

# Domestic Relations

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## Tax Relief for an "Innocent Spouse"

*by Terri A. Lastovka, CPA, JD, ASA*

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. Internal Revenue Code 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.")



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When neither of those two sections apply, an innocent spouse may still gain relief under the equitable relief provisions of IRC 6015(f).

To benefit from any of the relief provisions, 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 individual 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 some 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 individual'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 her liability to her 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 an electing individual 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.

To qualify for Innocent Spouse Relief under IRC 6015(b), certain conditions must be met. First, the electing individual must have filed a joint return which has an understatement of tax due to erroneous items of her spouse. An erroneous item may be either (1) income received by the [former] spouse that is not reported, or (2) any improper deduction, credit, or property basis claimed by the [former] spouse. Second, the electing individual must establish that at the time she signed the joint return she did not know, and had no reason to know, that there was an understatement of tax. The IRS may rely on all facts and circumstances in determining whether the electing individual actually knew of an erroneous item at the time she signed the return. The facts and circumstances considered include:

- The nature of the erroneous item and the amount of the erroneous item relative to other items.
- The financial situation of the electing individual and the [former] spouse.
- The electing individual's educational background and business experience.
- The extent of the electing individual's participation in the activity that resulted in the erroneous item.
- Whether the electing individual failed to ask, at or before the time the return was signed, about items on the return or omitted from the return that a reasonable person would question.
- Whether the erroneous item represented a departure from a recurring pattern reflected in prior years' returns (for

example, omitted income from an investment regularly reported on prior years' returns).

An electing individual may be eligible for partial relief when a portion of an erroneous item is unknown. For example, if the electing individual knew that her spouse did not report \$5,000 of gambling winning, yet the IRS determined that the unreported gambling winnings were actually \$25,000, the understatement of tax due to the \$20,000 will qualify for innocent spouse relief if all the other requirements are met. The understatement of tax due to the known \$5,000 of gambling winnings will not qualify for relief.

Finally, to qualify for innocent spouse relief, taking into account all the facts and circumstances, it would be unfair to hold the electing individual liable for the understatement of tax. The following are examples of factors the IRS will consider.

- Whether the electing individual received a significant benefit, either directly or indirectly, from the understatement.
- Whether the [former] spouse deserted the electing individual.
- Whether the parties have been divorced or separated since filing the joint return.
- Whether the electing individual received a benefit on the return from the understatement.

A significant benefit is any benefit in excess of normal support. Normal support depends on the particular circumstances. Evidence of a direct or indirect benefit may consist of transfers of property or rights to property, including transfers that may be received several years after the year of the understatement. An example would be if the electing individual received money from her [former] spouse that is beyond normal support, and that money can be traced to his lottery winnings that were not reported on the joint return under examination. The electing individual will be considered to have received a significant benefit from that income. This would

be true even if he gave her the money several years after he received it.

**Relief by Separation of Liability** may be available if the electing individual does not qualify for Innocent Spouse Relief. Under this type of relief, the understatement of tax (plus interest and penalties) on the joint return is allocated between the spouses. This is available for unpaid liabilities resulting from understatements of tax on a joint return. To request relief by separation of liability the electing individual must not have actual knowledge of any erroneous items giving rise to the deficiency, and meet either of the following requirements at the time the request is made:

- The parties are no longer married or are legally separated. Under this rule, no longer being married includes being widowed.
- The parties were not members of the same household at any time during the 12-month period ending on the date relief is requested. However, spouses are considered members of the same household if any of the following conditions are met:
  1. Both parties reside in the same dwelling.
  2. The parties reside in separate dwellings but are not estranged, and one is temporarily absent from the other's household, as explained in (3) below.
  3. Either spouse is temporarily absent from the household and it is reasonable to assume that the absent spouse will return to the household, and the household or a substantially equivalent household is maintained in anticipation of the absent spouse's return. Examples of temporary absences include absence due to imprisonment, illness, business, vacation, military service, or education.

Even if an electing individual had actual knowledge, relief may still be available under the domestic abuse exception. To qualify under this exception, the electing individual must establish that she was the victim of domestic abuse before signing the return, and because of that abuse, she did not challenge the treatment of any items on the return because she was afraid her [former] spouse would retaliate. If she established that she signed the joint return under duress, then it is not a joint return, and she will not be liable for any tax shown on that return or any tax deficiency for that return. However, she may be required to file a separate return for that tax year.

If innocent spouse relief and relief by separation of liability are denied, the IRS will consider whether *Equitable Relief* is appropriate. Unlike the first two types of relief discussed, equitable relief is available for both an understatement of tax, and an underpayment of tax. An underpayment of tax is an amount of tax that was properly reported on the return but the tax was not paid. To qualify for equitable relief, the following conditions must be met:

1. The electing individual is not eligible for innocent spouse relief or relief by separation of liability.
2. The spouses did not transfer assets to one another as a part of a fraudulent scheme to defraud the IRS or another third party, such as a creditor, ex-spouse, or business partner.
3. The [former] spouse did not transfer property to the electing individual for the main purpose of avoiding tax or the payment of tax.
4. There was no intent to commit fraud by the filing or failure to file the tax return.
5. All the tax due was not paid.
6. The electing individual can establish that it would be unfair to be held liable for the understatement or underpayment of tax.
7. The income tax liability must be attributable to an item of the [former]

spouse with whom the electing individual filed the joint return, unless:

- a. If the item is titled in the electing individual's name, the item is presumed to be attributable to that spouse. However, presumption can be rebutted based on the facts and circumstances.
- b. The electing individual did not know, and had no reason to know that funds intended for the payment of tax were misappropriated by the [former] spouse.
- c. The electing individual can establish that she was the victim of abuse before signing the return, and that, as a result of the prior abuse, she did not challenge the treatment of any items on the return for fear of the [former] spouse's retaliation.

The IRS will consider all of the facts and circumstances in order to determine whether it is unfair to hold the electing individual responsible for the understatement or underpayment of tax. The following are examples of factors that the IRS will consider to determine whether to grant equitable relief.

- Whether the parties were separated (whether legally or not) or divorced. Temporary absences, as discussed above, are not considered separation for this purpose.
- Whether the electing individual would suffer a significant economic hardship if relief is not granted. In other words, she would not be able to pay her reasonable basic living expenses.
- Whether the electing individual has a legal obligation under a divorce decree or agreement to pay the tax. This factor will not weigh in favor of relief if the electing individual knew or had reason to know, when entering into the divorce decree or agreement, that the [former] spouse would not pay the income tax liability.

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- Whether the electing individual received a significant benefit (beyond normal support) from the unpaid tax or item causing the understatement of tax.
  - Whether the electing individual made a good faith effort to comply with federal income tax laws for the tax year for which relief is requested or the following years.
  - Whether the electing individual knew or had reason to know about the items causing the understatement or that the tax would not be paid.

Factors that will weigh in favor of equitable relief are whether the electing individual was abused by the [former] spouse, and whether the electing individual was in poor mental or physical health on the date the return was signed or at the time relief was requested.

Options are available to assist taxpayers from joint and several liability so long as they are truly "innocent" in the eyes of the Internal Revenue Service. The rules may be extensive, but are workable. ❖