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Taxpayer Bill of Rights 3: 1998 Tax Law, Part 1 - New Rules for Innocent and Ex-Spouses

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Summary

This is the first in a series of reports designed to analyze changes to tax law made in the Taxpayer Bill of Rights 3, enacted as Title III of the IRS Reform and Restructuring Act of 1998 (P.L. 105-206). This report describes and analyzes the liability of spouses for taxes due on joint returns, the recent changes in that law, and its historical development. It will be updated as necessary.

Shortly after the enactment of the modern income tax law, it was amended to permit joint returns for spouses. IRS soon took the position that, when joint returns were filed, spouses were to be treated as one for tax purposes, including liability. Later, Congress specifically provided for joint and several liability for joint returns.

Incidents of inequitable results prompted an attempt to moderate the impact of joint spousal liability through enactment of the so-called innocent spouse provisions. Under the law as it existed prior to the 1998 amendments, however, it was possible to qualify as an innocent spouse and avoid the operation of the joint and several liability rules only if a taxpayer satisfied very stringent conditions. This stringency led to some harsh results and considerable criticism.

Congress responded to this criticism, by including in the IRS Restructuring and Reform Act of 1998 provisions designed to ease the requirements that must be met to qualify for the innocent spouse exception, to eliminate the monetary thresholds for claiming relief, to modify the requirement that an understatement of tax liability be the result of a *grossly* erroneous item of the other spouse, and to permit a separate liability election by taxpayers who are divorced, legally separated, or who have lived separate and apart for 12 months.

Background

When the modern income tax was enacted in 1913, there was no provision allowing married individuals to file joint returns. Separate returns were required.[1] Five years later, in 1918, the statutes were amended to permit, but not require, the filing of joint returns.[2] At that time there were no special rates for married taxpayers filing jointly. The most significant benefit may have been convenience for the taxpayers and collectors. The statute did not address the question of the nature of the tax liability imposed, and one might presume that the old rules were not changed by allowing joint filing. Nevertheless, the Internal Revenue Bureau (predecessor of the IRS) soon took the position that spouses filing jointly were a single taxable unit, and jointly and severally liable for taxes owed on the joint return.[3] While that interpretation was rejected by the courts,[4] Congress eventually accepted the Bureau's position and amended the tax law to impose joint and several liability on joint filers in 1938.[5] At this point, there were no separate rates for married taxpayers, and the primary beneficiary of joint filing remained the tax collector.

Thirty years after the enactment of the optional joint return provision and ten years after the adoption of the joint and several liability provision, Congress acted to provide a separate rate structure for married taxpayers filing jointly, in effect incorporating income splitting into the rate structure.[6] That provision was part of a 1948 statutory overhaul intended to equalize the treatment of taxpayers from common law and community property states.[7] In 1969, apparently in response to complaints from single taxpayers that they

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[1]Tariff Act of 1913, P.L. 63-16, ch. 16, § II; *see especially* § II(A)(2) - personal returns to be made. 38 Stat. 114, 166.

[2]Revenue Act of 1918, P.L. 65-254, ch. 18, § 223, 40 Stat. 1057, 1074.

[3]I.T. 1575, 2-1 C.B. 144.

[4]*See, e.g.*, Cole v. Commissioner, 81 F.2d 485 (9th Cir. 1935).

[5]Revenue Act of 1938, P.L. 75-554, ch. 289, § 51(b), 52 Stat. 447, 476. "In the case of a husband and wife living together the income of each (even though one had no gross income) may be included in a single return made by them jointly, in which case, the tax shall be computed on the aggregate income, and the liability with respect to the tax shall be joint and several." In its report the House Ways and Means Committee said of this amendment that: "It is necessary, for administrative reasons, that any doubt as to the existence of such liability should be set at rest, if the privilege of filing such joint returns is continued.'' H.Rept. 75-1860, 75th Cong., 3rd Sess. 21 (1938).

[6]Revenue Act of 1948, P.L. 80-471, ch. 168, § 301, 62 Stat. 110, 114. "In the case of a joint return of husband and wife under section 51(b), the combined normal tax and surtax under section 11 and subsection (b) of this section shall be twice the normal tax and surtax that would be determined if the net income and the applicable credits against net income provided by section 25 were reduced by one-half." The result is that the income is taxed at a lower rate — the rate that applies to one-half the total — instead of at the higher rate that would apply to the total, as under prior law.

[7]For a discussion of this aspect of the 1948 Revenue Act, see S.Rept. 80-1013, 80th Cong., 2nd Sess., reprinted in 1948 U.S. Code Cong. & Ad. News at 1163, 1184-1191. There the Committee said:

> Under the existing law the treatment accorded families earning the same amount of income is very different if they happen to live in States using the community-property

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were not being treated as well as married couples filing jointly, Congress reduced the rates for single taxpayers, revised the head-of-household rates, and retained the old rates for married taxpayers.[8]

Changes in society, with an increasing number of two earner couples and a higher divorce rate, led to more spousal tax liability cases before the courts, and the criticism of the harshness of the liability rule mounted.[9] Responding to some egregious cases which were brought to its attention, Congress provided limited relief for the harshest circumstances with the adoption of the "innocent spouse" exception.[10]

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> system or in States which use common law. Chiefly, this is due to the fact that under the community-property system the earnings of a married couple are considered to be one-half the property of each. Income arising out of an accumulation which took place during the marriage is divided in the same manner, and in some community-property States the same division is made of income from assets which are the separate property of one of the spouses. No similar division takes place under common law. The earnings of the husband are his own and taxed to him. The income from his property is his income and is taxed as such. (at 1184)
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> Your committee believes that the best answer to the problem of geographical equalization is the splitting of the combined income of the husband and wife. Income splitting is effected under H.R. 4790, as amended, by giving husbands and wives in all States the option to file joint returns. In these returns their combined net income and their combined exemptions are divided by 2. A tax is computed on this basis and multiplied by 2.
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> Income splitting will produce the same result in common-law States which now obtain in a community-property State when the entire income of both spouses is community income. If, however, spouses in community-property States have separate income, they may split their income by electing to file a joint return. Under existing law, separate income in community-property States is taxed in full to the spouse who receives it. Thus, the type of solution embodied in H.R. 4790 as amended, benefits residents of both common law and community-property States. (at 1186)

[8]Tax Reform Act of 1969, P.L. 91-172, §803, 83 Stat. 487, 678-709. For an explanation of this provision, see Staff of the Joint Comm. on Taxation, GENERAL EXPLANATION OF THE TAX REFORM ACT OF 1969, 91st Cong., 2nd Sess. 222-224 (Comm. Print 1970). Thus began what has become known as the marriage penalty. While it has been frequently argued that the liability imposed on married persons filing jointly is the price they pay for the advantages of filing jointly, history shows that joint and several liability was urged by the I.R.B. before the enactment of income splitting, that Congress adopted the joint and several liability rule before enactment of income splitting, and that the benefits of income splitting were substantially reduced by the 1969 changes. Indeed, for many two-income married taxpayers a return to 1913 law with separate returns and one rate structure would seem preferable.

[9]Richard C. E. Beck, *The Innocent Spouse Rules: Joint and Several Liability for Income Taxes Should Be Repealed*, 43 VAND. L. REV. 317, 348-49 (1990).

[10]P.L. 91-679, 84 Stat. 206. In its report on the provision the House Ways and Means Committee made it plain that this was the reason for the legislation, quoting an opinion from the Tax Court suggesting the need for a legislative remedy. H.Rept. 91-1734, 91st Cong., 2nd Sess. 2 (1970).

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Innocent Spouse: Before Taxpayer Bill of Rights 3

Prior to the adoption of the 1998 amendments, the innocent spouse rules were codified at I.R.C. §6013. Briefly, the prerequisites were: 1) the making of a joint return; 2) a "substantial understatement" of tax liability due to "grossly erroneous items" attributable to the "not so innocent" spouse; 3) no knowledge of, and no reason to know of, the substantial understatement by the "innocent" spouse when signing the return; 4) and inequity, under all the facts and circumstances, to hold the "innocent" spouse liable for the tax deficiency resulting from the understatement. The burden of proof for all these elements was on the party claiming innocent spouse status. One potential difficulty, especially when the spouses subsequently separated or divorced, was that the one claiming innocent spouse status might well not have access to the data needed to determine the liability and establish the claim. Not surprisingly, the not so innocent spouses did not always prove cooperative.

The innocent spouse rule was oft criticized as hard, inconsistent and inequitable in application, and ex-wives continued to pay for former husbands' tax indiscretions in many cases.[11] I.R.C. § 6013(e)(2) defined "grossly erroneous items" as any omitted item of income and "any claim of a deduction, credit, or basis ... in an amount for which there is no basis in law or fact." If the spouse succeeded in establishing that there was no basis in law or fact for a deduction and thus satisfied the second standard, the tax collector might counter that the spouse proved that she (he) knew or should have known about the substantial understatement and thus could not qualify for innocent spouse status.[12] Mounting criticism of the innocent spouse rule led to calls for a congressional review of the rule.

Congress Acts: 105th Congress

Reacting to these concerns , the 105th Congress witnessed the introduction of various proposals. Hearings were held by the tax writing committees in both the House and Senate. At Senate Finance Committee hearings held on February 11, 1998, the Committee heard testimony from four women who were objects of IRS collection efforts for taxes resulting from activities of their former spouses. One of those witnesses was Elizabeth Cockrell, from whom the IRS was attempting to collect some $680,000 in taxes, penalties and interest. As a young Canadian college graduate, she had married an American and

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Originally applicable only to cases involving omissions from income, the innocent spouse exception to joint and several liability was extended to cases where the deficiency was the result of an improperly taken deduction, credit or basis. P.L. 98-369, § 424, 98 Stat. 494, 801-803 (1984). In all cases, however, there were stringent requirements that a taxpayer seeking innocent spouse status had to satisfy to qualify for the exception.

[11]*See, e.g.*, Beck, *supra* note 9 and Lisa K. Edison-Smith, Comment, *"If You Love Me, You'll Sign My Tax Return:" Spousal Joint and Several Liability for Federal Income Taxes and the "Innocent Spouse" Exception*, 18 HAMLINE L. REV. 102 (1994). Beck also noted the pattern of inconsistency in the application of these standards.

[12]Jerome Borison, *Innocent Spouse Relief: A Call for Legislative and Judicial Liberalization*, 40 TAX LAW. 819, 842-860., contains an extended discussion of the burden of proof and the no basis in law or fact requirement, including the "Catch 22" position the spouse may face.

moved to the United States in 1979. Her husband was a commodities broker, she an English literature major, who became a stock broker trainee in December of 1980 and got her license early in the following year. Nothing in her training or background gave her expertise in commodities trading. For 1979-1981, the husband prepared or had prepared, and she signed, joint returns. The couple separated in 1982 and divorced the following year. In 1987 her ex-husband told her of correspondence from IRS involving a dispute over losses claimed on their joint returns and resulting from commodities straddle transactions he had engaged in. He asked her to sign some papers to help settle the case and sent her a letter acknowledging that the transactions were his and that he was responsible for any taxes due on them. What she signed was a waiver of the statute of limitations, and in 1992 IRS began efforts to collect the taxes due from Ms. Cockrell.[13] Ms. Cockrell sought refuge in the innocent spouse exception, but to no avail, as her claims were rejected twice by the Tax Court, a decision affirmed by the U.S. Court of Appeals (2nd Cir.).[14] In sum, Ms. Cockrell was liable for taxes due as a result of transactions by and for her ex-husband — who apparently had seven-figure Swiss bank accounts and who was an expert commodities trader — and despite the fact that she was acknowledged to have been ignorant of the underlying transactions. Three other ex-wives provided similar testimony of IRS pursuit of them as a result of tax liabilities predicated on financial transactions of former spouses. The Committee also heard from tax experts who called for reform or replacement of the existing rules. Responding to what appears to have been a broad consensus, Congress made substantial changes in the rules governing joint and several liability of spouses filing joint returns in the Internal Revenue Service Reform and Restructuring Act of 1998.[15]

Innocent Spouse: Taxpayer Bill of Rights 3

The new statutory provisions provide three avenues of relief: 1) for married taxpayers filing jointly, more liberal standards for innocent spouse status than were available under prior law; 2) for those who have since separated or divorced, the opportunity to elect separate liability; and 3) for taxpayers who fail to qualify for innocent spouse or separate liability relief, discretionary authority for equitable relief.[16]

Those who filed joint returns can seek innocent spouse status under more liberalized rules than were imposed by prior law. Under the new law such relief is available for any understatement of tax liability. Under the old law relief was available only for "substantial understatements," and those were defined by dollar amounts ($500 or a percentage of income). The prior law requirement that the understatement be attributable to "grossly erroneous" items attributable to the other spouse has also been eliminated. It is enough now that there is an understatement attributable to the other spouse. Those claiming the status must still establish that they did not know and had no reason to know of the

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[13]For an unofficial transcript of the Senate Finance Committee hearings *see*, 98 TNT 32-23, Doc. 98-6302, TAX NOTES TODAY, February 18, 1998.

[14]Crowley v. Commissioner, T.C. Memo 1193-503 (Nov. 1, 1993), T.C. Memo 1995-551 (Nov. 20, 1995); *aff'd.sub nom.* Cockrell v Commissioner, 116 F.3rd 1472 (2nd Cir. 1997); *cert. denied* 118 S.Ct. 1163 (1998).

[15]P.L. 105-206, §3201.

[16]I.R.C. §6015.

understatement of tax, and taking into account all the facts and circumstances it must still be found unfair to hold claimant liable for the taxes due. A spouse pursuing innocent spouse status may be entitled to a refund.

The new law permits those who are divorced, legally separated, or have lived separate and apart for a year to request separation of liability. If the taxpayer filed a joint return and is now divorced, legally separated, or has lived separate and apart for at least a year prior to filing the request, she(he) will qualify for such treatment and tax liability will be determined in much the same manner as if separate returns had been filed. Special rules were included to prevent the improper use of the election. Thus, even if otherwise qualifying, a request for separate liability may be refused if IRS proves that the spouses (or former spouses) transferred assets as part of a fraudulent scheme or to avoid taxes or the payment of taxes, or if IRS proves actual knowledge that items giving rise to the deficiency and attributable to a spouse (or former spouse) were incorrect. This provision would have benefitted Ms. Cockrell and the other women who testified before the Senate Committee on Finance with her. Only the hard to attain innocent spouse exemption was available to former and separated spouses under prior law. A request for separation of liability will not generate a refund.

Equitable relief may be available for those who cannot qualify for separation of liability or innocent spouse status, including spouses from community property states who file separately. The Secretary may make such relief available when under all the facts and circumstances it would be unfair to hold the taxpayer liable for the understatement or underpayment of a tax. This is the one remedy available for an underpayment of taxes. Under prior law, if a spouse took funds intended for taxes for his or her own use, there was no escape from joint and several liability.[17]

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[17]The conference committee report discussed the anticipated uses of this equitable authority:

> The conference agreement does not include the portion of the Senate amendment that could provide relief in situations where tax was shown on the joint return, but not paid with the return. The conferees intend that the Secretary will consider using the grant of authority to provide equitable relief in appropriate situations to avoid the inequitable treatment of spouses in such situations. For example, the conferees intend that equitable relief 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.
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> The conferees do not intend to limit the use of the Secretary's authority to provide equitable relief to situations where the tax is shown on a return but not paid. The conferees intend that such authority be used where, taking into account all the facts and circumstances, it is inequitable to hold an individual liable for all or 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. H.Rept. 105-599, 105th Cong., 2nd Sess. 254-255 (1998).