What is the Effect of Community Property on the New Unemployment Compensation Exclusion?

By David M. Fogel, EA, CPA

Introduction

On March 11, 2021, the President signed into law the American Rescue Plan Act of 2021.[1] Section 9042 of this law added a new section of the Internal Revenue Code (section 85(c)) providing an exclusion from gross income for unemployment compensation.

Under this new Code section, a taxpayer whose gross income is less than $150,000 (without the unemployment compensation income) may exclude up to $10,200 of unemployment compensation income for 2020.

The New Section 85(c)

Here is the actual wording of the new IRC §85(c) (without the conforming amendments):

> (c) SPECIAL RULE FOR 2020.—
>
> (1) IN GENERAL.—In the case of any taxable year beginning in 2020, if the adjusted gross income of the taxpayer for such taxable year is less than $150,000, the gross income of such taxpayer shall not include so much of the unemployment compensation received by such taxpayer (or, in the case of a joint return, received by each spouse) as does not exceed $10,200.
>
> (2) APPLICATION.—For purposes of paragraph (1), the adjusted gross income of the taxpayer shall be determined—
>
> (A) after application of sections 86, 135, 137, 219, 221, 222, and 469, and
>
> (B) without regard to this section.

Note the language I've highlighted. Only the spouse who "received" the unemployment compensation is entitled to the exclusion.

There is no legislative history that might explain what Congress meant when it used the word "received" in this section. Section 9042 wasn't originally part of the bill. In the Senate, Joe Manchin (D-WV) was going to vote against the bill because he didn't approve of the unemployment benefits provisions. That would mean that the bill would fail by a vote of 49 to 51. To get him to change his vote, several senators introduced an amendment (Senate Amendment 1378) that changed the unemployment benefits provisions and added section 9042 (with IRC §85(c) as shown above).[2] On March 6, 2021, Senate Amendment 1378 passed the Senate by a vote of 50 to 49, and the bill then passed the Senate by the same margin. It was sent to the House, where it passed on March 10, 2021, and was signed into law on March 11, 2021. There was no discussion or debate on this amendment.

Unemployment Compensation Received in Community Property States

Controversy has arisen as to how IRC §85(c) applies in a community property state. If one spouse received the unemployment compensation income but the other spouse had a one-half interest in that income, are both spouses entitled to the exclusion? If adjusted gross income on a joint return is $150,000 or more, should the spouses file separate returns in order to get below the $150,000 threshold? Nine states are community property states (Arizona, California, Idaho, Louisiana, Nevada, New Mexico, Texas, Washington and Wisconsin), so these questions have widespread impact.

In these states, the Tax Court has held that unemployment compensation is community income that must be split between the spouses.[3] One spouse is required to report one-half of the unemployment compensation income received by the other spouse because each spouse has a present interest in one-half of such income.[4]

The court cases involving community income have held that each spouse has a "vested interest" or "present interest" or "owns" one-half of the community

---

[1] H.R. 1319, P.L. 117-2.

[2] Senate Amendment 1378 may be found starting on page S1388 of the March 5, 2021 *Congressional Record – Senate*, which may be found here: https://www.congress.gov/117/crec/2021/03/05/CREC-2021-03-05-pt1-PgS1291.pdf

[3] See *Oliver v. Commissioner*, T.C. Memo. 2011-43 (Arizona); *Hardy v. Commissioner*, T.C. Memo. 1997-97 (Nevada); *Calhoun v. Commissioner*, T.C. Memo. 1992-408 (California); *Trolinger v. Commissioner*, T.C. Memo. 1988-333 (California).

[4] *Id*.

income of the other spouse.[5] But none of these court cases uses the word "receive" — the word used in the new IRC §85(c) — to refer to the non-receiving spouse's entitlement to one-half of the income. Therefore, there is a question as to whether the non-receiving spouse is entitled to use the new IRC §85(c) to exclude his or her one-half share of unemployment compensation income.

Some tax professionals have argued that in a community property state, each spouse is entitled to the exclusion even if only one spouse received the unemployment compensation income. Some have argued that under community property rules, each spouse is "deemed to have received" one-half of the unemployment compensation income of the other spouse.

Will this expanded interpretation of the word "received" in IRC §85(c) be allowed? Probably not. IRC §85(c) is an exclusion section, and the United States Supreme Court has repeatedly held that exclusions from gross income must be narrowly construed.[6] The expanded interpretation is questionable because it is changing the word "received" in the statute to "deemed to have received" when the law requires exclusions to be narrowly construed.

One of the most recent applications of the "narrowly construed" principle is the Tax Court's ruling in *Gates v. Commissioner*.[7] In this case, the taxpayers tore down part of their residence and built a new residence on the same site, but never occupied the new residence. Then, they sold the residence and its land, resulting in a gain. The Tax Court denied the $500,000 principal residence exclusion of IRC §121(a) on the grounds that the taxpayers hadn't satisfied the "use" requirement. The Tax Court construed the IRC §121(a) "use" requirement narrowly to mean "use of the dwelling unit."

As a result, unless the IRS issues further guidance that will allow the IRC §85(c) exclusion for a non-receiving spouse's community property interest in unemployment compensation, I don't see that the exclusion is allowable.[8]

Possible Scenarios

Scenario #1

George and Gracie file a joint return for 2020 with an AGI of less than $150,000. During 2020, George received unemployment compensation of $25,000. Gracie didn't receive any unemployment compensation. Under community property rules, each spouse's share of that income is $12,500. Are George and Gracie each entitled to exclude $10,200 for a total exclusion of $20,400?

Under the expanded interpretation of the statute, George and Gracie each get a $10,200 exclusion. However, this interpretation is an opinion rendered by a tax professional and may not be relied upon as substantial authority.[9] Neither is this article. But if you follow the statutory language of IRC §85(c) and construe the exclusion narrowly as the U.S. Supreme Court has ruled, then only George gets a $10,200 exclusion.

Does this mean that you may not prepare the return by claiming a $20,400 exclusion? No. To take a position on a return, all you need is a reasonable basis for the position as long as it is disclosed.[10] "Reasonable basis" has been interpreted to be about a 20% chance of success.[11] But if you take this position, you should certainly advise your client that the IRS may, at a later date, audit the return and disallow $10,200 of the $20,400 exclusion.

Scenario #2

Mickie and Minnie file a joint return for 2020 with an AGI of less than $150,000. During 2020, Mickie received unemployment compensation of $15,400 and Minnie received unemployment compensation of $5,000. Under community property rules, each spouse's share of that income is $10,200. Are Mickie and Minnie each entitled to exclude $10,200 for a total exclusion of $20,400, or does Mickie get a $10,200

---

[5] See, for example, *Hindman v. Commissioner*, T.C. Memo. 1975-315; *Schmitz v. Commissioner*, T.C. Memo. 1983-482; *Porter v. Commissioner*, T.C. Memo. 1979-104; Chief Counsel Advice 201112016. See also *Gleason v. Commissioner*, T.C. Memo. 2011-154; *Green v. Commissioner*, T.C. Memo. 2007-39; *Leonard v. Commissioner*, T.C. Memo. 1998-290; *Gross v. Commissioner*, T.C. Memo. 1995-425.

[6] See *Commissioner v. Schleier*, 515 U.S. 323, 328 (1995); *United States v. Centennial Savings Bank FSB*, 499 U.S. 573, 583 (1991); *Commissioner v. Jacobson*, 336 U.S. 28, 49 (1949).

[7] *Gates v. Commissioner*, 135 T.C. 1 (2010), appeal dismissed by stipulation, No. 10-73209 (9th Cir. 2011).

[8] Thomas A. Gorcynski, EA, USTCP, agrees with this view. See "Tom Talks Taxes – 2021" (Apr. 2, 2021), which may be found here: https://www.tomtalkstaxes.com/

[9] See Treas. Reg. §1.6662-4(d)(3)(iii).

[10] See Treas. Reg. §1.6662-3(b)(3); IRC §6694(a)(2)(B); §10.34 of Circular 230.

[11] See Joint Committee on Taxation, "Study of Present-Law Penalty and Interest Provisions as Required by Section 3801 of the Internal Revenue Service Restructuring and Reform Act of 1998 (Including Provisions Relating to Corporate Tax Shelters", JCS-3-99, Vol. 1, Table 7, p. 160, which may be found here: https://www.jct.gov/publications/1999/jcs-3-99-volume-i/

exclusion for his $15,400, and Minnie get a $5,000 exclusion for her $5,000?

Like *Scenario #1*, under the expanded interpretation of the statute, Mickie and Minnie each get a $10,200 exclusion, but if you follow the statutory language of IRC §85(c) and construe the exclusion narrowly, then Mickie and Minnie get exclusions of $10,200 and $5,000, respectively.

Scenario #3

Sonny and Cher have an AGI for 2020 of $200,000. During 2020, Cher received unemployment compensation of $25,000. Sonny didn't receive any unemployment compensation. If they file a joint return, then they would not receive any exclusion because their AGI exceeds the $150,000 threshold. If they file separate returns, then each spouse's AGI would be $100,000, which is below the $150,000 threshold. Are Sonny and Cher each entitled to exclude $10,200 on their separate returns?

It depends. The decision to file separate returns may not depend solely upon the IRC §85(c) exclusion. Several other tax benefits may only be obtained if the spouses file a joint return, such as the earned income credit, the child and dependent care credit, education credits, the credit for adoption expenses, and the exclusion of U.S. savings bonds interest used for higher education expenses. So, you should calculate Sonny and Cher's returns both ways to see which way results in the lowest combined tax liability.

If there is no other advantage to filing a joint return, then filing separate returns again depends upon your interpretation of IRC §85(c). Like *Scenario #1*, under the expanded interpretation of the statute, Sonny and Cher would each get a $10,200 exclusion, but if you follow the statutory language of IRC §85(c) and construe the exclusion narrowly, then only Cher would get an exclusion of $10,200. But there would be an advantage to filing separate returns because each spouse's AGI would be below $150,000.

Scenario #4

Bonnie and Clyde have an AGI for 2020 of $200,000 and each of them received unemployment compensation income of $10,000. They filed a joint return before the law was enacted, and are not entitled to any exclusion because their AGI exceeds the $150,000 threshold. Filing separate returns would not eliminate any tax benefits. May they file amended separate returns, where each spouse's AGI would be $100,000 (below the $150,000 threshold), and where Bonnie and Clyde would each be able to exclude the $10,000 unemployment compensation?

This requires you to understand the concept of a "superseding return." A superseding return is a return filed on or before the due date (including extension). It takes the place of the original return, and is not treated as an amended return.[12] It may be filed on an original return form such as Form 1040 or an amended return form such as Form 1040-X.[13]

The IRS says that taxpayers who have already made the election to file a joint return cannot change to filing separate returns between the unextended due date and the extended due date because filing a joint return is an irrevocable election.[14]

In Notice 2021-21,[15] the IRS delayed the unextended due date for filing 2020 Form 1040 from April 15 to May 17, 2021. As a result, spouses who have already filed a joint return may change to filing separate returns if they file superseding returns by May 17, 2021. After that, the IRS may challenge their right to change from joint to separate returns.

Accordingly, Bonnie and Clyde may file superseding returns on or before May 17, 2021 to change to separate returns where each would be able to exclude $10,000 in unemployment compensation income.

What if Bonnie and Clyde e-filed their original joint return? They can't e-file separate returns because the system would reject them. They may e-file amended returns on Forms 1040-X,[16] but won't the IRS treat these as amended returns and not as superseding returns? No. As stated above, a superseding return may be filed on Form 1040 or Form 1040-X. So, they may e-file the superseding returns.

Conclusion

IRC §85(c) allows a taxpayer to exclude up to $10,200 of unemployment compensation income "received" if the taxpayer's adjusted gross income, computed without the unemployment compensation, is less than $150,000. In a community property state, each spouse is required to report one-half of the unemployment compensation income received by the other spouse because each spouse has a present interest in one-half of such income. But having a "present interest" in the unemployment compensation income is not the same as "received." And under U.S. Supreme Court precedent, since IRC §85(c) is an exclusion section, the exclusion must be narrowly construed.

If you were to follow these rules, then you may not claim the exclusion for a non-receiving spouse's

[12] See *Haggar Co. v. Helvering*, 308 U.S. 389, 395-96 (1940).

[13] See IRM 21.6.7.4.10 and CCA 200645019.

[14] See IRM 21.6.7.4.10, paragraph (2).

[15] Notice 2021-21 may be found here: https://www.irs.gov/pub/irs-drop/n-21-21.pdf

[16] See IRS News Release IR-2020-182.

one-half share of unemployment compensation that was actually received by the other spouse. But since there has been no guidance in either the legislative history or from the IRS, there is some doubt. You should take the position on the return that is most beneficial for your client. You should calculate the tax returns both ways to determine whether the spouses should file joint or separate returns and choose the way that results in the lowest tax liability. If you choose to claim the exclusion for the non-receiving spouse's one-half of the unemployment compensation income, then you should disclose this position on the return and warn that spouse that the IRS might issue later guidance requiring your clients to file an amended return, or may audit the return and disallow the exclusion.

David M. Fogel, EA, CPA, is a self-employed tax consultant providing tax consulting services to other tax practitioners. He has over 46 years of tax experience including 26 years working for the IRS and 20 years in private practice. He has written over 70 articles on various tax issues and is a member of several professional organizations. He is also admitted to practice before the U.S. Tax Court. He can be reached by email at dfogel@surewest.net or on the Internet at www.fogelcpa.com.