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IRS REV. PROC. 2013-34 SIGNIFICANTLY EXPANDS GROUNDS

FOR EQUITABLE INNOCENT SPOUSE RELIEF

By David Gair

Various forms of relief for “innocent spouses” are found in the Internal Revenue Code; but only § 6015(f) relieves filers from responsibility for underpayments of tax shown on the face of a jointly-filed income tax return (as distinguished from audit deficiencies later determined by the IRS). Section 6015(f) provides for “equitable relief” if, based on the facts and circumstances, it would be inequitable to hold the individual liable for such taxes.

In January 2012 the IRS issued IRS Notice 2012-8 containing a proposed revenue procedure which according to the IRS is “designed to provide relief to **more** innocent spouses requesting equitable relief from income tax liability.” IRS Notice 2012-8 significantly expanded the facts and circumstances (previously set out in Rev. Proc. 2003-61) which the IRS will consider in determining whether or not §6015(f) relief should be granted. On September 16, 2013 the IRS issued Revenue Procedure 2013-34 which largely adopted the procedures proposed in Notice 2012-8 with a few taxpayer favorable changes.

The IRS also issued proposed regulations on August 13, 2013 [REG-132251-11] related to limited aspects of innocent spouse relief. The proposed regulations generally relate to the time period for making a request for equitable relief – that is the request can be made any time within the statute of limitations on collection. The IRS previously issued notices regarding this change of position.

Background on Innocent Spouse Relief

In 1971, Congress amended the Internal Revenue Code by the addition of Sec. 6013(e), which provided that “innocent spouses” filing joint returns could be relieved from tax liability for omissions from reported gross income attributable to their partners under certain circumstances. The innocent spouse rules were significantly changed as part of the 1998 Reform Act to expand the possibilities for relief (including the possibility of equitable relief). The proposed revenue procedure in IRS Notice 2012-8 is one of the most significant changes to equitable innocent spouse relief since the 1998 Reform Act.

Sources of Joint Liability

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. “Joint and several liability” covers not only the tax liabilities expressed on the face of the return, but also any deficiencies for taxes, penalties or interest that may subsequently be determined by the IRS. Filing a joint return is the rough equivalent of a married couple signing an open-ended promissory note acknowledging that either party is fully responsible for all income taxes or additions to tax for the tax year in question. The IRS need not collect

the taxes equally from each party. It can collect all of the taxes (or any portion thereof) from the husband; or all taxes (or any portion thereof) from the wife. Divorce documents that purport to lay all responsibility for the payment of taxes on one party or the other are not binding upon the IRS. Second, community property laws also operate to create joint liability.

Laws also can give rise to a type of joint responsibility, since (absent a partition agreement or similar document) community property laws can cause half of the income earned by one spouse to be considered income of the non-earning spouse. But this is different from joint and several liability that arises from filing of a joint income tax return. If a Texas married couple files "married, filing separately" each will be liable for one-half of the community's total income, and therefore also liable for income taxes attributable to such one-half share. In contrast, if the same couple files a joint return, each party is liable for 100 percent of the taxes on 100 percent of the community's income.

First Considerations in All Cases

The initial consideration in all cases is to determine if there actually is a joint return. Was a joint return filed with a forged signature, or was it 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 not legal to file a joint return.

Types of Innocent Spouse Relief

The Internal Revenue Code provides for several types of innocent spouse relief. It is important to evaluate your client's facts and circumstances to determine what type of relief is applicable.

- 1) "Traditional" innocent spouse relief is provided by IRC § 6015(b). This provision type of relief is useful to eliminate liability for an innocent spouse where there has been an understatement of tax, i.e., an audit deficiency. IRC § 6015(b) does not provide for relief for an underpayment of taxes, i.e., where the amount of tax stated on the face of the joint return is not contested, but such taxes have simply not been paid over to the IRS.
- 2) "Separation of Liability" relief is provided by IRC § 6015(c). This type of relief can limit liability for understatements (not underpayments) to the portion of the deficiency properly allocable to that individual's earnings. Again, this provision is helpful only where there has been an understatement of tax, not an underpayment. Moreover, IRC § 6015(c) does not eliminate the force of community property laws. Relief from community property laws (i.e. limiting tax liability to income actually earned by the spouse in question) is made possible by IRC § 66, under circumstances that are parallel to the provisions of IRC § 6015(c).
- 3) "Equitable" relief is provided by IRC § 6015(f). This type of relief can be used to limit or eliminate liability for understatements and the only type of innocent spouse relief that is effective to eliminate an underpayment of tax shown on the face of the return.

According to IRC § 6015(f), relief is to be granted if based on the facts and circumstances, it would be inequitable to hold the individual liable. What “facts and circumstances” are necessary for the granting of innocent spouse relief is the focus of the article.

General Requirements for Equitable Relief according to Rev. Proc. 2013-34

The major changes to equitable innocent spouse relief under §6015(f) provided by ***Rev. Proc. 2013-34*** are discussed below.

First Step. In order to be considered for innocent spouse relief, there is a requirement that certain threshold conditions be met, as follows:

- a) Joint return was filed.
- b) Relief is not available through other provisions of IRC §6015(b) or (c).
- c) Request for relief was made timely (i.e. before collection or refund or credit statute expires) .
- d) Assets were not transferred as part of a fraudulent scheme to avoid collection.
- e) Disqualified assets were not transferred.
- f) Requesting spouse did not knowingly participate in the filing of a fraudulent joint return.
- g) The tax liability is attributable, in full or part, to the non-requesting spouse. Several exceptions to this general rule exist:
 - i) attribution solely due to the operation of community property law;
 - ii) nominal ownership;
 - iii) misappropriation of funds;
 - iv) abuse; and
 - v) fraud of non-requesting spouse.

Additionally, relief under IRC § 66 requires the taxpayer to meet these conditions as well, except conditions a and b above.

Second step. If the threshold conditions are satisfied, the IRS will make a “streamlined” determination, and ordinarily will grant relief if:

- a) The spouses are:
 - i) no longer married;
 - ii) legally separated;

- iii) one spouse is a widow/widower; or
- iv) the spouses have not been members of the same household during the past year; and
- b) The requesting spouse will suffer economic hardship if the Service does not grant relief; and
- c) The requesting spouse did not:
 - i) know of or have reason to know of the deficiency;
 - ii) know or have reason to know that the non-requesting spouse would not or could not pay the underpayment; or
 - iii) know or have reason to know of the item of community income.

Note that the existence of abuse or financial control by non-requesting spouse can satisfy this requirement even if the requisite knowledge exists.

Third Step. If “streamlined” relief is not available, the IRS will go on to consider other facts and circumstances to determine if it would be inequitable to hold the requesting spouse liable for all or part of the liability. The factors include:

- a) Marital status (i.e. being divorced weighs in favor of relief)
- b) Economic hardship (unable to pay reasonable living expenses based on rules similar to those provided in Treas. Reg. § 301.6343-1(b)(4))
- c) Knowledge
 - i) Understatement cases – Issue is whether spouse had knowledge or reason to know of the item giving rise to the understatement or deficiency at the time the requesting spouse signed the joint return.
 - ii) Underpayment cases – Issue is whether spouse knew or had reason to know at the time the requesting spouse signed the joint return that the nonrequesting spouse would not or could not pay the tax liability at the time the joint return was filed or within a reasonably prompt time after the filing of the joint return.
 - iii) Section 66 cases – Issue is whether the spouse knew or had reason to know of an item of community income that should have been included in gross income.
 - iv) Similar to streamlined relief, if abuse or financial control exists this factor can weigh in favor of relief even if the requisite knowledge exists.

- d) Legal obligations (i.e. one spouse has agreed to pay the liability in a divorce decree or other legally binding agreement. Note: clients are often surprised to learn that a court decree requiring the other spouse to pay is not binding on the IRS.)
- e) Significant benefit beyond normal support (lavish lifestyle such as owning luxury assets and taking expensive vacations).
- f) Good faith efforts to comply with tax laws (in the years following the year to which the request relates).
- g) Physical or mental health status when the return was filed or at the time the requesting spouse requested relief.

Significant Changes to Equitable Relief resulting from IRS Notice 2012-8 & Rev. Proc. 2013-34

IRS Notice 2012-8 and Rev. Proc. 2013-34 very significantly alter the standards for relief as set out in previous IRS guidance such as Rev. Proc. 2003-61.

Change #1: Greater deference is given to the presence of abuse than Rev. Proc. 2003-61. Existence of abuse can outweigh or negate other factors.

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

Change #3: Threshold conditions previously required that the income tax liability must be attributable to the non-requesting spouse. New exception exists if the item stems from the non-requesting spouse's fraud and thus gave rise to the understatements of tax.

Change #4: Streamlined determinations now apply to understatements of tax, underpayments of tax and claims for equitable relief under IRC § 66(c).

Change #5: No one factor or majority of factors controls a determination – it all depends on the facts and circumstances.

Change #6: Standards for economic hardship are revised. A lack of economic hardship will now be viewed as a neutral factor.

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 the knowledge factor to weigh in favor of relief.

Change #8: Similar to change #7 above, 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.

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 to make payment to the IRS).

Change #10: The significant benefit factor will not weigh against relief if the nonrequesting spouse abused or maintained financial control over the nonrequesting spouse and the nonrequesting spouse made the decisions about living a more lavish lifestyle.

Change #11: Subsequent compliance with income tax laws will now way in favor of relief, instead of just being viewed as a neutral factor.

Change #12: Refunds are now available in deficiency cases for payments made other than through an installment agreement.

When can innocent spouse relief be requested?

Generally, an innocent spouse request is made by filing an application for administrative relief (Form 8857) with the IRS Collection Division within the appropriate time period (within 2 years after the IRS begins collection activities for IRC § 6015(b) & (c) and within the collection statute of limitations for § 6015(f)). It can also be raised in other ways, for example, as a defense in a Tax Court Petition in response to a statutory notice of deficiency, or as a defense in a collection due process hearing.

Conclusion

The IRS appears to have come to the conclusion that equitable relief really should take into account all the facts and circumstances, as IRC § 6015(f) requires. No longer do we have arbitrary requirements like the two year filing deadline for IRC § 6015(f) relief. It is absolutely vital to work diligently to understand the new rules and to work hard with your client to gather as many facts as possible to support the various factors. At the same time, it is important to neutralize unfavorable facts if at all possible. Innocent Spouse Relief cases can be a lot of fun and a chance for you to be an advocate for your client – likely someone who really needs your help.

Anecdotally, since the time period that Notice 2012-8 was published in February of 2012, the changes have been a very positive development for Taxpayers. The administrative process seems to be fairer and appropriate requests for relief are being granted with greater frequency.

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