An Update on Innocent Spouse Claims

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I. <u>ISSUES RELATED TO THE FILING OF RETURNS DURING DIVORCE OR WITH TROUBLED MARRIAGES</u>.

A. <u>Joint Returns and Joint and Several Liability</u>. The decision to file a joint return is one that must be carefully thought out during periods of separation and divorce or within a trouble marriage because of the joint and several liability issues in connection with the filing of a joint return.

II. <u>OVERVIEW OF INNOCENT SPOUSE RULES</u>. Thankfully, legislation provides relief to certain spouses who have filed joint returns. The relief is found in I.R.C. §6015. The following three types of relief are available:

A. <u>§6015(b) Traditional Innocent Spouse Relief is provided where:</u>.

1) A joint return has been filed for the taxable year;

2) There is an understatement of tax on the return attributable to the erroneous items of the nonrequesting spouse;

3) In signing the return, the requesting spouse did not know or had no reason to know, that there was such an understatement; and

4) Taking into account all of the fact and circumstances, it is inequitable to hold the requesting spouse liable for the deficiency in tax.

B. <u>§6015(c) Separate Liability Election is provided where:</u>.

1) At the time the election is filed, the requesting spouse is no longer married to, or is legally separated from, the nonrequesting spouse; or

2) The requesting spouse was not a member of the same household as the nonrequesting spouse at any time during the 12 month period ending on the date the election is filed.

C. <u>§6015(f) Equitable Relief provided where:</u>.

1) Relief is not available under §6015(b) or (c); and

2) Taking into account all the facts and circumstances, it is inequitable to hold the requesting spouse liable.

D. Protective Language should be added to the Decree of Divorce Specifying that the Innocent Spouse Provisions have not been Waived. Be aware that I.R.C. §6015 does not provide relief to non-filers.

E. Congress Amended §6015(e) and Provided Authority for the Tax Court to Review §6015(f) Cases.

See the Tax Relief and Health Care Act of 2006 (TRHCA), Pub. L. 109-432, div. C. sec. 408(a), 120 Stat. 2922, 3061 (hereinafter "TRHCA").

III. JOINT VS. MARRIED FILING SEPARATE RETURNS.

A. Consider Filing Separately:. Historically, the tax on married couples filing jointly generally has been lower than the combined tax on married couples filing separate returns. Now, however, in many cases, a married couple's tax will be the same whether they file jointly or separately. That's because (1) the end point of the 15% bracket for married couples filing jointly is now twice the end of the 15% bracket for a single filer or a married person filing separately, (Code Sec. 1(f)(8)) and (2) the standard deduction for a married couple filing jointly is twice the standard deduction of a single person or a married person filing separately. (Code Sec. 63(c)(2)). Thus, if there is a pending divorce or a spouse has questionable tax items, there may now be greater occasion to file separately than in the past because, in many cases, filing separately may no longer involve an increased tax cost or may only involve a slightly or moderately increased tax cost. However, joint filing may still produce a lower tax cost in many situations because there is still a marriage penalty for the income brackets above the 15% bracket and numerous tax breaks are unavailable[1] or less favorable on separate returns.

IV. KEY CASES.

A. Porter v. Commissioner, 132 T.C. No. 11 (April 23, 2009).

It is now clear that the Tax Court uses de novo standard to review to determine whether a taxpayer spouse is entitled to equitable innocent spouse relief. A divided Tax Court has held that a de novo standard of review now is the appropriate review standard required in determining if a taxpayer-spouse is entitled to Code Sec. 6015(f) equitable innocent spouse relief. Applying this standard, the Court in Porter v. Commissioner, 132 T.C. No. 11 (April 23, 2009), concluded that the taxpayer was entitled to equitable relief.

Suzanne L. Porter (also known as Suzanne L. Holman) applied for relief from joint and several liability for additional tax under Code Sec. 72(t), related to a penalty for early distribution taken by her ex-husband from his individual retirement account (IRA). The Tax Court concluded that in determining whether a taxpayer, such as Porter, was entitled to equitable relief under I.R.C. §6015(f), the Court must apply a de novo standard of review, rather than an abuse of discretion standard as it had previously done. While the Court noted that it had always applied a de novo scope and standard of review in determining whether relief was warranted

[1] Filing a separate return can result in the loss of important tax credits. For example, a married couple cannot file separate returns and claim the earned income tax credit.

under I.R.C. §6015(b) (traditional innocent spouse relief) or I.R.C. §6015(c) (separate liability relief), it had not previously done so for I.R.C. §6015(f) relief cases.

With the passage of the TRHCA, Court now concluded that there was no longer any reason to apply a different standard of review for Code Sec. 6015(f) relief cases. Accordingly, in cases brought under I.R.C. §6015(f), the Court now applies a de novo standard of review as well as a de novo scope of review.

Applying that standard in Porter, supra, the Court concluded that Ms. Porter was entitled to I.R.C. §6015(f) equitable relief. The Court found that the factors favoring relief were that she and her husband were divorced, that she would suffer hardship if relief were not granted, that she didn't receive a significant benefit beyond normal support from the IRA distribution, and that she diligently complied with income tax laws in later years. The Court provided relief even though, Ms. Porter had reason to know of the IRA distribution because it appeared on the face of their return.

Under abuse of discretion standard, the Court noted that it has upheld Internal Revenue Service's denial of I.R.C. §6015(f) equitable relief where the taxpayer knew or had reason to know of the item giving rise to the deficiency or that the tax would not be paid. However, the Court was no longer restricted to determining whether Internal Revenue Service's determination was an abuse of discretion. Under a de novo standard of review, the Court took into account all the facts and circumstances to determine whether it was inequitable to hold the requesting spouse liable for the unpaid tax or deficiency. The Court recognized that Porter had reason to know of the IRA distribution because she signed the return and didn't inquire into its contents. But, this factor was tempered by the fact that she regularly inquired into her husband's finances during the preceding year and he refused to answer or answered evasively.

Important to note is that the Tax Court decision included two concurring opinions and a dissenting opinion in which six judges joined.

B. Lantz v. Commissioner, 132 T.C. No. 8 (April 7, 2009).

In Lantz v. Commissioner, 132 T.C. No. 8 (April 7, 2009), the Tax Court held Treas. Reg. §1.6015-5(b)(1) as an invalid interpretation of I.R.C. §6015(f). The Tax Court found that the regulation improperly limited the availability of equitable relief to a requesting spouse who filed for relief within two (2) years of the Internal Revenue Service's first collection activity. The Court found it instructive that I.R.C. §§6015(b) and (c) explicitly provide that the requesting spouse must elect relief within two (2) years whereas there is no such limitation in I.R.C. §6015(f). Id. at pg. 14.

The majority opinion passed with 12 judges approving, and 4 dissenting. This is a fabulous victory for taxpayers on an issue that has not heretofore been challenged. The case is likely to be appealed by the Internal Revenue Service, so stay tuned.

C. Mannella v. Commissioner, 132 T.C. No. 10 (April 13, 2009).

In Mannella v. Commissioner, 132 T.C. No. 10 (April 13, 2009), the Tax Court upheld the governments summary judgment motion as to Ms. Mannella's innocent spouse claim under I.R.C. §§6015(b) and (c), but followed Lantz, supra and again invalidated Treas. Reg. Treas. Reg. §1.6015-5(b)(1). The Tax Court allowed the §6015(f) claim to proceed despite that Ms. Mannella had filed the claim more than two (2) years after the Internal Revenue Service collection activity had begun. The Mannella case is particularly poignant because her spouse signed for her Internal Revenue Service correspondence and then hid the mail from her, preventing any opportunity for her to respond and protect her rights. Again, this case is likely to be appealed.

D. Barnes v. Commissioner, 130 T.C. 248 (2008).

In Barnes v. Commissioner, 130 T.C. 248 (2008), the court granted an Internal Revenue Service motion to dismiss because taxpayer Judith Barnes had already filed a claim for relief and the second claim was essentially duplicative of the first claim. The second claim simply had more information, but was not a qualifying request for relief under Treas. Reg. §1.6015-1(h)(5). Note that the taxpayer did not challenge the validity of the regulations as with Lantz, and Mannella, supra.

E. Kollar v. Commissioner, 131 T.C. No. 12 (Nov. 25, 2008).

In Kollar v. Commissioner, 131 T.C. No. 12 (Nov. 25, 2008), the issue was whether innocent spouse relief could be granted under §6015(f) where the underlying tax liability had been paid and only accrued interest remained unpaid. The taxpayer filed for equitable relief under section 6015(f). The Internal Revenue Service denied relief relying on 408 of TRHCA. The court held that the word "taxes" included the accrued interest related to the tax and allowed the case to proceed.

F. Maier v. Commissioner, 119 T.C. 267 (2002).

In Maier v. Commissioner, 119 T.C. 267 (2002), The Internal Revenue Service granted relief under I.R.C. §6015(f) to Judith Maier during the administrative proceedings.

The husband, John Maier, filed a petition in Tax Court seeking a redetermination of the innocent spouse relief to Judith. Noting that it is a court of limited jurisdiction, the Tax Court held that if the Judith did not file a petition for review of the Internal Revenue Service determination, John could not file a petition and oppose the administrative determination granting relief as Congress had not imbued the Tax Court with jurisdiction to hear his case. Compare and contrast this decision with that of King v. Commissioner, 115 T.C. 118 (2000) in which a non- requesting spouse is allowed to intervene. See also T.C. Rule 325.

G. McGee v. Commissioner, 123 T.C. 314 (2004).

In McGee v. Commissioner, 123 T.C. 314 (2004), the Taxpayer filed a claim for innocent spouse relief more than two years after her tax refund was offset, but the Internal Revenue Service had not provided the notice of a taxpayer's right to claim innocent spouse relief. The Tax Court held that the Restructuring and Reform Act of 1998 required the Internal Revenue Service to provide information to taxpayers so that they could assert their rights.

H. Chief Counsel Notice CC 2009-012.

Chief Counsel Notice (CCN) 2009-012, was issued April 17, 2009 in response to the Lantz and Mannella, supra, decisions. It provides guidance to Internal Revenue Service attorneys where a taxpayer-spouse requests equitable relief under I.R.C. §6015(f) after the two-year limit in Treas. Reg. § 1.6015-5(b)(1) – i.e., more than two years from the first collection activity against the spouse. The Internal Revenue Service disagrees with the Tax Court's recent decision in Lantz invalidating that regulation but nonetheless has changed its litigation tactics in response to the decision.

To be eligible for relief under I.R.C. §6015(b) (innocent spouse relief) or I.R.C. §§6015(c) (separate liability relief), the Code explicitly provides that the requesting spouse must elect relief not later than the date that is 2 years after the date that Internal Revenue Service has begun collection activities with respect to the individual making the election. (I.R.C. §§ 6015(b)(1)(E), and 6015(c)(3)(B)) However, no such limitation is imposed in I.R.C. § 6015(f). In contrast, the regulations, however, do impose a parallel limitation. Treas. Reg. § 1.6015-5(b)(1).

As discussed above in Lantz, the Tax Court held that Treas. Reg § 1.6015-5(b)(1)'s two-year time limit for claiming relief under I.R.C. §6015(f) was an invalid interpretation of the Code. The Court found that the regulation, by imposing a limitation that Congress explicitly incorporated into I.R.C. §6015(b) and I.R.C. §6015(c) but omitted from I.R.C. §6015(f), failed to give effect to the unambiguously expressed intent of Congress. Under Lantz, the Tax Court will consider whether a requesting spouse is entitled to relief under I.R.C. §6015(f) regardless of the time elapsed between the collection activity and the filing of the claim for relief.

Chief Counsel Notice 2009-012 directs that Chief Counsel attorneys shouldn't file motions for summary judgment arguing that the spouse's claim for I.R.C. §6015(f) relief was untimely under Treas. Reg. § 1.6015-5(b)(1). If the spouse also requested relief under I.R.C. §§6015(b) or 6015(c), the attorneys should file a motion for partial summary judgment.

Area Counsel attorneys will continue to argue that I.R.C. §6015(f) relief is unavailable in cases in which the spouse's claim for relief was filed more than two years after Internal Revenue Service's first collection activity against the requesting spouse and will raise the issue in the pre-trial memos, at trial, and on brief, etc.

I. Reconsideration.

Certain taxpayers who were denied innocent spouse relief at the administrative level due to poor communications or the inability to provide necessary information or other unjust reasons may now ask the Internal Revenue Service to reconsider their case similar to the process for audit reconsideration.

Use of this procedure may be helpful in those I.R.C. §6015(f) cases denied only due to the election more than two (2) years from the start of the Internal Revenue Service collection activity. See Lantz, supra and Mannella, supra. It will also be interesting to see if the Tax Court allows for judicial review of a §6015(f) case filed in this manner in light of its decision in Barnes, supra.

V. COMMUNITY VS. SEPARATE PROPERTY.

Divorcing spouses' tax liabilities are also affected by characterizations of community versus separate property.

A. Texas Law.

In Texas, all property owned by either spouse is community or separate property. Property acquired during marriage is community property. The spouse claiming any of the property to be separate property has the burden of proof to show that the property is that spouse's separate property.

B. Presumption of Community..

Property possessed by either spouse during marriage is presumed to be community. The separate property nature of the item must be proven.

C. Income vs. Gains From Separate Property..

a. Income from separate property is community income.
b. Capital gains from separate property are allocated to the spouse owning the separate property.

D. Commingling of Property-Tracing.

Separate property assets may become so commingled with community property that they lose their identity as separate property. *Newland v. Newland*, 529 S.W.2d 105 (Tex. Civ. App.–Ft. Worth 1974, writ dism'd.)

VI. HOW TO ESCAPE THE PROBLEMS OF COMMUNITY INCOME IN THE YEAR OF DIVORCE: INTERNAL REVENUE CODE SECTION 66.

A. I.R.C. §66.

In Texas, a community property state, tax returns filed during periods of separation and in the year of divorce can be a trap for the unwary. It is important to note that, with the exception that will be discussed below related to I.R.C. §66, spouses are required to file either joint returns or married filing separate returns during periods of separation. In addition, in the year of divorce, one-half of all community income must be reported on the Federal income tax return of the non-earning spouse, if earned prior to the date the decree becomes final. Community income includes wages, partnership income and other business income generated by a former spouse. This means where there is a gross disparity in earning power as between husband and wife, in the year of divorce, the lower earning spouse will have a substantial tax liability for the one-half of all community income earned by the higher earning spouse up until the dissolution of the marriage. That lower income spouse may not have the assets to cover that liability.

B. Requirements for I.R.C. §66.

The Congress of the United States recognized this potential disparity and passed I.R.C. §66 as a solution for some spouses. However, the rules under I.R.C. §66 are very stringent and do not apply in all situations. In order for I.R.C. §66 to apply,

a. The spouses must live apart **at all times** during the calendar year.
b. They must not file a joint tax return for that year.
c. They must have earned income which is community income.
d. They must not transfer any portion of that earned income between spouses except for the payment of child support.

If these conditions are met, then the earned community income, meaning wages and self employment income from trades or businesses or partnerships, will be reportable by the party who earned the income rather than one-half being allocated to the non-earning spouse under community property laws. Very importantly, all other community income such as interest, dividends or capital gains are split equally and must be reported one-half by each spouse, even under the application of I.R.C. §66.

It should be made clear that alimony payments, during the period of separation, destroy the applicability of I.R.C. §66 because they allow for the transfer of income. Any support and separate maintenance payments are also problematic to the applicability of I.R.C.§66. On the other hand, payment of child support during periods of separation is acceptable and does not impair the parties ability to use I.R.C. §66.

This means that where income is shared between spouses (except for child support) I.R.C. §66 will not apply. To avoid this egregious result, the earned income between spouses should be separately accounted for during the periods of separation. If there are other assets available to maintain and support the spouse, those assets should be used during the periods of separation. For example, if there is an existing bank account or investment account with sufficient assets to pay the house payment and other direct expenses, those assets should be used rather than the continuing earned income during the year of separation. All checks should be written by the spouse living in and using the house (electricity, etc.). If the earned income of the higher earning spouse is used to make house payments and pay other bills, the provisions of I.R.C. §66 will not apply.

C. Client Doesn't Want I.R.C. §66 to Apply.

If it is beneficial to your client to split earned income, he/she may be precluded from doing so under I.R.C. §66(b), unless such client notifies the other spouse prior to the due date of the return (April 15th) the amount of the community income to be split and the nature of such income (wages, interest earnings, partnership income, etc.).

D. Case Law.

Will the Internal Revenue Service look into these items? What has the Internal Revenue Service done in the past? Although not a targeted area, the Internal Revenue Service has shown a willingness to investigate I.R.C. §66 abuses. For example, in a case involving a Texas couple, Cline v. Commissioner, T.C. Memo 1982-44, the Clines, a separated but not yet divorced couple who were residents of Texas during 1977, filed married, filing separate returns. Mrs. Cline reported 100% of the community income as it was earned by her. She also paid 100% of the tax liability attributable to that income. In later years, the Internal Revenue Service audited Mr. Cline's return and allocated to him one-half of the community income, even though that tax had already been paid by Mrs. Cline on her return. The court upheld the determination by the Internal Revenue Service.

In another Texas case, Adams v. Commissioner, 82 T.C. 563 (1984), a Texas couple was divorced in 1977. The husband was partner in a CPA firm. On each of their returns in the year of divorce, the couple reported their share of the partnership income up until the time of divorce. Mrs. Adams used a per share per day pro rata method of allocating income and Mr. Adams awaited the closing of the books and made an allocation based on the full year's earnings. Mr. Adams' return was subsequently adjusted, even though his manner of reporting the income was an acceptable method. Mr. Adams' method was inconsistent with the methods as between both spouses and resulted in a loss of revenue to the taxing authority based on the different methods used between the parties. The lesson learned in this case was that the parties must agree in the decree of divorce how business income of partnerships, S-corporations, or limited liability companies will be allocated in the year of divorce.

VII. OTHER CONSIDERATIONS.

A. How to File as Head of Household Prior to Divorce. I.R.C. §66 helps spouses deal with inequities resulting from the application of community property laws during periods of separation and divorce. In addition, the Internal Revenue Code provides an additional benefit for separated spouses who maintain a household for a dependent child or children. That benefit is found at I.R.C. §7703.

1. I.R.C. §7703. Under I.R.C. §7703, a taxpayer may file an individual return claiming head of household status, even though married, if the following requirements are met:

a. The taxpayer has a child;
b. The taxpayer has paid greater than one-half of the expenses maintaining the household for that child;
c. The parties were separated for greater than 6 months;
d. The spouse has not lived in the home for the last six months of the tax year.

This is an excellent opportunity for the taxpayer supporting a child to take advantage of the head of household rate schedules, rather than deciding between a Married Filing Separate tax return or the liability associated with a Joint Return. Remember though that I.R.C. §7703 deals with filing status only; to avoid reporting 1/2 of community income on the head of household return refer to I.R.C. §66(b) discussion above.

2. The Noncustodial Spouse. The logical extension of the rule under I.R.C. §7703 is that the separated spouse, who is not maintaining a household for the child(ren) will have to file under a married filing separate status.