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Joint Tax Return Liability And Bankruptcy

By Ann F. Thomas*

Conventional wisdom holds that bankruptcy offers a debtor a slate cleaned of financial liabilities from the past. But not all liabilities are discharged in bankruptcy. Certain tax liabilities can be significant exceptions. But one of the many transpositions that occurs when bankruptcy follows a divorce or threatens to occur during matrimonial litigation is that the tax problems of the bankrupt or debtor spouse can suddenly become a crushing financial burden for the other spouse. A case in point is where there is joint and several liability arising from the filing of joint returns.

Although not all tax liabilities are dischargeable in bankruptcy, in the proceeding the trustee usually has the opportunity to concede, defend, litigate and settle federal income tax claims against the debtor for all open years. Typically the Internal Revenue Service accelerates the tax audit process upon the filing of the petition in bankruptcy and files proofs of claim along with the other creditors. The bankruptcy court has jurisdiction over these claims and increasingly decides large tax cases. Thus, despite the distinction between dischargeable and priority tax claims, a debtor spouse can emerge from bankruptcy with all his tax claims settled.

The same result may not be available to a non-debtor spouse who has joint and several tax liability with the debtor spouse. For her, the tax case may only really begin when her former husband's case is settled in the bankruptcy proceeding.

A Harsh Result

In 1992, in *Kroh*, 98 T.C. No. 29 (4/9/92) the Tax Court squarely faced the question of the meaning of joint and several liability for the non-debtor spouse following the compromise of joint return year liabilities of the debtor spouse as part of his bankruptcy proceeding. The tax controversy involved a constructive dividend arising from a reallocation under IRC section 482 in a real estate transaction. Mrs. Kroh was a housewife and not involved in her husband's business affairs. As part of his bankruptcy proceeding Mr. Kroh reached a settlement with the IRS for the joint return years in question that was approved by the bankruptcy court, as all compromises

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with creditors must be. Although they were still married, Mrs. Kroh had not filed a petition in bankruptcy with him.

The issue of Mrs. Kroh's continuing liability for the amounts not collected from Mr. Kroh came up on a motion for a partial summary judgment. The Tax Court held that "nothing arising out of Mr. Kroh's bankruptcy case precludes respondent [IRS] in these cases from litigating the correctness of petitioner's tax deficiencies and additions to tax." The Tax Court rejected the alternative defenses put forward by Mrs. Kroh of res judicata, collateral estoppel and privity with her husband. There was a strong dissenting opinion.

Consider filing a proof of claim for indemnification.

The lesson of *Kroh* is harsh but clear. The IRS can and will pursue a spouse or former spouse for joint and several liability even after settling with the other spouse in a bankruptcy proceeding. It is even possible that a settlement with the debtor spouse, having drawn the attention of the IRS to the case, will increase rather than reduce the likelihood of an assessment against the non-debtor spouse. Further, with the intervention of the bankruptcy proceeding, any indemnification or hold harmless agreement, which is the normal protection for the supported spouse concerned about joint and several tax liability, is not likely to be enforceable. Thus the non-debtor spouse or former spouse can find herself with a significant tax liability to pay after her former husband's bankruptcy. This result is hardly a fresh start for the non-debtor spouse. Indeed it may be ruinous.

How to Avoid Liability

What can a non-debtor spouse do to avoid the *Kroh* outcome?

Refraining from filing a joint return with a financially troubled spouse would be an excellent solution, but obviously is not one that is available after the return for the year has been filed. (Moreover, in community property states filing separately is not enough. The spouses must take steps to dissolve their marital community.) Timing is a problem in taking this approach also. Arguably the greater risk for the non-debtor spouse arises in the period more than three years prior to the commencement of the case when the financial problems of the debtor spouse may have been less apparent.¹

Assuming that a joint filing was made and that the settlement did include a hold harmless provision for joint and several tax liability, the non-debtor spouse should consider filing a proof claim for the indemnification. Whether such a provision would be treated as support

and be exempt from discharge or as an executory contract is not clear. The courts have very broad discretion on this point. Where the intention to indemnify the non-debtor spouse for tax liability is well documented, the former spouse has been successful in some cases.²

"Innocent Spouse" Defense

The "innocent spouse" defense to joint and several liability is another possible approach. IRC sections 6103(e) and 66 create a narrow safe harbor for a non-debtor spouse who did not herself earn or create the income in question. But these provisions include so many arbitrarily objective and subtly subjective requirements for exemption from joint and several liability or community property liability that very few spouses can prevail on this basis. Nonetheless, it may be useful to pursue such a defense. According to some commentators, certain types of spouses, in particular divorced women who were housewives in a traditional marriage, do seem to find the courts to be sympathetic.³

Joining in Bankruptcy Proceeding

But the harder question that *Kroh* poses is when a non-debtor spouse should consider filing in bankruptcy in order to have tax liabilities settled for her as well. The bankruptcy court is not compelled to consolidate the joint bankruptcy filing of even a married couple, 11 U.S.C. §320 (however, the court does). It is not clear how a divorced couple or even an estranged couple would fare even if it was clearly in the interests of both spouses to deal with their creditors in a single case. In addition to understanding the nature and extent of assets and liabilities, important questions to ask would be the extent of the homestead exemption, and the likelihood of an alimony or support arrangement for a non-debtor spouse qualifying for exemption from discharge. The existence of other non-dischargeable liabilities is also a factor in predicting how a fresh start could be obtained through a bankruptcy proceeding.

Participating in Bankruptcy Proceeding

Short of joining the bankruptcy proceeding, the non-debtor spouse may be able to demonstrate that the tax case itself cannot be properly considered without her participation. The difficulty with this approach lies with the bankruptcy court, whose jurisdiction is limited and ordinarily does not include disputes with third parties that do not include the debtor and his property. Thus, although this theoretical basis for including the non-debtor spouse in the tax portion of the proceeding is clearly there, it is rarely available.⁴ But, at the least, the non-debtor spouse would seem to have an interest in the substance of the tax case even if she could not join in the settlement, particularly if it involves the separate busi-

ness affairs of the debtor spouse. If discovery of material information outside her control is involved and leads to a stipulation of fact, she will be doubly disadvantaged if she cannot participate and her estranged spouse is not sympathetic to her position.

Another approach to consider, therefore, is including in the matrimonial settlement agreement a contractual right to notice and participation in the defense of joint return-year liabilities. It is difficult to see upon what basis the IRS could object to the presence of a taxpayer in an audit or settlement negotiation for a year for which she has liability. The trustee, however, might seek to disavow such an agreement as an executory contract and try to proceed with the IRS in its own settlement, knowing, as does the Commissioner, that with joint and several liability, the IRS has two bites at the apple, and may be able to recover the difference from the nondebtor spouse.

Include in the matrimonial settlement a contractual right to participate in defense of joint liabilities.

But query whether the domestic relations court might not be willing to assert joint jurisdiction with the bankruptcy court if its decrees are being ignored. In this connection a divorced or estranged spouse may have an advantage.⁵

NOTES

1. This is because claims for the tax years within three years prior to the filing of the petition are priority tax claims and will not be discharged. Hence it is more likely that the debtor spouse would be left with these tax liabilities after the proceeding and that his plan may have included provision to pay these tax debts over time. See 11 U.S.C. section 1129(a)(9)(C).
2. Compare *In re Welborn*, 126 Bankr. 948 (E.D. Va. 1991), with *In re Szuch*, 117 Bankr. 296 (N.D. Ohio 1990).
3. See, Beck, "The Innocent Spouse Problem: Joint and Several Liability Should Be Repealed," 43 *Vand.L.Rev.* 317 (1990).
4. See *Richmond v. United States*, 456 F.2d 458 (3rd Cir. 1972) (wife's joint and several tax liability not determined in bankruptcy proceeding despite her consent to referee's determination of ownership of assets that were subject to government jeopardy assessment but over which she had a claim).
5. See *Hagaman*, 60 TCM 1525 (1990), where bankruptcy court stayed and then lifted stay on Tax Court proceedings to permit wife to litigate question of her liability.