Report to the Congress on Joint Liability and Innocent Spouse Issues

Department of the Treasury
February 1998

2/9/98

The Honorable Bill Archer
Chairman
Committee on Ways and Means
U.S. House of Representatives
Washington, DC 20515

Dear Mr. Chairman:

Section 401 of the Taxpayer Bill of Rights 2, Pub. L. No. 104-168, 110 Stat. 1453 (July 30, 1996), requires the Treasury Department to conduct a study of issues relating to joint income tax returns. Enclosed is our report of that study. As directed by Congress, the issues discussed include:

1) The effects of changing liability for tax on a joint return from being joint and several to being proportionate to the tax attributable to each spouse;

2) The effects of providing that, if a divorce decree allocates liability for tax on a joint return filed before the divorce, the Secretary may collect such liability only in accordance with the decree;

3) Whether those provisions of the Internal Revenue Code of 1986 intended to provide relief to innocent spouses provide meaningful relief in all cases where such relief is appropriate;

4) The effect of providing that community income (as defined in section 66(d) of the Internal Revenue Code) which, in accordance with the rules contained in section 879(a) of such Code, would be treated as the income of one spouse, is exempt from a levy for failure to pay any tax imposed by subtitle A by the other spouse for a taxable year ending before their marriage.

The Administration recently proposed, as part of the Fiscal Year 1999 Budget, legislation that would amend the innocent spouse provisions of the Internal Revenue Code of 1986. Legislation currently pending in Congress (particularly H. R. 2676) also would amend these provisions. We look forward to working with Congress to adopt meaningful solutions to this important problem.

I am sending a similar letter to Mr. Rangel.

Sincerely,

/signed/

Donald C. Lubick
Acting Assistant Secretary
(Tax Policy)

2/9/98

The Honorable William V. Roth, Jr.
Chairman
Committee on Finance
United States Senate
Washington, DC 20510

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Donald C. Lubick
Acting Assistant Secretary
(Tax Policy)

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EXECUTIVE SUMMARY

The innocent spouse rules currently do not provide relief from joint and several liability in certain meritorious cases. In section 401 of the Taxpayer Bill of Rights 2, Pub. L. No. 104-168, 110 Stat. 1453 (July 30, 1996), Congress directed the Treasury Department and the IRS to conduct a study analyzing whether existing law provides meaningful relief in all cases where it is appropriate and considering the effects of various proposals to change the liability rules for joint filers. This report discusses the results of that study. Treasury and the IRS are proposing a series of legislative and administrative changes to address the liability issues affecting innocent spouses.

Background

Under the Internal Revenue Code of 1986 ("Code"), married taxpayers may elect to file their annual income tax returns either jointly or separately. The filing status that the taxpayers elect determines not only the computation of their correct tax but also their ultimate liability for the proper amount of tax due. Under current law, a married taxpayer who files separately is liable only for the proper amount of tax attributable to his or her own return, and not for the tax attributable to his or her spouse's return. By contrast, taxpayers who file joint returns are held jointly and severally liable for the full, correct amount of tax for both spouses (using joint filing status) for the year at issue. These rules (permitting married taxpayers to elect their filing status and attaching certain liability consequences to that decision) have evolved over the course of the development of the income tax for several reasons, in particular to facilitate treating married couples as a single economic and taxpaying unit and to accommodate certain differences between community property and non-community property states. Further, because of the current structure of the income tax, there generally is an economic incentive for married couples to file jointly, rather than as married filing separately. The systems of the Internal Revenue Service ("IRS") for processing tax returns, collecting unpaid tax liabilities, and resolving tax disputes are also substantially structured to reflect the joint filing rules.

Until the enactment of various relief provisions (beginning in 1971), an individual could avoid the liability consequences of joint return filing only under common law doctrines, for instance by demonstrating that the individual's signature was a forgery or that it was obtained as a result of fraud, duress, misrepresentation, or mistake. Often the most sympathetic cases involve a separated or divorced individual whose former spouse withholds knowledge of the inaccuracy of the joint return and who later finds himself or herself facing a joint and several liability significantly larger than anticipated when the return was filed.

Therefore, in 1971, 1980, and again in 1984, Congress enacted provisions enabling spouses to obtain equitable relief from joint and several liability in various circumstances. In most cases under current law, these "innocent spouse" rules provide relief from joint and several liability only if a joint return filer can demonstrate four separate statutory requirements: (1) that a joint return was made for the taxable year; (2) that the joint return contains a substantial understatement of tax attributable to grossly erroneous items of the other spouse; (3) that the taxpayer did not know, and had no reason to know, of the substantial understatement when he or she signed the joint return; and (4) that it would be inequitable to hold the taxpayer liable for the deficiency in income tax attributable to the substantial understatement.

Findings

The report acknowledges that the current joint and several liability and innocent spouse rules are imperfect in certain respects. It reviews various proposals to change these rules and concludes that each has certain advantages in comparison to the present system but also suffers from defects of its own. In particular, proposals to limit one spouse's liability for items of income, deduction, or credit that are considered properly attributable (under various formulations) to the other spouse would impose increased burdens on taxpayers and the IRS yet would still require some kind of equitable relief provisions in certain egregious situations.

In an effort to improve the application of the current innocent spouse provisions, the Treasury Department and the IRS have implemented, and are in the process of implementing, several administrative actions. These administrative steps include:

- Expediting the issuance of a new form to assist taxpayers in preparing claims for relief under the innocent spouse provisions. These forms will be processed in one central location to ensure the technical expertise of the IRS examiner and consistent treatment for taxpayers.

- Reviewing current training materials to ensure that they stress the responsibility of employees to identify situations where the innocent spouse provisions might apply, even if the taxpayer does not know about the provisions. When appropriate, the IRS will provide these taxpayers with the new form and assist them in preparing it.

- Making telephone assistors, specially trained in the innocent spouse provisions, available to answer questions from taxpayers received through IRS' toll free telephone system.

- Developing special training courses on the innocent spouse provisions to be given to IRS collection and examination personnel in both basic training as well as annual continuing professional education training.

- Alerting couples who file joint income tax returns of the legal consequences of joint filing in the instructions in their tax packages, and revising other publications to make innocent spouses more aware of the relief provisions available to them.

- Conducting focused outreach on both the national and local levels to community organizations that serve abused or battered spouses to identify those who might qualify for relief under the innocent spouse provisions.

Treasury and the IRS also recommend certain statutory changes that would preserve the advantages of the current system and yet afford innocent spouse relief in more situations. In particular, we recommend legislation that would:

- Automatically suspend collection efforts against one spouse when the other is contesting a proposed joint assessment in Tax Court.

- Make innocent spouse relief easier to obtain by changing statutory standards to help additional taxpayers, including those with smaller tax bills who are presently ineligible for relief in many cases.

- Give more taxpayers who are denied innocent spouse relief by the IRS an opportunity to appeal the IRS decision to Tax Court, and automatically suspending collection while the Tax Court considers the appeal.

These legislative proposals were proposed previously by President Clinton last October and were included in the Administration's fiscal year 1999 budget. The Treasury Department and the IRS look forward to working with the tax-writing committees to implement these recommendations as promptly as possible.

INTRODUCTION

In 1996, with the support of the Internal Revenue Service and the Department of the Treasury, Congress enacted the Taxpayer Bill of Rights 2, Pub. L. No. 104-168, 110 Stat. 1453 (July 30, 1996).[1/] As part of the TBOR 2 process, Congress heard from taxpayers and their representatives about how the tax system works for married taxpayers who file joint returns, particularly those joint filers who later divorce or separate. Many of the comments focused on how the Internal Revenue Code's current standard of joint and several liability affects married taxpayers who file joint returns. Therefore, in TBOR 2, Congress directed Treasury and the IRS to conduct a study analyzing the following four items:

(1) The effects of changing the liability for tax on a joint return from being joint and several to being proportionate to the tax attributable to each spouse.

(2) The effects of providing that, if a divorce decree allocates liability for tax on a joint return filed before the divorce, the Secretary may collect such liability only in accordance with the decree.

(3) Whether those provisions of the Internal Revenue Code of 1986 intended to provide relief to innocent spouses provide meaningful relief in all cases where such relief is appropriate.

(4) The effect of providing that community income (as defined in I.R.C. § 66(d)) which, in accordance with the rules contained in I.R.C. § 879(a), would be treated as the income of one spouse, is exempt from a levy for failure to pay any tax imposed by subtitle A by the other spouse for a taxable year ending before their marriage.

<u>See</u> TBOR 2, § 401.

The House Committee on Ways and Means Report concerning TBOR 2 further directed Treasury and the IRS to "examine the tax policy implications, the equity implications, and operational changes which would face the IRS if the liability standard were changed." H.R. Rep. No. 506, 103rd Cong., 2d Sess. 50 (1996). The House Report also directed Treasury and the IRS to examine "the effects of overturning the application of <u>Poe v. Seaborn</u>, 282 U.S. 101 (1930), for income tax purposes in community property states" in connection with the fourth topic specified in the statutory provision.

[1/] For convenience, the Internal Revenue Service will be referred to as either "the IRS" or "the Service," the Taxpayer Bill of Rights 2, Pub. L. No. 104-168, 110 Stat. 1453 (July 30, 1996), will be referred to as "TBOR 2," and the Internal Revenue Code will be referred to as "the Code" or as "I.R.C." when referring to a specific section ("§").

Treasury and the IRS began studying these issues before enactment of TBOR 2 as part of the "Administrative Initiatives to Enhance Taxpayer's Rights," Announcement 96-4, 1996-4 I.R.B. 99 at 101 (January 22, 1996). Treasury and the IRS requested public comments on the study topics and reform proposals in Notice 96-19, 1996-1 C.B. 371. The following report sets out the results of the study.

This report first traces the development of the joint and several liability standard and the innocent spouse provisions, and it then describes current IRS procedures for administering these provisions. These discussions provide the context for understanding proposals to reform or replace the joint and several liability standard, the innocent spouse provisions, and certain community property laws. The report analyzes several proposals for change and concludes with a discussion of the Administration's own administrative and legislative proposals in this area.

BACKGROUND AND PRESENT LAW CONCERNING JOINT AND SEVERAL LIABILITY

A. Joint Filing for Married Taxpayers

1. Origin of Joint Filing

Early revenue acts based income taxation on the individual rather than on a marital unit. For example, the 1894 Income Tax Law, assessed tax "upon the gains, profits, and income received . . . by every citizen. . . ." Act of Aug. 27, 1894, ch. 349, § 27, 28 Stat. 553. This focus on the individual, rather than on households or marital units, was retained in 1913 when the first income tax law based on the Sixteenth Amendment imposed a tax "upon the entire net income arising or accruing from all sources . . . to every citizen of the United States . . . and to every person residing in the United States, though not a citizen thereof." Act of Oct. 3, 1913, ch. 16, § II(A)(1), 38 Stat. 166. The Revenue Act of 1916 likewise adopted an individual model of taxation, by taxing "the entire net income received . . . by every individual." Ch. 463, § 1(a), 39 Stat. 756 (1916).

In 1918, married taxpayers were allowed to file joint returns. This earliest form of joint filing permitted spouses to offset deductions and losses against each other's income. There was only one tax rate schedule for taxpayers, however, regardless of whether they filed jointly or separately. If both spouses earned income and did not have offsetting deductions or losses, the result of filing jointly would have been an increase in total tax because of the single tax rate schedule and that schedule's progressivity.[2/] In addition, it was unclear whether the election to file jointly caused each spouse to have joint and several liability.[3/] The issue was extensively litigated in these early years. See, e.g., Cole v. Commissioner, 81 F.2d 485 (9th Cir. 1935), rev'g 29 B.T.A. 601 (1933) and cases cited therein.

In 1938, Congress enacted the predecessor of I.R.C. § 6013(d), which introduced explicit statutory joint and several liability for joint returns. As explained in the legislative history, the provision was enacted to preserve the administrative ease of joint filing for taxpayers and the Government:

> Unless the husband and wife are to be held jointly and severally liable for the tax upon their aggregate net income, it will be necessary for the [IRS] to require that their

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2/ For example, assume each spouse earned $10,000 of income. Also, assume that the rate structure in effect taxed the first $10,000 of income at 10 percent and all income over $10,000 at 20 percent. If the married couple filed jointly, they would have owed tax of $3,000 ($10,000 x 10 percent + $10,000 x 20 percent). If the couple had filed separately, however, their combined tax would have been only $2,000 ($10,000 x 10 percent for each return).

3/ Joint and several liability means that each party is held responsible for 100 percent of a liability until it is paid.

individual incomes and deductions shall be separately stated in the return, in order that their respective income-tax liability may be separately determined. Such a requirement would cause considerable hardship upon taxpayers with moderate incomes and would largely eliminate the advantages of the joint return.

H.R. 1860, 75th Cong. 2d Sess., 1939-1 C.B. 749.

2. Effect of Community Property Law on Joint Filing

Nine states follow a property system for married couples known as "community property."[4/] Although details of these systems vary among jurisdictions, their operation is similar in broad outline. Typically, each spouse is considered as owning one-half of community property as well as his or her separate property. In general, all property acquired during the marriage is considered community property. For example, wages earned by one spouse during the marriage are generally considered community property. By contrast, in general, property owned by one spouse on the date of the marriage, acquired afterwards by gift or inheritance or designated as separately owned by agreement between the spouses is considered "separate property." In addition, property acquired with separate property remains separate property. In some jurisdictions, however, income derived from separate property is considered community property.

In Poe v. Seaborn, 282 U.S. 101 (1930), the Supreme Court held that a husband and wife in a community property state were entitled to file separate returns, each treating one-half of the couple's community income as his or her respective income for Federal income tax purposes. Because of progressive rate structures, the immediate effect of Poe v. Seaborn was that many married couples with only one income earner who resided in community property states could pay significantly less tax than their counterparts in common law states by choosing to report their income on separate returns. The legislative history to the Revenue Act of 1948, which attempted to remedy this disparity, states: "Since the rates applied under the income tax are steeply progressive, the same family income divided in two halves by community property law will be taxed far less severely than in a common-law State where the whole income is apt to be taxed to one spouse."[5/] S. Rep. No. 1013, 80th Cong., 2d Sess. 22 (1948).

4/ The nine states are Arizona, California, Idaho, Louisiana, Nevada, New Mexico, Texas, Washington, and Wisconsin. Twenty seven percent of all married taxpayers, approximately 13 million couples, live in these states.

5/ For example, the Senate Report explaining the Revenue Act of 1948 states that, given the tax rates then in effect, a married couple residing in a noncommunity property state with income of $10,000 would pay a tax that is 19 percent greater than a similarly situated community property couple. At $25,000, the tax would be 41 percent larger. S. Rep. No. 1013, 80th Cong., 2d Sess. 22 (1948).

To provide the same income-splitting advantages available to married couples in community property states after Poe v. Seaborn, many common law states adopted or attempted to adopt the community property system. The legislative history itself commented on the trend to adopt the community property system in order to achieve an income tax advantage:

> Recently, however, a number of States have shifted from the common-law to the community-property system. In these cases benefits under the Federal income tax which residents of the State would obtain under the community-property system were largely responsible for the abandonment of common law.

S. Rep. No. 1013 at 23-24.

Congress in the Revenue Act of 1948 allowed all spouses, including those in common law states, to split their income in much the same way as spouses in community property states already could. The new provision permitted a married couple, regardless of their state of residence, to file a joint return including the income of both spouses. The tax was effectively computed on one-half of the combined income under the rates applicable to single taxpayers, and then multiplied by two to arrive at the couple's tax liability. This effect was actually achieved by applying a new tax rate schedule with tax brackets twice as wide as in the tax rate schedule for unmarried taxpayers. The purpose of the new law was to produce the same income-splitting in common law states as in community property states. This regime resulted in splitting all income, however, and not just the income that would effectively be split under community property laws.

The joint return provisions of current law evolved from the income-splitting system created by Congress in 1948. The joint return filing option and the related rate schedule are based on the effort to give married taxpayers the same tax treatment, regardless of whether they reside in community property states or common law jurisdictions. The tax savings provided by the joint return rates (relative to the married filing separate rates) may be a significant factor giving rise to the preference of most couples for filing joint returns.[6/]

3. Current Joint Filing

Under present law, married taxpayers may elect whether to file two separate returns or a single joint return. This election determines not only the manner in which the taxpayers report their

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[6/] Different rates for single taxpayers and married taxpayers filing separately were instituted in 1969 because of concern about penalties on single taxpayers. As a result, married taxpayers who file separately will ordinarily pay more than those (at the same level of income) who file as single (unmarried) taxpayers, and also will generally pay more than they would pay if they filed jointly. These differences are exacerbated by special tax rates (with wider tax rate brackets) for "heads of household," that is, unmarried taxpayers who maintain a household for another person, typically a dependent.

income, but also the application of various computational rules such as the appropriate tax rate schedule and the amount of the standard deduction.

For the 95 percent of married taxpayers (approximately 49 million couples) who choose to file jointly, all of the couple's items of income, deductions, credits and exemptions (whether individual or joint) are combined on the return. The couple then calculates the tax due using the limits for deductions, credits and other items appropriate for the married filing jointly status and using the married filing jointly tax rate schedule. There is no need to determine which item belongs to which spouse.

The tax rate schedule and the standard deduction for married couples filing joint returns are based on the view that their combined income should be taxed as though it were equally split between the spouses. For married individuals with substantially disproportionate incomes, such income-splitting generally lowers their overall taxes (compared to single returns) because some of the higher earner's income falls into a lower bracket. This phenomenon is commonly referred to as a "marriage bonus." On the other hand, for spouses with relatively equal incomes, the joint return rate schedule may produce a higher overall tax liability than would apply if the spouses were two single taxpayers. This phenomenon is commonly referred to as a "marriage penalty."[7/]

Upon filing a joint return, each spouse generally becomes jointly and severally liable[8/] for all taxes, additions to tax, penalties and interest due with respect to the joint return. This joint and several liability continues indefinitely, regardless of which spouse's tax items gave rise to the liability, and even if the couple later divorces or separates. This joint and several liability to the Government is unaffected by the terms of any divorce decree or separation agreement.

For the 5 percent of couples who choose to file separately (approximately 2.5 million couples), each spouse must determine his or her own income, deductions, credits and exemptions. This determination must be made for both separate items and each spouse's share of any joint items. For example, if the couple has income from jointly held property or pays a deductible expense from joint funds, the item must be allocated between the spouses and reported separately. Each spouse then calculates the tax due using the limits for deductions, credits and other items appropriate for the married filing separately status and using the married filing separately tax rate schedule.

Couples who select married filing separate filing status do not get the benefits of income-splitting (except in community property states). The limitations on deductions and the tax rate structure for married filing separate taxpayers are generally one half of those for married filing jointly;

[7/] The causes and effects of the "marriage bonus" and "marriage penalty" are beyond the scope of this study, which focuses on joint and several liability and relief provisions intended to ameliorate the effect of joint and several liability in certain cases involving innocent spouses.

[8/] As noted above, the common law concept of joint and several liability was expressly adopted by Congress in 1938 and is now incorporated in I.R.C. § 6013(d)(3).

accordingly, married individuals with disproportionate incomes could pay more tax by choosing this filing option. On the other hand, despite the less advantageous rate schedule, separate filing could produce tax savings for some married couples (e.g., if one spouse has deductions that would otherwise be unusable because of limits based on income).

Regardless of whether separate filing produces a higher or lower total tax liability, it avoids the joint and several liability associated with a joint return. Upon filing a separate return, each spouse is solely liable for the taxes required to be reported on his or her separate return and is not responsible for any liability based on the other spouse's return.

B. Collecting Unpaid Tax

1. In General

The majority of Federal taxes are collected through payroll tax withholding, estimated tax deposits, and payments made by taxpayers at the time of filing their returns. In 1996, approximately 83 percent of the total individual income taxes estimated to be due, and over 95 percent of the total individual income taxes actually collected, were collected through these taxpayer-initiated processes, without any affirmative action by the IRS to enforce collection.

If, however, a taxpayer does not pay the taxes that are due after the IRS assesses the taxes and sends the taxpayer a notice and demand for payment, then a Federal tax lien arises by operation of law and attaches to "all property and rights to property, whether real or personal, belonging to" the taxpayer. I.R.C. § 6321. The courts look to state law to define what constitutes property or a right to property. Aquilino v. United States, 363 U.S. 512 (1960).

Where voluntary, timely payment of tax liabilities is not made, the IRS must initiate steps to ensure the collection of due and owing tax liabilities. In certain instances, the IRS must take affirmative steps to enforce collection based on that lien either through an administrative levy or by litigation.

To enforce collection of a tax liability based on a lien, the IRS may administratively levy on any property subject to the lien pursuant to I.R.C. § 6331(a). Alternatively, or in addition, the IRS may also commence litigation under I.R.C. § 7403 to enforce the tax lien or to subject certain property to the payment of tax. Although administrative levy is the most common and cost-effective method of enforced tax collection, litigation under I.R.C. § 7403 is the normal method used by the Service to collect tax liabilities from real property held jointly by married couples.

2. Collecting Unpaid Taxes of Married Taxpayers

As stated above, when a married couple files a joint return, each spouse is jointly and severally liable for the tax relating to that return. Any tax lien that might result from a joint return will attach to any property interests of either spouse as defined under relevant state law, regardless of whether the couple is still married at the time the lien arises. As a result, a joint and several tax liability can be satisfied from any property owned separately by either spouse (or former spouse), as well as from property owned jointly. This would include property held by the spouses as tenants by the entirety, joint tenants, and tenants in common, or as community property.

In contrast, when a married taxpayer files a separate return, the Service generally can collect a tax liability related to that return only from that taxpayer's separately owned property or interest in property held as joint tenants or tenants in common. The tax lien arising from one spouse's liability does not attach to the separate property of the other spouse. Likewise, property held by a couple as tenants by the entirety generally is insulated from tax collection actions based on the separate return liability of one of the spouses because courts have found the liable spouse to have no separate or separable interest in the estate by the entirety. United States v. Hutcherson, 188 F.2d 326 (8th Cir. 1951).

In community property states, any property acquired during the marriage is generally presumed to be community property, unless the property is specifically designated as separate property under state law. In most community property states, income earned during the marriage from both jointly and separately owned property will also be community property. The interests of each spouse in community property are subject to tax liens and can be seized by levy for a separate tax liability incurred during the marriage. Many community property states, however, permit spouses to shield property from each other's debts through a written or oral agreement that certain property will be a spouse's separate property.

The extent to which the Service can satisfy an antenuptial debt from community property varies greatly among community property states. With respect to Federal tax liabilities, established case law allows the Service to collect antenuptial debts from income that is community property in California, Louisiana, and under some circumstances in Texas.[9/] Louisiana law allows all creditors to collect antenuptial debts from community property.[10/] In Washington and Arizona, the Service can collect a taxpayer's tax liability from a spouse's wages where they are community property, but only to the extent of the taxpayer's one-half interest in that community property.[11/] In Idaho, Nevada, Wisconsin, and New Mexico, the ability to collect antenuptial debts from community property is unclear.

9/ Babb v. Schmidt, 496 F.2d 957 (9th Cir. 1974); Broday v. United States, 455 F.2d 1097 (5th Cir. 1972).

10/ Pan American Import Co. v. Buck, 440 So. 2d 182 (La. Ct. App. 1983), rev'd in part on other grounds, 452 So. 2d 1167 (La. 1984).

11/ In re Ackerman, 424 F.2d 1148 (9th Cir. 1970); United States v. Overman, 424 F.2d 1142 (9th Cir. 1970).

C. Relief Provisions

1. Background: The Need for Relief

From the time joint and several liability was enacted in the tax law in 1938 until enactment of the Innocent Spouse Act of 1971, spouses could avoid the liability consequences of joint return filing only under common law doctrines where the spouse's signature was shown to be a forgery or was obtained by duress, misrepresentation, fraud, or mistake. Some courts reacted to their inability to grant relief from joint and several liability outside of common law doctrines by including pleas for legislative relief in their opinions.[12/]

Responding to such concerns, Congress passed the Innocent Spouse Act of 1971, adding I.R.C. §§ 6013(e) and 6653(b)(4) (currently I.R.C. § 6663(c)). Pub. L. No. 91-679, 84 Stat. 2063.[13/] These innocent spouse provisions were significantly expanded in 1984 to cover certain cases that did not qualify for relief under prior law. For example, the statute originally provided relief only for tax attributable to omissions of income but, in 1984, was amended to apply to the tax attributable to erroneous deductions as well.

Community property rules also have been discovered to produce inequitable results in certain cases where the couple elects to file separate returns. As demonstrated by the decision in United States v. Mitchell, 403 U.S. 190 (1970), problems may arise because income that is considered community property under state law is taxed in equal shares to a husband and wife. If a husband and wife in a community property state file separate returns, each is required to report one-half of the community property income (as well as 100 percent of their separate income). Unlike their counterparts in common law states, community property taxpayers cannot necessarily insulate themselves from liability with respect to their partners' earnings by electing married filing separately status. Moreover, because applicability of the innocent spouse provisions of I.R.C. § 6013(e) depends on the filing of a joint return, filing a separate return precludes relief provided under that section.[14/] I.R.C. § 6013(e)(1).

12/ For example, the court in Wissing v. Commissioner, 54 T.C. 1428 (1970), vacated, 441 F.2d 553 (6th Cir. 1971), stated that it "would welcome a rule which would grant relief to a victimized spouse who has no knowledge of or reason to have knowledge of, and does not benefit from, unreported income, at least where that income is fruit of a crime." However, it saw no way to do so given the language of section 6013(d)(3) without ameliorating legislation.

13/ As described by Congressman Boggs when urging its consideration, this legislation was intended to "provide relief in compelling situations . . . in connection with the imposition upon innocent spouses of large liabilities for taxes and penalties attributable to income omitted from a joint return by the other spouse." 116 Cong. Rec. 43350 (1970).

14/ See, e.g., Galliher v. Commissioner, 62 T.C. 760 (1974), aff'd in an unpublished opinion, (continued...)

As with the joint and several liability imposed upon the filing of a joint return under I.R.C. § 6013(d), absent a relief provision, courts concluded that they were unable to prevent the harsh results that sometimes ensued when one-half of the community income was attributed to an otherwise "innocent" spouse.[15/] Often the most egregious cases involved abandoned spouses who were separated but not divorced and who neither received nor benefited from the income imputed to them.[16/] As it did in 1971 with the enactment of I.R.C. § 6013(e), Congress again heeded calls for reform and, in 1980, added I.R.C. § 66(a) to the Internal Revenue Code, which provided relief in limited circumstances for taxpayers living in community property states.

2. Current Requirements for Innocent Spouse Relief for Joint Return Filers

To qualify for relief from joint and several liability under the current innocent spouse provisions, a joint return filer must satisfy four separate statutory requirements. Failure to meet any one of the requirements precludes relief. As discussed in greater detail below, the taxpayer must show that:

(1) a joint return has been made for the taxable year;

(2) the joint return contains a substantial understatement of tax attributable to grossly erroneous items of the other spouse;

(3) the taxpayer did not know, and had no reason to know, of the substantial understatement when he or she signed the joint return; and

(4) it would be inequitable to hold the taxpayer liable for the deficiency in income tax attributable to such substantial understatement.

I.R.C. § 6013(e)(1)(A)-(D).

a. A Joint Return Has Been Made For The Taxable Year

In the absence of a joint return, there is no joint liability from which relief need be sought. Accordingly, the simplest defense to the imposition of joint and several liability is the lack of a joint return.

[14/] (...continued)
512 F.2d 1404 (5th Cir. 1975).

[15/] See, e.g., Ramos v. Commissioner, T.C. Memo. 1969-157.

[16/] See, e.g., Bagur v. Commissioner, 66 T.C. 817 (1976), remanded, 603 F.2d 491 (5th Cir. 1979). See also, H.R. Rep. No. 1278, 96th Cong., 2d. Sess. 7 (1980).

Whether a joint return has been filed is a question of fact, and because a joint return requires the mutual assent of both spouses, the spouses' intent is determinative. A return is considered joint, even if a spouse did not sign the return or give express authorization to the other spouse, if the facts indicate that a spouse tacitly consented to the return.[17/] On the other hand, a signature obtained under conditions of duress, mistake, fraud, or misrepresentation is not considered the signature of that person, and the resulting return is not a "joint" return because the spouse's consent was not knowing or voluntary.[18/]

b. There is a Substantial Understatement of Tax Attributable to Grossly Erroneous Items of the Other Spouse

This statutory requirement has three separate elements. First, the understatement of tax must be substantial. Second, the understatement must be attributable to a grossly erroneous item. Finally, the understatement must be attributable to the other spouse.

i. The Return Contained a Substantial Understatement of Tax

The statute limits innocent spouse relief to situations where the liability arises from a substantial understatement of tax. An understatement of tax must exceed $500 (exclusive of penalties and interest) if it is to be considered substantial for purposes of this statute. I.R.C. § 6013(e)(3).

In addition, to qualify for relief, an understatement of tax attributable to grossly erroneous items of deduction, credit or basis must also exceed a specified percentage of the taxpayer's adjusted gross income (AGI) in the most recent tax year ending before the deficiency notice is mailed (referred to as the "preadjustment year"). I.R.C. § 6013(e)(4). Where AGI in the preadjustment year is $20,000 or less, the understatement in tax must exceed 10 percent of AGI. Where AGI in the preadjustment year exceeds $20,000, the understatement of tax must be greater than 25 percent of AGI. To calculate the specified percentage of income requirement, the "liability" includes penalties and interest up to, but not after, the date of the notice of deficiency.[19/] If the spouse has remarried, the new spouse's income is included in calculating AGI, whether or not the new couple files a joint return. I.R.C. § 6013(e)(4)(E).

These limitations based on the taxpayer's AGI for the preadjustment year were added in 1984 to liberalize an earlier rule which allowed innocent spouse relief only in the case of omissions from

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17/ See, e.g., Federbush v. Commissioner, 34 T.C. 740 (1960), aff'd per curiam, 325 F.2d 1 (2d Cir. 1963); Estate of Campbell v. Commissioner, 56 T.C. 1 (1971); Acquaviva v. Commissioner, T.C. Memo. 1996-54.

18/ See, e.g., Scudder v. Commissioner, 48 T.C. 36 (1967), rev'd on other grounds, 405 F.2d 222 (6th Cir. 1968); Stanley v. Commissioner, 81 T.C. 634 (1983).

19/ Farmer v. Commissioner, 794 F.2d 1163 (6th Cir. 1986).

gross income that exceeded 25 percent of the gross income shown on the joint return as filed. Congress sought to alleviate the hardships that could result from the stricter requirements of prior law. Because Congress retained some standards relating to the magnitude of the adjustment necessary to qualify for relief, it appears that Congress retained the concern it had in 1970 to limit relief to situations involving significant financial hardships.[20/]

ii. The Understatement Was Grossly Erroneous

To qualify for innocent spouse relief, the items causing the substantial understatement also must be grossly erroneous. Under the statute, any omission from gross income is automatically grossly erroneous. I.R.C. § 6013(e)(2)(A). It is irrelevant whether the omission results from simple negligence or fraudulent behavior on the part of the other spouse.

Conversely, for items of deduction, credit or basis to be considered grossly erroneous,[21/] the items must be shown to be without basis in fact or law. I.R.C. § 6103(e)(2)(B). Whether an item is grossly erroneous is evaluated as of the date of filing the return claiming the item.[22/] Neither disallowance of the item alone, nor lack of substantiation is sufficient to prove that the item was grossly erroneous.[23/] Rather, guided by the legislative history, the established judicial interpretation is that a deduction has no basis in fact when the expense for which the deduction is taken was never paid, and has no basis in law when the expense does not qualify for deduction under well-established legal principles, or when no substantial legal argument can be made to support the deduction. Referring to the committee report, courts frequently describe such a deduction as "frivolous, fraudulent, or phony."[24/]

[20/] S. Rep. No. 1537, 91st Cong., 2d Sess. 3 (1970).

[21/] Prior to 1984, innocent spouse relief was available only with respect to omissions from income. In 1984, Congress added rules regarding items of deduction, credit or basis to allow innocent spouse relief in more situations. H.R. Rep. No. 432, pt. 2, 98th Cong., 2d Sess. 1502 (1984).

[22/] Purcell v. Commissioner, 826 F.2d 470 (6th Cir. 1987).

[23/] Flynn v. Commissioner, 93 T.C. 355 (1989); Douglas v. Commissioner, 86 T.C. 758 (1986), aff'd by unpublished opinion (10th Cir. 1989).

[24/] Douglas, supra, citing H.R. Rep. No. 432, pt. 2, 98th Cong., 2d Sess. 1502 (1984).

iii. The Understatement Was Attributable to the Other Spouse

Innocent spouse relief is available only for grossly erroneous items attributable to the other spouse. Accordingly, it is incumbent upon the spouse claiming relief to prove attribution of the item to the other spouse.[25]

In determining the spouse to whom items of income are attributable, community property laws are disregarded except for income from property. I.R.C. § 6013(e)(5). Where omitted income is generated by the performance of substantial services by one spouse, that income is attributed to that spouse even if it is income from a business that is community property. However, if the spouse does not perform substantial services, even if the income is from a trade or business, that income is "income from property" subject to attribution in accordance with community property laws.[26]

c. The Taxpayer Did Not Know, and Had No Reason To Know, of the Substantial Understatement

Section 6013(e) requires the taxpayer to establish that he or she did not know and had no reason to know of the understatement of tax. This requirement is rooted in the common law of restitution. A taxpayer must affirmatively establish that he or she was a "wholly innocent spouse." S. Rep. No. 1537, 91st Cong., 2d Sess. 6089 (1970).

I. The Taxpayer Did Not Know

In cases involving income omission, actual knowledge of the transaction constitutes reason to know, even when the spouse is ignorant of the tax consequences.[27] For example, a taxpayer has knowledge if he or she knows that money was received. Failure to understand that the money was gross income does not demonstrate lack of actual knowledge.[28]

Because items of deduction, credit or basis are reported on the return, applying the lack of knowledge requirement to these items has been more problematic. No clear consensus among the courts has been established on the meaning of the knowledge requirement. The Ninth Circuit in Price v. Commissioner held that mere knowledge of the transaction that was the basis of an erroneous

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[25] Feldman v. Commissioner, 20 F.3d 1128 (11th Cir. 1994), aff'g T.C. Memo. 1993-17; Hayman v. Commissioner, 992 F.2d 1256 (2d Cir. 1993); Schultz v. Commissioner, T.C. Memo. 1987-459; Hodges v. Commissioner, T.C. Memo. 1986-67.

[26] Allen v. Commissioner, 514 F.2d 912 (5th Cir. 1973).

[27] McCoy v. Commissioner, 57 T.C. 732 (1972).

[28] See, e.g., Ratana v. Commissioner, 662 F.2d 220 (4th Cir. 1981).

deduction did not preclude innocent spouse relief.[29/] The court found that the wife knew of the transaction, but that she did not know enough about the circumstances surrounding it to realize that it would cause an understatement on the return. The Court concluded that the wife neither knew nor had reason to know of the understatement. By contrast, the knowledge test in Price has been specifically rejected by the United States Tax Court.[30/] Under the legal standard adopted by the Tax Court, a taxpayer claiming innocent spouse status must establish that he or she was unaware of the circumstances that gave rise to the error on the tax return, and not merely that he or she was unaware of the tax consequences.

ii. The Taxpayer Had No Reason To Know

Despite the lack of consensus regarding the actual knowledge requirement, courts have uniformly accepted a standard for determining whether a person claiming innocent spouse relief has "reason to know" of an understatement on a joint return. The proper standard is whether a reasonably prudent taxpayer under the circumstances of the spouse at the time of signing the return could be expected to know that the tax liability stated was erroneous or that further investigation was warranted. Firmly established within this standard is a spouse's duty of inquiry. Although the application may vary from case to case, courts universally require a taxpayer seeking innocent spouse relief to demonstrate that the duty of inquiry was satisfied or that attempts to ascertain facts would have been futile.[31/] The following factors are among those the courts consider in analyzing the constructive knowledge requirement:

(1) The relief-seeking spouse's level of education. Reynolds v. Commissioner, T.C. Memo. 1991-210.

(2) The presence of expenditures that appear lavish or unusual when compared to the family's past levels of income, standard of living, and spending patterns. Estate of Jackson v. Commissioner, 72 T.C. 356 (1979); Mysse v. Commissioner, 57 T.C. 680 (1972).

(3) Participation in the other spouse's business and family finances. Sonnenborn v. Commissioner, 57 T.C. 373 (1971).

[29/] 887 F.2d 959 (9th Cir. 1989), rev'g an unpublished Tax Court bench opinion.

[30/] See Bokum v. Commissioner, 94 T.C. 126 (1990), aff'd on other grounds, 992 F.2d 1132 (11th Cir. 1993); Purcell v. Commissioner, 826 F.2d 470 (6th Cir. 1987).

[31/] Barnhill v. Commissioner, T.C. Memo. 1996-97; Wolfram v. Commissioner, T.C. Memo. 1987-422, aff'd by unpublished opinion (9th Cir. December 6, 1989); Liddy v. Commissioner, T.C. Memo. 1985-107, aff'd without discussion of this issue, 808 F.2d 312 (4th Cir. 1986).

(4) The other spouse's evasiveness or deceit concerning the couple's finances. Pappadio v. Commissioner, T.C. Memo. 1992-568; Hayes v. Commissioner, T.C. Memo. 1989-327.

d. **It Would Be Inequitable To Hold The Taxpayer Liable For The Deficiency**

In determining whether it would be inequitable to hold a spouse liable, a principal question is whether the taxpayer seeking relief derived a benefit beyond normal support from the income giving rise to the understatement. Prior to 1984, the statute specifically stated that the equitable considerations should include whether or not the spouse "significantly benefited directly or indirectly from the items omitted from gross income." When the statute was changed to permit innocent spouse relief relating to items other than omitted income, this language was deleted, but the legislative history stated that it should continue to be a consideration in determining the equities of each case. H.R. Rep. No. 432, pt. 2, 98th Cong., 2d Sess. 1502 (1984).

Moreover, equity precludes granting relief where the claimant has enjoyed a significant benefit, directly or indirectly, from an understatement of income. Treas. Reg. § 1.6013-5(b). Like the "reason to know" test (where the presence of lavish or unusual expenditures may provide notice that income is not being reported), this requirement involves a review of the taxpayer's financial affairs and the effect the understatement had on the claimant's lifestyle. The presence of unusual or lavish expenditures traceable to the errors on the return weighs against an equitable claim for relief. Recognizing that one person's luxury can be another's necessity, courts generally compare actual expenditures received by or on behalf of the relief-seeking spouse to what is "ordinary" for that particular household. Likewise, transfers of property, including those received several years later, such as an inheritance of property or life insurance proceeds traceable to omissions from income may also preclude relief.

While significant benefit may be the most important factor, it is not the only one. The statute and regulations direct that all the facts and circumstances be considered. Other factors that are considered by the Service and the courts include: whether financial hardship would ensue, whether the spouse was deserted or divorced, and whether the other spouse was also "innocent." Thus, even in the presence of significant benefit, relief is not always denied.[32/]

32/ See, e.g., Saunders v. Commissioner, 509 F.2d 162 (5th Cir. 1975).

3. Requirements for Relief for Separate Return Filers in Community Property States

In certain cases, a spouse who resides in a community property state and files a separate return may be relieved of tax liability arising from the income-splitting rules of community property. I.R.C. § 66. Section 66 has three subsections, discussed below, which address different situations.[33]

Section 66(a) provides relief from the allocation of earned income under community property law for couples who remain married although they live apart if:

(1) the spouses are married to each other at any time during the calendar year;

(2) the couple lived apart at all times during the calendar year and did not file a joint return with each other;

(3) one or both spouses had earned income which is community income; and

(4) no portion of the earned income was transferred, directly or indirectly, between the spouses during the calendar year.

If these conditions are satisfied, community income of qualifying spouses is treated in the same manner as income of United States citizens or residents married to nonresident aliens under I.R.C. § 879.

Section 879(a) divides community income into five categories and provides how the income in each category is to be attributed between the spouses. Generally, earned community income is attributed to the spouse who rendered the personal services. Community income from separate property is attributed to the owner; while dividends, interest, and royalties are attributed to the spouse with a proprietary vested interest in the income under state law. I.R.C. §§ 879(a)(1), (a)(3); Treas. Reg. § 1.879-1. Trade or business income and deductions are treated as belonging to the husband, unless the wife exercised substantially all management and control over the trade or business. Partnership income is attributed to the spouse who has the partnership interest. I.R.C. §§ 879(a)(2), 1402(a)(5).

Section 66(b) is not really a relief provision for taxpayers. Rather, it allows the Service to disregard community property laws by denying the benefits of income-splitting to the earner or

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[33] As originally enacted, I.R.C. § 66 included only the relief provision currently found in I.R.C. § 66(a). Congress, however, found its initial efforts too restrictive, and amended the relief provision of I.R.C. § 66 as part of the Tax Reform Act of 1984, by adding two additional provisions, I.R.C. §§ 66(b) and (c). Pub. L. No. 98-369, 98th Cong., 2d. Sess. § 424 (1984).

recipient of community income who fails to inform the other spouse of the amount of the income received and who treats the income as though it belonged solely to the earner/recipient. The effect of I.R.C. § 66(b) is thus to require the income-earning spouse to report the entire amount of income.

Section 66(c) provides relief to certain spouses who have failed to include in gross income an item of community income attributable to the earnings of the other spouse. With language similar to I.R.C. § 6013(e), the statute provides that to establish that he or she is entitled to relief the taxpayer must show:

(1) a joint return was not filed for the taxable year;

(2) an item was omitted from gross income that would have been attributed to the other spouse under the rules contained in I.R.C. § 879(a);

(3) at the time of filing his or her separate return the spouse did not know and had no reason to know of the item of community income; and

(4) it would be inequitable to include the unreported income in the gross income of the relief-seeking spouse.

Pursuant to I.R.C. § 66(c), if separate returns are filed, one spouse will be relieved of liability for omissions of income attributable to the other spouse, provided that the relief-seeking spouse did not know and had no reason to know of the omission, and it would be inequitable to hold that spouse liable for the omission. If these requirements are met, I.R.C. § 66(c), in effect, overrides community property laws by not treating the relevant items as community income.

OVERVIEW OF CURRENT IRS ADMINISTRATION OF JOINT RETURNS

In 1996, the IRS processed over 118 million individual income tax returns.[34/] About 51 million returns were from married taxpayers and about 67 million were from single taxpayers. Of the 51 million returns from married taxpayers, approximately 49 million were from married couples filing jointly, while over 2 million separate returns were filed by married taxpayers.

The IRS processes a joint return as though it were filed by a single taxpaying entity. The married couple's tax account information is stored in one account on the Master File, the main IRS database. The only separate items that appear on this tax account are the spouses' names and social security numbers. All other information is aggregated on the Master File account, just as it is on the joint return filed by the married couple. For example, the couple's items of income, deduction, credits, and exemptions are shown in the aggregate.

A Master File account also shows the date the married couple's return was due and the date the couple filed their return. These dates are relevant for establishing the statute of limitations for the IRS to make any additional assessment and collection of tax, interest or penalties and for the married couple to file any claims for refund.

The IRS has other information systems, some of which incorporate data from the Master File, and others of which store data derived from processing tax returns, examining returns and pursuing collection actions. Some of these systems maintain records for the couple in the same aggregate format as the Master File, but others store data separately for each spouse.

The vast majority of taxpayers, including married couples, have no further contact with the IRS for a given tax year after a return is filed for that year. The IRS does, however, contact some taxpayers each year with respect to some aspect of their tax returns. For example, the IRS may contact taxpayers to verify that their returns correctly reflect income, deductions or credits, or to seek payments when their tax liability is not fully paid through withholding, estimated tax payments, or a check submitted with a balance due on the joint return. The IRS selects returns for audit if they meet certain criteria that apply to all taxpayers, including joint filers. In addition, the IRS contacts taxpayers when there is a discrepancy between the information reported on the income tax return and that reported on information returns (e.g., Forms W-2 and 1099). Of the 48 million joint returns filed for tax year 1992, for example, the IRS assessed additional taxes with respect to approximately 1.25 million joint returns as a result of both the matching information return program and the audit program.

If a taxpayer, including a married taxpayer, does not agree with the additional tax proposed through the information matching or audit programs, that taxpayer has the right to dispute the proposed additional tax through an administrative process before IRS Appeals or to immediately

34/ The other numbers given in this paragraph are based on earlier years and adjusted to reflect approximate 1996 totals.

petition the Tax Court for relief. If the taxpayer disagrees with the decision of IRS Appeals, the taxpayer may then seek judicial relief.

The IRS takes actions to collect a tax liability after it has been assessed but not paid. This situation can result from the taxpayer not paying the balance due shown on a return filed by the taxpayer, from an adjustment to the return from the information matching program, from an audit adjustment, or after a decision by IRS Appeals or a court. The IRS first sends several notices to a taxpayer requesting payment and, if the taxpayer does not respond, then the IRS will initiate collection actions, such as the filing of liens and service of levies, or will negotiate an installment agreement or offer in compromise. Taxpayers also have the right to appeal these collection actions first to a Collection Group Manager and then to IRS Appeals.

A married taxpayer who filed a joint return may raise an innocent spouse claim at any time in the examination, appeals or collection processes. As seen above, IRS procedures for evaluating innocent spouse claims follow the law established by the courts and applicable regulations interpreting I.R.C. § 6013(e). In addition, a spouse who has filed a joint return can learn from the IRS if there are any pending IRS collection actions against the other spouse to collect their joint taxes with respect to such return. The IRS also has procedures to allow a spouse to inform the IRS of assets of the other spouse that may not be known to the IRS.

PROPOSALS TO REPLACE OR REFORM THE JOINT AND SEVERAL LIABILITY STANDARD

A. Introduction

The reform proposals identified by Congress for study in the TBOR 2 legislation, as well as other reform proposals that Treasury and the IRS identified as part of their study, all share the common goal of lessening or eliminating some of the difficulties that joint filers have experienced as a result of the joint and several liability standard. These difficulties are especially significant for divorced and separated taxpayers. The reform proposals, however, differ substantially on how they achieve this goal.

For convenience, this section of the report generally analyzes the reform proposals in descending order of magnitude of change to current law. The first section discusses the proposal that would effect the most comprehensive change to current law: the complete elimination of joint filing in favor of mandated separate return filing for all married taxpayers.

The next level of reform proposals seeks to preserve joint filing but allow married couples to separate their joint tax liability in a variety of ways. These proposals range from a separation of liability at the time a joint return is filed to a separation of liability for the married couple at the time of a collection action. These proposals are: "front end" proportionate liability; the ABA's separate liability proposal; the AICPA's allocated liability proposal; and a proposal to separate a formerly married couple's Federal tax liability based on the terms of a divorce decree.

This study analyzes each reform proposal by asking three basic questions:

(1) Would the proposal substantially increase or decrease the burden on taxpayers to comply with the tax law?[35/]

(2) Would the proposal significantly increase or decrease the burden to the Government of administering the tax law?

(3) How well would the proposal attain the goal of lessening or eliminating difficulties that joint filers may have experienced with joint and several liability, particularly those who are divorced or separated?

Although each proposal has its particular advantages and disadvantages based on the above criteria, the purpose of this study is not to conclude whether one proposal is clearly superior over the

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35/ Possible changes in taxpayers' total tax liability as a result of these proposals could of course present a significant financial burden or benefit to taxpayers. To the extent such potential changes are due to the "marriage penalty" or "marriage bonus," they are mentioned but not specifically focused on in this study.

others. The study, instead, seeks to identify the strengths and weaknesses of each proposal and the issues that would need to be addressed if the proposal were adopted.

While the analysis of the administrative effects on the IRS necessarily depends upon current IRS procedures and technological capabilities. Although this report identifies certain adverse administrative effects on the IRS from particular reform proposals, it does not imply that these difficulties are insoluble given the appropriate reallocation of current IRS resources[36/] or allocation of additional resources or advances in technology.

B. Mandatory Separate Returns For All Filers

1. Description of Proposal

Congress directed Treasury and the IRS to study reform proposals under which "each spouse would be liable only for the income tax attributable to the income of each spouse." H. R. Rep. No. 506, 104th Cong. 2d Sess. 30-31 (1996). The most direct way to accomplish this goal (though not the only way) would be to mandate separate returns for all married individuals. The mandated separate return approach would require each spouse to file a separate return to report his or her income, deductions, exemptions and credits. A spouse would be liable only for the tax attributable to his or her return and would not be liable for the tax arising from omitted or erroneous items on his or her spouse's return.

This proposal would shift away from a model that taxes married taxpayers as a single economic unit to a model that taxes each spouse as an individual taxpayer. Assuming that it did not intend for this shift to produce a significant change in the overall tax revenues, Congress would have to consider appropriate offsetting changes to the tax rate structure and certain deductions and credits if it adopted this approach to resolving joint and several liability issues. For instance, Congress would have to determine whether to eliminate "married filing separately" status (and possibly "head of household" status) and make all individual taxpayers use single filing status, or to maintain the differences between the effective tax rates applicable to married taxpayers who file separately, unmarried individuals, and heads of households.[37/] Moreover, while elimination of the income-splitting effect of joint filing would tend to increase the tax liability of some married couples, other factors could tend to reduce overall tax liability. But absent a specific statutory directive to ignore community property laws for Federal tax purposes, elimination of joint filing would not affect married taxpayers who reside in community property states and file separately; they would retain income-splitting by operation of state law.

36/ It is worth noting that the reallocation of IRS resources could adversely affect the effectiveness of other IRS programs.

37/ For example, for 1998 the standard deduction is $7,100 for a married couple filing jointly, or $3,550 each for married individuals filing separately, but $4,250 for an unmarried individual and $6,250 for a head of household. See I.R.C. § 63(c)(2).

2. **Effect on Taxpayers**

Mandated separate filing would cause the total tax liability of many families to depend on the division of income between spouses.[38/] Because of certain differences in the factors that influence effective tax rates (such as progressive marginal rates, income-splitting, standard deduction amounts, etc.), most joint-filing couples would not have the exact same total tax liability if they filed separately under the current law's married filing separately status. When compared with joint filers at the same levels of combined income and otherwise in similar circumstances, total taxes would generally be higher when one spouse had most or all of the income (e.g., "one-earner" couples), while total taxes would generally remain approximately the same for couples where both spouses have similar incomes (e.g., "two-earner" couples). Moreover, even if all of the factors influencing effective tax rates were adjusted to make married filing separately status, unmarried filing status, and head of household filing status exactly the same, there would continue to be marriage penalties or bonuses affecting some taxpayers.

Married taxpayers already have the option to file separate returns if they wish by choosing the "married filing separately" option. Of the more than 51 million tax returns filed by married taxpayers, however, less than 5 percent are filed this way. Apart from possible increases in their overall tax liability if they file separately, there may be many other reasons for the overwhelming preference by married taxpayers for joint returns over separate returns, including convenience and the ability to claim certain benefits.[39/]

One dramatic effect on taxpayers of a mandatory system of separate returns would be the need for couples who are currently filing jointly to prepare two tax returns annually instead of the one currently permitted. Requiring this extra return would effectively double the paperwork burden on most of the 49 million couples who currently file jointly. As discussed above, joint filing was originally introduced in part to lessen the administrative burden on married taxpayers and the Government alike.

Under a mandated separate return approach, married taxpayers would need to determine which spouse should report, and in what amount, income that was produced by a jointly-held asset or deductions and expenses paid from a joint account. On more complex returns, the list of such joint items could include items such as: income or loss from a joint business or investment; a joint taxable refund from a prior year; credits for child and dependent care expenses; mortgage interest on a jointly-owned home; joint charitable contributions; and deductible expenses paid from a joint account.

38/ Mandated separate filing would therefore arguably be inconsistent with horizontal equity, one of the economic goals of taxation, because similar families would be taxed differently based on the division of income between spouses.

39/ For example, married taxpayers generally must file joint returns to claim a credit for household and dependent care services under I.R.C. § 21 or the earned income tax credit under I.R.C. § 32.

Comprehensive rules would need to be implemented, most likely through legislation, to instruct taxpayers and the Service on how to allocate any number of items between the spouses. Because of the relatively small number of married filing separately taxpayers, most such questions are currently handled on a case-by-case approach.

The simplest allocation approach would be to split each item between the spouses either evenly or on some other formulary basis. Any such formula would inevitably result in the taxation of some spouses on a basis that did not reflect their actual economic contribution to the item. This administrably simple but economically imprecise allocation would undercut the rationale for separate filing, or for any other approach (such as proportionate liability) intended to limit each spouse's separate liability to his or her separate economic activities.

The allocation method most consistent with the rationale for any of the reform proposals designed to eliminate joint liability would generally require a married couple to allocate tax items between the spouses strictly on the basis of their relative economic contributions to the item. In many cases, determining the proper allocation of items arising from the expenditure of joint funds would require establishing the amount that each spouse contributed to the joint funds. Comprehensive tracing rules may be difficult to develop and apply, however. These tracing rules would likely require a significant increase in the kinds and amounts of financial records kept by many taxpayers. Default rules for apportioning items would also be necessary for cases where the spouses are not cooperating with the IRS or with each other or where the information about joint items is difficult to obtain, inconclusive, or contradictory.

Additional tax complexity would also arise from such allocations. Taxpayers would try to predict their expected allocations and plan to minimize their total tax liability, for example by deciding how payments for certain deductible household expenses should be made and allocated. Only the most skillful taxpayers would be able to take full advantage of the opportunities for tax reduction. In addition to creating complexity, such tax-directed planning activities are generally considered to be economically inefficient and wasteful to the economy as a whole.

A shift to separate returns would reintroduce differences in tax treatment between married couples in community and noncommunity property states resulting solely from the operation of state law. Unlike married couples in common law states, taxpayers in community property states would continue to have the advantage of income-splitting even if separate returns were mandated. In addition, because married taxpayers filing separately in common law states are only liable for their own items of income, real estate held as tenants by the entirety would be protected from enforced collection where only one spouse owed taxes. By contrast, real estate held as community property would still be subject to enforced collection activity even where only one of the spouses owed a Federal tax liability, because a creditor can collect the separate debt of one spouse from the community property.[40/]

[40/] See United States v. Overman, 424 F.2d 1142 (9th Cir. 1970) (the Government has a lien
(continued...)

Mandatory separate returns would eliminate the need for the Internal Revenue Code provisions relating to joint filing, joint and several liability and innocent spouse relief. Overall it is unlikely, however, that this simplification would outweigh the increase in burden and complexity caused by the new Code and regulatory provisions necessary to guide taxpayers on how to allocate or apportion jointly-held tax items between two returns for tax purposes.

3. Effect on IRS Administration

The mandated separate return proposal would have a number of significant effects on each stage of the IRS administrative process. Most serious would be the need to process up to 49 million additional tax returns, or about a 40 percent increase in the total number of individual income tax returns processed each year. The IRS does not currently have the resources to handle 49 million potential new tax accounts. Although there is enough capacity on the IRS's Master File system, the other IRS computer systems that store data from processing returns, or from which information is entered onto the tax accounts contained in the Master File, would be unable to accommodate the additional data from these new returns.

Current IRS plans to upgrade its information systems are based on certain assumptions, including the continuing existence of joint filing and the joint and several liability standard. These plans would need to be revised to accommodate the additional taxpayer accounts that would result from legislation mandating separate returns. The revised upgrades could take a number of years to accomplish, and this time schedule would need to be reflected in the effective date of any legislation. It is likely that the cost estimates for these plans would need to be similarly revised to reflect the substantial increase in equipment and resources necessary to store data from processing the increased number of tax returns, examined returns, and pursued collection actions.

Even after the IRS had created the infrastructure capable of handling a massive number of additional returns, it would still need to devote substantial additional resources each year to process the new returns and to issue refunds in a timely manner. For example, the IRS would need to hire additional seasonal workers to transcribe data from the returns.

Mandatory separate returns would also affect the methods the Service uses to establish the correct tax liability. For current IRS information matching programs to continue to work effectively under a mandated separate return approach, information reporters would have to report separate information to the IRS regarding each spouse's share of joint income items, deductions or credits. This would require the married couple to notify the information reporter of the appropriate allocation for joint items. Without such separate reporting, the IRS would be required to cross-check between the couple's two returns to confirm that each spouse had accurately reported the item reflected on

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[40](...continued)
on the husband's undivided one-half interest in the marital community that could be reached to satisfy his separate tax debt); Babb v. Schmidt, 496 F.2d 957 (9th Cir. 1974) (community property in California can be reached to satisfy a husband's separate tax debt).

the information return. Currently, this kind of cross-checking is done manually for married couples filing separate returns (or for other taxpayers owning joint assets). A dramatic increase in manual cross-checking would be much less effective and efficient than automated document matching. It could also lead to many more IRS contacts with taxpayers to verify information and would likely reduce the amount of revenue collected from the information reporting program.

With regard to conducting audits, the IRS would first need to revise its current audit selection system to be able to identify returns that would most likely result in additional tax assessments. The IRS would probably then conduct audits in a manner similar to those currently conducted for taxpayers choosing the "married filing separately" option. In auditing the return of a married individual, the IRS examiner would likely also analyze the return of the other spouse to ensure that any joint items of income, deductions, exemptions and credits had been properly reported and allocated on the return under examination. If the examination resulted in an adjustment that would affect the other spouse's return as well, the IRS would then open an audit on that return to make the corresponding adjustment.

IRS efforts to ensure the proper allocation of tax items between two separate returns for a married couple could divert resources from audit activities more likely to result in the assessment of additional tax because of the underreporting of income or the overstatement of deductions and credits. In addition, if the IRS were required to trace the proper source of income, deductions and credits, both the examinations and appeals processes would take longer to conduct. Finally, the ability to make corresponding adjustments on the other spouse's return would depend on the applicable statute of limitations; this could prove difficult where, for example, one spouse is willing to consent to an extension of the statute but the other spouse is not.

Any reform proposal that resulted in separate tax liabilities for married taxpayers could preclude the Service from collecting outstanding liabilities from property held by married persons as tenants by the entirety in those common law states with such property rights. A number of such states allow only creditors with joint and several liabilities of both spouses to collect those liabilities from property held in tenancy by the entirety.

Under the mandated separate return proposal, married taxpayers would no longer be jointly and severally liable for their tax liabilities. The proposal would not, however, affect debts to other creditors. It is reasonable to expect that many debts incurred by married couples will continue to be joint and several debts regardless of whether they benefit one spouse more than the other.[41/] As a result, creditors who require married couples to be jointly and severally liable for their debts would be able to collect those debts from the tenancy by the entirety property of married couples even

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[41/] Financial institutions would most likely continue to require that debts incurred by married couples be incurred as joint and several liabilities. For example, credit card issuers who issue joint credit cards would require both spouses to be jointly and severally liable even where the debt was attributable to only one spouse.

though the IRS could not. Thus, a system of separate tax assessments for each spouse could afford relief to the taxpayers' other creditors, rather than to the taxpayers themselves.

4. Effectiveness of the Proposal

Outside of community property states, mandating separate returns would largely eliminate the principal concern with the joint and several liability standard that were identified in TBOR 2. With mandatory separate returns, a spouse would only be responsible for his or her own tax items, including an apportioned share of any joint items; neither spouse would face potential liability for taxes based on the income, deductions or credits of the other spouse. Thus, a spouse would not have to satisfy the current innocent spouse standards to avoid the tax liability associated with such items.

In community property states, however, mandatory separate returns would have only limited benefits for taxpayers unless Poe v. Seaborn were overruled by legislation. The effect of Poe v. Seaborn in community property states is that community income is shared between the spouses, generally 50-50. Mandating separate returns for couples who live in these states would continue to result in a 50-50 division of liability for the tax associated with the total community income, regardless of the amounts actually earned by each spouse. To treat taxpayers who live in community property and common law states equally under mandatory separate returns, the Poe v. Seaborn holding would have to be legislatively reversed. This subject is discussed later in this report.

5. Summary

By eliminating joint and several liability, the mandated separate return proposal would eliminate the difficulties that some married taxpayers (especially those residing in non-community property states) and some divorced or separated taxpayers may experience with current law. Eliminating joint filing, however, would be a significant departure from the premise that married couples form a single economic unit for tax purposes. Moreover, if the adoption of the separate return proposal were designed to be revenue-neutral, Congress would need to consider potentially far-reaching adjustments to current law, including tax rate schedules, deductions and credits. Finally, the proposal would add significant administrative burdens for all married taxpayers and the Service.

C. Proportionate Liability

Congress described proportionate liability as a standard where "each spouse would be liable only for the income tax attributable to the income of each spouse." H. R. Rep. No. 506, 104th Cong., 2d Sess. 30-31 (1996). While this goal could be achieved by a system of mandatory separate returns, adopting this approach could result in significant changes in overall tax revenues and the distribution of tax liability among taxpayers as described above.[42] Accordingly, this section describes how the

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[42] For example, both the disadvantages of income aggregation and the advantages of income-splitting built into the current tax rate structure would be eliminated for taxpayers in (continued...)

goal also could be achieved by maintaining joint filing but allocating the resulting tax liability between the spouses through a proportionate liability approach. Proportionate liability would continue to allow a married couple to compute their tax liability as a single economic unit by splitting income and sharing deductions. In some respects, this approach would view a married couple as similar to a business partnership rather than a single economic unit.

This section analyzes two methods of achieving proportionate liability, which are referred to for these purposes as "front end" and "back end" proportionate liability. Both methods preserve the option of joint filing for married taxpayers while attempting to limit the tax liability of each spouse to that portion of the total liability attributable to that spouse. The methods differ significantly in how and when the tax liability is apportioned between the spouses. “Front end” proportionate liability would require all joint filers to allocate each tax item at the time of filing on the return to one spouse or the other. By contrast, “back end” proportionate liability would apply only in the case of the assertion of additional liability or the collection of unpaid tax. If and when that occurred, items of income and deduction would have to be allocated between the spouses to determine, assess, and collect the proportionate amount from each spouse.

As with mandatory separate returns, both variations of proportionate liability would require the allocation of each item of income, deduction and credit between married taxpayers. New rules would be needed to provide taxpayers with guidance on how to make these allocations.[43/] Proportionate liability proposals also would require additional allocation rules that would not be necessary for separate returns, such as the proper allocation of the standard deduction and similar items that are based on joint filing status.

1. Front End Proportionate Liability

a. Description of Proposal

Under front end proportionate liability, married taxpayers choosing to file joint returns would separately report their items of income, deductions, exemptions and credits on their joint returns. Although these items would be computed separately for each spouse, a married couple's tax liability would continue to be calculated using the current joint return tax rate schedule, and associated limits for deductions, exemptions and credits. For example, the tax forms could contain three columns for joint filers: two columns for the spouses to report their respective tax items and a column for the aggregate amount of each item. Each spouse would be liable for their proportionate share of the tax.

[42/](...continued)
common law states. The impact of this approach in community property states would depend on whether Poe v. Seaborn was overruled legislatively.

[43/] Such rules would presumably be similar to those discussed above in connection with the analysis of mandatory separate returns.

After the couple's aggregate tax liability was computed it would be apportioned between the spouses using a formula intended to reflect each spouse's proper economic share of that liability. A relatively simple formula would use a ratio based on each spouse's taxable income to the couple's total taxable income. For example, if the couple's total taxable income were $100,000, with one spouse responsible for $40,000, and the other $60,000, then the tax liability would be apportioned in a 40 percent to 60 percent split.

b. **Effect on Taxpayers**

While this proposal would maintain joint filing, the burden on married couples in preparing their joint returns could be substantially increased. Married couples would continue to report their total income, deductions, exemptions, and credits on the joint return to calculate their aggregate liability. In addition, a married couple would be required to allocate separate and joint items between themselves on the return itself in order to apportion their aggregate liability, perhaps by a ratio of their respective gross incomes or taxable incomes or by some similar formula.

Although married couples would not have to fill out two returns, as contemplated by the mandated separate return proposal, they would essentially need to perform the same amount of work to allocate the items on their joint return in accordance with whatever allocation methodology was adopted. Taxpayers would need to prepare and maintain sufficient documentation to develop and support their allocations. Tax payments (including estimated tax payments) likewise would probably need to be allocated between the spouses in order to determine which spouse had paid his or her respective share of the aggregate tax liability.

c. **Effect on IRS Administration**

One approach to administering front end proportionate liability would be to treat the couple as having two separate tax assessments from the time they file their return. This would essentially present all of the same administrative issues as mandatory separate returns, discussed above. Front end proportionate liability, however, would present additional difficulties for IRS returns processing operations and information systems that would not be present under the mandated separate return approach.

IRS computer systems would probably need to be set up to process three rather than one column of numbers (husband's, wife's and combined), then simultaneously compute and cross-check those numbers. This would need to be done to verify the accuracy of returns adequately and to utilize existing examination and collection processes. While this can be done, the work entailed would be the equivalent of combining three tax accounts in one. This would require all Form 1040 programming to be rewritten to allow for the separate computation of any penalty and interest, issuance of notices, application of credits and offset, and other such items. Moreover, it would triple data entry and approximately quadruple the programming and computer processing time needed to process a joint return.

An alternative approach would essentially require the IRS to process only the aggregate data reported on the couple's return (as it currently does for joint returns) and then to make a joint tax assessment for the couple. Under this approach, the spouse's reported proportionate shares of such aggregate amounts would only be relevant in the event that one or both of the spouses notify the IRS that they want a separation of the joint liability into their proportionate shares. For example, this could occur in the event of an audit, collection action or additional tax assessment. A full discussion of the administrative effects of this system is presented in the next section on back end proportionate liability.

Regardless of which administrative approach is chosen to implement front end proportionate liability, there would need to be a method of determining which spouse was the source of a payment of tax, since each spouse would be solely liable for his or her allocated share of a tax liability. Either the IRS Master File would need to have the capability to maintain separate accounts for each spouse, or these determinations would need to be made manually when they become relevant. Many, perhaps most, payments could be traced to one spouse or the other, such as withholding payments attributable to one spouse's wages. For other payments, the attribution might not be obvious, e.g., a check drawn on a joint account. A possible solution would be to allocate all unattributable tax payments in accordance with the taxpayers' allocation formula for tax liabilities.

Proportionate liability would also complicate the issuance of refunds by the IRS. Under current law, if a refund is due with respect to a joint return, the Service issues a refund check in the names of the joint filers. Under a proportionate liability approach, however, the spouses may wish separate refund checks reflecting their proportionate shares of the total overpayment. Moreover, there may be situations where one spouse has overpaid and the other has fully paid or underpaid. A legal rule would be needed to determine whether the IRS should credit the overpayment against the underpayment or else to allow a refund to one spouse even though the other spouse (and perhaps the couple together) has underpaid the amount of tax due.

Examinations of front end proportionate liability returns would present many of the same issues as with mandatory separate returns. For example, under either approach, audits could involve verifying the proper allocation of joint items and adjusting each spouse’s tax assessment accordingly. Because adjustments to one spouse’s items would often change the couple’s allocations, such adjustments in a front end proportionate liability scheme return would probably change the other spouse's tax liability more frequently than under a mandatory separate return system.

d. Effectiveness of Proposal

Front end proportionate liability would allow each spouse to be liable only for the income tax attributable to his/her own economic situation and thus would address one of the fundamental aspects of perceived inequity in current law. It would also preserve the benefits of the income-splitting associated with current joint returns. These benefits include offsetting the income, deductions, exemptions and credits of the two spouses and possibly lowering the marginal tax rate that would otherwise apply to the higher earning spouse.

From an examination perspective, a front end proportionate liability system has one advantage over the other proportionate liability systems, because the spouses' respective shares of the combined liability would be reflected on the return as filed. By contemporaneously and jointly determining the allocation of tax items on the joint return at the time of filing, taxpayers would presumably have used and would retain a major part of the information necessary to establish their correct allocable share of the total tax due (provided the spouses correctly allocated joint items between themselves).

Front end proportionate liability would also preserve some of the disadvantages of current joint filings, although potentially to a lesser degree. Under current law, both spouses who have signed a joint return are liable for 100 percent of the tax associated with the tax items of either spouse (unless the innocent spouse provisions apply). Under front end proportionate liability, subsequently discovered items could often change the couple's total tax liability and thus both spouses' proportionate shares of that liability, unless the items were solely attributable to the earning spouse in a single earner couple. This could lead to an increase in the amount of tax due even by the spouse to whom the additional items are not allocable.

While this type of adjustment may seem appropriate in some cases, there could also be situations in which it would seem to raise the same questions of equity that are addressed by the innocent spouse provisions of current law. Two examples illustrate this point:

> Example 1: Assume H has a deduction from a tax shelter investment solely in his own name and no income with which to offset the deduction. W has income of $100 from her medical practice. On audit it is determined that the tax shelter was a sham transaction lacking in economic substance and H's claimed loss of $100 is disallowed. Under front end proportionate liability, W will be liable for the entire amount of the deficiency, because her husband's taxable income is zero. That W is held liable for tax stemming from a disallowed deduction attributable to her husband may appear unfair, but in fact her liability is attributable to her true economic situation: $100 of taxable income and no deductions.

> Example 2: Assume H and W's combined reported taxable income is $40,000 with each reporting $20,000 in taxable income (or a 50-50 split) resulting in a reported joint tax liability of $6,004 on their return (using 1996 rates). Under a proportionate liability standard allocation, each would pay $3,002. If it is later discovered, however, that H has omitted taxable income of $100,000, the couple's joint taxable income rises to $140,000. The tax due on $140,000 is $37,435. When allocated in proportion to taxable income, the new ratio is 85.7 percent to 14.3 percent and H's share of the tax liability increases to $32,087, but W's share of the tax liability also increases to $5,348 (a 78 percent increase).

Finally, as with mandatory separate returns, front end proportionate liability would be less effective in resolving current difficulties that taxpayers may be facing with the joint and several liability standard in community property states, unless Poe v. Seaborn were overruled by legislation.

In community property states, community income is legally deemed to be shared between the spouses. Thus, in most instances, proportionate liability would result in roughly a 50-50 allocation of tax between the spouses, regardless of what portion of the income each spouse actually earned, since such income is likely to be community income.

e. **Summary**

The principal effect of front end proportionate liability would be to limit a spouse's liability to a portion of the total liability based on an allocation formula. The simplest allocation approach would be to split the item evenly between the spouses or to use some other formulary basis. Such approaches could result in the taxation of one spouse in disproportion to his or her actual economic contribution to the item. The allocation method most consistent with the rationale for limiting joint and several liability would generally require a married couple to allocate tax items between the spouses strictly on the basis of their relative economic contributions to the item. The complex rules required to reach this result would cause substantial additional compliance burdens for taxpayers and administrative burdens on the IRS.

It is also likely that some form of innocent spouse or equitable relief comparable to that provided by current law would continue to be required, because later discovered items of income or improper deductions, credits, or exemptions, could result in additional tax to the nonearning spouse due to the allocation formula. Finally, front end proportionate liability would not fully address the problems with joint and several liability of taxpayers in community property states.

2. **Back End Proportionate Liability - ABA Separate Liability Proposal**

a. **Description of Proposal**

The ABA's separate liability proposal is a variation of back end proportionate liability.[44/] Under the ABA proposal, married couples would determine their tax liability by filing joint returns in generally the same manner as under present law. In contrast to the front end proportionate liability proposal, the spouses would not be required to allocate the tax items shown on the return at the time of filing. The ABA proposes that the allocation of tax items and the separation of a tax liability or assessment would occur only in two situations: (1) upon an election by one spouse following an assessment for unpaid tax; or (2) upon the assertion of a deficiency of tax.

In the first situation, if the IRS were to make an assessment against the joint filers because they had not fully paid the taxes shown as due on the joint return, either spouse could elect to

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[44/] The ABA's proposal was submitted to the IRS by the American Bar Association's Tax Section Committee on Domestic Relations in response to Notice 96-19. The proposal is referred to as the ABA proposal solely for convenience; the submission specifically noted that the positions taken represented the individual views of the members who prepared it and did not represent the position of the ABA or its Tax Section Committee.

separate the tax liability. The spouse seeking to separate the liability would be required to provide the information needed to allocate each item of income, deduction, exemption and credit between the spouses. Once the correct allocation of tax items was established, each spouse's liability would be computed by a formula apportioning the total tax between the spouses, as under front end proportionate liability. If partial payment had been made with respect to the joint return, the payment would also need to be allocated between the spouses.

In the second situation (assertion of a deficiency), the ABA proposes that recomputation of separate tax liability would occur only with regard to items that were adjusted on examination. As stated in the Appendix to the ABA's legislative proposal, the IRS would determine which taxpayer is responsible for a particular tax item at the time that an auditor determined an item was improperly reported, as follows:

> Failure to report [earned] income: Deficiencies based upon failure to report income would be assessed solely against the party that earned the income.
>
> Disallowed individual deductions: Deficiencies based upon improper individual deductions would be assessed solely against the party on whose behalf the deduction was taken, up to the amount of income of that party. If the deduction exceeded the income of that party, the deficiency for the remainder of the deduction would be assessed against the nonresponsible spouse whose income was sheltered in whole or in part by the deduction.
>
> Disallowed joint deductions: Disallowed joint deductions would be allocated to each spouse in proportion to his or her income.
>
> Credit for tax payments: Credit for taxes paid by withholding, estimated payments or payments with the return would not be given to one spouse, individually, but would be credited to taxes previously assessed.

Appendix to ABA Legislative Proposal, Annual Meeting, August 1994, at 19.

An issue not explicitly covered by the ABA's proposal is how to apportion tax attributable to the income generated by a joint asset, such as a joint bank account or a jointly held business or a separate item purchased with joint assets. A logical extension of the ABA proposal would be to require that the tax attributable to a joint asset be allocated between the spouses in direct proportion to their ownership of the property (i.e., generally half to each spouse).

Under the ABA proposal, neither spouse would be entitled to a refund when there was an underpayment with respect to the couple's aggregate tax liability. That is, if after separation of liability, one spouse were overpaid and the other underpaid, no refund would be issued to the overpaid spouse.

Under the ABA's proposal, additional assessments would be made against each spouse based on the spouse's responsibility for the individual items giving rise to the assessment. The application of this rule would be straightforward when only one spouse was affected and the adjustments did not result in crossing a threshold amount for a rate increase or limitation on deductions. More complicated rules would be needed to allocate the additional tax liability between spouses when there were multiple adjustments affecting both spouses (possibly arising at different times) or where the adjustments would result in a change in tax bracket for the spouses.

b. **Effect on Taxpayers**

The ABA proposal would allow married couples to file joint returns in essentially the same manner as under current law. Taxpayers would not be affected by the proposal unless they elected to separate any unpaid liability (for example, in the case of divorce or separation), or until the IRS proposed an adjustment to the couple's tax liability (in which case separation might be automatic or elective).

Taxpayers who seek to separate their liabilities would need sufficient records to establish the appropriate allocation or they would be denied relief from joint and several liability. Presumably, the ABA proposal assumes that all well-advised married taxpayers would take on the additional burden of maintaining such records, because they would not know at the time their joint return was filed whether or not the records would be necessary at a later time. In general, the records would have to be maintained until the statute of limitations for the tax year had closed.

As was true of the front end proportionate liability proposal, unless there was also a legislative reversal of the rule of Poe v. Seaborn, married taxpayers living in community property states would not be helped by this proposal to nearly the same extent as married taxpayers in common law states. So long as Poe v. Seaborn continues to be law, community income would continue to be allocated and taxed to each spouse in a 50-50 ratio, by operation of state law.

c. **Effect on IRS Administration**

The back end proportionate liability proposal would have no significant effect on IRS returns processing operations. Returns for married couples would be processed in essentially the same way as joint returns are processed under current law.

It is less certain how extensively IRS information systems would need to be modified to accommodate the separation of a couple's tax assessment that could be required under the conditions of the proposal (i.e., if taxes shown on the return are not paid, or if additional taxes are assessed through the IRS audit process). If separation of liability were required in a large number of cases, the most efficient and cost-effective method would be to incorporate the separation of liabilities into Master File programming. Such changes would require significant alterations to existing Master File programming (to allow a couple's tax account to be divided into two subaccounts, one for each spouse) and to the IRS's ongoing modernization efforts.

Alternatively, the IRS could handle separation of liability cases under this proposal as it currently does for joint tax assessments that are separated in the event that innocent spouse relief is granted. This is currently accomplished on a separate computer system that is used primarily for collection actions on a former joint account. This separate system has more limited capability than the Master File; for example, it does not automatically generate notices or make interest and penalty calculations.

In the case of an examination, there would be two approaches to administering a separation of tax liabilities. The IRS might be required in all cases to determine the spouse to whom a specific adjustment is attributable and automatically assess the additional liability only against that spouse. Alternatively, an additional tax assessment against a married couple could be presumptively treated as a joint liability, and the liability would be separated only if one of the spouses makes an election.

While the effect of this proposal on other IRS operations could be reduced by an elective regime (for example, by reducing the need for comprehensive changes to computer systems), the examination of returns and collection of taxes could be subject to delays, increased costs, and greater risk of noncollection.[45] To mitigate these results, it might be appropriate to restrict the time when a spouse may make an election to separate liabilities. On the other hand, an unrestricted election approach might be considered necessary to avoid inequitable results.

d. **Effectiveness of Proposal**

The back end proportionate liability proposal would preserve the benefits of income-splitting associated with joint filing under current law. At the same time, it would allow a spouse in some circumstances to avoid liability associated with the tax items of the other spouse. By providing a spouse the ability to avoid a portion of a joint liability, the proposal would lessen the difficulties that some taxpayers experience under current law.

However, if the goal of the proposal is to ensure that no spouse is required to pay more than his or her proportionate share of a couple's tax liability, then some form of innocent spouse or similar equitable relief would be needed in addition to the basic proposal. The ABA proposal would not protect a spouse where the spouse had overpaid relative to his or her own liability but not relative to the joint liability, for example through withholding. In addition, back end proportionate liability would not eliminate the questions of equity that are discussed above with respect to front end proportionate liability (see examples 1 and 2 in the discussion of front end proportionate liability). Finally, the proposal would not offer relief if the IRS collected the full joint tax liability before the election to treat the spouses' liabilities separately had been made, although the frequency of this problem would depend on the rules governing the timing of the election.

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[45] For example, if a spouse could make an election after the Service had begun a seizure of property that would require the Service to return the property, the Service would be seriously hampered in its ability to collect taxes.

In addition, many of the problems that individuals experience with the current innocent spouse provisions relate to the individuals' inability to prove that they qualify for the relief. Similar problems might arise under the ABA proposal where the proper allocation of a challenged item is unclear, since the ABA proposal would place the evidentiary burden on the spouse wishing to separate a liability.

Finally, as with the other reform proposals discussed above, this proposal would be less effective in resolving current difficulties taxpayers may be facing in community property states, unless Poe v. Seaborn were overruled legislatively, as advocated by the ABA. See the discussion of community property issues, below. In community property states, community income is shared between the spouses. Thus, without a special rule, an understatement of income earned by one spouse will result in an increased tax liability for both spouses.

e. Summary

The principal effect of back end proportionate liability would be to allow a spouse to avoid additional tax liability attributable to the tax items of the other spouse resulting from an examination or from tax not paid upon the filing of a return. Under this proposal, taxpayers would be required to maintain and produce the records needed to establish the appropriate allocation of tax liability. Under back end proportionate liability, some form of innocent spouse or similar equitable relief would also still be needed to ensure that no individual is required to pay more than his or her proportionate share of a couple's tax liability.

Married taxpayers living in community property states would not be helped as much by this proposal, because community income would continue to be allocated and taxed to each spouse 50-50 by operation of state law.

D. AICPA Proposal: Allocated Liability Standard

1. Description of Proposal

Under the AICPA proposal, joint filers would determine their aggregate income tax liability, as they presently do, on a single tax form.[46/] No new calculations, columns or rules would be required to determine the couple's tax liability. Once the joint tax liability was determined, joint filers would provide an allocation of that aggregate liability on their tax return. The AICPA proposal has two basic rules for allocating aggregate income tax liabilities between spouses in the event of an IRS

46/ For convenience, "Comments on Notice 96-19, Study on Joint Return and Community Property Issues for Divorced and Separated Taxpayers," prepared by the Individual Taxation Committee-Domestic Relations Working Group of the American Institute of Certified Public Accountants (AICPA), which was provided to the IRS on July 2, 1996, is referred to as the AICPA proposal. The AICPA proposal was approved by both the Individual Taxation and Tax Executive Committees of the AICPA.

collection action -- one for known liabilities (i.e. , liabilities reported on the return) and one for unknown liabilities (i.e., liabilities other than those reported on the return).

For known liabilities, a couple could state on the face of their return how their aggregate liability would be allocated between them in the event of an IRS collection action. Taxpayers would have complete discretion on how to determine their allocation. They could base their respective percentages on a detailed income/deduction analysis, or simply choose a particular allocation. If the taxpayers did not choose an allocation, the default allocation would be a 50-50 split. The AICPA proposal presumably would permit taxpayers to file amended returns to change their allocations of known liabilities. Taxpayers could also change such allocations through a divorce decree or separation agreement.

Unknown liabilities would also be governed by the allocation on either the original return or any amended return. In the event of a divorce or separation, however, unknown liabilities could also be allocated by the couples' divorce decree or separate maintenance agreement. If those documents contained no allocation of the specific liability at issue or of tax liabilities in general, the percentage allocation would be the same as the allocation on the taxpayers' tax return for the tax year in question. If that tax return had no allocation, the final default allocation would be a 50-50 split. The issues involved in binding the Service by divorce decrees are discussed below in this report.

The AICPA proposes that the IRS generally would have to respect allocations for known and unknown liabilities unless there was a clearly abusive situation. The IRS, for example, could ignore an allocation that resulted from the use of force, coercion or intimidation by one spouse against the other. The IRS would also not have to respect allocations undertaken for purposes of fraud or the undue manipulation of tax rules, perhaps determined under standards similar to those for transferee liability. Taxpayers would also be bound by their allocations.

2. Effect on Taxpayers

Married couples would be required to consider carefully the allocation of liabilities on their joint return, or at least to determine that the default 50-50 split was appropriate for their situation. If the couple filed an amended return reflecting a change in their overall tax liability, they might need to reexamine their original allocation in order to obtain the division of tax liability they want.

Because the AICPA proposal would give spouses the opportunity to choose an allocation formula unrelated to the economic situation of the two taxpayers, the proposal could create an additional difficulty for taxpayers who retain professionals to prepare their income tax returns or to represent them in disputes with the IRS. Such professionals could face a conflict of interest to the extent they are advising the two spouses with regard to negotiation of an allocation formula on either the original return or on a subsequent amended return. By contrast, under current law, such professionals generally have no conflict because the spouses' interests are joint, although conflicts may arise later when an innocent spouse defense becomes available.[47]

3. Effect on IRS Administration

The AICPA's proposal presents many of the same administrative issues as the front end and back end proportionate liability proposals. Significant administrative effects would first arise whenever there was a need to determine the spouses' separate liabilities. This could occur at the time the return was filed (if the model used was similar to front end proportionate liability) or when either spouse chose to separate their liabilities (if the model selected was similar to back end proportionate liability). Consequently, the effects on IRS administration would be similar to those described above for front end and back end proportionate liability, depending on which model was selected. These effects are discussed in connection with the analysis of the front end and back end proportionate liability proposals above.

An additional potential complication under the allocated liability standard could arise in connection with modifications to the allocation (e.g., on amended returns). Changes to the allocation could require abatements to one spouse's tax account and additional assessments to the other. It could also be administratively difficult to reallocate payments and refunds.

The allocated liability proposal is subject to the possibility of collusive abuse between the spouses, for example by assigning most of the joint tax liability to the spouse without assets from which the liability can be collected. Although the AICPA suggests that the IRS could change allocations "in situations where there is undue manipulation of the rules . . . or fraud," it does not set forth standards for such reallocations. It is difficult to foresee what standards would be appropriate or administrable. Standards based on the spouses' economic contributions would effectively result in a proportionate liability system. In contrast, a standard based on fraud would effectively preclude the IRS from changing an allocation, since the proposal does not impose any substantive limits on the spouses' ability to choose a particular allocation formula.

4. Effectiveness of Proposal

While the AICPA proposal does not necessarily limit a spouse's liability to that spouse's economic situation, it does limit the ultimate amount collectible from a spouse to either the percentage that the spouse has agreed to or the 50 percent default allocation. The AICPA believes that this result better comports with how joint filers view themselves -- namely, as an economic unit to which each spouse contributes. The allocated liability standard would allow married taxpayers to

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[47] Even under the present joint return and innocent spouse rules, conflicts of interest arise and the courts occasionally have vacated a decision where one spouse was inadequately represented. See, e.g., Devore v. Commissioner, 963 F.2d 280 (9th Cir. 1992). The allocated liability standard could increase these conflicts.

choose an allocation percentage based on their own view of their economic arrangement and would provide a 50-50 default rule for couples who do not make a different choice.

The AICPA believes that there would be less need for the innocent spouse rules, because each spouse would be liable only for his or her allocated percentage of the total tax liability, rather than for 100 percent of the total liability as under current law. It is questionable, however, whether this degree of relief would be considered adequate by a taxpayer who believes that he or she should not be responsible for any liability attributable to the unreported income or improper deductions of the other spouse. Considering the equities that support claims for innocent spouse relief under current law, it would be reasonable to expect many taxpayers to disagree with the AICPA's belief that merely reducing a joint filer's proportionate liability below 100 percent is an adequate response to the perceived unfairness of joint and several liability. To address these concerns, some form of equitable relief presumably would still be necessary to ensure that the nonresponsible spouse is not assessed tax equitably attributable to the other spouse.

To the extent that equitable relief was made available to one spouse in order to eliminate an obligation to pay an amount of tax allocated under the initial formula, an issue would then arise as to whether the other spouse would be required to pay the difference. While such a shifting of liability might be inconsistent with the basic premise of the allocated liability standard, it would be supported by the rationale for providing equitable relief to the innocent spouse. It would also be consistent with the rules of present law and might be appropriate to minimize any overall revenue loss from the proposal.

5. <u>Summary</u>

The principal effect of the AICPA proposal would be to limit the spouse's maximum potential liability by the chosen allocation percentage, in most cases to less than 100 percent of the deficiency. Because a spouse could remain liable for tax not attributable to his or her actions, the AICPA proposal would not eliminate the need for equitable relief in many circumstances. Taxpayers who might now claim innocent spouse relief could continue to need equitable relief even though their liability was less than 100 percent. At the same time, the proposal might provide taxpayers with less incentive to challenge inequitable results simply because of the lower tax liability amounts at issue.

E. Determine Tax Liability in Accordance With Divorce Decree

1. <u>Description of Proposal</u>

Section 401(2) of TBOR 2 directed Treasury and the IRS to examine "[t]he effects of requiring the IRS to be bound by the terms of a divorce decree which addresses the responsibility for the tax liability on prior joint returns." This direction was accompanied by the following legislative history:

> In some cases, a couple addresses the responsibility for tax liability as part of their divorce decree. However, these agreements are not binding on the IRS because the IRS was not a party to the divorce proceeding. Thus, if a former spouse violates the tax responsibilities assigned to him or her in a divorce decree, the other spouse may not rely on the decree in dealing with the IRS.

H.R. Rep. No. 56, 104th Cong., 2d Sess. 30 (1996).

The divorce decree proposal would limit each spouse's individual liability with respect to previously filed joint returns to the amount specified in a divorce decree. Any joint liabilities affected by the divorce decree would become two separate liabilities once the IRS was notified of the divorce decree.[48] This proposal would have substantially the same effect on taxpayers in both common law and community property states.

2. **Effect on Taxpayers**

As noted in the ABA's comments, divorce decrees and property settlements often fail to address the division of tax liabilities, and in many other cases use ambiguous wording that leads to disputes between former spouses as to which spouse is liable for a prior joint liability. The ABA comments suggest that this problem is unlikely to be eliminated unless many more taxpayers spend additional resources to be represented by tax attorneys during their divorce proceedings.

Moreover, even if divorcing taxpayers routinely seek expert tax advice to deal with these issues, it could be difficult for them to allocate fairly, in the midst of dealing with all the other aspects of a divorce, a tax liability that might not become an issue until after the divorce is concluded. This difficulty could also present an opportunity for one spouse to gain an advantage over the other in allocating a joint liability. In some circumstances, an additional form of equitable relief might be considered appropriate.

3. **Effect on IRS Administration**

The divorce decree proposal would have no significant effect on how the IRS currently processes tax returns. When the IRS received a divorce decree, any joint liabilities affected by the divorce decree would become two separate liabilities. The extent to which IRS information systems would need to be modified to accommodate this proposal would depend largely on the number of divorce allocations the IRS would be required to track.[49]

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[48] The notification to the IRS could be made routinely as part of divorce court proceedings or else might be required only in cases where the IRS begins collection actions against one of the former spouses.

[49] Approximately 1,191,000 divorces were granted in the United States in 1994. National (continued...)

Assuming that the IRS would not be made a party to every divorce proceeding in which tax liability was allocated, it is not clear how the Government's interest in collecting the proper amount of tax revenue would be protected. It is reasonable to expect that the non-tax considerations of divorce proceedings would overshadow the parties' concern about the ability of the Federal Government to collect the proper amount of tax. At the same time, this proposal presents the potential for abuses such as allocating liabilities to asset-poor spouses.

While the IRS could theoretically be granted a right of intervention in divorce proceedings to protect the Federal Government's interests, creation of such a right would require an overhaul of Federal law and the laws of the 50 states, and would require consideration of social, family and economic policy issues far beyond the scope of this study. Even apart from these larger concerns, the IRS does not have the resources to participate in the approximately 1.2 million divorces that occur annually. While many of these divorcing couples would not have unpaid tax liabilities relating to their jointly filed returns, it would be difficult for the IRS to identify those cases in which intervention might be necessary to protect the Federal Government's interests.

One administrative issue that would have to be resolved is how and when the IRS would be advised that a divorce decree might effect the separation of the couple's tax assessment. Procedures preferably would specify that spouses must present divorce decrees at the beginning of an examination or collection action. This would be necessary to prevent the delay and additional expense associated with initiating an administrative action on a joint liability only to learn later that a divorce decree had effectively created two separate liabilities for the former couple, requiring separate assessment and collection. It is unclear how this concern would be addressed in cases where the divorce proceedings are not completed by the specified time.

Because the divorce decree proposal would require the Service to substitute two new separate tax liabilities in place of a joint liability, the effect on the IRS' ability to collect would largely be the same as those noted for the proportionate liability and AICPA proposals. See the discussions of those proposals above for more detailed explanations of these issues.

A significant additional complication, however, arises because a divorce decree could alter a preexisting IRS collection action on a joint liability. For example, a divorce decree could assign a joint liability to one of the spouses, and the assets subject to a preexisting lien to the other spouse. In such situations, the IRS would have to incur the costs and complications of first removing its prior lien because the assets would no longer be subject to satisfying the liability, and then asserting a new lien against other assets of the liable spouse, to the extent the spouse has such assets.

[49/](...continued)
Center of Health Statistics of the Department of Health and Human Services, Monthly Vital Statistics Report (October, 1995).

4. Effectiveness of Proposal

Many taxpayers are apparently surprised to learn that under current law their divorce decree's allocation of liabilities is not binding on creditors (including the IRS) who do not participate in the divorce proceedings. The divorce decree proposal would allow divorced taxpayers to limit the amount of tax they owe on jointly filed returns through the operation of their divorce decree. Proponents of this proposal believe that limiting the Service's ability to collect taxes to the taxpayers' expectations as shown in their divorce decree would be fairer to taxpayers.

While the proposal would permit a couple to separate their joint and several tax liabilities, it would have no effect on other joint and several liabilities, such as those owed on mortgages or credit cards. As a result, other creditors could collect from either spouse even if inconsistent with a divorce decree, while the IRS would be limited in its ability to collect outstanding tax liabilities. The proposal might thus shift collections from the Government to private creditors.

In addition, the divorce decree proposal fails to address a significant criticism of the joint and several liability standard -- that one spouse can be held liable for amounts attributable to the tax items of the other spouse. This could continue to occur if a state court were to apportion Federal tax liabilities during the divorce based on non-tax considerations. Furthermore, a spouse might not disclose the existence of unreported income or questionable deductions and credits in the course of negotiating the divorce decree. Without such information, the other spouse could agree to an allocation of liability that would not be considered fair had he or she known the full extent of the potential liabilities of the other spouse. Because of these situations, some form of innocent spouse or equitable relief would still be necessary. In such cases, either the state court would have to modify the prior agreement or the Federal tax law would have to override the terms of the state divorce decree.

5. Summary

As stated above, the divorce decree proposal would limit the effects of joint and several liability on divorced taxpayers. While this might alleviate some of the difficulties currently faced by divorcing taxpayers, the proposal would not eliminate the need for equitable relief in some cases. Finally, through the approval of divorce decrees, states (and not the Federal Government) would be responsible for the apportionment of Federal tax liabilities between formerly married taxpayers. As a result, the proposal could produce uneven treatment of taxpayers across the nation. Because of the many factors a divorce court must take into account in dividing assets and liabilities of a divorcing couple, and because the IRS would not be a party to divorce proceedings, the proposal likely would affect tax collections adversely.

COMMUNITY PROPERTY ISSUES

As part of TBOR 2, Congress asked Treasury and the IRS to consider two issues directly related to community property laws and their effect on married couples. In the statute, Congress expressly focused on:

> The effect of providing that community income (as defined in section 66(d) of such Code) which, in accordance with the rules contained in section 879(a) of such Code, would be treated as the income of one spouse is exempt from a levy for failure to pay any tax imposed by subtitle A by the other spouse for a taxable year ending before their marriage.

TBOR 2, § 401(4).

In addition, Congress indicated in the legislative history of TBOR 2 that it was interested in the effect on taxpayers of a statutory repeal of the Poe v. Seaborn doctrine. See H.R. Rep. No. 506, 103rd Cong., 2d Sess. 50 (1996).

A. Limiting Community Property That is Subject to Federal Tax Collection

Under present law, the Service can collect tax liabilities from "all property and rights to property, whether real or personal belonging to" the person liable for the tax. For this purpose, a taxpayer's property rights are determined under state law. Aquilino v. United States, 363 U.S. 512 (1960).

Some of the nine community property states allow the IRS to collect tax debts of one spouse arising prior to a marriage from all of the income (including wages of the other spouse) that is defined as community property.[50/] Other community property states allow the Service to collect one spouse's tax liability from the other spouse's income (where it is community property) but only to the extent of the debtor spouse's one-half interest in that community property.[51/] In the remaining community property states, resolution of the issue is unclear.[52/] By comparison, in common law states, it is clear

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[50/] Babb v. Schmidt, 496 F.2d 957 (9th Cir. 1974) (California law); Broday v. United States, 455 F.2d 1097 (5th Cir. 1972) (Texas law). Louisiana law allows all creditors to collect antenuptial debts from community property. Pan American Import Co. v. Buck, 440 So. 2d 182 (La. Ct. App. 1983), rev'd in part on other grounds, 452 So. 2d 1167 (La. 1984).

[51/] In re Ackerman, 424 F.2d 1148 (9th Cir. 1970) (Arizona law); United States v. Overman, 424 F.2d 1142 (9th Cir. 1970) (Washington law).

[52/] That is, under the community property laws of Idaho, Nevada, Wisconsin, and New Mexico, it is unclear to what extent the IRS may collect pre-nuptial tax debts of one spouse from (continued...)

that the Service has no right to collect an antenuptial tax liability of one spouse from the income (including wages) of the other spouse.

As suggested in § 401(4) of TBOR 2, Congress could limit the types of community property on which the IRS could place a levy. For example, if Congress concluded that antenuptial tax debts of one spouse should not be collected from the income of the other spouse in community property states, an exemption from levy could be added to the other exemptions already contained in I.R.C. § 6334. Such an exemption would provide taxpayers in community property states the same treatment with respect to this issue as now applies to taxpayers in common law states.

The exemption suggested by the legislative history of TBOR 2 would look to I.R.C. § 879(a) to define which community income would be treated as the separate income of one spouse. Such an exemption would protect the nonliable spouse's earned income, trade or business income,[53] distributive share of partnership income, and income derived from property treated as separate property under community property law.[54]

It should be noted, however, that an exemption in the Internal Revenue Code would not change the extent to which property is protected from other creditors under state law. Thus, other creditors of the debtor spouse would still be able to attach community property attributable to the nondebtor spouse to satisfy nontax debts. As a result, a Federal exemption from levy that is broader than state exemption laws governing creditors' rights generally might not ultimately benefit the nondebtor spouse. Community property states could address this issue by revising their exemption laws to match the Federal tax exemption.

Another alternative approach to this issue would be an amendment to the Internal Revenue Code providing that community property law should simply be disregarded for purposes of

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[52](...continued)
community property income.

[53] The exemption incorporating I.R.C. § 879(a) by reference would operate slightly differently where a husband was entitled to the exemption than where a wife was entitled to the exemption. Any trade or business income of the husband's would be protected, regardless of his degree of management and control over the business, if he were entitled to the exemption from levy. A wife's income from a trade or business would only be exempt from levy to the extent that she exercised substantially all of the management and control over the business. This difference is the result of the language of I.R.C. § 1402(a)(5) which creates a presumption that trade or business income is that of the husband.

[54] Many community property states already provide a mechanism for spouses to shield property from the debts of their spouse. Married couples can agree, typically in writing, that certain property should be the spouse's separate property which is not subject to the payment of the debts of the other spouse.

determining whether a spouse's property is subject to levy for the debt of the liable spouse. Under such an approach, however, it would be difficult to know what law should be applied to determine taxpayers' property rights. For example, what law would govern questions such as "Are the wages earned by one spouse treated as that spouse's property (and therefore exempt from levy to satisfy the other spouse's tax debts) even after they are commingled in a joint bank account?"[55/] Presumably, much more detailed and extensive Federal rules would need to be developed to define property rights if this approach were adopted.

Finally, it has been suggested that a legislative repeal of Poe v. Seaborn would have the effect of limiting the community property that is subject to Federal tax collection. Poe v. Seaborn, however, addresses only the issue of how married couples in community property states must report their taxable income when filing separate returns. A legislative repeal of Poe v. Seaborn would change only this result. It would not, by itself, prevent the collection of a pre-existing tax liability from community property associated with a new marriage, such as from the earnings of a new spouse, where otherwise permitted under state law.

B. Effect of Overruling Poe v. Seaborn

As noted by the Supreme Court in Poe v. Seaborn, the incidence of Federal income taxation is based on the rights of a taxpayer to income under state law. Thus, if Poe v. Seaborn was legislatively repealed, the Internal Revenue Code would need to provide new Federal rules addressing the allocation of income for married couples in community property states who file separate returns.[56/] This would constitute a marked departure for the Federal Government, which has long followed state law to determine what constitutes property or a right to property.

A more limited approach, which would be more consistent with the Federal Government's traditional deference to state laws in defining property rights, would be to suggest that the states determine whether their community property laws produce inequitable results that should be eliminated and how to resolve those inequities appropriately. To achieve a result equivalent to a legislative overruling of Poe v. Seaborn, however, the states would likely have to opt out of the community property system, or at least provide that each spouse has only an expectancy, but not a present vested interest, in the income of the other spouse.

Another option would be to adopt the already existing rules of I.R.C. § 879(a), which supersede community property laws with regard to certain income. Under these rules, salary and

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[55/] See generally Treas. Reg. § 301. 6334-2(b)(example).

[56/] No commentator has questioned Congress' authority to enact legislation that would overturn Poe v. Seaborn.

other earned income are attributable only to the earning spouse.[57/] Section 879 continues to follow the community property laws relating to income from other sources (generally, investment income) in allocating items between the spouses. Additional rules would be required to deal with investment income under the control of only one spouse if the goal of repealing Poe v. Seaborn was to ensure that a spouse is never liable for tax on income over which he or she has no control.

For most taxpayers a repeal of Poe v. Seaborn would, by itself, have little effect, because the vast majority of married taxpayers file joint returns. Further, I.R.C. § 66 is intended to address those cases in which Poe v. Seaborn produces particularly inequitable results for married taxpayers in community property states who choose to file separate returns. See the discussion of section 66, above.

As noted earlier, however, repeal of Poe v. Seaborn would have a significant impact on joint filers if it were coupled with the adoption of a proportionate liability standard in place of joint and several liability. Under any proportionate liability standard, one spouse's share of a couple's aggregate tax liability will depend upon the allocation of income between the spouses.

57/ It might also be appropriate to amend I.R.C. § 1402(a)(5) (which is incorporated by reference in I.R.C. § 879) to remove the presumption that income earned through a sole proprietorship or a partnership is attributable to a husband rather than his wife.

REFORM OF THE INNOCENT SPOUSE PROVISIONS

A. Introduction

Congress expressed concern that the innocent spouse provisions do not provide "meaningful relief in all cases where such relief is appropriate." TBOR 2, § 401. Indeed, the criteria of I.R.C. § 6013(e) were significantly modified in 1984 when Congress recognized certain "compelling" cases which did not qualify for relief under prior law. The statute originally provided relief only for tax attributable to omissions of income but, in 1984, was amended to apply to the tax attributable to items of deduction, credit or basis as well. As an alternative to the broader reform proposals discussed above, further amendments to the innocent spouse provisions may help eliminate or lessen inequities which have been experienced by some married taxpayers, particularly in the case of divorce or separation.

B. Perceived Problems Under I.R.C. § 6013(e)

1. <u>Substantial Understatement</u>

To qualify for relief under I.R.C. § 6013(e), there must be a "substantial understatement" of tax. The amount of an understatement of tax equals the excess of the correct tax for the year over the amount of tax reported on the return as filed. To qualify as "substantial," the understatement of tax must exceed the tax reported on the return by more than $500. In addition, if the understatement of tax is attributable to an item of deduction, credit or basis, it must also exceed a specified percentage of the taxpayer's adjusted gross income in the preadjustment year, <u>i.e.</u>, the year before the adjustment is proposed (10 percent if the taxpayer's adjusted gross income is $20,000 or less in the preadjustment year; 25 percent if the taxpayer's adjusted gross income is more than $20,000 in the preadjustment year). If the taxpayer seeking relief has remarried, the income of the new spouse must be included in this calculation. Given how the Code defines "substantial understatement of tax," taxpayers may find it difficult to obtain innocent spouse relief.

First, even if the return as filed shows the correct amount of tax, it is possible that a spouse would be held liable for an amount that he or she believed had already been paid by the other spouse. Innocent spouse relief, however, currently does not apply to underpayments of tax. Because some of these spouses might be able to satisfy the other equitable factors of I.R.C. § 6013(e), it is questionable whether it is fair to exclude them from attempting to obtain innocent spouse relief in this situation.

Second, as noted above, there are separate limitations for understatements of gross income reported on the return as opposed to understatements attributable to items of deduction, credit or basis. There is no apparent reason why different limitations should apply in these two different situations. In addition, while the limitations introduce a measure of progressivity for taxpayers to qualify for relief, a mere one dollar addition to income over $20,000 can raise the understatement threshold by $3,000.[58] Moreover, the income thresholds for determining eligibility for innocent spouse relief with respect to a joint return filed with a former spouse are determined by including income of a new spouse to determine the proper amount of the income thresholds. Taxpayers may find this rule particularly inequitable.

Third, some taxpayers could find it inequitable to be denied relief if their liability is $500 or less. For some taxpayers, amounts of $500 or less could result in a substantial hardship.

2. Grossly Erroneous Items

For an item to qualify for innocent spouse relief, the item must be grossly erroneous. Any omission from income is by definition grossly erroneous. A deduction, on the other hand, must be "without basis in fact or law" in order to be grossly erroneous. The requirement that an item of deduction, credit or basis be without "basis in fact or law" before it is considered to be grossly erroneous may prevent some taxpayers from qualifying for innocent spouse relief even though they might be able to satisfy the other equitable factors of I.R.C. § 6013(e). It is questionable whether the distinction between gross income and deductions is an appropriate criterion on which to deny relief to taxpayers who would otherwise qualify for innocent spouse relief.

In certain circumstances, an adjustment to a return may produce an understatement that is not attributable to an omission of income, or an erroneous claim of deduction, credit or basis. For example, a taxpayer might incorrectly characterize income as capital gain. In these cases, no innocent spouse relief is currently available.

The ABA proposes to eliminate the grossly erroneous requirement, noting that the nature of the claimed item could be a factor in measuring the equities. This would eliminate some of the complexity currently contained in I.R.C. § 6013(e), and would instead focus the inquiry on equitable factors. There is no logical rationale for limiting innocent spouse relief to specific types of items on a return, when relief arguably is equally equitable and appropriate with respect to any item which may cause an understatement.

In addition, this proposal would eliminate the problem of requiring one spouse, generally after divorce or separation, to prove the degree of error in the tax treatment of an item arising from a transaction into which the other spouse entered. Further, eliminating the "grossly erroneous" requirement would eliminate disputes about whether a deduction or credit claimed was merely "wrong" or was "very wrong." It also avoids conflicts of interest of representatives who wish to argue alternatively that the particular item is allowable, but if not, that one spouse is innocent as to it.

On the other hand, any expansion of the innocent spouse relief available may reduce the incentive for each spouse to scrutinize the joint return. The proposed amendment also may allow

[58] At $20,000 of income, the threshold is $2,000. At $20,001, the threshold is $5,000.

relief for "run of the mill" errors rather than errors that are caused by the wrongdoing of the "guilty" spouse. Finally, the change would likely cause some loss of revenue.

3. <u>Actual or Constructive Knowledge</u>

To obtain innocent spouse relief with respect to an erroneous item on a joint return, a spouse must demonstrate that "he or she did not know, and had no reason to know" of the error. Because this criterion is fact-intensive, it has resulted in considerable litigation, and there is a division among the courts as to how this requirement should be applied.

Dissatisfaction with the knowledge standard stems from its fact-intensive nature and the perception that it is applied inconsistently. Thus, commentators such as the ABA and AICPA have suggested that the knowledge standard be clarified, changed or even eliminated.

The ABA, for example, proposes that the knowledge standard could be modified so that the question of liability turns on the ability of the spouse, from his or her own knowledge of the parties' business affairs, to understand that a potential tax liability exists. Under this proposal, it appears that a taxpayer's duty to inquire about and understand the consequences of a transaction reported on his or her tax return would vary depending on the complexity of the transaction. Thus, the incidence of tax liability might turn on the parties' knowledge and understanding of the tax law. If this proposal were adopted, ignorance of the law could become a defense to the imposition of tax. Under such an approach, there is no apparent reason why the tax liability of both spouses should not be excused if they both did not understand the tax consequences of their transaction.

The AICPA takes a more limited approach and proposes that the Service should, in regulations, list factors to be considered in determining whether a spouse knew or had reason to know of a substantial understatement of tax. As discussed below, adding such factors could improve consistency in the application of the knowledge requirement.

4. <u>Equitable Factors</u>

In addition to meeting the other requirements of I.R.C. § 6013(e), a taxpayer seeking innocent spouse relief must demonstrate that "taking into account all the facts and circumstances, it is inequitable" to hold him or her liable for the deficiency. A taxpayer might meet all of the other tests of I.R.C. § 6013(e) and still remain liable for an underpayment of tax if the equities indicate that it is inappropriate to grant relief.

One of the most important factors to be considered is whether the spouse significantly benefited directly or indirectly from the items which gave rise to the understatement. H.R. Rep. No. 432 (part 2), 98th Cong., 2d Sess. 1502 (1984); Treas. Reg. § 1.6013-5(b). Other factors taken into account by courts and the Service in determining the equities applicable to the taxpayer include whether financial hardship will ensue, whether a spouse was deserted or divorced, and whether the other spouse also was unaware of the tax consequences of the transaction. The similarity of some of these factors to other tests in I.R.C. § 6013(e), in particular the knowledge test, has led the ABA to propose that the equitable test could be eliminated.

Other commentators, however, have suggested that equitable factors should be the sole and determinative tests for deciding whether innocent spouse relief should be allowed. Moreover, eliminating the equitable test would provide innocent spouse relief in certain circumstances where it might be considered inappropriate. For example, while a spouse might not have actual or constructive knowledge of omitted income when the return is filed, he or she might later benefit from the income. This could occur in the case of a subsequent gift or bequest by the earning spouse. Treas. Reg. § 1.6013-5(b). Without a separate equities test, the non-earning spouse could qualify for relief in such a circumstance. As a result, income could escape tax altogether, even though the non-earning spouse has received the benefit of such income, e.g., where spouse A is responsible for the understatement, then dies, and spouse B inherits the income.

C. Improvements to the Innocent Spouse Provisions

1. Administrative Improvements

As stated above, some taxpayers have encountered difficulties with the existing innocent spouse provisions. Treasury and the IRS have already taken several administrative steps to improve the operation of the statute. Pursuant to an administrative initiative that was subsequently codified by TBOR 2, the IRS is making information available to divorced or separated spouses with respect to collection of joint liabilities from the other spouse. In addition, to ensure that taxpayers do not lose their right to innocent spouse relief, the IRS Office of Chief Counsel is informing practitioners that may intend to represent both spouses simultaneously to determine whether a conflict exists. Counsel is also requiring enhanced management supervision in cases where innocent spouse claims are asserted. CCDM (35)515; Chief Counsel Notice N(35)000-138 Innocent Spouse Cases.

In connection with this study and in response to certain suggestions made by the GAO in their parallel TBOR 2 study of joint return issues, the IRS also intends to make several other improvements. The IRS will revise its publications to inform taxpayers more fully of their potential right to innocent spouse relief. As a legislative matter, Congress could codify this requirement, by providing that the IRS must establish procedures to alert married taxpayers clearly of their joint and several liability on appropriate tax publications and instructions, within a certain time frame such as 180 days. Further, the IRS will develop a special form and related procedures for taxpayers to claim such relief and will use the form to educate its employees about innocent spouse claims to achieve greater consistency in processing those claims. Congress again could require the IRS to develop such a separate form with instructions for taxpayers to use in applying for innocent spouse relief.

The IRS is making additional administrative changes designed to improve the treatment of innocent spouses, including: 1) reviewing current training materials to ensure that they stress the responsibility of employees to identify situations where the innocent spouse provisions might apply, even if the taxpayer does not know about the provisions. When appropriate, the IRS will provide these taxpayers with the new form and assist them in preparing it; 2) making telephone assistors, specially trained in the innocent spouse provisions, available to answer questions from taxpayers received through IRS' toll free telephone system; 3) developing special training courses on the innocent spouse provisions to be given to IRS collection and examination personnel in both basic training as well as annual continuing professional education training; and 4) conducting focused outreach on both the national and local levels to community organizations that serve abused or battered spouses to identify those who might qualify for relief under the innocent spouse provisions.

2. <u>Potential Legislative and Regulatory Improvements</u>

Treasury and the IRS have identified a number of possible improvements to the innocent spouse provisions. These improvements would require changes to either the statute or the regulations.

a. <u>Substantial Understatement</u>

In order to permit relief in cases where there is no "understatement of tax" on the joint return as filed, the statute could be amended to apply to any "underpayment of tax" as well. For example, if the joint return correctly stated the amount of tax due, but full payment did not accompany the return, relief would be available if one spouse could establish that he or she did not know of the underpayment and met the other innocent spouse criteria.

Also, as described above, an understatement of tax attributable to an item of deduction, credit, or basis, may be the subject of innocent spouse relief only if it exceeds a specified percentage of the taxpayer's adjusted gross income in the year before the adjustment is proposed (10 percent if the taxpayer's adjusted gross income is $20,000 or less, 25 percent if adjusted gross income is more than $20,000 in the preadjustment year). No similar rule applies to an omission from gross income.

These special thresholds relating to items of deduction, credit or basis could be deleted. Alternatively, the 10 percent threshold could be adopted for all income levels. In either case, this would equalize the treatment of taxpayers whose liabilities result from different forms of inaccuracy, and would eliminate the arbitrary results which occur at the $20,000 threshold under current law. These proposed changes would require legislation.

b. <u>Grossly Erroneous Items</u>

Under I.R.C. § 6013(e)(2), any omission from gross income is automatically considered a grossly erroneous item. In contrast, an erroneously claimed item of deduction, credit or basis must have "no basis in fact or law" in order to be grossly erroneous. This "no basis in fact or law" requirement could be eliminated in order to equalize the treatment of similarly situated taxpayers.

Alternatively, the requirement that the understatement be attributable to a grossly erroneous item could be eliminated. This change would extend relief to situations where the understatement is not attributable to an omission of income, or an erroneous claim of deduction, credit or basis. Again, this proposal would require statutory amendment of section 6013(e).

c. <u>Actual or Constructive Knowledge</u>

There currently is no discussion in the regulations relating to the requirement in section 6013(e)(1)(C) that the taxpayer "did not know, and had no reason to know" of the understatement. As noted previously, the AICPA suggests that the knowledge requirement might be applied more consistently if courts and the IRS were provided with additional guidance, in the form of a list of factors that could be taken into account in making this determination. In general, knowledge of an understatement will always be a factual question that relates to the taxpayer's state of mind, financial expertise, and similar considerations.

A list of factors would be helpful in providing guidance on either the issue of "constructive" or "actual" knowledge. This list need not be enacted legislatively, however. In conjunction with the other proposals described in this section, Treasury and the IRS are considering whether to issue regulations or other guidance that would provide additional uniformity in the application of the knowledge test.

d. <u>Equitable Factors</u>

The existing regulations relating to the application of the equitable requirement of I.R.C. § 6013(e)(1)(D) have not been updated since 1974, and several commentators have suggested changes that could be made to clarify the application of the equity test under current law. For example, the regulations fail to reflect the 1984 changes that permit innocent spouse relief in the case of erroneous deductions, credits or basis.

Commentators have suggested a specific list of factors that should be taken into account in determining whether relief is equitable. Treasury and the IRS intend to issue updated regulatory guidance on this issue.

e. <u>I.R.C. § 66</u>

As discussed above, I.R.C. § 66(c) is roughly analogous to I.R.C. § 6013(e) and is intended to provide a form of innocent spouse relief to spouses who reside in community property states and file separate returns, each reporting half the community income. Although several of the considerations taken into account in determining whether relief is appropriate are similar in the two provisions (for example, a knowledge requirement in both I.R.C. §§ 66(c)(3) and 6013(e)(1)(C) and an equities requirement in both I.R.C. §§ 66(c)(4) and 6013(e)(1)(D)), I.R.C. § 66(c) is limited to omissions from gross income while I.R.C. § 6013(e) may apply to erroneously claimed items of deduction, credit, or basis as well. There also are no minimum understatement amounts in I.R.C. § 66(c), as there are in I.R.C. § 6013(e). To the extent the terms of I.R.C. § 66(c) differ from the terms of I.R.C. § 6013(e), however, similarly situated taxpayers can be treated very differently. By eliminating disparities and conforming the terms of the two provisions, greater uniformity and consistent treatment of taxpayers could be achieved.

In addition to the innocent spouse relief provided under I.R.C. § 66(c), community property laws may also be disregarded under I.R.C. § 66(a) if spouses who live apart during the taxable year file separate returns. Under current law, this relief is available only if the spouses live apart at all times during the calendar year. This rule could be relaxed to permit brief periods of reconciliation; however, we question whether such a relaxed rule would be administrable. Alternatively, Congress could provide that community property laws would be disregarded whenever taxpayers are legally separated.

Another requirement of I.R.C. § 66(a) is that no earned income be transferred between the spouses. This requirement also could be relaxed. For example, transfers of a de minimis amount could be permitted. Another possibility would be to amend I.R.C. § 66(a) to remove the prohibition on transfers of earned income between the spouses. If amended to permit transfers between spouses, I.R.C. § 66(a) should be further amended to address the treatment of those transferred amounts. One option would be to treat the transferred amounts in a manner similar to the treatment in common law states. Thus, if the alimony rules of I.R.C. § 71 are satisfied, the transferred amounts would be income to the transferee and deductible by the transferor. A second option would be to treat any transferred amount as earned income of the transferee spouse, taxable to the transferee spouse under I.R.C. § 879(a).[59/]

f. Better Access to Tax Court

The forum provided for contesting a denial by the Secretary of innocent spouse relief is determined by whether an underpayment is asserted or the taxpayer is seeking a refund of overpaid taxes. Accordingly, the Tax Court may not have jurisdiction to review all denials of innocent spouse relief.

It would be appropriate for Congress to expand the Tax Court's jurisdiction to allow it to review any denial (or failure to rule) by the IRS regarding an application for innocent spouse relief. Under this proposal, the taxpayer would have to file a petition for review with the Tax Court during a stated period after the denial of relief by the IRS. Except for termination and jeopardy assessments, the IRS would not be allowed to levy or proceed in court to collect from a taxpayer claiming innocent spouse status with regard to such tax until the expiration of the stated statutory period or, if the taxpayer petitions the Tax Court, before the decision of the Tax Court has become final. The running of the statute of limitations would need to be suspended in such situations with respect to the spouse claiming innocent spouse status.

[59/] If this alternative is adopted, it is also recommended that I.R.C. § 1402(a)(5) (which is incorporated in I.R.C. § 879) be amended to eliminate the presumption that income earned through a sole proprietorship or partnership is attributable to the husband rather than to the wife.

g. Collection Stay During Litigation

Where one spouse files a petition in the Tax Court concerning a joint return, there are no provisions in the Code or regulations addressing administrative collection action against a nonpetitioning spouse during the pendency of the Tax Court proceeding. (Collection of the tax is not an issue in a refund suit, because a prerequisite to jurisdiction in the refund courts is full payment of the tax.) The IRS's policy is generally to forebear from administrative collection of a liability from a nonpetitioning spouse during pendency of a Tax Court proceeding by the other spouse where there is reasonable doubt that the assessment is correct, provided that adjustment of the claim is within the control of the Service and the interests of the Government will not be jeopardized. There are some circumstances where collection action may be appropriate, however, such as when the petitioning spouse is seeking relief solely as an innocent spouse, or it is anticipated that the nonpetitioning spouse may file a bankruptcy petition, or when the majority of the assets are held in the name of the nonpetitioning spouse, or there is reason to believe that jeopardy exists with respect to collection from the nonpetitioning spouse.

In many other circumstances, a nonpetitioning spouse should receive the same protection against IRS collection action as the spouse who has filed a petition in Tax Court contesting a proposed deficiency. Therefore, Congress could enact legislation providing that, when a married couple's joint return is the subject of a Tax Court proceeding, the Service must withhold collection by levy against a nonpetitioning spouse for that liability during the pendency of the Tax Court proceeding. This would treat the nonpetitioning spouse the same as the petitioning spouse in most situations. Exceptions would be appropriate in certain situations, such as jeopardy, or when the taxpayer waives this protection (i.e., agrees to the collection action), or for some other, limited but automatic kinds of collection activity, such as automatic refund offset, filing of protective notices of Federal tax lien, etc. The statute of limitations on assessment and collection would need to be stayed for the period during which collection is barred. If there is a final decision that reduces the proposed assessment against the petitioning spouse, the assessment against the nonpetitioning spouse would likewise be reduced.

CONCLUSION

The Department of the Treasury and the IRS agree with the concern expressed by Congress in TBOR 2 that the innocent spouse provisions may not provide "meaningful relief in all cases where such relief is appropriate." TBOR 2, § 401. Proposals to rectify this problem have focused mostly on fundamental changes to the joint and several liability standard itself, rather than on amending the relief provisions in sections 6013(e) and 66. As illustrated in the analysis set forth above, each of these reform proposals presents some advantages when compared to current law, but also suffers from potential defects, which need to be considered.

This analysis has led Treasury and the IRS to several conclusions. First, there are sound policy reasons for permitting married couples to file joint income tax returns, such as treating them as a single economic unit for tax purposes, permitting them to offset each other's income and losses, providing that couples in similar economic situations pay the same amount of tax, and permitting married taxpayers in common law property jurisdictions the same income-splitting effect that is available to taxpayers in community property jurisdictions. There are also practical reasons for joint filing, in particular to simplify filing obligations for married couples and to reduce by up to half the resources that the IRS must devote to processing individual returns.

Second, the basic principle that taxpayers who file joint income tax returns are jointly and severally liable for the correct amount of tax due for the period covered by the return is appropriate in the vast majority of cases. By signing and filing a joint return, and thus obtaining the advantages of joint filing, each spouse voluntarily undertakes the responsibility for the correct joint liability. Taxpayers who wish to avoid this rule, and in effect obtain proportional liability, already may elect to file separate returns using married filing separate status, although there is usually an economic penalty for doing so. Undeniably, however, additional effort should be made to ensure that taxpayers are fully aware of their filing status options and the consequences of each filing status.

Third, the proposals for completely eliminating joint and several liability have significant drawbacks. Shifting to a mandatory separate return system or a front-end proportionate liability system would impose large burdens on taxpayers and the IRS, yet provide very little compensating benefits to the operation of the tax system. The back-end proportionate liability and allocated liability approaches would be less disruptive to the processing of income tax returns than the two front-end approaches. Each proposal, however, would still require the application of equitable or other relief factors in situations where the liability-limiting rule may still be considered unfair, and would create difficulties in tax administration and collection for the IRS.

Finally, the proposals to limit the community property that may be subject to collection for joint tax liabilities or to overrule Poe v. Seaborn legislatively would be inconsistent with the longstanding Federal tax policy of generally following state law in determining what constitutes property or rights to property. They would also unilaterally disadvantage the Federal Government, in its status as a tax creditor, vis-a-vis other creditors who would continue to follow and be bound by state property law.

To improve the tax liability rules affecting innocent spouses, Treasury and the IRS instead recommend that the relief provisions in the Internal Revenue Code be modified to accommodate more cases. The immediately preceding section of this report discusses such proposals, and the President's FY 1999 budget proposal incorporated several of these proposals. Treasury and the IRS are prepared to work with the tax-writing committees of Congress to enact this legislation.