals considered the issue of joint and several liability in

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[4] See Poe v. Seaborn, 282 U.S. 101 (1930).

[5] Revenue Act of 1918, ch. 18, section 223, 40 Stat. 1057, 1074.

[6] Revenue Act of 1921, ch. 136, section 223(b)(2), 42 Stat. 227, 250.

[7] I.T. 1575, II-1 C.B. 144 (1923).

1935 in Cole v. Commissioner.[8] In Cole, the IRS was barred from collecting the income tax liability from the estate of the wife because of the statute of limitations. The wife's income for the year at issue exceeded $250,000, but the husband's income was less than $10,000. The IRS argued that because the joint return did not segregate the respective income and expense of the spouses, it would be impossible to determine the respective tax liabilities of the spouses. Thus, administrative simplicity required joint and several liability. The IRS also argued that joint and several liability was the price for the privilege of filing a joint return. The Ninth Circuit Court of Appeals rejected these arguments for joint and several liability, noting that the IRS examination had revealed the respective net income of the spouses, a fact that was stipulated before the Board of Tax Appeals. The Ninth Circuit Court of Appeals held for the taxpayer. Cole was followed by the Board of Tax Appeals and several other circuit courts of appeals.[9] In 1938, Congress legislatively overruled Cole and its progeny by enacting marital joint and several liability.[10] This provision is currently found in Code section 6013(d).

Although the IRS argued in Cole that filing a joint return was a valuable privilege, most married taxpayers derived no tax benefit from filing a joint return until 1948.[11] Before 1948, there was only one income tax schedule, and all individuals were liable for tax as separate filing units. This structure created an incentive to split incomes because with a progressive income tax, a married couple with only one spouse earning income could reduce its combined tax liability if it could split the income and assign half to each spouse. While the Supreme Court upheld the denial of contractual attempts to split income,[12] it ruled that in States with community property laws, income splitting was required for community income.[13] Thus, in community property States, married couples could achieve income splitting benefits, whether they filed a joint return or not. In separate property States, married couples were not allowed income splitting benefits, whether they filed a joint return or not.

The Revenue Act of 1948 provided the benefit of income splitting to all married couples

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[8] 81 F.2d 485 (9th Cir. 1935)

[9] See, e.g., Commissioner v. Uniacke, 132 F.2d 781 (2d Cir. 1941); Sachs v. Commissioner, 111 F.2d 648 (6th Cir. 1940); Flaherty v. Commissioner, 35 B.T.A. 1131 (1937); Darling v. Commissioner, 34 B.T.A. 1062 (1936).

[10] Revenue Act of 1938, ch. 289, sec. 51(b), 52 Stat. 447, 476 (1938).

[11] See Pierce v. Commissioner, 100 F.2d 397 (2d Cir. 1938) (the only advantage derived from filing a joint return is when the allowable deductions of one spouse exceed his or her income).

[12] Lucas v. Earl, 281 U.S. 111 (1930).

[13] Poe v. Seaborn, supra n. 4. The community property States are Arizona, California, Idaho, Louisiana, Nevada, New Mexico, Texas, Washington, and Wisconsin.

by establishing a separate tax schedule for joint returns. That schedule was designed so that married couples would pay twice the tax of a single taxpayer having one-half the couple's taxable income. (This relationship between rate schedules is the same as that between joint returns and separate returns for married couples under present law.) While this new schedule equalized treatment between married couples in States with community property laws and those in States with separate property laws, it introduced a marriage bonus into the tax law for couples in States with separate property laws.[14]

Historical background of the "innocent spouse" provisions

In 1970, Congress enacted a provision providing relief from joint and several liability for "innocent spouses" in certain limited circumstances. Congress was concerned about the "grave injustice" imposed by joint and several liability in cases in which, for example, the culpable spouse embezzles funds, fails to report the proceeds, deserts the innocent spouse, and squanders the funds. Congress concluded that only a legislative remedy could ameliorate the harsh effects of joint and several liability.[15] The provision set forth three tests for determining whether innocent spouse relief should be available: (1) the income omitted should be a significant amount relative to the reported income;[16] (2) the innocent spouse must prove that he or she did not know of, and had no reason to know of, the omission from income; and (3) as a matter of fact, the innocent spouse did not benefit from the items omitted from gross income. Congress intended that an innocent spouse should not be considered as having received a benefit from the omitted income unless the benefit was significant and, after taking into account all other facts and circumstances, it would not be inequitable to hold the spouse liable for the deficiency in tax.

In 1980, Congress addressed the issue of tax liability of spouses living in community

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[14] Since income splitting had been available in community property States prior to 1948, a marriage bonus had already existed in such States.

[15] S. Rept. 91-1537, 91st Cong., 2d Sess. 2 (1970). The legislative history cites as an example the opinion in Scudder v. Commissioner, 48 T.C. 36, 41 (1967), in which the court stated "[a]lthough we have much sympathy for petitioner's unhappy situation and are appalled at the harshness of this result in the instant case, the inflexible statute leaves no room for amelioration. It would seem that only remedial legislation can soften the impact of the rule of strict individual liability for income taxes on the many married women who are unknowingly subjected to its provisions by filing joint returns."

[16] The provision originally provided that the amount omitted from gross income must equal more than 25 percent of the gross income shown on the return. Current law requires the innocent spouse to establish that the understatement of tax exceeds the greater of $500 or a specified percentage of the innocent spouse's adjusted gross income for the preadjustment (most recent) year and is attributable to a grossly erroneous item of the other spouse. The specified percentage of adjusted gross income is 10 percent if adjusted gross income in the preadjustment year is $20,000 or less. Otherwise, the specified percentage is 25 percent.

property states.[17] In Poe v. Seaborn,[18] the Supreme Court held that, in a community property state, each spouse is liable for the tax on one-half of the other spouse's earned income, even when they file separately. Congress noted that this rule may result in an abandoned spouse being liable for Federal income tax on one-half of the income earned by the other spouse even though the abandoned spouse has not actually received or benefitted from any of the income.[19] To change this result, Congress enacted Code section 66, which provided that a spouse would not be liable for Federal income tax on one-half of the income earned by the other spouse in a community property State if (1) the spouses live apart at all times during the calendar year; (2) they do not file a joint return; (3) one or both spouses have income which is community income; and (4) no portion of such earned income is transferred, directly or indirectly, between such spouses during the calendar year. Rather, each spouse would be liable for the tax on their respective earned incomes and on community income derived from the separate property (determined under applicable community property laws) of each spouse.[20]

Congress last significantly altered the structure of the innocent spouse rules in 1984. In 1984, Congress broadened the reach of the innocent spouse provisions to include relief from tax liability attributable to improper deductions as well as that attributable to unreported income. Congress was specifically concerned about the situation where, for example, "one spouse claims phony business deductions in order to avoid paying tax and the other spouse has no reason to know that the deductions are phony."[21] Deductions were included by requiring that the understatement of tax be attributable to "grossly erroneous items."[22] Grossly erroneous items include omissions of gross income and deductions, credits or basis for which there is no basis in fact or in law.[23]

Congress provided similar, but not identical, innocent spouse relief to married couples who lived together and filed separate returns in community property States.[24] Congress amended Code section 66 to provide that an innocent spouse may not be held liable for tax on community

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[17] Section 101 of the Miscellaneous Revenue Act of 1980, Public Law 96-605.

[18] See supra n. 4.

[19] S. Rept. 96-1036, 96th Cong., 2d Sess. 8 (1980).

[20] See Code section 879.

[21] H.R. Rept. 98-432, 98th Cong., 1st Sess. 201 (1983).

[22] Code section 6013(e)(1)(B).

[23] Code section 6013(e)(2).

[24] The relief granted by the provision enacted in 1980 only applied if the spouses lived apart during the entire calendar year.

income derived from the separate property of the other spouse, if the innocent spouse proves that he or she did not know of, and had no reason to know of, the omitted income and that it would be inequitable to hold the innocent spouse liable for such tax.[25]

Congress also changed the income threshold for innocent spouse relief. Instead of requiring that the omission of income exceed 25 percent of the gross income reported on the return, under present law, the innocent spouse must establish that the understatement of tax exceeds the greater of $500 or a specified percentage of the innocent spouse's adjusted gross income for the preadjustment (most recent) year and is attributable to a grossly erroneous item[26] of the other spouse. The specified percentage of adjusted gross income is 10 percent if adjusted gross income is $20,000 or less. Otherwise, the specified percentage is 25 percent. This change made it easier for an innocent spouse to obtain relief if the other spouse's income was relatively high. Under the original rule, if $100,000 in gross income was reported on the joint return, a spouse with an adjusted gross income of $10,000 when the deficiency was asserted would only be eligible for innocent spouse relief if the omission in income exceeded $25,000. Under present law, the same spouse would be eligible for relief for an omission of $1,000.

Judicial application of the present-law innocent spouse provisions

In general

To qualify for relief, the Code provides that the innocent spouse must establish, by a preponderance of the evidence:[27] (1) that a joint return was made; (2) that an understatement of tax is attributable to a grossly erroneous item of the other spouse; (3) that in signing the return, the innocent spouse did not know, and had no reason to know, that there was an understatement; and (4) taking into account all the facts and circumstances, it is inequitable to hold the innocent spouse liable for the deficiency in tax. The statutory innocent spouse provisions have been considered in hundreds of cases. Not surprisingly, given the inherently subjective and factual nature of certain of the elements, it has been difficult for the courts to apply consistent and objective standards in determining eligibility for innocent spouse relief. In particular, the determinations of whether an item of deduction is grossly erroneous and whether the spouse knew or had reason to know of the substantial understatement have presented difficult factual issues to the courts. With respect to both these elements, the innocent spouse is faced with the

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[25] Code section 66(c), unlike Code section 6013(e), does not require that the omitted income be substantial in proportion to the innocent spouse's gross income.

[26] Grossly erroneous items include items of gross income that are omitted from reported income and claims of deductions, credits, or basis in an amount for which there is no basis in fact or law (Code sec. 6013(e)(2)).

[27] See, Stevens v. Commissioner, 872 F.2d 1499, 1504 (4th Cir. 1989) (holding that the taxpayer seeking innocent spouse relief bears the burden of proving each statutory element by a preponderance of the evidence).

difficult task of proving a negative proposition in order to gain relief.

Grossly erroneous items

While the grossly erroneous standard is a bright line test with respect to omitted income items,[28] with respect to items of deduction, the innocent spouse must prove that the deduction has no basis in law or in fact. The courts have differed widely in defining the evidence that the innocent spouse must produce to meet this burden. The Tax Court held that a spouse had failed to prove that a deduction had no basis in fact or in law by showing that the deduction was disallowed[29] or by showing that the other spouse produced no evidence to substantiate the deduction.[30] On the other hand, some courts have permitted innocent spouse relief with respect to the amount of a deduction even if the claim of deduction had some basis in fact or law.[31]

Knowledge (or reason to know) of the understatement

Courts have applied different standards in determining whether an innocent spouse knew or had reason to know of an omission of income and in determining whether an innocent spouse knew or had reason to know of an erroneous item of deduction. With respect to omitted income, the spouse's knowledge of the transaction giving rise to the omitted income is sufficient to preclude innocent spouse relief.[32] With respect to an erroneous or overstated deduction, the courts have recognized that applying the "knowledge of the transaction" standard would "eviscerate the innocent spouse defense, since merely looking at the tax return informs the spouse of the transaction . . . that gave rise to the deduction."[33] In Price v. Commissioner,[34] the

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[28] The innocent spouse simply must show that the amount of the omitted income exceeds the threshold amounts.

[29] See, e.g., Cohn v. Commissioner, T.C. Memo. 1993-293 (investment loss deductions, though denied, had a factual and legal basis.)

[30] Kaye v. Commissioner, T.C. Memo. 1995-335.

[31] In Ness v. Commissioner, 954 F.2d 1495 (9th Cir. 1992), the court permitted innocent spouse relief with respect to the portion of a lump-sum deduction that was disallowed under the at-risk rules of Code section 465, even though part of the deduction had been allowed. In Shenker v. Commissioner, 804 F.2d 109 (8th Cir. 1986), cert. denied, 481 U.S. 1068 (1987), the court permitted innocent spouse relief with respect to a loss prematurely taken by the husband taxpayer. The loss had a basis in fact, but could not properly be taken until the subsequent year.

[32] Friedman v. Commissioner, 53 F.3d 523 (2d Cir. 1995).

[33] Id. at 530. Cf. Bokum v. Commissioner, 94 T.C. 126, 146 (1990), aff'd on other grounds, 992 F.2d 1132 (11th Cir. 1993) (noting that the statutory language added in 1984 permitting innocent spouse relief for deductions did not "change the old rule that the taxpayer

court applied a four factor test in analyzing whether a "reasonably prudent taxpayer" would have reason to know of the deduction: (1) the spouse's level of education; (2) the spouse's involvement in the business affairs of the family; (3) the presence of unusual or lavish expenditures; and (4) the culpable spouse's deceit or evasiveness. Although most of the circuit courts of appeals have adopted some form of the Price test,[35] they have not applied it in a uniform fashion.[36]

Parameters of innocent spouse relief

It is unclear under present law whether a court may grant partial innocent spouse relief. The Ninth Circuit Court of Appeals in Wiksell v. Commissioner[37] has allowed partial innocent spouse relief where the spouse did not know, and had no reason to know, the magnitude of the understatement of tax, even though the spouse knew that the return may have included some understatement. No innocent spouse relief is available if the amount stated on the return is correct but the tax simply was not paid.[38]

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claiming innocent spouse relief must establish that he or she is unaware of the circumstances that give rise to the error on the tax return, and not merely be unaware of the tax consequences.")

[34] 887 F.2d 959 (9th Cir. 1989).

[35] See Reser v. Commissioner, 97-1 USTC 50,416 (5th Cir.); Resser v. Commissioner, 74 F.3d 1528 (7th Cir. 1996); Kistner v. Commissioner, 18 F.3d 1521 (11th Cir. 1994); Hayman v. Commissioner, 992 F.2d 1256 (2d Cir. 1993); Erdahl v. Commissioner, 930 F.2d 585 (8th Cir. 1991).

[36] For example, the courts have widely differed in their analysis of the education level of the innocent spouse. In Bliss v. Commissioner, 59 F.3d 374 (2d Cir. 1995), the court denied innocent spouse relief to a spouse that had not finished high school, noting that even taxpayers without a high school diploma should know that taxes are paid on income. In another case, Robertson v. Commissioner, T.C. Memo. 1992-32, the court granted innocent spouse relief to a spouse with multiple college degrees, noting that specialization in liberal arts did not give the innocent spouse sufficient knowledge to question the culpable spouse's financial decisions.

[37] 90 F.3d 1459 (9th Cir. 1997).

[38] See United States v. Bingham, 78-1 USTC 9368 (D. Conn).

III. DESCRIPTION OF PROPOSALS

A. H.R. 2676[39]

The House bill generally makes innocent spouse status easier to obtain. The bill eliminates all of the understatement thresholds and requires only that the understatement of tax be attributable to an erroneous (and not just a grossly erroneous) item of the other spouse.

The House bill provides that innocent spouse relief may be provided on an apportioned basis. That is, the spouse may be relieved of liability as an innocent spouse to the extent the liability is attributable to the portion of an understatement of tax which such spouse did not know of and had no reason to know of.

The House bill specifically provides that the Tax Court has jurisdiction to review any denial (or failure to rule) by the Secretary regarding an application for innocent spouse relief. The Tax Court may order refunds as appropriate where it determines the spouse qualifies for relief and an overpayment exists as a result of the innocent spouse qualifying for such relief. The taxpayer must file his or her petition for review with the Tax Court during the 90-day period that begins on the earlier of (1) 6 months after the date the taxpayer filed his or her claim for innocent spouse relief with the Secretary or (2) the date a notice denying innocent spouse relief was mailed by the Secretary. Except for termination and jeopardy assessments (secs. 6851, 6861), the Secretary may not levy or proceed in court to collect any tax from a taxpayer claiming innocent spouse status with regard to such tax until the expiration of the 90-day period in which such taxpayer may petition the Tax Court or, if the Tax Court considers such petition, before the decision of the Tax Court has become final. The running of the statute of limitations is suspended in such situations with respect to the spouse claiming innocent spouse status.

The House bill also requires the Secretary of the Treasury to develop a separate form with instructions for taxpayers to use in applying for innocent spouse relief within 180 days from the date of enactment. An innocent spouse seeking relief under this provision must claim innocent spouse status with regard to any assessment not later than two years after the date of such assessment.

Effective date: The provision is effective for understatements with respect to taxable years beginning after the date of enactment.

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[39] Section 321 of H.R. 2676 (the "Internal Revenue Service Restructuring and Reform Act of 1997"), passed by the House of Representatives on November 5, 1997.

B. American Bar Association Proposal

Summary

Rather than reform the present-law innocent spouse provision, the American Bar Association ("ABA") proposes its replacement with a system based on separate liability.[40] Liability for deficiencies determined after a joint return is filed would be allocated to the spouse to whom the item of income and expense giving rise to the deficiency is apportionable. Liability for the tax shown on the joint return would be apportioned between the spouses in proportion to what would have been their relative tax liabilities, had each filed a separate return reporting his or her apportionable share of any item of income, expense or credit.

The separate liability system proposed by the ABA would determine which spouse is ultimately responsible for the payment of taxes owed. It would not change the combined liability of a married couple filing a joint return, and it could not be used to increase or initiate a refund of taxes previously paid.

Allocation of deficiencies

The issue of joint and several liability frequently arises where the IRS asserts a deficiency against a couple who filed a joint return. Generally, the ABA proposal would impose liability for the deficiency on the spouse to whom the item of income or expense giving rise to the deficiency is apportionable. Where the deficiency arises as a result of an item of expense, the amount of the deficiency allocated to the spouse to whom the expense is apportionable is limited to the extent that income apportioned to such spouse was offset by the deduction. This limits the separate liability of the spouse to the amount of separate tax benefit he or she originally received from the disallowed deduction.[41]

Apportionment of items of income and expense would follow the apportionment rules of

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[40] The American Bar Association proposal is more fully described in its Legislative Recommendation LEG-9206-012, adopted by its House of Delegates in February, 1995. This discussion is based on the proposed statutory language included in that document, as explained by the language of the recommendation.

[41] For example, assume that a married couple has wage income of $200,000 apportionable to the wife, and $10,000 of interest and dividends apportionable to both spouses equally. On examination, a $20,000 charitable contribution nominally apportionable to the husband is disallowed. Under the proposal, only $5,000 of the disallowed deduction is apportionable to the husband, since that is the amount that would fully offset the income apportionable to him. The remaining $15,000 of the charitable deduction offset income apportioned to the wife, and is accordingly apportioned to her.

present law.[42] The Secretary of the Treasury would be authorized to establish simplified apportionment methods.

The apportionment of items of income under present law generally follows the source of the income. Wage income is apportioned to the spouse who holds the job and receives the W-2. Business and investment income (including any capital gains) is apportioned according to the ownership of the business or investment that produces the income. Where ownership of the business or investment is held by both spouses as joint tenants, it is expected that any income would be apportioned equally to each spouse, even if one spouse operated the business or received the income.

The apportionment of deductions and expenses under present law is less clear. Business expenses will be apportioned according to the ownership of the business in the same manner as business income. Items of personal deduction may be equally divided between spouses, but may also be apportioned to the spouse whose funds are used to make the payment in certain circumstances. Certain items, such as interest and taxes, may be apportioned to the spouse who is liable for the obligation without regard to which spouse makes the payment or from whose funds the payment is made.

The exemption for dependents is generally allowed only to the spouse who provides over one-half of the dependent's support for the year. In the case of a married couple living together this may be difficult to determine. Credits related to dependents, such as the child tax credit or the dependent care credit, would presumably be apportioned in the same manner as the dependent's exemption.

Allocation of tax shown on a return

The ABA proposal also provides for the application of the separate liability system to a joint return as filed.[43] In this case, the liability of each spouse would be determined by the ratio of their liabilities as if each had filed a separate return of a married individual. Taxpayers would bear the burden of proving the liability of each spouse.

As refunds are only payable to the extent an overpayment on the joint return exists, the

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[42] The proposed statutory language included in the ABA document specifically references the apportionment rules in section 861 (determination of income from sources within the United States) and the regulations thereunder. However, discussion elsewhere in the document suggests that a broader resort to present law may be anticipated.

[43] Explanatory material included in the ABA document suggest that application of the separate liability system to returns as filed is elective. However, the proposed statutory language does not provide for an election, and appears to make application of the separate liability system mandatory.

separate liability system would not create a refund or increase the amount of a refund that would otherwise be allowed. However, the separate liability system could result in a refund being directed to a particular spouse. The separate liability system would also determine which spouse is ultimately liable for any amount shown as due on the return that is not paid with the return.[44]

Community property issues

The ABA proposal also would overrule the decision in Poe v. Seaborn,[45] which holds that one-half of the earned community income of each spouse is taxable to the nonearning spouse. Under the proposal, items of income and deductions generally would be apportioned between spouses under rules similar to the allocation rules of section 879(a), which determine the treatment of community income of nonresident alien individuals. In general, items of income and deduction would be apportioned under the general rules without regard to a taxpayer's status as the resident of a community property State. For the purpose of apportioning these items, the

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[44] The operation of the separate liability system can be demonstrated by the following multi-step example for a married couple filing a joint return:

(A) Taxes per joint return			$15,000
Withholding			
	Husband	$9,000	
	Wife	5,000	14,000
Taxes owed on joint return			$1,000

(B) Taxes if separate returns had been filed:

Husband	$12,000
Wife	4,000
Total	$16,000

(C) The liability of each spouse is computed as follows:

Husband:	$12,000/$16,000 times $15,000 =	$11,250
Wife:	$4,000/$16,000 times $15,000 =	$3,750

If the $1,000 is not paid with the return, it would be the liability of the husband, since the wife's withholding has already exceeded her separate liability by $1,250. However, the wife is not able to claim a refund of the over withheld amount, since no refund is due on the joint return.

[45] See supra, n. 4.

ownership of property would be determined without regard to community property rules. Thus, for example, income earned on investment property that is held in the husband's name presumably would be apportioned to the husband, even if the investment property had been purchased with community funds and is considered to be community property under State law.