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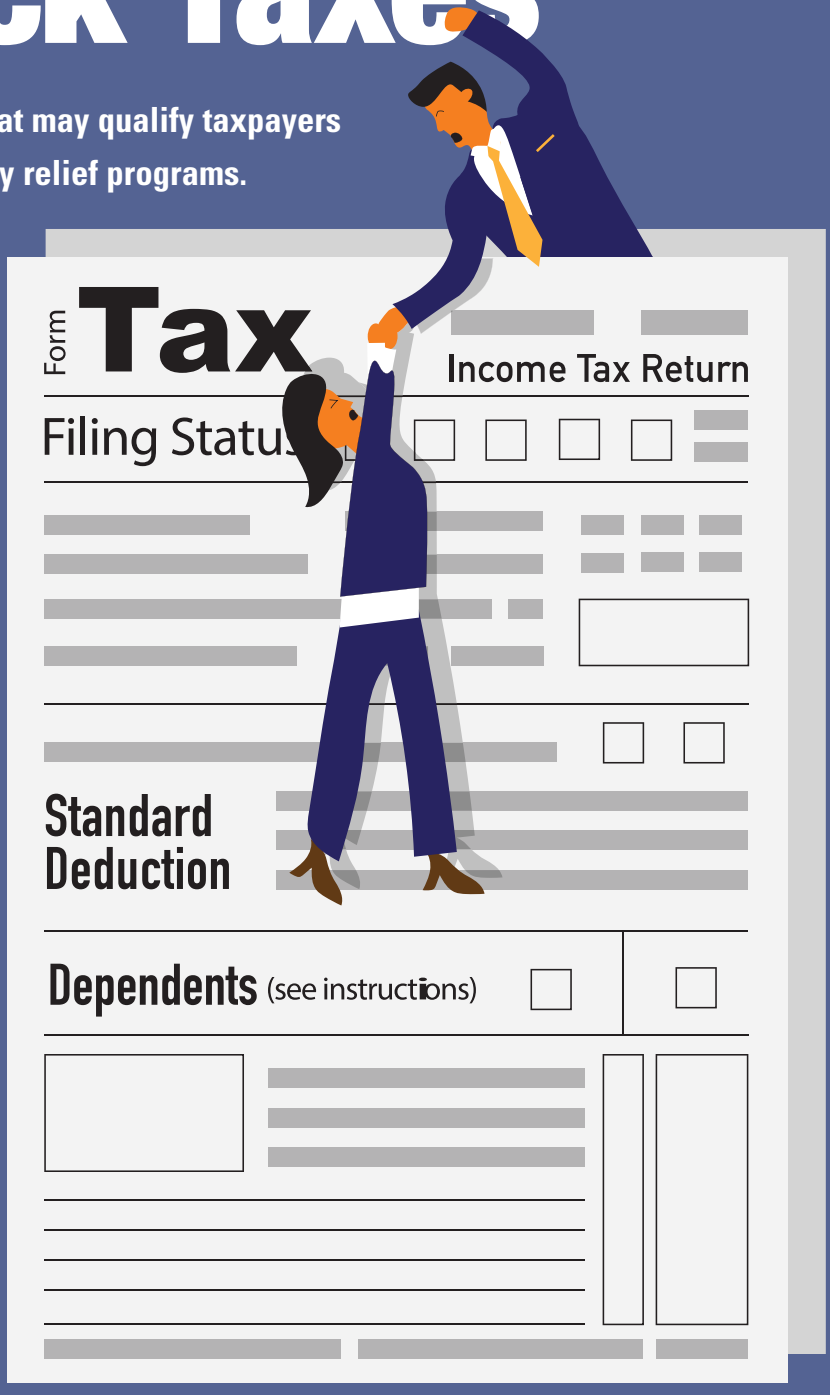
Banishing Back Taxes

Circumstances that may qualify taxpayers for the IRS's equity relief programs.



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ISBA RESOURCES >>

- Stephanie L. Tang, *Chair Column: Commonly Overlooked Tax Return Issues in Divorce*, Family Law (Oct. 2022), law.isba.org/3TQ2Jet.
- William T. Kaplan, *A Man Without a Country (Almost)*, Federal Taxation (Dec. 2019), law.isba.org/3OF0fPb.
- William H. Mayer, *Final Regulations Ease Hardship Distribution Requirements*, Employee Benefits (Oct. 2019), law.isba.org/3u7rSHb.

DIVERSITY, EQUITY, AND INCLUSION (DEI) RULES ARE UBIQUITOUS IN today's legal environment, and the ISBA has taken an active role promoting DEI throughout the organization.[1] However, most lawyers will be surprised to learn that the Internal Revenue Service (IRS) has also embraced the equity component of DEI by promulgating rules benefiting individuals owing IRS back taxes. A lawyer can obtain hero status in a client's eye by utilizing these IRS equity programs to eliminate a qualified client's full IRS back-tax liability without paying a penny to the IRS. Best of all, the client does not have to file bankruptcy to discharge the tax liability.[2]

The first part of this article addresses the IRS's "Innocent Spouse Relief" equity program that applies to a qualifying divorcing/divorced client who suffers from IRS back taxes as a result of their spouse's bad acts or omissions. The second part of this article addresses the IRS's "Effective Tax Administration" equity program that applies to any qualified individual owing IRS back taxes, whether divorced or happily married. This article empowers lawyers to spot the tax issues, suggest tax solutions, navigate the IRS labyrinth, or make a referral to a tax attorney.

Innocent spouse relief

Most family law attorneys will represent a client who is suffering from IRS back taxes. The client blames the other spouse for the unpaid tax liability. The family law attorney can try to shift the payment obligation onto the other spouse in the marital settlement agreement or divorce decree. Regardless, the client has no defenses should the IRS initiate collection action against the client (wage garnishment, bank levy, or tax lien) if the other spouse refuses to pay or suffers economic distress and lacks the financial wherewithal to pay the back taxes. Thankfully, Congress has added an equity arrow to the family law attorney's quiver.

Congress jumped on the equity bandwagon when it enacted section 6015 of the Internal Revenue Code (the "Tax Code"), which authorized the U.S. Department of the Treasury to eliminate IRS back taxes by granting innocent spouse relief.[3] Congress also authorized the Treasury to promulgate rules and regulations to implement the innocent spouse relief program.[4]

Throughout this article, the term "spouse" refers to an individual, whether married, separated, or divorced. For clarity, the "innocent" spouse is the individual who is suffering from IRS back taxes because of the other spouse's bad acts or omissions. The "guilty" spouse is the other spouse who caused the tax liability's existence by any means, including by:

1. Illinois State Bar Association, Diversity, Equity, & Inclusion, isba.org/diversity.
2. Robert Schaller, *Yes, Income Taxes Are Dischargeable in Bankruptcy*, 104 Ill. B.J. 32 (July 201), *available at* law.isba.org/3AopH5d (Bankruptcy Code allows debtors to discharge income taxes if they wait long enough before filing and didn't commit fraud or evade paying tax).
3. 26 U.S.C. § 6015.
4. 26 U.S.C. § 6015(h); 26 U.S.C. § 7805(a); *Haag v. Comm. of Internal Revenue*, 683 F.3d 26, 29 (1st Cir. 2012).

TAKEAWAYS >>

- Family law attorneys and all other lawyers should consider the IRS's equity relief programs whenever clients owe IRS back taxes.
- Family law attorneys can help clients navigate the IRS's innocent spouse relief program to eliminate tax liability owed by an innocent spouse who has been wronged by a guilty spouse's bad acts or omissions.
- All other attorneys can help clients eliminate back taxes by utilizing the IRS's effective tax administration program.

GOOD LAWYERING WILL PERSUADE THE IRS THAT THE INNOCENT SPOUSE'S MONTHLY BUDGET BARELY COVERS NECESSARY EXPENSES RELATING TO MORTGAGE/RENT, FOOD, CLOTHING, TRANSPORTATION, UTILITIES, MEDICINE, INSURANCE, ETC., LEAVING NOTHING AVAILABLE TO PAY TOWARD IRS BACK TAXES.

failing to pay the tax liability identified on any IRS Form 1040; failing to report all income; taking an improper tax credit; claiming unwarranted business deductions; or participating in other actions or omissions that caused an understatement of tax liability.[5]

An innocent spouse gets entangled in a guilty spouse's wrongdoing when filing a joint IRS Form 1040 tax return. When filing a joint return, both spouses are jointly and severally liable for the tax and any additions to tax, interest, and penalties that arise from the joint return even if they later divorce.[6] As the name suggests, innocent spouse relief is available to an innocent spouse who has tax liability imposed upon them because of the guilty spouse's bad acts or omissions.

Innocent spouse relief is equitable relief. The innocent spouse does not claim that the back taxes were improperly assessed per the Tax Code. Rather, the innocent spouse pleads that the properly assessed tax liability should be eliminated because equity warrants it.

The IRS provides equitable relief when the innocent spouse establishes that it is inequitable to hold the innocent spouse liable for any unpaid tax or any tax deficiency caused by a tax return understatement of net income.[7] Happily, the IRS issued Revenue Procedure 2013-34 to articulate several factors the IRS will consider in its equity analysis.[8]

First, and most importantly, the IRS will probe whether the innocent spouse had actual knowledge or reason to know that the guilty spouse understated the income on 1040 forms or failed to pay the tax liability. The IRS considers it inequitable to eliminate back taxes when the allegedly innocent spouse had knowledge of or reason to know about the guilty spouse's bad acts or omissions.

Knowledge of the bad acts or omissions can be neutralized by proving the innocent spouse was abused by the guilty spouse or the guilty spouse controlled the household finances by restricting the innocent spouse's access to financial information.[9] The innocent spouse must show that because of the abuse or financial control, the innocent spouse was not able to challenge the treatment of any items on the joint return for fear of the guilty spouse's retaliation.[10] A professional opinion from a licensed clinical psychologist will buttress the innocent spouse's retaliatory fear assertion.[11]

Second, equity can be established when the innocent spouse will suffer economic hardship if equitable relief is not granted. Hardship exists if the innocent spouse is unable to pay reasonable basic living expenses. Good lawyering will persuade the IRS that the innocent spouse's monthly budget barely covers necessary expenses relating to mortgage/rent, food, clothing, transportation, utilities, medicine, insurance, etc., leaving nothing available to pay toward IRS back taxes.

Third, equity may warrant innocent spouse relief when the marital settlement agreement or divorce decree has shifted the IRS back-tax liability to the guilty spouse. Equity is best established when the family law attorney drafts the marital settlement agreement placing the sole obligation to pay the tax liability onto the shoulders of the guilty spouse.

Fourth, equity may rise or fall on whether the innocent spouse significantly benefited from the unpaid income tax liability or understatement of tax.[12] Enjoying a lavish lifestyle paid on the IRS's dime is a hard stop. The IRS does not reward taxpayers who take extravagant vacations paid with money that should have been tendered to the IRS. The "significant benefit" test was examined by the U.S. Court of Appeals for the District of Columbia Circuit in *Mitchell v. Comm. Internal Revenue*.[13] In *Mitchell*, the unreported income item was a $666,564 pension distribution. The innocent spouse argued unsuccessfully that this pension distribution did not constitute a "significant benefit" because it reflected a normal spousal support payment. The *Mitchell* court rejected that argument and affirmed the tax court's decision to deny innocent spouse relief finding that the tax court did not abuse its discretion.

Fifth, equity is afforded only to an innocent spouse who has made a good-faith effort to comply with the Tax Code in the taxable years following the taxable year or years to which the request for equitable relief relates. A flawless Tax Code compliance record goes a long way. The IRS will almost certainly find innocent spouse relief inequitable for those taxpayers who flaunt their tax filing and payment obligations. Counsel must obtain the client's IRS tax transcripts and carefully analyze the transcripts for tax compliance confirmation prior to filing any innocent spouse relief request.

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5. 26 U.S.C. § 6013(d)(3); 26 C.F.R. § 1.6015-1(a). The term "guilty" refers to civil violations of the Tax Code as well as criminal violations.
6. *Haag v. Comm. of Internal Revenue*, 683 F.3d 26, 29 (1st Cir. 2012); *Rubel v. Comm. of Internal Revenue*, 856 F.3d 301, 303 (3d Cir. 2017); *Pullins v. Comm. of Internal Revenue*, 136 T.C. 432, 437 (2011).
7. 26 U.S.C. § 6015(f).
8. Internal Revenue Service, Rev. Proc. 2013-34, law.isba.org/3V7cQfV.
9. See Maria Puppo Martinez, *Not Under Control*, 110 Ill. B.J. 24 (Apr. 2022), law.isba.org/3V4vgOe (exploring coercive control and the Illinois Domestic Violence Act).
10. See Donald Alexander Downs, More Than Victims: Battered Women, the Syndrome Society, and the Law (The University of Chicago Press) (offering an analysis of the problems attending the use of battered-woman syndrome as a legal defense).
11. See, *e.g.*, Dr. Gretchen A. Boules, President & CEO of Boules Clinical Psychology Group, PLLC, law.isba.org/3EoHkD8 (developed and implemented a psychoeducational outpatient group for adult survivors of sexual abuse).
12. See 26 C.F.R. § 1.6015-2(d).
13. *Mitchell v. Comm. Internal Revenue*, 292 F.3d 800 (D.C. Cir. 2002); see also *Busse v. United States*, 542 F.2d 421, 427 (7th Cir. 1976).

Sixth, equity is found more frequently when the innocent spouse struggled with poor physical or mental health at the time the faulty tax returns were filed. The IRS will consider the nature, extent, and duration of the health condition, including the ongoing economic impact of any illness.

Lawyers should note that the IRS's innocent spouse relief is not an all-or-nothing game. Partial relief may be available when the guilty spouse is not the sole culprit. If the liability is partially attributable to the innocent spouse, then equitable relief still may be considered for the portion of the liability attributable to the guilty spouse only.

How to get rejected

Family law attorneys should advise their clients that the IRS will reject an innocent spouse's request for equitable relief under three circumstances. First, a fraudulent tax filing is an immediate disqualification. An innocent spouse is not eligible for equitable relief if the innocent spouse knowingly participated in the filing of a fraudulent tax return.

Second, fraudulent conveyances will get the innocent spouse bounced out of equity consideration. To be truly innocent, the innocent spouse must not have conveyed assets between the spouses to defeat the IRS or other creditors, including ex-spouses and business partners.[14]

Third, the innocent spouse must not have received "disqualified" assets from the guilty spouse in an effort to defeat payment of the IRS tax liability by minimizing the guilty spouse's wherewithal to pay the liability. A disqualified asset[15] includes any property or right to property transferred to an innocent spouse if the principal purpose of the transfer was the avoidance of tax or payment of tax by the guilty spouse.[16]

Attorneys who want to grapple with the IRS should familiarize themselves with IRS Form 8857[17] and IRS Publication 971.[18] Together, these documents provide the basic framework explaining when a spouse may be relieved of tax, interest, and penalties on a joint tax return.

Effective tax administration

Congress expanded equitable relief when it enacted section 7122 of the Tax Code, which authorized the U.S. Treasury to eliminate or "compromise" any civil or criminal debt arising under the internal revenue laws.[19] Congress granted broad authority to the U.S. Treasury to compromise back taxes.[20] The Treasury then delegated this authority to the commissioner of the IRS.[21]

The IRS's Effective Tax Administration (ETA) program is available to a client when there are "compelling public policy or equity considerations" that warrant compromise.[22] The U.S. Treasury promulgated Rule 301.7122-1 to guide the IRS when addressing compelling public policy or equity considerations.[23] The Rule provides that back taxes will be eliminated when, due to exceptional circumstances, collection of the full liability will undermine public confidence that the tax laws are being administered in a fair and equitable manner. A taxpayer proposing compromise under Rule 301.7122-1(b)(3)(ii) will be expected to demonstrate facts that justify compromise even though a similarly situated taxpayer may have paid his liability in full.[24]

Consider these examples contained in the regulation[25] illustrating compelling public policy or equity considerations:

Example 1. In 2018, the taxpayer developed a serious illness leaving the taxpayer unable to manage his financial affairs and unable to file tax returns for multiple years. The taxpayer had begun to attend to his tax affairs after his health improved and discovered that the IRS prepared a substitute return for the 2018 tax year and had assessed a tax deficiency. With penalties and interest, the tax bill is more than three times the original tax liability. The taxpayer's overall compliance history weighs in favor of reducing the taxpayer's IRS back taxes.

Example 2. The taxpayer learned that he could earn a higher rate of interest on his IRA by moving those funds from a money management account to a certificate of deposit at a different financial institution. Prior to transferring his IRA, the taxpayer emailed the IRS requesting information about the steps he must take to avoid penalties. The IRS responded erroneously, stating penalties will be avoided if he deposits the funds in a new IRA account within 90 days. The taxpayer withdrew the funds and deposited them in a new IRA account 63 days later. Upon audit, the taxpayer learned that he had been misinformed about the required rollover period and that he was liable for additional taxes, penalties, and "additions to tax" for not having redeposited the amount within 60 days. Had it not been for the IRS's erroneous advice, the taxpayer would have redeposited the amount within the required 60-day period. The taxpayer's overall compliance weighs in favor of eliminating the taxpayer's IRS back taxes.

A client's eligibility to eliminate IRS back taxes through the ETA program is not

LAWYERS SHOULD NOTE THAT THE IRS'S INNOCENT SPOUSE RELIEF IS NOT AN ALL-OR-NOTHING GAME. PARTIAL RELIEF MAY BE AVAILABLE WHEN THE GUILTY SPOUSE IS NOT THE SOLE CULPRIT.

14. Internal Revenue Manual, § 25.15.3.8.2.2(2) (Dec. 12, 2016); see 26 C.F.R. § 1.6015-1(d).
15. 26 U.S.C. § 6015(c)(4).
16. Online Innocent Spouse Relief training is offered by the National Offer in Compromise Academy at oicacademy.com/.
17. Internal Revenue Service, Request for Innocent Spouse Relief, Form 8857, irs.gov/pub/irs-pdf/f8857.pdf.
18. Internal Revenue Service, Innocent Spouse Relief, Publication 971, irs.gov/pub/irs-pdf/p971.pdf.
19. 26 U.S.C. § 7122(a).
20. *McGee v. USA*, 566 F.Supp. 960, 961 (M.D. Fla. 1982).
21. Internal Revenue Manual, § 1.2.2.6.1 (June 5, 2018).
22. 26 C.F.R. § 301.7122-1(b)(3)(ii).
23. *Id.* at § 301.7122-1.
24. *Id.* at § 301.7122-1(b)(3)(ii).
25. *Id.* at § 301.7122-1(c)(3)(iv).

dependent on the client's inability to fully pay the IRS back taxes. In fact, the ETA program is specifically designed to help taxpayers who can fully pay the tax liability but not without "economic hardship."[26]

A lawyer must persuade the IRS that an economic hardship exists. It is a question of fact that can only be determined after analyzing many factors. Rule 301.7122-1(c)(3)(i) offers three factors supporting a determination that payment of the IRS back taxes will cause economic hardship within the regulatory meaning:[27]

1) when a client's monthly income is exhausted each month by providing for the care of dependents with no other means of support;
2) when a client is unable to borrow against the equity in the client's assets and liquidation of those assets to pay IRS back taxes would render the client unable to meet basic living expenses; or
3) when a client is incapable of earning a living because of a long-term illness, medical condition, or disability, and it is reasonably foreseeable that the client's financial resources will be exhausted providing for care and support during the condition.

Consider these examples contained in the regulation[28] illustrating economic hardship:

Example 1. The taxpayer has assets sufficient to satisfy the tax liability. The taxpayer provides full-time care and assistance to her dependent child, who has a serious long-term illness. It is expected that the taxpayer will need to use the equity in his assets to provide for adequate basic living expenses and medical care for his child. The taxpayer's overall circumstances weigh in favor of eliminating the IRS back taxes.

Example 2. The retired taxpayer's only income is a pension. The taxpayer's only asset is a retirement account, and the funds in the account are sufficient to satisfy the liability. Liquidation of the retirement account will leave the taxpayer without an adequate means to provide for basic living expenses. The taxpayer's overall circumstances weigh in favor of eliminating the IRS back taxes.

Example 3. The disabled taxpayer lives on a fixed income that will not, after allowance of basic living expenses, permit full payment of his liability under an installment agreement. The taxpayer also owns a modest house specially equipped to accommodate his disability. The taxpayer's equity in the house is sufficient to permit payment of the liability he owes. However, because of his disability and limited earning potential, the taxpayer is unable to obtain a mortgage or otherwise borrow against this equity. In addition, because the taxpayer's home has been specially equipped to accommodate his disability, forced sale of the taxpayer's residence will create severe adverse consequences for the taxpayer. The taxpayer's overall circumstances weigh in favor of eliminating the IRS back taxes.

No compromise to promote effective tax administration may be entered into if elimination of the back taxes will undermine compliance by taxpayers with the tax laws.[29] Rule 301.7122-1(c)(3)(ii) provides three factors supporting a determination that collection undermines compliance within the regulatory meaning: 1) the taxpayer has a history of noncompliance with the filing and payment requirements of the Tax Code; 2) the taxpayer has taken deliberate actions to avoid the payment of taxes; and 3) the taxpayer has encouraged others to refuse to comply with the tax laws.[30]

The ultimate decision to eliminate IRS back taxes is within the IRS's discretion and must be based upon all the facts and circumstances.[31] Thankfully, lawyers are masterful persuaders and skillful at marshalling facts to buttress their clients' goals.

Attorneys who want to battle with the IRS should familiarize themselves with IRS Form 656[32] and IRS Publication Form 656 Booklet Offer in Compromise.[33] Together, these documents provide the basic framework explaining when a spouse may be relieved of tax, interest, and penalties on a joint tax return.[34]

26. *Id.* at § 301.7122-1(b)(3)(i).
27. *Id.* at § 301.7122-1(c)(3)(i).
28. *Id.* at § 301.7122-1(c)(3)(iii).
29. *Id.* at § 301.7122-1(b)(3)(iii).
30. *Id.* at § 301.7122-1(c)(3)(ii).
31. 26 C.F.R. § 301.7122-1(c)(1); *Johnson v. Comm. Internal Revenue*, 136 T.C. 475, 485 (2011); *Christopher Cross, Inc. v. U.S.*, 363 F.Supp. 2d 855, 857 (E.D. La. 2004).
32. Internal Revenue Service, Offer in Compromise, Form 656, law.isba.org/3AsZH9b.
33. Internal Revenue Service, Offer in Compromise, Form 656 Booklet, law.isba.org/3Gt7ZkY.
34. For a deeper dive into the IRS's Innocent Spouse Relief program, see Robert Schaller, IRS Innocent Spouse Tax Relief: A Treatise for Attorneys, CPAs & Tax Preparers (Amazon Press).