Assessing the Hazards to an "Innocent Spouse" of Civil and Criminal Liability for Tax Offenses in a Dissolution of Marriage Proceeding

by
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Married couples commonly file joint tax returns to avail themselves of certain associated benefits. Often, one spouse assumes primary responsibility for a couple's finances and, specifically, for the preparation and filing of the couple's joint returns. In such case, the other spouse's role in reporting income to the IRS may consist of little more than signing his or her name where told. The Internal Revenue Code provides, however, that each spouse on a joint return is jointly and severally liable for the taxes owed on that return, regardless of how the couple delegated between themselves the duty to disclose.[1] In other words, even where a spouse who prepared a couple's return in any year deliberately concealed from the other spouse his or her failure to report income in order to evade taxes, the spouse who lacked knowledge of such evasion could be compelled to pay the couple's outstanding tax obligation in full, including substantial penalties and interest that potentially dwarf the original tax obligation. What is more, the spouse who was a mere signatory to the return risks *criminal* liability for various tax (and nontax) offenses if a court finds that he or she had remained willfully blind to the return's omissions and fraudulent representations.[2] In a dissolution of marriage proceeding, then, a spouse must tread very carefully—and only with the advice of expert counsel—before, for example, asserting claims of any kind against previously hidden assets and revenues.

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1 *See* 26 U.S.C. § 6013(d)(3) (2006).

2 *See, e.g.*, 26 U.S.C. §§ 7201 (tax evasion), 7203 (failure to pay tax), 7206(1) (fraud and false statements), 7207 (fraudulent returns) (2006).

This article discusses: (I) avenues for obtaining relief from civil tax liability as an "innocent spouse;" (II) criminal tax liability and the requisite element of "willfulness;" and finally, (III) the intersection of federal tax law and state family law.

I. "Innocent Spouse" Relief from Civil Tax Liability

Fortunately, Congress has not ignored the potential inequities resulting from joint civil liability on joint income tax returns. The Internal Revenue Code provides three distinct avenues of relief to so-called innocent spouse.[3]

In the case of unreported income, the first avenue pursuant to § 6015(b) of the Code requires, among other things, that the taxpayer petitioning for innocent spouse relief demonstrate not only that he or she lacked actual knowledge of his or her spouse's attempted fraud but, further, that he or she had no reason to know of any understatement on their return and no reason to know even of the *possibility* of any understatement such that an unfulfilled duty to inquire had arisen.[4] In effect, a court may impute constructive knowledge of fraud to a spouse who turned a blind eye to the other's accounting.[5]

In the case of erroneous deductions, the petitioning spouse must prove that a reasonably prudent taxpayer in his or her position at the time he or she signed the return could not have been expected to know the return contained a substantial understatement of the couple's tax liability.[6] In evaluating this defense, the court will consider four factors: (1) the petitioner's financial education, (2) the petitioner's involvement in the family's financial affairs, (3) the presence of unusual or lavish expenditures beyond the family's norm, and (4) the other spouse's evasiveness or deceitfulness concerning the family's finances.[7] Being a homemaker will not, alone, assure a petitioner of success.[8]

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3 *See* 26 U.S.C. § 6015(b), (c), & (f) (2006).

4 Greer v. Comm'r, 595 F.3d 338, 345 (6th Cir. 2010).

5 *Id.*

6 *Id.* at 346-47.

7 *Id.*

8 *Id.* at 351.

While this first avenue relieves an innocent spouse of liability for taxes attributable to the understatement on a return, the second avenue of relief pursuant to § 6015(c) allows for the allocation of a couple's tax liability as though each spouse had separately filed individual returns.[9] Only one who is no longer married to, or who is legally separated from, his or her spouse or who was not a member of the same household as his or her spouse throughout the year preceding his or her petition for innocent spouse relief can obtain relief in this way.[10] Moreover, the IRS may bar a taxpayer from obtaining such relief by establishing that the taxpayer had actual awareness of an unreported item of income or actual knowledge of the factual circumstances that rendered a deduction unallowable.[11]

Finally, if a taxpayer cannot secure relief through either of the above two avenues, perhaps because he or she petitioned for relief later than two years after the IRS began collection activities against him or her,[12] the taxpayer may nonetheless obtain innocent spouse relief pursuant to § 6015(f) by proving that it would be inequitable to hold him or her liable for any outstanding tax obligation.[13] Inevitably, the concept of equity remains somewhat amorphous and depends in large part on the particular facts of each case. IRS regulations provide a nonexclusive list of factors for consideration in determining whether equitable relief should be granted, including whether the petitioner is separated or divorced from his or her spouse and whether the petitioner significantly benefited from the unpaid tax liability[14] by virtue,

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9 26 U.S.C. § 6015(d)(3)(A) (2006).

10 26 U.S.C. § 6015(c)(3)(A)(i).

11 Cheshire v. Comm'r, 282 F.3d 326, 337 (5th Cir. 2002).

12 *See* 26 U.S.C. § 6015(b)(1)(E), (c)(3)(B) (2006). Note that the IRS has recently proposed to expand the availability of equitable relief under § 6015(f) by, for example, extending the limitations period within which an individual may request equitable relief under § 6015(f) from two years to ten years, generally. *See* Notice 2012-8, 2012-4 I.R.B. 312.

13 26 U.S.C. § 6015(f).

14 *See* Rev. Proc. 2003-61, 2003-2 C.B. 296 § 4.03 (2003); *see also* Notice 2012-8, 2012-4 I.R.B. 309 (proposing to revise Rev. Proc. 2003-61, 2003-2 C.B. 296 "to ensure that requests for innocent spouse relief are granted under section 6015(f) when the facts and circumstances warrant and that, when appropriate, requests are granted in the initial stage of the administrative process."). The IRS's proposed revisions of Rev. Proc. 2003-61, 2003-2 C.B. 296 include clarifications such as that "no one factor or a majority of factors necessarily

for example, of having had greater disposable income than he or she otherwise would have had and having made expenditures that he or she otherwise would not have been able to make.[15] As described in connection with the first avenue for relief, reason to know and actual knowledge weigh against relief.[16] Still, even the existence of knowledge may not preclude relief when other factors weigh more strongly in relief's favor,[17] such as when a spouse who, despite knowing at the time she signed her joint return that certain tax liabilities arising from her husband's business would not be paid, exercised no control over the income from her husband's business and had no direct access to the busi-

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controls the determination [of whether or not to grant equitable relief]." *Id.* at 311. The IRS also seeks to "expand[ ] how the IRS will take into account abuse and financial control by the nonrequesting spouse in determining whether equitable relief is warranted. . . . [because, for example,] when a requesting spouse has been abused by the nonrequesting spouse, the requesting spouse may not have been able to challenge the treatment of any items on the joint return, question the payment of the taxes reported as due on the joint return, or challenge the nonrequesting spouse's assurance regarding the payment of the taxes. . . . [L]ack of financial control may have a similar impact on the requesting spouse's ability to satisfy joint tax liabilities. As a result . . . abuse or lack of financial control may mitigate other factors that might otherwise weigh against granting equitable relief under section 6015(f)." *Id.* at 309. Notwithstanding that the IRS's newly proposed revenue procedure has yet to be finalized, the IRS will already apply the provisions of its proposed revenue procedure, unless requested to do otherwise by an applicant for relief, because the proposed procedure simply "expand[s] the equitable relief analysis by providing additional considerations for taxpayers seeking relief . . . ." *Id.* at 310.

15 Albin v. Comm'r, 88 T.C.M. (CCH) ¶ 340, No. 17605-02, 2004 WL 2284380, at *11 (T.C. Oct. 12, 2004).

16 *See* Rev. Proc. 2003-61, 2003-2 C.B. 296 § 4.03(2)(a)(iii)(B) (providing that "[r]eason to know of the item giving rise to the deficiency will not be weighed more heavily than other factors. Actual knowledge of the item giving rise to the deficiency, however, is a strong factor weighing against relief."); *see also* Notice 2012-8, 2012-4 I.R.B. 311 (proposing to revise Rev. Proc. 2003-61, 2003-2 C.B. 296 such that "actual knowledge of the item giving rise to an understatement or deficiency will no longer be weighed more heavily than other factors.").

17 Under Rev. Proc. 2003-61, 2003-2 C.B. 296 § 4.03(2)(a)(iii)(B), those factors in favor of relief must be "particularly compelling" to overcome the factor of actual knowledge which weighs strongly against relief. Under the IRS's newly proposed revenue procedure, however, as previously noted, actual knowledge will no longer necessarily carry disproportionate weight. *See* Notice 2012-8, 2012-4 I.R.B. 311.

ness's receipts.[18] Similarly, a court may grant relief if the collection of taxes would render the petitioner unable to pay reasonable basic living expenses,[19] given such factors as the cost of living in the geographic area in which the petitioner resides, the amount of property exempt from levy that is available to pay the petitioner's expenses, and the petitioner's age, employment status and history, ability to earn, and number of dependents.[20]

II. Criminal Tax Liability and "Willfulness"

Criminal liability for tax offenses requires a greater showing of culpability than does civil liability: namely, evidence of "willfulness."[21] Willfulness connotes "a voluntary, intentional violation of a known legal duty."[22] In view of the Internal Revenue Code's sometimes bewildering complexity, for the purpose of criminal tax prosecutions, Congress has softened the impact of the common law presumption that every person knows the law.[23] The taxpayer who proves that he or she acted in good faith and simply misunderstood his or her legal duty to report income or pay taxes may elude conviction, even if his or her mistake was objectively unreasonable.[24] Nonetheless, a mere signatory to a false return will have acted willfully if that person, in the phrasing of the courts, consciously refused to take basic investigatory

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18 Farmer v. Comm'r, 93 T.C.M. (CCH) ¶ 1052, No. 19966-05, 2007 WL 1364406, at *4 (T.C. Mar. 29, 2007).

19 *See, e.g.*, Wiener v. Comm'r, 96 T.C.M. (CCH) ¶ 227, No. 17984-04, 2008 WL 4568030, at *12-18 (T.C. Oct. 14, 2008) (granting equitable relief to petitioner who had reason to know of items giving rise to tax deficiencies and/or failed to satisfy her duty of inquiry regarding these items but who would suffer economic hardship if relief were not granted).

20 *See* Rev. Proc. 2003-61, 2003-2 C.B. 296 § 4. 03(2)(a)(ii); Treas. Reg. § 301.6343-1(b)(4) (2002); *see also* Notice 2012-8, 2012-4 I.R.B. 311 (proposing "to provide minimum standards based on income, expenses, and assets, for determining whether the requesting spouse would suffer economic hardship if relief is not granted.").

21 *See* 26 U.S.C. §§ 7201 (tax evasion), 7203 (failure to pay tax), 7206(1) (fraud and false statements), & 7207 (fraudulent returns).

22 United States v. Pomponio, 429 U.S. 10, 12 (1976) (per curiam) (citations omitted).

23 Cheek v. United States, 498 U.S. 192, 199-200 (1991).

24 *Id.* at 201-02.

steps,[25] closed his or her eyes to what would otherwise have been obvious,[26] chose to keep himself or herself uninformed,[27] or deliberately avoided asking natural follow-up questions despite awareness of a high probability that the return he or she signed contained omissions and falsehoods.[28] The failure to pay taxes in each year constitutes a separate offense,[29] and a court may infer knowing, willful falsification of a return from repetitious omissions of items of income.[30] Having relied in good faith on the professional advice of a qualified accountant may serve as an adequate defense but only where that accountant had been fully informed of all the pertinent facts at the outset.[31]

Generally, the IRS must assess any tax associated with a particular return within three years of that return's having been filed.[32] There exists no such period of limitations, however, for the assessment of taxes in the case of a false or fraudulent return designed to evade taxes.[33] That is, the IRS may collect taxes associated with a false return at any time, no matter how many years distant from the return's filing. By contrast, the government must bring a criminal indictment for tax evasion, failing to pay taxes, or filing a false return within six years of the commission of the offense.[34] Thus, the passage of time, alone, can secure an individual's freedom from prosecution, while the passage of time also rapidly exacerbates the threat of civil liability as daily compounding interest accumulates on unpaid taxes[35].

The taxpayer who voluntarily discloses to the IRS unreported past income and who satisfies any outstanding tax obliga-

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25 United States v. Anthony, 545 F.3d 60, 64 (1st Cir. 2008) (citation omitted).

26 United States v. Dykstra, 991 F.2d 450, 452 (8th Cir. 1993).

27 United States v. Harper, 458 F.2d 891, 895 (7th Cir. 1971).

28 United States v. Stadtmauer, No. 09-1575, 2010 WL 3504321, at *18 (3rd Cir. Sept. 9, 2010).

29 United States v. Smith, 335 F.2d 898, 901 (7th Cir. 1964) (citation omitted).

30 United States v. Allen, 551 F.2d 208, 210 (8th Cir. 1977) (citation omitted).

31 United States v. Whyte, 699 F.2d 375, 379-80 (7th Cir. 1983).

32 *See* 26 U.S.C. § 6501(a) (2006).

33 *See* 26 U.S.C. § 6501(c)(1).

34 *See* 26 U.S.C. § 6531(2), (4), & (5) (2006).

35 *See* 26 U.S.C. § 6622(a) (2006).

tions will at least thereby limit his or her exposure to civil liability. Without guaranteeing immunity from prosecution,[36] voluntary disclosure may also avert the imposition of criminal sanctions if the disclosure is truthful, complete, and made prior to the IRS's having initiated any investigation of the taxpayer, notified the taxpayer of its intent to initiate such an investigation, or otherwise received information regarding the taxpayer's noncompliance.[37] On the other hand, voluntary disclosure may be extraordinarily costly.

III. Federal Tax Law and State Family Law

Adding to the complexity of these issues, marriage and its dissolution are governed by state law, and state courts tasked with the responsibility of dividing marital property equitably upon divorce have predominantly affirmed their right to exercise authority separately from, and independently of, any proceeding by the IRS or in federal tax court. Representing something of an opposing view, in 1994, the Appellate Court of Illinois in *In re Marriage of Dunseth*[38] rebuked a trial court for having attempted to shield the wife in a dissolution of marriage proceeding from various creditors, including the IRS. The creditors were not parties to the proceeding, the appellate court asserted, and were not bound by the trial court's order that the husband, and not the wife, pay their debts.[39] According to the appellate court, while the wife might be able to persuade the IRS that she was an innocent spouse, she would have to do so in a proceeding to which the IRS was a party.[40] Notably, however, the *Dunseth* court appeared skeptical that the wife should qualify for innocent spouse relief of any kind at all since "[she] was a party to the irresponsible, overindulgent, and lavish lifestyle established during the marriage," and she "benefited from [her husband's] failure to

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36 United States v. Hebel, 668 F.2d 995, 998-99 (8th Cir. 1982).

37 *See* INTERNAL REVENUE SERVICE, INTERNAL REVENUE MANUAL 9.5 11.9, *available at http://www.irs.gov/newsroom/article/0,,id=104361,00.html* (last visited July 13, 2012).

38 In re Marriage of Dunseth, 633 N.E.2d 82, 94-95 (Ill. App. Ct. 1994).

39 *Id.* at 94.

40 *Id.*

pay taxes, was aware of the arrearage in taxes, and had a responsibility, along with her husband, to resolve [their] debt."[41]

Notwithstanding *Dunseth*'s analysis, the party to a divorce who acted as a mere signatory may feel optimistic about the possibility of persuading the trial court to make its own independent judgment, separate from any IRS or tax court determination, of that which equity requires in apportioning the couple's tax liabilities between him or her and the other spouse who acted with some higher order of culpability. Several months after the publication of *Dunseth*, the Ninth Circuit Court of Appeals held that an innocent spouse determination by the IRS does not, under either the Supremacy Clause or the doctrine of res judicata, control contribution rights under state law, whether those rights emerge from a divorce decree or from a general contribution statute.[42] According to the Ninth Circuit, "[t]he question whether, under federal law, [a wife] escapes taxes which [her husband] must pay to the IRS, does not control the state law determination of whether, as an equitable matter, [the wife] should have to contribute anything to [her husband]."[43]

Agreeing with the Ninth Circuit that state courts have the power to enforce contribution rights in favor of one spouse, despite the IRS's choosing not to pursue the other innocent spouse, the California Court of Appeal reasoned that "the federal government has no interest in how the states allocate tax liability between divorcing spouses, as long as they do not attempt to interfere with IRS collection efforts."[44] The Court of Appeals of

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41 *Id.* at 95.

42 Estate of Ravetti v. United States, 37 F.3d 1393, 1395 (9th Cir. 1994). In this case, a former husband sought to challenge the Tax Court's acceptance of his ex-wife's and the IRS's stipulation that the ex-wife was an innocent spouse "on the ground that she relied on her husband and their accountant to assure that the returns were properly prepared, and she did not benefit from the understatement of tax because the unpaid tax money was spent on his new wife or previous affairs." *Id.* at 1394 (internal quotations omitted).

43 *Id.* at 1395-96.

44 *In re* Marriage of Hargrave, 43 Cal. Rptr. 2d 474, 478 (Ct. App. 1995). *Hargrave* serves to warn that a spouse should not necessarily expect to enjoy tangible relief from any tax liability by securing innocent spouse status with the IRS when a state court has already apportioned that liability to him or her in whole or in part upon dissolution of marriage. In *Hargrave*, the former wife first agreed to assume responsibility for a fixed share of the parties' tax liability in one year, then raised no objection on appeal to the court's assigning to her

Kentucky ruled that "[t]he IRS's determination for innocent spouse relief is not entitled to preemption or res judicata because it involves only an administrative process rather than an adjudication, and the only rights adjudged go to which party the IRS pursues for payment. . . . Thus . . . a determination by the IRS or the Federal Tax Court is not dispositive in a division of a marital debt that includes tax liability."[45]

The Court of Appeals of Washington has held that a trial court can consider the deliberate and unnecessary incurring of tax liabilities by one spouse to a couple in apportioning liabilities between each upon dissolution of their marriage, although the trial court cannot base its decree on a finding that either party qualifies as an innocent spouse under federal law[46] (presumably because "federal tax liability should be litigated exclusively in the federal courts . . . ."[47]). The Court of Appeals of Wisconsin simi-

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half of their outstanding tax liability in three other years, and finally entered into a post-dissolution Stipulation and Judgment on Reserved Issues that provided that the then-existing division of assets and liabilities would remain in full force and effect, before later successfully obtaining innocent spouse status. *Id.* at 475-76. . While her former husband negotiated with the IRS over the course of years to minimize the parties' tax liability (presumably at his own expense and at a time when the former wife felt uncertain about her prospects as an innocent spouse), she "waited to see what kind of deal [he] could strike, and then sought at avoid responsibility for any portion." *Id.* at 479. As a result, notwithstanding her success with the IRS, she had ultimately to pay tens of thousands of dollars of interest that could otherwise have been avoided in addition to her original share of the liabilities. *Id.* at 478-79.

45 Dobson v. Dobson, 159 S.W.3d 335, 337 (Ky. Ct. App. 2004) (citation omitted).

46 In re Marriage of Steadman, 821 P.2d 59, 61-62 (Wash. Ct. App. 1991). *But see* In re Marriage of Behar, No. D045377, 2005 WL 2697250, at *8 (Cal. App. Ct. Oct. 21, 2005) (stating that the trial court's conclusion that husband would not be eligible for relief from joint liability under federal tax law provided support for charging the marital community with the tax liability incurred by wife for unreported separate property income received during the marriage).

47 Lakewood Plantation, Inc. v. United States, 272 F. Supp. 290, 294 (D.S.C. 1967). *See also* Craig v. United States, 69 F. Supp. 229, 239 (W.D. Pa. 1946) ("[I]n order to achieve absolute uniformity in all of the states of the Union in connection with tax liability created by Revenue Acts enacted by Congress. . . . the state courts' decisions of questions, over which they have final say, cannot and should not decide issues of federal tax law and thus hamper the effective enforcement of a valid federal tax.").

larly noted in *In re Marriage of Jahimiak*[48] that the trial court had no authority to determine whether a party qualified for innocent spouse relief pursuant to the federal tax code but affirmed that, in its judgment of divorce, the trial court properly assigned tax liability to the spouse who was the family financial officer and tax preparer and who was the sole beneficiary of inaccuracies in their returns. In *Killough v. Killough*,[49] the Court of Appeals of Arkansas upheld the trial court's divorce decree holding the husband solely responsible to pay any penalties and interest on his unreported income while requiring the wife to pay half of the original tax liability on that income, *i.e.*, the amount for which she would have been responsible if the income had been timely reported to begin with. The Supreme Court of Nebraska has likewise characterized penalties and interest on a tax liability as the nonmarital debt of the spouse responsible for their assessment.[50] It has also characterized as the nonmarital debt of a single spouse any funds owed to the IRS that were spent by that spouse on nonmarital pursuits.[51]

Although it likely remains within the trial court's discretion to leave allocation of a divorcing couple's tax liability to the taxing authorities,[52] the dissolution of marriage action presents an opportunity, beyond the Internal Revenue Code's innocent spouse provisions, to avert the costs of civil, though not criminal, tax liability by convincing the trial court that, in its own judgment, equity requires one outcome over another in the apportionment of any tax liability between spouses. Conversely, the dissolution action presents added risk insofar as the trial court bears no greater obligation to preserve the relief granted by the taxing authorities than it does to conform to that relief's denial.[53] The drafting of any consent judgment or marital settlement agreement that effectively allocates a couple's tax liability by contract between the spouses, themselves, demands particular

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48 No. 99-0922, 2000 WL 280300, at *5 (Wis. Ct. App. Mar. 16, 2000).

49 Killough v. Killough, 32 S.W.3d 57, 58-59 (Ark. Ct. App. 2000).

50 Carter v. Carter, 626 N.W.2d 576, 581-82 (Neb. 2001).

51 *Id.* at 581.

52 *See* Dunham v. Dunham, 870 N.E.2d 168, 173-74 (Ohio Ct. App. 2007).

53 *See, e.g.*, *Dobson*, 159 S.W.3d 335 (affirming trial court's assignment of forty percent of a divorcing couple's tax liability to wife, despite her having been previously granted innocent spouse status by the IRS).

caution because state courts have consistently enforced the terms of such a judgment or agreement, notwithstanding the subsequent success of one party to the judgment or agreement in securing innocent spouse status.[54]

Within the shelter of the attorney-client privilege, a taxpayer may gauge and evaluate the varied interests at stake to identify the course forward that best suits his or her circumstances, needs, preferences, and risk tolerance. For example, asserting a questionable claim of martial property over previously unreported income that the trial court will likely deem nonmarital may ultimately invite greater costs than benefits. A spouse under serious threat of criminal tax liability for an unpaid tax obligation of manageable size, relative to his or her ability to pay, may wish to avoid drawing any possible attention to historic tax payments prior to the expiration of the period within which the government may pursue a criminal indictment, even if doing so requires postponing divorce litigation or foregoing a claim of dissipation of marital assets. A divorce decree that assigns to one spouse full responsibility for paying an outstanding tax liability may, in time, afford limited protection from the IRS to the other spouse insofar as the spouse assigned responsibility under the decree later has (or purports to have) inadequate means either to pay the tax liability directly or to indemnify the other spouse in the event the IRS compels that other spouse to pay it. Each case, of course, will present its own myriad factors to consider.

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54 *See, e.g.*, PM v. MW, Nos. 1095-83, 06-28642, 2007 WL 1518621 (Del. Fam. Ct. Feb. 23, 2007); Kozak v. Kozak, No. 198799, 1998 WL 1990458 (Mich. Ct. App. Aug. 4, 1998); Bryant v. Flint, 894 S.W.2d 397 (Tex. App. 1994).