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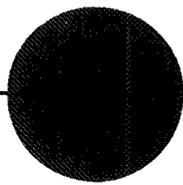
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The Innocent Spouse Rules

BY RICHARD C. E. BECK

A former spouse's income tax liabilities can unexpectedly plague the other spouse even years after a final divorce, as most spouses are liable for each other's taxes on income earned during a marriage. The sources of such liability are twofold. First, under Internal Revenue Code (I.R.C.) § 6013(d)(3), if a couple files a joint return, each spouse becomes jointly and severally liable for the full amount of tax due on the couple's combined earnings. Because nearly all couples file jointly, almost every ex-spouse is exposed to liability for an audit adjustment to the other ex-spouse's taxes, as long as the statute of limitations remains open for the joint return year.

In community property (CP) states, each spouse is liable for federal income taxes on one-half of the other's CP income under the doctrine of *Poe v. Seaborn*, 282 U.S. 101 (1930). Liability under *Seaborn* arises even when the spouses file separate or no returns, and it results automatically from residence in a CP jurisdiction.

Many experts believe that both forms of liability are unjustified and should be repealed. Recently, the ABA Tax Section's Committee on Domestic Relations Tax Problems unanimously recommended repeal, in the hope that the ABA will officially adopt that position and persuade Congress to act. In the meantime, we must live with the law as it is.

Relief rules do exist for both forms of liability for the "innocent spouse," discussed later, under certain limited circumstances, but the rules are uncertain and inadequate. It is conservatively estimated that there are at least

10,000 instances a year that tax is collected from the "wrong" spouse (generally the woman), despite the innocent spouse rules, and many involve substantial sums.

The income tax laws of many states may also impose joint return liability and/or CP tax liability. Many such states provide innocent spouse relief modeled on the federal rules, but the relief rules may differ in detail. (California, for example, has especially generous relief rules.)

Most taxpayers—even those advised by accountants or attorneys—are completely unaware of having assumed their spouses' tax liabilities. The wife's attorney should inform her in particular about all aspects of this. Although both the joint return and CP liability rules are gender-neutral, in practice the vast majority of taxpayers who are forced to pay their ex-spouses' taxes are women. For simplicity, the nonearning spouse will be referred to here as the wife (W), and the earning spouse as the husband (H), even though occasionally it may be H who must pay the tax on W's income.

Joint return liability

More than 95 percent of married couples elect to file jointly each year to enjoy the tax savings that usually result. Thus virtually all married persons (even in CP states) are subject to joint return liability. Even if W earned nothing during the taxable year, and all the tax liability resulted solely from H's income, the IRS may, and often does, attempt to collect the entire tax from W, sometimes years after the parties are separated or divorced. Fur-

ther, W's liability is not limited to the tax stated on the return. She is also liable for subsequent assessments due to H's unreported income or disallowed deductions, and for interest and penalties (except for the fraud penalty, for which actual fraud must be proved against her personally). I.R.C. § 6653(b)(3)). The IRS is under no obligation to pursue H first, and generally chooses to collect from the spouse from whom collection appears easier. Also, W has no right to require the IRS, or any tax forum, to join H as a party in collection proceedings.

Innocent spouse rules

Under I.R.C. § 6013(e), W may obtain relief from liability for tax on certain items attributable to H, despite having made a joint return with H, if she can qualify as an "innocent spouse." The statutory requirements for relief are: if (A) a joint return must be made, W must prove (B) that there is a "substantial understatement" on the return, attributable to H's "grossly erroneous items"; (C) that in signing the return, W did not know, and had no reason to know, that there was such a substantial understatement; and (D) that it would be inequitable under the circumstances to hold W liable for the deficiency attributable to such understatement. The burden of proof for each of the above elements is on W. *Adams*, 60 T.C. 300, 303 (1973).

A good defense

Joint Election. The best defense is that W did not file a joint return in the first place, and that I.R.C. § 6013(d) does not apply. Whether the election was made is a question of W's intent. Even if W did not sign the return, the return may be joint if there is evidence

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of her acquiescence. *Hanesworth v. U.S.*, 936 F.2d 583 (10th Cir. 1991). If W signs under duress, the joint election is not valid. *Pirnia*, 60 T.C.M. 554 (1990). If the couple is not legally married, a joint return is invalid.

Grossly Erroneous Items. A grossly erroneous tax item is either (A) income that has been omitted from the tax return, or (B) a claim of deduction, credit, or basis for which there is "no basis in fact or in law." I.R.C. § 6013(e)(2). Thus, no relief is available if H simply fails to pay the tax that was correctly reported on his return. Nor is relief available for items other than omitted income, and disallowed deductions, credits, and claims of basis. For example, there is no relief from nonpayment of self-employment taxes. *Sivils*, 86 T.C. 79 (1986).

Case law is confusing as to when deductions have "no basis in fact or law." It is clear that mere disallowance is not enough to meet the test. *Russo*, 298 T.C. 28 (1992). The legislative history indicates that deductions that are frivolous or phony do meet the test. Anything in between mere disallowance and frivolous or phony deductions is uncertain. For example, authorities are divided as to whether partially disallowed tax shelter deductions qualify. *Ness*, 95A F.2d 1495 (9th Cir. 1992).

Dollar Limits. An understatement due to omitted income is "substantial" only if it exceeds \$500 (net of interest and penalties). I.R.C. § 6013(e)(3). Smaller amounts do not qualify for relief. For erroneous claims of deduction, credit, or basis, the dollar limits are more strict. If W's adjusted gross income (AGI) for the year immediately preceding assessment of the deficiency is \$20,000 or less, the tax understatement must not only be larger than \$500, but the tax liability attributable to the understatement must also exceed 10 percent of her AGI. If W's AGI for that year is more than \$20,000, the tax liability must exceed 25 percent of her AGI. Note also that if W has remarried, her new husband's income must be aggregated with her own for purposes of determining "her" AGI; this is so even if W and the new husband did not file a joint return. I.R.C. § 6013(e)(4)(D).

The only way W can defend against collection proceedings brought by the IRS on the ground of joint return liability is through the innocent spouse rules. For the limited effectiveness of a tax indemnification agreement between H and W, see page 33.

Innocence

The burden of proof is on W to establish that she had no reason to know of the grossly erroneous item(s). This "innocence" requirement is the most difficult to prove, and the most frequently litigated issue. If W is aware of facts that ought to put a reasonable person with her education and experience on notice that H may have omitted income or overstated deductions, W has a duty to look into such facts before signing the return. For example, awareness of large or unusual expenditures has been held to put W on notice about unreported income. Also, W's involvement in H's business affairs or in the family finances may be deemed to put her on notice, if H's tax delinquency was reasonably inferred from such involvement. W's higher education, especially in business or accounting, and/or her independent business experience, has sometimes been held against her, on the ground that such experience ought to give her greater awareness of her tax responsibilities.

It has been held that large tax losses on the return without any corresponding reduction in standard of living should put W on notice. But the courts have been inconsistent as to whether W has a duty to review the tax return in the first place. Compare *Shapiro*, 51 T.C.M. 818 (1986), with *Hinds*, 56 T.C.M. 104 (1988). How much inquiry into such items is reasonable has also been decided inconsistently. Compare *Cohen*, 54 T.C.M. 944 (1987), with *Price v. U.S.*, 887 F.2d 959 (9th Cir. 1989). A similar uncertainty clouds the question whether W's good faith reliance on professional tax advice is enough to exonerate W.

If H refuses to discuss his tax or financial affairs with W, that does not in itself put W on notice, at least if the refusal is a long-standing pattern of the marriage. *Estate of Weissbart*, 63 T.C.M. 1845 (1992). An often-successful de-

fense has held that H systematically kept W in the dark as to his finances, especially where W was dependent and financially unsophisticated.

McCoy doctrine

A line of cases has held that where W is aware of the existence of the underlying transaction, her ignorance of the tax consequences does not constitute innocence. Where both W and H were ignorant of the tax consequences, relief has been denied on the questionable ground that W was not misled by H. *McCoy*, 57 T.C. 732 (1972). On the other hand, in all cases involving omitted income, W was still living with H at the time of trial, which may have been the unexplained ground of decision. The "ignorance of the law is no excuse" theory of *McCoy* has been ignored in many decisions granting relief when W was widowed or divorced. See, e.g., *Ratana*, 662 F.2d 220 (4th Cir. 1981).

Taken literally, the *McCoy* doctrine would preclude relief for all disallowed deductions, because W is necessarily aware of the existence of the item deducted on the return. The Tax Court has rendered this strict interpretation, but in a case where W was still married. *Bokum*, 94 T.C. 126 (1990). Appeals courts have been more flexible in granting relief, and have held that bare knowledge of the item's existence is not enough to preclude relief. W must be aware of at least some questionable circumstances as well. *Erdahl*, 930 F.2d 585 (8th Cir. 1991).

Equity

The question whether it would be "inequitable" under the circumstances to hold W liable translates in practice to whether W can demonstrate that she did not receive any significant economic benefit from the unpaid taxes over and above ordinary support. Both lifestyle during marriage and property settlements at termination are relevant to the benefit test. The courts have occasionally been lenient in finding that substantial property settlements do not exceed ordinary support, especially in cases where W has children to support. *Terzian*, 72 T.C. 1164 (1979). As with the innocence issue, these cases are largely

irreconcilable in terms of the rules. They turn upon their facts.

Sympathy

The sympathy test is not in the statute, but it is perhaps the most important factor of all. H's mistreatment or abandonment of W is usually mentioned in her favor in reported decisions. Women who were homemakers and mothers have received more sympathy in the Tax Court than have well-educated or independent women. And, of course, it helps if W is poor and has children to support. Conversely, it appears all but impossible for W to obtain relief if she is still living with H at the time of trial. Treasury Reg. § 1.6013-5(b) permits the court to take into consideration whether W was deserted or is separated from H; but the Tax Court sometimes seems to consider separation or pending divorce a necessary element for relief. *Hunt*, 62 T.C.M. 1238 (1991).

Reduce future exposure

Married couples are eligible to file a joint federal tax return if they are still married on the last day of the taxable year, whether or not they are separated, and even if they are already divorced at the time of filing. During settlement negotiations, H will often suggest that a provision be included in the separation agreement requiring the parties to file a joint return for the current or future years to achieve a tax saving. Counsel for W should exercise great caution before agreeing to such a request. The tax saving is usually modest and benefits H more than W because H is on average the higher earner. But the risk from joint return liability is borne primarily by W, and may involve sums far in excess of the tax saving. Even if the spouses negotiate to share the saving equally, W's portion often isn't worth the substantial risk. There is no obligation to agree to such a request. A divorce court cannot force W to sign a joint return, because joint filing is a voluntary election. *Leftwich v. Leftwich*, 442 A.2d 139 (D.C. Ct. App. 1980).

Counsel should be especially wary of allowing W to sign joint returns for prior tax years that are already delinquent. When there is any risk that H

will not pay the overdue taxes, counsel may be exposed to actionable malpractice. *Newberry v. Johnson*, 294 Ark. 455, 743 S.W.2d 811 (1988). Filing separately avoids joint return liability altogether.

Protect your client

A properly drafted separation agreement should specify which spouse is obligated to pay contingent tax liabilities arising from joint returns for past years, as well as for the current year. But counsel should not be overly confident about the protection afforded by such an indemnity clause: It is not binding on the IRS, but the IRS may pursue W notwithstanding the agreement. *Buchine*, 63 T.C.M. 1838 (1992). An agreement will facilitate W's action for indemnity against H in the event that she is forced to pay the joint taxes. But even without an indemnity clause, all states provide W with an equivalent right of action for contribution under common law, and most states also by statute, if she is forced to overpay her share of the joint obligation. *Bormaster v. Bormaster*, 177 Kan. 1, 274 P.2d 757 (1954). Enforcing a tax indemnity provision may be impractical, however, because of the litigation expense or because H is unable to pay the judgment. Case reports for suits for contribution are exceedingly rare. Even if W is eventually successful in her suit for contribution (or indemnity), having to pay the tax first may be onerous. If her claim for reimbursement is uncollectible, she is not entitled to a bad-debt deduction, even if she is a judgment creditor. *Rude*, 48 T.C. 165 (1967).

Mitigate exposure

The financial disclosure process of the divorce action offers you a chance to assess tax risks. If H is not cooperative, or appears deceptive about his financial affairs, he has likely been evasive in tax matters as well. Counsel should exercise special care if H is self-employed or manages a small business, particularly one in which transactions are primarily in cash, as such businesses allow significant opportunity for tax avoidance or evasion.

Examine prior joint returns for warning signs of tax problems. Pay special

attention to large partnership deductions and to any apparent discrepancies between prior reported income and the family's standard of living. If these signs appear, W should consider laying the groundwork for a future innocent spouse claim. For example, any tax indemnity clause contained in the settlement agreement might recite that W had no knowledge of, or involvement in, H's business or tax matters for as many tax years as you can possibly include. (Remember that the statute of limitations never expires for tax fraud.) Similarly, if W's knowledge of and participation in family financial affairs was limited, it would be wise to recite this in the agreement.

Such assertions are more persuasive if they are documented before any audit or assessment. Recitations in the signed agreement also help preclude H from testifying to the contrary in any future innocent spouse litigation. Document the source of any property transferred from H to W, and avoid accepting any property that might have been derived from H's unreported income or from refunds from tax shelter losses.

If H has outstanding unpaid tax liabilities from joint returns, W's counsel should insist that they be paid or that W be given appropriate security to protect her in the event that she becomes obligated to pay the IRS.

Finally, make sure that W sends to the IRS a notice of H's change of address as soon as he leaves the marital residence. This will ensure that any future deficiency notice will be sent to H, as well as to W, and may help direct IRS collection efforts toward H. If H has moved to a different IRS district, however (there are 64 in the United States), the IRS collection agent is still likely to proceed against W if she appears able to pay, rather than transfer the case to another district.

Note that under a recent IRS policy change, collection personnel may (but are not required to) pursue H first and defer collection from W, if W makes an innocent spouse claim and requests relief.

CP liability

Under *Poe v. Seaborn*, *supra*, a taxpayer who resides in a CP jurisdiction

is liable for one-half of a spouse's income taxes incurred by earnings that are treated as CP under applicable state family-property law. *Seaborn* construed family property law in the CP states as creating this liability, on the theory that CP earnings during marriage are owned by and taxable to each spouse in equal amounts. This form of liability does not depend on filing a joint return. It results automatically from residence in a CP jurisdiction, unless the couple elected not to live under community property rules.

W's best defense is that the item of H's income in question is not CP income at all. Federal taxation of CP income depends on state law, and state rules vary greatly as to which items qualify as CP while the community remains in effect. (Income from separate property, for example, is separate property in some states, but it is CP in others.) State law also varies significantly as to how and when the community may be severed by separation of the spouses or by agreement. If H's income was earned after the community was severed, liability under *Seaborn* does not apply.

Current CP states include Arizona, California, Idaho, Louisiana, Nevada, New Mexico, Texas, Washington, and Wisconsin.

Relief under I.R.C. § 66

The innocent spouse provisions for relief from CP liability under I.R.C. § 66 are analogous in many respects to relief under I.R.C. § 6013(e). The rules are more restrictive, however, and they have often failed to prevent obviously unfair results. The reported case law shows that nearly all petitioners for relief under I.R.C. § 66 have lost. When I.R.C. § 66 was enacted, its revenue cost was estimated to be "negligible"; the prediction has proved accurate.

I.R.C. § 66(c) is similar to I.R.C. § 6013(e) and contains the same requirements of "innocence" and "equity" discussed earlier. There are no dollar limits, however, and the provision applies only to unreported income. The innocence test is nearly impossible to meet, because if W knows H was employed, she loses, even though she may have no knowledge of the amount of his earnings.

Dooley, 63 T.C.M. 1858 (1992).

Two other provisions allow relief without proof of innocence, but they suffer other shortcomings. None of the I.R.C. § 66 provisions provide any relief for items other than omissions of income. Nor is relief available for taxes on CP investment income under I.R.C. § 66(a) and (b).

I.R.C. § 66(a) provides relief only if the couple lived apart during the calendar year, and none of the earned income in question was transferred between them. Even one day of cohabitation during the year, or any payments (other than child support) that are not minimal, will preclude relief.

I.R.C. § 66(b) provides that CP-law benefits may be disallowed to any taxpayer who acts as if he alone is entitled to the community income and fails to notify his spouse of the nature and amount of such income before the due date for the taxable year. The "benefit" in this situation is H's relief of tax liability for one-half of his earnings. This provision may be defeated if H notifies W of her liability, even if he transfers nothing to her.

The *Seaborn* doctrine does not apply to payroll taxes, which in principle must be withheld in full. Although one-half of H's wage withholding for fed-

eral income taxes is automatically credited against W's tax liability, if H deliberately underwithholds (or if withholding is not required, as for dividends, interest, and capital gains), H can in effect deliberately transfer liability for one-half of the resulting deficiency to W.

Indemnity

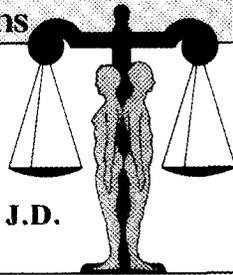
Where state law permits severance of the community by voluntary action or agreement, take the necessary steps for severance as soon as possible. Agreements to end the community are respected for federal tax purposes if valid under state law. Ending the community thus stops the clock on any further tax liability. *Schoenhair*, 45 B.T.A. 576 (1941) (Arizona).

A tax indemnity clause in the property settlement agreement would be useful, because (unlike under joint return liability) if W is forced to pay H's taxes under *Seaborn*, she otherwise has no right to reimbursement from H under state law. It is perhaps desirable as well to include recitations to lay the foundation for a future claim of innocence under I.R.C. § 66(c), but, as noted earlier in this article, little reliance can realistically be placed on such a claim. ■

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