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When An Innocent Spouse Seeks Tax Relief

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Innocent spouse? Even in this day of no-fault divorce, when a marriage is in trouble - be it Tiger Woods' or Joe Schmo's - it's not unusual for one party to be viewed as a wronged party, an innocent spouse.

Similarly, when a couple files a joint tax return and then becomes delinquent in paying taxes, the Internal Revenue Service can judge one party an "innocent spouse," letting him (or more often her) off the hook. But convincing the IRS isn't easy despite efforts by Congress, as part of 1998 taxpayer protection reforms, to make sure that duped innocent spouses have a way of seeking relief from both the IRS and the U.S. Tax Court.

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Separate But Equal?

You don't have to co-mingle assets when you marry. You can keep assets separate, and have a pre- or post-nuptial agreement (or both) providing for that. Yet even some couples who are scrupulous about keeping their financial affairs separate, are surprisingly trusting of their better half when it comes to taxes. That's odd, because tax liabilities can complicate a marriage and its aftermath in a big way.

If you're married, you probably file joint tax returns. IRS statistics show that for the 2007 tax year some 54 million returns were filed listing the "married filing jointly" status. That compared with only about 2.7 million returns with "married filing separately" status, meaning that only 1.35 million couples chose to keep their tax filings separate. (For related reading, see *Happily Married? File Separately!*)

The Wages of Marriage

As a married couple, your tax filing choice is married filing jointly or married filing separately. You are often significantly better off in terms of overall tax liability if you file jointly, particularly if your earnings are unequal. There's been much attention paid to the marriage penalty: cases in which couples pay more taxes than they'd pay if they were single. But couples with unequal earnings who file jointly usually get a marriage bonus, paying less overall than if they were single.

You can use tax software such as Intuit's TurboTax or H&R Block's At Home (formerly TaxCut) to calculate it both ways, or have your return preparer do so, before you decide. That way you can see the dollar difference, enabling you to make a calculated decision which way to go. You can make a different decision about how to file each year if you wish, but if you have items that are carried over from one year to the next - such as unused capital losses - this can complicate your filings considerably.

Big Stakes
The stakes are far more important than merely a few dollars one way or the other. In fact, there can be long-term effects. If you file jointly, the liability is "joint and several," meaning that the IRS can generally come after either one of you for 100% of the debt.

By filing a joint return, you pay tax as one person. Even if your spouse earned 100% of the income, the tax liability is joint. If your spouse dies, goes to prison, flees the country, or simply divorces you and disappears with no forwarding address, you can be left holding the proverbial bag.

Plus, the joint liability extends not merely to whatever you put on your tax return. It also covers whatever else turns up that may or may not have been disclosed on the return you signed. For example, if you file a joint tax return but it turns out your spouse had millions in undeclared gambling winnings, you're just as liable for the tax as your spouse.

All of this makes it prudent for you to know whether your spouse has any past tax skeletons in the closet and to keep tabs on any tax problems he or she might generate during your marriage. However much you learn, you also should know something about claiming innocent spouse relief.

Innocent Who?
Innocent spouse relief is often invoked by taxpayers claiming they didn't know what their spouse was doing. While it's frequently invoked, the IRS is stingy when it comes to granting this status. So here are a few facts to keep in mind.

As you might expect, innocent spouse claims arise most frequently when a couple was married at tax time but later divorced. However, you can make an innocent spouse claim while you're still married. If the IRS is trying to collect taxes from you that you think are really your current or former spouse's problem, you must speak up.

You generally start the process by filing an IRS Form 8857, Request for Innocent Spouse Relief, requesting a separate tax liability, distinct from your current or former spouse. You must show not only that the understated tax on your joint return was due to erroneous items of your spouse, but also that when you signed the return you did not know, and had no reason to know, of the understated tax. In addition, you must demonstrate that taking into account all the facts and circumstances, it would be unfair to hold you liable.

Some of this - particularly the issue of "fairness" under the circumstances - is subjective. The IRS will evaluate your case, taking into account:

- The nature of the erroneous item and its amount relative to other items on your return;
- Your financial situation and that of your spouse (or former spouse);
- Your educational background and business experience;
- The extent you participated in the activity that resulted in the erroneous

item;
- If you failed to ask before signing the return about items on (or omitted from) the return that a reasonable person would question; and
- If the erroneous item was a departure from a recurring pattern on prior years' returns (for example, if it omitted income from an investment regularly reported on prior years' returns).

Actual Knowledge or Participation
Much of the IRS's focus is on just how innocent you seem. You won't fare well if you were an active participant in the problems. Even if you meet the four requirements of innocent spouse relief, your request will not be granted if:

- The IRS proves you and your spouse transferred assets to one another as part of a fraudulent scheme. A fraudulent scheme includes a scheme to defraud the IRS or a third-party, such as a creditor, ex-spouse, or business partner.
- Your spouse transferred property to you to avoid paying tax.
- The IRS proves that at the time you signed your joint return, you had actual knowledge or a reason to know of erroneous items that were allocable to your spouse. A reason to know exists when, based a variety of facts and circumstances considered by the IRS, a reasonable person in similar circumstances would have known of the erroneous item.

What's Fair?
There's a lot of attention paid to the relative equities and what looks fair. Under all the circumstances, is it inequitable to hold you liable for your spouse's tax problems? Here are some factors the IRS considers:

- Are the taxes really attributable to your spouse or ex-spouse?
- Are you still married to that spouse?
- Did you believe your spouse would pay the taxes on the original return?
- Did you know about the items changed in the audit?
- Will you be able to pay for basic living expenses like food, shelter, and clothing (or otherwise face hardship) if you are required to pay the tax?
- Did you significantly benefit (above normal support) from the unpaid taxes?
- Did you suffer abuse during your marriage?

Timing and Relief
Timing matters too. If you want to claim innocent spouse relief you must "generally" (see below) do so within two years after the IRS first begins trying to collect a tax debt. That "first collection activity" might be an IRS notice of intent to levy. However, it also might be something more innocuous, like a notice from the IRS that offsets a refund from another tax year. You have to be mindful so you don't try to claim relief belatedly.

This issue of timing has become controversial. The statute itself seems to state the rule flatly, and the IRS regulations echo it. But the U.S. Tax Court has said the claims for equitable relief under Internal Revenue Code Section 6015(f)--a kind of subset of innocent spouse claims--are different, and not so constrained. (See *Lantz v. Commissioner, 132 T.C. No. 8, April 7, 2009*).

The IRS has gone on record to its attorneys (IRS Chief Counsel Notice CC-2009-012, April 17, 2009) instructing them to keep fighting this issue. That means there will probably be additional fisticuffs about timing and what claims are barred. Of course, if you want to be ruled "innocent," you're better off avoiding the timing fuss and complying with the two-year deadline if you can.

Tell It to the Judge

Finally, if the IRS doesn't see fit to grant you innocent spouse relief, you can go to the U.S. Tax Court. The IRS has long maintained that the courts are simply there to decide - in light of the facts presented to it - whether the IRS made a reasonable decision. But taxpayers have claimed, and the U.S. Tax Court agreed this year that it can take a fresh look at the case, based on facts that may not have been considered by the IRS. That could lead to more spouses getting relief.

What sort of spouse does the court consider innocent? In one recent case, the Tax Court overruled the IRS and granted relief to a 70-year-old disabled and retired nurse who discovered only after his death that her husband of 38 years had left a financial mess. The husband, a lawyer, had handled all the family finances and had the back tax and other creditor bills sent directly to the U.S. Post Office, where he picked up the mail. In an effort to pay off the debts, she had sold off possessions and their long-time Iowa home and moved into a trailer. Collecting more of the debt from her, the court concluded, would be an unfair economic hardship.

You may be able to get innocent spouse relief based on less compelling facts, but you should be aware that the standards are pretty high.