

The Innocent Spouse – Is it Real or Memorex?

In recent years, there has been significant improvement (from a taxpayer's perspective) of the rules on what is needed in order to qualify as an innocent spouse. The changes brought about in this area are uniformly favorable to taxpayers, greatly easing what was necessary to qualify as an innocent spouse, without the IRS taking back with one hand what it gave with another. This article will very briefly provide an overview of the innocent spouse area as it relates to taxation – it is of particular interest in the area of divorce litigation.

It is important to keep in mind that the need for innocent spouse protection arises out of a tax, penalty or interest assessment against a joint tax return, where one of the spouses has (possibly) a basis for claiming innocent status. The key issue here is the filing of a joint return. There is no need to claim innocent spouse on a separate return filed by your spouse – because you have no responsibility for someone else's return, for a return to which you are not a signator. The filing of a joint return binds both people to that joint return, creating joint and several liability - thus creating the possibility for the need for protection as an innocent spouse. A joint tax return is optional – it is available only to married couples, but is not a required form of filing. Either spouse has the right to not file jointly – to file married separately. Of course, there may be a wide range of other issues that have to be taken into account, especially when a divorce action is being conducted and one spouse refuses to sign a joint return, creating additional tax liabilities. It is certainly a consideration, in the absence of a solid reason not to file a joint return, that the spouse refusing to do so should be charged with the responsibility for the additional tax burden and tax preparation fees. That's a separate issue, and not directly related to the innocent spouse concerns.

The basic rule, with a very significant area of grace (which will be referenced afterwards), is that to qualify as an innocent spouse, one needs to have not benefited from the wrongdoings of the other spouse, and needs to have not known of the wrongdoings. Most of us will read these words and believe that perhaps relatively few spouses can indeed qualify, since even the most ignorant spouse tends to have some knowledge of what's going on, and just living together tended to benefit from what was going on. However, the IRS was basically instructed to, and tends to, treat this area gently with a most liberal approach towards the taxpayer. Largely, this can be attributed to Congress' concerns (which for the most part were well founded) that all too many women, many of them going through a divorce or abandoned, were suffering greatly under a system that treated the wrongdoer as well as the often long-term spouse who went along because there was little else possible, as equally culpable. Thus, even if there is doubt as to a person's real "innocence", you may be surprised at how many people can actually qualify.

Earlier in this article there was reference to an area of grace – this revolves around the word inequitable. That is, if all else fails, if your client doesn't satisfy the IRS as having been ignorant of what was going on or in another way qualify as described above, the safety catch-all is that it would be inequitable to hold that spouse responsible for the tax burden. This cuts across a wide swath of possibilities, and is often the difference between a person qualifying and not qualifying as an innocent spouse. Thus, even a spouse who knew that there was something wrong, but perhaps was effectively powerless to do anything about it, will get the IRS' blessing of innocence. Note that there is a difference between what would truly qualify someone as "innocent", or what would be qualified as "inequitable" in a court of law (certainly all of the readers of this article are well versed in that area and know how they can pick apart claims of such innocence or inequity) – as contrasted to what the tax law is intended to do in this area, and what the IRS, to its credit, has allowed to be considered either innocence or inequity. In a crude sense, with a thank you nod to Michael Douglas, and spoken sotto voce, dumb is good – the dumber, the more ignorant, the person, the more likely the IRS will be favorably inclined to bestow its favor on a request for innocent spouse relief.

Examples of some of the situations which might cause the need to seek innocent spouse protection include:

- A tax balance was due with the return and has never been paid
- One spouse with a business with unreported income
- Very substantial (egregious) perquisites taken from the business of one spouse
- Withdrawing money from a retirement plan and not paying taxes on it
- Omitting a K-1 from the return
- In general, any action or inaction that results in a tax, penalty or interest due to the IRS

Timing may be a critical issue – and essentially the caution here is that there is rarely a reason to rush into a claim of innocent spouse. The reason is that seeking to secure innocent spouse status too soon (i.e. before an actual IRS attack), may simply alert the IRS to a problem area, bringing it down on everyone for no good reason. In addition, if the IRS does not see things your way, if they do not consider your client an innocent spouse, you have now created an IRS conflict where perhaps none would be. The key point here is that generally there is no reason to file for innocent spouse protection until you are aware that something needs protecting. The rules provide that you can seek innocent spouse protection within two years (and in some cases, within 10 years) from when the IRS starts an action. For

this purpose, an action would include notice of a tax examination, collection notice or something along those lines. Thus, why precipitate IRS activity before it is necessary?

Request for innocent spouse determination is done through the filing of a Form 8857. Like so many other tax filings of major consequence and complexity, this is one that should not be done by the client, but rather, whether through your direction or otherwise, by a tax savvy CPA. Often, the forensic accountant involved in your matter, providing that he/she has not been engaged as a neutral or court appointed expert, would be the most likely one to proceed on these lines.