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Innocence in the Eyes of the Internal Revenue Service

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INNOCENCE IN THE EYES OF THE INTERNAL REVENUE SERVICE

By

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ABSTRACT

The filing of a joint return by a married couple usually results in overall tax savings. The downside of filing jointly, however, is that the parties to the joint return are together, and individually, responsible for the accuracy of the return, for the full tax liability, and for any interest or penalty relating to the return. This so-called *joint and several liability* extends not only to the tax shown on the return, but also to any tax that should have been but was not reported on the return. Consequently, each spouse becomes responsible for the tax infractions of the other. Because the joint and several liability rule was found to be overly harsh, since 1971, the tax law has contained a provision under which a spouse could seek relief from liability if he or she met the definition of an *innocent spouse*. As it turned out, however, the requirements that had to be met in order to obtain innocent spouse relief were very stringent and failed to protect spouses, in most cases the wife or ex-wife, where fairness dictated that relief was warranted. Accordingly, in 1998, Congress significantly liberalized the rules for obtaining innocent spouse relief by enacting a new section of the Internal Revenue Code and expunging the prior provisions. This paper analyzes the new Code section and also analyzes a recent Revenue Procedure, issued in 2000, that details the requirements for obtaining innocent spouse relief under one of the provisions of the new law, namely, equitable relief.

I. INTRODUCTION

It is common knowledge that the standard of proof for conviction of a crime is guilt beyond a reasonable doubt, and that anyone charged with a crime is presumed innocent. Moreover, the burden of proving such guilt rests on the government, and those indicted are not required to testify. When the government charges a person with an understatement of tax, however, the presumption is generally just the opposite. In most tax controversies, it is assumed that the government is correct. In other words, the taxpayer is presumed *guilty* of owing additional taxes where the government alleges so, and the taxpayer generally has the burden of proving otherwise.[1] Accordingly, where a tax deficiency imposed by the Internal Revenue Service ("IRS") is litigated, the taxpayer cannot simply hunker down as in a criminal case and, in effect, declare to the government *go prove it*.[2]

The good news is that, in most cases, filing a joint return saves taxes for a married couple. The bad news is that the signatories to a joint return are jointly and severally liable for the accuracy of the return, for the full tax liability, and for any interest or penalty relating to the return.[3] Such liability extends not only to the tax shown on the return that was filed, but also to any tax that should have been but was not reported on the return. Because of the presumption of correctness that applies to understatements of tax asserted by the government, a spouse signing a joint return is placed in a particularly difficult position. Basically, each spouse becomes responsible for the tax transgressions of the other. Here, the marriage vow *for better or for worse* is apropos. Joint responsibility is applicable regardless of which spouse is responsible for income omitted or for false or exaggerated deductions taken, and notwithstanding the fact that one spouse may be less informed about the contents of the return.[4]

A review of the numerous litigated cases involving joint liability reveals that it is usually the wife (or ex-wife as the case may be), for whom signing jointly was in retrospect a mistake. Most often, the husband assumes control over the couple's financial decision-making and preparation of their tax return. In numerous situations, the wife signs the return blindly or with only a cursory review. Unfortunately, the day of reckoning frequently occurs after a separation or divorce, which is often caused by the husband's misfortune, financial or otherwise. Although the husband is equally responsible for any understatement of tax, he may be deceased, financially destitute, or have left town and therefore be difficult for the IRS to find. Consequently, the wife becomes the easier source of collection and ends up being assessed by the IRS for the entire understatement of tax, plus interest and penalties. Although a possible escape route is for the wife to file for bankruptcy, she may have too much income or assets to qualify for bankruptcy protection, or she may not meet the requirement that the tax obligation be more than three years old.[5] In order to avoid being responsible for the tax sins of the other spouse, one could file as a *married person filing separately*. Although filing this way is generally more costly, it may be advisable where one

spouse is aware of the dishonesty of the other spouse, and especially where there is marital strife and separation or divorce is in the winds.

Because of the perceived unfairness in certain cases of the joint and several liability rule when a joint return is filed, the Internal Revenue Code has long contained the possibility of relief for someone who met the standard of being an *innocent spouse*.[6] Numerous horror stories began to surface, however, concerning how the existing rules provided inadequate protection to spouses in situations where fairness dictated that there should be relief from joint and several liability. Consequently, Congress recognized that the existing rules should be softened.[7] As the rules stood, innocent spouse relief was available only in the most egregious cases where the understatement of tax was large and the tax position taken was *grossly* erroneous. Accordingly, in 1998, Congress enacted a new section of the Internal Revenue Code that makes innocent spouse relief easier to obtain, and expunged the prior innocent spouse rules.[8] The new law is effective for any tax liability arising after its effective date: July 22, 1998. The purpose of this article is to explicate the new rules. Accordingly, the old rules will be referred to only where deemed appropriate for purposes of contrast.[9]

It was reported in the New York Times that the IRS expected 3,000 claims for relief after enactment of the new law, but instead has received over 45,000 claims, with hundreds more being received each week. More than 90% of the new claims are from women. Apparently, many divorce lawyers are routinely filing innocent spouse relief claims along with the filing of divorce papers as a means of protecting their client or as a bargaining chip against a spouse in danger of an audit. Because it has been inundated with so many claims, the IRS reportedly has assigned 500 auditors to deal with the situation, which is more than 3% of its auditing force.[10]

To provide guidance to taxpayers on how to seek relief under certain provisions of the new law, specifically those dealing with equitable relief, the IRS issued a new revenue procedure in January of 2000.[11] This article will also consider this new procedure.

II. STATUTORY ANALYSIS

The new law allows general relief from liability for all joint filers if certain conditions, which are enumerated below, are met. In addition to seeking general relief, joint filers who are divorced, widowed, legally separated, or not living together may choose to limit their liability under a new allocation procedure that operates as if *separate returns* had been filed. The option of limiting liability may be sought in tandem with a request for general relief where the granting of general relief is uncertain, which most often will be the case. Where general relief seems clearly unavailable, a joint filer who qualifies may proceed only under the option of limiting liability. If a joint filer does not meet the requirements for general or limited relief, there is a backup method under which the IRS may grant relief if it

is *inequitable* to hold the individual liable. As just mentioned, a new revenue procedure provides guidance on seeking equitable relief. A request to be relieved from liability under any of the foregoing procedures must be made within a certain time limit, as explained below. Finally, a joint filer is given permission to petition the United States Tax Court, and the Court is given jurisdiction to determine appropriate relief where the joint filer's election for innocent spouse relief is denied by the IRS.

A. RELIEF APPLICABLE TO ALL JOINT FILERS

The basic conditions that must be met for general relief from liability are that:

(i) a joint return has been made for the taxable year,
(ii) there is an understatement[12] of tax attributable to an erroneous item of one of the parties to the return,[13]
(iii) the party seeking relief demonstrates that when the return was signed, she[14] did not know, and had no reason to know, of such understatement,
(iv) under all the facts and circumstances, it would be inequitable to hold the party seeking relief liable for the tax attributable to such understatement, and
(v) the party seeking relief *elects* the benefits of the new law within a certain time limit.[15] The procedure for electing relief will be discussed later in this article.

If all of the foregoing requirements are met, the person seeking relief will be completely relieved of liability for tax (including interest, penalties and other amounts) to the extent the liability is attributable to the understatement of tax on account of the erroneous item.[16]

1. Time Limits

Relief must be sought within two years after the IRS has begun collection efforts.[17] In this regard, the two-year period first begins when the IRS gives the spouse notice that it will attempt to collect the joint liability from her.[18] For example, a wage garnishment or notice of intent to levy against the property of a spouse would constitute collection efforts. However, the mailing of a notice of deficiency and demand for payment to the last known address of a spouse, addressed to both spouses, would not constitute a collection effort.[19] The implication, however, is that a mailing of a notice of intent to levy to a spouse at her last known address would constitute proper notice of collection. Accordingly, in divorce or separation situations, practitioners should consider advising a client to file a protective election for relief, especially where there is suspicion that the client's spouse has been cheating on the couple's tax return. As noted, the election must be filed within two years of notice of collection efforts. A potential pitfall is that a collection notice will not be received within the requisite two-year

period where a spouse has moved from the last known address recorded by the IRS.

The IRS has made available Form 8857, Request for Innocent Spouse Relief, together with instructions, to facilitate requests for relief. This form should be filed when a taxpayer becomes aware of a tax liability that she believes is the obligation of her spouse (or ex-spouse). Awareness of a joint liability may arise upon examination of a return or upon the receipt of a notice from the IRS. In any event, the spouse requesting relief should file the form no later than two years after the first attempt by the IRS to collect the tax from her. The form should be accompanied by a statement detailing the reasons why the taxpayer feels she qualifies for relief, using the best information available to her.[20] Care should be taken to properly complete Form 8857 since the IRS has noted that between March of 1999 and March of 2000, it could not timely process approximately 21% of such forms due to taxpayer errors or omissions.[21]

2. Joint Return Determination

Whether a joint return has been filed depends on the intent of the parties. Clearly, the act of signing must be voluntary. Thus, a spouse who signs a joint return under duress may be relieved of liability for any understatement of tax. For example, a signature ordered by a divorce court has been held to be involuntary,[22] as well as one signed to accommodate the wishes of a dying spouse.[23] Whether there is sufficient duress to obviate a joint return depends on the particular facts and circumstances, and there are a number of litigated cases concerning this issue. Moreover, the failure of one spouse to sign the return does not rule out the existence of a joint return, especially where the non-signing spouse does not object to the filing of the return and does not file a separate return. Thus, if a husband, for example, signs his wife's name, she would have the burden of proving that her signature was unauthorized. If joint returns had been filed in the past, this would tend to show that a joint return was intended.[24] If it can be shown that a joint return was filed under sufficient duress, the spouse so signing is not subject to joint and several liability, and the innocent spouse rules have no applicability.

3. Apportionment of Relief

Under prior law, it was unclear whether a court could grant partial innocent spouse relief where, for instance, the spouse knew some of the gory details of her husband's tax chicanery, but not all of them. The Ninth Circuit Court of Appeals allowed partial relief where the spouse did not know, and had no reason to know, the magnitude of the understatement, even though the spouse may have known of some understatement.[25] The new law adopts the underlying rationale of this case. Consequently, if a joint filer knew or had reason to know of an understatement, but did not know or had no reason to know of its full extent, she may be relieved of liability on an apportioned basis – i.e., to the extent the liability is attributable

to that part of the understatement of which she did not know and had no reason to know.[26] For example, when a wife signs a joint return she may be aware that her husband omitted a certain amount of income, but did not know and had no reason to know of other income omissions. Accordingly, she may be relieved of liability for additional taxes to the extent the additional taxes are attributable to omitted income of which she had no knowledge and had no reason to know about.

4. Knowledge

The language *did not know, and had no reason to know* has been carried forward from the prior innocent spouse rules. Under the prior rules, the most heavily litigated of the elements that a spouse seeking innocent spouse relief had to prove, and the most judicially unsettled, was the requirement that when she signed the return she did not know and had no reason to know of the understatement. Since the new law carries over verbatim the same standard of knowledge, the case law dealing with this aspect of innocent spouse relief should still have value as precedent. Under prior law, the courts uniformly held that mere knowledge of the underlying transaction that produced *omitted income* was sufficient to deny innocent spouse relief.[27] However, the courts had split on whether mere knowledge of the underlying transaction was sufficient to deny innocent spouse relief for *deduction*, *credit* or *tax basis* items.[28] Where actual knowledge was not evident, the general rule, which was difficult in application, was whether under the particular facts and circumstances a *reasonably prudent* taxpayer should have deduced that her spouse had been cheating.[29]

Quite often the result turned on the sophistication and financial acumen of the spouse seeking relief. For example, a spouse who was a housewife and unemployed former secretary with a high school education "possessing only a rudimentary grasp of the simplest tax principles," and who did not participate in her husband's affairs, was granted relief.[30] On the contrary, a highly paid, college educated spouse, a vice president of a national retailer, as well as a joint investor with her husband, was denied relief *as a matter of law,* although she may not have specifically understood the tax consequences of her husband's tax shelter investments.[31]

B. RELIEF FOR TAXPAYERS DIVORCED, WIDOWED, SEPARATED, OR LIVING APART

In addition to an election to seek general relief, or as an alternative thereto, a joint filer who meets prescribed conditions, as enumerated below, may *elect* to limit liability for an understatement of tax to the portion of the understatement allocable to such electing individual.[32] However, the individual seeking such relief has the burden of proving the amount of the understatement allocable to her.[33] The possibility of electing to limit liability did not exist under the old law. If the conditions to limit liability are not met, apportioned liability may still be possible as discussed under part II.A.3. of this article, above.

In general, if the conditions to limit liability are met, items are to be allocated between spouses as if they had filed *separate returns*.[34] When separate returns are filed, items of income are apportioned based on the source of the income. Business and investment income (including capital gains) are allocated based on each spouse's proportionate ownership of the business and investments. If the business or investments are owned equally, the income therefrom will generally be allocated equally unless there is *clear and convincing* evidence to support a different allocation.[35] Business deductions are expected to follow the ownership of the business, and personal deductions will be allocated equally unless it is shown that a different allocation is appropriate.[36] For example, a charitable deduction that would normally be allocated equally may be allocated to the husband if is clearly shown that the property donated was his separate property. Thus, any deficiency assessed on account of a valuation overstatement would be allocated entirely to the husband.[37] Income tax withholding is allocated to the spouse from whom it is withheld and estimated tax payments are to be allocated to the spouse who made the payments. If the estimated payments are made jointly, then an equal allocation is the rule, in the absence of evidence supporting a different allocation.[38] Although items are generally to be allocated according to the rules of allocation where separate returns are filed by a married couple, the IRS may provide for some other method of allocation where it can show that another method is appropriate due to the *fraud* of one or both of the spouses.[39] Also, the IRS is granted authority to issue regulations providing for methods of allocation.[40]

The key conditions that must be met in order to secure relief under the election to limit liability are:

(i) at the time of the election, the individual seeking relief is no longer married to, or is legally separated from the person who was the co-signatory on the return,[41] or

(ii) the individual was not a member of the same household as the co-signatory on the return at any time during the 12-month period preceding the filing of the election.

The provision to limit liability would come into play where, for example, the tax deficiency related to unreported income of the husband and the couple were divorced, legally separated, had lived apart for 12 months, or the husband was deceased. In such case, the deficiency would be the sole responsibility of the husband or ex-husband (or his estate). If, on the other hand, the deficiency relates to items of both spouses, the deficiency is allocated between them.

<u>Example</u>: A deficiency is assessed against both spouses on account of $70,000 unreported income of the husband and a disallowance of $30,000 of miscellaneous deductions allocable to the wife. If no longer married, separated,

or living apart, either may elect limited liability. Liability to an electing party would be limited to 70% of the deficiency in the case of the husband and 30% in the case of the wife. This would be the result even if some of the miscellaneous deductions had been disallowed under the 2% offset rule. Limited liability is available only if a proper election is filed. A failure to make an election means that a spouse is liable for the full deficiency.[42]

If a deficiency arises due to the disallowance of a deduction or a credit, the amount of a tax deficiency allocable to a spouse is limited to the amount of income allocated to the spouse that was offset by the deduction, or to the amount of tax allocated to the spouse that was offset by the credit.

Example: On a joint return, the husband has wage income of $100,000 and the wife has self-employment income of $30,000. A deduction of $20,000 allocable to the husband is disallowed, resulting in a tax deficiency of $5,600. Since the deficiency is attributable solely to the husband, and he has sufficient income to offset the disallowed deduction, he is responsible for the entire deficiency. The wife has no liability regardless of the ability of the IRS to collect from the husband.

However, if the husband had income of only $15,000, there would be insufficient income to absorb the $20,000 disallowed. Here, the shortfall of $5,000 would be deemed to have offset income of the wife. Accordingly, the deficiency of $5,600 would be allocated ¾ to the husband, or $4,200 ($15,000/$20,000 x $5,600) and ¼ to the wife, or $1,400 ($5,000/$20,000 x $5,600).[43]

If a deficiency is attributable to the disallowance of a credit against the tax, or is attributable to any tax other than the income tax or alternative minimum tax, the deficiency attributable to such credit or other tax is considered first.[44]

Example: There is an overall tax deficiency of $10,000, consisting of $2,800 of self-employment tax and $7,200 of income tax. The income tax deficiency is attributable to $20,000 of self-employment income unreported by the husband and a disallowed itemized deduction of $5,000 allocable to the wife. The $2,800 of self-employment tax is first allocated to the husband. The $7,200 of income tax deficiency is allocated 80% ($20,000/$25,000) to the husband and 20% ($5,000/$25,000) to the wife.[45]

The right to limit liability as if separate returns were filed is available only where there is a *tax deficiency* -- that is, where the IRS claims that additional taxes are owed.[46] Consequently, this option is not available to obtain a refund of amounts already paid.[47] Moreover, the option to limit liability is not available where there is a tax shown on the return, but has not been paid since technically the amount shown as owed is not a deficiency. In this case, however, there is the

possibility of equitable relief in an appropriate situation. The possibility of equitable relief is discussed later in this article.

1. Time for Making Election

An election to limit liability must be made in a timely manner. In this regard, the election must be made within the same time frame that is imposed for an election to request complete relief – i.e., within two years after the IRS has begun collection efforts against the person seeking relief.[48] As previously noted, a protective election should be considered where there is a matrimonial dispute, and Form 8857 is available to facilitate an election.

2. Actual Knowledge of Falsification Prevents Election

Congress was concerned, however, that some persons might attempt to use the election to limit liability inappropriately. Accordingly, the new law contains a provision that denies limited liability relief to an individual so seeking it who, at the time of the signing of the return, had *actual knowledge* of any item giving rise to a deficiency (or a portion thereof) that was not allocable to such individual. Here the burden of proving actual knowledge is placed on the IRS.[49] This should be contrasted with the standard, *did not know, and had no reason to know*, where the burden of proving is placed on the taxpayer. Apparently, the government was unwilling to let a spouse elect to limit liability where that spouse actually knew of the falsifications of the other spouse when she signed the return. However, the proof submitted by the government would apparently have to be substantial, since actual knowledge is *not to be inferred* based on indications that the electing spouse had a reason to know.[50]

<u>Example</u>: A joint return is filed reflecting wage income of $150,000 allocable to the wife and $30,000 of self-employment income allocable to the husband. The IRS assesses a deficiency based upon $20,000 of unreported self-employment income of the husband resulting in a tax deficiency of $9,000. The IRS clearly proves that the wife knew of $5,000 of the husband's unreported income, but is unable to prove that she knew of the remaining $15,000. Here, the husband would, of course, be responsible for the entire tax deficiency. The wife would be responsible only for a deficiency based upon $5,000 of unreported income. The IRS thus could collect the deficiency based upon $5,000 from either spouse, but could collect the remainder of the deficiency only from the husband.[51]

3. Signing Under Duress with Actual Knowledge

Although a joint return is signed with actual knowledge of an understatement (or a portion thereof), the joint filer with such actual knowledge may nevertheless elect to limit liability if she can establish that the return was signed under duress.[52] Apparently, there was testimony before Congress that some spouses signed tax returns under duress, including physical duress.[53] However, joint filers

that still want to secure the benefits of limited liability on the basis that they were coerced into signing have the burden of proving the circumstances of the coercion.[54]

4. Transfers of Property to Avoid Tax

Congress was also concerned that the election to limit liability might in certain cases be inappropriately used. Accordingly, the new law contains provisions that come into play where a *disqualified asset*is transferred with a principal purpose to avoid tax or the payment of tax.[55] If such a transfer takes place, the portion of the tax deficiency for which an electing spouse would otherwise be responsible is increased by the value of the disqualified asset transferred to that spouse.[56] A disqualified asset is basically defined as any property or right to property where the principal purpose of its transfer is tax avoidance.[57] In this regard, there is a refutable presumption of tax avoidance where property is transferred within the one-year period preceding the date the IRS sends a proposed notice of deficiency notifying the taxpayer of his or her rights to administrative review by the IRS Office of Appeals.[58] This presumption against the taxpayer will not apply, however, to a transfer made within the foregoing one-year period where the transfer is pursuant to a court decree of divorce or maintenance, or a written instrument (e.g., a marital agreement) incident to such decree. Also, the presumption may be rebutted if the taxpayer electing to limit liability can demonstrate that the transfer did not have tax avoidance as its principal purpose.[59]

5. Other Restrictions on Election to Apportion Liability

An item otherwise allocable to a spouse under separate return allocation concepts is required to be allocated to the other spouse filing the joint return, to the extent the item gave rise to a tax benefit on the joint return to such other spouse.[60] Also, if an item is disallowed in its entirety solely because a separate return is filed, the disallowed item is disregarded and the item must be computed as if a joint return had been filed and then allocated between the spouses accordingly.[61] A similar rule is to apply for purposes of computing taxable social security.[62] Consequently, a base amount and an adjusted base amount will be allowed in the determination of the taxable portion of the social security without regard to the rule restricting the base amount for married taxpayers filing separately.[63] Finally, a child's tax liability included on a joint return is disregarded in computing separate liability, and is then to be allocated appropriately between the spouses.[64]

III. NOTICE REQUIREMENTS

Congress wanted to assure that taxpayers filing joint returns are properly notified of their rights to elect relief under the new law. Accordingly, notice is to appear in IRS Publication 1, dealing with taxpayer rights, and in collection-related notices sent to taxpayers.[65] Also, wherever practicable, the IRS is required to

send any notice relating to a joint return separately to each individual filing the joint return.[66] Further, the Tax Court is to establish rules that provide the individual filing a joint return but not electing to seek relief under the new law with adequate notice and an opportunity to become a party to the Tax Court proceeding.[67] Finally, the IRS is required to issue regulations providing for an individual who has filed a joint return to have notice of, and an opportunity to participate in, any administrative proceeding with respect to an election to seek innocent spouse relief by the other individual filing the joint return.[68]

IV. TAX COURT REVIEW

If the IRS denies an individual's request for general relief or a request to limit liability, the individual is given the right to petition the Tax Court to determine the appropriate relief available to the individual.[69]

A. FILING THE PETITION

A petition to the Tax Court must be made within a 90-day period beginning when the IRS mails, by certified or registered mail, a notice to such individual of the IRS's determination of the relief available to the individual, if any. However, an individual may file the petition at any time within 6 months after filing an election seeking relief and before the close of the aforementioned 90-day period.[70] Accordingly, the taxpayer need not wait until receiving a determination from the IRS, and can petition the Tax Court immediately after filing an election seeking relief. As noted, an election seeking relief is made on Form 8857.

B. COLLECTION ACTIVITIES SUSPENDED

Apart from situations where a taxpayer is about to leave the United States, remove assets therefrom, about to conceal herself or her property, or collecting the tax would be jeopardized by delay,[71] the IRS is prohibited from levying or proceeding in court to collect any assessment until the expiration of the 90-day period, or if a petition has been filed with the Tax Court, until a decision of the Tax Court has become final. However, the IRS may require a bond to stay collection.[72]

C. ENJOINDER OF COLLECTION ACTIVITIES

Despite restrictions on lawsuits initiated to obtain a restraining order against the IRS on assessment or collection,[73] where the IRS attempts collection activities within the restricted time period just noted, a proceeding to enjoin collection activities against the IRS may be brought in any proper court, including the Tax Court. However, the Tax Court is given jurisdiction to enjoin collection only where a petition to the Court has been timely filed, and then only to the extent of the amount of the assessment with respect to which the taxpayer is seeking innocent spouse relief.[74]

D. SUSPENSION OF STATUTE OF LIMITATIONS

During the period of time the IRS is prohibited from collecting by levy or by court proceeding, as a result of the filing of a petition in Tax Court, the statute of limitations on collection of an assessment is suspended, and for 60 days thereafter.

E. REFUNDS CAN BE ORDERED BY TAX COURT

The Tax Court is a forum to get a hearing without first paying additional taxes assessed by the IRS. Consequently, a taxpayer seeking a refund of taxes already paid had to proceed in a United States District Court or the United States Court of Federal Claims. Now, however, with certain exceptions, the Tax Court is authorized to grant refunds to the extent applicable to the new innocent spouse rules.[75]

F. RES JUDICATA

A taxpayer may have participated in a Tax Court proceeding with respect to a particular taxable year, but made no claim for innocent spouse relief. If that is the case, the taxpayer cannot come back into Tax Court and attempt to adjudicate the issues all over again under the pretext of now seeking innocent spouse relief. The decision of the Tax Court will be conclusive as to matters determined, except with respect to the qualification of such taxpayer for innocent spouse relief that was not at issue in the prior proceeding. Nevertheless, a spouse will be precluded from seeking innocent spouse relief in a Tax Court proceeding if she participated *meaningfully* in a prior Tax Court proceeding, even if no claim for innocent spouse relief was raised in the prior proceeding.[76]

G. TRANSFER OF JURISDICTION

If a suit for refund is initiated by either party filing a joint return, the Tax Court loses jurisdiction to the extent jurisdiction is acquired by a District Court or the United States Court of Federal Claims over the taxable years that are the subject of the suit for refund. The court acquiring jurisdiction will then have jurisdiction over the petition filed in Tax Court seeking innocent spouse relief. Accordingly, the court in which the refund claim is filed would then determine whether a spouse is entitled to innocent spouse relief in considering the refund claim.

V. EQUITABLE RELIEF

By the terms of the new law, in order to qualify for relief under both the general relief and limited liability provisions, there must be either a proposed or assessed *deficiency* – i.e. an understatement of tax. Accordingly, relief under these provisions is not available where the tax return was correct and showed an

amount as owing, but such amount had not been paid. The reason is that the failure to pay a tax liability that is accurately reported on a return is technically not an understatement of tax. In order to cover this situation, and possibly other situations where relief is not available under either the general relief or limited liability provisions, Congress gave the IRS authority to relieve a taxpayer of liability for *any unpaid tax* or *any deficiency*, or any portion of either, and the taxpayer is able to demonstrate that, under all of the facts and circumstances, it would be *inequitable*to hold her liable. [77]

According to the Conference Report on the new law, equitable relief should be "available to a spouse that does not know, and had no reason to know, that funds intended for the payment of tax were instead taken by the other spouse for such other spouse's benefit." The Conference Report goes on to provide that the IRS use its authority to grant equitable relief "where, taking into account all the facts and circumstances, it is inequitable to hold an individual liable for all or a part of any unpaid tax or deficiency arising from a joint return. The conferees intend that relief be available where there is both an understatement and an underpayment of tax."[78] Equitable relief may be granted only by the IRS since the Tax Court is given authority to review only denials of general relief or limited liability relief.[79] However, in a recent case, the Tax Court concluded that it had jurisdiction to review a request for equitable relief where the taxpayer made the required election and timely filed a petition with the Tax Court. The Tax Court rejected the IRS's argument that the court lacked jurisdiction to grant equitable relief "because the granting of equitable relief is discretionary."[80]

Since the requirements that must be met for obtaining equitable relief were not clear, the IRS issued some interim guidance shortly after enactment of the new law.[81] The interim rules have now been superseded by a permanent revenue procedure. The new revenue procedure sets forth (i) general eligibility rules that must be met for equitable relief, (ii) circumstances under which equitable relief will *ordinarily* be granted (only available for taxes shown on a return and unpaid), and (iii) circumstances under which general relief will be granted where the taxpayer does not qualify under clause ii, and where under all the facts and circumstances it would be inequitable to hold the taxpayer responsible. This clause covers both unpaid liability shown on return and a deficiency. However, equitable relief is available for a deficiency only if the taxpayer does not qualify for general or limited liability relief. This possibility, which is extremely limited, will be further explained below.

A. GENERAL ELIGIBILITY RULES

The threshold conditions that must all be met for equitable relief are:

1. A joint return was filed for the taxable year by the party seeking relief with respect to such year,
2. Neither general relief nor limited liability relief is available,

3. Relief is applied for within two years after the IRS's first collection efforts after July 22, 1998,
4. The liability remains unpaid (apparently, this includes both an unpaid amount shown on a return and an understatement of tax),
5. There was no fraudulent transfer of assets between the spouses signing the joint return,
6. There were no disqualified assets transferred to the spouse requesting relief by the spouse not requesting relief (if such assets were transferred, equitable relief is available only to the extent that the liability exceeds the value of the disqualified assets), and
7. The requesting spouse did not file the return with fraudulent intent.

B. CONDITIONS UNDER WHICH EQUITABLE RELIEF WILL ORDINARILY BE GIVEN

This option is available only where a liability reported on a joint return is unpaid. According to the revenue procedure, relief will *ordinarily* be granted if *all* of the following conditions are met:

1. At the time equitable relief is requested, the spouse asking for relief is no longer married to, is legally separated from, or has not been a member of the same household as the spouse not requesting relief at any time during the 12-month period preceding the date relief was requested.
2. At the time the return was signed, the spouse asking for relief had no knowledge or reason to know that the tax shown as due on the return would not be paid. In this regard, the taxpayer asking for relief must establish that it was reasonable for her to believe that her spouse would pay the reported liability. Partial relief is possible where the requesting spouse can only establish that she had no knowledge or reason to know that the her spouse would pay only part of the reported liability.
3. The spouse asking for relief can show that she will suffer economic hardship if relief is not granted.[82]

Relief under this provision is subject to certain limitations: (a) If the return has been adjusted to reflect an understatement, relief will be available only to the extent of the liability shown on the return prior to adjustment, and (b) relief will only be available to the extent the unpaid liability is allocable to the spouse not requesting relief.

C. OTHER CIRCUMSTANCES WHERE EQUITABLE RELIEF MAY BE GRANTED

A spouse may not meet the requirements where relief would ordinarily be given. She may not, for example, fit the profile of being divorced, legally separated, or living apart from her husband, or there is an understatement of tax (deficiency). As noted, relief would ordinarily be given only where there is a liability reported on a return that is unpaid. Nevertheless, equitable relief may be available, if based upon all the facts and circumstances, it would be inequitable to hold the requesting spouse liable for all or a part of the unpaid liability or deficiency. Here, the revenue procedure presents a list of positive and negative factors that the IRS will take into account, and weigh, in determining whether full or partial equitable relief should be granted. No single factor is determinative and the factors listed are not necessarily all that the IRS will consider.

Factors weighing in favor of relief are:

1. The requesting spouse is divorced, legally separated, or living apart from the non-requesting spouse.
2. The requesting spouse would suffer economic hardship if relief is not granted.
3. The requesting spouse was abused by the non-requesting spouse, but not sufficiently for the abuse to amount to duress. If the abuse is so severe as to amount to duress, a joint return will not be considered as filed.
4. The requesting spouse did not know and had no reason to know that the liability reported on the return would not be paid, and in the case of a deficiency, did not know and had no reason to know of the items giving rise to the deficiency.
5. The non-requesting spouse had a legal obligation, pursuant to a divorce decree or marital agreement, to pay the outstanding obligation. However, this factor will not be considered if the requesting spouse knew at the time the decree was entered or the marital agreement signed that the amount would not be paid.
6. The liability from which relief is requested was solely attributable to the non-requesting spouse.

Factors weighing against relief are:

1. The unpaid liability or item that gave rise to the deficiency is attributable to the requesting spouse.
2. The requesting spouse knew or had reason to know of the item giving rise to the deficiency, or that the reported liability would be unpaid at the time she signed the return. According to the revenue procedure, this is an *extremely strong factor* weighing against relief. However, it may be appropriate in *limited situations* to grant relief where the

requesting spouse knew or had reason to know that the liability would not be paid, and in *very limited situations* where the requesting spouse knew or had reason to know of an item giving rise to a deficiency. The requesting spouse has benefited, beyond normal support, from the unpaid liability or items giving rise to the deficiency.[83]

3. The requesting spouse will not suffer economic hardship if relief is not granted.
4. The requesting spouse has not made a good faith effort to comply with the tax laws for years following the year or years for which relief is requested.
5. The requesting spouse has a legal obligation to pay the liability pursuant to a divorce decree or martial agreement.

A spouse does not qualify for general relief if she knew or had reason to know of an understatement at the time she signed the return. Also, if a spouse had *actual knowledge* of an understatement at the time she signed the return, she does not qualify to limit liability. The failure to qualify under either of those two provisions, however, opens the door to equitable relief under very limited circumstances. For example, if a spouse in fact knows of falsifications, but is abused, it seems possible that she might have an escape hatch under the equitable relief provision. Also, under the same rationale, an abused spouse who knew that a liability shown on a return would not be paid may qualify for equitable relief. Other possible situations might include dementia or mental illness. In such cases, a person may know something, but otherwise may not have the cognizance to fully understand the implications.

A request for equitable relief must be filed in a timely manner and Form 8857 may be used for this purpose. If an individual has filed for general relief or to limit liability, and it is determined by the IRS that no relief or only partial relief is available, the IRS will consider whether equitable relief is available for the portion of the liability for which general or limited liability relief is not granted. A subsequent filing of another Form 8857 is not necessary. The new revenue procedure became effective on January 18, 2000.

VI. CONCLUSION

The prior rules for obtaining innocent spouse relief were quite complex. As can be seen, the new rules are also complex. However, the new rules are clearly more favorable to taxpayers. For instance, the possibility of limiting liability under a separate return concept is new, as is the possibility of apportioned liability. The new rules are less restrictive in numerous other respects and should grant relief in situations where relief was not available under the old law. As of the date of the writing of this article, no temporary or permanent regulations have been issued on the new law. Due to the complexity of the new law, and that a determination one way or the other will often revolve around the particular facts and circumstances, taxpayers seeking innocent spouse relief would be well advised to retain competent counsel. As the new law ages, and cases start to come down from the courts, practitioners will have more background material with which to advise clients. As is the case with any new law, it takes time for clarification and parameters to be established.

The new innocent spouse rules, and other pro-taxpayer rules, came about as a result of the considerable criticism leveled against the IRS in recent years. In this context, the IRS has been trying to change its image and has been advertising itself as new and friendlier. Hopefully, the IRS will be friendly in granting innocent spouse relief under the new rules, and especially in exercising its discretion in granting equitable relief. For those who have dealt with IRS collection personnel, however, a raised eyebrow is in order.

ENDNOTES

[1] Tax Court Rule 142 generally places the burden of proof on the taxpayer. An IRS notice of deficiency is presumptively correct and the burden is on the taxpayer to prove otherwise (Welch v. Helvering, 299 U.S. 111 (1933)). In addition to rebutting the presumption, the taxpayer must show the merits of his or her position by a preponderance of the evidence (Danville Plywood Corp. v Comm'r, 16 Cl. Ct. 584, 1989 U.S. Cl.Ct. LEXIS 47 (1989)).

[2] There are a number of Internal Revenue Code sections that expressly place the burden of proof on the government. Some examples, but not an all-inclusive listing, are fraud (I.R.C. §§ 7422(e) and 7454(a)), transferee liability (I.R.C. § 6902(a)), unreasonable accumulation of earnings and profits (I.R.C. § 534), disallowance of illegal bribes, kickbacks and other payments (I.R.C. §162(c)(1)), and income tax preparer's penalty (I.R.C. § 7427). All references herein to "I.R.C." are to the Internal Revenue Code of 1986, as amended. In addition, the IRS Restructuring and Reform Act of 1998 (Pub. L. 105-206, 112 Stat. 742) added a new section, I.R.C. § 7491, that shifts the burden of proof in court proceedings where an issue of fact is in dispute. The conditions that must be met in order to shift the burden of proof are quite technical and beyond the scope of this paper. The new code section may turn out to be of little or no advantage to taxpayers -- despite being billed by the government as a major pro-taxpayer advantage -- due to the tough standards that must be met to shift the burden of proof, the uncertainty of their application and additional costs that might be incurred.

[3] I.R.C. § 6013(d)(3) (2000).

[4] Sonnenborn v. Comm'r, 57 T.C. 373, 381 (1971).

[5] Federal bankruptcy law permits a discharge for federal, state or local taxes, if a return was filed, due more than three years before filing a bankruptcy petition, unless fraud or willful evasion is shown. 11 U.S.C. § 523(a)(7)(b) (2000). If a return is filed late, taxes more than three years old may be discharged provided the late return is filed more than two years before the filing of the bankruptcy petition. No discharge is permitted for any tax required to be collected or withheld. 11 U.S.C. §§ 523(a)(1)(A) & 507(a)(7)(C). *See also* United States v. Sotelo Et Ux, 436 U.S. 268 (1978).

[6] I.R.C. § 6013(e). This section was enacted in 1971 (Pub. L. No. 91-679, 84 Stat. 2063).

[7] According to testimony presented before Congress, innocent spouse relief was only "theoretically" available because it was extremely difficult for the standards for such relief to be met. "In fact there are some 50,000 women, generally ex-spouses, who are caught up in this 100-percent responsibility for a tax return." Senate Floor Debate for Amendment No. 2369 (144 CONG. REC. 56, S4473 (1998)).

[8] I.R.C. § 6015. Added by Internal Revenue Service Restructuring and Reform Act of 1998 (Pub. L. 105-206, 112 Stat. 742). The Act removed the prior code section dealing with innocent spouse relief, I.R.C. § 6013(e).

[9] For a detailed analysis of the prior rules, *see* Martin H. Zern, *The Innocent Spouse: Appeals Courts Endorse Pro-Taxpayer Standard*, Journal of Legal Studies in Business, Volume 5, Number 2 (1997).

[10] David Cay Johnston, *With Law Change, Innocent Spouse Claims Flood IRS,* New York Times, 12-29-99, p.1.

[11] Rev. Proc. 2000-15, 2000-5 I.R.B. 447, 2000 IRB LEXIS 17. The new procedure is effective on January 18, 2000 and supercedes Notice 98-61, 1998-51 I.R.B. 13 (1998).

[12] The new law defers to I.R.C. § 6662(d)(2)(A) for a definition of *understatement* (I.R.C. § 6015(b)(3)). The former section defines an *understatement* as the excess of the amount of the tax required to be shown on a return for the taxable year over the amount of the tax imposed which is shown on the return, reduced by any rebate (within the meaning of section 6211(b)(2)).

[13] Under the prior law, there was relief only if the understatement of tax was attributable to a *grossly* erroneous item. A grossly erroneous item was defined as *any* item of gross income of a spouse which was omitted from gross income, and any claim for a deduction, credit or tax basis by a spouse for which there is no basis in fact or law. The taxpayer seeking relief had the difficult burden of proving that the item had no basis in fact or law. Also there was a threshold that denied relief unless the understatement of tax exceeded the greater of $500 or a specified percentage of the innocent spouse's adjusted gross income for the most recent taxable year. The new law eliminates all of the thresholds and provides that the understatement be attributable only to an erroneous item, and not a grossly erroneous item. Thus, the taxpayer seeking relief no longer has to show that the deduction, etc., had no basis in fact or law.

[14] To avoid awkward references to *he or she* or *him or her*, pronoun references will be to *she* or *her* since it is predominantly the wife (or ex-wife) who is seeking innocent spouse relief.

[15] I.R.C. § 6015 (b)(1) (2000).

[16] The election applies to all unpaid taxes under subtitle A of the Internal Revenue Code including the income tax and the self-employment tax. S. REP. NO. 105-174, 105th Congress, 2d Sess. (1998).

[17] I.R.C. § 6015 (b)(1)(E) (2000).

[18] There is a transitional rule applicable where collection efforts began prior to the effective date of the new law (July 22, 1998). In such case, the two-year period does not expire until two years after collection efforts that have occurred after such effective date. H.R. CONF. REP. NO. 105-599, 105th Congress, 2d Sess. (1998).

[19] S. REP. NO. 105-174, 105th Congress, 2d Sess. (1998).

[20] *See* General Instructions to Form 8857.

[21] In a recent Electronic Dispatch, the IRS identified the most frequent reasons why it could not timely process 15,500 of the 73,777 Forms 8857 submitted to it between March of 1999 and March of 2000: (1) the collection statute of limitations has already expired, (2) the taxpayer was an "injured spouse" and should have filed Form 8379 (Injured Spouse Claim and Allocation) instead, (3) the requesting spouse did not file a joint federal tax return for the year relief was requested, (4) incomplete information was submitted and the requesting spouse did not respond to IRS requests for additional data, and (5) the year for which relief was requested was not properly identified.

[22] Anderson v. Commissioner, T.C. Memo. 1984-82 (1984).

[23] Hickey v. Commissioner, T.C. Memo. 1955-149 (1955).

[24] Evans v. Commissioner, T.C. Memo. 1982-700 (1982).

[25] Wiksell v. Commissioner, 90 F.3d 1459 (9th Cir. 1997).

[26] I.R.C. § 6015(b)(2) (2000).

[27] *See* Hayman v. Comm'r, 992 F.2d 1256 (2d Cir. 1993); Erdahl v. Comm'r, 930 F.2d 585 (8th Cir. 1991).

[28] *See* Stevens v. Comm'r, 872 F.2d 1499 (11th Cir. 1989) (pro government decision). *Cf* Price v. Comm'r, 887 F.2d 959 (9th Cir. 1989), Erdahl v. Comm'r, 930 F.2d 585 (8th Cir. 1991) and Friedman v. Comm'r, 53 F.3d 523 (2d Cir. 1995) (pro taxpayer decisions).

[29] Price v. Comm'r, 887 F.2d 959 (9th Cir. 1989).

[30] Friedman v. Comm'r, 53 F.3d 523 (2d Cir. 1995). *Also see* Erdahl v. Comm'r, 930 F.2d 585 (8th Cir. 1991).

[31] Hayman v. Comm'r, 992 F.2d 1256 (2d Cir. 1993).

[32] I.R.C. § 6015(c) (2000).

[33] I.R.C. § 6015(c)(2) (2000).

[34] I.R.C. § 6015(d)(3)(A) (2000).

[35] S. REP. NO. 105-174, 105th Congress, 2d Sess. (1998).

[36] *Id*.

[37] *Id*.

[38] *Id*.

[39] I.R.C. § 6015(d)(3)(C) (2000).

[40] I.R.C. § 6015(g)(1) (2000).

[41] A person is considered no longer married if widowed. H.R. CONF. REP. NO. 105-599, 105th Congress, 2d Sess. (1998).

[42] H.R. CONF. REP. NO. 105-599, 105th Congress, 2d Sess. (1998).

[43] *Id*.

[44] I.R.C. § 6015(d)(2) (2000).

[45] H.R. CONF. REP. NO. 105-599, 105th Congress, 2d Sess. (1998).

[46] I.R.C. § 6015(c)(1) (2000).

[47] *See* General Instructions to Form 8857.

[48] I.R.C. § 6015(c)(3)(B) (2000).
[49] I.R.C. § 6015(c)(3)(C) (2000).

[50] S. REP. NO. 105-174, 105th Congress, 2d Sess. (1998).

[51] *Id*.

[52] I.R.C. § 6015(c)(3)(C) (2000).

[53] Senate Floor Debate for Amendment No. 2369 (144 CONG. REC. 56, S4473 (1998)).

[54] *Id*.

[55] I.R.C. § 6015(c)(4) (2000).

[56] I.R.C. § 6015(c)(4)(A) (2000).

[57] I.R.C. § 6015(c)(4)(B)(i) (2000).

[58] I.R.C. § 6015(c)(4)(B)(ii)(I) (2000).

[59] I.R.C. § 6015(c)(4)(B)(ii)(II) (2000).

[60] I.R.C. § 6015(d)(3)(B) (2000). There was no example in the Congressional Committee Reports as to how this rule operates. An example, however, might be the recovery by a divorced spouse in a negligence action of medical expenses she incurred that were previously deducted on a joint return. Since her husband received an equal tax benefit by the deduction, the income to be picked up as a result of the recovery of the tax benefit arguably should be allocated partly to her ex-husband.

[61] For example, provisions requiring the filing of a joint return in order to claim a credit, such as the dependent care credit, credit for the elderly and permanently disabled, adoption credit, Hope and learning credit, and earned income credit would not apply in computing separate tax liability. The deduction for interest on an education loan would be an example of a rule disallowing a deduction that would not apply. S. REP. NO. 105-174, 105th Congress, 2d Sess. (1998).

[62] I.R.C. § 6015(d)(4) (2000).

[63] S. REP. NO. 105-174, 105th Congress, 2d Sess. (1998).

[64] I.R.C. § 6015(d)(5) (2000).

[65] Act Sec. 3501(b), Pub. L. 105-206, 112 Stat. 742.

[66] Act Sec. 3501(d), Pub. L. 105-206, 112 Stat. 742.

[67] I.R.C. § 6015(e)(4) (2000). In this regard, *see* Thomas Corson, 114 T.C. No. 24 (2000), where the Court held that a nonelecting spouse should have the opportunity to litigate a decision by the IRS to grant relief from joint and several liability to the electing spouse.

[68] I.R.C. § 6015(g)(2) (2000).

[69] I.R.C. § 6015(e) (2000).
[70] I.R.C. § 6015(e)(1)(A) (2000).

[71] I.R.C. §§ 6851 and 6861 (2000).

[72] I.R.C. § 6015(e)(1)(B)(i) (2000).

[73] I.R.C. § 7421 (2000).

[74] I.R.C. § 6015(e)(1)(B)(ii) (2000).

[75] I.R.C. § 6015(e)(3)(A) (2000).

[76] I.R.C. § 6015(e)(3)(B) (2000).

[77] I.R.C. § 6015(f) (2000).

[78] H.R. CONF. REP. NO. 105-599, 105th Congress, 2d Sess. (1998).

[79] I.R.C. §§ 6015(e) and 6015(f) (2000).

[80] Fernandez v. Comm'r, 114 T.C. No. 21 (2000).

[81] Notice 98-61, 1998-51 I.R.B. 13 (1998).

[82] The revenue procedure refers to Treasury Regulation § 301.6343-1(b)(4) for rules delineating economic hardship.

[83] According to the Internal Revenue Manual, the term "benefit" is something beyond ordinary support. Accordingly, a spouse would benefit if omitted income sustained a higher living standard than would be possible without the omitted income. The Manual goes into specifics, such as gifts of jewelry and furs, and goes on to list situations where the spouse, perhaps obviously, does not benefit. For example, the Manual states that a spouse would not benefit if the other spouse used the omitted income for: supporting an extramarital affair, gambling, benefiting third person, purchasing assets not held jointly or for joint benefit and maintaining a separate bank account or otherwise accumulating caches of money without the spouse's knowledge. Internal Revenue Manual 45 (11) (20).