

Beating a Dead Horse: Tax Indemnity Payments to Ex-Spouses

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Tax indemnity payments are common features of many transactions, such as litigation settlement agreements, merger documents, purchase and sale agreements, leases, and so forth. Regardless of the context, in general, they say: "If you get taxed as a result of the transaction, I'll cover it."

Sometimes, indemnity provisions are part of a divorce settlement. Take the divorce of one of the most famous corporate executives of all time, Jack Welch, former chairman of GE. His highly publicized divorce included a tax indemnity agreement with his ex-wife, Jane Beasley. Kranhold, "Welch Sets Tax Indemnity for Ex-Wife," *The Wall Street Journal*, July 7, 2003, at C7. The saga of From-The-Gut-Jack has us thinking about the tax consequences of this type of indemnity arrangement.

Why would you include a tax indemnity provision in a divorce settlement? Because filing a joint return with your spouse results in joint and several liability — that is, each spouse is potentially liable for the entire amount of any tax deficiencies, interest, and penalties. See section 6013(d); *Hayman v. Commissioner*, 992 F.2d 1256, 1259, *Doc 93-5551* (19 pages), 93 TNT 104-15 (2d Cir. 1993), *aff'g* T.C. Memo. 1992-228, *Doc 92-3412* (11 pages), 92 TNT 85-12; *Osborn v. Commissioner*, T.C. Memo. 1993-312, *Doc 93-7811* (22 pages), 93 TNT 149-11.

Beasley's attorneys obviously considered this in negotiating her settlement with From-The-Gut-Jack. Of course, an angry ex is not Welch's only problem. He is being scrutinized by the SEC for various matters relating to his years of service as chairman of GE. Kranhold, *supra*. Frankly, that would make anyone's gut hurt (we might suggest Pepcid AC or Tums).

Welch can only hope the IRS does not read *The Wall Street Journal* or chat with its brethren at the SEC. If the SEC turns up skeletons in his closet, it would not be a huge surprise to find Welch under audit by the IRS. When the smoke clears, Welch and Beasley could end up with substantial additional tax liabilities, interest, and penalties for any years they filed joint returns.

Beating the Rap on Joint and Several Liability

A tax indemnity agreement might help you recover unexpected tax liabilities from your former spouse. That's great. But, will it help you beat the rap on joint and several liability with the IRS? Hardly. See, for example, *Buchine v. Commissioner*, T.C. Memo. 1992-36, *Doc 92-583* (21 pages), 92 TNT 12-23, *aff'd* 20 F.3d 173, *Doc 94-4791* (10 pages), 94 TNT 94-86 (5th Cir. 1994). While there are other ways to beat the rap on joint and several liability, the most popular method is innocent spouse relief. See section 6015(b).

Still, playing the part of the innocent spouse is more difficult than you might think. To qualify as such, you must prove that there is an understatement of tax attributable to items of income that belong to your

spouse (or former spouse); you were unaware of this understatement when signing the return; it would be inequitable to hold you liable for the deficiency (based on all the facts and circumstances); and you sought relief within two years of the commencement of collection activities by the IRS. The spouse seeking relief bears the burden of proving that *each* of these elements is satisfied. *Welch v. Helvering*, 290 U.S. 111, 115 (1933); *Bokum v. Commissioner*, 94 T.C. 126, 138, *Doc 90-1664* (62 pages), 90 TNT 47-28 (1990), *aff'd* 992 F.2d 1132, *Doc 93-6463* (9 pages), 93 TNT 121-11 (11th Cir. 1993).

Sounds tough, doesn't it? It is. In fact, if you fail to fulfill *any* of these requirements, you are precluded from qualifying as an innocent spouse. *Shea v. Commissioner*, 780 F.2d 561, 565, *Doc 86-392* (15 pages), 86 TNT 10-55 (6th Cir. 1986), *aff'g in part and rev'g in part* T.C. Memo. 1984-310; *Estate of Jackson v. Commissioner*, 72 T.C. 356, 362 (1979). The Tax Court has frequently been unsympathetic to the plight of alleged innocent spouses. See, for example, *Stiteler v. Commissioner*, T.C. Memo. 1995-279, *Doc 95-6286* (43 pages), 95 TNT 124-18, *aff'd without published opinion* 108 F.3d 339, *Doc 97-6137* (4 pages), 97 TNT 42-20 (9th Cir. 1997); *Knapp v. Commissioner*, T.C. Memo. 1988-109, *Doc 88-9431* (5 pages), 88 TNT 243-27.

Tax on the Tax?

So what happens if Beasley gets hit with a tax bill from the IRS and Welch indemnifies her for it? How is the indemnity payment treated for tax purposes? Can Welch just write her a check for the gross amount and make it all better? Or will Welch have to "gross up" any payment to account for taxes that Beasley may be subject to on receipt of the indemnity payment?

Well, as they say, it depends whose story you believe. The IRS would likely argue that the receipt of a tax indemnity payment is taxable income to Beasley. (Gee, there's a surprise!) See, for example, LTRs 9833007, *Doc 98-25747* (3 pages), 98 TNT 158-12; 9743035, *Doc 97-29235* (3 pages), 97 TNT 207-11; 9743034, *Doc 97-29234* (3 pages), 97 TNT 207-10; 9728052, *Doc 97-20252* (4 pages), 97 TNT 134-27; and 9226033, 92 TNT 133-37.

There is substantial uncertainty surrounding the proper taxation of indemnity payments. Unfortunately, there have been very few developments in this area of the law in recent years. Taxpayers have generally cited *Clark v. Commissioner*, 40 B.T.A. 33 (1939), *nonacq. sub nom.* 1939-2 C.B. 45; *acq.* 1957-2 C.B. 4., for the proposition that tax indemnity payments are excludable from gross income. *Clark* is an old, hoary, even ancient case. In fact, it goes back to 1939 — more than a coon's age in tax lore.

The IRS has made no secret of the fact that notwithstanding *Clark*, it generally considers tax indemnity payments to be fully taxable. The IRS has frequently attacked tax indemnity payments as being taxable by asserting that under section 61 gross income is income from whatever source derived, and that under Treas. reg. section 1.61-14(a), the payment of another person's income tax (directly or indirectly) results in gross income to that person (unless otherwise excluded

by law). See, for example, LTRs 9833007, 9743035, 9743034, 9728052, 9226033. See also *Old Colony Trust Co. v. Commissioner*, 279 U.S. 716 (1929).

Nonetheless, one can argue that tax indemnity payments, such as those contemplated by From-The-Gut-Jack to his ex, are not gross income. These types of tax indemnity payments are distinguishable from the tax payments in *Old Colony Trust Co. v. Commissioner* as well as those contemplated by Treas. reg. section 1.61-14(a). In this case, Beasley would clearly end up paying additional taxes as a result of her association with her former husband. *Old Colony Trust* and Treas. reg. section 1.61-14(a) contemplate the payment of another's taxes when the person making those payments is not doing so to make the recipient whole.

As noted by the court in *Centex Corporation v. United States*, 55 Fed. Cl. 381, *Doc 2003-17565* (17 original pages), 2003 TNT 153-3 (2003), a common thread in recent private letter rulings dealing with tax indemnification is to distinguish *Clark v. Commissioner*. 55 Fed. Cl. 381, 389. In *Centex*, the court held that unlike the situation in *Clark*, the taxpayer was not ultimately paying any more in federal income tax than it otherwise would have, but for the negligence of another; hence, the tax indemnity payment it received was includable in gross income. 55 Fed. Cl. 381, 389, *citing* LTRs 9833007, 9743035, 9743034, 9728052, and 9226033. If Beasley can prove that she paid more in federal income taxes than she would have if she had not filed a joint return with Welch, we think that she would have a credible argument under *Centex* that any indemnification she receives is not taxable.

A Fond Farewell

We may never know how this whole thing turns out for Beasley and Welch. Most tax indemnity provisions do seem to sit unnoticed most of the time. Thus, it is entirely possible that From-The-Gut-Jack's ex will never need to claim benefits under the tax indemnity agreement with him. If she does, if Welch pays, if she fails to report the payment as income, and if she finds herself in a precarious position with the IRS (admittedly a lot of ifs), we wish her the best in trying to convince the Service that the indemnity payments she receives from Welch are not gross income. Let's see, she may have to gut it out. . . .

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