VALUATION OBSERVATIONS

Some practical observations from a practicing business appraiser.

VLC

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Vol. 8, No. 1

ALLOCATION OF TAX REFUNDS

Property settlement agreements often state which party will be responsible for paying any unpaid income tax liabilities and which party will receive any tax refunds with respect to prior and future year joint returns. These allocations are binding on the parties but not the IRS. Parties to a joint tax return are joint and severally liable, and therefore, the IRS may seek payment of income tax liabilities from either party, regardless of the property settlement terms. A problem can also arise with respect to attempted allocation of refunds.

Although taxpayers filing joint returns are jointly and severally liable for the tax on the return, each taxpayer has a separate interest in any overpayment (e.g., refunds, overpaid tax from a prior year carried over to apply to taxes owed in the current year). Consequently, if either spouse has an unpaid separate tax liability from another year (or a separate debt to which a tax refund can be applied, such as a federal student loan), the IRS can apply the debtor's share of the overpayment to such liability, but not the other spouse's share.

According to the IRS, each spouse's interest in a refund or other overpayment is determined as follows:

Step One: Determine each spouse's allocable percentage of the joint tax liability on the return by multiplying the joint tax liability by a "separate tax" fraction as follows: (1) Tax had the spouse filed a separate return computed using married filing separately rates; over (2) the sum of H's separate tax liability plus W's separate tax liability.

Step Two: A spouse's share of a joint refund or other overpayment is determined by subtracting that spouse's percentage of the joint tax liability as figured in Step One above, from his or her actual contributions toward the payment of the joint liability. A spouse's contributions include his or her withholding and earned income credits, and any individual estimated tax payments for the taxable year. If the parties filed a joint declaration of estimated tax and/or made a tax payment with a joint return, they may agree on the allocation of the payment. But, in the absence of an agreement and/or "clear and convincing evidence as to each spouse's actual contribution," the IRS will apply the parties' separate tax filing ratio to the payment to determine the allocation. The IRS has also ruled that a refund attributable to a taxpayer's separate net operating loss (NOL) which carried forward or back to a year in which he or she filed a joint return is apportionable under the separate tax filing formula, with the NOL solely applied to reduce the business owner's separate tax liability under the formula.

In *Hathoway v. U.S.,* 93-1 USTC, a couple's tax liability was not readily apportionable and it was impossible to discern which portion of the tax liability refund was attributable to the taxpayer. The resulting refund was allocated one-half to the taxpayer and one-half to the spouse.

In *U.S. v. Elam*, 112 F.3d 1036 (9th Cir. 1997), a prenuptial agreement was held valid, which characterized funds that were used to generate the overpayment in question as husband's separate property. The Tax Court found this relevant in determining to whom an overpayment credit on a joint return is allocable.

If the IRS applies one spouse's overpayment to the separate debt of the other spouse, the non-debtor spouse can recover his or her share of the refund erroneously applied to the other spouse's debt by filing an amended return for the taxable year in question with IRS Form 8379, *Injured Spouse Claim and Allocation.*

If you would like additional information, or have a question, please do not hesitate to call.

Very truly yours,

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Terri Lastovka is the founder of Valuation & Litigation Consulting, LLC. Her practice focuses on business valuations and litigation consulting in the areas of domestic relations, gift and estate tax, probate, shareholder disputes, economic damages, and forensic accounting. She draws from a wide range of experiences, including public accounting, law, banking, and CFO. She has received extensive training from the American Society of Appraisers in the area of business valuation and works closely with members of the bar to effectuate practical settlements. Terri also serves as the Director of Legal & Finance for Journey of Hope, a grass roots non-profit organization providing financial support to cancer survivors.