Marital Property, Taxation, and Estate Planning in Wisconsin

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by

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With the Assistance of

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Foreword

The University of Wisconsin Law School is pleased to publish *Marital Property, Taxation, and Estate Planning in Wisconsin* written by a distinguished member of its faculty, Professor Howard S. Erlanger. Howard's interest in writing this book and other material on Wisconsin's Marital Property Act is a clear demonstration of the continued vitality of the Wisconsin Idea.

The book also benefits from the practical experience of Faye A. Patzner and Kimberly A. Reinecke, two Wisconsin attorneys and Law School alumni, who assisted Professor Erlanger. The result is a basic, practice-oriented book that highlights problems, suggests solutions, and proposes valuable planning techniques and strategies.

We are proud that this publication will join the growing body of professional literature assisting Wisconsin lawyers in understanding the many changes in practice, both subtle and significant, created by the Marital Property Act.

Several individuals from the Law School participated in publishing this book. Sheri Humphrey coordinated the project and provided editorial assistance. Roger Bruesewitz handled the technical editing responsibilities and coordinated printing. Joanne Breunig formatted the manuscript and typeset the camera copy.

February 1991

David E. Schultz
Associate Dean
University of Wisconsin Law School

Introduction

This publication is a general introduction to taxation of marital property in the estate planning context in Wisconsin. It is intended for the general practitioner and nontax specialist, as well as for the lawyer who may be familiar with tax principles but not with marital property rules. The goals of this book are to:

> (1) Identify the tax issues that are likely to arise in routine estate planning for married persons;[1]
> (2) Indicate the likely resolution of these issues, especially in those situations where the result is fairly predictable; and
> (3) Indicate sources of additional information concerning the more complex topics and those issues where the resolution is unclear.

As a result, this book is not intended to supplant existing sources of information but instead serves as an introduction to them, hopefully making those other sources more accessible. By far the most important reference source is the State Bar of Wisconsin CLE publication, *Marital Property Law in Wisconsin* (by Christiansen, Haberman, Haydon, Kinnamon, McGarity, and Wilcox), which is frequently referred to in the footnotes, using the unpronounceable acronym MPLW. Persons consulting that source should be certain that their copy includes all updates. Chapters 10 (Estate Planning), 9 (Income and Transfer Taxes), and 7 (Marriage Agreements) of that multivolume set are the most relevant to the tax context. Readers unfamiliar with marital property law in Wisconsin will find a comprehensive treatment of the central issues in chapter 2 (Classification of Property) of *Marital Property Law in Wisconsin*. Introductory and summary treatments of marital property law may be found in Langer's and Roberson's publication, *A Guide to Property Classification Under Wisconsin's Marital Property Act* (State Bar of Wisconsin CLE, 1986),[2] and in Weisberger and Meuer, *A Marital Property Handbook* (Center for Public Representation [Madison, Wisconsin], 2d ed., 1989).[3] An overview of Wisconsin law in the context of

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[1] One topic that may not be routine, but that nonetheless arises with some frequency, is that of the buy-sell agreement among principals in a closely held business. Estate planning involving buy-sell agreements is beyond the scope of this book but is discussed in some detail in MPLW §§ 4.53 and 10.31.

[2] Note that the Langer and Roberson volume predates the Trailer Bill II (1987 Act 393) revisions of the Marital Property Act.

[3] Early articles concerning estate planning issues under the Marital Property Act which are still useful include George A. Dionisopoulos, *The Wisconsin Marital Property Law and Its Effect on Estate Planning*, 13 COMMUNITY PROP. J. 62-91 (1986), and Carl J. Rasmussen, *The Sexual*

other community property states may be found in Mennell and Boykoff, *Community Property in a Nutshell* (West Publishing Co., 1988).

Citations to the Wisconsin Marital Property Act are to the original Act passed in 1984 (1983 Act 186) as amended in 1985 by Trailer Bill I (1985 Act 37) and in 1988 by Trailer Bill II (1987 Act 393). Citations are current through June 30, 1990.

Citations to statutory notes to Trailer Bills I and II, and to notes to the Uniform Marital Property Act, have the following status as authority:

(a) There are no legislative notes to the original Wisconsin Marital Property Act (1983 Act 186). However, much of the Wisconsin Act is based on the Uniform Marital Property Act. Hence, for each section of the Wisconsin Act, one can check the corresponding section of the Uniform Act; if the provisions are the same, then the comments to the Uniform Act are relevant for interpretation of the Wisconsin Act.

(b) For Trailer Bill I (1985 Act 37), there are two sets of extensive notes created by the Legislative Council Committee that drafted the statute. One set was completed before the Act was passed, and these notes were enacted by the legislature as part of the statute. Some of these notes were included by the Revisor of the Statutes in the published version of the statutes. However, the enacted notes that were published have no special legal status compared to those that were not.

(c) The second set of notes to Trailer Bill I (1985 Act 37) — referred to as Supplementary Notes — was prepared by the same group that prepared the first set, but the notes were not completed until after the Act was passed. The Supplementary Notes were voted on and approved by the Legislative Council Committee but not by the legislature. Hence, while they are important indicators of legislative intent, they do not have the same official status as the enacted notes.

(d) For Trailer Bill II (1987 Act 393), there are extensive notes, including a long prefatory note, prepared by the Legislative Council Committee and enacted by the legislature.

Finally, readers should bear in mind that marital property can only be created while the Marital Property Act applies to a marriage, *i.e.*, those periods after December 31, 1985, during which both spouses are domiciled in the state.

Politics of Estate Planning in Wisconsin: An Introduction to the Marital Property Act, 21 REAL PROP., PROB., AND TR. J. 485-512 (1986). *See also* Howard S. Erlanger, Barbara S. Hughes, and June Miller Weisberger, *Estate Planning under Wisconsin's Marital Property Act, For Happily Married Clients with an Intact Family and Typical Assets*, WIS. BAR BULL., February 1986, p. 14 ff.

See Wis. Stat. §§ 766.01(5), 766.01(8), 766.03, as revised by Trailer Bill II.[4] Once marital property rights are created, the fact that the Act may no longer apply to the marriage does not in itself affect these rights. Wis. Stat. § 766.03(3).

This book represents an attempt to analyze and organize a complex subject. It is designed to be helpful to the practitioner but is not and cannot be considered a replacement for analysis of statutes and case law in the context of a specific fact situation. Although we have attempted to ensure accuracy, this book is not a substitute for individual professional judgment. The authors and publisher disclaim any liability for any direct, indirect, inadvertent, or consequential damages resulting from the use or misuse of this book.

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[4] For the period beginning January 1, 1986 (the effective date of the original Act) and ending with May 3, 1988 (the effective date of Trailer Bill II), it is unclear whether one spouse's domicile in Wisconsin was sufficient to trigger application of the Act. *See also* Wis. Stat. § 766.03(5).

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Authors

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1
Income Tax Basis

§ 1.1 General Rule
§ 1.2 Adjustment or No Adjustment
§ 1.3 Joint Tenancy and Tenancy in Common
§ 1.4 Survivorship Marital Property
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§ 1.6 Deferred Marital Property
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§ 1.8 Income in Respect of a Decedent (IRD)
§ 1.9 Partnership Interests
§ 1.10 Depreciation of Former Marital Property Following Death

"Basis" is the starting point for the determination of gain or loss for income tax purposes, upon disposition of an asset. Thus, other things being equal, a taxpayer will prefer as high a basis as possible. Basis adjustment is discussed in detail at *Marital Property Law in Wisconsin* § 9.16.

§ 1.1 GENERAL RULE

In general, a taxpayer's basis in an asset is his or her cost. However, various actions or events can result in an adjustment to basis; in the estate planning context, the most important of these is the death of the owner. Under I.R.C. § 1014(a), property owned by a decedent receives a new basis[5] equal to its properly includable[6] value for estate tax purposes under I.R.C. §§ 2031 (definition of gross estate), 2032 (alternate valuation), or 2032A (valuation of

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[5] The new basis rule is very often mischaracterized as one that provides for "stepped up basis." This mischaracterization results from the assumption that the property has a fair market value in excess of its basis, an assumption that all too many investors realize is unwarranted. The new basis rule is not limited to "step ups"; it can also lead to a "step down." *See also* discussion below.

[6] We use the term "properly includable" rather than "reported" to reflect the possibilities that no return may actually be due; that if a return is filed, it may be amended or changed on audit; or that the value for death tax purposes could be challenged for income tax purposes, when the asset is ultimately disposed of.

certain real property). I.R.C. § 1014(b)(6) extends this rule to provide a new basis for both halves of community property, if at least half the "community interest" was includable in the decedent's gross estate for tax purposes. *For federal tax purposes, Wisconsin's marital property is a form of community property.* Rev. Rul. 87-13, 1987-1 C.B. 20.[7] (All revenue rulings cited in the text are reproduced in Appendix B.) Community property assets held in a revocable trust by either or both spouses are entitled to the full adjustment. Rev. Rul. 66-283, 1966-2 C.B. 297. Neither the filing of an estate tax return nor the payment of federal estate tax is a prerequisite to obtaining new basis at death; application of the rule is "automatic." Treas. Reg. § 1.1014-2(a)(5) (1957).

> *Example:* Spouses A and B own marital property with a basis of $80,000. At A's death, the fair market value of the property is $100,000; A's one-half interest is includable in A's gross estate at a value of $50,000 under I.R.C. §§ 2031 and 2033. The new basis for A's one-half interest (now owned by A's estate) is $50,000, and the basis for B's one-half interest is now $50,000 as well. There has been a "double step up" in basis.
>
> *Example:* If, in the preceding example, the property were worth $60,000 at A's death, and $30,000 were includable in A's gross estate, then the new basis for A's one-half interest and B's one-half interest would be $30,000 each. In this case, there would be a "double step down" in basis.

It should be noted that I.R.C. § 1223(11) contains a companion rule to the general rule on the holding period of assets acquired from a decedent. Under that provision, both halves of community property receiving a basis adjustment under I.R.C. § 1014(b)(6) are given long-term capital gain treatment — to the extent that treatment is available[8] — regardless of whether the surviving spouse sells the property before the usual holding period has elapsed.

Wisconsin follows the federal rule and provides for a full adjustment in basis for both spouses' share of marital property if one-half is includable for purposes of computing the federal estate tax. Wis. Stat. § 71.05(10)(e) [originally numbered 71.05(1)(g)].[9] However, in certain circumstances, the valuation for

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7. This revenue ruling has some technical errors regarding Wisconsin marital property law, but those errors do not affect the holding reported in the text.

8. As of 1990, the I.R.C. does not provide for special treatment of capital gains, but Wisconsin taxes only 40% of the gain.

9. Citations to Chapter 71 of the Wisconsin statutes refer to the revised numbering system

federal purposes may be different. For example, Wisconsin values all property as of the date of death; Wisconsin has no parallel provisions to I.R.C. § 2032 (alternate valuation) or § 2032A (valuation of certain real property). *Despite these differences, there is an overriding similarity between federal and Wisconsin tax law in this area,*[10] *and the remainder of this book does not generally distinguish between the two bodies of law.* Where a significant divergence exists, it is specifically noted.

§ 1.2 ADJUSTMENT OR NO ADJUSTMENT

The double adjustment in basis is advantageous where the property's fair market value is greater than its basis (*i.e.*, property on which the owner has a taxable gain) and disadvantageous where its value is less than its basis (*i.e.*, property where the owner has a loss which may be deductible). Thus, by entering into a marital property agreement which reclassifies property, spouses can take advantage of the double adjustment for gain property by classifying such property as marital property. On the other hand, they can avoid the double adjustment for loss property by classifying such property as the individual property of the spouse expected to be the survivor.

> *Example:* Spouse A owns a cabin which A inherited and is therefore A's individual property. The cabin's basis is $25,000, but its value is $75,000. If A dies, the cabin will get a new basis of $75,000 because it will be included in A's gross estate. However, if B dies, the cabin will not get a basis adjustment since B has no interest in it. If, on the other hand, A reclassifies the cabin as marital property, it will receive a new basis on the death of either A or B, subject to the "gifts within one year of death" rule discussed below.
>
> *Example:* Spouses A and B purchased a cabin in 1986 for $75,000 and hold it as survivorship marital property. In 1989, B becomes terminally ill and A plans to sell the cabin after B's death. The cabin has decreased in value to $25,000. If B dies, the cabin's basis will fall to $25,000. If A and B reclassify the property as A's individual property prior to B's death, then the cabin will retain its $75,000 basis in A's hands. This will be advantageous if the cabin appreciates in value after B's death or if a loss on the sale is deductible under I.R.C. § 165(c).

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as affected by 1987 Wisconsin Act 312 and other acts of the 1987-88 Wisconsin Legislature, effective January 1, 1989.

[10] Some of the differences between Wisconsin and federal tax treatment are a function of the Wisconsin inheritance tax, which will be repealed as of January 1, 1992.

§ 1.3 JOINT TENANCY AND TENANCY IN COMMON

Only community property receives a new basis in both halves of the property; joint tenancies and tenancies in common, even when they are solely between spouses, do *not* qualify for a full basis adjustment. Instead, that property qualifies for a basis adjustment only on the portion properly includable for death tax purposes, which in the case of spouses will be one-half the value of the property.

> *Example:* Spouses A and B own property which has been titled in joint tenancy since 1980. It has a basis of $80,000. At A's death, the property is worth $100,000. A's one-half interest is includable in A's gross estate at a value of $50,000 under I.R.C. §§ 2031 and 2040(b). The new basis for A's one-half interest is $50,000. The basis for B's one-half remains at $40,000. There is no "double step up" in basis; the new basis in the property at A's death is $90,000.

Under certain circumstances, if title is held in joint tenancy or tenancy in common, but the spouses intend to hold the property as community property, it may be possible for both halves to receive new basis. *See, e.g.*, Rev. Rul. 87-98, 1987-39 I.R.B. 15. The key issue is whether the property is community (marital) property under local law.[11]

In the future, there will be far fewer joint tenancies and tenancies in common between spouses in Wisconsin than in other community property states. This is because the marital property law provides that if a document of title, instrument of transfer, or bill of sale expresses an intent to establish a joint tenancy exclusively between spouses *after* the determination date,[12] the property is survivorship marital property; similarly, if the document of acquisition indicates an intent to create a tenancy in common exclusively between spouses *after* the determination date, the property is marital property. Wis. Stat. § 766.60(4)(b)1. Similarly, if a third party attempts to create a joint

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[11] When residents of a community property state purchase real estate in a noncommunity property state, or when they migrate to a noncommunity property state, the community property interest in property should remain intact, but there can be issue as to the "nature of that interest under local law. The resolution of that issue can affect the application of I.R.C. § 1014(b)(6). *See* Gary C. Randall, *Of Visigoths, Community Property, Death, and Income Tax Basis*, 25 GONZAGA L. REV. 237-52 (1989-90).

[12] The determination date is the date that Wisconsin marital property law first applies to the marriage. Wis. Stat. § 766.01(5). Presumably, the rules discussed in this paragraph would not apply if the attempted creation of a joint tenancy or tenancy in common took place after the determination date but not during a period in which the Act applied to the marriage. *See* Wis. Stat. §§ 766.01(8) and 766.03(2).

tenancy or tenancy in common exclusively between spouses by gift after the determination date, the property will instead be survivorship marital property or marital property unless the donor provides otherwise. Wis. Stat. § 766.60(4)(b)2. In these instances, the statute, and not the document, controls. If spouses wish to have the incidents of traditional joint tenancy or tenancy in common govern, regardless of the classification of the property, it appears that they may so provide by marital property agreement.[13] Such an agreement should specifically countermand Wis. Stat. § 766.60(4)(b)1, and the property should be titled in accordance with the intended form of holding.[14] *However*, it is not clear whether a joint tenancy created by marital property agreement changes the rights of creditors who do not have notice of the agreement. *See Marital Property Law in Wisconsin* § 2.123d.

Once created, joint tenancies and tenancies in common between spouses retain their character under the Act. Wis. Stat. § 766.60(4)(a). Thus, spouses who hold property in joint tenancy or tenancy in common and who want the double adjustment of I.R.C. § 1014(b)(6) to apply should reclassify the property as marital property or survivorship marital property, using one of the methods described in Wis. Stat. § 766.31(10).[15] As long as the reclassification is valid

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[13] Supplemental Committee Note, 1985 Act 37, at Wis. Stat. § 766.60(4)(b). (For a discussion of the authoritative status of Supplemental Committee Notes, *see* page xii, *supra*.) *See also* the provisions of the statutory terminable individual property agreement, Wis. Stat. § 766.589(1)(c).

[14] For example, the document of title might read ". . . as joint tenants and not as survivorship marital property."

Caution. In most cases, reclassification of property will constitute a transfer between the spouses for little or no consideration, and thus not be subject to transfer tax if a deed is recorded. However, it is possible for some transfers to be construed as involving substantial consideration if, for example, each spouse gives up individual property as part of a coordinated plan. In this case, it is possible that a transfer tax would be assessed, and spouses may be better off if they effectuate reclassification of real property by marital property agreement, without recording title.

[15] Merely retitling an asset may not be sufficient. For example, retitling from the name of one spouse to those of both spouses as marital property may be an intended reclassification by gift, but the gift may not be effective without delivery. However, retitling by a conveyance signed by both spouses will be sufficient. Wis. Stat. § 766.31(10), as amended by Trailer Bill II.

In addition, there is some disagreement as to whether survivorship marital property can be created without retitling. If, for example, there is an attempt to create survivorship marital property through use of a marital property agreement, but the title is not changed, it is possible that there is a reclassification, but that the survivorship right is either unenforceable (unlikely in the writers' view) or enforceable only as a contractual obligation under the agreement, pursuant to Wis. Stat. § 766.58(3)(f). This has important consequences for the rights of creditors at the death of one spouse, because survivorship marital property is

under state law, it should be valid for tax purposes as well. *See United States v. Pierotti*, 154 F.2d 758 (9th Cir. 1946), and Rev. Rul. 87-98, 1987-39 I.R.B. 15.

In some circumstances, a joint tenancy or tenancy in common may be said to "contain" marital property. This might occur when, for example, the principal balance on a mortgage taken out before the determination date is reduced using marital property, and the marital property component can be traced. There is some dispute as to whether, upon the death of one co-tenant, the basis is determined solely by the ordinary nonmarital property rules, or whether the marital property component of the asset receives a double adjustment.[16] With respect to joint tenancies, a Supplemental Committee Note to Wis. Stat. Ch. 71 states that:

> Each half of the marital property component of a property owned exclusively by the spouses in joint tenancy receives a basis adjusted to the date of death value. Otherwise, only the decedent's share of the nonmarital property component of such a joint tenancy receives an adjusted basis. Wis. Stat. § 71.05(1)(g) [subsequently renumbered 71.05(10)(e)] Supplemental Committee Notes at Ch. 37, Laws of 1985.

In accordance with this Supplemental Note, an early statement by the Wisconsin Department of Revenue (DOR) called for a double basis adjustment for the marital property component of joint tenancies and tenancies in common, pending a contrary ruling by the IRS. Department of Revenue Position Paper, "Basis Adjustment for Marital Property," October 2, 1986. (This publication is reproduced in Appendix A.) However, since then, the IRS has taken the position that, "under Wis. Stat. 766.60, property held in the common law estates of joint tenancy or tenancy in common is not marital property" except in certain limited circumstances,[17] which do not include the existence of a marital

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generally exempt from the claims of unsecured creditors, while a marital property agreement will not affect the property available for satisfaction of obligations at death. Wis. Stat. §§ 766.55(4m), 859.18(4).

Finally, it is possible that if a joint tenancy is reclassified as "marital property" by agreement, the survivorship feature and the protection against unsecured creditors at death will be lost.

16. The existence of a marital property component in a common law form of property ownership is a special case of the problem of *mixed property*, which is discussed in more detail below.

17. The "limited circumstances stated in the *Newsletter* include post-1985 attempts to create a joint tenancy or tenancy in common between spouses (which in any case do not result in

property component. *Tax Practitioner Newsletter*, IRS Milwaukee District, April 1988, p. A-4. (This *Newsletter* is reproduced in Appendix A.) The Department of Revenue has therefore withdrawn its provisional position and announced that it will follow the IRS position. The Department of Revenue reads the IRS position to be that, if an item is titled in joint tenancy (and is not survivorship marital property pursuant to Wis. Stat. § 766.60(4) to (6)) then, if the title is not changed, the only way the item can be marital property is by marital property agreement, and apparently such an agreement must reclassify "the whole of joint tenancy or tenancy in common," not just a component.[18] A similar situation exists with respect to tenancy in common. Department of Revenue, "Department of Revenue Updates — Marital Property Positions," October 20, 1988, pp. A-81 to A-83. *See also* Department of Revenue, Wisconsin Tax Bulletin #60, April 1989, pp. A-90 and A-91, and Department of Revenue, "Federal and Wisconsin Income Tax Reporting Under the Marital Property Act," Department of Revenue Publication 113, November 1990, p. A-65. (The three above publications are reproduced in Appendix A.)

At this time, it is not possible to predict the ultimate resolution of these issues. Prior to the Act, most married couples titled their home (and possibly other real estate) in joint tenancy and most of these properties either were subject to substantial mortgages or will be subject to substantial mortgages in the future. Since these mortgages will generally be paid off using marital property, over the years the marital property component will become significant. If there is also inflation in the value of these properties, there will likely be litigation on the basis issue. Using the above cited Supplemental Committee Note to Wis. Stat. § 71.05(1)(g) as authority, an argument can be made that the Department of Revenue should recognize a marital property component in joint tenancies (and implicitly in tenancies in common) for purposes of income tax basis. Moreover, if the Supplemental Committee Note can be construed as reflecting the legislature's view of Wisconsin property law, then the IRS also

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property being held in a "common law estate" because of the operation of Wis. Stat. § 766.60(4)(b)) and deferred marital property (which is erroneously included).

Because the *Newsletter* (now renamed *Tax News Quarterly*) is only intended as an informational bulletin, the positions stated there are not well-developed or documented and are not necessarily binding on the IRS. In addition, some of the positions regarding taxation of marital property have been unclear, and some statements of Wisconsin law have been incorrect.

[18] The IRS, and thus the Department of Revenue, apparently also will not recognize for tax purposes the reclassification of a joint tenancy or tenancy in common under the "mixing" rule of Wis. Stat. § 766.63(1) or the "active appreciation" rule of Wis. Stat. § 766.63(2).

may be obligated to recognize the marital property component, because of the statement in Rev. Rul. 87-98 (cited above) that federal taxation follows the classification of property under state law. Given this morass, from a planning point of view, there is no question that the best procedure is to reclassify a joint tenancy or tenancy in common if it does not reflect the classification or tax treatment desired by the spouses.

Some of the difficult issues regarding the addition of marital property to a joint tenancy or tenancy in common between the spouses are discussed in *Marital Property Law in Wisconsin* §§ 2.123a-b, 3.24, 9.16d(1), and 10.50. Note that as of June 1990, the *Marital Property Law in Wisconsin* sections cited do not deal with the IRS and Department of Revenue publications cited in the discussion here.

§ 1.4 SURVIVORSHIP MARITAL PROPERTY

Some practitioners have expressed concern about the status of survivorship marital property under I.R.C. § 1014(b)(6) because its survivorship feature is similar to that of common law joint tenancy. However, the director of the Milwaukee District of the IRS has stated that "[b]ased on advice received from the National Office, survivorship marital property will definitely be considered community property for federal income tax basis purposes." *Tax Practitioner Newsletter*, IRS Milwaukee District, April 1988, p. A-3. The Department of Revenue has also adopted this position. Department of Revenue, "Department of Revenue Updates — Marital Property Positions," October 20, 1988, p. A-80. *See also* Department of Revenue, Wisconsin Tax Bulletin #60, April 1989, p. A-90.

§ 1.5 MIXED PROPERTY

"Mixed property" (which is not a separate classification of property under the Marital Property Act) refers to the situation in which marital property has been commingled with nonmarital property, *i.e.*, individual property or property acquired during a period in which the Act did not apply to the marriage. There are many ways by which this commingling could occur; these include the use of marital property to reduce a mortgage or to fund additions or improvements, as well as application of the "active appreciation" rule of Wis. Stat. § 766.63(2). Under Wis. Stat. § 766.63(1), the nonmarital component of mixed property is reclassified as marital property, unless it can be traced.

The IRS appears willing to recognize a marital property component (and probably a reclassification of the entire asset if the nonmarital property

component cannot be traced) for tax purposes in those situations where *one spouse* is the titled owner, and neither the other spouse nor a third party is a co-owner.[19] *Tax Practitioner Newsletter*, IRS Milwaukee District, April 1988, p. A-4, as interpreted by the Department of Revenue in "Department of Revenue Updates — Marital Property Positions," October 20, 1988, pp. A-83 and A-84.[20] *See also* Department of Revenue, Wisconsin Tax Bulletin #60, April 1989, p. A-90.

Recognition of a marital property component or reclassification of the entire asset is, of course, important when the property has appreciated and a double adjustment to basis is desired under I.R.C. § 1014(b)(6). When the adjustment is sought for a marital property *component*, rather than for the entire commingled asset, a separate issue is the allocation of the appreciation between the marital and nonmarital components. This allocation seems to be an issue of state property law; Wisconsin does not as yet have an allocation principle, but the experience of other community states, as well as the Wisconsin experience in the divorce context, will presumably be used by the courts to develop one. *See Marital Property Law in Wisconsin*, Ch. 3, *especially* §§ 3.23, 3.25.

§ 1.6 DEFERRED MARITAL PROPERTY

Deferred marital property is property which would have been marital property had the Act applied when the property was acquired. Wis. Stat. § 851.055. When a spouse dies owning property which is determined to be deferred marital property, that spouse had full ownership interest at the time of death. Wis. Stat. § 766.31(8). Accordingly, the full interest of the decedent is included in his or her gross estate for tax purposes and therefore receives a full new ("stepped up" or "stepped down") basis under the standard new basis rule, I.R.C. § 1014(a).

Rights to deferred marital property are nonreciprocal; the decedent spouse's estate has no rights to or claims against the survivor's property that would have been marital property had the Act applied when it was acquired. *See* Wis. Stat. § 861.02 (including Legislative Council Note at Ch. 37, Laws of 1985) and Wis. Stat. § 861.03. Therefore, there is no mechanism to trigger the

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19. *See* discussion of joint tenancy and tenancy in common in book § 1.3.

20. The IRS position stated in the *Newsletter* is unclear and contains several errors, including an irrelevant reference to the augmented marital property estate election under Wis. Stat. § 861.03, a reference to "separate" rather than "individual" property, failure to refer to nonmarital property other than individual property, and a reference to labor by the "nontitle" spouse rather than either spouse as the trigger for the active appreciation rule.

applicability of I.R.C. § 1014(b)(6) to such property owned by the surviving spouse.[21]

§ 1.7 TRANSFERS WITHIN ONE YEAR OF DEATH

The unlimited estate tax marital deduction and the increased unified credit phased in under ERTA (Economic Recovery Tax Act of 1981) coupled with the possibility of "stepped up basis" available under the standard new basis rule of I.R.C. § 1014(a) creates an incentive for manipulation of basis. A taxpayer could, for example, gratuitously transfer appreciated assets to an elderly or ill relative who does not have a taxable estate, with the understanding that these assets would be transferred back at the recipient's death, at which time they would have a "stepped up" basis. To limit this strategy, I.R.C. § 1014(e) provides that where appreciated property was acquired by gift within one year of the donee's death and the property (or its proceeds) passes back to the donor, the donee's basis before death is carried over.

> *Example:* C owns real estate with a basis of $35,000 and a current market value of $125,000 which C is interested in selling. In order to avoid income tax on the $90,000 capital gain, C transfers the real estate to D, who is terminally ill, with the expectation that D will transfer the real estate back to C at death. (Assume that even with the transferred assets, D's estate will owe no estate tax; also assume that the gift tax consequences to C are negligible in comparison with the income tax savings.) If D lives for more than a year after the transfer, C's goal will be accomplished because the real estate will receive a "step up" in basis equal to the then current market value. However, if D dies within a year, the property would not receive a new basis and, thus, the gain would remain. The rule of I.R.C. § 1014(e) is irrebuttable; it applies whether or not the transfer was made in contemplation of death and whether or not there is an expectation by the donor that he or she will receive the property back.

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21. The April 1988 *Tax Practitioner Newsletter* from the Milwaukee District of the IRS takes the position that if a predetermination date joint tenancy or tenancy in common exclusively between spouses is deferred marital property, then both halves receive new basis. In a subsequent publication, this error was corrected. *Tax News Quarterly*, IRS Milwaukee District, Winter 1989, p 3. However, the IRS continues to present a confused analysis of deferred marital property in its contribution to Department of Revenue Publication 113, "Federal and Wisconsin Income Tax Reporting Under the Marital Property Act," November 1990, pp. A-64 and A-65.

When spouses reclassify property, a gift may or may not be deemed to have taken place. If the reclassification is a gift, then I.R.C. § 1014(e) clearly will apply.

> ***Example:*** Spouse A owns some highly appreciated stock, acquired by inheritance. The stock is reclassified as marital property, and this reclassification is determined to involve a gift of a half-interest in the stock from A to B. If B dies within one year of the transfer and A receives the stock or its proceeds, then there will not be a full basis adjustment.

In this example, the half-interest that passed to Spouse B and then back to Spouse A upon B's death clearly does not get new basis.[22] But what of the half-interest that was retained by the Spouse A? Arguably it could receive new basis because it meets the requirements of I.R.C. § 1014(b)(6): it "represents the surviving spouse's one-half share of community property," where one-half of the community property interest was includable in the gross estate.

The IRS has not issued a ruling on this question, and there is apparently no case law from the community property jurisdictions.[23] However, the Department of Revenue has taken the position that the surviving spouse's one-half interest, as well as the decedent spouse's one-half interest, is denied a basis adjustment because of the congressional intent underlying I.R.C. § 1014(e). Department of Revenue Position Paper, "Basis Adjustment for Marital Property," October 2, 1986; Department of Revenue, Wisconsin Tax Bulletin #60, April 1989, p. A-92; Department of Revenue "Federal and Wisconsin Income Tax Reporting Under the Marital Property Act," Department of Revenue Publication 113, November 1990. The Department of Revenue had previously indicated that its position is contingent on a contrary ruling by the IRS, but the IRS has indicated that it is likely to agree with the Department of Revenue position. Department of Revenue Publication 113, pp. A-64 and A-65. *See also Marital Property Law in Wisconsin* § 9.16g as revised, June 1990. For other discussions that reach

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[22] It is unclear whether this rule would apply in the unlikely situation where appreciated marital property was reclassified as the individual property of one spouse, who died within a year and left the property to the surviving spouse. Literal application of the statute would dictate that the surviving spouse not receive new basis on the half-interest he or she formerly owned. However, since the property would have received a double basis adjustment as marital property, the evil that I.R.C. § 1014(e) was to remedy does not exist and arguably the statute should not apply.

[23] The November 1986 *Tax Practitioner Newsletter* from the Milwaukee District of the IRS notes that the situation needs further study.

contrasting conclusions, *see Estate Planning and Taxation Coordinator,* (RIA) 28, 141, and *Standard Fed. Tax Reports* (CCH) 4522.019.

When reclassification is not by gift, the application of I.R.C. § 1014(e) is less certain. For example, reclassification may be pursuant to a coordinated plan (perhaps embodied in a marital property agreement) under which both spouses make transfers. In this situation, there may be adequate consideration for the transfer to the decedent spouse, so that there is no gift element; the exchange would also be free of income tax because of I.R.C. § 1041. Arguably, since I.R.C. § 1014(e) only applies to gifts, the "boomerang basis" rule would not apply. However, I.R.C. § 1041(b)(1) states that "for purposes of [income taxes], the property shall be treated as acquired by the transferee by gift"; hence, it could be that since I.R.C. § 1041 applies at the time of the exchange, I.R.C. § 1014(e) is triggered if a spouse dies within one year and transfers his or her interest to the surviving spouse. The Department of Revenue has adopted the latter position. Department of Revenue, Wisconsin Tax Bulletin #60, April 1989, p. A-90.

Note that in any case, I.R.C. § 1014(e) only limits the adjustment to basis at the death of the *recipient* of a gift. If the donor dies, the usual rules apply.

> *Example:* A makes a gift to B by reclassifying an item of individual property as marital property, such as in the earlier example. If A dies, one-half the value of the property will be included in A's gross estate, and there will be a double adjustment in basis under I.R.C. § 1014(b)(6). This is consistent with the fact that if A had remained the sole owner of the property, it would have received a full basis adjustment.

In addition, I.R.C. § 1014(e) should not apply to the reclassification of a joint tenancy (or a tenancy in common owned equally) between the spouses to marital property (whether or not held as survivorship marital property). There will be no gift because the shares of ownership will not have changed, and there will have been no transfer "between spouses" to trigger operation of I.R.C. § 1041(b)(1). *See also Marital Property Law in Wisconsin* § 9.16g as revised, June 1990.

Finally, note that the "boomerang basis" rule of I.R.C. § 1014(e) only applies when the *donor* of the property receives it back from the recipient. If a third party receives it, the usual rules apply.

> *Example:* As in the example on page 3, Spouse A acquired a cabin as individual property and retitled it as marital property. One week later Spouse B died. Assume B's will

> leaves B's interest in the cottage to A & B's children. I.R.C. § 1014(e) would not apply, and both A's interest and the children's interest in the cottage would receive new basis under I.R.C. § 1014(b)(6).

It is unclear whether a trust in which the donor spouse has an interest would be considered a third party.

§ 1.8 INCOME IN RESPECT OF A DECEDENT (IRD)

Income in respect of a decedent is an income tax concept that refers to items of income which were due or had accrued to the decedent on the date of death but which were not actually received and thus not includable on the decedent's final income tax return. Common examples of IRD include accrued wage or salary payments; accrued interest, dividends, or rents; retirement and deferred compensation arrangements; accounts receivable; and installment obligations. Income in respect of a decedent does not receive a new basis on the owner's death [I.R.C. §§ 1014(c) and 691]; hence, there is no adjustment to basis for community IRD interests under I.R.C. § 1014(b)(6). *See Stanley v. Commissioner of Internal Revenue*, 338 F.2d 434 (9th Cir. 1964), *aff'g*, 40 T.C. 851 (1963); Rev. Rul. 68-506, 1968-2 C.B. 332.

§ 1.9 PARTNERSHIP INTERESTS

A partnership interest that is marital property is eligible for the full basis adjustment under I.R.C. § 1014(b)(6). However, this adjustment is only for the spouse's basis in his or her interest in the partnership itself; it is not an adjustment available to the partnership for the assets *it* holds. For the latter adjustment in basis to take effect, timely elections under I.R.C. §§ 743 and 754 may be necessary.[24] *See Marital Property Law in Wisconsin* § 9.16f.

§ 1.10 DEPRECIATION OF FORMER MARITAL PROPERTY FOLLOWING DEATH

Depreciable property held by a decedent receives a new basis at death, but there has been some dispute as to whether the surviving spouse's interest, while receiving a new basis for capital gains purposes, also receives a new basis for

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[24] A more complete analysis of this complex issue is beyond the scope of this book. It should be noted, however, that it is possible to argue that marital property cannot exist in a partnership that includes third parties, for reasons analogous to those given by the IRS in the context of joint tenancy and tenancy in common.

depreciation purposes. Some of these issues are dealt with in *Estate of Gasser v. Commissioner of Internal Revenue*, 93 T.C. 236 (1989), which is discussed in *Marital Property Law in Wisconsin* § 9.15d as revised, June 1990.

2
Reclassification of Property

§ 2.1 Immediate Tax Consequences
§ 2.2 Special Problems in the Reclassification of Income
§ 2.3 Planning Techniques and Precautions
A. "Unintended" Gifts to Third Parties: Advantages and Disadvantages
B. Unintended Retained Interests
C. Underfunding of Family Trust in "Bypass" Estate Plan
D. Disclaimers
E. Business Interests

Property may be reclassified under the Marital Property Act by deliberate act or through inadvertence. Spouses can deliberately reclassify property by entering into a marital property agreement [Wis. Stat. §§ 766.58, 766.587, 766.588, 766.589]; by making a gift from one spouse to the other [Wis. Stat. § 766.31(10)]; by making certain conveyances [Wis. Stat. § 766.31(10)]; by executing a written consent with respect to insurance policies, reclassifying the premiums or policies or both [Wis. Stat. § 766.61(3)(e); *see* book § 3.1E]; by executing a unilateral statement with respect to income attributable to nonmarital property [Wis. Stat. § 766.59]; or by mixing property in such a way that the nonmarital portion cannot be traced [Wis. Stat. § 766.63(1)]. This ability to reclassify property provides many planning opportunities. But the process of reclassification is also fraught with pitfalls for the unwary. Understanding the tax consequences of reclassification is essential to making good decisions as to whether property should be reclassified and, if so, how the reclassification can be done most advantageously.

If there is to be a reclassification of property, care should be taken to assure that it will be effective for both property and tax purposes. Special caution is required when property is to be reclassified by gift, where a deed is to be the sole evidence of intent to reclassify, and where real property outside the state is to be reclassified.[25] To reclassify by gift, the common law requirements —

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[25] With respect to reclassification of property outside Wisconsin, Wis. Stat. § 766.58(3)(a) states that a marital property agreement can reclassify property "wherever ... located";

which include delivery — must be met, and often the most effective method of documenting the gift will involve a document signed by both spouses. *See Marital Property Law in Wisconsin* §§ 2.4 and, *especially*, 10.56. A Trailer Bill II amendment and Legislative Note to Wis. Stat. § 766.31(10) specify that spouses may use a deed or other conveyance to reclassify property even when the transaction does not meet all the requirements of a gift or marital property agreement, as long as the conveyance is signed by both spouses. Examples include husband and wife as joint tenants to husband and wife as survivorship marital property; and one spouse to both spouses as marital property. *See also* book § 1.3, including the caution in note 14.

Caveat. Reclassification of property should never be undertaken solely to reach a tax result. Reclassification fundamentally affects the property rights of the spouses with respect to management and control of assets, including the right to make unilateral gifts; the division of property at divorce;[26] the ability to transfer the property at death; and the rights of creditors. All of these ramifications must be seriously considered along with the tax implications before a spouse can determine his or her best interest. In some circumstances, spouses will need separate representation in order to properly pursue these possibilities.[27]

§ 2.1 IMMEDIATE TAX CONSEQUENCES

Reclassification of property will generally have no immediate tax consequences. No basis adjustment will be made [I.R.C. § 1041(b); Wis. Stat. § 71.05(10)(e)], and if the transfer qualifies for the marital deduction, no gift tax will be due [I.R.C. § 2523(a); Wis. Stat. § 72.76(8)]. In addition, there should no longer be any risk of income tax consequences on exchanges between spouses

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however, it is unclear what steps are necessary to insure that the classification will be effective. On this issue, *see* June Miller Weisberger, *Selected Conflict of Laws Issues in Wisconsin's New Marital (Community) Property Act*, 35 AMER. J. OF COMP. L. 295 (1987).

[26] While, in general, Wis. Stat. Ch. 766 does not directly affect the divorce chapter (Wis. Stat. Ch. 767), there are a number of ways in which reclassification could indirectly have an effect on property division at divorce. To consider just one example, reclassification of inherited property as marital property will probably be interpreted as a gift from one spouse to the other for purposes of property division at divorce, and thus affect division under Wis. Stat. § 767.255. For an analogous situation, *see* Bonnell v. Bonnell, 117 Wis. 2d 241, 344 N.W.2d 123 (1984).

[27] For an excellent overview of the factors to consider when evaluating whether separate representation is required in the estate planning context, *see* MPLW, Ch. 14. An overview of other nontax considerations in reclassification may be found in MPLW § 10.55.

since the "Davis Rule" [*United States v. Davis*, 370 U.S. 65 (1962)], which imposed a tax on certain transfers of appreciated property between spouses, has been repealed by I.R.C. § 1041 and Wis. Stat. § 71.03(2).

However, note that the IRS has taken the position that I.R.C. § 1041 only applies to gain on disposition of property, and that it does not apply to *accrued income* that is ordinarily recognized upon the assignment of income. Hence, in Rev. Rul. 87-112, 1987-2 C.B. 207, the IRS ruled that "the deferred, accrued interest on United States savings bonds is includable in the transferor's gross income in the taxable year in which the bonds are transferred to the transferor's spouse." (All revenue rulings cited in the text are reproduced in Appendix B.) *See also Marital Property Law in Wisconsin* § 9.12 as revised, June 1990. This ruling could have implications for any reclassification that involved assets with deferred income, such as IRAs, retirement plans, or tax sheltered annuities. The ruling seems to be based on a very narrow reading of I.R.C. § 1041; in addition, it is out of keeping with the policy that underlies this statute and is contrary to IRS acquiescence in an analogous situation in the corporate context.[28] Hopefully, the ruling will not be applied to assets other than savings bonds and will eventually be retracted by the IRS or overturned by the courts.[29]

§ 2.2 SPECIAL PROBLEMS IN THE RECLASSIFICATION OF INCOME

Under the Marital Property Act, spouses may alter any "rights in and obligations with respect to any of either or both spouses' property whenever and wherever acquired or located" through use of a marital property agreement. Wis. Stat. § 766.58(3)(a). Thus, virtually any reclassification can be valid under Wisconsin law, if the other requirements of the statute are followed. Reclassification does not affect the taxation of income flowing from the

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[28] *See* Hempt Bros. Inc., 490 F.2d 1172 (3rd Cir. 1974), *cert. denied*, 419 U.S. 826; Rev. Rul. 80-198, 1980-2 C.B. 113.

[29] Several private letter rulings have taken positions consistent with Rev. Rul. 87-112, but the IRS position has been vigorously and cogently criticized in at least three recent publications: Michael Asimow, *The Assault on Tax-Free Divorce: Carryover Basis and Assignment of Income*, 44 Tax L. REV. 65-112 (1988); *Transfers of Property Between Spouses and Former Spouses: Recent Developments Under Code Sec. 1041*, CCH-STANDARD TAX REPORTS-1988, Vol. 10, para. 8678; and Walter H. Nunnallee, *The Assignment of Income Doctrine as Applied to Section 1041 Divorce Transfers: How the Service Got it Wrong*, 68 OR. L. REV. 615-47 (1989).

Rev. Rul. 87-112 was not taken into account in a recent private letter ruling, Priv. Ltr. Rul. 89-29-046 (July 21, 1989), where a marriage agreement that terminated the wife's interest in her husband's IRA, making the IRA the husband's separate property, was held to have no income tax effects because of the operation of I.R.C. § 1041.

reclassified interest unless the spouses file separate returns. The overwhelming majority of Wisconsin residents file joint returns for federal and state purposes, so in that sense, the impact of the discussion that follows is limited.[30] However, since marital conflict — especially separation or divorce — is one of the major factors that leads to separate filing, the rules regarding classification of income can be very important in those situations where they do apply.

In general, the IRS will recognize any classification that is valid under state law and will tax income accordingly. Hence, for example, if spouses enter into a valid agreement stating that the earnings of each will be the solely owned (or individual) property of the earner, the earnings will be taxed in that way. Rev. Rul. 73-390, 1973-2 C.B. 12. There are, however, at least three important limits on this principle. First, the IRS will generally not recognize the reclassification of the income stream from an asset if the classification of the asset itself remains unchanged.[31] Rev. Rul. 77-359, 1977-2 C.B. 24; *Commissioner of Internal Revenue v. Harmon*, 323 U.S. 44 (1944). Presumably, the IRS position also covers income from wages, as in the case where an agreement provides that the income from the future services of one spouse will be the individual property of the other. The Department of Revenue has taken a different position, holding that such an agreement "could be valid." Department of Revenue, "Department of Revenue Updates — Marital Property Positions," October 20, 1988, p. A-78. However, the Department of Revenue will not recognize a reclassification which is stated to be "for income tax reporting purposes only," without a concomitant reclassification of the property. (*ibid.*, p. A-85.)[32]

The second limit on the recognition of reclassification agreements is that both the IRS and the Department of Revenue have been emphatic that they will not recognize a retroactive reclassification of income. *See*, for example, the joint statement by Lawrence M. Phillips (Wisconsin District Director of the IRS) and Robert C. Stellick, Jr., (Department of Revenue), "Tax Reporting in the Year a

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[30] Income tax issues involving spouses filing separately are discussed in detail in Department of Revenue, "Tax Information for Married Persons Filing Separate Returns and Persons Divorced in 1990," Publication 109, November 1990, and Department of Revenue, "Federal and Wisconsin Income Tax Reporting under the Marital Property Act," Publication 113, November 1990. (Publications 109 and 113 are reproduced in Appendix A.) *See also* MPLW, Ch. 9.

[31] Reclassification under a unilateral statement (Wis. Stat. § 766.59) is probably an exception, because the resulting ownership of the income stream is consistent with the ownership of the underlying property.

[32] For a useful discussion of this and a variety of the Wisconsin income tax issues related to reclassification, *see* Robert C. Stellick, Jr., *Marital Property and Personal Income Taxes — Another Set of Strange Bedfellows?* 2 AM. J. OF FAM. L. 352-76 (Winter 1988).

Divorce Decree is Granted," *Wisconsin Journal of Family Law*, September 1986, p. 8.[33] The IRS-Department of Revenue joint statement stresses that, for IRS purposes at least, the fact that a retroactive reclassification has been ordered by a state court (*e.g.*, as part of a divorce proceeding)[34] will not make it binding for federal tax purposes; it appears that the Department of Revenue position is the same. The Department of Revenue has also noted that a prospective agreement to reclassify property for "the year in which we get divorced" would also be a retrospective reclassification that would not be recognized for tax purposes (unless the divorce took place on January 1st, in which case there would be no need for reclassification). Department of Revenue, "Department of Revenue Updates — Marital Property Positions," October 20, 1988, p. A-85. *See also* Department of Revenue, "Federal and Wisconsin Income Tax Reporting Under the Marital Property Act," Department of Revenue Publication 113, November 1990, and *Marital Property Law in Wisconsin* § 9.18 as revised, June 1990.

Finally, Wisconsin law provides that during the period of time when one or both of the spouses is not domiciled in Wisconsin, an agreement or a unilateral statement does not affect either the determination of income that is taxable by Wisconsin or the person who must report the income. Wis. Stat. § 71.01(1g). Thus, the statute prevents one spouse from shifting income otherwise taxable by Wisconsin to a spouse who resides in a state with a lower tax rate. However, the statute only negates the effect of marital property agreements and unilateral statements and not the effect of reclassification by gift. Therefore, a gift of income producing property could shift the income produced by that property from the donor spouse to the donee spouse. Of course, the irrevocable nature of these transfers will have important property law consequences as well, including effects on property division if the spouses become divorced.

An additional Wisconsin principle is that a marital property agreement (or unilateral statement under Wis. Stat. § 766.59) does not generally affect the determination of the homestead tax credit (Wis. Stat. § 71.52(6)-(8)), the credit

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[33] *See also* Department of Revenue Position Paper, "Retroactive Reclassification of Income Received under Marital Property Law," October 2, 1986; Lawrence M. Phillips, *Federal Tax Problems under WUMPA*, WIS. J. OF FAM. L., December 1986, p. 27, and MPLW §§ 9.18, 9.26.

[34] Generally, the best tax result will be obtained if the income is split between the spouses and the divorce occurs late in the year, so that each spouse will file as a single taxpayer reporting half of the combined income. However, animosity or distrust between the spouses often makes this arrangement impractical.

for married persons filing a joint return (Wis. Stat. § 71.07(6)), or division of refunds on a joint return (Wis. Stat. § 71.75(6)). *See also Marital Property Law in Wisconsin* § 9.26.[35] Reclassification by other methods, such as by gift, could affect the determination of the homestead tax credit.

§ 2.3 PLANNING TECHNIQUES AND PRECAUTIONS

A. "Unintended" Gifts to Third Parties: Advantages and Disadvantages

When life insurance, deferred employment benefits, or property which is the subject of a specific bequest is marital property (or contains a marital property component) and there is a nonspouse beneficiary, there may be an unintended gift by the surviving spouse. If the surviving spouse goes along with the decedent spouse's designation of a third party beneficiary for the entire item or proceeds, the surviving spouse has made a gift of his or her marital property interest to the third party. *See Marital Property Law in Wisconsin* § 9.51b. Depending on the size of the gift, it may be subject to tax. To the extent that the unintended gift causes a problem (and as we shall discuss below, these gifts may in fact be advantageous), the problem is caused by the planner's failure to be aware of the consequences of the classification of the property. The tax results are not anomalous; rather they follow directly from the form of ownership of the property.

> *Example:* Spouse A is the designated owner of a $100,000 life insurance policy on A's life which was provided to A by A's employer during a period in which the Act applied to A's marriage. C, the child of A and Spouse B, is named as beneficiary. If the policy has not been reclassified by written consent (under Wis. Stat. § 766.61(3)(e)) or by marital property agreement (under Wis. Stat. §§ 766.58 or 766.589), it is marital property and will remain so unless one or both spouses move their domicile out of Wisconsin. Wis. Stat. § 766.61(3)(a)1 and 2. Spouse A dies. One-half of the proceeds is includable in A's gross estate under I.R.C. § 2042 (*see* Treas. Reg. § 20.2042-1(c)(5) (1974)); the other half is owned by B. Assume that B does not disagree with child receiving the full $100,000 in proceeds and does not attempt

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[35] Further discussion of marital property issues related to the homestead tax credit may be found in the Wisconsin Department of Revenue Position Paper, "Homestead Credit under Marital Property Law," November 5, 1986, and "Department of Revenue Updates — Marital Property Positions," October 20, 1988, pp. A-86 and A-87. The earned income credit for married persons is discussed further in MPLW § 9.21b.

to claim any of it pursuant to Wis. Stat. § 766.70(6)(b). B's inaction results in a $50,000 gift to Child C. *Whiteley v. United States*, 214 F. Supp. 489 (W.D. Wash. 1963).

Example: Spouse A inherited a cottage worth $50,000. Improvements worth $10,000 are then made to the cottage, using marital property. At the completion, the property is worth $60,000. One-sixth of the property is now marital property, and at A's death, Spouse B owns a one-twelfth interest. Assume that at A's death, A leaves the property to Child C, and B does not object. The property is retitled in C's name. B has made a gift of one-twelfth of $60,000, or $5,000, to C.[36]

Example: In the example just above, assume that A leaves the property to Spouse B and Child C as equal tenants in common, and it is retitled as such. Arguably, one-twelfth of the half- interest transferred to C ($2,500) actually belongs to Spouse B, and B's failure to assert the right to this interest constitutes a gift to C. A 5th Circuit decision appears to have rejected this approach, holding that as long as B receives more than B's marital property share, there is no gift from B to C for tax purposes. *Kaufman v. United States*, 462 F.2d 439 (5th Cir. 1972). However, the law remains unsettled in this regard.

Example: As a consequence of Spouse A's employment, there is a $100,000 deferred employment benefit plan containing a $30,000 marital property component. If A dies and designates a third party as beneficiary under the plan, Spouse B still owns one-half the marital component, equal to $15,000. If B does not exercise his or her right to claim this amount, B has made a $15,000 gift to the third party. (This example ignores any spousal rights under ERISA.)

As illustrated by these examples, if a 100% interest in an asset is transferred to a third party, both the original asset and any additions to or reductions of secured indebtedness on the asset must be from nonmarital property in order to avoid an unintended gift by the surviving spouse of his or her marital property interest. A marital property agreement (or written consent in the case of life insurance, *see* book § 3.1) reclassifying the asset and subsequent additions

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36. If B is also a beneficiary under the will, the doctrine of equitable election (Wis. Stat. § 853.15) may apply. If it does, B may decide to release his or her rights to the cabin in exchange for the other rights under the will, with the probable result that no gift would have been made. The doctrine of equitable election is discussed in MPLW § 12.42.

to or payments on the asset as one spouse's individual property will avoid the unintended gift.

However, this division of the gift between the spouses is not necessarily disadvantageous; sometimes it will achieve tax savings. The division of the gift will be advantageous if the gift taxes on the surviving spouse's share are less than the additional death taxes that would result if the total transfer were from the decedent spouse. If the value of the surviving spouse's marital property interest is less than $10,000 (and for federal purposes the present interest requirement of I.R.C. § 2503(b) is satisfied), no federal or state gift tax will be due on the gift from the surviving spouse, and estate or inheritance tax may be saved. Thus, a sophisticated estate plan will often include *intentional* division of gifts between the spouses. It is interesting that in the marital property context, division of gifts between the spouses tends to be seen as a problem, while in other contexts, it is typically seen as an advantage, especially in situations where both spouses' annual exemptions can be used.

> ***Example:*** Spouse A dies with a $500,000 estate including a $60,000 life insurance policy on A's life. The life insurance policy contains a $20,000 marital property component. A's mother is the designated beneficiary under the policy. Payment of the proceeds to A's mother should be deemed a $50,000 transfer at death from A and a $10,000 gift from B. In that case, there is no federal estate tax on the transfer from A because A's estate is less than the $600,000 covered by the unified credit available to A's estate under the present version of I.R.C. § 2010. In addition, there is no inheritance tax on the $50,000 transfer from A to mother because the first $50,000 passes tax free to lineal ancestors. There should be no federal or state gift tax on the gift from B to mother because of the $10,000 annual exclusion. Therefore, transfer of the $60,000 policy partly by transfer at death and partly by gift should result in no tax due.[37] If, on the other hand, A and B had reclassified the policy as A's individual policy in

[37] The Department of Revenue has announced that it will treat transfers such as these as "equivalent to a disclaimer." Department of Revenue Position Paper, "Marital Property's Impact on Inheritance and Gift," October 2, 1986, p. 2; *see also* "Department of Revenue Updates — Marital Property Positions," October 20, 1988, p. A-79. The basis for this position is that the Department of Revenue does not see itself as being able to determine whether there is a marital property component to the transfer. However, if the transfers are reported in accord with their ownership status under the Marital Property Act, the Department of Revenue will apparently accept that characterization. *See also* text at note 55.

In any case, after 1991 this point will be moot, because of the elimination of gift and inheritance taxes in Wisconsin.

> order to avoid a gift from B to mother, under the rates applicable in 1989, there would be a $450 inheritance tax due on the $60,000 transfer at death. The division of the transfer between the spouses has reduced this tax to zero.

If the value of the surviving spouse's marital property interest is greater than $10,000, the analysis is more complex and depends on a number of factors. To the extent that the gift from the surviving spouse is greater than $10,000, the excess will erode the surviving spouse's unified credit for federal gift and estate tax purposes. If the remaining unified credit will be sufficient to cover the tax due on the survivor's estate, then the survivor need not be concerned. But if the surviving spouse's taxable estate is at risk of being greater than the amount covered by unified credit applicable at that spouse's death ($600,000 in 1989), then the tax cost or benefit of the gift depends on the marginal estate tax rates of the two estates, the value of the tax deferral, and the willingness of the surviving spouse to bear the tax.[38]

In addition to the effect on the surviving spouse's unified credit, until Wisconsin gift and inheritance taxes are fully phased out in 1992, the state tax consequences must be considered for gifts in excess of $10,000.[39] When a gift exceeds that amount, the gift tax must be compared to any inheritance tax saved to see if there is a net savings. If the third party recipient has the same blood relation to both spouses, then the gift tax will generally be either the same as or lower than the inheritance tax saved. Where the third party does not have the same blood relation to both spouses, then the result depends on the respective relationships. In any case, any Wisconsin gift tax due could be borne by the recipient and thus have no cost to the surviving spouse.

> *Example:* Spouse A owns a $100,000 life insurance policy which is entirely marital property. A's total estate subject to tax is $300,000. Spouse B's estate subject to tax is currently $200,000. A dies, leaving everything to B except for the life insurance on which the child of A and B is named as sole beneficiary. Assume that B does not claim B's share of the life insurance proceeds. Thus, there is a gift of $50,000 from B to child.

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38. Another way to achieve tax savings by dividing the gift is for the surviving spouse to claim his or her interest, but then transfer it to the third party beneficiary in increments that each qualify for the annual exclusion.

39. The position of the Department of Revenue, discussed in note 37, *supra*, is not integrated into the following discussion.

> For federal tax purposes, B will be allowed a $10,000 annual exclusion (I.R.C. § 2503(b)); the remaining $40,000 will be a taxable gift, but no tax will be due, because of the unified credit available for gifts under I.R.C. § 2505. When B dies, the $40,000 taxable gift will be included in B's taxable estate as an "adjusted taxable gift," under I.R.C. § 2001(b). But it appears that, even with the adjusted taxable gift included in B's estate, B's gross estate will be only $440,000 ($200,000 received from A; $200,000 owned already; $40,000 adjusted taxable gift). Since this amount is less than $600,000, there will be no federal estate tax consequences of the gift unless B's assets increase or the unified credit is reduced.
>
> The gift will not generate any state gift tax either, if B has not previously used up the $50,000 lifetime exemption under Wis. Stat. § 72.82(b). If A and B had reclassified the insurance as A's individual property so that the transfer was solely from A, an inheritance tax of $2,250 would have been due under the rates applicable in 1989. Therefore, the splitting of the gift saves this amount.
>
> *Example:* If the child in the above example were not the child of A and B, but instead were A's child from outside this marriage, there would still be a savings of $2,250 in inheritance taxes in 1989. However, under the 1989 rates, there would be a gift tax of $2,700 on the transfer from B to child. In that case, the split gift would result in a net cost of $450, a tax which can probably be avoided by reporting the transfer in the form preferred by the Department of Revenue. *See* note 37, *supra.*

B. Unintended Retained Interests

If the donor of property retains the use of that property, the right to the income, or the right to control others' use of the property, the value of the interest that has been retained is generally included in the donor's estate under I.R.C. §§ 2036 or 2038. Until 1992, it is also generally subject to Wisconsin inheritance tax under Wis. Stat. § 72.12(4)(b). When marital property is the subject of the gift, it is important to remember that *both spouses* will be treated as donors and that one must therefore be attentive to the possibility of a retained interest for *either* spouse. The income and estate tax consequences of marital property gifts with retained interests are as complex as they are important. They are discussed in detail in *Marital Property Law in Wisconsin* §§ 9.17 and 9.35.

Several basic estate planning techniques are affected by the problem of unintended retained interests. For example, many *revocable trusts* (especially

those created before the Marital Property Act became effective) have only one spouse as settlor. These trusts are generally not well designed to deal with the fact that a contribution of marital property to the trust in effect adds the other spouse as a second settlor. The problems that can ensue are explained in *Marital Property Law in Wisconsin* § 10.33; tax issues are addressed specifically in *Marital Property Law in Wisconsin* § 10.33h. Generally these problems can be eliminated through use of a marital property agreement or the creation of a joint revocable trust specifically designed to hold marital and nonmarital property. A suggested form for this type of trust may be found at *Marital Property Law in Wisconsin* § 10.61.

The problem of unintended retained interests is also of great significance in the funding of *irrevocable life insurance trusts* because the provisions of Wis. Stat. § 766.61 strongly favor the classification of life insurance as marital property. This topic is discussed in greater detail in book § 3.3.

Under certain circumstances, a spouse's relinquishing of his or her interest in the other spouse's *deferred employment benefit plan* may create retained interest problems similar to those just mentioned. The state of the law in this area is uncertain, because of new developments in federal law protecting the rights of the spouse of the worker covered by the plan and the unknown interaction of those provisions with state community property provisions, such as Wis. Stat. § 766.62. The complex nature of the issue and the myriad of problems that can result are summarized in *Marital Property Law in Wisconsin* §§ 9.37 and 9.54. Some estate planners believe that because of the complexity and uncertainty in this area, whenever possible the surviving spouse should be named the outright beneficiary of any death benefit from a deferred employment benefit plan covered by ERISA.[40] If the client desires a different outcome, sometimes the equivalent result can be reached by making changes elsewhere in the estate plan.

Finally, an unintended retained interest can arise on *outright gifts between the spouses*. However, because of unique features of the Marital Property Act, this should be less of a problem in Wisconsin than it is in some other community property jurisdictions. The source of the potential problem is that under the "civil law rule" that Wisconsin has adopted, all investment income — like earned income — is marital property, no matter what the classification of the property that generated the income. Hence, if community

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[40] It does not necessarily follow, however, that a joint and survivor annuity should be elected during life. *See* McCaffrey, *Gift Tax Consequences of a Failure to Elect Retirement Benefits in a Form Other than a Joint and Survivor Annuity*, 13 PROB. NOTES 42 (1987).

property or the separate property of one spouse is reclassified as the separate property of the other spouse, the spouse who relinquished his or her rights would still have a half community property interest in the subsequent income. But Wis. Stat. § 766.31(10) provides that, unless a contrary intent is established, if an interspousal transfer is intended to be the individual property of the recipient spouse, then the income is also individual property, not marital property. *See also Estate of Wyly v. Commissioner of Internal Revenue*, 610 F.2d 1282 (5th Cir. 1980); Rev. Rul. 81-221, 1981-2 C.B. 178, and the discussion in *Marital Property Law in Wisconsin* § 9.35a.

C. Underfunding of Family Trust in "Bypass" Estate Plan

When the total assets owned by the spouses exceed the exemption equivalent of the unified credit available under I.R.C. § 2010 ($600,000 in 1989), many spouses engage in "bypass" estate planning. Under this approach, the first spouse to die leaves an amount up to the exemption equivalent[41] in a trust in which the surviving spouse may be a lifetime beneficiary and in which other family members receive the remainder at death (and may also be beneficiaries during the surviving spouse's lifetime). If the trust is properly drafted, even if the surviving spouse is a beneficiary, he or she will not be deemed an owner of the trust, and it will not be included in his or her gross estate. This property is thus covered by the unified credit in the estate of the first spouse to die and bypasses the estate of the second spouse to die, thus passing to the next generation totally free of estate tax. The surviving spouse is then free to use his or her unified credit to shelter additional assets.

Marital property rules in and of themselves do not interfere with bypass planning; in fact they can facilitate the plan by dividing ownership between the spouses, thus insuring that whichever spouse dies first will have property with which to fund the family trust. However, the operation of marital property rules could undermine the assumptions underlying a bypass plan that was created without regard to classification of property.

> ***Example:*** Spouses A and B create bypass estate plans. There is $450,000 of property titled in A's name; since this property is derived from income from A's employment and investments over the years, and the post-1985 component of

[41] Because of the many factors involved in determining the precise amount of the unified credit that is available to shelter the bypass bequest, this bequest will often be done by formula. One example of such a formula is discussed in the context of the revocable trust presented in MPLW § 10.61 at subsection II(B). An alternative method which has gained popularity is funding by means of disclaimer by the surviving spouse.

> that income cannot be traced, the full $450,000 is classified as marital property. There is $450,000 of inherited property titled in B's name, which is therefore classified as individual property. A and B intend that whoever dies first will leave "their" $450,000 to the bypass trust. However, if A dies first, A's trust will be underfunded because A in fact owns only $225,000. B owns $675,000, which will trigger an estate tax at B's death, if that amount stays constant or increases, and if the excess over the exemption equivalent is not left in a form that qualifies for the charitable or marital deductions.[42]

Bypass planning under the Act is discussed in *Marital Property Law in Wisconsin* § 10.43.

D. Disclaimers

Like any other beneficiary, a surviving spouse may make a qualified disclaimer (under Wis. Stat. § 853.40 and I.R.C. § 2518) of property to be received from the decedent spouse. In some instances, a disclaimer can avoid future estate tax at the survivor's death by keeping his or her estate from exceeding the $600,000 credit equivalent.[43]

> *Example:* Spouse A dies owning $500,000 of individual property which is left entirely to Spouse B. B currently has individual property worth $400,000. After receiving the property from A, B would own $900,000 which — if unchanged and if not left in a manner that qualified for the charitable or marital deductions — would generate estate tax at B's death. However, if B disclaims three-fifths of A's estate ($300,000), thereby allowing it to pass as though B had predeceased, B's estate would not exceed the $600,000 credit equivalent and both estates would then pass free of estate tax. Of course, by this act, B would give up the ownership of the $300,000, which may not be an acceptable price.

While disclaimer law itself has not changed, the ability to disclaim interests freely is affected by marital property law, since a surviving spouse cannot disclaim his or her vested share of marital property. The surviving spouse

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[42] If B dies first, there is no tax problem because B can leave the excess over the exemption equivalent (the excess would be $75,000 in 1989, on these facts) to A in a form that qualifies for the marital deduction. A's estate will then still be less than the current $600,000 exemption equivalent.

[43] Note that several requirements must be met if a disclaimer is to be effective for tax purposes. Perhaps the two most important are that the disclaimant must not have accepted the interest or any of its benefits and that the disclaimer must be timely made.

already owns a one-half interest in marital property — even if he or she had no idea of the existence of the property — and does not "receive" it from the decedent.

> *Example:* Change the previous example so that the $500,000 attributed to A is now marital property, while B's $400,000 remains B's individual property. Now B owns $650,000 ($250,000 plus $400,000). Although B can disclaim A's $250,000 share of the marital property, B cannot disclaim his or her own share. Thus, B is unable to reduce his or her potential estate below $600,000 by disclaiming.

Because of the inability to disclaim one's own share of marital property, spouses should not rely on the assumption that disclaimers can be used at death to avoid subsequent tax. Instead, appropriate reclassification of assets and amendment of estate plans should be made during life.

E. Business Interests

When business interests are involved, the tax implications of marital property ownership can be far reaching, resulting in both planning opportunities and traps for the unwary. Since many closely held business interests are highly appreciated in value, the double basis adjustment rule of I.R.C. § 1014(b)(6) can be especially relevant. The more subtle effects of marital property ownership on special use valuation under I.R.C. § 2032A, qualified redemptions under I.R.C. § 302(b)(3), and other rules should be fully considered by the planner in this context, because the results can be striking. The following example shows one such result, but, in general, tax planning for business interests involving marital property is beyond the scope of this book.

> *Example:* Spouse A is a major shareholder in a closely held corporation. Spouses A and B both work in the business, but all their stock is in A's name. The corporation redeems all of A's stock and A retires from the business, pursuant to a plan for a qualified redemption under I.R.C. § 302(b)(3). B continues to be involved in the business, albeit in a relatively minor way. If the stock is determined to have been marital property, then B's half does not qualify, and the redemption of that portion of the stock is a dividend under I.R.C. § 302(c)(2)(A)(i). B has lost the advantage of being taxed only on the capital gain in the stock.

3
Life Insurance

§ 3.1 Classification of Life Insurance
- A. Policies on the Life of a Spouse, Where That Spouse is also the Named Owner
- B. Policies on the Life of a Spouse, Where the Other Spouse is Named Owner
- C. Policies on Life of a Spouse, Where a Third Party is Named Owner
- D. Policies on Life of Third Parties, Owned by a Spouse
- E. Release of Rights

§ 3.2 Taxation of Life Insurance
- A. Policies on Decedent's Life
  1. Taxation at Death
  2. Gift Tax Implications of Allowing Proceeds to Go to a Third Party or Allowing Reclassification of the Policy
- B. Policy Owned by Decedent, Insuring Another's Life

§ 3.3 Life Insurance Trusts and Retained Interests
- A. Estate Taxation
- B. Gift Taxation
- C. Income Taxation
- D. Caveat

Because life insurance comprises a significant part of many estates, it often provides estate planning opportunities to those knowledgeable about the estate, income, and gift tax implications of various plans. An understanding of the tax implications begins with an understanding of the general classification rules for life insurance under the Marital Property Act. Classification of life insurance is discussed in *Marital Property Law in Wisconsin* §§ 2.90-2.91; *see also* the summary chart in *Marital Property Law in Wisconsin* § 10.58.

§ 3.1 CLASSIFICATION OF LIFE INSURANCE

The extent to which life insurance is taxable in a decedent's estate depends upon the classification of the policy. A spouse is the "owner" of a policy if that spouse appears on the issuer's records as the person with the ownership interest

or as the insured when no one is named as owner. Wis. Stat. § 766.61(1)(a). When group insurance is purchased by an employer as a fringe benefit for employees, the employer is typically listed as the owner of the policy. But it is the employee who holds the incidents of ownership (most importantly, the right to name the beneficiary) and who is treated as the owner of record for purposes of marital property law. *See* Wis. Stat. § 766.61(1)(a), amended by 1987 Act 393, to clarify this point.

Typically, only one spouse will be listed as or considered to be the "owner" of a policy. However, designation of a spouse as the owner of record does *not* determine the classification of that policy. Wis. Stat. § 766.51(1)(d); 766.51(5). Instead, classification is determined by a special set of rules set out in Wis. Stat. § 766.61.

A. Policies on the Life of a Spouse, Where That Spouse is also the Named Owner

If a policy is issued on the life of a spouse *after the determination date*[44] and is owned by the insured spouse, that policy is marital property. Wis. Stat. § 766.61(3)(a)1. The source of the premium payments is irrelevant.

> *Example:* A and B marry in 1984. In 1986, Spouse A buys (and is listed as owner with the insurer) a policy on A's life. All premiums are paid from A's individual property, an inheritance A received. The policy is marital property.

If a policy is issued *before the determination date* and the insured spouse is the owner of record, it retains its status as nonmarital property unless a premium is paid from marital property funds. Once marital property is used to pay a premium, the policy becomes mixed property. The marital property component is determined by a statutory formula that considers the length of time that the policy was in effect after the first premium payment out of marital property, compared to the total amount of time the policy was in effect. Wis. Stat. § 766.31(3)(b). Specifically, for a policy currently in effect:

[44] The determination date is the date that Wisconsin marital property law first applies to the marriage. Wis. Stat. § 766.01(5). If one or both spouses subsequently moved their domicile out of Wisconsin, the policy would not be marital property for the period of nondomicile, and the policy would become mixed property. Wis. Stat. § 766.61(3)(a)2.

If a policy is taken out after the determination date but during a period in which the Act did not apply to the marriage, it appears that Wis. Stat. §§ 766.61(3)(a)1 and 2 would still apply, but that there would be no marital property component until both spouses had reestablished domicile in Wisconsin, at which time the policy would become mixed property.

$$\text{Marital Property Component} = \text{Entire Interest} \times \frac{\text{Period during marriage[45] after date of first premium paid from marital property}}{\text{Period that policy has been in effect}}$$

Even if all premium payments after the date of the first payment from marital property are made from individual property, the result under this "straddle formula" does not change. As soon as one payment (or, possibly, even a part of a payment) is made from marital property, the source of all subsequent payments is irrelevant.[46]

> ***Example:*** Spouse A is named as the owner of a $100,000 life insurance policy issued July 1, 1984, with premiums due annually. The 1986 premium can be traced to A's nonmarital property. However, on June 30, 1987, the premium is paid from property whose origins cannot be traced and therefore is presumed to be marital property. A died on June 30, 1989. Since two years passed from the date of the first payment from marital property and the policy was in effect for five years, two-fifths (or $40,000) of the proceeds would be marital property. The remaining three-fifths (or $60,000) would be A's nonmarital property.

If the policy is employer sponsored, a payment by the employer during a period in which the Act applies to the marriage is considered to come from marital property, since the payment is a form of compensation. Wis. Stat. § 766.01(10). Therefore, the date of the first payment by the employer will be the key date for the formula. The effect of change in the amount of coverage under the policy, change in the carrier for a group policy, and change in domicile of one spouse are addressed by amendments in Trailer Bill II. *See* Wis. Stat. § 766.61(2m), 766.61(3)(a)2, and accompanying legislative notes.[47]

Both classification rules just discussed apply to policies owned by a spouse insuring that spouse's life, irrespective of beneficiary designation. However, if the surviving spouse is named as beneficiary, the classification will be irrelevant (except if he or she wishes to disclaim the decedent spouse's half) because the

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45. Note that the term "during marriage" has a specific meaning for purposes of Chapter 766. *See* Wis. Stat. § 766.01(8), as amended by 1987 Act 393.

46. If the spouse named as owner acquired the policy pursuant to certain court decrees or property settlements, a special rule applies. Wis. Stat. § 766.61(5).

47. Note that the "effective date" of a policy is not necessarily the same as the "date of issue." This has important implications for the interrelationship between Wis. Stat. § 766.61(2m)(a) or (b) with 766.61(3)(a)1.

surviving spouse will have a right to receive all proceeds in any case. There are also no tax consequences when the surviving spouse receives all the proceeds because any portion included in the decedent spouse's estate will qualify for the unlimited marital deduction. On the other hand, when a third party — including a trust for the benefit of the surviving spouse — is named as beneficiary, classification issues can have important tax and property law consequences.

To the extent that a policy is marital property, the spouse designated as owner has the rights of management and control in dealings with the insurance company. Wis. Stat. § 766.51(1)(d). As with other marital property, the spouse not listed as owner has a vested one-half interest in the marital property component of the policy; that spouse has a remedy if these proceeds are paid to someone else. Wis. Stat. § 766.70(6)(b) and accompanying Legislative Note under 1985 Act 37. *See also Marital Property Law in Wisconsin* § 2.95. Failure to exercise that right will typically result in a gift to the beneficiary. *See* book § 2.3A.

In addition to the right to one-half the marital property component, the spouse not listed as owner may have an elective right to part[48] of the value of the nonmarital component if the nonmarital component is part of the "augmented marital property estate." Wis. Stat. § 861.03. Briefly, the nonmarital property component of the policy will be in the augmented marital property estate if it is deferred marital property (as defined in Wis. Stat. § 851.055); the beneficiary is not the surviving spouse; the beneficiary designation was made or changed after April 3, 1984; and the transfer is made without the consent of the noninsured spouse and without consideration. Wis. Stat. § 861.05. The election is subject to reduction if various transfers during lifetime or at death were made to the surviving spouse by the decedent spouse, and the amount determined to be subject to election does not have to be satisfied from the proceeds of the policy. Wis. Stat. §§ 861.07, 861.09. The election is barred if not timely made and may cease with the surviving spouse's death. Wis. Stat. § 861.11. *See also* the discussion in Erlanger and Weisberger, "New probate and non-probate property elections under Wisconsin's Marital Property Act," Part 2, *Wisconsin Bar Bulletin*, November 1986.

> *Example:* In the previous example, two-fifths (or $40,000) of the life insurance policy was marital property. If there is a

[48] The election may be limited to only part of the value of the nonmarital component because part of that component may not be deferred marital property or because the amount subject to election was reduced pursuant to Wis. Stat. § 861.07.

> third party beneficiary and Spouse B does not exercise B's right to receive $20,000 of the proceeds, then B will have made a gift of that amount to the beneficiary. In addition, since the beneficiary was named after April 3, 1984, some or all of the three-fifths nonmarital property component may be deferred marital property to which the election relates. However, since this latter right is not a vested right, failure to exercise it will not constitute a gift from Spouse B to the beneficiary.

Note that the generation of a possibly unintended gift from the surviving spouse to the beneficiary is not necessarily a negative event. Often, division of gifts in this way can save taxes or have no tax consequences. *See* discussion in book § 2.3A.

B. Policies on the Life of a Spouse, Where the Other Spouse is Named Owner

A policy owned by one spouse insuring the life of the other spouse is the individual property of the owner, regardless of the source of the premiums. Wis. Stat. § 766.61(3)(c). (However, note that if such a policy is taken out within three years of the death of the insured spouse, there may be a tax problem under I.R.C. § 2035. *See Marital Property Law in Wisconsin* § 9.34.)

> *Example:* A and B marry in 1984. In 1986, Spouse A buys, and is listed as owner on the records of the insurer, a policy on Spouse B's life. (Industry practice requires B's consent or acquiescence in this situation.) All premiums are paid from marital property. The policy is Spouse A's individual property.

C. Policies on Life of a Spouse, Where a Third Party is Named Owner

When a policy on the life of a spouse is owned by a third party, there are two ways in which the marital property rules can affect the ownership of the policy. First, if marital property from the insured spouse's marriage (as contrasted to property owned or controlled by the third party owner) is used to pay a premium on such a policy, then special rules apply. To some extent, the policy is treated as one owned by the insured spouse, with the marital property component determined using the straddle formula. Wis. Stat. § 766.61(3)(d). Second, as the next section indicates, if the third party owner is married, the use of marital property from the owner's marriage will affect ownership rights in that marriage.

> *Example:* On Jan. 1, 1980, Spouse A, who is married to Spouse B, took out a $100,000 policy on A's life naming child

> as owner. All premiums except one were paid by child. The one exception was the Jan. 1, 1987, premium which A paid, using A's and B's marital property. Spouse A died on Jan. 1, 1990. Three-tenths of the policy is A's and B's marital property and seven-tenths is the property of child. If child is married, ownership of child's interest will be determined under the rules for a "policy on life of a third party, owned by a spouse."

One typical way in which third parties come to own insurance on the life of another person is through a gift from the insured. For this reason, it is very important to bear in mind that a spouse's ability to give away life insurance on his or her life is severely limited. A spouse acting alone can freely give marital property to a third person only if its value does not aggregate more than $1,000 in a calendar year (or a larger amount, if "reasonable"); a gift larger to this amount can be made, but if the spouses did not act together, the gift is subject to the remedies of Wis. Stat. § 766.70(6). For purposes of this rule, a gift of a life insurance policy is valued at its face value. Wis. Stat. § 766.53. Since virtually all life insurance policies have a face value of over $1,000, the gift of a policy that has a marital property component will almost always require that the spouses "act together" within the meaning of the statute[49] for the remedies not to apply.

Another typical situation in which a third party owns life insurance is in a business relationship, which is covered by the following section.

D. Policies on Life of Third Parties, Owned by a Spouse

While special life insurance classification rules of Wis. Stat. § 766.62 apply to policies *on the life of a spouse*, they do not apply to policies *on the lives of third parties*. Rather, the general marital property classification rules apply to a policy owned by a spouse and insuring a third party. Therefore, the presumption of marital property and the tracing rules the Wisconsin courts adopt pursuant to Wis. Stat. §§ 766.31 and 766.63(1) will apply.

> *Example:* Child is listed on the records of a life insurance company as the owner of a policy on parent's life. The policy was taken out on January 1, 1987, and all premiums have been paid by child. The first year's premium was paid with marital property. The next two years' premiums were paid with child's individual property. At the end of the first three

[49] To "act together," the spouses do not necessarily have to act simultaneously; subsequent consent should be sufficient. *See* Wis. Stat. § 766.53 Supplemental Committee Notes at Ch. 37, Laws of 1985.

years, assuming child can trace the individual property component and that a source of premiums rule is adopted by the courts, the policy would be one-third marital property and two-thirds individual property.[50]

Example: Spouse A and a third party (TP) are business partners. After 1986, A and TP purchase policies on each other's lives with the intent of using the proceeds to buy out the insured's interest upon the death of that partner. Spouse A pays the premiums on the policy insuring TP's life from A's partnership draw. The policy is the marital property of A and A's spouse, since all payments made on the policy came from marital property. If the proceeds are used to purchase TP's partnership interest, that interest will be marital property.

E. Release of Rights

The noninsured spouse may release his or her rights in a life insurance policy. This can be done by consent to a specific beneficiary designation or by reclassification of the policy and future premiums.[51] *See Marital Property Law in Wisconsin* § 2.94.

The noninsured spouse may give written consent to the designation of another person as the beneficiary of the proceeds of a policy. Wis. Stat. § 766.61(3)(e). Depending upon the wording of the instrument, the consent will relinquish all or a portion of that spouse's interest in the proceeds of the policy, regardless of the classification of the property used to pay the premiums. The consent is revocable and effective only with respect to the named beneficiary unless it specifically provides otherwise. Even if the consent as to a named beneficiary is irrevocable, by its logic it will not be effective if the beneficiary is changed by the owner spouse or if the beneficiary predeceases the owner spouse.

Instead of consenting to the beneficiary designation, the noninsured spouse may consent to a reclassification of all of that spouse's interest in property used to pay premiums on the policy or in the ownership interest or proceeds of the

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[50] The community property states have adopted a variety of methods for classification of life insurance policies. California has used a rule that focuses on the source of the premiums. *See* MPLW § 2.93.

[51] As amended by 1987 Act 393, Wis. Stat. § 766.61 allows the use of consents regarding *any* insurance policy, not just one where a spouse is named as the insured. Wis. Stat. § 766.61(1)(c).

policy as the individual property of the insured spouse. Wis. Stat. § 766.61(3)(e).[52] To relinquish all present and future interest in the policy, the consent to reclassification should be worded to cover both the policy and all future premiums. If only one of these interests is reclassified, the result may be a policy subject to the "straddle formula." To be fully effective, the document should also state that it is irrevocable. Under this method, the insured spouse would have full ownership rights to the policy and could name any beneficiary.

The written consent provided for in Wis. Stat. § 766.61(3)(e) is unilateral; only the noninsured spouse need sign it. Moreover, the general rules for the validity of marital property agreements, including the need for financial disclosure, do not apply. Nonetheless, an attorney or other professional advising one or both spouses should remain keenly attuned to the possibility of conflict of interest in this situation. In particular, *a consent form should not be presented to the noninsured spouse as a trivial or "technical" matter merely requiring his or her signature.* In some cases, separate representation of the spouses will be needed.[53]

The results achievable by written consent can alternatively be achieved through use of a marital property agreement between the spouses, under Wis. Stat. § 766.58.

Both the written consent and the marital property agreement can be very useful in planning for insurance policies held outright by a spouse or in trust. However, there are many important tax consequences to the techniques outlined above, both when the documents are executed and at the death of the insured spouse; these issues are reviewed in the following section. In addition, there are special problems when a policy is owned by a trust; these concerns are discussed in book § 3.3.

§ 3.2 TAXATION OF LIFE INSURANCE

A. Policies on Decedent's Life

1. Taxation at Death. In general, proceeds of insurance policies on the life of the decedent are taxable in the decedent's gross estate if he or she possesses any incidents of ownership or if the proceeds are payable to the estate. I.R.C. § 2042. Under the "incidents of ownership" test, if a decedent holds any ownership right (*e.g.*, right to change beneficiary designation, right to borrow,

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[52] Other types of reclassification are also possible under the statute.

[53] *See* the discussion of ethical problems in marital property practice in MPLW, Ch. 14.

etc.) on a policy insuring his or her life, the full proceeds to which that right applies will be included in the gross estate. Thus, if a policy on the decedent's life were the decedent's individual property, the full amount of the proceeds would be includable in the gross estate.

> *Example:* Spouse A has an interest in a life insurance policy insuring A's life. This is a group policy through A's employer and has been in effect since 1983. The policy would therefore be mixed property, with a marital property component determined under the "straddle formula" of Wis. Stat. § 766.61(3)(b). However, in 1987, Spouse B executed a valid consent under Wis. Stat. § 766.61(3)(e), which irrevocably reclassified the policy and all future premiums as the individual property of Spouse A. On A's death, the entire proceeds are includable in A's gross estate because A held the incidents of ownership over the entire policy.

Although the statute does not specifically refer to community property, Treas. Reg. § 20.2042-1(c)(5) (1974) states that in a community property state, an insured spouse is deemed to possess incidents of ownership in only one-half of a policy that is community property. This regulation apparently assumes that a policy will either be entirely community (marital) property or entirely separate (individual) property. However, as discussed in book § 3.1, in Wisconsin, it is possible for a policy to be *mixed property* with a marital property *component*. In that situation, it appears reasonable to assume that all but the noninsured spouse's marital property interest would be included in the decedent's gross estate.

> *Example:* Spouse A is the owner of record on a $100,000 policy issued July 1, 1984. The July 1, 1987, premium was paid from marital property, and Spouse A died on June 30, 1989. Under the "straddle formula," of Wis. Stat. § 766.61(3)(b), three-fifths of the policy ($60,000) is A's nonmarital property, and two-fifths of the policy ($40,000) is marital property. (*See* example in book § 3.1A.) All of the nonmarital component and one-half of the marital property component (a total of $80,000) will be included in A's gross estate under I.R.C. § 2042. The remaining $20,000 is owned by the surviving spouse.

2. *Gift Tax Implications of Allowing Proceeds to Go to a Third Party or Allowing Reclassification of the Policy.* The fact that a policy is marital property not only affects the amount included in the decedent spouse's estate, but it may also have gift tax implications if there is a third party beneficiary and the surviving spouse allows the full proceeds to pass to that beneficiary. This

may occur because the surviving spouse has agreed to the beneficiary designation (but not to a reclassification of the policy and all future premiums) through a written consent or marital property agreement (*see* discussion in book § 3.1E)[54] or simply because the surviving spouse fails to exercise his or her rights to claim half the marital property interest in the proceeds using the remedy provided by Wis. Stat. § 766.70(6)(b). In either case, the result will be a gift of the surviving spouse's marital property interest in the proceeds from the surviving spouse to the beneficiary.

If the surviving spouse fails to exercise his or her rights at the death of the insured spouse, a gift results because it is as though the survivor had received his or her share of the proceeds and then given it to the beneficiary. Although this may appear to be similar to a disclaimer — and may be treated as such by the Department of Revenue[55] — in fact, it is fundamentally different from a disclaimer because the surviving spouse already had a vested interest in the policy. If the surviving spouse previously executed a consent to the beneficiary named in the policy and therefore cannot challenge the transfer at the insured spouse's death, the taxable event is still the transfer at death. Until the death of the insured, the gift was incomplete because the beneficiary may fail to outlive the insured spouse, the beneficiary may be changed, or the policy may lapse.

The gift from the surviving spouse to the beneficiary of the policy will typically qualify for the $10,000 annual exclusion available under I.R.C. § 2503(b); any excess amount will be a taxable gift. As discussed in book § 2.3A, in most cases, no gift tax will actually have to be paid, and often there are tax advantages to this method of dividing the gift between the spouses.

> *Example:* After 1985, Spouse A takes out a $100,000 policy on A's life, naming child as beneficiary. Spouse A is listed as owner; the policy is marital property. Spouse A dies. Since A had incidents of ownership for a one-half interest in the policy, $50,000 is includable in A's gross estate under

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54. Consent to a named beneficiary will be an incomplete gift for gift tax purposes, even if the consent is irrevocable, because (a) the beneficiary may predecease the insured spouse, (b) the beneficiary may be changed by the insured spouse, or (c) the policy may be terminated before the death of the insured spouse. It is possible, however, that the spouse relinquishing the rights will have made a transfer for value under I.R.C. § 101, and that as a consequence, the proceeds of the policy will lose their income tax exemption. *See* Reg. § 1.101-1(b)(4) and Carl J. Rasmussen and Susan Erickson, *Some Tax Aspects of Provisions for Disposition of Property at Death in Marital Agreements*, EST. PLAN., Warren, Gorham & Lamont, to be published in 1991.

55. *See* note 37, *supra*.

> I.R.C. § 2042. Child's receipt of the full $100,000 proceeds would mean that there was a gift of $50,000 from B to child. Ten thousand dollars of the gift from B qualifies for the annual exclusion under I.R.C. § 2503(b). There will be no gift tax due at the time of the transfer unless Spouse B's accumulated taxable gifts since 1976 total more than $600,000, because of the unified credit available (as of 1989) under I.R.C. § 2505. The taxable gift will be included in B's tentative estate tax base at death, but if the tentative estate tax base is $600,000 or less, the unified credit available (as of 1989) under I.R.C. § 2001 will offset any estate tax due.

The possibility of "double counting" may exist when a policy is marital property and the insured spouse names his or her probate estate as the beneficiary, and the surviving spouse gives up the right to his or her marital property share, either by consent or inaction. Since the full proceeds of the policy will be received by the probate estate, they may all be includable in the gross estate for tax purposes under I.R.C. § 2042(a). But in addition, the surviving spouse may be deemed to have made a taxable gift of his or her interest in the policy to the estate. This transfer would not qualify for the marital deduction for gifts (I.R.C. § 2523) because it would be a gift to the beneficiaries.

Note that to the extent that the shared ownership of the policy by the spouses is a problem, it can be remedied by reclassification of the policy and all future premiums as the individual property of one of the spouses (most often the insured spouse). *See* book § 3.1E. Since reclassification constitutes an outright gift of ownership interest in the property, the gift by the spouse who relinquishes these rights qualifies for the unlimited gift tax marital deduction available under I.R.C. § 2523.

B. Policy Owned by Decedent, Insuring Another's Life

I.R.C. § 2033 mandates the inclusion in the decedent's gross estate of the value of property owned by a decedent. Therefore, if a decedent has an interest in an unmatured policy, the value of that interest will be included in the decedent's gross estate. Ownership of such unmatured interests at death is quite common under a community property system because life insurance on the surviving spouse's life often will have a marital property component.

> ***Example:*** After 1985, Spouse A buys a $200,000 whole life policy on A's life. The policy is marital property. In 1996, Spouse B dies. At that time, the fair market value of the policy is $10,000. Therefore, B's interest is $5,000, and that amount is included in B's gross estate. (This interest is

> transferable by will, subject to A's right to buy out the beneficiary. *See* Wis. Stat. §§ 766.61(7), 766.70(7).)

§ 3.3 LIFE INSURANCE TRUSTS AND RETAINED INTERESTS

Most irrevocable life insurance trusts are designed as "bypass trusts," whose purpose is to keep the insurance proceeds out of both spouses' gross estates. This is accomplished by giving the surviving spouse either no interest or only limited interests that will not cause the trust property to be included in his or her estate. Often the surviving spouse receives a life income interest and perhaps also a limited power of appointment and/or the right to receive discretionary distributions made by an independent trustee. The remainder usually goes to the decedent's children, who may also be discretionary beneficiaries during the surviving spouse's lifetime. Some general problems with retained interests are discussed in book § 2.3A, and *Marital Property Law in Wisconsin* §§ 9.17 and 9.35. Irrevocable life insurance trusts are specifically addressed at *Marital Property Law in Wisconsin* § 10.35.

A. Estate Taxation

A risk involved with any life insurance trust is that the full value will be included in the insured's estate under I.R.C. § 2035 if the insured dies within three years of the transfer to the trust. Assuming the insured survives the three years,[56] the proceeds will not be included in his or her estate as long as the insured does not retain any incidents of ownership in the policy. I.R.C. §§ 2042, 2036, 2038.

> *Example:* Spouses A and B live in a *common law* property state. Spouse A is the insured and owner of a $500,000 life insurance policy. A sets up a bypass trust, funded with life insurance, with income to B and the remainder to their children. If A lives three years after the gift of the policy to the trust, the proceeds will not be included in A's gross estate. The proceeds will also escape taxation in B's estate because B holds only a life interest.

Serious problems arise when there is a marital property component to a policy transferred to an irrevocable life insurance trust. Because the identity of the grantor depends upon the underlying classification of the policy, both

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[56] The three-year rule may not apply if the insured does not acquire the policy and never possesses, even for a transitory period, any ownership interest in the policy. *See* Estate of Joseph Leder, 89 T.C. 235 (1987).

spouses will be considered grantors if there is a marital property component. In addition, a marital property component may be generated if even one subsequent premium is made from marital property. Wis. Stat. § 766.61(3)(d). The decedent spouse will not be affected because that spouse is not a beneficiary of the trust. But if the surviving spouse has an interest in the income (or principal) of the trust, that spouse's interest will be included in his or her gross estate under I.R.C. § 2036. *See also Marital Property Law in Wisconsin* § 10.35.

> *Example:* Assume in the preceding example that Spouses A and B live in Wisconsin, that the life insurance policy is marital property when transferred to the trust, and that subsequent premiums are paid from marital property. If A survives three years after the gift of the policy to the trust, nothing is includable in A's gross estate. But since B would be the transferor of half the corpus, half the value of the corpus at B's death would be included in B's gross estate because of B's retained interest, unless this problem is recognized and addressed appropriately.

To avoid inclusion in the gross estate of the noninsured spouse, that spouse should have an interest in neither the policy transferred to the trust nor the funds used to make subsequent premium payments. This can be difficult to accomplish without special planning. For example, in a group policy sponsored by the insured's employer, premiums paid by the employer will be marital property. Wis. Stat. § 766.31(4); Rev. Rul. 76-490, 1976-2 C.B. 300.

In theory, there is no retained interest problem if the policy and all subsequent premiums are the individual property of the insured. If they are not already the insured's individual property, they can be reclassified as such with a marital property agreement or a written consent. *See* book § 3.1E. However, the IRS might challenge the transfer as a "sham" if it appears that the reclassification was predicated on the receipt of future benefits under the trust and that the only purpose of the reclassification was to avoid taxation. Similarly, the IRS might argue that the step-transaction doctrine applies and treat the noninsured spouse as a co-grantor. Therefore, one way to avoid inclusion of the proceeds in the noninsured spouse's estate is for the reclassification to be independent from the decision to create and fund the

trust.[57] For this reason, it can be difficult to reclassify the marital property component of a life insurance policy that is already in an irrevocable trust.

Another way to avoid the retained interest problem is by sale of the noninsured spouse's interest to the trust. However, this alternative is generally not feasible for two reasons. First, the trust is usually not funded with sufficient assets to support the purchase plus subsequent premiums. Second, the sale could cause the proceeds to be subject to income tax when paid. I.R.C. § 101(a)(2).

B. Gift Taxation

If the policy transferred to the trust is *marital* property, a separate gift of each spouse's half-interest in the policy will have been made, and the two parts of the transfer must be analyzed separately. The gift of a half-interest by the "owner" spouse will be partly to the "nonowner" spouse and partly to the other beneficiaries. Depending on the terms of the trust, the gift to the "nonowner" spouse may qualify for the gift tax marital deduction under I.R.C. § 2523.[58] The gift of a half-interest by the "nonowner" spouse will be partly a retained interest not subject to tax and partly a gift to the other beneficiaries. *See Commissioner of Internal Revenue v. Chase Manhattan Bank,* 259 F.2d 231 (5th Cir. 1958), *cert. denied,* 359 U.S. 913 (1959).

When the policy transferred to the trust is term insurance, the value of the gift is not substantial. Nonetheless, the trust must be drafted to provide withdrawal powers (Crummey powers) so that the benefit of the annual exclusion under I.R.C. § 2503(b) can be obtained.

C. Income Taxation

After the death of the insured spouse, the trust will be fully funded with the proceeds of the policy. Ordinarily, the income earned by the trust at that point would be taxed to the trust or to those beneficiaries who received it. However, where the surviving spouse is a beneficiary of the trust and is also considered a grantor of the trust for the reasons discussed above, the grantor trust rules of I.R.C. §§ 676 and 677 will be triggered. Under these sections, part

[57] Alternatively, if the reclassification of the policy and the creation of the trust are completed as part of a coordinated transaction, it may be that an exchange for consideration has taken place. This transaction would not trigger the income tax consequences mentioned in the following paragraph, as long as the exception in I.R.C. § 101(a)(2)(B) is met.

[58] If the policy transferred to the trust is *nonmarital* property, this analysis will apply to the entire transfer.

of the trust income may be taxable to the surviving spouse, even if that income is accumulated in the trust or paid out to another beneficiary.

D. Caveat

The discussion here has focused only on the tax consequences of a spouse being the beneficiary of an irrevocable life insurance trust, where there is a marital property component to the policy held by the trust. It does not address other tax issues related to this type of trust nor does it address drafting considerations. There are many excellent analyses of these issues, including Berall's comprehensive treatment in "Use of Irrevocable Life Insurance Trusts," Chapter 21, *37th USC Law Center Tax Institute*, 1985; Zaritsky's forms and commentary in *Tax Planning for Family Wealth Transfers* (Warren, Gorham & Lamont, 1985, with supplements) § 6.04; and Mirabello's and Slota's "Current Developments in Planning and Drafting Irrevocable Life Insurance Trusts," Chapter 16, *New York University, 48th Annual Institute on Federal Taxation*, 1990.[59]

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[59]. After the enactment of the Revenue Act of 1987, which created I.R.C. § 2036(c) in an attempt to limit "asset-value freezes," there was concern that the new provision would eliminate the estate tax advantages of life insurance trusts. However, IRS Notice 89-99 apparently eliminates that concern. Rev. Rul. 89-99, 1982-2 C.B. 422. Also, in situations where funds are not needed until the death of the surviving spouse, the use of a joint and survivor life insurance policy can avoid many of the tax problems in life insurance trusts.

4

Problems in Irrevocable Coordinated Plans

§ 4.1 Will Substitute Agreements

§ 4.2 "Forced Choice" Plans

A. One Spouse's Attempt to Dispose of All Marital Property

B. Forcing the Surviving Spouse to Choose Between the Deferred Marital Property Elections and Taking Under the Estate Plan

Estate planning commentators typically frown on the use of irrevocable coordinated plans between the spouses because of their inflexibility in changing circumstances. Nonetheless, two aspects of the Marital Property Act could encourage the use of this type of plan. This chapter briefly considers these plans and their tax consequences.

§ 4.1 WILL SUBSTITUTE AGREEMENTS

Wis. Stat. § 766.58(3)(f) states that a marital property agreement may provide for the nonprobate transfer of any or all of the property of either or both spouses at the death of either spouse. This far reaching provision is patterned after a long standing Washington State statute and is sometimes referred to as the "Washington Will" provision. This transfer is not, however, a will. Rather, it is an interspousal contract that functions as a will substitute. Wis. Stat. §§ 863.27, 865.201, 867.046. Depending on its provisions, it may supersede the designation of beneficiaries on other nonprobate transfers, such as life insurance, deferred employment benefits, and joint tenancies. As a result, it is important that a marital property agreement embodying these provisions be carefully drafted and well understood by the spouses. To avoid ambiguity and conflict at death, the disposition provisions of documents superseded by the marital property agreement should be changed to conform to the agreement.

A marital property agreement can only be changed by a subsequent marital property agreement. Wis. Stat. § 766.58(4). Thus, in general, a marital property agreement becomes irrevocable at the death of a spouse. However, Wis. Stat. § 766.58(3)(f) states that if the agreement provides for the passing of property upon the death of the surviving spouse, the survivor may amend the agreement following the death of the first spouse unless the agreement provides otherwise

or the property is held in a trust created by the agreement. This provision was added to protect the surviving spouse in the event of a change in circumstances between the first spouse's death and the death of the surviving spouse; however, it also may contradict a primary purpose of the agreement.

If the spouses decide to expressly prohibit any modification to the agreement by the surviving spouse, not only will the surviving spouse be bound by the agreement following the death of the first spouse but also at the death of the first spouse, there will probably be a taxable gift of the remainder interest to the ultimate beneficiaries. This is clearly the case for joint and mutual wills, and a Wisconsin nonamendable agreement with third party beneficiaries seems to be a very similar type of instrument. Regarding the taxation of joint and mutual wills and related community property agreements in other states, *see* Rev. Rul. 69-346, 1969-1 C.B. 227; Rev. Rul. 71-51, 1971-1 C.B. 274; and especially the recent Seventh Circuit cases, *Pyle v. United States*, 766 F.2d 1141 (7th Cir. 1985), and *Estate of Jesse L. Grimes v. Commissioner of Internal Revenue*, 851 F.2d 1005 (7th Cir. 1988), which control for Wisconsin.[60]

Given the similarity between a marital property agreement that provides irrevocably for the disposition of the spouse's property at the surviving spouse's death on the one hand and a contractual will on the other, planners should proceed with caution in this area. For many years, commentators have discouraged the use of contractual wills because of their reputation as "notorious litigation breeders" and their frequently adverse tax consequences. *See* Comment, "The Contractual Will: Invitation to Litigation and Excess Taxation," 48 *Tex. L. Rev.* 909 (1970); Comment, "Contracts to Make Joint or Mutual Wills," 55 *Marq. L. Rev.* 103 (1972).[61] Often, the use of trusts can avoid the problems of contractual wills while still achieving the client's goals. On these issues, *see* the extensive commentary at *Marital Property Law in Wisconsin* § 7.16 and the analysis of the *Pyle* case at *Marital Property Law in Wisconsin* § 9.50d.

The critique in the last two paragraphs has focused on the use of a marital property agreement to control the disposition of property at the death of the

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[60] In both *Pyle* and *Grimes*, there were disputes over the constraints on the surviving spouse's power to consume, which were decided under Illinois law. Nevertheless, the holding — that if a nonamendable contract exists, such that disposition of the spouses' property is fixed and the surviving spouse's right to consume is limited, then a gift to the remainder beneficiary takes place at the death of the first spouse — seems directly applicable to transfers pursuant to Wis. Stat. § 766.58(3)(f).

[61] There is, however, some dissent to this view. For a recent argument advocating the use of contractual wills in certain situations, *see* Hunt, *Joint Wills May Provide a Solution to Drafting Problems for Clients Concerned with Remarriage*, EST. PLAN., March 1985, pp. 88-93.

surviving spouse. Many of the problems do not occur with respect to a marital property agreement that disposes of property at the death of the first spouse only. Some estate planners use marital property agreements to create marital property with survivorship[62] or to insure that a spouse who has relinquished rights to marital property will be protected if that spouse is the survivor.

§ 4.2 "FORCED CHOICE" PLANS

A. One Spouse's Attempt to Dispose of All Marital Property

Each spouse has a vested one-half interest in marital property and is free to dispose of that interest at death. At the first spouse's death, the surviving spouse retains his or her vested interest in each item of property. Wis. Stat. § 861.01. Nonetheless, the first spouse to die may wish to exert control over "both halves" of the marital property. Absent a marital property agreement, one method of doing this is for the first spouse to make his or her dispositions in favor of the surviving spouse dependent on the survivor's relinquishment of certain rights to the marital property.

> *Example:* A and B own a large amount of marital property. A's estate plan creates two trusts, the X trust and Y trust. A gives B mandatory income rights in both trusts, on the condition that B transfer B's one-half interest in the marital property to the Y trust. If not, B receives nothing under the plan. (This example adapted from *Marital Property Law in Wisconsin* § 10.44b.)

This type of plan has sometimes been used in the other community property states, and it has been the subject of extensive literature. *See Marital Property Law in Wisconsin* § 10.44a.

The forced election plan has extensive income, gift, and estate tax consequences to both spouses, similar to those of contractual wills.[63] The plan also has important nontax implications for management and control. These aspects are reviewed in *Marital Property Law in Wisconsin* §§ 9.15b, 9.35b, 9.38a, 9.51a, and 10.44.

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62. Note, however, that a survivorship provision in a marital property agreement generally will not result in protection against creditors at death. *See* note 15, *supra*.

63. The *Gradow* case (11 Cl. Ct. 808 [1987], 59 AFTR 2d 87-1221, 87-1 USTC ¶ 13,711) addresses some of the estate tax problems faced by the surviving spouse in this sort of plan, in situations where the tax liability is greater than the unified credit available under I.R.C. § 2001. The *Gradow* case was recently upheld by the court of appeals for the federal circuit (90-1, USTC ¶ 60,010 (CA-FC 1990). *See also* MPLW 9.35b as revised, June 1990.

B. Forcing the Surviving Spouse to Choose Between the Deferred Marital Property Elections and Taking Under the Estate Plan

Unlike the elective share provisions in most common law property states (and under former Wisconsin law), the elections relating to deferred marital property under Wis. Stat. §§ 861.02 and 861.03 do not generally preclude the surviving spouse from also taking under the decedent's estate plan. Spouses who wish to limit their survivor's ability to take under both the statutes and the estate plan can draft to reduce or eliminate benefits under the plan if the statutory elections are exercised. *See, e.g.*, Erlanger and Weisberger, "New probate and non-probate elections under Wisconsin's Marital Property Act," Parts 1 and 2, *Wisconsin Bar Bulletin*, October and November 1986.

The authors of *Marital Property Law in Wisconsin* convincingly argue that property passing to the surviving spouse under the Wis. Stat. §§ 861.02 or § 861.03 election qualifies as a nonterminable interest under the federal marital deduction statute, I.R.C. § 2056, as does the property taken under a "forced choice" provision in lieu of the statutory elections. *Marital Property Law in Wisconsin* § 9.40b. Nonetheless, there is no IRS ruling directly on the point, and in any case, the surviving spouse may be offended by the forced choice provision. Therefore, use of such a provision might best be reserved for situations in which there is a significant probability that the provision is necessary in order to effectuate the plan.

5
Income and Transfer Tax Consequences of Gifts of Marital Property

§ 5.1 General Rule
§ 5.2 Transfer of Marital Property by One Spouse

§ 5.1 GENERAL RULE

In general, the tax consequences of gifts of marital property are the same as the consequences for gifts of nonmarital property. Transfers may be subject to the gift tax under I.R.C. § 2501 (except to the extent to which they qualify for the annual exclusion under I.R.C. § 2503(b) or (c)), and gifts to qualified charitable organizations may be deductible for income tax purposes under I.R.C. § 170. When a completed gift of marital property is made, the gift is deemed to be one-half from each spouse. Thus each spouse is considered to have made one-half the gift for gift tax purposes and may use his or her annual exemption (if the gift qualifies) without resort to the "split gift" provisions of I.R.C. § 2513. Similarly, each spouse may deduct half of a qualifying charitable contribution if the spouses file separate income tax returns.[64]

This analysis only applies to *completed* gifts. Neither the gift tax nor the charitable deduction applies to gifts that are incomplete. The general rule is that a gift is complete when "the donor has so parted with dominion and control as to leave . . . [the donor] . . . no power to change its disposition." Treas. Reg. 25.2511-2(a); *Sanford v. Commissioner of Internal Revenue,* 308 U.S. 39 (1939). The application of this rule is usually straightforward when outright transfers are made.

§ 5.2 TRANSFER OF MARITAL PROPERTY BY ONE SPOUSE

When marital property is transferred by one spouse, even when there are apparently no reserved powers, there is a complication because of the limit on each spouse's power of management and control. Wis. Stat. § 766.53 provides that "a spouse acting alone may give to a 3rd person marital property that the

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[64] If a joint income tax return is filed, this feature is irrelevant.

spouse has a right to manage and control only if the value of the marital property given to the 3rd person does not aggregate more than either $1,000 in a calendar year" or a larger amount if "reasonable." If a spouse acting alone gives more than the permitted amount, remedies are available under Wis. Stat. § 766.70(6)(b). Since these remedies can have the effect of revoking all or part of the transfer, it is unclear whether a gift of marital property in excess of the "safe harbor" amount can be a completed gift before the statute of limitations for the remedies has expired or the remedy has otherwise been barred. Since the point at which a gift is deemed complete is a matter of state property law, the resolution of this issue ought to depend on legislative pronouncements and state court interpretation of the Marital Property Act.

The legislature attempted to resolve the issue in Trailer Bill I (1985 Act 37) when it amended the management and control provisions of Wis. Stat. § 766.51(4) to read that "the right to manage and control marital property permits gifts of that property, subject to remedies under this chapter." A Supplemental Note to that provision states in part, "[t]he revised language assumes that, even if a remedy is available, the gift was made when the transfer occurred." Supplemental Committee Note to Wis. Stat. § 766.51(4) at Ch. 37, Laws of 1985. This position is supported by the fact that use of the remedy requires court intervention, could involve an action against the donor spouse rather that against the recipient, and could involve monetary compensation rather than return of the property. A Supplemental Note to Trailer Bill I also clarified that Wis. Stat. § 766.53 does not literally require the spouses to "act together"; rather "subsequent consent by the other spouse is sufficient," and "common law defenses regarding consent . . . apply." The Supplemental Note also states that "it is further assumed that, if subsequently consented to by a spouse, a gift was made when the original transfer occurred." Supplemental Committee Note to Wis. Stat. § 766.53 at Ch. 37, Laws of 1985.[65]

Nonetheless, the IRS has taken the position that "Wis. Stat. § 766.53 casts serious doubts upon the validity of charitable gifts of marital property in excess of $1,000 when both spouses do not join in the gift." *Tax Practitioner Newsletter*, IRS Milwaukee District, April 1988, p. A-6.[66] The IRS position appears to be

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[65] For a discussion of the authoritative status of Supplemental Committee Notes, *see* page xii, *supra*.

[66] For a similar statement regarding gift tax, *see* the *Tax Practitioner Newsletter*, January 1987. Note that under this reasoning, gifts subject to the gift tax will, if incomplete, be included in the decedent's gross estate at their date of death value. The donor will lose the possibility of using the annual exclusion, and the asset will receive a new basis under

that the gift is not complete until there is consent and that the filing of a joint return constitutes that consent, if it has not been given earlier.

Aside from the fact that the IRS position seems contradictory to the state property law on which it should be based, it may also be incorrect because signing the joint return may only constitute *notice* of the gift to the nondonor spouse, not *consent* to the gift. The IRS position is that the gift is properly deductible only in the year that a joint return reporting it was filed. For example, a gift made by a spouse "acting alone" in 1989 would be complete in 1990 if a joint return were filed in that year and would be properly reportable on a return filed in 1991. A seemingly more logical position for the IRS to take, given its (erroneous) starting point, would be that this gift would be complete in 1991, when the statute of limitations (which, among other provisions, allows one year after discovery of the gift) would have run. *See* Wis. Stat. § 766.70(6)(a).[67] The Department of Revenue does not concur in the IRS position but must follow it with respect to charitable contributions because the Wisconsin itemized deduction credit is computed solely on the basis of federal deductions allowed. Department of Revenue, "Department of Revenue Updates — Marital Property Positions," October 20, 1988, pp. A-78 and A-79. For further discussion of these issues, *see Marital Property Law in Wisconsin* § 9.50.

In its discussion of this issue, the authors of *Marital Property Law in Wisconsin* note that the IRS position is unnecessary (and possibly contrary to that taken by the IRS on other community property jurisdictions)[68] in part because, if the property were in fact recovered in a subsequent year, it would be taxable in that year under the "tax benefit rule" of I.R.C. § 111(a), if it had reduced the amount of income subject to tax in the earlier year. *Marital Property Law in*

I.R.C. § 1014(a). Whether this is a positive or negative development will depend on whether the property has appreciated and whether an estate tax is due.

[67] Note that, following the IRS approach, a gift of marital property made by a spouse "acting alone" and reported in full on that spouse's *separate* return — and possibly a gift deducted on a joint return but not itemized there — could remain incomplete until there was consent, until one year after discovery, or until the claims period has run after the death of one of the spouses. Wis. Stat. § 766.70(6)(a). This analysis assumes that the donor spouse improperly reported the entire gift on that spouse's return instead of informing the other spouse of the opportunity to deduct half. (This might occur if the donor spouse believed that the gift was made from nonmarital property.)

[68] MPLW § 9.50b states that "the IRS in community property states apparently has not disallowed deductions for unilaterally made charitable contributions on joint tax returns" but gives no examples or citations.

Wisconsin § 9.50b. Although the Milwaukee office has indicated that it is unlikely to pursue the question in most audits (*Tax Practitioner Newsletter,* April 1988, p. A-6)[69] unless the tax benefit rule position is formally adopted by the IRS,[70] prudent practice dictates the obtaining of some form of consent, during the year of the transfer, from the nondonor spouse for gifts in excess of the statutory limit. Note that Wis. Stat. § 766.53 does not require that this consent be in writing nor that any record of its existence be made or preserved.

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[69] The April 1988 *Newsletter* cited in the text states that "the type of transfers discussed raise the possibility of challenge by the Service, but may not present an audit question because of the mere shifting of deduction between tax years." However, even this tentative statement is not binding on the IRS, and in any case, it implies that if the marginal tax rate were significantly higher in the later year, the IRS might press the issue.

[70] Subsequent to the April 1988 *Newsletter*, the IRS has acknowledged that the tax benefit doctrine may apply in this situation. Department of Revenue, "Federal and Wisconsin Income Tax Reporting Under the Marital Property Act," Department of Revenue Publication 113, November 1990, p. A-58.

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Department of the Treasury

District Director
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TAX PRACTITIONER NEWSLETTER

April 1988

Federal Tax Implications of The Wisconsin Marital Property Act
(3rd Special Edition)
also,
Impact of The New Federal Child Support Guidelines on Family Support Awards and its Deductibility Under IRC Section 71

By L. M. Phillips
District Director

This is a follow-up to the November 1986 and January 1987 **Practitioner Newsletters** concerning the federal tax treatment of the Wisconsin Marital Property Act. In addition, this newsletter will also state the Milwaukee District position on the deductibility of family support allowance resulting from recent changes in Wisconsin law.

Wisconsin Marital Property Act

Federal Tax Basis

A. Survivorship Marital Property
The question surrounding tax treatment of this classification of property was alluded to in the earlier newsletters and was strongly suggested in the second newsletter that this type of property classification would be considered marital property for federal tax purposes. Based upon advice received from the National Office, survivorship marital property will definitely be considered community property for federal income tax basis purposes. This means, upon the death of the first spouse, a full step up in basis will be received under IRC section 1014.

B. Revenue Ruling 87-98 1987-39, IRB 15
This recently issued revenue ruling did not identify a particular state, but dealt with the problem of property held in joint tenancy by a husband and wife who are domiciled in a community property state. It answered the issue of how this property would be treated for purposes of Internal Revenue Code section 1014(b)(6). The assumption was that this property, under State law, would be characterized as community property and, therefore, would be treated as community property for purposes of Code section 1014(b)(6). Based upon the rationale of this revenue ruling, we would take the position that any time property is "titled" in a common law estate but is marital property under Wisconsin law, it would qualify for the stepped-up basis under IRC 1014(b)(6).

Under Wis. Stat. 766.60, property held in the common law estates of joint tenancy or tenancy in common is not marital property except in the following limited circumstances:

1. If the property was acquired after the determination date in joint tenancy exclusively between the spouses, it is survivorship marital property, unless it was acquired by gift and the donor provides otherwise. (See Wis. Stat. 766-60(4)(b)1.a and (b)2.);

2. If the property was acquired after the determination date in tenancy in common exclusively between the spouses, it is marital property unless it was acquired by gift and the donor provides otherwise. (See Wis. Stat. 766-60(4)(b)1.b and (b)2.); or

3. If the property was acquired before the determination date in either joint tenancy or tenancy in common exclusively between spouses after marriage, in which case it would be deferred marital property upon the death of a spouse (See Wis. Stat. 851.055.)

Thus, upon the death of the first spouse having an interest in marital property, the survivor who held the other interest would obtain a full step up in basis for the property as a tenant in common with the decedent.

C. The Possibility of A Marital Property Component

Where an additional title holder exists besides husband and wife, questions have arisen whether there could be a marital property component. Where the property is held by spouses with other individuals as joint tenants or tenants in common, there is no marital property component and the property would not qualify under IRC 1014(b)(6). (See Wis. Stat. 766.60(4)). We have not yet taken a position as to whether property which is subject to an augmented marital property estate election is community property for purposes of IRC 1014(b)(6). (See Wis. Stat. 861.03 et seq.)

A very interesting question arises on the implication of Wis. Stat. 766.63(2), which provides for the marital property component arising from separate property where the non-title spouse provides efforts that cause appreciation, and reasonable compensation was not received for those efforts. As long as no third party has an interest in the property as a joint tenant or tenant in common, the application is marital property. However, based upon Wis. Stat. 766.60(4)(a) dealing with joint tenancy, if a third party has an interest in the property as a joint tenant or tenant in common, it is the conclusion of Milwaukee District Counsel that the appreciation in value would not be marital property.

Income Reporting

Numerous questions have come in concerning income reporting pending a divorce when the income of the other spouse is unknown and unattainable. In some instances, the one spouse is aware of the other one's employment, but is not in a position to obtain the required income information in order to file a tax return. In this situation, the Service, as an administrative expediency, is suggesting that it would be preferable for the one spouse to file a return reporting all of their individual income and attaching a statement advising the Internal Revenue Service that they are subject to community income reporting but are unable to obtain the income of the other spouse. Admittedly, this is a very difficult situation in which there is no right answer. This is based upon the fact it is a close question whether the one spouse would obtain relief under IRC Section 66(c) when they are aware of the other spouse's employment and income sources, but do not know the amount of income. IRC Sec. 66(c) allows a spouse not to report community income when they did not know, or have reason to know, the other spouse's income. A recent court decision, Bobbie J. Roberts v. Commissioner, TC Memo 1987-391, reflects that IRC Section 66 relief won't be granted unless four conditions are met, one of which is not knowing or having no reason to know of the other spouse's community income. In this case, the Court found that the fact the petitioner was aware of the other spouse's source of income would not entitle her to relief by reason of not knowing the amount of that income.

As indicated, this is an unresolved dilemma that can only be handled by reporting the amounts of known income and stating that there is community income that can't be ascertained. This approach could relieve the filer of potential penalty problems and would clearly signal that the return may be subject to IRC Sec. 66 relief.

Sub-S Corporation Elections

Under a temporary Treasury regulation, § 18.1362-2(b)(2), there is a requirement that in a community property state where a non-shareholder spouse is entitled to ownership in the stock or the income therefrom, he/she would be required to join in the S-Corporation election. General knowledge of this regulation did not come about until late 1986 at which time there were a number of S-Corporation elections taking place in order to avoid some of the provisions of the 1986 Tax Act. There were many instances where appropriate S-Corporation elections were filed; but, through oversight, did not include the signature of the non-shareholder spouse. These late 1986 and early 1987 S-Corporation elections were subsequently perfected by filing a new election form which contained the non-owner spouse's signature. Based upon discussion with the Kansas City Service Center, and the fact that the Marital Property Act has been operative for over two years, the Service is taking the position that new S-Corporation elections without both spouses' signatures will not be considered a valid election and that it will not be possible to retroactively correct them by submitting a new form with the signatures of both spouses.

Charitable Gifts of Marital Property

Wis. Stat. 766.53 casts serious doubts upon the validity of charitable gifts of marital property in excess of $1,000 when both spouses do not join in the gift. The assumption here is that the gift consists of marital property and, secondly, it is being claimed as a charitable deduction on an income tax return. Under Wisconsin statute, this gift is subject to recall by the non-consenting spouse anytime within a year of becoming aware of the transfer. If this is the case, the next question is, what is the impact of signing a joint income tax return where the donation of marital property is listed as one of the charitable deductions. Under federal income tax law, the taxpayer is charged with knowledge of and responsibility for everything on the tax return. It would, therefore, be difficult to dispute the fact that the non-consenting spouse did subsequently affirm the gift by signing a joint tax return. This, then, leaves the problem of when is the gift completed. There is a long line of federal cases that stand for the proposition that a transfer is not complete until powers that would divest that transfer have expired. Therefore, if a gift is made in the year 1987, and is not affirmed until a joint income tax return for that year is signed on April 15, 1988, a strong possibility exists that the transfer does not take place until the subsequent year. Obviously, the best solution would be to have these charitable transfers concurred in by both spouses. When that isn't feasible, or is inadvertently overlooked, then it comes down to a timing question which, in many instances, would not be raised. As an example, if the particular tax situation is similar in both tax years, it would not be appropriate for an audit adjustment to be made to shift the gift to the technically correct year.

In summary, transfers of the type described here raise the possibility of challenge by the Service, but may not present an audit question because of the mere shifting of a deduction between tax years.

Refund Offset - Estimated Tax Payments

For a number of years the Service, under statute, has been directed to offset refunds in order to pay delinquent child support payments, student loans, and other amounts due the Federal government. In the past, the refund amount has been offset on joint returns, and then the non-debtor spouse has been permitted to file a 1040X under the "injured spouse" provision and claim their share of the withholding. Since enactment of the Wisconsin Marital Property Act, the Service has been treating the total refund as marital property and applying a delinquent debt against half of the refund amount even though the other joint filer was not in debt to the government. Based upon review of two court decisions, the Service will consider estimated tax payments that are filed individually and not jointly to be separate property. This question was addressed by the Tax Court in the Lyta J. Morris, TC Memo 1966-245 and Janus v. United States 557 Fed. 2d. 1268. These decisions appear to preclude looking beyond the individual's estimated tax payment declaration to determine whether the funds arose from community property or separate property. However, it may be necessary to look to the source of funds to determine whether, under local law, any other person has an interest in the overpayment (e.g., because the funds giving rise to the overpayment came from marital property that may be subject to a federal tax lien under IRC 6321.)

Deductibility of Wisconsin Family Support Allowances

Under federal law, states were required to adopt child support standards by October 1, 1987. These new standards were passed in Wisconsin and became effective July 1, 1987. The Wisconsin standards establish that a formula approach would be used to calculate a percentage of gross income as child support. This does not mean that every family support allowance has to meet that percentage guideline, but that the Court order needs to explain why there is a variance. Under IRC section 71(c)(2), amounts under a family support allowance that are dependent upon support of a child or, in the alternative, have contingencies which reflect support of a child, then that portion of the award will be considered child support and not alimony.

The Internal Revenue Service is considering the issuance of a revenue ruling on this question, since the change does affect all of the states and the manner in which alimony is fixed. Until that revenue ruling is issued, the Milwaukee District is adopting the position that amounts determined in accordance with the guidelines established by Wisconsin Statute (HSS 80) are considered child support and, thus, not deductible as alimony. An example of how this applies is as follows:

> Assume that the non-custodial parent has one child, and has annual gross income of $10,000. Pursuant to a divorce decree, this non-custodial parent is ordered to pay $2,000 a year as a family support allowance to the ex-spouse and one child. Under the guidelines established in HSS 80, 17 percent of the gross income must be awarded as support for the minor child. Thus, $1,700 of the family support allowance is considered child support and would not be deductible as alimony.

Since this is a position that has only been adopted on a local level, pending formal guidance under a revenue ruling, taxpayers should consider protecting their rights to claim the family support allowance as deductible alimony by the use of protective refund claims.

X X X X

INFORMATION REPORTING OF REAL ESTATE TRANSACTIONS INCIDENT TO DIVORCE

There is no requirement the Form 1099-B be filed to report the assignment of an interest in real property in a divorce situation.

IRC 1041 deems transfers of property incident to divorce "gifts".

Treasury Regulation 1.6045-3T deals with information reporting on real estate transactions. The regulation specifically excludes transfers of real estate by gift.

SALE OF BUSINESS ASSETS

TRA '86 requires buyers and sellers of businesses to allocate the sales price of the business to the various business assets (using the residual method).

Both the buyer and seller are required to report this allocation to IRS by using Form 8594, Asset Acquisition Statement.

As of this writing, the regulations have not been finalized; therefore, the Form 8594 is also temporarily "on hold". We expect to receive further guidance in the near future.

FRONT LOADING OF ALIMONY PAYMENTS HAVE BEEN CHANGED

The '86 Reform Act revises the front loading alimony rules to compute recapture, on the basis of amounts paid during the first 3 years after the separation, where the difference between the first year and the average in the second and third years exceed $15,000, and where the difference between the second and third years exceeds $15,000. The excess is a recapture of income by the payor spouse and a deduction by the payee spouse in the taxable year, beginning with the third year of the separation.

*Note: The recapture does not apply to the following:

1. Where either spouse dies or remarries before the close of the third year of separation, and the alimony or separate maintenance payment cease because of the death or remarriage.

2. Temporary support payments.

3. To payments which are a fixed portion of income from a business, or property, or compensation from employment or self-employment, for at least three years and tend to be different each year because of the change in income.

Wisconsin
Department of Revenue

TAX INFORMATION FOR MARRIED PERSONS FILING SEPARATE RETURNS AND PERSONS DIVORCED IN 1990

PUBLICATION 109 (11/90)

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■ INTRODUCTION

On January 1, 1986, Wisconsin became a marital property state. As part of marital property reform, Wisconsin now allows persons married at the end of the taxable year to file joint income tax returns. If you and your spouse file a joint return, Wisconsin's marital property law won't affect the amount of income that you must report for Wisconsin income tax purposes. If you file a separate return or if you became divorced in 1990, however, Wisconsin's marital property law generally will affect the amount of income that you must report for Wisconsin income tax purposes.

If you've never filed a Wisconsin return because you haven't earned sufficient income, the automatic sharing of marital property income may require you to now file a separate return, or to join with your spouse in the filing of a joint return.

This publication explains how Wisconsin's marital property law affects married persons who file separate returns and persons who became divorced in 1990 for Wisconsin income tax purposes. You should understand how the marital property law affects the way you figure your Wisconsin tax before filling in your Wisconsin income tax return. For information about how to fill in your federal income tax return, obtain federal Publication 504, *Tax Information for Divorced or Separated Individuals*, and federal Publication 555, *Community Property and the Federal Income Tax*, from the Internal Revenue Service. In addition, the Milwaukee District Office of the Internal Revenue Service and the Department of Revenue have a joint publication titled *Federal and Wisconsin Income Tax Reporting Under the Marital Property Act*, which you may obtain from either the Milwaukee District Office of the IRS or the Department of Revenue (ask for Wisconsin Publication 113).

This publication is divided into three parts. The first part gives an overview of Wisconsin's marital property law. The second part explains how to figure your Wisconsin income tax under the marital property law. The third part explains how to figure your homestead credit if you maintained a separate home or if you became divorced in 1990.

If, after reading this publication, you have any questions about how to figure your Wisconsin income tax or homestead credit, please contact any Department of Revenue office or write to the Technical Services Staff, Wisconsin Department of Revenue, P.O. Box 8933, Madison, WI 53708.

CAUTION

The information in this publication reflects the interpretations by the Wisconsin Department of Revenue of laws enacted by the Wisconsin Legislature as of November 1, 1990. Laws enacted after that date, new administrative rules, and court decisions may change the interpretations in this publication.

■ I. OVERVIEW OF WISCONSIN'S MARITAL PROPERTY LAW

A. What is Wisconsin's marital property law?

The marital property law changed Wisconsin's property law system from a "common law property system" to a type of "community property system." Wisconsin is the ninth community property state—Arizona, California, Idaho, Louisiana, Nevada, New Mexico, Texas, and Washington are the other community property states.

1. What is a "common law property system"?

Under a common law property system, property acquired during marriage generally belongs to the spouse who acquired the property. You own what you yourself earn, buy, inherit, or receive as a gift from another person. You own the income from your property. You own, and you have complete control over, the property titled in your name. You can sell or give away your property without violating your spouse's rights. However, your spouse has rights to support by you during life and to a portion of your property at your death.

Under a common law property system, the title to property generally determines ownership of property between you and your spouse. For example, title may be in the form of a deed to land, a stock certificate, or a certificate of title to a car. The title to property also determines what income is reportable by you and your spouse on separate income tax returns while domiciled in a common law property state.

2. What is a "community property system"?

Under a community property system, property acquired during a marriage generally belongs to both spouses equally. Marriage is a legal and economic partnership. You and your spouse are equal partners, whether you contribute money or services or both to the marriage, and you and your spouse will share equally all property acquired during your marriage, except property that you alone inherit or receive as a gift from another

person. You and your spouse may own equally what either of you earns or buys. You and your spouse may own equally the income from property owned by either of you. However, you have the right to manage and control property titled in your name or in neither spouse's name. Management rights don't determine ownership.

Under a community property system, the classification of property generally determines ownership of property between you and your spouse. The classification of property generally is based on two factors: when the property was acquired and how the property was acquired. You and your spouse may reclassify property by agreement. The classification of property also determines what income is reportable by you and your spouse on separate income tax returns while domiciled in a community property state.

Wisconsin's marital property law has borrowed many features from the existing community property states. But the law also has features that no community property state has.

B. When does Wisconsin's marital property law apply?

Wisconsin's marital property law took effect on January 1, 1986, and applies to you and your spouse after the "determination date."

1. What is the "determination date"?

Your determination date is the last to occur of the following:

- If you were married and domiciled in Wisconsin on January 1, 1986, the marital property law applied to you on January 1, 1986.
- If you marry after January 1, 1986, and you are domiciled in Wisconsin at the time of your marriage, the marital property law applies to you on the date of your marriage.
- If you are married and you establish a Wisconsin domicile after January 1, 1986, the marital property law applies to you on the date you and your spouse establish a Wisconsin domicile.

Note. The marital property law generally applies only while both spouses are domiciled in Wisconsin.

2. What is a "domicile"?

Your domicile is your true, fixed, and permanent home where you intend to remain permanently and indefinitely and to which, whenever absent, you intend to return. You can be physically present or residing in one locality but maintain a domicile in another. You can have only one domicile at any time.

Your domicile doesn't change if you leave your state of domicile —

- For a brief rest or vacation, or
- To complete a particular transaction, perform a particular contract, or fulfill a particular engagement, but you intend to return to your state of domicile whether or not you complete the transaction, contract, or engagement, or
- To accomplish a particular purpose, but you don't intend to remain in the new state once you accomplish your purpose. For example, a student who doesn't intend to remain in the state of his or her school after graduation hasn't changed his or her domicile.

You aren't domiciled in Wisconsin if —

- You are passing through Wisconsin on your way to another state or country, or
- You are in Wisconsin for a brief rest or vacation, or
- You are in Wisconsin to complete a particular transaction, perform a particular contract, or fulfill a particular engagement which requires your presence in Wisconsin for a short period of time, and you haven't abandoned your domicile in another state.

Your domicile, once established, isn't lost until all three of the following occur or exist:

- You specifically intend to abandon your old domicile and take actions consistent with such intent, and
- You intend to acquire a new domicile and take actions consistent with such intent, and
- You are physically present in the new domicile.

No change of domicile results from leaving Wisconsin to go to another state if you intend to remain there only for a limited time and then to return to Wisconsin.

C. How does Wisconsin's marital property law classify property?

Under the marital property law, all property that you and your spouse acquire after the determination date is generally classified as "marital property" or as "individual property." (Please note that the rules described below for classifying property may not apply for purposes of determining the basis of property upon the death of a spouse. For information about basis adjustment, see Wisconsin Publication 113, *Federal and Wisconsin Income Tax Reporting Under the Marital Property Act.*)

1. What is "marital property"?

Marital property is all property classified as marital property and all property acquired by you or your spouse during marriage after the determination date, unless it is otherwise classified by the marital property law. The law presumes that all property owned by spouses is marital property. Any person who contends that certain property isn't marital property must prove that the property's classification is something else.

You and your spouse each have a present, undivided one-half ownership interest in each item of marital property. All marital property belongs as much to you as it does to your spouse, regardless of how it is titled.

Marital property generally includes:

- Income earned or accrued by a spouse or derived from marital property and nonmarital property owned by a spouse during the marriage and after the determination date. "Income" includes wages, salaries, commissions, bonuses, other employment benefits, dividends, interest, net rents, and other earnings from marital property and nonmarital property.
- The substantial increase in value of nonmarital property which resulted from the substantial efforts of either spouse that weren't reasonably compensated.
- Nonmarital property that is mixed with marital property and can no longer be identified by tracing.

Note. In this publication, the term "nonmarital property" refers to all property which isn't marital property. Nonmarital property includes individual property and unclassified property.

2. What is "individual property"?

Individual property is property owned by one spouse alone under the marital property system.

After the determination date and during the marriage, individual property includes:

- Property acquired by one spouse by gift or inheritance during the marriage.
- Property acquired in exchange for, or with the proceeds of, individual property.
- The increase in value of nonmarital property, except to the extent that this increase in value is classified as marital property.
- Income (and principal) to one spouse from a trust created by a third person, unless the trust provides otherwise.
- Income from a gift of property from one spouse to the other spouse, unless the spouse making the gift provides otherwise.
- Income or property designated individual property by a marital property agreement or a court decree.
- Income derived from the nonmarital property of a spouse which that spouse has designated in a unilateral statement as his or her individual income.
- For marriages occuring after December 31, 1985, property owned at a marriage by a Wisconsin-domiciled person.

3. What is "unclassified property"?

Property owned by spouses before their determination date isn't classified by the marital property law. Such unclassified property is treated as if it were individual property during the marriage. At death, property of the decedent spouse acquired during the marriage and before the determination date, which would have been marital property if acquired after the determination date, is treated as if it were marital property for certain elective rights of the surviving spouse.

4. What happens if marital property is mixed with other property?

If marital property is mixed with any other type of property, the other type of property becomes marital property, unless that other type of property can be traced. This mixing rule doesn't apply for income tax basis purposes for property held in joint tenancy or tenancy in common.

For example, if you had bought a home before your marriage and you make mortgage loan principal payments from your wages during the marriage, the home is "mixed property." If you had invested $20,000 in the home before you married and you have records to prove this, at least $20,000 of the home's value will retain its character as nonmarital property. The presumption is that the rest is marital property and half of it belongs to your spouse. If you don't have adequate records to prove the amount of nonmarital property, the full value of the home is marital property.

5. How are retirement benefits classified?

Special rules apply to retirement benefits and other deferred employment benefits. Deferred employment benefits also include payments from profit-sharing and stock bonus plans, annuities, and deferred compensation plans.

Note. Unemployment compensation and individual retirement arrangements (IRAs) aren't considered to be deferred employment benefits.

- Benefits resulting from the employment of a spouse that starts after the determination date are entirely marital property.
- Benefits resulting from the employment of a spouse entirely before the determination date are nonmarital property.
- Benefits resulting from the employment of a spouse partly before and partly after the determination date are mixed property. Figure the marital property portion using this formula:

$$\frac{\text{Period of employment while the marital property law applies}}{\text{Total period of employment}} \times \text{Total retirement benefits} = \text{Marital property portion of the retirement benefits}$$

Example. You worked for ABC Company from January 1, 1981, through August 31, 1990. Since you have been married and domiciled in Wisconsin for the past 15 years, your determination date is January 1, 1986. A portion of your retirement benefits from ABC Company is marital property because you worked for this company both before and after January 1, 1986. You figure the marital property portion as follows:

$$\frac{\text{56 months employment after 1/1/86}}{\text{116 months total employment}} = \text{48\% marital property}$$

If you receive $3,000 of retirement benefits from ABC Company in 1990, $1,440 (48% x $3,000) is marital property owned equally by you and your spouse. The remaining $1,560 is your nonmarital property. Thus you own $2,280 of the $3,000 of retirement benefits ($1,560 nonmarital property plus half of $1,440).

D. Can married persons change the classification of property?

You and your spouse can change the classification of property by gift or marital property agreement. Certain real property may be reclassified by conveyance, signed by both you and your spouse. You can change the classification of income from certain property by unilateral statement.

1. What is a "marital property agreement"?

A marital property agreement is an agreement solely between you and your spouse. The agreement must be in writing, and it must be signed by both you and your spouse. A marital property agreement remains in effect until replaced by another marital property agreement.

By using a marital property agreement, you and your spouse can have your own system of ownership of your property and income. You can also use a marital property agreement to dispose of your property at your death without probate. However, the law places certain restrictions on marital property agreements. You can't use a marital property agreement to affect the right of a child to support. Nor can you use an agreement to modify or eliminate spousal support to make one spouse eligible for public assistance. Also, you can't use an agreement to defraud creditors or bona fide purchasers of marital property.

In addition, the law limits the effect of marital property agreements for Wisconsin income tax and homestead credit purposes. These limitations are explained in Parts II and III of this publication. For example, you can't use a marital property agreement to retroactively reclassify income for income tax purposes. Since the Department of Revenue isn't bound by any marital property agreement not provided to the department before the issuance of an assessment or billing, you may want to send a copy of the agreement to the department at the time it is executed. Mail the agreement to the attention of the Custodian of Files, Wisconsin Department of Revenue, P.O. Box 8903, Madison, WI 53708.

The marital property law provides special forms for "statutory property classification agreements." You and your spouse may use these agreements to classify your marital property as the individual property of the owning spouse or to classify all of your property as marital property. If there is no disclosure of assets and liabilities, the agreement terminates 3 years after the date both you and your spouse sign the agreement. However, if you and your spouse complete the disclosure form which is provided as an attachment to the agreement form, the agreement is effective until dissolution of the marriage or death. You or your spouse may, however, terminate a statutory property classification agreement unilaterally.

Note. The marital property law had provided for a "statutory individual property classification agreement," often incorrectly called an "opt-out" agreement, for spouses who wished to classify property owned on December 31, 1985, and other property acquired in 1986 as the individual property of the owner. By law, these agreements terminated January 1, 1987. This reclassification of the spouses' property as individually-owned property isn't changed by the January 1, 1987, termination.

Thus, if you had a statutory individual property classification agreement, wages earned during 1986 remain the individual property of the spouse who performed the services as long as the wages can be traced. However, if you and your spouse don't have another marital property agreement which classifies property acquired in 1987 and after as individual property, wages earned in 1987 and after are marital property. Also, if your home was classified as individual property in 1986, you don't have a marital property agreement for 1987 and after, and you use marital property to make principal payments on the mortgage loan in 1987 and after, mixing will occur and your home will have a marital property component.

2. **What is a "unilateral statement"?**

A unilateral statement is a document affecting the *income* from nonmarital property. If you wish to classify the income from nonmarital property as your individual property, you can use a unilateral statement. You can't use a unilateral statement to classify your wages as your individual property. The unilateral statement must be in writing, signed by you, and notarized. Within 5 days after signing the statement, you must deliver a copy to your spouse. A unilateral statement applies only to income accrued *after* the statement is signed. You can't use it to retroactively reclassify income. You may revoke the unilateral statement at any time; you must deliver a copy of the revocation to your spouse.

The limitations on marital property agreements for Wisconsin income tax and homestead credit purposes also apply to unilateral statements.

E. How are debts treated under Wisconsin's marital property law?

Under Wisconsin's marital property law, the type of debt determines what property a creditor can take to satisfy the debt. Debts are classified based on two factors: when the debt was incurred and the reason the debt was incurred. The law classifies debts as follows:

- Support debts are amounts you owe for the support of your spouse or a child of the marriage. Support debts are collectable from all marital property and all of your other property, if you are the incurring spouse.
- Family purpose debts are amounts that you have incurred in the interest of the marriage or the family. The law presumes that debts incurred by a spouse during the marriage are in the interest of the marriage or the family. Family purpose debts are collectable from all marital property and all of your other property, if you are the incurring spouse.
- Premarriage debts are amounts that you incurred before your marriage. Premarriage debts are collectable from your nonmarital property and from that part of the marital property which would have been your property if you hadn't married (such as wages).
- Predetermination date debts are amounts that you incurred before January 1, 1986. Predetermination date debts are collectable from your nonmarital property and from that part of the marital property which would have been your property if you hadn't married (such as wages).
- Tort debts (such as from a car accident) that you incur during marriage are collectable from your nonmarital property and your interest in marital property.
- All other debts that you incur during marriage are collectable only from your nonmarital property and your interest in marital property, in that order.

Tax debts incurred during marriage by a spouse after the determination date are incurred in the interest of the marriage or the family. Special presumptions apply to the collection of tax debts and other debts owed to the state. See the "innocent spouse" rules explained in the "Exception" to who is responsible for the tax on a joint return or on a separate return in Parts II.A.1. and 2. of this publication. Also see Part II.E.2.

■ II. FIGURING YOUR WISCONSIN INCOME TAX UNDER WISCONSIN'S MARITAL PROPERTY LAW

A. Filing Status

Your filing status determines which column of the Tax Table or which Tax Rate Schedule you use to figure your Wisconsin income tax. *Wisconsin and federal law differ with respect to filing status.*

Single. You are considered single for the whole year if you were unmarried or legally separated under a final decree of divorce or separate maintenance on December 31, 1990.

You can't consider yourself unmarried if you were married but lived apart from your spouse during the whole year. *Wisconsin and federal law differ on this point.*

Married. You are considered married for the whole year if you were married as of December 31, 1990. If your spouse died during 1990, consider yourself married for the whole year.

You are considered married if —

- You are separated, but you haven't obtained a final decree of divorce or separate maintenance by December 31, 1990.
- You are separated under an interlocutory decree. This isn't a final decree.

If you are married, you and your spouse may be able to file a joint return or you may file separate returns. The marital property law has little effect on the filing of joint returns. Your tax will generally be lower if you file a joint return. You should figure your tax both ways to make sure you are using the method that will result in the lower tax.

If you and your spouse meet the requirements, you may file a joint Wisconsin return even though you file separate federal returns.

1. **Joint Return**

You must include all income, deductions, and credits for you and your spouse on your joint return. Both of you must sign the return, or it won't be considered a joint return.

Both of you are responsible for any tax, interest, penalties, and fees due on a joint return, so if one of you doesn't pay, the other may have to. One spouse may be held responsible for the entire amount due even though the other spouse's services or property generated all of the income.

Exception. You may not have to pay the *additional* tax, interest, penalties, and fees assessed on a joint return if you prove that you didn't know, and had no reason to know, that there was an understatement of tax that resulted from your spouse's omitting a gross income item, or claiming a deduction, credit, or property basis in an amount for which there is no basis in fact or law. Taking into account the facts and circumstances, it must also be inequitable to hold you liable for the tax due. If you are relieved of liability for additional tax assessments under this "innocent spouse" rule, the tax liability of your spouse is collectable only from your spouse's nonmarital property and from your spouse's interest in marital property (such as wages), in that order.

Divorced taxpayers. You are still jointly and individually responsible for any tax, interest, penalties, and fees due on a joint return filed before your divorce. This responsibility applies even if your divorce decree states that your former spouse will be responsible for any amounts due on previously filed joint returns.

Separate returns after joint return. If you file a joint return, you can't, after the due date of your return, change your mind and file a separate return. If you are allowed to file a separate return, you and your spouse must divide the tax paid on the joint return between you in proportion to the tax you figure on your separate returns. If the amount paid on the joint return isn't equal to or more than the tax shown on your separate returns, you must pay the additional tax due on your separate return when you file it.

2. **Separate Returns**

If you choose to file separate returns, you and your spouse must each report half of your combined marital property income, deductions, and credits (but see the "Exceptions" described below and in Part II.B.4.). This is true even if you haven't received any of the income from your spouse. In addition, you must each report your own individual income, deductions, and credits. Attach a worksheet to your return showing how you figured the income, deductions, and credits each of you reported. See the Appendix for a worksheet to fill in and attach to your Wisconsin income tax return.

If you file a separate return, you and your spouse will generally pay more combined Wisconsin income tax. This is because the standard deduction may be lower for married persons filing separately. The following also apply:

- You can't take the credit for a married couple when both work.
- You generally can't take the earned income credit.
- If you lived with your spouse at any time in 1990—
  a. You may have to include in income the total amount of any unemployment compensation you received in 1990.
  b. You may have to include in income up to one-half of any social security benefits you received in 1990.
- You won't qualify for the disability income exclusion.

If you and your spouse file separately, you are responsible for the tax due on your own return. Your marital property (such as wages) may also be the source for payment of your spouse's tax since all tax debts, including interest, penalties, and fees, incurred during marriage by a spouse after the determination date are incurred in the interest of the marriage or the family. Therefore, *all* marital property and all other property of the spouse filing the separate return may be used to pay the amount due on a separate return.

Exception. You may not have to pay the *additional* tax, interest, penalties, and fees assessed on a separate return if it is determined that you weren't notified of the unreported marital property income that resulted from your spouse's services or property. In such cases, the Department of Revenue will include the entire amount of that unreported marital property income in the in-

come of the spouse who had the right to control it. Title to property determines which spouse has management and control rights. If you are relieved of liability for additional tax assessments under this "innocent spouse" rule, the tax liability of your spouse is collectable only from your spouse's nonmarital property and from your spouse's interest in marital property (such as wages), in that order.

Joint return after separate returns. If you or your spouse or both file separate returns, you may change to a joint return any time within 4 years from the due date of the separate returns. This 4-year period doesn't include any extensions. If the amount paid on your separate returns isn't equal to or more than the total tax shown on the joint return, you must pay the additional tax due on the joint return when you file it.

B. Income Under the Marital Property Law

To figure the best way to file your return — jointly or separately — you must identify your marital property income and individual income according to Wisconsin law. Generally, marital property income not taxable by Wisconsin keeps its nontaxable status for both spouses.

If both spouses are domiciled in Wisconsin, you generally must follow the marital property law in figuring your total income subject to tax, even though you are separated from your spouse. If you are divorced during the taxable year, you may have marital property income up to the date of your divorce.

Any income that is classified as marital property income is taxed half to each spouse, unless one of the exceptions applies (see *Exceptions to Reporting Income Under the Marital Property Law for Wisconsin Tax Purposes* in Part II.B.4.). Any income that is classified as individual income is taxed to the spouse who owns it.

1. Marital Property Income

Marital property income includes the following:

- Wages, salaries, commissions, bonuses, gratuities, payments in kind, deferred employment benefits, and other economic benefits attributable to the effort of a spouse. (Note: Deferred employment benefits include payments from pension, profit-sharing, and stock bonus plans, annuities, self-employment retirement plans, and deferred compensation plans. See Part I.C.5. for a special rule for figuring the marital property portion of these benefits.)
- Dividends from stock that is marital, individual, or unclassified property.
- Interest from savings accounts and other investments that are marital, individual, or unclassified property.
- Net rents from marital, individual, or unclassified property.
- Gain on the sale of marital property.
- Gain on the sale of individual or unclassified property to the extent that the substantial increase in value is due to the substantial efforts of either spouse that weren't reasonably compensated.

2. Individual Income

Income from the following sources is generally individual property:

- Income to one spouse from a trust created by a third party, unless the trust provides otherwise.
- Income from a gift of property from one spouse to the other spouse, unless the spouse making the gift provides otherwise.
- Gain on the sale of individual or unclassified property (unless the gain is the result of a substantial increase in value due to the substantial efforts of either spouse that weren't reasonably compensated).
- Income classified as individual property by a marital property agreement.
- Income classified as individual property by a unilateral statement.
- Income classified as individual property by a court decree.

For more examples of marital property and individual income, see *Classification of Income* in the Appendix.

3. Income Earned by Separated or Divorced Spouses

Separated spouses. Even if you are separated from your spouse, you and your spouse must treat both of your incomes as marital property income. Income you earn after your separation but before a final decree of divorce is granted continues to be marital property income. However, you and your spouse may enter into a marital property agreement providing that income earned by either of you is your individual income. Income earned by either of you *after* the effective date of such an agreement is treated as the individual income of the spouse earning the income, not as marital property income. You can't use a marital property agreement to reclassify income earned prior to the agreement for income tax purposes.

Divorced spouses. An absolute decree of divorce ends the marital community. When the marital community is ended, the marital property assets are divided between the spouses. Any income earned after the marriage ends is taxable only to the spouse to whom it belongs. However, each spouse is generally taxed on half of the marital

property income for the part of the year before the marital community ends. You can't use a marital property agreement to reclassify income earned prior to the agreement for income tax purposes. Nor can a court order retroactively reclassify income for income tax purposes.

4. **Exceptions to Reporting Income Under the Marital Property Law for Wisconsin Tax Purposes**

Wisconsin law provides three exceptions to the general rule that income is marital property and one-half is reportable by each spouse.

a. **Marital Property Agreements and Unilateral Statements**

For Wisconsin income tax purposes, a marital property agreement or unilateral statement applies only if you file a copy with the Department of Revenue *before* an assessment or billing is issued.

If you filed a separate return and you are notified that your return is being audited, the Department of Revenue will request a copy of your marital property agreement or unilateral statement at that time.

In addition, a marital property agreement or unilateral statement applies only while both you and your spouse are domiciled in Wisconsin.

Example. You and your spouse sign a marital property agreement which states that the interest income from your savings accounts is your spouse's individual property. Both of you are domiciled in Wisconsin for all of 1990. You file separate Wisconsin income tax returns for 1990. Per your marital property agreement, you don't report any interest income and your spouse reports $600 of interest income, which your spouse thought was the total amount of interest income. According to information returns (1099 forms) filed by the bank, you actually had $1,000 of interest income in 1990. This additional $400 of interest income is reportable by your spouse if you file a copy of the marital property agreement with the Department of Revenue before any assessment is issued. If you don't furnish a copy of the agreement, $500 of interest income is reportable by you and $500 is reportable by your spouse.

Note. As of November 1, 1990, the Internal Revenue Service has indicated that it won't follow any marital property agreement that allocates more than half of your wages or the income from marital property titled in your name to your spouse. In the above example, you and your spouse must each report half ($500) of the interest income on separate federal returns.

b. **Part-Year Residents and Nonresidents**

For Wisconsin income tax purposes, the marital property law applies only while both you and your spouse are domiciled in Wisconsin. During any period that you and your spouse aren't both domiciled in Wisconsin, you must report your income based on title and ownership under the common law property system. (See Part I.A.1. for more information about the common law property system.)

Example. You are a full-year Wisconsin resident and your spouse is a full-year Illinois resident in 1990. Stocks titled in your name produce $10,000 of dividend income. This income generally would be marital property income reportable half by each spouse. Because your spouse is a nonresident, the marital property law doesn't apply. If you file separately, you must report the entire $10,000 of dividend income on your separate Wisconsin income tax return.

c. **Innocent Spouse Rule**

The Wisconsin and federal laws differ as to the determination of who is an "innocent spouse." For Wisconsin tax purposes, this determination is based on whether there is notification between spouses of the amount and nature of marital property income over which each spouse has control. The Wisconsin income tax law doesn't require notification, nor does the law specify how you must notify your spouse. However, for notification to be timely, you must notify your spouse of the amount and nature of marital property income over which you have control before the due date, including extensions, for filing your Wisconsin income tax return. To be timely, your spouse must notify you of the amount and nature of marital property income over which your spouse has control before the due date, including extensions, for filing your spouse's Wisconsin income tax return.

- If both spouses' services and property produced marital property income and they timely notify each other of the amount and nature of this income, each spouse must report half of the combined marital property income on his/her separate Wisconsin returns. For example, if the husband's services and property produced $15,000 of marital property income, the wife's services and property produced $10,000 of marital property income, and each timely notifies the other,

each spouse must report $12,500 of marital property income.

- If both spouses' services and property produced marital property income but only one spouse timely notifies the other spouse of the amount and nature of this income, the notifying spouse must report half of the marital property income over which he or she had control. The notified spouse must report all of the marital property income over which he or she had control plus half of the marital property income over which the other spouse had control. For example, if the husband's services and property produced $15,000 of marital property income, the wife's services and property produced $10,000 of marital property income, and the husband timely notifies the wife but the wife doesn't notify the husband, the husband must report $7,500, which is half of the marital property income over which he had control. The wife must report $17,500, which is all ($10,000) of the marital property income her services and property produced plus half ($7,500) of the marital property income her husband's services and property produced.

- If both spouses' services and property produced marital property income but neither spouse timely notifies the other of the amount and nature of this income, each spouse must report all of the marital property income over which he or she had control on their separate Wisconsin returns. The other spouse won't have any liability for this income. For example, if the husband's services and property produced $15,000 of marital property income, the wife's services and property produced $10,000 of marital property income, and neither spouse timely notifies the other spouse, the husband must report $15,000 of marital property income on his separate Wisconsin return and the wife must report $10,000 of marital property income on her separate Wisconsin return.

Should a dispute about notification occur, you will have to prove to the Wisconsin Tax Appeals Commission that you notified your spouse about the amount and nature of the marital property income your services and property produced. Since the law doesn't specify how you must notify your spouse, the department can't determine whether the notification was adequate. Where a dispute between spouses over notification does exist, the department will likely assess both spouses for the disputed income. Such assessments are called "assessments in the alternative."

The department may assess each spouse for the entire amount due on marital property income when, in the department's opinion, more than one spouse could be held liable. The purpose of assessments in the alternative is to have the spouses mutually agree on the facts of notification. If the spouses are unable to agree, they may appeal the assessments to the Wisconsin Tax Appeals Commission. After a determination is made about whether notification was adequate, the assessments will be adjusted to reflect the correct amount due for each spouse.

Example. In 1990, your services produce $20,000 of wages and you have $1,000 of Wisconsin tax withheld. Your spouse's services produce $15,000 of wages and your spouse has $500 of Wisconsin tax withheld. You and your spouse file separate Wisconsin returns. You and your spouse each claim that you notified the other about the amount of the wages. However, you each claim that you weren't notified about the amount of the other's wages. On your return, you report $10,000 of wages and claim $500 of tax withheld, which is half of your wages and withholding. Your spouse reports $7,500 of wages and claims $250 of tax withheld, which is half of your spouse's wages and withholding. The department will issue assessments in the alternative, as follows:

- You will be assessed the tax on $27,500 of income (all of your wages, $20,000, and half of your spouse's wages, $7,500). You will be allowed credit for $500 of Wisconsin tax withheld (half of your withholding).

- Your spouse will be assessed the tax on $25,000 of income (all of your spouse's wages, $15,000, and half of your wages, $10,000). Your spouse will be allowed credit for $250 of Wisconsin tax withheld (half of your spouse's withholding).

Note. The innocent spouse exception doesn't reclassify marital property income to individual income. The income remains marital property. The "innocent spouse" treatment does change the property from which the department may collect the debt. While the department may still collect the debt from marital property, it must first exhaust the obligated spouse's nonmarital property.

5. Differences Between Federal and Wisconsin Reporting of Marital Property Income

For federal income tax purposes, the laws of the state in which you are domiciled generally determine whether your income is marital property (community) income or

individual (separate) income. However, the federal treatment of the exceptions discussed in Part II.B.4. differs from the Wisconsin treatment.

If you and your spouse live apart all year, for Wisconsin income tax purposes you must report your income under the marital property law unless one of the above three exceptions in Wisconsin law applies. Federal law differs in that if you live apart from your spouse at all times during the taxable year and meet three other conditions, you must disregard certain state community property laws for federal income tax purposes (generally called the "living apart all year rule"). *Wisconsin doesn't follow this federal treatment of spouses living apart all year.*

Your federal income is the starting point for figuring your Wisconsin taxable income. Because of these differences between Wisconsin and federal law, you may be required to make adjustments (called "modifications") to your federal income in order to arrive at your correct Wisconsin income. Examples of modifications which may be required for Wisconsin purposes follow.

Example 1. You and your spouse live apart all year. Your services produce $25,000 of wages and your spouse's services produce $18,000 of wages. Neither you nor your spouse transfers any of the wages between yourselves before the end of the year. You and your spouse both notify the other about the amount of wages. For federal purposes, assume that you must disregard the marital property law and follow the federal living apart all year rule because certain conditions exist. Therefore, you report the $25,000 of wages your services produced on your 1990 federal return. For Wisconsin purposes, you must report half of the wages your services produced and half of the wages your spouse's services produced. Thus, you must make two modifications to your federal income to arrive at your correct Wisconsin income of $21,500: (1) An addition modification for $9,000 to include half of your spouse's wages in your income; and (2) a subtraction modification for $12,500 to exclude half of your wages from your income.

Example 2. You and your spouse live apart during the last 3 months of 1990. Your services produce $2,000 of wages and your spouse's services produce $30,000 of wages. You timely notify your spouse, but claim that your spouse didn't notify you about the amount of your spouse's wages. For federal purposes, assume that you must follow the marital property law and report half of the combined marital property income. Therefore, you report $16,000 of wages on your federal return (half of the wages your services produced and half of the wages your spouse's services produced). For Wisconsin purposes, you assume that you qualify as an "innocent spouse." Thus, you must make a subtraction modification for $15,000 to exclude from your Wisconsin income your one-half interest in the wages your spouse's services produced.

C. Losses, Expenses, Deductions, and Credits

How you treat your deductions generally depends on the type of expense and the reason it was incurred. If you and your spouse file separate returns, you must divide losses, depreciation, depletion, deductions, and expenses between you in the same manner as income would be divided, with certain exceptions. The federal treatment of the following items may differ from the Wisconsin treatment explained below.

1. Capital Losses

For Wisconsin income tax purposes, losses have the same character as the property from which the loss arose. For example, a loss on the sale of individual property, such as stock you inherited and held separately, is an "individual loss." A loss on the sale of marital property is a "marital property loss." A loss on the sale of unclassified property is an individual loss or a marital property loss depending on whether the capital gain income would be individual or marital property.

If you file separately, neither you nor your spouse may deduct any part of the other's individual loss. In the case of a marital property loss, half is deductible by you and half is deductible by your spouse on separate returns.

Capital loss carryovers. If you and your spouse file a joint return, you must combine your capital loss carryovers. If you and your spouse file separate returns, any capital loss carryover can be deducted only on the return of the spouse who actually had the loss. For a capital loss carryover from a year before the marital property law applies to you, title to the property determines which spouse may deduct the loss. For a capital loss carryover from a year to which the marital property law applies, the classification of the property determines which spouse may deduct the loss.

2. Other Losses

Losses have the same character as income from the activity would have. For example, if income from a business is marital property income, a loss from that business is a marital property loss.

Net operating loss carryovers. If you and your spouse file a joint return, you can use both your and your spouse's net operating loss carryovers to figure the deduction for 1990, provided you and your spouse were

married to each other in the year of the loss. If you have a loss from before your marriage, you can apply the loss against only your income (as figured under marital property law) on a joint return. If you file separate returns, neither you nor your spouse may deduct any part of the other's net operating loss carryover.

3. **Business and Investment Expenses**

If you file separately, you must generally divide expenses incurred to earn or produce marital property income equally between you and your spouse. Each of you can deduct half of the expenses of a trade or business on your separate return. Allocate expenses incurred to earn or produce individual income to the spouse who owns that income.

4. **Individual Retirement Arrangements**

You can't take a deduction on your separate return for payments to an individual retirement arrangement (IRA) based on the earnings of your spouse. Under federal law, the deductible amount is based on your own wages, without regard to state community or marital property laws. For example, assume your spouse's services produced $30,000 of wages and your spouse paid $2,000 to an IRA. Also assume that your services produced $1,500 of wages and you paid $1,000 to an IRA. On separate returns, you can take an IRA deduction of $1,000 and your spouse can take an IRA deduction of $2,000.

If you file a separate return, you can't claim a deduction for payments to a spousal IRA. You must file a joint return to take a deduction for payments to a spousal IRA.

5. **Alimony**

You can deduct qualifying alimony payments that you are required to make to your spouse during your marriage only to the extent that the payments exceed your spouse's share of marital property income to which he or she would be entitled. For example, if you pay $15,000 of alimony to your spouse pursuant to a temporary order and your combined marital property income is $40,000, no part of the $15,000 is deductible as alimony. Your payment merely gave your spouse control of the $15,000, not ownership, which your spouse already had under the marital property law. If, however, your combined marital property income is only $25,000, then $2,500 ($15,000 minus $12,500) is deductible as alimony.

If none of the income is marital property, you can deduct qualifying alimony payments that you make to your spouse. If a portion of the income is marital property and a portion is individual property, you can deduct qualifying alimony payments that you can prove by tracing are payments from your individual income.

As indicated previously, the innocent spouse exception doesn't reclassify marital property income to individual income. Therefore, you can't qualify for an alimony deduction by failing to notify your spouse about the nature and amount of the marital property income your services and property produced. For example, assume that your services and property produced $20,000 of marital property income, your spouse's services and property didn't produce any marital property income, and you pay $7,000 of alimony to your spouse. If you don't notify your spouse about the nature and amount of the marital property income your services and property produced, you will be subject to tax on the entire $20,000. However, you can't claim a deduction for alimony because you are merely giving your spouse control of marital property income which he or she already owned.

Qualifying alimony payments that you make after your divorce becomes final are deductible.

Qualifying alimony payments that you receive from your spouse during your marriage are taxable income to you to the extent they exceed your share of marital property income. Qualifying alimony payments from your spouse's individual income are also taxable to you. In addition, qualifying alimony payments that you receive after your divorce becomes final are taxable.

6. **Dependent Credit**

If you and your spouse file separate returns, you can't divide the $50 credit for a dependent between you. When you have more than one dependent, you may divide the number of dependents between you if they are supported with marital property funds. You may take the $50 credit only for dependents claimed on your return.

Example. You and your spouse support three dependent children with marital property funds. On separate returns, you may divide the dependents between you. If you claim two dependents, your spouse can claim one dependent. In this case, you would take a $100 dependent credit and your spouse would take a $50 dependent credit. You can't divide the total dependent credit ($150) equally between you. You must divide the credit into multiples of $50 (a full credit).

7. **Senior Citizen Credit**

If you file a separate return, you can't take your spouse's $25 senior citizen credit. This is true even if your spouse had no income and wasn't the dependent of another taxpayer.

8. **Wisconsin Itemized Deduction Credit**

The Wisconsin itemized deduction credit is based on certain amounts which are allowed as itemized deductions for federal purposes. Under federal law, the nature of the obligation and the source of the funds used to make payment generally determine how to treat the expenses on separate returns. Obligations for which an itemized deduction credit may be claimed generally are considered as being incurred in the interest of the marriage or the family and paid from marital property funds. As such, half of the amount paid is generally allocated to each spouse for purposes of figuring the itemized deduction credit on separate returns.

Allocate employe business expenses in the same manner as you report your wages. If you and your spouse file separate returns and each of you reports one-half of the wages, divide the employe business expenses equally between you.

Divide investment interest expenses incurred to earn marital property income equally between you. Allocate investment interest expense incurred to produce individual income to the spouse who owns that income, provided the expense was paid from individual property. It is not presently clear how to allocate expenses incurred to produce individual income if the expenses were paid from nonindividual property.

9. **Renter's School Property Tax Credit**

If you and your spouse file separate returns, figure your renter's credit as follows:

- If you and your spouse shared rented living quarters, each may take a renter's credit based on half of the rent paid.
- If you and your spouse maintained separate homes, each may take a renter's credit based on the rent you paid for the separate living quarters.

Note. If you and your spouse maintained separate homes all year, you lived in a home owned equally by you and your spouse, and you paid all of the taxes on that home, you may claim your spouse's share of the taxes as rent. As indicated below, your spouse can't take a credit based on his or her share of the property taxes on the home that you occupied since that home wasn't your spouse's principal residence.

On your separate return, the total of your renter's and home owner's credits can't be more than $100. You can't claim any part of your spouse's credit.

10. **Home Owner's School Property Tax Credit**

Your home owner's credit is based on your share of the taxes paid (even if you personally didn't make the payment), but limited to the time that you occupied the home as your principal home. Since the marital property law presumes that all property of spouses is marital property, half of the taxes paid would normally be your share. If you contend that the home isn't marital property, you must prove that the home's classification is something else. If you file separately, figure your home owner's credit as follows:

- If you and your spouse lived together, each may take a credit based on half of the taxes paid on your principal home.
- If you and your spouse maintained separate homes, each may take a credit based on half of the taxes on the home you occupied. (Note: If you can show that your home isn't marital property, you may claim all of the taxes on the home you owned and occupied as your principal home.)

On your separate return, the total of your renter's and home owner's credits can't be more than $100. You can't claim any part of your spouse's credit.

11. **Married Couple Credit**

You can't claim the married couple credit if you and your spouse file separate returns. You can't claim this credit if you were legally separated under a final decree of divorce or separate maintenance on December 31, 1990.

Your earned income for purposes of the married couple credit is computed without regard to the marital property law.

12. **Earned Income Credit**

If you are married, you and your spouse generally must file a joint return to claim this credit. However, even if you are married, you may claim this credit on your separate return if —

- Your spouse didn't live in your home at any time during the last 6 months of the year,

- You paid more than half the cost to keep up your home for the year, and
- Your home was, for more than half of the year, the principal home of your child for whom you will be entitled to claim an exemption for federal income tax purposes. You won't have to claim the exemption for your child if your child's other parent will be able to claim the exemption because either you release your claim in writing or the exemption is granted to your child's other parent by a pre-1985 separation agreement or divorce decree.

For purposes of the earned income credit, your earned income is computed without regard to the marital property law.

13. Farmland Preservation Credit

For information about claiming farmland preservation credit, see Publication 503, *Wisconsin Farmland Preservation Credit*, which may be obtained from any Department of Revenue office.

D. Tax Payments

1. Wisconsin Income Tax Withheld

Report the credit for Wisconsin income tax withheld on marital property wages in the same manner as you report your wages. If you and your spouse file separate returns and each of you reports half of the combined wages, each of you may claim half of the income tax withheld on those wages. Attach a copy of each wage statement (W-2 form) for both spouses to your separate returns. If you don't have enough copies of your W-2 forms for both returns, you may attach legible photocopies.

2. Wisconsin Estimated Tax Payments

Whether you and your spouse pay estimated tax jointly or separately, you have a choice of filing joint or separate income tax returns for the year.

Joint estimated tax payments. If you and your spouse paid estimated tax jointly, but want to file separate Wisconsin income tax returns, either of you may claim all of the estimated tax paid, or you may each claim part of it. You can divide joint estimated tax payments in any way that you agree upon. If you can't agree, you must divide the joint estimated tax payments in proportion to each spouse's individual tax as shown on your separate Wisconsin returns, or the Department of Revenue will divide the payments based on estimates of the amounts you and your spouse will owe. Your tax is the amount shown on 1990 Wisconsin Form 1, line 16, or Wisconsin Form 1NPR, line 43.

Example. You made $2,000 of joint estimated tax payments for 1990. You and your spouse can't agree on how to divide the payments on your separate returns. You show tax of $1,500 on Wisconsin Form 1, line 16. Your spouse shows tax of $900 on Wisconsin Form 1, line 16. You can claim $1,250 of estimated tax, which you figure as follows:

$$\frac{\text{\$1,500 tax shown on line 16 of your return}}{\text{\$2,400 total tax shown on your return and your spouse's return}} \times \text{\$2,000 joint estimated tax payments} = \text{\$1,250}$$

Your spouse can claim $750 of estimated tax.

These rules also apply if you made joint estimated tax payments and you became divorced in 1990.

Separate estimated tax payments. If you made separate estimated tax payments, you can claim them on a joint return or on your separate return. Your spouse can't claim any part of your separate estimated tax payments on his or her separate return. You can't claim any part of your spouse's separate estimated tax payments on your separate return.

E. Refunds

1. Claims for Refund

If you and your spouse are claiming a refund either on your original joint return or on an amended joint return, both of you must sign the return. If you are claiming a refund either on your original separate return or on an amended separate return, you alone must sign the return.

Marital property agreements and unilateral statements don't affect claims for refund.

The Department of Revenue will issue a refund relating to a joint return jointly to both spouses. The Department of Revenue will issue a refund relating to a separate return to the spouse who filed the return.

2. Applying Overpayments Against Liabilities

Wisconsin's income tax law permits the Department of Revenue to apply overpayments, refundable credits, or refunds against certain tax debts, debts owed to other state agencies, or delinquent child support. However, the nonobligated spouse may claim a refund from the Department of Revenue within specified periods of

time upon proof that all or part of the amounts credited were the nonmarital property of the nonobligated spouse.

Joint returns. The Department of Revenue may apply an income tax overpayment, refundable credit, or refund on a joint return as follows:

- Against any liability from a joint return.
- Against any separate liability incurred during marriage by either you or your spouse after the determination date.
- Against any separate liability incurred by either you or your spouse before January 1, 1986, or before marriage, to the extent that the overpayment or refund is based on the Wisconsin adjusted gross income which would have been the property of the incurring spouse if you hadn't married.

Nonjoint returns. The Department of Revenue may apply an income tax overpayment, refundable credit, or refund on your separate or individual return against any liability incurred by you, including any liability from a joint return.

Note. If the "innocent spouse" rule applies, or in the case of a remarriage, special limitations may apply. For more information, see Wisconsin Publication 113, *Federal and Wisconsin Income Tax Reporting Under the Marital Property Act.*

F. Extensions

If you are filing a joint return and you need more time to file, you and your spouse (or your authorized representatives) must both sign the request for an extension. If you and your spouse file separate returns, you each must request an extension. An extension of time allowed to you for filing your separate return doesn't extend the time for filing the separate return of your spouse.

G. Wisconsin Income Tax Examples

Following are three examples which show how to figure your Wisconsin income tax under the marital property law.

1. Both Spouses Domiciled in Wisconsin All Year

A husband and wife are married and domiciled in Wisconsin for all of 1990. Their two children and the wife's mother live with them and qualify as dependents. Amounts paid for their support were paid out of marital property funds.

The husband's services and property produced $22,000 of wages and $150 of interest income in 1990. The husband had $750 of unreimbursed employe business expenses. Wisconsin income tax withheld from his wages was $1,160.

In 1990, the wife's services and property produced $10,000 of wages, $50 of interest income, and $270 of dividend income. She also earned $3,600 of net rental income (after expenses) from individual property. The wife paid $500 to an IRA. Wisconsin income tax withheld from her wages was $250.

The husband and wife paid $3,000 of interest on their Wisconsin home mortgage loan. They also paid $2,000 of interest on a car loan and credit cards. They had $1,100 of medical expenses and $200 of charitable contributions. They paid $1,200 of property taxes on their home, which is titled as marital property. All amounts were paid out of marital property funds.

To see if it is to their advantage to file a joint return or separate returns, they prepare a worksheet (Worksheet 1, shown later) to figure their Wisconsin income tax. The worksheet shows that it is to the taxpayers' advantage to file a joint Wisconsin income tax return.

How to figure the amounts shown on Worksheet 1.

- The husband's wages and interest income are marital property income. Half is reported on each separate return.
- Since the husband's wages are marital property income and half is reported by each spouse, the employe business expenses incurred to earn those wages are divided equally between the spouses on their separate returns.
- The wife's wages, interest income, and dividends are marital property income. Half is reported on each separate return.
- Although the rental property is the wife's individual property, the net rental income is marital property income and half is reported by each spouse on their separate returns.
- Under federal law, only the wife may take the $500 deduction for the amount she paid to her IRA. The husband can't take any part of this deduction on his separate return.
- The tax on their joint return is from the married filing jointly column of the Tax Table. The tax on their separate returns is from the married filing separately column of the Tax Table.
- On their separate returns, the husband chose to claim two dependents and the wife chose to claim one dependent.
- Wisconsin home mortgage loan interest, other interest, medical expenses, charitable contributions, and the husband's unreimbursed employe business expenses are divided equally between the spouses to

figure the Wisconsin itemized deduction credit on their separate returns.

- Since the home is marital property, the property taxes are divided equally between the spouses.
- The married couple credit is 2% of the wife's qualified earned income of $9,500 ($10,000 of wages minus $500 IRA deduction). They can't claim this credit if they file separate returns.
- Since the husband's wages and the wife's wages are divided equally between the spouses, their Wisconsin income tax withheld is also divided equally between them on their separate returns.
- It's assumed that timely notification took place.

2. **One Spouse Domiciled in Wisconsin All Year**

A husband and wife are married for all of 1990. The husband is domiciled in Florida from January through March, and he is domiciled in Wisconsin for the rest of the year. The wife is domiciled in Wisconsin all year. Their determination date is April 1, 1990. Their child lives with the wife all year and qualifies as their dependent. From January through March, the spouses contributed equally to their child's support. After that time, the child's support was paid out of marital property funds.

The husband's services and property produced the following income: (1) $8,000 of wages while he was domiciled and employed in Florida and $25,000 of wages while domiciled in Wisconsin, and (2) $400 of interest income from a Florida savings account from January through March and $700 for the rest of the year. Wisconsin income tax withheld from his wages was $1,760.

The wife's services and property produced the following income: (1) $1,300 of wages from January through March and $3,700 for the rest of the year, (2) $1,200 of interest income from January through March and $4,200 for the rest of the year, and (3) $1,400 of dividend income from January through March and $1,100 for the rest of the year. Wisconsin income tax withheld from her wages was $20 from January through March and $30 for the rest of the year. She made separate estimated tax payments of $600.

WORKSHEET 1

Both Spouses Domiciled in Wisconsin All Year

	Wisconsin Joint Return		Wisconsin Separate Returns: Husband		Wisconsin Separate Returns: Wife	
Income (Husband's)						
Wages	$22,000		$11,000		$11,000	
Interest income	150		75		75	
Total		$22,150		$11,075		$11,075
Income (Wife's)						
Wages	$10,000		$ 5,000		$ 5,000	
Interest income	50		25		25	
Dividends	270		135		135	
Net rental income	3,600		1,800		1,800	
IRA deduction	(500)		0		(500)	
Total		13,420		6,960		6,460
Wisconsin income		$35,570		$18,035		$17,535
Tax from Tax Table		$ 1,956		$ 1,020		$ 978
Dependent credit (3 x $50)	$ 150		$ 100		$ 50	
Wisconsin itemized deduction credit	0		8		3	
School property tax credit	121		61		61	
Married couple credit	190		0		0	
Total credits		461		169		114
Net tax		$ 1,495		$ 851		$ 864
Less: Wisconsin income tax withheld		1,410		705		705
Amount due		$ 85		$ 146		$ 159

The spouses had the following expenses: (1) $6,500 of home mortgage loan interest. Both spouses are obligated on the mortgage. From January through March, the payments were made from a joint checking account to which the spouses had contributed equally. For the rest of the year, the payments were made from marital property funds. (2) $500 of deductible investment interest expense which was paid after April 1, 1990, using marital property funds. (3) $350 of charitable contributions made from April through December using marital property funds. (4) $2,000 of property taxes paid on their Wisconsin home in December using marital property funds. The spouses had originally held title to their home as joint tenants, but they reclassified it as survivorship marital property on April 1, 1990. (5) $2,000 of rent, which didn't include heat, paid by the husband on an apartment in Florida.

To see if it is to their advantage to file a joint return or separate returns, they prepare a worksheet (Worksheet 2, shown below) to figure their Wisconsin income tax. The worksheet shows that it is to the taxpayers' advantage to file a joint return.

Note. Both spouses must be domiciled in Wisconsin before the marital property law applies to them.

How to figure the amounts shown on Worksheet 2.

- The husband's wages and interest income earned while domiciled in Wisconsin are marital property income. Half is reported on each separate return.
- The wife reports the $1,300 of wages, $1,200 of interest income, and $1,400 of dividend income she earned from January through March on her separate return. Since her husband wasn't domiciled in Wisconsin during this time, the marital property law doesn't apply to her for federal or Wisconsin income tax purposes. The wife's $3,700 of wages, $4,200 of interest income, and $1,100 of dividend income for the rest of the year are marital property income. Half is reported on each separate return.
- On their joint return, the standard deduction is from the married filing jointly column of the Standard Deduction Table in the Form 1NPR booklet and is based on their joint federal income of $47,000. They must prorate the standard deduction based on the

WORKSHEET 2

One Spouse Domiciled in Wisconsin All Year

	Wisconsin Joint Return		Wisconsin Separate Returns: Husband		Wisconsin Separate Returns: Wife	
Income (Husband's)						
Wisconsin wages	$25,000		$12,500		$12,500	
Wisconsin interest income	700		350		350	
Total		$25,700		$12,850		$12,850
Income (Wife's)						
Wages	$ 5,000		$ 1,850		$ 3,150	
Interest income	5,400		2,100		3,300	
Dividends	2,500		550		1,950	
Total		12,900		4,500		8,400
Wisconsin income		$38,600		$17,350		$21,250
Standard deduction		1,259		52		
Wisconsin net income		$37,341		$17,298		
Tax		$ 2,347		$ 1,075		$ 1,285
Dependent credit	$ 50		$ 0		$ 50	
Wisconsin itemized deduction credit	305		181		135	
Renter's school property tax credit	51		51		0	
Home owner's school property tax credit	149		49		100	
Prorated credits	$ 456		$ 189			
Married couple credit	100		0		0	
Total credits		556		189		285
Net tax		$ 1,791		$ 886		$ 1,000
Less: Wisconsin income tax withheld		1,810		895		915
Estimated tax payments		600		0		600
Amount due (Refund)		$ (619)		$ (9)		$ (515)

ratio of their joint Wisconsin income to their joint federal income ($38,600/$47,000 x $1,533 = $1,259).

- On the husband's separate return, the standard deduction is from the married filing separately column of the Standard Deduction Table in the Form 1NPR booklet and is based on his separate federal income of $25,750. He must prorate the standard deduction based on the ratio of his separate Wisconsin income to his separate federal income ($17,350/25,750 x $77 = $52).
- On her separate return, the wife doesn't have to figure her standard deduction. It's built into the Tax Table in the Form 1 booklet for full-year Wisconsin residents.
- On their joint return, the tax is from the married filing jointly column of the Tax Table in the Form 1NPR booklet for nonresidents and part-year residents.
- On the husband's separate return, the tax is from the married filing separately column of the Tax Table in the Form 1NPR booklet for nonresidents and part-year residents.
- On the wife's separate return, the tax is from the married filing separately column of the Tax Table in the Form 1 booklet for full-year Wisconsin residents.
- Since their child is supported equally by the spouses prior to April 1 and with marital property funds after that date, the wife can take the dependent credit on her separate return.
- Wisconsin home mortgage loan interest, other interest, and charitable contributions are divided equally between the spouses to figure the Wisconsin itemized deduction credit on their separate returns.
- Since the husband paid for his heat separately from his rent, his renter's credit is from column 2 of the Renter's School Property Tax Credit Table.
- On their joint return, the home owner's credit is based on $1,750 of the property taxes paid. Since the home was joint tenancy property prior to April 1 and survivorship marital property after that date, the property taxes paid are divided equally between the spouses ($1,000 to each spouse). The husband's share of the taxes is then limited to the number of months that he occupied the home as his principal home (9/12 x $1,000 = $750). Because the total of the renter's credit and the home owner's credit can't be more than $200 on a joint return, the home owner's credit is limited to $149 ($200 minus $51 renter's credit).
- On the husband's separate return, the home owner's credit is based on $750 of property taxes paid but limited to $49 ($100 minus $51 renter's credit).
- On the wife's separate return, the home owner's credit is based on $1,000 of property taxes paid but limited to $100.
- On their joint return, they must prorate the credits based on the ratio of their joint Wisconsin income to their joint federal income ($38,600/$47,000 x $555 = $456).
- On his separate return, the husband must prorate his credits based on the ratio of his Wisconsin income to his federal income ($17,350/$25,750 x $281 = $189).
- On her separate return, the wife can claim the entire amount of her credits because she is domiciled in Wisconsin all year.
- The married couple credit is 2% of the wife's wages of $5,000. They can't claim this credit if they file separate returns.
- The husband's Wisconsin income tax withheld of $1,760 is divided equally between them on their separate returns. The wife claims her Wisconsin income tax withheld from January through March of $20. Since her wages for the rest of the year are marital property income, her withholding for the rest of the year of $30 is divided equally between them on their separate returns.
- The husband can't claim any part of the wife's separate estimated tax payments on his separate return.
- It's assumed that timely notification took place.

3. Spouses Divorced During 1990

A husband and wife are domiciled in Wisconsin for all of 1990. They became separated in February 1990 and were divorced on September 16, 1990. Their three children live with the wife all year and qualify as dependents. The wife signs a written declaration that she will not claim the dependent credits.

The husband's services and property produced the following income: (1) $29,000 of wages from January through September 15, 1990, and $15,000 for the rest of the year, and (2) $2,000 of interest income from January through September 15 and $500 for the rest of the year. In addition, his share of partnership income was $5,000, of which $3,550 was allocated to the period from January through September 15. The husband paid $4,000 of alimony, pursuant to a temporary court order, prior to September 15 and none after that date. Wisconsin income tax withheld from his wages was $1,000 from January through September 15 and $970 for the rest of the year. He made separate estimated tax payments of $750.

The wife's services produced $8,000 of wages from January through September 15 and $5,000 for the rest of the year. Wisconsin income tax of $240 was withheld from her wages from January through September 15 and $220 was withheld for the rest of the year.

The wife paid $2,500 of property taxes on their home in December 1990. The wife lived in the home all year, but the husband lived there only until March 1. The home was titled as marital property, but was awarded to the

wife as part of the divorce settlement. The husband paid rent of $5,000, which included heat, from March through December.

They prepare a worksheet (Worksheet 3, shown later) to figure their Wisconsin income tax. They must file individual returns since on December 31, 1990, neither is married. The amounts shown on Worksheet 3 assume that timely notification took place and are figured as follows:

- The husband's wages, interest income, and partnership income earned through September 15 are marital property income. The wife doesn't challenge this allocation of partnership income. Half is reported on each individual return.
- The wife's wages earned through September 15 are marital property income. Half is reported on each individual return.
- Since the husband's alimony payments weren't more than half of the combined marital property income, the husband doesn't claim a deduction for alimony and the wife doesn't report the alimony as income.
- The tax is from the single column of the Tax Table.
- The husband claims the three dependent credits since the wife signed a statement agreeing not to claim them.
- Since the husband's rent included heat, his renter's credit is from column 1 of the Renter's School Property Tax Credit Table.
- On the husband's return, the home owner's credit is based on $208 of the property taxes paid, figured as follows. Since the home is marital property through September 15, the property taxes for 8 1/2 months are divided equally between the spouses, regardless of who makes the payment (1/2 x 8.5/12 x $2,500 = $885). The husband's share of the taxes is then limited to the number of months that he occupied the home as his principal home (2/8.5 x $885 = $208).
- Since the wife paid the property taxes, she may claim a renter's credit based on the husband's share of the property taxes for the 6 1/2 months that he owned but didn't occupy the home (1/2 x 6.5/12 x $2,500 = $677).
- On the wife's return, the home owner's credit is based on $1,615 of the property taxes paid ($2,500 minus $885 allocated to the husband). The property taxes for 8 1/2 months are divided equally between the spouses ($885). In addition, the wife may claim the property taxes for the 3 1/2 months that she was the sole owner (3.5/12 x $2,500 = $730).
- Since the husband's and wife's wages from January through September 15 are divided equally between the spouses, their Wisconsin income tax withheld during that time is also divided equally between them. Each spouse claims his or her own withholding for the rest of the year.
- The wife can't claim any part of the husband's separate estimated tax payments.

WORKSHEET 3

Spouses Divorced During 1990

	Wisconsin Individual Returns			
	Husband		Wife	
Income (Husband's)				
Wages				
Jan. 1 - Sept. 15	$14,500		$14,500	
Sept. 16 - Dec. 31	15,000		0	
Interest income				
Jan. 1 - Sept. 15	1,000		1,000	
Sept. 16 - Dec. 31	500		0	
Partnership income				
Jan. 1 - Sept. 15	1,775		1,775	
Sept. 16 - Dec. 31	1,450		0	
Total		$34,225		$17,275
Wages (Wife's)				
Jan. 1 - Sept. 15	$ 4,000		$ 4,000	
Sept. 16 - Dec. 31	0		5,000	
Total		4,000		9,000
Wisconsin income		$38,225		$26,275
Tax		$ 2,365		$ 1,434
Dependent credit	$ 150		$ 0	
Renter's school property tax credit	101		16	
Home owner's school property tax credit	21		161	
Total credits		272		177
Net tax		$ 2,093		$ 1,257
Less: Wisconsin income tax withheld				
Husband's				
Jan. 1 - Sept. 15	$ 500		$ 500	
Sept. 16 - Dec. 31	970		0	
Wife's				
Jan. 1 - Sept. 15	120		120	
Sept. 16 - Dec. 31	0		220	
Total		1,590		840
Estimated tax payments		750		0
Amount due (Refund)		$ (247)		$ 417

III. FIGURING YOUR HOMESTEAD CREDIT UNDER WISCONSIN'S MARITAL PROPERTY LAW

For homestead credit purposes, you must generally figure your household income, property taxes accrued, and rent constituting property taxes accrued under the marital property law. If you and your spouse lived together in 1990, only one of you may file a homestead credit claim for 1990. If you and your spouse maintained separate homes on December 31, 1990, or if you became divorced in 1990, you may each file a separate homestead credit claim for 1990.

A. Household Income

1. Figuring Household Income Under the Marital Property Law

If you lived with your spouse for all of 1990, you must combine your income with your spouse's income to figure your total household income. (Only one of you can file a homestead credit claim.)

If you and your spouse maintained separate homes on December 31, 1990, or if you became divorced in 1990, you must figure your total household income as follows:

- The combined income of you and your spouse while married and maintaining the same home, plus
- Your income (as figured under Wisconsin's marital property law, with certain exceptions described later) while married but maintaining a separate home, plus
- Your income while unmarried.

Your income while married but maintaining a separate home is generally half of the total marital property income of you and your spouse, plus all of your individual income for that period of time.

If you and your spouse live together all year, your household income for homestead credit purposes generally is the same regardless of whether you file a joint or a separate income tax return.

2. Exceptions to Figuring Household Income Under the Marital Property Law

- You can't use marital property agreements and unilateral statements to figure your household income for homestead credit purposes. There may be a difference between the amount of income you must report on your Wisconsin income tax return and the amount you must report on your homestead credit claim.

  Example. You and your spouse maintained separate homes all year. You and your spouse have a marital property agreement which states that wages are the individual property of the wage earner. Your services produced $5,000 of wages and your spouse's services produced $15,000 of wages. For Wisconsin income tax purposes, you reported $5,000 of wages based on your marital property agreement. For homestead credit purposes, you must report $10,000 of wages (half of $20,000 combined wages) assuming notification occurred. This is true even though you don't receive control of more than $5,000 of income.

- You must figure your household income without regard to the marital property law during any period of time that your spouse isn't domiciled in Wisconsin.

  Example. Your services produced wages of $12,000. Your spouse's services produced wages of $10,000. Your spouse is a full-year Rhode Island resident. For both Wisconsin income tax and homestead credit purposes, you must report $12,000 of wages.

- You must figure certain household income without regard to the marital property law if you don't notify your spouse of the amount and nature of the marital property income your services and property produced. Also, you must figure your household income without regard to certain marital property income if your spouse doesn't notify you of the amount and nature of the marital property income his or her services and property produced.

  Example. You and your spouse maintained separate homes all year. Your services produced $15,000 of wages. If you notify your spouse of the amount of wages your services produced, you would report half of your wages ($7,500) for both Wisconsin income tax and homestead credit purposes. Your spouse must report the other half of the wages your services produced. If you don't notify your spouse of the wages your services produced, you must report all of the wages ($15,000) for both Wisconsin income tax and homestead credit purposes. If your spouse notifies you of the amount of income his or her services and property produced, you must also include half of that income in your income for Wisconsin income tax and homestead credit purposes.

B. Property Taxes Accrued

The marital property law presumes that all property of spouses is marital property. If you contend that property isn't marital property, you must prove that the property's classification is something else.

If you lived with your spouse for all of 1990 in a home owned by either or both of you, you can claim the entire amount of property taxes accrued on your home. (Only one of you can file a homestead credit claim.)

If you and your spouse maintained separate homes on December 31, 1990, or if you became divorced in 1990, you must figure your property taxes accrued on your home as follows:

- The total amount of property taxes on your home for the period of time you and your spouse maintained the same home, plus

- Half of the property taxes on your home for the period of time while married but maintaining a separate home, plus
- Your share (based on title) of the property taxes on your home for the period of time you are unmarried.

During your marriage, title generally doesn't determine ownership of your home between you and your spouse for homestead credit purposes. In addition, you can't use a marital property agreement or unilateral statement to figure property taxes accrued for homestead credit purposes.

Example 1. You are married but don't live with your spouse at any time during 1990. You live in a home which is titled in joint tenancy with your spouse. You pay the entire amount of property taxes ($800). You can claim $500 as property taxes accrued and rent constituting property taxes accrued. You are allowed one-half of the property taxes ($400) as property taxes accrued. You are allowed one-fourth of the remaining property taxes paid ($100) as rent constituting property taxes accrued. The result is the same if the home is titled as marital property or is titled solely in your name or solely in your spouse's name but is classified as marital property.

Example 2. You are married but don't live with your spouse at any time during 1990. You live in a home which is titled in your spouse's name. On December 31, 1985, you and your spouse signed a marital property agreement which states that you can claim all of the property taxes paid on the home for income tax and homestead credit purposes. You pay the 1990 taxes of $800. Since such an agreement doesn't affect your homestead credit, you can claim $500 as property taxes accrued and rent constituting property taxes accrued. You are allowed one-half of the property taxes ($400) as property taxes accrued. You are allowed one-fourth of the remaining property taxes paid ($100) as rent constituting property taxes accrued.

C. Rent Constituting Property Taxes Accrued

If you lived with your spouse for all of 1990 in rented living quarters, you can claim the entire amount of rent paid. (Only one of you can file a homestead credit claim.)

If you and your spouse maintained separate homes on December 31, 1990, or if you became divorced in 1990, you must figure your rent constituting property taxes accrued as follows:

- The total amount of rent paid on your living quarters for the period of time you and your spouse maintained the same home, plus
- The total amount of rent you paid on your own living quarters while married and maintaining a separate home or while unmarried.

D. Homestead Credit Examples

Following are three examples which show how to figure your household income, property taxes accrued, and rent constituting property taxes accrued if you and your spouse maintained separate homes on December 31, 1990, or became divorced during the year.

1. Separate Homes on December 31, 1990

A husband and wife resided in their jointly-titled home from January 1 to July 31, when the wife moved permanently to a nursing home. The husband paid all of the property taxes for the year of $600. The wife paid rent for occupancy, not including food, at the nursing home for the period August 1 through December 31 of $500. The husband's services and property produced income of $4,500 from January 1 through July 31, and $4,000 for the rest of the year. The wife's services and property produced income of $1,500 from January 1 through July 31, and $3,000 for the rest of the year. Both husband and wife qualify for homestead credit. Figure household income, property taxes accrued, and rent constituting property taxes accrued applicable to each spouse as shown below.

Note. The income and taxes for the time the spouses shared the same home are reported on both homestead credit claims. The husband may claim 25% of the wife's share of property taxes for the period she didn't live in their home, since he paid the tax.

	Husband	Wife
Household Income		
(H) January 1- July 31	$4,500	$4,500
(W) January 1- July 31	1,500	1,500
(H) August 1- December 31	2,000	2,000
(W) August 1- December 31	1,500	1,500
Total Household Income	$9,500	$9,500
Property Taxes Accrued		
(H) January 1- July 31 (7/12 x $600 x 1/2)	$ 175	$ 175
(W) January 1- July 31 (7/12 x $600 x 1/2)	175	175
(H) August 1- December 31 (5/12 x $600 x 1/2)	125	0
(W) August 1- December 31	(see below)	0
Total Property Taxes Accrued	$ 475	$ 350
Rent Constituting Property Taxes Accrued		
(H) 25% of wife's share of property taxes paid by husband for the period August 1 - December 31 (5/12 x $600 x 1/2) x 25%	$ 31.25	0
(W) 20% of rent paid for occupancy only (20% x $500)	0	$ 100
Total Allowable Taxes and Rent	$506.25	$ 450

2. Spouses Live Apart All Year

A husband and wife maintained separate homes all year. The husband resided in the family home, which was acquired prior to January 1, 1986, and was solely titled in his name. The home was fully paid for prior to January 1986, and no improvements were made after that date. He paid all of the property taxes for the year of $700. The wife resided in a nursing home for the entire year and paid rent for occupancy, not including food, of $3,000. The husband's income was $6,000 of social security and $3,000 of pension income attributable to employment prior to 1986. The wife's income was $5,000 of social security benefits. Both husband and wife qualify for homestead credit. Figure household income, property taxes accrued, and rent constituting property taxes accrued applicable to each spouse as shown below.

Note. The home is not classified by the marital property law since it was acquired prior to January 1, 1986, and there has been no subsequent marital property mixing. All of the household income is classified as individual income.

	Husband	Wife
Household Income		
Social security	$6,000	$5,000
Pension	3,000	0
Total household income	$9,000	$5,000
Property Taxes Accrued	$700	0
Rent Contituting Property Taxes Accrued		
20% of rent paid for occupancy only (20% x $3,000)	0	$600
Total Allowable Taxes and Rent	$700	$600

3. Divorce During 1990

A husband and wife lived together through May 31 and paid rent, which didn't include heat, of $200 per month to that date. On June 1 they both moved. The husband paid rent, which didn't include heat, of $150 per month and the wife paid rent, which didn't include heat, of $175 per month. On December 1, 1990, they became divorced. The husband's services and property produced income for the year of $5,000 through May 31, $2,500 from June 1 to December 1, and $500 after that date. The wife's services and property produced income of $1,000 through May 31, $1,500 from June 1 to December 1, and $1,000 after that date. In this situation, figure household income and rent constituting property taxes accrued for each homestead credit claim as shown below.

Note. The income and rent for the time the spouses shared the same home are reported on both claims.

	Husband	Wife
Household Income		
(H) January 1- May 31	$5,000	$5,000
(W) January 1- May 31	1,000	1,000
(H) June 1- November 30	1,250	1,250
(W) June 1- November 30	750	750
(H) December 1- December 31	500	0
(W) December 1- December 31	0	1,000
Total Household Income	$8,500	$9,000
Rent		
(H) & (W) January 1- May 31	$1,000	$1,000
(H) June 1- December 31	1,050	0
(W) June 1- December 31	0	1,225
Total Rent	$2,050	$2,225
Rent Constituting Property Taxes Accrued		
25% of rent paid for occupancy only	$512.50	$556.25

■ APPENDIX

Classification of Income

Marital property income. Marital property income must generally be divided equally between spouses on separate Wisconsin income tax returns and separate homestead credit claims (unless one of the exceptions to the marital property law applies). The following is a list of types of income reported on income tax returns and/or homestead credit claims which are generally marital property income when received:

- Wages
- Interest income
- Dividends
- Business income
- Capital gains from marital property
- Capital gains from individual or unclassified property to the extent attributable to the substantial efforts of either spouse that weren't reasonably compensated
- Pensions and annuities to the extent attributable to employment after the determination date
- Net rents and royalties, partnership income, and distributed S corporation income
- IRA distributions to the extent classified as marital property
- Farm income
- Unemployment compensation
- Railroad retirement benefits to the extent attributable to employment after the determination date (except Tier 1 benefits)
- Worker's compensation (except amounts for pain or suffering)
- Scholarships, fellowships, and grants
- G.I. bill benefits to the extent attributable to military service after the determination date
- Nontaxable military compensation and cash benefits

Individual income. The following is a list of types of income reported on income tax returns and/or homestead credit claims which are generally individual income when received:

- Alimony (if in excess of half of the marital property income of both spouses or if paid from individual income)
- Capital gains from individual or unclassified property to the extent the gain wasn't substantial or wasn't due to the substantial efforts of either spouse, or if the gain was substantial and due to the substantial efforts of either spouse, those efforts were reasonably compensated
- Pensions and annuities to the extent attributable to employment before the determination date
- IRA distributions to the extent classified as nonmarital property
- Estate and trust income to one spouse
- Undistributed S corporation income
- Social security benefits
- SSI payments
- Tier 1 railroad retirement benefits
- Railroad retirement benefits to the extent attributable to employment before the determination date
- Worker's compensation to the extent for pain or suffering
- Support money
- Cash public assistance (such as AFDC and foster care payments) and general relief
- G.I. bill benefits to the extent attributable to employment before the determination date
- Income from property gifted by one spouse to the other, absent a contrary intent

Note. The income tax law requires the reporting of items which the marital property law doesn't consider "income," such as capital gains which aren't due to the substantial efforts of either spouse and undistributed S corporation income. Although the department has shown these items as if they were individual income, this may not be the correct treatment. Should a dispute about the treatment of such income arise, it would likely be resolved by assessments in the alternative.

Worksheet for Married Persons Filing Separate Returns and Persons Divorced in 1990

Attach to your 1990 Wisconsin income tax return

Fill in your name and social security number ______________________________

	Total marital property of you and your spouse	Marital property amount you are reporting	Other amount you are reporting	Total amount you are reporting on your 1990 return
1. Wages, salaries, tips, etc.				
2. Interest income				
3. Dividends				
4. Business income or (loss)				
5. Capital gains or (losses)				
6. Pensions, IRA distributions, and annuities				
7. Rents, royalties, partnerships, estates, trusts, etc.				
8. Farm income or (loss)				
9. Unemployment compensation				
10. Social security benefits				
11. Other income				
12. Wisconsin taxes withheld				
13. Wisconsin estimated tax payments				

Check the box which explains how you are figuring the amounts to report on your 1990 Wisconsin income tax return.

☐ I am figuring my income and withholding for 1990 based on Wisconsin's marital property law.

☐ I became married in 1990. I am figuring my income and withholding based on Wisconsin's marital property law for the period from ________ to ________.

☐ I became divorced in 1990. I am figuring my income and withholding based on Wisconsin's marital property law for the period from ________ to ________. My former spouse's name and social security number are ______________________________.

☐ I was a part-year Wisconsin resident, or I was married to a part-year Wisconsin resident, in 1990. I am figuring my income and withholding based on Wisconsin's marital property law for the period from ________ to ________.

☐ I am figuring my income and withholding to reflect a marital property agreement or unilateral statement.

☐ Other reason—explain here. ______________________________

____

____

Worksheet for Married Persons Filing Separate Returns and Persons Divorced in 1990

Attach to your 1990 Wisconsin income tax return

Fill in your name and social security number ______________________________

	Total marital property of you and your spouse	Marital property amount you are reporting	Other amount you are reporting	Total amount you are reporting on your 1990 return
1. Wages, salaries, tips, etc.				
2. Interest income				
3. Dividends				
4. Business income or (loss)				
5. Capital gains or (losses)				
6. Pensions, IRA distributions, and annuities				
7. Rents, royalties, partnerships, estates, trusts, etc.				
8. Farm income or (loss)				
9. Unemployment compensation				
10. Social security benefits				
11. Other income				
12. Wisconsin taxes withheld				
13. Wisconsin estimated tax payments				

Check the box which explains how you are figuring the amounts to report on your 1990 Wisconsin income tax return.

☐ I am figuring my income and withholding for 1990 based on Wisconsin's marital property law.

☐ I became married in 1990. I am figuring my income and withholding based on Wisconsin's marital property law for the period from ________ to ________.

☐ I became divorced in 1990. I am figuring my income and withholding based on Wisconsin's marital property law for the period from ________ to ________. My former spouse's name and social security number are ______________________________.

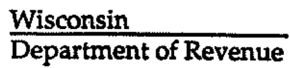
☐ I was a part-year Wisconsin resident, or I was married to a part-year Wisconsin resident, in 1990. I am figuring my income and withholding based on Wisconsin's marital property law for the period from ________ to ________.

☐ I am figuring my income and withholding to reflect a marital property agreement or unilateral statement.

☐ Other reason—explain here. ______________________________

____

____



FEDERAL AND WISCONSIN INCOME TAX REPORTING UNDER THE MARITAL PROPERTY ACT

Publication 113 (11/90)

In this publication, the "Federal Treatment" reflects the interpretations of Wisconsin's Marital Property Act by the Milwaukee District Office of the Internal Revenue Service and the "Wisconsin Treatment" reflects the interpretations by the Wisconsin Department of Revenue as of November 1, 1990. Federal and state laws enacted after this date, new federal regulations and rulings, new state administrative rules, and federal and state court decisions may change the interpretations in this publication.

The Department of Revenue acknowledges the Milwaukee District Office of the Internal Revenue Service for writing the "Federal Treatment" portion of this publication.

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I. BACKGROUND

Federal Treatment

On January 1, 1986, Wisconsin joined eight other states (Arizona, California, Idaho, Louisiana, Nevada, New Mexico, Texas, and Washington) as a jurisdiction whose laws are administered under the community property concept. The Wisconsin Marital Property Act creates a type of property under state law that is referred to as marital property. The Internal Revenue Service has ruled that marital property in Wisconsin is a form of community property, and is to be treated that way for tax purposes. [Revenue Ruling 87-13, 1987-1 C.B. 20.] While the Marital Property Act indirectly affects everyone who lives in Wisconsin, it only directly affects the property of married individuals.

The date that married couples become subject to the Marital Property Act is referred to as the "determination date." [*See* Wis. Stat. § 766.01(5).] This is the date after all of the following have occurred: the date of marriage, January 1, 1986 (the effective date of the Act), and the date both spouses domiciled in Wisconsin. "Domicile" is a legal concept that, in this context, is similar to establishing permanent legal residency.

Although there are exceptions, property acquired by spouses after the determination date is marital property. [Wis. Stat. § 766.31(1), (2) and (4); *see also* the exceptions in § 766.31(7).] As will be discussed, the statute gives each spouse an undivided half interest in marital property. [Wis. Stat. § 766.31(3).] The Act does not, by itself, change the character of property owned by spouses prior to the effective date of the Act, prior to both spouses establishing a Wisconsin domicile, or prior to the marriage. [Wis. Stat. § 766.31(6) and (9).] Property owned by a spouse prior to marriage is his or her individual property. [Wis. Stat. § 766.31(6).] Property owned by a spouse prior to January 1, 1986, or prior to both spouses establishing a Wisconsin domicile is not reclassified, but is treated as if it were individual property. [Wis. Stat. § 766.31(9).] Property can be reclassified in several different ways under the Act. The simplest way is by entering into a marital property agreement. [Wis. Stat. § 766.31(10).]

Community property has historically been subject to special treatment under the tax laws. [*See Poe v. Seaborn*, 282 U.S. 101 (1930).] The adoption of marital property law in Wisconsin affects the reporting, payment, and collection of income taxes. The effect of the Marital Property Act on Federal Taxation is complex. There is no way that it can be thoroughly addressed in this type of publication. The purpose of this publication is merely to provide general guidance. We have cited legal authority (both statutory and case law), as appropriate, in brackets [ ] for some of the rules that are stated in this publication. For further information, these sources can be consulted.

Wisconsin Treatment

As part of marital property reform, Wisconsin adopted the concept of joint income tax returns for married persons. Under prior law, each spouse was required to report his or her own income separately, either on separate forms or in separate columns on the same form (called a "combined" return). Joint returns simplify income tax filing for the majority of married couples. If spouses do file separately, the income that each spouse must report is determined under marital property law rather than under common law. Because the marital property law does not address many income tax issues, the reporting of income on separate returns may be difficult.

II. TERMS USED IN THIS PUBLICATION

Following is a discussion of terms used in this publication.

Common Law Property System — Under the common law property system, property acquired during marriage generally belongs to the spouse who acquired the property. The title to property generally determines ownership of property between spouses. A spouse owns and has complete control over property titled in that spouse's name. A spouse owns the income from his or her own property. For tax purposes, the title to property determines what income is reportable by each spouse on separate returns filed while domiciled in a common law property state.

Marital Property System — Under the marital property system, property acquired during marriage generally belongs to both spouses equally. The spouses are equal partners, whether each contributes money or services or both to the marriage, and both spouses will share equally all property acquired during the marriage, except property that one spouse alone inherits or receives as a gift from another person. Generally, the spouses own equally what either earns or buys and the income from property owned by either of them. However, a spouse has the right to manage and control property titled in his or her own name and property titled in neither spouse's name. Under the marital property system, the classification of property generally determines ownership of property between spouses. In the absence of an agreement or court order, the classification of property is based on two factors: when and how the property was acquired. The classification of the property also determines what income is reportable by each spouse on separate income tax returns while domiciled in Wisconsin.

Note: This publication often refers to "income earned by the husband," "income earned by the wife," "the husband's earnings," or "the wife's earnings." However, the income produced by a spouse's efforts or property is treated as if it

were earned by both spouses under the Marital Property Act.

Determination Date — Wisconsin's marital property law applies to spouses after the "determination date." The determination date is the last to occur of the following [Wis. Stat. § 766.01(5)]:

- January 1, 1986.
- Date of marriage.
- Date both spouses establish a Wisconsin domicile.

Note: For Wisconsin income tax and homestead credit purposes, the marital property law applies only while both spouses are domiciled in Wisconsin. [Wis. Stat. § 71.10(6)(d).] Effective May 3, 1988, the law generally applies for all purposes only while both spouses are domiciled in Wisconsin.

Domicile — A person's domicile is his or her true, fixed, and permanent home where he or she intends to remain permanently and indefinitely and to which, whenever absent, he or she intends to return.

Classification of Property — Under the marital property law, all property that spouses acquire after the determination date is generally classified as "marital property" or "individual property." Note that these rules may not apply for purposes of determining the basis of property upon the death of a spouse. For more information on basis, see Part V.

Marital Property — Marital property is all property classified as marital property and all property acquired by either spouse after the determination date, unless it is otherwise classified by the marital property law. [Wis. Stat. § 766.31(1).] The law presumes that all property owned by spouses is marital property. [Wis. Stat. § 766.31(2).] Any person who contends that certain property isn't marital property must prove that the property's classification is something else. Each spouse has a present, undivided one-half ownership interest in each item of marital property. [Wis. Stat. § 766.31(3).]

Marital property generally includes:

- Income earned or accrued by a spouse or derived from marital property and nonmarital property owned by a spouse during the marriage and after the determination date.

  "Income" means wages, salaries, commissions, bonuses, gratuities, payments in kind, deferred employment benefits, proceeds other than death benefits of any health, accident, or disability insurance policy or of any plan, fund, program, or other arrangement providing benefits similar to those forms of insurance, other economic benefits having value attributable to the effort of a spouse, dividends, dividends on life insurance and annuity contracts to the extent that the aggregate of the dividends exceeds the aggregate premiums paid, interest, income distributed from trusts and estates, and net rents and other net returns attributable to investment, rental, licensing, or other use of property, unless attributable to a return of capital or to appreciation. [Wis. Stat. § 766.01(10).]

- The substantial increase in value of nonmarital property which resulted from the substantial efforts of either spouse that weren't reasonably compensated. [Wis. Stat. § 766.63(2).]
- Nonmarital property that is mixed with marital property and can no longer be identified by tracing. [Wis. Stat. § 766.63(1).]

Individual Property — Individual property is property owned by one spouse alone under the marital property system. After the determination date and during the marriage, individual property includes:

- Property acquired by one spouse by gift or inheritance during the marriage. [Wis. Stat. § 766.31(7)(a).]
- Property acquired in exchange for, or with the proceeds of, individual property. [Wis. Stat. § 766.31(7)(b).]
- The increase in value of individual property, except to the extent that this increase in value is classified as marital property. [Wis. Stat. § 766.31(7)(c).] (Predetermination date unclassified property is treated "as if" individual property. [Wis. Stat. § 766.31(9).])
- Income (and principal) to one spouse from a trust created by a third person, unless the trust provides otherwise. [Wis. Stat. § 766.31(7)(a).]
- Income from a gift of property from one spouse to the other spouse, unless the spouse making the gift provides otherwise. [Wis. Stat. § 766.31(10).]
- Income or property designated individual property by a marital property agreement or a court decree. [Wis. Stat. § 766.31(7)(d).]
- Income derived from the nonmarital property of a spouse which that spouse has designated in a unilateral statement as his or her individual income. [Wis. Stat. §§ 766.31(7p) and 766.59.]
- For marriages occurring after December 31, 1985, property owned at a marriage by a Wisconsin-domiciled person. [Wis. Stat. § 766.31(6).]

Unclassified Property — Property owned by spouses before their determination date isn't classified by the Marital Property Act. Such unclassified property is treated as if individual property during the marriage. At death, property of the decedent spouse acquired during the marriage and before the determination date, which would have been marital property if acquired after the determination date, is treated as if it were marital property for certain elective rights of the surviving spouse.

Mixed Property — If marital property is mixed with any other type of property, the other type of property becomes marital property, unless that other type of property can be traced. This mixing rule doesn't apply for income tax basis purposes for property held in joint tenancy or tenancy in common. See Part V for more information.

Marital Property Agreement — A marital property agreement is an agreement solely between spouses. The agreement must be in writing, and it must be signed by both spouses. It remains in effect until replaced by another marital property agreement. [Wis. Stat. § 766.58.] The law provides special forms for "statutory property classification agreements." Spouses may use these agreements to classify their marital property as the individual property of the owning spouse or to classify all of their property as marital property. If there is no disclosure of assets and liabilities, the agreement terminates three years after the date both spouses sign the agreement. However, if the spouses complete the disclosure form which is provided as an attachment to the agreement form, the agreement is effective until dissolution of the marriage or death. Either spouse may, however, terminate a statutory property classification agreement unilaterally. [Wis. Stat. §§ 766.588 and 766.589.]

Unilateral Statement — A unilateral statement is a document affecting the income from nonmarital property. The statement must be in writing, signed by the spouse who owns the nonmarital property, and notarized. Within five days after signing the statement, the spouse must deliver a copy to the other spouse. A unilateral statement applies only to income accrued after it is signed. A unilateral statement may be revoked at any time by delivering a copy of the revocation to the other spouse. It does not apply to earned income. [Wis. Stat. § 766.59.]

■ III. INCOME, DEDUCTIONS, AND TAX PAYMENTS

A. Reporting Marital Property Income

Federal Treatment

The Wisconsin Marital Property Act may change the manner of reporting income and claiming deductions on federal income tax returns. With a few limited exceptions, the Marital Property Act provides that income earned or accrued by a spouse after the determination date is marital property. [Wis. Stat. § 766.31(4).] Income is defined by the statute as including, among other things, wages, interest, dividends, and economic benefits attributable to the efforts of a spouse. [*See* Wis. Stat. § 766.01(10).] Generally, interest and dividend income will be marital property even if the property that generates the income is not marital property. For example, dividends received after the determination date on stock purchased before the determination date would still be marital property.

The most notable exception to the rule that all income is marital property has to do with appreciation in value of individual property. The appreciation in value of individual property of a spouse is individual property, unless it can be attributed to efforts of either spouse that were not reasonably compensated. [Wis. Stat. §§ 766.31(7)(c) and 766.63.] Thus, for example, if real estate that was purchased prior to marriage increases in value because of market conditions, the increase in value is individual property. If, however, the increase in value is due to improvements to the property made by either spouse after the determination date that were not reasonably compensated, the increase in value is marital property. [Wis. Stat. § 766.63.]

Under the Act, each spouse has an undivided 50% interest in marital property. [Wis. Stat. § 766.31(3).] If spouses file a joint return, there is no tax impact from marital property law, because all income of both spouses (including any marital property income) is reported on one return. But when spouses file separate returns, the spouses must determine how to divide the income. In common law states, this is not difficult. Each spouse reports his or her own wages or other income from his or her labors, and any income attributable to property he or she owns. Under community property principles, since each spouse has a half interest in income that is marital property, each spouse should report half of that income. [*Poe v. Seaborn*, 282 U.S. 101 (1930).]

The reporting of marital property income is best illustrated by the following examples:

> **Example 1:** H and W were married during 1988. During 1990, H is unemployed and receives no wage income. W receives wages of $20,000. She has $5,000 of withholding from wages. In this case, if H and W file separate returns, each would report income of $10,000 (one-half of the wages received by W). Each also would report half of the withholding.

> **Example 2:** H and W were married during 1986. During 1990, H receives wages of $50,000. W owns a service business and makes a profit of $80,000. H also receives interest of $2,000 on a savings account started prior to

marriage. W receives dividends of $2,500 on stock she bought before marriage. W sells the stock for a profit of $3,000. On their separate returns, each would report the following:

Item	H	W
Wages earned by H	$25,000	$25,000
Business income of W	40,000	40,000
Interest	1,000	1,000
Dividends	1,250	1,250
Capital gain on stock	-0-	3,000
Total income reported	$67,250	$70,250

All of the income in this example is marital property, except for the income from the sale of the stock. This income is not marital property, because it is appreciation in value of individual property. Yet the dividends from the same property are marital property and should be split if separate returns are filed.

In either of the above examples, each spouse could claim half of the credit for any federal income tax withheld. Similarly, with certain exceptions, each spouse could claim half of any deductions.

As will be discussed later, spouses can change the effect of the Marital Property Act with respect to the reporting of income and deductions by entering into a marital property agreement.

Although splitting marital property income is the correct way to report it, filing a return in this manner could result in future contacts from the Internal Revenue Service. In the examples above, W-2 Forms would be issued in the name of one spouse alone. When a W-2 Form is sent to the IRS by the employer, it is reported as though it is entirely the income of one spouse.

The Internal Revenue Service matches information received under social security or taxpayer identification numbers with filed returns to ensure that all income is reported. In the examples above, when the matching process takes place, the W-2 Form will not reconcile with the return, unless the return contains an explanation. If there is no explanation, the IRS will contact the taxpayer. To avoid this contact, it is necessary to explain the discrepancy on the return. The easiest way to do this is to use a *Reconciliation Worksheet for Community Property,* which is included in Internal Revenue Service Publication 555, *Community Property and the Federal Income Tax.* Thus, under Example 1 above, the husband's and wife's reconciliation worksheets for community property would reflect the amounts indicated in Exhibits 1 and 2 that follow.

Wisconsin Treatment

As for federal purposes, Wisconsin's Marital Property Act generally won't affect spouses who file a joint Wisconsin income tax return. However, spouses who file separate Wisconsin income tax returns, or persons who become divorced during the tax year, are likely to be affected by the Marital Property Act. Since each spouse has an undivided 50% interest in marital property income, each spouse generally must report half of that income on separate returns. Examples 1 and 2 above also illustrate the reporting of marital property income for Wisconsin purposes.

Married persons who file separate returns, or persons who file individually because they are divorced during the year, are likely to be questioned if it isn't clear to the Department of Revenue how they have allocated their income, deductions, or credits or if it appears that they haven't reported all of their income. Therefore, such persons who file separate or individual Wisconsin returns should attach a copy of the *Worksheet for Married Persons Filing Separate Returns and Persons Divorced in 1990,* which is included in the back of Wisconsin Publication 109, *Tax Information for Married Persons Filing Separate Returns and Persons Divorced in 1990.* On this worksheet they show how they figured the income, deductions, and credits that each is reporting.

Thus, under Example 1 above, the husband's and wife's worksheets would reflect the amounts indicated in Exhibits 3 and 4 that follow. In this example, assume that $1,000 of Wisconsin income tax is withheld from W's wages.

If spouses or former spouses treat items on their separate or individual returns inconsistently, the Department will contact both of them in order to resolve the discrepancies. For example, the Department may question a spouse who reports one-half of the wages he or she earned but claims all of the withholding from those wages.

B. Exception to Marital Property Reporting — Innocent Spouses

Federal Treatment

As discussed earlier, by virtue of the Marital Property Act, if a spouse files a separate return, he or she is required to report one-half of the wages earned by the other spouse as income. This can create problems when, as frequently happens, spouses do not live together and do not communicate. Congress recognized this problem and enacted section 66 of the Internal Revenue Code to deal with it.

Section 66 allows spouses to ignore community property reporting rules in certain circumstances. It has two separate sections that could grant relief to spouses. The first provision, section 66(a), is general in effect, which means that if it

EXHIBIT 1

Husband's

Reconciliation Worksheet for Community Property

	1 Reported on Information Forms (W-2, 1099, etc.)	2 Reported on This Return	3 Difference Between Columns 1 and 2
1. Wages (each employer)	-0-	$10,000	$10,000
2. Interest Income (each payer)			
3. Dividends (each payer)			
4. State Income Tax Refund			
5. Capital Gains			
6. Pension Income			
7. Rents, Royalties, Partnerships, Estates, Trusts			
8. Taxes Withheld	-0-	$2,500	$2,500
9. Other items such as: Social Security Benefits, Business & Farm Income or Loss, Unemployment Compensation, Mortgage Interest Deduction, etc.			

REASONS FOR LISTING AMOUNTS DIFFERENT THAN THOSE PROVIDED WITH INFORMATION RETURNS
(Please Explain Below)

Spouses are reporting their income and tax withholding pursuant to the Wisconsin Marital Property Act.

Spouse's Name:

Spouse's SSN:

EXHIBIT 2

Wife's

Reconciliation Worksheet for Community Property

	1 Reported on Information Forms (W-2, 1099, etc.)	2 Reported on This Return	3 Difference Between Columns 1 and 2
1. Wages (each employer)	$20,000	$10,000	$10,000
2. Interest Income (each payer)			
3. Dividends (each payer)			
4. State Income Tax Refund			
5. Capital Gains			
6. Pension Income			
7. Rents, Royalties, Partnerships, Estates, Trusts			
8. Taxes Withheld	$5,000	$2,500	$2,500
9. Other items such as: Social Security Benefits, Business & Farm Income or Loss, Unemployment Compensation, Mortgage Interest Deduction, etc.			

REASONS FOR LISTING AMOUNTS DIFFERENT THAN THOSE PROVIDED WITH INFORMATION RETURNS
(Please Explain Below)

Spouses are reporting their income and tax withholding pursuant to the Wisconsin Marital Property Act.

Spouse's Name:

Spouse's SSN:

EXHIBIT 3

Husband's

Worksheet for Married Persons Filing Separate Returns and Persons Divorced in 1990
Attach to your 1990 Wisconsin income tax return

Fill in your name and social security number

	Total marital property of you and your spouse	Marital property amount you are reporting	Other amount you are reporting	Total amount you are reporting on your 1990 return
1. Wages, salaries, tips, etc.	$20,000	$10,000	- 0 -	$10,000
2. Interest income				
3. Dividends				
4. Business income or (loss)				
5. Capital gains or (losses)				
6. Pensions, IRA distributions, and annuities				
7. Rents, royalties, partnerships, estates, trusts, etc.				
8. Farm income or (loss)				
9. Unemployment compensation				
10. Social security benefits				
11. Other income				
12. Wisconsin taxes withheld	$1,000	$500	- 0 -	$500
13. Wisconsin estimated tax payments				

Check the box which explains how you are figuring the amounts to report on your 1990 Wisconsin income tax return.

[X] I am figuring my income and withholding for 1990 based on Wisconsin's marital property law.

[ ] I became married in 1990. I am figuring my income and withholding based on Wisconsin's marital property law for the period from ______ to ______.

[ ] I became divorced in 1990. I am figuring my income and withholding based on Wisconsin's marital property law for the period from ______ to ______. My former spouse's name and social security number are ______.

[ ] I was a part-year Wisconsin resident, or I was married to a part-year Wisconsin resident, in 1990. I am figuring my income and withholding based on Wisconsin's marital property law for the period from ______ to ______.

[ ] I am figuring my income and withholding to reflect a marital property agreement or unilateral statement.

[ ] Other reason—explain here. ______

EXHIBIT 4

Wife's

Worksheet for Married Persons Filing Separate Returns and Persons Divorced in 1990

Attach to your 1990 Wisconsin income tax return

Fill in your name and social security number

		Total marital property of you and your spouse	Marital property amount you are reporting	Other amount you are reporting	Total amount you are reporting on your 1990 return
1.	Wages, salaries, tips, etc.	$20,000	$10,000	- 0 -	$10,000
2.	Interest income				
3.	Dividends				
4.	Business income or (loss)				
5.	Capital gains or (losses)				
6.	Pensions, IRA distributions, and annuities				
7.	Rents, royalties, partnerships, estates, trusts, etc.				
8.	Farm income or (loss)				
9.	Unemployment compensation				
10.	Social security benefits				
11.	Other income				
12.	Wisconsin taxes withheld	$1,000	$500	- 0 -	$500
13.	Wisconsin estimated tax payments				

Check the box which explains how you are figuring the amounts to report on your 1990 Wisconsin income tax return.

[X] I am figuring my income and withholding for 1990 based on Wisconsin's marital property law.

[ ] I became married in 1990. I am figuring my income and withholding based on Wisconsin's marital property law for the period from ______ to ______.

[ ] I became divorced in 1990. I am figuring my income and withholding based on Wisconsin's marital property law for the period from ______ to ______. My former spouse's name and social security number are ______.

[ ] I was a part-year Wisconsin resident, or I was married to a part-year Wisconsin resident, in 1990. I am figuring my income and withholding based on Wisconsin's marital property law for the period from ______ to ______.

[ ] I am figuring my income and withholding to reflect a marital property agreement or unilateral statement.

[ ] Other reason—explain here. ______

applies, spouses do not report most community property income under community property rules. The second section, 66(c), is a more specific provision. It is the community property equivalent of an "innocent spouse" provision. It removes the burden of reporting half of certain items of community property income from a spouse. Both 66(a) and (c) have specific requirements that must be met, if they are to apply.

Section 66(a) provides that if:

1. The spouses are married to each other at any time during the calendar year,
2. The spouses live apart at all times during the calendar year,
3. The spouses do not file a joint return for the calendar year,
4. One or both spouses had earned income that is community property, and
5. No part of the community income is transferred between the spouses during the calendar year (this does not include child support or de minimis amounts),

then for most purposes, community property reporting rules will be ignored.

If section 66(a) applies, earned income (other than trade or business income) is taxed to the spouse who earned it. Trade or business (Schedule C) income is treated as the husband's unless the wife exercised substantially all management and control over the business. Income from a partnership is taxed to the partner spouse. Community income derived from separate property of one spouse is treated as the income of that spouse. All other community income is treated as provided under the applicable state community property law.

The second relief provision, section 66(c), is not as broad and may apply to all items of community property or only a few. This section provides that if:

1. The spouse did not file a joint return,
2. The spouse did not report an item of community income on an income tax return,
3. The spouse did not know, or have reason to know, of the item of community income, and
4. Considering all facts and circumstances it would be inequitable to require the spouse to include the item in gross income,

then the unreported item of income will be taxed wholly to the other spouse, and not split.

The third requirement of section 66(c), that the spouse did not know or have reason to know of the community income, has been interpreted strictly by the courts. If a spouse is even aware that the other spouse is earning or receiving community income, that spouse will not qualify for section 66(c) relief. If he or she knows that the other spouse is earning income, then he or she had "reason to know of the community income." It does not matter whether he or she does not know how much income was earned. [*Rimple v. Commissioner*, T.C. Memo 1985-245; *Sanders v. Commissioner*, T.C. Memo 1986-26, *affirmed*, 812 F.2d 715 (9th Cir. 1987), *cert. denied*, 484 U.S. 830 (1987); and *Thatcher v. Commissioner*, T.C. Memo 1988-537.] Whether a spouse can meet the requirements of section 66(c) will depend on the facts.

Because section 66 has been interpreted so strictly, it has not solved all of the income reporting problems created by community property laws. Many spouses do not know where their husbands or wives are. Some spouses refuse to provide information about their earned incomes. A spouse who has to deal with these problems may not know whether he or she can get help from section 66. In those situations, if it is possible, the spouse should notify his wife or her husband of the amount of his or her income and deductions. He or she also should request the same information in return. Then, if the taxpayer still does not have enough information to report the marital property income, he or she should report his or her income, deductions, and withholding, ignoring community property law principles (*i.e.*, report and pay the tax on 100% of the income earned or produced by that spouse). The return should state that although the taxpayer may be responsible for reporting marital property income that is not shown on the return, income, deductions, and tax payments are being reported on a common law basis because it is impossible to determine the community income share.

If the Internal Revenue Service subsequently audits the return and determines that the taxpayer qualifies under section 66, no changes would have to be made to the return. However, if the taxpayer does not qualify for section 66 relief, the Internal Revenue Service could, nevertheless, recalculate the tax due using community property principles. Still, this manner of filing the return should relieve this taxpayer of any penalties for failing to report the community income.

A taxpayer who has this problem and is reporting income in this way, or wants to benefit from section 66, must tell the other spouse of the amount of any community income he or she knows about. Section 66 contains a section (§ 66(b)) that allows the IRS to require a spouse to report 100% of an item of community property. This section only applies if a spouse

fails to notify the other spouse before the filing date of the nature and amount of that item of community property.

Thus for example:

> H and W are married. H earns $25,000 in wages for 1990. Under Wisconsin law, the wages are marital property. H and W file separate returns for 1990. H does not tell W how much income he earned for 1990 before April 15, 1991, the due date of 1990 returns. The IRS could require H to report the entire $25,000 in income under section 66(b). A taxpayer who does not know where his or her spouse is should not have to meet the notice requirement.

Wisconsin Treatment

Wisconsin does not follow the federal "living apart all year" rule found in IRC section 66(a). Although the Department of Revenue had proposed that a similar Wisconsin rule be included in the marital property trailer bill, the Legislature's Special Committee on Marital Property Implementation rejected this approach because the Wisconsin Marital Property Act applies to spouses until the dissolution of the marriage. Instead, the Legislature created a much broader Wisconsin "innocent spouse" rule [Wis, Stat. § 71.10(6)(b)], which states:

> A spouse filing a separate return may be relieved of liability for the tax, interest, penalties, fees, additions to tax and additional assessments under this chapter with regard to unreported marital property income in the manner specified in section 66(c) of the internal revenue code. The department may not apply ch. 766 in assessing a taxpayer with respect to marital property income the taxpayer did not report if that taxpayer failed to notify the taxpayer's spouse about the amount and nature of the income before the due date, including extensions, for filing the return for the taxable year in which the income was derived. The department shall include all of that marital property income in the gross income of the taxpayer and exclude all of that marital property income from the gross income of the taxpayer's spouse.

Substantially the same treatment applies for formerly married and remarried persons. [Wis. Stat. § 71.10(6m).]

Wisconsin adjusted gross income is defined as federal adjusted gross income as determined under the Internal Revenue Code in effect for Wisconsin purposes, with certain modifications. [*See* Wis. Stat. §§ 71.01(13) and 71.05(6) to (12), (19), and (20).] Among the required modifications are additions to or subtractions from federal adjusted gross income, as appropriate, for the amount necessary to reflect

- The inapplicability of the federal "living apart all year" rule (IRC § 66(a)),
- The applicability of the Wisconsin rules regarding "innocent spouses," marital property agreements, and part-year residents and nonresidents of Wisconsin (Wis. Stat. § 71.10(6)(b) to (d)), and
- Any other differences between the treatment of marital income for federal income tax purposes and the treatment of marital income for Wisconsin income tax purposes.

[Wis. Stat. § 71.05(10)(f), (g), and (h).]

Under the Wisconsin "innocent spouse" statute, the burden is on the earner spouse to notify the nonearning spouse about the amount and nature of marital property income. If the nonearning spouse isn't notified, he or she is an "innocent spouse" with respect to that marital property income. The statute provides that notification is timely only if made by the due date, including extensions, for filing the earner spouse's tax return. This timing for notification may cause a hardship for the nonearning spouse when the earner spouse delays notification to the last day or obtains an extension. Nevertheless, the nonearner will have to file an amended return to report the additional income. [*Joyce A. Bennett vs. Wisconsin Department of Revenue*, W.T.A.C., Docket No. 88-I-542 (November 15, 1989).]

Section 71.10(6)(b), Wis. Stats., does not require the earner spouse to make notification for income tax purposes. (There may, however, be a property law requirement to provide notification of marital property income.) If the earner spouse doesn't provide notification about the nature and amount of marital property income over which he or she had control, the earner spouse must report all of that marital property income. Thus, failure to make notification may result in treatment similar to that provided in the federal "living apart all year" rule or to that available if the spouses had signed a marital property agreement to classify their income as individual property. By not making notification, each spouse would be an innocent spouse with respect to the other's marital property income. It should be noted that the spouse with the higher income will pay additional tax as a result and, therefore, may notify in order to secure the income-splitting benefit. Consequently, a spouse who doesn't provide notification may be taxed on more than half of the couple's total marital property income. The spouses may wish to enter into an agreement that neither spouse will provide notification; however, such an agreement would not be binding on the Department of Revenue should one spouse violate the agreement and make notification.

The following example illustrates the problem that may arise.

H and W are married. W doesn't notify H about the marital property income her services and property produced but instead reports the entire amount on her separate return which she files before the April 15 due date. After filing her return, W receives notification about the nature and amount of the marital property income H's services and property produced. Provided H's notification is timely, W must amend her return and report one-half of the marital property income H's services and property produced. If H notifies before April 15, there is the possibility that W may still notify him by April 15 of the nature and amount of her marital property income and report one-half of the combined marital property income on an amended return. However, if H has an extension to file until August 15 and provides notification on August 1, W cannot then notify him about her marital property income since it is after the due date of her return. Thus, W must file an amended return reporting all of her marital property income and one-half of H's marital property income, whereas H would report one-half of his marital property income.

In addition, the statute doesn't specify how notification is to be made. (Due to opposition from the Legislature's Marital Property Implementation Committee, the Department had to abandon its attempt to promulgate an administrative rule concerning notification. It was felt that a rule would unduly limit the innocent spouse protection and that it would be better to let the courts determine whether notification was sufficient under the facts of a particular situation.) Therefore, the Department of Revenue has no guidance for determining whether proper notification has taken place and will issue assessments in the alternative when a problem arises.

If the nonearning spouse disputes that notification occurred, the earner spouse should be prepared to prove when notification was made, what it consisted of, and how it was accomplished. Although the Department cannot state that either of the following two methods is adequate notice, it appears that (1) notification made by mail may be evidenced by sending it by certified mail, return receipt requested, and retaining a copy of what was sent, and (2) notification made in person could be done in front of a disinterested person who signs an affidavit with a copy of the income information attached. In addition, although the Department cannot state what the notice must contain, it probably isn't sufficient to give just a total dollar amount of income, since the spouse won't know how to report it. The Department believes that sufficient information to file a tax return is the "goal" of notification.

The notification of marital property income and failure to notify about expenses, deductions, and withholding related to that income will not enable the earner spouse to claim the entire amount of those items. Certain negative income items must be allocated in the same manner as the income is or would be allocated, and a similar rule applies for withholding. [*See* Wis. Stat. §§ 71.01(16) and 71.64(1)(c).] Such incomplete notification may result in the conclusion that no notification took place and the earner spouse must report all of the marital property income.

Whenever it is apparent to the Department that there is a dispute as to whether notification has occurred, the Department will issue assessments in the alternative. For example, if the earner spouse reports one-half of the marital property income his or her property and services produced and the nonearning spouse fails to report the other half, the Department will issue assessments in the alternative, which will reflect more than the total income of both spouses. The earner spouse will be assessed tax on 100% of the income his or her property and services produced, thus denying that proper notification occurred. The nonearner will be assessed tax on one-half of that income, thus denying that spouse's claim to be an innocent spouse. Upon final determination of the proper income reporting, the Department will adjust either or both spouses' incomes, expenses, and deductions, as appropriate.

The following example further illustrates assessments in the alternative.

H and W are married. H's efforts produce $50,000 of wages, and he has $3,000 of Wisconsin tax withheld. W's efforts produce $14,000 of wages, and she has $700 of Wisconsin tax withheld. H claims to have notified W about his wages but she claims that she wasn't notified. The spouses agree that W didn't notify H about the amount of her wages. On his Wisconsin return, H reports $25,000 of wages and claims $1,500 of withholding. On her Wisconsin return, W reports $14,000 of wages and claims $700 of withholding. The Department will issue assessments in the alternative, as follows:

H will be assessed the tax on $50,000 of wages (all of his wages) and will be allowed credit for $1,500 of withholding (one-half of his withholding). W will be assessed the tax on $39,000 of wages (all of her wages and one-half of H's wages). She will be allowed credit for $700 of withholding (all of her withholding). After the Tax Appeals Commission determines whether proper notification was made, the assessments will be adjusted accordingly. The notification issue may also be resolved between the spouses by agreement, thus avoiding a hearing on the issue.

Comparison of Federal and Wisconsin Innocent Spouse Treatment

Suppose that a husband and wife are married and their determination date is January 1, 1986. The husband's efforts produce $40,000 of wages. Stocks gifted to him in

1988 as individual property produce $1,000 of dividend income. The wife operates a business which generates $10,000 of income. In addition, a corporate bond that she inherited in 1986 produces $500 of interest income, and real estate that she inherited in 1986 produces net rental income of $1,500. All of the income is marital property. Their income would be reported as follows:

Federal Returns

	If IRC Sec. 66(a) Applies		If IRC Sec. 66(a) Does Not Apply	
	Husband	**Wife**	**Husband**	**Wife**
Wages	$40,000	$ 0	$20,000	$20,000
Interest	0	500	250	250
Dividends	1,000	0	500	500
Business income	0	10,000	5,000	5,000
Net rental income	0	1,500	750	750
Total income reported	$41,000	$12,000	$26,500	$26,500

Wisconsin Returns

	If Neither Spouse Notifies		If Both Spouses Notify	
	Husband	**Wife**	**Husband**	**Wife**
Wages	$40,000	$ 0	$20,000	$20,000
Interest	0	500	250	250
Dividends	1,000	0	500	500
Business income	0	10,000	5,000	5,000
Net rental income	0	1,500	750	750
Total income reported	$41,000	$12,000	$26,500	$26,500

	If Only Husband Notifies		If Only Wife Notifies	
	Husband	**Wife**	**Husband**	**Wife**
Wages	$20,000	$20,000	$40,000	$ 0
Interest	0	500	250	250
Dividends	500	500	1,000	0
Business income	0	10,000	5,000	5,000
Net rental income	0	1,500	750	750
Total income reported	$20,500	$32,500	$47,000	$ 6,000

C. Estimated Tax Payments

Federal Treatment

There are no significant community income reporting problems with estimated tax payments where spouses file a joint return. But, in those situations where the spouses file separate returns, they need to exercise caution in claiming estimated tax payments. Where spouses file a joint 1040-ES (Estimated Tax) Form with estimated tax payments, each spouse may claim half the payment as a credit against the tax due. But, where a 1040-ES Form is filed in the name and tax identification number of only one spouse, the payment can be credited only to that spouse, and his or her spouse cannot claim a credit for half of it. [*Janus v. United States*, 557 F.2d 1268 (9th Cir. 1977); and *Morris v. Commissioner*, T.C. Memo 1966-245.] This is true even if the money for the estimated tax payment is community (marital) property.

Theoretically this rule of law could lead to some harsh results. A spouse may be required to report half of the community income and yet be unable to claim half of an estimated tax payment.

For example:

> H and W are married. H operates a business that is a sole proprietorship. For the year 1990, the business earns $50,000. H files a separate declaration of estimated tax and makes a payment of $10,000 toward his 1990 federal income tax liability. If H and W file separate returns, each would be required to report half of the profit from the business, or $25,000. However, since W did not join in making the estimated tax payment, she could not take credit for half of the estimated tax payment. This is a potential problem that can be avoided through a joint declaration of estimated tax.

This should not cause problems for spouses who are subject to federal income tax withholding and do not make estimated tax payments. Federal withholding is treated as marital property and should be split equally between the spouses if the income is being split. In any event, the withholding credits should be treated in a manner consistent with the reporting of income.

Wisconsin Treatment

Wisconsin's estimated tax statutes are patterned after the federal regulations and court decisions. If married persons file a joint return, it makes no difference whether they have made joint or separate estimated tax payments, as the full amount may be claimed. However, difficulties do arise if married persons file separate Wisconsin returns. On separate returns, joint estimated tax payments can be divided any way that the spouses choose. If the spouses can't agree, the Department will divide the payments in proportion to the tax liability shown on the separate returns. [Wis. Stat. § 71.09(16).] If spouses make separate estimated tax payments, no part of the payment may be allocated to the other spouse. [Wis. Stat. § 71.09(16).] Withholding, as previously indicated, must be allocated in the same way that the income is or would be reported. [Wis. Stat. § 71.64(1)(c).]

D. Marital Property Agreements

Federal Treatment

The Service will recognize the validity of marital property agreements for federal income tax reporting purposes if they provide that any future income earned by either spouse for personal services will be the individual property of that spouse, rather than the marital property income of both spouses. It is even possible to have such agreements provide that a percentage of what would normally be marital property income would be considered individual property. However, never more than 50% of the total marital property income can be reclassified as the income of the nonearner spouse.

> By way of an example, assume that one spouse has $10,000 of earned income and the other spouse has no income. The nonearning spouse is entitled to $5,000 of this earned income as his or her share of marital property. Suppose, however, that to take advantage of tax deductions that might otherwise be missed, the spouse earning income chooses to execute a marital property agreement assigning more than $5,000 to the nonearning spouse. The Service would not recognize such an agreement because it involves the contracting away of property that was not owned by the wage earner because he or she is only entitled to 50% of the earned income under the Marital Property Act.

Provisions are also made under the Marital Property Act to allow parties to "opt out" of the Act for prescribed periods. Earlier legislation permitted this on a one-year basis which expired January 1, 1987. Subsequent trailer bill legislation has extended that provision to three years under what is known as a statutory opt out agreement. Also, a provision under the Marital Property Act allows a spouse who owns individual property, which generates income, to serve a unilateral statement on the other spouse advising him or her that he or she is not entitled to treat that income as marital property. Although the Service recognizes these agreements and unilateral statements for federal tax reporting purposes, they do have their limitations which are discussed under the sections on divorce, basis, and delinquent taxes. The enabling statute prescribes notice requirements on these agreements in terms of altering creditor rights. The Internal Revenue Service does not prescribe a notice requirement, and will accept marital property agreements at the time of taxpayer contact for income reporting purposes. The marital property agreement will only be recognized prospectively from the date it was executed. The IRS does not recognize retroactive reclassification agreements. For reasons discussed in the sections on divorce and delinquent taxes, it is generally a good idea to serve a copy of the agreement with the Internal Revenue Service at the time it is executed. These agreements should be mailed to the following address:

Internal Revenue Service
Attn: Special Procedures Staff
P.O. Box 963
Milwaukee, Wisconsin 53201

A marital property agreement may not be effective to change the character of income that has already been received or earned from marital property to individual property, retroactively, for federal income tax reporting purposes.

Wisconsin Treatment

For Wisconsin income tax purposes, as well as federally, spouses cannot use a marital property agreement to retroactively reclassify income previously received, whether from marital property income to individual income or vice versa, and a court may not order such a retroactive reclassification either. An agreement may classify income received only from the date of signing forward.

There are several important differences between the federal and Wisconsin treatment of marital property agreements. First of all, the Department of Revenue, unlike the Internal Revenue Service, will recognize an agreement which allocates more than half of the marital property income to the nonearning spouse. Second, the Department of Revenue isn't bound by any marital property agreement or unilateral statement not provided to the Department before the issuance of an assessment. [Wis. Stat. § 71.10(6)(c).] Third, such an agreement or statement isn't effective for state purposes for any time that both spouses aren't domiciled in Wisconsin. [Wis. Stat. § 71.10(6)(c).] Fourth, such agreements or statements don't affect claims for refund. [Wis. Stat. § 71.75(6).] Finally, a marital property agreement or unilateral statement can't be used in computing income, property taxes accrued, or rent constituting property taxes accrued for homestead credit purposes. [Wis. Stat. § 71.52(6), (7), and (8).]

Since the Department of Revenue isn't bound by any marital property agreement not provided to the Department before the issuance of an assessment or billing, spouses may want to send a copy of any agreement to the Department at the time it is executed. Send marital property agreements to the following address:

Wisconsin Department of Revenue
Custodian of Files
P.O. Box 8903
Madison, Wisconsin 53708

Note that the Department does not acknowledge the receipt of unsolicited agreements and does not review them.

E. Divorce

Federal Treatment

The tax impact of the Marital Property Act takes on a severe implication in those situations in which a divorce action is pending, with the spouses separated and living apart. Except for the innocent spouse provisions (IRC section 6013) and IRC section 66, which was discussed under income reporting, little is available to ameliorate the difficulties encountered when spouses do not communicate tax information. Because of the requirement that marital property income be equally divided, there is often a taxing of income to one spouse even though he or she did not receive the income. In essence, even though the parties are separated, living apart, and not communicating, the marital property statute (Wis. Stat. § 766.01) provides that the marital property estate can be dissolved only through divorce, annulment, or a decree of legal separation or separate maintenance. This means that absent a marital property agreement, which is only prospective in nature, the parties must report their respective shares of marital property income even though a divorce petition has been filed.

Since enactment of the Marital Property Act, divorce litigants have attempted, through a marital property agreement, to reclassify income in the year of decree or in the year in which a petition is filed into individual income versus marital property income. Undoubtedly, this recharacterization of income would be the easiest way to handle an already difficult situation. Regrettably, this is not possible since the marital property income was already actually or constructively received. This situation is compounded further by the fact that the parties, in the year in which the decree is rendered, would have income for a portion of the year reportable as marital property income and for the portion of the year subsequent to the decree reportable as income of the spouse who earned it. There are a few solutions to this dilemma. One is to have a marital property agreement take effect at the beginning of the next tax year; another is to have the decree rendered on December 31, which would make the entire prior year subject to marital property income reporting.

The following example illustrates the tax reporting problems confronting a husband and wife undergoing a divorce.

> For this illustration assume H and W are divorced. The divorce decree was rendered on March 31. H earned a total of $48,000 in income and had $8,000 in federal income tax withholding. W earned $18,000 and had $4,000 withheld for federal income tax. There is no marital property agreement.
>
> In this situation, all income earned before March 31 is marital property. All income earned after March 31 is the property of the spouse who earned it. Since H and W were married for three months, 3/12 of the income earned by each should be split and reported by the other spouse, and 9/12 should be reported by the spouse who earned it.
>
> Therefore, income should be reported as follows:

	Total	W's Share	H's Share
3/12 W's wages (marital property share)	$ 4,500	$ 2,250	$ 2,250
3/12 H's wages (marital property share)	12,000	6,000	6,000
9/12 W's wages	13,500	13,500	-0-
9/12 H's wages	36,000	-0-	36,000
Total to be reported	$66,000	$21,750	$44,250

> Federal withholding credits should be claimed as follows:

	Total	W's Share	H's Share
3/12 W's withholding (marital property share)	$ 1,000	$ 500	$ 500
3/12 H's withholding (marital property share)	2,000	1,000	1,000
9/12 W's withholding	3,000	3,000	-0-
9/12 H's withholding	6,000	-0-	6,000
Total withholding	$12,000	$4,500	$7,500

> Of course, the above example assumes that both spouses are employes and their earnings are relatively constant. Dividing income by the number of months (or days, if appropriate) would approximate the actual amount of money earned before and after the divorce. If, however, either spouse's earnings vary during the year, the division would have to be made based on how much money was actually earned prior to and after the divorce.

As you can see in the above example, in the year of divorce this ex-husband ends up with less income and withholding than his W-2 Form indicates, and his ex-wife ends up with more income and withholding. Again, as in the situation with "married filing separately," these individuals, who will likely be filing single returns in the year of divorce, *must* attach some form of explanation (preferably the suggested worksheet in the rear of Publication 555, *Community Property and the Federal Income Tax*) which reconciles the discrepancy of their tax returns with the amount reported to the Internal Revenue Service. The remarks section of the form should indicate the date on which the divorce decree was entered. It is not necessary to attach a copy of the decree.

Wisconsin Treatment

For Wisconsin purposes as well as for federal purposes, income earned by spouses after they separate but prior to the date of divorce continues to be marital property and must be treated as such on their income tax returns. The federal example of how income and withholding up to the date of divorce is allocated also applies for Wisconsin purposes. The only exceptions to this treatment are if (1) the spouses entered into a marital property agreement at the time of separation to classify the income subsequently received as the individual income of the recipient, or (2) the innocent spouse rule in Wis. Stat. section 71.10(6)(b) or (6m) applies.

Caution must be exercised in the drafting of marital property agreements since the Department won't recognize agreements which retroactively reclassify income. An agreement which states that in the year a divorce is granted the income of the spouses will be individual income, is still retroactive since the granting of the divorce decree is what triggers the classification of income received before the decree is granted. If a future event is to trigger the reclassification of income, that event must occur before the income is generated. For example, an agreement that provides that all income received after the filing of a petition for divorce will be the individual income of the earner spouse would be acceptable, provided that the agreement is signed before the income is earned.

The innocent spouse rule for persons who will file individual returns for the year of divorce is the same as the notification rule previously discussed for separate returns. It must be remembered that the innocent spouse rule doesn't reclassify marital property income to individual income for purposes of determining whether alimony is deductible by the payer spouse and taxable to the recipient (see Part F below). In divorce situations, the question arises as to whether the disclosure of income in the divorce proceedings is adequate notification. Since the courts have not issued any opinions in this area, the Department is unable to provide any guidance. The Department suggests that the spouses' accountants and/or attorneys try to get the spouses to agree on whether they will or will not notify each other of the amount and nature of their marital property income.

F. Alimony

Federal Treatment

Further complications arise in computing the alimony deduction under community tax law standards. Ordinarily, IRC section 215 permits a deduction for alimony or separate maintenance by the payer and section 71 requires the corresponding reporting of that payment as income by the recipient. Since community property law already equally divides the income between the spouses, any alimony payment below that 50% level is not deductible since reporting that half of the income is already required for the receiving spouse until the date of the divorce decree. [*See Furgatch v. Commissioner*, 74 T.C. 1205 (1980).]

> By way of example, assume that the husband earned $20,000 and was ordered to pay $500 a month of temporary support, and that the decree rendered on December 31 provided for a permanent support allowance of $500 a month. In the tax year in which the decree was rendered, the husband would not have an IRC section 215 alimony deduction because the $6,000 support payment ($500 X 12 months) is less than the wife's share of marital property income of $10,000. In fact, under the reporting requirements, the husband's return would reflect $10,000 of earned income and the wife's return would reflect her share, or $10,000, of marital property income. The year subsequent to the decree, after the marriage had been dissolved, the ex-husband's return would reflect $20,000 of earned income and a $6,000 alimony deduction. The ex-wife's return would show this $6,000 as income.

These special rules only apply until there is a "dissolution." After dissolution, earnings or other income of a former spouse would no longer be marital property, and each former spouse would own an undivided half interest in any former item of marital property. [Wis. Stat. § 766.75.] Dissolution occurs if there is a decree of dissolution, divorce, or annulment, or decree of legal separation or separate maintenance. [*See* Wis. Stat. § 766.01(7).] At this time, as the above example assumes, it is the position of the IRS that a temporary order for support or maintenance [*see* Wis. Stat. § 767.23] is not a dissolution for purposes of the Marital Property Act.

Wisconsin Treatment

Wisconsin's treatment of alimony income and deductions is the same as the federal treatment described above.

> In the above example, if the husband notifies the wife of the amount and nature of his marital property income, the spouses would each report $10,000 of marital property income on their Wisconsin returns, the same as for federal purposes. If the husband doesn't provide notification, he must report the entire $20,000 of marital property income, while his wife would report nothing. Since the innocent spouse rule doesn't change the classification of property, the husband wouldn't have an IRC section 215 alimony deduction and the wife wouldn't have any alimony income. For the year subsequent to divorce, the ex-husband's Wisconsin return would show $20,000 of income and a $6,000 alimony deduction. The ex-wife's return would show $6,000 of alimony income.

G. Payment of Taxes

Federal Treatment

When the marital estate is divided pursuant to a divorce decree, provisions are sometimes made for the payment of federal income tax. Generally, these provisions will provide that one spouse is responsible to pay any taxes owed the last year a joint income tax return was filed. Typically, joint returns are filed pending the divorce action since those tax rates are more favorable than the married filing separate rates. Caution needs to be exercised in this area because those decrees affixing federal income tax responsibilities are not binding upon the Internal Revenue Service. In the situation involving a joint return, the tax liability is joint and several. Therefore, the Service will enforce collection against either party and leave the compliance with the decree provision as a matter for the spouses, or former spouses, to resolve with the State Court. The best course of action for divorcing spouses is to ensure that these taxes are paid with the filed return or to verify, before the decree is rendered, that the joint tax return liability has been satisfied. Either spouse can authorize a disclosure of joint return information to his or her power of attorney, and the easiest way to secure this information is by signing a Form 2848-D, *Tax Information Authorization and Declaration of Representative,* which will permit the Service to disclose whether all payments have been made.

If pre-divorce tax relief is not available through application of IRC section 66(c) income reporting and the income stream was not terminated through a marital property agreement, the only other relief available would be the application of the "innocent spouse" provision, which is contained in IRC section 6013. Many of its provisions are very specific in nature and require a threshold to be met before judgmental factors come into play. Following is a brief summary of the IRC section 6013 requirements:

1. That a joint return was filed for the tax year involved,

2. That there was a substantial understatement attributable to the grossly erroneous items of the other spouse,

3. That in signing the return, the spouse seeking relief did not know and had no reason to know that there was a substantial understatement on the return, and

4. Taking into account all the facts and circumstances, it is inequitable to hold the spouse seeking the relief liable for the deficiency in tax attributable to the substantial understatement for the applicable tax year.

The requirement that there be a substantial understatement means that if the spouse's adjusted gross income for the preadjustment year is $20,000 or less, the proposed deficiency, plus interest and penalties, must be more than 10% of that amount. If the spouse's adjusted gross income for the preadjustment year is $20,000 or more, the proposed deficiency, plus interest and penalties, must be more than 25% of that amount. The preadjustment year is the most recent tax year or the year ending before the year the notice of deficiency is mailed. In either event, the understatement must exceed $500.

The requirement that the understatement be attributable to grossly erroneous items of a spouse means that the return must contain a claim of a deduction, credit, or basis that has no basis in fact or law, or, omit an item of gross income. The grossly erroneous item must be attributable to the other spouse.

If the above requirements are met, community property law is disregarded. This means the computation can be made without the necessity of having a share of marital property income imposed on the spouse seeking relief. Utilizing IRC section 6013 in a community property state presents some burdens. A spouse involved in a divorce action must report community income as married filing separately or file a joint return and be subjected to joint and several liability which can only be avoided through the section 6013 "innocent spouse" provision. This latter option presents a number of problems. For example, in applying the gross income limitation, gross sales of a business must be considered rather than net profit.

Lack of knowledge on the part of the spouse seeking relief is also difficult since constructive awareness can be imposed. It even comes down to a "reasonably prudent" person concept in terms of being cognizant of the other spouse's behavior. This situation frequently arises in criminal conduct on the part of the other spouse (typically embezzlement) where the spouse seeking relief under section 6013 should have known of the acts engaged in by the guilty spouse. Benefiting from the omitted income imputes knowledge, but doesn't include normal support. However, the transfer of property which may result from a division of assets under a divorce decree could be considered a benefit that precludes relief. Examples where the benefit provision won't preclude relief are when the guilty spouse is:

1. Using the omitted income for personal purposes such as payments to third parties,

2. Purchasing assets in his/her individual name,

3. Engaging in an extravagant lifestyle not enjoyed by the other spouse,

4. Squandering the money on gambling activities.

Payments for ordinary support do not constitute benefit. In summary, because of the numerous case decisions falling on both sides of this Code provision, caution should be exercised in filing a joint return with the expectation of subsequently seeking innocent spouse relief.

Wisconsin Treatment

Married persons who file a joint Wisconsin income tax return are jointly and severally liable for the tax due, the same as for federal purposes. Likewise, a divorce decree or other court order affixing state income tax liabilities isn't binding on the Department of Revenue. Additionally, a spouse may be relieved of liability on a joint Wisconsin return in the manner specified in IRC section 6013(e), as described above, except that the amount and percentage of the understatement requirements don't apply. [Wis. Stat. § 71.10(6)(a).]

H. Deductions

As was the case of joint income reporting and the election to file a joint return, the Marital Property Act creates no new problems for claiming income tax deductions. However, there is some impact for deductions in the case of income reporting under the married filing separate status. Following are the rules for claiming deductions:

1. Itemized Deductions

Federal Treatment

If the expenses are associated with marital property income, then those expenses are equally divided between the two spouses' returns. If one spouse has individual income as a result of a marital property agreement, then that spouse can deduct only expenses attributable to that individual property, provided that the payments were made from individual funds. If the expenses were paid from marital property funds, then half of the expenses are deductible by each spouse.

Wisconsin Treatment

Although itemized deductions cannot be claimed for Wisconsin purposes, certain itemized deductions may be used in the computation of Wisconsin's itemized deduction credit. The Wisconsin treatment of expenses allowed in the computation of the itemized deduction credit is the same as the federal treatment of these expenses. Expenses incurred to earn or produce marital property income are generally divided equally between the spouses. Expenses incurred to earn or produce individual income are allocated to the spouse who owns the income, provided that spouse paid the expenses from his or her individual property. Expenses that aren't attributable to any specific income, such as medical expenses or charitable contributions, are deductible by the spouse who pays them. However, if these personal expenses are paid from marital property funds, then the amounts are divided equally between the spouses.

2. Exemptions for Dependents

Federal Treatment

This deduction could be claimed on either return providing that support arose from marital property funds.

Wisconsin Treatment

Since a $50 credit is provided for each person for whom the taxpayer is entitled to an exemption under IRC section 151(c), the Wisconsin treatment is the same as the federal treatment. When more than one dependent is supported with marital property funds, the spouses may divide the number of dependents between themselves on separate returns in any manner they choose. No division of a $50 credit is allowed.

3. Casualty Loss Deductions

Federal Treatment

This retains the same character as the property that was subject to the loss. If it was a marital property asset that was destroyed through fire or theft, or other sudden unexpected events, then the deduction would be equally divided.

Wisconsin Treatment

The loss retains the same character as the property that was subject to the loss, the same as federally. Note that casualty losses allowed as itemized deductions for federal purposes aren't deductible or allowable in the itemized deduction credit for Wisconsin purposes.

4. IRA Deductions

Federal Treatment

The right to this deduction is predicated upon *earned* income; therefore, the payment into a separate IRA could only be claimed on the spouse's return to the extent of IRA limitations imposed, e.g., cap on adjusted gross income. In other words, if there is a nonworking spouse, half of the marital property income earned by the other spouse could not be reported on the nonworking spouse's separate return in order to claim an IRA deduction.

Wisconsin Treatment

Wisconsin's treatment of IRA deductions is the same as the federal treatment. The deduction is based on each spouse's earnings, determined without regard to the marital property law.

5. Charitable Deductions

Federal Treatment

The Marital Property Act causes some questions to arise in charitable gifts in which both spouses do not concur in the transfer. Under Wis. Stat. section 766.70(6), a right is created on the behalf of one spouse who does not concur in a gift of marital property to a third party the opportunity to seek recovery against that third party or the gifting spouse. This right exists up until one year after becoming aware of the transfer, and could cause complete restoration of the transfer during the lifetime of the grantor. If the gift is made to a charitable institution and if there is a nonconsenting spouse involved with the gift, a question could be raised that it was not a completed gift, which would allow an itemized charitable deduction. Under the provisions of section 766.53, this problem would not arise for gifts under $1,000 (permitted without consent) or for larger gifts depending on the economic circumstances of the donor. It is possible to donate without consent large sums of money or property if the donor were in such an economic situation that the amount conveyed would be negligible in comparison to the donor's total worth.

If the threshold question is met on the basis that one spouse cannot make a charitable, tax-deductible gift of marital property without the consent of the other, then the question arises about what events could take away the possibility of later challenge by the Internal Revenue Service. Obviously, the best approach would be to have both spouses concur in the transfer, or have the nonconsenting spouse subsequently affirm the gift. Under the Wisconsin Statute, if one year passes after the nonconsenting spouse became aware of the transfer and no steps were taken to set it aside, it is a completed gift. This type of event legitimately raises the question, just when did the gift take place? It would seem that the charitable contribution might be deductible one year after the other spouse has notice of the gift, since it is on this date that the other spouse can no longer contest the gift. [*See* Wis. Stat. §§ 766.53 and 766.70(6)(a).] Another possibility would be that the deduction is allowable in the year the gift is ratified by the other spouse.

In summary, this tentative position taken by the Service has raised a number of questions that have not been fully resolved. It is possible a problem could never arise due to the fact that it may only result in moving a deduction between tax years with negligible effect. Or, in the alternative, the deduction was allowable in the year of the gift and would not be subject to challenge unless the nonconsenting spouse subsequently brought a cause of action that caused the restoration of the donated property. Then, the amount of deduction would be required to be reported as income in that year under a tax benefit doctrine.

Wisconsin Treatment

The federal treatment of charitable gifts also applies for Wisconsin purposes.

6. Business Expenses

Federal Treatment

In a situation where a Schedule C is filed with a tax return with the business generating marital property income, those expenses associated with the business are divided equally between the spouses. In deducting business expenses, other limitations under the Internal Revenue Code may apply.

Wisconsin Treatment

Wisconsin follows the federal treatment of business expenses.

■ IV. COLLECTION OF DELINQUENT TAXES

A. Delinquent Taxes and the Marital Property Act

Federal Treatment

Generally, when a taxpayer fails to pay back taxes after receiving a notice that they are owed and a demand for payment from the Internal Revenue Service, a lien is created in favor of the IRS. This lien attaches to all of the delinquent taxpayer's property and rights to property. [IRC § 6321.] Except for certain exemptions recognized by federal law, the IRS could collect any property subject to the lien to pay the tax liability.

The major impact of the Marital Property Act is to alter spouses' property rights. If a taxpayer's property rights are changed, the IRS' lien will be affected in the same way, because it attaches to the taxpayer's property and rights to property. Thus, for example, if state law gives a delinquent taxpayer a half interest in marital property, the IRS' lien would attach to that half interest, since it is a right to property.

Also, the Marital Property Act classifies debts and gives creditors different collection remedies depending on the type of debt. These state remedies also may be used by the IRS in addition to the collection authority given under federal law.

The most important classification of debts under Wisconsin law is whether they "arose" before or after the "determination date." The "determination date" is the date that spouses and their property become subject to the Marital Property Act. [Wis. Stat. § 766.01(5).] This date is after all of the following have occurred:

1. January 1, 1986,
2. The date the spouses were married, and
3. The date that both spouses were "domiciled" in Wisconsin.

As previously stated, the term "domicile" is a legal term that is similar to establishing permanent legal residency.

As will be discussed in the sections that follow, there are different federal tax collection consequences depending on whether the debt "arose" before or after the spouses became subject to the Marital Property Act. The date the debt "arises" would be the date that the act or omission that created the obligation occurred. Thus, an income tax liability may "arise" at the end of the tax year or no later than the due date of the return. It would not arise when the IRS assesses the liability or demands payment.

Wisconsin Treatment

Wisconsin income taxes not paid by the due date are delinquent, and the Department of Revenue will begin collection action. Any unpaid tax is a perfected lien in favor of the Department upon all of the debtor's property and rights to property. The lien is effective at the time taxes are due or at the time an assessment is made, and it continues until the liability is satisfied. [Wis. Stat. § 71.91(4).]

Special presumptions apply to the collection of tax debts and other debts owed to the state. Generally, tax debts are classified based on when the debt was incurred. The type of debt determines what property the Department of Revenue can take to satisfy the debt.

All tax debts, including interest, penalties, and costs, incurred during marriage by a spouse after December 31, 1985, or after both spouses are domiciled in Wisconsin, whichever is later, are incurred in the interest of the marriage or the family. [Wis. Stat. § 71.91(3).] For Wisconsin income tax purposes, a tax debt, including interest, penalties, and costs, is incurred on the date of the Department's initial assessment or notice of the amount due. [Wis. Stat. § 71.91(2).] This treatment applies for debts incurred for the 1986 tax year and later years.

As a result of these special presumptions which apply to the collection of delinquent Wisconsin taxes, the property of spouses available to satisfy delinquent federal and state tax debts may differ. These differences will be discussed in the sections that follow.

B. Delinquent Taxes Arising Before the Determination Date

Federal Treatment

As already discussed, the IRS has different collection rights depending on when the obligation was incurred. It is the position of the Internal Revenue Service that, with regard to delinquent taxes arising before the determination date (*i.e.*, before the marriage, January 1, 1986, or the date both spouses domiciled in Wisconsin), the liability can be collected from any of the following sources:

1. All of the property of the spouse who owes the taxes that is not marital property,
2. Any part of marital property that would have been property of the spouse but for the marriage or the enactment of marital property law, and
3. The interest in marital property of the delinquent spouse (presumably half).

The creditor's rights to collect from the first two sources listed above are granted by the Marital Property Act. [Wis. Stat. § 766.55(2)(c) 1. and 2.] The right of the federal government to collect from half of marital property is a federal law consequence of the state law that gives each spouse a half interest in marital property.

The impact of the marital property law on tax debts that arose before the determination date is illustrated by the following example:

> H and W are married during 1988. H owes taxes that arose before marriage. Both H and W are employed and earn wages. H has real estate that was purchased during 1985. W owns stocks that she purchased during 1986. Under the Marital Property Act, the wages of both spouses are marital property; however, H's wages would have been his property alone but for the marriage. The real estate is treated as if it were the individual property of H. The stocks are treated as if they were the individual property of W. Therefore, the IRS could collect the delinquent taxes from all of H's wages, half of W's wages, and all of H's real property. The stocks and half

of W's wages, as the property of W, would not be available to the IRS.

Although the Marital Property Act does not allow collection of predetermination date debts from marital property [*see* Wis. Stat. § 766.55(2)(c)1. and 2.], these restrictions are not applicable to the collection of unpaid federal taxes. Since federal law gives the Internal Revenue Service a lien against all of the delinquent taxpayer's property and rights to property, the federal tax lien would attach to the delinquent taxpayer's half interest in marital property without regard to state law restrictions. [*Vorhies v. Z Management*, 87-1 U.S.T.C. 9200, 59 A.F.T.R.2d 87-658 (W.D. Wis. 1987); *Medaris v. United States*, 884 F.2d 832 (5th Cir. 1989); *In re Ackerman*, 424 F.2d 1148 (9th Cir. 1970); *In re Overman*, 424 F.2d 1142 (9th Cir. 1970); and *Broday v. United States*, 455 F.2d 1097 (5th Cir. 1972).]

Wisconsin Treatment

As previously indicated, for Wisconsin purposes a tax debt is incurred on the date of the Department's initial assessment or notice of the amount due. [Wis. Stat. § 71.91(2).] However, this system of debt collection first applies to the 1986 tax year. Pre-1986 tax year debts are collected as predetermination date debts. Thus, the debt may be collected from the following sources:

1. All nonmarital property of the spouse who incurred the debt, and
2. That part of the marital property which would have been the debtor spouse's property if unmarried.

The collection of Wisconsin income tax debts is illustrated by the following examples:

> **Example 1:** Assume that the facts are the same as in the federal example above. The Department of Revenue issues H an assessment in 1989 for the tax year 1985. The Department may collect the 1985 tax debt from H's wages and H's real property. W's wages and W's stock are not available to the Department to satisfy H's 1985 tax debt.

> **Example 2:** Assume the same facts as in example 1, but the Department issues an assessment to H in 1989 for the tax year 1986. Tax debts for the 1986 tax year and later tax years are incurred on the date of the Department's assessment. Therefore, H's 1986 tax debt is considered to be incurred in the interest of the marriage and the family because it was assessed after the determination date and during marriage. In this case, the debt is collected as explained in Part C below.

C. Delinquent Taxes Arising After the Determination Date

Federal Treatment

If the federal tax liability arose after the determination date (*i.e.*, after the date of marriage, January 1, 1986, and the date both spouses domiciled in Wisconsin), the property that the IRS may use to satisfy delinquent taxes is different from that which may be used to satisfy a predetermination date debt.

The Marital Property Act classifies post-determination date debts as follows:

1. Those that are incurred in the interest of the marriage and the family (family purpose obligations), and
2. Those that are not incurred in the interest of the marriage and family (non-family purpose obligations).

[*See* Wis. Stat. § 766.55(1).] The remedies available to the IRS are different for each type of debt.

There is a presumption under the Marital Property Act that debts arising after marriage and after the effective date of the Act are family purpose obligations. The law therefore assumes that the debt was incurred in the interest of the marriage or family, unless the taxpayer shows otherwise. [Wis. Stat. § 766.55(1).] It is the position of the Internal Revenue Service at this time that taxes and most penalties are family purpose obligations.

With regard to family purpose obligations arising after the determination date, these debts can be collected from any of the following sources:

1. All of the property of the spouse who owes the taxes that is not marital property, and
2. All marital property.

[*See* Wis. Stat. § 766.55(2)(b).]

With regard to non-family purpose obligations arising after marriage and after January 1, 1986, these debts can be collected from any of the following sources:

1. All of the property of the spouse who owes the taxes that is not marital property, and
2. 1/2 of marital property.

[*See* Wis. Stat. § 766.55(2)(d).]

This effect of the marital property law in these situations is illustrated by the following example:

> H and W were married during 1987. For 1988, H filed a separate income tax return reporting a tax liability, but did not pay the tax due. H and W both are earning wages. H owns real estate that he bought during 1986. W has stock she bought during 1986. The wages of both spouses are marital property. The real estate is the individual property of H, and the stock is the individual property of W. An income tax liability incurred after marriage is probably a family purpose obligation. Therefore, the IRS could collect the tax due from all of either spouse's wages, or the real estate. The stock would not be subject to the claim, because it is not marital property or the individual property of the spouse who owes the tax liability. If the tax liability was not a family purpose obligation, the IRS could only collect the debt from one-half of each spouse's wages and the real property.

Wisconsin Treatment

As for federal purposes, the type of debt determines what property the Department can take to satisfy it. Tax debts, including interest, penalties, and costs, for 1986 and later tax years incurred during marriage by a spouse after the determination date are incurred in the interest of the marriage or the family. Therefore, the following property is available for collection:

1. All marital property, and

2. All other property of the spouse who incurred the debt.

[*See* Wis. Stat. §§ 71.91(3), 766.55(2)(b), and 859.18.]

If the Department determines that one spouse is an "innocent spouse" and, therefore, is relieved from liability for the debt, the Department may collect the debt from the following property:

1. All nonmarital property of the spouse who incurred the debt, and

2. The debtor spouse's interest in marital property, in that order.

[*See* Wis. Stat. §§ 71.91(3) and 766.55(2)(d).] Therefore, even though a spouse may be an "innocent spouse" under Wis. Stat. section 71.10(6), a portion of the marital property income that his or her property or services produced may be used to satisfy a tax debt of the other spouse.

D. Bankruptcy Marital Property Implications

Federal Treatment

The impact of the Marital Property Act on bankruptcy is greatest in situations where only one spouse owes taxes, and that spouse files a separate bankruptcy petition without his or her spouse. Where this happens, all marital property, including the interest of the spouse who is not in bankruptcy, may be subject to the bankruptcy proceeding.

Under federal law, property that is part of the bankruptcy proceeding is referred to as being part of the "debtor's estate." The amount that creditors receive from the bankruptcy often depends on the value and amount of property that is included in the estate. If more property is included in the estate, it is more likely a creditor will be able to collect an unpaid debt.

Under section 766.55 of the Wisconsin Statutes, debts incurred in the interest of the marriage or family may be satisfied from all marital property. All debts incurred by either spouse after the marriage are rebuttably presumed to be incurred in the interest of the marriage or family. Because a creditor could collect a debt from both spouses' halves of an item of marital property, that item would be included in the bankruptcy estate. This is so even though one spouse is not in bankruptcy.

Where a spouse who owes taxes files a separate petition in bankruptcy, the Internal Revenue Service, like any other creditor, attempts to collect as much tax as it is entitled to by law. In that case, the IRS will:

1. Decide if the spouse who is not in bankruptcy has delinquent tax liabilities, and

2. Decide if all assets that should be included in the bankruptcy estate have been disclosed.

Where only one spouse owes taxes and the other spouse files a separate bankruptcy petition, the Internal Revenue Service may file a claim in the bankruptcy relating to the liability of the spouse who is not in bankruptcy. This protects the Internal Revenue Service's claim to any marital property.

Because of the complexity of applying federal bankruptcy and tax laws to the Marital Property Act, the Internal Revenue Service will be cautious in taking enforcement action in all bankruptcy cases involving the separate bankruptcy petition of a spouse. These cases will be monitored by the Special Procedures Staff in the Milwaukee Office.

Wisconsin Treatment

The Marital Property Act impacts various aspects of bankruptcy law in cases of married persons filing for relief under the bankruptcy code. A "claim against the debtor" includes a claim against the debtor or the debtor's property. [11 U.S.C. § 102(2).] Additionally, the bankruptcy estate under 11 U.S.C. section 541(a) includes nonmarital property of the spouse filing for bankruptcy, together with the marital property of both spouses, even if one spouse doesn't join in the bankruptcy petition. Since marital property of spouses can be reached in varying degrees by a creditor of either spouse in the case of a marital, premarital, or predetermination date debt, creditors pursuing debts incurred by the spouse who is not filing for bankruptcy will now participate in separate bankruptcy petitions filed by the other spouse.

When a spouse who doesn't owe delinquent taxes files a separate bankruptcy petition and the Department has a marital, premarital, or predetermination date tax delinquency against the other spouse, the Department may file a proof of claim representing the taxes owed by the spouse who isn't filing for bankruptcy. If both the spouse who is filing for bankruptcy and the spouse who isn't joining in the bankruptcy petition have incurred tax liabilities, proof of claim will be filed covering both spouses' obligations. In the case of a joint bankruptcy petition, proof of claim will be filed for both spouses' obligations. Generally, the Department handles bankruptcy matters on a case-by-case basis.

E. Refund Offset Program

Federal Treatment

Section 6402(a) of the Internal Revenue Code gives the Internal Revenue Service authority to take current year tax refunds and apply them to unpaid taxes from prior years. Sections 6402(c) and (d) give the Internal Revenue Service authority to offset refunds for debts owed other federal agencies or for past due child support. This procedure is referred to as a "refund offset."

The enactment of the Marital Property Act affects the refund offset procedures largely in the area of so-called "injured spouse" claims. An injured spouse claim arises where spouses file a joint return claiming a refund. The IRS will offset the entire refund if either or both spouses are liable for past due child support, back taxes, or other federal obligations. If only one of the spouses is liable for the debt, the Internal Revenue Service will still offset the entire refund. This is done even though the other spouse may have a claim to part of the refund. The spouse who does not owe the obligation (the "injured spouse") could file a claim for his or her portion of the refund. These types of claims are called "injured spouse" claims.

Currently, the Internal Revenue Service has been encouraging spouses to file injured spouse claims with their original returns. Where a claim is received, the IRS would only offset the portion of the refund that belongs to the taxpayer who owes the debt. If no claim is filed, however, the Internal Revenue Service will still offset 100% of the refund.

Whether taxpayers live in community property states or common law states, the question that must be answered in processing an injured spouse claim is the same: What portion of the refund rightfully belongs to the injured spouse? In common law states, each spouse's tax liability is calculated separately based on their separate earnings or income. Payments are also divided between the spouses and applied to their separate liabilities. This allows the IRS to decide the amount of each spouse's separate share of the refund. [*See* Revenue Ruling 80-7, 1980-1 C.B. 296, and Revenue Ruling 80-8, 1980-1 C.B. 298.] Since the Marital Property Act changes spouses' property rights, it also changes the formula for determining each spouse's interest in an income tax refund.

Under the Marital Property Act, the allocation would be based on distinguishing between marital and individual property. Marital property income is split equally between the spouses. Income that is not marital property will be allocated to the spouse who owns it. If it is not clear from the return whether the income is marital property, the income will be treated as marital property. The Internal Revenue Service will make this assumption because the Marital Property Act creates a rebuttable presumption that all property of spouses is marital property. [*See* Wis. Stat. § 766.31(1) and (2).] Withholding from wages and payments from a joint declaration of estimated tax will be treated as marital property and split equally between the spouses. Payments received from a separate declaration of estimated tax will be treated as the separate property of the spouse who made the declaration. But the analysis does not stop here.

As was discussed, a decision must be made whether the debt being offset arose before or after the determination date (*i.e.*, after the date of marriage, January 1, 1986, and the date both spouses domiciled in Wisconsin). If the liability was incurred after the determination date, then it must be decided whether it was incurred in the interest of the marriage or family.

Where the debt arose before the determination date, the Internal Revenue Service can retain the portion of the refund that is the individual property of the spouse who owes the debt and any property that would have been the property of that spouse if the Marital Property Act had not been enacted or the spouses had not married. [*See* Wis. Stat. § 766.55(2)(c)1. and 2.] Thus, for example, the entire portion of the refund attributable to the withholding of the spouse who owes the debt could be applied to the debt. This is because the

withholding would have been the sole property of that spouse if not for the marriage or the enactment of the marital property law.

Also, as a consequence of federal law, the IRS may retain half of the portion of the refund that would be considered marital property, but would not have been separate property of that spouse except for the marriage or the enactment of the Marital Property Act. This means that the IRS could retain half of the portion of the refund that can be traced to the other spouse's withholding.

However, if the debt arose after the determination date, the debt may be satisfied from all marital property and the individual property of the spouse who incurred the liability. As was already discussed, there is a presumption under Wisconsin law that all debts incurred during marriage are in the interest of the marriage or family. [*See* Wis. Stat. § 766.55(1).] This means that the law will assume that a debt is family purpose, subject to the spouse's right to establish otherwise. If the debt is family purpose, the Internal Revenue Service may retain any portion of the refund that is the individual property of the spouse who owes the debt. The IRS also may retain all of the rest of the refund that is marital property. This would include, for example, 100% of any portion of the refund attributable to either spouse's withholding. If an injured spouse claim is filed here, it probably will be denied, unless the injured spouse made a separate declaration of estimated tax.

If the debt was incurred after the determination date, but not in the interest of the marriage or family, it may be satisfied from property of the spouse who owes the liability that is not marital property and from that spouse's half interest in marital property. [*See* Wis. Stat. § 766.55(2)(d).] Generally, this means half of the refund can be used to satisfy the claim, unless either spouse made a separate declaration of estimated tax.

Wisconsin Treatment

Chapter 71 of the Wisconsin Statutes contains special rules for the application of overpayments, refundable credits, or refunds claimed on joint, separate, or individual returns against amounts owed to the Department of Revenue, debts owed to other state agencies, or delinquent child or spousal support. As previously explained, for Wisconsin purposes, any tax debt is incurred on the date of the Department's initial assessment or notice of the amount due. [Wis. Stat. § 71.91(2).] All tax debts incurred by a spouse during marriage after the determination date are incurred in the interest of the marriage or the family and may be satisfied only from all marital property and all other property of the incurring spouse. [Wis. Stat. §§ 71.91(3), 766.55(2)(b), and 859.18.]

However, if an "innocent spouse" exists (that is, a spouse is relieved of liability under Wis. Stat. § 71.10(6)(a) or (b) or (6m)), the obligation of the other spouse may be satisfied only from property of the debtor spouse that isn't marital property and from that spouse's interest in marital property, in that order. [*See* Wis. Stat. §§ 71.91(3) and 766.55(2)(d); *see also* the set-off provisions under §§ 71.55(1), 71.61(1), and 71.80(3) and (3m).]

A claim for refund on a separate return must be issued to the filer of that return, and a refund payable on a joint return must be issued jointly to the persons who filed that return. [Wis. Stat. § 71.75(8).] In addition, a marital property agreement or a unilateral statement cannot affect claims for refund. [Wis. Stat. § 71.75(6).]

1. Joint Return

The Department must give notice to spouses who have filed a joint return that it intends to reduce an overpayment, credit, or refund claimed by the amount of any liability. The amount will be credited against the liability unless, within 20 days of the notice date, the spouse who didn't incur the debt shows by clear and convincing evidence that the refund is his or her nonmarital property. If a spouse doesn't receive notice of the proposed offset and if the refund is incorrectly credited, a claim for refund of the incorrectly credited amount may be filed within 2 years.

Notwithstanding Wis. Stat. section 766.55(2)(d), the Department may apply an overpayment from a joint return as follows:

- Against any liability from a joint return, unless an "innocent spouse" exists.
- Against any separate liability incurred during marriage by either spouse after the determination date, unless the spouse who doesn't owe the debt is an "innocent spouse."
- Against any amount owed the Department of Revenue that was incurred before January 1, 1986, or before marriage, whichever is later, to the extent that the refund is based on the Wisconsin adjusted gross income which would have been the property of the incurring spouse but for the marriage.
- Against any separate liability incurred by either spouse before the determination date to the extent that the refund is based on the Wisconsin adjusted gross income which would have been the property of the incurring spouse but for the marriage.

[Wis. Stat. § 71.80(3m).]

If an "innocent spouse" exists, the overpayment is prorated based on the ratio of the amount that would be the "guilty" or incurring spouse's income if not married to the total income of the spouses.

2. Separate or Individual Return

The Department of Revenue presumes that an overpayment, credit, or refund claimed on a separate or individual return is the nonmarital property of the filer. The Department may credit such an overpayment against amounts owed the Department, debts owed other state agencies, or delinquent child or spousal support owed by the filer. However, the spouse or former spouse of the filer may be able to claim a refund of amounts credited. The claim for refund must be made within 2 years after the overpayment was credited. The spouse who didn't incur the debt must be able to show by clear and convincing evidence that all or part of the overpayment was his or her nonmarital property.

Overpayments from separate or individual returns may be applied as follows:

- Against any separate liability incurred by the filer of the return.
- Against any liability from a joint return, unless the filer is an "innocent spouse."

[Wis. Stat. § 71.80(3).]

F. Offers in Compromise

Federal Treatment

The Service is permitted to compromise delinquent tax liabilities, based upon "doubt as to collectibility." [IRC § 7122.] In an offer in compromise, the Service may accept less than the full amount of tax due, if the taxpayer can show that the amount he is offering is greater than the Service would collect by selling the taxpayer's assets or from future income.

Based on the type of liability involved (pre- or post-determination date), and subject to the rules regarding collection sources discussed in the Delinquent Taxes sections of this publication, the Service may consider all or part of existing marital property assets in evaluating the sufficiency of an offer in compromise.

Also as part of the compromise arrangement, it is not unusual to have the delinquent taxpayer provide for contingent future payments based on increases in income. This arrangement is called a collateral agreement. As appropriate, a revenue officer may consider the income potential of the spouse who does not owe tax based on marital property.

Wisconsin Treatment

The Department of Revenue is also permitted to compromise delinquent tax liabilities in cases where the taxpayer is unable to pay the full amount. [Wis. Stat. § 71.92.] The Department may consider the income of the spouse who doesn't owe the tax.

■ V. FEDERAL TAX BASIS

Federal Treatment

The chart identified as Exhibit 5 summarizes the tax basis of marital property under IRC section 1014. In approaching the questions of tax basis, the Service is governed by Revenue Ruling 87-98, 1987-2 C.B. 206, which states that property classified as marital property under state law would receive the double basis adjustment under IRC section 1014(b)(6). The Wisconsin Marital Property Act presumes that property owned by the spouses is marital property (§ 766.31(2)) which can be rebutted. By the same token, property that is mixed can be reclassified to marital (§ 766.63(1)). Based upon the rationale of Revenue Ruling 87-98, the Service has taken the position that any time property is "titled" in a common law estate, but is marital property under Wisconsin law, it would qualify for the double basis adjustment under IRC section 1014(b)(6). Applying Wis. Stat. section 766.60, property titled in joint tenancy or tenancy in common would be considered marital property under the following conditions:

A. Acquisition *after* the determination date (January 1, 1986, or date of marriage if later) in joint tenancy between spouses would be considered survivorship marital property and, thus, receive a double basis adjustment upon the death of a spouse unless the property had been acquired by gift where the donor provided otherwise. [Wis. Stat. § 766.60(4)(b)1.a.]

B. If the property was acquired as tenants in common *after* the determination date (January 1, 1986, or subsequent date of marriage) exclusively between the spouses, it would be considered marital property. [Wis. Stat. § 766.60(4)(b)1.b.]

In applying the above revenue ruling to the types of property holdings, it is clear that property titled in the name of one spouse after the determination date becomes marital property absent contrary provisions in a marital property agreement. This means that post-determination date conveyances which reflect ownership as joint tenants, tenants in common, survivorship marital property, or a single name are all presumed to be marital property.

Departing from these types of arrangements casts some doubt about receiving a double basis adjustment under IRC section 1014(b)(6). This is illustrated as follows:

A. Property considered as marital property — Under the Act, a surviving spouse was provided an election under Wis. Stat. section 861.02 to have predetermination date property treated as marital property. It is the Service's position that community property under IRC section 1014(b)(6) must exist at the time of decedent's death. [*Murphy v. Comm.*, 342 F.2d 356 (9th Cir. 1965).] Since the spouse's election can only take place after the decedent's death, and only involves predetermination date property that was obviously held in a common law estate, the estate could not receive the double basis adjustment.

   Of course, any property or interest in property that was included in the decedent's estate would receive a basis adjustment to fair market value under IRC section 1014(a). Thus, for example, if a decedent and his spouse held property acquired prior to the determination date in joint tenancy (a common law estate), the decedent's half of the property would be adjusted to fair market value under IRC section 1014(a).

B. Transfers to a spouse which are returned to the donor spouse after death of the donee within one year — It is possible under a marital property agreement for a spouse owning nonmarital property to transmute that property into marital property by way of a marital property agreement. If this property is converted to marital property, and the original "nontitled" spouse dies within one year bequeathing the marital share back to the transferring spouse, IRC section 1014(e) prohibits a double basis adjustment. This means that the donor spouse who reacquires the property receives the portion from decedent using that adjusted basis prior to death, and receives no basis adjustment on the marital half owned by them. There is an interesting question in the application of IRC section 1014(e) on whether there is a basis increase on the surviving spouse's one-half of the marital property that was retained as a result of the transfer. Formal ruling has not been rendered on this question, but it would appear that the denial by IRC section 1014(e) of a basis adjustment to the decedent's one-half would also foreclose an adjustment to the surviving spouse's half. This points out the problem of property transfers returning to the donating spouse within one year, but there are other code sections that create similar problems.

   As an example, assume that A and B had been married ten years and, during that time, resided in a house owned by A that was acquired before the determination date (1/1/86 or date of marriage if later). Assume that B is now 55 years of age and A is 53 years of age, and they wish to sell the property to take advantage of the IRC section 121 exemption from gain ($125,000 capital gain exemption). Assume further that they convert this to a marital property asset through a marital property agreement, and plan to sell the home and file a joint return. Under IRC section 121(a) it is provided that if one spouse meets the requirement (principal home for three years out of the five years preceding the sale), then both husband and wife are treated as satisfying the age, ownership, and use requirements which permits the $125,000 exemption. Under this hypothetical situation, A owned the property for more than ten years and used it as a principal residence, but was not 55 years of age; B, on the other hand, used the property as principal residence for ten years and was 55 years of age, but did not have ownership until the marital property agreement. This situation fails the requirements of IRC section 121(a). This stems from the fact that no one spouse meets all of the requirements and, further, their qualifications cannot be combined to exempt the sale.

C. Exchange of marital property as part of estate administration — Under Trailer Bill II (Wis. Stat. § 857.03(2)) the surviving spouse and other heirs of the estate are allowed to exchange probate property in order to minimize fractional interest. Although Wis. Stat. section 71.05(12)(d) allows for carry-over basis as though the exchange were a gift, it is the position of the Internal Revenue Service that these provisions do not apply for federal tax purposes and, therefore, the basis of property would be established at the moment of death. This means that basis adjustment takes place on all marital property held by the estate.

D. Joint tenancy and tenancy in common acquired before determination date — Absent a marital property agreement, this form of ownership will not be classified as marital property and, therefore, only receives a basis adjustment on the half includable in the estate.

E. Joint tenancy and tenancy in common acquired with third party — It is also the Service's position that the addition of a third party to joint tenancy and tenancy in common precludes the possibility of ever classifying that property as marital property under the position that the name of a nonspouse commits the property to common law estate treatment. Examples of this situation would be a farm arrangement where husband, wife, and child title the land in the names of all three before or after the determination date.

F. Marital property component — Under Wis. Stat. section 766.63(2), it is possible to have a marital property com-

ponent arising from nonmarital property where either spouse provides substantial efforts that caused appreciation. For this situation to receive a double basis adjustment, the spouse contributing services must not be reasonably compensated and there can be no third party title holder as indicated above.

> As an example, if one spouse owns nonmarital property worth $50,000 that was increased in value to $100,000 solely through the efforts of either spouse, that $50,000 appreciation in value would be a marital property component which would receive the benefits of IRC section 1014(b)(6).

Wisconsin Treatment

The Wisconsin basis of property acquired from a decedent is determined under section 1014 of the Internal Revenue Code, as illustrated in Exhibit 5. However, a modification may be necessary to recognize any difference between the federal estate tax and Wisconsin inheritance tax values. [Wis. Stat. § 71.05(10)(e).] Caution: A basis adjustment may be down as well as up.

For Wisconsin income tax purposes, the exchange of former marital property interests between a surviving spouse and a distributee of the decedent spouse is a nontaxable exchange. Any gain or loss recognized on such an exchange for federal income tax purposes is treated as a subtraction from or an addition to federal adjusted gross income, as appropriate, on the Wisconsin income tax return. [Wis. Stat. § 71.05(6)(a)16. and (b)12.] The exchange is treated for basis purposes as if each asset received in the exchange were acquired by gift from the other party. [Wis. Stat. § 71.05(12)(d).]

■ VI. S CORPORATIONS

A. S Corporation Elections

Federal Treatment

Under a temporary Treasury Regulation, section 18.1362-2(b)(2), there is a requirement that in a community property state where a nonshareholder spouse is entitled to ownership in the stock or the income from that stock, he or she would be required to join in the S-Corporation election.

EXHIBIT 5

Basis Adjustment Under IRC Section 1014

Assets which will receive a double basis adjustment (i.e., both the decedent's and the surviving spouse's shares are adjusted to fair market value):

A. Property acquired after the spouses' determination date titled as marital property
B. Property acquired after the spouses' determination date titled as survivorship marital property
C. Joint tenancy property exclusively between the spouses acquired after the determination date (this is survivorship marital property)
D. Tenancy in common property exclusively between the spouses acquired after the determination date (this is marital property)
E. Property acquired before the spouses' determination date reclassified as marital property by a marital property agreement or court order
F. Joint tenancy property exclusively between the spouses acquired before the determination date which is reclassified as marital property by a marital property agreement
G. Tenancy in common property exclusively between the spouses acquired before the determination date which is reclassified as marital property by a marital property agreement
H. Predetermination date property titled in one spouse's name which has become marital property as a result of mixing
I. Untitled property acquired before or after the determination date that is classified as marital property

Assets which will receive a basis adjustment to the extent included in the decedent's estate for death tax purposes:

A. Joint tenancy property exclusively between the spouses acquired before the determination date
B. Tenancy in common property exclusively between the spouses acquired before the determination date
C. Joint tenancy property held by a nonspouse and spouse, regardless of when acquired
D. Tenancy in common property held by a nonspouse and spouse, regardless of when acquired
E. Individual property
F. Predetermination date property titled in one spouse's name
G. Property subject to the surviving spouse's elective rights: deferred marital property and the augmented marital property estate

[Note: Possible exceptions to the above exist in unusual circumstances.]

There was considerable lack of awareness on the applicability of this regulation following the enactment of the Marital Property Act, coupled with a large number of S-Corporation elections after TRA 86. This resulted in subsequent renewals of S-Corporation elections in order to perfect the original request by including the signatures of both spouses. The Kansas City Service Center, which processes these requests, has taken the position that the practitioners are aware of this regulation, and will not treat an election as valid unless both spouses sign the original request form.

Wisconsin Treatment

For Wisconsin purposes, a tax-option (S) corporation is defined as a corporation which is treated as an S corporation under Subchapter S of the Internal Revenue Code and has not elected out of tax-option corporation status under Wis. Stat. section 71.365(4)(a). If a federal S election isn't valid because both spouses didn't sign it, then the election won't be valid for Wisconsin purposes either.

B. Income and Losses From an S Corporation

Federal Treatment

A number of questions have been raised about the reporting of income and losses from an S corporation on separate returns when the S corporation stock is the nonmarital property of one spouse. S corporation income is reportable for income tax purposes even though it isn't distributed to the shareholders. The marital property law defines "income" to include dividends, but specifically excludes net returns attributable to return of capital or to appreciation. [Wis. Stat. § 766.01(10).] The statute doesn't classify undistributed S corporation income. Is the S corporation income which is earned but not distributed marital property which must be divided equally between the spouses on separate returns? Alternatively, is only the income which is distributed during the taxable year marital property? These questions are being studied.

Losses incurred by an S corporation are passed through to and deductible by its shareholders. However, IRC section 1367(b)(2)(A) limits the deduction for losses to the S corporation shareholder's basis in the company. If the S corporation stock is the nonmarital property of one spouse, are losses divided equally between the spouses on separate returns? May the nonowning spouse claim one-half of the loss even though he or she has no basis in the S corporation stock? Or is the entire loss deductible by the owner spouse? These questions are also being studied.

Wisconsin Treatment

Wisconsin is likely to follow the federal treatment of S corporation income and losses.

■ VII. ADDITIONAL INFORMATION

If, after reading this publication, you have further questions about the federal or Wisconsin treatment of items under Wisconsin's Marital Property Act, please contact the following:

Federal Questions

Internal Revenue Service
Attn: Technical Referral Area
P.O. Box 493
Milwaukee, Wisconsin 53201

Telephone: (414) 297-3500

Wisconsin Questions

Wisconsin Department of Revenue
Technical Services Staff
P.O. Box 8933
Madison, Wisconsin 53708

Telephone: (608) 266-2772

BASIS ADJUSTMENT FOR MARITAL PROPERTY

Background

The Wisconsin basis for the recognition of gain or loss in a transfer is dependent on the Internal Revenue Code, with a modification made for property inherited from a decedent, under sec. 71.05(1)(g), Stats., to recognize any difference between the federal estate tax and Wisconsin inheritance tax values. Wisconsin amended that subsection to provide a basis adjustment similar to that under I.R.C. § 1014(b)(6) for both components of marital property, the decedent's one-half and the surviving spouse's one-half. This double-basis adjustment is permitted whenever at least one-half of the marital property is includable for purposes of computing the federal estate tax on the decedent's estate. Questions have arisen with respect to basis adjustment. The Department has made a request for a ruling on several of these questions, which request is still pending.

I. Wisconsin Follows I.R.S. Determination as to Whether Wisconsin's System of Marital Property is a Form of Community Property, Per I.R.C. § 1014(b)(6)

The Wisconsin income tax basis is tied to the federal determination of whether the Wisconsin marital property system is a form of community property. As of the time of the writing (September 1986) of this paper, no official determination has been made by the Internal Revenue Service. However, the Department expects that the Service will determine Wisconsin's marital property system to be a type of community property, consistent with the expressed intent of the Legislature, sec. 766.002(2), Stats., and the other provisions of Chapter 766. Accordingly, the Department will provisionally treat marital property as receiving a double-basis adjustment to the date-of-death value, under sec. 71.05(1)(g), Stats. Should the Service render a contrary determination, assessments may be issued to adjust for the basis differences.

Question has also arisen whether Wisconsin's survivorship marital property would be treated as marital property by the Service. Again, until a determination is made by the Service, the Department will provisionally treat survivorship marital property as marital property with the subsequent possibility of assessment for basis differences, should the Service rule contrary to this position.

Wisconsin law presumes that all property of the spouses is marital property [sec. 766.31(2), Stats.], and indicates that when nonmarital and marital property is mixed, a reclassification occurs of the property, except to the extent that the nonmarital portion can be identified [secs. 766.31(1) and 766.63(1), Stats.]. Accordingly, it is possible, and even probable, that assets will exist with both marital and nonmarital components. One example of this process would be an improvement made to a jointly-owned summer cabin originally purchased before January 1, 1986. If the improvement is paid for out of 1986 or later income, it would be a mixing of a marital property improvement with the traceable nonmarital cabin. In this situation, it is not clear if the marital property component receives a double-adjustment, or whether a transmutation of the marital property component into a nonmarital one has occurred, in which no double-adjustment can occur.

Until guidance is received from the Internal Revenue Service, the Department will treat mixed-component assets as receiving basis adjustment according to the nature of the component--i.e., an asset solely-owned by the decedent which has a 20% marital property component will receive the pre-1986 basis adjustment as to 80%, and a double-basis adjustment of the 20% marital property component. [See Section III. for examples.]

II. Internal Revenue Code § 1014(e).

Internal Revenue Code § 1014(e) provides that where a decedent is gifted appreciated property within one year of the death, and the property is reacquired by the donor (or the spouse of the donor), the basis of the property will be the adjusted basis in the hands of the decedent immediately prior to the decedent's death. The tax basis in the hands of the decedent is "carried-over" into the hands of the donor (and spouse). Consequently, there is no basis adjustment on account of the death. This provision has equally applied for Wisconsin, and will continue to do so.

It should be noted that, for income tax purposes, I.R.C. § 1041, defines any transfer between spouses, even those for full and adequate consideration, as having been acquired by gift. Consequently, any transfer to the decedent by the decedent's spouse may result in an I.R.C. § 1014(e) basis adjustment denial.

There is a lack of clarity as to the result if the surviving spouse had been the transferor and the transferred property is marital property at death. For example, if the spouses signed a marital property agreement reclassifying all their nonmarital property as marital, to pass to the survivor of the two at death, it is unclear whether the surviving spouse's one-half of the newly-reclassified marital property receives a basis adjustment. (It is clear that there is no basis adjustment to the decedent's one-half.)

Commentators often acknowledge that Congress clearly did not intend to permit the basis adjustment, but also state that until the regulations deny it, or the statute is clarified, such basis adjustment might be permitted. It is the Department's position, again contingent upon a contrary ruling by the Internal Revenue Service, that if an I.R.C. § 1014(e) denial exists for the decedent's one-half, it is also denied for the surviving spouse's one-half.

III. Basis Adjustment Method and Examples.

Basis adjustment is done in three steps:

1. Amount subject to death tax; plus
2. Amount of marital property not adjusted above; plus
3. Amount of original basis not adjusted above.

Prior to 1986 (and continuing for nonmarital property assets), only steps 1 and 3 were utilized. For example, a solely-owned asset worth $100,000 on date of death, but having a basis of $40,000, was adjusted to $100,000 (step 3 was omitted as all the basis was adjusted). If the same asset had been a tenancy-in-common, owned 50% by the decedent and

50% by the surviving spouse and passing to the surviving spouse, the surviving spouse's new basis would have been $70,000, determined in the following manner:

1. Amount subject to death tax (1/2 x $100,000 = $50,000)	$50,000
3. Amount of original basis not adjusted above (1/2 x $40,000 = $20,000)	20,000
	$70,000

After 1985, the surviving spouse's marital property must be considered. Assume a $100,000 date-of-death value, $40,000 original basis titled as a tenancy-in-common, and having a 20% marital property component. The new basis to the surviving spouse receiving the asset upon death would be $76,000, determined in the following manner:

1. Amount subject to death tax; plus Nonmarital-(1/2 of 80% x $100,000 = $40,000) Marital-(1/2 of 20% x $100,000 = $10,000)	$50,000
2. Amount of marital property not adjusted above; plus (1/2 of 20% x $100,000 = $10,000)	10,000
3. Amount of original basis not adjusted above (1/2 of 80% x $40,000 = $16,000)	16,000
	$76,000

If the surviving spouse is not the recipient of the tenancy-in-common asset at death, the basis of the surviving spouse in the one-half retained would be the original basis (1/2 of 80% x $40,000 = $16,000), plus the marital property adjustment (1/2 of 20% x $100,000 = $10,000), or $26,000, and the distributee's basis would be $50,000.

If the asset is 100% marital property, step 3 is omitted. Assume a $100,000 date-of-death value marital property asset, with a $40,000 basis, passing to the surviving spouse. The new basis in the hands of the surviving spouse would be $100,000, as determined in the following manner:

1. Amount subject to death tax; plus (1/2 x $100,000 = $50,000)	$ 50,000
2. Amount of marital property not adjusted above; plus (1/2 x $100,000 = $50,000)	50,000
3. Amount of original basis not adjusted above (Full basis adjusted above)	-0-
	$100,000

Section 71.05(1)(g), Stats., has the same requirement as I.R.C. § 1014(b)(6) that no double-basis adjustment is accorded unless at least one-half of all marital property is includable in the computation of federal estate tax. [A federal estate tax payment need not be made, nor a return filed, in order to meet the test of includability.]

The failure to have at least one-half of the marital property component of a single asset being includable in the decedent's federal estate will result in a denial of the adjustment of all of the surviving spouse's half of marital property, including those assets where one-half of the marital property component was includable. The decedent's one-half of marital property, to the extent it was included in the estate, will receive a basis adjustment. Consequently, the basis adjustment would be the same as was done prior to marital property--only the surviving spouse's marital property will not receive an adjustment.

Summary

Subject to a contrary position being taken by the Internal Revenue Service:

1. The Department will provisionally allow a basis adjustment to the surviving spouse's half of marital property, in addition to the decedent's half of marital property, subject to I.R.C. § 1014(e) denial.
2. The Department will provisionally treat survivorship marital property as marital property for purposes of basis adjustment.
3. The Department will provisionally treat an asset containing marital property as if it had a marital property component, subject to double-basis adjustment, and a nonmarital property component, subject to basis adjustment of only that portion included in the estate. The marital and nonmarital components will be adjusted on a proportionate basis, following the three steps outlined above.
4. No basis adjustment of the surviving spouse's marital property will occur if less than one-half of the marital property is includable in the determination of the federal estate tax.

ADDENDUM TO "BASIS ADJUSTMENT FOR MARITAL PROPERTY"

The previous position paper, dated October 2, 1986, dealt with the basis adjustment of assets owned exclusively by spouses. The basis adjustment of assets owned in part by non-spouses and containing marital property is somewhat different. Caution--this addendum is again provisional only, awaiting direction from the Internal Revenue Service.

In determining the basis adjustment of assets owned in part by non-spouses, it must be kept in mind that the marital component no longer represents an undivided part of the whole, but a part of only the spouse's interest in the whole. The spouse's interest represents the maximum value that the marital component can obtain, since to do otherwise would be taking of the non-spouse's interest. Steps 1 and 2 will thus deal only with the decedent spouse's interest in the whole. Step 3 will deal only with the non-spouse's interest, as the whole of the decedent spouse's interest will be adjusted in Steps 1 and 2. This procedure is illustrated as follows:

> Assume a $120,000 date-of-death value asset owned by the decedent and child as a tenancy-in-common (the decedent's interest in the whole of the asset is $60,000), original basis, $80,000, and a marital component worth $40,000:

Step		Amount
1.	Amount subject to death tax, plus Nonmarital - ($60,000 - $40,000 marital = $20,000) Marital - (½ x $40,000 = $20,000)	$ 40,000
2.	Amount of marital property not adjusted above, plus (½ x $40,000 = $20,000)	$ 20,000
3.	Amount of original basis not adjusted above (½ x $80,000 = $40,000)	$ 40,000
		$100,000

If the surviving spouse received the decendent's interest in the tenancy at death, the spouse's basis would be $60,000--$40,000 from the decedent's estate (Step 1) and the marital property adjustment of $20,000 (Step 2)--in one-half of an asset worth $120,000; the child would retain a $40,000 basis in one-half of an asset worth $120,000.

If the child had received the decedent's interest at death, the child's basis would have been $80,000--$40,000 from Step 1 and $40,000 of the retained original basis; however, the child would not own the entire asset, as the surviving spouse would retain one-half of the former marital property component in the decedent's interest--$20,000; and consequently, the child would have a basis of $80,000 in a $100,000 portion of the asset.

If the decedent's entire interest in the above example had been marital, the basis adjustment would have been as follows:

1.	Amount subject to death tax, plus Nonmarital - None Marital - (½ x $60,000 = $30,000)	$ 30,000
2.	Amount of marital property not adjusted above, plus (½ x $60,000 = $30,000)	$30,000
3.	Amount of original basis not adjusted above (½ x $80,000 = $40,000)	$ 40,000
		$100,000

If the surviving spouse received the decedent's interest at death, the basis would remain $60,000--$30,000 from Step 1 and $30,000 from Step 2--in one-half of an asset worth $120,000 and the child would retain a $40,000 basis in the other half of the $120,000 asset.

If the child had received the decedent's interest at death, the basis would be $70,000 ($30,000 from Step 1 and $40,000 from Step 3) in an $90,000 asset--the surviving spouse would have a $30,000 basis in the one-half of the former marital property worth $30,000.

DOR UPDATES - MARITAL PROPERTY POSITIONS

Marital property became the law of Wisconsin on January 1, 1986. The original legislation, 1983 Wis. Act 186, has seen many changes: 1985 Wis. Act 29, dealing with tax provisions; 1985 Wis. Act 37, the first "trailer bill"; 1987 Wis. Act 27, again dealing with tax provisions; and most recently, 1987 Wis. Act 393, the second "trailer bill". Since the marital property law became effective, the Department has issued various position papers: four dated October 2, 1986 - "Marital Property's Impact on Inheritance and Gift", "Retroactive Reclassification of Income Received under Marital Property Law", "Definition of Wisconsin Adjusted Gross Income" and "Basis Adjustment for Marital Property"; "Homestead Credit Under Marital Property Law" dated November 5, 1986; and an addendum to the "Basis Adjustment for Marital Property" paper, dated July 21, 1987. The Department also puts out a yearly document, Publication 109, which, since 1985, has given general information about marital property and its tax effects, titled "Tax Information for Married Persons Filing Separate Returns and Persons Divorced in ____" These position papers are available from the Department by requesting them--write to Technical Services, P.O. Box 8933, Madison, WI 53708.

The Internal Revenue Service has also issued various documents regarding Wisconsin marital property law. Revenue Ruling 87-13, 1987-1 C.B. 20, stated that Wisconsin's marital property system was a version of community property that would be recognized for income splitting purposes. The Milwaukee District Office has issued four Tax Practitioner Newsletters-in January and November of

1986, January of 1987, and April of 1988. The Internal Revenue Service also has general publications dealing with community property concerns: Publication 555, "Community Property and the Federal Income Tax" and Publication 551, "Basis of Assets."

It now is appropriate to review these documents and update or correct positions that have been changed. One general change is that all of Chapter 71 has been renumbered, effective in 1989. The new statutory citation is reflected in [brackets].

1. "Definition of Wisconsin Adjusted Gross Income" Position Paper

This paper, consisting of two pages of narrative and 33 pages of examples, demonstrated how the Department expected the Internal Revenue Service and the Department to view a variety of income tax situations under marital property law. The paper noted that Wisconsin does not have the federal "living separate and apart" treatment of I.R.C.§ 66(a), so that marital property law would apply for Wisconsin income tax purposes in some marriages when it doesn't for federal income tax purposes. It listed three sections of Wisconsin law that the Internal Revenue Service does not have: Section 71.01(1g) [71.10(6)(c)], Stats., states that a marital property agreement or unilateral statement is effective only if filed with the Department before an assessment is issued and that such documents are not effective for any period one or both spouses are not domiciled in Wisconsin; section 71.01(1r) [71.10(6)(d)], Stats., states that income of spouses will be reported without regard to marital property law during any period one or both spouses are not domiciled in Wisconsin; and Section 71.11(2m) [71.10(6)(b)],

Stats., which states that the Department may not apply marital property law in assessing a taxpayer filing a separate return for unreported marital property income if the taxpayer failed to notify his/her spouse of the amount and nature of the income before the due date of the return (an "innocent spouse" provision based in part on I.R.C.§ 66(c)). The paper also indicated that it was unclear whether marital property law continued to apply for federal purposes should one spouse be domiciled outside Wisconsin. For Wisconsin income tax purposes, marital property law would cease, due to section 71.01(1r)[71.10(6)(d)], Stats., but it may still continue for federal purposes. The paper's examples assumed that marital property income would still be created, even after one spouse was no longer a Wisconsin domiciliary, for federal purposes since it was not clearly incorrect and because it increased the contrast between Wisconsin and Federal treatment.

Changes:

A. Wisconsin's 1987 Act 393 has clarified the domicile question. Starting from May 3, 1988, marital property law generally applies only while both spouses are domiciled in Wisconsin. As a consequence, the examples in the position paper where a domicile change occurred now are accurate only up until May 2, 1988; on May 3, 1988, and thereafter, the Wisconsin and federal gross incomes for a resident/non-resident situation will not differ because of that fact.

B. Wisconsin has added an "innocent spouse" provision for individuals who file returns after a divorce or remarriage - Section 71.11(2r) [71.10(6m)],

Stats. This provision, effective for the 1988 tax year, is patterned after the separate return "innocent spouse" provision and covers the person filing an individual return or separate or joint returns with a new spouse.

NOTE - The Department's joint return "innocent spouse provision" - Section 71.11(2) [71.10(6)(a)], Stats., is based upon I.R.C § 6013(e), except that no percentage of adjusted gross income or threshold amount of liability exists for Wisconsin.

Caution The Internal Revenue Service has indicated (January 1986 Newsletter) that a marital property agreement could provide that any income would be that spouse's separate, or individual, income and that the Internal Revenue Service would recognize the agreement. However, the Internal Revenue Service urged caution where such agreements shift income to one spouse while the underlying property remains in the hands of the other. It is not clear if the Internal Revenue Service position includes income from wages (i.e., husband agrees that income from his future services would be individual income of his wife). For Wisconsin income tax purposes, such agreements could be valid.

2. "Marital Property's Impact on Inheritance and Gift."

This paper, consisting of three pages, provided some general information about marital property and its gift and death effects. It indicated that gifting of marital property by both spouses resulted in a joint gift, regardless of title, and that gifts by one spouse would be presumed to be of property the donor could gift alone. It cited sec. 72.86(4), Stats., as providing relief in the situation where gifted marital property is recovered by the non-donor spouse.

In the April 1988 Newsletter, the Internal Revenue Service indicated that gifts of marital property to charities in excess of the $1,000 safe harbor would not be deductible for income tax purposes until the year the transfer can no longer be recovered by the nonconsenting spouse; that the signing of a joint return containing such a deduction would be considered evidence of consenting to the gift, making that year the proper year of deduction, but that the Service would not shift the deduction to the technically correct year if the two tax years were similar. Wisconsin no longer has a deduction for charitable gifting. Instead, Wisconsin has an itemized deduction credit (Section 71.09(6r)(a)[71.07(5)], Stats.) that is dependent upon I.R.C.§ 170. Consequently, the Wisconsin income tax position will be controlled by the Internal Revenue Service position, despite the differences in approach.

The inheritance tax portion of the paper indicated that the Wisconsin basis for property received from a decedent was dependent upon I.R.C.§ 1014 with the Wisconsin value used instead of the federal estate tax value, with marital property acquiring a full basis adjustment. (See Section 3, below, for changes on basis). The paper also indicated that the failure of a surviving spouse to exercise his/her statutory recovery rights to the marital property components in insurance, retirement benefits, and other assets, would be treated as equivalent to a disclaimer for inheritance tax purposes and thus taxed to the person entitled to receive.

3. "Basis Adjustment for Marital Property".

This position paper again indicated that Wisconsin's basis adjustment was dependent upon the federal system. While awaiting a determination from the

Internal Revenue Service, the Department indicated it would provisionally grant marital property and survivorship marital property a double basis adjustment (both the decedent's one-half and the surviving spouse's one-half of such property would get a basis adjustment) including marital property that was a component in an asset due to mixing marital property with nonmarital property. The paper also indicated that, if a I.R.C.§ 1014(e) denial of basis adjustment applied for the decedent's one-half of marital property, a basis change would also be denied for the surviving spouse's one-half, pending a contrary Internal Revenue Service position. It was indicated that I.R.C.§ 1014(e) applies where property is gifted to a decedent within a year of the decedent's death and is reacquired by the donor from the decedent. The Internal Revenue Service has commented on the § 1014(e) situation as needing more clarification [November 1986 Newsletter].

Changes:

A. The November 1986 Tax Practitioner Newsletter indicated that marital property would receive a basis adjustment as community property. Accordingly, the Department's provisional granting of such double-basis adjustment is permanent.

B. The April 1988 Tax Practitioner Newsletter indicated that survivorship marital property would also be considered marital property and receive a basis adjustment as such. Accordingly, the Department's provisional granting is again permanent.

C. The April 1988 Tax Practitioner Newsletter also indicated that property acquired before the determination date in either joint tenancy or tenancy in common exclusively between the spouses after marriage would be "deferred marital property" and would receive a basis adjustment as marital property. The Department considered this position to be in error as such property is not a classification of marital property, but merely a shorthand term for property owned by a decedent that would have been marital property if acquired under marital property law. Such property is subject to the election by the surviving spouse as a substitute for the one-third elective share the marital property legislation repealed. The Department is informed that the Internal Revenue Service has reconsidered its position and now agrees with the Department that such property would not receive a marital property basis adjustment. (Unpublished letter of July 18, 1988, by L. M. Phillips, Milwaukee I.R.S. District Director.) The Internal Revenue Service also indicated that the "augmented marital property estate" property is not to receive a marital property basis treatment for the same reason. The property included in the decedent's estate will still receive a basis adjustment to date of death value.

D. The Department's understanding of the I.R.S. position on joint tenancies exclusively between spouses is that marital property and joint tenancies are incompatible ownership forms, so that a joint tenancy, whether all marital property or containing assets that previously were marital property, will not receive a marital property basis adjustment. Section 766.60(4)(a), Stats., is cited as a basis for this position for common law tenancies created before the determination date; for joint tenancies created exclusively between spouses after the determination date, the provision indicates that the property is survivorship marital property.

However, the unpublished letter cited in C. above indicated that a marital property agreement can reclassify a joint tenancy into marital property under state law and will thus receive a basis treatment by the Internal Revenue Service as marital property. This is a construction apparently based on Revenue Ruling 87-98, 1987-2 C.B. 206, cited in the April 1988 Newsletter. That ruling, which did not deal with Wisconsin law, held that if state law characterized a joint tenancy as community property, the Internal Revenue Service would treat the asset as community property for basis purposes. This Internal Revenue Service position was previously mentioned in the November 1986 Newsletter in a discussion of sec. 1014(e), I.R.C., where the Service indicated that it "would likely recognize" a marital property agreement reclassifying a common law tenancy.

The Department's position paper provisionally granted a marital property basis adjustment for marital property components in a joint tenancy. The Internal Revenue Service position is contrary to the provisional position taken by the Department, and will control for Wisconsin income tax purposes under present law. Consequently, absent a marital property agreement, a joint tenancy will not be treated at death as containing marital property for basis purposes by Wisconsin. It would also appear that a marital property agreement must reclassify the whole of the common law tenancy, under the Internal Revenue Service position.

E. It is the Department's understanding that the Internal Revenue Service position on tenancies in common is the same as for joint tenancies, but that there is little case law or other authority on the question, and that

this position would be reevaluated as case law occurs.
Section 766.60(4)(b)1.b., Stats., provides that a tenancy in common created exclusively between the spouses after the determination date is marital property.

The Department's position paper provisionally granted a basis adjustment for marital property components in a tenancy in common. Since the Internal Revenue Service position, although not apparently as strongly held as the joint tenancy position, is still contrary to the provisional position taken by the Department, it will control for Wisconsin income tax purposes under present law.

F. The April 1988 Tax Practitioner Newsletter indicates that it is possible to create a marital property component in separate property under sec. 766.63(2), Stats. That provision states that marital property is created when a spouse applies substantial labor or skill to either spouse's nonmarital property if substantial appreciation of the property results and if the reasonable compensation was not received for the labor (often called the "substantial efforts" rule). The Department believes that the Newsletter's use of "separate" property was inadvertent, as was the reference to the efforts being made by only the "non-title spouse". Whether the result of the "substantial efforts" rule, or the addition of marital property to a solely-owned asset, another statute, sec. 766.63(1), Stats., provides that a reclassification of the entire asset to marital property occurs unless the nonmarital property component of the asset can be traced (popularly called the "mixing" rule). The Department's position paper assumed that the "mixing" rule resulted in marital property that would receive a basis adjustment as such. The Internal Revenue Service

position does not indicate whether the mixing rule would reclassify the entire asset. The Department will continue to assume that a reclassification of the entire asset to marital property occurs whenever the nonmarital property portion cannot be traced. Where the nonmarital portion is traceable, the Internal Revenue Service position would seem to require a marital property basis adjustment for the marital property component only.

4. Addendum to "Basis Adjustment for Marital Property".

This position paper covered basis adjustment of assets owned by one or both spouses with a non-spouse. The Internal Revenue Service position, as stated in the April 1988 Newsletter and the unpublished letter, is that there can be no marital property in an asset held with a non-spouse. The Department had assumed that the "substantial efforts" and "mixing" rules could result in either reclassification of the spouse's interest or recognition of the identified marital property component. Accordingly, there will be no adjustment on a marital property basis of such an asset on the federal level, and correspondingly, on the state level under existing law.

5. Retroactive Reclassification of Income Received Under Marital Property Law".

This position paper indicated that once income had acquired a character, it was not possible to reclassify the income federally. Since Wisconsin's starting point for income determination was the federal adjusted gross amount, the same

situation applied for Wisconsin. It was also indicated that retroactive reclassification was not possible for tax purposes whether attempted by marital property agreement or order of a divorce court. The January 1987 Newsletter contained language which supported this position.

Caution The Department has become aware of a number of agreements which would also be ineffective attempts at retroactive reclassifications. Example: Husband and wife agree on December 20, 1988, that in the year of their divorce, all the income from January 1 of that year until the divorce decree is individual property of the earning spouse. Since the year the divorce decree is granted is an unknown, income will have a marital property character until the decree is granted, at which time the agreement would attempt to reclassify it as individual income from that date back to January 1 of that year. The agreement, while dealing with future income, still attempts to reclassify income that will be received before a described (but unknown) date, just as if the spouses had agreed to reclassify their prior income at the time of the divorce proceeding. In essence, if the spouses wish to have their income be individual income in order to simplify their tax filings, they must do so by picking future periods which are ascertainable at the time of the signing of the agreement, such as: 1989 and thereafter; January 1, 1989 to December 31, 1991; etc.

Caution The Department has also become aware of language being used in marital property agreements that is potentially troublesome. Some agreements recite that income is reclassified "for income tax reporting purposes only". It is the Department's belief that classifications for income tax reporting purposes only, without there being a corresponding property law classification, is not effective.

6. "Homestead Credit Under Marital Property Law".

This paper indicated that since the starting point for income for homestead credit purposes is the Wisconsin adjusted gross income, the provisions affecting income for tax purposes also applied for homestead credit purposes, such as the "innocent spouse" provision separate filer and sec. 71.01(1r), [71.10(6)(d)], Stats. The position paper dealt primarily with spouses who were filing separate returns and no changes have occurred. As to spouses who file joint income tax returns, it should be emphasized that the Department will follow the marital property presumption that all property (including income) is marital property, owned one-half by each spouse. When a spouse has filed a joint return and applies for homestead credit, the Department will thus be initially requiring the applicant to report one-half of the joint return income, even if the applicant never had possession or control of that amount.

The applicant may report a smaller amount of income for homestead credit purposes from a joint return, but the applicant will have the burden to show the Department that the unreported income was the individual income of the other spouse.

NOTE For determination of the real estate taxes, the position paper indicates that marital property law presumed that all property of spouses is marital property, and Example 1 dealt with a home acquired in joint tenancy exclusively by the spouses before January 1, 1986. The position paper also indicated mixing marital property into other property would reclassify the other property into marital property, unless the nonmarital property component could be traced. The Internal Revenue Services positions on joint tenancies, tenancies in common and

"mixing" raise questions about the Department's position. However, there is no need to change any of the examples, including Example 1, since the indicated amounts are unchanged under the Internal Revenue Service treatment also.

Wisconsin Tax Bulletin #60
(Excerpt of Pages 11, 12, 13, and 14)

TAX RELEASES

("Tax Releases" are designed to provide answers to the specific tax questions covered, based on the facts indicated. However, the answer may not apply to all questions of a similar nature. In situations where the facts vary from those given herein, it is recommended that advice be sought from the department. Unless otherwise indicated, Tax Releases apply for all periods open to adjustment. All references to section numbers are to the Wisconsin Statutes unless otherwise noted.)

The following Tax Releases are included:

Individual Income Taxes

1. Basis Adjustment Under Wisconsin's Marital Property Law (p. 11)

Corporation Franchise or Income Taxes

1. Carryovers in Certain Corporate Acquisitions (p. 14)
2. Manufacturing for Purposes of the Manufacturer's Sales Tax Credit (p. 15)
3. Unrelated Business Income - Exemption for State and Other Units of Government (p. 15)

Sales/Use Taxes

1. Cooling Towers - Real or Personal Property/Manufacturing (p. 16)
2. Discount Cards (p. 16)

County Sales/Use Taxes

1. County Tax: Transitional Provisions Relating to Services (p. 16)

INDIVIDUAL INCOME TAXES

1. Basis Adjustment Under Wisconsin's Marital Property Law

Statutes: Section 71.05(10)(e), Wis. Stats. (1987-88)

Note: This Tax Release applies with respect to deaths occurring on or after January 1, 1986.

Background: Generally, Internal Revenue Code sec. 1014 provides that the basis of real or personal property acquired from a decedent is its fair market value on the date of the decedent's death (or on the alternate valuation date, if chosen). In community property states, a husband and wife usually are considered as each owning half of the community property. If either spouse dies, the surviving spouse's half of the community property, as well as the decedent spouse's half, is entitled to a basis adjustment to the date-of-death value (IRC sec. 1014(b)(6)). For this double-basis adjustment to apply, at least half of the community property must be includable in the decedent's gross estate for federal estate tax purposes.

Internal Revenue Code sec. 1014(e) provides that where a decedent receives a gift of appreciated property within one year of death, and the property is reacquired by the donor or the donor's spouse, the decedent's adjusted basis immediately prior to the decedent's death is carried over and becomes the donor's (and donor's spouse's) basis in the property. Consequently, there is no basis adjustment on account of the death. For income tax purposes, IRC sec. 1041 defines any transfer between spouses, even those for full and adequate consideration, as having been acquired by gift. Therefore, any transfer to the decedent by the decedent's spouse may result in an IRC sec. 1014(e) basis adjustment denial.

For Wisconsin purposes, the basis of real or personal property acquired from a decedent is determined under the Internal Revenue Code. However, a modification is required, under sec. 71.05(10)(e), Wis. Stats. (1987-88), for any difference between the federal estate tax value and the Wisconsin inheritance tax value.

Note: Throughout this Tax Release, it should be understood that marital property and survivorship marital property can be created only while the classification rules of ch. 766, Wis. Stats., apply to the marriage. These rules apply "during marriage" which is defined as that period in which both spouses are domiciled in Wisconsin that begins at the determination date and ends at dissolution of the marriage or at the death of a spouse (sec. 766.01(8), Wis. Stats. (1987-88)).

Question 1: Under Wisconsin's marital property law, upon the death of one spouse, will the property of both spouses receive a double- basis adjustment under sec. 1014(b)(6), IRC, to the date-of-death value?

Answer 1: The Internal Revenue Service has determined that Wisconsin's marital property system is a type of community property (Rev. Rul. 87-13, 1987-1 C.B. 20). Therefore, for federal and Wisconsin tax purposes, certain property of spouses will receive a double-basis adjustment under sec. 1014(b)(6), IRC. However, the Internal Revenue Service has indicated that certain assets cannot be classified as marital property or as containing marital property and, therefore, will not receive a double-basis adjustment upon the death of one spouse.

The following property will receive a double-basis adjustment for both federal and Wisconsin purposes:

a. Property acquired after the spouses' determination date which is titled as marital property.

b. Property acquired after the spouses' determination date which is titled as survivorship marital property.

c. Property acquired after the spouses' determination date which is classified as marital property or survivorship marital property by operation of law (sec. 766.60(4)(b)1. and 2., Wis. Stats. (1987-88)). For example, if a document of title expresses an intent to establish a tenancy in common exclusively between spouses after their determination date, the property is marital property. If a document of title expresses an intent to establish a joint tenancy exclusively between spouses after their determination date, the property is survivorship marital property.

d. Property acquired before the spouses' determination date which is reclassified as marital property by a marital property agreement or court order. If a marital property agreement or court order reclassifies the whole of joint tenancy or tenancy in common property as marital property, the property will be treated as marital property for basis adjustment purposes (Rev. Rul. 87-98, 1987-2 C.B. 206).

e. Property acquired before the spouses' determination date and titled solely in one spouse's name if, as a result of mixing, it is not possible to trace the nonmarital property component. Mixing can occur in two ways and can result in either the whole of the property, or only a portion, being classified as marital property.

   First, marital property (either cash or assets) can be mixed with nonmarital property. For example, if one spouse purchased a home prior to the marriage and marital property wages are used to make mortgage loan payments or substantial home improvements, the home is mixed property. If the nonmarital property component cannot be traced, the mixing rule will reclassify the whole of the home as marital property. If the nonmarital property component can be traced, only the remaining component would be classified as marital property.

   Second, a marital property component is created when there is substantial appreciation of nonmarital property resulting from the substantial efforts of either spouse, for which reasonable compensation was not received.

f. Untitled property acquired before the spouses' determination date where the presumption that the property is marital property isn't rebutted.

g. Untitled property acquired after the spouses' determination date which the marital property law classifies as marital property.

The following property of spouses will not receive a double-basis adjustment for either federal or Wisconsin purposes:

a. Property acquired before the spouses' determination date in joint tenancy solely between the spouses. It is the department's understanding that the Internal Revenue Service's position is that marital property and joint tenancy are incompatible ownership forms; therefore, property held in a joint tenancy form that was acquired in whole or in part with marital property will not receive a double-basis adjustment, even if it were otherwise classified by the mixing rule as marital property. (However, see the exception in previous part c.) The portion of the joint tenancy in the decedent's estate for death tax purposes will receive a basis adjustment to the date-of-death value for both federal and Wisconsin purposes.

b. Property acquired before the spouses' determination date in tenancy in common exclusively between the spouses. It is the department's understanding that the Internal Revenue Service's position on tenancies in common is the same as for joint tenancies. Therefore, for both federal and Wisconsin purposes, only the property included in the decedent's estate for death tax purposes will receive a basis adjustment to the date-of-death value.

c. Property owned by one or both spouses with another person either as joint tenants or tenants in common. The Internal Revenue Service has indicated that there can be no marital property in an asset held with a nonspouse. It appears that a marital property agreement cannot classify such an asset as marital property. A basis adjustment to the date-of-death value will occur only upon the death of the titled spouse; the death of the nontitled spouse will not result in a basis adjustment.

d. Property owned by a decedent that would have been marital property if acquired under the marital property law, called "deferred marital property," and "augmented marital property estate" property. Despite the Internal Revenue Service's previous statement to the contrary, the Internal Revenue Service now agrees with the department that such property will not receive a double- basis adjustment. However, the property included in the decedent's estate for death tax purposes will still receive a basis adjustment to the date-of-death value.

Example: A husband and wife were married and domiciled in Wisconsin on January 1, 1986. They did not have a marital property agreement. On September 1, 1988, the wife died. The husband is the sole beneficiary of the wife's estate. At the date of death, the husband and wife owned the following property:

a. Home acquired in 1960 in joint tenancy for $35,000. Substantial improvements costing $25,000, which were paid for out of marital property funds, were made in 1987. The home's fair market value on September 1, 1988, was $150,000.

b. Rental property acquired in 1975 in tenancy in common for $100,000. Mortgage payments made in 1986, 1987, and 1988 were from marital property. Depreciation of $59,250 was claimed. The property's fair market value was $350,000 on September 1, 1988.

c. Stock A acquired in 1970 by the wife by inheritance. Its fair market value in 1960 was $1,000 and on September 1, 1988, was $100,000.

d. Stock B acquired in 1986, titled as marital property, for $10,000. Its fair market value on September 1, 1988, was $11,000.

e. Stock C acquired in 1980 by the wife for $15,000 using her wages, and titled in her name alone. Its fair market value on September 1, 1988, was $20,000.

The husband's new basis in the property is computed as follows:

a. Home	
Amount subject to death tax (1/2 x $150,000), plus	$ 75,000
Amount of original basis not adjusted above (1/2 x $60,000)	30,000
Total basis of home	$105,000
b. Rental property	
Amount subject to death tax (1/2 x $350,000)	$175,000
Amount of original basis not adjusted above (1/2 x ($100,000 - $59,250))	20,375
Total basis of rental property	$195,375
c. Stock A	
Amount subject to death tax (100% x $100,000)	$100,000
Amount of original basis not adjusted above (full basis adjusted above)	-0-
Total basis of stock A	$100,000
d. Stock B	
Amount subject to death tax (1/2 x $11,000)	$ 5,500
Amount of marital property not adjusted above (1/2 x $11,000)	5,500
Total basis of stock B	$ 11,000
e. Stock C	
Amount subject to death tax (100% x $20,000)	$ 20,000
Amount of original basis not adjusted above (full basis adjusted above)	-0-
Total basis of stock C	$ 20,000

Question 2: If spouses use a marital property agreement to reclassify their property as marital property, to pass to the survivor of the two at death, and one spouse dies within one year of making the agreement, will either the decedent's one-half or the surviving spouse's one-half of the newly-reclassified marital property receive a basis adjustment?

Answer 2: Under IRC sec. 1014(e), the transfer to the decedent by the decedent's spouse would result in the denial of a basis adjustment to the decedent's one-half of such property that passes back to the spouse. However, it is unclear whether the surviving spouse's one-half of such property will receive a basis adjustment. It is the department's position, contingent upon a contrary ruling by the Internal Revenue Service, that if a sec. 1014(e), IRC denial exists for the decedent's one-half, a basis adjustment is also denied for the surviving spouse's one-half of the property.

□

Supplemental Committee Note to 1985 Act 37
(Subsection 766.51(4))

Clarifies that a gift of marital property to a 3rd person by a spouse who has the right to manage and control the marital property is "subject to remedies provided under ch. 766". The revised language replaces the rule that the right to manage and control marital property permits gifts of that property "only to the extent provided in s. 766.53". The revised language assumes that, even if a remedy is available, the gift was made when the transfer occurred.

Appendix B

Rev. Rul. 66-283 . . . . B-3

Rev. Rul. 68-506 . . . . B-5

Rev. Rul. 69-346 . . . . B-6

Rev. Rul. 71-51 . . . . B-7

Rev. Rul. 73-390 . . . . B-8

Rev. Rul. 76-490 . . . . B-9

Rev. Rul. 77-359 . . . . B-11

Rev. Rul. 81-221 . . . . B-12

Rev. Rul. 87-13 . . . . B-13

Rev. Rul. 87-98 . . . . B-14

Rev. Rul. 87-112 . . . . B-15

I.R.C. § 1014 . . . . B-17

I.R.C. § 1041 . . . . B-20

SECTION 1014.—BASIS OF PROPERTY ACQUIRED FROM A DECEDENT

26 CFR 1.1014-2: Property acquired from a decedent. **Rev. Rul. 66-283**
(Also Sections 2033, 2036, 2038; 20.2033-1, 20.2036-1, 20.2038-1.)

A husband and wife transferred their California community property to a revocable trust, reserving to themselves a life income interest therein. Upon the death of one of the spouses, one-half of the value of the community interest in the property held in the trust is includible under sections 2033, 2036(a)(1) and 2038(a)(1) of the Internal Revenue Code of 1954 in determining the value of the decedent's gross estate. The property which represents the surviving spouse's one-half interest in the community property held in the revocable trust is considered under section 1014(b)(6) of the Code to have been acquired from or to have passed from the decedent and its basis is determined in accordance with the provisions of section 1014(a) of the Code.

Advice has been requested with respect to the application of section 1014(b)(6) of the Internal Revenue Code of 1954 to the income tax basis of a surviving spouse's one-half interest in California community property which has been transferred to a revocable trust.

H and *W* are husband and wife and domiciliaries of the State of California. Under California community property law a husband and wife may by agreement characterize their property as community or separate. Section 158 of the California Civil Code; *Mears* v. *Mears* (1960) 4 Cal. Rptr. 618; *Tomaier* v. *Tomaier* (1944) 146 P. 2d 905. Under California law, community property may also be held by a trustee without losing its character as such. *Berniker* v. *Berniker* (1947) 182 P. 2d 557. In 1958 *H* and *W* executed a revocable trust and transferred to it certain property held by them as community property under the laws of California. The trust instrument provides that the property transferred to the trust shall retain its character as community property. Under the terms of the trust, *H* and *W*, as long as both are alive, may at any time alter, amend or revoke the trust in whole or in part, provided that any part of the trust estate so withdrawn shall be transferred to *H* and *W* as community property. The net income from the trust is community property, and is to be paid to or applied for the benefit of the grantors.

Upon the death of either *H* or *W*, the trust estate is to be divided into two equal shares, each to be held and administered as a separate trust. One share is to consist of the community interest of *H*, and the other of the community interest of *W*. During the lifetime of the survivor, the trustee is to pay to the survivor all of the net income from his or her share, and to pay to the survivor and another designated beneficiary the net income from the decedent's share. The trust consisting of the community interest of the decedent is to be irrevocable, but the trust consisting of the survivor's community interest may be altered, amended, or revoked by the survivor at any time.

One of the spouses died in 1965. As of the date of the decedent's death, the trust had not been altered, amended or revoked.

Section 1014(b)(6) of the Code provides, in pertinent part, that in the case of decedents dying after December 31, 1947, property which represents the surviving spouse's one-half share of community prop-

erty held by the decedent and the surviving spouse under the community property laws of any State, is considered, for purposes of section 1014(a) of the Code, to have been acquired from or to have passed from the decedent if at least one-half of the whole of the community interest in such property was includible in determining the value of the decedent's gross estate under chapter 11 of subtitle B (sec. 2001 and following, relating to estate tax).

Section 676(a) of the Code, dealing with power to revoke, treats the grantor as the owner of any portion of a trust where he has at any time the power to revest in himself title to such portion. Section 671 of the Code provides, generally, that where the grantor is treated as the owner of any portion of a trust under subpart E (sec. 671 and following), part I, subchapter J, chapter 1 of the Code, the items of income, deductions, and credits against tax of the trust which are attributable to that portion of the trust shall be included in computing the taxable income and credits of the grantor.

For purposes of section 1014(b)(6) of the Code, *H* and *W* are considered as continuing to own the property transferred by them to the revocable trust as their community property.

Under section 2033 of the Code the value of the gross estate includes the value of all property to the extent of the interest therein of the decedent at the time of his death.

Section 2036(a)(1) of the Code provides that the value of the gross estate shall include the value of all property to the extent of any interest therein of which the decedent has at any time made a transfer (except in case of a bona fide sale for an adequate and full consideration in money or money's worth), by trust or otherwise, under which he has retained for his life or for any period not ascertainable without reference to his death or for any period which does not in fact end before his death the possession or enjoyment of, or the right to the income from, the property.

Section 2038(a)(1) of the Code provides that the value of the gross estate shall include the value of all property to the extent of any interest therein of which the decedent has at any time after June 22, 1936, made a transfer (except in case of a bona fide sale for an adequate and full consideration in money or money's worth), by trust or otherwise, where the enjoyment thereof was subject at the date of his death to any change through the exercise of a power (in whatever capacity exercisable) by the decedent alone or by the decedent in conjunction with any other person (without regard to when or from what source the decedent acquired such power), to alter, amend, revoke, or terminate, or where any such power is relinquished in contemplation of decedent's death.

In this case, one-half of the value of the community interest in the property held in the revocable trust is includible under sections 2033, 2036(a)(1), and 2038(a)(1) of the Code in determining the value of the gross estate of the first spouse to die, because both spouses had retained for their lives the right to the income from the community property held in the trust and possessed at the date of the decedent spouse's death a power to alter, amend or revoke the trust. The property which represents the surviving spouse's one-half interest in the community property held in the revocable trust is considered under section 1014(b)(6) of the Code to have been acquired from or to have passed from the decedent and, accordingly, its basis is determined under the provisions of section 1014(a) of the Code.

SECTION 1014.—BASIS OF PROPERTY ACQUIRED FROM A DECEDENT

26 CFR 1.1014-1: Basis of property acquired from a decedent. — Rev. Rul. 68-506
(Also Section 691; 1.691(a)-1.)

Advice has been requested whether, for Federal income tax purposes, any part of a lump-sum cash distribution paid to a retiring employee is property acquired from a decedent under the circumstances described below.

A and his wife *B* lived in a community property state. *B* died intestate in 1965, leaving *A* as her only heir. A Federal estate tax return was not required to be filed. In 1966, *A* received upon retirement a lump-sum cash distribution payable to him from an employee's trust exempt from tax under section 501(a) of the Internal Revenue Code of 1954 as an organization described in section 401(a) of the Code. The amounts to be credited in the account were completely vested at the time of *B*'s death. Under the provisions of section 402(a)(2) of the Code, the excess of the distribution over *A*'s contributions to the trust is long-term capital gain.

If property acquired by a husband and wife is community property under the laws of their state and, if on the death of one of them at least one-half of the whole of the community interest in such property is includible in determining the value of the decedent's gross estate, then that part of the property which represents the surviving spouse's one-half share of community property is considered to have been acquired from the decedent under section 1014(b)(6) of the Code and the one-half share of community property which is includible in the estate of the decedent is considered to have been acquired from the decedent under section 1014(b)(1) of the Code. Under section 1014(a) of the Code the basis of property in the hands of the person acquiring the property from the decedent is its fair market value at the date of death or other applicable valuation date.

Although *B*'s one-half community interest in the amount to be distributed from the employees' trust was includible on her death in her gross estate for Federal estate tax purposes, the income element embodied in the interest did not lose its character as income for Federal income tax purposes, and was inherited by *A* as a right to income in respect of a decedent. See sections 402(a) and 691(a) of the Code. The basis rules under section 1014 of the Code are inapplicable to income in respect of a decedent. See section 1014(c) of the Code.

Accordingly, the amount that represents *B*'s vested interest in the employees' trust attributable to the capital gain element in the lump-sum distribution from the employees' trust does not acquire a basis under section 1014(a) of the Code. Furthermore, this amount is includible in the gross income of *A* as income in respect of a decedent at the time he receives the lump-sum distribution.

With respect to *A*'s one-half community interest in the employees' trust, which under the provisions of section 1014(b)(6) of the Code is considered to have passed to him from the decedent, the income element embodied in the interest did not lose its character as income. Inasmuch as it is deemed to have passed to him from the decedent, it too is income in respect of a decedent and, as such, acquires no basis under section 1014(a) of the Code. Compare *Stanley et al* v *Commissioner*, 338 F. 2d 434 (1964), involving the analogous principle relative to installment obligations.

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26 CFR 25.2511–2: Cessation of donor's dominion and control.

The effective date of a gift, under an agreement whereby a wife agrees to transfer her community interest in her husband's estate to a testamentary trust for her benefit when his estate is settled, is the date of her husband's death.

Rev. Rul. 69–346

Advice has been requested as to the effective date of a transfer of property for Federal gift tax purposes pursuant to section 2511 of the Internal Revenue Code of 1954 under the circumstances described below.

The taxpayer and her husband, both domiciliaries of the State of Washington, entered into an agreement that was properly executed in compliance with section 26.16.120 of the Revised Code of Washington. Under the terms of the instrument the taxpayer agreed that if her husband would make provisions for her comfort in a trust to be created under his will, she would transfer her one-half interest in their community property to the trust. However, the agreement provided that the taxpayer would not be required to transfer her interest to the trust until the executor had completed its administration of the husband's estate and had assumed its duties as trustee.

The taxpayer's husband died in 1967 leaving a will consistent with the agreement. At the time of his death, the value of the property that the taxpayer was required to transfer was greater than the interest that she acquired. As of December 31, 1967, the trust under the husband's will was not yet established and the taxpayer was not required to transfer ownership of her interest to the trustee. The question presented is when, for Federal gift tax purposes, the taxpayer will be deemed to have made a completed gift.

Section 26.16.120 of the Revised Code of Washington provides that no law of the State of Washington shall prevent a husband and wife from jointly entering into any agreement concerning the status or disposition of the whole or any portion of the community property then owned by them or afterwards to be acquired by them, which agreement shall take effect upon the death of either. It has been held that an agreement entered into in conformance with that statute is an enforceable contract, which contract becomes completely executed when one of the parties to the contract dies. *In Re Wittman's Estate,* 58 Wash. 2d 841, 365 P. 2d 17 (1961); *In Re Brown's Estate,* 29 Wash. 2d 20, 185 P. 2d 125 (1947).

Section 2501 of the Code imposes a tax on the transfer of property by gift. Generally, a transfer is complete when the donor has so parted with dominion or control as to leave in him no power to change its disposition, whether for his own benefit or for the benefit of another. Section 25.2511–2 (b) of the Gift Tax Regulations.

Revenue Ruling 69–347, this page, this Bulletin, holds that the effective date of a gift for Federal gift tax purposes is the date upon which a promise to make a future transfer becomes enforceable under State law, and not the date upon which an actual transfer of property is made, provided the gift is susceptible of valuation at the time it becomes enforceable.

In the above-described circumstances, the agreement between the taxpayer and her husband was enforceable at the time entered into. However, it was not determinable at that time whether the taxpayer had made a gift and, if so, of what value. Accordingly, it is held that the taxpayer in the instant case is not considered to have made a taxable gift until the death of her husband, at which time the amount of the gift first became susceptible of valuation. Compare *Pacific National Bank of Seattle, Executor* v. *Commissioner,* 40 B.T.A. 128 (1939), acquiescence, C.B. 1939–2, 28; *Estate of Emma Bressani* v. *Commissioner,* 45 T.C. 373 (1966), acquiescence, C.B. 1966–2, 4.

26 CFR 25.2511–2: Cessation of donor's dominion and control.

The effective date of a gift that is to be made in future years pursuant to a legally enforceable antenuptial agreement is the date of marriage provided such gift is susceptible of valuation at that time.

Section 2056.—Bequests, etc., to Surviving Spouse

26 CFR 20.2056(b)-1: Marital deduction; limitation in case of life estate or other "terminable interest".
(Also Section 2036; 20.2036-1.)

Jointly owned property, restricted by a joint and mutual will as to its ultimate distribution, and life insurance proceeds passing to a surviving wife qualify for the marital deduction and the total value thereof is includible in her gross estate.

Rev. Rul. 71-51

Advice has been requested as to the treatment, for Federal estate tax purposes, of jointly owned property and the proceeds of life insurance under the circumstances described below.

A husband and wife owned certain property as joint tenants. The husband owned several insurance policies on his life in which his wife was designated beneficiary. In 1955 they executed a joint, mutual, and contractual will that provided that all property, real as well as personal, of whatever kind and wherever situated at the time of the death of either, was to be held by the survivor during his or her life with the right to the income therefrom for life. Upon the death of the survivor, the remainder interest in the property was to be distributed to their children.

In 1964 the husband died. His gross estate consisted mainly of the aforementioned jointly held property and the proceeds of the policies of insurance.

The surviving wife died in 1968. The property originally held jointly with her husband and the insurance proceeds remained substantially intact and were distributed to the children as required by the terms of the joint and mutual will.

The following specific questions arose.

Question 1. In view of the outstanding joint and mutual will, does the interest in property that passed to the surviving wife upon the death of her husband qualify for the marital deduction?

Question 2. Is the value of property originally held jointly with her husband and the value of the proceeds of the insurance on his life includable in the deceased wife's gross estate?

Section 2036(a) of the Internal Revenue Code of 1954 provides that the value of the gross estate shall include the value of all property to the extent of any interest therein transferred by the decedent without consideration, by trust or otherwise, under which he has retained for his life the possession or enjoyment of, or the right to the income from the property.

Section 2056(a) of the Code provides that in determining the value of the taxable estate for Federal estate tax purposes a marital deduction shall be allowed from the value of the gross estate in an amount equal to the value of any interest which passes or has passed from the decedent to his surviving spouse, subject to certain conditions and limitations. Section 2056(b) of the Code provides, however, that if the interest passing to the surviving spouse is a "terminable interest," no deduction shall be allowed for such interest. Section 2056(e)(5) of the Code provides that property interests devolving upon the surviving spouse as surviving coowner with the decedent under any form of joint ownership under which the right of survivorship existed are considered as passing from the decedent to his surviving spouse.

Under the general rule relating to joint tenancies, a joint tenant who survives does not take the interest of the other tenant from him as his successor, but takes it by right under the instrument by which the tenancy was created. Thus, joint tenancy property passes outside of a will even though the interest that vests in the surviving tenant is limited by the terms of the instrument. Similarly, the proceeds of life insurance pass to the named beneficiary by reason of the designation in the insurance contract and no under the will or pursuant to any contractual provision in the will. Any restriction limiting the surviving tenant's (beneficiary's) interest to a life estate is not placed on the property by the decedent, but arises out of the contract voluntarily entered into by the survivor. *Estate of Emmet Aetry* v. *Commissioner*, 221 F. 2d 749 (1955), *W. R. McLean* v. *United States*, 224 F. Supp. 726, affirmed, 15 AFTR 1355, 65-2 USTC 12,326 (1965), and *United States* v. *La Rue Ford*, 377 F. 2d 93 (1967).

Accordingly, it is held in answer to *Question 1* that complete ownership of the jointly held property and the proceeds of insurance passed from the decedent to the surviving wife within the meaning of 2056(e) of the Code. Such complete ownership is a nonterminable interest that qualifies for the marital deduction under section 2056(a) of the Code notwithstanding that such property is subject to the restriction of the joint and mutual will as to its ultimate distribution.

The surviving wife's survivorship interest in the jointly held property and the insurance proceeds ripened into absolute ownership upon the death of her husband. However, under the contractual aspects of the joint and mutual will that were irrevocable at the death of the husband, the wife's fee interest in the property was reduced to a life estate, the remainder interest passing to the children. Thus, the wife is deemed to have made a transfer in 1964 of the entire value of the property, under which she retained for her life the right to the income from the property.

Accordingly, it is held in answer to *Question 2* that the entire value of the remainder of the property held jointly with her husband and the proceeds of insurance on his life is includible in the deceased wife's gross estate under section 2036 of the Code.

26 CFR 1.61-1: Gross income.

Community income; separate earnings agreement; California. Income earned by either a husband or wife for personal services, subsequent to a valid agreement under California law that the earnings of each would be the separate property of the earner, is treated as the separate income of the spouse earning the income and not as community income; G.C.M. 18884 superseded.

Rev. Rul. 73-390 [1]

The purpose of this Revenue Ruling is to update and restate, under the current statute and regulations, the position set forth in G.C.M. 18884, 1937-2 C.B. 58.

The question presented is whether, under the circumstances described below, the separately earned income of spouses residing in California is treated as their separate or community income, for Federal income tax purposes.

A husband and wife, residing and working in California, entered into a valid agreement whereby it was stated that any income subsequently earned by either of them for personal services would be his or her separate property.

Under California law, the respective interests of the husband and wife in community property during continuance of the marriage relation are present, existing, and equal. See section 5105 of the Civil Code of California. The earnings of a husband and a wife during marriage are normally community property of the spouses. *Thorpe* v. *Thorpe,* 75 Cal. App. 2d 605 (1946); *Sbarbaro* v. *Rosa,* 48 Cal. App. 2d 584 (1942).

Under California law, either husband or wife may enter into any engagement or transaction with the other, or with any other person, respecting property, which either might if unmarried, subject, in transactions between themselves, to the general rules which control the actions of persons occupying confidential relations with each other. See section 5103 of the Civil Code of California.

Where a husband and wife, residing in California, entered into a valid agreement that the wife's earnings would be her separate property, such earnings could not be taxed as community income. See *Dale Van Every* v. *Commissioner,* 108 F.2d 650 (1940), certiorari denied, 309 U.S. 689 (1940); *Helvering* v. *Hickman,* 70 F.2d 985 (1934), XIII-2 C.B. 274 (1934). See also Rev. Rul. 73-391, this page, which involves the treatment of amounts paid by a partnership to a husband for services where the husband and his wife are members of the partnership.

Accordingly, in the instant case, since the husband and wife entered into a valid agreement under the law of California, whereby any income subsequently earned by either of them for personal services would be his her separate property, such incon earned by either of them after tl agreement was consummated is treat as the separate income of the spou earning the income and not as cor munity income, for Federal incon tax purposes.

G.C.M. 18884 is hereby supersede since the position set forth therein restated under current law in tl Revenue Ruling.

[1] Prepared pursuant to Rev. Proc. 67-6, 1967-1 C.B. 576.

26 CFR 25.2511-1: Transfers in general. (Also Section 2503; 25.2503-3.)

Insurance policy transferred to irrevocable trust; employer's plan. Life insurance premiums voluntarily paid by an employer with respect to a group term policy held by an irrevocable trust created by an employee are subject to tax as indirect transfers by the employee and qualify as a gift of a present interest for purposes of the annual $3,000 exclusion.

Rev. Rul. 76-490

Advice has been requested whether certain life insurance premiums paid by an employer with respect to a group term policy held by a trust created by an employee are subject to the gift tax under section 2501 of the Internal Revenue Code of 1954 as indirect transfers under section 2511 of the Code, under the circumstances described below, and if so whether the gift is a gift of a present interest that qualifies for the annual exclusion under section 2503(b).

In 1970, *X* Company entered into an agreement with an insurance company providing for a master group term insurance policy insuring the lives of its employees. Only an employee was entitled to be insured. By the terms of the insurance contract, premiums were to be paid monthly in advance, on the first day of each month, by *X* Company. On January 31, 1975, *D*, an employee of *X* Company, created an irrevocable trust and assigned thereto all right, title and interest in a group term life insurance policy on *D*'s life issued pursuant to the master policy. Under the terms of the trust, the beneficiary or the beneficiary's estate was to receive the full proceeds of the policy immediately on *D*'s death.

The policy assigned to the trust provided insurance coverage in an amount of 200*x* dollars until *D* reached age 65, or ceased employment with *X* Company, whichever occurred first. Neither *D* nor the trust had a contractual right to require *X* Company to maintain the group contract. The premiums paid by *X* Company with respect to *D*'s group insurance coverage were not reported as gifts by *D* in 1975. *D* did not report such sums as gifts because of *D*'s belief that, by reason of the assignment, *X* Company paid the premiums for the direct benefit of the trust beneficiary.

Section 2501 of the Code imposes a tax on the transfer of property by gift during a calendar quarter by any individual. Section 2511 provides that, subject to certain limitations, the gift tax applies whether the transfer is in trust or otherwise, direct or indirect, and whether the property transferred is real or personal, tangible or intangible.

Section 25.2511-1(c) of the Gift Tax Regulations provides that:

> * * * all transactions whereby property or property rights or interests are gratuitously passed or conferred upon another, regardless of the means or device employed, constitute gifts subject to tax.

Section 25.2511-2(b) of the regulations provides, in part, as follows:

> As to any property, or part thereof or interest therein, of which the donor has so parted with dominion and control as to leave him no power to change its disposition, whether for his own benefit or for the benefit of another, the gift is complete.

Section 25.2511-1(h)(8) of the regulations provides, in part, as follows:

> If the insured purchases a life insurance policy, or pays a premium on a previously issued policy, the proceeds of which are payable to a beneficiary or beneficiaries other than his estate, and with respect to which the insured retains no reversionary interest in himself or his estate and no power to revest the economic benefits in himself or his estate or to change the beneficiaries or their proportionate benefits (or if the insured relinquishes by assignment, by designation of a new beneficiary or otherwise, every such power that was retained in a previously issued policy), the insured has made a gift of the value of the policy, or to the extent of the premium paid, even though the right of the assignee or beneficiary to receive the benefits is conditioned upon his surviving the insured. * * *

Section 2503(b) of the Code permits the exclusion of $3,000 of gifts made to any one donee during the calendar quarter (except gifts of future interests in property), less the aggregate of the amount of such gifts to such person during all preceding calendar quarters of the calendar year, in determining the total amount of gifts for the calendar quarter. The entire value of any gift of a future interest must be included in the total amount of gifts for the calendar quarter in which the gift is made.

Section 25.2503-3(a) of the regulations provides, in part, as follows:

> "Future interests" is a legal term, and includes reversions, remainders, and other interests or estates, whether vested or contingent, and whether or not supported by a particular interest or estate, which are limited to commence in use, possession or enjoyment at some future date or time. The term has no reference to such contractual rights as exist in a bond, note * * * or in a *policy of insurance,* the obligations of which are to be discharged by payments in the future. (Emphasis added.)

Section 25.2503-3(c), Example (6) of the regulations, provides:

> *L* pays premiums on a policy of insurance on his life. All the incidents of ownership in the policy (including the right to surrender the policy) are vested in *M*. The payment of premiums by *L* constitutes a gift of a present interest in property.

The interest in the group policy that the employee assigned to the irrevocable trust had no ascertainable value at the time it was transferred since the employer could have simply failed to make further premium payments. Therefore, no taxable gift occurred.

As to the payment of the premiums by the employer, it is well established for purposes of various estate tax provisions that, in an appropriate case, a transfer by an employee can take place where, in consideration of an employee's past and future services, the employer promises to pay a survivor's benefit. *Estate of Bogley v. United States,* 514 F. 2d 1027 (Ct. Cl. 1975); *Estate of Tully, Sr. v. United States,* 528 F. 2d 1401 (Ct. Cl. 1976); *Estate of Fried,* 54 T.C. 805 (1970), *aff'd,* 445 F. 2d 979 (2d. Cir. 1971), *cert denied,* 404 U.S. 1016 (1972). Compare Rev. Rul. 76-304, page 269, this Bulletin. Of course, the exact timing of when the transfer takes place would depend on all the facts and circumstances. Although the case under consideration involves the gift tax, rather than the estate tax, the provisions dealing with both taxes should, possible, be interpreted *in pari ma ria, Sanford v. Commissioner,* 3 U.S. 39 (1939), 1939-2 C.B. 340.

Each time a premium was paid X Company additional compensati was conferred on *D*. By irrevocab assigning the insurance policy to t trust and continuing participation the group term life insurance contra *D* caused the economic benefit of t additional compensation to inure the assignee as each payment w made.

Accordingly, in the instant ca each premium payment made by t employer for group term life insu ance on the life of *D*, where *D* irre ocably assigned the policy to t trust, is deemed an indirect transf by *D* to the assignee of the policy f purposes of section 2511 of the Cod and subject to the gift tax imposed section 2501.

In addition, the payment of ea monthly premium for the group ter life insurance is not a gift of a futu interest in property and, therefo qualifies for the $3,000 annual excl sion provided by section 2503(b) the Code.

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26 CFR 1.61-1: Gross income.
(Also Section 2511; 25.2511-1.)

Community property; conversion from separate; Washington State. The tax treatment is set forth for a husband and wife, residing in Washington State, who agree in writing or orally that all presently owned and subsequently acquired real and personal property will be community property; G.C.M. 19248 superseded.

Rev. Rul. 77-359 [1]

The purpose of this Revenue Ruling is to update and restate, under the current statute and regulations, the position set forth in G.C.M. 19248, 1937-2 C.B. 59, concerning the effect, for Federal income tax purposes, of community property agreements entered into between a husband and wife residing in the State of Washington.

The taxpayers, husband and wife, are residents of the State of Washington. Each presently owns property separately, and each expects to separately acquire property in future years. During 1975, the taxpayers agree in writing that all presently owned property and all property to be acquired thereafter, both real and personal, will be community property.

[1] Prepared pursuant to Rev. Proc. 67-6, 1967-1 C.B. 576.

The specific question presented is whether such an agreement changes the status of presently owned separate property and subsequently acquired separate property of one spouse to community property under the laws of the State of Washington.

The Supreme Court of the State of Washington in *Volz v. Zang*, 113 Wash. 378, 194 P. 409 (1920), held that a written agreement between husband and wife that each parcel of land wherever situated, both presently owned or thereafter to be acquired, should be deemed community property was a valid contract and operated to convert separate real property into community property. In reaching this conclusion, the court said that under the laws of Washington husband and wife were given the right to deal in every possible manner with their property, and that the husband and wife could change the status of separate property to community property.

The theory of *Volz v. Zang* has been followed by Washington courts in more recent cases concerned with this subject. See *Estate of Shea*, 60 Wash. 2d 810, 376 P. 2d 147 (1962), *Neeley v. Lockton*, 63 Wash. 2d 929, 389 P. 2d 909 (1964), *Estate of Verbeek*, 2 Wash. App. 144, 467 P. 2d 178 (1970), and *Merriman v. Curl*, 8 Wash. App. 894, 509 F. 2d 765 (1973).

In *Estate of Verbeek*, the court stated that it is also true that under the laws of the State of Washington, the status of real property as distinguished from personal property cannot be changed by mere oral agreement of the spouses. See also *Leroux v. Knoll*, 28 Wash. 2d 964, 184 P. 2d 564 (1974), and Revised Code of Washington Annotated, Title 26, Section 26.16.050 (1962).

Accordingly, where a husband and wife residing in the State of Washington agree in writing that all presently owned property and all property to be acquired thereafter, both real and personal, will be community property, such agreement changes the status of presently owned separate property and subsequently acquired separate property to community property.

Further, if such an agreement is entered into orally, it changes the status of presently owned separate personal property and subsequently acquired separate personal property to community property. However, the status of separate real property located in the State of Washington can be changed to community property only by a proper written agreement.

To the extent that the agreement affects the income from separate property and not the separate property itself, the Service will not permit the spouses to split that income for Federal income tax purposes where they file separate income tax returns. See *Commissioner v. Harmon*, 323 U.S. 44 (1944), 1944 C.B. 166.

Whether the agreement affects only the income from separate property or the property itself, the Federal gift tax is applicable to the conversion of separate property into community property. Under section 2511 of the Internal Revenue Code of 1954, a single gift will take place with respect to the conversion of the separately owned properties and the value of the single gift will be the net difference between the value of the husband's (or the wife's) separate property before its conversion into community property and the value of the husband's (or the wife's) interest in the community property resulting from the conversion. Compare Rev. Rul. 69-505, 1969-2 C.B. 179. Additional gifts will occur with respect to separate properties acquired in future years that will be converted into community property by reason of the 1975 agreement between the spouses. The value of the additional gifts will be determined in the manner indicated herein with respect to the presently-owned separate properties.

G.C.M. 19248 is superseded since the position set forth therein is restated under current law in this Revenue Ruling.

Section 2036.—Transfers With Retained Life Estate

26 CFR 20.2036-1: Transfers with retained life estate.

Texas community property; decedent's interest in separate property. Separate property under Texas community property law that a decedent transferred to the spouse prior to death and which was held by the spouse as separate property, is not includible in the decedent's gross estate. Rev. Rul. 75-504 revoked.

Rev. Rul. 81-221

ISSUE

The Internal Revenue Service has been asked to reconsider Rev. Rul. 75-504, 1975-2 C.B. 363, in view of the Fifth Circuit's opinion in *Estate of Wyly v. Commissioner*, 610 F.2d 1282 (5th Cir. 1980), which considers whether the value of property that is considered separate property under Texas community property law is includible in the gross estate of a decedent under section 2036 of the Internal Revenue Code when the decedent transferred separate ownership of that property to a spouse prior to death.

FACTS

In Rev. Rul. 75-504, *A* gave $15,000 in cash to spouse *B*. Prior to the transfer, *A* held the above amount as separate property. Upon receipt of the gift, *B* placed the entire $15,000 in a separate savings account. *B* continued to hold the money, together with $3,058 in interest that subsequently accrued, in a separate savings account until the death of *A*.

Rev. Rul. 75-504 states that under Texas community property law, although the separate property of one spouse may be transferred to the other spouse as separate property, the donor-spouse retains the right to one-half the income from the transferred property subsequent to the transfer. Accordingly, Rev. Rul. 75-504 concludes that where a deceased Texas spouse transferred separate property to the other spouse, one-half of the value of the transferred property together with one-half of the accumulated income therefrom is includible in the gross estate of the deceased donor-spouse under section 2036(a)(1) of the Code.

LAW AND ANALYSIS

Section 2036(a)(1) of the Code provides that the value of the gross estate shall include the value of all property to the extent of any interest therein of which the decedent has at any time made a transfer under which the decedent retained for life the possession or enjoyment of, or the right to income from, the property.

Section 20.2036-1(a) of the Estate Tax Regulations provides that if the decedent retained an interest with respect to only a part of the property transferred, the amount to be included in the decedent's gross estate under section 2036 is the proportionate amount of corpus.

In *Estate of Wyly v. Commissioner*, the Fifth Circuit considered the application of section 2036 in a fact situation similar to that presented in Rev. Rul. 75-504. The court reviewed Texas community property law and concluded that the donor-spouse's community interest in the income of the transferred property was not a general community interest subject to joint management and control. The court stated that the donor-spouse had inchoate rights in the transferred property that could be asserted only if the donee mismanaged the property in certain ways. Thus, the donor-spo has a mere expectancy and not a ri to the income from the property tra ferred to the other spouse. Accordi ly, the Fifth Circuit concluded t none of the property transferred one spouse to the other spouse was cludible in the deceased don spouse's gross estate under secti 2036(a)(1) of the Code.

In view of *Estate of Wyly v. Co missioner*, the Service has determin that the interpretation of Texas co munity property law contained in R Rul. 75-504 is incorrect. Under Te community property law, as int preted by the Fifth Circuit, wh property is transferred from o spouse to another spouse, the don spouse does not possess a right to t income from the transferred propert

HOLDING

The value of property that is co sidered separate property under Tex community property law is not i cludible in the gross estate of decedent under section 2036 of t Code when the decedent transferr separate ownership of that property a spouse prior to death.

EFFECTS ON OTHER REVENU RULINGS

Rev. Rul. 75-504 is revoked.

Section 61

26 CFR 1.61-1: Gross income.
(Also Section 66.)

Community property; Wisconsin. Under the provisions of the Wisconsin Marital Property Reform Act, the rights of spouses in Wisconsin are community property rights.

Rev. Rul. 87-13

ISSUE

How must earned income and investment income be reported by married individuals who are domiciled in Wisconsin in 1986 and file separate federal income tax returns?

FACTS

During all of 1986, *A* and *B* were married individuals domiciled in the State of Wisconsin. *A* and *B* separated during 1986. Prior to the end of 1986 there was no decree of legal separation or separate maintenance. During 1986, *A* realized $64,000 in wages, and *B* realized $20,000 in wages and $28,000 in self-employment income derived from a service business. *B* also received $7,200 in dividends from securities acquired by *B* before marriage and derived $8,000 in capital gains from the sale of certain publicly held securities, some of which *B* acquired before marriage and some of which *B* acquired during marriage by reinvesting the proceeds of property acquired before marriage. *A* and *B* filed separate income tax returns for 1986. The provisions of section 66 of the Internal Revenue Code do not apply to them. They have not entered into a marital property agreement or otherwise modified their statutory property rights.

LAW AND ANALYSIS

The question presented is whether, for purposes of determining their liabilities for 1986 income tax, *A* and *B* each realized as income 50 percent of the wages, business earnings, and investment income received by the other.

The Wisconsin Marital Property Reform Act (the Act), Wis. Stat. Ann. sections 766.001–766.97 (West Supp. 1986), was enacted on April 4, 1984, effective January 1, 1986. The Act is based upon the Uniform Marital Property Act and creates a new system of property rights applicable to property owned by married residents of Wisconsin.

Under the Act, each spouse has a present, undivided 50 percent interest in marital property. Generally, marital property consists of property acquired by spouses "during marriage" and on or after the "determination date." The term "during marriage" is defined as the period that begins at marriage and ends at (1) the death of a spouse, (2) termination of the marriage by a decree of dissolution, divorce, annullment or declaration of invalidity, or (3) entry of a decree of legal separation or separate maintenance. Wis. Stat. section 766.01(7) and (8). The "determination date" is the last to occur of (1) marriage, (2) date of establishment of marital domicile in the state, or (3) January 1, 1986.

Marital property includes interest, dividends, rents and other income from investment property that is marital property. Marital property also includes income derived during marriage and after the determination date from the individual property of a spouse. Income representing appreciation in the value of the individual property of one spouse, however, remains individual property, unless there is substantial appreciation due to the substantial undercompensated efforts of either spouse. Wis. Stat. section 766.31.

Generally, individual property is property owned by one of the spouses before the determination date, property acquired by one of the spouses during marriage and after the determination date by gift or inheritance, and property acquired during marriage and after the determination date in exchange for individual property or with the proceeds of its sale.

Although not relevant to the present situation, the Act also provides that spouses and persons intending to marry may make enforceable marital property agreements.

Poe v. Seaborn, 282 U.S. 101 (1930), IX-2 C.B. 202 (1930), holds that where state law gives each spouse a present vested interest in community income and property, the gross income of each spouse includes half of the community income. *Commissioner v. Harmon*, 323 U.S. 44 (1944), 1944 C.B. 166, adds that each spouse's vested half interest in community property must be dictated by state law as an incident of marriage. Community property laws are in effect in the states of Arizona, California, Idaho, Louisiana, Nevada, New Mexico, Texas, and Washington.

Unless the rights of the spouses are altered by agreement, the Act automatically vests a 50 percent interest in marital property in each spouse. Under the provisions of the Act, therefore, the rights of spouses in Wisconsin are community property rights. Married individuals who are not subject to a decree of legal separation or separate maintenance, who were domiciled in Wisconsin during a year governed by the Act, who file separate returns, and who have not altered their property rights through a marital property agreement must each report 50 percent of the earnings and investment income received by either spouse during the marriage (as that term is defined by the Act).

HOLDING

Under the relevant provisions of Wisconsin law, *A* and *B* must each report as income $59,600 (half of the total wages of $84,000, plus half of the $28,000 self-employment income, plus half of the $7,200 dividend income). *B* must report the entire $8,000 capital gain as separate income because, under Wisconsin law, income representing the substantial appreciation in value of the individual property of one spouse is itself individual property, unless either spouse's substantial undercompensated efforts produced the appreciation.

Section 1014.—Basis of Property Acquired from a Decedent

26 CFR 1.1014-1: Basis of property acquired from a decedent.

Basis; property acquired from decedent; community property. Property held in joint tenancy is community property for purposes of section 1014(b)(6) of the Code if its status was community property under state law.

Rev. Rul. 87-98

ISSUE

If property is held in a common law estate but, for state law purposes, the property is characterized as community property, then is that property community property for purposes of section 1014(b)(6) of the Internal Revenue Code?

FACTS

D and *D*'s spouse *S*, residents of community property state *X*, purchased real property in *X* with community funds and took title as joint tenants with rights of survivorship. However, *D* and *S* later executed joint wills in which they declared the property to be a community asset.

Although *X* is a community property state, under the laws of *X*, spouses may hold property in joint tenancy or other common law estate. Because the laws of *X* do not make specific provision for the coexistence of a common law estate and a community property interest, taking title in a common law estate raises the presumption that the spouses intended to terminate the community interest, effectively transmuting the property's character from community to separate. This presumption is overcome by evidence that the spouses intended for the property not to be transmuted to separate property, in such a case, the community nature of the property is preserved. Under the law of *X*, an express statement of such intent in joint wills precludes transmutation by reason of taking title in joint tenancy.

D died in 1985. At the time of *D*'s death, the fair market value of the property was 100*x* dollars. The value of *D*'s one-half interest in the property was included in *D*'s estate for federal estate tax purposes.

LAW AND ANALYSIS

Section 1012 of the Code provides that the basis of property shall be the cost of such property.

Section 1014(a) of the Code provides that the basis of property in the hands of a person acquiring the property from a decedent or to whom the property passed from a decedent shall be the fair market value of the property at the decedent's death.

Section 1014(b)(6) of the Code provides that the surviving spouse's one-half share of community property held by the decedent and the surviving spouse under the community property laws of any state shall be considered to have been acquired from the decedent if at least one-half of the whole of the community interest in the property was includible in determining the value of the decedent's gross estate for federal estate tax purposes.

Rev. Rul. 68-80, 1968-1 C.B. 348, concerns property that was obtained by a husband and wife as tenants in common. Even though acquired in exchange for community assets, it constituted separate property under state law. The ruling holds that the property was not community property for purposes of section 1014 (b)(6). Accordingly, the surviving spouse's interest did not take a fair market value basis on the death of the first spouse. However, the controlling factor was the state law determination that the property did not constitute community property. *See Morgan v. Commissioner*, 309 U.S. 78 (1940) (local law creates legal rights and interests; federal law determines the federal tax treatment thereof).

In the present situation, under the laws of *X*, the property remained community property. Even though the property was held in joint tenancy, a common law estate, the clear intention of *D* and *S*, as expressed in their joint wills, prevented its transmutation to separate property. Because it is community property under state law, it is also community property within the meaning of section 1014(b)(6). Therefore, *S*'s interest in one-half of the property receives a fair market value basis under section 1014(a). The interest in the one-half of the property that was considered to have padded from *D* and that was included in *D*'s estate also receives a fair market value basis pursuant to the provisions of section 1014(a). Accordingly, after *D*'s death, *S* owns the entire property with a basis of 100*x* dollars.

HOLDING

If property held in a common law estate is community property under state law, it is community property for purposes of section 1014(b)(6) of the Code, regardless of the form in which title was taken.

Section 1041.—Transfers Of Property Between Spouses Or Incident To Divorce

26 CFR 1.1041-1T: Treatment of transfer of property between spouses or incident to divorce.
(Also Sections 61, 454; 1.61-7, 1.454-1)

Transfer of property between spouses or incident to divorce. The deferred, accrued interest on U.S. savings bonds is includible in the transferor's gross income in the taxable year in which the transferor transfers the bonds to the transferor's spouse or former spouse in a transfer described in section 1041(a) of the Code. The transferee's basis in the bonds immediately after the transfer is equal to the transferor's basis in the bonds increased by the interest income includible by the transferor as a result of the transfer of the bonds.

Rev. Rul. 87-112

ISSUES

(1) If a taxpayer transfers United States savings bonds to the taxpayer's spouse or former spouse in a transfer described in section 1041(a) of the Internal Revenue Code, must the taxpayer include the deferred, accrued interest on the bonds in gross income in the year of the transfer?

(2) What is the basis in the bonds of the taxpayer's spouse or former spouse immediately after the transfer of the bonds?

FACTS

A, an individual who uses the cash receipts and disbursements method of accounting, held Series E and EE bonds with maturity dates after 1985. The bonds were registered in *A*'s name and purchased entirely with *A*'s funds. *A* had not elected pursuant to section 454 of the Code currently to include in income any interest accrued on the bonds. In taxable year 1985, as part of a divorce property settlement, *A* transferred the bonds to *B*, *A*'s former spouse. *B* redeemed the bonds in 1986.

LAW AND ANALYSIS

Section 61(a) of the Code provides that, unless otherwise excluded by law, gross income means all income from whatever source derived, including interest.

Under section 454(c) of the Code and section 1.454-1(a) of the Income Tax Regulations thereunder, if a taxpayer holds a United States saving bond issued at a discount and redeemable for fixed amounts increasing at stated intervals, the increase in redemption value is includible in gross income as interest income for the taxable year in which the bond matures, is redeemed, or is disposed of, whichever is earlier, unless the taxpayer elects under section 454 to report this interest income in the years in which increments in the redemption value of the bond occur.

Under section 1.454-1(a)(1) of the regulations, an owner of Series E bonds may elect to report the increment on these bonds each year. This election is exercised by reporting as interest income, with respect to bonds owned at any time during a taxable year, the increments that occurred in taxable years up to and including the taxable year for which the income is reported. The same rules are applicable to Series EE bonds.

Section 1041(a) of the Code pro-

vides that no gain or loss will be recognized on a transfer of property from an individual to (or in trust for the benefit of) (1) a spouse, or (2) a former spouse (but only if the transfer to the former spouse is incident to the divorce). The effect of section 1041 is to defer the tax consequences (recognition of gain or loss) until the transferee disposes of the property.

Although section 1041(a) of the Code shields from recognition gain that would ordinarily be recognized on a sale or exchange of property, it does not shield from recognition income that is ordinarily recognized upon the assignment of that income to another taxpayer. Because the income at issue here is accrued but unrecognized interest, rather than gain, section 1041(a) does not shield that income from recognition. The transferred bonds in the present situation contain an interest element that has not been included in income. Accordingly, the specific rule of section 1.454-1(a) of the regulations for dispositions of interest-deferred obligations applies to require that the transferor include the accrued interest in income in the year of the transfer. *See* Rev. Rul. 55-278, 1955-1 C.B. 471 (interest accrued on bonds prior to reissue to transferee includible in transferor's gross income for taxable year in which gift made), and Rev. Rul. 54-143, 1954-1 C.B. 12 (transferor recognizes interest accrued on bond upon transfer of interest in bond to daughter).

Section 1041(b)(1) of the Code provides that, in the case of any transfer of property described in section 1041(a), for purposes of subtitle A, the property will be treated as acquired by the transferee by gift. Section 1041(b)(2) provides that, in the case of any transfer of property described in section 1041(a), the basis of the transferee in the property will be the same as the adjusted basis of the transferor. In general, section 1041(b)(2) is intended to operate in the same manner as section 1015(a), which applies to property acquired by gift in transfers not described in section 1041(a). The difference between the two provisions is that under section 1041(b)(2) the carryover basis rule applies to property having a fair market value less than the transferor's basis as well as to property having a fair market value equal to or greater than the transferor's basis. *See* section 1.1041-1T(d) of the Temporary Income Tax Regulations under the Tax Reform Act of 1984.

Rev. Rul. 79-371, 1979-2 C.B. 294, considered the donee's basis under section 1015 for an installment note in a situation where the donor's transfer of the note to the donee resulted in the recognition of gain to the donor. The gain was required to be recognized under the former version of section 453B(a) and (b) of the Code (section 453(d)(1) and (2) of the Code as in effect immediately prior to the enactment of the Installment Sales Revision Act of 1980, 1980-2 C.B. 489). Under section 1015(a), the donor's basis in the installment obligation at the time of the gift became the donee's basis in the installment obligation. That revenue ruling holds that for this purpose the donor's basis is increased to include the gain resulting from the disposition. Accordingly, in the instant case, immediately after the transfer the transferee's basis in the bonds is the sum of the transferor's basis in the bonds immediately prior to the transfer plus any income recognized by the transferor under section 1.454-1(a) of the regulations as a result of the transfer of the bonds.

HOLDING

(1) The deferred, accrued interest on United States savings bonds is includible in the transferor's gross income in the taxable year in which the transferor transfers the bonds to the transferor's spouse or former spouse in a transfer described in section 1041(a) of the Code. The deferred, accrued interest from the date of original issuance of the bonds to the date of transfer of the bonds to *B* is includible in *A*'s gross income. Only the deferred, accrued interest on the bonds from the date of the transfer to the date of redemption of the bonds by *B* is includible in *B*'s gross income. *See* Rev. Rul. 54-143.

(2) The transferee's basis in the bonds immediately after the transfer is equal to the transferor's basis in the bonds increased by the interest income includible by the transferor as a result of the transfer of the bonds.

[Sec. 1014]

SEC. 1014. BASIS OF PROPERTY ACQUIRED FROM A DECEDENT.

[Sec. 1014(a)]

(a) IN GENERAL.—Except as otherwise provided in this section, the basis of property in the hands of a person acquiring the property from a decedent or to whom the property passed from a decedent shall, if not sold, exchanged, or otherwise disposed of before the decedent's death by such person, be—

(1) the fair market value of the property at the date of the decedent's death, or

(2) in the case of an election under either section 2032 or section 811(j) of the Internal Revenue Code of 1939 where the decedent died after October 21, 1942, its value at the applicable valuation date prescribed by those sections, or

(3) in the case of an election under section 2032A, its value determined under such section.

Amendments

P.L. 96-222, § 107(a)(2)(A):

Amended Code Sec. 1014(a)(3) by changing "section 2032.1" to "section 2032A", applicable to estates of decedents dying after December 31, 1976.

P.L. 95-600, § 702(c)(1)(A), (c)(10):

Amended Code Sec. 1014(a) to read as above, effective as if such amendment was included in amendments made by P.L. 94-455 [Sec. 2003(e), applicable to estates of decedents dying after December 31, 1976]. Before amendment, such section read:

"(a) IN GENERAL.—Except as otherwise provided in this section, the basis of property in the hands of a person acquiring the property from a decedent or to whom the property passed from a decedent shall, if not sold, exchanged, or otherwise disposed of before the decedent's death by such person, be the fair market value of the property at the date of the decedent's death, or, in the case of an election under either section 2032 or section 811(j) of the Internal Revenue Code of 1939 where the decedent died after October 21, 1942, its value at the applicable valuation date prescribed by those sections."

[Sec. 1014(b)]

(b) PROPERTY ACQUIRED FROM THE DECEDENT.—For purposes of subsection (a), the following property shall be considered to have been acquired from or to have passed from the decedent:

(1) Property acquired by bequest, devise, or inheritance, or by the decedent's estate from the decedent;

(2) Property transferred by the decedent during his lifetime in trust to pay the income for life to or on the order or direction of the decedent, with the right reserved to the decedent at all times before his death to revoke the trust;

(3) In the case of decedents dying after December 31, 1951, property transferred by the decedent during his lifetime in trust to pay the income for life to or on the order or direction of the decedent with the right reserved to the decedent at all times before his death to make any change in the enjoyment thereof through the exercise of a power to alter, amend, or terminate the trust;

(4) Property passing without full and adequate consideration under a general power of appointment exercised by the decedent by will;

(5) In the case of decedents dying after August 26, 1937, property acquired by bequest, devise, or inheritance or by the decedent's estate from the decedent, if the property consists of stock or securities of a foreign corporation, which with respect to its taxable year next preceding the date of the decedent's death was, under the law applicable to such year, a foreign personal holding company. In such case, the basis shall be the fair market value of such property at the date of the decedent's death or the basis in the hands of the decedent, whichever is lower;

(6) In the case of decedents dying after December 31, 1947, property which represents the surviving spouse's one-half share of community property held by the decedent and the surviving spouse under the community property laws of any State, or possession of the United States or any foreign country, if at least one-half of the whole of the community interest in such property was includible in determining the value of the decedent's gross estate under chapter 11 of subtitle B (section 2001 and following, relating to estate tax) or section 811 of the Internal Revenue Code of 1939;

(7) In the case of decedents dying after October 21, 1942, and on or before December 31, 1947, such part of any property, representing the surviving spouse's one-half share of property held by a decedent and the surviving spouse under the community property laws of any State, or possession of the United States or any foreign country, as was included in determining the value of the gross estate of the decedent, if a tax under chapter 3 of the Internal Revenue Code of 1939 was payable on the transfer of the net estate of the decedent. In such case, nothing in this paragraph shall reduce the basis below that which would exist if the Revenue Act of 1948 had not been enacted;

(8) In the case of decedents dying after December 31, 1950, and before January 1, 1954, property which represents the survivor's interest in a joint and survivor's annuity if the value of any part of such interest was required to be included in determining the value of decedent's gross estate under section 811 of the Internal Revenue Code of 1939;

(9) In the case of decedents dying after December 31, 1953, property acquired from the decedent by reason of death, form of ownership, or other conditions (including property acquired through the exercise or non-exercise of a power of appointment), if by reason thereof the property is required to be included in determining the value of the decedent's gross estate under chapter 11 of subtitle B or under the Internal Revenue Code of 1939. In such case, if the property is acquired before the death of the decedent, the basis shall be the amount determined under subsection (a) reduced by the amount allowed to the taxpayer as deductions in computing taxable income under this subtitle or prior income tax laws for exhaustion, wear and tear, obsolescence, amortization, and depletion on such property before the death of the decedent. Such basis shall be applicable to the property commencing on the death of the decedent. This paragraph shall not apply to—

(A) annuities described in section 72;

(B) property to which paragraph (5) would apply if the property had been acquired by bequest; and

(C) property described in any other paragraph of this subsection.

(10) Property includible in the gross estate of the decedent under section 2044 (relating to certain property for which marital deduction was previously allowed). In any such case, the last 3 sentences of paragraph (9) shall apply as if such property were described in the first sentence of paragraph (9).

Amendments

P.L. 97-448, § 104(a)(1)(A):

Added Code Sec. 1014(b)(10), above. Effective as if such amendment had been included in the provision of P.L. 97-34 to which it relates.

P.L. 94-455, § 1901(c)(8):

Struck out "Territory," following "State," in Code Secs. 1014(b)(6) and 1014(b)(7). Applicable to taxable years beginning after December 31, 1976.

[Sec. 1014(c)]

(c) PROPERTY REPRESENTING INCOME IN RESPECT OF A DECEDENT.—This section shall not apply to property which constitutes a right to receive an item of income in respect of a decedent under section 691.

[Sec. 1014(d)]

(d) SPECIAL RULE WITH RESPECT TO DISC STOCK.—If stock owned by a decedent in a DISC or former DISC (as defined in section 992(a)) acquires a new basis under subsection (a), such basis (determined before the application of this subsection) shall be reduced by the amount (if any) which would have been included in gross income under section 995(c) as a dividend if the decedent had lived and sold the stock at its fair market value on the estate tax valuation date. In computing the gain the decedent would have had if he had lived and sold the stock, his basis shall be determined without regard to the last sentence of section 996(e)(2) (relating to reductions of basis of DISC stock). For purposes of this subsection, the estate tax valuation date is the date of the decedent's death or, in the case of an election under section 2032, the applicable valuation date prescribed by that section.

Amendments

P.L. 96-223, § 401(a):

Repealed Code Sec. 1014(d) as amended by P.L. 94-455, Act Sec. 2005(a)(1), applicable in respect of decedents dying after December 31, 1976. However, in the case of a decedent dying after December 31, 1976 and before November 7, 1978, the executor of an estate may make a special election of the carryover basis rules. The text of Act Sec. 401(d) which authorizes such an election is reproduced below.

Prior to repeal, Code Sec. 1014(d) read as follows:

(d) DECEDENTS DYING AFTER DECEMBER 31, 1979.—In the case of a decedent dying after December 31, 1979, this section shall not apply to any property for which a carryover basis is provided by section 1023.

P.L. 96-223, § 401(b):

Revived Code Sec. 1014(d) before its amendment by P.L. 94-455 and P.L. 95-600, applicable in respect of decedents dying after December 31, 1976.

P.L. 96-223, § 401(d) provides:

(d) ELECTION OF CARRYOVER BASIS RULES BY CERTAIN ESTATES.—Notwithstanding any other provision of law, in the case of a decedent dying after December 31, 1976, and before November 7, 1978, the executor (within the meaning of section 2203 of the Internal Revenue Code of 1954) of such decedent's estate may irrevocably elect, within 120 days following the date of enactment of this Act and in such manner as the Secretary of the Treasury or his delegate shall prescribe, to have the basis of all property acquired from or passing from the decedent (within the meaning of section 1014(b) of the Internal Revenue Code of 1954) determined for all purposes under such Code as though the provisions of section 2005 of the Tax Reform Act of 1976 (as amended by the provisions of section 702(c) of the Revenue Act of 1978) applied to such property acquired or passing from such decedent.

P.L. 95-600, § 515(1):

Amended Code Sec. 1014(d), effective on November 7, 1978, by striking out "December 31, 1976" and inserting in place thereof "December 31, 1979" in the caption and text of such section.

P.L. 94-455, § 2005(a)(1), (f)(1):

Amended Code Sec. 1014(d) to read as above, applicable in respect of decedents dying after December 31, 1979, as amended by P.L. 95-600, § 515(6). Prior to amendment, Code Sec. 1014(d) read as follows:

(d) SPECIAL RULE WITH RESPECT TO DISC STOCK.—If stock owned by a decedent in a DISC or former DISC (as defined in section 992(a)) acquires a new basis under subsection (a), such basis (determined before the application of this subsection) shall be reduced by the amount (if any) which would have been included in gross income under section 995(c) as a dividend if the decedent had lived and sold the stock at its fair market value on the estate tax valuation date. In computing the gain the decedent would have had if he had lived and sold the stock, his basis shall be determined without regard to the last sentence of section 996(e)(2) (relating to reductions of basis of DISC stock). For purposes of this subsection, the estate tax valuation date is the date of the decedent's death or, in the case of an election under section 2032, the applicable valuation date prescribed by that section.

P.L. 92-178, § 502(f):

Added Code Sec. 1014(d) to read as above before amendment by P.L. 94-455. Effective date is governed by the effective date for Code Sec. 992.

P.L. 85-320, § 2:

Repealed 1954 Code Sec. 1014(d).

Prior to repeal, Sec. 1014(d) read:

"(d) Employee Stock Options.—This section shall not apply to restricted stock options described in section 421 which the employee has not exercised at death."

Applicable with respect to taxable years ending after 12-31-56, but only in the case of employees dying after such date.

[Sec. 1014(e)]

(e) APPRECIATED PROPERTY ACQUIRED BY DECEDENT BY GIFT WITHIN 1 YEAR OF DEATH.—

(1) IN GENERAL.—In the case of a decedent dying after December 31, 1981, if—

(A) appreciated property was acquired by the decedent by gift during the 1-year period ending on the date of the decedent's death, and

(B) such property is acquired from the decedent by (or passes from the decedent to) the donor of such property (or the spouse of such donor),

the basis of such property in the hands of such donor (or spouse) shall be the adjusted basis of such property in the hands of the decedent immediately before the death of the decedent.

(2) DEFINITIONS.—For purposes of paragraph (1)—

(A) APPRECIATED PROPERTY.—The term "appreciated property" means any property if the fair market value of such property on the day it was transferred to the decedent by gift exceeds its adjusted basis.

(B) TREATMENT OF CERTAIN PROPERTY SOLD BY ESTATE.—In the case of any appreciated property described in subparagraph (A) of paragraph (1) sold by the estate of the decedent or by a trust of which the decedent was the grantor, rules similar to the rules of paragraph (1) shall apply to the extent the donor of such property (or the spouse of such donor) is entitled to the proceeds from such sale.

Amendments

P.L. 97-34, § 425(a):

Added Code Sec. 1014(e) to read as above, applicable to property acquired after August 13, 1981 by decedents dying after December 31, 1981.

[Sec. 1041]

SEC. 1041. TRANSFERS OF PROPERTY BETWEEN SPOUSES OR INCIDENT TO DIVORCE.

[Sec. 1041(a)]

(a) GENERAL RULE.—No gain or loss shall be recognized on a transfer of property from an individual to (or in trust for the benefit of)—

(1) a spouse, or

(2) a former spouse, but only if the transfer is incident to the divorce.

[Sec. 1041(b)]

(b) TRANSFER TREATED AS GIFT; TRANSFEREE HAS TRANSFEROR'S BASIS.—In the case of any transfer of property described in subsection (a)—

(1) for purposes of this subtitle, the property shall be treated as acquired by the transferee by gift, and

(2) the basis of the transferee in the property shall be the adjusted basis of the transferor.

[Sec. 1041(c)]

(c) INCIDENT TO DIVORCE.—For purposes of subsection (a)(2), a transfer of property is incident to the divorce if such transfer—

(1) occurs within 1 year after the date on which the marriage ceases, or

(2) is related to the cessation of the marriage.

[Sec. 1041(d)]

(d) SPECIAL RULE WHERE SPOUSE IS NONRESIDENT ALIEN.—Subsection (a) shall not apply if the spouse (or former spouse) of the individual making the transfer is a nonresident alien.

Amendments

P.L. 100-647, § 1018(l)(3)(A)-(B):

Act Sec. 1018(l)(3)(A)-(B) amended Code Sec. 1041(d) by striking out "Paragraph (1) of subsection (a)" and inserting in lieu thereof "Subsection (a)"; and by striking out "the spouse" and inserting in lieu thereof "the spouse (or former spouse)".

The above amendment is effective with respect to transfers after June 21, 1988.

[Sec. 1041(e)]

(e) TRANSFERS IN TRUST WHERE LIABILITY EXCEEDS BASIS.—Subsection (a) shall not apply to the transfer of property in trust to the extent that—

(1) the sum of the amount of the liabilities assumed, plus the amount of the liabilities to which the property is subject, exceeds

(2) the total of the adjusted basis of the property transferred.

Proper adjustment shall be made under subsection (b) in the basis of the transferee in such property to take into account gain recognized by reason of the preceding sentence.

Amendments

P.L. 99-514, § 1842(b):

Act Sec. 1842(b) amended Code Sec. 1041 by adding at the end thereof new subsection (e) to read as above.

The above amendment is effective as if included in the provision of P.L. 98-369 to which such amendment relates.

P.L. 98-369, § 421(a):

Act Sec. 421(a) amended Part III of subchapter O of chapter 1 by adding at the end thereof a new section 1041 to read as above.

The above amendment applies to transfers after July 18, 1984 in tax years ending after such date. Special rules appear below.

P.L. 98-369, § 421(d)(2)-(4) provides:

(2) Election To Have Amendments Apply To Transfers After 1983.—If both spouses or former spouses make an election under this paragraph, the amendments made by this section shall apply to all transfers made by such spouses (or former spouses) after December 31, 1983.

(3) Exception for Transfers Pursuant to Existing Decrees.—Except in the case of an election under paragraph (2), the amendments made by this section shall not apply to transfers under any instrument in effect on or before the date of the enactment of this Act unless both spouses (or former spouses) elect to have such amendments apply to transfers under such instrument.

(4) Election.—Any election under paragraph (2) or (3) shall be made in such manner, at such time, and subject to such conditions, as the Secretary of the Treasury or his delegate may by regulations prescribe.

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