

IRS Changes Policy, Relaxes Rules for Innocent Spouse Relief

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A recent revenue procedure and chief counsel notice reflect significant IRS policy and procedural changes for claims under section 6015(f). The IRS has relaxed the eligibility conditions for innocent spouse relief, and for the first time, there is now uniform law in the Tax Court. A taxpayer obtains a *de novo* trial, and there is no deference given in court to the IRS's innocent spouse determination. So even if a taxpayer does not prevail before the IRS, the Tax Court will give the case a fresh look. This article examines the recent policy changes and discusses issues that tax advisers should be aware of when counseling clients seeking equitable innocent spouse relief from joint and several liability.

Section 6015(f) authorizes the IRS to grant equitable relief from joint and several liability if, taking into account all the facts and circumstances, it is inequitable to hold the individual taxpayer liable for the unpaid tax or any income tax deficiency arising from a jointly filed return. But ever since Congress added section 6015(f) to the code in 1998, there has been considerable controversy (and hard-fought litigation) over what particular facts and circumstances justify granting equitable relief. Treasury issued reg. section 1.6015-4 in July 2002, but the only real, substantive guidance came the following year, when the IRS issued Rev. Proc. 2003-61, 2003-2 C.B. 296.

Based on its experience in working section 6015(f) cases, the IRS recently attempted to clarify when an individual is entitled to equitable relief. On September 16 it issued Rev. Proc. 2013-34, 2013-43 IRB 397, which provides updated guidance for taxpayers seeking equitable relief from income tax liability under section 66(c) or 6015(f). Most notably, the IRS now gives greater deference to the presence of abuse or financial control by the non-requesting spouse. It also recognizes that abuse can come in many forms, including physical, psychological, sexual, or emotional abuse. The IRS acknowledges that abuse or financial control may mitigate other factors that might otherwise weigh

against granting equitable relief. This and other significant policy changes are a breath of fresh air to taxpayers seeking relief from unpaid taxes because of a former spouse who was abusive or maintained control over the household finances by restricting access to financial information.

The revenue procedure was preceded by a chief counsel notice, CC-2013-011, providing litigation guidance for cases that involve claims for relief under section 6015(f). The notice, released June 7, discusses important policy changes and new procedural rules regarding how the IRS Office of Chief Counsel handles section 6015(f) cases docketed in the Tax Court.

Both Rev. Proc. 2013-34 and CC-2013-011 are important documents for practitioners to read when counseling clients on innocent spouse cases. This article examines that guidance and highlights issues that tax advisers should be aware of when advising clients seeking innocent spouse relief.

A. Overview

It may come as a surprise to some clients that a married individual who jointly files a federal income tax return is on the hook for any tax deficiency resulting from that return, even if the individual's former spouse was the breadwinner.¹ Therefore, the IRS can hold one spouse jointly and severally liable and collect the entire amount of unpaid taxes from that spouse.

This article will draw from the following example: Assume Beth and Robert have been married for several years, have two children together, and live in California. Beth owns a small boutique in San Francisco, and Robert works as a biotech executive. The couple is obtaining a divorce, and Beth discovers that there is an income tax deficiency for 2011 stemming from an investment that Robert made in a Hong Kong limited partnership. The IRS disallowed deductions flowing from the investment claimed on the couple's tax return. Robert also sold stock on the Hong Kong Stock Exchange, deposited the sale proceeds in a Shanghai bank account, and never reported and paid tax on the gain. Robert forgot to tell Beth about the transaction. Upon further probing, Beth's divorce attorney discovered

¹Section 6013(d)(3).

that Robert failed to pay the IRS for the balance due on the couple's 2012 return.

Fast forward to 2013. The IRS is now collecting the tax deficiency for 2011 and the unpaid taxes for 2012. It can pursue either Beth or Robert to collect the full amount of the tax debt. Unfortunately for Beth, Robert has taken a job transfer and is now living and working in Shanghai for a start-up biotech company. Unable to easily communicate with Robert, the IRS decides to go after the low-hanging fruit and commences collection activity against Beth's assets in California. The IRS has garnished her wages, sent a notice of intent to levy against her bank account, and is threatening to file tax liens unless a collection alternative is proposed (that is, an installment agreement).

Beth's divorce attorney has advised her not to worry because he is negotiating a divorce decree or other legally binding agreement in state court that will allocate responsibility to pay the taxes between Beth and Robert. But unbeknownst to the attorney, the IRS is not legally bound by a state court order and can still take collection action against one or both spouses.

Under the innocent spouse provisions, however, Beth may be able to work out an arrangement under which she is no longer liable for the income taxes and the IRS is forced to collect only from Robert. The guidance announced in Rev. Proc. 2013-34 may give her greater opportunity to obtain relief than before.

B. Rev. Proc. 2013-34

1. Threshold eligibility conditions. Rev. Proc. 2013-34 begins by listing the following threshold conditions that a requesting spouse must satisfy to be eligible to submit a request for equitable relief under section 6015(f):

1. the requesting spouse filed a joint return;
2. relief is not available under section 6015(b) or (c);
3. the claim for relief was timely filed;
4. no assets were transferred between spouses as part of a fraudulent scheme;
5. the non-requesting spouse did not transfer disqualified assets to the requesting spouse;
6. the requesting spouse did not knowingly participate in the filing of a fraudulent joint return; and
7. the income tax liability from which the requesting spouse seeks relief is attributable (in full or in part) to an item of the non-

requesting spouse or an underpayment resulting from the non-requesting spouse's income.²

Two important observations can be made about the threshold conditions. First, the IRS has expanded the time frame in which a requesting spouse can file a claim for relief. The IRS previously maintained that a requesting spouse had to apply for relief no later than two years after the date of the first collection activity.³ A request for relief now must be filed before the expiration of either the 10-year collection period under section 6502 or the section 6511 limitations period for credit or refund (to the extent the taxpayer seeks a refund of taxes paid).⁴

The two-year rule was a common trap for the unwary. Individuals often were unaware of their ability to file an innocent spouse claim until long after the IRS began collection activity. Beth, for example, was unaware of her ability to seek relief until the divorce proceedings were well underway. The two-year rule would preclude her from obtaining relief on an otherwise valid claim. The expanded time frame under Rev. Proc. 2013-34 gives Beth more opportunity to work with a competent tax adviser, factually develop her case, and submit a well-supported claim for equitable innocent spouse relief.

Second, the attribution threshold condition (factor 7) had been problematic for some taxpayers to satisfy because the IRS previously required that the income tax liability from which relief was sought be "attributable to an item of the individual with whom the requesting spouse filed the joint return."⁵ If any of the unpaid taxes in our example were caused by unreported income or disallowed deductions stemming from Beth's boutique business, she could be barred from relief. Fortunately, the IRS has relaxed this requirement by adding the phrase "either in full or in part" to factor 7.⁶ A requesting spouse can now obtain relief even if the unpaid taxes are attributable only in part to an item of the non-requesting spouse. This is a welcome policy change.

There also are now several exceptions to the attribution threshold condition. The IRS will consider granting relief, regardless of whether the understatement, deficiency, or underpayment is attributable to the requesting spouse, if any of the following exceptions apply:

²Rev. Proc. 2013-34, section 4.01.

³Rev. Proc. 2003-61; reg. section 1.6015-5(b)(1).

⁴Rev. Proc. 2013-34, section 3.02.

⁵Rev. Proc. 2003-61, section 4.01(7).

⁶Rev. Proc. 2013-34, section 4.01(7).

1. attribution resulting solely from the operation of community property law;
2. nominal ownership;
3. misappropriation of funds;
4. abuse; and
5. fraud committed by the non-requesting spouse.⁷

The IRS added a new exception, fraud, to the requirement that the income tax be attributable to the non-requesting spouse. If, in our example, Beth can establish that Robert's fraud gave rise to the understatement of taxes owed for 2011, she would get a free pass and not have to be concerned about satisfying the more difficult attribution threshold condition.

Suppose Robert fraudulently accessed Beth's separate bank account and used the funds to purchase stock on the Hong Kong Stock Exchange. As in the original example, Robert later sold the stock on the Hong Kong Stock Exchange, deposited the proceeds in a Shanghai financial account, and never reported and paid tax on the stock's gain. Beth could argue that unpaid taxes resulting from the sale of the investments are attributable to Robert because he committed fraud.⁸ In that case, Beth would satisfy the fraud exception to factor 7.

In short, the expanded threshold conditions offer greater opportunities for individuals seeking innocent spouse relief under section 6015(f).

2. Streamlined relief determinations. If a requesting spouse satisfies all seven threshold requirements, the IRS will consider whether she is entitled to a streamlined determination of equitable relief. To be eligible for the streamlined procedure, the requesting spouse must satisfy three conditions, regarding (1) marital status, (2) economic hardship, and (3) knowledge or reason to know.⁹

Beth's best course appears to be to seek a streamlined relief determination from the IRS that she is not liable for the income tax deficiency for 2010 or unpaid taxes due for 2011. However, streamlined determinations come with a serious drawback: the requirement of economic hardship. While many spouses in Beth's situation surely will suffer a significant economic detriment from having to pay all or a portion of the unpaid taxes, most will not suffer economic hardship as defined by the IRS.

Economic hardship exists if satisfying the tax liability in whole or in part would cause the requesting spouse to be unable to pay reasonable

basic living expenses.¹⁰ To determine economic hardship, the IRS requires Beth to submit a detailed financial statement showing her monthly income and expenses. The IRS will compare Beth's income to the federal poverty guidelines and allow only reasonable basic living expenses. Therefore, paying a mortgage in Silicon Valley, sending children to a private college, and similar expenses probably are out of the equation. Because Beth owns a small clothing boutique — that is, she has a separate source of income — she likely would not qualify.

The IRS should recognize that there is a class of individuals like Beth who would benefit from streamlined relief determinations and who would otherwise qualify under section 6015(f). Adding flexibility to the economic hardship requirement would benefit the IRS, as well as taxpayers, because of the added efficiency in working section 6015(f) cases.

Finally, tax advisers may want to counsel requesting spouses to properly time the filing of a request for relief under section 6015(f) to satisfy the marital status condition.¹¹ This factor considers whether the requesting spouse is no longer married to the non-requesting spouse as of the date the IRS makes its determination.¹² One of the ways that a requesting spouse will qualify as no longer married is if she has not been a member of the same household as the non-requesting spouse at any time during the 12-month period ending on the date the IRS makes its determination.¹³

For example, assuming Beth otherwise qualified for relief, she may want to wait until she has not been living in the same household as Robert for the last 12 months before filing her request for equitable innocent spouse relief. Otherwise, her application could be rejected.

3. Nonexclusive list of factors. If the requesting spouse does not qualify for a streamlined determination, the IRS may still provide relief if, taking into account all the facts and circumstances, it determines that it would be inequitable to hold the requesting spouse liable for the income tax owed. The factors to be considered include the following:

1. marital status;
2. economic hardship;
3. knowledge or reason to know;
4. legal obligation;
5. significant benefit;

¹⁰*Id.* at section 4.03(2)(b).

¹¹A request for relief under section 6015(f) can be made on Form 8857, "Request for Innocent Spouse Relief."

¹²Rev. Proc. 2013-34, section 4.03(a).

¹³*Id.* at section 4.03(a)(iv).

⁷*Id.* at section 4.01(7)(a)-(e).

⁸*Id.* at section 4.01(7)(e).

⁹*Id.* at section 4.02.

6. compliance with income tax laws; and
7. mental or physical health.¹⁴

Rev. Proc. 2013-34 clarifies that no one factor or a majority of factors necessarily controls the determination. In the past, the IRS maintained that if the number of factors weighing against relief exceeded the number weighing in favor of relief, a denial was appropriate. The new guidance represents a significant policy change in favor of a requesting spouse. Therefore, tax advisers would be wise to draft a request for innocent spouse relief in a way that tells a persuasive story, has a theme, and considers all the facts and circumstances of the case (as opposed to mechanically analyzing and balancing the various factors).

4. Actual knowledge or reason to know. Generally, whether a requesting spouse knew or should have known that there was an understatement or a deficiency on a joint tax return has been a point of controversy in innocent spouse cases. Cases have often turned on whether the requesting spouse had actual knowledge or reason to know of the item giving rise to the understatement or deficiency.¹⁵

The IRS has made important policy changes that add considerable flexibility in seeking equitable innocent spouse relief. First, in the past, the IRS asserted that actual knowledge of the item giving rise to the deficiency weighed strongly against relief.¹⁶ Now, that factor will no longer be weighted more heavily than others.¹⁷ This policy change is consistent with the IRS's overall revised approach of taking into consideration all the facts and circumstances of a particular case.

Second, if the non-requesting spouse abused the requesting spouse or maintained control over the household finances, and if because of that abuse or control the requesting spouse was unable to challenge the treatment of any items on the joint return for fear of retaliation, the knowledge factor will not weigh against the requesting spouse, even if she knew or had reason to know of the items giving rise to the understatement or deficiency or that the non-requesting spouse would not pay the tax liability.¹⁸

Cases with evidence of abuse or financial control should be fully factually developed with supporting documentation. For example, a spouse may

have maintained notes or a secret diary documenting the abuse or confided in a close friend who would be willing to execute an affidavit. There may be relevant orders from the family law court. Presenting this evidence will best position the requesting spouse to counter any arguments by the IRS that she knew or should have known of the items giving rise to the understatement or deficiency or that the taxes were not paid.

Significant abuse or financial control may rise to the level of duress. If an individual signs a joint return under duress, the election to file jointly is invalid and there is no valid return with the spouse. In that case, section 6015(f) does not apply.¹⁹ The duress defense can be easier to factually establish — and, strategically, a better option to pursue — because an individual merely must show that she signed the tax return under duress, as opposed to satisfying the various factors set forth in Rev. Proc. 2013-34 for granting equitable relief.

Finally, in cases involving an underpayment of taxes, the IRS will consider whether the requesting spouse reasonably expected that the non-requesting spouse would pay the tax liability when the return was filed or within a reasonable period thereafter.²⁰ In our example, Beth may be able to successfully prove that she did not know or have reason to know that Robert failed to pay the 2011 taxes by producing evidence that she reasonably expected him to pay them. This could be shown by documentary and testimonial evidence that Robert was the one who always paid the taxes and that Beth had little or no involvement in the finances (that is, cancelled checks signed by Robert and an affidavit signed by Beth).

C. CC-2013-011

Tax advisers should read CC-2013-011 in conjunction with Rev. Proc. 2013-34 when advising clients seeking innocent spouse relief. A few highlights from the notice are discussed below.

1. Scope of review and standard of review. CC-2013-011 announced a significant IRS policy change regarding the scope of review (the right to have specific evidence considered by the Tax Court) and standard of review (the amount of deference given by the Tax Court when reviewing an agency's determination). The notice announced that the

¹⁴*Id.* at section 4.03.

¹⁵*See Starr v. Commissioner*, T.C. Memo. 1995-190 (relief denied when requesting spouse failed to satisfy her duty of inquiry); and reg. section 1.6015-3(c)(2)(iv) (determination whether the requesting spouse made a deliberate effort to avoid learning about the item in order to be shielded from liability).

¹⁶Rev. Proc. 2003-61, section 4.03(2)(a)(iii)(B).

¹⁷Rev. Proc. 2013-34, section 3.07.

¹⁸*Id.* at section 3.08.

¹⁹*See* reg. section 1.6013(d) (if an individual asserts and establishes that he signed a return under duress, it is not a joint return); *Hiramanek v. Commissioner*, T.C. Memo. 2011-280 (individual was not jointly and severally liable for an income tax deficiency because she did not file a valid joint return with her former husband, because she signed the return under duress).

²⁰Rev. Proc. 2013-34, section 3.08.

scope of review is *de novo* and that the Tax Court can consider new evidence from outside the administrative record.²¹

Historically, the IRS has attempted to preclude Tax Court petitioners from relying at trial on evidence that was not part of the administrative record. This made it problematic for petitioners to prevail if, for example, a key piece of new evidence was not considered during an IRS examination or at an Appeals hearing. The IRS also argued that the proper standard of review should be abuse of discretion and not *de novo* review. An abuse of discretion standard requires greater deference by the Tax Court when reviewing the agency's determination in a section 6015(f) case.²² Therefore, the Tax Court would consider whether the commissioner's decision was based on an error of law or clearly erroneous findings of fact, or whether the IRS ruled irrationally.²³

The IRS, after unsuccessfully litigating the scope of review and standard of review questions in the Tax Court and several courts of appeals, finally acquiesced on the matter in *Wilson v. Commissioner*.²⁴ Now, taxpayers can present evidence at trial that was otherwise not considered during the administrative process, and the Tax Court will review the IRS's determination under a *de novo* standard of review (that is, with no deference to the agency's determination).

In short, the IRS's policy change makes petitioning adverse IRS decisions to the Tax Court a more viable option for individuals seeking relief from joint and several liabilities under section 6015(f).

2. The right to request agency determination regarding relief before the Tax Court. CC-2013-011 also identifies a new procedural right for taxpayers.

²¹CC-2013-011.

²²See *Fargo v. Commissioner*, 447 F.3d 706, 709 (9th Cir. 2006), *aff'g* T.C. Memo. 2004-13; and *United States v. Sherburne*, 249 F.3d 1121, 1125-1126 (9th Cir. 2001).

²³*Id.*

²⁴705 F.3d 980 (9th Cir. 2013), *acq.* AOD 2012-07. In *Wilson*, the Ninth Circuit held that the Tax Court properly considered new evidence from outside the administrative record. The court further held that the Tax Court correctly applied a *de novo* standard of review in determining a taxpayer's eligibility for equitable relief.

According to the notice, if the IRS has not made a determination regarding entitlement to equitable relief, the trial attorney must request a determination and should share it with the taxpayer.²⁵ In short, there is a procedural mechanism for the agency to make an administrative determination of a docketed case before litigating it in the Tax Court. A petitioner should seek a written copy of the IRS's determination and not rely merely on oral communication of the decision by counsel. The written decision and administrative record can provide helpful insights into the IRS's basis for denying section 6015(f) relief and therefore better prepare the petitioner for litigation.

3. Right to have Appeals settlement conference. CC-2013-011 also discusses the requesting spouse's procedural right to a settlement conference with the IRS Office of Appeals. Generally, it is advisable for Appeals to review a case before proceeding to the Tax Court, because its mission is "to resolve tax controversies, without litigation, on a basis which is fair and impartial to both the Government and the taxpayer, and in a manner that will enhance voluntary compliance and public confidence in the integrity and efficiency of the Service."²⁶

In sum, CC-2013-011 highlights important procedural rules that should be followed in cases docketed before the Tax Court. An individual should consult with a competent tax counsel who is familiar with the rules and can take adequate steps, when necessary, to ensure that the individual's rights are respected.

D. Conclusion

Both Rev. Proc. 2013-34 and CC-2013-011 reflect significant policy and procedural changes to the way the IRS handles innocent spouse cases under section 6015(f). The new rules are less rigid and take into account all the facts and circumstances of a particular case. As a result, individuals who believe they may be entitled to equitable relief under section 6015(f) may now have a greater chance of success at the administrative and judicial levels.

²⁵CC-2013-011.

²⁶Internal Revenue Manual section 8.1.1.1.