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INNOCENT SPOUSE

Alternatives For Improving Innocent Spouse Relief

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Statement

Innocent Spouse: Alternatives for Improving Innocent Spouse Relief

Madame Chairman and Members of the Subcommittee:

We are pleased to be here today to discuss our report on the innocent spouse provisions of the Internal Revenue Code. Like the Department of the Treasury (Treasury), we were required under section 401 of the Taxpayer Bill of Rights 2 to report to the Congress on certain issues related to joint and several liability and the application of the innocent spouse provisions.

Our comments today are based on our report, which was issued in March 1997.[1] It has findings and, in several cases, recommendations similar to those in the more recent Treasury report.[2] Specifically, our report discussed (1) the universe of taxpayers potentially eligible for innocent spouse relief, (2) the Internal Revenue Service's (IRS) practices and procedures for handling requests for such relief, (3) whether the existing innocent spouse provisions provide the same opportunity for relief for all taxpayers, (4) the potential effects of replacing the joint and several liability standard with a proportionate liability standard, (5) the potential effects on IRS of requiring it to abide by the terms of divorce decrees that allocate tax liabilities, and (6) the potential effects of limiting IRS' ability to seize community income to satisfy the tax liabilities incurred by one of the spouses before the marriage.

Our testimony today makes the following points:

- Under current law, only about 1 percent of the couples who filed joint returns in 1992 had additional tax assessments that potentially met the dollar threshold for innocent spouse relief. If only divorced taxpayers were counted, about 35,000 of the 587,000 couples with additional tax assessments of more than $500 for 1992 may have been eligible for innocent spouse relief. However, our estimate of 587,000 couples represents the maximum number of couples potentially eligible for innocent spouse relief; fewer would probably actually qualify. For instance, some of the 587,000 couples may not have qualified for innocent spouse protection because they knew there was a substantial tax understatement. This knowledge would have made them ineligible for relief even if the tax deficiency was solely attributable to the actions of one spouse.

[1] Tax Policy: Information on the Joint and Several Liability Standard (GAO/GGD-97-34, March 12, 1997).

[2] Report to the Congress on Joint Liability and Innocent Spouse Issues (Department of the Treasury, February 9, 1998).

- The limited information available indicated that IRS received few requests for innocent spouse relief and denied most of them. Although we could not determine why few requests were made, we observed that IRS publications provide little information on how to request innocent spouse relief and that IRS has no specific form or process for applying for such relief.
- The current provisions may not ensure that all deserving taxpayers receive equivalent relief. For example, the dollar thresholds for claiming innocent spouse relief may preclude some deserving taxpayers from obtaining relief because of the amount of their liability. We estimated that for tax year 1992, about 40,000 additional divorced couples might have been eligible for innocent spouse relief if the dollar thresholds had been eliminated.
- One way to address concerns with the innocent spouse provisions would be to replace the joint and several liability standard with a proportionate liability standard. Under the joint and several liability standard, each spouse becomes individually responsible for the entire amount of the tax associated with a joint return. Under a proportionate liability standard, couples would be responsible only for the taxes generated by their individual incomes and assets. Options for administering proportionate liability include (1) requiring all taxpayers to file separately, (2) modifying joint returns so that each spouse's income and deductions are reported separately, and (3) applying proportionate liability only in cases where there are unpaid taxes or subsequent tax assessments. Each of these options represents a trade-off between clearly establishing each taxpayer's liability and the amount of paperwork and administrative burden created for taxpayers and IRS. Each could also increase the costs of IRS' enforcement programs.
- Requiring IRS to be bound by divorce decrees is impractical for two major reasons. First, federal tax matters are the exclusive jurisdiction of certain federal courts, while divorce matters are generally handled by state courts. Thus, there is currently no legal forum where IRS and the parties to a divorce could resolve issues relating to both tax and divorce matters. Second, this proposal could require IRS to become involved in every divorce settlement to ensure that the government's interest is protected. In 1994, about 1.2 million divorce decrees were granted in the United States. Even if IRS were bound by divorce decrees, these decrees could be manipulated to thwart IRS' collection efforts. For example, one spouse might retain sole ownership of the couple's residence, the couple's major asset, while the spouse without assets takes responsibility for the taxes. Thus, IRS would not be able to place a lien against the residence to force collection action for any delinquent taxes.
- In community property states, IRS can levy one spouse's income to satisfy the premarital tax debts of the other spouse because of the joint

ownership of property in those states. In contrast, IRS cannot levy the income of one spouse to pay the premarital tax debts of the other spouse in common law states because spouses do not have a legal entitlement to each other's property. Since IRS does not maintain data on how often it levies community property to settle premarital tax debts, we could not assess the potential impact on IRS of changing the law to treat everyone the way it treats taxpayers in common law states.

- Treasury's report parallels our report on identifying ways to improve the administration of the current innocent spouse provisions. They include revising publications to better educate and inform taxpayers on the provisions, creating a new form for applying for relief, training IRS staff on how to handle innocent spouse claims, and developing a process for ensuring consistency in processing innocent spouse claims. Also, Treasury recommended several statutory changes that would give more taxpayers opportunities to qualify for innocent spouse relief, would allow the Tax Court to review IRS denials of innocent spouse claims, and would suspend collection actions against one spouse when the other is contesting a proposed assessment in Tax Court. While we did not recommend any statutory changes, we did point out in our report the inequities of not allowing more taxpayers to be eligible for relief. Our report did not discuss having the Tax Court review denied innocent spouse claims or suspending collection actions on Tax Court cases.

I would like to discuss each of these points in more detail after providing an overview of the current innocent spouse provisions and presenting several examples of how IRS administers the provisions.

Innocent Spouse Provisions

Under the joint and several liability standard, when a married couple files a joint federal income tax return, each spouse becomes individually responsible for paying the entire amount of the tax associated with that return. As a result, one spouse can be held liable for tax deficiencies assessed after a joint return was filed, even if the additional taxes were solely attributable to the income of the other spouse. Married couples can file separately and be held liable only for the taxes accruing from their own income, but couples who file this way may face a higher total tax bill than if they filed jointly.

An example of the potential liability resulting from joint filing would be if IRS discovered that one spouse actually had an additional $5,000 in income not reported on the joint return that the other spouse was not aware of. If IRS cannot collect the additional taxes owed on the unreported income

from the culpable spouse, it may seek to collect the taxes from the "innocent spouse." However, the innocent spouse may obtain relief from the additional tax liability if certain conditions are met.

The current innocent spouse provisions only apply to taxes assessed after the joint return was filed. The provisions do not apply to underpayments of the taxes reported on the joint return because any underpayments are expected to be known by both spouses signing the joint return. The provisions allow relief from the joint and several liability standard when

- the innocent spouse has filed a joint return with the culpable spouse;
- the innocent spouse did not know and had no reason to know there was a substantial tax understatement (knowledge test); and
- taking into account all the facts and circumstances, it is inequitable to hold the spouse liable for the additional tax attributable to the substantial understatement of the culpable spouse.

In addition, the spouse requesting relief must meet certain dollar thresholds that vary depending on the cause of the additional assessment:

- A tax liability resulting from an omission of gross income must exceed $500.
- A tax liability resulting from a deduction, credit, or basis that has no basis in fact or law must exceed $500 and also be in excess of certain income levels.[3] If the innocent spouse has remarried, the new spouse's income is included in this calculation whether or not they file a joint return.

The following case histories illustrate the types of situations that IRS and taxpayers confront when applying these standards:

- A taxpayer learned of an assessment of over $3,000 against a 1985 joint return when IRS levied her wages in 1992. The assessment was generated primarily by her ex-husband's disallowed business and moving expenses, although he also had some unreported income. The taxpayer submitted documentation demonstrating that the unreported income was generated by her husband and received relief for about $200. According to an IRS official, she could not substantiate her husband's disallowed business expenses and was held liable for the remainder of the tax.
- A taxpayer's ex-husband, a wanted fugitive, had not paid the tax reported for 2 tax years. The taxpayer remarried, and IRS placed liens against her

[3]These income levels are (1) 10 percent of the innocent spouse's adjusted gross income for their preadjustment tax year if the taxpayer's income is less than or equal to $20,000; or (2) 25 percent of the innocent spouse's income if the taxpayer's income is greater than $20,000.

new husband's property. IRS denied innocent spouse relief. This was in part because the liability was for taxes reported on the joint return rather than taxes assessed after the return was filed; that is, there was an underpayment. IRS did accept an Offer in Compromise for both years and for a third year where the ex-husband had failed to report income.

- In 1995, a taxpayer wrote to IRS to protest taxes due on 3 joint returns that were attributable to income derived from her ex-husband's fraudulent activities. In 1996, IRS informed the taxpayer she was not eligible for innocent spouse relief for 2 tax years because these balances were for taxes reported as due on the original returns but not paid when the returns were filed. However, IRS staff informed the taxpayer they would consider innocent spouse relief for 1 year if the taxpayer could demonstrate she had no knowledge of the unreported income. She submitted third-party statements that she did not live a lavish or enhanced lifestyle as well as copies of police records on her ex-husband's arrest and trial. IRS eventually granted innocent spouse relief for that 1 year.
- A taxpayer learned of an assessment of about $1,200 on joint returns for 2 years when IRS seized her 1995 tax refund. The assessment was generated by her ex-husband's unreported income. The taxpayer argued that the couple had maintained separate checking and savings accounts, and therefore she did not know of the unreported income. Furthermore, the divorce decree specified that her ex-husband would be responsible for outstanding tax debts incurred during the marriage. IRS denied innocent spouse relief for 1 year because the additional tax assessment for that year was less than the $500 threshold. IRS denied innocent spouse relief for the other year because the taxpayer did not meet the knowledge requirement. Because the unreported income was more than 75 percent of the ex-husband's total income, IRS staff believed she should have been aware of the income earned even though the spouses had separate accounts.
- A taxpayer was assessed over $3,000 on joint returns filed in 4 tax years generated by her husband's disallowed deductions for gambling losses. She was denied innocent spouse relief for 1 year because the additional tax assessment for that year was less than the $500 threshold. She was denied innocent spouse relief for the other 3 years because the additional tax assessment in each of those years was less than 25 percent of her adjusted gross income.

Estimated Universe of Potential Innocent Spouses

Because IRS did not have data on the number of innocent spouse requests filed, we developed an estimate of the potential universe of innocent spouses by analyzing data relating to the 1.2 million joint returns which were assessed additional taxes under IRS' 1992 audit and underreporter

programs. Of these 1.2 million returns, about 587,000 had additional tax assessments exceeding $500, which is the minimum dollar threshold required for innocent spouse relief.

However, our estimate of 587,000 couples represents the maximum number of taxpayers potentially eligible for innocent spouse relief. This is more than would probably actually qualify. For instance, some couples were probably assessed additional taxes as a result of overstated deductions, credits, or basis, which have other dollar thresholds in addition to the $500 threshold. Further, some of the 587,000 couples may not have qualified for innocent spouse protection because they both knew there was a substantial tax understatement. This knowledge would have made them ineligible for relief even if the tax deficiency was solely attributable to the actions of one spouse.

Since divorced taxpayers seek innocent spouse relief most frequently, we also estimated the number of taxpayers who could potentially be eligible for relief and may have divorced during the 3 years since the 1992 joint returns were filed. Using a 2-percent per year divorce rate, we estimated that 35,000 divorced taxpayers had additional tax assessments of more than $500.

Information Available on Applying for Innocent Spouse Relief Was Limited

Although innocent spouse relief is clearly established in law and regulation, we observed that little information about the criteria for granting it or how to apply for it was available from IRS. The innocent spouse relief provisions are described in several IRS publications, but these publications do not provide any guidance on how to request relief. Furthermore, these publications are developed to help taxpayers prepare their returns, which is far in advance of the time that taxpayers might need information on innocent spouse relief. Moreover, the publications most directly related to the enforcement and collection procedures that apply when taxpayers are billed for their spouses' taxes are totally silent about innocent spouse relief.

Because IRS lacked well-defined procedures for taxpayers to request innocent spouse relief, the taxpayers involved in the innocent spouse cases we reviewed resorted to existing avenues that were designed to resolve other types of problems. In most cases, we found that either the taxpayers or their representatives had (1) contacted Problem Resolution Offices, which were established to assist taxpayers who cannot resolve their problems through normal IRS channels; or (2) had requested relief

through an Offer in Compromise, which is used in the cases of taxpayers who cannot pay the full amount of the balance due and decide to offer a lesser amount. The fact that taxpayers are commonly using these two approaches to seek innocent spouse relief indicates to us that IRS does not provide taxpayers with adequate guidance for seeking relief.

Some IRS staff are as confused as taxpayers about how to request innocent spouse relief. The various IRS units we contacted took different approaches to providing relief. For example, two district offices granted relief using Offers in Compromise based on doubt as to liability, while staff at one service center routinely denied such requests as inappropriate.

Modifying Tax Code Provisions Could Allow More Taxpayers to Qualify for Relief

The current provisions may not ensure that taxpayers receive equitable relief. For example, the dollar thresholds represent eligibility criteria for relief based on income or the size of the liability. These criteria appear to be more related to an ability to pay or degree of hardship than to the innocence of the taxpayer. The logic behind the income thresholds is particularly cloudy because the potential innocent spouse's income is based on the tax year ending before the notice of deficiency (which may be several years after the tax year of the joint return) and must include the income of any new spouse. Finally, the dollar thresholds prevent taxpayers with smaller liabilities from obtaining relief. Since the minimum understatement of tax in all cases must be more than $500, lower income taxpayers could be precluded from obtaining relief. We estimated that if the dollar thresholds were eliminated, the maximum number of couples filing tax year 1992 returns potentially eligible for innocent spouse relief would have been 1.2 million, which consist of all couples who were assessed additional taxes under IRS' audit and underreporter programs.

Also, under the current provisions, spouses can receive relief if deductions, credits, or basis have absolutely no basis in fact or law, but not if they are simply erroneous. The distinction between a deduction having no basis in fact or law versus its just being erroneous is difficult to comprehend and can lead to various interpretations by IRS and the courts. This problem is compounded by the fact that IRS' regulations governing innocent spouse relief were issued in 1974 and have not been updated to incorporate more recent changes to the provisions.

The "knowledge" factor is perhaps the most subjective element in the current innocent spouse provisions. For someone to prove that they did not know and had no reason to know of a financial transaction undertaken

by his or her spouse would generally be difficult, if not impossible. IRS and the courts consider circumstantial factors, such as education, involvement in the family's financial affairs, and lifestyle, in assessing this contention. For example, one indicator that IRS uses to determine if spouses were aware of the tax avoidance is whether they benefited by living a lifestyle significantly better than could be supported by the reported income. However, according to critics, determining whether a taxpayer's lifestyle was significantly better because of the tax avoidance is fairly subjective and the courts have interpreted the criteria differently.

Potential Impact of Replacing the Joint and Several Liability Standard With Proportionate Liability

One way to ensure that taxpayers are not held liable for their spouses' taxes would be to replace the joint and several liability standard with a proportionate liability standard. Under proportionate liability, taxpayers would be held responsible only for the taxes generated by their own individual incomes and assets or, for taxpayers living in community property states, for the tax associated with one-half of the community income. We identified three options for administering a proportionate liability standard. The options are to (1) eliminate joint returns and require all taxpayers to file separately, (2) retain joint returns but modify them so that each spouse's income and deductions are reported in separate columns (this is called front-end proportionality), and (3) retain the current joint return requirements but apply proportionate liability only in cases where there are delinquent taxes or subsequent tax assessments (this is called back-end proportionality).

We evaluated the potential effects of these options on IRS' tax administration processes and taxpayers' burden. Table 1 shows the pros and cons of the three options for taxpayers and IRS.

Table 1: Pros and Cons of Different Methods of Administering a Proportionate Liability Standard

Entity	Separate return option[a]	Modified joint return option[b]	Current joint return option[c]
Taxpayers			
Pros	If divorced, individual liability is more clearly established.	If divorced, individual liability is more clearly established.	No additional paperwork burden.
Cons	Must prepare two returns but receive limited or no benefit while married.	Must allocate joint income, deductions, and credits but receive limited or no benefit while married.	Must establish individual liability if additional taxes assessed.
	May have a higher tax liability.	May have a higher tax liability.	
IRS			
Pros	Individual liability more clearly established.	Individual liability more clearly established.	No additional return-processing costs.
Cons	Increased costs for processing up to twice as many returns for married couples.	Might increase costs for keying additional data into computer systems.	Must establish individual liability if additional taxes assessed.
	Increased difficulty in matching income reported on returns to information returns.	Increased difficulty in matching income reported on returns to information returns.	
	Increased collection costs because IRS would have to collect from each taxpayer.	Increased collection costs because IRS would have to collect from each taxpayer.	Increased collection costs because IRS would have to collect from each taxpayer.

[a]Each spouse files separate return.

[b]Income split out separately on joint return.

[c]Proportionate income only for returns with unpaid taxes or subsequent tax assessments.

Source: GAO's analysis of three proportionate liability options.

As shown in the table, these options represent trade-offs between clearly establishing each taxpayer's liability on their tax returns and the amount of paperwork and administrative burden created for taxpayers and IRS.

Binding IRS to Divorce Decrees Would Be Impractical

Divorcing couples may specify in their divorce decrees how future liabilities resulting from their prior joint returns are to be handled, such as one spouse is entirely liable, both spouses are equally liable, or some other permutation. However, IRS is not bound by these divorce decrees because it is not a party to the decree.

We found that a legislative change to bind IRS to divorce decrees appears impractical for two major reasons. First, current federal law provides no mechanism whereby IRS can be a party to divorce proceedings. Federal tax matters are the exclusive jurisdiction of the federal courts. Divorce matters, however, are generally handled by state courts. Federal courts have traditionally refused to consider any legal action involving divorce. Thus, providing a legal forum where IRS and the parties to a divorce could resolve issues relating to both tax matters and divorce proceedings would require a fundamental and extensive change in either federal tax law or state domestic relations law.

Second, binding IRS to divorce decrees could require IRS to become involved in every divorce settlement or trial. In 1994, about 1.2 million divorce decrees were granted in the United States. To be a party to this many legal proceedings nationwide each year would create a significant administrative burden for IRS.

IRS officials also believe the number of appeals would increase because divorce decrees can be lengthy and complex documents that are open to more than one interpretation. Furthermore, IRS officials fear that divorce decrees would be manipulated to thwart its collection efforts. For example, one spouse might retain sole ownership of the couple's residence, the couple's major asset, while the spouse without assets takes responsibility for the taxes. Thus, IRS would not be able to place a lien against the residence to force collection action for any delinquent taxes.

IRS Follows State Property Laws in Collecting Premarital Tax Debts

About 13 million, or 27 percent, of all taxpayers who filed joint returns in 1992 lived in community property states. Some of these taxpayers may have been held financially responsible for tax liabilities incurred by their spouses before their marriage, which they would not have been if they lived in a common law state. This disparate treatment between taxpayers residing in community property states versus those living in common law states occurs because IRS, as with other creditors, follows state law in classifying married couples' rights in property.

Because the income, including wages, of taxpayers living in certain community property states is considered community property, IRS can place a levy on the wages or other separate income of either spouse to satisfy an existing tax debt, even if that tax debt was incurred by the other spouse before their marriage. In contrast, IRS cannot place a levy on the separate income of one spouse to pay the taxes due from the other spouse in a common law state. Once the income of either spouse is placed in a joint account it would be subject to IRS seizure in both community property and common law states.

According to IRS officials, the agency does not have specific procedures for placing levies on a spouse's income for premarital taxes incurred by the other spouse. Officials told us that under IRS' collection procedures, levy action is generally to be taken against the individually held income. For example, wages of the taxpayer who incurred the tax debt or any jointly held income, such as an interest-bearing account, may be levied but not the separate income of the other spouse.

Treasury's Report Parallels Our Administrative Recommendations

Treasury's February 1998 report indicates that IRS is currently undertaking a number of actions to improve the administration of the current innocent spouse provisions. Several of these actions were recommended in our March 1997 report and will include:

- issuing a new form to assist taxpayers in preparing claims for innocent spouse relief,
- processing the new form in one central location to ensure greater consistency in evaluating the claims,
- developing training courses on the innocent spouse provisions for collections and examination personnel, and
- revising tax form instructions and other publications to make innocent spouses more aware of the relief available to them.

Other actions Treasury reports IRS to be undertaking include:

- reviewing current training materials to ensure that they stress the responsibilities of IRS employees to identify situations where innocent spouse provisions might apply, even where the taxpayer does not know of the provisions,
- making telephone assistors, specially trained in innocent spouse provisions, available to answer questions from taxpayers received through IRS' toll free telephone system, and
- conducting outreach to community organizations that serve abused and battered spouses to identify those who might qualify for innocent spouse relief.

We believe these administrative actions if implemented effectively should make more taxpayers aware of their rights under the innocent spouse provisions and provide for more consistent application of the provisions by IRS employees.

Treasury's report made three statutory recommendations. One dealt with making it easier to qualify for innocent spouse relief by changing statutory standards to help additional taxpayers, including those with smaller tax liabilities who are presently ineligible for relief. These changes would include lowering or eliminating the income thresholds, allowing underpayment as well as understatement of taxes to be covered by the provisions, and eliminating the "no basis in fact or law" requirement for erroneously claimed deduction, credit, or basis, which would put these items on the same footing as omissions from income. While we did not recommend any of these changes, our report did point out similar problems with these provisions.

Treasury recommended two other statutory changes that would help taxpayers. One would allow the Tax Court to review IRS denials of innocent spouse claims, and the other would suspend collection actions against one spouse when the other is contesting a proposed assessment in Tax Court.

Summary

In summary, Madame Chairman, we found that the existing innocent spouse provisions are complex, difficult to understand, and pose a serious challenge for IRS and taxpayers. In addition, they result in the inequitable treatment of taxpayers. There are both administrative and statutory

options for improving the innocent spouse provisions. On the administrative level, we have made recommendations, which are echoed in the Treasury report. If the recommendations are properly implemented, they would put both taxpayers and IRS employees in a better position to understand and be in compliance with the provisions. We believe these improvements should be undertaken regardless of whether there are changes made to the statute.

On the statutory level, repeal of the qualifying thresholds and inclusion of erroneous deductions and underpayment as well as understatement of tax could make the provisions less complex and more equitable.

Finally, there is the issue of replacing the joint and several liability standard with a proportionate liability standard. While there are several alternatives for doing this, each represents trade-offs between establishing individual taxpayer liability on a tax return and the amount of paperwork and administrative burden created for taxpayers and IRS.

This concludes our prepared statement. We would be pleased to answer any questions.

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