VALUATION OBSERVATIONS

Some practical observations from a practicing business appraiser.

VLC

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TAX RELIEF FOR AN "INNOCENT SPOUSE"

As a general rule, when a married couple files a joint tax return, each spouse is jointly and severally liable for the tax due and for interest and penalties that may become due. The liability exists 100% for both taxpayers even if they later divorce, regardless of the division of responsibility set out in the divorce decree.

Although the state courts recognize cross indemnification provisions in divorce decrees as a means of enforcing obligations between the parties, these agreements are ineffective against IRS assertions of unpaid taxes. The IRS does recognize, however, that joint and several liability may not always be fair. IRC Sec. 6015 provides three potential sources of relief to spouses and former spouses facing joint and several liability problems.

IRC 6015(b) provides a "general" relief rule available to all joint filers, including those who are still married to each other. IRC 6015(c) covers additional relief available to joint filers who at the time an election is filed either are divorced or legally separated from the other party to the joint return in question, or have lived apart from the other party for the preceding 12 months. (This is sometimes referred to as the "separate liability election.") When neither of those two sections applies, an innocent spouse may still gain relief under the equitable relief provisions of IRC 6015(f).

To benefit from either relief provision, a taxpayer must elect within two years of the commencement of IRS collection activity against the electing individuals for amounts related to the joint return year in question. The general relief rule under IRC 6015(b) is available to electing joint filers (whether or not still married) when there is a tax understatement attributable to "erroneous items" of the other party and if the electing individual establishes that (1) he did not know of the understatement and (2) he had no reason to know of it. In addition, it must be shown that it would be inequitable to hold the electing individual responsible for the understatement after considering all facts and circumstances. If these conditions are satisfied and the individual makes a timely election for relief, the electing party is fully relieved of liability attributable to the understatement.

This general relief rule can also extend to what might be called "semi-innocent" individuals (those who have some knowledge of an understatement as long as they did not know and had no reason to know the full extent of the understatement). In this case, a semi-innocent joint filer can make the election and receive relief for the "unknown portion" of the tax understatement caused by the other party.

The Section 6015(b) election provides more complete liability protection than the Section 6015(c) election, but its availability may be doubtful in come cases. Therefore, both the Section 6015(b) and (c) elections should be made when the joint filer is divorced or separated. If complete relief fails under the first election, the second could potentially limit the spouse's exposure.

Practitioners should consider advising all divorced clients receiving a deficiency for a pre-divorce jointly filed return to file the separate liability elections. This preserves the client's right to limit his liability to his separately computed portion. If a client is hesitant of filing such an election for fear of triggering reprisal from an abusive [former] spouse, appropriate steps may be taken to protect such a client. The IRS has initiated a series of steps to protect victims of domestic violence who apply for innocent spouse relief. Additionally, if a requesting spouse establishes that she was the victim of domestic abuse before the return was signed, and that, as a result of the prior abuse, she did not challenge the treatment of any items on the return for fear of reprisal; the actual knowledge limitation will not apply.

Sam F. Ford, et al. v. Commission, (2005) TC Memo 2005-18
Taxpayer wasn't entitled to Code Sec. 6015(b) relief from joint liabilities for year she and self-employed husband failed to report millions of dollars in capital gain income from concealed securities trades. Taxpayer knew or had reason to know of underpayment when she signed the return where she had been intimately involved in the underlying trading transactions, and actively participated in the operation of the nominee entities that were used to effect those transactions.

Charma Gatlin Cook v. Commissioner, (2005) TC Memo 2005-22
Ex-wife was granted Code Sec. 6015(c) relief from joint liability attributable solely to ex-husband's unreported business income. The IRS didn't prove taxpayer had actual knowledge of the omitted income. Evidence that taxpayer collected ex-husband's receipts and prepared his business invoices and monthly summaries showed only that she might have known about the subject income, not that she know of its omission; and, given their abusive relationship, she was in no position to question him.

Joan P. Levy v. Commissioner, (2005) TC Memo 2005-92
Taxpayer was entitled to Code Sec. 6015(c) relief from joint liability for 1 year's deficiency attributable to ex-husband's erroneous tax shelter loss. Although taxpayer failed Code Sec. 6015(b)(1)(C)'s "no reason to know" requirement because she didn't inquire as to the loss's offset of ex-husband's other income and substantial reduction of couple's tax liability, relief was available under Code Sec. 6015(c) where testimony and other evidence showed that taxpayer didn't participate in the tax shelter investment or ex-husband's medical business but was instead was a full-time homemaker without any source of income for that year.

Wayne Payne, et al. v. Commissioner, (2005) TC Memo 2005-130
Taxpayer wasn't entitled to innocent spouse relief from liability relating to unreported receipts from her and husband's roofing partnership. Taxpayer was precluded from relief under Code Sec. 6015(b) where she had reason to know of the understatement by her active involvement in the partnership bookkeeping, return preparation and various other aspects of its operation. And, Code Sec. 6015(f) relief wasn't warranted where she worked with husband to actively conceal subject income from return preparer and filed fraudulent returns.

Eugene McClelland, et al. v. Commissioner, (2205) TC Memo 2005-121
Taxpayer was entitled to Code Sec. 6015(b) relief from liability for deficiency arising from her and husband's tugboat S Corp's false interest deduction. Taxpayer didn't actually know about the deduction where it was reported only on the corporate return that she neither reviewed nor signed, husband admittedly caused and hid the false reporting from taxpayer, taxpayer played only a limited role in family finances and corporate operations, and family lifestyle didn't significantly change because of the

deduction. Also, taxpayer didn't have a duty to inquire into or have reason to know about the deduction given her limited involvement in financial affairs and non-participation in the corporate return. And although she financially benefited from the deduction, it would be inequitable within the meaning of Code Sec. 6015(b)(1)(D) to hold her liable because that benefit was used to compensate her for past underpaid services to the corporation, and because husband caused and concealed the false deduction from her.

Patricia A. Hendricks, et vir. v. Commissioner, (2005) TC Memo 2005-72
Retiree's request for Code Sec. 6015(b) relief from joint liabilities attributable to husband's partnership investment was upheld. Although taxpayer signed subject year return, she didn't actually know about the understatement. Notably, the partnership interest was in husband's name alone and all payments and mail relating thereto were made through his business office and separate account. Also, taxpayer lacked reason to know within the meaning of Code Sec. 6015(b)(1)(C) where she had no education or experience in tax/financial matters, played no real role in husband's businesses or family finances, didn't change her lifestyle or spending as a result of the understatement, and couldn't have been put on notice by a return that listed the subject item not on the face but only on Schedule E along with a number of other items. Similarly, it would be inequitable to hold taxpayer liable within the meaning of Code Sec. 6015(b)(1)(D) given lack of significant benefit, plus facts that she had made good faith effort to comply with tax laws in all subsequent years and would suffer economic hardship from the liability.

If you would like additional information, or have a question, please do not hesitate to call.

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Terri Lastovka is the founder of Valuation & Litigation Consulting, LLC. Her practice focuses on business valuations and litigation consulting in the areas of domestic relations, gift and estate tax, probate, shareholder disputes, economic damages, and forensic accounting. She draws from a wide range of experiences, including public accounting, law, banking, and CFO. She has received extensive training from the American Society of Appraisers in the area of business valuation and works closely with members of the bar to effectuate practical settlements. Terri also serves as the Director of Legal & Finance for Journey of Hope, a grass roots non-profit organization providing financial support to cancer survivors.