RECENT CHANGES IN INNOCENT SPOUSE RELIEF

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IT'S NOT EASY BEING GREEN
(or an innocent spouse)

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Helpful Facts

- You are broke. Payment of the taxes you want to avoid should leave you penniless (unless you are that way already).
- You are lonely (divorced, separated or widowed from the spouse who earned the income in question).
- You have been financially abandoned. No significant part of the income giving rise to the taxes in question has benefitted you beyond normal spousal support.
- You are under-educated and unsophisticated. Being just plain dumb is even better.
- You are an abused spouse. Physical abuse is best (add photos of the bruises if possible). Psychological abuse and intimidation will do in a pinch.
- You are honest. You have not participated in any fraud against the IRS.

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Background on Innocent Spouse Relief

- In 1971, Congress enacted Pub.L. No. 91-679, 84 Stat. 2063, (codified as amended at 26 U.S.C. Sec. 6013(e)), which provided that innocent spouses filing joint returns would be relieved from tax liability for omissions from reported gross income attributable to their partners.
- The Innocent Spouse Rules were significantly changed as part of the 1998 Reform Act. This expanded the possibilities for relief (including the possibility of equitable relief).

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Background on Innocent Spouse Relief

- On January 5, 2012 another round of significant changes to innocent spouse relief occurred when the IRS issued Notice 2012-8. This notice updates Rev. Proc. 2003-61. A new Rev. Proc. will be issued after the IRS receives comments (due by February 21, 2012).

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Sources of Joint Liability

1. **Joint Income Tax Returns.**
   - **IRC § 6013(d)(3) provides that married taxpayers who file joint returns will be jointly and severally liable for the income tax liabilities arising from that joint return.**
2. **Community Property Laws.**
   - **Community property consists of the property, other than separate property, acquired by either spouse during marriage. Tex. Fam. Code § 3.002**

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First Considerations in All Cases

1. Was a joint return filed with a **forged** signature or signed under **duress**?

- Was the couple legally married?
- There is **no joint return** if either individual did not intend to file a joint return or if it was illegal to file a joint return.

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Types of Innocent Spouse Relief

1. Traditional Innocent Spouse Relief - IRC § 6015(b)
2. Separation of Liability Relief - IRC § 6015(c)
3. Equitable Relief - IRC § 6015(f)
4. Relief from community property laws - IRC § 66

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Types of Innocent Spouse Relief

- Traditional Relief Requirements:
  1. Joint Return which resulted in an "understatement of tax" as a result of "erroneous items" of one spouse or former spouse.
  2. The understatement must be attributable to some erroneous item or items on the return by the other (i.e., non-innocent) spouse.
  3. At the time the innocent spouse signed the joint return, he/she did not know, or did not have any reason to know, that there was an understatement of tax due to an erroneous item/items.
  4. Based on the circumstances, it would be unfair to hold the proposed innocent spouse liable for the understatement of tax.

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Types of Innocent Spouse Relief

- Traditional Relief Example:

Husband is an entrepreneur with a very successful business. Wife is a stay-at-home mom with three young children. Husband is a tremendous salesman, but has a hard time with accounting. His books and records are a mess. Return for 2009 was filed showing $1,000,000 in tax – all of which was paid. However, client gets audited and is assessed an additional $500,000 in tax.

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Types of Innocent Spouse Relief

- Separation of Liability Requirements
  1. Joint return filed
  2. Only applies to understatements or deficiencies (not underpayments)
  3. Persons are no longer married or not members of the same household for past 12 months

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Types of Innocent Spouse Relief

- **<u>Separation of Liability Example</u>**:

Husband is a successful photographer with his own business. Wife is real estate agent. Neither was perfect with their taxes. Couple gets divorced and a year later are audited and additional assessment occur after divorce. Innocent spouse will not be liable for the deficiency that is allocable to the "guilty" spouse.

- This "no fault" relief may be an easier route for recently divorced individuals.

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Relief from Community property laws.

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- Three different types of relief are available:
  1) IRC § 66(a) - Lived apart during year in question and no part of earned income was transferred to innocent spouse.
  2) IRC § 66(b) – Guilty spouse fails to notify innocent spouse of income before due date of return.
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Equitable Relief

- This is applicable to 6015(f) and 66(c) cases.
- Three Steps:

1. Threshold Conditions
2. Streamlined Determination Conditions
3. Equitable Relief Factors

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Equitable Relief

- Threshold Conditions:

1. Joint return was filed
2. Relief unavailable through other provisions of IRC § § 6015 or 66.
3. Request made before collection statute expires
4. Assets were not transferred as part of a fraudulent scheme
5. Disqualified assets not transferred
6. Requesting spouse did not file or fail to file with intent to defraud IRS.
7. A tax liability attributable to non-requesting spouse remains (with certain exceptions)

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Equitable Relief

- When Threshold Conditions are satisfied, then IRS will make a "streamlined" determination, and grant relief if:
  1. **The spouses are no longer married, are legally separated, or have not been a members of the same household during the past year; and**
  2. **The requesting spouse will suffer economic hardship if the Service does not grant relief; and**
  3. **The requesting spouse did not know or have reason to know of the deficiency – or know or have reason to know that the non-requesting spouse would not or could not pay the underpayment.**

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Equitable Relief

- If "streamlined" relief is not available the IRS will consider other facts and circumstances including:
  1. Economic hardship.
  2. Knowledge or Reason to know
     a) focus on abuse/financial control
  3. Legal obligations (divorce decrees or agreements)
  4. Significant benefit beyond normal support
  5. Good faith efforts to comply with tax laws
  6. Whether a history of abuse exists
  7. Physical or mental health status when the return was filed.

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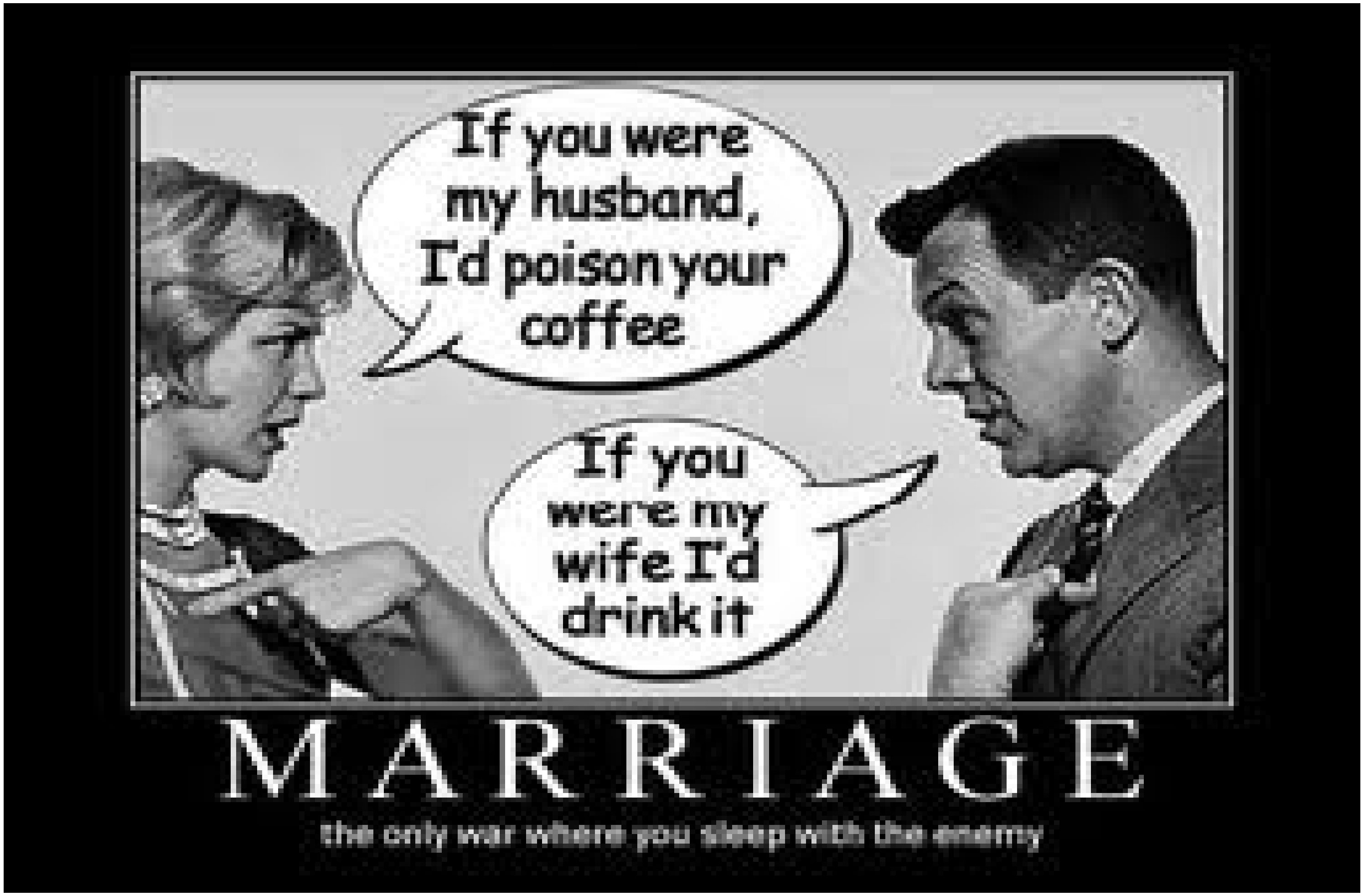
Isn’t Marriage Great?



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Significant Changes to Equitable Relief

- Change #1

Request for equitable relief can be filed any time before the collection statute runs. Previously, the rule used to be that relief had to be requested within 2 years of collection action. This change actually happened in 2011 (Notice 2011-70).

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Significant Changes to Equitable Relief

- Change #2

Threshold conditions previously required that the income tax liability must be attributable to the non-requesting spouse. New exception exists if the item of stems from the non-requesting spouse's fraud and thus gave rise to the understatements of tax.

Significant Changes to Equitable Relief

- Change #3

Equitable relief now applies to both understatements of tax as well as underpayments.

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Significant Changes to Equitable Relief

- Change #4

Streamlined determinations now also apply to claims for equitable relief under IRC § 66(c)

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Significant Changes to Equitable Relief

- Change #5

No one factor or majority of factors controls a determination – it all depends on the facts and circumstances.

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Significant Changes to Equitable Relief

- Change #6

Standards for economic hardship are revised.

A lack of economic hardship will now be viewed as a neutral factor.

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Significant Changes to Equitable Relief

- Change #7

A finding of actual knowledge of an item, giving rise to an understatement, will no longer be weighed more heavily than other factors.

Abuse or financial control by nonrequesting spouse causing fear of retaliation will result in this factor weighing in favor of relief.

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Significant Changes to Equitable Relief

- Change #8

Similarly, in a situation where the spouse had knowledge that nonrequesting spouse would not pay liability within a reasonably prompt time frame – the existence of abuse or financial control causing a fear of retaliation - will cause this factor to weigh in favor of relief.

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Significant Changes to Equitable Relief

- Change #9

IRS clarifies that the legal obligation of the requesting spouse is a consideration (not just whether the non-requesting spouse has an obligation).

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Significant Changes to Equitable Relief

- Change #10

Refunds are now available in deficiency cases for payment made other than through an installment agreement

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Case Studies – Do the new rules matter?

- As you can imagine, with a “facts and circumstances” analysis the courts are all over the map.

Case Studies – Do the new rules matter?

- Knowledge Factor
  - Courts in the past have often pointed to "knowledge" as the factor that weighs heavier than others.

  Lopez, TC Memo 2005-36

  - Ms. Lopez had three factors that weighed in her favor and three against. Court said that her knowledge or reason to know that the reported liability would be unpaid weighed more heavily than other factors.
  - Given the new guidance, knowledge should not bear more heavily than other factors. Additionally, more tools are available now to soften the effect of the knowledge factor (i.e. abuse and financial control).

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Case Studies – Do the new rules matter?

- Economic Hardship Factor
  - Courts in the past have often pointed to economic hardship as the factor that weighs more heavily than others.

Bowen, TC Summary Opinion 2005-32

- All factors except economic hardship weighed in favor of relief. Wife was abused, did not significantly benefit from the unpaid liability, liability was attributable to ex- husband and husband had legal obligation to pay. Court denied relief saying it was not an abuse of discretion to deny.
- The result here would probably be different today. First, the standard is no longer "abuse of discretion" but rather there is a "de novo" review. Additionally, the IRS gives the impression that "abuse" is to be given strong weight.

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Case Studies – Do the new rules matter?

- Legal Obligation Factor
  - Legal obligation is generally not a deciding factor in such cases. The IRS is certainly not bound to court orders regarding responsibilities in divorce matters.

<u>Pullins, 136 TC 432 (2011)</u>

- The Tax Court considered this case a "close call" – some factors were in favor of relief, others not. It is interesting that the court considered it "weighty" that the divorce court had ordered the husband to pay the taxes.

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Case Studies – Do the new rules matter?

- Number of Factors
  - A simple majority of factors will not necessarily weigh in favor of relief.

<u>Taylor, TC Summary Opinion 2005-48</u>

- In this case more factors favored relief than the numbers of factors weighing against relief. The court still did not grant relief. With the new rules stating that no factor is more important than any other – this case may have been decided differently.

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When can innocent spouse relief be requested?

- Application for administrative relief (Form 8857)
- Raised as a defense in response to a Notice of Deficiency
- Raised as a defense in a collection due process hearing
- As part of an offer in compromise – doubt as to liability

Recommendations to Improve Chances of Success

- Before filing requests for innocent spouse relief, try to build facts that will be helpful to your client, including:

a) Get Divorced!

b) Get the other side to agree to pay the tax in the divorce decree/agreement!

c) Insist your client current with the IRS!

d) Obtain evidence of abuse or financial control!

e) Develop your facts so that you have as many factors on your side and try to neutralize bad facts!

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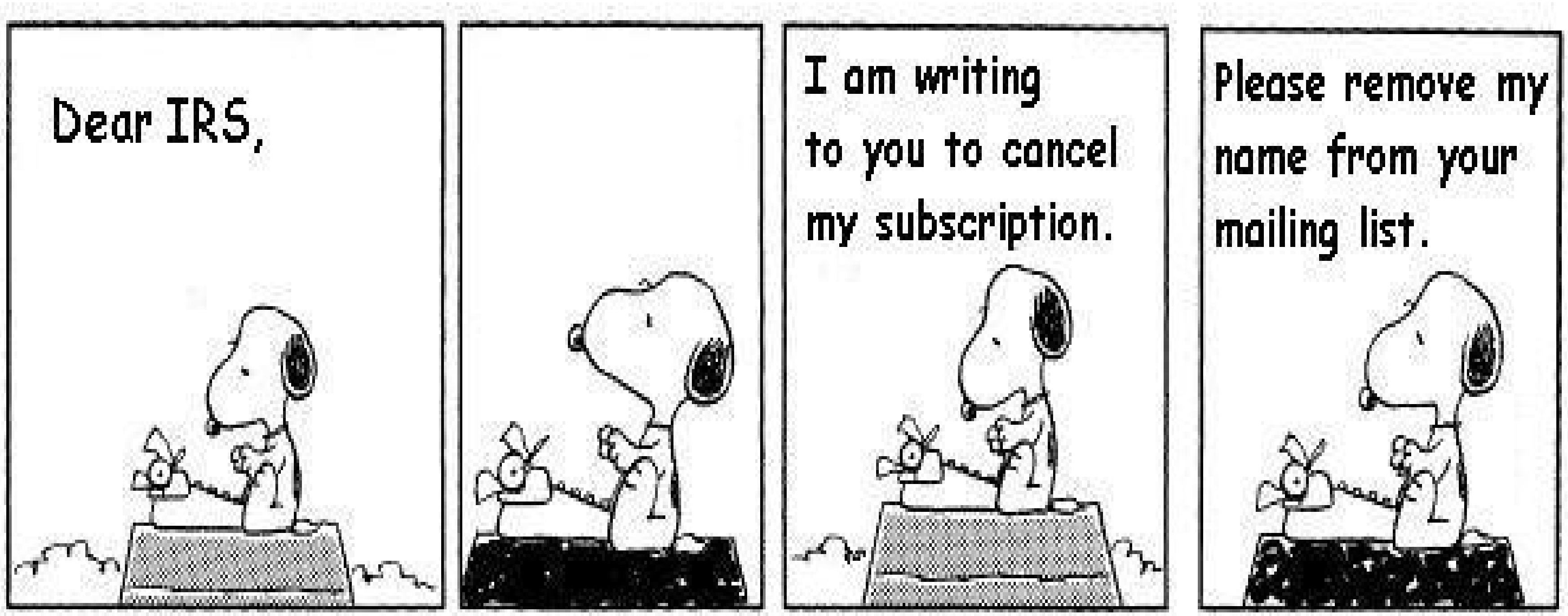
The Goal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About Me …

• Mr. Gair was admitted to practice in Texas in 2007 and in Colorado in 2005.

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- •LLM - Taxation, University of Denver, 2006
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