

## **INNOCENT SPOUSE DEFENSE**

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When a married couple files its tax return jointly, they enjoy certain tax benefits, including a lower effective tax rate. But the tradeoff of those benefits is joint and several liability for their tax liability, interest and penalties. This can rapidly become a major issue for one of the spouses if the couple separates and one had control of joint finances or control of a family business whose income passed through to their joint return. One spouse, caught unaware of financial or tax mismanagement, may suddenly become individually liable for a major tax liability and penalties. This can have a substantial and adverse financial impact on the spouse and the family business. This program will provide you with a real-world guide to the “Innocent Spouse” and “Injured Spouse” defenses, the relief each affords, how to successfully assert them against IRS collection activity, and special issues for the non-requesting spouse.

- Understanding the “Innocent Spouse” and “Injured Spouse” defenses
- Types of relief available and how to successfully assert each defense
- Special issues when a family business with pass-through income is involved
- Issues for the spouse not asserting the defense
- Collection holds and the statute of limitations
- Audit issues

### **Speaker:**

**Stephen J. Turanchik** is an attorney in the Los Angeles office of Paul Hastings, LLP, where his practice focuses on tax litigation at the state and federal levels as well as tax controversy work at the administrative levels. Before entering private practice, he is previously litigated for six years for the U.S. Department of Justice, Tax Division, where he litigated over 300 tax cases in federal, bankruptcy, state and probate court. He has also lectured at Loyola Law School and California State University, Fullerton on topics relating to tax litigation. Mr. Turanchik received his B.A. from the College of the Holy Cross, his J.D. from Fordham University School of Law, and his LL.M. in Taxation from New York University School of Law.

**Matthew L. Kadish** is a partner in the Cleveland office of Kadish, Hinkel & Weibel, LPA, where he has an extensive tax, estate planning and business transactions practice. His practice also encompasses exempt organizations, retirement planning and IRS controversy cases. Mr. Kadish is a Fellow of the American College of Trust & Estate Counsel and is vice president of litigation of the Small Business Council of America. Before entering private practice, he served as a judicial clerk to Judge Herbert L. Chabot of the U.S. Tax Court. Mr. Kadish received his B.A. from Williams College, his J.D. from Case Western Reserve University School of Law, and his LL.M. in taxation from New York University.

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# INNOCENT SPOUSE DEFENSE

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- I. Understanding the “Innocent Spouse” and “Injured Spouse” defenses
  - A. Innocent Spouse Relief = Relief from Joint and Several Liability
    1. Joint income tax return is optional; if chosen, liability is “joint and several”.
    2. Husband and wife
    3. Beware joint representation issues (how many attorneys already represent H & W even before IRS audit)?
    4. Gender note – feminine pronouns are used in this outline to refer to the requesting (or would-be “innocent”) spouse merely as a shorthand. Experience has shown many cases where the would-be innocent spouse is in fact the husband.
  - B. Injured Spouse Relief
    1. Under joint and several liability, Government(s) can apply one spouse’s overpayment against the liabilities of the other spouse, including:
      - a. past-due federal tax;
      - b. child or spousal support;
      - c. federal nontax debts such as student loans; or
      - d. state income tax.
    2. The “injured” spouse can submit information to the IRS to determine the share of an overpayment on a joint return that is to be refunded to the injured spouse. See Form 8379 (Injured Spouse Claim and Allocation).
  - C. Internal Revenue Code
    1. IRS Restructuring and Reform Act of 1998
    2. New IRC § 6015 provides different types of relief

3. Three different subsections of the Internal Revenue Code

II. Types of Relief Available

A. Section 6015(b) Relief – If Spouses Are Still Married

1. Relief available -- from all tax, interest, penalties, and other amounts
2. Requesting spouse must establish all of the following:
  - a. A joint return was filed for the taxable year;
  - b. On the joint return, there was an understatement of tax attributable to erroneous items of one spouse;
  - c. In signing the return, the requesting spouse both did not know and had no reason to know, that there was such understatement;
  - d. Taking into account all the facts and circumstances, it is inequitable to hold the requesting spouse liable for the deficiency in tax for such taxable year attributable to the deficiency; and
  - e. The requesting spouse must properly elect the benefits of Section 6015(b) no later than two years after the date on which the IRS first began collection activities.
2. Knowledge determined by:
  - a. the nature of the item relative to other items;
  - b. the couple's financial position;
  - c. the requesting spouse's educational background and business experience;
  - d. the extent of the requesting spouse's participation in the activity at or before the time the return was signed about items that a reasonable person would question; and
  - e. whether the erroneous item represented a departure from past years' return positions.
  - f. Knowledge refers to being aware of the facts relating to the income omission. Ignorance of the legal consequences of a transaction giving rise to the omission is irrelevant.
3. Income Omission vs. Deduction-Caused Understatements

Some courts have been more lenient with the knowledge requirement when the understatement arose from overstated deductions (as opposed to from omissions of income).

4. Knowledge of the transaction itself does not preclude relief.
  - a. Even if the spouse did not have reason to know that the deduction gave rise to a substantial understatement, the court is also required to determine whether the spouse knew enough facts to put her on inquiry notice (sufficient knowledge that would lead a reasonably prudent taxpayer in her position to question the legitimacy of the deduction). *Price v. Comm'r* (9th Cir.); *Greer v. Comm'r* (6th Cir.).
  - b. Other courts differ: spouse seeking relief must establish she was unaware of the circumstances reported in error on the return and not just of the tax consequences. *Bokum v. Comm'r*, (11th Cir.)

B. Section 6015(c) Relief – If the Joint Filers Are No Longer Married or Are Otherwise Legally Separated

1. Requesting spouse is:
  - a. no longer married to (or widowed from);
  - b. is legally separated from; or
  - c. has been living apart at all times for at least twelve months from the person with whom she originally filed the return.
2. Relief Available - Separate Allocation of Deficiency
  - a. the individual's liability for any deficiency that is assessed with respect to the return will not exceed the portion of the deficiency properly allocable to the individual.
  - b. An item giving rise to a deficiency will be allocated in the same manner as it would have been if both spouses had filed separate returns.
3. Knowledge Requirement – easier to meet under §6015(c).
  - a. Heightened to actual knowledge.

- b. Actual and clear awareness (as opposed to reason to know) of the existence of an item which gives rise to the deficiency (or portion thereof).
  - 1) Knowledge of the source of an erroneous item (such as the fact of stock ownership but lack of knowledge that a dividend was paid) is not sufficient to establish actual knowledge.
  - 2) Facts and circumstances that may be relied on in showing that a requesting spouse had actual knowledge include whether a requesting spouse made a deliberate effort to avoid learning about an item in order to be shielded from liability.
  - 3) Joint ownership of an asset also may be a factor supporting the finding of actual knowledge.

C. Section 6015(f) Relief – Equitable Relief

- 1. IRS has discretion to relieve a spouse or former spouse from joint return liability when:
  - a. taking into account all the facts and circumstances, it is inequitable to hold the innocent spouse liable for any unpaid tax or deficiency in tax; and
  - b. relief is not available under section 6015(b) or (c).
  - c. Relief can be also granted for failure to pay tax.<sup>1</sup>
- 2. Six threshold requirements:
  - a. The requesting spouse filed a joint return for the taxable year for which he or she seeks relief;
  - b. Relief is not available to the requesting spouse under either section 6015(b) or section 6015(c);
  - c. No assets were transferred between the spouses as part of a fraudulent scheme by the spouses;

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<sup>1</sup> STEVE – INTERESTING; I DIDN'T KNOW THAT.

- d. The nonrequesting spouse did not transfer disqualified assets to the requesting spouse;
    - 1) If the nonrequesting spouse transferred disqualified assets to the requesting spouse, relief will be available only to the extent that the income tax liability exceeds the value of disqualified assets.
  - e. The requesting spouse did not file or fail to file the return with fraudulent intent; and
  - f. The income tax liability from which the requesting spouse seeks relief is attributable to the non-requesting spouse, except:
    - 1) Where an item is attributable or partially attributable to the requesting spouse solely because of community property law;
    - 2) As to items in the name of the requesting spouse, where the requesting spouse can rebut the presumption that the item is presumptively attributable to the requesting spouse;
    - 3) Where the requesting spouse did not know, and had no reason to know, that funds intended for the payment of tax were misappropriated by the non-requesting spouse for the non-requesting spouse's benefit (but only to the extent funds were taken by the nonrequesting spouse); or
    - 4) Where the requesting spouse establishes that he or she was the victim of abuse prior to when the return was signed, and as a result of the prior abuse, did not challenge the treatment of any items on the return for fear of the non-requesting spouse's retaliation
3. Factors (non-exclusive) the IRS Considers re- Whether to Grant Equitable Relief
- a. Whether the requesting spouse is separated (legally or living apart) or divorced from the nonrequesting spouse.
    - 1) “Separation” does not include temporary absences from the home.
  - b. Whether the requesting spouse will suffer economic hardship if relief is not granted.

- 1) Meaning requesting spouse cannot pay reasonable basic living expenses.
- c. In cases of unpaid taxes, whether the requesting spouse had no knowledge or reason to know that the non-requesting spouse would not pay the liability.
  - 1) In cases where the liability arose from a deficiency, whether the requesting spouse had no knowledge or reason to know of the item giving rise to the deficiency.
  - 2) Actual knowledge of the deficiency will strongly weigh against relief, unless the factors in favor of relief are particularly compelling.
- d. Whether the non-requesting spouse has a legal obligation to pay the outstanding liability pursuant to a divorce decree or agreement.
- e. Whether the requesting spouse received significant benefit from the unpaid liability or the item giving rise to the deficiency.
- f. Whether the requesting spouse has made a good faith effort to comply with income tax laws in later taxable years.
4. Bonus Factors
  - a. The following factors, if present, will weigh in favor of equitable relief (but an absence will not harm the requesting spouse):
    - 1) Whether the nonrequesting spouse abused the requesting spouse.
      - a) A history of abuse by the nonrequesting spouse may mitigate a requesting spouse's knowledge or reason to know.
    - 2) Whether the requesting spouse was in poor mental or physical health on the date the requesting spouse signed the return or at the time the spouse requested relief.

### III. Time Limits for Requesting Relief

#### A. First Collection Activity Commences Request Period

1. Under 6015(b) or 6015(c) the requesting spouse must request relief no later than two years from the date of the first collection activity.
2. Under 6015(f), the two-year statute does not apply.
  - a. If requesting spouse is seeking a refund, then statute of limitation for refund claims applies:
    - 1) Two years from date of payment; or
    - 2) Three years from date tax return was due (including extensions).
  - b. Otherwise, can be raised against the IRS' within the time for the IRS to collect the tax liabilities (generally 10 years from date of assessment).
  - c. For more information, see Notice 2011-70.
3. Collection Activity
  - a. Includes:
    - 1) Notice of service of a §6330 notice of right to hearing before levy;
    - 2) Offset of an overpayment of the requesting spouse against a liability;
    - 3) The filing of a suit by the federal government against the requesting spouse for collection of the joint tax liability; or
    - 4) The filing of a claim by the government in a court proceeding in which the requesting spouse is a party or which involves property of the requesting spouse.
      - a) A claim in an interpleader action involving multiple claims to funds owed to the requesting spouse would constitute collection activity.
      - b) The filing of a U.S. claim against the requesting spouse in a suit to foreclose a mortgage on property jointly owned by the requesting and nonrequesting spouse would start the running of the two-year time period.

- c) Filing of a proof of claim in a bankruptcy proceeding.
  - b. Does not include:
    - 1) Issuance of a notice of deficiency;
    - 2) The filing of a Notice of Federal Tax Lien; or
    - 3) A demand for payment of tax.
- B. Earliest Time for Filing Request for Relief
  - 1. Receipt of a notification of an audit; or
  - 2. A letter or notice from the IRS indicating the possibility of an outstanding liability for the year in question.
    - a. request for relief may be made in connection with an audit or examination of the joint return or a demand for payment.
    - b. may also be made in connection with a collection due process hearing under §6320 concerning the filing of a Notice of Federal Tax Lien.
  - 3. Any request for relief filed before these notifications will be considered premature and will not be considered.

#### IV. Stay on Collection

- A. Collection is Stayed Pending Determination
  - 1. From the date of your request until 90 days after a Notice of Determination is issued
  - 2. If Tax Court petition is filed, then collection is stayed until 60 days after the Tax Court's final decision.
  - 3. If the Tax Court's decision is appealed to a U.S. Court of Appeals, the collection period will begin 60 days after the appeal is filed, unless a bond is posted.

V. Issues for the Non-Requesting Spouse

- A. Non-Requesting Spouse is entitled to notice and to participate in the requesting spouse's proceedings
  - 1. Administrative proceedings
    - a. IRS informs the nonrequesting spouse of his opportunity to submit information to be considered by the Service in its administrative determination.
    - b. Nonrequesting spouse is not required to provide information.
    - c. The Service will consider all relevant information submitted by the requesting spouse and the nonrequesting spouse in determining whether to grant or deny relief.
  - 2. Appeal of Administrative Determination
    - a. Once the preliminary determination is made regarding the requesting spouse's claim for relief, a protest can proceed with the IRS Office of Appeals by:
      - 1) Requesting spouse;
      - 2) Nonrequesting spouse; or
      - 3) Both.
  - 3. Tax Court
    - a. Only the requesting spouse can file a petition in Tax Court contesting the final determination
    - b. No provisions allow nonrequesting spouse to file in Tax Court
    - c. However, if the requesting spouse files a petition, the non-requesting spouse may become a party to the proceedings.
- B. If requesting spouse obtains relief, the non-requesting spouse still remains liable