

[PRESENTATION TO LOCAL ACCOUNTANTS – 1999]

The New Innocent Spouse Rules: Have They Finally Gotten it Right?

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I. The problem is that both husband and wife have joint and several liability for all tax, interest and penalty, including audit deficiencies, when they file a joint return. IRC § 6103(d).

II. The first innocent spouse rules, enacted in the early 1970's, turned out to be an inadequate response to the problem. In general, the putative non-liable spouse had to show:

- 1) an understatement of tax attributable to the nonrequesting spouse;
- 2) the requesting spouse, in signing the return, did not know and had no reason to know of the underpayment of tax; and
- 3) taking into account all the facts and circumstances, it would be inequitable to hold the requesting spouse liable. This last factor was satisfied if the requesting spouse received no benefit other than normal support from either the tax savings or the amount in question.

III. The new federal rules, effective July 22, 1998 but retroactive to all unpaid liabilities, are more generous than before, plus there are new procedural advantages. § 6015. California conformed, effective October 1999.

IV. The major change is a new **separate liability election**.

1) If made, liability is limited to the amount of deficiency arising from items that would have been allocable to the electing taxpayer if he or she had filed a separate return. (Community property is ignored for purposes of the innocent spouse rules.)

2) To be eligible, the requesting spouse must be **no longer married or legally separated** from the nonrequesting spouse, or the requesting spouse must not have been living in the same household as the other spouse during the twelve months preceding the election. The election is invalid if the IRS shows that the requesting spouse had actual knowledge of the understatement, unless the return was signed under duress.

3) Liability is increased by the amount of any transfer having a principal purpose to avoid tax or to avoid payment of tax. Any transfer within a year of the first

proposed notice of deficiency is presumed to be to avoid tax. But the presumption does not apply to a transfer made pursuant to a decree of divorce or separate maintenance.

V. **Innocent spouse relief**, under the pre-1998 rules, is still available. Here, there is no requirement that the spouses be divorced, separated or living apart. In this regard, the new rules allow **apportionment** of liability if the requesting spouse did not know of the extent of the liability.

VI. The availability of **equitable relief** is a major advance in the new rules.

1) Equitable relief is available for taxes shown on the original return, as well as audit deficiencies. In contrast, the separate liability election and traditional innocent spouse relief apply only to audit deficiencies.

2) Equitable relief is available only if relief is not available under the other provision, and when, taking into account all the **facts and circumstances**, it is inequitable to hold the requesting spouse liable. IRS has said that important factors are whether the requester knew or had reason to know that the taxes would not be paid, reasonable belief that the taxes would be paid by the other spouse, significant undue hardship if relief is not granted, any abusive behavior by the other spouse, and, the other spouse had an obligation under a divorce decree or agreement to pay the taxes. Notice 98-61m IR 98-73 (Dec. 7, 1998).

VII. Innocent spouse relief is elected by filing **Form 8857**. A taxpayer may elect innocent spouse relief as late as two years after IRS begins collection activity with respect to the requesting taxpayer.

VIII. IRS must give **notice to the other joint filer** and an opportunity to participate in any administrative proceeding regarding a request for innocent spouse relief. The Tax Court has also made provisions for the other spouse to participate in relevant proceedings.

IX. **Tax Court review** is available, if IRS denies or fails to act upon a request for innocent spouse relief. The Tax Court petition must be filed within 90 days following the date of the determination, or may be filed after six months after the election is filed.